APRACA FinServAccess Programme

Assessment of Enabling Conditions of Rural Financial Services Development in Nepal

An APRACA FinServAccess Publication with the Special Sponsorship of the International Fund for Agricultural Development (IFAD)

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Assessment of Enabling Conditions of Rural Financial Services Development in Nepal

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This report is published during the incumbencies of Mr. Kim Vada (APRACA Chairman), Mr. Shitangshu Kumar Sur Chowdhury (APRACA Vice-Chairman), Mr. Won-Sik Noh (APRACA Secretary General) and Dr. Marlowe U. Aquino (FinServAccess Project Manager).

Message

Over the past years, the Asia-Pacific Rural and Agricultural Credit Association (APRACA) have dealt with the development and progress of its members. It has provided several avenues for institutional and human resource developments that enabled its members and its officers to learn and exchange experiences of knowledge, expertise and best practices.

Through the continuous challenges and opportunities encountered by financial institutions and its clientele, it is but fitting to address and work these for the betterment of its management, programs, products and delivery of services.

We are fortunate at APRACA because we have a very supportive partner, the International Fund for Agricultural Development (IFAD) that constantly guide our operations and programs in addressing the issues, constraints and challenges and providing opportunities for development. The present IFAD-APRACA Grant Project – the FinServAccess enables our target project countries, Bangladesh, Cambodia, Myanmar and Nepal the needed boost for improvement especially on enabling financial access for the rural poor people.

The Assessment of Enabling Conditions of Rural Financial Services Development in Nepal, one of the two assessments conducted this year in responding to the global, regional and national challenges in rural and agricultural finance. As the country of Nepal undergoes transition and reforms in rural and agricultural development including banking and finance may the key players and stakeholders understand the findings and find them useful in preparing their next step to development.

We thank and congratulate the research team headed by Ms. Jovita M. Corpuz and Dr. Ramon Yedra including the research participants and Mr. Ghuran Thakur, focal person in Nepal for doing an excellent job in coming up with this important document. May the results of the assessment report be an input to start a new dynamic, vibrant and responsive Nepali player towards improving productivity, profitability, sustainability and access to the required banking and finance services by the clients.

Kim Vada
Chairman
APRACA

Acknowledgement

The Nepal government, Nepal Rastra Bank and the different financial institutions and clients have placed its efforts to building a progressive rural and agricultural condition in the country.

Through the strong support of the International Fund for Agricultural Development (IFAD), APRACA is grateful for its continued support in uplifting the state of its members and clients to be at par with the rest of the world in terms of banking and financial development.

As we maintain our partnership with APRACA, we are thankful that relevant activities are unfolding right before our eyes in terms of policy direction and advocacy, capacity building both for institutions and human resources and effective knowledge exchange.

The completed work on the assessment of the rural financial services of Nepal, another one with Cambodia through the IFAD-APRACA Grant Project – FinServAccess is an important output for the country and the Asia-Pacific region as it addresses challenges in rural and agricultural development including the financial sector. APRACA is grateful to this project and its activities in order to ensure that the goal of reducing poverty in the region and Nepal will be slowly be minimized.

I greatly appreciate and thank the research team of Ms. Jovita M. Corpuz, Dr. Ramon C. Yedra together with our partners in Nepal for this excellent output. Special thanks to the different participants during the conduct of key informant interviews and focus group discussions. With the researchers/authors appreciation, we extend our gratitude to the officers and staff of the Nepal Rastra Bank, Agricultural Development Bank Ltd., Department of Agriculture, Department of Cooperatives, and Microfinance and Cooperative Institutions (Rural Microfinance Development Centre, First Microfinance Development Bank, Sana Kisan Bikas Bank, Development Project Service Centre, Centre for Self-help Development, National Agricultural Cooperatives Central Federation) who made themselves available for the interviews and provided the authors with valuable data and information. Also, the kindness of the farmers and microfinance borrowers for making themselves available and sharing their insights and perceptions during entire assessment process. CONGRATULATIONS TO THE TEAM!

May our APRACA members and partners find this assessment report also relevant to you all as we move in more unified and systematic programs in helping our clientele access to the financial services, support and needs especially in rural and agricultural development.

Won-Sik Noh
Secretary General
APRACA

Executive Summary

The report covers a review and update of the current status of rural finance services in Nepal, enabling policy environment and existing credit and credit enhancement programs. The review focused on the assessment of major factors that affect rural finance services development in Nepal that included: (a) macro socio-economic conditions and national development policies, plans and programs; (b) finance policy and regulatory framework governing rural finance and microfinance institutions; (c) efficiency and effectiveness of rural finance and microfinance institutions (d) credit programs and credit enhancement support programs; and (e) demand and supply side constraints and access issues.

The financial sector reforms initiated by the government brought positive outcomes to the formal financial system in Nepal. Financial health and efficiency of formal financial institutions in Nepal have improved over the years. There was remarkable growth in resources as well continued efficiency improvements among the licensed microfinance institutions as well as growth in the number and resources among semi-formal financial institutions (cooperatives, non-government organizations). There are supply and demand side constraints that need to be addressed. On the demand side, farmers are generally engaged in subsistence level agriculture, faced with problems on input supply availability, unstable markets and lack of adequate farm extension support. On the supply side, the major issues are: (a) un-even geographic coverage distribution, (b) weak governance and limited financial capacities of a large number of cooperatives and (c) limited resource mobilization capacities of microfinance development banks. In spite of positive developments in the financial system, access to financial services by rural poor households particularly in hill and mountain areas remained constrained. The financing gap appeared to be high among agricultural households.

The recommended government actions are: (a) provision of credit support schemes and incentives to encourage lending to agriculture and deprived sectors such as agricultural insurance and credit guarantee schemes; (b) improvement of institutional coordination among rural finance institutions and agricultural extension/agri-business promotion agencies; (c) implementation of a wider scale institutional capacity building program for cooperatives and (d) continuation of liberalization policies such as non-imposition of caps on interest rates and interest spreads and allowing microfinance banks to engage in deposit taking and loan diversification. The report concluded that the rural financial system would likely to continue to be composed of numerous small retail microfinance institutions while bigger commercial and development banks will likely continue to shy away from directly lending to agriculture and deprived sectors. The report recommended that state-owned Agricultural Development Bank as well as other apex wholesaler institutions perform the strategic intermediation role of mobilizing funds and efficiently channelling such funds to retail microfinance institutions.

List of Acronyms

ADB	Asian Development Bank
ADBL	Agricultural Development Bank, Ltd. of Nepal
CBS	Central Bureau of Statistics of Nepal
DEPROSC	Development Project Service Centre
FINGOs	Financial Intermediary Non-Government Organizations
FMDB	First Microfinance Development Bank
GTZ	Gesellschaft fur Technische Zusammenarbeit
IFAD	International Fund for Agricultural Development
MOAD	Ministry of Agricultural Development of Nepal
MFI	Microfinance Institutions
NACCFL	National Agricultural Cooperatives Central Federation, Ltd.
NCFN	National Cooperative Federation of Nepal
NEFSCUN	National Federation of Savings and Credit Cooperative Union, Ltd.
NGOs	Non-Government Organizations
NRB	Nepal Rastra Bank (Central Bank of Nepal)
RMDC	Rural Microfinance Development Center
SFCL	Small Farmers Cooperatives, Ltd.
SKBBL	Sana Kisan Bikas Bank Ltd. (Small Farmers Development Bank)

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CHAPTER 1
Introduction

Background

Nepal is a low-income country with a population of 27.6 million in 2012 and a per capita Gross Domestic Product of US$ 709 (ADB, 2013). Nepal had a Gross Domestic Product (GDP) of US$ 19.4 billion, ranked 110th out of 220 countries. Poverty incidence has declined over the years, from 42% in 1996 to 25% in 2011. But in spite of some progress in poverty reduction, Nepal remains one of the poorest countries in the world with a Human Development Index (HDI) of 0.46.

About 81% of Nepal's population live in rural areas, most of whom have little or no access to primary health care, education, safe drinking water, sanitation or other basic services. The poor are mostly engaged in subsistence agriculture. Farm incomes are often insufficient to meet basic needs. The low income returns from agriculture led to migration out of rural areas seeking employment in urban areas and abroad. As of 2011, an estimated 15% of the population migrates out of rural areas and about 29% of total households have at least one family member working abroad.

Microfinance has been recognized by the government as a poverty alleviation tool. The government of Nepal has supported microfinance over the last two decades. Beginning the 1990s, the government introduced the Grameen Bank model which paved the way for the creation of microfinance development banks and the Grameen Bikas Banks. The microfinance sector grew rapidly since then. To date the microfinance sector is comprised of formal microfinance institutions regulated by the Nepal Central Bank and thousands of cooperatives and non-government organizations.

Similarly, over-all bank credit expanded dramatically in the last decade. Bank credit grew from 44% of GDP in 2006 to 55% of GDP in 2012 (NRB, 2012a). But banks have not expanded financial services in rural areas. In spite of the increase in the number of bank branches, bank branch ratio is only 1.78 per 100,000 persons, the lowest in South Asia. Despite the increase in resources of financial institutions and dramatic growth of the microfinance sector over the past decade, access by the rural poor to financial services in Nepal remains constrained. An updated review is important to keep abreast of developments and identify lingering constraints and issues on financial services access of the rural poor that need to be addressed.

Objectives of the Review

This review has been conducted to provide an updated understanding of the developments on the rural finance services in Nepal: what has been done so far, current state of rural finance and microfinance and remaining gaps.

This review has the following specific objectives:

- To undertake a review and update of the current status of Nepal rural finance services, its enabling policy environment and existing credit and credit enhancement programs;
- To determine innovative strategies, critical rural finance issues, concerns and gaps on rural financial services development;
- To analyze such issues and gaps and how these could influence (positively and negatively) sustainable rural financial service delivery system;
- To recommend specific measures on how to address these issues, concerns and gaps.

Scope and Methodology

The review focused on assessment of major factors that affect rural finance service development in Nepal and the identification of critical issues that affect efficiency, sustainability and outreach of the rural financial system. The rural financial system covered in this review includes formal and semi-formal financial institutions engaged in agricultural finance and microfinance. The enabling conditions and factors assessed included: (a) macro socio-economic conditions and national development policies, plans and programs; (b) finance policy and regulatory framework governing rural finance and microfinance institutions; (c) efficiency and effectiveness of rural finance and microfinance institutions; (d) credit programs and credit enhancement support programs; and (e) demand and supply side constraints and access issues.

The study was conducted through a desk review of articles, papers and reports and internet searches. Interviews with key informants from major rural finance players that included the Central Bank and other government agencies, major rural finance and microfinance institutions and as well as focus group discussions with agricultural and microfinance borrowers were conducted to gather updated information as well as qualitative information. To the extent feasible, data gathered are as of 2013.

Organization of the Report

This report is divided into six parts. The first part discusses the macro socio-economic conditions in Nepal focusing on macro-economic condition, the general state of the agriculture and poverty situation. The second part reviews the finance policy, legal and regulatory framework governing financial institutions, the financial structure and interest rates in Nepal. The third part discusses the state of rural credit delivery system, reviews the performance of various types of rural finance and microfinance institutions and discusses major supply and demand side issues. The fourth part discusses the government plans and programs that impact on the supply and demand sides of rural finance. The fifth part discusses major issues on rural financial services and makes recommendations. The last part summarizes and makes conclusions based on the analysis of findings.

CHAPTER 2
Macro Socio-Economic Conditions

Macro-Economic Condition

Despite dissolution of the Constituent Assembly and political uncertainties, the Gross Domestic Product (GDP) grew by 4.5% in 2012, better than previous years' growth of 3.9% in 2011 and 2009, backed by agriculture and services growth (ADB, 2013). Supported by favourable weather, agriculture posted 5% growth in 2012, higher that previous years' annual growth of 3%. Sustained remittances of overseas workers and tourism sector performance contributed to the 4.5% services growth. Remittances from Nepalese working abroad continued to be a major contributor of economic growth. One in every four households (or 1.38 million households) in Nepal has at least one member working abroad. In 2012, the amount of remittances from those working abroad was equivalent to 23.6% of the GDP. With a population of 26.7 million, average per capita GDP in 2012 was $709. The growth of per capita GDP in nominal terms is estimated to be 9.28% in 2012. However, the growth of per capita income in real terms is very minimal over the years and even negative in some of the years of the last decade.

Agriculture, together with forestry and fishing sectors, contributes to about 35% to GDP and provides livelihood options to 74% of households. Rice contributes to about 20% of total agricultural production, thus, a small drop in rice production would have a significant dent on total agriculture production, and in turn on overall GDP growth. The unresolved structural constraints along with political uncertainties are adversely impacting the investment climate, which in turn is inhibiting the industry sector growth. The construction sub-sector, which grew by just 0.02% in 2012 compared to 4.79% in 2011, is not expected to recover significantly by 2013 due to low capital expenditure and low private sector confidence. Similarly, the manufacturing activities continue to be beset by power shortage, high labor cost, low productivity and low competitiveness. Overall, the ADB noted that the industry sector, which contributes about 15% to GDP, is expected to exhibit inhibited growth.

Nepal has been lurching with political crisis after crisis for years. Its last parliament, the Constituent Assembly (CA), elected in 2008, expired its term in 2012 after failing to fulfil its mandate to write a new constitution. A new election government under the chairmanship of Chief Justice Khil Raj Regmi was instituted following a breakthrough political agreement among the political parties on 14 March 2013. The new government is expected to hold the CA election by December 2013. These developments are expected to normalize the political situation and approval of a full budget. In 2012, capital expenditure was only 3.3% of GDP, down from 6.5% in the previous year due to the delay in approval of a full budget. Hopefully, the approval of a full budget would improve capital spending backlog of the government which has hampered economic growth. Further, as noted by the ADB, the inability of the government to boost spending which normally flows through banks, has contributed to banks' liquidity constraints pushing interbank interest rates in 2012. Major macro-economic indicators of Nepal are shown in Table 1.

Table1. Macro-economic indicators of Nepal (selected years)

Indicators	2008	2009	2010	2011	2012
GDP (in Rs billion)	816	988	1,193	1,367	1,536
Agriculture					
GVA (in Rs billion)	243	305	392	473	511
% of GDP	30%	31%	33%	35%	33%
Per capita GDP (US$)	494	498	611	678	709
Annual Growth Rate (%)					
GDP	5.8	3.9	4.3	3.8	4.5
Agriculture	5.8	3.0	2.0	4.5	5.0
Inflation rate (%)	7.7	12.6	9.6	9.6	8.3
Population (million)	25.5	25.9	26.3	26.5	26.9

Sources: Nepal Central Bureau of Statistics, National Accounts FY 2012/13; ADB 2013 Macro-Economic Update. GDP = Gross Domestic Product; GVA = Gross Value Added; Rs = Nepalese Rupees.

Poverty Situation

As of 2011 Census, poverty incidence in Nepal has gone down to 25.2% of the total population from a high 42% in 1996 (CBS, 2012b). While there is significant reduction in poverty incidence at the aggregate level, the wide disparity in poverty incidences across geographical and ecological zones persists. Within the urban areas, poverty ranges from a low 9% in urban Hills compared to 22% in urban *Terai*. Within the rural *Terai*, poverty ranges from 16% in Eastern region to 37% in Mid and Far Western regions. Among the three ecological zones, the Mountains ecological zone has the highest poverty incidence at 42% compared to 24% and 23% in the Hills and Terai zones. However, in terms of number, 45% of the total poor population are found in *Terai* zone as this is the most densely populated and only 12% are found in the Mountains.

Secondly, the disparity of poverty incidence across social groups continues to persist. The percentage of poor among *Dalits* is 42% compared to 23% among non-*Dalits*. Table 2 shows the comparative poverty incidences and distribution of the poor across ecological zones in 1996 and 2011.

Table 2. Poverty incidence and distribution of the poor by geographical zones

Parameter	Poverty Incidence (%)		Distribution (%) in 2011	
	1996	2011	of the poor	of population
By sector				
Rural	44	27	12	19
Urban	23	15	88	81
By ecological zone				
Mountains	56	42	12	7
Hills	41	24	43	44
Terai	42	23	45	49
National	42	25	100	100

Source: Nepal Central Bureau of Statistics.

Access to basic social services continues to be inadequate. Less than 50% of households have access to tap water while tube well remains as main drinking water source of 35% of total households. The population is skewedly distributed with the *Terai* region having 49% of the total population, hilly areas having 44% and mountain areas with 7%. The central region has the highest concentration (36.5% of total population). Kathmandu district has the highest density of 4,416 persons per square km compared to the national average of only 180 persons per square km.

By source of income, poverty incidence continued to be highest among those employed in agriculture. Incidence of poverty in 2011 was 47% among agricultural workers and 27% among small owner-tillers compared to 13% poverty incidence among those engaged in trade and 20% poverty incidence to those engaged in services. Contributing to higher poverty incidence among households engaged in agriculture is land size and low productivity. Of the 3.3 million farms in Nepal, 74% are below one hectare, 17.5% are one to two hectares farms and only 2.8% of total farms are three hectares or above (CBS, 2012b). The national average landholding is only 0.8 hectare. Of the 2.6 million hectares, 1.4 million hectares are located in the *Terai* region with average landholding of 0.96 hectare, while the Hilly and Mountain regions have 1.04 million hectares and 218,900 hectares, respectively.

Agriculture

Cereals remain as the dominant crops produced. Seventy five percent of the total agricultural land is cultivated to cereals. The principal cereal crops are rice (33% of total production area), maize (19%) and wheat (19%). Rice and maize yields improved in recent years, from 2.5 tons/ha for rice in 2007 to 3.3 tons/ha in 2012 while maize yields increased slightly from 1.9 tons/ha to 2.5 tons per ha (MOAD, 2012). Production area of pulses and vegetables expanded in recent years and is now produced in 346,000 hectares which accounts for 12% of total production area.

Agricultural producers are heavily dependent on monsoon rains. Thirty seven percent of total farm holdings are irrigated but not all irrigated areas have access to year round irrigation. Thus, national average cropping intensity is 1.8 times per year. Average net returns of the major crops are Rs 29,320 per ha for rice, Rs 13,700 for corn and Rs 14,790 for maize. Such returns for an average 0.8 hectare landholding are barely enough to meet basic needs. Poverty threshold income in Nepal was Rs 14,430 in 2012. Table 3 shows the cultivated areas and production volumes of major crops in Nepal as of FY 2011/12.

Table 3. Major crops by cultivated area, production volume and yields (2012)

Particulars	Area ('000 ha)	% of Total	Production ('000 MT)	Yield (MT/ha)
Total farm holdings	3,364	100%		
Total irrigated area	1,254	37%		
Cereals	3,485	75%		
Rice	1,531	33%	5,072	3.31
Maize	871	19%	2,179	2.50
Wheat	765	16%	1,846	2.40
Cash crops	482	10%		
Oil seeds	215	5%	179	0.83
Potato	190	4%	2,584	13.6
Pulses	334	7%	320	0.96
Vegetables	245	5%	3,299	13.5
Fruits	101	2%	1,030	10.2
Total production area	4,647	100%		

Source: Ministry of Agricultural Development (MOAD). MT = metric tons.

Each of the three ecological zones has its own unique resource endowments, cropping patterns and farming systems leading to differences in major crops/livestock produced and productivity levels. *Terai* zone has 23% of the land area where 49% of the population reside and produces 55% of the nation's food grains supply. The hill zone has 42% of the land area, where 44% of the population reside with maize as main crop while the mountain ecological zone has 35% of the land area where the rest of the 7% of the population reside and where yields are lowest.

Livestock is an important resource among rural households. About three in every four households raise livestock and poultry. In 2004, about 89% of farm households have large ruminants (cattle, buffalo), 55% have small ruminants (goats, sheep), and 12% of households raise swine (Maltsoglou and Tanaguchi, 2004). The average number of livestock raised increased from 2.2 head per farm household in 2004 to 5.8 head per household by 2012. Only about 10-20% of livestock growers are commercial growers.

Productivity level among poultry and livestock growers has remained low for years as farmers have been using the same livestock husbandry practices for generations and due to genetic inferiority of local breeds. Poor husbandry practices and poor access to veterinary services make livestock and poultry farms susceptible to disease outbreaks. Reportedly 73% of rural villages remain without government supported services. The most recent outbreak is the occurrence of "bird flu" this year which required culling of over one million heads of poultry. Livestock products (1.6 million metric tons of milk, 2.9 million metric tons of meat products) constitute about 26% of total agricultural output while cereal crops contribute to about 47% of total agricultural output (MOAD, 2012). Local production of livestock is insufficient. Nepal imports some 500,000 goats per year from India.

CHAPTER 3
Finance Policy, Regulatory Framework and Financial Structure

Finance Policy and Regulatory Framework

The government of Nepal began to liberalize the financial market together with other sectors of the economy (trade, public enterprises) beginning 1984 (Bhusal, 2004). The primary objective was to minimize the direct intervention of government in the financial system and create incentives to increase private sector's participation. Previous to these reforms, the financial sector was dominated by state-owned commercial banks.

Policy Reforms. The first phase of reforms (1984-1990) paved the way for the establishment of joint public-private venture commercial banks (e.g. Nepal Arab Bank, Nepal Indosuez Bank, Nepal Grindlays Bank) which allowed foreign investment in the banking sector and facilitated the transfer of modern banking technologies in the country. Interest rates were deregulated which allowed commercial banks to set their interest rates except for exports and 'priority sector credit'. Institutional reforms were also undertaken on the state-owned bank, the Agricultural Development Bank, Ltd. (ADBL) to strengthen its financial capacity, by granting authority to undertake commercial banking operations enabling it to mobilize deposits in urban areas as well as mobilize funds from the capital market. The second phase of reforms (1990s) continued the liberalization measures to allow ease of entry of banking and non-banking financial institutions (finance companies) as well allow more freedom in their business operations. Credit control measures such as the statutory liquidity ratio which restrict the lending capacity of banks were removed.

The instituted reforms from mid 1980s to 1990s resulted in the dramatic increase in number of financial institutions. In 1990, there were only five commercial banks (three of which are state owned), two development banks and other few quasi financial institutions. By 2000, there were 11 commercial banks, 5 regional rural development banks, 44 finance companies, 29 savings and credit cooperatives and 30 non-government organizations licensed by the Central Bank.

With the proliferation of licensed financial institutions, the third phase of policy reforms beginning the 2000s focused on strengthening the regulatory and supervision functions of the Central Bank in a liberalized market so that it can exercise independence and equipped with authority to ensure a healthy financial system. The emphasis on prudential regulations shifted to ensuring stability of banks such as imposition or risk based capital adequacy among banks. A Financial Reform Strategy was crafted in 2000, main elements of which are: (a) restructuring plans for the large commercial banks and two biggest development banks; (b) strengthening of reportorial and auditing standards and Central Bank's supervisory capacity to enforce compliance on regulations; (c) strengthening corporate governance particularly on risk management and loan recovery and (d) phasing out of directed credit role of the Central Bank. However, there were policy measures that impeded full liberalization of the financial system such as restrictions in opening branches, continued imposition of mandatory loan allocation for 'priority sectors' and restriction of entry of foreign-owned banks.

Enabling Laws. There were a couple of laws that were enacted over the years that supported the financial liberalization. Among these were: (a) Amendment of the Commercial Bank Act in 1984 which removed entry barriers for private commercial banks and provided legal basis for establishing public-private joint venture commercial banks ; (b) Development Bank Act of 1996 which paved the way for the establishment and entry of development banks; (c) the Nepal *Rastra* Bank Act (Central Bank Act) of 2002 which allowed the Central Bank to have more autonomy and independence in exercising regulatory and regulatory functions in ensuring efficient and healthy financial system. The more recent laws focused on rationalizing previous laws and ensuring financial health of banks. These include: (a) the Banks and Financial Institutions Act of 2006 which consolidated the previous laws related to banks and the (b) Capital Adequacy Framework of 2007 which provided the guidelines for capitalization requirements following the BASEL II framework. The Banks Act of 2006 replaced the Development Bank of 1996, Commercial Bank Act of 1984 and Agricultural Development Bank Act of 1967, and which classified all financial institutions licensed and supervised by the Central Bank. This Act also paved the way for licensing a new category of banks, Class "D" which consists of microfinance institutions.

Mandatory Loan Allocation. While instituting financial liberalization reforms, the Central Bank continued to implement the "Deprived Sector Loan Program" which was introduced in 1991. Under this program, Class A, B and C financial institutions are mandated to allocate a portion of their loanable funds for deprived sector lending. "Deprived sector" is defined as "low income and especially socially backward people, women, tribal people, *Dalit*, blind, hearing impaired and physically incapacitated persons, marginalized and small farmers, craftsmen, laborers and landless squatters families". All microfinance loans extended for self-employment oriented micro-enterprises of deprived sectors was defined as "deprived sector lending".

Previous to the deprived sector lending, there was the so-called "priority sector lending" (lending to priority economic sectors such as agriculture) introduced in 1974 which was initially set to as high as 12% of loan portfolio. This ratio was reduced over the years and eventually phased out by 2007. For deprived sector lending, as per directive by the Central Bank (Directive No. 17/067) in 2010, the commercial banks (Class A), development banks (Class B) and finance companies (Class C) were required to allocate 3%, 2% and 1.5%, respectively, of their loan portfolio for lending to the deprived sectors. The mandated loan allocation was increased by 0.5% per year the following three years. By fiscal year 2013/14, the mandated allocation is now 4.5% for commercial banks, 4% for development banks and 3.5% for finance companies (NRB, 2013a).

Banks can either lend directly to the deprived sector or indirectly by extending wholesale loans to microfinance institutions (Class D financial institutions). In 2013, total loans extended as compliance to the mandated allocation amounted to Rs 26 billion which is about 3.1% of the total portfolio of the Class A, B and C banks. Sixty-three percent of the deprived sector loans are wholesale loans, mostly to microfinance development banks. The Central bank sets the loan limits for deprived sector loans. As per 2013 directive of the Central Bank, for class D institutions, the loan ceilings to deprived sector and low-income groups were increased as follows: (a) for non-collateralized loans: increased from the previous ceiling of Rs 100,000 to Rs 150,000 per borrower for micro-enterprises and (b) for collateralized loans: increased from previous ceiling of Rs 300,000 to Rs 400,000. Banks can lend up to Rs 500,000 for projects promoted by women groups. Likewise, the Central Bank sets the limits of portfolio mix for collateralized loans e.g. total loans with collateral should not exceed one third of the total loan portfolio. Banks however are free to set interest rates, i.e., commercial and development banks can set their wholesale interest rates charged to the Class D institutions while Class D institutions can set their pass-on rates to end borrowers.

Recent Policy Thrusts. Current finance policies are geared towards ensuring continued stability and achieving efficiency among financial institutions while making banking more transparent and competitive. The Central bank announced that it will continue to implement provisions to achieve capital adequacy within the Basel II standards, issue guidelines for internal capital adequacy assessment of banks and strengthen its inspection and supervision functions to monitor quality of loan portfolios. Mergers and consolidations among financial institutions are likewise being promoted instead of granting licenses to new banks to achieve better efficiency among existing players.

To expand financial services in the priority sectors and in underserved geographic areas, the Central Bank (NRB, 2013a) implements the following measures until the next two to three years: (a) open a special refinancing facility with reduced rates (reduced from existing 1.5% to 1% interest rate per annum which the banks can relend up to 4.5%) for lending to small and cottage industries, enterprises operated by women, and other small enterprises; (b) increase the deprived sector lending mandatory allocation to 5% of total loan portfolio within two years; (c) require commercial banks to allocate at least 12% of their loan portfolio to agriculture and energy sectors and within the year, require commercial banks to submit action plans that would enable them to have at least 20% of total loan portfolio to priority sectors by 2015; and (d) provide interest free loans up to Rs 2 million to Class D banks that would open new branches in remote districts while there will be a moratorium on licensing new Class A, B, and C banks, Central Bank will still be open on licensing new Class D (microfinance development banks) with priority in districts with very limited financial services.

Financial Structure

- **Formal Financial Institutions**

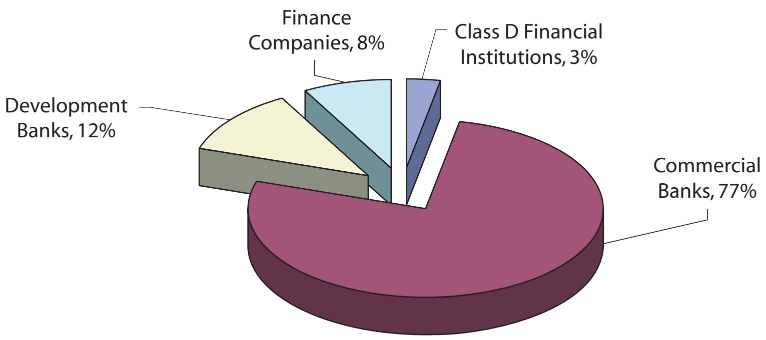
The Banking and Financial Institutions Act of 2006 consolidated previous laws related to banks and defined the new classification of banks and financial institutions to be licensed and supervised by the Nepal Central Bank. The classification is based on minimum paid up capital requirements and specific financial transactions which the particular category of banks/financial institutions are authorized to carry out. The categories are: (a) Class A – commercial banks (b) Class B – development banks; (c) Class C – finance companies and (d) Class D – microfinance financial institutions. Class D are specialized microfinance financial institutions that include: microfinance development banks, financial intermediary non-government organizations (FINGOs) and savings and credit cooperatives that are granted limited banking authorities. These include the authority to: (a) extend microfinance loans and (b) obtain loans or grants from domestic or foreign institutions. Accepting deposits is subject to approval by the Central Bank. Class D institutions are currently allowed to accept savings from members of their microfinance groups but not from the general public.

As of June 2013, there are 32 commercial banks (Class A), 90 development banks (Class B), 30 finance companies (Class C) and 30 microfinance development banks (Class D). In addition to the 30 microfinance banks, the Central Bank supervises 36 FINGOs and 16 savings and credit cooperatives licensed by Central Bank to conduct limited banking activities. Including the assets of FINGOs and cooperatives, the total resources of licensed financial institutions is about Rs 155 billion as of June 2013 (NRB, 2013b). Commercial banks' share in the total resources of licensed financial institutions is 77%. The two state-owned banks (Nepal Bank Ltd. and the Agricultural Development Bank, Ltd.) constitute 30% of the total commercial banks' resources. Development banks' share in the total resources is 12% while Finance Companies has 8% share. Class D financial institutions constitute only about 3% of the total resources of the formal financial system. Among Class D institutions, the microfinance development banks have total resources of Rs 34 billion which is equivalent to 2.2% of the total resources of the formal financial system while the shares of the licensed cooperatives and FINGOs are very minimal at 0.8% and 0.4%, respectively.

In terms of geographic distribution, total number of bank branches as of January 2013 of Class A financial institutions was 1,460 (60% of total number of bank branches) while Class B financial institutions had 712 offices (28% of total bank branches). Class D institutions had 297 offices (12% of total number of bank branches). Out of total bank branches, 27% were operating in the Kathmandu valley, 31% in Hills and Mountain and 42% in the *Terai* region (NRB, 2013c).

The commercial banks account for 81% of the total deposits and 73% of total credit of the formal financial system. On the other hand, deposits generated by microfinance development banks account only for 0.6% of total deposits generated by the banking system. It should be noted though that unlike other banks, microfinance institutions' authority granted by the Central Bank to mobilize deposits is limited only to member clients that they are servicing. As of June 2013, microfinance development banks cater to 1.16 million members, of whom 848,974 are borrowers. Total loans of microfinance banks amounted to Rs 22 billion, equivalent to 2.2% of total loans of the banking system.

Figure 1. Percentage shares on total resources by category of financial institutions (June 2013)



Data Source: Nepal Central Bank (2013)

Table 4. Selected data on formal financial institutions in Nepal (June 2013)

Indicators	Class A	Class B	Class C	Class D	Total
Number of banks	32	90	64	30	216
Number of branches	1,489	721	303	598	3,111
Total resources					
In Rs million	1,186,037	192,709	118,913	33,640	1,531,298
In US$ million	11,860	1,927	1,189	336	15,313
% of total	77.5%	12.6%	7.8%	2.2%	100%
Total deposits					
In Rs million	945,780	139,513	78,878	6,636	1,170,807
% of total	80.8%	11.9%	6.7%	0.6%	100%
Total loans					
In Rs million	736,372	123,590	75,528	22,424	1,005,971
% of total	73.2%	12.3%	12.3%	2.2%	100%
In % of GDP	43.3%	7.3%	4.4%	1.3%	59.1%

Source: Nepal Central Bank. Data excludes non-government organizations and credit cooperatives which had total resources as of January 2013 of Rs 6,475 million and Rs 12,474 million, respectively.

- ### Semi-formal Financial Institutions

Semi-formal financial institutions are composed of savings and credit cooperatives and financial non-government organizations that are not supervised by the Central Bank but registered under the Department of Cooperatives. The informal financial sector on the other hand consists of informal self-help groups and informal lenders (merchants/traders, landlords, friends and relatives).

Cooperatives. The cooperative movement started in the 1970s but no savings and credit cooperatives were established until 1994. In 1995, 228 savings and credit cooperatives were registered. The number increased to 1,271 by 1999 and 2,262 by 2002. In 2002, the first 34 savings and credit cooperatives were licensed with limited banking authority by the Central Bank. By 2013, there are 12,614 savings and credit cooperatives out of the total 29,000 cooperatives registered with the Department of Cooperatives. However, the number of savings and credit cooperatives licensed by the Central Bank decreased to 16.

Other types of cooperatives are agricultural cooperatives, small farmer cooperatives, producer cooperatives (tea, dairy, herbal) and multi-purpose cooperatives. Total membership of cooperatives is estimated to be 4.7 million, about 2.2 million are members of savings and credit cooperatives. About 20,000 of the registered cooperatives are active. As of 2013, the cooperatives have a total paid up capital of Rs 29 billion, mobilized Rs 150 billion savings from members and extended Rs 140 billion loans to members. Most savings and credit cooperatives are located in urban cities and capital towns while most agricultural cooperatives are located in rural areas. In Kathmandu City alone, there are 60 savings and credit cooperatives with total assets of Rs 500 million. While the Department of Cooperatives register and monitor the activities of cooperatives, the Department permits the cooperatives to be "self-regulated" by their respective federations or apex organizations.

The major apex organizations or federations in the cooperative movement are (a) National Federation of Savings and Credit Cooperative Unions, Ltd. (NEFSCUN), (b) National Agricultural Cooperatives Central Federation, Ltd. (NACCFL) and (c) National Cooperative Federation of Nepal (NCFN). The NEFSCUN is the national apex organization of savings and credit societies, currently with 1,717 member-cooperatives from 69 districts and over 1 million individual members (NEFSCUN, 2013). Its current programs for member cooperatives are micro-insurance, training and education, inter-lending and microfinance. Under its microfinance program which was initiated in 2001, NEFSCUN has lent to 188 member cooperatives as of December 2012 benefitting 92,131 individual members from 25 districts and has mobilized Rs 561 million in savings.

NACCFL on the other hand is the federation of Small Farmers Cooperatives, Ltd. (SFCL). The SFCLs are an offshoot of an institution building program of the Agricultural Development Bank, Ltd. (ADBL) initiated in 1987 with support from the GTZ. From the initial first four farmer groups converted into SFCLs in 1993, the program was expanded such that by 2009, there were 225 SFCLs in 40 districts with 415,419 members. SCFLs are multi-service cooperatives that extend loans and other services to members. SCFLs target only small farmers as members. NACCFL is the apex organization that provides non-financial services (training) to SCFLs.

The unique set-up of the SFCL system is its government-private partnership nurtured over the years. The ADBL remains the major source of wholesale loan funds of the SFCL system. The wholesale loan funds are channelled to the Sana Kisan Bikas Bank, Ltd. (Small Farmers Development Bank) which in turn extends wholesale loans to the SFCLs. The Sana Kisan Bank is a microfinance development bank (licensed Class D bank) established in 2001 with equity investments from the SFCLs, the government, commercial banks and the ADBL. As of 2012, ADBN's capital share is 31% while SFCLs is 56%. As of June 2012, the Sana Kisan Bank has lent to 287 SFCLs with outstanding loans of Rs 6.35 billion to 2.25 million individual clients (SKBB, 2013).

The NCFN, established in 1993, is the apex body of all types of cooperatives in Nepal. Currently it has 27,000 member-cooperatives which include those that are members of NEFSCUN and NACCFL. Number of individual members is about 4.7 million. It coordinates with the Ministry of Cooperatives for the conduct of trainings to member cooperatives as well as in the implementation of the "small grants program" of the Ministry. In 2013, the grant program has a budget of Rs 400 million. The program extends about Rs 100,000 grant to small producer and agricultural cooperatives for facilities (e.g. processing, cold storage, etc.). In 2012, 40 cooperatives received grants from the Ministry.

Financial Intermediary Non-Government Organizations (FINGOs). As of 2013, out of 10,000 NGOs there are 36 FINGOs licensed and supervised by the Central Bank. The NGOs are community based organizations that provide financial (savings and loans) and non-financial services (health, education and other social services) and obtain wholesale loans from microfinance development banks, commercial banks and government and international donor programs. Involvement of NGOs in microfinance started in the 1990s following the replication of the Grameen Bank model. Several of these NGOs later on converted into microfinance development banks. Three of the microfinance banks are wholesaler institutions. As of 2009, licensed FINGOs reached 381,392 clients from 38 districts. There are no official consolidated data on the financial services of all NGOs. Most NGOs that are active in microfinance are being tapped by wholesale microfinance banks.

Interest Rates

Following financial deregulation policy, the Central Bank issued Directive No. 15/067 in 2010 that Class A, B and C Banks are free to set interest rates for both deposits and loans while Class D banks have to seek prior approval from Central Bank before setting its interest rates. In practice though, the Class D banks are only required to inform the Central Bank on the interest rates to be imposed by the microfinance banks prior to making such rates effective and are required to publish such rates in local media at least twice a year. Thus, all financial institutions including Class D are in effect, free to set their interest rates.

In 2012, the Central Bank also issued a directive requiring banks to publish "base rates". The banks were required to calculate "base rates" based on five indicators (cost of fund, cash reserve ratio, statutory liquidity ratio, operational costs and return on assets). The concept of base rate has been implemented with the objective of reducing the interest spread (difference between loan interest rate and deposit interest cost) by making lending rate more transparent and competitive. The base rate of commercial banks ranged between 6.7% to maximum of 12.8% in mid-June 2013, whereas average base rate remained at 9.8%. The weighted average interest rates of deposits and lending of commercial banks have started to be published. The weighted average deposit rate and lending rate of commercial banks remained at 5.2 and 12.3% respectively in mid-June 2013, resulting in an interest rate spread of 7.1% (NRB, 2013c).

In 2013, a possible reversal from deregulation policy has been announced. It its published monetary policy for Fiscal Year 2013/14, the Central Bank indicated that it will implement a directive "to bring an average interest spread rate between lending rates and deposit interest rates of Class 'A', 'B' and 'C' banks to five percent within a certain time period." This recent policy initiative has been criticized by private banks as this would be impractical as decision on loan interest rates is also based on risk assessment of particular borrowers or loan categories. Fixing interest spread runs counter to risk based interest pricing that is being promoted consistent with risk based capital adequacy framework. The move is viewed by private banks to be counter-productive as this would discourage lending. As of date, however, the formal directive has not been issued.

Government financing facilities (through the Central Bank) are priced at lower than prevailing market rates. However, microfinance institutions, cooperatives and NGOs borrow mostly from the private sector (commercial banks, development banks and finance companies). Government sourced funds comprise only 6% of total borrowings of microfinance development banks thus, the government programs' lower rates hardly have any influence in the pricing of pass-on interest rates to end-borrowers. The prevailing interest rates of major wholesaler microfinance institutions are given below.

Table 5. Interest rates of major wholesaler microfinance development banks

Particulars	SKBBL	RMDC	FMDB
Total Assets (Rs million)	4,531	4,431	882
Total Borrowings (Rs million)	3,439	2,870	757
Total Loans to Retailers (Rs million)	3,580	2,154	766
Cost of Borrowed Funds	4 to 8%	5%	5%
Lending Rates			
Wholesaler to Retailers	10%	7% to 7.5%	7%
Retailers to end-borrowers	13 to 17%	18 to 25%	18 to 20%

Source of data: Reports and key informants interview. SKBBL= Sana Kisan Bikas Bank Ltd.; RMDC= Rural Microfinance Development Center; FMDB = First Microfinance Development Bank.

CHAPTER 4
State of Rural Finance

Rural Credit Delivery System

The rural credit delivery system in Nepal consists of two tracks. One mode is a two tiered structure where Class A, B and C financial institutions extend wholesale loans to retailer institutions. Retailer institutions are those that lend directly to individual borrowers. These consist of microfinance development banks, financial intermediary non-government organizations (FINGOS) and cooperatives. The other mode is a three-tiered structure where commercial banks lend to wholesaler microfinance banks that in turn lend to retailer institutions.

There are three private wholesaler microfinance banks, namely: (a) Rural Microfinance Development Center (RMDC), (b) Sana Kisan Bikas Bank Ltd. (SKBBL) and (c) First Microfinance Development Bank. The state-owned Agricultural Development Bank Ltd. (ADBL) extends wholesale loans mainly to SKBBL which in turn lends primarily to Small Farmer Cooperatives, Ltd. (SFCLs). The other two wholesaler institutions on the other hand extend wholesale loans to various types of microfinance retailer institutions (microfinance development banks, cooperatives and FINGOs).

There are no official consolidated data on the total credit outreach of both formal and semi-formal microfinance institutions as not all submit data to the Central Bank or to the Department of Cooperatives. However, some microfinance networks conduct consolidation of data from member microfinance institutions. One estimate is from the South Asian Microfinance Network (SAMN). SAMN (2011) reported in its website that there are an estimated total 1.8 million loan clients in 2009. The shares in the total outreach of credit cooperatives, small farmer cooperatives, FINGOs and microfinance development banks are 40%, 8%, 21% and 31%, respectively.

In case of formal financial institutions, as of June 2013, the Class A, B and C financial institutions extended 3.5% of their loan portfolio to the deprived sector which is just within the mandated allocation (Table 6). Loans extended to agricultural sector by all financial institutions was Rs 39 billion, equivalent to 4.2% of their total loan portfolio. The major suppliers of deprived sector loans are commercial banks which accounted for 81% of total deprived sector loans, while development banks and finance companies contributed 13% and 6%, respectively.

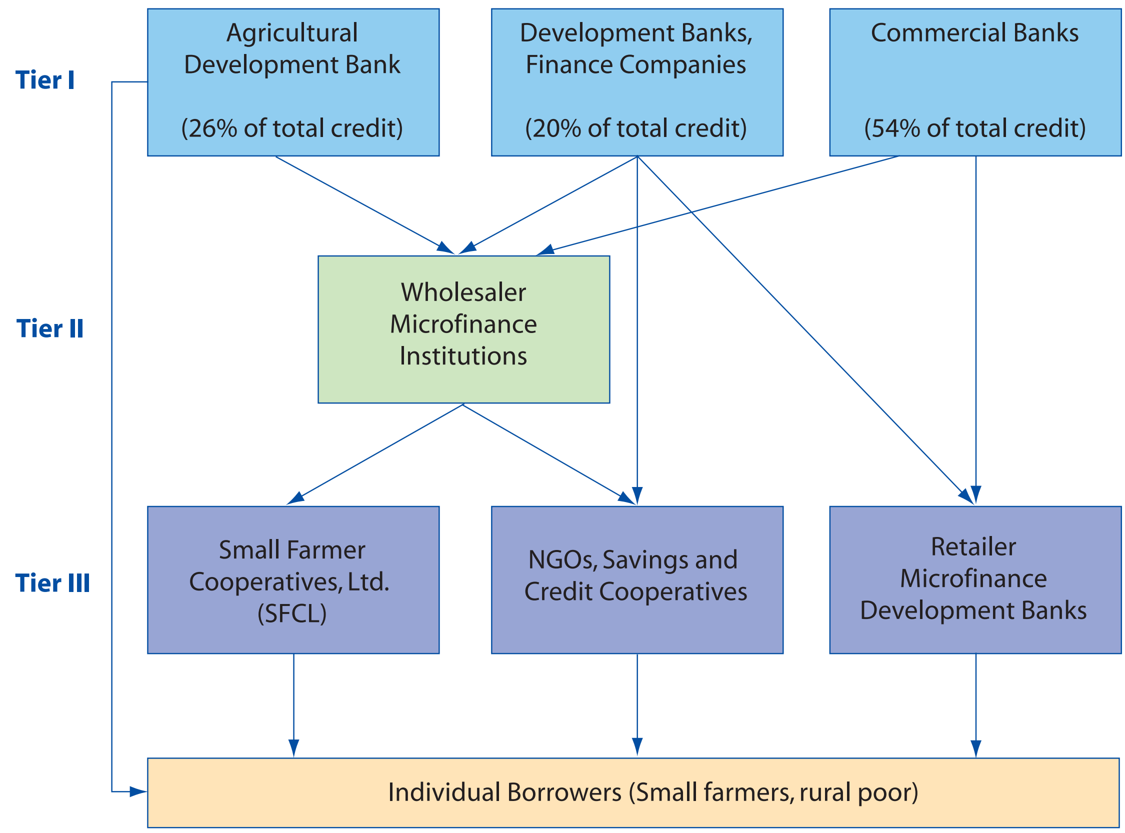
In case of agricultural sector loans, commercial banks' share on the total agricultural loans is 79% of which 42% was contributed by the state-owned Agricultural Development Bank, Ltd. (ADBL). This means that ADBL contributes to about 33% of the total agricultural loans in the system. There are overlaps between the reported figures on agricultural sector loans and deprived sector loans. About 30% of deprived sector loans are agricultural loans classified as microfinance loans. Adjusted, the corresponding share of ADBL on total supply of both agricultural and deprived sector loans is about 26%. Correspondingly the share of private commercial banks is about 54%. Figure 2 illustrates the credit delivery system for agricultural and deprived sector lending.

Table 6. Agricultural and deprived sector loans by category of banks (June 2013)

Particulars	Class A	Class B	Class C	Class D	Total
Number of banks	32	90	64	30	216
Total loans					
In Rs million	736,372	123,590	75,528	22,424	1,005,971
% of total	73.2%	12.3%	12.3%	2.2%	100%
Agricultural and fishery loans					
In Rs million	31,066	5,882	2,231		39,178
% of total	79.3%	15.0%	5.7%		100%
% of agri-loans to total loan portfolio	4.2%	4.8%	3.0%		4.2%
Deprived sector loans					
In Rs million	28,348	4,493	2,061		34,902
% of total	81.2%	12.9%	5.9%		100%
% of total loan portfolio	3.8%	3.6%	2.7%		3.5%

Source: Nepal Central Bank.

Figure 2. Credit delivery system for agricultural and deprived sector lending in Nepal



Performance of Rural Financial Institutions

- **Agricultural Development Bank, Ltd. (ADBL)**

The ADBL remains the major player in extending credit to agriculture and small farmers. ADBL underwent strategic changes and institutional reforms over the years from a financially unsustainable agricultural bank to a financially healthy commercial bank in recent years. Among the changes were: (a) expanded authority to undertake commercial banking activities (e.g. mobilizing deposits from the public), (b) privatization of share capital and (c) increased autonomy. Its Small Farmer's Development Program – in which the bank organized small farmers into self-help groups was extensively replicated in other parts of the country in the 1990s. By 2002, the small farmers groups were converted into registered Small Farmers Cooperatives, Limited (SFCL) and an apex organization – the Sana Kisan Bikas Bank Ltd. was created to provide wholesale loans to SFCLs. Sana Kisan Bikas Bank continues to be the major wholesaler partner microfinance bank of ADBL in extending loans to member SFCLs and in reaching out to small farmers.

ADBL's asset growth and financial health significantly improved after its restructuring program initiated in 2006. Its assets grew by almost half (48%) from 2007 to 2012 while deposits grew by 33%. Capital adequacy improved from a low capital to risk asset ratio of 6.5% in 2007 to 18.3% by 2012 which is well above the international BASEL II standard. Similarly loan quality improved from a high non-performing loan ratio of 16.5% in 2007 to 6.4% by 2012. However, agricultural loan portfolio declined. While total loan portfolio grew by 26% from 2007 to 2012, agricultural loans grew by only 5%. The percentage of agricultural loans to total loans has declined from 28% in 2007 to 24% in 2010. This ratio of agricultural loans to total loans has been maintained until 2013. The financial performance of ADBL from 2007 until 2012 is shown in Table 7.

Table 7. Performance of ADBL on selected years

Indicators	2007	2010	2012
Financial Data (in Rs million)			
Assets	53,497	60,582	79,257
Capital	215	8,976	12,463
Borrowings	374	2,551	3,227
Deposits	32,407	32,463	43,239
Loans	34,225	39,375	43,239
Agricultural loans	9,638	9,255	10,162
Deprived sector loans	1,160	3,483	5,358
Ratios			
Non-performing loan ratio (%)	16.5	8.2	6.4
Capital to risk assets ratio (%)	6.5	18.1	18.3
Deposits to assets (%)	60.6	53.6	54.6
% agricultural loans to total loans	28.2	23.5	23.5

Source: Nepal Central Bank.

As of June 2013, ADBL has the largest branch network with 243 branches, 3,000 staff and total loan portfolio of Rs 54 Billion. Its wholesale loan to Sana Kisa Bank was Rs 225 million while total loans to cooperatives amount to Rs 103 million. While agricultural loan portfolio is 24% of its total portfolio, ADBL officers reported that majority of its 200,000 end-borrowers are small farmer holders. ADBL's average loan size in its direct lending mode is Rs 320,000. In the field interview with ADBL borrowers, they reported to have loans from other sources. They argued that they do this since the loans from ADBL are not sufficient to cover their project needs. ADBL's share in the agricultural and fishery loans of the banking system is 33% while its share on the total deprived sector loans is 17%. ADBL's total assets of

Rs 86 billion account for about 7% of the total assets of all commercial banks. ABDL plans to increase agricultural loan portfolio by 10% a year in the next three years following the 2004 Agricultural Perspectives Plan and the forthcoming Agricultural Development Strategy where ABDL is expected to play a major role.

- **Wholesaler Microfinance Institutions**

There are three private wholesaler microfinance banks, namely: (a) Rural Microfinance Development Center (RMDC), (b) Sana Kisan Bikas Bank Ltd. (SKBBL), and First Microfinance Development Bank (FMDB). The financial performance highlights of the three banks are discussed below. Table 8 shows the comparative financial performance of the three wholesaler institutions.

Table 8. Comparative financial profiles of wholesaler microfinance institutions (June 2013)

Institution	Total Assets (Rs million)	Total Capital (Rs million)	Total Borrowings (Rs million)	No. of Partner Retailers	Total Loan Portfolio (Rs million)	% Share
RMDC	4,431	1,165	2,870	136	2,154	33.5%
SKBBL	4,531	604	3,439	287	3,580	55.6%
FMDB	1,069	106	918	90	700	10.9%
Total	10,031	1,875	7,226	513	6,434	100%

Source: Nepal Central Bank; Reports of RMDC, SKBBL and FMDB.

(1) Rural Microfinance Development Center (RMDC). The Center was organized in 1998 and was licensed by the Central Bank as a Class D financial institution in 2006 following the Banks and Financial Institutions Act of 2006. RMDC was the first microfinance wholesaler bank in Nepal. It has the largest capitalization among the three wholesalers at Rs 1.16 billion. Although it does not mobilize deposits from the general public, it had total assets of Rs 4.43 billion as of June 2013 (RMDC, 2013). It lent to 136 partner retailer microfinance institutions. Loan receivables from these retailers amount to Rs 2.15 billion. Except for the mountain areas, the repayment rate is 100% due to careful selection of partner microfinance institutions and rigorous monitoring. Eighty percent of its loan portfolio are wholesale loans to microfinance institutions for microfinance lending while 10% are wholesale loans to cooperatives in support of agricultural lending to their members and another 10% are for wholesale loans for lending in Mountain districts. The current interest rate for the regular wholesale microfinance lending is 7% while wholesale lending in Mountain areas is 2% per annum. According to the Chief Executive Officer of RMDC, the main source of funds is borrowing from commercial banks which stood at Rs 2.39 billion as of June 2013, equivalent to 54% of its total assets. RMDC estimates that over 1.3 million from 67 districts have been served by its partner institutions. However, RMDC reports that some of its retailers encounter problems of "credit pollution", i.e. some of the microfinance clients get loans from multiple sources. Apart from wholesale lending, RMDC provides training to its partner institutions and their clients. In 2012, it has conducted 42 training programs participated by 1,133 staff and officers from partner institutions. It has a lean manpower complement consisting of 25 staff.

(2) Sana Kisan Bikas Bank Ltd. (SKBBL). The bank is the major partner of the state-owned ADBL in lending to small farmers. SKBBL was established in 2001 upon the initiation of ADBL and licensed as a Class D bank in 2006. The capital ownership was initially composed of ADBL contributing 44%, Nepal Central Bank at 12% and the Small Farmer Cooperatives, Ltd. (SFCL) contributing the balance. As of 2012, ADBL and the Central Bank's capital share have decreased to 31.5% and 8.8%, respectively while SFCLs' share accounted for 56%. Its member SFCLs increased to 287 in 2012 from 141 in 2006. Its total client outreach was 235,494 in 2012 which is 174% increase from 85,736 clients in 2006 (SKBBL, 2012). It has maintained loan recovery rate of 97 to 98% during the last four years which is an improvement from the 85% recovery rate in 2006 and 2007. It has manpower complement consisting of 49 staff. The wholesale loan programs of the bank includes: microfinance, livestock (for meat production), self-employment for unemployed and other socially excluded sectors, and small business expansion program. The bulk of the portfolio is microfinance wholesale credit. Apart from the lending programs, SKBBL provides capacity building assistance to member SFCLs which include: management training programs for officers and staff of member SFCLs, farmer to farmer technology extension, livestock insurance and remittance services.

(3) First Microfinance Development Bank (FMDB). The bank, established in 2010, is the newest licensed wholesaler microfinance bank. Currently, it has 90 partner microfinance retailer institutions. As of June 2013, it has a capital of Rs 106 million and total borrowings of Rs 917 million (FMDB, 2013). It borrowed from 13 commercial banks, seven Finance Companies and three development banks. It had zero borrowing from the Central Bank. Its institutional loans portfolio was Ns 700 million. It estimates that around 20,000 clients have been served under its wholesale lending program with partner retailer institutions. Of the 90 partner retailers, 61 are savings and credit cooperatives, 10 multi-purpose cooperatives, 16 microfinance development banks and three financial intermediary non-government organizations.

- **Performance of Retailer Microfinance Institutions**

There are no consolidated financial data on all types of microfinance institutions. For the licensed institutions, the financial data for licensed microfinance development banks are available while the data for the licensed financial non-government organizations (NGOs) and savings and credit cooperatives are not available due to incomplete submission to the Central Bank. However, the major microfinance institutions (MFIs) including NGOs and cooperatives are submitting financial data to the Microfinance Information Exchange (MIX) which can provide indications on the general profile of retail microfinance institutions.

General Characteristics. Based on the 33 MFIs that submitted financial data to the Microfinance Information Exchange (2013), the following are indications of the general characteristics of MFIs in Nepal:

- 45% are small MFIs (number of borrowers of less than 10,000), 33% are large MFIs (number of borrowers is more than 30,000) and 21% are medium MFIs (10,000 to 30,000 borrowers);
- 90% of the MFIs have voluntary savings deposit products with amount mobilized equivalent to 42% of loan portfolio;
- 40% of the MFIs are offering micro-insurance services;
- Penetration rate (number of loan clients over number of poor population) is estimated to be 14% which is a slight increase from previous year's 13%.

The comparative performance of the different types of MFIs in Nepal is shown in Table 9. Microfinance development banks are the largest, a bank has an average of 51 branches and over 60,000 borrowers. An average savings and credit cooperative is ten times smaller with five branches and 6,000 borrowers. The cooperatives and microfinance development banks have comparable cost and operating efficiencies but gross yields are higher for microfinance banks which may be attributed to higher interest rates charged to borrowers. All types of MFIs exhibit financial and operational sustainability with Operating Self-Sufficiency ratios of 109% for financial NGOs, 128% for microfinance development banks and 133% for savings and credit cooperatives.

Table 9. Comparative performance by type of microfinance institutions in Nepal (2013)

Indicator	Microfinance Banks	Cooperatives	Financial NGOs
Average number of branch offices	51	5	17
Average number of clients	61,239	6,222	18,282
Average loan size (in Rs)	26,600	67,900	17,000
Loan size as% of per capita Gross National Income	50	127	32
Cost per loan (in Rs)	2,400	2,300	1,500
Gross yield on loans (%)	19	15	23
Return on Assets (%)	3	3	4
Operating Self sufficiency (%)	128	133	109
Financial Self-sufficiency (%)	112	101	97

Source: Dhakal (2013) with financial data sourced from MIX.

Retailer Microfinance Development Banks. The number of Class D licensed microfinance and rural development banks increased from 18 in 2010 to 30 by 2013. Of these licensed institutions, five are *Grameen Bikas Banks* or regional rural development banks and three wholesaler microfinance development banks. The rest are microfinance development banks that are into retail microfinance lending. Most of these retail microfinance institutions replicated the Grameen Bank model or similar lending methodology.

The total assets of the sector grew by an average of 22% per year in the last three years. The microfinance development banks continue to depend on borrowings as primary source of loan funds. Borrowings from Class A, B and C banks constitute 80% of the total assets in 2013 which is a slight decrease from 89% in 2011. It is to be noted that there has been an average annual growth in deposits of 30%. Deposit share to total assets increased from 14% in 2010 to 20% by 2013. The financial profile of microfinance development banks are shown in Table 10.

Table 10. Financial profile of microfinance development banks in Nepal (2011-2013)

Indicators	2011	2012	2013
Number of institutions	21	28	30
Capital	2,409	2,817	3,452
Borrowings	13,038	16,586	17,914
Deposits	3,537	5,235	6,636
Total assets	21,496	30,008	33,640
Total loan portfolio	14,650	17,738	22,424
Liquid funds	3,272	5,844	4,463
% annual increase in			
Assets	14%	40%	12%
Deposits	14%	48%	27%
Borrowings to loan ratio (%)	89%	94%	80%
% of deposits on total assets	16%	17%	20%
% of liquid funds on total assets	15%	19%	13%

Source: Nepal Central Bank.

Performance on key indicators (outreach and asset quality) of microfinance development banks as of 2012 is shown in Table 11. The total number of active borrowers was 848,974 with outstanding loans of Rs 21 billion. Past due loans is manageable at 3.2% of total loan portfolio. Savings deposits mobilized was equivalent to 30% of loan portfolio.

Table 11. Performance of microfinance development banks on selected indicators (2012)

Indicators	Results
Number of institutions	28
Number of loan clients	848,974
Number of depositors	866,222
Total loan disbursed (Rs million)	129,519
Microenterprise loans (Rs million)	104,856
Total loan outstanding (Rs million)	21,015
Total past due loans (Rs million)	669
% of micro-enterprise loans over total loans	81.0%
% past due loans	3.2%
% number of borrowers with past due loans	6.2%
% of savings over loan portfolio	30.5%

Source: Nepal Central Bank.

Savings and Credit Cooperatives. The number of registered savings and credit cooperatives increased by 10% a year in the last three years, from 10,558 in 2011 to 12,614 by 2013. Loans of cooperatives granted to their members increased by average of 21% a year, from Rs 81 billion in 2011 to Rs 115 billion by 2013. The amount of savings mobilized however was maintained at the same level at Rs 98 billion. The share of savings and credit cooperatives to the total loans of all cooperatives is about 87% while the share in total savings deposits of all cooperatives is 80%.

Table 12. Growth of savings and credit cooperatives (2011 to 2013)

Particulars	2011	2012	2013
Number of Institutions	10,558	11,392	12,614
Loan portfolio (Rs billion)	81	101.1	115
Savings deposits (Rs billion)	98	96.2	97.6
% Increase in number	n/a	8%	11%
% Increase in loans	n/a	25%	14%
% Increase in deposits	n/a	-2%	1%

Source: Nepal Central Bank, Department of Cooperatives.

Savings and credit cooperatives operate in local communities for the mutual benefits of their members and are supposed to collect savings from or lend to their members only. They are heavily concentrated in urban areas, particularly, in Kathmandu Valley doing similar activities as banks. Some big savings and credit cooperatives have loan business volume and geographic coverage exceeding Class C financial institutions.

The performance among savings and credit cooperatives is highly diverse. There are no consolidated data on savings and credit cooperatives, indications of the sector's performance can be gleaned from few cooperatives with financial data submitted to some microfinance networks. Table 13 below shows the comparative profiles of cooperatives by different size categories based on 11 savings and credit cooperatives that submitted financial data to the Microfinance Information Exchange (MIX) in 2012. The Microfinance Information Exchange classifies sizes of Microfinance Institutions into large (those with clients more than 30,000), medium (10,000 to 30,000) and small (less than 10,000 clients). In Nepal, majority of cooperatives have less than 10,000 clients and can be further sub-classified. It should be noted, however, that the sample of MIX has not been randomly selected and may not be representative of the actual population. Nevertheless, the profile gives indications of the performance of the cooperatives across different sizes.

The bigger cooperatives tend to have a more leveraged financial structure (higher borrowings as source of loan funds) and higher loan sizes extended to borrowers. Average Loan sizes of borrowers tend to become bigger as the cooperative grows in asset size, e.g. a very small cooperative (loan clients of 500 or less) has an average loan of Ns 13,000 while a large cooperative has average loan size of Ns 57,000. The return on assets and asset quality are comparable across different size categories of cooperatives.

Table 13. Comparative profiles of sample savings and credit cooperatives (n = 11)

Indicators	Large (n = 1)	Small-A (n = 3)	Small-B (n = 7)
Total assets (Rs million)	1,089	359	14
Loan Portfolio (Rs million)	755	199	6.1
No. of offices	32	6	1
Manpower	187	15	3
Number of loan clients	43,163	3,476	482
Average loan per borrower (Rs)	57,379	49,903	12,676
Capital/asset ratio	17%	18%	26%
Debt to equity ratio	4.8	4.7	3.0
Deposits to loans	65%	101%	94%
Deposits to total assets	47%	77%	71%
Gross loan portfolio to total assets	73%	77%	78%
Return on Assets	3.1%	1.1%	2.4%
Portfolio at Risk (%)	4.6%	1.6%	1.2%

Source of data: Microfinance Information Exchange (2012).

Supply-Side Issues and Constraints

Financing Structure of Microfinance Institutions. As microfinance development banks provide about a third of total loans to the poor, it is important that their financial capacities expand in order to broaden financial services outreach. The microfinance sector goal of reaching 2.4 million households hinges on the capacity of these microfinance institutions to expand outreach. A major constraint is their ability to source funds. Currently, borrowings of microfinance development banks from big banks finance 80% of their loan portfolio or only 20% is sourced from their own funds. One factor is the limited authority granted by the Central Bank on deposit taking activities i.e., deposit taking is limited to mobilizing client-members' savings.

The financial capacity of microfinance development banks hinges on the continued imposition of the mandatory deprived sector loan allocation required by the Central Bank to all Class A, B and C banks. Wholesale lending to microfinance institutions has been the preferred route of these banks to comply with this provision. This means future microfinance financial capacity growth will actually be dictated by continued imposition of the mandatory allocation and not as a result of the sector's true competitive strength. This mandatory allocation may be counter-productive in the long run as this may create distortions e.g. obtaining loans from banks beyond absorptive capacity which may result to excess liquidity.

Geographic Distribution of Bank Offices. The current geographical distribution of bank offices creates unequal opportunities for the rural poor in accessing financial services. Twenty-seven percent (27%) of the total branch offices are concentrated in the more developed Kathmandu valley and 42% in all *Terai* areas. Even among microfinance development banks, out of the total 562 branches, 76% are in *Terai* areas and only 24% in hill areas. In some of the hills districts there is no single microfinance development bank whereas in the Terai there are areas where up to 30 Microfinance branches can be found in a single district (Shrestha, 2013). The same distribution pattern is observed among savings and credit cooperatives. This un-even geographic distribution leads to multiple borrowing by loan clients in accessible areas while the poor in other areas remain without formal credit access. However, going to the hill and mountain areas pose operational constraints to microfinance institutions such as high overhead cost, higher personal security risk and transportation problems. To encourage banks to open branches in unbanked or underserved areas, the Central Bank has relaxed branch opening requirements and has offered zero cost loans of up to Rs 2 million. But to date, there are no takers.

Cooperatives' Weak Governance. While there are 29,000 registered cooperatives, their potential in financial services delivery has not been maximized. About 4.4 million people are members of cooperatives of which 2.2 million are members of savings and credit cooperatives. A study conducted in 2012 by the Department of Cooperatives noted that many cooperatives were run as family businesses, with family members working as chief executive, employees, directors, and audit committee member. The cooperatives were found transferring fixed assets like land, buildings and shares as collaterals in the name of board members or other companies they have promoted (NRB, 2013d). The study noted that approximately Rs 35 billion (36% of total deposits of all cooperatives) members' deposits are high risk due to poor to irregular management practices.

The success of the Small Farmer Development Cooperatives program can be attributed to an institutional capacity building intervention which extended over a period of time wherein the government (through the Agricultural Development Bank) had a direct role in organizing farmer cooperatives. After the passage of the Cooperative Act in 1992, the government's role has been limited mainly to registering and monitoring. Although the government recently created a new agency focused on cooperatives, i.e. the Ministry of Cooperatives and Poverty Alleviation where the registering authority (Department of Cooperatives) has been transferred, the budget support for capacity building is very limited. The Ministry has a small grant assistance program for producer coops, but the program is focused on extending seed capital (for fixed assets, equipment acquisition) and only 40 cooperatives out of the 29,000 registered cooperatives so far have been assisted. The Ministry of Cooperatives has one National Training Center and five Regional Training Centers which conduct trainings in the districts at cost sharing basis with cooperative networks. Capacity building intervention has been limited to short training programs offered by major cooperative federations. These are inadequate to respond to the huge capacity building needs of the cooperative sector.

Demand Side Issues and Constraints

As of the 2006 national survey on financial services access, 32% of households obtain credit either from informal, semi-formal or formal sources (Ferrari, *et al*, 2006). Financial NGOs and cooperatives are the major sources (28% of those who borrow), followed by banks (24%) and informal lenders (20%). This means that only about 22% of total households borrow from formal and semi-formal sources. In rural areas, a greater proportion borrows from informal sources (40%) and especially among the poorest households (47%). Further, reliance on informal lenders is greater in the Hill and mountain areas (46%) compared to Terai (33%) and Kathmandu (15%). By administrative region, exclusive reliance on informal lenders is more common in Western region (52% of households) followed by Central region (39%). As of the latest survey of 2010/11, only twenty percent (20%) borrow from formal financial institutions indicating that there has not been substantial change from the 2006 survey (NRB, 2013c).

There is no recent market research conducted on the characteristics of rural borrowers. However, based on interviews conducted in this study, there are indications that broadly, borrowers can be categorized into: (a) small scale agri-based enterprise borrowers and (b) microfinance borrowers. As per government's official definition, small enterprises are those with assets of more than Ns 200,000 but not exceeding Rs 30 million. This type of borrowers are engaged in production, processing or marketing of agricultural products and appears to have the following characteristics: (a) with identified market outlets, (b) with established track records in their projects, and (c) can prepare and submit business/ project plans as may be required by banks. Microfinance borrowers on the other hand, consist of microentrepreneurs and small farmers with projects requiring less than Rs 150,000 which is the loan ceiling for non-collateralized loans.

The most common practice of microfinance institutions in Nepal is to require at least monthly interest payments on all loans regardless of purpose although the principal payments vary depending on the purpose of the loan e.g. weekly to monthly payments for microenterprises payable in six to 12 months while the term for agricultural loans will depend on the production cycle of the activity financed. This practice implicitly requires that borrowers have at least monthly cash flows. Current practices on loan product design may have a bearing on the projects financed as only about 30% of total loans financed are agricultural projects, with the rest mostly trading type projects.

In case of small scale agri-based entrepreneurs, the constraints are: (a) land collateral, (b) low productivity and (c) access to markets. Banks normally peg the loan amount at 60 to 80% of the assessed value of the collateral following Central Bank's regulation. Farmer-borrowers interviewed noted that this credit policy tend to limit the amount of loan which they borrow which is usually lower than the actual required capital requirements of their agri-enterprise project. It should be noted that average landholding in Nepal is only 0.8 hectare. The second major constraint is low productivity which is mainly due to poor technology adoption. Technical assistance either through training or on-site visits from agricultural technicians is generally not available. Likewise, cost of production inputs is high and in some areas, there are problems of availability of inputs. The third constraint is market risk ranging from unreliable market outlets, seasonality of demand and erratic prices. Access to markets particularly in hill and mountain areas is difficult due to poor road networks. Roads in these areas are usually impassable during monsoon months. Most farmers have no agricultural insurance as the current insurance program is only at a pilot stage and on very limited scale. Farmers have to fully absorb losses except in rare cases where the government implements a rescue program (e.g. in the recent bird flu epidemic poultry growers can expect some compensation for the losses).

CHAPTER 5
Government Development Plans and Programs

Agricultural Development Plans and Programs

The 20-year (1995-2015) Agriculture Perspective Plan (APP) outlines the broad policy context for agricultural development in Nepal. The APP and the Agricultural Development Policy of 2004 form the foundation of Nepal's agricultural policies which are incorporated in the national development plans. Following the end of Nepal's 10th medium-term development plan, Nepal crafted Interim Three Year development plans due to the protracted political transition. Currently, the government is implementing the second Interim Three Year Development Plan which covers fiscal years 2010/11 to 2012/13 and currently preparing the third Interim Year Plan for fiscal years 2013/14 to 2015/16.

The upcoming Three Year Interim Plan has a long term vision of transforming Nepal from a least developed nation to a developing nation within 20 years. The government is targeting an average annual growth rate of 6% over the next three years with the agriculture sector targeted at 4.5%. The current three year plan which ends this 2013 targeted over-all annual growth rate of 5.5% and agriculture's targeted growth of 3.9%. Financial intermediation sector is targeted to grow by 6.2% backed by remittances-backed demand. The government is targeting to reduce poverty incidence to 23.8% by 2014. The goal is to reduce poverty to 21% and achieve Millennium Development Goals by 2015 through sustained economic growth. Over-all, the government is targeting total investment of 25.8% of GDP by FY 2016, with investment to agricultural sector of about 4% of GDP. Priorities indicated in the Plan are: (a) energy development, (b) agriculture productivity, diversification and commercialization, (c) roads and physical infrastructures, (d) social services (education, health, drinking water and sanitation), (e) tourism, industry and trade, and (f) good governance. The size of the proposed budget is 27% of GDP by 2014 to 29% of GDP by 2016.

For the agricultural sector, the government has initiated crafting a comprehensive long term Agriculture Development Strategy (ADS) with technical support from 11 international donors. To date, a vision statement has been crafted after series of consultation meetings. The vision of the ADS is to attain sustainable, competitive and inclusive agricultural sector that drives the economic growth while providing improved livelihoods and food and nutrition security among its populace. Priorities of the ADS are (a) improved governance, (b) productivity improvement through decentralized research and extension, inputs management, (c) commercialization through national value chain programs, improvement of market information; (d) enhancing competiveness through improvement in market infrastructure and food safety and quality. However, operational plans have yet to be crafted. The ADS is expected to be implemented starting Fiscal Year 2014/15.

For the current fiscal year (2013/14), the government continues to adopt the policies under the Agricultural Development Policy (ADP) of 2004. The vision of the ADP is to transform agriculture from subsistence farming to commercial and competitive farming system. Major strategies identified are: (a) production and productivity improvement through better land use, improved irrigation, development of high value crops, development of input (seeds, plant varieties) resource centers, mobilizing farmer groups in extension activities and ensuring flow of credit to support agricultural enterprises; and (b) development of commercial and competitive farming system through integrated development of contiguous large production areas, implementation of livestock insurance system and eventually covering high value crops, systematizing quarantine and safety regulations, regulation of sale and distribution of improved production inputs (high yielding breeds, etc.), promotion of cooperative based agricultural enterprises, encouraging private sector investments and development of market linkages between producers and buyers. The third component of the plan is the protection of natural resources and environment and promotion of biological diversity.

However, in spite of the priority given to agriculture in the government's development plans, there are lingering issues in budget programming and implementation. Although government's over-all spending has doubled since 2006, government's budget for the Ministry of Agriculture remained at 4% of total budget in 2013 (Rs 21.4 billion out of the total budget of Rs 517 billion). The Ministry of Agriculture's budget is equivalent to only 1.4% of GDP. The agricultural research in particular suffers from inadequate funding. Within the budget for agriculture, the proportion of budget for agricultural research even declined from 14.4% in 1997/98 to 7.1% in 2008/09.

Although there was a substantial increase in agricultural research budget from Rs 550 million in 2012 to Rs 1.75 billion in the 2013 budget, this is only 8% of the total agricultural budget or only 0.3% of the total government's budget. A bigger budget allocation of Rs 6.7 billion (31% of agriculture's budget) has been allocated to providing subsidies to procurement of fertilizers, seeds, and farm machinery. Only Rs 20 million has been allotted for the agricultural insurance premium subsidy.

Extension services are likewise strained due to inadequate funding support. The Department of Agriculture has 378 extension offices nationwide with each station catering to 11,000 farmers or a ratio of one technician per 1,580 farmers. As of 2003 survey, only 6% of farmers have reported to have accessed agricultural extension services and 14% have accessed veterinary services (Dillon, *et al*, 2011). Officers of the Department of Agriculture interviewed in this study noted that these figures have not changed as of 2013.

Nevertheless, the following are the recent positive developments on agricultural extension services (Kaur, 2013):

- A participatory planning process has been developed and institutionalized where local priorities are identified and incorporated in the Department of Agriculture's extension programs;
- A declared policy towards promotion of public-private partnerships in extension services where the role of public sector will be re-oriented towards that of a facilitator rather than service provider recognizing the roles of Non-Government Organizations and the private sector in extension services delivery.

Although there are government programs to improve supply of production inputs (good seeds and fertilizers), local supply is still very inadequate. The state-owned fertilizer company estimates local supply of 150,000 tons can only meet 30% of the total demand for fertilizers (IRIN, 2013). Finally, the budget allocation for the needed physical infrastructures has not practically changed since 10 years ago. Irrigation has been allocated Rs 12.6 billion while physical infrastructure (road networks) with Rs 35 billion or a total of 9% of the total budget in 2013 compared to 9.54% in 2003. Poor road networks continue to hamper delivery of agricultural goods and services from farms to markets.

Credit Programs

Microfinance Sector Development Strategy. With an objective of bringing microfinance services under the single umbrella through creating necessary structural and legal provisions the Government of Nepal declared the National Microfinance Policy in May 2008. The main objective of this policy is to support in reducing poverty through sustained, simplified and accessible micro-finance services. The other provisions of the 2008 National Microfinance Policy are as follows (NRB, 2013d):

- Expansion of microfinance services to the targeted deprived sector people through (a) setting criteria to identify deprived sector people to extend credit with or without collateral, (b) encouraging wholesale lending agencies, (c) coordination with other poverty reducing programs and (d) developing institutional relationship with other microfinance service providers at the local level.
- To establish a separate institution for regulation, supervision, monitoring and evaluation of microfinance service providers and establish a separate national microfinance development fund.
- To expand savings deposit mobilization through (a) savings mobilization awareness campaign among the targeted deprived sector clients, (b) liberalizing deposit collection provisions by microfinance institutions based on their services delivered and share capital.
- To conduct a survey pertaining to information as well as numbers, service delivery systems and access of existing cooperatives and microfinance institutions and to conduct trainings for enhancing professionalism among microfinance institutions.
- To adopt "flexible policy" on taxation for microfinance institutions and deprived sector clients.

Among the concrete steps undertaken by the Nepal Central Bank as of 2013 to expand microfinance services following the 2008 Microfinance Policy are:

- Establishing an interest free loan facility for banks and financial institutions that will open branches in 17 remote districts (currently unserved) for a specified period. A policy provision has also been implemented under which the banks can open branch in Kathmandu valley only after opening one branch in specified remote districts and one in other district.
- A policy provision has been introduced allowing banks to provide banking services in unbanked areas and rural areas through e-banking and mobile devices to increase access to financial services. Branchless banking has been recognised as an important tool by the Central Bank to increase banking access to the people living in geographically difficult-to-reach places in Nepal.
- Policy of increasing the deprived sector loan by 0.5 percentage point every year up to 3 years by BFIs has been made. For fiscal year 2012/13 commercial banks, development banks and finance companies are required to lend 4%, 3.5% and 3% respectively of their total loans to the deprived sector. As a policy to promote productive sector lending, commercial banks are required to prepare and submit a plan to provide minimum 20% loan from their total loan and investment on various productive sectors such as agriculture, energy, tourism, household and small industries within mid-July 2012 and also, minimum 10% loan should be provided to agriculture and energy within mid-July 2013.
- A new law, "Micro Finance Authority Act" has been drafted and proposed with the provision of establishing a new authority that would regulate and supervise various types of Microfinance Institutions in the country. Likewise the proposed law will establish the "National Microfinance Development Fund" which will replace the existing "Rural Self Reliance Fund" and which will act as an autonomous wholesale lending fund.

Central Bank's Credit Programs. Coupled with the mandatory allocation for deprived sector lending, the government established the "Rural Self Reliance Fund" (RSRF) in February 1991 with an initial fund of Rs 10 million. As of 2013, Fund's total capital stood at Rs 443.4 million with Rs 190 million contributed by the Government of Nepal and Rs 254.4 contributed by Nepal Central Bank. Under the RSRF which the Central Bank administers, wholesale loans are extended to cooperatives and non-government organizations to support deprived sector lending and for extending long-term loans to support agricultural priority commodities/projects e.g. tea, cold storage projects of small farmers. In 2012, the Program has disbursed Rs 833 million to 711 institutions from 63 districts benefitting 36,847 households. Roughly this outreach is about two percent of the total poor households.

Apart from the RSRF, the Central Bank also has a financing facility for banks and financial institutions. Central Bank is providing refinance rate of 5% per annum for loans extended to small and medium enterprises but with a condition that banks lend not higher than 10% per annum. As of June 2013, total amount availed by banks from Central Bank's financing facilities amounted to Rs 2.9 billion which is 6% of their total borrowings amounting to Rs 48 billion. Microfinance development banks, in particular, only borrowed Rs 194 million which is just 1% of their total borrowings.

Foreign-Assisted Credit Projects. There are a number of projects with funding support from international donor agencies. Three major on-going projects are briefly discussed below.

Enhancing Access to Financial Services (EAFS). The project is being implemented by the Nepal Central Bank with support from UNDP and UNCDF. The project has a US$ 3 million budget initiated in November 2008 and ending December 2012 (UNDP, 2013). Implementing partners of the Central Bank are 18 financial institutions. The project's goal is to extend the reach of financial services to Nepal's remote areas. As of the 2011 report, the project has supported opening of 94 new branches, 54 of which are in 27 of the 38 priority districts with a total outreach of 158,424 new loan clients, 68% fo whom are from disadvantaged groups. The Project also extended training assistance to the partner institutions and linked 17 institutions with the international rating agency for microfinance. Ten of these institutions got positive rating of 'good performance on a positive trend'. The Project also assisted partners in linking self-help groups with banking institutions. A total of 2,455 self-help groups were linked with nine of the 18 partner financial institutions.

IFAD Supported Projects. The IFAD supported projects include: (a) Western Uplands Poverty Alleviation Project ($ 20.3 million funding) initiated 2003 ending 2014; (b) Leasehold Forestry and Livestock Programme ($ 11.7 million) from 2004 to 2013, (c) Poverty alleviation Fund II ($ 4.0 million) from 2008 to 2012 and (d) High-Value Agricultural Project in Hill and Mountain Areas ($ 15.3 million) from 2010 to 2017. These projects have supplementary rural finance component that aimed to improve access to finance for poor farmers and facilitate institutional and capacity development of financial institutions. The leasehold project (HLFFDP) contained a credit scheme managed by ADBL under its Small Farmer Development Programme that was generally not successful and achieved only 56 per cent of targeted disbursements.

The results of the rural finance component of the IFAD assisted projects are as follows (IFAD, 2012):

- Leasehold Forestry and Livestock Project sought to establish and link village associations with financial institutions. The results were: 26 village associations were linked but hampered by weak management capacities and poor accounting systems, only 17% of organized groups were found to be active with financial activities with average savings of only Ns 12.60 per month;
- Poverty Alleviation Project included a credit scheme to the organized groups using Grameen Bank methodology and sought to operate a revolving credit fund. The results were: Rs 132 million was lent to 21,627 households but none of the 16 replicators achieved financial viability where 65% of loans disbursed was not recovered;
- Western Uplands Poverty Alleviation Project included introduction of rotating savings and credit organizations where NGOs were contracted to undertake social mobilization and capacity building of the community organizations. The results were: social mobilizers have limited experience in microfinance. High non-repayment rates (up to 47% in some districts) on loans acquired from the Project but loans of members from internal savings had good repayments of 84% which improved in recent period to 95%.

Overall effectiveness of the rural finance components in the above projects was rated by the IFAD Independent Office of Evaluation as unsatisfactory noting that rural finance component in the assisted projects played a secondary role in the projects and suffered from inadequate design and resource allocations for capacity-building and most loans served consumption purposes and not productive activities. It concluded that efforts to develop microfinance through introduction of the Grameen model were not successful.

ADB Rural Finance Sector Development Cluster Program (Subprogram 2). The objective of the Program is to improve the soundness, efficiency, and outreach of the Nepal's rural finance sector through policy, legal, regulatory and institutional reform. The executing agency is the Ministry of Finance. It has an approved funding as of June 2010 of $ 72.5 million, of which $ 12.1 million is a technical assistance grant for capacity building while $ 60.4 million is long term loan. Loan and grant closing dates were extended to December 2014. The components of the Program are; (a) Legal and Regulatory reforms, (b) Institutional restructuring of the Agricultural Development Bank, Ltd. (ADBL), the Small Farmers Development Bank (SFDB), and the Grameen Bikas Banks; (3) establishment of National Banking Training Institute for rural and microfinance institutions; (4) establishment of a credit information bureau.

As of June 2013, the ADB review mission noted that major desired outputs were achieved (ADB, 2013b). Among the outputs were:

- ADBL restructuring generally proceeded as targeted except for the divestment of public shares in favour of private shares;
- SFDB restructuring and strategies to expand in the hills and mountain areas are on track, reaching 24 new small farmer cooperatives in 16 districts with 93,965 farmer-members;
- The National Banking Institute is operational and has trained over 5,414 personnel from 400 rural financial institutions.

The drafting of the Microfinance Act was supported by this Project and was a targeted output for 2013. The enactment of the Act was delayed due to the delay of having an elected Constituent Assembly. On the establishment of a credit information bureau, procurement of credit information system has been initiated. Member registration and data collection data is expected to commence by 2014. The Project was assessed by the ADB Review Mission to be generally satisfactory.

CHAPTER 6
Discussion and Recommendations

Financial health and efficiency of formal financial institutions in Nepal have improved over the years. There was remarkable growth in resources as well continued efficiency improvements among the licensed microfinance development banks. There was also growth in number and resources among cooperatives and non-government organizations. Although there are conflicting assessments on the over-all performance of the cooperatives as there were reported financial losses among many cooperatives, there are indications of continued efficiency improvements among soundly managed financial cooperatives. In spite of these positive developments, financial access among the rural poor households particularly hill and mountain areas remained constrained with only minimal improvement over the recent years. The major issues that need to be addressed and corresponding recommended actions to improve rural financial services in Nepal are discussed below.

Policy and Regulatory Issues and Recommendations

The current main strategy of the government in ensuring credit to the disadvantaged sectors of the population is the imposition of the mandatory loan allocation for the deprived sector lending. The preferred route of banks is to extend institutional loans to microfinance institutions that in turn lend directly to the deprived sectors. So far, this mandatory loan allocation appears to have no noticeable negative impacts on the financial health of the commercial banking sector as loans to microfinance institutions are at market rates and are being repaid. Partly this was due to the maturity of the microfinance sector that achieved an efficiency level that enabled microfinance institutions to manage well the borrowed funds. The Central Bank thus can still continue the mandated allocation in the coming years.

Other regulatory issues that have impact on the functioning of rural finance and microfinance institutions are discussed below.

1. **Reversal of liberalization policy.** To ensure that funds lent by Class A, B and C financial institutions to microfinance institutions are lent by the latter to intended use i.e., microfinance institutions actually lend to deprived sectors and lent at "reasonable" interest rates, the Central Bank has the tendency to issue directives that already delve on business operations impacting on the efficiency of retailer microfinance institutions. Among these is a recent directive requiring microfinance banks to immediately lend within the day reflows from borrowed funds which microfinance banks find impractical. Secondly, there is the planned directive to control interest spread among banks as publicly announced in the Monetary Policy for FY 2013/14. There is also the announced policy of reviving the imposition of the loan allocation for so-called priority sector e.g. agriculture sector, which was already removed in 2007. These recent policies send mixed signals to banks and microfinance institutions.

2. **Regulatory framework under the proposed Microfinance Act.** Broadly, the plan is to spin-off the supervision of microfinance institutions to a new regulatory body. The proposal will transfer the direct supervision of microfinance institutions from the Central Bank to the new body. Such new regulatory body will supervise all types of microfinance institutions – including thousands of un-supervised savings and credit cooperatives and non-government organizations. There have been positive outcomes (growth and efficiency) on exercising prudential supervision by the Central Bank over microfinance development banks. These banks now comprise 2.2% of total banking resources. These banks will be lumped with

thousands other cooperatives whose ownership and governance structures are completely different and which may require a different regulatory approach.

3. **Limited resource mobilization authority.** The current provision under the law allows microfinance development banks to undertake deposit taking activities from the general public but with prior approval from the Central Bank. To date the Central Bank has not granted this authority. The microfinance banks are limited to mobilizing deposits only from members of client groups. This limits the fund mobilization capacity of microfinance development banks. Among the categories of banks, microfinance development banks have the potential to reach out to rural areas. There are huge rural savings resulting from overseas workers' remittances that remain unharnessed. Microfinance banks and large credit cooperatives have the potential to become the local community-based financial institutions that can do financial intermediation in rural areas.

Based on the above observations, the following are recommended:

1. **Provide support measures to encourage increased lending to agriculture and deprived sectors.** So far, since the imposition of the mandatory deprived sector loan allocation, banks have lent just within the prescribed ratios, implying that banks are not inclined to lend beyond the mandated ratios. The government thus may need to explore provision of other incentives and support schemes to entice increased lending to agriculture and deprived sectors rather than solely relying on increasing the mandated loan allocation. Among possible incentives are tax incentives and regulatory relief to those that will lend to agriculture and deprived sectors beyond the mandated allocation or open branches in underserved areas. Regulatory relief refers to regulations which can be 'relaxed' by the Central Bank within a specific period of time but which do not jeopardize soundness and stability of the financial system. An example is possible relaxation of minimum capitalization to set up new branches. Support schemes that mitigate the credit risks faced by banks associated with lending to the agricultural and deprived sectors should be explored by the government. These include: (a) expansion of the agricultural insurance program and (b) implementation of credit guarantee schemes. Agricultural insurance is currently on a pilot and limited scale. The insurance program must be adequately capitalized and expanded to have a wider coverage. Meanwhile, as the agricultural insurance may not be able to cover a large number of crops/livestock and large number of farmers, an agricultural loan guarantee scheme may be set up to encourage banks to lend to agricultural borrowers. Likewise, a guarantee or credit surety fund may be set up that provides guarantee coverage to microfinance institutions that extend loans in priority geographic areas. This guarantee scheme will boost confidence of wholesaler banks to lend more to these microfinance retailers. When these support measures are in place and are producing results, the government can then review the time frame of the continued imposition of the mandatory allocation.

2. **Maintain prudential supervision of Class D banks under the Central Bank.** These institutions have the potential to be the smallest unit banks of the rural financial system that can take care of the lower market segments. The current share of Class D banks' share in total resources is 2.2%. This is similar to the share of rural banks on the total banking resources in the Philippines which has remained at 2.3% in the past two decades, yet rural banks in the Philippines play a major role in rural finance as they have the largest shares in loans extended to agriculture, micro and small enterprises. The Class D banks of Nepal have similar potential. Regulatory rules however must be conducive to the entry and growth of community rural banks. Class D banks that comply with prudential conditions should be allowed to perform other banking activities such as (a) deposit taking and (b) lending not limited to microfinance loans. The first will improve their financial capacities while the latter will enable banks to

diversify risks which will further improve their viability and competitiveness as banking institutions. The Central Bank should continue to concentrate on ensuring compliance on financial soundness standards which must be reviewed from time to time based on benchmarks of Class D banks. Central Bank should refrain from "over-regulation" that impedes business operations efficiency or issuing directives prescribing ownership structures. The Central Bank should concentrate on prudential supervision i.e., ensuring financial soundness, stability and liquidity of financial institutions.

3. **Regulatory approach for financial cooperatives and non-government organizations.** Financial cooperatives and NGO sector must be viewed as a highly diverse sector – in asset size, financial performance and quality of management and governance. Given the diversity and huge number of institutions involved, a single regulatory approach may not be practical. Prudential supervision should be applied only to those financial cooperatives and non-government organizations which are mobilizing huge amounts of deposits and in effect are already mobilizing public savings which are being lent or intermediated. On the other hand, non-prudential regulation is recommended to the rest of thousands of smaller sized cooperatives and non-government organizations. The concentration of oversight function for this category will be to ensure adoption of uniform accounting and reporting systems, good management and governance systems and performance standards. The approach must be coupled with a good monitoring system to weed out bad ones i.e., disenfranchising non-performing or badly managed cooperatives. An independent rating system for cooperatives and financial NGOs should be established as this would guide the wholesaler banks that lend to these types of microfinance institutions.

Addressing Demand Side Constraints

The transformation from subsistence to commercialized agriculture is not foreseen to be realized in the medium term given the fiscal constraints of the government and other enormous constraints of the sector. Agriculture is likely to be still dominated by very small producers with problems on both input supply and output markets. Given this scenario, a major concern is how to expand financial services to the agricultural sector without jeopardizing the viability of rural finance and microfinance institutions. A supply led approach is not recommended as this may be counter-productive to the continued viability of financial institutions. The planned revival of mandated loan allocation for agriculture should be carefully calibrated such that the proposed mandated allocation actually corresponds to the effective demand of agricultural borrowers. The recommended actions are:

1. **Improve institutional coordination.** The institutional coordination between the lenders and agricultural extension/agri-business promotion agencies must be improved. There must be close coordination between the state-owned Agricultural Development Bank and the Ministry of Agriculture, from the central office down to district offices. Similar coordination mechanism should be encouraged among private microfinance institutions and government/private agencies involved in agricultural extension and agribusiness promotion. This is to ensure that enabling conditions (e.g. presence of markets) for the viability of agricultural value chains are present in the geographic areas where financial institutions would extend financing.

2. **Need for innovative financing schemes for agricultural borrowers.** Most microfinance institutions have not developed innovative loan products suited to the nuances of agricultural borrowers in Nepal. The microfinance institutions normally adopt the Grameen Bank model and similar methodologies requiring frequent payments which are more suited to trading type of projects. Some foreign assisted projects embarked on geographic focus and client targeted rural finance schemes but adopting traditional microfinance methodologies. These proved to be unsuccessful. There are very few institutions that ventured innovative

approaches such as value chain financing and these are still on pilot or very limited scale. Piloting new agricultural financing schemes must be encouraged and supported. Good practices on innovative agricultural financing schemes should be identified and should be supported for possible replication or up-scaling.

Addressing Supply Side Issues

Institutional Capacity Building of Cooperatives

The current rural financial services system operates on a two-tier and three tier structures. The commercial and development banks are the principal sources of funds while microfinance institutions (microfinance development banks, cooperatives, financial non-government organizations) are retailers of microfinance loans. To broaden outreach depends heavily on the capacity and efficiency of these retailers. Among these retailers, the cooperative sector has the largest potential in reaching out to the unbanked areas and underserved areas. They are community based and operate on lower overhead costs than microfinance development banks. The principal constraint is weak governance and management. Improvements in the efficiency and viability of the cooperatives would largely depend on capacity enhancement i.e. human resources and financial capacity enhancement. This was proven in the case of the Small Farmer Cooperative Development program where farmer groups were transformed into viable efficiently run cooperatives that can now ably manage lending to farmer-members. Currently, institutional development efforts for cooperatives are on a project to project basis such as foreign-assisted projects where there is a capacity building component. The government's intervention, through the Ministry of Cooperatives, on the other hand is limited to sponsorship of few training courses. Both approaches have very limited coverage. A wider national scale institutional capacity program for financial cooperatives is needed to make a dent on improving the over-all performance of the cooperative sector.

Strategic role and Capacity building of Agricultural Development Bank, Ltd. (ADBL)

Strategic Role. The ADBL plays a strategic role in broadening rural financial services in Nepal. ADBL is currently correctly pursuing the path of financial sustainability. However in the process of instituting changes, ADBL has effectively reduced the proportion of agricultural and small farmer loans on its total loan portfolio. ADBL may have to review its current strategic path. In the medium term, the rural financial system will still likely be composed of numerous small financial institutions while the big banks will likely continue to shy away from lending directly to rural micro and small enterprise borrowers. Big banks will continue the preferred route of wholesale lending to smaller financial institutions. Thus, what the system needs are efficiently run apex institutions that can mobilize huge funds from the big players and efficiently channel such funds to the numerous smaller institutions. This can be a strategic role of ADBL. It can expand its role as the major apex institution for rural finance. Currently its wholesaling activity is very limited accounting for only three percent of its total loan portfolio. Its wholesale lending activity is limited to Sana Kisan Bikas Bank. ADBL should explore expanding its wholesaling activity to other organizations to cover all possible types of rural financial institutions e.g. microfinance development banks, savings and credit cooperatives, financial non-government organizations. At the same time, it may continue financing strategic agri-business enterprises that can catalyze development of agricultural value chains in priority geographic areas and priority commodities. This way ADBL can pursue financial sustainability while fulfilling its strategic developmental roles.

Capacity Building. In view of the envisioned strategic role as major apex institution for rural finance institutions, it is important to maintain a continuing capability building program for the officers and staff of ADBL. This will ensure that ADBL will have developed a cadre of officers and staff knowledgeable and capable in performing ADBL's new role and in coming up with innovative financing schemes for the various clientele and sectors assisted.

Creation of Credit Bureau

The proposal of microfinance institutions to establish a Credit Information Bureau for the microfinance sector should be supported as this will mitigate the problem of credit pollution. The Central Bank should take the lead in its establishment. The Credit Bureau will serve as repository repository of credit information on microfinance and small agricultural borrowers which may be accessed by banks and microfinance institutions. It can improve the transparency and risk management which is expected to encourage more lending to the unbanked and underbanked sectors. The banks and microfinance institutions can more efficiently assess credit risk and reduce lending costs, especially in the conduct of credit investigation. Bad borrowers can be identified through the Credit Bureau and those with good credit track record can easily avail themselves of financing. An efficiently run Credit Bureau addresses the issue of multiple borrowing and over-indebtedness of small borrowers.

Profiling of Agricultural Borrowers

The ADBL and microfinance institutions are faced with the dilemma of serving the financing needs of the rural poor while at the same time maintaining profitability. Serving the poor borrowers started off with the microfinance institutions but eventually, profit seeking stance caught up with them, preferring to lend to less risky and better-off borrowers. Which is why even if the rural financial system in Nepal is healthy, only 20% of rural borrowers has accessed financing from formal sources. One problem confronting rural finance and microfinance institutions is inadequate information on rural borrowers. There has been no market research or profiling of rural and agricultural borrowers. The rural agricultural clients have diverse characteristics and needs. Different socio-economic profiles would require different interventions. For instance, for the very poor, the intervention appropriate may be direct subsidies, e.g. such as 'conditional-cash-transfer' (conditional grant assistance) program as they are not yet economically viable to join the mainstream credit delivery system. The 'entrepreneurial poor' or those that can join the mainstream financing, on the other hand, consists of various segments with differing characteristics that cannot just be lumped in a single broad category. There are different socio-economic profiles and characteristics based on different agricultural resource endowments which would require different financing schemes and development intervention approaches. The government, either through the Central and/or jointly with the Ministry of Agriculture can help establish the 'profiling' of rural poor and agricultural loan clients.

CHAPTER 7
Summary and Conclusion

The financial sector reforms initiated by the government brought positive outcomes to the formal financial system in Nepal. Banks and financial institutions are now generally stable, liquid and have improved asset quality and profitability. The microfinance sector likewise has grown and matured considerably compared to its initial years. The total outreach of microfinance institutions – that include microfinance development banks, financial non-government organizations and cooperatives – is estimated to be close to two million. Total resources of microfinance development banks now account for 2.2% of the total resources of the formal financial system. Financial performance of microfinance institutions, in general likewise show indications of continued efficiency and sustainability.

There are however lingering issues. The proportion of rural poor who has not gained credit access from formal and semi-formal institutions remained large. The percentage of those that borrow from formal and semi-formal sources has remained essentially the same since the last credit survey of 2006. The un-even geographic distribution of those having access to financial services likewise has not changed. Savings in rural areas arising from remittances remain largely unharnessed.

There are supply and demand side constraints that need to be addressed. The financing gap appeared to be high among agricultural households. Agriculture is generally subsistence level with farm lots of less than a hectare. Farmers are faced with problems on input supply availability and high cost, unstable markets and lack of adequate farm extension support. On the supply side, the major issues are: (a) un-even geographic coverage distribution, (b) weak governance and limited financial capacities of a large number of cooperatives and (c) limited financial capacities of microfinance development banks. While the number of microfinance institutions increased, the location of offices is un-evenly distributed where in some lowland areas there are already problems of multiple borrowing from microfinance clients while in some hill areas there is not a single microfinance institution that operates. The cooperatives are the largest in number and have the potential to reach the underserved areas, but are currently not maximized due to generally weak governance and management. The financial capacity of microfinance development banks on the other hand is constrained by its limited banking authorities and low capitalization.

While there are efforts made by the government to improve agriculture, it is likely that lenders will continue to be faced with higher risks in lending to the sector. Thus, a supply led approach in lending is not recommended as this would likely be counter-productive on the continued viability of rural finance and microfinance institutions. The recommended government actions are: (a) provision of credit support schemes and incentives to encourage lending to agriculture and deprived sectors such as expansion of agricultural insurance and implementation of credit guarantee schemes; (b) improvement of institutional coordination among rural finance institutions (e.g. ADBL) and agricultural extension/agri-business promotion agencies; (c) implementation of a wider scale institutional capacity building program for cooperatives and (d) continuation of liberalization policies such as non-imposition of caps on interest rates or on interest spreads, allowing microfinance banks to engage in deposit taking and loan diversification.

Finally, the rural financial system is most likely to continue to be composed of numerous small retail microfinance institutions while the bigger commercial and development banks will likely continue to shy away from directly lending to the agriculture and deprived sectors. Thus, what the system needs are strong apex institutions that can mobilize funds and efficiently channel such funds to the retail institutions. The state-owned Agricultural Development Bank can perform this strategic role.

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ANNEX A
List of Institutions Visited and Persons Interviewed

Institution	Name	Position
Nepal Rastra Bank	Maha Prasad Adhikari	Deputy Governor
	Narayan Prasad Paudel	Acting Executive Director, Microfinance Supervision Department
	Bama Dev Sigdel	Director, Microfinance Supervision Department
Agricultural Development Bank, Ltd.	Tej Bahadur Budhathoki	Chief Executive Officer
	Sagar Chandra Joshi	Deputy General Manager (HR)
	Ghuran Thakur	Division Chief, Office of the CEO
Department of Agriculture, Ministry of Agricultural Development	Suresh Babu Tiwari	Deputy Director General Monitoring, Evaluation and Management
Department of Cooperatives, Ministry of Cooperatives and Poverty Alleviation	Kedar Neupane	Registrar (Joint Secretary)
Rural Microfinance Development Center (RMDC)	Shankar Man Shrestha	Chief Executive Officer
First Microfinance Development Bank (FMDB)	Numanath Poudel	Chief Executive Officer
Sana Kisan Bikas Bank	Jalan Kumar Sharma	Chief Executive Officer
	Jhalendra Bhattarai	Senior Manager
Development Project Service Centre (DEPROSC)	Pitambar Pd. Acharya	Executive Director
	Vrigu Rishi Duwadi	Program Advisor
Centre for Self-help Development (CSD)	Mukunda B. Bista	Executive Director
National Agricultural Cooperatives Central Federation, Ltd. (NACCFL)	Khem Bahadur Pathak	Chairman

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