

# **Effectiveness of Microfinancing in Nepal: Institutional Development, Regulation and Supervision<sup>1</sup>**

**L.N.Bhusal, Deputy Governor, Nepal Rastra Bank**

## **1. Nepalese Economy and Poverty**

Nepal, with a per capita income of US \$210 p.a. and having more than 24 million people, is one of the least developed countries. It is dominantly a subsistence agricultural economy, which contributes near about 40 percent of the GDP from this sector. More than 85 percent of the people live in rural areas where basic infrastructure as roads, drinking water, financial institutions, health and even educational services are poor and inadequate. So, the nature of the economy is dual type: one, urban areas full of sophisticated facilities and a market-oriented economy and two, rural areas mostly with rampant poverty, hunger and lack of basic infrastructure facilities.

Being in between two large growth-led economy, China and India, even has been achieving 3 percent growth rate per annum. Some times it goes to the negative growth rate because of higher population growth rate i.e. 2.1 percent. From the imperative studies, it is difficult to reduce poverty only through growth-led policies but the specific programs have effective impact in this respect. Different programs and other efforts have shown some positive impact and the poverty level has been declined from 42 percent in 1995 to near about to 31 percent in 2005 during 10 years period.

In recent years Nepal has been facing insurgent problem in the rural areas and which has influenced the following development challenges in economic front:

- Structural challenges, such as low factor productivity compared to other south Asian countries and low resource availability;
- High contribution of agriculture to the GDP, while agricultural productivity remains dependent on factors not fully controllable;
- Low domestic savings;
- Declining public and private sector investment;
- Weak financial sector and regulatory oversight;
- Inefficient public enterprises; and
- High dependence on foreign aid.

---

<sup>1</sup> Paper originally presented at the "Seminar on Regulation and Supervision" held in New York on 9 Nov. 2005.

## **2. Role of Nepal Rastra Bank in Microfinance institutional Development:**

Microfinance is considered as one of the powerful and effective financial products for poverty reduction. Nepal Rastra Bank (the Central Bank of Nepal) has defined microcredit from the stand point of loan limit, which says any loan up to 40,000 (US\$ 600) provided by MFIs, is considered as microcredit. Practically, any small amount that goes to the poor people as credit is known as microcredit, which has specific objectives and contribution on income generating of specific group from the specific activities.

In the past NRB, had played an important role in building rural financial system. For this it has participated in the equity of many financial institutions in the country which has helped to mobilize scattered savings and allocate it into productive sector. Looking at the over-all scenario of the poverty in Nepal, the importance of development finance and micro finance in particular is highly relevant. Different studies had shown that there is a wide gap between rural credit demand and supply. The Asian Development Bank had assessed such gap at around RS13 billion i.e. around US\$ 0.25 billion. The latest rural credit survey has also revealed that informal sector dominated around 80% of rural credit.

The importance of microfinance has led policy makers of many countries to adopt national microfinance policies and programs. The increased number of microfinance practitioners around the globe is an indication that the microfinance sector can play important role not only to help increase the income level of poor people through various types of income generating activities. In this respect Nepal Rastra Bank has initiated to establish institutional set up and policies reform. The beginning of microfinance in Nepal started as early as 1974 when NRB directed commercial banks to lend 5% of their total deposit to small sector which was later converted into priority sector credit in 1976. The lending percentage requirement was also raised in from time to time and has been fixed at 12% of the total outstanding loans and advances of the commercial banks (CBs) in 1990. It was a mandatory direction of the NRB to CBs. In 1981, NRB introduced a new rural financing model under the name of 'Intensive Banking Program (IBP). Under IBP, the CBs were also required to lend a certain percentage of their priority sector loan to the people below the poverty line as group based lending, wherein loans were disbursed to group members on the basis of group guarantee. IBP was purely based on the area approach lending mechanism where the government sector was also made responsible for providing services other than the credit. According to deprived sector credit program, CBs are required to lend 3% of their total loan portfolio to the deprived sector.

The Agricultural Development Bank introduced the 'Small Farmer's Development Project (SFDP) in 1975, which was directed towards the social and economic uplift of the small and landless farmers.

After the liberalization policy of the financial sector, regional rural development banks (RRBBs) were established in 1992 onwards, with the major share participation of NRB, as a replication of the Grameen model of Bangladesh. The objectives of the establishment of these banks are to provide microcredit to the poor women of the rural sector. These banks are providing microfinance services to the deprived sector people of rural areas where incidence of poverty is high. Apart from these GBBs, few MFIs, Nirdhan, Centre for Self-help Development (CSD), DEPROSC Chhimek were converted into microfinance development banks and now operating in the private sector. The formal financial institution, established for wholesale lending to rural credit institutions,

were called Rural Micro Finance Development Centre (RMDC), Rural Self-Reliance Fund (RSRF), Sana Kishan Bikas Bank (SKBB) and National Co-operative Development Bank (NCDB). There are currently 9 micro finance development banks, several co-operatives and NGOs and 4 wholesale lending institutions comprising the major microfinancial service providers in the rural and micro finance sector.

### **3. Policy Option Adopted by NRB for Corrective Action**

NRB has always been positive and pro-active in creating a conducive policy environment for rural and microfinance. Realizing the status of low coverage in priority sector and deprived areas, NRB introduced the 'Deprived Sector Credit Program' in 1990. Under this program, CBs are required to invest 3% of their total loans and advances to the hard core poor.

The efforts on creating regulatory environment in the microfinance sector are an advanced step towards correcting policy on microfinance operation. This policy correction has established Nepal as a pioneer in the microfinance sector development in the world. NRB has adopted various policies on bank licensing and introduced prudential regulation effective from mid-April 2003. It has also strengthened its system for supervising and monitoring MFIs.

To make MFIs sustainable and accessible to rural poor, NRB has introduced a 5- year restructuring program for the GBBs . The program has 15-point reforms which is directed towards making microfinance business viable, sustainable and accessible to most of the poorer and weaker section of the society

### **4. Introduction of Prudential Regulation**

After the introduction of the Bank and Financial Institution Act, all microfinance development banks fall under category 'D' financial institution. NRB prudential regulations for MFDBs are presented below:

- Capital requirement for establishing MFDB: To open a national level MFDB, a minimum paid up capital of NRs 100 million is required. Likewise, MFDB to be operated within 4 to 10 districts excluding Kathmandu valley requires NRs 20 millions and only 10 millions for 3 districts excluding Kathmandu valley.
- Limit for promoter's stake at MFDB: Minimum of 15 promoters is required to promote MFDB. Promoters of MFDB can hold maximum of 70% stake. At least 30% shares should be allocated to the general public.
- Provision for foreign stake holding: Foreign institutional investors can hold minimum of 10% to maximum of 51% stake at MFDB. However, such staking should not effect the public allocation, i.e. 30 percent. Foreign individuals are restricted to have equity at MFDB.
- Individual share holding limit: Any individual, firm, family, group, houses, company falling in the same group cannot hold more than 15% share of MFDB. Such limit is also applied to the promoters.
- Licensing procedures: NRB, if the proposals for establishing MFDB found technically and financially viable from every aspect, will issue banking license to such MFDB within 4

months of the application submitted with cash deposit to NRB by the promoters .An amount equivalent to 20% of the promoter's shares should compulsorily be deposited with NRB's account at the time of application for a bank. Another 30% of such amount should be deposited at the time of receiving 'Letter of Intent' from the NRB. NRB doesn't provide any interest on such deposits. On the other hand, if the proposal is found non-viable and the promoters could not submit the required documents and also fail to deposit cash amount within the timeframe given, NRB rejects such proposals and notifies the applicants within the timeframe as mentioned above.

- Graduation of MFDB: MFDB ( presently falls under grade D ) can graduate if it fulfills all requirement for upgrading from grade 'd' to 'c' and likewise 'c' to 'b' and 'b' to 'a' but it can not be upgraded directly from 'd' to 'b' and 'a'.
- Priority for license: MFDB to be operated in rural areas are given top priority for business license by the NRB.
- Prudential regulation: NRB has introduced, effective from mid-April 2003, prudential regulation for MFDB operating in the country .with the objectives of making microfinance business more viable and sustainable as well as competent and effective in delivering services, the prudential regulation of the central bank has been designed in line with the Basel's prescription for commercial banks. However, there is some relaxation for microfinance activities in the Nepalese context. Some important highlights of the regulation are presented below:
  - Capital Adequacy: Based on the weighted risk assets (WRA), MFDB is required to keep its capital adequacy at the ratios presented in the table below. Primary capital includes paid-up capital, general reserves, retained earnings and premium on share. The secondary or tier-ii capital includes other reserves, which are not reflected in tier-i capital or primary. The losses should be deducted from the capital, if any, for calculation purpose.

Fiscal years	Ratios required (In percentage of WRA)	
	Primary capital (tier-i)	Total capital adequacy
2004	2	4
2005	3	6
2006 onwards	4	8

Risks associated with the assets of MFDBs are categorized as under:

Assets	Weighted Risk (percentage)
a. Cash in vault	0
b. Cash with NRB	0
c. Balance with commercial banks and financial institutions	20
d. Investment on NRB's and Govt. securities	0
e. Any other investments	50
f. Loan and advance ( micro -credit )	100
g. Fixed Assets	100
h. Other Assets	100

- Cap on Mobilizing financial resources; MFDB can mobilize financial resources up to the maximum limit of 20 times of the core capital such financial resources include group saving special savings and borrowings.

likewise , MFDB which has already exceeded the limit of 20 times at the time of regulation issued (Mid-April,2003) should also bring down their position to the limit at prescribed by NRB within the time frame given by NRB . For the calculation of capital adequacy, MFDBs are monitored bi-annually.

- Liquidity Requirement: MFDB should compulsory maintain a minimum liquidity balance at 2.5% of their savings deposits as a liquidity ratio, out of which 0.5% should be kept as a cash reserve requirement . 'Liquidity' includes; cash at vault, investment in government securities, investment in NRB bonds and balance held at licensed commercial banks and financial institutions. For monitoring purpose, such liquidity ratio is calculated each month based on daily averages. For failure to keep the minimum requirement, MFDBs are subjected to pay a heavy penalty to the central bank as stated in the NRB Act 2002.
- Loan classification and provisioning for loan losses: Based on the aging of overdue MFDB's credit is classified into 4 groups as under. After the classification, MFDBs are required to allocate provisions on annual basis as specified in the following:

Loan classification	Basis of classification (aging of overdue)	provisions required (% of the loan)
Good	No overdue and overdue by 3 months	1
Sub-standard	Above 3 months- 9 months overdue	25
Doubtful	Above 9 months- 1 yr. overdue	50
Bad	Overdue by above 1 yr	100

- Business operation area and branch expansion policy: MFDBs are given autonomy for the expansion, closure and merger of their branches with the approved geographical working area. However, the bank should seek prior-approval from NRB while expanding their existing geographical working area that is licensed by NRB. The opening-up of a new branch should be based on the business plan and their respective boards should approve such plan.
- Single Borrower limit: MFDB can extend up to NRs. 40,000/-(max.) per member of the group as microcredit for income generating activities. This is simply because all deprived sector loans are limited to Rs. 40,000/- per borrower as upper limit for microcredit. However the bank can extend up to NRs.100,000 to the graduated members for running micro and small enterprises, if that is found viable and feasible. The bank can invest up to 25% of the total credit and investment on such schemes.
- Good Governance: The present regulation has also tried to establish corporate governance culture within the micro finance development bank. In this regard a number of disciplines have been chalked- out. In

short, some of the standard set by NRB for good corporate governance practices are presented below:

- Minimum qualification requirement for promoters, Members of the Board of Directors and Chief Executive Officer;
- Restriction on family-related borrowings;
- Code of conduct for Board Members, CEO and staff;
- Restriction to staff for affiliating oneself to any political parties and their sister organizations;
- Segregation of internal and external audit; and
- Declaration of property by bank's officials for transparency purposes.

The basic objective of any regulation should be thrived into practices of good corporate culture which should be transparent, competent as well as to maintain healthy financial condition of the institutions regulated. The importance of good corporate governance in any MFDBs is directly motivated to the healthy supply of rural financial services based on sound practices. But it is a gradual process, which needs to change in attitudes, behaviors and self-awareness. Strong commitments from the top management and high values and deep organizational culture are also equally responsible for the practices of good corporate governance. It is equally difficult to make it practically happen, especially in developing countries like Nepal. Hence, with the absence of transparency in operation and policies, the chances of corruption, unaccountability and irresponsibility are higher. Under such circumstances, no one will expect good corporate governance in any organization. Nepal Rastra Bank's regulation on this aspect is also a beginning. Transparency, accountability and responsiveness to the public as well as presence of non-corruption are the fundamentals for having good corporate governance in any public organization.

## **5. Future Agenda**

It was the expectation at the time of phasing out of 'priority sector' that commercial banks would also volunteer on development finance. Liberalization of the financial market would lead the Nepalese rural financial system to be more competitive, prudent and rural friendly . The establishment of Grameen banks in 5-development regions and the other 4 replicating banks would also strengthen the microfinance sector rapidly. The establishment of RMDC would also help support the MFDBs including 5 GBBs. But, as of today this expectation are not achieved as expected.

With a view that mandatory development finance requirement for commercial banks does not work in reality, NRB had phased-out such requirement in the year 2002. However, no improvements are seen thereafter in the voluntarily credit expansion into this area. The total credit outstanding of this sector has declined from Rs.15.45 billion (as of mid-July 2004) to 11.9 billion (as of mid-October 2004), within a period of six months after the phasing out. This has further created a great vacuum in rural credit supply. The operation of savings and credit cooperatives (not licensed by NRB) are not monitored by NRB but their role in rural and microcredit delivery could be remarkable. NRB, though, has issued licenses to 49 FINGOs for limited banking operation the FINGOs Act 1998 has confined their activities in the microfinance sector for its integration and coordination.

With the growing number of financial institutions in the rural finance sector, it is also incumbent that institutions should properly be monitored, supervised and coordinated. Accordingly, NRB is formulating a national microfinance policy to address all issues and challenges relating to MF sector. This has been announced in the current monetary policy for FY 2004/05. NRB, in this connection, has already set up a top-level Steering Committee (SC) under the Chairmanship of the Deputy Governor who looks after the Microfinance Department. Various key personnel from the Ministries, Planning Commission, Poverty Alleviation Fund, Social Co-ordination Council and the private sector's MF Experts are selected as members of the 'steering committee'. The Executive Director of the Microfinance Department is responsible as a Member-Secretary. The SC will also coordinate and monitor research activities of the MF sector development.

## **6. CONCLUSION**

Even in the era of economic liberalization and marketbased financial system it is the duty of any government or the central bank to smoothen the system of rural credit supply that is greatly required in Nepal. Government and central bank should formulate policy in such a way that stimulate MFIs and CBs to adopt appropriate micro and rural financing plans, strategies and programs. The time has also come to provide resources to MFIs for capacity buildings and institutions support.

Despite various efforts on strengthening institutional credit to the rural people it is interesting to know that majority of the rural households have thinner access to formal financial institutions. On top of that, the supply side analysis of rural finance in Nepal has indicated that there is a wide gap between demand for and supply of credit. These two facts have shown tremendous opportunities to many rural financial institutions in future. The policy commitments of the Government in the planning document (10<sup>th</sup> plan) have also motivated MFIs to continue their business-operation at greater extent. Only, the ongoing insurgency problem in the country de-motivate commercial banks and even Agricultural Development Bank to remain in rural areas . This is reflected in the closure of many rural branches of ADB/N and the largest two commercial banks in the recent past. For example, ADB/N has now, as of mid-July 2004, only 347 branches compared to 542 in 2002. Thus, the expansion of development finance, agricultural and rural finance, microfinance in particular if handled carefully, is possible in the future. The present modalities of rural credit operation can also be changed and for such purpose development banks, including ADB/N and other MFIs, could finance their beneficiaries through savings and credit co-operatives, FINGOs and village banks and also through the consumers' groups and societies that are in the local areas and are not much affected by the current insurgency problem and internal conflict. For this, commitments from the government as well as from the central bank are highly desirable to work smoothly in the MF sector development. The proposed national microfinance policy should be formulated in such a way that policy makers, practitioners, donors and investors should come through a single window so as to develop MF sector in the field of poverty alleviation and sustainable outreach of the development finance, in particular, because, during the last four decades, development finance, in different nomenclatures has never been a business opportunity to most financial institutions and remained as a risky area of financing. The banks' finances on Agricultural sector shared only 2.3 percent of the total credit at the end of the 9<sup>th</sup> plan period. This has indicated that commercial banks are not interested financing this sector. The share of industrial finance of commercial banks, during the 9<sup>th</sup> plan period, however remained at around 42% to the

total credit has indicated its scope in development finance. But the question arises here: have the CBs finances on industry really created enough opportunity for employment and capital formation? Of course, this is more important in development finance. This has also been reflected into the finances of development finance. This has also been reflected in the finances of new DBs, which are established, particularly after the democratization in 1991. The central banks' requirement for this sector was also treated as imposition. Thus, those efforts introduced in this sector in the past did not work properly in out reaching development finance at greater scale and and at a faster pace. Development finance, the terminology, does not differentiate from agriculture finance, rural finance and microfinance these days in Nepal. The ultimate goal of such finance is to increase the access of rural people to the inclusive financial services from the organized sector.