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Access to Financial Services in Nepal

Aurora Ferrari
with Guillemette Jaffrin and Sabin Raj Shrestha

THE WORLD BANK

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THE WORLD BANK
Washington, D.C.

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1818 H Street NW
Washington DC 20433
Telephone: 202-473-1000
Internet: www.worldbank.org
E-mail: feedback@worldbank.org

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Contents

Foreword

A publication on access to financial services in Nepal could not be more timely. The recent political developments and social movements across the country are the result of deep dissatisfaction with how the market economy has worked—or not worked—in Nepal.

Nepal has not fully reaped the benefits of a market economy. Although there have been considerable improvements in the 10 years since liberalization began, the average per capita income is just $270, and nearly a third of the population lives below the poverty line—making Nepal the poorest country in South Asia and one of the poorest in the world.

The introduction of market principles has also not yielded the desired outcomes in the financial sector. Over the past decade the financial sector has increased in both size and number of institutions, and has become more stable. But access to and use of financial services remain limited. Only 26 percent of households have a bank account, and 45 percent of these households prefer to save at home—while 53 percent prefer to borrow from the informal sector.

Although stable financial systems are essential for economic growth, stability does not necessarily result in an inclusive financial sector. To help reduce poverty, the financial sector needs to be inclusive as well as stable. For example, access to savings helps poor people cope better with shocks such as health care emergencies. Through access to credit, they can invest in income-generating activities or, in the future, by obtaining education or migrating. Financial services also play an important role in supporting the growth of small businesses—crucial for creating jobs for low-skill workers.

Surprisingly, access to financial services has not been researched much until recently. In fact, there is limited understanding of which factors are important in expanding access. But despite a lack of theoretical knowledge, several approaches have worked in practice. These approaches are based on two pillars: supporting institutions with potential to expand access and developing an enabling environment (for example, by promoting institutions that increase transparency between borrowers and lenders). This report analyzes Nepal's financial sector and explains how these approaches could be implemented—benefiting all of Nepal's people, especially the poor.

Praful Patel
Vice President
South Asia Region

Michael Klein
Vice President
Financial and Private
Sector Development

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The report draws heavily on Nepal's 2006 Access to Financial Services Survey, undertaken jointly by the World Bank and Total Management Services in association with Solutions Consultant. It also draws on several background papers and materials: "Market for Small Business Lending in Nepal," by Caroline Bright and Andrew Pospielovsky (Development Alternatives International Europe); "Microfinance Market Study," by Sanjay Sinha (EDA UK); ratings of microfinance institutions conducted by Micro-Credit Ratings International Limited (M-CRIL); and "Nepal-Qatar Remittance Corridor Study," by Raul Hernandez-Coss and Isaku Endo (World Bank).

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The report incorporates extensive suggestions and comments from representatives of the Government of Nepal, Nepal Rastra Bank, and various Nepalese commercial banks, microfinance institutions, and development partners who attended meetings and workshops in Kathmandu in September 2006 and in Washington, D.C., in November 2006, where the findings of the report were presented and discussed.

Abbreviations

BISCOL	Bindabasani Savings Cooperative Society Limited
FINGO	financial nongovernmental organization
FORWARD	Forum for Rural Women Ardency Development
JVS	Jeevum Vikas Samaj
M-CRIL	Micro-Credit Ratings International Limited
MFDB	microfinance development bank
NGO	nongovernmental organization
NUBL	Nirdhan Utthan Bank Limited
PGBB	Pashchimanchal Grameen Bikas Bank Ltd
RRDB	regional rural development bank
SBB	Swabalamban Bikas Bank Ltd

Exchange rate (effective 15 July 2005)
Currency unit = Nepalese rupees (NRs)
US$1 = 69.25 NRs

Executive Summary

Over the past 20 years Nepal's financial sector has become deeper and the number and type of financial intermediaries have grown rapidly. In addition, recent reforms have made banks more stable. Still, access to financial services remains limited for many people in many parts of Nepal and in recent years has been declining. This report examines the country's supply of and demand for financial services and the constraints to increasing access to them, and offers recommendations for making the financial sector work for all of Nepal's people, especially the poor.

The Supply of Financial Services

For much of the past 50 years Nepal's government has tried to increase access to formal financial services for small businesses and low-income households. (This report defines low-income households as those in the three bottom spending quintiles.) The government has introduced directed lending programs for small businesses and low-income households, required banks to open branches outside the Kathmandu valley, created specialized wholesale and retail institutions, and lowered market entry requirements to foster the development of different types of financial institutions.

Despite government efforts, access to formal financial services is declining. Financial intermediation is stagnating, the number of bank deposit and loan accounts per inhabitant is falling, and lending targets for low-income households have generated excess liquidity among microfinance institutions without significantly increasing their outreach. And despite 40 years of government mandates to lend to small businesses, banks have been withdrawing from this segment as these requirements have been lowered. Access to bank infrastructure has also decreased. Moreover, as a result of the government's efforts to increase access, the central bank (Nepal Rastra Bank) now has to supervise 180 institutions.

Even the large foreign remittances received by Nepalese households—mostly from migrant workers—seem to be a missed opportunity for increasing access to formal financial services. Despite the entrance of money transfer operators and the growth in formal remittance flows they have generated, the bulk of remittances enter the country informally.

The Demand for Financial Services

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

Only 26 percent of Nepalese households have a bank account, and banks' procedures are perceived as being the most cumbersome among financial institutions. Accordingly, clients prefer not to save in them. Banks dominated in urban areas and among the wealthiest.

Financial NGOs and cooperatives run a close second as largest provider of deposit accounts, serving 18 percent of households. These institutions are the preferred provider for low-income households, but are close to banks even for wealthier households. Microfinance and regional rural development banks are a distant third provider of deposit accounts, serving only 4 percent of households—mainly poor, rural ones.

About 38 percent of Nepalese households have an outstanding loan exclusively from the informal sector, 16 percent from both the informal and formal sector, and 15 percent from only the formal sector (that is, a bank, finance company, financial NGO or cooperative, or microfinance or rural regional development bank). Family and friends are by far the largest informal providers of loans to households—and, contrary to common belief, family and friends often charge interest. Most households who borrow from informal providers do not bother trying to borrow from financial institutions, mainly because formal institutions cannot meet their financial needs on time. Informal providers also require less physical collateral. Even among the wealthiest households, half of those with a bank account prefer informal lenders because of their rapid delivery. Similarly, informal lenders are the preferred providers of working capital for small businesses, again because they are faster at sanctioning loans than are formal financial institutions.

Of households that borrow from the formal sector, financial NGOs and cooperatives are the largest provider of loans (except for the wealthiest households). They dominate the market for loans under NRs 50,000, even for households with a bank account. Banks are the second largest provider—mainly in urban areas and for loans larger than NRs 50,000. Microfinance and regional rural development banks are the third largest providers, serving mainly in rural areas and in the Terai. Finance companies are the least preferred formal lenders, and operate mainly in the Kathmandu valley.

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

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

Why Have Government Efforts to Increase Access Failed?

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

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

Why Don't Banks Scale up Lending to Small Businesses?

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

- Bank procedures for small business loans are too complex, making such lending unnecessarily long and expensive for both the businesses and the banks.
- The most popular bank product, overdrafts (lines of credit), is inappropriate for many small businesses, which do not deposit their revenues in banks.
- The interest rates that banks charge on loans to small businesses do not adequately reflect the costs of serving them.
- Banks require high levels of immovable collateral, while small businesses tend to have only movable assets.

- Although Nepalese banks have sophisticated management information systems, they generally do not use them to measure staff and loan performance—which is crucial for profitable small business lending.

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

- There is no registry to record liens on movable assets, which makes such assets almost unusable as collateral.
- The credit bureau only covers loans larger than NRs 1 million, and does not provide accurate and timely information.
- Loan loss provisioning rules—especially for short-term loans—are too lax and do not provide the right incentives for stringent monitoring of small business loans. At the same time, provisioning requirements for loans secured only with unregistered movable collateral and personal guarantees are too stringent, discriminating against small businesses that cannot offer immovable assets as collateral.
- The method used to calculate fines for not meeting priority and deprived lending targets discourages banks from charging appropriate interest rates for small business loans. (Fines are calculated by multiplying the shortfall amount against the highest interest rate that the bank charges its clients.)

Why Haven't Microfinance Institutions Provided More Services to Low-income Households?

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

Several factors explain the disappointing state of Nepal's microfinance sector, including:

- A complicated geo-political environment.
- Weak technical capacity in key areas, such as accounting and auditing, strategic planning, financial analysis, and human resource management.
- Lack of commercial orientation and slow professionalization—mainly because microfinance is often considered a charitable activity.
- Distortions arising from the government's deprived sector lending program that generate high liquidity among many microfinance institutions, as these institutions are encouraged to borrow beyond their needs and invest these low-cost funds in other financial institutions.

Although often cited as an obstacle, Nepal's legal and regulatory framework is not a binding constraint on the growth of the microfinance sector. Still, the framework for microfinance is convoluted and confusing. Although this framework is not hampering microfinance growth per se, supervision of the sector is problematic. Small institutions that pose no systemic risk are supervised, while larger ones are not—and supervisory capacity is weak. As a result microfinance consumers can be misled, and supervisors cannot ensure the sector's stability.

Why Do Informal Channels Dominate the Remittance Market?

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

How Can the Government Increase Access for Small Businesses and Low-income Households?

Although there is little theoretical knowledge of what expands access, several approaches have worked in practice, based on two principles. First, government should not require financial institutions to lend to specific sectors or open branches in specific areas. Rather, it should support financial institutions with potential to increase access sustainably, by helping providers profitably reach their desired market segments. Second, government must develop an enabling environment—for example, by promoting institutions that reduce information asymmetries between borrowers and lenders.

To help banks increase small business lending, the government could undertake two initiatives:

Initiative 1:
Create a technical assistance fund to help banks with potential develop appropriate products and procedures for profitable lending to small businesses.

Initiative 2:
Develop an enabling environment that makes small business lending safer, cheaper, and faster. Efforts should include:

- Creating a registry for secured transactions.
- Increasing loan loss provisioning requirements overall while reducing them for small loans without registered movable collateral.
- Strengthening Nepal's credit bureau.

To help microfinance institutions serve a large number of low-income households, the government could undertake two initiatives:

Initiative 3:

Promote the microfinance industry by upgrading technical skills, reenergizing the sector, and reforming state-owned providers. Efforts should include:

- Articulating a vision for the sector.
- Encouraging professionalization of the sector by supporting a technical assistance fund to upgrade capacity in key technical areas.
- Attracting a demonstration institution—that is, a commercially oriented microfinance player—to expedite change.
- Restructuring state-owned microfinance providers and apex institutions.

Initiative 4:

Create a legal and regulatory environment that protects microfinance consumers and promotes stability. Efforts should include:

- Reviewing the legal and regulatory framework for microfinance, with a view to simplifying it.
- Determining which institutions should be supervised, to target only those that could threaten the microfinance sector's stability.
- Developing a business plan for a stronger microfinance supervisor.
- Drafting new legislation or amending existing legislation.

To make remittances more effective, the government could undertake two initiatives:

Initiative 5:

Enhance the financial literacy of migrants and tackle legal and regulatory obstacles in the India-Nepal corridor to increase formal remittances.

Initiative 6:

Promote a viable loan scheme for migrants—one that reduces the share of remittances used to repay loans.

Chapter 1

The Supply of Financial Services

Although recent developments in Nepal's financial sector have moderately improved its performance, including the entry of many new actors, the sector remains fragile and access to financial services has been declining. This chapter reviews these developments, the performance of formal financial institutions, government efforts to increase access to financial services, and missed opportunities for remittances in the financial sector. Most of the analysis is based on data from Nepal Rastra Bank.[1]

Recent Developments in the Financial Sector

In recent decades Nepal has seen exponential growth in the number of its financial institutions. In 1980 there were 4 licensed financial institutions; by 2005 there were 180.[2] In 2005 Nepal had 17 commercial banks, 25 development banks, and 59 finance companies.[3] In addition, the regulated microfinance sector comprised 4 microfinance development banks, 5 regional rural development banks, 20 financial cooperatives, and 47 financial intermediary nongovernmental organizations (FINGOs), as well as 3 "apex" (wholesale) institutions that do not provide direct financial services to poor households (box 1.1).[4]

In recent years the depth of Nepal's financial sector (as measured by M2 relative to GDP) has increased, mainly due to growth in bank assets. But commercial banks' dominance of the financial sector is slowly being eroded by new entrants. M2 rose from 45 percent of GDP in 1999 to 57 percent in 2005, and financial sector assets jumped from 62 percent of GDP in 2000 to 93 percent in 2005. Yet commercial bank assets accounted for 87 percent of financial sector assets in 2005—6 percentage points less than in 2000, mainly due to the growth of development banks and finance companies (figure 1.1).

Although recent reforms have strengthened the banking sector, it remains weak. Since the late 1990s the authorities have improved the legal framework for banks, strengthened Nepal Rastra Bank, and partially restructured three insolvent state-owned commercial banks and development banks: Nepal Bank Limited, Rastriya

BOX 1.1

Nepal's regulated and unregulated retail microfinance sector

The portion of Nepal's retail microfinance sector licensed and regulated by Nepal Rastra Bank includes nine microfinance development banks. Four are privately owned microfinance development banks and five are regional rural development banks, four of which are state owned.

All cooperatives and NGOs are required to register with the Department of Cooperatives and local authorities. In addition, all cooperatives and NGOs engaged in microfinance are supposed to be licensed and regulated by Nepal Rastra Bank—but many are not. Accordingly, the microfinance sector licensed and regulated by Nepal Rastra Bank, for which financial data are available, represents only a small portion of Nepal's microfinance activity.

Indeed, an estimated 2,300 cooperatives are involved in financial services, yet only 20 fall under the supervision of Nepal Rastra Bank. Similarly, of the estimated 15,000 NGOs undertaking financial activities, just 47 are under the bank's supervision, representing 39,000 loans. In 2005 the regulated microfinance sector had 360,000 clients (box table 1.1; see also appendix B).

BOX TABLE 1.1

What types of retail microfinance institutions are regulated?

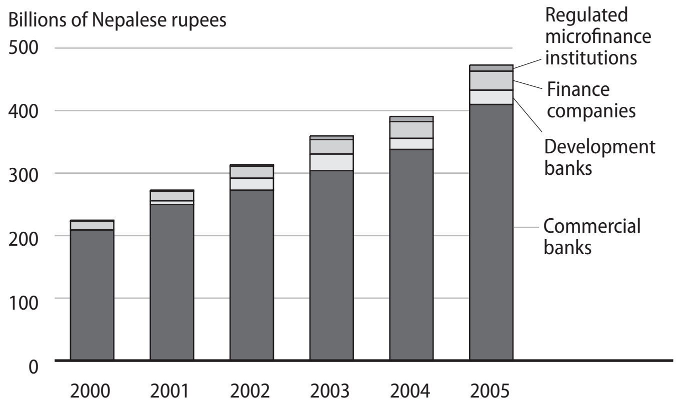
Type of institution	Total number	Number regulated	Number of loans from regulated institutions
Financial cooperative	About 2,300 financial cooperatives and 190 small farmers cooperatives	20	28,000
Financial intermediary NGO	15,000	47	39,000
Microfinance development bank	4	4	104,000
Regional rural development bank	5	5	190,000

Source: Author analysis of data from Nepal Rastra Bank.

Banijya Bank, and the Agricultural Development Bank, including the appointment of new management teams for the first two (box 1.2). Although the sector has become more stable, the picture remains bleak. In 2005 commercial banks (public and private) had an average capital adequacy ratio of –6.3 percent and nonperforming loans of 19 percent—mainly due to the large accumulated losses of Nepal Bank Limited and Rastriya Banijya Bank (table 1.1).

Private banks perform better than public ones, but they also exhibit weaknesses. In 2005 the average capital adequacy ratio for private commercial banks was 11.4 percent, and nonperforming loans averaged 5.3 percent. But 4 of 15 private commercial banks did not meet capital adequacy requirements (whether

FIGURE 1.1
Financial assets have grown quickly in recent years



Source: Nepal Rastra Bank 2006.

TABLE 1.1
Indicators of soundness for commercial banks, 2001–05

Indicator	2001	2002	2003	2004	2005
Profitability (millions of Nepalese rupees)	**–7,843**	**–9,428**	**–3,317**	**3,707**	**5,205**
Nepal Bank Limited	–2,178	–3,071	–252	710	1,730
Rastriya Banijya Bank	–7,083	–7,068	–4,839	1,040	1,323
Nonperforming loans (percentage of total)	**29.3**	**30.4**	**28.8**	**22.8**	**18.9**
Nepal Bank Limited	50.8	56.3	60.5	53.7	49.6
Rastriya Banijya Bank	48.2	55.1	60.2	57.6	53.0
Capital adequacy ratio	**–5.5**	**–9.9**	**–12.0**	**–9.1**	**–6.3**
Nepal Bank Limited	n.a.	n.a.	–28.3	–25.0	–19.5
Rastriya Banijya Bank	n.a.	n.a.	–44.3	–42.12	–40.5

n.a. Not applicable.
Source: Nepal Rastra Bank 2006.

based on national or international standards, which are very similar), and 3 had nonperforming loans of more than 10 percent (IMF 2006b).

Even the nonbank financial sector shows serious shortcomings. At the end of the first quarter of fiscal 2006, 8 development banks and 24 finance companies did not meet capital adequacy requirements, and 2 had negative net worth (IMF 2006b). In addition, during 2004–06 the share of nonperforming loans rose for both types of institutions. The performance of microfinance institutions has also been fragile, with about a quarter of regulated institutions incurring losses.

BOX 1.2

A history of three big banks: Nepal Bank Limited, Rastriya Banijya Bank, and the Agricultural Development Bank

Nepal Bank Limited, established in 1937, is Nepal's oldest bank. In 1998 the government reduced its ownership of the bank to 41 percent. But shortly after, the bank started being used as a "pocket bank," and connected lending and nonperforming loans increased considerably. Because of such mismanagement, in 2002 Nepal Bank Limited was taken over by Nepal Rastra Bank. Rastriya Banijya Bank was established in 1966 and is fully owned by the government.

Nepal Bank Limited and Rastriya Banijya Bank were put under new management in 2002. Nepal Bank Limited's performance has since improved dramatically, though it still has negative equity. The bank has run an operating profit since 2003, is on track to be fully computerized in 2007, and in 2006 nonperforming loans accounted for 25 percent of the total, compared with 61 percent in 2003. Rastriya Banijya Bank's reforms have been less successful, and it lags behind on these and other indicators of progress.

The Agricultural Development Bank was created in 1968. It is mainly owned by the government and Nepal Rastra Bank, with a small percentage owned by farmers. Its mandate is to extend credit to cooperatives, individuals, and enterprises engaged in agriculture. In addition to its agriculture and commercial banking divisions, in 1975 the Agricultural Development Bank established the Small Farmers Development Program to provide credit to small groups of farmers on a group guarantee basis. With support from the German Agency for Technical Cooperation, in 1992 Nepal introduced the Cooperative Act and the program started being reorganized into the Small Farmers Cooperatives Limited—a federation of autonomous cooperatives. In 2001 the Small Farmers Development Bank was established to provide wholesale funds to these cooperatives. By July 2004 there were 161 such cooperatives, with 90,000 members and about $4.0 million in deposits and $18.3 million in outstanding loans.

A 2003 review of the Agricultural Development Bank's financial performance revealed serious concerns about its financial health. Nonperforming loans were alarmingly high, reaching 40 percent in the Small Farmers Development Program. Accordingly, it was recommended that the program's transformation into independent cooperatives be accelerated.

Despite the uneven financial performance of these three banks, their extensive branch networks—which together account for 61 percent of Nepal's bank branches—offer enormous potential for expanding access to financial services. Moreover, while private banks focus on the "top end" of the market, these institutions are perceived as being closer to the general population and low-income households.

Government Efforts to Increase Access to Financial Services

Since the late 1950s Nepal's government has made many efforts to increase access to financial services, especially for low-income households and small businesses. These efforts have included:

- Requiring banks, private and public, to direct a certain percentage of their loans to low-income households and small businesses—so-called deprived and priority sector lending.
- Introducing policies to encourage banks to open more branches outside the Kathmandu valley.
- Creating institutions to cater to the underserved, such as cooperatives, postal savings banks, regional rural development banks, and the Small Farmers Development Bank, Rural Self-Reliance Fund, and Rural Microfinance Development Center.
- Licensing two new types of financial institutions—finance companies and development banks—with lower capital requirements, thus sharply increasing the number of financial institutions.

On the first point, in 2006 banks were required to invest 4 percent of their loan portfolios in the priority sector (this requirement is expected to be phased out in 2007) and 3 percent in the deprived sector. Priority sector loans are not to exceed NRs 2.5 million, and are limited to manufacturing and service firms whose total fixed investment does not exceed NRs 10 million. Deprived sector loans must be less than NRs 30,000. Banks can fulfill these targets by lending directly to these sectors or through intermediaries. Moreover, banks that invest in the equity of microfinance banks can classify these investments as deprived sector lending. Banks that do not meet the priority and deprived sector lending targets are subject to fines, which are calculated by multiplying the shortfall amounts against the highest interest rates that the banks charge to their clients.

On the second point, the government has required banks that want to expand their branch networks within the Kathmandu valley to also expand outside it. To encourage such expansion, Nepal Rastra Bank has introduced a policy that allows banks to open a branch in the valley only if they also open one outside it.

On the third point, the government has created a number of institutions aimed at increasing access for poor and rural households. In the late 1950s it created, by executive order, cooperatives catering to farmers. In the mid-1970s it created the Postal Savings Bank (with more than 100 branches), with the goal of mobilizing small savings in rural areas. In the early 1990s it established five regional rural development banks, one for each administrative region. All these institutions remain state-owned except one that was privatized in 2005.

In the 1990s the government also created the Rural Self-Reliance Fund (managed by Nepal Rastra Bank; box 1.3); the independently managed Rural Microfinance Development Center, which lends funds to financial NGOs and financial cooperatives; and the Small Farmers Development Bank, which lends to Small Farmers Cooperatives (those created by the Agricultural Development Bank's Small Farmers Development Program; see box 1.2 and appendix B). All three of these are apex microfinance institutions—that is, they receive funds from different sources at subsidized rates and lend them to retail microfinance institutions. But in Nepal the apex institutions do not pass on the subsidies to the final borrowers.

On the fourth point, in another effort to increase access, over the past 10 years Nepal Rastra Bank introduced two new types of financial institutions with lower capital requirements—finance companies and development banks—sharply increasing the number of financial institutions. The new development banks include four private microfinance development banks that target low-income households (see box 1.1).

BOX 1.3

Activities and performance of the Rural Self-Reliance Fund

Nepal Rastra Bank created the Rural Self-Reliance Fund in 1990 to supply funds to microfinance institutions. It also provides financing to development banks involved in national priority areas, such as tea growing and processing.

The Rural Self-Reliance Fund makes loans to financial cooperatives and financial NGOs at an annual interest rate of 8 percent, with the provision that three-quarters of the interest on principle be repaid on time. Loan tenors are three years, and institutions are only eligible for three loans—the first for NRs 1.0 million, the second for NRs 1.5 million, and the third for NRs 2.5 million. The fund provides longer-term loans to development banks and microfinance development banks.

Since the inception of the Rural Self-Reliance Fund, the government and Nepal Rastra Bank have given it nearly NRs 340 million in grant capital—yet only a bit more than half has been used for lending. In January 2005 outstanding loans to financial cooperatives and financial NGOs totaled NRs 25 million (NRs 22 million for the cooperatives and NRs 3 million for the NGOs), to the Agricultural Development Bank, NRs 92 million, and to regional rural development banks, NRs 15 million. Total outstanding loans were NRs 190 million.

Although the Rural Self-Reliance Fund reports that its repayment rate is 91 percent, it appears that the repayment performance of financial NGOs and cooperatives is unsatisfactory. Preliminary analysis has found that nearly 30 percent of this segment of the fund's loan portfolio is more than 90 days overdue.

Source: Golden Jubilee 2005.

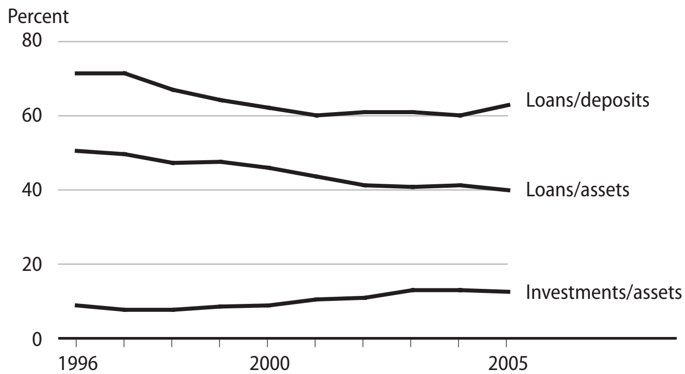
Despite Government Efforts, Access to Financial Services Is Declining

In recent years financial intermediation—the degree to which the banking sector puts its deposits back into the economy—has been stagnating. Over the past 10 years, despite the negative real interest rate on deposits, deposit volumes have grown faster than credit volumes. The ratio of credit to deposits fell from 71 percent in 1996 to 63 percent in 2005 (figure 1.2). Banks have also increased their investments in government securities, from 9 percent of total assets in 1996 to 12 percent in 2005.[5]

Access, as measured by the number of bank deposit and loan accounts per 1,000 people, has decreased. The number of deposit accounts per 1,000 people dropped from 113 in 2001 to 90 in 2005 (figure 1.3). Similarly, the number of loan accounts per 1,000 people fell from 19 to 10 during this period.

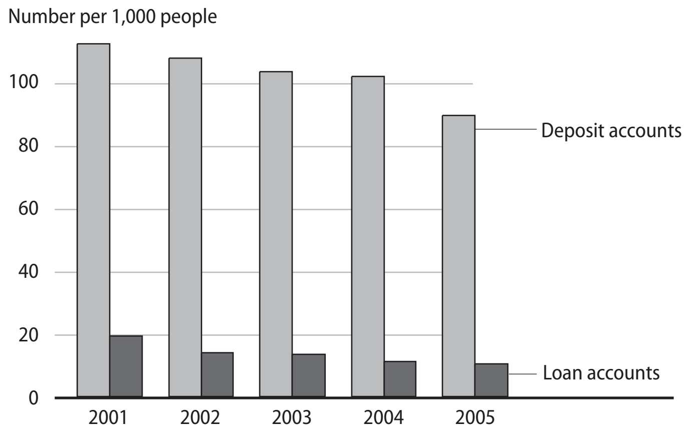
Lending targets for deprived sectors have generated excess liquidity among microfinance institutions (figure 1.4), yet this has not translated into larger outreach. As of July 2005, most deprived sector lending occurred indirectly, and 11 of the 17 commercial banks (excluding the Agricultural Development Bank) preferred to pay fines and not meet their targets for deprived sector lending.[6] Despite this, deprived sector lending has led to high liquidity in the microfinance sector, with liquid funds and investments accounting for more than 20 percent of assets for all the institutions (see figure 1.4). Still, this has not resulted in large loan portfolios. In 2005 the microfinance sector had only 360,000 borrowers—not many, given that some microfinance institutions have been operating for more than 10 years. Detailed analysis of the financial performance of microfinance institutions is presented in appendix B.

FIGURE 1.2
Over the past decade commercial banks have seen loans fall and investments in government securities slightly increase



Note: Includes the Agricultural Development Bank.
Source: Nepal Rastra Bank 2001, 2006.

FIGURE 1.3
Bank deposit and loan accounts have been falling



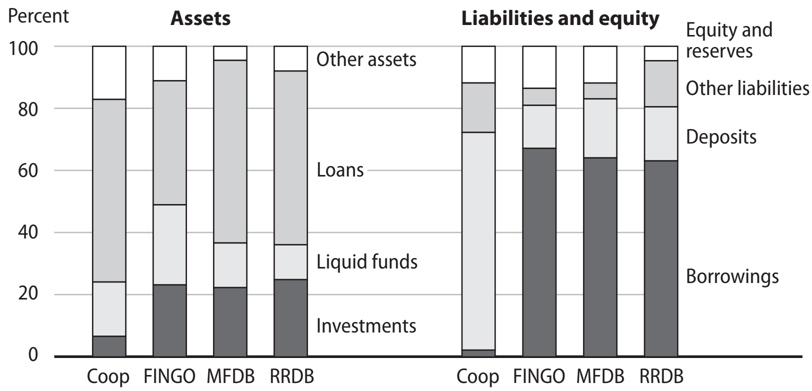
Source: Nepal Rastra Bank 2006.

Similarly, as Nepal Rastra Bank has lowered targets for priority sector loans, banks have reduced lending to the priority sector—showing that the policy has not resulted in sustainable lending to the sector. In the 1970s, when the requirement was introduced, priority sector loans were to account for 12 percent of bank portfolios; as noted, the requirement is expected to be phased out in 2007. Moreover, in July 2005 only 84 percent of priority sector loans were made directly by banks; the rest went through intermediaries (microfinance institutions). Rastriya Banijya Bank and Nepal Bank Limited account for 40 percent of priority sector loans.

The Postal Savings Bank has also had disappointing outcomes. Despite its 30 years of operation, 117 branches, and higher interest rates on deposits, the bank has hardly made a dent in the financial sector. In 2005 it collected only NRs 151 million in savings and processed just 5,311 remittance transactions (615 foreign and 4,696 domestic, totaling about NRs 23 million). In July 2006 total deposits were NRs 422 million.

Despite a 2001 restructuring program (box 1.4), regional rural development banks—Nepal's largest providers of microfinance—are in poor financial health. In 2005 the loan portfolios of the five regional rural development banks accounted for 36 percent of loans from regulated microfinance institutions. But only two of the five recorded profits in 2005, and two had negative capital adequacy ratios. Moreover, one of the two profitable banks—the Western Region Rural Development Bank, privatized that year—made its profit by investing the funds received as deprived sector lending in fixed term deposits with other financial institutions, rather than from its own lending operations.

FIGURE 1.4
Microfinance institutions have considerable liquidity, 2005

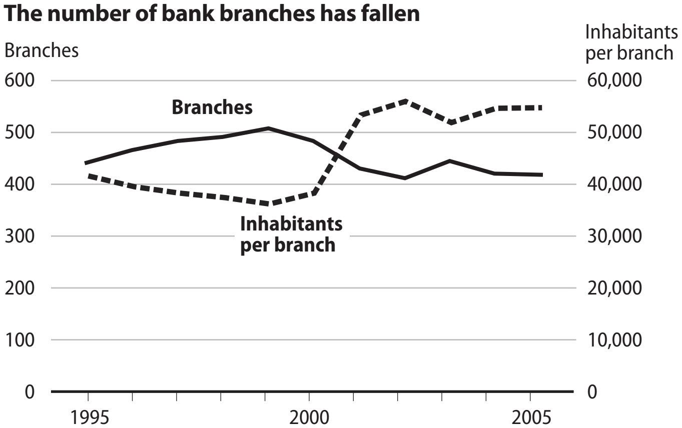


Note: Coop stands for financial cooperatives, FINGO for financial intermediary NGOs, MFDB for microfinance development banks, and RRDB for regional rural development banks.
Source: Nepal Rastra Bank 2006.

Since 1995—and especially since 1999—the number of bank branches per inhabitant has fallen, further reducing access to bank infrastructure (figure 1.5). This has been because of the closure of branches of the two state-owned commercial banks, due to both the Maoist insurgency and a process of rationalization. Between 1999 and 2005 the average number of inhabitants per branch rose from 36,100 to 54,000.

Although every district has at least one bank branch, access is skewed toward the Central region, where there is one branch for roughly every 50,000 inhabitants—

FIGURE 1.5
The number of bank branches has fallen



Note: Includes the Agricultural Development Bank.
Source: Nepal Rastra Bank 2006.

BOX 1.4

The reform program for regional rural development banks

In 2001 the government and Nepal Rastra Bank committed to a five-year restructuring program for regional rural development banks. This program included recapitalization of four of the five banks (equivalent to NRs 163 million), reforms of the banks' operating practices, and progressive privatization of profitable ones. Reforms included introducing productivity measures for each bank, appointing executive directors through open competition, and implementing cost reduction schemes, such as for voluntary retirement. Under the restructuring program, 40–50 percent of shares of profitable regional rural development banks are to be sold to bank clients, while Nepal Rastra Bank keeps up to 10 percent and the government up to 20 percent. The remaining shares are to be split among employees, other banks, and other investors.

As a result of the recapitalization and the reforms, the Western Region Rural Development Bank and Eastern Region Rural Development Bank generated profits in 2005. Improvements have also been seen in the three other regional rural development banks.

As per the restructuring program, privatization was completed for the Western Region Rural Development Bank in 2005. The bank is now owned by its clients (40 percent) and employees (1 percent), five commercial banks (23 percent), the government (17 percent), Nepal Rastra Bank (10 percent), and Nirdhan Utthan Bank Limited (10 percent). Although the privatization was successful, the performance of the privatized bank has not been very good. In 2005 it made a profit only due to income generated by depositing its share of deprived sector lending in other financial institutions.

The other profitable regional rural development bank, covering the Eastern Region, started its privatization program in December 2004. Under the program Nepal Rastra Bank will divest all but 10 percent of its 67 percent share in the bank. Of that 57 percent, 42 percent is allocated for the bank's clients, 5 percent for its employees, and 10 percent for the public. It is not known when the program will be complete.

Divestment of shares from the regional rural development banks is an important step toward developing private sector involvement in the microfinance sector. Still, as a token of its commitment to the sector, Nepal Rastra Bank will continue to hold 10 percent equity in all five banks, even after their privatization.

Source: Golden Jubilee 2005.

compared with one for every 111,000 in the mid Western region (table 1.2). This regional disparity is mainly due to the fact that private commercial banks are concentrated in the Central region, which contains 46 percent of their branches.[7]

The fact that private banks offer much better services than public banks, makes the regional disparity even bigger. Many branches of public banks cannot offer the same range of products as their private counterparts due to lack of computerization.[8] For example, branches of public commercial banks often cannot offer real overdrafts (the most popular product for small businesses). In fact, they do not allow clients

TABLE 1.2
Inhabitants per bank branch by region, 2005

Region	Number
Eastern	70,954
Central (incl. Kathmandu)	49,617
Western	57,444
Mid Western	110,714
Far Western	100,654

Source: Nepal Rastra Bank 2006.

to use overdraft accounts for their businesses, because the branches are not computerized and have difficulties in calculating daily interest rates on overdrafts. Hence, while their clients receive overdrafts in theory, in practice they draw it down completely and use personal accounts for their daily business operations—thus paying interest on the full amount of overdrafts at all times. They also have very long delivery times. Moreover, none of the public bank branches offers electronic payment facilities.

Making matters worse, non-branch infrastructure is largely undeveloped. In 2004 Nepal had just 27 automated teller machines (ATMs)—all but one in the Central region (with the other in the Western region). Except for branches, which are more expensive to operate due to security requirements, banks are only allowed to open extension counters. But such counters cannot be used to sanction loans.[9]

The government's push to increase access, by allowing the creation of specialized institutions and introducing new types of institutions, has also complicated things for Nepal Rastra Bank. The bank now has to supervise 17 commercial banks as well as 163 other financial institutions. In addition to the increased regulatory and supervisory burden, the creation of various tiers of financial institutions can potentially create regulatory arbitrage and result in a fragmented, vulnerable sector (IMF 2006b).

Remittances Are a Missed Opportunity for the Financial Sector

Nepal's official remittance inflows have been increasing continuously over the past decade, reaching $908 million in fiscal 2005—equivalent to 12 percent of GDP (IMF 2006a). But informal remittances far outweigh formal ones. The International Monetary Fund (IMF) estimates that 80 percent of foreign remittances are informal: 78 percent through migrants, their families, and friends, and 2 percent through the informal system (hundi).[10] Informal channels dominate largely because 90 percent of remittances come from India, whose proximity and porous border facilitate informal channels (Khatiwada 2005). The importance of informal providers is also confirmed by the 2006 Access to Financial Services Survey and the 2003/04 Nepal Living Standards Survey II, which found data of a similar magnitude.

Among formal remittance channels, money transfer operators are the largest. Since these operators were allowed to enter the market in 2001, formal remittances have tripled. But the presence of money transfer operators remains limited

BOX 1.5

Prabhu Money Transfer: An innovator in Nepal's remittance business

The group to which Prabhu Money Transfer belongs started operations in 1991 with the establishment of a travel agency. Then in 1996 it established an agency specializing in sending workers overseas, and in 2002 it established Prabhu Money Transfer. Prabhu has contact offices in the Gulf countries, Hong Kong (China), Israel, the Republic of Korea, the United Kingdom, and the United States. Prabhu is Nepal's largest remittance company in terms of number of transactions (followed by Himalayan Bank and International Money Express). It transfers the equivalent of $16 million a month—80 percent of which comes from the Gulf countries.

Prabhu Money Transfer has 125 payout locations across Nepal (branches or agents), some in remote areas such as Dang and Myagdi. Even in remote areas, payments arrive on the same or next day. Prabhu usually has one agent per city (as opposed to Western Union, which often has many agents per city). Prabhu competes with international money transfer operators on price: for a $1,000 transaction, Prabhu is about $35 cheaper than international operators. Prabhu has also developed a partnership with Chhimek Development Bank, a microfinance development bank that acts as its agent in 18 locations.

In addition, in 2006 Prabhu established a finance company targeted at remittance senders and receivers. This company plans to offer foreign employment loans and to use Prabhu's agents in recipient countries to monitor them. It costs about $1,000 to secure an overseas job, with the staffing agency usually requiring a 25 percent down payment. Prabhu's finance company will accept nontraditional collateral, such as group guarantees. In addition, it plans to tap into the deprived sector lending window of commercial banks to finance these loans.

The finance company has also proposed offering deposit accounts in Nepal for foreign workers. Such accounts would allow these workers to save money at home so that they can build savings for when they return. Workers would be able to open such accounts from abroad and wire remittances directly into them. The company advertises its services through newspapers and leaflets provided to workers; it also runs a staffing agency. In addition, Prabhu organizes cultural events in countries with large communities of Nepalese workers.

Prabhu's finance company is also considering other innovations, including electronic banking, running its operations every day of the year, and introducing credit and debit cards. The company plans to open about new 10 branches over the next two years, focusing on localities that traditionally send workers overseas. Just five months after its opening, the finance company had 1,000 accounts. The target is 5,000 by July 2007.

BOX 1.6

Microfinance development banks enter the remittance market

Nirdhan Utthan Bank Limited, one of Nepal's largest microfinance development banks, has signed partnerships with several commercial banks—Nepal Investment Bank, Nabil Bank, Bank of Kathmandu, Laxmi Bank—that allow them to use Nirdhan Utthan's branch network for remittance services. (These banks have also developed such partnerships with international and national money transfer operators as well as foreign banks, such as Doha Bank.) Although Nirdhan Utthan has 43 branches, it offers remittance services in only 25. These partnerships provide the bank with additional income—it receives nearly half the commission from remittance transactions—and its clients appreciate having this additional service. Nirdhan Utthan provides the remittances in cash or bearer checks, based on the amount and the liquidity of the branch. Between February 2005 and July 2006 the bank conducted nearly 2,000 remittance transactions totaling $686,000, with an average payment of $344.

on the India-Nepal corridor due to regulatory obstacles in India. Still, thanks to simple procedures for establishing and expanding them[11] and their more favorable exchange rates,[12] money transfer operators have grown rapidly in number and importance. Although no data exist on the various formal channels, this point is supported by both the Access to Financial Services Survey and Nepal Living Standards Survey II.

Both global (such as Western Union and MoneyGram) and national (such as International Money Express and Prabhu Money Transfer) operators have entered the market (box 1.5). Global money transfer operators have a broad agent network that includes commercial banks, local operators, and other companies (such as travel agencies). National money transfer operators tend to specialize in the main remittance corridors—such as the Gulf region and Malaysia—to Nepal. Interviews with money transfer operators have found that to remit funds from India to Nepal, special approvals are required from the Reserve Bank of India, and the process is cumbersome.

Other remittance providers include banks—including microfinance development banks (box 1.6)—and post offices. Banks offer basic remittance services through bank-to-bank transfers or bank drafts. Some banks serve as agents for international money transfer operators such as Western Union. Banks have also developed special partnerships with banks in remitting countries. For example, Nabil Bank, Himalayan Bank, Nepal Bangladesh Bank, and Nepal Investment Bank have partnered with Doha Bank to offer remittance services to Nepalese workers in Qatar. Still, banks are not large players in the remittance market. And the post office, despite its large network, is insignificant.

Chapter 1 notes

1 Unless otherwise stated, all the data in this chapter are as of mid-July (for the year indicated), which is the end of the fiscal year in Nepal.

2 Various other institutions complement Nepal's financial sector, including 18 insurance companies and specialized financial institutions such as the Employees Provident Fund and Nepal Stock Exchange. More than 100 branches of the Postal Savings Bank were created in 1977, but their activities have been very limited.

3 Development banks and finance companies offer almost all the same products as commercial banks, but have lower minimum capital requirements.

4 Appendix A provides an overview of the legal framework for the regulated microfinance sector; appendix B provides a summary of its performance.

5 The growth in deposits has been accompanied on the asset side by large growth (NRs 75,289 million) in "reconciliation" accounts—indicating weak accounting and management information systems in the Agricultural Development Bank and a number of commercial and development banks.

6 Nepal Bank Limited and Rastriya Banijya Bank represent 35 percent of total deprived sector lending and they mostly lend directly (86 percent of their deprived sector lending is indirect). The four other banks that meet their target make 99.6 percent of their deprived sector lending indirectly.

7 Of Nepal's 75 districts, only 23 have a branch of a private commercial bank. Private commercial banks are concentrated in wealthier districts—17 of the 23 districts where private banks operate have a per capita GDP higher than the national average. Conversely, only 14 of the 52 districts where private banks do not operate have a per capita GDP higher than the national average.

8 For example, branches of public commercial banks often cannot offer real overdrafts (the most popular product for small businesses). In fact, they do not allow clients to use overdraft accounts for their businesses, because the branches are not computerized and have difficulties in calculating daily interest rates on overdrafts. Hence, while their clients receive overdrafts in theory, in practice they draw it down completely and use personal accounts for their daily business operations—thus paying interest on the full amount of overdrafts at all times.

9 Although mobile banking is not explicitly forbidden, it is also not encouraged by Nepal Rastra Bank.

10 Hundi is one of the names used to describe informal remittance systems used in the Middle East and South Asia. A typical hundi transaction involves the remitter, the recipient, and two intermediaries. The remitter makes payment in local currency in the sending country to a service provider. The provider contacts a partner service provider in the receiving country, who arranges payment in local currency to the recipient in exchange for a reference code given to the remitter by the provider in the sending country.

11 For money transfer operators seeking to obtain a branch or agent license, National Rastra Bank requires only that the licensee have electricity and a telephone line. Access to the Internet is not compulsory: if an agent does not have Internet access, it contacts the head office (using a toll-free number), which processes the transaction.

12 The central bank offers a higher buying rate, usually 15 paisa per $1 more, than the lowest rate offered to money transfer operators by commercial banks.

Chapter 2

The Demand for Financial Services

Micro-level analysis of the behavior of financial services users can complement the broad picture of access provided by measures of the supply of such services. So, to complement the supply indicators in chapter 1 and better understand who has access to what and why in Nepal, the 2006 Access to Financial Services Survey was conducted. The survey was the first attempt to measure Nepalese households' access to deposit, credit, and payment services, broken down by types of providers.

The survey team held several consultative meetings with government officials, development partners, and private sector actors to put the results of the survey in Nepal's political economy context. The team also visited some of the country's main financial institutions—including apex microfinance institutions, which deal with clients across the country—and the general view was that the survey results reflected the political economy environment in which the different service providers have been operating.

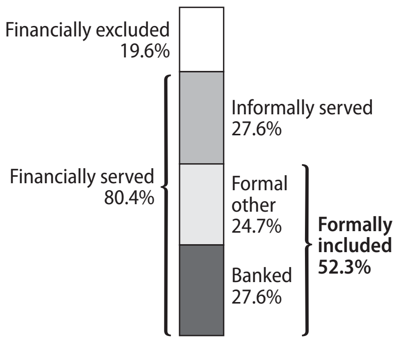
Providers of financial services are grouped into two broad categories: formal and informal. Formal institutions are banks, finance companies, microfinance development banks and regional rural development banks,[1] and financial NGOs and cooperatives[2] —both licensed and not licensed by Nepal Rastra Bank. Informal providers include family members, friends, moneylenders, hundi, dikhuti (informal institutions similar to rotating savings and credit associations), shopkeepers, landlords, and employers.

Because Access to Financial Services is a cross-sectional survey of household access in 2006, it does not allow for comparisons of trends over time. The survey covered 1,710 households and was constructed to be representative of the entire country (see appendix C for details on the survey's main building blocks, methodology, and sampling).

Just 28 percent of Nepalese households have an account with or loan from a bank (figure 2.1). Another 25 percent have an account with or loan from a formal financial institution other than a bank. Some 28 percent rely solely on informal financial services, and 20 percent are financially excluded—with no services from the formal or informal financial sector.

Comparable data on access to bank accounts are scarce. Still, available data indicate that Nepal performs poorly relative to other countries (table 2.1).[3] Among

FIGURE 2.1
About half of Nepal's households have access to formal financial services, 2006
Percentage of households



Note: A household with an account in a bank and a loan from the informal sector belongs to the "banked" group.
Source: Access to Financial Services Survey 2006.

TABLE 2.1
Access to bank accounts in various countries
(percentage of population with a bank account)

Country	Percent
Botswana	43
Brazil	43
Colombia	39
Kyrgyz Republic	5
Mexico	23
Namibia	51
Nepal	4
South Africa	47

Source: Chidzero, Ellis, and Kumar 2006 and World Bank staff data.

the countries for which data are available, the Kyrgyz Republic is probably the most comparable. Although its GDP per capita ($500) is slightly higher than Nepal's ($270), it has similar geographic conditions as both countries are mountainous and landlocked. In the Kyrgyz Republic 5 percent of the population is estimated to have a bank account; in Nepal, 4 percent.

In addition, access to bank accounts and use of payment services is worse in rural Nepal than in rural India (World Bank 2006b). Among other South Asian countries, only India has data on access to financial services, but only for rural areas. In rural India 21 percent of households have a bank account, while in rural Nepal only 16 percent do. Moreover, 48 percent of rural Indian households receive their incomes in cash, compared with 66 percent in Nepal.

Most Deposit Accounts Are Held by Banks, Followed Closely by Financial NGOs and Cooperatives

Only 49 percent of Nepalese households have a deposit account with any financial institution.[4] Not surprisingly, access to accounts is concentrated in urban areas (where 74 percent of households have one; table 2.2), in the Terai (52 percent), and among the wealthy (32 percent in the bottom quintile, compared with 79 percent in the top; table 2.3).[5] This report considers low-income households to be those that fall in the three bottom spending quintiles.

In particular, households in the bottom quintile in the Western and Central regions had the highest percentage of households with no account (87 percent and 84 percent, respectively). Two surprising facts emerged from the regional data on access to deposits. First, access is below the national average in the Central and Western regions—unexpected given their relatively high GDP per capita (table 2.4). Second, access is above the national average in the Far and Mid Western region, which has the country's lowest GDP per capita.

But when the data are disaggregated, these anomalies are explained by the high presence of financial NGOs and cooperatives in the Far and Mid Western region and the low presence of these institutions in the Western and Central regions. (Such institutions served 26 percent of households in the Far and Mid Western region, 4 percent in the Western region, and 13 percent in the Central region.) As expected, households in the Central and Western regions had the highest shares of

TABLE 2.2
Household access to bank accounts in urban and rural areas, 2006
(percentage of households in each area)

Area	No account	Bank	Finance company	MFDB or RRDB	FINGO or cooperative	Multiple accounts
Katmandu and Lalitpur	23.8	50.5	9.5	1.0	2.4	12.9
Other urban areas	27.1	43.3	3.3	1.0	12.9	12.3
Rural	55.4	15.9	0.2	4.4	19.3	4.7
Average	51.0	20.4	0.9	3.9	17.9	5.9

Source: Access to Financial Services Survey 2006.

TABLE 2.3
Household access to bank accounts by spending quintile, 2006
(percentage of households in each quintile)

Quintile	No account	Bank	Finance company	MFDB or RRDB	FINGO or cooperative	Multiple accounts
Bottom	68.3	11.4	0.0	4.0	13.7	2.6
2	63.0	8.4	0.0	9.2	18.0	1.4
3	59.9	15.0	0.5	2.6	20.2	1.8
4	41.9	23.4	0.6	3.0	21.1	10.1
Top	21.5	43.7	3.6	0.7	16.7	13.7
Average	51.0	20.4	0.9	3.9	17.9	5.9

Source: Access to Financial Services Survey 2006.

TABLE 2.4
Household access to bank accounts by administrative region, 2006
(percentage of households in each region)

Region	No account	Bank	Finance company	MFDB or RRDB	FINGO or cooperative	Multiple accounts
Eastern	41.5	14.3	0.7	5.4	29.8	8.2
Central	57.1	20.2	1.8	2.6	13.4	5.0
Western	61.8	26.5	0.5	4.8	3.9	2.5
Far and Mid	39.5	22.0	0.0	3.8	26.4	8.4
Average	51.0	20.4	0.9	3.9	17.9	5.9

Source: Access to Financial Services Survey 2006.

households with accounts in banks and finance companies and availed themselves of several financial services. By contrast, households in the Western and Far and Mid Western regions use financial institutions primarily for loans.

Although access to deposit services is higher in the Terai than in the Hills and Mountains, the difference does not appear to be large.[6] In fact, despite the more difficult geographic conditions, 44 percent of households had at least one account in the Hills and Mountains, while in the Terai (excluding Kathmandu) 51 percent did (table 2.5). Moreover, low bank penetration in the Hills and Mountains is compensated by a higher presence of financial NGOs and cooperatives: 45 percent of households with an account in a financial institution were served by financial NGOs and cooperatives.

Almost one-third of households with a deposit account had infrequent contact with the financial institution where they had the most-used account, contacting it less than once a month. Use of bank accounts is particularly low: 54 percent of households with such accounts reported going to the bank less than once a month.[7]

Most households that had a deposit account as well as savings in the previous year kept any cash earned at home; only 37 percent deposited it in financial institutions. Rural households did not save in financial institutions mainly because the institutions were too far away (45 percent), while urban households avoided it mainly because deposit and withdrawal procedures were too cumbersome (41 percent). This was true both for poor and wealthy households (21 percent in the bottom spending quintile, 36 percent in the top).

Because procedures are cumbersome, personal relationships matter when dealing with financial institutions. Nearly two-thirds of households with an account in a financial institution said that they knew someone in the institution who had facilitated the opening of the account.

Of the 49 percent of households with a deposit account, 42 percent are served by banks—followed closely by financial NGOs and cooperatives, which serve 37 percent (table 2.6). Banks tend to serve urban areas (61 percent of accounts there) and the wealthy (56 percent of accounts held by the top spending quintile, compared with 36 percent of the bottom; table 2.7). Surprisingly, among households without a deposit account, just 1 percent have ever applied for one. Of households that have never applied, 23 percent claimed that they did not need an account (many of these households were in Kathmandu and had no account with any financial institution), 21 percent said that financial institutions were too far away (most of these households were in rural areas and among the poorest quintiles), and 19 percent said that they had no money to put in an account (mainly in the poorest quintiles).

Among households with a bank account and that had savings in the previous year, 55 percent preferred not to save in the bank—and 45 percent saved at home. A third of these households preferred not to save in their bank because it was too far away (these households were mainly rural), and a third because procedures

TABLE 2.5
Household access to bank accounts by agroclimatic region, 2006
(percentage of households in each region)

Region	No account	Bank	Finance company	MFDB or RRDB	FINGO or cooperative	Multiple accounts
Terai	48.8	21.3	0.4	7.1	17.5	4.9
Hills and Mountains.	56.0	16.6	0.9	0.1	19.7	6.7
Kathmandu and Lalitpur	23.8	50.5	9.5	1.0	2.4	12.9
Average	51.0	20.4	0.9	3.9	17.9	5.9

Source: Access to Financial Services Survey 2006.

TABLE 2.6
Types of bank accounts in urban and rural areas, 2006
(percentage of households in each area)

Area	Bank	Finance company	MFDB or RRDB	FINGO or cooperative	Multiple accounts
Kathmandu and Lalitpur	66.3	12.5	1.3	3.1	16.9
Other urban areas	59.4	4.6	1.4	17.7	16.9
Rural	35.7	0.6	10.0	43.2	10.6
Average	41.5	1.9	8.0	36.5	12.1

Source: Access to Financial Services Survey 2006.

TABLE 2.7
Types of bank accounts by spending quintile, 2006
(percentage of households in each quintile)

Quintile	Bank	Finance company	MFDB or RRDB	FINGO or cooperative	Multiple accounts
Bottom	35.9	0.0	12.7	43.2	8.1
2	22.6	0.0	24.9	48.6	3.9
3	37.3	1.3	6.6	50.2	4.6
4	40.3	1.0	5.1	36.2	17.3
Top	55.7	4.6	0.9	21.3	17.5
Average	41.5	1.9	8.0	36.5	12.1

Source: Access to Financial Services Survey 2006.

were too complicated (these households were evenly spread across urban and rural areas, and among spending quintiles).

As noted, financial NGOs and cooperatives are the second biggest provider of deposit accounts. In addition, they are the biggest provider in rural areas (43 percent) and the preferred provider for the three bottom quintiles. They are also close to being the top provider in the fourth quintile, providing 36 percent of accounts compared with 40 percent for banks (see table 2.7).

Microfinance development banks and regional rural development banks are a distant third provider of deposit accounts—serving less than a tenth of households that have accounts, mainly the poor. These banks mainly serve rural areas and the Terai, where they hold 10 percent and 13 percent of accounts, respectively. Although microfinance development banks and regional rural development banks serve the poor, they serve more in the second spending quintile (providing 25 percent of accounts held in the quintile) than in the first (13 percent).

Finance companies serve only 2 percent of the population and focus almost exclusively on the wealthiest (nearly 5 percent of the top quintile, compared with 0 percent of the bottom) and urban areas (nearly 7 percent, compared with less than 1 percent in rural areas).

For Loans, Financial NGOs and Cooperatives Are the Largest Providers

Just over two-thirds of Nepalese households have an outstanding loan, whether from a formal financial institution, informal provider, or both (table 2.8).[8] Nearly 38 percent had one from the informal sector only and 15 percent from the formal sector only. The rest had loans from both formal financial institutions and the informal sector. When considering all the sources for both formal and informal loans, financial NGOs and cooperatives are by far the largest providers (28 percent), followed by banks (24 percent) and family and friends (20 percent).

Informal borrowing is more prevalent only in rural areas (reaching 40 percent of rural households), the Hills and Mountains (46 percent; table 2.9), and especially among the poorest households (47 percent in the bottom quintile, compared with 25 percent in the top; table 2.10). But it is also significant in urban areas (26 percent) and among the wealthiest households (25 percent). Exclusive reliance on informal lending is more common in the Western region (52 percent of households; table 2.11), especially for poorer households (70 percent in the bottom quintile), and for the bottom quintile of the Central region. As with deposit accounts, the prevalence of informal lending in the Central and Western regions is explained by the limited penetration of financial NGOs and cooperatives, which in the Eastern and Far and Mid Western regions are the largest providers of credit to the poorest quintile.

Formal lending

Financial NGOs and cooperatives are the largest providers of formal loans, serving 41 percent of households with a loan from a formal institution (table 2.12). They are the largest providers in rural areas (45 percent of households) and the Hills and Mountains (60 percent; table 2.13), though they are also substantial providers in the Terai (35 percent). They are also the largest provider of credit for every quintile except the top one—though even there they serve more than a third of households with loans (table 2.14).

Financial NGOs and cooperatives are the largest providers of household loans under NRs 50,000, which account for 79 percent of the total. Even households with bank accounts borrow mainly from financial NGOs and cooperatives for loans under NRs 50,000. These institutions seem to be preferred over other providers because they are faster at issuing loans (11 days once all required documents have been provided), require physical collateral only for just 38 percent of loans, and

TABLE 2.8
Households with and without credit in urban and rural areas, 2006
(percentage of households in each area)

Area	None	Formal only	Informal only	Both
Urban	43.4	18.3	26.0	12.3
Rural	30.0	14.4	39.6	16.0
Average	32.1	15.0	37.5	15.5

Source: Access to Financial Services Survey 2006.

TABLE 2.9
Households with and without credit by agroclimatic region, 2006
(percentage of households by region)

Area	None	Formal only	Informal only	Both
Terai	27.8	19.7	32.8	19.6
Hills and Mountains	34.8	8.8	45.5	10.9
Katmandu	63.8	14.8	15.2	6.2
Average	32.1	15.0	37.5	15.5

Source: Access to Financial Services Survey 2006.

TABLE 2.10
Households with and without credit by spending quintile, 2006
(percentage of households in each quintile)

Quintile	None	Formal only	Informal only	Both
Bottom	26.8	11.0	47.3	14.8
2	29.5	10.7	42.6	17.2
3	36.0	12.5	40.1	11.4
4	27.1	20.7	32.6	19.5
Top	40.9	19.9	24.7	14.5
Average	32.1	15.0	37.5	15.5

Source: Access to Financial Services Survey 2006.

TABLE 2.11
Households with and without credit by administrative region, 2006
(percentage of households in each region)

Region	None	Formal only	Informal only	Both
Eastern	26.4	17.6	30.8	25.2
Central	40.1	14.6	38.5	6.8
Western	25.2	13.7	51.7	9.4
Far and Mid	30.2	13.8	29.3	26.6
Average	32.1	15.0	37.5	15.5

Source: Access to Financial Services Survey 2006.

TABLE 2.12
Households with credit from formal institutions in urban and rural areas, 2006
(percentage of households in each area)

Area	Bank	Finance company	MFDB or RRDB	FINGO or cooperative
Katmandu and Lalitpur	43.2	43.2	4.5	9.1
Other urban	56.1	9.6	10.0	24.3
Rural	31.7	1.4	22.4	44.6
Average	35.1	3.4	20.4	41.1

Source: Access to Financial Services Survey 2006.

TABLE 2.13
Households with credit from formal institutions by agroclimatic region, 2006
(percentage of households in each region)

Area	Bank	Finance company	MFDB or RRDB	FINGO or cooperative
Terai	37.1	1.1	26.7	35.1
Hills and Mountains	29.3	5.9	5.4	59.5
Kathmandu and Lalitpur	43.2	43.2	4.5	9.1
Average	35.1	3.4	20.4	41.1

Source: Access to Financial Services Survey 2006.

TABLE 2.14
Households with credit from formal institutions by spending quintile, 2006
(percentage of households in each quintile)

Quintile	Bank	Finance company	MFDB or RRDB	FINGO or cooperative
Bottom	29.2	0.3	26.2	44.3
2	21.1	0.0	40.5	38.4
3	36.6	0.7	24.0	38.7
4	38.0	2.4	15.6	44.0
Top	46.5	11.7	2.7	39.1
Average	35.1	3.4	20.4	41.1

Source: Access to Financial Services Survey 2006.

more readily accept movable collateral (53 percent of loans with collateral are collateralized with movable assets).

Banks are the second largest provider of formal credit, serving 35 percent of households with a loan from a formal financial institution. Banks tend to serve urban areas (54 percent) and the wealthiest households (47 percent). Banks also mainly serve the Terai, where 37 percent of households have a loan from them. Banks are the largest providers of loans larger than NRs 50,000—and by far the largest provider of loans larger than NRs 100,000.

Microfinance development banks and regional rural development banks serve 20 percent of households with formal loans, mainly in rural areas and in the Terai, and are the largest providers of credit to the second quintile. The large difference between households with a deposit account in these institutions (8 percent) and an outstanding loan from them (20 percent) is because they mostly finance their loan portfolios through the deprived sector lending windows of commercial banks (see figure 1.4) rather than through client deposits. Microfinance development banks and regional rural development banks mainly serve clients for loans under NRs 50,000. Finance companies are the least preferred providers, reaching just 3.4 percent of households with loans from formal institutions—almost exclusively in urban areas around Kathmandu and mainly in the top quintile.

Informal lending

Family and friends are by far the largest providers of informal loans, accounting for 64 percent, followed by moneylenders, with 29 percent. Moneylenders are more active in rural areas (accounting for 33 percent of loans to households in such areas) and among poor households—though not for the poorest, who borrow more from family and friends (25 percent from moneylenders compared with 56 percent from family and friends). Rather, moneylenders lend mostly to the second (49 percent of loans to households in the quintile) and third quintiles (60 percent; box 2.1). Most loans from informal providers are less than NRs 50,000. For loans provided by family and friends, 42 percent charge interest rates. On average, poorer households paid informal sources 10 percentage points more interest than did wealthier households for a similar loan.

Only 15 percent of households with informal loans had tried to borrow from a formal financial institution; the rest did not apply to such institutions because their processes were perceived as being too long. That informal lenders are much faster in disbursing loans is confirmed by the purposes for which such loans were used: 20 percent were for health care, while only 5 percent of loans from formal institutions were used for that purpose. Moreover, informal providers required physical collateral for just 8 percent of loans, compared with 64 percent for formal loans.

The informal sector is competitive with the formal one even for households with a bank account. Half of those in the wealthiest quintile had only informal loans, because they considered procedures at formal institutions too lengthy.

For Payment and Remittance Services, the Informal Sector Dominates

Nepal is predominantly a cash economy, with the formal payment system virtually unused. The 2006 Access to Financial Services Survey found that less than 1 percent of households received their income—and just 0.2 made their largest non-routine payment outside their district—through the formal payment system. Although the wealthiest households tend to use the formal payment system[9] slightly more than the poorest, the difference is marginal (with 3.8 percent of the top quintile and 0 percent of the bottom receiving their income through the payment system).

More than two-thirds of remittances from abroad (including India) come through informal channels, with family and friends being the most common delivery mode.[10] A far larger portion of rural households receive remittances through family and friends—73 percent, compared with 34 percent of urban households (table 2.15). Poorer households also prefer informal channels, which are used by 86 percent in the bottom quintile compared with 28 percent in the top (table 2.16).

Family and friends are the preferred remittance providers even by households with bank accounts. Among such households receiving remittances, 31 percent

TABLE 2.15
International remittances by area and mode of payment, 2006
(percentage of households in each area)

Area	Personal delivery	Remittance company	Transfer to own bank account	Transfer to other's bank account	Check or Bank draft	Money order	Hundi
Urban	33.9	29.7	25.4	3.4	3.4	2.5	1.7
Rural	73.4	16.5	4.0	0.0	1.8	4.3	0.0
Average	68.8	18.1	6.5	0.4	2.0	4.1	0.2

Source: Access to Financial Services Survey 2006.

TABLE 2.16
International remittances by spending quintile, 2006
(percentage of households in each quintile

Quintile	Personal delivery	Remittance company	Transfer to own bank account	Transfer to other's bank account	Check/ Bank draft	Money order	Hundi
Bottom	86.3	6.7	0.0	0.0	3.7	3.4	0.0
2	95.7	4.0	0.4	0.0	0.0	0.0	0.0
3	62.0	24.0	10.1	0.0	0.0	3.9	0.0.
4	39.0	29.2	13.5	1.4	5.2	11.0	0.7
Top	27.9	44.1	16.6	1.4	2.8	6.6	0.7
Average	68.8	18.1	6.5	0.4	2.0	4.1	0.2

Source: Access to Financial Services Survey 2006.

TABLE 2.17
Use of most recent remittance by spending quintile, 2006
(percentage of households in each quintile)

Quintile	Savings	Education	Health	Consumption	Built home	Invested in agriculture	Livestock	Paid loan	Other
Bottom	3.7	21.7	7.3	39.4	3.4	3.0	5.0	16.6	0.0
2	0.0	6.0	10.4	46.7	6.2	0.0	0.0	26.4	4.3
3	5.2	19.3	3.4	33.4	6.4	0.0	0.0	32.3	0.0
4	19.0	18.2	1.4	23.3	12.0	0.0	0.0	15.1	11.1
Top	12.4	19.0	15.3	20.6	13.5	2.1	0.0	5.6	11.4
Average	6.4	15.9	7.7	35.2	7.5	1.0	1.1	20.7	4.6

Source: Access to Financial Services Survey 2006.

TABLE 2.18
Use of most recent remittance in urban and rural areas, 2006
(percentage of households in each area)

Area	Savings	Education	Health	Consumption	Built home	Invested in agriculture	Livestock	Paid loan	Other
Urban	19.5	26.3	8.5	22.0	9.3	2.5	0.0	2.5	9.3
Rural	4.7	14.5	7.6	37.0	7.3	0.8	1.3	23.1	3.9
Average	6.4	15.9	7.7	35.2	7.5	1.0	1.1	20.7	4.6

Source: Access to Financial Services Survey 2006.

BOX 2.1

Financing migration between Nepal and Qatar

Migrating from Nepal to work in Qatar cost about $1,500, including official fees (about $400 for authorities in both countries), middleman agencies (that is, the Qatari staffing agency that matches the Nepalese agency with a Qatari company), migration agency fees for the staffing agencies, and travel costs. To pay this, many migrants borrow from moneylenders or staffing agencies, usually at annual interest rates above 24 percent. As a result remittances sent by migrant workers in the first year or two are used to repay loans—limiting the amount that can actually be used by recipient families.

In 2005 Nepal's government designed a loan migration scheme to encourage banks to lend to migrants, to make migration costs more affordable. The government would direct potential migrants to Nepalese banks. The banks would finance the loans using their own funds, but would be guaranteed (in case of default) up to 75 percent by the Credit Guarantee Corporation. Under this scheme the banks were not able to select the borrowers. In addition, the banks did not have access to the future earnings of the migrants—for example, automatically deducting loan payments from their salaries. Four banks participated in the scheme, and almost the entire loan portfolio is in arrears. No other bank has since participated in the scheme.

got them through family and friends, 27 through remittance companies, and just 24 percent through their bank account.

Among the households surveyed, 47 percent considered speed the most valued feature of remittance providers, while 38 percent said reliability. Speed and reliability were the most valued features for both urban and rural and for poor and wealthy households. Interestingly, low fees were more valued by wealthier than poorer households (cited by 2 percent as the most valued feature in the bottom quintile, compared with 16 percent in the top).

Just 6 percent of the most recent remittances were saved in a financial institution, while 35 percent were used for consumption and 21 percent to repay a loan (table 2.17). Not surprisingly, the percentage of poorer and rural households that used their most recent remittance to repay a loan was higher than the percentage of wealthy and urban households that did so. Among urban households, considerably higher shares used remittances for savings and education (table 2.18).

Chapter 2 notes

1 Microfinance development banks and regional rural development banks are grouped into one category because they essentially provide the same services.

2 Differences in the legal status of financial NGOs and cooperatives are often not understood by borrowers. Borrowers from financial NGOs often must make deposits to get loans, just as members of cooperatives must deposit equity contributions to join. Many Nepalese interviewees referred to the two types of institutions interchangeably. Hence, after the pilot of the survey, it was decided to

put the two in one category. During the pilot it also became clear that many clients of these institutions were not aware of whether they were licensed by Nepal Rastra Bank. Thus while the supply analysis in chapter 1 refers only to financial NGOs and cooperatives licensed and supervised by Nepal Rastra Bank—a very small subset of the total—the data collected by the survey are for all such institutions, both licensed and not licensed.

3 Data are for 2002 for Brazil, Colombia, and Mexico; for 2004 for Botswana and Namibia; for 2005 for South Africa; and for 2006 for Nepal and the Kyrgyz Republic. Data for all countries except the last two were collected through individual-level surveys and measure the number of people with a bank account as a percentage of the total population. In Nepal the number of people with a bank account had to be estimated from data collected through a household survey. The number of accounts was estimated by multiplying the number of households (obtained by dividing the total population by average household size) by the percentage of households with accounts. During the survey test it became clear that households with more than one account—2.7 percent of the total, with 2.2 percent having two accounts and 0.5 percent having three or more—use the name of the same family member for all accounts. Hence, because the goal was to determine the number of people with a bank account as a percentage of the total population (that is, the banked population), it seemed reasonable to treat households with more than one account as just one person with an account. Data for the Kyrgyz Republic were estimated from central bank data and estimate the ratio of personal accounts to the total population, so it does not adjust for people holding more than one account.

4 All the data in this section are for households with just one account. Only 6 percent of the Nepalese households surveyed (and 12 percent of those with accounts in financial institutions) had accounts in multiple institutions. About 46 percent of these households were in the top spending quintile, and 93 percent had at least one account in a bank (99 percent in urban areas and 90 percent in rural areas).

5 This section expresses welfare in terms of per capita spending by quintile, which was imputed from data on household and housing characteristics from the National Living Standards Survey II. To estimate the level of welfare enjoyed by households, rather than asking direct questions about income—a time-consuming endeavor—the Access to Financial Services Survey used information on consumption from the National Living Standards Survey II. That survey collected information on consumption and a number of variables correlated with it (such as demographic characteristics, household assets, and housing characteristics). The same questions on variables correlated with consumption were included in the Access to Financial Services Survey. Using data from the National Living Standards Survey II, household consumption levels were estimated by regressing consumption on the correlates mentioned above, then the estimated coefficients were multiplied by the values of the correlates found by the Access to Financial Services Survey.

6 For the purposes of the Access to Financial Services Survey and for practical reasons, the Hills and Mountains are grouped in one agroclimatic region. Although access in the Hills is expected to be much higher than in the Mountains, the Mountains account only for 7 percent of Nepal's population. Moreover, with an altitude of 4,000 meters or higher, inclement climatic conditions, and rugged topographic conditions, the Mountains have very limited economic activities.

7 In Nepal the use of online banking is almost nil. Hence, going to a bank or automated teller machine (ATM) is synonymous with using the account.

8 The data in this section refer to outstanding loans. If a household had more than one outstanding loan, questions were asked about the most recent loans.

9 Non-routine expenditures are defined as those other than for food, matches, and cigarettes.

10 Appendix C includes an analysis of households that receive remittances.

Chapter 3

Constraints to Increased Access for Small Businesses and Low-income Households

This chapter identifies the main obstacles—institutional, legal, and regulatory—that hamper access to financial services for small businesses and low-income households in Nepal. The analysis is based on the data presented in chapters 1 and 2, case studies of two banks and detailed discussions with several others on how they serve small businesses, six focus group discussions with small entrepreneurs, and ratings of seven microfinance providers.

Government Policies Have Not Tackled the Root Causes of Low Access

Since the late 1950s the government has tried to increase access with a series of policies and direct market interventions. Yet 50 years later, 63 percent of households with accounts in formal financial institutions prefer to save elsewhere, 38 percent of households borrow only informally, and another 16 percent borrow both formally and informally. Although access to and use of financial services are limited in general, the problem is more acute for low-income households and for small, household-based businesses (box 3.1). Indeed, both access and use are closely correlated with household income and business loan size.

Government policies have not achieved the desired outcomes because they have addressed only the symptoms of limited access to financial services—not the root causes. For example, priority sector lending has not considered the sustainability of banks' lending to this market segment, while deprived sector lending has not taken into account the microfinance sector's capacity to generate large volumes of loans. Achieving both goals depends on financial institutions being able to serve these segments in a financially sustainable way. But lending profitably to small

TABLE 3.1
Small businesses with formal loans by type of lending institution, 2006
(percentage of small businesses)

Loan size (NRs)	Bank	Finance company	MFDB or RRDB	FINGO or cooperative
Total	45.5	17.8	11.5	25.2

Source: Access to Financial Services Survey 2006.

TABLE 3.2
Small business loans by type of lending institution and loan size
(percentage of small businesses for each type by row)

Loan size (NRs)	Bank	Finance company	MFDB or RRDB	FINGO or cooperative
Less than10,000	0.0	9.7	0.0	90.3
10,000–50,000	19.2	16.7	25.6	38.5
50,001–100,000	70.3	9.9	0.0	19.8
100,001–250,000	68.9	26.4	0.0	4.7
250,001–500,000	67.1	25.7	0.0	7.2
More than 500,000	94.7	5.3	0.0	0.0
Average	45.5	17.8	11.5	25.2

Source: Access to Financial Services Survey 2006..

businesses requires a high degree of efficiency, while operating a growing microfinance institution is not easy and requires a certain level of specialization.

In the short to medium term, increasing access to financial services in Nepal will require tackling obstacles in both the banking and microfinance sectors. International experience shows that banks are better suited to serving small businesses—due to the size of the transactions involved—and microfinance institutions are more suited to serving low-income households. In the near term, based on the performance of the microfinance sector, banks are better placed to serve small businesses needing loans larger than NRs 100,000, while microfinance institutions should serve low-income households and microenterprises (that is, those with loan needs under NRs 100,000). The rest of this chapter analyzes the obstacles to increased access in these two market segments. It also briefly assesses potential obstacles to formalizing remittances, which primarily benefit low-income households.

Why Don't Banks Scale Up Lending to Small Businesses?

Banks provide nearly half of formal loans to small businesses (table 3.1) and are by far the largest providers of loans larger than NRs 50,000 (table 3.2). Still, most small businesses meet their financing needs through internal sources and supplier credit. Indeed, 77 percent of small businesses say that they have no outstanding loans, while 72 percent say that they regularly buy on credit for lack of cash at the time of purchase (see box 3.1).

BOX 3.1

Households with small businesses

Among the households interviewed by Nepal's 2006 Access to Financial Services Survey, 33 percent had a small business (defined as sole proprietors and partnerships). Of these households, 82 percent said that income from the business was one of their two main sources of income. Just over 77 percent of small businesses seem to finance themselves through internal sources (box table 3.1). If they do borrow, the loans tend to come from formal financial institutions (17 percent).

Still, 72 percent of the small businesses interviewed said that they usually buy on credit from their suppliers due to lack of cash at the time of purchase. This is true for both urban and rural small businesses, and for small businesses owned by members of the top and bottom quintiles. This discrepancy is probably due to the fact that buying on credit is such a routine business practice that it is no longer considered borrowing—although technically, it is informal borrowing. Suppliers are preferred over formal financial institutions because they are faster at providing loans.

BOX TABLE 3.1

Small businesses with loans by area and type of lending institution, 2006

(percentage of small businesses in each area)

Area	None	Formal	Informal	Both
Urban	70.8	24.5	3.5	1.2
Rural	80.4	12.4	6.4	0.8
Average	77.1	16.6	5.4	0.9

Source: Access to Financial Services Survey 2006.

Among formal financial institutions, banks play a larger role in providing loans to small businesses than to households. Although financial NGOs and cooperatives compete strongly in rural areas, banks are the largest providers because business loans are larger than household loans, and financial NGOs and cooperatives often have limited equity—constraining their capacity to provide large loans. In the segment where there is competition among the various formal financial institutions (that is, for loans under NRs 50,000), banks are not the preferred providers—even though they charge lower interest rates and fees than do financial NGOs and cooperatives or microfinance development banks. This is probably because banks take almost twice as long to issue a loan, require physical collateral in almost all cases, and rarely accept movable collateral. And though the direct costs of borrowing from banks (interest and fees) are lower, the indirect costs are higher (such as the costs of preparing financial statements and of registering and evaluating collateral).

In Nepal small businesses have very different features from large corporations—the traditional clients of banks. Small businesses are often young companies with unsophisticated accounts and low assets. Business and household finances may not be clearly delineated and are often strongly interdependent. Most small businesses have minimal or no banking relationships, work primarily with cash, and finance their operations through profits or informal financing. They are usually family businesses, run and managed by one or two people who take full, hands-on responsibility for all aspects of the business. Although these individuals typically know their business, they are weaker at producing written business and financial plans and are discouraged by the documentation requirements of banks. Moreover, management rarely plans their operations far in advance—so when they do require financing, they usually need it immediately.

To serve small businesses profitably, banks need to minimize transaction costs and generate large volumes of high-quality loans. As in other activities with small profit margins, commercial banks need to increase revenue by making many loans while lowering expenses—for example, by making loan officers more productive and avoiding bad loans.

Nepalese banks find it difficult to serve small businesses profitably. When lending, banks—including those that have tried to create dedicated loan products for small businesses—make little or no distinction between large corporate and small business clients in terms of the products they offer or the demands and procedures they apply. The main obstacles to increasing bank loans for small businesses are complex lending procedures, inappropriate products, pricing policies that do not appear to allow cost recovery, little use of movable collateral, and no measures of small business performance—despite the capacity to do so with existing management information systems. These obstacles are discussed in more detail below and summarized in box 3.2.

Complex lending procedures

Bank procedures for lending to small businesses are too complex for the market segment—making such lending unnecessarily time-consuming and costly for both the businesses and the banks. Banks require the same documents and information (such as business plans, financial statements, and collateral valuation and registration) from small businesses as they do from large corporations. Because small businesses often do not have the in-house resources required to produce such documentation, they must hire outsiders. This adds extra costs, time, and meetings for the businesses and the banks.

Producing such documents for a NRs 500,000 loan costs about NRs 15,000, or 3 percent of the loan amount. Given the complexity of the documentation required, a small business owner normally has at least five meetings with the bank to obtain a loan (for the initial application, site visit, collateral evaluation, signing of the required documents, and loan disbursement). Because small businesses have

BOX 3.2

Best practices for lending to small businesses and current Nepalese practices

Best practices	Current Nepalese practices
Loan approvals should take one to five days	Loan approvals take three to four weeks
The application process should be simple, requiring no financial statements or business plans	Financial statements—and sometimes business plans—are required
Products should be standardized, repaid in monthly installments	Overdrafts are widely used, and principal repayment rare
Each loan officer should process 15–20 loans a month	Each loan officer processes 3–4 loans a month
Collateral requirements should be flexible, including allowing movable assets as primary collateral	Real estate collateral is mandatory
Interest income should exceed lending costs	Interest income does not cover lending costs
Portfolio at risk above 30 days should be monitored	Portfolio at risk measurements are meaningless due to de facto bullet loans and perpetual overdrafts
Individual staff performance should be closely monitored and rewarded	Individual staff performance is not monitored or rewarded

Source: Case studies and interviews on how Nepalese banks serve small businesses.

limited staff, any time that management spends dealing with a bank is time taken from business activities—increasing the indirect costs of applying for a loan. In addition, Nepalese banks often have very centralized credit decision processes, further lengthening loan approvals. As a result it takes a new client a minimum of one month to get a loan once all the required documents have been submitted.

Banks, on the other hand, need to generate large loan volumes to make such small transactions profitable. But given the lengthy procedures, it is difficult for loan officers to approve more than three or four loans a month—well below what is required to break even.

Inappropriate products

The most popular bank product—overdrafts, or lines of credit—is inappropriate for many small businesses, which tend not to deposit their revenues in banks. In Nepal overdrafts come in two forms. The first are one-off overdrafts, typically approved for terms of 3–12 months, with clients paying monthly or quarterly interest payments on the outstanding amount. Clients can draw down and make principal repayments as they see fit during this period, as long as they remain within the approved limit. The entire outstanding amount is then due at the end of the term. This type of overdraft (or credit line) resembles a bullet loan, where clients typically draw down up to the approved limit shortly after approval and are then faced with a large repayment at the end of the loan period—and often have to borrow from informal sources or another bank to repay.

More popular, and even more risky, are perpetually revolving overdrafts. These are approved for 12-month terms. At the end of this period they are reviewed, with a view to revolving or extending for another 12-month term. Most banks make no demands on clients to make principal repayments. As a result many clients pay only interest, without repaying any principal, year after year. Analysis of both the supply and demand has found that this product accounts for the vast bulk of small business lending in Nepal. According to the 2006 Access to Financial Services Survey, 40 percent of bank loans to small businesses have a maturity of five years or more.

Neither type of overdraft is appropriate for small businesses, as they neither instill discipline in clients who have limited experience with formal borrowing nor test their capacity to repay or cope with increasing debt. Even if a client repays interest on time, the bank has no way of knowing whether the business could repay the debt and what the real quality of the loan is. This, understandably, also discourages banks from increasing financing—even after many years of working with a client.

From a risk management perspective, it is not a good idea to extend overdrafts to small businesses whose turnover does not pass through the account. Under term loans with monthly installments, the lending bank quickly realizes if a business is deteriorating—as evident from smaller repayments—and can take immediate appropriate action. With credit lines, where businesses only have to repay interest, the bank is unlikely to realize that there is a problem until later, at which point it may be too late to take appropriate action and collateral may have disappeared. Furthermore, when problems develop with credit lines, the entire amount is usually outstanding and at risk—while with standard loans, clients have usually made a number of principal repayments, lowering losses to banks.

Pricing policies that impede cost recovery

Bank loans to small businesses do not seem to adequately reflect the cost of serving this market segment. To serve this segment on a sustainable basis, banks must be able to make a profit. While profitability analysis is bank-specific, the interest rates that Nepalese banks charge to small businesses appear too low to make this segment profitable. Banks charge almost the same interest rates to small businesses as they do to large corporations: 8–10 percent a year, with application fees of 0.5–1.0 percent of the loan amount and annual renewal fees of about NRs 1,000 for loans of NRs 1 million. With annual inflation running at about 5 percent, loans to small businesses do not provide banks with a very strong income stream. Profits are further eroded by the relatively high portfolio at risk for such loans.

The costs of making small loans will always be higher (in percentage terms) than the costs of making larger loans—even if banks substantially lower transaction costs. Accordingly, in countries where small business lending is profitable, interest rates on small loans are usually higher than rates on large loans, given that retail purchases are more expensive than bulk purchases.

By offering low interest rates to small businesses, Nepalese banks make lending to them unprofitable—leading to their exclusion from the formal financial sector. The 2006 Access to Financial Services Survey found fact that small Nepalese businesses consider faster service and lower collateral requirements more important than lower interest rates. As noted, 72 percent of small businesses regularly buy on credit from the informal sector, despite its much higher interest rates, because they prefer its faster lending. But if banks were able to lend profitably to small businesses, they could also contribute to their development by giving them access to the formal financial sector and its wider array of loans and services.

Little use of movable collateral

Banks require high levels of immovable collateral, yet small businesses tend to have only movable assets. The high-risk structure used by Nepalese banks for small business lending and the absence of appropriate lending products encourage banks to focus on collateral. Although banks will accept a mix of collateral, including inventory, collateral that is not real estate is generally accepted only as additional collateral.[1] In fact, securing a loan with movable collateral is not technically secure in Nepal. Because there is no secured transactions registry for movable assets, it is virtually impossible for a bank to verify whether another lender has a priority claim over the same assets.

Given the risky loan structure and the difficulties that banks face in seizing the collateral of defaulting borrowers, banks not only demand high levels of collateral, they are also very restrictive on what constitutes acceptable real estate collateral. Typically, real estate used for collateral must be within city limits and have direct road access—meaning that only prime urban real estate is accepted. This approach both greatly restricts the pool of small businesses with sufficient collateral to obtain loans and limits the amount of financing they can obtain. Most small businesses do not own enough high-quality urban real estate to provide as collateral for bank loans. The only real estate owned by many small businesses is their family home, which is often located in areas that banks are unwilling to accept. Potential female borrowers are at a particular disadvantage because they are usually not the legal owners of the family home. But small businesses do have movable assets that could be used as collateral, including vehicles, machinery, equipment, generators, inventory, and other personal goods.

Limited measurement of small business lending performance

Although Nepalese banks have sophisticated management information systems, they generally do not use them to measure the performance of small business lending. Given the lower profit margins on each small business loan, it is crucial to monitor the efficiency and portfolio quality and ensure that staff incentives are aligned with these goals. Most Nepalese banks have sophisticated information systems that allow them to monitor the efficiency of individual staff members and lending departments, yet such efficiency is rarely monitored—and staff rewards are usually unrelated to efficiency or the quality of the portfolio that they manage.

Banks need to serve small businesses—not the other way around

Lending to small businesses requires profound changes in the culture of banks and their staff. Private banks focus on sophisticated corporate clients and wealthy individuals. To be successful small business lenders, private banks need to adapt to this market segment—which is not used to working with banks. In particular, private banks need to understand the needs of small businesses. They also need to learn how to communicate with small business owners and build trust.

Public banks need to become more customer-oriented. In addition, the levels of efficiency and productivity needed for profitable small business lending requires that banks, whether public or private, significantly change how they do business. This can be a challenging and painful process, as changes are required at every level of the institution—from loan officers to lawyers to top managers. Managing the needed cultural changes is a major challenge for banks that embark on lending to small businesses.

Laws and regulations should facilitate lending to small businesses

Although Nepal's legal and regulatory framework is not necessarily a binding constraint on small business lending, it could be improved to facilitate bank loans to this market segment. An analysis of this framework has found that it is not hampering small business lending. But the lack of a secured transactions registry for movable collateral, limited functions of the credit bureau, and certain loan loss provisioning rules do not facilitate lending to these businesses:[2] The main obstacles in the legal and regulatory framework are that:

Nepal has no registry to record pledges on movable collateral. Although pledges on immovable assets are registered in the land registry, there is no registry to register liens on movable assets. Nepal's parliament approved a secured transactions law in 2006, but the law cannot be implemented because no registry has been created. Such a registry is crucial for ensuring that lenders that want to use an asset as collateral can ascertain what rights other lenders may have over the same asset. A centrally held, public registry also provides a convenient method for determining the hierarchy of competing claims on the same asset by different lenders.

The credit bureau covers only loans above NRs 1 million and is slow in generating credit reports.[3] Because the credit bureau requests information and keeps records only for borrowers with loans above NRs 1 million, it is not useful for small business lending. And although the bureau is supposed to generate credit reports within three days, in practice it generally takes a week for banks to receive them. This delay slows the growth of loan portfolios for small businesses. In addition, the credit bureau provides limited information on borrowers—for example, its reports do not provide historical information on borrowers, whether they have other loans, and the number of days other outstanding loans have been overdue.[4] Finally, because banks provide the bureau with information only on a quarterly basis, it takes a long time for the bureau to update its records. As a result credit bureau reports are often up to six months out of date.

Loan loss provisioning rules—especially for short-term loans—are too lax and do not create the right incentives for stringent monitoring of small business lending. Nepal Rastra Bank regulations for loans less than a year require that only principal repayments be considered when calculating arrears. Moreover, if a loan is secured with tangible collateral registered in the appropriate office, provisioning is calculated as shown in table 3.3.[5] Given that small business lending is usually short term, that banks need to test the capacity to repay of previously unbanked clients, and that to achieve profitability on small business lending the portfolio at risk above 30 days has to be very low, current low provisioning requirements could encourage banks to undertake lax supervision of their small business loan portfolios.

TABLE 3.3
Loan loss provisioning requirements

Indicator	Pass	Substandard	Doubtful	Loss
Length of arears (months)	Less than 3	3–6	6–12	More than 12
Amount of provision (percent)	1	25	50	100

Source: Nepal Rastra Bank.

On the other hand, provisioning requirements for loans secured only with personal guarantees are too stringent—discriminating against small businesses that cannot offer immovable assets as collateral. Most small businesses can offer only movable collateral and personal guarantees as collateral. But because Nepal has no registry for liens on movable assets for the purpose of calculating provisioning, such loans are considered secured only with personal guarantees. As such the loans are subject to an additional 20 percent provisioning requirement even if they are serviced on time—making small business lending more costly for banks.[6] Although it is generally prudent to require tangible and registered collateral, this discourages lending to small businesses. Priority sector loans insured with the deposit insurance and credit guarantee corporation are exempt from this higher provisioning requirement, but such lending is expected to be phased out in 2007.[7]

Penalties for priority and deprived sector lending discourage banks from charging appropriate interest rates for small business lending. Although banks can set their own interest rates, those that do not lend 4 percent of their portfolios to the priority sector and 3 percent to the deprived sector are subject to fines—which are calculated by multiplying the shortfall amount by the highest interest rate that the bank charges its clients. This approach obviously discourages banks from charging appropriate interest rates to small businesses.

Why Haven't Microfinance Institutions Provided More Financial Services to Low-income Households?

Microfinance institutions play a key role in providing financial services to low-income households (those in the bottom three spending quintiles). Yet many microfinance clients prefer to save and borrow with the informal sector. Financial NGOs and cooperatives, followed by microfinance development banks and regional rural development banks, are the largest providers of financial services for low-income households. Still, many microfinance clients prefer to use the informal sector for deposit accounts and loans (see chapter 2).

The reason is that informal providers offer products and services better suited to the needs of low-income households—that is, with quick availability and no requirement for immovable collateral. Low-income households are much more likely than wealthier ones to have irregular incomes. In addition, many of their non-routine expenditures are for health care. Thus they often require quick access to financial resources. Moreover, half of Nepal's low-income households cannot use their homes as collateral because they do not have the required documents and because their dwellings are in a bad area, in poor condition, or both. Informal providers better serve the needs of such clients by offering faster service and requiring no collateral. A third of the bottom three quintiles (the largest proportion) said that they borrowed informally because formal financial institutions take too long to provide loans. Moreover, less than 10 percent of informal loans are secured with collateral, compared with 64 percent of formal ones.

The limited ability of formal microfinance institutions to adequately serve low-income households is reflected in their poor outreach, sluggish growth, high liquidity, and low profitability. Although regulated microfinance institutions represents only the tip of the iceberg of Nepal's microfinance sector, they are broadly representative of the sector—if not better performing.

Several factors explain the poor state of the formal microfinance sector in Nepal, including the complicated geo-political environment, weak technical capacity, lack of commercial orientation, and distortions arising from deprived sector lending policies. These factors affect the sector's profitability and are discussed below.

Complicated geo-political environment

The geo-political environment of Nepal—a mountainous country that has been experiencing conflict in recent years—poses significant challenges. The performance of many small farmers cooperatives and financial NGOs and cooperatives has been severely affected by the insurgency.[8] The conflict has affected all formal microfinance providers, though to different degrees depending on their location and ownership structure.

Although microfinance development banks have faced difficulties, they have been able to keep looting under control by maintaining good relations with clients and with insurgents in their areas. Regional rural development banks are perceived by the general public as being government institutions, making them particularly vulnerable to the insurgency. As a result their operations have been badly affected. These banks have experienced frequent thefts of cash, physical threats to their employees, and damages to their properties. To mitigate risks, microfinance providers have developed a number of strategies, including minimizing cash transfers and disbursing loans immediately after collecting repayments. Microfinance providers have also spent time explaining to Maoists that their microfinance activities benefit the population.

Weak technical capacity

Formal microfinance institutions suffer from limited capacity in key technical areas such as accounting and auditing, strategic planning, financial analysis, and human resource management. This weak technical capacity clearly slows the sector's growth. Most microfinance providers face similar challenges: a lack of professionally trained staff in technical areas, weak internal control systems, no internal or external audit mechanisms, inadequate management information systems, and low capacity for product development.[9]

Although the Rural Microfinance Development Center has provided crucial capacity building and "hand holding" support to its borrowers, it has limited resources for such activities. Significant additional efforts are required to build capacity in the sector—both for providers of technical assistance to microfinance providers and for the sector itself.

Lack of commercial orientation

Lack of commercial orientation and slow professionalization of the sector hamper its profitability; many still consider microfinance a charitable activity. By design, NGOs do not have a commercial orientation. In addition, they tend to have weak governance structures, due to lack of clear ownership. That is why the NGO legal form is inappropriate for providing sustainable microfinance. Accordingly, many

NGOs in other countries aiming to evolve into strong microfinance institutions have chosen to transform themselves into companies.

This transformation has also occurred in Nepal with the creation of Nirdhan Utthan Bank Limited, the Development Project Service Center Development Bank, Chhimek Bikas Bank, and Swambalamban Bikas Bank from their respective NGOs. Government ownership of the five regional rural development banks also undermined their commercial orientation (which explains efforts to privatize them; see box 1.4). Similarly, the four private microfinance development banks do not have a strong commercial orientation.

Distortions arising from deprived sector lending policies

Deprived sector lending has led to high liquidity and distorted capital adequacy ratios among formal microfinance institutions. The balance sheets of Nepal's licensed microfinance providers have extremely high levels of liquidity, with investments and liquid funds accounting for more than 20 percent of assets in all these institutions (see figure 1.4). This situation is particularly striking for microfinance and regional rural development banks (with this figure approaching 40 percent) and financial NGOs (with this figure approaching 50 percent). This high level of liquidity is matched by high loans, which account for more than 60 percent of liabilities for financial NGOs, regional rural development banks, and microfinance development banks. (In contrast, loans represent only 2 percent of liabilities for financial cooperatives.) Not surprisingly, the Rural Self-Reliance Fund has large undisbursed amounts of loans, while the Rural Microfinance Development Center has committed the full amount available only after nine years of operations.

Such high levels of liquidity and loans are a result of the deprived sector lending window. In some cases, because commercial banks are uncertain about the capacity of some microfinance providers they lend to, they ask the providers to invest these low-cost funds (with annual interest rates of 3–5 percent) in fixed deposits. The microfinance providers earn a profit on these investments; the interest rate margin is usually 2–3 percent. In other cases commercial banks trust microfinance providers to onlend the funds, but the provider might not have the retail capacity to do so. Deprived sector lending also has a perverse effect on the capital adequacy ratios of microfinance providers, because it inflates the ratios for institutions (particularly financial NGOs) that receive high levels of deprived lending and entrust these funds to banks or financial companies instead of onlending them to their clients.

Low profitability

These various obstacles translate into low profitability in the formal microfinance sector. In 2005 only 8 of 20 financial cooperatives and 4 of 47 financial NGOs recorded profits over NRs 1 million. And despite Nepal Rastra Bank's reform program, just two of the five regional rural development banks recorded profits that year. Moreover, the one privatized regional rural development bank made a profit only due to income from its investments in deprived sector lending by other financial institutions. Still, all four microfinance development banks are profitable, though historical data indicate that this profitability is fragile. For example, Nirdhan Utthan Bank Limited recorded losses until July 2004, with its financial performance improving only recently.

Other obstacles and issues

Other obstacles in the formal microfinance sector are more specific to the type of institution. For instance, financial cooperatives do not properly manage delinquency, which is often blamed on their self-governance structure. Regional rural development banks also face difficulties linked to their governance structures. These banks generally do not have active boards of directors; their boards are made up of government officials who are not in a position to give adequate attention to the performance of the banks' management and who lack understanding of and technical expertise in microfinance. In addition, it is questionable whether the strategy chosen by Nepal Rastra Bank to privatize regional rural development banks—selling their shares to their clients—will allow for the best governance structure. Overall, microfinance development banks perform better than other microfinance providers. But they also have weaknesses that hamper their growth. Their management systems have not improved in line with their outreach and experience, and their accounting and internal controls should be strengthened. Accordingly, microfinance development banks have not been able to keep pace with international best practices in microfinance.

Still, even though the current regulatory framework is convoluted and confusing, especially for consumers (who often do not know which microfinance institutions are regulated and which are not; see appendix A), it does not appear to be hampering the growth of the formal microfinance sector. An assessment of the legal and regulatory microfinance framework has found that none of the prudential requirements are a binding constraint.

Looking ahead at the potential growth of Nepal's formal microfinance sector, a major source of confusion in the legal and regulatory framework involves the possible participation of foreign institutions (including for-profit ones). Different texts make contradictory statements. The Bank and Financial Institution Act (2006) says that licensed microfinance institutions can obtain loans or grants from any licensed institution or domestic or foreign organization or association. But a recent publication from Nepal Rastra Bank says that foreign institutional investors (except foreign individuals, who are barred altogether) can hold a minimum of 10 percent to a maximum of 51 percent stake in microfinance development banks (Golden Jubilee 2005). Such stake should not effect the public allocation (30 percent).

For regional rural development banks the same publication says that, under the government's five-year restructuring program, Nepal Rastra Bank is restructuring the banks and divesting its majority shares of profitable ones—maintaining 10

BOX 3.3

Rwanda's microfinance crisis

Hundreds of savings and credit cooperatives have emerged in Rwanda over the past decade, building a base of depositors three times that held by commercial banks. In June 2006 the Central Bank of Rwanda announced the immediate closure of eight of these cooperatives—citing gross mismanagement, significant losses incurred due to poor credit management, failure to meet minimal conditions for licensing, and loss of customer confidence. These closures resulted in massive withdrawals of deposits from many of the county's savings and credit cooperatives, and discouraged new deposits.

In explaining the closures, the governor of the central bank said that it could not "remain indifferent to the situation currently prevailing in the microfinance sector, where people risk losing their savings placed in some of the microfinance institutions, and therefore compromising the future of this sector in Rwanda." This announcement led microfinance stakeholders to wonder whether the measure taken by the central bank would serve as a warning to other savings and credit cooperatives engaged in improper dealings to clean up their acts—or further lower confidence in the sector, leading to a rush by clients to withdraw their savings and resulting in the bankruptcy and eventual closure of many others.

The central bank later announced that it would pay back half the money owed to depositors in the closed cooperatives at the branches nearest them. It also promised to sell the assets of the closed cooperatives and enforce payment of their default loans before reimbursing the remaining amounts owed to depositors.

This crisis originated in November 2005, when the central bank closed a savings and credit cooperative for gross mismanagement and poor credit management that led to bankruptcy. At that time the central bank also issued several warnings to other institutions cited to have improper dealings. These actions caused many people to lose confidence in the microfinance sector and rush to withdraw their savings, leading to the bankruptcy of a number of cooperatives. Deposits in the nine cooperatives closed by the central bank totaled about $6 million.

Source: Nshuti 2006.

percent of the banks' equity while selling 40–50 percent to clients and employees (see box 1.4). That publication says that to make the financial sector attractive to foreign investors, the 50 percent ceiling on ownership by foreigners has been increased up to 75 percent. Yet Save the Children U.S. expressed interest in buying shares of Nirdhan Utthan Bank Limited and Nepal Rastra Bank denied it, without clear reason. Allowing international microfinance investors could have a positive impact on Nepal's formal microfinance sector, providing crucial equity capital and possibly new dynamism.[10]

Moreover, supervision of the microfinance sector is not robust: institutions that pose no systemic risk are supervised while large ones are not, and supervisory capacity is very weak. Of the 76 microfinance institutions that Nepal Rastra Bank currently supervises, 47 are financial NGOs, which account for only 3 percent of the deposits of regulated institutions. Some of these NGOs have fewer than 200 clients. Moreover, as noted, the regulated microfinance sector only represents the tip of the iceberg: there are a lot more microfinance players about which little is known. In addition, the institutions currently regulated are not adequately supervised. In fact, inspection visits take place only once every two to three years, and inspection teams lack sufficient understanding of and experience with microfinance. This is partly due to the lack of relevant skills in Nepal Rastra Bank's Financial Institutions Supervision Department, as well as the constant rotation that the bank's staff undergo (changing positions every three to four years). This rotation is intended to stem corruption, but it prevents specialization and supervisory expertise.

Because of the haphazard way in which microfinance institutions have been licensed and the legal and regulatory framework is applied, microfinance consumers find it difficult to understand which institutions are supervised. In addition, the fact that many small institutions are supervised while large ones often are not does not allow supervisors to have a pulse on the sector and foresee possible crises. Crises can occur in the microfinance sector just as in the banking sector (box 3.3).

Why Do Informal Channels Dominate the Remittance Market?

Bringing remittances into the formal financial sector offers considerable benefits for Nepal and its migrants. Using formal channels reduces the risk of money laundering and financing of illegal activities. Formal channels also present benefits for migrants and their families, as they can gain access to other financial services and eventually save.

Yet formal remittance services are scarcely used in Nepal, because money transfer operators—by far the most popular formal channel—have a limited presence on the India-Nepal corridor, Nepal is primarily a cash economy, and low-income and rural households have limited familiarity with the financial sector (see chapter 1). The 2006 Access to Financial Services Survey found that only 31 percent of households receiving remittances used formal channels. Of these, money transfer operators were by far the most preferred channel.

Analysis of the remittance market has shown that since money transfer operators entered the market in 2001, remittance services have improved substantially, with remittances being delivered in a day or two at relatively low cost, even in remote areas (see boxes 1.5 and 1.6). Still, money transfer operators are not very active in the India-Nepal corridor due to legal and regulatory constraints in India. The proximity and ease of entry for migrants (no visa is required) also explain some of the reasons for the widespread informality of remittances in the India-Nepal corridor. And as noted, informal channels are used less due to limited familiarity with the financial sector—especially by low-income and rural households, which tend to emigrate more—and a perception that family and friends are safer delivery mechanisms, rather than to a lack of alternatives.

Large shares of remittance transfers are used to repay loans (most likely incurred during the immigration process), reducing the potential impact of remittances on household welfare. Evidence from the Access to Financial Services Survey and an analysis of migration between Nepal and Qatar shows that, for lack of pre-emigration financing schemes, many migrants end up borrowing from staffing agencies at high interest rates. The migrants' families then use large portions of the remittances to repay interest and principal.

Chapter 3 notes

1 Notable exceptions include consumer loans for buying vehicles, which are secured with the vehicles themselves. For such loans the bank is registered as the owner of the vehicle until the loan is fully repaid, which effectively makes such loans capital leases. But because there is no register for pledging vehicles or other movable assets as collateral, even if a borrower has a vehicle that could be used as collateral for a working capital loan, banks do not accept such items as primary collateral.

2 This report does not analyze the regime for immovable collateral, because this is a complex topic that requires separate analysis. But a recent World Bank analysis of creditor rights identifies the weak institutional capacity of the land registry (where mortgages are also registered) as the main obstacle to a well-functioning banking system.

3 Nepal Rastra Bank, Unified Directive 12, 16 July 2005.

4 Such data are reported if the borrower has a loan larger than NRs 2.5 million or has been blacklisted—that is, the borrower has loans overdue for more than six months, is bankrupt or has disappeared, and the like.

5 The number of months of arrears is the most important criterion for assets classification, and loan loss provision is based on the entire amount outstanding (that is, without deducting the value of collateral).

6 Nepal Rastra Bank, Unified Directive 2, 16 July 2005.

7 Nepal Rastra Bank, Unified Directive 2, 16 July 2005.

8 A Rural Finance Nepal (2004) study of 125 small farmers cooperatives found that 34 had been attacked by Maoists. Six lost their offices through fires, destroying important documents. In addition, the study found that local Maoist commanders put pressure on the cooperatives to lower their loan interest rates and encouraged farmers not to repay loans. Maoists are thought to have become more hostile toward community and development work in general, and consider the cooperatives an extension of the Agricultural Development Bank—an institution that, since the conflict began in 1996, has been a prime target. By destroying the loan records of Agricultural Development Bank branches, Maoists assume that farmers will not have to repay their loans.

9 This weak capacity is confirmed by ratings provided by Micro-Credit Ratings International Ltd. (M-CRIL) of 7 microfinance providers: Bindabasani Savings Cooperative Society Limited (BISCOL), Forum for Rural Women Ardency Development (FORWARD), Jeevum Vikas Samaj (JVS), Nirdhan Utthan Bank Limited (NUBL), Pashchimanchal Grameen Bikas Bank Limited (PGBB), Swabalamban Bikas Bank Limited (SBB), and VYCCU. The ratings are available at http://www.themix.org, and range from alpha minus for BISCOL and SBB, to beta for FORWARD, PGBB, and VYCCU, to beta plus for JVS and NUBL. On a scale of 1 to 10, alpha minus represents 5, beta plus 6, and beta 7.

10 http://www.mix.org provides example of such investors, including Responsibility and Unitus.

Chapter 4

Making the Financial Sector Work for Small Businesses and Low-income Households

This chapter provides some conclusions and offers suggestions for improving access to financial services for small businesses and low-income households. Efforts should focus on strengthening the enabling environment and institutions with the potential to expand such access.

Key Principles for Successful Government Intervention

Empirical international evidence has shown that stable, privately owned financial sectors do not necessarily create inclusive financial systems. Hence governments have a reason to be concerned about expanding access. Yet there is limited understanding of the issues that are important to expanding access.

Although this is a relatively new area of economic development, general consensus has been reached on two principles:

- Government is better placed to act as a facilitator rather than a direct provider of financial services.[1] Facilitation involves creating an enabling environment and, if needed, supporting initiatives that can help private institutions increase access.
- Any effort to expand access should address sustainability issues among providers of financial services—that is, help them profitably reach their desired market segments, rather than require them to lend to specific sectors or open branches in specific areas.

These principles have already been proven true in Nepal. Despite government efforts, regional rural development banks are the worst-performing microfinance institutions, and their branches remain concentrated in the Central region. Meanwhile, as priority sector lending requirements have been reduced, banks have withdrawn from the sector. And despite its high liquidity, the microfinance sector's loan portfolio is stagnating.

Helping Banks Expand Lending to Small Businesses

Priority sector lending, which sought to increase access to credit by small businesses, is considered a burden by banks. Almost 40 years after such lending was introduced, banks are reducing it as Nepal Rastra Bank lowers requirements for it. Banks perceive priority sector lending as a sort of annual tax that they must pay to do business, as they are not equipped with the right products, procedures, and lending technologies to serve small businesses profitably.

Public banks are struggling with negative equity, and profitable private banks have few incentives to seek out new markets or develop products for new market segments. If left to their own devices, banks would probably develop appropriate lending methods for small businesses—but only after a few years, as competition increases in the corporate and consumer segments. Nepal's government could undertake two initiatives to expedite this process: encourage financial institutions with potential to move the market frontier forward and develop an appropriate enabling environment.

Initiative 1:
Create a technical assistance fund to help banks with potential develop appropriate products and procedures for profitable lending to small businesses.

With help from its development partners, the government could support grant-funded technical assistance programs to help selected banks adapt their lending procedures to significantly increase small business lending.[2] This technical assistance should focus on removing the key obstacles to increasing such lending, identified in chapter 3.

Not every bank will be a suitable candidate for small business lending, so technical assistance should be given only to those fully committed to it. Profitably serving small businesses is not just about introducing new products and procedures: it also requires changing the entire corporate culture and the way that banks operate. Hence technical assistance should go only to banks whose investors' mandates fit these changes. While it may seem unfair to target technical assistance to a small group of banks, long-term effects are rarely achieved when such assistance is spread too thinly. Similarly, when technical assistance is spread among a lot of institutions, it ends up including those whose managers are not fully committed to the intended outcomes—often with disappointing results. Moreover, focusing on a small group of banks and helping them achieve profitable small business lending will force the rest of the market to take note and follow suit.

Banks with large branch networks and a focus on retail lending usually have a comparative advantage in entering this market segment (box 4.1), but smaller private banks can also be targeted to serve as catalysts. In Nepal, Nepal Bank Limited and possibly the Agricultural Development Bank could serve as the large banks.[3] But while Nepal Bank Limited has already undergone major changes, the Agricultural Development Bank still needs to prove that it can be turned around.

Although small business lending programs have been very successful in state-owned banks with large networks in the medium term, these banks are often slow in implementing the required changes at the beginning. This is why technical assistance should also be given to a few other banks—including smaller, faster-moving private banks. But while such banks are faster in implementing changes at the beginning, acting as a catalyst for the state-owned banks, they reach a plateau after a few years due to their smaller networks.

The technical assistance program should be comprehensive and cover the entire loan cycle. The program should last at least two years and involve resident advisory teams. It should include a redesign of bank products to meet client needs, a robust management information system, and a scheme to ensure that staff incentives are aligned with banks' efficiency targets.

Finally, the technical assistance program should include performance agreements identifying minimum targets, signed by the partner bank and the technical assistance provider (and its funder, if a different institution). These agreements should specify the number and volume of loans disbursed and outstanding to be

BOX 4.1

Capitalizing on a large branch network: Khan Bank

In 1991 Mongolia created Khan Bank from the assets of a former state bank, with the goal of serving rural areas. After being placed under receivership in 2000, Khan Bank was recapitalized and put under a restructuring plan. A large component of the restructuring involved downsizing.

The bank was privatized in 2003. Between December 2001 and June 2006 its loan portfolio grew from $9 million to $149 million. In 2006, 76 percent of its loan portfolio was in rural areas, business loans accounted for 45 percent of all loans, customer loans for 28 percent, and agricultural loans for 26 percent, and the portfolio at risk over 30 days was just 2.5 percent. In June 2006 Khan Bank had 410 branches—all of them profitable.

Early in its restructuring, Khan Bank implemented a technical assistance program to increase lending to small businesses, which helped the bank refocus on its comparative advantage (having Mongolia's largest branch network). The program started by developing simple, standardized products with simplified, decentralized approval processes. The new products and procedures where piloted in a few urban branches, then soon rolled out to the entire branch network. This quick rollout was facilitated by the gradual delegation of authority and a training of trainers approach. Over time Khan Bank has increased its product range, and now offers a wide array of loan, deposit, and fee services. Loan products range from express micro loans, loans to small and medium-size enterprises, and crop and herder credits to pension advances, consumer loans, and larger corporate loans.

Source: Dyer, Morrow, and Young 2004; www.khanbank.com.

achieved by a given date, as well as an indicator of portfolio quality (such as keeping the portfolio at risk over 30 days to less than 3 percent). These targets should be monitored monthly, and remedial actions should be taken if they are not met.

Initiative 2: Develop an enabling environment that makes small business lending safer, cheaper, and faster

Although the creation of an enabling environment will not move forward the market frontier per se, it would facilitate small business lending. A supportive environment would enable banks to lend profitably to small businesses—a market segment that usually lacks traditional collateral. It would also cut the costs of such lending and reduce information asymmetries. Although Nepal's legal and regulatory framework does not impose any binding constraints on small business lending, the government could take a number of steps to facilitate it.

Creating a secured transaction registry would empower small businesses with movable collateral (box 4.2). The government could create a registry for charges over movable assets, allowing any small business with movable assets to use them as collateral. Before creating the registry, the government should conduct a thorough analysis to decide which institution should operate it. The registry should be based on the following principles:

- The system should permit charges on all kinds of assets, and should be centrally administered.
- A regime for secured credit should provide for effective publicity of charges on assets, enabling lenders to ascertain existing charges and enabling third parties to discover such prior rights.
- The registry should provide an easy method for determining the order of ranking between competing rights claimed on the same asset.
- Failure to publicize a charge should mean that no security right can be effective against third parties.
- The system for registering and accessing information should be simple, fast, and inexpensive. Modern technology should make it possible to obtain searches within a few minutes of the request.
- The register should be accessible by all citizens and businesses. Various contact points should be made available throughout the country.
- The system and its method for recording, storing, and accessing information should protect against error, abuse, and fraud.
- The registry should be managed transparently, and independent audits should be conducted regularly.
- The registry, whether public or private, should be required to report regularly to a supervising authority (EBRD 2004).

BOX 4.2

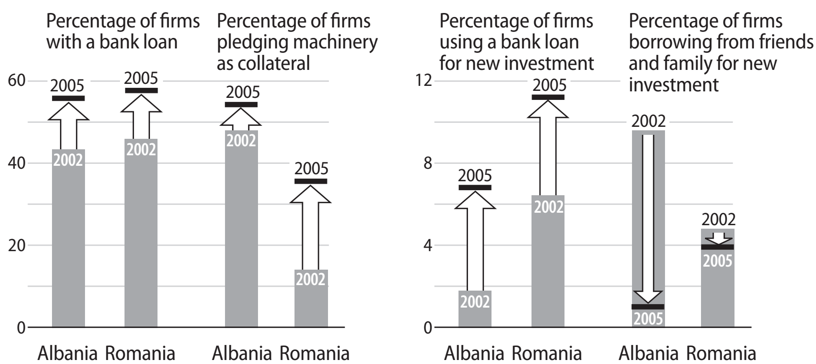
Secured transactions and small and medium-size enterprise lending in Albania and Romania

In Albania, after a new law governing the use of collateral was passed and a pledge registry created in 2001, bank lending to small and medium-size firms increased by 10 percentage points between 2002 and 2005 (box figure 4.1). Romania had a similar experience. After reforming operations in its pledge registry in 2000, the number of small and medium-size enterprises with loans increased by 10 percentage points.

Although not all of the increase in small business lending can be attributed to reforms of secured transactions, the number of small and medium-size enterprises pledging machinery as primary collateral increased substantially between 2002 and 2005, from 40 to 45 percent in Albania and from 12 to 30 percent in Romania. At the same time, small and medium-size enterprises firms increasingly relied on commercial sources of finance (bank loans, financial leases) and less on informal sources (family, friends, moneylenders; box figure 4.2).

BOX FIGURES 4.1 & 4.2

Small and medium-size enterprise borrowing and sources of finance for new investments in Albania and Romania, 2002 and 2005



Source: Adapted from Safavian, Fleisig, and Steinbuks 2006.

Nepal Rastra Bank should strengthen its monitoring of small business lending and lower the costs of lending to this segment. It could do so by increasing overall loan loss provisioning requirements in line with international standards that make no distinction between short- and longer-term loans. It could also allow financial institutions to lend to small businesses (say, for loans under NRs 500,000) without registered movable collateral and without requiring extra provisioning, as banks become familiar with the functions of the new secured transactions regime and the registry is established and begins to function smoothly.

To reduce information asymmetries between lenders and borrowers, Nepal's credit bureau should be strengthened. A well-functioning credit bureau can greatly reduce such asymmetries—especially for small businesses, which often have limited credit histories. As a shareholder, Nepal Rastra Bank could upgrade the services provided by the bureau by:

- Ensuring that the bureau's data are electronically accessible by financial institutions, as this will shorten delivery times for credit reports and ensure that the bureau's information is up to date.
- Lowering the reporting threshold to the credit bureau to cover loans larger than NRs 100,000 (down from the current NRs 1 million).
- Requiring the bureau to include more information in its reports, such as historical data, information on how many days payments are in arrears, and information on other businesses of borrowers even if they are not blacklisted.

Helping Microfinance Institutions Serve More Low-income Households

For the past 40 years Nepal's government has supported a number of interventions aimed at increasing access to financial services for low-income households (defined here as those in the bottom three spending quintiles). First the government established financial cooperatives, then it introduced deprived sector lending, then it created regional rural development banks, and finally it sponsored the three apex microfinance institutions. In all these attempts the government either acted as the direct provider or required the private sector to lend to these households.

Yet few of these attempts have been successful, and the outreach of the microfinance sector remains limited. The root causes appear to be the sector's low capacity in technical areas and a charity mindset among many microfinance providers. The sector and the government should recognize that low-income households do not need charitable institutions, but instead service providers that meet their needs on time. To do so, microfinance institutions need to be professionally managed and profitable. The financial sector is not unlike other industries, where some companies focus on the low end of the market (such as Hindustan Leaver in India, Grameen Phone in Bangladesh, and McDonalds and Wal-Mart in the United States).

The government could be instrumental in promoting this new approach by undertaking initiatives that strengthen technical skills and reenergize the microfinance sector (including reforms of state-owned providers), and create a legal and regulatory framework that promotes consumer protection and stability.

Initiative 3:
Promote the microfinance industry by upgrading technical skills, reenergizing the sector, and reforming state-owned providers.

The government should articulate a vision for the sector by finalizing its microfinance policy. This policy should provide a roadmap on how to improve access to financial services for low-income households and identify that the shift in the sector is a priority. The government's role as a facilitator should increase, and its role as a direct provider decrease. The policy should also recognize that microfinance is not an appropriate tool for serving the poorest of the poor, as they do not have enough income to repay loans (box 4.3). Rather, dedicated grant programs should be established for the poorest to raise their living standards until they "graduate" to regular microfinance services. In formulating the policy, institutional consultations should occur at various levels, with a working group involving ministries, Nepal Rastra Bank, and microfinance institutions.

With the assistance of its development partners, the government could also create a technical assistance fund to upgrade the capacity of microfinance institutions in key technical areas and expand access to safe, microfinance services outside the Terai.[4] Nepal's microfinance institutions need to be strengthened in several areas, including internal controls, management information systems, human resource management, product development, accounting, financial analysis, and business planning. Currently, microfinance institutions have neither the resources nor the incentives to buy such services. As a result there are no providers—such as information technology providers or accountants specializing in microfinance—of these types of services to the microfinance sector. To increase access to safe, professional financial services in less densely populated areas, new delivery mechanisms should be piloted (box 4.4). These could include linking community savings and loans associations to formal microfinance institutions and using technology to deliver financial services to such areas. As it stands microfinance institutions have no incentive to expand outreach because doing so would require investing in new products, and they have a more easily accessible market in the Terai.

The technical assistance fund should aim at strengthening the capacity of microfinance providers in key technical areas; working with service providers (auditors, information technology providers, consultants, trainers, the credit bureau, and so on) to build capacity to service the sector; supporting initiatives to increase microfinance outreach outside the Terai and help community savings and loans

BOX 4.3

Microcredit—not the answer for severely disadvantaged rural areas and the chronically destitute

Microcredit is one of many interventions designed to alleviate poverty, generate income, and promote employment. But it is not a one size fits all solution. In choosing the most appropriate intervention for a specific situation, microcredit should be carefully evaluated against alternatives. In many cases savings and insurance services, microgrants, infrastructure improvements, employment and training programs, and other nonfinancial services may be more effective for reducing poverty and creating jobs. Microcredit is generally most appropriate for individuals or households that are already engaged in economic activities and have sufficient cash flows. Otherwise it may create an excessive debt burden.

Microcredit may also be inappropriate in immediate post-emergency environments, severely disadvantaged rural areas, and as an intervention for the chronically destitute. Moreover, microcredit is not recommended where there is dependence on a single economic activity or barter transactions; high risk of civil violence, natural disaster, or hyperinflation; or in the absence of law and order.

Grants, rather than microcredit, can best be used to overcome the social isolation, lack of productive skills, and low self-confidence of extremely poor people, preparing them for eventual use of microcredit. Microgrants and other financial entitlements can work well as first steps of comprehensive programs designed to move the poorest people from vulnerability to economic self-sufficiency.

An example of a graduated strategy is the Income Generation for Vulnerable Groups Development Program, offered by the Bangladesh Rural Advancement Committee. The program combines free food, skills training, health care, and savings creation in an 18-month program designed to graduate clients to the committee's mainstream microcredit program. Most graduated programs should, however, be implemented by multiple organizations working together.

Other interventions to strengthen the livelihoods of poor people include investments in public infrastructure (including roads, communications, and education), community-level investments in commercial and productive infrastructure (such as market centers or small-scale irrigation infrastructure), and nonfinancial services (from literacy and business training to business development services).

Source: Adapted from CGAP 2002.

BOX 4.4

XacBank Mongolia: Providing microfinance in remote areas

XacBank Mongolia, founded in 1998, is developing an interesting approach to reach remote villages and nomadic herders: the "franchise" service. Through this service the bank provides technical assistance to savings and credit cooperatives to help them become sustainable financial providers in remote rural areas. The service involves four main activities: organizing extensive training for the creation and establishment of rural savings and credit cooperatives, building the capacity of existing rural cooperative to enhance financial services, providing basic office equipment for new cooperatives, and giving cooperatives advisory and other technical support.

XacBank aims to offer rural clients the safety of a bank and the convenience of a local cooperative—at a cost that enables the bank to reach rural clients on a sustainable basis. By March 2006, 58 savings and credit cooperatives had received the franchise service. The portfolios of these cooperatives totaled $351,000 in loans and $73,800 in deposits. The cooperatives have more than 3,200 members, who have invested $182,400 in total share capital.

Source: Adapted from CGAP 2006c and USAID 2005.

associations link up with microfinance institutions; and increasing the monitoring capacity of microfinance networks—for example, by promoting voluntary disclosure and collecting data on financial performance.

To speed up reforms, the government could facilitate the entry of a new demonstration institution in the microfinance sector. Such an institution should challenge the sector by introducing new ways of doing business and rapidly increasing its client base. This new player should have a sound track record in microfinance and a strong, committed board. To attract such an institutional investor, the government should first clarify whether foreign institutions—including equity funds—are allowed to hold shares in Nepalese financial institutions. A number of well-regarded institutional investors in microfinance have created equity funds that have invested in microfinance institutions in South Asia, Eastern Europe, Latin America, and Africa.[5] To raise investor awareness of Nepal's microfinance sector, the government could sponsor a fair for foreign microfinance investors.

The government also needs to continue restructuring state-owned regional rural development banks. Although the government's reform program is a step in the right direction, given the six years since it began, it is appropriate to learn from its achievements to date. Two issues in particular need to be revisited: whether enough information was provided on the banks to be privatized, to ensure that the best privatization method was designed; and whether selling most of the government's shares to clients was conducive to the best governance outcome—especially given the possible future growth of these institutions. Based on such an assessment, a program to improve the financial performance of these institutions, without decreasing their outreach, should be formulated and implemented.

Finally, management of the Rural Self-Reliance Fund should be professionalized, and the institution given greater independence. Since its creation in 1990 the fund has had mixed performance at best; a substantial portion of its loan portfolio is in arrears and, partly due to the high liquidity in the microfinance sector, it has disbursed just over of its available funds (see box 1.3). To improve the fund's performance, it is imperative that its management be professionalized and that it operate independently from Nepal Rastra Bank. Professional management will also ensure that no conflicts of interest arise between the fund and its regulator (Nepal Rastra Bank).

Initiative 4:
Create a legal and regulatory environment that protects microfinance consumers and promotes stability.

The legal and regulatory framework for microfinance should be simplified to reduce confusion and strengthened to increase stability. Although the framework is not a major constraint to the sector's growth, the haphazard ways in which microfinance institutions have been licensed and the framework has been applied have led to confusion and weak supervision. First, microfinance consumers do not know which institutions are supervised and which are not. Second, supervision of the sector is weak, so supervisors rarely foresee or recognize the problems facing it. Finally, the fact that small institutions are often supervised while large ones are not does not allow supervisors to guarantee the sector's stability. To improve the legal and regulatory framework, the government should:

- Prioritize the institutions that should be supervised, to target only those that can pose a threat to the microfinance sector's stability. The 2006 Access to Financial Services Survey found that regulated microfinance institutions are only the tip of the iceberg in terms of service providers. To understand which institutions matter, the government should map the entire sector and develop quantitative criteria for licensing institutions. For institutions that do not meet these criteria and will not be regulated—and especially for financial cooperatives—the government should explore the possibility of auxiliary supervision (such as by the Nepal Federation of Savings and Credit Cooperatives).
- Develop a business plan for stronger microfinance supervision. Once there is agreement on which institutions need to be prudentially supervised, a business plan should be developed for the supervisory agency. This should address issues such as work plans (onsite supervision, offsite supervision), human resource requirements (number of staff, skills, training), and budgets.

If the microfinance supervisory agency is not the central bank, additional issues will need to be addressed, such as accountability and the legal nature of the agency.

- Review microfinance regulations and prudential requirements to simplify and clarify a number of points for industry participants. This would involve an analysis of the inconsistencies between different texts (for example, on foreign ownership of microfinance institutions) and possibly a rationalization of the different legal forms of microfinance institutions (for example, whether different legal forms are needed for regional rural development banks and microfinance development banks).
- Draft new legislation or amend existing legislation. This process should not be rushed, and should happen only once consensus has been reached on the regulatory and supervisory framework for microfinance institutions.

Making Remittances More Effective

The government should also take steps to increase the use of formal financial remittances, and to make such remittances more effective.

Initiative 5:
Enhance the financial literacy of migrants and tackle legal and regulatory obstacles in the India-Nepal corridor to increase formal remittances.

Formal remittances could be increased by enhancing the financial literacy of migrants. Although migrants are required to undergo a two-day training course before departure, the course does not cover financial literacy. By introducing such a module, the government could raise awareness about the potential channels for sending remittances and the different costs, advantages, and disadvantages of each, and provide training on financial literacy.

In addition, the use of money transfer operators on the Nepal-India corridor could be expanded by lobbying India's central bank to address the legal and regulatory constraints involved. First, though, Nepal's government needs to map the legal and regulatory constraints facing money transfer operators. After doing so, it should initiate a dialogue with the Reserve Bank of India on this subject.

Initiative 6:
Promote a viable loan scheme for migrants—one that reduces the share of remittances used to repay loans.

Finally, the proportion of remittances used to repay loans could be reduced by developing a viable loan scheme for migrants. To promote sustainable pre-emigration finance, the government should reform the existing scheme (see box 2.1) to ensure that formal lenders can select their clients and loans are linked to remittance flows. These changes might help reduce reliance on the high-interest loans provided by the informal sector and staffing agencies. Such an arrangement would require cooperation from migrants' employers and lenders to deduct loan payments from wages at the source and transfer them to the borrower's account in Nepal, which could be under the name of the migrant worker or a beneficiary.

Chapter 4 notes

1 Notable exceptions are Brazil's Banco de Nordeste, Indonesia's Bank Rakyat, and Thailand's Bank for Agriculture and Agricultural Cooperatives.

2 A number of countries, including China and several in Eastern Europe and the Commonwealth of Independent States, have adopted similar schemes for both state-owned and private banks—generally with very successful results.

3 Rastriya Banijya Bank and the Postal Savings Bank could have the outreach to become retail banks. But Rastriya Banijya Bank appears to be too insolvent to fulfill this mandate. And despite its large branch network, the Postal Savings Bank is an insignificant player in the financial sector, and its staff lack even basic training in banking. The Agricultural Development Bank is included despite its poor financial performance because it has just been recapitalized and is undergoing changes in management.

4 Several countries have designed capacity-building initiatives for their microfinance sectors. The Small Industries Development Bank of India provides funds for onlending coupled with capacity-building funds (http://www.sidbi.in/Micro/aboutus.htm). Afghanistan's Microfinance Investment Support Facility provides similar support (http://www.misfa.org.af), and its approach is being replicated by Sierra Leone's Microfinance Investment and Technical Assistance Facility (http://mitaf.esglobal.com/index.htm).

5 For example, the Bangladesh Rural Advancement Committee (http://www.brac.net) created a new institution in Afghanistan and is expanding its activities in East Africa. Similarly, ACCION International (http://www.accion.org) and FINCA International (http://www.villagebanking.org) are developing networks of microfinance institutions in Africa and Latin America.

Appendix A

Legal Framework of the Regulated Microfinance Sector

Nepal's legal and regulatory framework requires that all NGOs and cooperatives engaged in microfinance activities—that is, financial NGOs and cooperatives—be licensed by Nepal Rastra Bank. The microfinance sector also includes microfinance and regional rural development banks. Table A.1 summarizes the legal texts to which they are subject.

TABLE A.1
Legal texts covering microfinance activities, by legal form

Legal form	Legal texts
Financial NGO	NGOs can be established under the 1978 Society Registration Act and 1991 Social Welfare Act. The 1998 Financial Intermediary Society Act allows NGOs to provide microcredit to their members, as financial intermediary NGOs (FINGOs). Financial NGOs fall under the 2006 Banks and Financial Institutions Act, as Class D institutions.
Cooperative	Cooperatives can be established under the 1992 Cooperatives Act. The 2002 Cooperative Societies Holding Limited Banking Transactions Directive enables financial cooperatives to mobilize savings and provide credit. Financial cooperatives fall under the 2006 Banks and Financial Institutions Act, as Class D institutions.
Microfinance development bank	Microfinance development banks can be established under the 1964 and 1991 Company Acts, and registered with Nepal Rastra Bank under the 2006 Banks and Financial Institutions Act, as Class D institutions.
Regional rural development bank	Four regional rural development banks were established under the 1984 Commercial Banks Act, and the fifth under the 1996 Development Banks Act. These banks fall under the 2006 Banks and Financial Institutions Act, as Class D institutions.[a]

a. The 2006 Banks and Financial Institutions Act repealed the 1967 Agricultural Development Bank Act, 1974 Commercial Bank Act, 1985 Finance Company Act, 1990 Nepal Industrial Development Corporation Act, and 1996 Development Banks Act.

Nepal Rastra Bank classifies licensed institutions into four classes (A, B, C, and D) based on the minimum paid-up capital needed for a license. This classification indicates the financial transactions institutions are permitted to conduct.[1] All microfinance institutions fall under category D. Class D institutions can:

- Supply credit as prescribed.
- Supply microcredit with or without any movable or immovable property as collateral or security for operating any microenterprise. Such credit can go only to an institution's groups or members who have saved for the period and the amount prescribed by Nepal Rastra Bank.
- Accept deposits with or without paying interest and refund such deposits, subject to the limit prescribed by Nepal Rastra Bank.
- Perform such other functions as prescribed by Nepal Rastra Bank.[2]

In addition, the 2005 Banks and Financial Institutions Directives allow Class D institutions to:

- Provide loans to deprived and low-income individuals or groups of up to NRs 40,000 to operate microenterprises, with no more than NRs 100,000 going to a single microenterprise. In addition, such loans should account for up to 25 percent of the institution's total loans and advances.[3]
- Mobilize savings up to 30 times their core capital funds. Deposits from nonmembers are not allowed.[4]

Notes

1 From the 2006 Banks and Financial Institutions Act, Article 31.1.

2 From the 2006 Banks and Financial Institutions Act, Article 47.4.

3 From Directive 3, Article 1.2.

4 From Directive 16, Article 1.4.

Appendix B

Performance of Regulated Microfinance Institutions

The regulated microfinance sector consists of nine microfinance banks: five publicly owned regional rural development banks (one per region of Nepal) and four private microfinance development banks (table B.1). The two largest microfinance banks are Nirdhan Utthan Bank Limited and Swabalamban Bikas Bank Limited, which both originated from the transfer of the microfinance portfolios of their parent NGOs, Nirdhan and the Center for Self-Help Development. In addition, Chhimek Bikas Bank was promoted by the NGO Neighborhood Society Service Center, while Deprosc Development Bank was established by the NGO Development Project Service Center.

The microfinance sector also includes 47 financial NGOs and 20 financial cooperatives. The most important financial NGOs are those at the core of rural microfinance banks (such as the Center for Self-Help Development, Deprosc Development Bank, and Neighborhood Society Service Center). Prominent cooperatives include the Women's Cooperative Society and Bindabasani Savings Cooperative Society Limited, both of which combine Grameen Bank methodologies and cooperative principles for their microfinance clients.

In addition, Nepal has three apex microfinance institutions: the Rural Microfinance Development Center, Rural Self-Reliance Fund (managed by Nepal Rastra Bank), and Small Farmers Development Bank (Sana Kisan Bikas Bank). The Rural Self-Reliance Fund had a portfolio of NRs 126 million outstanding as of July 2005 (table B.2). As of September 2006, the Rural Microfinance Development Center had NRs 412 million in outstanding loans. About 83 percent of its outstanding portfolio is with microfinance development banks, 14 percent with financial NGOs, and 3 percent with financial cooperatives.

The nine microfinance development banks and regional rural development banks account for 37 percent of the total loan portfolio of regulated institutions and 23 percent of deposits. Financial cooperatives represent 22 percent of the loan portfolio and 53 percent of deposits. Financial NGOs account for just 6 percent of the portfolio and 1 percent of deposits.

Growth and Outreach of the Regulated Microfinance Sector

Data on the amount and number of loans and deposits for regulated microfinance providers—5 regional rural development banks, 4 microfinance development banks, 37 financial NGOs[1], and 20 cooperatives—were gathered for 1995, 2000, and 2004.

Financial NGOs play a marginal role in the growth of the microfinance sector. Since 1995, in term of the amount of loans, financial cooperatives and regional rural development banks have been growing at a similar pace—reaching NRs 1,341 million for the regional banks and NRs 1,157 million for the cooperatives in 2004 (figure B.1). But data on the number of loans reveal the differences in lending pattern of these two types of institutions: financial cooperatives

TABLE B.1
Summary of the regulated microfinance sector

Number and type	Institutions
5 regional rural development banks (also known as Grameen Bikas Banks), with one for each region:	Eastern (Purbanchal Grameen Bikas Bank) Western (Pashchimanchal Grameen Bikas Bank) Central (Madhyamanchal Grameen Bikas Bank) Mid Western (Madhya-Pashchimanchal Grameen Bikas Bank) Far Western (Sudur-Pashchimanchal Grameen Bikas Bank)
4 microfinance development banks:	Nirdhan Utthan Development Bank Swabalamban Bikas Bank Chhimek Bikas Bank Deprosc Development Bank
47 financial NGOs	
20 financial cooperatives	

Source: Nepal Rastra Bank data.

TABLE B.2
Outstanding portfolios of apex microfinance institutions

Institution	Millions of NRs	Millions of US$
Rural Microfinance Development Center	411.8	5.9
Rural Self-Reliance Fund	125.5	1.8
Small Farmers Development Bank	864.1	12.3

Source: Nepal Rastra Bank data.

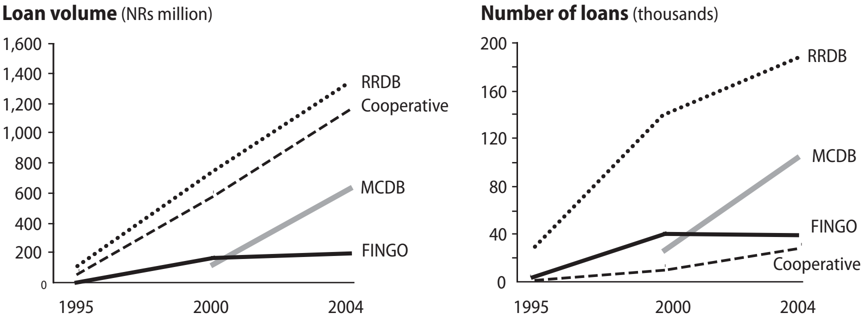
are making larger and fewer loans than regional rural development banks. In 2004 the regional banks had nearly 190,000 outstanding loans, while financial cooperatives had 28,000.

Since their creation between 1999 and 2002, microfinance development banks have been growing at a similar pace as regional rural development banks in terms of the amount of loans. In terms of both loan amounts and numbers, financial NGOs have grown more slowly. This slow growth has been exacerbated by the transfer of partial or total loan portfolios by NGOs such as Nirdhan and the Development Project Service Center to their microfinance development banks.

Financial cooperatives are the dominant player in term of mobilizing deposits (figure B.2). Such cooperatives have been growing fastest in terms of the amount of deposits, and in 2004 they accounted for 63 percent of the deposits mobilized by microfinance providers. Regional rural development banks accounted for 23 percent, microfinance development banks for 10 percent, and financial NGOs for 3 percent. In 2004 financial cooperatives and regional development banks had a similar number of deposit accounts; thus the average deposit balance is higher in the cooperatives.

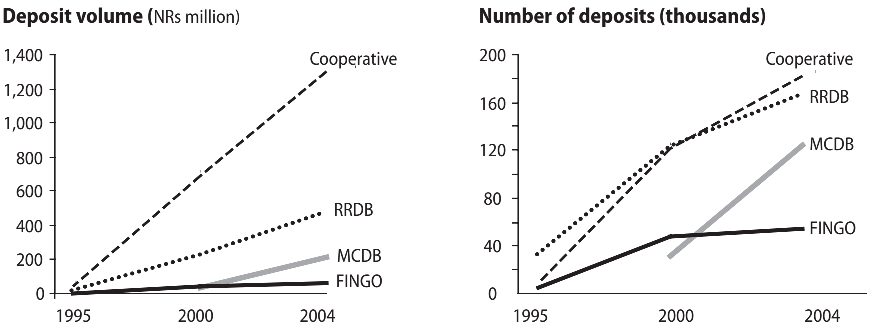
The strongest growth in the amount of loans has been taking place in the Central region, which in 2004 accounted for 46 percent of regulated microfinance loans (figure B.3). The slowest growth occurred in the Far Western and Mid Western regions. The picture is similar for the amount of deposits, with the Central region accounting for 57 percent in 2004.

FIGURE B.1
Amount and number of loans provided by regulated microfinance providers, 1995–2004



Source: Data reported by institutions.

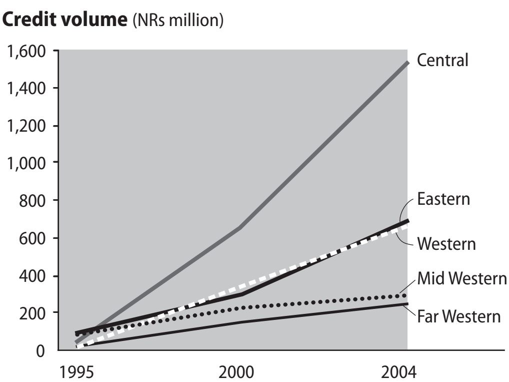
FIGURE B.2
Amount and number of deposit accounts held by regulated microfinance providers, 1995–2004



Source: Data reported by institutions.

FINGO: Financial NGO
MCDB: Microfinance development bank
RRDB: Regional rural development bank

FIGURE B.3
Amount of loans provided by regulated microfinance providers by region, 1995–2004



Source: Data reported by institutions.

Every region has a diversity of microfinance providers. Although each region has a regional rural development bank, the Central Regional Rural Development Bank accounts for just 16 percent of regulated microfinance loans in the region—compared with 72 percent in the Eastern region, 57 percent in the Far Western and Mid Western regions, and 52 percent in the Western region (figure B.4). Microfinance development banks are present only in the Central and Western regions. Although financial cooperatives are present in all five regions, they play a particularly important role in the Central region, accounting for 56 percent of microfinance loans. Financial NGOs are also present in all five regions, but their contributions are most visible in the Central and Eastern regions, accounting for 4 percent and 14 percent of microfinance loans, respectively.

The picture is similar for deposits. One important difference, already discussed, is the dominant role played by financial cooperatives when it comes to mobilizing deposits. In the Central region financial cooperatives account for 79 percent of all deposits mobilized by regulated microfinance institutions.

Credit and deposits are concentrated in the Terai. About 72 percent of credit is concentrated in the Terai region, with the rest in the Hills (figure B.5). Only financial NGOs provide loans in the Mountains, but they are insignificant (0.02 percent of regulated microfinance loans). The Terai also dominates for deposits, accounting for 59 percent of the total held by regulated microfinance providers.

While 48 percent of Nepal's population lives in the Terai, the region receives 72 percent of the loans provided by the regulated microfinance sector (figure B.6). The Hills contain 44 percent of the population yet receive just 28 percent of these loans. Finally, the Mountains represent 7 percent of the population and receive 0.02 percent of these loans.

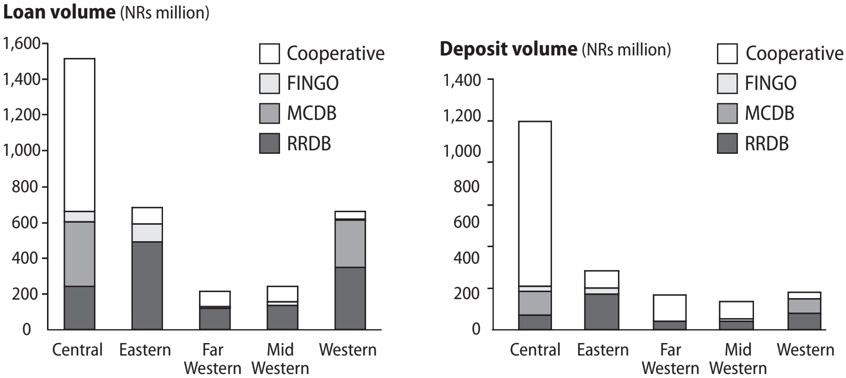
Performance of Financial Cooperatives

In 2005 the 20 regulated financial cooperatives had about 180,000 depositors and 28,000 borrowers, with outstanding loans totaling NRs 1,421 million ($20.3 million) and deposits of NRs 1,715 million ($24.5 million). Data compiled by the Mix show that the average loan balance of financial cooperatives is 117 percent of national per capita income, compared with 35 percent for microfinance development banks and 46 percent for financial NGOs.[2] If the average disbursed loan size is taken as an indication of the clients that financial cooperatives are reaching, it can be concluded that they focus on wealthier targets than do microfinance development banks and financial NGOs.

Financial cooperatives tend to focus on smaller areas and provide services to communities as a whole regardless of individuals' wealth. The average savings balance is also higher for cooperatives, at $206, compared with $3–38 for other microfinance institutions. Financial cooperatives are relatively concentrated, with the seven largest accounting for 66 percent of deposits and 62 percent of outstanding loans.

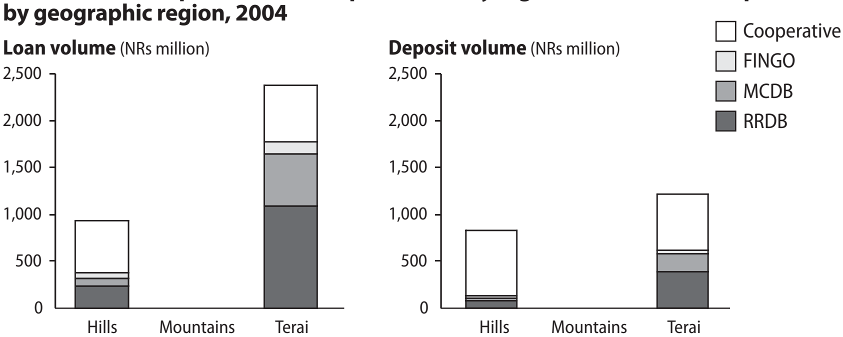
Most financial cooperatives rely on internal funding. Among the 20 regulated cooperatives, aggregate deposits represent 120 percent of outstanding loans (127 percent for the seven largest; table B.3). Five financial cooperatives (which are not among the seven largest) have total deposits inferior to their loan portfolios.[3] Four borrow funds externally for their operations, but only one borrows funds from a commercial bank. The other three borrow from other financial institutions—the Rural Microfinance Development Center, Rural Self-Reliance Fund, or another Nepal Rastra Bank program.[4]

FIGURE B.4
Amount of loans provided and deposits held by regulated microfinance providers, by region and type of institutions, 2004



Source: Data reported by institutions.

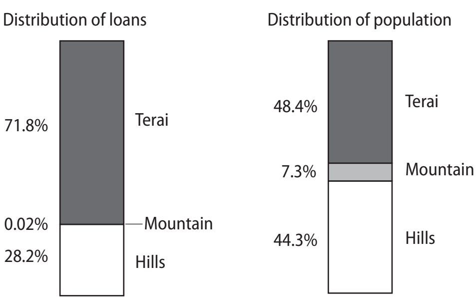
FIGURE B.5
Amount of loans provided and deposits held by regulated microfinance providers, by geographic region, 2004



Source: Data reported by institutions.

FINGO: Financial NGO
MCDB: Microfinance development bank
RRDB: Regional rural development bank

FIGURE B.6
Distribution of loans provided by regulated microfinance providers and distribution of national population by geographic region, 2004



Source: Data reported by institutions.

TABLE B.3
Portfolios of Nepal's seven largest financial cooperatives, July 2005

Cooperative	Outstanding loans NRs mill.	Outstanding loans US$ mill.	Deposits NRs mill.	Deposits US$ mill.	Deposits/ loans (percent)
Sahara Loan, Saving, and Investment Society	216.8	3.08	246.2	3.50	114
Himalaya Cooperative Finance	193.9	2.75	224.6	3.19	116
Raj Shree Saving and Investment Cooperative Society	108.7	1.54	147.1	2.09	135
Nepal Cooperative Finance Society	103.8	1.47	139.8	1.99	135
Nabajiban Cooperative Society	101.2	1.44	178.9	2.54	177
Bahooudeshiya Saving and Loan Cooperative Society	86.5	1.23	87.8	1.25	101
Amarwati Bahoodeshya Sahakari Sanstha	79.9	1.13	111.3	1.58	139
Subtotal	890.8	12.65	1,135.7	16.13	127
Total for all licensed cooperatives	1,431.4	20.33	1,724.5	24.50	120
Percentage of total of 7 largest	62		66		

Source: Nepal Rastra Bank data.

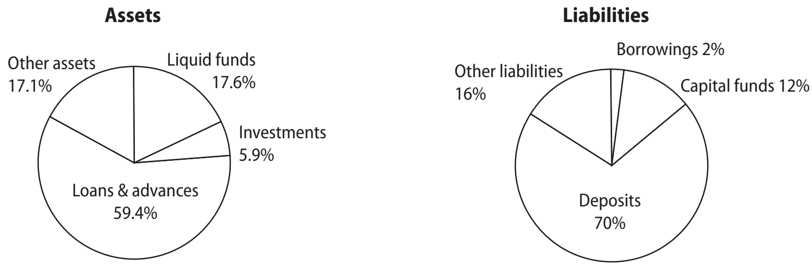
Liquid funds represent 18 percent of the total assets of financial cooperatives (figure B.7). In 2005 liquid funds relative to deposits stood at 23 percent for the 20 financial cooperatives. This is high based on international standards—such as the World Council of Credit Unions' PEARLS ratios, which recommend that this ratio be 10 percent.[5] But given Nepal's recent political instability, a higher liquidity ratio is recommended to allow institutions to cope with sudden requests from depositors to get back their deposits.

Although the profitability of financial cooperatives is improving, it still lags other microfinance providers. The 20 licensed cooperatives have incurred consolidated losses of about NRs 4.5 million ($64,000)—even though 14 registered profits for the fiscal year that ended in June 2005. Over the years the losses of financial cooperatives have improved: in January 2003 their losses were NRs 32.8 million ($469,000). But this improvement was mainly due to the de-licensing of 15 financial cooperatives between 2003 and 2005.

Eight financial cooperatives recorded profits of more than NRs 1 million ($14,000) in fiscal 2005 (figure B.8). The total losses incurred by the six loss-making cooperatives were substantial, reaching NRs 39.6 million ($562,000). The consolidated return on assets of the 20 financial cooperatives was negative, at –0.2 percent. Only six had a comfortable return on assets—that is, above 2 percent.

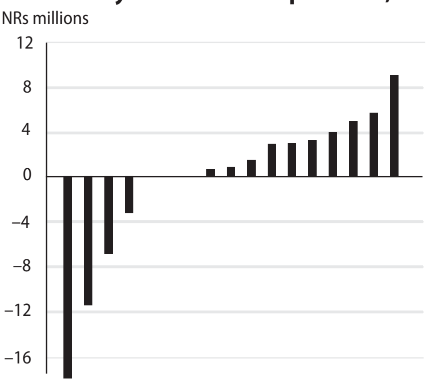
With an average capital adequacy ratio of 15 percent in fiscal 2005, the prudential status of financial cooperatives was reasonable. Half of the 20 cooperatives maintained a capital adequacy ratio above 15 percent during the fiscal year, mainly as a result of their high liquidity and investments in government bonds. Although Nepal Rastra Bank prescribes a capital adequacy ratio of just 10 percent, the overall figure of 15 percent is lower than the 15–20 percent prescribed by many central banks for community finance institutions. Of the seven largest financial cooperatives, only two have capital adequacy in the safe zone (above 15 percent), which is cause for concern (table B.4).

FIGURE B.7
Consolidated balance sheet of financial cooperatives, 2005



Source: Nepal Rastra Bank data.

FIGURE B.8
Profitability of financial cooperatives, 2005



Source: Nepal Rastra Bank data.

TABLE B.4
Capital adequacy ratios of financial cooperatives, 2005

Ratio (percent)	Number of cooperatives
Less than 12	6
12–14.9	4
15–20	5
More than 20	5
Seven largest with >12	4
Seven largest with >15	2

Source: Nepal Rastra Bank data.

The capital adequacy of the 20 licensed financial cooperatives is reasonable for current lending levels. But to significantly increase their loan portfolios, these cooperatives would need additional equity—which can only be raised from members. It is not clear whether members would be willing or able to contribute further equity to financial cooperatives, which limits their growth.

In addition, widespread defaults by financial cooperatives have adversely affected their creditworthiness, making it extremely difficult for them to borrow from commercial banks—even under the deprived sector lending window. Without a substantial effort to improve the profitability of most cooperatives, capital adequacy will not improve in the long run and fund mobilization will be difficult, further impeding their ability to grow and generate profits.

Performance of Financial NGOs

Financial NGOs had about 40,000 borrowers in 2004. These data show a high degree of concentration among financial NGOs: the four largest accounted for 65 percent of the total outstanding loan portfolio, and the seven largest for nearly 80 percent (table B.5). The four largest include two organizations—the Development Project Service Center and Neighborhood Society Service Center—that also run microfinance development banks under separate programs. When the average loan is used as a proxy, it becomes evident that financial NGOs focus more on poorer clients than do other microfinance providers.

In July 2005 domestic sources accounted for 97 percent of borrowing by financial NGOs. (Only 3 percent came from foreign institutions.) In fiscal 2005 borrowing totaled NRs 640.4 million ($9.15 million). Of this, 53 percent came from domestic banks (figure B.9)—mainly to park deprived sector lending funds in financial NGOs (which are then asked to deposit the funds in finance companies). This results in some of the leading financial NGOs borrowing 2.5 to 3.5 times their loan portfolios (table B.5).

In 2005 financial NGOs kept 26 percent of their total sources of funding in liquid funds (2 percent as cash in hand and 24 percent with domestic banks), which is high. Microfinance institutions usually keep 8–12 percent of their funds in cash and bank balances. About 40 percent of the funds of financial NGOs were used for microfinance loans. About 23 percent were reported as directed investments. These high levels of liquid funds and directed investments are a result of the deprived sector lending window, through which commercial banks provide financing on the condition that money be kept only with institutions that they select.

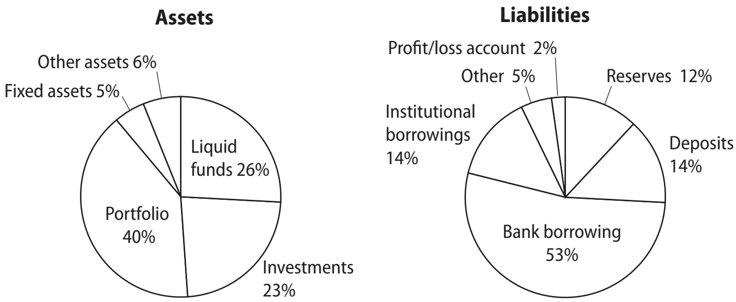
Just 7 of the financial NGOs recorded profits above NRs 0.5 million ($7,000). The profits recorded by 13 others totaled just NRs 0.9 million ($13,000), and the losses incurred by 7 other totaled NRs –1.3 million (–$19,000). Seven institutions did not report any profit or loss. The consolidated return on assets of all the financial NGOs was about 2 percent. Nine of the financial NGOs had good performance, with returns on assets above 5 percent (Figure B.10).

TABLE B.5
Portfolios of Nepal's seven largest financial NGOs, July 2005

Institution	Outstanding loans		Borrowing		Borrowing/ loans
	NRs mill.	US$ mill.	NRs mill.	US$ mill.	(percent)
Neighborhood Society Service Center	47.6	0.68	129.2	1.84	271
Nepal Grameen Bikas Samaj Kendra	46.2	0.66	22.4	0.32	49
Development Project Service Center	37.4	0.53	40.0	0.57	107
Singana Youth Club	36.0	0.51	104.0	1.48	289
Nepal Rural Development Society Center	14.7	0.21	51.6	0.73	351
Jeevan Bikas Samaj	12.9	0.18	9.2	0.13	71
Mahuli Samudayik Bikas Kendra	10.0	0.14	9.6	0.14	96
Subtotal	204.8	2.91	366.1	5.20	179
Total for all licensed FINGOs	258.7	3.67	437.6	6.22	169
Percentage of total of seven largest	79.2		83.7		

Note: Borrowing refers to loans taken by financial NGOs from other financial intermediaries.
Source: Nepal Rastra Bank data.

FIGURE B.9
Consolidated balance sheet of financial NGOs, 2005



Source: Nepal Rastra Bank data.

FIGURE B.10
Profitability of financial NGOs, 2005

Source: Nepal Rastra Bank data.

In fiscal 2005 the consolidated capital adequacy ratio of financial NGOs was 8.6 percent, which is low based on international standards. As table B.6 shows, 12 financial NGOs had ratios above 12 percent at end of the fiscal year, which is reasonable given that financial NGOs do not have a strong capital base. These high ratios were possible only because a large portion (26 percent) of the funds of financial NGOs are liquid (in cash and banks)—a result of the parking of deprived sector loans by commercial banks. Of the seven largest financial NGOs, only three have a capital adequacy ratio above 12 percent, and two above 15 percent.

TABLE B.6
Capital adequacy ratios of financial NGOs, 2005

Ratio (percent)	Number of financial NGOs
Negative	5
0	3
0–7.9	12
8–12	2
12–15	2
>15	10
Seven largest >12 percent	3
Seven largest >15 percent	2

Source: Nepal Rastra Bank data.

Performance of Microfinance Development Banks

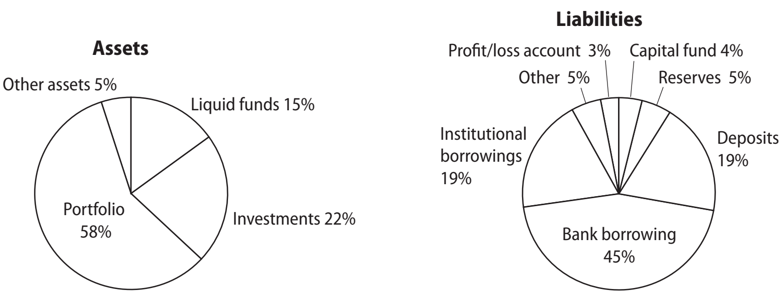
After the promulgation of the 1996 Development Banks Act, in 1999 Nirdhan—an NGO in operation since 1991—became the first organization to transfer its microfinance portfolio to an autonomous microfinance bank, Nirdhan Utthan Bank Limited.[6] Following this example, the Development Project Service Center transferred its portfolio to Deprosc Development Bank in 2001, the Neighborhood Society Service Center transferred its portfolio to Chhimek Bikas Bank in 2001, and the Center for Self-Help Development transferred part of its portfolio to Swabalamban Bikas Bank Limited in 2002 (Banking With The Poor Network Asia 2004).

In July 2005 the four microfinance development banks reached about 130,000 members. Nirdhan and Swabalamban each had around 50,000 clients, and Chhimek and Deprosc each had 12,000–15,000. As of July 2004, Nirdhan and Swabalamban accounted for around 73 percent of the combined loan portfolios of the four microfinance banks (table B.7).

In 2005 borrowing by the four microfinance development banks accounted for almost two-thirds of their funds (figure B.11). Deposits accounted for about 19 percent of their funds. Thus, despite having the freedom to collect deposits from members, extensive deposit mobilization has not occurred because people do not yet fully trust microfinance banks and so are reluctant to put deposits in them.

Funding of microfinance development banks has increased steadily in recent years, from NRs 808 million ($11.5 million) in January 2003 to NRs 1,530 ($21.9 million) in July 2005. The capital funds of microfinance banks have also increased, because more equity has been

FIGURE B.11
Consolidated balance sheet of microfinance development banks, 2005



Source: Nepal Rastra Bank data.

TABLE B.7
Outreach of Nepal's microfinance development banks, July 2002–04

Indicator	July 2002	July 2003	July 2004
Number of members	69,033	86,489	103,215
Number of borrowers	56,513	67,842	100,548
Outstanding loans (NRs mill.)	380	480	620
Number of village development committees covered	448	644	795
Number of districts covered	17	29	32
Number of staff	361	324	467

Source: Nepal Rastra Bank data.

TABLE B.8
Portfolios of Nepal's microfinance development banks, July 2005

Institution	Outstanding loans (millions) NRs	Outstanding loans (millions) US$	Deposits (millions) NRs	Deposits (millions) US$	Borrowing (millions) NRs	Borrowing (millions) US$	Deposits/ loans (percent)	Borrowing/ loans (percent)
Nirdhan	409.8	5.85	117.4	1.68	425.7	6.08	29	104
Swabalamban	233.5	3.34	112.9	1.61	209.8	3.00	48	90
Deprosc	120.8	1.73	25.6	0.37	136.0	1.94	21	113
Chhimek	117.5	1.68	39.6	0.57	204.3	2.92	34	174
Total	881.6	12.55	295.5	4.23	975.8	13.94	34	111

Note: Borrowing refers to loans taken by financial NGOs from other financial intermediaries.
Source: Nepal Rastra Bank.

invested by commercial banks (under pressure from Nepal Rastra Bank) and more share contributions have been provided by members (in the form of compulsory savings).

A large share of these banks' funds (58 percent) is used for their loan portfolios. The share of funds deployed as investments is 22 percent—indicating that, like financial NGOs, microfinance development banks receive significant amounts of deprived sector funds that commercial banks ask them to park in safe investment options. This has resulted in three of the four microfinance development banks having borrowing higher than their outstanding loans (table B.8). Liquid funds account for just 15 percent of the uses of total funds.

In fiscal 2005 the four microfinance development banks registered cumulative profits of NRs 48.2 million ($700,000). As with loans, Nirdhan and Swabalamban accounted for about 70 percent of these profits. The average return on assets of the microfinance banks was good, at 3.2 percent. Moreover, all these banks had a return on assets above 2.0 percent—with Deprosc (3.3 percent), Chimmek (3.4 percent), and Swabalamban (3.5 percent) above 3 percent.

The average capital adequacy ratio of the microfinance development banks was 18 percent in 2005, well above the 8 percent norm prescribed by Nepal Rastra Bank. Nirdhan and Deprosc maintained ratios above 19 percent. Only Chimmek had a capital adequacy ratio below 15 percent (13.7 percent), while Swabalamban's was 16.2 percent. These high ratios are partly due to deprived sector lending, which distorts the balance sheets of microfinance providers.

Performance of Regional Rural Development Banks

The five regional rural development banks were established between 1992 and 1996: the Eastern and Far Western ones in 1992, the Central and Mid Western ones in 1995, and the Western one in 1996. Operating autonomously in each of Nepal's five regions, each has a slightly different ownership pattern—though until recently, the government and Nepal Rastra Bank dominated all of them. In addition, the two state-owned commercial banks (Rastriya Banijya Bank and Nepal Bank Limited) have an additional 10 percent ownership stake in the five regional banks. Their remaining shares are owned by private banks, which are encouraged to take equity position in the regional development banks under the deprived sector lending window.

The regional development banks are currently going through a restructuring process, led by Nepal Rastra Bank, that will ultimately result in their privatization. This effort has already reduced Nepal Rastra Bank's stake in the Western Region Rural Development Bank from 61

TABLE B.9
Microfinance outreach of regional rural development banks, July 2002–04

Indicator	July 2002	July 2003	July 2004
Number of members	163,960	169,440	166,815
Number of borrowers	149,549	152,719	146,277
Outstanding loans (NRs mill.)	1,190	1,290	1,350
Number of village development committees covered	950	987	966
Number of districts covered	42	43	43
Number of staff	1,108	1,094	1,020

Source: Nepal Rastra Bank data.

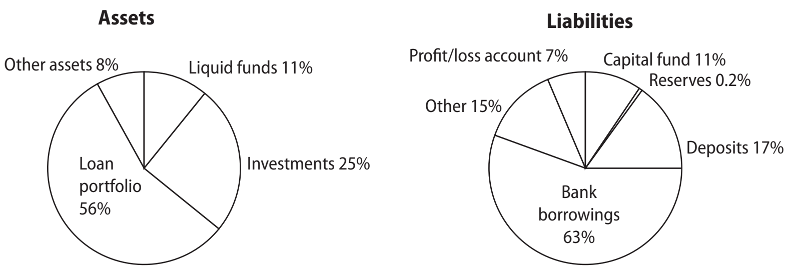
percent to 10 percent. In addition, the Eastern Region Rural Development Bank—considered the most successful in terms of outreach—is undergoing privatization (see chapter 2).

Between July 2003 and 2004 the five regional rural development banks experienced a slight decrease in number of members and borrowers, mainly because of the political disturbances in Nepal (table B.9). The Eastern bank—the largest—accounted for 36 percent of the overall portfolio followed by the Western one (26 percent) and Central one (19 percent).

In 2005 borrowing was the main source of funds (63 percent) for regional rural development banks, followed by deposits (17 percent) and other sources (15 percent; figure B.12). As a result all regional rural development banks but one have borrowing higher than their outstanding loans (table B.10). This is due to deprived sector lending, which encourages banks to lend significant amounts of funding to a few microfinance providers. Either because they are pressured by their lenders or because their clients cannot absorb this increase in funding, the regional banks invest these additional funds in financial institutions—making a comfortable margin. Interestingly, the Western region bank appears relatively profitable because of its income from such investments (and not because of the income generated by its loan portfolio).

In fiscal 2005 only two of the five regional rural development banks registered a profit—and combined, they incurred a loss of NRs 181 million ($2.59 million). The two profitable banks were in the Eastern and Western regions, with profits of NRs 11.5 million ($160,000) and NRs 9.3 million ($130,000), respectively. The three other regional development banks together had a loss of NRs 201.9 million ($2.88 million). The performance of the Far Western bank was the worst, followed by the Mid Western and Central ones. Because three of the five regional banks

FIGURE B.12
Consolidated balance sheet of regional rural development banks, 2005



Source: Nepal Rastra Bank data.

TABLE B.10
Portfolio of Nepal's regional rural development banks, July 2005

Institution	Outstanding loans (millions)		Deposits (millions)		Borrowing (millions)		Deposits/ loans (percent)	Borrowing/ loans (percent)
	NRs	US$	NRs	US$	NRs	US$		
Eastern	523.5	7.48	159.5	2.28	370.1	5.29	30	71
Western	385.4	5.51	92.5	1.32	500.3	7.15	24	130
Central	285.5	4.08	97.5	1.39	316.8	4.53	34	111
Mid Western	141.3	2.02	48.9	0.70	223.9	3.20	35	158
Far Western	130.3	1.86	41.5	0.59	264.7	3.78	32	203
Total	1,466.0	20.94	439.8	6.28	1,675.8	23.94	30	114

Note: Borrowing refers to loans taken by financial NGOs from other financial intermediaries.
Source: Nepal Rastra Bank.

incurred losses in fiscal 2005, their consolidated return on assets was poor, at –7 percent. Only the Eastern (2 percent) and Western (1 percent) banks had positive returns on assets.

The consolidated capital adequacy ratio of the regional banks was also poor in fiscal 2005, at 7 percent—below Nepal Rastra Bank's requirement of 12 percent. Only the Western (16 percent) and Eastern (12 percent) banks maintained a capital adequacy ratio above 12 percent. The Mid Western and Far Western banks are in a worrisome state, having exhausted their paid-up capital. Their capital adequacy ratios stand at –8 percent and –16 percent, respectively.

Notes

1 Of the 47 regulated financial NGOs, it was possible to gather data for only 37.

2 The Mix analysis relied on data provided by eight microfinance institutions in Nepal: Chhimek Bikas Bank, Deprosc Development Bank, Swabalamban Bikas Bank, Central Regional Rural Development Bank, Western Regional Rural Development Bank, Nirdhan Utthan Bank, Neighborhood Society Service Center, and VYCCU (http://www.themix.org).

3 Of these five cooperatives, two profitable institutions borrow from other financial institutions. The other three (two unprofitable and one profitable) rely on their capital funds to fill these gaps.

4 Other programs include Production Credit for Rural Women, Micro-Credit Project for Women, Community Groundwater Irrigation Sector Project, and Third Livestock Development Project.

5 PEARLS stands for **p**rotection, **e**ffective financial structure, **a**sset quality, **r**ates of return and cost, **l**iquidity, and **s**igns of growth.

6 The Rural Microfinance Development Center and Small Farmers Development Bank are also registered as microfinance development banks but are not discussed in this section because they are apex institutions, not direct microfinance providers.

Appendix C

The Access to Financial Services Survey

The Access to Financial Services Survey provides data on household access to financial services in Nepal in 2006. The survey collected information on payment, deposit, and credit products provided to Nepalese households by both formal and informal institutions. Particular attention was paid to understanding the reasons for such choices, as explained by the households. In addition, the survey gathered data on gender, age, education, ethnicity, and religion, as well as housing amenities and characteristics, to allow the imputation of household welfare based on the data gathered by the 2003/04 Nepal Living Standards Survey II.

Survey Questionnaire

The Access to Financial Services Survey consisted of one household questionnaire divided into nine parts. The first part (Part 0) collected basic survey information, such as on region, district, and municipality. Part I gathered information on the composition, education, ethnicity, housing characteristics, and participation in local organizations of households. Part II covered payment services used to receive and send income and other transfers, and the main routine and nonroutine expenditures. Part III surveyed deposits in banks, finance companies, microfinance and regional rural development banks, and financial NGOs and cooperatives, and reasons for not having deposit accounts. Part IV asked about loans from banks, finance companies, microfinance and regional rural development banks, and financial NGOs and cooperatives. Part IV asked about loans contracted by households for all purposes, including businesses. Part V collected information on informal loans and, where applicable, reasons for not applying to formal sources. Part VI surveyed informal lending, and Part VII gathered data on trade credit for households with small unlimited liability enterprises. Finally, Part VIII asked about remittances received from abroad.

Sampling Frame

The sampling frame was the list of all the wards in Nepal from the 2001 population census (tables C.1 and C.2). Primary sampling units were selected with probability proportional to size, where the chosen measure of size was the number of households in each ward.

Sampling Size and Design

The sample size was originally set at 1,800 households. But because three wards could not be visited due to the security situation at the time, the final sample size was 1,710 households.

The sample was split into strata based on three criteria: location (urban or rural), administrative region (Eastern, Central, Western, Mid and Far Western), and agroclimatic region (Terai, Hills and Mountains). To reduce the survey's costs and the time required to conduct it, and after discussions with Nepal Rastra Bank and microfinance practitioners, the Mid and Far Western administrative regions were grouped together because household access to financial services is similar in the two regions. In addition, the Hills and Mountains agroclimatic regions were grouped together because only 7 percent of Nepal's population lives in the Mountains.

The following table shows how the sample was allocated among the 16 strata.

TABLE C.1
Rural clusters selected for the survey

Region (Number of clusters allocated)	**VDC Code**	**District, VDC**	**Ward number**
Eastern Hills and Mountains (3)	01	Udayapur, Hadiya	3
	02[a]	Panchthar, Oyam	2
	03	Illam, Kolbung	6
Eastern Terai (4)	04	Sunsari, Chhitaha	2
	05	Saptari, Rampurjamuwa	6
	06	Morang, Mrigauliya	5
	07	Jhapa, Mahabara	6
Central Hills (5)	08	Sindhuli, Arunthakur	1
	09	Makwanpur, Sarikhetpalase	6
	10	Kavre, Mahadevtar	8
	11	Kathmandu, Bajrayogini (Sankhu)	1
	12	Bhaktapur, Gundu	2
Central Terai (5)	13	Sarlahi, Simara	5
	14	Rautahat, Rajpurfarhadawa	2
	15	Parsa, Bageshwaritirtrona	2
	16	Dhanusha, Sabela	7
	17	Chitwan, Jagatpur	6
Western Hills (4)	18	Syangja, Manakamana	9
	19	Myagdi, Jyamrukot	2
	20	Gulmi, Foksing	1
	21[a]	Baglung, Akhikarichaur	6
Western Terai (2)	22	Rupandehi, Hatibangai	6
	23	Nawalparasi, Amraut	6
Far and Mid Western Hills and Mountains (4)	24	Surkhet, Mehelkuna	2
	25	Pyuthan, Wangemarot	6
	26	Doti, Chhapali	2
	27	Bajhang, Malumela	1
Far and Mid Western Terai (3)	28[a]	Kailali, Mohanyal	3
	29	Dang, Duruwa	2
	30	Banke, Kanchanpur	5

Note: VDC stands for village development committee.
a. Fieldwork was not carried out in three clusters due to the uncertain security situation at the time.
Source: Access to Financial Services Survey 2006.

TABLE C.2
Urban clusters selected for the survey

Region (Number of clusters allocated)	VDC Code	District, VDC	Ward number
Eastern Hills and Mountains (1)	31	Udayapur, Triyuga	9
Eastern Terai (5)	32	Jhapa, Mechinagar	6
	33	Sunsari, Inaruwa	5
	34	Sunsari, Dharan	4
	35	Morang, Biratnagar	14
	35	Morang, Biratnagar	1
Central Hills and Mountains (10)	36	Lalitpur, Lalitpur	15
	37	Kathmandu, Kirtipur	18
	38	Kathmandu, Kathmandu	34
	38	Kathmandu, Kathmandu	27
	38	Kathmandu, Kathmandu	16
	38	Kathmandu, Kathmandu	12
	38	Kathmandu, Kathmandu	7
	38	Kathmandu, Kathmandu	3
	39	Makwanpur, Hetauda	2
	40	Kavrepalanchok, Banepa	6
Central Terai (5)	41	Bara, Kalaiya	6
	42	Dhanusha, Janakpur	1
	43	Parsa, Birgunj	14
	44	Chitwan, Bharatpur	11
	44	Chitwan, Bharatpur	2
Western Hills and Mountains (3)	45	Kaski, Pokhara	16
	45	Kaski, Pokhara	4
	46	Tanahu, Byas	2
Western Terai (2)	47	Nawalparasi, Ramgram	2
	48	Rupandehi, Butwal	6
Far and Mid Western Hills and Mountains (1)	49	Doti, Dipayal Silgadhi	13
Far and Mid Western Terai (3)	50	Dang, Tulsipur	10
	51	Banke, Nepalgunj	17
	52	Kanchanpur, Mahendranagar	3

Note: VDC stands for village development committee.
a. Fieldwork was not carried out in three clusters due to the uncertain security situation at the time.
Source: Access to Financial Services Survey 2006.

Sample Selection

A three-stage stratified sampling procedure was used to select the sample. In the first stage, wards were selected independently in each stratum using probability proportional to size.

To reduce the costs and time required to complete the listing of all households in large sampled wards, in the second stage four urban wards were segmented into sub-wards of roughly equal size, one of which was randomly selected with equal probability. Wards and sub-wards (where applicable) represent the penultimate sampling units of the survey; 60 of them were selected from the sampling frame, covering 52 districts. As noted, three rural wards could not be surveyed, so the survey covered 57 wards and 49 districts.

In the final stage 45 households were randomly selected from each penultimate sampling unit. But only 30 of these were target households to be visited by the survey; every third household on the list was designated as a potential replacement household and interviewed only if it was not possible to interview either of the two households immediately preceding it on the list.

In the end the survey covered 900 urban households and 810 rural ones, for a total of 1,710 households.

The survey also interviewed 563 small businesses. Sampling was conducted by identifying which households in the sample owned a small business.

Sampling Weights

Since primary sampling units were selected using probability proportional to size and the same number of households was interviewed in each unit, the urban and rural samples are nominally self-weighted. Still, raising factors were needed for national analysis because urban areas were over-sampled relative to rural areas since three rural clusters had to be excluded. If no sampling weights were used, the resulting estimates would be biased because different types of households are not represented in the sample in the same proportion as they exist in the population as a whole.

The raising factor for urban households was set equal to 1. Raising factors for rural households were calculated as $W_{ij} = (N_r/N_u)N_{ij}/n_{ij}$, where W_{ij} is the raising factor of rural households in the stratum *i* (belt) *j* (region), N_r and N_u are the total number of rural and urban households in Nepal, N_{ij} is the number of urban households in stratum *ij*, and n_{ij} is the number of urban households interviewed in stratum *ij*.

Basic Sample Statistics

Tables C.2–C.5 report the sample composition by region, location, belt, and ethnic group.

TABLE C.2
Share and number of surveyed households by region

Region	Share (percent)	Number
Eastern	23.6	360
Central	37.7	750
Western and Far and Mid Western	38.7	600
Total	100.0	1,710

Source: Access to Financial Services Survey 2006.

TABLE C.3
Share and number of surveyed households by location

Location	Share (percent)	Number
Kathmandu	3.6	210
Other urban areas	11.7	690
Rural	84.7	810
Total	100.0	1,710

Source: Access to Financial Services Survey 2006.

TABLE C.4
Share and number of surveyed households by belt

Belt	Share (percent)	Number
Kathmandu	54.4	840
Other urban areas	42.0	660
Rural	3.6	210
Total	100.0	1,710

Source: Access to Financial Services Survey 2006.

TABLE C.5
Share and number of surveyed households by ethnic group of household head

Ethic group	Share (percent)	Number
Upper caste	30.0	627
Terai middle castes	7.6	66
Dalits	5.4	82
Newar	5.9	237
Hill Janajati	17.1	242
Terai Janajati	9.9	113
Religious minorities	2.9	42
Other	21.3	301
Total	100.0	1,710

Source: Access to Financial Services Survey 2006.

Appendix D

Households Receiving Foreign Remittances

The 2006 Access to Financial Services Survey found that slightly less than a third of Nepalese households received remittances from abroad. More poor and rural households receive foreign remittances than wealthier ones. Overall, 19 percent of households had received a foreign remittance in the previous 12 months (table D.1).

Households in the second bottom spending quintile received the largest share of foreign remittances, with 25 percent of households in the quintile receiving one, compared with 15 percent in the top quintile. In addition, a slightly larger share of rural households received remittances (19 percent) than urban ones (16 percent)—with the share even lower in Kathmandu and Lalitpur (10 percent; table D.2). .

Wealthy and urban households received more remittances per household than poorer households, and in larger amounts. While on average Nepalese households received about two foreign remittances a year, the frequency is higher in urban centers than in rural areas, as well as in the top quintile as relative to the bottom quintile. And while more than half of the households had received less than NRs 20,000 in their most recent remittance, the share of households that last received more than NRs 50,000 was 38 percent in the top quintile compared with 8 percent in the bottom one.

The findings on remittances from the 2006 Access to Financial Services Survey confirm findings from the 2003/04 National Living Standards Survey II. But relative to the 1995/96 Nepal Living Standard Survey I, the data show an increase in the share of households that received foreign remittances (table D.3).

As far as the channels through which households receive foreign remittances, comparing the data from the Access to Financial Services Survey and the National Living Standards Survey II is difficult for two reasons. First, in the National Living Standards Survey II remittances are surveyed at the individual level, and individuals in the same household may use different channels. Second, the possible channels listed in the two surveys are different.

In any case, in the Access to Financial Services Survey 56 percent of households reported receiving foreign remittances through financial institutions or other channels, 43 percent in person, and just 0.2 percent through hundi. In the National Living Standards Survey II, on the other hand, 17 percent of individuals received remittances through financial institutions or other channels, 79 percent in person, and 4 percent through hundi. The National Living Standards Survey I provides no information on the channels through which remittances were received.

TABLE D.1
Households receiving foreign remittances by spending quintile, 2006
(percentage of households)

Quintile	Received remittances	Did not receive remittances
Bottom	20.0	80.0
2	24.9	75.1
3	19.0	81.0
4	13.6	86.4
Top	15.2	84.8
Average	18.5	81.5

Source: Access to Financial Services Survey 2006.

TABLE D.2
Households receiving foreign remittances, urban and rural, 2006
(percentage of households)

Quintile	Received remittances	Did not receive remittances
Katmandu and Lalitpur	9.5	90.5
Other urban areas	15.9	84.1
Rural	19.3	80.7
Average	18.5	81.5

Source: Access to Financial Services Survey 2006.

TABLE D.3
Households receiving foreign remittances, 1995/96 and 2003/04
(percentage of households)

	1995/96	2003/04
Received remittances	10.8	11.5
Did not receive remittances	89.2	88.5

Source: National Living Standards Surveys I and II.

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Index

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Over the past 20 years Nepal's financial sector has become deeper and the number and type of financial intermediaries have grown rapidly. Recent reforms have also made the banking sector more stable. Still, access to financial services remains limited for many people in Nepal, and has even been declining in recent years. This book examines the country's supply of and demand for financial services and the constraints to increasing access to them. It offers recommendations on how to make the financial sector work for all of Nepal's people, and especially for low-income households and small businesses.

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