

**MICROFINANCE IN NEPAL:
SAME SAME, BUT DIFFERENT**

by

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ABSTRACT

The introduction of Grameen model microfinance in Nepal was a neoliberal strategy that employed the perceived efficiency of women to distribute credit to rural households. Microfinance mitigated state-directed rural development finance outreach failures of subsidized credit capture by elites and use of funds for political patronage. Yet the very poor in Nepal are still not reached by microfinance. Nepal retained targeted lending through the Deprived Sector Lending Program, resulting in excess liquidity and low efficiency in microfinance institutions. The number of microfinance institutions has grown exponentially, yet microfinance still does not reach the remote hills and mountain areas. Dalits, the poorest caste group, are negligibly included in microfinance cooperatives. Women have gained valued access to credit through microfinance, but research about empowerment is inconclusive. Greater transparency and increased assessment of microfinance institutions, including social performance measurement, is required. There is no systematic research showing that microfinance in Nepal reduces poverty.

Keywords: microfinance; Nepal; Deprived Sector Lending Policy; Dalit; women's empowerment; poverty alleviation

DEDICATION

To the beautiful and resilient people of Nepal, whose call I cannot resist.

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GLOSSARY

aama sahuna

Bikas

Dalit

dharam bhakari

Dhukuti

Guthi

Janajati

Newar

Terai

Mothers' group

Development

Hindu caste group formerly referred to as untouchables.

Group grain associations

Traditional rotating savings and credit group

Traditional community savings group

Ethnic people

Indigenous people of the Kathmandu valley, with their own caste system.

Plains area bordering India to the south

ACRONYMS

ADB	Agricultural Development Bank of Nepal
CBO	Community based organization
CECI	Centre for International Studies and Cooperation
CIB	Credit Information Bureau
CIDA	Canadian International Development Agency
CMF	Centre for Microfinance
DSL	Deprived Sector Lending Program
FINGO	Financial intermediary non-governmental organization
GESA	Gender and social exclusion assessment
GNN	Grameen Network Nepal
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
M-CRIL	Micro-Credit Ratings International
MFC	Microfinance cooperative
MFDB	Microfinance development bank
MFI	Microfinance Institution
MIFAN	Microfinance Association of Nepal
MIX	Microfinance Information eXchange
NEFSCUN	Nepal Federation of Saving and Credit Co-operative Unions
NGO	Non-governmental organization
NLSS	Nepal Living Standards Survey
NMBA	Nepal Microfinance Bankers' Association
NMDB	Nepal Microfinance Development Bank
NRB	Nepal Rastra Bank
NRs	Nepal rupee
NUBL	Nirdhan Utthan Bank Limited
PAF	Poverty Alleviation Fund
RMDC	Rural Microfinance Development Centre
RRDB	Regional rural development banks
RSRF	Rural self-reliance fund
RUFIN	Rural Finance Nepal
SBB	Swabalamban Bikas Bank
SCC	Savings and credit cooperative

SFCL	Small Farmers Cooperative Limited
SHG	Self-help group
SIF	Social inclusion factor
SKBBL	Sana Kisan Bikas Bank Limited
USAID	United States Agency for International Development
VDC	Village development committee
WEP	Women Empowerment Project

Exchange rate (effective 9 August, 2011)

Currency unit = Nepalese rupees (NRs)

CAD \$1 = 73.11 NRs

INTRODUCTION

Microfinance is often described as a revolution or a panacea in fight against poverty. It provides access to financial services to those who are excluded from traditional banks. Microfinance assumes that the poor have the capacity to become small entrepreneurs, and given access to microcredit in particular, they will create economic and social transformation. The successes of the first major microfinance institutions, such as Grameen Bank of Bangladesh, received attention from the development community as an alternative to state-subsidized rural development finance. (Arun 2009) Now, after decades of implementation worldwide, some say microfinance is no panacea, but simply the latest in a series of approaches to rural development finance. (Armendaiz 2010)

The Grameen model of microfinance was adopted in Nepal during its financial sector liberalization. It enabled a shift from state-subsidized rural finance programs to a market driven approach, employing the perceived efficiency of women borrowers to increase household incomes. Microfinance solved the outreach failures of elite capture of directed loans and the use of subsidized credit for political patronage. (Rankin 2007) It moved distribution of credit away from state-run regional rural development banks to NGOs and microfinance

development banks. Significantly, however, Nepal retained targeted lending in its Deprived Sector Lending Program.

Microfinance in Nepal is the “same same, but different”, as the Nepali saying goes. Most of Nepal’s microfinance institutions use the widespread Grameen Bank model and have begun to follow international best practices as described by the Consultative Group to Assist the Poor (CGAP). Despite these generalist practices, the context of microfinance in Nepal is unique.

The decade long Maoist insurgency against the government from 1996-2006 caused the withdrawal of commercial banking services from many rural and remote areas, leaving a void to be filled mostly by semi-formal microfinance institutions. Political instability continues, fuelled by a high degree of inequality and the complex caste and ethnic composition of the population; caste is the most powerful indicator of poverty in Nepal. (World Bank/DFID 2006) There are stark differences in population density and infrastructure in the country’s three geographic zones that pose challenges to Grameen model methodology and standard financial products and services. Distortions caused by the Deprived Sector Lending Program (DSLPP) have resulted in high liquidity in many microfinance institutions. Within microfinance institutions, there is weak technical capacity in the areas of accounting and auditing, strategic planning, financial analysis and human resources. (Ferrari 2007)

Microfinance may be simply the latest in a series of approaches to rural development finance. However, the enthusiasm with which it has been received has created assumptions and generalizations that have yet to be proven by rigorous empirical study (Morduch 2009), the most significant of which is that microfinance actually works. (Bateman 2010) Microfinance today is expected to both alleviate poverty and develop the institutional capacity of financial systems. (Morduch 2009) Multilateral development agencies, donor and social investors look to microfinance programs for a 'double bottom line' and a "win-win" scenario (Morduch 2009) where financial sustainability and good banking practices yield social outcomes. The mobilization of women and marginalized groups to create change is considered one of the particular successes of the Grameen model, the model most widely used in Nepal. Microfinance in Nepal, therefore, is expected alleviate poverty and develop financial institutions while empowering women (Mayoux 2009, Shakya 2008) and generating socially inclusive growth (Gutierrez-Nieto 2009, Shakya 2008).

This paper seeks to review the literature to analyse the impacts of microfinance in Nepal. In considering whether microfinance does what is expected to do, the paper will examine the literature from two angles, i) impacts on social goals: poverty alleviation, social inclusion and women's empowerment and ii) the impact of regulation and the Deprived Sector Lending Program on the development of financial institutions.

The paper will begin by describing the state of microfinance in Nepal. It will map and describe financial sectors and microfinance models to create a foundation understanding of the industry.

To analyse impacts on poverty alleviation, a study of factors that moved families out of poverty between 1995/1996 and 2003/2004 will be reviewed. The paper will argue that the very poor are not being reached, and that caste is the most powerful predictor of poverty in Nepal. A study of Dalits (the caste group formerly known as untouchables) in microfinance financial cooperatives (MFCs) will be reviewed to explore social inclusion in microfinance, and shed light on some of the reasons why this group, which comprises the largest portion of the poor, is underrepresented in MFCs. Next, literature on women and microfinance in Nepal will be reviewed to consider whether women have been empowered by microfinance and how it has served them otherwise.

Analysis of a 2006 benchmarking exercise conducted by Microfinance Information eXchange (MIX) will show the performance of Nepali MFIs, and lead into a discussion of the assessment of microfinance institutions. The paper will argue that the low levels of financial analysis and the lack of social performance assessment in Nepal's microfinance industry deter international investors. A simple model using a portion of MIX's 2006 data will be used to discuss the social efficiency of a sample of MFIs.

To consider the impact of microfinance on institutions, a review of literature on Nepal's Deprived Sector Lending Program and MFI regulation will lead to the conclusion with recommendations for the industry and possibilities for a way forward.

1: THE STATE OF MICROFINANCE IN NEPAL

Microfinance is not limited to the provision of credit. It provides financial services, including savings and insurance, to people in a condition of social exclusion, who have no access to traditional banking services. (Gutierrez-Nieto 2009) Without access to banks, poor people generally borrow from informal sources within their community, such as moneylenders, relatives and friends, and local traders. These lenders assess risk and base contracts on familiarity with and local information about the borrower. (Armendaiz 2010) Microfinance institutions (MFIs) differ from traditional banks by offering small amounts of credit without marketable assets as collateral, often using social guarantees in their place. They also differ from banks by having different sources of income, often donations, and by having social goals that are of importance to donors. MFIs are similar to banks in the way that they can bring in resources from outside the community. (Armendaiz 2010)

In the past two decades, Nepal's financial sector, along with the number and type of financial institutions, has grown rapidly due to reforms and liberalization. The recent commercialization of microfinance NGOs and their transformation into microfinance development banks has made the microfinance sector more diversified. Nevertheless, access to financial services remains limited mainly to a

small segment of the population in easily accessible regions of the country. About half of Nepal's households do not have access to formal financial services. Only 28% of Nepalese households have a bank account or have taken a bank loan. Another 25% have an account or loan from other types of formal financial institutions. 28% are dependent solely on informal financial sources, and 20% receive no financial services whatsoever. It is estimated that the total rural credit requirement in Nepal is 23.3 billion Nepal rupees (\$1 CAD = 73.11 NRs), while the total supply from the formal and semi-formal sectors is NRS 9.6 billion. (BWTP 2009)

Due to this shortfall, the number of retail MFIs has grown exponentially. Commercial banks provide wholesale loans to MFIs, under the mandatory Deprived Sector Lending Program (DSLPL), but do not lend directly to the poor. MFIs in the form of microfinance development banks (MFDBs), financial intermediary NGOs (FINGOs) and savings and credit cooperatives (SCCs) generally provide small loans below NRs 50,000. In the Terai, where the population density is high and transportation is good, MFDBs provide most of the service, while FINGOs and cooperatives are the largest service providers in the hills and mountains. (BWTP 2009)

MFDBs hold the highest share of the MFI market in Nepal. An average MFDB serves 25,000 to 80,000 clients, while a FINGO has 2,000 to 30,000 clients and a SCC 50-200. These MFIs serve only their members and provide short-term

loans of less than 18 months for productive uses such as agriculture, livestock, poultry, petty trading and grocery stores. Most offer savings services, and a few MFDBs and cooperatives offer remittance transfer service products. In addition, most of the rural MFIs offer some form of micro-insurance. (BWTP 2009)

1.1 Financial Sector in Nepal

Nepal's financial sector includes informal lenders and several institutional forms in the semi-formal and formal sectors, including apex and meso-level organizations. The central bank, Nepal Rastra Bank (NRB) oversees licensed institutions while savings and credit cooperatives are registered with the Department of Cooperatives (DOC). The following sections describe the categories of institutions and list the major players in the microfinance industry.

1.1.1 The Informal Sector

In rural and remote areas Nepal's informal sector has traditionally dominated the credit scene. Of the aggregate supply of rural credit, nearly three quarters comes from informal sources. The World Bank reports that 47.3% of the bottom quintile of the population relies exclusively on informal loans, while the percentage drops to 24.7 in the case of the top quintile. (Majorano 2007)

Moneylenders can be landlords, merchants, goldsmiths, friends or relatives. Friends and family are the informal lenders, providing 84.4% of loans in urban Nepal and 60.5% in rural areas. Other types of moneylenders make up the bulk of the remaining loans in rural areas (33.4%) and a negligible portion in urban areas. (Majorano 2007) Emergencies, such as an illness, or cultural obligations, such as weddings, are typical reasons for using moneylenders. The interest rates are normally high, but simple loan decision making processes, quick delivery of loans, and flexibility in loan size and utilization are among the reasons borrowers use these sources.

Group informal lenders include dhukuti (rotating savings and credit associations), traditional villages groups used by ethnic trading communities for savings and credit, and dharam bhakari. Dharam bhakari are group grain associations in which each member provides an equal contribution at harvest time and can draw from it in times of need. Guthi, similar to dhukuti, are traditional, male-dominated savings groups that use funds for community activities such as festivals. (Bhatta 2001)

1.1.2 The Semi-formal Sector

The semi-formal sector consists of Financial Intermediary Non-Governmental Organizations (FINGOs), Savings and Credit Cooperatives (SCCs) and Small Farmers Cooperative Limited (SFCL) groups that fall between informal lenders

and the formal mechanisms of banks and MFIs. Some of the groups are externally funded, using the Nepal government and international NGOs as fund sources, while others use funds generated by the group members themselves. Internally funded groups tend to be more financially sustainable than those with external funding, and utilize their own funds to cover operating costs. (Bhatta 2001)

1.1.3 The Formal Sector

Members of the formal sector as of 2009 included 23 commercial banks, 79 finance companies 58 development (bikas) banks, 10 microfinance development banks (MFDBs) and 16 financial cooperatives holding Limited Banking Licenses. Of these, only MFDBs, FINGOs, and Limited Banking Licensed cooperatives provide microfinance services directly to the poor. (SKBBL 2010)

Of the 10 MFDBs, five are regional rural development banks (RRDBs), three of which have been privatized. Five are private sector owned banks: i) Nirdhan Utthan Bank Ltd. (NUBL), ii) Swabalamban Bikas Bank Ltd (SBB) iii) Chimek Bikas Bank Ltd. iv) Nerude Microfinance Development Bank Ltd. (NMDB) and v) Deprosc Microfinance Development Bank Ltd. The private MFDBs are performing better than the government promoted RRDBs in terms of outreach, portfolio quality, efficiency and profitability. (BWTP 2009)

1.1.4 Apex Organizations

Four apex organizations exist to supply wholesale funds to retail MFIs. The Rural Microfinance Development Centre, Ltd. (RMDC) and Sana Kisan Bikas Bank Ltd. (SKBBL) are the two largest. The Rural Self Reliance Fund (RSRF), operated by the central bank, offers funds to NGOs, cooperatives and the Agriculture Development Bank of Nepal (ABDN). The National Development Bank provides funds to SCCs. (BWTP 2009)

1.1.5 Meso-Level Organizations

There are several organizations in the Nepali microfinance environment that serve to organize, promote or provide training to MFIs.

RMDC

The Rural Microfinance Development Centre Ltd. (RMDC) began operations in 1998. In its first ten years of operation, it promoted and developed 50 MFIs. RMDC identifies potential institutions, either cooperatives or NGOs operating in Nepal, and assists them through training and technical support to become retail MFIs. It also supplies the MFIs with loan funds. RMDC trains staff at all levels, from field workers through managers to executive committee members. As of December 2007, RMDC had trained 10,100 MFI staff and 365,000 clients. (RMDC 2009)

RUFIN

Rural Finance Nepal (RUFIN) is a joint German-Nepali project that provides technical assistance to the ADBN. It was involved in the transformation of credit groups formed under the Small Farmers Development Program into credit cooperatives (SFCLs). RUFIN also provided assistance in establishing the apex organization that funds SFCLs, Sana Kisan Bikas Bank Ltd. (SKBBL), in 2001.

Centre for Microfinance, Nepal

Centre for Microfinance (CMF), Nepal was established in 2001 as a not-for-profit company. CMF was the result of a project implemented by Centre for International Studies and Cooperation (CECI), and funded by CIDA and the Ford Foundation. CMF acts as a capacity building, research, advocacy and lobbying organization for the microfinance industry in Nepal. It conducts on-going training for microfinance professionals, and organized Microfinance Summit Nepal 2008 and 2010. CMF regularly partners with international non-governmental organizations, and has recently worked to draft legislation for the microfinance and micro-insurance industries in Nepal. (CMF Nepal 2008)

Nepal Federation of Saving and Credit Co-operative Unions (NEFSCUN)

NEFSCUN was established in 1988, and acts as an apex organization for savings and credit cooperatives in Nepal. It offers capacity building support and training to member cooperatives, and provides some retail products, including

software packages and micro-insurance plans. NEFSCUN has 350,000 individual members from 639 cooperatives in 57 districts. (NEFSCUN 2010)

Credit Information Bureau Limited

The Credit Information Bureau (CIB) is an initiative of the Central Bank, established in 1989, registered as a company in September, and operational since March 2005. It acts as a repository of credit information for all banks and financial institutions in Nepal.

1.2 Microfinance Models

In mapping the landscape of microfinance in Nepal, it is important to recognize the models used and their roles in formation and operation of institutions. A number of methodologies are in use by Nepal's microfinance providers. These include the Grameen Bank Model, cooperative model, Small Farmers Cooperative Limited (SFCL) model, village bank model, and community based organizations, or self-help groups. Of these, Grameen Bank, cooperative and SFCL models are the most widely used. Use of the models is often determined by geographic context and population density.

Grameen Bank

The Grameen Bank model was introduced to Nepal in the early 1990s by two NGOs (Nirdhan and SCD), and the five RDMBs. The model is now in use by

numerous MFIs mostly in the Terai region, where the population is dense and where transportation and other infrastructure are relatively more developed than in higher elevations. The Grameen methodology is based on peer groups. Each group has just five members, and three or more groups are organized into a centre. Loans are provided by group guarantee and without physical collateral. Membership is targeted to poor families, who are identified by ranking systems or surveys. Eligible members must attend pre-group training and regular group meetings.

This model is more suitable for use in the Terai zone, where it is easier for members to attend meetings than in the mountains, where transportation infrastructure is poor. Traditional Grameen groups meet weekly and follow the model's regular procedures, while Grameen replicant groups in the hills and mountains have made modifications to suit local conditions and requirements. (BWTP 2009) Most of the FINGOs, microfinance cooperatives and microfinance development banks follow the Grameen Bank model.

Cooperative Model

The Cooperative Act, 1991, allows a group of 25 people from a community to form a cooperative by registering it with the Department of Cooperatives. Savings and Credit Cooperatives (SCCs) are not included under the regulatory framework of the Central Bank, except those that have a Limited Banking License from previous regulatory structures. Cooperative members tend to be

from wealthier families, although membership is technically open to all community members. Average group size is around 100. SCCs are supposed to be self-regulated, but this is often not effective due to lack of cooperative training among the members or shareholders. No higher authority is in place to supervise the SCCs, and as a consequence most of them do not have proper accounting, sound management or good governance. (BWTP 2009) Recently, in a move towards sustainability, NEFSCUN has encouraged cooperatives to expand their range of products and welcome poorer members.

This model has worked well in hill and mountain areas. It provides both savings and credit services through local people in a familiar atmosphere without too much bureaucracy. Due to low operating costs, interest rates are also lower than other financial institutions. (RMDC 2009)

Small Farmer Cooperative Limited (SFCL) Model

This cooperative model was developed in 1993 by ABDN with technical support from the German Agency for Technical Cooperation (GTZ), and seven years of action research. Its institutional structure has three tiers: credit solidarity groups at the village level, an inter-group at the ward level, and a main executive committee at the institutional level. Members of each of the three tier groups form the executive committee. Credit groups organize regular meetings where they collect savings and loan instalments. Each SFCL generally confines its services to one village development committee (VDC), and has on average

around 500 members. Loans are granted with or without collateral. (BWTP 2009)

Latin American Village Bank Model

The village bank model was used by USAID from 1998 to 2001 in PACT Nepal's Women Empowerment Project (WEP). (Ashe 2001) The model uses community-managed credit and savings associations designed to provide financial services to women in rural communities regardless of social or economic status. The village bank is formed by a group of 40-50 women who receive preliminary literacy and savings training for six months. Women then use members' savings as loans among the group for productive or consumption activities. This model is not widely used in Nepal. RMDC states that rigid operating modality prevents them from partnering with villages banks, which in turn have not had a strong focus on their operational sustainability, and are therefore gradually disappearing. (BWTP 2009)

Self-help Groups (SHGs) and Community Based Organizations (CBOs)

These informal savings and credit groups may be promoted by different programs and projects and can be transformed into formal groups as credit cooperatives or FINGOs. The United Nations Development Program's Local Governance Strengthening Project has used small revolving funds with CBOs. There have been sustainability issues with these groups due to the influence on their activities by village development and district development committees. The

project is trying to link groups with banks and financial institutions to increase their institutional sustainability. (Majorano 2007) In a similar project, the government of Nepal, with the support of the World Bank, has been providing funds for lending through the Poverty Alleviation Fund (PAF) to local CBOs, in amounts up to NRs 5 million per village development committee. With these projects, there is the fear that subsidies will create a dependency among the rural families. (BWTP, 2009)

SHGs can also include aama samuha (mothers' groups). These groups are generally formed with one or more social change objectives, such as campaigns against alcoholism and girl trafficking. The groups pool savings and provide credit to members, but their activities are not necessarily targeted to the poor, and they are not linked to any formal financial institutions. They are very common in the hills and mountains, particularly in western Nepal. (RMDC 2009)

2: SOCIAL GOALS OF MICROFINANCE IN NEPAL

Microfinance institutions are different from traditional banks by their social mission. Microfinance in Nepal is not entirely a commercial venture. Even the largest institutions retain a social mission, specifically poverty alleviation, often empowerment of women, and less often, economic inclusion of a caste or ethnic group in the local community. In Nepal, social exclusion by caste or ethnicity has been shown to be the most powerful predictor of poverty. (World Bank/DFID 2006, Niimi 2010) This section seeks to analyze how well microfinance in Nepal has fulfilled its social goals.

2.1 Poverty Alleviation

The spread of microfinance institutions in Nepal, number of borrowers, savings collected and loans disbursed are all taken as evidence that poverty is being reduced in Nepal. Outreach figures are an imperfect measure of poverty alleviation. Even so, if we consider outreach alone, the impact of microfinance on poverty alleviation seems minimal. Despite microfinance services reaching 1,778,762 members in July 2009, (see Table 1) it is estimated that about 10 million people in Nepal needs microfinance services. Microfinance has reached only 18% of the target population in Nepal. (SKBBL 2010)

Table 1: Outreach of Microfinance in Nepal, July 2009.

Type of MF Institution	No. of institutions	No. of members	Savings mobilization in millions NRs.	Outstanding loans in millions NRs.
MFDB	13	547,435	1766	5992
FINGO	45	381,392	1317	2394
SFCL	225	145,419	1304	2302
SCC	5161	714,516	16247	13634
Total	5444	1,788,762	20,634	24,322

Source: SKBBL (2010).

It is commonly stated in Nepal that to alleviate poverty, microfinance must reach the very poor, those referred to as the ultra-poor, the hard-core poor, or the poorest of the poor. This statement assumes that allowing the very poor access to microfinance will have an impact on income generation and contributes to poverty alleviation. However, when the very poor are able to borrow, their small loans are seldom invested in new technology, fixed capital or hiring labour. (Mosley 2009) Instead they may be used for consumption or working capital. The very poor are often in poor health, malnourished and lack the skills and opportunities to create employment. (Robinson 2009) It is an oversimplification to state that access to credit alone can lift the poor out of poverty.

Nepal's very poor are concentrated in rural areas, in the hills and mountains where the population is sparse, infrastructure is poor, and access is difficult. It is well recognized in that the very poor in remote areas are not being reached.

(Pandey 2010) Critical to the argument for microfinance in Nepal, these poor are excluded from formal banking services not only by their lack of capital, but also by lack of physical access to financial services. (NUBL 2010)

No literature exists for the systematic effect of microfinance on poverty alleviation in Nepal. If we look for evidence other than outreach figures, there is only program level data to show whether microfinance impacts poverty. Impact assessment of programs, however, compares results to the alternative of doing nothing. Research is not available to demonstrate empirically whether microfinance clients are able to raise their incomes more than non-clients with similar access to funds. (Bateman 2010) Therefore, this paper will review a study of the factors that are linked with poverty alleviation in Nepal, and discuss literature about the obstacles of delivering microfinance to the very poor.

2.1.1 State of Poverty Alleviation in Nepal

The major source for data about poverty in Nepal is the Nepal Living Standard Surveys of 1995-6 and 2004-4 (NLSS I and II). Analysis of this data shows that while poverty was reduced during the period, economic growth was not inclusive. Overall, poverty incidence fell from 42% in 1995-1996 to 31% in 2003-2004. At the same time, the measure of inequality using the Gini coefficient rose sharply from 34.2 in 1995-1996 to 41.4 in 2003-2004. There was a tendency for well-off households to benefit more than poorer households. Urban areas showed a greater reduction in poverty than rural areas (56% and 20% respectively), despite

the fact that the poverty headcount was higher in rural areas. Only 3% of the population in Kathmandu (and 13% in other urban areas) was still under the poverty line in 2003-2004, compared to 35% of the rural population. (Niimi 2010)

Could microfinance have contributed to moving households out of poverty? The study determined that the major factors that helped households move out of poverty were: educational attainment, land ownership, access to irrigation, occupation in the non-agricultural sector, and receipt of remittances. When changes in inequality were considered by occupation of household head, an increase in skill premiums was observed from 1995-1996 to 2003-2004. Even after controlling for other factors, however, Dalits (formerly known as untouchables) were less likely to move out of poverty than other caste or ethnic groups. (Niimi 2010)

Research is required to determine to what extent microfinance can provide access to factors known to contribute to poverty alleviation: education, land ownership, access to irrigation and non-agricultural employment. When searching for mention of contributing factors in existing literature on microfinance, we find educational and overseas employment loans for offer on the NUBL website and a longstanding irrigation project bundled with microfinance (NRB 2008). This suggests that microfinance institutions recognize these factors and have developed products and programs that support them. However, research is not available to determine their impact on poverty alleviation.

2.1.2 Obstacles facing poverty alleviation:

While CGAP global best practices for MFIs exist, it is not always known what works best in the context of Nepal. Microfinance professionals in Nepal have identified a number of difficulties in reaching the poorest of the poor. Included are the high costs of running programs; the lack of infrastructure, low population densities, distances between settlements and rough terrain of the hills and mountains. (Pandey 2010) It must also be recognized that program design, products and services need to be tailored to conditions in Nepal. They must accommodate not only geographic differences but accommodate ethnic and caste differences that cause borrowers to be excluded from groups. They must also tailor loan size and repayment schedule to accommodate for return on investments in the agricultural sector. (ADB 2009a)

Niimi (2010) found that well off households benefitted more from the change in poverty levels between in 2003-4. Without careful policy and program design, MFIs may exclude the poorest of the poor through self-selection of better off borrowers within groups. First, group selection is fundamentally biased favouring those who appear to be the least risky and most profitable clients. (Bateman 2010) In addition, borrowers have a tendency to self-select for group members of similar economic background and status (Fernando 2006). MFIs in Nepal, notably cooperatives, often reach relatively wealthier clients. (BWTP 2009) Cooperatives have been shown to be negligibly inclusive of Dalit individuals (the poorest demographic group) in their staff, management and boards, while Dalit

individuals often self-exclude from cooperative membership. (Man 2009) The effect of this selection is to concentrate microfinance services among those better off, with other forms of capital, and exclude the poorest of the poor. (Rankin 2002)

Furthermore, although microcredit programs are extended to those without traditional collateral, MFIs use social capital (Rankin 2002) and local information about borrowers (Armendaiz 2010) as guarantees of repayment. Reliance on peer group pressure as repayment guarantee does not mean that credit checks of another sort are not performed. Group leaders and NGOs may use other assessments of wealth such as household inventories to assess creditworthiness, again excluding the poorest of the poor and concentrating the benefits of microfinance in wealthier households. (Fernando 2006)

An Asian Development Bank (ADB) evaluation of rural microfinance in Nepal found the ultra poor taking agricultural loans might not be using loans for productive purposes. One reason for this was that repayment was due one month after disbursement, too soon to allow any returns on the sort of investments made possible by microcredit. (ADB 2009a) As is often reported (Shakya 2008, Mayoux 2009, Fernando 2009, Mosley 2009) the poorest of borrowers did not use their loans for business development, according to the purpose of the loan, but instead used them for daily expenses, taking a loan from a moneylender or second MFI to repay the first. (ADB 2009a) It has been

questioned whether loans for small business can reach the poorest of the poor or hard-core poor, whose needs are more directly related to consumption and basic needs. The very poor are often not healthy or well nourished enough to engage in entrepreneurship, nor do they necessarily have skills or employment opportunities. In these cases, subsidies may be a more appropriate intervention than microcredit, which may follow later. (Mayoux 2009, Robinson 2009)

2.2 Social Inclusiveness and Microfinance

Inclusive growth both generates economic opportunity and ensures equal access. Growth is therefore considered to be inclusive when all members of a society equally participate in, contribute and benefit from it. (Ali 2007) Gutierrez-Nieto (2009) identifies those without financial services as an excluded group. Grameen model microfinance, women's savings and credit cooperatives and NGO-employed village bank models have done much to include women as productive members of Nepal's formal economy. There is less known about the impact of microfinance programs on excluded caste and ethnic groups. However, it is acknowledged that exclusion is a formidable obstacle to development in Nepal, and caste is the most powerful predictor of poverty. (World Bank/DFID 2006)

2.2.1 Caste, Ethnicity and Poverty in Nepal

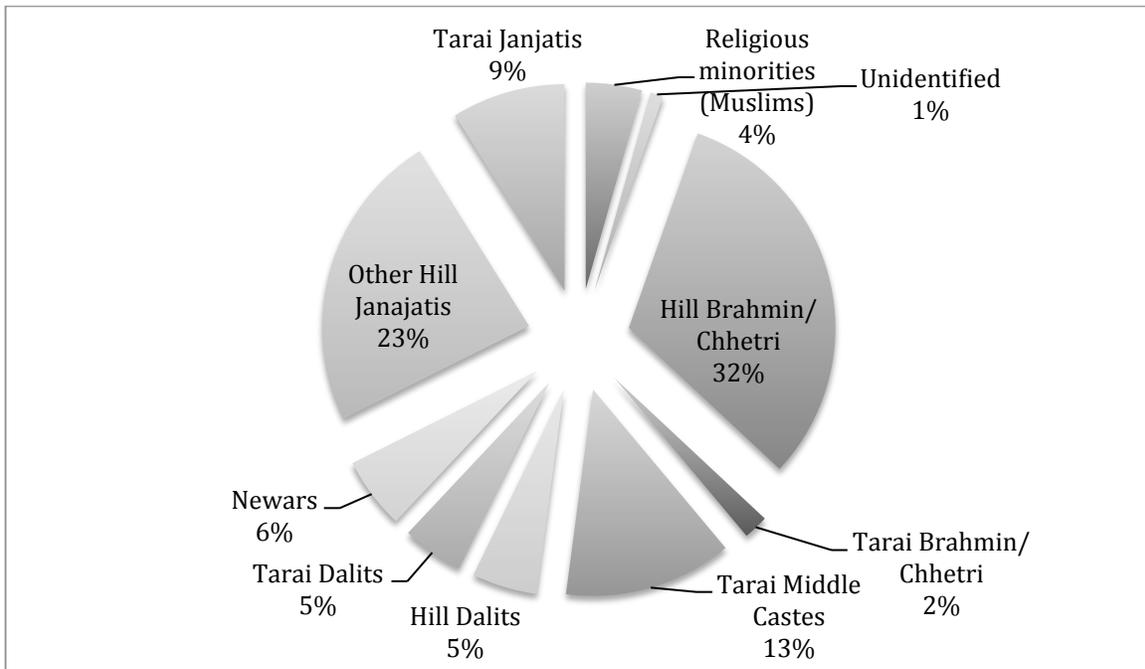
Poverty also frequently overlaps and reinforces other types of social exclusion, such as those based on race, gender, or ethnicity. (World Bank/DFID 2006)

Inclusiveness is not always considered when analysing performance of MFIs, but is a significant factor in Nepal, where Hindu castes and a large number of ethnic groups create the opportunity for exclusion.

The 2001 census listed 103 social groups based on caste, ethnicity, language and religion. A Gender and Social Exclusion Analysis (GSEA) performed by the World Bank placed 57.5% of the total population under the broad category of Hindu caste groups, 37.2% under Janajatis, 4.3% as Muslims and 1% as others. (See Figure 1.)

Within the Hindu caste groups, there are 3 main divisions: i) higher caste groups, referred to commonly as Brahmins and Chhetris, ii) the middle castes of the Tarai, and the (composed of several subgroups) and iii) the Dalits (formerly referred to as untouchables or outcastes). Among the Janajati, there are 3 divisions: i) the Newar (indigenous people of the Kathmandu valley with their own caste system), ii) Hill Janajatis, and iii) Tarai Janajatis.

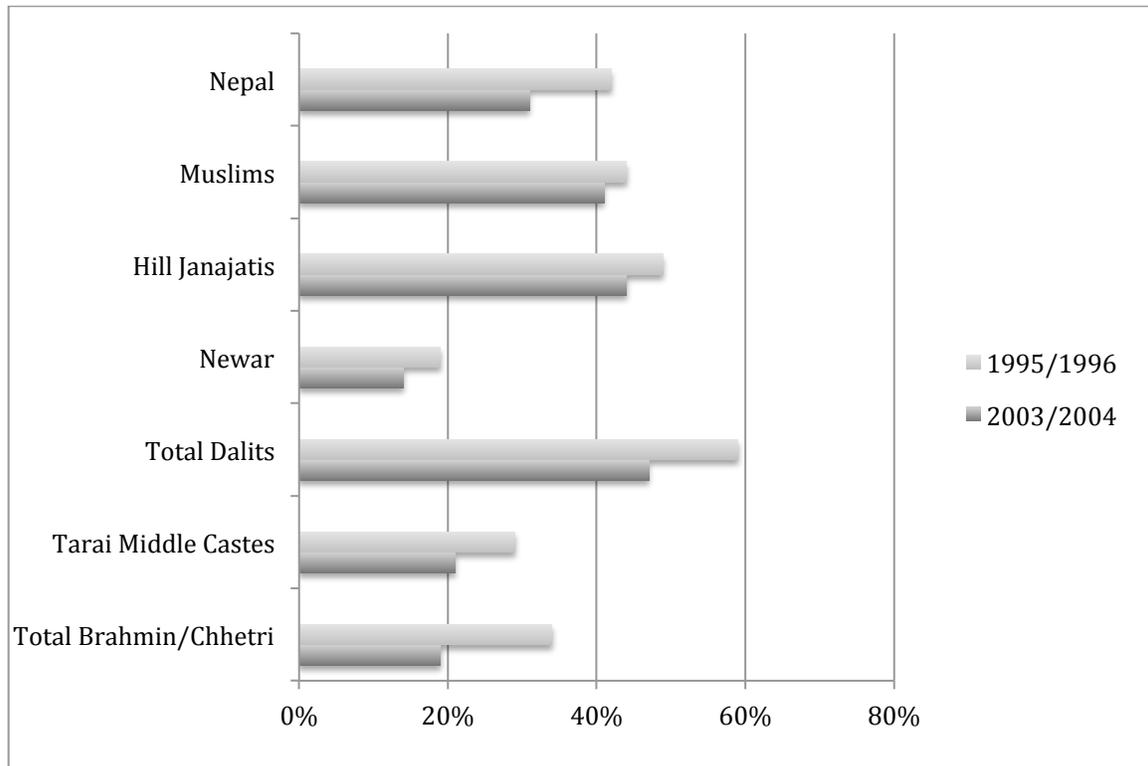
Figure 1: Percentage Composition of the Nepal Population by Caste/Ethnicity



Source: World Bank/ DFID (2006).

Nepal Living Standards Survey II, 2003-2004 revealed that the Brahmin/Chhetri and Newar groups had the fewest households living in poverty. Almost half the Dalits lived in poverty during the same period, while Hill Janajatis and Muslims had a poverty incidence significantly higher than the national average. (See Figure 2) The GESA performed by World Bank concluded that certain groups paid a penalty in terms of lower household per capita consumption because of their caste, ethnic or religious identity. (World Bank/DFID 2006)

Figure 2: Incidence of Poverty by Caste, 1995-1996 and 2003-2004



Source: World Bank/DFID (2006).

The GESA carried out a separate survey to measure and analyse the relative empowerment and social inclusion levels of a sample of one man and one woman from each of 1000 households in 60 villages. The survey found that Brahmin/Chhetris and Newars (BCN) scored highest on both empowerment and social inclusion, and Dalits scored lowest. Janajatis were between the two groups, scoring closer to BCN in some measures of livelihood empowerment, but closer to Dalits with respect to other measures. In all groups men scored higher than women, but women from non-Dalit groups scored higher than Dalit men. Overall, caste and gender together were found to account for 1/3 of the variation

in empowerment and inclusion levels. Significantly, caste was a more powerful predictor than gender.

2.2.2 A Case Study of inclusion in Microfinance Cooperatives

Much consideration is given to gender in microfinance, as women make up the largest portion on the poor worldwide. (Daley-Harris 2009) Findings from the NLSS II survey show that Dalits compose the highest proportion of the poor, followed by Janjati, or ethnic people. It is significant, however, that caste was a greater predictor than gender of empowerment and inclusion levels. (World Bank/DFID 2006) The concept of social inclusion is largely absent from the literature about microfinance in Nepal. NGO programs, however, often target Dalit or Janajati populations in their microfinance programs. This is not always the case with SCCs or commercial MFIs.

Dalits, sometimes called untouchables, form the lowest group in the Hindu caste hierarchy. A 2007 study using a sample of 420 microfinance cooperatives (MFCs) registered with Nepal Federations of Savings and Credit Cooperative Unions (NEFSCUN) and 169 Small Farmers' Cooperatives revealed the complex nature of Dalit exclusion. Social Inclusion Factor (SIF), a measure that incorporated governance, management and outreach, was used to assess 58 of the MFCs. 84.8% of the MFCs were found to be negligibly inclusive, 7% less inclusive, and 2% moderately inclusive. None of the MFCs was found to be

highly inclusive. Dalits were represented in only 4% of the staff, 3% of the governance, and 1% of the management. (Man 2009)

Although it did not specify best practices, the study found institutional factors that affected inclusion of Dalit members were policy framework, credit methodology, product mix and design, nature and source of lending, social structure of the locality, age of the cooperative and demographic of the locality. Factors that influenced inclusion of Dalits on the individual level included self-exclusion, exclusion by staff, exclusion by other members, and exclusion by program design. (Man 2009)

The study included a field survey of 314 clients (198 Dalits and 116 non-Dalits) and 97 non-clients revealed that microfinance cooperatives were more successful in reaching the middle class and those belonging to upper castes. Barriers affecting inclusion of Dalits in MFCs were the membership of the executive committee, low educational levels that prevented employment, and stigmatization due to cultural background. As well as being excluded for reasons of caste, the poorest individuals were excluded due to physical and economic barriers. Many lived in remote areas with no access to financial services. Where services were available, mandatory attendance at weekly or monthly meetings was prohibited by the cost of transportation or the opportunity cost of attendance. Furthermore, the very poor were socially intimidated, and believed that microfinance products and services were not suitable to their needs. (Man 2009)

More research needs to be conducted in Nepal on social inclusion in microfinance programs. NGOs operate programs targeting Dalit and Janajati individuals at the community level, but little is known about inclusion in retail microfinance institutions.

2.3 Women's Empowerment and Microfinance in Nepal

Of the 106.6 million poorest clients reached by microcredit worldwide at the end of 2007, 83.2%, or 88.7 million are women. (Daley-Harris 2009) Women are targeted for microfinance because of higher levels of female poverty and because of women's role in household wellbeing. (Mayoux 2009) On a global basis women are reported to have higher loan repayment rates than men (Cheston 2002) and are considered a lower credit risk. The Small Farmer's Development Bank reports that as of mid-July 2009, the Nepali microfinance industry served 1,387,043 female clients, and 401,719 male. According to these figures, 77.5% of microfinance clients in Nepal are women. (SKBBL 2010)

It widely accepted that women contribute a greater proportion of their incomes to household welfare than men, (Kabeer 1994) making them a more efficient means of distributing benefits of economic growth. It is theorized that because women have access to fewer alternative sources of credit, they are more likely to select themselves into microcredit programs with conditions such as small initial amounts, training sessions and, weekly meetings and joint responsibility. Where

women lack the opportunity to access labour markets, they will value self-employment opportunities and have stronger incentives for paying loans. (Emran 2007)

International NGOs and multilateral organizations focus on gender equality as a social goal. Efficiency however, rather than gender inequality, was the motivating factor in the adoption of microfinance as a rural development strategy in Nepal. The use of solidarity in self-regulating groups of borrowers was intended to reduce administrative costs and motivate repayment. (Rankin 2002) The issue in Nepal's rural finance development was not women's rights to access capital, but rather how to utilize women's capacity to undertake local development. (Rankin 2007) Gender inequality, although important to donors, is a culture-specific concept that in Nepal is considered inappropriate for outside intervention. (Mayoux 2009)

Despite this, Nepali MFIs and NGOs readily use the term "women empowerment" [sic] as a goal for microfinance programs. In the context of Nepali microfinance programs, empowerment for women is intended as the enabling of individual decision about savings and credit use, the capacity to set up microenterprise, and the increased ability to control income. The expectation is that through individual economic empowerment, women will gain greater wellbeing and ultimately act to achieve social and political empowerment. (Mayoux 2009) It is not only empowerment of individual women that is thought to bring change. The

effect of group lending programs with their focus on empowerment through entrepreneurial activity, combined with solidarity among a group of like-minded women is thought to lead to formation of institutions and broader social change. (Fernando 2006, Rankin 2001) Is this the case in Nepal?

If individual decisions about savings and credit use are a means for women to gain empowerment, the question arises whether women in Nepal retain control of the income they earn through microenterprises. Does the income they earn come under the control of male household heads? Rankin's finding among the Newar community in Nepal was that while women assisted in all aspects of household enterprises they did not generally assume primary decision making roles within these enterprises or control and manage earnings from them. Rankin concluded that targeted lending strategies that were intended to create social opportunity demonstrated a failure to articulate effectively with the cultural contexts to which they were targeted. Social opportunity for women could not be reduced to the simple matter of capital access. (Rankin 2001)

In contrast, there is survey-based evidence that Nepali women's participation in microfinance programs can increase their decision making power. The Women's Empowerment Program, a USAID village bank model program that operated in Nepal from 1998-2001, conducted a survey that showed an average of 89,000 out of 130,000 (68%) of women in its program experienced an increase in decision-making roles. Decision making power increased in areas normally dominated by

men, including family planning, children's marriage, buying and selling property, and sending daughters to school. (Ashe 2001)

Impact analyses of microfinance programs are generally based on quantitative indicators such as number of women borrowers and loan repayment rates, not qualitative research of the sort described above. Quantitative analysis does not provide information about institutional processes through which outcomes are achieved (Fernando 2006) or social changes that might result. Most studies have not considered whether women's high repayment rates result in empowerment or have any impact on gender relations. Instead, they consider repayment and increases in productivity as a proxy for empowerment. While women's efficiency in repayment may have any number of causes, no study has yet considered if it has resulted in any change in the institutions that are oppressive to them. (Fernando 2006)

In fact, it is argued that the institutional relations women experience upon joining microcredit programs may in fact be impediments to individual empowerment. The use of peer group pressure to ensure loan repayment can strengthen or weaken institutions that are oppressive to women. (Fernando 2006) The policing function of Grameen style groups in Nepal was found to mitigate possibilities for solidarity and sometimes exacerbate existing inequalities. (Shakya 2008) Because of group responsibility for loan repayment, individual households are afforded less autonomy from the larger society. (Fernando 2006) Shakya and

Rankin (2008) found that while group lending in Nepal allows some women gain access to credit, it is not without significant social costs. It constrains as much as it creates opportunity in mobilizing and generating social capital. (Shakya 2008)

While Shakya and Rankin (2008) see a 'resubjectification' of women in the group-lending practices of Nepal, they also see a borrower non-conformity they consider "more than resourcefulness but not quite resistance". The practice of using loans for non-productive purposes and 'loan-swapping'¹ is a subversion of development technology that reveals a capacity for innovation that might be instructive in reshaping the politics of development.

Rankin's (2007) observation that women were chosen to deliver rural development finance because they were more efficient at distributing funds than men indicates that the empowerment of women is a secondary goal of microfinance. Mayoux (2009) notes that of the three competing paradigms of microfinance (financial sustainability, poverty alleviation and women's empowerment), women's empowerment takes last place.

Therefore it is not surprising that microfinance in Nepal has inconclusive impacts on women's empowerment. It does not specifically address the Western concept of gender inequality, nor is there consistent evidence that women have gained decision-making power. Women are, however, gaining access to financial

¹ Loan swapping refers to the practice of sustaining long-term debt financing by borrowing from multiple sources and repaying credit with debt. (Bateman 2010)

services and finding room to manoeuvre within the model to suit their purposes. The question is whether women are bearing the high cost of borrowing and paying off debt with more credit, certainly without becoming empowered or even raising household incomes. Some believe high loan volumes and repayment rates conceal the failure of the model to generate real change, while the whole system rests on ever-expanding cycles of debt. (Shakya 2008) Further research is required to determine precisely how loans to women in Nepal are being used.

3: ASSESSMENT OF MICROFINANCE INSTITUTIONS IN NEPAL

The lack of consistent and reliable data collection in MFIs has been partly a due to the myth of microfinance as a panacea and the fundamental assumption that it works, based on the successes of individual programs. (Morduch 2009) Most large scale MFIs in Nepal have data management systems, but lack the technical capability to properly operate them. (Ferrari 2007, Mercy Corps 2008)

Furthermore, staff with high client loads feel they do not have the time to collect data, nor do they recognize its value. (Kerer 2008)

It is a common concern among donors worldwide that reliable data about the financial and social performance of MFIs is unavailable, or that available data is not standardized. In many cases MFIs cannot be ranked and compared against a benchmark, as is common practice for traditional banking institutions.

(Gutierrez-Nieto 2009) This has been damaging to the microfinance industry in Nepal, which still views microfinance as a charitable activity, has relied heavily on DPSSL as a source of funds and has not positioned itself to attract international investment. (Tazi 2008) A higher level of transparency in the industry would allow for better mechanism for funds allocation, to the benefit of donors and investors. (Tucker 2001) Microfinance Association of Nepal (MIFAN), the

Grameen Network Nepal (GNN) and Nepal Microfinance Bankers Association (NMBA) have all been formed as attempts to organize the microfinance industry in Nepal, but none has been successful. There is no national agency that rates Nepali MFIs, although MIX lists Micro-Credit Ratings International (M-CRIL) ratings for the MFIs reporting to its database. Wholesale lenders must generally conduct their own appraisals of applicant institutions before lending funds. (BWTP 2009)

3.1 MIX 2006 Microfinance Bank Benchmarking

Microfinance Information eXchange (MIX) conducted the first benchmarking exercise for Nepali microfinance banks using 2006 data from 18 institutions: 9 retail microfinance banks (MFBs), 4 microfinance development banks (MFDBs) and 5 regional rural development banks (RRDBs). This event was a major step in the legitimization of Nepali MFIs, and tells us much about the strength and weaknesses of the industry when compared to a global standard. The sample represents only a portion of the MFIs licensed by NRB (see Table 6) and is restricted to MFIs with women clients. An analysis (Tazi 2008) showed that outreach by MFBs was limited, and there was considerable room for expansion using funds provided by the Deprived Sector Lending Program. The analysis found that Nepali MFBs have low operational costs that could allow for increased profits, but need to ensure sustainability by increasing portfolio quality to lower risk and strengthen revenue streams.

It was recommended that all MFBs (RRDBs in particular) abandon the view of microfinance as a charitable enterprise and adopt appropriate product-pricing policies that cover direct costs of service and provide for provisioning and funding expenses. (Tazi 2008) Although interest rates for loans to microfinance clients are not regulated in Nepal, small MFIs have argued that the government policy of posting interest rates forces rates so low that they cannot cover costs of service provision. (Mercy Corps Nepal 2008)

Nepali MDBs faced obstacles to growth in political instability and challenges posed by the Maoist Insurgency. Government-affiliated Regional Rural Development Banks (RRDBs) in particular faced threats to personnel, looting and property damage from Maoist insurgents. (Tazi 2008)

Due to their branch networks and high staff productivity, the nine retail MFBs were responsible for four-fifths of all the 376,000 borrowers reached by the sample. Growth of the smaller MFBs in the sample was limited by competition in the Terai and urban areas, and the rough terrain and low population density of Nepal's underserved hill and mountain areas. Still, average growth in the 2006 fiscal year was 27%. The MFDBs grew the most at a median 34%. The RRDBs experienced stagnation, partly due to undergoing a privatization process, but also due to losses from Maoist insurgent activity.

Average loan balance for all institution types in the sample was USD 137. This figure was 1/3 the global benchmark, but represented half the local income level. This indicated that MFIs were not properly supplying the low-income market segment, or the poorest of the poor. This figure might also reflect the weakness of the industry outside urban areas. (Tazi 2008)

Analysis recommended that MFB expand into the savings market. Despite mandatory savings practices in Grameen model banks, Nepali MFBs reach only half as many depositors as lenders. Unlike many other South Asian countries, Nepal's regulations allow MFBs to collect savings. Adapting products and services to meet client needs would allow MFBs to attract new customers to microfinance and provide a source of funds, decreasing dependency on deprived sector lending funds. (Tazi 2008)

Priority Sector Lending has created a heavy reliance on borrowed funds. (Mercy Corps 2008, Tazi 2008) Nepali MFIs operate with very little capital reserve and raise 13.5 times their equity in debt. South Asian MFIs typically raise 4.2 dollars in debt for every dollar in equity, compared to 2.6 dollars at the global level. (Tazi 2008)

MFBs in the MIX 2006 sample invested a large portion of assets in activities other than microfinance. MFIs generally stayed under two-thirds of resources allocated to portfolio, much less than the 79% typical in South Asia. The

availability of other investment options diverts funds from microfinance service provision. This may be due to a tendency for MFIs to cater to lenders seeking safer investments. Deprived Sector Lending requirements in 2006 lacked a provision specifying that funds invested in MFIs be on-lent to clients. (Tazi 2008)

MFIs in Nepal generally earn the lowest revenues in South Asia, 12% compared to 18% of assets for a typical South Asian MFI. Lower interest rates charged to clients and low allocations of funds to the loan portfolio contribute to the low revenues. Nepali MFBs have lower operating costs than typical in South Asia. Only 5% goes to personnel costs, and 1.3% to administrative expenses. They spend 11 cents to manage each dollar of loans, compared to 17% typical in the region. Most of the MFBs are profitable or nearing the break-even point, but return on assets was only 0.1%. The low interest rate structure in Nepal and the need to spend 5 to 7% to secure funds from the Deprived Sector Lending Program for on-lending requires MFBs to keep costs of service provision low. (Tazi 2008)

Nepali MFIs could be more profitable through improvements in portfolio quality. Portfolio at risk stands at 4.7%, the highest of the South Asian Region. The median loan loss ratio for Nepali MFBs was 4.2%. Client default is responsible for draining revenue stream, particularly for the RRDBs, where Maoist calls to farmers to default on loans caused an average 12% portfolio loss over the year. MFBs need to enhance portfolio tracking systems and adopt best practices for

writing off delinquent loans to better comprehend their portfolio quality and better address risks. (Tazi 2008)

3.2 Social Performance Measurement

Social performance measurement of MFIs is important to multilateral agencies, donors and social investor. Beyond simple outreach measures, social performance measurement reveals how social goals are being met. There are several tools available for social performance measurement (SPM) in various contexts. Such tools aim to measure MFI adherence to social mission, governance, environmental and social responsibility, enterprises and employment created, and human resource practices, among other factors.

Unlike financial performance, there is no standardized methodology to measure MFI social performance. (Gutierrez-Nieto 2009) In depth analysis of microfinance program depth of outreach can be prohibitively expensive. Institutions may use simpler tools or incorporate social performance measurement into existing monitoring systems. (Isern 2008) Nirdhan Utthan Bank Limited (NUBL), for example, includes client empowerment monitoring in its customer service data management system. This time-consuming and potentially invasive process meets some resistance with staff and with customers. In addition, management information systems, when available, are costly and MFI personnel lack the capacity to use them. (Kerer 2008). The costs of collecting and analysing data,

therefore, appear to be the principal reason there is no systematic measurement of social performance data in Nepal. No Nepali MFI, including NUBL, has yet reported its social performance to MIX market.

Investors expect transparency and full disclosure of both financial data and social performance to ensure that their donations alleviate poverty in a socially responsible way. In the absence of information about MFI social performance, investors may turn to the relatively few large and high profile MFIs offering high financial returns, even though other MFIs may yield higher combined social and financial returns. (Kerer 2008) Furthermore, SPM is important in overcoming the reliance on DPSL funds. Microfinance is under increased scrutiny and competes for public and private funds. Commercial banks in Nepal may soon enter the microfinance market for profit or risk diversification. It is important for MFIs to measure their social performance to justify their higher operation costs and interest rates to politicians and the public. (Kerer 2008)

3.3 Sustainability and Social Efficiency Assessment

A modified version of the Yaron (1994) framework used to assess sustainability and outreach of rural financial institutions (RFIs) is generally used to assess MFIs in Nepal. (Gutierrez-Nieto 2009) Success for MFIs is not determined through quantifiable measures of profit, as it is for traditional financial institutions. (Yaron 1994) As is the case with rural finance institutions, it is desirable to

reduce or eliminate dependence on subsidies. The focus is on sustainability, using ratios to calculate operational self-sufficiency, return on assets, and return on equity. The Consultative Group to Assist the Poor (CGAP) has set guidelines for microfinance financial analysis terms, ratios and adjustment, based on the framework Yaron describes. Centre for Microfinance, Nepal, regularly conducts financial analysis training sessions for microfinance professionals based on CGAPs guidelines.

Many of Nepal's MFIs perform financial analyses for internal purposes, but do not generally make public reports of their findings. Centre for Microfinance, Nepal (CMF) facilitates data reporting for most Nepali MFIs that report to Microfinance Information eXchange (MIX). None of the Nepali MFIs reporting to MIX provide social performance data.

Of the three paradigms of microfinance, (financial sustainability, women's empowerment and poverty alleviation) some argue that financial sustainability is prioritized, often to the detriment of women's empowerment in particular.

(Mayoux 2009) Dependency on subsidies and grants to cover operating costs is increasingly discouraged. Nepali MFIs are encouraged by meso-level organizations to perform financial analysis and strive for operational self-sufficiency. This does not mean that social goals are abandoned in the name of sustainability. A study found that institutions chose financial efficiency over social efficiency in order to ensure that they could continue their social mission.

For this reason, socially efficient MFIs are also financially efficient. (Gutierrez-Nieto 2009)

Gutierrez-Nieto et al. concluded that NGOs are more socially efficient than MFIs operated under other organizational structures. For MFIs following all models, no relationship was found between profitability, age and information disclosure and social efficiency. (Gutierrez-Nieto 2009) The study determined that although NGOs are more likely to emphasize a social mission than other types of MFIs, they are equally driven to ensure sustainability, and are likely equally financially efficient. (Gutierrez-Nieto 2009) NGOs, however, are often small-scale operations with capital constraints and limited outreach. (Robinson 2009)

3.3.1 Social Efficiency Assessment of MIX Data

MFIs use the number of active borrowers as an indicator of outreach breadth. The assumption is that an MFI making loans to a larger number of clients is more successful in reaching the poor. But not all borrowers need to be poor. (Gutierrez-Nieto 2009) Furthermore, small loans may not be exclusive to the very poor. Some clients such as petty traders and small enterprises take small loans for high margin, quick turnaround investments. (Morduch 2009) Some MFIs, such as NUBL, screen clients to ensure that they fall within a target level of poverty, but this is not always the case. Nonetheless, MIX uses 'average loan balance per borrower' as an indicator of commitment to poverty reduction. The

smaller the average loan balance, the more likely it is that loans are being made to the very poor. (Gutierrez-Nieto 2009)

'Average loan balance per borrower' is divided by 'per capita Gross National Income' to better reflect the local value of the loan. (Gutierrez-Nieto 2009) MIX routinely reports this figure for every MFI.

$$K = \frac{\text{average loan balance per borrower}}{\text{pcGNI}}$$

From the MIX 2006 data, the 10 MFIs reaching the poor most effectively by making the smallest average loans (lowest K) were equally divided between profit and non-profit status. (See Table 2) Of the top 10 small loan providers, only one was a bank. Five had the legal status of NGO, and 4 had the status of non-bank financial institution (NBFI). Of these 4, SOLVE describes itself as an NGO, BAYOCA is a youth club organization, JVS a life development centre, and SCDC a community development centre. In other words, nine of ten of the MFIs that reached the poorest individuals had a social mission.

Table 2: 2006 MFIs with Lowest average Loan Balance per borrower/GNI per capita (K)

MFI Name	Current legal status	Average loan balance per borrower (USD)	Average loan balance per borrower / GNI per capita (K)	Number of active borrowers	Loans to poorest indicator
UNYC	NGO	30.49	0.0953	191	1.00
SOLVE	NBFI	38.31	0.1197	1698	0.99
CSD	NGO	46.89	0.1465	21593	0.99
BAYOCA	NBFI	53.13	0.166	1832	0.98
JVS	NBFI	54.66	0.1708	8415	0.98
NRDSC	Bank	67.84	0.212	18473	0.97
Mahuli	NGO	68.1	0.2128	4430	0.97
CYC	NGO	70.51	0.2203	1402	0.97
FORWARD	NGO	72.09	0.2253	11842	0.97
SCDC	NBFI	79.34	0.2479	1402	0.97

Source: MIX: www.mixmarket.org, 2011

Gutierrez-Nieto et al calculated p to standardize the value of K between 0 and 1, where a value near to 1 indicates an institution lends to the poorest. Each institution is represented by i and $\min K$ is the minimum value over all K . Range (K) is the maximum value of K over all i minus the minimum value of K over all i .

$$P_i = 1 - \frac{K_i - \text{Min}(K)}{\text{Range}(K)}$$

An indicator that reflects the most loans of the lowest value is obtained by multiplying p for each institution by the number of active borrowers for that institution. (Gutierrez-Nieto 2009) (See table 3) When analysed in this way, Nirdhan (NUBL) emerges as the most efficient institution in providing the most loans to poor borrowers. The average loan per borrower at NUBL is USD

125.77, slightly less than the average of USD 137 and far more than the USD 30.49 average loan at UNYC. The larger number of active borrowers at NUBL (54,923) compared to UNYC (191) means its overall impact is greater, even though it is likely reaching households and individuals who are not members of the hard-core poor. UNYC's website states that its social mission is to reach the very poor, particularly Dalits and ethnic Tharu people. Its low loan amounts reflect the needs of its clientele, who are offered general loans under a group model. The low numbers served likely reflect capital constraints of the NGO and the methodology, which uses pooled savings for lending.

Table 3: 2006 Top Ten MFIs Reaching Poorest Borrowers

MFI name	Current Legal Status	Average loan balance per borrower (USD)	Average loan balance per borrower/ GNI per capita (K)	Number of active borrowers (n)	Loans to poorest indicator (p)	Loans to most poor borrowers (p*n)
Nirdhan	Bank	125.77	0.393	58679	.936	54,923
GBNB	Rural Bank	155.4	0.4856	51079	.916	46,788
SB Bank	NBFI	90.13	0.2817	47811	.960	45,898
MGBB	Rural Bank	100.9	0.3153	42058	.953	40,081
PGBB	Rural Bank	140.03	0.4376	41097	.926	38,055
CBB	Rural Bank	115.4	0.3607	23153	.943	21,833
CSD	NGO	46.89	0.1465	21593	.989	21,355
NRDSC	Bank	67.84	0.212	18473	.975	18,011
DEPROSC	NGO	114.19	0.3568	16689	.944	15,754
DD Bank	NBFI	151.87	0.4746	16102	.918	14,781

Source: MIX www.mixmarket.org 2011

Gutierrez et al went on to perform a banking industry standard DEA analysis using output P and other financial indicators, plus the percentage of women clients and number of employees, to calculate a social efficiency indicator for each MFI in their sample. DEA analysis of data from Nepal is beyond the scope of this paper. However, Gutierrez et al. report that there is a positive but low correlation between the social efficiency and financial efficiency of MFIs, which is consistent with the view that MFIs need to be financially sound to perform their social mission. They also found a significant and positive relationship between efficiency in supporting women and efficiency in fighting poverty. Furthermore, NGOs were found to be more socially efficient than MFIs run under other organization structures. (Gutierrez-Nieto 2009)

Our results of the institutions in Nepal with the highest P (most poor borrowers reached) show that only two of the top ten are NGOs. The highest scores for efficiency belong to banks and rural banks. This reflects the larger number of borrowers reached by banks and relative to NGOs. It is important to note however, that the institutions with the highest P value, Nirdhan Utthan Bank Limited (NUBL), now a MFDB, began as an NGO. It is also important to note the two NGOs in the list, DEPROSC and CSD, operate as financial intermediary NGOs. They are not simply NGOs running microfinance programs associated with a larger project, which is often the case in Nepal.

Gutierrez-Nieto found no relationship between profitability or age of institution and social efficiency. This poses interesting questions about the assumption that MFIs become more efficient with age, and presumably with scale. The conventional wisdom promoted by the World Bank and other multilateral agencies is that MFIs should expand over time to become financially sustainable and increase their outreach. (Mayoux 2009) It has always been assumed, too, that smaller loans are less cost effective for MFIs, and that institutions making larger loans are more sustainable, because the cost of making small loans is practically the same as making large loans. This may be one of the reasons that MFIs are not reaching the very poor.

A comparison of operational self-sufficiency trends of MFIs, however, showed that there is not much difference in sustainability between small, medium and large-size lenders. Smaller lenders were able to cover their costs by charging higher interest rates and finding concessional sources of funding. (Kniending 2008) Covering costs in this way could be more difficult in Nepal, where interest rates are kept low through public and political pressure. (Ferrari 2007, Mercy Corps 2008) It also cannot be concluded that the very poor can always pay higher interest rates. Small entrepreneurs such as shopkeepers who can accomplish quick turnaround on small loans at higher interest may represent a special group of borrowers willing to pay higher rates. (Morduch 2009) More research is needed on the occupations and incomes of clients taking small loans.

4: REGULATION AND THE INSTITUTIONALIZATION OF MICROFINANCE IN NEPAL

Development of institutional capacity of financial systems is one of the ways in which microfinance is different from other rural finance interventions. (Morduch 2009) This section reviews literature on regulation and the function of apex institutions and meso-level organizations in Nepal to determine how microfinance has impacted financial institutions.

Development finance in Nepal, as in other developing countries, is sensitive to donor terms and requirements for aid. Prior to the arrival of microfinance, 'poverty-lending' programs and the emphasis of UN and other multilateral development agencies on the role of the state in capital formation and development influenced Nepal's rural development finance. (Adams 1992)

Directed credit programs were intended to increase the supply of funds available for lending to small farmers through subsidized interest rates and government financed loan guarantees. Nepal first institutionalized the poverty-lending concept through a national-level regulatory framework aimed at ensuring that commercial banks engage in social protection. (Rankin 2007)

Nepal's finance sector was later subject to liberalization beginning in the mid-1980s. State banks were restructured and a new set of institutions emerged to

perform rural credit delivery. Microfinance, with its market-determined interest rates, was a solution for unsustainable rural credit institutions with outreach failures caused by subsidized credit captured by local elites or used as rewards for political patronage. (Rankin 2007) In the case of Nepal, however, where outreach failures were well recognized, targeted lending was not entirely abandoned. Only the delivery model changed. (Rankin 2001) Due to the shift in rural development finance from subsidy to market orientation, new forms of regulations were required to ensure institutionalization. (Peck 2002)

4.1 Historical Perspective

A review of the history of rural development finance in Nepal shows that small loans granted without collateral and group lending were used by the state in Nepal before the arrival of Grameen model microfinance. Microfinance in Nepal provided more of the same strategy, but differently, using NGOs and microfinance development banks to disburse loans. An understanding of the history of financial cooperatives and an appreciation of the failure of previous rural finance interventions can also help to explain the regulatory division between SCCs and other MFIs.

Rural credit began in 1956 when thirteen credit cooperatives were established by the Nepal government in Chitwan District. The Cooperative Development Fund was established to provide credit to settlers in the district. In 1963, the

government established the Cooperative Bank, which was converted into the Agricultural Development Bank Nepal (ABDN) in 1968. Prior to that, cooperatives faced problems of fund shortages and misappropriation of funds by officials. In 1968 the government commissioned a fact-finding mission to investigate the operations of the 1489 cooperatives then registered with the Department of Cooperatives. Most were found at the defunct stage and were liquidated. The government then introduced a Cooperative Revitalization Program in 1971, and authorized the ABDN to run cooperatives. (RMDC 2009)

In 1974, two state-owned commercial banks, Nepal Bank Ltd., and Rastriya Banijya Bank were directed by the central bank, Nepal Rastra Bank (NRB), to invest a minimum of 5% of their deposit liabilities in the 'small sector'. In 1975, ABDN launched the Small Farmers Development Program (SFDP), which organized farmers and provided credit under group guarantee, as well as focusing on savings. In 1976, the scope of the small sector was broadened to include agriculture and cottage industries, and renamed the 'Priority Sector'.

The Sajha Program was launched in 1976, and cooperatives were renamed 'Sajha Societies'. A benchmark survey in 1983/4 found that 85% of Sajha Societies were extending credit, as well as dealing with transactions of agricultural input. (RMDC 2009) But credit did not reach the poor; instead only influential and well-connected people with collateral accessed the program. (BWTP 2010) This led to the development of targeted initiatives, such as the

Intensive Banking program in 1981, which partnered with commercial banks and allowed group guarantee for loan repayment.

In 1990, when multiparty democracy was reinstated, the government established the Rural Self-Reliance Fund (RSRF), to provide wholesale loans to NGOs, cooperatives and other financial intermediaries, for on-lending to the poor. In that same year, the government also established the Deprived Sector Lending Program, dissolved the Sajha Central Committee and appointed a seven-member National Cooperative Consultation Committee. It assigned 11 members of the National Cooperative Development Board (NCDB) to provide policy directives to the cooperatives, and enacted a new cooperative act in 1992.

(RMDC 2009)

Also in 1992, following a directive from Nepal Rastra Bank, the government established Regional Rural Development Banks (RRDBs) in 5 development regions, modelling these on the Grameen Bank methodology. The government of Nepal was the majority owner of these banks, along with NRB, and the two state-owned commercial banks. The remaining shares were owned by private, joint-venture commercial banks. (Sinha 2007) At the same time some NGOs, such as Nirdhan and the Centre for Self-Help Development, also adopted the Grameen methodology. Later in the 1990s, with technical assistance from the German Agency for Technical Cooperation (GTZ) local branches of ADBN reorganized the Small Farmers' Development Program into federations of small farmers

groups as Small Farmer Cooperatives Ltd. (SFCL), each operating as an autonomous cooperative.

NGOs in Nepal were not at first permitted to undertake 'profit oriented' activities such as financial intermediation. But their growing role in social development created a need to permit them to extend some basic services such as microfinance. The decision to license NGOs to provide financial services was also made in response to the closing of a number of rural branches of the two government-owned commercial banks, Nepal Bank Ltd, and Rastriya Banijya Bank, which together accounted for about 95% of Nepal's rural commercial bank branches. The closures were due to local conflicts and growing pressure to restructure. (Sinha 2007) Meanwhile, the government acknowledged the poor performance of its RRDBs under public ownership, and the central bank began a restructuring program, supported by the World Bank, to privatize the 5 RRDBs. (BWTP 2009)

The Development Bank Act of 1995 allowed NGOs to transfer their microfinance portfolios into autonomous microfinance rural development banks (MRDBs). Nirdhan was the first NGO to do this, forming Nirdhan Utthan Development Bank (NUBL). Three other MRDBs were formed after 2000 through the same process: DEPROSC Development Bank, Swabalamban Bikas Bank Ltd and Chhimek Bikas Bank. The Development Banks Act (DBA) limited MRDBs to specific types of lending and deposit mobilization activity and allowed for more relaxed

prudential regulations than those afforded to commercial banks. The DBA was repealed upon the passage of an umbrella act, the Banks and Financial Institutions Ordinance (BFIO) in 2004, which in turn was replaced the Banks and Financial Institutions Act (BFIA), 2006. (Sinha 2007)

Reforms undertaken from 2000-2003 enabled Nepal Rastra Bank to bring banking regulations in line with international standards, with the support of the World Bank and International Monetary Fund's Technical Assistance.

Deregulation of the formal financial sector was brought about on several fronts, including dismantling of credit allocation systems established under the Priority Sector Program. The Deprived Sector Lending Program initially required commercial banks to disburse at least 0.25-3% of their total loan portfolio to poor households directly or through MFIs. In 2008 this amount was set at 3%. The policy was extended in 2008 to include development banks (required to lend 1.5%) and finance companies (1%). In 2009, the mandated levels were raised to 2% for development banks 2%, and 1.5 % for finance companies. (NUBL 2010)

In 2003, the government established the Poverty Alleviation Fund, which assists community based organizations (CBOs) and NGOs to organize subsidized microfinance programs using a revolving fund scheme. The government is expected to dismantle its direct interventions in the rural finance and microfinance sectors, focus on improving the quality of existing institutions, and undertake rural infrastructure development. (BWTP 2009)

Currently MFIs are regulated by different acts according to their type of business. NGOs are regulated by the Financial Intermediary Non-governmental Organizations (FINGO) Act (1988, amended 2002), cooperatives by the Cooperative Act (1991). Commercial banks, development banks, finance companies, and microfinance development are regulated under the Bank and Financial Institutions Act, 2006. All licensed institutions remain under the purview of NRB, which is responsible for supervising and inspecting all institutions engaged in commercial banking. (BWTP 2010)

The government of Nepal created a National Microfinance Policy in 2007. The policy has a number of objectives intended to facilitate the growth of the microfinance industry and increase outreach of services. Included in the objectives are development of institutional infrastructures to maintain financial discipline and accountability in the industry, and formulation of microfinance specific laws. The first Nepal Microfinance Summit in 2008 formed a task force, including representatives of all microfinance models, to draft a micro-insurance policy as a first step in the formulation of new laws. (CMF 2008) The draft has been submitted to NRB.

4.2 Impacts of Policy and Regulation

Microfinance is well suited to the neoliberal view that markets should be the mechanism to achieve growth. (Rankin 2001) It is therefore noteworthy that Nepal, in its process of financial liberalization, retained targeted lending through Deprived Sector Lending. Regulations for MFIs have created a shift in credit delivery from commercial banks to special purpose rural development banks and NGOs, most of which use group borrowing microcredit following Grameen Bank methodology.

The Deprived Sector Lending Program was intended increase the supply of funds available for lending through microfinance. The deprived sector definition seeks to encompass all low-income individuals excluded from traditional banking systems, particularly women, endogenous people, the disabled, crafts persons and artisans, small and marginal farmers and landless people. (NRB 2010b) Financial institutions may lend directly to microfinance clients, or indirectly, by providing wholesale funds to or investments in MFIs.

Private sector commercial banks are reluctant to lend directly to clients in rural and remote areas because of the difficulties of adapting their systems, high costs and lower returns. Initially they were paying penalties to NRB or parking their funds at finance companies through microfinance banks, such as regional rural development banks, instead of disbursing them to MFIs. (Majorano 2007)

Regulation was modified in 2009 to include finance companies and development banks in the requirement to lend to the Deprived Sector. Currently, private sector commercial banks lend funds wholesale to MFIs rather than lending directly to clients. (NUBL 2010)

Institutions can fulfil their requirement by lending in the following ways:

1. Up to 60,000 NRs without collateral to individuals or group members for income generating activities.
2. Up to 150,000 NRs per person for foreign employment.
3. Up to 400,000 NRs for housing.
4. Up to 150,000 for micro enterprises under a group guarantee or collateral based loan.
5. Up to 60,000 per person for micro hydro or household energy generating projects.
6. Up to 5% of a bank's core capital for lending to a community hospital.
7. Up to 200, 000 for youth and small entrepreneur loans.
8. Wholesale lending to MFIs, financial intermediaries, rural cooperatives and small farmer cooperatives.
9. Up to 150,000 NRs to agricultural and livestock related enterprises.
10. Equity investment in MFDBs and their subsidiaries.
11. Investment in the Youth Self-Employment Fund.

(NRB 2010b)

The purpose of the Deprived Sector Lending Program, which maintains a supply of funds for MFIs, is interpreted as ensuring the sustainability of MFIs and a continuous supply of microfinance services to the rural poor. In practice, the policy does not ensure either sustainability of MFIs or supply of services. The main source of wholesale funds for MFIs is commercial banks under Deprived Sector Lending. Sources of funds for MFIs are diminishing due to changes in regulation that requires 1/3 of Deprived Sector funds be directed to the new youth self employment program. This diverts funds from MFI for use in direct lending to clients. (NUBL 2010)

At the same time, new types of institutions, products and services are emerging in response to Deprived Sector Lending requirement. Taking advantage of a source of funds for micro-hydro or household energy generating loans, institutions such as The Alternative Energy Promotion Centre (AEPC), and Clean Energy Development Bank Ltd have appeared, while other MFIs are advised to develop appropriate loan products. (CMF 2010)

4.3 Loan Funds Supply and Demand Analysis

Supply constraints have led MFIs in Nepal secure funds 3 months in advance as a standard operating practice. MFIs need funding not only for on-lending but also for operating expenses, capital expenditure and mandatory reserves and provisions. (NUBL 2010) Commercial and development banks are required to set aside a portion of their loan funds for indirect lending to the deprived sector. The net supply of funds through Deprived Sector Lending available for lending to MFIs (5,715,626) (See table 4) was expected to fall short of the demand of funding for MFIs in 2009/10 (11,323,861). (See table 5) This projected demand represents roughly 20% of net domestic credit for 2010 (56,569,300,000 NRs). (See Figure 3) Changes to regulation in 2010 allows MFDBs to mobilize public deposits if they maintain capital adequacy, have been profitable for three consecutive years, not have non-performing loans in excess of 5%, and limit deposit mobilization from the general public at five times their primary capital.

Table 4: Status of Loan Disbursement and Available DSLP Funding 2006/07-2009/10 (in thousands NRs)

Types of Financial institutions	Loan Type	Actual			Projected
		2006/07	2007/08	2008/09	2009/10
Commercial Banks	Total	215,978,400	292,500,400	382,082,290	476,838,697
	Deprived Sector	7,213,325	9,670,417	12,869,333	14,305,160
Development Banks	Total	11,930,334	21,533,633	39,425,641	57,163,236
	Deprived Sector			724,137	1,143,264
Finance Companies	Total	21,085,294	36,902,652	51,165,790	69,263,129
	Deprived Sector				
Total Amount available under Deprived Sector		7,213,325	9,670,417	14,253,352	16,487,372
Youth Self-Employment Funding (1/3 Deprived Sector)					5,495,790
Amount for direct lending to clients (32%)					5,275,956
Remaining Amount for lending to MFIs					5,715,626

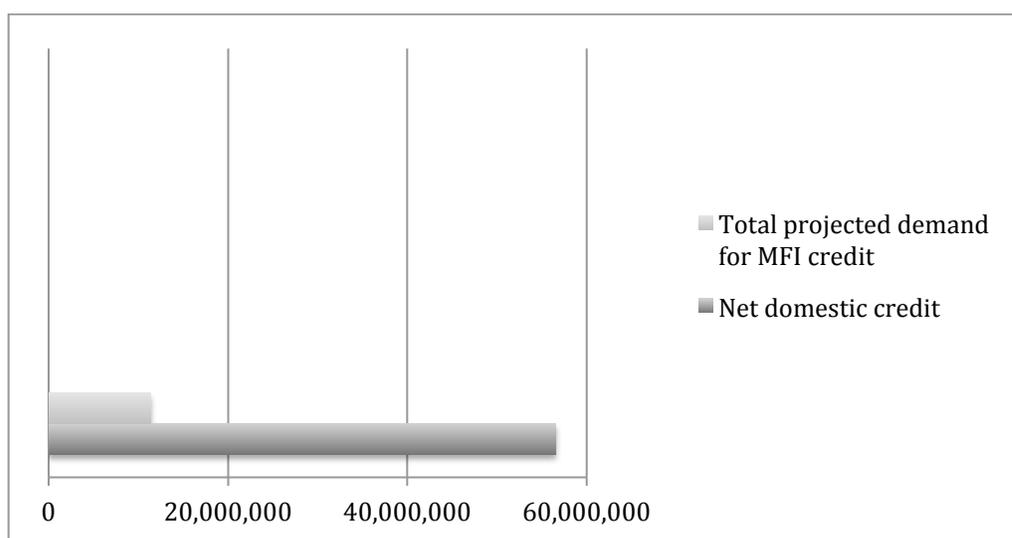
Source: NUBL (2010).

Table 5: Demand for funding of MFIs in FY 2009/10 (in thousands NRs.)

Types of MFIs	Expected No. of Clients	Funds needed for on-lending	Funding needed for additional 3 months	Total funds needed
MFDs	658,678	5,753,160	1,438,290	7,191,450
FINGOS	362,731	1,450,833	362,708	1,813,541
SACCOS	785,968	1,855,096	463,774	2,318,870
Total	1,807,377	9,059,089	2,264,742	11,323,861

Source: NUBL (2010).

Figure 3: Projected Demand for Credit and Net Domestic Credit 2010 (in thousands NRs)



Source: NRB (2010)

Changes to Deprived Sector Lending have been anticipated in the microfinance industry for some years. While deposits could provide an additional source of funds, MFIs (with the recent exception of MFDBs) are not authorized to collect savings from the public, and are limited to mobilizing member and client deposits. MFIs had long been advised to modify their products and services to capture a bigger share of the savings market. (Tazi 2008) Only MFDB's have been effectively accessing the savings market. Savings of poor people only in microfinance development banks was 1.76 billion NRs in July 2009, before the change in regulation allowing mobilization of public deposits. (NRB 2010b)

MFIs, however, would prefer to see DSL remain with modifications, specifically that the funds designated for hospitals, youth employment, micro-hydro and housing be redirected for lending to clients. (Pandey 2010)

The Deprived Sector Lending Policy provided access to funds for microcredit, and in doing so allowed access to formal financial services for the rural poor. It also allowed for the establishment of microfinance institutions and the participation of the private sector in the microfinance industry. The availability of funds, however, resulted in highly liquid MFIs. It did not significantly increase their outreach, (Ferrari 2007) and left them with little incentive to improve efficiency or engage the savings market. (Mercy Corps 2008) In this way, the policy distorted the market and hindered the development of a truly commercial microfinance industry in Nepal. (Mercy Corps 2008)

Nevertheless, the number of NRB licensed MFIs has increased significantly, particularly the number of development banks, which has increased from 28 in 2007 to 63 in 2009, creating competition for funds. (See table 6) The number of development bank branches has increased 113.67 %. ² (See table 7) NRB has noted the increasing number of microfinance subsidiaries of commercial banks and finance companies brought about by changes in capital requirements. These subsidiaries may be designed purely to meet deprived sector lending requirements and to “park” funds. (NRB 2010b)

Table 6: Banks and Financial Institutions Licensed by NRB

Institution Type	2007	2008	2009
Commercial banks	20	25	26
Development banks	38	58	63
Finance Companies	74	78	77
Microfinance development banks	12	12	15
NGOs	47	46	45
Cooperatives	17	16	16

Source: NRB (2010).

² It should be noted that unlicensed NGO lending programs and savings and credit cooperatives form the semi-formal sector do not appear in these figures.

Table 7: Change in the Number of Branches 2008-2009

Institution type	July 2008	July 2009	% change
Commercial banks	555	752	35.50
Development banks	117	250	113.67
Finance companies	132	165	25.00
Microfinance development banks	349	367	5.73

Source: NRB (2010).

The muddle (Sinha 2007) of regulation in Nepal has caused many to call for second party regulation by an organization other than the NRB. The small size of many institutions, their relatively small impact on the financial sector, and the costs of developing regulation argue against this. (Arun 2009) It is also not clear of the exact role of the second party. Currently, apex institutions act effectively as regulators by setting standards to which MFIs must adhere before receiving wholesale loans.

4.3.1 Interest Rates

Interest rates in Nepal are not regulated. Rates for both clients and institutions borrowing funds are significantly lower in Nepal than in other part of the world. (Mercy Corps 2008, Tazi 2008) Not only has the Deprived Sector Lending Policy distorted the market for funds, but also client interest rates are kept low by “pro-

poor” politicians seeking election. (Mercy Corps 2008) Despite this, the microfinance industry lobbies for lowered cost of funds derived from DSLP. The MFIs claim that sustainability and expansion of outreach is difficult otherwise. Subsidized cost of funds for expansion to remote hill and mountain areas has been suggested. (Pandey 2010) A benchmark analysis performed by MIX, however, states that Nepali MFIs need to reduce their dependency on charity and subsidy. (Tazi 2008)

Shakya and Rankin found that consumer credit supply and interest rates were impacted by the concentration of MFIs and informal moneylenders in the Terai plains. In this area, with its dense population close to the Indian border, microfinance programs are widely duplicated. (Dhakal 2007) At the same time, remittances flow in to the area from India, and the surplus income generated by them is often invested in informal moneylending. Moneylenders, with little overhead, can compete with and undercut microfinance programs. MFIs set their rates to achieve operational sustainability, without regard to other suppliers in the market. These two observations defy the general perception that microfinance offers credit at lower rates than moneylenders.

4.4 Institutional growth and development

A Mercy Corps Survey showed that microfinance institutions in Nepal have a need for all types of technical services except financial services. There is a strong demand and relatively weak supply of training, research and Management Information Systems. (Mercy Corps 2008) RMDC and NEFSCUN provide training to their clients and members, while CMF acts as a service provider for both training and research for a fee. NUBL's training program is almost entirely in-house. The low operating cost structure of Nepali MFIs likely does not provide for fee-based training.

Funding for institutional development could be made available if NRB established a reduced corporate tax rate for MFIs. Currently MFIS are taxed at the same rate as commercial banks (30%), but have lower profits. Tax rebates could be allowed for expansion of service, research and capacity building of both staff and clients. (Pandey 2010)

5: CONCLUSION

Microfinance is neither a revolution nor a panacea, it is simply the latest development model used to provide financial services for the poor, with both successes and failures. There are many myths and generalizations about microfinance that have yet to be empirically tested. (Morduch 2009) When compared to previous rural development interventions, microfinance is the “same same, but different,” according to the common Nepali expression. Different in its delivery model, microfinance is a neoliberal strategy that shifted rural credit from subsidy to market-determined interest rates and engendered rural finance, shifting the onus to women as economic providers for households. (Rankin 2007)

Microfinance solved outreach failures of state directed rural development finance, but new created outreach failures of its own. Microfinance in Nepal still does not reach the very poor. It is the bankable poor, or small-scale entrepreneurs and farmers, who have received much of the benefit of microfinance. It is well recognized that savings and credit cooperatives in particular cater to wealthier clients, and Dalits, the poorest demographic group, are only negligibly included.

There is little research about the impacts of microfinance in Nepal beyond the program level. There is a lack of standardized, reliable data. Where available,

outreach indicators used to measure the success of microfinance in Nepal do not reveal whether institutions achieve goals of poverty alleviation, inclusive growth or women's empowerment. Success is measured by the number of borrowers reached, the number of women reached, average loan size and repayment rates. We can assume that the smaller the average loan size per borrower, the more likely it is that an MFI is reaching very poor borrowers. When analysing 2006 data collected by MIX, it appears that some NGOs and non-bank financial institutions are indeed on average making very small loans, but have limited outreach. However, outreach measures alone give us little idea of whether loans are used for consumption or for income-generation or whether clients are loan-swapping, borrowing from multiple sources to pay off old debt.

Better data collection by MFIs including the occupation of the borrower, income levels and loan uses would shed light on true effectiveness of lending programs and assist with development of products and services. (Morduch 2009) A centralized data source such as a credit bureau and better communication between MFIs would assist in reducing loan-swapping and duplication of services.

Loan-swapping is one of the innovations women have used to create their own conditions in microfinance. Microfinance has provided much-needed credit to women in Nepal. The number of women clients at Nirdhan alone has increased from 2811 in 1996 to 85,323 in 2010. Still, it is inconclusive whether access to

credit and savings has created individual empowerment; more research is needed. There are conflicting reports of microfinance's ability to increase the decision-making roles of women in households. (Shakya 2008) Peer pressure loan collection methods and borrowing conditions are the conditions women accept to receive credit, (Emran 2007) but they are often disempowering. (Shakya 2008)

The number of reports (ADB 2009a, Shakya 2008, Mayoux 2009, Fernando 2006, Mosley 2009) that women use loans for consumption rather than productive activities is disguised by high repayment rates and repeated loans, which are considered measures of success. There seems no easy solution to this, except to remove conditions from loans and allow general loans that function as a line of credit. In many cases, women are bearing individual responsibility for household loans; this is not empowerment.

Caste, however, is a more powerful predictor of poverty than gender. Dalit men are less socially and economically empowered than women from other caste and ethnic groups. (World Bank/DFID 2006) Microfinance cooperatives in Nepal are negligibly inclusive of Dalits, who often exclude themselves from microfinance services or have physical barriers to reaching a microfinance institution. The poverty of Dalits stands out as the biggest development challenge for Nepal. Microfinance institutions should include Dalits in their mission, membership, staff, and governance, and tailor products and services to this client group.

Increased assessment, data reporting and transparency of MFIs would attract international investment opportunities. Social performance assessment in particular would attract social investors who value combined social and financial returns. (Kerer 2008) Dependence on DSPL as a source of funds and a pervasive view of microfinance as a charitable venture lessen the initiative to conduct social performance measurement. However, should commercial banks enter the microfinance industry in Nepal, SPM will provide information to justify higher operational costs and interest rates. (Kerer 2008)

Institutions have grown rapidly since economic reforms began, and the microfinance sector has become more diversified. 5444 institutions are registered with NRB, with 24,322 million NRs in loans outstanding as of mid-July 2009. Institutions are developing savings services, with deposits in July 2009 totalling 20,634 million NRs. Institutions themselves, however, need to develop their capacity in the area of accounting and auditing, strategic planning and financial analysis. (Ferrari 2007) The portfolio quality of Nepali MFIs is low. (Tazi 2008)

The poorest borrowers in remote rural areas are not being reached. MFIs are reluctant to expand operations into hilly and mountainous areas, due to lack of existing local institutions, infrastructure and the costs of operation in these areas. Standardization of best practices and use of the highly successful Grameen

model may also contribute to lack of expansion. The high level of generality in the microfinance delivery mechanisms (Morduch 2009) is limiting in Nepal, where conditions in the sparsely populated mountains and hills requires different delivery models than in the plains. The reluctance to expand to the hills has created a situation in which Grameen model MFIs overlap services in the Terai zone, where conditions more closely resemble those in Bangladesh, causing unhealthy competition and threatening quality. The Nepal Rastra bank has not been able to supervise this situation adequately.

Sustainability is an issue. As social investors have been reluctant to invest in Nepal's new Maoist governed economy, microfinance programs depending on international funding have suffered. Lack of capacity to perform financial analysis contributes to poor awareness of institutional sustainability, which may have been fostered by external funding, and a perception of microfinance as a charity among leaders and political parties. (BWTP 2009, Mercy Corps 2008, Tazi 2008) Highly subsidized microcredit programs threaten financial discipline and basic operating norms of microfinance systems. (BWTP 2010)

The DSLP, with its regulated interest rates for wholesale lending to MFIs, has lessened the incentive for MFIs to go to other lenders for funds or expand into savings markets as a source of funds. Important lessons to be learned from state-subsidized rural finance are the need for efficiency, transparency and appropriate management incentives. (Morduch 2009) DSLP targeted lending

may have allowed large Nepali MFIs such as RRDBs to continue old, inefficient practices. Privatization of RRDBs lagged because of resistance to change in the institutional culture. (World Bank 2010a)

Of the three paradigms of microfinance, (financial sustainability, women's empowerment and poverty alleviation) some argue that financial sustainability is prioritized, often to the detriment of women's empowerment in particular.

(Mayoux 2009) Nevertheless, sustainability ensures the continuance of an MFI.

Socially efficient MFIs were found to be financially efficient in almost all cases.

(Gutierrez-Nieto 2009) For the social goals of microfinance to be achieved in Nepal, MFIs must become sustainable.

Political instability in Nepal will continue to challenge the microfinance industry.

Continued changes of government have postponed regulatory decisions and stalled privatization of RRDBs. (World Bank 2010a) Existing regulation needs to be simplified, and new regulation is underway for micro-insurance. (CMF 2008)

It is uncertain whether the current government will dismantle the DSLP, but recent changes has directed funds away from microfinance. Increases in sustainability and transparency will help MFIs to prepare for change and be ready to attract donors and investors.

Despite many obstacles and challenges, microfinance has provided beneficial access to formal financial services to many who are excluded from traditional

banks. It has shifted credit and savings from the informal sectors. Microfinance is more attractive to borrowers in Nepal than traditional banks. Financial NGOs and cooperatives are the largest provider of loans under NRs 50,000 in the formal sector. (Ferrari 2007) Many of the services microfinance offers, such as insurance and remittance services, are the first such offerings in remote or rural areas. There is considerable room for expansion of remittance services. In 2007, an estimated 69% of remittances entered the country through family and friends. (Ferrari 2007)

Microfinance in Nepal has come a long way from traditional savings groups. Much has changed; nonetheless, reaching the very poor remains the biggest challenge. Without this accomplishment, microfinance will have failed its primary goal.

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