Nepal Microfinance Review

Microfinance rising above the turmoil

2012

Micro-Credit Ratings International Limited

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Micro-Credit Ratings International Limited
602 Pacific Square, 32nd Milestone NH8
Gurgaon 122 001 INDIA
www.m-cril.com

Preface/Access to the full Nepal Microfinance Review

This document is M-CRIL's review of microfinance in Nepal – of the performance of institutions in the country (MFIs) almost exclusively providing microfinance services to low income clients. Until now, M-CRIL has produced the following volumes of **country microfinance reviews**

Volume	Year	Sub-title
India 1	2001	
2	2003	
3	2005	
4	2007	*(in association with the MIX)*
5	2009	M-CRIL Microfinance Analytics (*brief review*)
6	2010	Microfinance Contributes to Financial Inclusion
7	2011	Anatomy of a Crisis
8	2012	MFIs in a Regulated Environment
Bangladesh	2009	A picture of a mature industry? *[published by BRAC Development Institute]*
Nepal	**2012**	**Rising above the turmoil**

In 2011 M-CRIL supported the BRAC Development Institute in publishing the **Bangladesh Microfinance Review** with data for 2009.

The current review is the first volume for Nepal in a series that aims to provide an empirical and analytical chronicle of MFIs in Asia.

In keeping with M-CRIL's tradition of independent research and analysis, this review is published to promote understanding of the role of microfinance in the Nepal economy and to focus on the current performance of the sector in relation to financial services in the country in general.

The 2012 Review is based on an analysis of financial data from the 19 largest MFIs in Nepal (each with more than 10,000 borrowers) for which reasonably reliable data (audited financial statements and credible operational data) was available. It also uses outreach and the limited social performance information provided by these MFIs and uploaded on the MIX Social Reporting platform until end-November 2012. Poverty profile information for the clients of these MFIs is not available at present. The Table of Contents of the main report provides an outline of the report along with the Executive Summary.

M-CRIL's Nepal Microfinance Review can be obtained in one of two ways

1 **Soft copy**: Please download from **www.m-cril.com**.
2 **Hard copy** (colour print): Please send an e-mail with a request to contact@m-cril.com.

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Executive Summary

Microfinance rising above the turmoil

– a financial and social analysis

M-CRIL's 2012 financial and social review of microfinance in Nepal presents an analysis of the performance of MFIs in that country in the context of the continuing uncertainty caused by political conditions there.

M-CRIL pioneered the now worldwide practice of undertaking country/regional analyses of microfinance performance. The first volume of a series of reviews of microfinance in India was published in Year 2001. M-CRIL's aim is to add value to the information available through its critical and analytical screening and presentation of data. While the first volume of the series, in 2001, covered rated MFIs in South and Southeast Asia (including Nepal), **this volume is the first review for any country other than India published by M-CRIL**.

This review is an integrated financial and social analysis. It uses financial information for Nepali MFIs taken directly from their audited financial statements as well as country level data from publications of the central bank, Nepal Rastra Bank, and the main microfinance wholesaler, Rural Microfinance Development Centre. Social performance information – to the limited extent that it is available – is taken from the social performance section of the Nepal country pages on the MIX website.

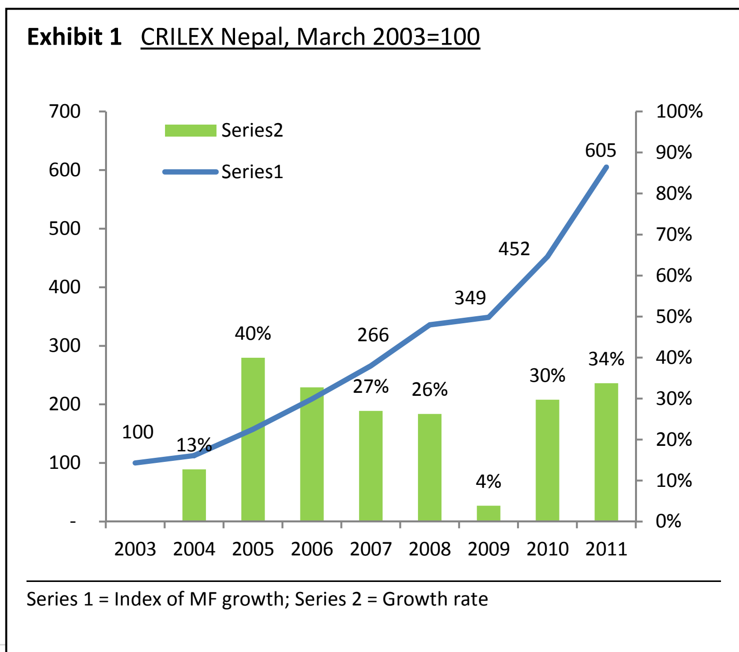
A fast growing financial sector but low inclusion

Nepal has a fast growing financial sector but, according to the World Bank's FINDEX study, has only 25% financial inclusion (including microfinance coverage) – M-CRIL estimates that perhaps just over half of this is provided by the microfinance sector with inclusion by the conventional finance sector estimated at no more than 12%.

Historically, the NGO legal form dominated the microfinance landscape but with the commercialisation of the sector during the previous decade, there has been a growing tendency for NGOs to transform to microfinance development banks (MFDBs). The decline in numbers of licensed FINGOs – from 45 in 2007 to 38 in 2011 – is largely explained by the conversion of FINGOs to such banks. Fresh MFDBs have also been established resulting in the total number reaching 21 by July 2011.

Apart from 2009, when political instability in the country and concerns about over-indebtedness in microfinance fostered a sense of crisis in the industry, microfinance in Nepal has grown more or less steadily at 25-40% per annum (average over 8 years, 2003-2011=25.2% per year). This is measured by M-CRIL's Nepal microfinance index, known as **CRILEX Nepal** plotted in **Exhibit 1**. Given the continuing steady performance of micro-

Exhibit 1 CRILEX Nepal, March 2003=100



Series 1 = Index of MF growth; Series 2 = Growth rate

finance in Nepal, compared to the wild growth followed by precipitous decline resulting from the crisis in microfinance in India, the benefits of steady growth are apparent.

Regulation has facilitated the practice of microfinance but was initially characterised by some confusion

Nepal was the first country in South Asia to introduce specific regulations for the microfinance sector: the Development Banks Act, 1996 and the Financial Intermediary Societies Act (FISA), 1998 were both aimed at stimulating the growth of financial services in the rural, mostly unbanked areas of the country. Unfortunately, the attempt at introducing regulation to promote and facilitate microfinance was characterised by a certain degree of confusion in its strategy towards poverty and financial inclusion. The original version of FISA included a clause that implied that the NRB would underwrite loans made to societies licensed under the Act. The clause was dropped in amendments made in 2003 after the NRB objected in the strongest terms. Ultimately, all financial legislation in Nepal was replaced in 2006 by one omnibus law called the Banks and Financial Institutions Act, 2006.

It was FISA that **introduced the concept of a "limited banking licence" as a way to legitimise the ongoing financial services activities of NGOs registered as societies and of cooperatives**. The main attraction of the limited banking licence for cooperatives was the stamp of legitimacy conferred by central bank supervision. At the same time, the stamp did not initially benefit either NGOs or cooperatives since these institutions were not particularly successful at raising voluntary deposits from members, let alone from the general public. It is partly for this reason that the number of cooperatives licensed under the act has declined, from 35 at the peak in 1999-2000 to just 16 in July 2011.

Overall, the regulatory framework put in place by the central bank has been quite liberal with limited capital requirements and low liquidity norms and no official limits on interest rates **though in a country with a political system that has been in turmoil for many years, political pressure on MFI interest rates still prevails.**

MFIs cover roughly 31% of families eligible for microfinance

As a result of the significant increase in the number of microfinance institutions, the number of clients served by MFIs in Nepal has grown substantially but not dramatically over the past 8 years as shown by **Exhibit 1**. The total number of borrower accounts covered by sample MFIs was 757,000 but the larger list of partners of RMDC Nepal reports nearly 856,000 borrower accounts for 56 MFIs in **mid-July 2011 – the reference date for this analysis since more recent data is not available** (at the time of writing in January 2013).

Since the number of families covered (after allowing for 20% overlap) is around 713,000, the calculations in this review shows that the MFI coverage of families eligible for microfinance is 31.0% which translates to 13.2% coverage of the overall population. Since the contribution of banks is very broadly (and optimistically) estimated at 12%, it is apparent that **MFIs are equally if not more important to financial inclusion in Nepal as conventional finance institutions**.

As a proportion of the overall financial system, however, MFI operations remain small. Nepal's MFIs have a portfolio that is just 2.2% of the overall financial system having increased from 1.9% in 2005. Like microfinance, the overall financial system is also growing well having registered an average growth of 23.0% per annum since 2005. Despite its relatively small size, the contribution of Nepali microfinance to the financial system far exceeds that in India where MFIs provide just 0.29% of the total credit outstanding from the banking system.

Since, unlike Indian microfinance during 2003-10, the growth rate of Nepal microfinance does not significantly exceed the overall financial system, and is within a moderate range (for microfinance), it appears to be manageable. However, it is apparent that the narrow geographical focus of MFIs within the *terai* districts of the eastern half of Nepal and, mainly, the Kathmandu valley will only result in a growing overlap of clients amongst them and with some of the smaller borrowers from the conventional finance institutions.

The real value of average loan balances has grown though it raises questions about the depth of outreach to the poor

From the perspective of client graduation to higher value activities, the most interesting aspect of loan balances is whether these increase over time in terms of real value. The analysis in the Nepal review shows that the nominal value of average loan balances has increased quite substantially from Rs7,800 ($110) in 2003 to as much as Rs18,700 ($265) in 2011. Deflating nominal values by the Consumer Price Index provides a better reflection of the true picture in terms of the impact of these loans on microfinance borrowers. Over the eight year period to July 2011 there was an increase of 40% in the real value of loan balances (at constant prices) over the base year. However, this is during a time when Nepal's GDP per capita increased by around 150% from $242 in 2003 to $619 in 2011. In practice, average loan balance as a proportion of GDP per capita fell below 40% in only a couple of years during the reference period but, **in real terms the MFI contribution to the economic lives of the low income families they serve has remained roughly constant at 37-45%**.

In a country with high levels of poverty, it is assumed that the bottom two income deciles cannot be usefully served by microfinance. However, a loan balance that is 45% of GDP per capita means that it is likely that MFIs are not serving the next two deciles either since, even for such families, servicing a loan balance of the order of Rs22,500 (after allowing for 20% overlap in microfinance loans to individual families) is likely to require a crippling 60% or more of annual income. **The implications** of this finding **for the depth of outreach of Nepali MFIs need to be considered**. There is a need to generate information on the poverty outreach of the leading MFIs in Nepal.

...and the savings orientation of Nepal microfinance is good thanks to the developmental approach of the regulator

Due to the early (1998) introduction of the MFI licensing system in Nepal, most of the larger MFIs in the country are able to offer deposit services. Initially, though, due to the lack of public confidence (in FINGOs, in particular) not all MFIs were able to take full advantage of this. However, as with MFIs in other countries, public confidence has grown with the longevity of the institutions and the savings orientation of MFIs in Nepal has improved considerably. Deposits, for the M-CRIL sample, average 47.5% of outstanding loan balances in July 2011.

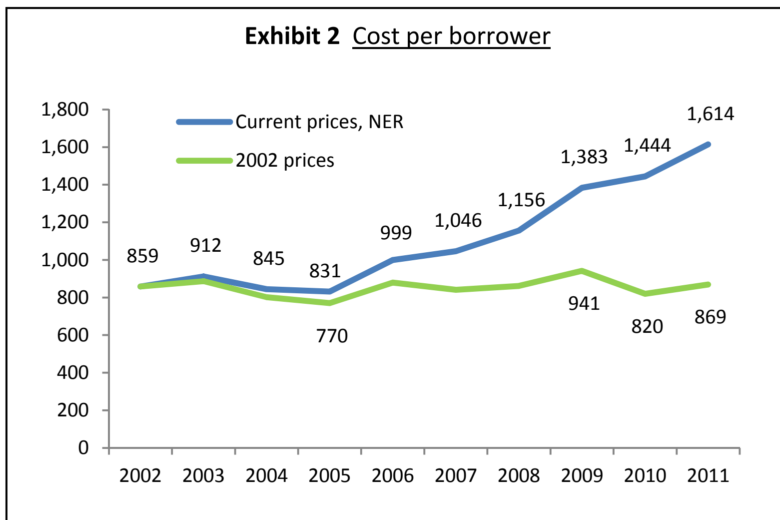
The deposit facility not only bolsters the availability of funds to MFIs it also assists in reducing default risk by increasing the proportion of average loan balance secured by member deposits. This rounding out of the relationship between MFIs and clients – as suppliers as well as users of funds – helps to reduce the risk of coercive collection practices by MFI staff. A two way relationship incorporating deposits as well as loans is much more wholesome, requiring an investment by MFIs in customer satisfaction as well as credit outreach. NRB, the central bank of Nepal, has done well to cast this issue in a developmental perspective rather than focusing, as others have done, purely on the risk to its own reputation that could result from a potential MFI collapse due to management inefficiency or fraud.

But the principle of responsibility in the provision of microfinance is also now taking hold

The concern for responsible microfinance is reflected in the Codes of Conduct developed by MFI networks and internationally in the client protection principles developed through the Smart Campaign. M-CRIL had already included evaluation of responsibility to clients as part of the Social Rating. Starting in late 2012, along with other specialist international rating agencies, M-CRIL has launched the Microfinance Institutional Rating (MIR), an enhanced service that incorporates client protection, indebtedness and mission orientation as an integral part of the output. Issues covered include integrity, transparency, governance, competition, client protection, appropriate staff behaviour and resolution of complaints. Most leading MFIs are in the process of taking action to improve performance in all these areas.

Cost efficiency has held steady over the years

The cost incurred by Nepali MFIs in servicing loan accounts is very low in comparison with the global benchmark of $85 global average on the MIX. Even when compared with other Asian MFIs, the cost per borrower in Nepal (Rs1,614 for all MFIs, $22) amounts to just 36% of the East Asian median of $61 and is also substantially lower than the MIX median for low end MFIs internationally ($64). The trend in the average cost per borrower for the delivery of micro-loans in Nepal is shown in **Exhibit 2**. The numbers for South Asia make international microfinance seem extravagant with only India and Bangladesh at similar levels to Nepal. Though the average cost per borrower has increased steadily over the past few years and has nearly doubled since 2004-05, **in real terms, the cost of serving the average microfinance borrower in Nepal has not changed.** It is apparent that Nepali MFIs have maintained their lending standards over the years and not allowed these to decline in a relentless search for operating economies.



As discussed above, the average Nepali microfinance client is served by MFIs that are significantly more efficient than those internationally. The weighted average OER for sample MFIs was just 9.6% in 2010-11. These expense ratios are well below the global median of around 20.0% and even below India and Bangladesh at 11-12%.

A key determinant of the operating expense ratio is the small loan size. As discussed in the report, the OER shows a very clear downward trend as the loan size increases. In an industry highly dependent on staff for customer satisfaction, **there is also an important positive correlation between the staff turnover rate and OER and a negative one between the proportion of women loan officers and OER**; whether the latter means that women loan officers are more efficient or that they are simply paid less is an open question. While the average staff turnover rate of 7% for Nepal MFIs is apparently comforting, it needs to be viewed with caution since the accuracy of this self-reported information could be open to question.

...but watch the yield-OER margin which has widened

The weighted average yield of 22.3% for 2010-11 has increased significantly over the 18.4% shown by the MIX for Nepali MFIs two years earlier. This appears to have happened partly because of an improvement in portfolio quality but also because of changes in fees charged and better collection efficiency. The average yield earned by Nepali MFIs is still substantially lower than the Asian and global medians of 25.8% and 28% respectively. When compared with moneylender rates of 60-120% in different parts of Nepal and consumer finance rates of 24-36% charged even by commercial banks for much larger loans, Nepal MFI interest rates appear to be very reasonable.

Since the weighted average (OER) for Nepal MFIs has increased gradually over the past few years but has been accompanied by a significant increase in yield, the margin available to the average MFI for covering financial expenses, loan loss provisions and surplus has widened. In absolute terms, however, a roughly 10% margin between yield and OER is not substantial in microfinance and is not much higher than the 9.1% margin of the Nepali commercial banks The margin for Indian MFIs has been in the 15-20% range until quite recently.

The MFIs report excellent portfolio quality; if it is real, they deserve congratulations

Analysis of portfolio quality data reported by M-CRIL's sample of 18 MFIs indicates that the MFIs in Nepal have excellent portfolio quality ratios. The sample average of PAR_{30} at 1.2% is better than the 1.8% of the non-AP portfolio in India, a lot better than the 6.6% of Bangladesh, 3.2% of Africa and 4.9% of Latin America (from the MIX). Other segments of the Nepali financial sector also report much higher non-performing loan ratios (more than 90 days overdue). These include the commercial banks at 3.2%, development banks at 4.2% and finance companies at 5.4%. In practice, it may be that the PAR information for Nepal presents a better picture than is justified.

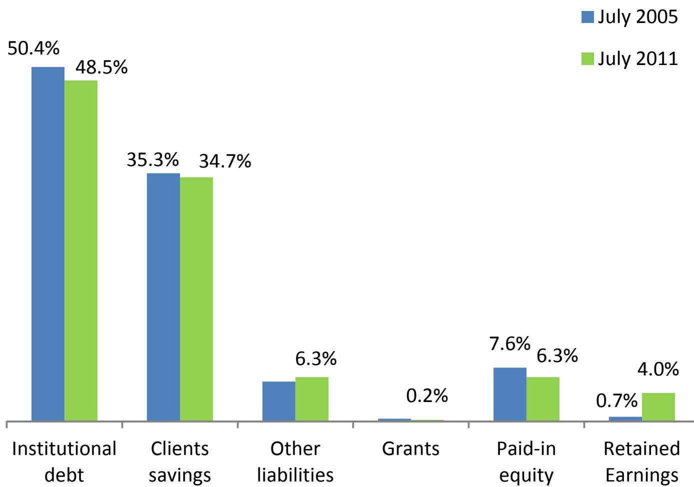
To what extent this improvement in portfolio quality is on account of the undoubted improvements in the functioning of the economy and improvement of MFI collection systems is something that bears investigation. It is also possible that some of the "improvement" has resulted from changes in human resource practices within MFIs, incentivising the reporting (if not necessarily achievement) of good portfolio performance while ignoring some of the problems on the ground. If the reported portfolio quality data is strictly accurate, the Nepal microfinance sector certainly deserves congratulations.

Exceptional circumstances aside, the client retention rate is generally accepted as being a key indicator of client satisfaction. While the correlation between the two, based on data for India, is not very strong it indicates a significant relationship between the client retention rate and portfolio quality. It suggests that as client satisfaction increases the portfolio quality also improves as shown in the report. Unfortunately Nepali MFIs have not reported their client retention rates so far.

Nepali MFIs now have a settled pattern of funding

The financing of microfinance in Nepal has settled into a pattern with not much change between 2005 and 2011. The distribution of sources of funds for microfinance, presented in **Exhibit 3**, shows that the share of debt in MFI finances has been steady at nearly 50% of total liabilities (Rs8.9 billion, $126 million in July 2011). The current level of institutional debt, amounting to 48.5% of total funds has been raised largely from RMDC, Nepal's main wholesale lending institution for microfinance, (18.6% of all debt funds) and from commercial banks. The latter funding is provided by banks to MFIs under the "deprived sector" directed credit mandated by NRB.

Exhibit 3 Sources of funds for microfinance operations

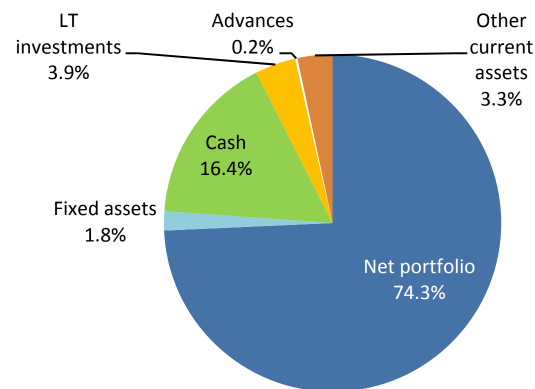


Unlike India, where MFIs (other than financial cooperatives) are not allowed to raise deposits, MFIs in Nepal are specifically licensed to provide deposit services to their members. As a result, around 35% of the funds of Nepali MFIs come from client savings. In Bangladesh where, for most MFIs, client savings have always been seen as an important part of financing (and commercial bank funding is quite limited), deposits constitute a somewhat higher 47% of total funds.

The use of funds has improved over the years with a greater degree of professionalization of management

The allocation of funds by Nepal MFIs conforms fairly well to international best practice norms. Of the total resources of Rs18.5 billion ($261 million) deployed in microfinance by the 18 sample MFIs, nearly 75% was in loans to clients at the end of July 2011 (**Exhibit 4**). Six years ago this was of the order of 55% which was below the 60-70% portfolio allocation level considered normal in international microfinance at the time.

Exhibit 4 Use of funds for microfinance operations



The cash holding of over 16% by Nepal MFIs, on the other hand, is somewhat higher than the global standard of around 10%. It is likely that, as in India, this is partly because of the release of a substantial amount of deprived sector lending funds by conventional financial institutions at the end of the financial year in order to comply with the requirements of the central bank. More information on the average holding of cash throughout the year would result in a more balanced picture on the use of funds by Nepali MFIs.

...resulting in better prudential management as well

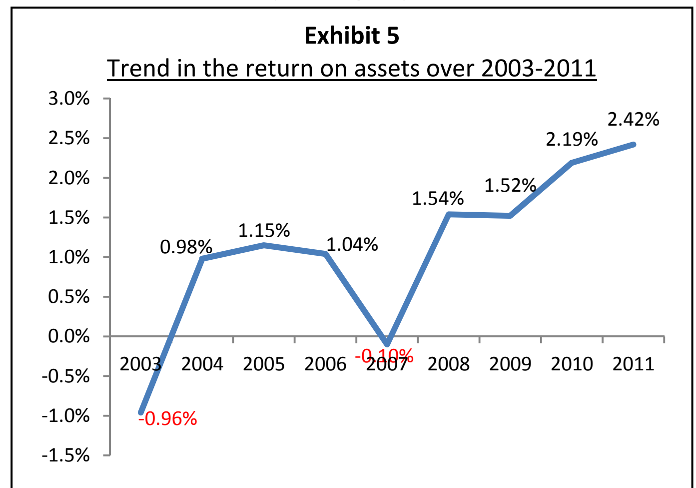
With an average capital adequacy ratio (CAR) of 13%, Nepal MFIs are mostly well above the NRB requirement that non-bank financial institutions maintain a CAR of 11%. Only some of the older MFDBs – the formerly public sector grameen development banks – have lower levels of CAR resulting in the “typical” CAR looking uncomfortably low at 4% for this category. Overall, just 5 MFIs have CAR below 11% while as many as 6 (of the 18 for which reliable data is available) have CAR greater than 15%. This is a substantial improvement on the situation in July 2005 when an analysis by M-CRIL showed that more than 50% of MFIs had CAR below 11%. The discussion below on profitability throws more light on this matter.

Returns to MFIs have improved as the increase in yields has widened margins

The trend in the financial performance of Nepal microfinance over the past eight years is illustrated in **Exhibit 5** using information on the return on assets (RoA) available from the MIX website. It illustrates how financial viability of microfinance institutions in Nepal has improved over the past few years particularly over the past two years. Currently the 3.0% weighted average Return on Assets of the M-CRIL sample of MFIs in Nepal nearly matches the 3.9% of non-AP MFIs in India and regional benchmarks across the globe; it significantly exceeds the 1.87% of the Nepali commercial banks. Even the typical MFI in Nepal earns around 2.0%. This is a great improvement over the 0.4% RoA of 2004-05 estimated by M-CRIL from a sample of rated Nepali MFIs at the time.

Exhibit 5

Trend in the return on assets over 2003-2011



And returns to equity are now at attractive levels in the 20-40% range, 28.9% on a weighted average basis for this 18 MFI sample in 2010-11. On a simple average basis, the typical MFI earned a higher 32.7% return on equity in 2010-11. This compares very well with the 11-12% average levels in Bangladesh and non-AP MFIs in India. Just 2 of 17 MFIs (that have an RoE) earned less than the minimum 15% return on equity that investors regard as worthy of consideration. If this level of return can be sustained and widened across a larger cohort of Nepali MFIs it certainly bodes well for the future of microfinance in the country.

Despite considerable scepticism at the time, early regulation has enabled Nepal microfinance to rise above the turmoil

In sum, despite considerable scepticism about Nepal's early foray into microfinance regulation in the late 1990s, it is now apparent that this seemingly quixotic intervention sowed the seeds for the lessons that were learned during the early 2000s. Improvements in the regulation and public confidence generated by association with the NRB over an extended period of time enabled the industry to withstand the challenges of political instability and turmoil in the middle of the decade. All the indications are that **a stable and responsible microfinance sector has now started to emerge in Nepal** and that this is likely to have a significant positive impact on financial inclusion in the country during the current decade.

Introduction to M-CRIL

A pioneer and world leader in microfinance ratings

Micro-Credit Ratings International Limited is one of the pioneers of financial performance ratings and the worldwide pioneer of social rating for MFIs. It is the world's leading specialist microfinance rating agency. By December 2012, M-CRIL had undertaken over 1,200 financial and social ratings of over 500 microfinance institutions (MFIs) in 32 countries of Asia, Europe and Africa.

M-CRIL is based in Gurgaon – outside Delhi, capital of India. It has an excellent team of 18 analysts with knowledge and experience of microfinance led by Dr Alok Misra, CEO.

M-CRIL also provides sector-wide advisory services and undertakes research and policy studies compatible with its concern to avoid conflicts of interest. Its rating and advisory services have been provided in many countries of Asia including all countries of South Asia and in Cambodia, East Timor, Indonesia, Myanmar, Papua New Guinea and the Philippines as well as in Samoa. In the NIS countries of the former Soviet Union, M-CRIL has experience of Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Russia and Tajikistan. In Africa, M-CRIL has worked in Congo, Ethiopia, Kenya, Malawi, Morocco, Nigeria, Rwanda, South Africa, Tanzania, Uganda.

In keeping with its pioneering tradition, in discussion with other international microfinance raters

M-CRIL has introduced a new rating product called

Microfinance Institutional Rating

along with other international microfinance rating agencies
incorporating responsible governance, management parameters and financial performance
along with client protection, transparency and mission orientation assessments

also ratings/assessments of

Microfinance Investment Vehicles (MIV)

(combined financial and social rating)

Low Cost Private Schools

(for children from low income families)

and

Value Chain Initiatives

(to assess their impact on poverty and
the efficiency and effectiveness of such programmes)

Chapter 1

Battling on despite political instability...

1.1 A country that is yet to realise its potential

Nepal is a landlocked country and one of the least developed economies of the world. It is sandwiched between two economic giants, China and India, with the nearest sea coast some 1,100 km away in India. It is a largely mountainous Himalayan country with just one-fourth of its total land area in the *terai,* a 26-32 km wide, 1,500 km long fertile plain contiguous with India. Only 17% of its land area is arable. However, Nepal is endowed with abundant water resources with its nine major rivers estimated to have a potential of 83,000 MW of hydropower (2.3% of the world's potential). Less than 1% of this potential has been exploited until now.

Nepal is estimated to have a population of 26.5 million according to the 2011 Census but with an absentee (mainly male, temporary economic migrant) population of 1.9 million. The current population growth rate is measured at 1.35% per annum and population density at 180 persons per square kilometre. Roughly 30% of the country in the mountainous Himalayan region to the north has virtually no human habitation because of perpetual snow but the population density increases as the terrain descends into the middle hills region and then the *terai* (plains) in the south. The country is largely rural with only 17% of the population living in urban areas.

Nepal has a per capita GNI of $540 at nominal rates (and $1,260 at purchasing power parity) in 2011, wide income disparities and poor access by a large section of the population to basic social services (according to the Asian Development Bank). It ranks 157 out of 180 countries covered with a score of 0.458 on the Human Development Index of UNDP. Its average GNI per capita growth rate of 1.9% during the period 1990-2010 was lower than the earlier 2.4% growth rate partly on account of a prolonged period of political instability that continues today. Its 2011 GDP growth rate of 3.9% was significantly lower than that of its two large neighbours. The share of agriculture in national income has fallen from 50% in the late 1980s to around 32% in 2011, while the contribution of services has increased substantially to 52.5% of income with the remaining 15.5% provided by industry.[1]

Traditionally, Nepal has had many programmes aimed at poverty alleviation but with a very limited infrastructure base and limited resources, the outreach of the government is limited and the impact of these programmes on poverty was greatly retarded by the state of virtual civil war that prevailed in the late 1990s and early 2000s. This situation has not been helped by the political instability prevailing since then. Nevertheless, the population living below the international poverty line of $1.25 per day at purchasing power parity has improved considerably in recent years and now amounts to just 24.8% of the total compared to over 50% in 2003-04. The proportion below the $2 a day norm is 57.3% while that below the national poverty line is 25.2%. Further progress in tackling the resource constraints and skill deficiencies that lie behind economic deprivation in the country, however, must await the establishment of stable government. In the absence of a settled, commonly accepted, constitutional framework however the establishment of a stable government remains an elusive goal.

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[1] Unless otherwise stated all macroeconomic data in this report is taken from the **World Development Indicators** on the website of the World Bank (www.data.worldbank.org).

1.2 A fast growing financial system promoted by NRB but just 25% inclusion

Over the past 20 years, the Nepali financial system has grown substantially in terms of numbers of institutions, resource mobilization, functional reach and financial viability. **Exhibit 1.1** provides a summary presentation of the financial system in Nepal (including regulated/licensed microfinance institutions). As shown by the table, the number of financial institutions in Nepal has grown strongly over the past few years. During 2005-11, there was a virtual explosion in the establishment of all the four major categories of regulated institutions, A to D Class (as specified by the central bank/regulator, Nepal Rastra Bank, NRB). While the number of regulated Savings & Credit Cooperatives (SACCOs) and financial intermediary NGOs (FINGOs) did not grow at all, this was only because the central bank stopped issuing microfinance licenses to such institutions so this does not indicate a slowdown in the proliferation of SACCOs and FINGOs throughout the country.

Exhibit 1.1

Evolution of the Nepali financial system

numbers

Class	Type of financial institution	1995	2000	2005	2007	2009	2011
A	Commercial banks	10	13	17	20	26	31
B	Development banks	3	7	26	38	63	87
C	Finance companies	21	45	60	74	77	79
D	Micro-finance development banks	4	7	11	12	15	21
Savings & credit cooperatives (licensed)		6	19	20	17	16	16
Financial intermediary NGOs (licensed)			7	47	47	45	38
	Total	**44**	**98**	**181**	**208**	**242**	**272**

Source: NRB, 2011. **Banking & Financial Statistics**, No.57, July.

By end-July 2011, the formal financial sector was comprised of 272 regulated financial institutions with a consolidated asset base of Rs1,166 billion (US$16.5 billion). This included 31 commercial banks with 1,245 branches, 87 Development Banks and 79 Finance Companies.

The financial system is dominated by the public sector with the two government owned commercial banks, Nepal Bank Limited and Rastriya Banijya Bank along with the commercial branches of the Agricultural Development Bank of Nepal (ADB/N) accounting for 473 (38%) of the 1,245 bank branches in July 2011. However, unlike the mid-1990s when the public sector banks dominated the financial system with two-thirds of all loans and 55% of deposits held by the formal financial sector, they now account for just 19% of loans outstanding and hold just 22% of all deposits. The growth of deposits in the formal financial system averaged over 20.6% per annum during 2005-11 whereas loans grew by nearly 23% per annum during the same period compared to the 15% per annum average growth rate of GDP in nominal currency terms.

With the liberalisation of the financial sector during the 2000s the 12% priority sector lending requirement was abolished but the requirement for banks to hold (now) 3.5% of their portfolio in loans to the 'deprived' sector (meant for the 'hard core' poor) continues. Development banks and finance companies are required to hold 3.0% and 2.5% respectively of their portfolios in loans to the deprived sector. A **deprived sector loan** is one provided on a group guarantee (ie. without physical collateral), hitherto up to a limit of NRs60,000 ($833) which was increased to Rs90,000 ($1,250) from financial year 2010-11 (mid-July to mid-July). Similarly, the limit for lending to microenterprises has been increased from Rs150,000 ($2,100) to Rs200,000 ($2,800) but this should not exceed 33% of all deprived sector lending. There are also various limits for lending to women owned enterprises and to community owned enterprises, such as micro-hydro units and cold stores, included in the

deprived sector requirement. Most importantly, the deprived sector lending requirement can no longer be fulfilled by making bulk deposits in microfinance institutions purely for the purpose of earning interest. The deprived sector lending of the financial system as a whole amounted to around 3.7% of total loans in July 2011 with the public sector providing 36% of such lending, making (apparently) a much greater contribution than its statutory requirement.

The central bank's commitment to microfinance is manifest in both the provision for the establishment of micro-finance development banks and the growth of such banks as shown by the information in the above table. From just 7 micro-finance banks (MFDB, including two apex funds) in Year 2000, the number of such banks has now increased to 21. More incentives are being provided for the establishment of such banks in districts with limited availability of banking services. These include the relaxation of minimum capital requirements for additional branches in districts with limited access to financial services and eligibility for opening additional branches in the commercially vibrant Kathmandu valley if branches are also opened simultaneously in limited access districts as well as in one district outside the Kathmandu valley. Interest free loans of Rs5-10 million are also provided by the central bank for opening branches in any of 22 remote districts (out of 75 in the country). This is sought to be reinforced by the policy to provide immediate licences to more institutions established to provide microfinance services in backward regions.

The flow of funds to microfinance institutions – micro-finance development banks, financial intermediary NGOs and SACCOs is supported by two apex funds, the Rural Microfinance Development Centre (RMDC) and the Rural Self-Reliance Fund (RSRF), proposed to be re-styled as the Microfinance Development Fund.

In this context, while the commitment of the regulatory authorities to the promotion of financial inclusion for facilitating peoples' lives is apparent, the level of inclusion achieved is not great. Though accurate information on financial inclusion is not available, at least 75% of the adult population is said to be unbanked (or lacking an account with a formal financial institution).[2]

With an estimated 1.2 deposit accounts per adult (a large proportion in multiple holdings), Nepal is well behind the 3.2 deposit accounts per adult average of the developed world. It is not surprising, therefore, that over the past few years the Nepali microfinance industry has grown substantially from less than 27,000 borrower accounts in 2000 to over 800,000 in July 2011 resulting in an outreach (estimated by M-CRIL) of around 31% of all potential microfinance borrowers in the country.

1.3 M-CRIL's July 2011 cohort of Nepali MFIs...

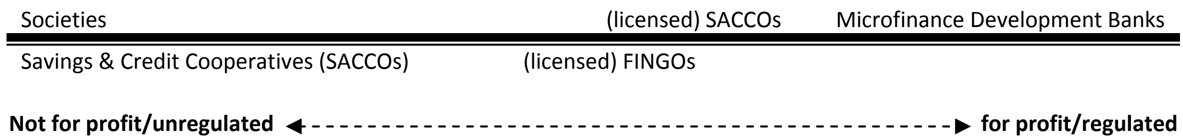
The group of institutions used for this analysis consists of Nepali MFIs whose detailed Annual Financial Statements were available for 16 July 2011, ***excluding MFIs with less than 10,000 active borrowers***. This resulted in a total of 19 MFIs with outreach data and 18 with financial information for this review. For the purpose of this analysis, the classification of information available to M-CRIL has been undertaken, where relevant, by

- form of legal registration, and
- portfolio size.

[2] Demirguc-Kunt, Asli and Klapper, L, 2012. "Measuring Financial Inclusion", **Policy Research Working Paper, 6025**. Washington: The World Bank, April; according to a survey that showed only 25% of the adult population in Nepal had an account with a formal institution (of any type including MFIs) and the number of women was just 21%.

MFIs in Nepal have three main institutional frameworks: not-for-profit Societies, savings and credit cooperatives (SACCOS) and microfinance development banks (MDBs) licensed by the Nepal Rastra Bank – the central bank of Nepal. These microfinance models and institutional framework adopted for use in this analysis are illustrated in **Exhibit 1.2**. Unregulated NGOs/societies and unlicensed SACCOs are, very largely, small, local institutions that do not figure in this analysis of MFIs with a minimum of 10,000 borrowers.

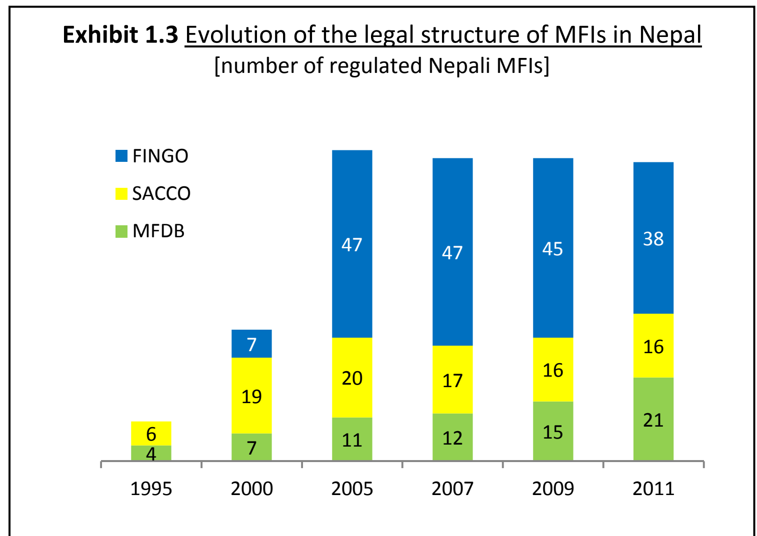
Exhibit 1.2 Institutional Framework



1.4 ...sees a growing trend to the establishment of microfinance banks

Historically, the NGO legal form dominated the microfinance landscape but with the commercialisation of the sector during the previous decade, there has been a growing tendency for these to transform to microfinance development banks. The decline in numbers of licensed FINGOs in **Exhibit 1.1** – from 45 in 2007 to 38 in 2011 – is largely explained by the conversion of FINGOs to such banks. The evolution of the distribution of sample MFIs across legal forms shown in **Exhibit 1.3** illustrates this transformation.

Exhibit 1.3 Evolution of the legal structure of MFIs in Nepal
[number of regulated Nepali MFIs]



Using the 10,000 borrower minimum criterion, the institutional distribution of the 19 MFIs covered by this analysis is shown in **Exhibit 1.4**. Given the fully regulated and professional nature of the development bank as an institution, inevitably the largest MFIs in Nepal are all MFDBs accounting for 58% of M-CRIL's sample for 16 July 2011.

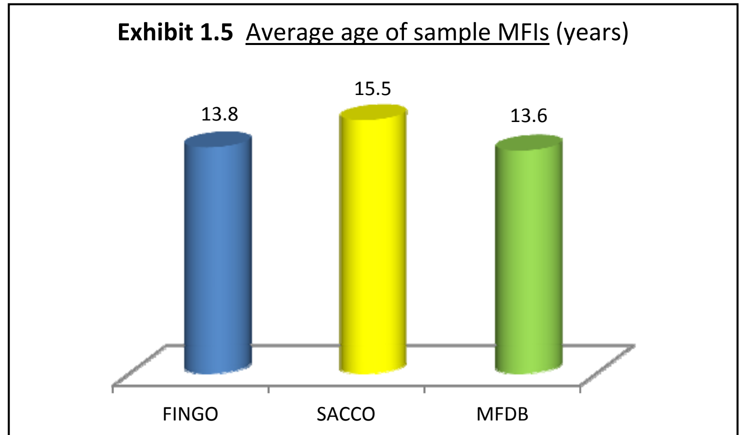
Exhibit 1.4
Distribution of sample by legal form

Profit orientation	Legal Type	Frequency	% of total
Not for profit	NGO – Societies	6	32%
Mutual benefit	SACCOS	2	11%
For profit	MFDBs	11	58%
Sample		**19**	**100%**

Cooperatives have been practising microfinance in Nepal for a long time but most are not competently managed and suffer the usual governance problems experienced by cooperatives all over South Asia. As a result SACCOs have not grown much and only two have reached the 10,000 cut-off for this sample. While many MFDBs have not been in operation as banks for so long others, such as the regional Grameen Development Banks, were established in the early 1990s and are, therefore, nearly 20 years old. Similarly, while others such as Nirdhan and Nerude became MFDBs

more recently, their microfinance operations were established as NGOs in the 1990s and, therefore, are still quite old as programmes. As a result the average age of all the MFIs in this sample is nearly 14 years with, as **Exhibit 1.5** shows, not much difference in age between the MFIs covered across the three institutional forms.

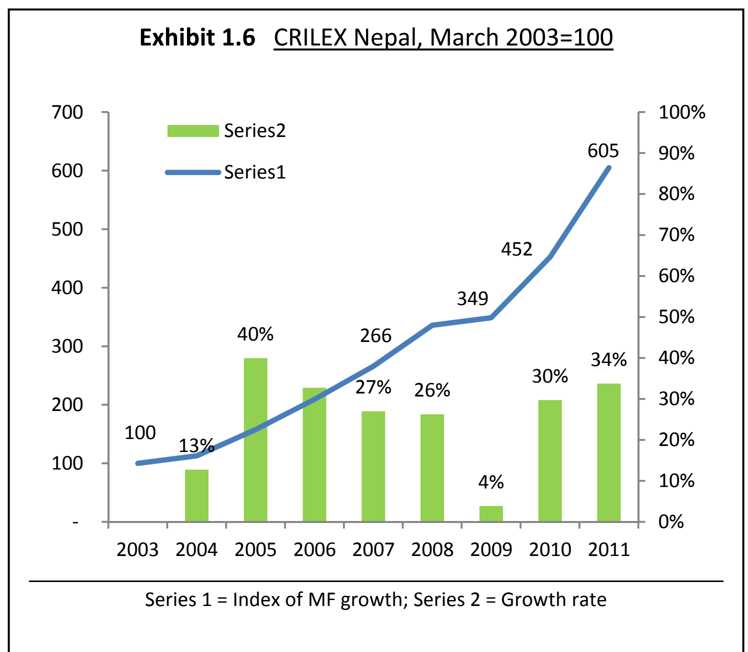
Exhibit 1.5 Average age of sample MFIs (years)



1.5 ...and, partly as a result, the growth of MFIs has continued

Apart from 2009, when political instability in the country and concerns about over-indebtedness in microfinance fostered a sense of crisis in the industry, microfinance in Nepal has grown more or less steadily at around 30% per annum (average over 8 years, 2003-2011=25.2% per year). This is measured by M-CRIL's Nepal microfinance index, known as **CRILEX Nepal** plotted in **Exhibit 1.6**. Note that the CRILEX Nepal value of 605 for July 2011 compares with a CRILEX India value of 8,005 for March 2011, also with 2003=100. **Given the continuing steady performance of microfinance in Nepal compared to the wild growth followed by precipitous decline resulting from the crisis in microfinance in India, the benefits of steady growth are apparent**.

Exhibit 1.6 CRILEX Nepal, March 2003=100



Series 1 = Index of MF growth; Series 2 = Growth rate

1.6 ...as reporting on social performance starts to be established

Concerns about the commitment of MFIs to the fulfilment of their social mission started to be expressed around 2005 as the mantra of growth and financial sustainability established a firm grip on the world of microfinance. M-CRIL was the first international technical agency in microfinance to introduce a social assessment framework through its social rating undertaken at the end of that year. Since then, other specialist microfinance raters have also introduced social ratings, the MIX has developed a social performance reporting platform and the CGAP-sponsored MIV reporting framework has incorporated social along with outreach and financial performance indicators. Though the MIX social reporting platform started as a pilot in 2008 and launched as a full platform in 2009, it is yet to take hold; while many MFIs have started to take the social reporting indicators more seriously, most have not yet incorporated all of the indicators into their MIS. As a result reporting on social performance remains incomplete.

As a pioneer in this field, M-CRIL regards social performance as key to the MFIs' development outcomes. For this reason, this review incorporates as much relevant information as is available from those Nepali MFIs that have reported to the MIX social platform (since at present that is the only collective source of data on these indicators). While to begin with the quantum of social performance information available was very limited, over time MFIs are providing increased information on their outreach, retention rates and social profile of their borrowers, though the quantity of social performance data available continues to be well below the necessary minimum. Information on client retention rates is particularly lacking with none of the 19 MFIs in this sample having provided information. Information on the crucial issue of depth of outreach – the poverty profile of clients – is all but non-existent. Analysis of the data that is available is integrated into this analysis in the next and subsequent chapters.

1.7 Regulation has facilitated the practice of microfinance but was initially characterised by some confusion

Nepal was the first country in South Asia to introduce specific regulations for the microfinance sector: the Development Banks Act, 1996 and the Financial Intermediary Societies Act (FISA), 1998 were both aimed at stimulating the growth of financial services in the rural, mostly unbanked areas of the country. Unfortunately, the attempt at introducing regulation to promote and facilitate microfinance was characterised by a certain degree of confusion in its strategy towards poverty and financial inclusion. While the Development Banks Act was aimed at encouraging private sector initiative in financial inclusion, FISA came as an extension.

1.7.1 The limited banking licence was designed to promote financial inclusion

It was FISA that introduced the concept of a "limited banking licence" as a way to legitimise the ongoing financial services activities of NGOs registered as societies and to improve the image of cooperatives amongst the public. The limited banking licence gives its holder the right to provide microcredit services to low income families and to collect the savings of such families as member-deposits. It carries with it the obligation to report to the central bank as regulator and to adhere to its prudential norms. However, from the start, FISA was more a source of confusion than the promotion of inclusion. The Act said nothing about the collection of savings from non-borrowing members of the public and, indeed, contradicted the Cooperatives Act which is more liberal regarding membership and does not include income or account size limitations that are incorporated in FISA. This placed cooperatives that are limited banking licence holders in a legal limbo with regard to deposit taking. It is partly for this reason that the number of cooperatives licensed under the Act has declined, from 35 at the peak in 1999-2000 to just 16 in July 2011 though the limited banking licence for cooperatives was meant to provide the stamp of legitimacy conferred by central bank supervision.

At the same time, this stamp did not initially benefit financial intermediary NGOs (FINGOs) either since these institutions were not particularly successful at raising voluntary deposits from members, let alone from the general public. As discussed above, the number of FINGOs has declined somewhat because of the conversion of some to MFDBs; despite their initial failure to raise deposits from members, access of FINGOs to preferential loans from RSRF (the government sponsored wholesale lender to MFIs) and commercial banks was still an advantage. Nevertheless, there has not been any rush to obtain fresh licences.

Apart from the confusion vis-a-vis cooperatives, the original version of FISA included a clause that implied that the NRB would underwrite loans made to societies licensed under the Act. The clause

was dropped in amendments made in 2003 after the NRB objected in the strongest terms. Ultimately, all financial legislation in Nepal was replaced in 2006 by one omnibus law called the Banks and Financial Institutions Act, 2006.

1.7.2 ...within a relatively liberal regulatory framework with limited capital requirements and liquidity norms

The minimum capital requirement for the establishment of commercial banks in Nepal is in the range Rs250-500 million ($3.5-7.0 million) in equity depending on the location of the head office and the geographical coverage of their business. These are fairly liberal requirements and compare with a minimum requirement of $60 million in India and $110 million in Pakistan. For MFDBs the requirements are significantly lower as shown in **Exhibit 1.7**. The capital requirement for operations at the national level have been reduced over the past few years from the earlier Rs160 million ($2.22 million). The first MFDBs (established as RRDBs) had an initial capital of Rs60 million ($0.83 million at the time). For SACCOs with limited banking licences the requirements are much lower as shown in the table. Since NGO operations are not based on equity ownership, FINGOs are required to limit each loan to less than Rs100,000 ($1,400) per individual and must build a risk reserve fund through the allocation of 10% of their operating profits.

Exhibit 1.7 Minimum capital requirements for MFDBs and licensed Cooperatives

Area of operation	Nepal Rs in millions	US dollars million
1 district	2.5	0.035
3 districts	10	0.14
10 districts	20	0.28
National	100	1.41
...and cooperatives with limited banking licence		
Municipality dist	2.5	0.035
Sub-metro' dist	5	0.07
Metro' district	10	0.14

The capital adequacy norms for all financial institutions have, however, been tightened in keeping with Basel II norms and banks are now required to maintain their capital fund at 10% of their risk weighted assets with at least 6% being core (or Tier 1) capital. Other financial institutions must maintain a capital fund equal to at least 11% of their risk weighted capital and at least 5.5% core capital.

Exhibit 1.8 Liquidity & cash reserve ratios*

Institutions	Liquidity ratio	Cash reserve
MFDBs	4%	2%
SACCOs	7%	2%
FINGOs	Not specified	

* as a proportion of deposits

Liquidity ratios specified by NRB for microfinance institutions are set out in **Exhibit 1.8**. NRB-licensed cooperatives also have to place 1% of their total deposits in an account with NRB.

The loan loss provisioning norms for financial institutions range from 1% to 100% depending on the quality and ageing of the loan. Good loans (less than 3 months overdue) must be provisioned at 1%, weak (3-6 months overdue) at 25%, doubtful (6-12 months overdue) at 50% and bad loans (more than 12 months overdue) at 100%.

Over the years, group guarantees have become accepted in Nepal as loan collateral for poverty lending. Even commercial banks involved in group lending have accepted these as a collateral substitute. In addition, the Development Banks Act specifically recognises joint liability of the group

as sufficient collateral for low income families up to a specified loan amount (Rs60,000, $850) given to them. For microenterprises, unsecured loans can be up to a level of Rs150,000 ($2,100).

1.7.3 ...and no official limits on interest rates though political pressure still prevails

There are no interest rate caps on micro-lending in Nepal. Interest rates can be fixed by the Board of Directors of the respective MFIs. However, decisions regarding changes and procedures have to be notified to the NRB within a few days of making them and information on effective interest rates have to be published in the local media at least once a year. However, in a country that is still in political ferment after the Maoist insurgency and the collapse of the monarchy, it is inevitable that populist action by political parties results in informal pressure on MFIs to limit their interest rates. By and large, effective interest rates in microfinance in Nepal (less than 25% with an average yield of just 22%) are amongst the lowest in the world.

The following chapters analyse and discuss the performance of MFIs in Nepal blessed with a liberal, if sometimes confusing, regulatory dispensation but having to battle on in an environment of political instability that affects their operations at the client level sometimes on a day-to-day basis.

Chapter 2

MFIs make an important contribution to inclusion

2.1 MFIs cover roughly 31% of families eligible for microfinance and are equally if not more important to financial inclusion as higher level financial institutions

Exhibit 2.1

Active borrower accounts of Nepal MFIs mid-July 2011

Legal Type (no. of MFIs)	Total borrower a/cs Number	%	Average accounts
FINGO (6)	167,030	22.1	27,838
SACCO (2)	56,526	7.5	28,263
MFDB (11)	533,458	70.5	48,496
Nepal Sample (19)	**757,014**	**100**	**44,530**
RMDC Nepal (37)	855,906		15,284
MIX South Asia (212)	42,190,159		
India, non-AP (56)	19,916,917		
MIX Bangladesh (37)	20,838,127		

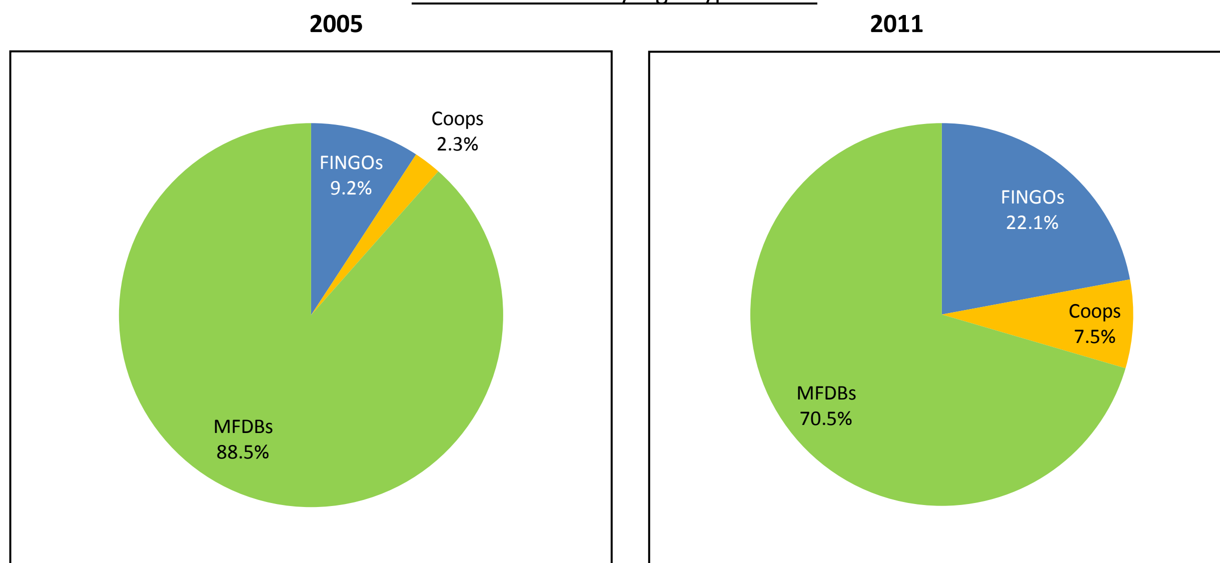
As a result of the significant increase in the number of microfinance institutions, the number of clients served by MFIs in Nepal has grown substantially but not dramatically over the past 8 years as shown by the information in **Chapter 1**. The total number of borrower accounts at sample MFIs was reported at just over 757,000 by mid-July 2011 (**Exhibit 2.1**). The larger list of partners of RMDC Nepal, the main wholesale microfinance lending institution in the country, reports nearly 856,000 borrower accounts for 56 MFIs in mid-July 2011.

The number of borrower accounts can, however, be misleading since these do not necessarily translate to numbers of borrowers. This is because, particularly in some of the densely populated areas like the Kathmandu valley and many of the *terai* districts, there is reported to be a significant amount of multiple lending. There are no reliable estimates on the extent of multiple lending but a conservative figure of 20% for overlap suggests that the number of borrowers served by MFIs was around 713,000 in July 2011.

MFDBs catered to over 70% of all borrower accounts (**Exhibit 2.2**) in July 2011 down from over 88% in July 2005. The proportion of borrower accounts with NRB-licensed FINGOs and SACCOs (or cooperatives) have increased significantly as a few institutions of each type have registered high growth. The average size of Nepali MFIs for the 19 MFIs in the M-CRIL sample for outreach is over 44,500, far higher than the RMDC Nepal average of nearly 15,300 but much smaller than the MIX international average of the order of 70,000 for year 2011.

Exhibit 2.2

Active borrowers by legal type of MFI



The contribution of MFIs to financial inclusion is estimated (based on the limited available information) in **Exhibit 2.3**. The calculation is based on the following data and assumptions

Exhibit 2.3
Contribution of MFIs to financial inclusion

Particulars	Estimates
Population	26,500,000
Average family size	4.9
Families	5,408,163
Terai + major valleys	75%
Financially excluded by banks and other formal institutions other than MFIs	88%
Ultra-poor not regarded as suitable for microfinance	20%
Families eligible for microfinance	2,758,163
MFI borrower accounts	855,906
Extent of overlap	20%
Borrower families served by MFIs	713,255
Microfinance outreach to eligible families	31.0%
Coverage of total number of families	13.2%
Outstanding per borrower (20% overlap, Rs	22,472
per capita income ($540)	38,232
Outstanding as % of pc GNI	58.8%

- Population and family size is taken from the 2011 Census for Nepal
- MFIs are known to operate mainly in the *terai* and the major valleys since microfinance operations in the middle hills and mountain areas are not viable – the population in these accessible areas is estimated at 75% of the total
- Since the FINDEX study of the World Bank referred to in the previous section found that the degree of financial exclusion in Nepal is 75% but included MFI accounts in the calculation, the best assumption on exclusion by banks and other formal financial institutions is 88%[1]
- 20% of the population is assumed to be ultra-poor and, therefore, unsuitable for microfinance
- The extent of overlap in outreach to families covered by MFIs is assumed to be 20% (as discussed above).

The result of this calculation is an estimate of over 2.6 million families financially excluded and eligible for financing by MFIs. Since the number of families covered (after allowing for overlap) is around 713,000, this means that the coverage of eligible families by MFIs is 31.0%. As a proportion of the overall population, the coverage of MFIs, or the **contribution of MFIs to financial inclusion, amounts to 13.2%** (based on the 20% overlap assumption made here). Since the contribution of banks is very broadly (and optimistically) estimated here at 12%, it is apparent that **MFIs are equally if not more important to financial inclusion in Nepal as the formal financial sector**.

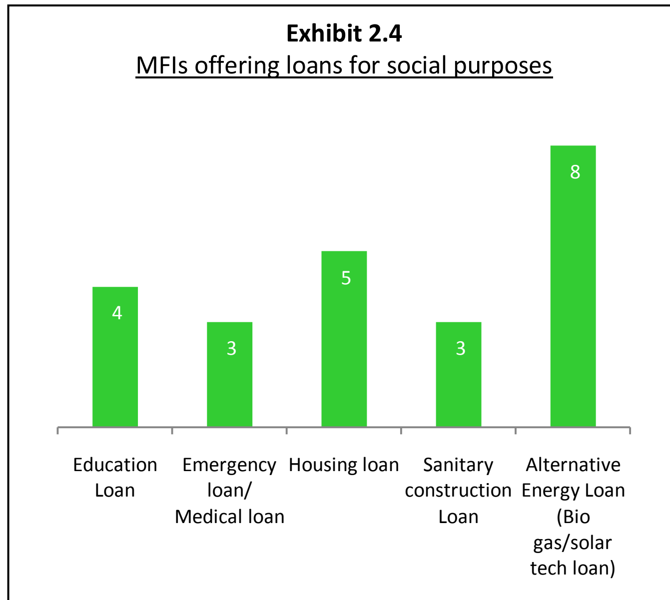
2.2 MFI development objectives are focused on the rural poor

While MFIs generally subscribe to development objectives, the articulation of those objectives varies. Very few MFIs in Nepal have provided information on their objectives and range of microfinance products on the MIX platform. A study of the annual reports/financial statements, websites and recent rating reports (of 10) of the 19 MFIs in the sample has enabled a review of the objectives of 11 MFIs and provided the range of products of 12.

Objectives: All 11 MFIs state the intention to work with rural households and 10 of the 11 to work with poor, needy or deprived sector households. Financial inclusion and access to financial services is mentioned explicitly by two MFIs. Employment generation, growth of existing businesses of target clients and movement towards gender equality are the other main objectives. Discussion of social and financial performance in this review is based upon these stated objectives.

[1] Given the lack of information on accounts in the formal financial sector, this is the best estimate possible.

Progress towards achieving the first two objectives, in particular, is dependent on the selection of clients. This begins with a statement of the target profile of clients for staff to use during the identification process. After many years of debate on the feasibility of poverty reduction through microfinance, significant numbers of MFIs have now realised the need to focus on low income clients – whose incomes may or may not be below the national or international poverty lines but who are, nevertheless, financially excluded. However, systematic poverty targeting is still undertaken by very few and ***none of the sample MFIs have provided information on the income profile of their clients*** to the MIX social performance platform.



Products: Further, increasingly recognising that credit designed for economic activities alone may not be sufficient for achieving their development objectives, MFIs in Nepal aim to offer financing for the social needs of their target clients. **Exhibit 2.4** summarises the offering of loans for social purposes by the 12 MFIs for which specific product information is available. While some have certainly developed financial products with the social needs of their clients in mind, they are all in the early stages of working on these needs and social products are still minor add-ons to the financial services for economic activities that they see as their main business.

2.3 And MFI portfolios, though small, are a growing part of the financial system

The M-CRIL sample of 19 Nepali MFIs reported a total portfolio outstanding of Rs14,176 million ($200 million) on 16 July 2011 whereas the total for the microfinance sector was Rs15,776 million ($223 million) roughly 11% higher according to central bank data (see source in **Exhibit 2.4**). This compares with a portfolio of Rs10,900 million ($154 million) in July 2010 – a growth of 45%. Over a six year period since July 2005 the portfolio has expanded 3.9 times from Rs4,050 million ($57 million) registering an annual growth rate of 25.4%.

As a proportion of the overall financial system, however, MFI operations remain small. As the table in **Exhibit 2.5** shows, Nepal's MFIs have a portfolio that is just 2.2% of the overall financial system having increased from 1.9% in 2005. Like microfinance, the overall financial system is also growing quite fast having registered an average growth of 23.0% per annum since 2005. Despite its relatively small size, the contribution of Nepali microfinance to the financial system far exceeds that in India where MFIs provide just 0.29% of the total credit outstanding from the banking system (down from 0.64% in March 2010 before the microfinance crisis), though it was still nearly 30% of the micro-credit portfolio of the Indian banking system (41% in 2010).[2] Inform-ation on the microcredit portfolio of the non-micro-finance (or conventional finan-ce) institutions in Nepal (with amounts outstanding less than Rs50,000) is not available.

[2] Information on India is from the **M-CRIL Microfinance Review 2012.**

Exhibit 2.5

Distribution of outstanding portfolio by legal type

Legal Type	Outstanding Portfolio					
	July 2005			July 2011		
	Rupees million	US$	% of total	Rupees million	US$	% of total
FINGOs	258	7.6	6.4	2,211	31.2	15.6
Coops	1,431	1.3	35.3	1,161	16.4	8.2
MFDBs	2,361	54.7	58.3	10,805	152.6	76.2
Sample MFIs				**14,176**	**200.2**	**100.0**
Nepal MFIs all*	**4,050**	**57.5**	**1.9**	**15,776**	**222.8**	**2.2**
Finance Companies	21,323	301.2	10.2	86,960	1,228.2	12.1
Development Banks	19,233	271.7	9.2	89,116	1,258.7	12.4
Commercial Banks	163,688	2,312	78.3	528,225	7,460.8	73.5
Nepali Financial System	209,053	2,969	100.0	718,674	10,151.8	100.0

Source: NRB, 2012. **Banking and Financial Statistics, No.57, July 2011.** Kathmandu: Nepal Rastra Bank

Whether or not the rate of growth of microfinance in Nepal is sustainable is also of interest. Since, unlike Indian microfinance during 2003-10, its growth rate does not significantly exceed the overall financial system, and is within a moderate range (for microfinance) of 25-40%, it appears to be manageable. However, it is apparent that its geographical focus within the *terai* districts of the eastern half of Nepal and mainly the Kathmandu valley will only result in increasing overlap of clients amongst the MFIs and with some of the smaller borrowers from the conventional finance institutions (development banks, finance companies).

As depicted in **Exhibit 2.6**, the average size of a Nepal MFI's portfolio is Rs746 million ($10.5 million) though MFDBs are larger at an average of Rs982 million ($13.9 million). In fact a number of the MFDBs rival conventional finance institutions, such as development banks and finance companies, in size with 5 MFDBs having larger or comparable portfolios to their respective Rs1,100 million and Rs1,024 million average portfolios. MFDBs, in particular, are an increasingly important part of the financial system.

Exhibit 2.6

Average portfolio & loan balance per borrower

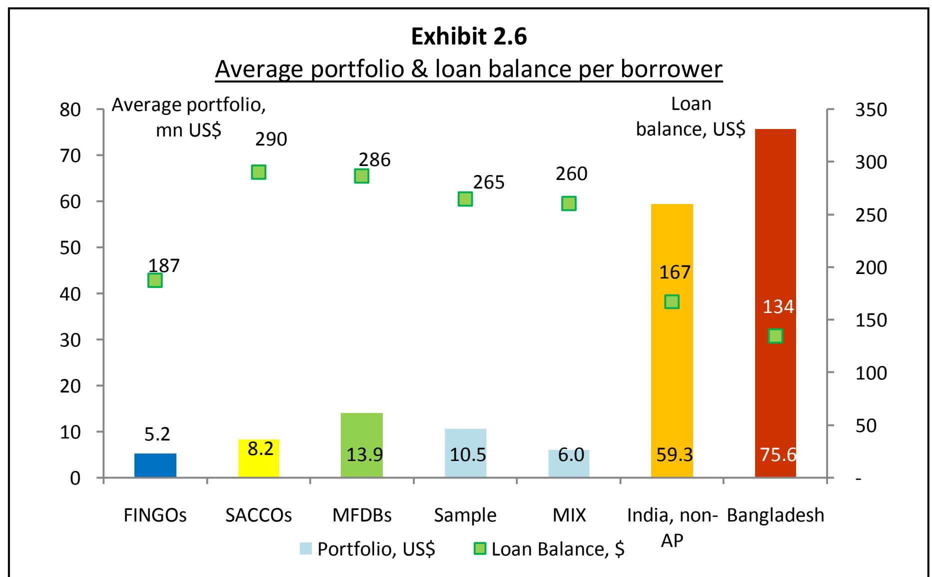


Exhibit 2.7 presents the portfolio size distribution of Nepali MFIs. There are 5 microfinance institutions with portfolios in excess of Rs1,000 million. These large MFDBs account for over 55% of the total outstanding portfolio of MFIs (and over 45% of the borrower accounts).

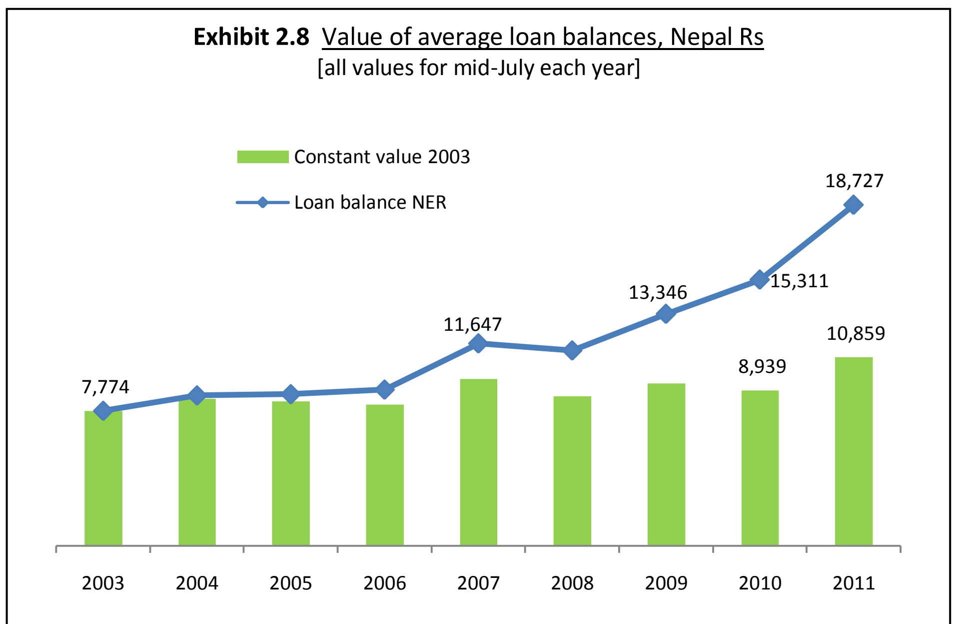
Exhibit 2.7: Portfolio size distribution of MFIs

Portfolio Size, Rupees million	Number of MFIs	Portfolio, Rs mn		Proportion of total	
		Total	Average	Portfolio	Borrower a/cs
<200	4	594	148	4.2%	11.2%
200 to <500	2	691	345	4.9%	4.3%
500 to <800	6	4,183	697	29.5%	33.5%
800 to <1000	1	886	886	6.2%	5.4%
>=1000	5	7,823	1,565	55.2%	45.6%
Sample	**18**	**14,176**	**788**	**100.0%**	**100.0%**

2.4 ...and, unlike Indian microfinance, the real value of average loan balances has grown though it raises questions about depth of outreach to the poor

In terms of their exposure to individual clients shown in **Exhibit 2.6** (above), at Rs20,254 ($286) and more, MFDBs and the two SACCOs in the M-CRIL sample have the highest outstanding loan balance per borrower in mid-July 2011. These are substantially larger than the average Rs13,000 ($186) loans outstanding from not-for-profit FINGOs.

Exhibit 2.8 Value of average loan balances, Nepal Rs
[all values for mid-July each year]



From the perspective of client graduation to higher value activities, the most interesting aspect of loan balances is whether these increase over time in terms of real value. **Exhibit 2.8** presents the real and nominal values of average loan balances of the sample MFIs in Nepal over the 9 year period July 2003 to July 2011.

As the figure shows, the nominal value of average loan balances per borrower account has increased quite substantially from Rs7,800 ($110) in 2003 to as much as Rs18,700 ($265) in 2011. The process has been fuelled by larger sums of money becoming available from both RMDC and the banking system for on-lending by MFIs.

Using the Consumer Price Index (CPI) to deflate nominal values provides a better reflection of the true picture in terms of the impact of these loans on microfinance borrowers. Over the eight year period to July 2011 there was an increase of 40% in the real value of loan balances (at constant prices) over the base year (**Exhibit 2.8**). This is during a period when Nepal's GDP per capita increased by around 150% from $242 in 2003 to $619 in 2011. **Exhibit 2.9** illustrates the relationship between MFI loan balances and the increase in GDP per capita. Average loan balance as a proportion of GDP per capita fell below 40% in a couple of years during the reference period. However, **in real terms the MFI contribution to the economic lives of the low income families they serve has remained roughly within the 37-45% range over the period**.

At the same time there is another issue to be considered here in the relatively high 45% loan balance of Nepali MFIs as a proportion of GDP per capita – compared to just 11% in India and around 20% in Bangladesh. This probably means that the lowest income segments of the population are not being served by MFIs. The above analysis has already assumed that the bottom two income deciles cannot be served by microfinance due to their level of poverty. A loan balance that is 45% of GDP means that it is likely that MFIs are not significantly serving the next two deciles either since, even for these, a loan balance of the order of $265 is likely to be a crippling 60% or more of income. It is only loan sizes that are substantially below average that would be suitable for this segment of the population.

Exhibit 2.9 Loan balance as % of GDP per capita
[level for mid-July each year]

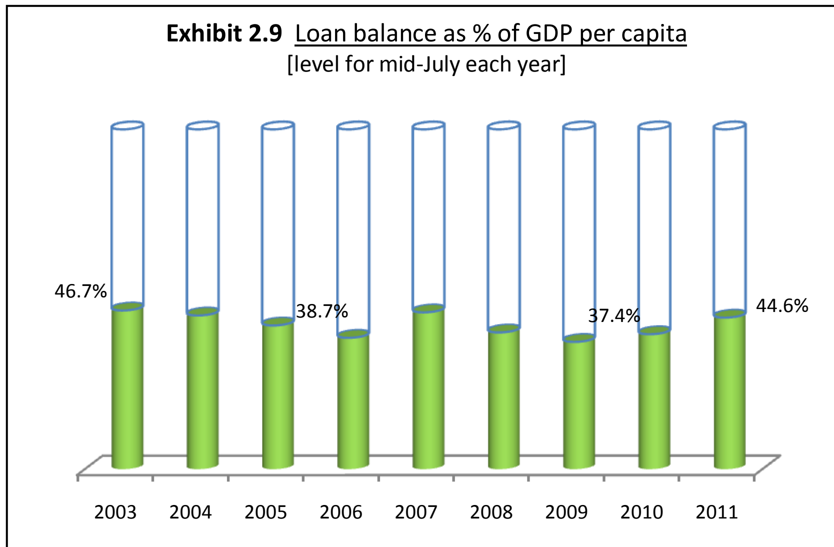


Exhibit 2.10
Estimation of depth of outreach of Nepal MFIs

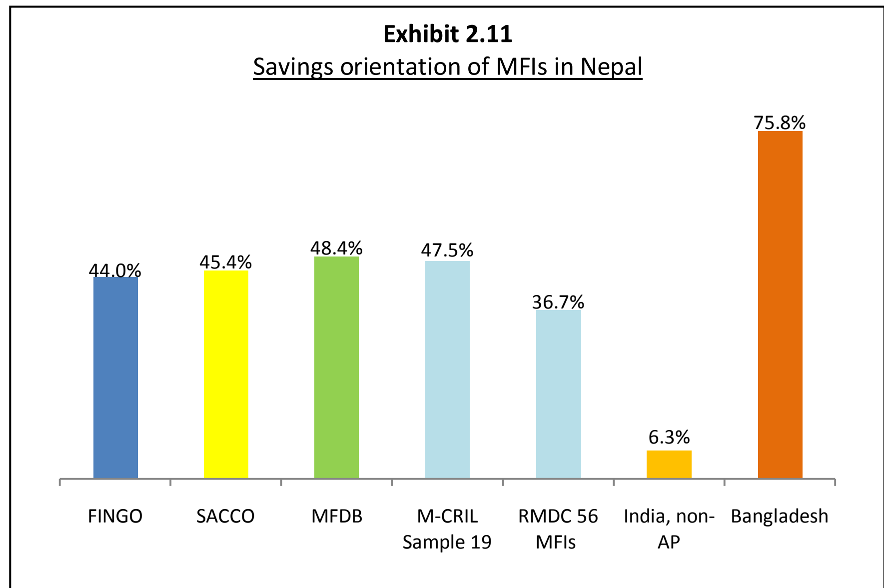
	Nepal Rupees*
Per capita income at $2.16 per day poverty line (PPI), in 2005*	36.33
Family size	4.9
Family income per day, 2005	178
Annual family income 2005	64,976
CPI 2011 with 2005=100	172
Annual family income 2011	**111,797**
Proportion below national poverty line, 2005	58.4%
Outstanding per family, 2011 (from **Exhibit 2.3**)	22,472
Outstanding as proportion of disbursement	55%
Loan size at disbursement, NRs	40,858
Interest yield (22.4%, **Chapter 3**)	5,034
Total payment by household over one year loan cycle	**45,892**
Payment as % of family income	**41%**

*unless otherwise stated

This assessment is validated by the calculations in **Exhibit 2.10**. It shows that the threshold annual family income for persons living above the $2.16 per day poverty line (as calculated by the Progress out of Poverty Index, PPI team) is nearly Rs112,000. With an average outstanding per family (from MFIs) of Rs22,472 this translates to an average loan size at disbursement of nearly Rs41,000 and would require payments over the year (given the 22.4% yield) of Rs46,000. This means that even a borrower at the $2.16 threshold would need to pay out 41% of family income to service her microfinance loan. Given that the family must meet its basic needs before it pays out to service a loan, a 41% level of payout is just about manageable. It is apparent, therefore, that the current average level of loan just services a $2.16 a day family (around the 60th income percentile since 58.4% of the population is below this level). Since the distribution of loan sizes is likely to be above this level as well as below, this would suggest that MFIs in Nepal service an approximate range of income groups from about the 35th to the 75th income percentile. Thus, as suggested above, the bottom 4 income deciles are apparently not being adequately served.

The implications of this finding **for the depth of outreach of Nepali MFIs need to be considered**. It would be interesting, in this context, to generate some information on the poverty outreach of the leading MFIs in Nepal. Such information is either not available at present or, at any rate, is not being reported to the social platform of the MIX.

2.5 The savings orientation of Nepal MFIs is good thanks to the developmental approach of the regulator



Thrift deposits are accepted formally by MFIs from their members and are recorded as part of their balance sheets wherever these are legally permitted. Due to the early (1998) introduction of the MFI licensing system in Nepal, most MFIs in the country (all 56 partner MFIs of RMDC, for instance) are able to offer deposit services. Initially, though, due to the lack of public confidence (in FINGOs, in particular) not all MFIs were able to take full advantage of this. However, as with MFIs in other countries, public confidence has improved with the longevity of the institutions and the savings orientation of MFIs in Nepal shown in **Exhibit 2.11** has improved considerably over the years. Deposits for the M-CRIL sample average 47.5% of outstanding loan balances in July 2011 while for all the RMDC partners taken together this ratio was 36.7%. By comparison, the savings orientation of Indian MFIs who have to contend with a very conservative regulator was just 6.3% in March 2012. In Bangladesh, on the other hand, where all MFIs are not-for-profit NGOs and have, therefore, been allowed to take deposits from members for a long time, the savings orientation is very high at 78%. The extent to which these deposits affect the overall funding status of MFIs is part of the balance sheet discussion that follows in **Chapter 4**.

Exhibit 2.12

Saving levels per depositor

Legal Form	Deposits, Rs million	Number of depositors	Savings/ Depositor (Rs)
FINGO	973	266,203	3,657
SACCO	527	87,108	6,047
MFDB	5,233	963,724	5,084
Sample (19)	**6,733**	**1,317,035**	**4,859**
RMDC (56)	5,795	1,202,351	4,820

The deposit facility not only bolsters the availability of funds to MFIs it also assists in reducing default risk by increasing the proportion of average loan balance secured by member deposits. **Exhibit 2.12** presents the amount of savings balances by different types of MFI. As elsewhere, cooperatives (SACCOs) have the highest savings per depositor ($85) and FINGOs the lowest (at $51) with an average of $68. The average savings balance per depositor is thus 25.7% of the average loan balance of $265.

This rounding out of the relationship between MFIs and clients – as suppliers as well as users of funds – helps to reduce the risk of coercive collection practices by MFI staff. This is a matter that lies at the centre of the microfinance crisis in India since it is allegations of coercion leading to suicides by MFI borrowers that led to the AP Government's action against the microfinance sector. A two way relationship incorporating deposits as well as loans is much more wholesome, requiring an investment by MFIs in customer satisfaction as well as credit outreach. NRB, the central bank of Nepal, has done well to cast this issue in a developmental perspective rather than focusing purely on the risk to its own reputation that could result from a potential collapse due to MFI management inefficiency or fraud.

2.6 While the rural orientation of MFI operations is reducing but, in any case, does not necessarily indicate particular poverty outreach

Exhibit 2.13
Rural/Urban breakdown

Area	MFIs	% of active borrower a/cs
Rural	19	76.5%
Urban	15	23.5%

Unlike much of Latin America and Eastern Europe, in particular, MFIs in Nepal (as in much of Asia) do not necessarily operate in urban areas. On the contrary, many of the leading MFIs started as rural institutions having located there on the assumption that poverty was largely a rural phenomenon. It is only in recent years that MFIs have placed more emphasis on urban operations seeing this as an easy way to increase growth, limit costs and maximise profits. Thus, 15 of the 19 MFIs in the M-CRIL sample work in urban as well as rural areas. There are no MFIs that do not have rural operations but 4 do not operate in urban areas at all (**Exhibit 2.13**). This aggregates to 76.5% of all MFI borrower accounts being held by rural-based clients (in July 2011) while urban clients held 23.5%. Over time, the rural-urban imbalance is declining as MFIs have shifted their developmental focus from more remote rural areas to easier-to-reach urban areas. That this rural-urban mix has nothing to do with the poverty profile of microfinance clients is part of the rating experience of M-CRIL. Hopefully, the recent heightened concerns for social performance will see more extensive client profile information becoming available – as a routine part of MFI reporting. In any case, it is apparent that rural location alone is not a good proxy indicator of poverty orientation, contrary to popular assumption in international discourse.

2.7 ...though the principle of responsibility in the provision of microfinance services is gradually taking hold

The concern for responsible microfinance is reflected in the Codes of Conduct (being) developed by MFI networks and internationally in the client protection principles developed through the SMART Campaign. M-CRIL has, until now, included evaluation of responsibility to clients as part of Social Rating. During 2011, along with other specialist international rating agencies, M-CRIL piloted a Responsible Finance Rating product, now renamed and launched as the Microfinance Institutional Rating (MIR). The MIR evaluates responsible performance including governance, client protection and responsibility to staff as well as a balanced level of profit as part of the overall rating of sustainability and risk. M-CRIL is not aware of any MIRs or Code of Conduct Assessments having been undertaken in Nepal so far.

The **following is a summary of some of the main issues** from the Code of Conduct Assessments, MIRs and Social Ratings of leading MFIs in India, undertaken during the past two years. This could act as a pointer to future approaches to the issue of social responsibility by MFIs in Nepal.

Integrity: The microfinance networks expect member MFIs to adopt a Code of Conduct through formal adoption by the Board. Leading MFIs have started to do this since late 2010. Some have also signed on to the global Client Protection Principles. There has been some confusion as MFIs have tried to combine features from the different documents. Within the past year, efforts (by the two networks and SIDBI) to converge the Codes for the India microfinance sector have resulted in the emergence of a single code of conduct that guides the practice of responsible microfinance.

For MFIs, following adoption by the Board, the next essential step is to introduce specific guidelines as part of operations: in the operations manual, in training for staff and in monitoring compliance through internal audit. These steps are still works in progress, and it takes time, especially for large MFIs, to introduce systematically as part of their operating culture. Overall, the incorporation of standards in the Codes of Conduct remains relatively weak. However, some MFIs have made an ex-

ceptional effort to ensure that their practices conform to the codes of networks and guidelines of regulators, to the extent of commissioning agencies like M-CRIL to validate the process.

Governance: Good governance has always required having a number of independent directors, with relevant professional skills, and their engagement through regular meetings and access to information. Responsible microfinance adds involvement of the Board in defining and reviewing sustainable rates of growth, responsible level of profit and allocation, remuneration of the CEO, and understanding and regular review of compliance with standards of client protection. MFI Boards are beginning to apply this part of their role of safeguarding stakeholder interests, depending on their exposure to expected standards.

Competition: There is increasing awareness of the need to deliver microfinance services to underserved regions and areas. At the same time this requires a systematic method to identify underserved areas. District level outreach being reported to Sa-Dhan this year may help to do this. Nevertheless, there is some indication of the over-stretching of management systems as MFIs seek to expand into different states. MFIN guidelines limiting recruitment of staff from other MFIs have low application in a situation where MFIs are having to consolidate if not cut back their operations. However, the principle is recognised and will require internal monitoring as part of HR systems.

Client protection: Of the seven principles of client protection, two - **appropriate product design** and **responsible financing** – are to some extent covered, at least for credit, under the new RBI guidelines, including more flexible options for repayment of loan instalments and a cap on interest rates, which MFIs now expect to implement. Apart from these, the direct appraisal of household cash flows and existing liabilities (to **prevent over-indebtedness**) as well as ensuring **effective transparency** with clients are major challenges for MFIs who have relied on standard loan products, peer assessment and the role of group leaders within the group methodology. A focus on these aspects requires different operational formats, training of field staff to apply them and to communicate – and ultimately sufficient time for field staff to engage effectively with clients. Most MFIs have printed details of fees, interest and instalments due on individual loan cards of group members; though sometimes this remains group based (kept by group leaders) and individual members do not have copies. Receipts for repayments are usually provided. Credit-life insurance details are not always provided along with the loan information – either the premium or details of coverage and process to claim, in the local language.

In general, in the group based model, MFIs have relied on the initial Group Recognition Test training – which consists of introductory sessions of up to 1 hour over 3 days. Feedback from clients during rating indicates that this needs to be reinforced by follow up explanations and communication. MFIs also prefer to ensure that clients know the repayment instalment, without ensuring understanding of the Effective Interest Rate – and it remains a moot point as to what clients find most relevant, though this is related to financial education (below).

MFIs are developing guidelines for **appropriate staff behaviour**, including procedures in case of default. These appear most effective when specific practices – do's and don'ts – are listed, and when there is a formal phasing of action in case of default, which includes distinguishing reasons for default, and the option for rescheduling loans in cases where clients are facing temporary and genuine difficulties in repayment – only using peer pressure and social collateral to a limited extent in the group model.

Mechanisms for client feedback and **resolution of complaints** are receiving more systematic attention – with many MFIs now including telephone numbers on the loan cards as well as having a designated person to receive and register complaints. In a few MFIs, senior management or Board mem-

bers are asking for regular reports with complaints categorised together with action taken – which is a positive development.

MFIs are beginning to consider opportunities for **financial education** of clients, going beyond the basic details of financial products offered to a wider consideration of financial planning, budgeting and managing debt.

The overall growth of outreach in terms of borrowers, portfolio outstanding, loan sizes, and savings discussed in this section inevitably affects operating expenses and portfolio performance of MFIs. These issues are discussed in the next chapter.

Chapter 3

...and have excellent operational efficiency

3.1 Cost efficiency has held steady over the years

As financial service agencies operating in a low technology arena, microfinance institutions are heavily dependent on staff for ensuring efficient and effective operations. Staff productivity measured by the number of clients served per staff member is, therefore, an important factor determining the efficiency of MFIs and feeds directly into the determination of the average cost per borrower served.

3.1.1 Staff numbers are small but client productivity is comparable with other countries of South Asia

The 19 MFIs in this outreach analysis have a staff strength ranging from 60 to 465; with a total of 3,519 (compared to 3,910 of the larger set of 56 RMDC partner MFIs). As **Exhibit 3.1** shows, similar to loan accounts and portfolio, the MFIs are only a fraction of the size of MFIs in Bangladesh and also India (even with their smaller average size after the AP crisis). The average per MFI for Bangladesh is two-thirds of the total for all RMDC partners and the India average is over 40% of the total. MFIs in Nepal are smaller than other MFIs in the region, a feature resulting partly from the disturbed governance conditions in the country but perhaps also a positive feature that has prevented the over-heating of the industry seen in India in recent years.

Exhibit 3.1
Average staff employed by MFIs

Legal Type	Total staff	Average number of staff /institution
FINGO	728	121
SACCO	225	113
MFDB	2,566	233
Sample 19 MFIs	**3,519**	**185**
RMDC 56 MFIs	3,910	70
India	89,372	1,596
Bangladesh	97,431	2,633

For measuring the efficiency of human resource utilisation, staff productivity ratios – clients per member of staff and outstanding portfolio per member of staff – are the two key indicators. This Review does not use the client-to-loan officer ratio and portfolio-to-loan officer ratio. The reason for this is the difficulty of classifying staff as loan officers across MFIs. Many MFIs give field officers responsibility for all functions related to microfinance groups. In this situation the definition of who is a loan officer is clear. In other MFIs, however, field officers are responsible for group formation and record keeping but branch-based tellers make disbursements and collect repayments as well as performing other branch office functions. In others the field officer is a facilitator of community based groups (resembling cooperatives) and does not directly either mobilise clients or collect repayments. These are two examples where the distinction between loan officers and other staff is unclear.

Exhibit 3.2
Staff productivity

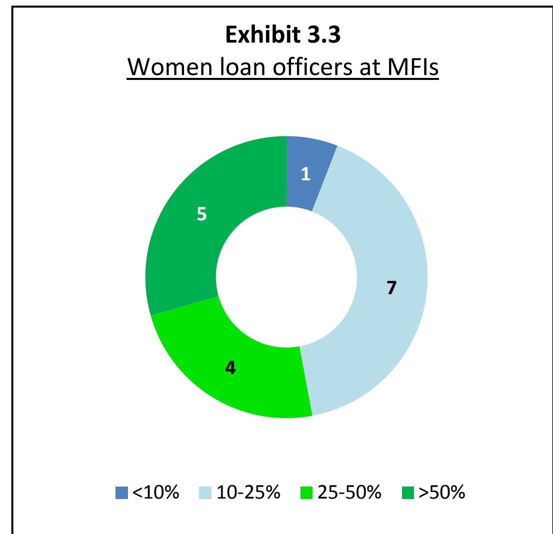
Legal Type	Accounts/ staff member	Portfolio serviced/staff member	
	2012	Rs '000	$ '000
FINGO	229	3,037	42.9
SACCO	251	5,158	72.9
MFDB	208	4,211	59.5
Sample MFIs	**215**	**4,029**	**56.9**
RMDC 56	219	4,035	57.0
India, non-AP	223	2,632	37.2
Bangladesh	214	2,032	28.7

Staff productivity by legal type/form of registration is depicted in **Exhibit 3.2**. The current level of average port-

folio per staff member, Rs4 million ($57,000), is significantly higher than that in India and Bangladesh on account of the much larger average loan size (discussed in **Chapter 2**). Staff productivities, (average 215 clients per staff) are comparable with India, Bangladesh and the 232 East Asian benchmark of the MIX. Due to the lack of data on numbers of credit and deposit accounts held in other types of financial institutions in Nepal, a comparison of staff productivity between MFIs and other segments of the financial sector is not possible.

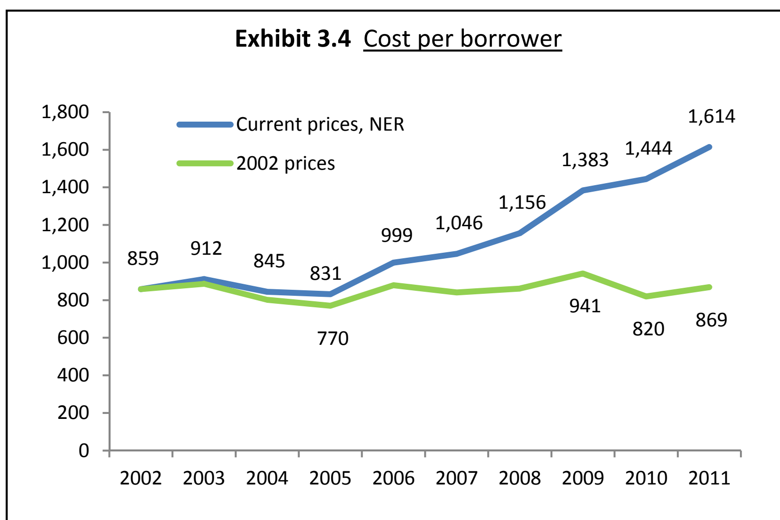
3.1.2 ...and a comparatively better proportion of women loan officers

The number of loan officers employed by the 17 MFIs in the sample reporting on women employees is estimated at 2,300 of whom 980 or 43% are women. **Exhibit 3.3** shows that 8 of the 17 (47%) MFIs have less than 25% women loan officers though nearly all (98.8%) clients are women. Many MFI managers feel that the loan officers' job of staying in constant contact with clients in their communities, on the one hand, and with branch offices on the other requires long hours of work and much field travel, an arduous task that is difficult for women to perform. Nepal MFIs are actually better placed than Indian and Bangladeshi MFIs in this matter; the proportion of women field officers in India is just 10.5%.



3.1.3 Cost per borrower has been constant in real terms over the past decade

The cost incurred by Nepali MFIs in servicing loan accounts is very low in comparison with the global benchmark of $85 global average on the MIX.[1] Even when compared with other Asian MFIs, the cost per borrower (Rs1,614 for all MFIs, $22) amounts to just 36% of the East Asian median of $61 and is also substantially lower than the MIX median for low end MFIs internationally ($64). The trend in the average cost per borrower for the delivery of micro-loans in Nepal is shown in **Exhibit 3.4**. The numbers for South Asia make international microfinance seem extravagant with only India and Bangladesh at similar levels. These numbers are, however, in absolute terms and do not take into account differences in standards of living across the region. The average cost per borrower has increased steadily over the past few years and has nearly doubled since 2004-05 at 11.7% per year. In real terms (at constant prices), however, the cost of serving the average microfinance borrower in Nepal has not changed. The cost of serving microfinance borrowers declined from Rs859 in 2001-02 to just Rs770 in 2004-5 (at 2002 prices) before rising to Rs869 in the year under review. **It is apparent that Nepali MFIs have maintained their lending standards** over the years. This issue is discussed further later in this document.



[1] Calculated by M-CRIL from regional data on the MIX since the website does not facilitate access to global averages.

3.2 Operating efficiency is excellent by the standards of international microfinance

3.2.1 ...with only a couple of relatively inefficient MFIs

For the purpose of analysis, operating expenses include four components – personnel expenses, travel costs, depreciation and other administrative expenses – with the **operating expense ratio (OER) measuring the total of these expenses as a proportion of average outstanding portfolio over a one year period**. *The operating expense ratio does not include the financial expenses or risk costs (loan loss provisions and write off expenses) incurred by an MFI.*

As discussed above, the average Nepali microfinance client is served by MFIs that are significantly more efficient than those internationally. The weighted average OER for sample MFIs was just 9.6% in 2010-11 (**Exhibit 3.5**). The typical Nepali MFI – as measured by the simple average across MFIs – had an OER of 12.0%. These expense ratios are well below the global median of the order of 20.0%.

Exhibit 3.5
Operating expense ratios of MFIs

Model	Weighted average (%)	Typical MFI ~median (%)	Operating Expense Ratio				Total MFIs
			<10%	10-15%	15-25%	>25%	
FINGO	10.5	12.5	3	2	-	1	6
SACCO	7.9	7.4	2	-	-	-	2
MFDB	9.7	12.6	4	5	-	1	10
Nepal 19 MFIs	**9.6**	**12.0**	**9**	**7**	**-**	**2**	**18**
	India non-AP	**Bangladesh**	**EAP**	**Africa**	**LAC**	**Nepal Comm'l Banks**	
	12.0	11.7	14.1	29.3	20.2	4.1	

The distribution of operating efficiency across different types of MFI is fairly even though, as expected, cooperatives have a somewhat lower average since their operational model is based on a significant degree of voluntary inputs to operations by members.

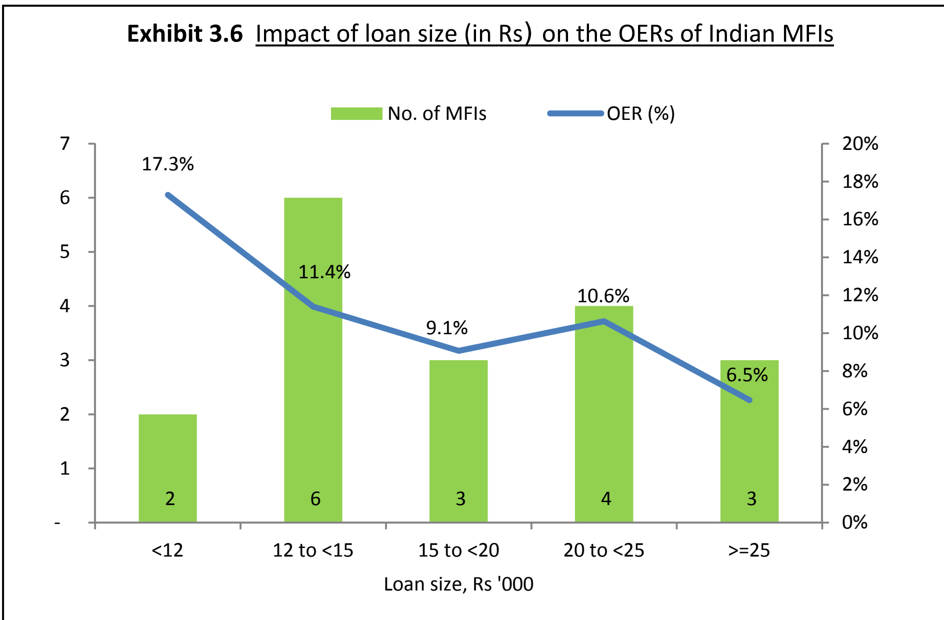
Comparing the performance of MFIs with that of the banking sector shows the real difference in MFI operations relative to the rest of the financial system. While Nepali MFIs are amongst the most efficient in the world their OERs are substantially higher than those of the commercial banking system with the weighted average OER being more than twice the 4.1% of the banks. As before, due to the lack of information it is not possible to compare the performance of MFIs with those of the Development Banks and Finance Companies.

It is apparent that the village/slum level service delivery model of the MFIs cannot compete with the branch based business model of other types of financial institutions. The substantially higher average loan size of the banking system is another factor in the cost efficiency of banks relative to MFIs. This is discussed in more detail below. The efficiency of Nepal microfinance sector relative to international benchmarks needs to be noted and should dispel the misguided impression amongst some observers that Nepali MFIs are "too costly".

3.2.2 ...and the small loan size makes it difficult to lower expenses

Another key determinant of the operating expense ratio is the small loan size. The OER shows a very clear downward trend as the loan size increases (**Exhibit 3.6**). MFIs with the smallest size of outstanding loan (less than Rs12,000, $170) record a weighted average OER of 17.3% whereas those in the largest average loan size category (above Rs25,000, $350) are able to reduce the OER below 7%.

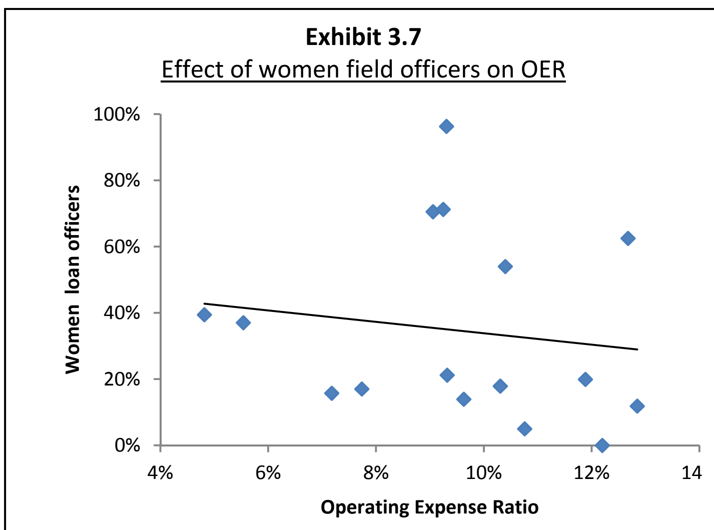
There is some correlation with the age of an MFI here since the newer MFIs tend to have smaller loan sizes but an even stronger correlation with the rate of growth of institutions since fast growing ones both incur higher costs in their growth phase and have lower loan sizes on account of having a larger proportion of new clients.



As MFIs stabilize in terms of growth and become older institutions, their OER declines as the costs of growth (training staff, opening new branches, reaching new geographical areas) are more limited while their average loan size increases as the number of clients getting the third, fourth or fifth repeat loan becomes quite high (perhaps 50-60%).

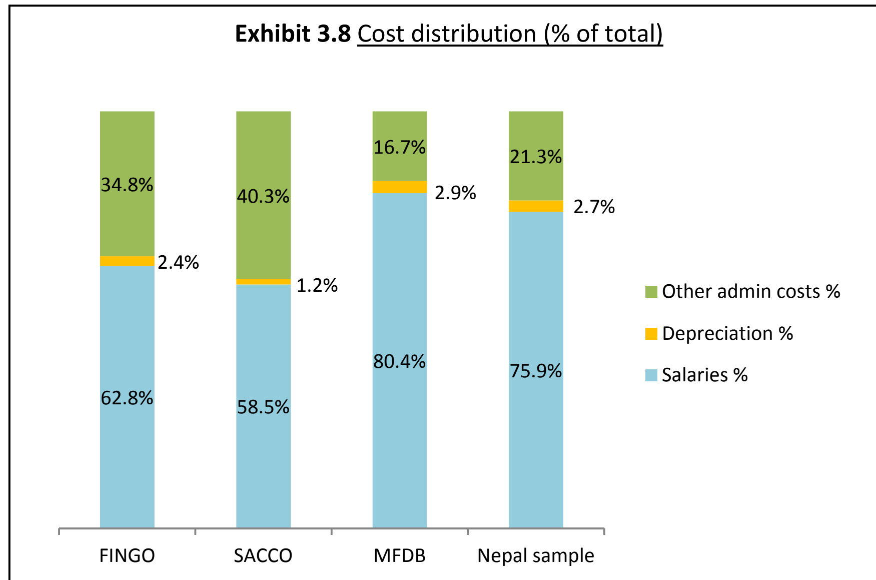
Conversely, MFIs operating with larger loan sizes are able to limit their operating expense ratios partly on that account. It is clear that MFI operating expenses in Nepal are at a low level both by the standards of international MFIs and in comparison with banks (relative to average loan size). It would be difficult to lower expenses further.

3.2.3 Is using women field officers an appropriate means of lowering expenses?



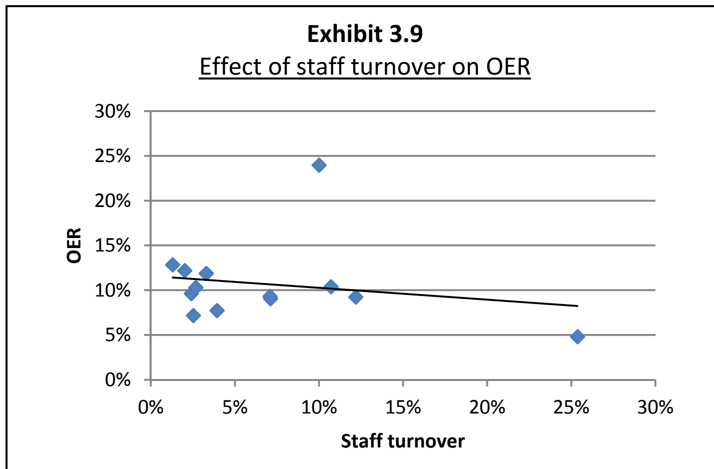
As discussed above, Nepali MFIs employ relatively few women field officers; just 5 of the 17 organisations reporting have more than 50% field officers who are women. This is in spite of the fact that nearly 99% of clients are women. The correlation between the proportion of women loan officers and OER is illustrated in **Exhibit 3.7**. The numbers of data points is not particularly high (and the self-reported social reporting data on the MIX is not entirely reliable) so it is difficult to see a significant correlation. However, as for Indian MFIs, rating experience suggests that MFIs with a higher proportion of women field officers have lower operating expense ratios as shown in the figure. Whether or not the difference means MFIs with more women field officers operate more efficiently or whether this means that women field officers are actually paid less on average than men (if not necessarily in the same institution), bears investigation. However, this is not possible with the data currently available.

3.2.4 The composition of operating expenses indicates high labour intensity



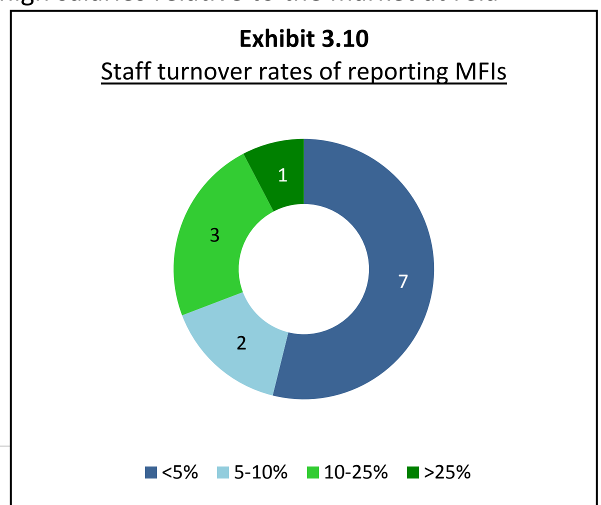
The major components of operating expense are disaggregated into the three main categories in **Exhibit 3.8**. The Nepali MFIs' salary allocation of 60-80% is high by global standards (Asia, 53.6%; global, 44.5%). It is apparent that the MFDBs have better staff compensation levels than other types of MFIs (along with somewhat lower staff productivities). The proportion of expenditure incurred on staff by MFDBs is high at over 80% compared to just 53% for the wage bills of commercial banks as a proportion of their total operating expenses. This is inevitable given the MFIs' community level services versus the branch-based service of the banks.

3.2.5 ...so perhaps it would be better to focus on working conditions to reduce staff turnover



Since the labour intensity of microfinance is quite high it is apparent that staff conditions have an important impact on the expense ratio. In theory, low wages and long working hours would reduce operating expenses and a few (but by no means all) of the leading MFIs in the region are known to follow this approach. Yet, it is bound to increase the staff turnover rate as over-worked, underpaid people seek and obtain better opportunities. With the caveat about the accuracy of the social performance information (reported by MFIs to the MIX), mentioned earlier, it appears to show, in **Exhibit 3.9**, that MFIs with higher staff turnover rates generally have lower operating expense ratios suggesting that Nepali MFIs try to limit their staff turnover by paying high salaries relative to the market at relatively low levels of productivity.

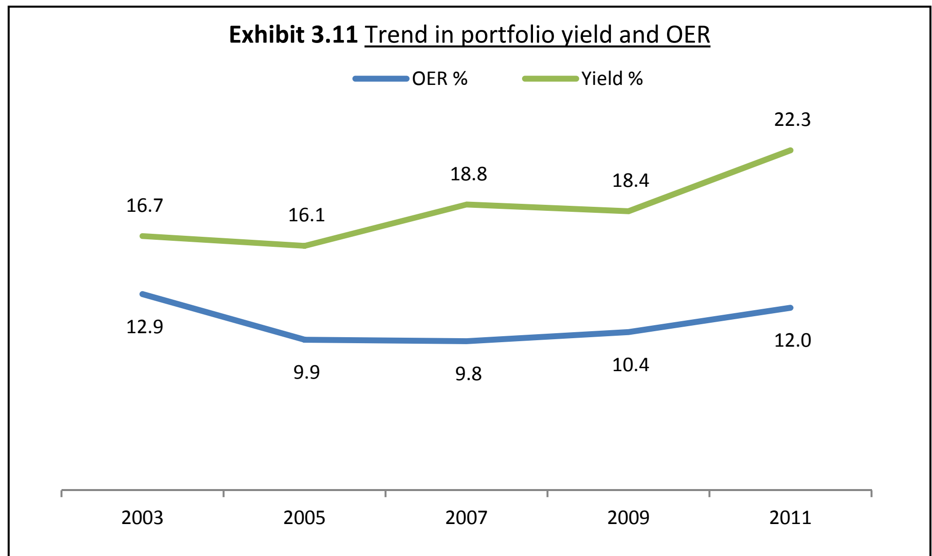
The average staff turnover rate for the 13 reporting MFIs in Nepal is relatively low at 7% (compared to 29% for India). The frequency of MFIs reporting various staff turnover rates is presented in **Exhibit 3.10;** as many as 7 of the reporting MFIs have staff turnover rates below 5% accordingly to data uploaded by them on the MIX. This finding needs to be viewed with caution, however, since the accuracy of this self-reported information could be open to question.



3.2.6 ...and watch the yield-OER margin which has widened

Besides looking at the contribution of various cost components to an MFI's operating expenses it is also instructive to compare OER – the cost incurred on servicing loans – with the yield (interest income earned from the portfolio outstanding for a given period) to ascertain the margin before accounting for the cost of funds and risk expenses. **Exhibit 3.11** shows the trend in portfolio yield and OER. The weighted average yield of 22.3% is significantly higher than the 18.4% shown by the MIX for Nepali MFIs two years earlier.

Exhibit 3.11 Trend in portfolio yield and OER



This appears to have happened partly because of an improvement in portfolio quality but also because of changes in fees charged and better collection efficiency. The average yield earned by Nepali MFIs is substantially lower than the Asian and global medians of 25.8% and 28% respectively. When compared with moneylender rates of 60-120% in different parts of Nepal and consumer finance rates of 24-36% charged even by commercial banks for much larger loans, Nepal MFI interest rates appear to be very reasonable.

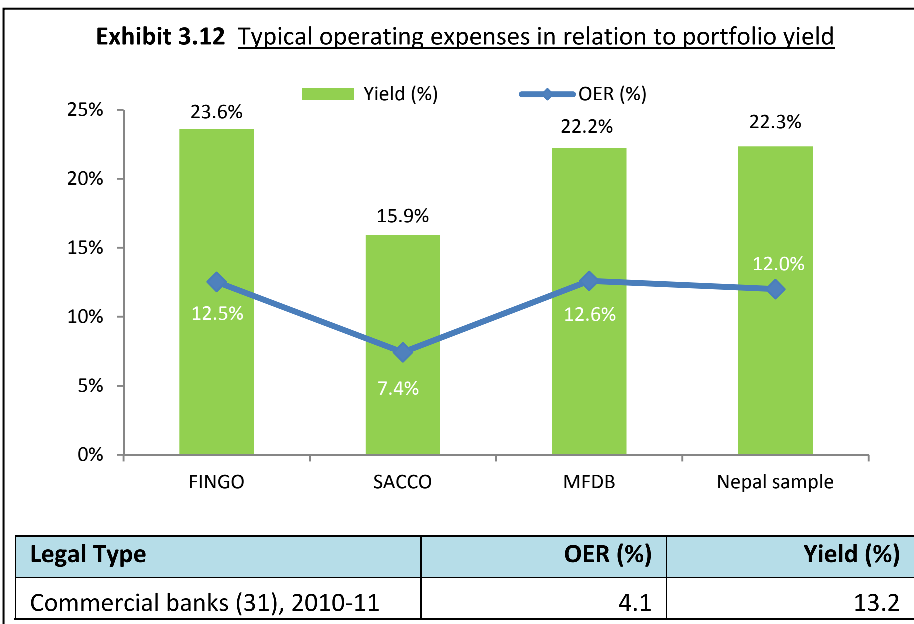
Since the weighted average (OER) for Nepal MFIs has increased gradually over the past few years but has been accompanied by a significant increase in yield, the margin available to the average MFI for covering financial expenses, loan loss provisions and surplus has increased during this period. In absolute terms, however, a roughly 10% margin between yield and OER is not substantial in microfinance as shown by the table below. The margin for Indian MFIs has been in the 15-20% range until quite recently. Amongst Nepali MFIs the margins are roughly even across types as shown by **Exhibit 3.12** and are not much higher than the 9.1% margin of the Nepali commercial banks.

Region	Yield*	OER*
South Asia	23.4	12.8
EAP	25.8	14.1
Africa	31.7	29.3
LAC	30.1	20.2

* MIX medians

The different levels of OER and yield are related to loan size and the very different business models of the banking system relative to microfinance (as discussed earlier).

Exhibit 3.12 Typical operating expenses in relation to portfolio yield



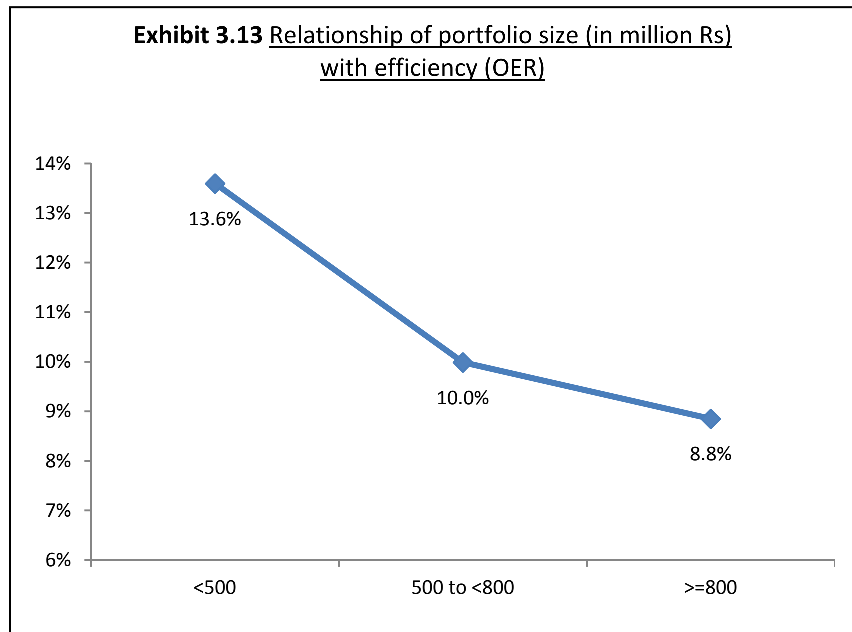
Legal Type	OER (%)	Yield (%)
Commercial banks (31), 2010-11	4.1	13.2

3.2.7 Economies in operation are determined partly by loan size but also by MFI scale

Economies of scale are generally expected in any economic activity. The relationship between the OER and overall portfolio size of individual MFIs is illustrated in **Exhibit 3.13**. Though the correlation is not perfect, a rough inverse relationship between portfolio size and operating expense ratio emerges from the sample information in the figure for portfolios ranging from <Rs500 million ($7 million) to >Rs800 million ($11 million). It goes down to below 9% as the portfolio increases beyond Rs800 million ($11 mn). However, this also depends on the methodology adopted by the MFI and is related to the concern of the management for achieving sustainability.

However, M-CRIL always had reservations about the manner in which cost efficiency was achieved by the largest MFIs in Nepal as well as India. M-CRIL's assessment is that "efficiency" over the years was achieved not so much through economies of scale as via an oversimplification of the relationship between MFIs and clients resulting in little time spent on group formation or group development processes. In the late 1990s a Grameen type solidarity/joint liability group was required to meet regularly for a minimum of 8 weeks before it became eligible and, crucially, members were required not to have a loan from any other source.

Exhibit 3.13 Relationship of portfolio size (in million Rs) with efficiency (OER)



By the time the race for growth became the norm around 2007-09, MFI loan officers had abandoned all concern for group processes and single source lending; the situation was reached where, in the extreme in India, an MFI loan officer waited outside a group meeting organized by another MFI in order to offer the same group another loan or to collect from the same group (since it had been previously enrolled by him). In the short term, this created a win-win situation for both MFIs and clients: it helped the MFI loan officer to meet his targets as easily as possible thereby helping his MFI to maximize its growth and it helped the client to gather ever larger sums of money in relatively short periods of time in order to meet her investment (and, in many cases, consumption) needs – whether or not she was in a position to repay.

This effectively reductionist approach meant that the relationship between the MFI and the client became one that was little different from consumer goods retailing; the development solidarity, preventive health and basic literacy objectives of the MFI group meetings of the 1990s were abandoned in the rush for growth. This phenomenon was not as pronounced in Nepal as in India but has, nevertheless, bee observed there as well. The effect of the resulting situation on portfolio quality, margins and profitability follows.

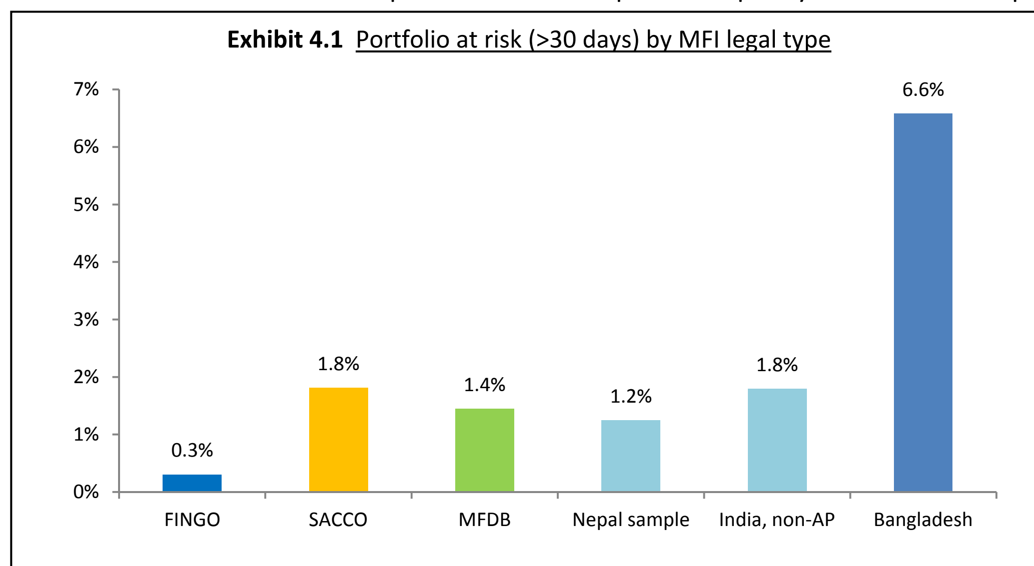
Chapter 4

...but is the portfolio performance real?

4.1 The industry reports excellent portfolio quality

Analysis of portfolio quality data reported by M-CRIL's sample of 18 MFIs (presented in **Exhibit 4.1**) indicates that MFIs in Nepal have excellent portfolio quality ratios. The sample average of PAR_{30} at 1.2% is better than the non-AP portfolio in India, a lot better than the 6.6% of Bangladesh (see the figure) and the 3.2% of Africa and 4.9% of Latin America (from the MIX). Other segments of the Nepali financial sector also report much higher non-performing loan ratios (more than 90 days overdue). These include the commercial banks at 3.2%, development banks at 4.2% and finance companies at 5.4%. In practice, therefore, it may be that the PAR information for Nepal presents a better picture than is justified.

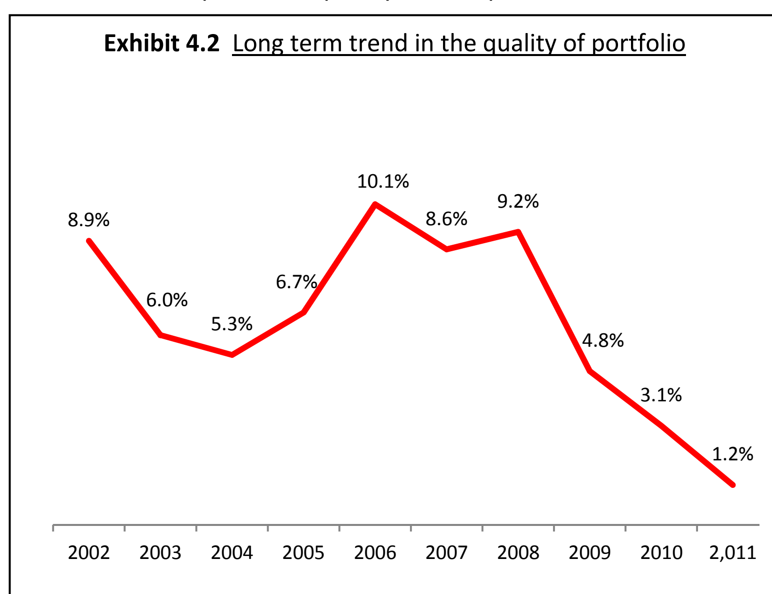
Exhibit 4.1 Portfolio at risk (>30 days) by MFI legal type



4.2 If this good performance is real the microfinance sector deserves congratulations

Exhibit 4.2 presents the long term trend in the quality of microfinance portfolios in Nepal. It is apparent from the figure that microfinance in the country went through a near-crisis experience in the middle of the last decade, 2006 to 2008. Since then there have apparently been dramatic improvements in portfolio quality as the political situation has stabilised, if not substantially improved, and as a result MFIs have been able to improve their collections. However, the reduction of the PAR_{30} ratio from 9.2% in July 2008 to as little as 1.2% in July 2011 is a dramatic change. To what extent this is on account of the undoubted improvements in the functioning of the economy and improvement of MFI collection systems is something that bears investigation. It is also possible that some of the "improvement" has resulted from changes in human resource practices within MFIs, incentivising the reporting (if not necessarily achievement) of good portfolio performance while ignoring some of the problems on the ground. If these reported numbers are strictly accurate, the Nepal microfinance sector certainly deserves congratulations.

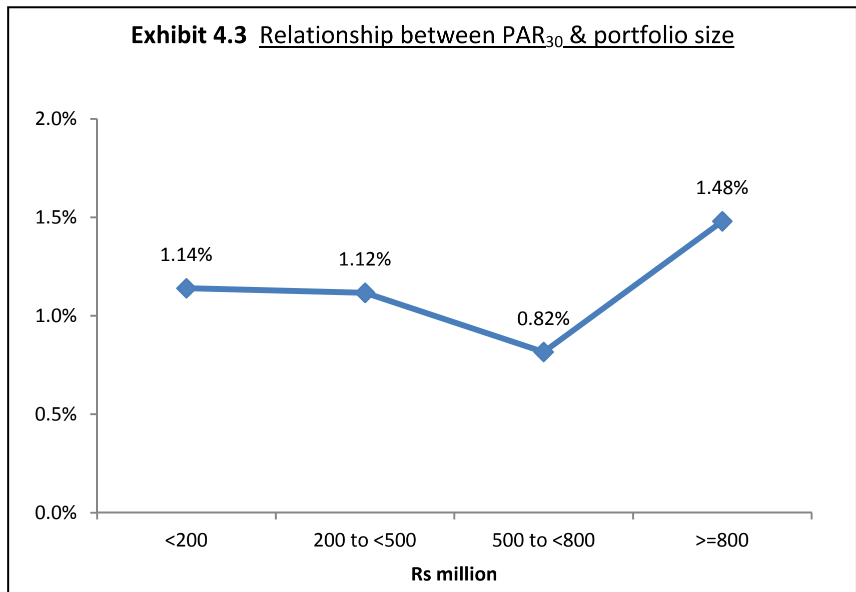
Exhibit 4.2 Long term trend in the quality of portfolio



It is nevertheless true that the crisis in India has prompted greater introspection on issues of multiple lending, the quality of internal control systems, how to improve portfolio quality and, above all, how to manage growth. The implications of high growth rates for the issues that emerged in microfinance are obvious: unbridled growth leads to untrained staff, an increase in multiple lending, a deterioration in control systems, and the potential for malpractices in loan collection. It is M-CRIL's belief that lower, 30-40% per annum, growth rates are more effective in ensuring the quality of microfinance provision than those in a faster growing sector. The fact that Nepali microfinance has grown no faster than 30-45%, even during the high PAR period of 2006-08, certainly helps to bolster the credibility of the reported portfolio quality numbers.

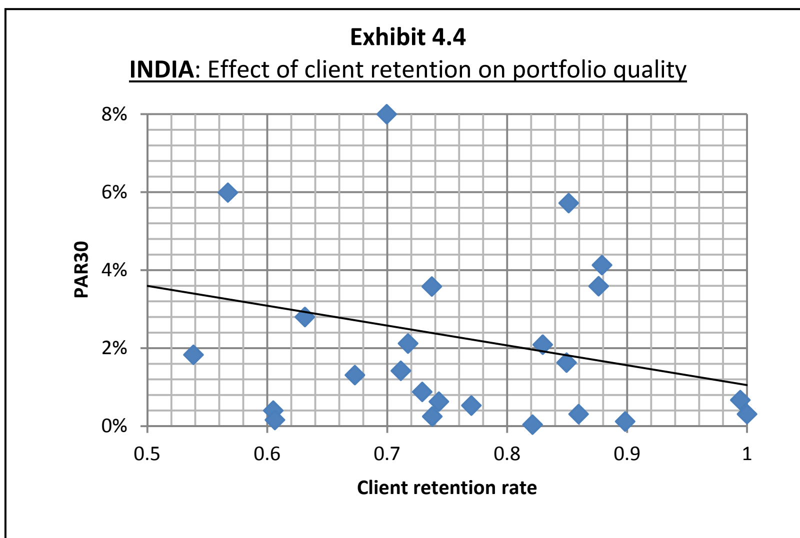
Exhibit 4.3 presents a cross-sectional analysis of PAR relative to portfolio size. Historically, there was a trend for the larger organisations to have better portfolio quality. The high PAR of a few organisations was attributable to a more relaxed approach to delinquency resulting from their NGO or public sector origins (of the Grameen Development Banks). Borrowers, aware of the traditional welfare orientation of such institutions take repayment discipline less seriously and the MFIs themselves are not as strict in follow up as some of the more professionally oriented private MFDBs. While the approach of the old MFIs is certainly client friendly, recognising the possibility of genuine repayment difficulties faced by some clients, it could, in some cases, also lead to clients taking undue advantage of what could appear to be a relaxed approach.

Exhibit 4.3 Relationship between PAR_{30} & portfolio size



4.3 Client satisfaction has an important effect on portfolio quality

Exhibit 4.4
INDIA: Effect of client retention on portfolio quality



Exceptional circumstances aside, the client retention rate is generally accepted as being a key indicator of client satisfaction which has an impact on portfolio quality. **None of the Nepali MFIs have reported on their client retention rates**. Therefore **Exhibit 4.4** uses India data to illustrate the point. It relates the client retention rates of the 25 non-AP MFIs for which this information is available to their portfolio quality. While the correlation is not very strong in the figure it indicates a significant relationship between the two variables. Thus, it suggests that as client satisfaction increases the portfolio quality also improves with PAR_{30} generally falling below 2% as the client retention rate rises above 80%.

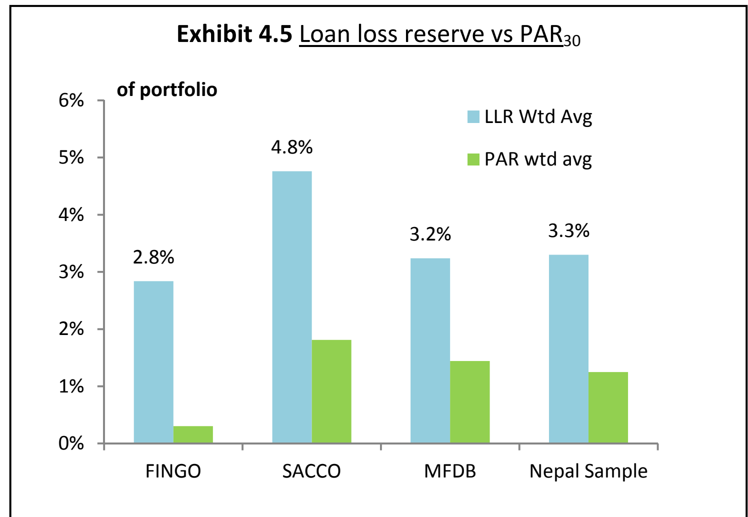
4.4 Provisioning for loan losses greatly exceeds the requirement

Exhibit 4.5 shows that MFDBs typically now have average loan loss reserve (LLR) rates of around 6%, while the typical PAR is just 1.5% and weighted average 1.4%. Given the present happy situation of the MFI sector, this level of loan loss reserve greatly exceeds the requirement.

as per cent of portfolio

Models	LLR typical	PAR typical	LLR wtd avg	PAR wtd avg
FINGO	2.7	0.5	2.8	0.3
SACCO	8.0	1.8	4.8	1.8
MFDB	6.2	1.5	3.2	1.4
Nepal 19	**5.1**	**1.2**	**3.3**	**1.2**

Exhibit 4.5 Loan loss reserve vs PAR_{30}



This is essentially on account of an accumulation of the (relatively high) 1% general provision required by the NRB on performing loans in addition to specific provisions for non-performing loans. It is apparent from the information in the exhibit that, in the present situation of relatively smooth functioning of the sector with low PAR ratios, these reserve levels are very high. However, given the on-going political crisis in the country and the related high risk of civil disorder at any time (as during the 2006-08 period) these high reserves may be justified.

The following section examines the financing of microfinance – sources of funds and the efficacy of fund utilization by MFIs providing financial services to low income clients in Nepal.

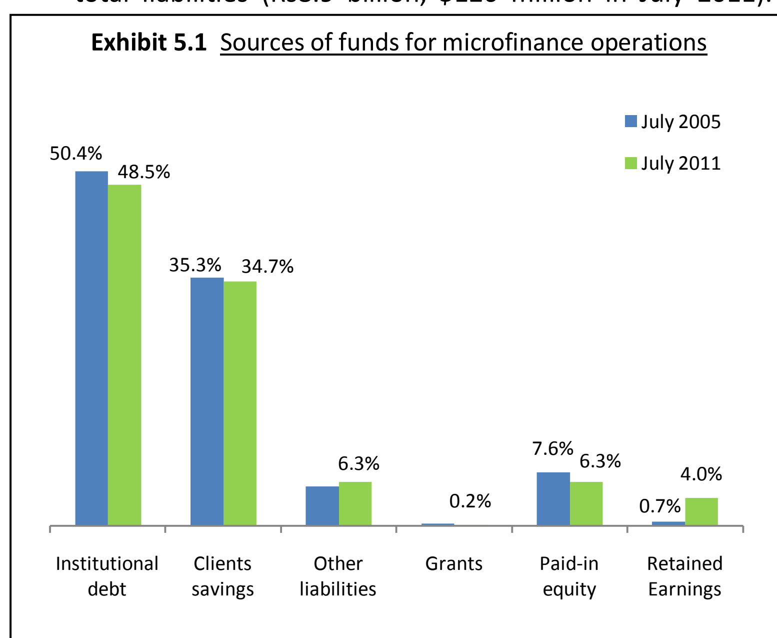
Chapter 5

Client deposits continue to be an important source of funds

5.1 MFIs in Nepal have a settled pattern of funding

The financing of microfinance in Nepal has settled into a pattern since the mid-2000s with not much change between 2005 and 2011. The distribution of sources of funds for microfinance, presented in **Exhibit 5.1**, based on a consolidation of information for the 18 leading MFIs for which reliable information was available, shows that the share of debt in MFI finances has been steady at nearly 50% of total liabilities (Rs8.9 billion, $126 million in July 2011). The current level of institutional debt, amounting to 48.5% of total funds has been raised largely from RMDC, Nepal's main wholesale lending institution for microfinance, (18.6% of debt funds) and from commercial banks. The latter funding is provided by banks to MFIs under the "deprived sector" directed credit mandated by NRB (and described in **Chapter 1**).

Exhibit 5.1 Sources of funds for microfinance operations



Unlike India, where MFIs (other than financial cooperatives) are not allowed to raise deposits, MFIs in Nepal are specifically licensed to provide deposit services to their members. As a result, around 35% of the funds of Nepali MFIs come from client savings. In Bangladesh where, for most MFIs, client savings have always been seen as an important part of financing (and commercial bank funding is quite limited), deposits constitute a somewhat higher 47% of funds.

As discussed earlier, the option to raise deposits from members is an important feature in the stability of MFIs in Nepal, not only providing them with diversity in funding options but also resulting in a more rounded relationship with clients than is possible in the uni-dimensional, credit only model dictated by the ban on deposit taking by MFIs in India.

The share of net worth (grants + paid in equity + retained surplus/deficit) on MFI balance sheets has increased from 8.7% in 2005 to 10.5% in 2011. While the share of grants (never very large) and of paid-in equity has declined, retained earnings have grown significantly to 4% of the total over the six year reference period. Though a moderate flow of equity into microfinance – mainly for the establishment of MFDBs – has continued, it is apparent that the profitability status of MFIs has improved substantially between 2005 and 2011 resulting in a positive change in the funding status of MFIs in Nepal.

As the information in **Exhibit 5.2** shows, the deposit funding of portfolios in Nepal has improved significantly over the past six years for MFDBs and very substantially for FINGOs. Both types of institution have gained in their deposit mobilisation efforts from the increasing length of their operations. The confidence of the public in the stability of an institution increases with time resulting in a greater willingness to place deposits with it. The apparent decline in the deposit funding of cooperatives is

partly the result of the small number (2) of SACCOs in the current sample but it is also due to the increased funding of cooperatives by RMDC. All Asian countries with flourishing microfinance sectors – Bangladesh, Indonesia and Philippines – have deposit ratios that account for even larger proportions of portfolio, however. This is partly the result of the longer records of their microfinance institutions but it also results from the relatively limited sources of commercial bank and other funding in these countries given the lack of a directed credit requirement like deprived sector in Nepal (and priority sector in India).

Exhibit 5.2
Deposit-portfolio ratios

Legal type	Deposits as % of portfolio			
Nepal	**2005**	**2011**		**2011**
FINGO	7.4	44.0	Bangladesh	78.5
SACCO	120.5	45.4	Indonesia*	55.1
MFDB	31.3	45.3	Philippines*	68.7
Nepal sample	**61.3**	**45.1**	Devt Banks	109
India, MFIs	14.6	1.5	Finance Cos.	98
- Comm'l banks		127	Comm'l Banks	132

*weighted average country data from MIX website

The pattern of funding sources does not vary much with the size of the portfolio. **Exhibit 5.3** shows that the smallest MFIs have relatively poor financial performance and have had to obtain a higher level of institutional debt (mainly from RMDC) in order to maintain their operations. Grant funding does not figure much in the financing of microfinance in Nepal since donors have never played a particularly important role in the development of the sector though a few organisations like UNCDF and GIZ have provided critical seed funding for capacity building.

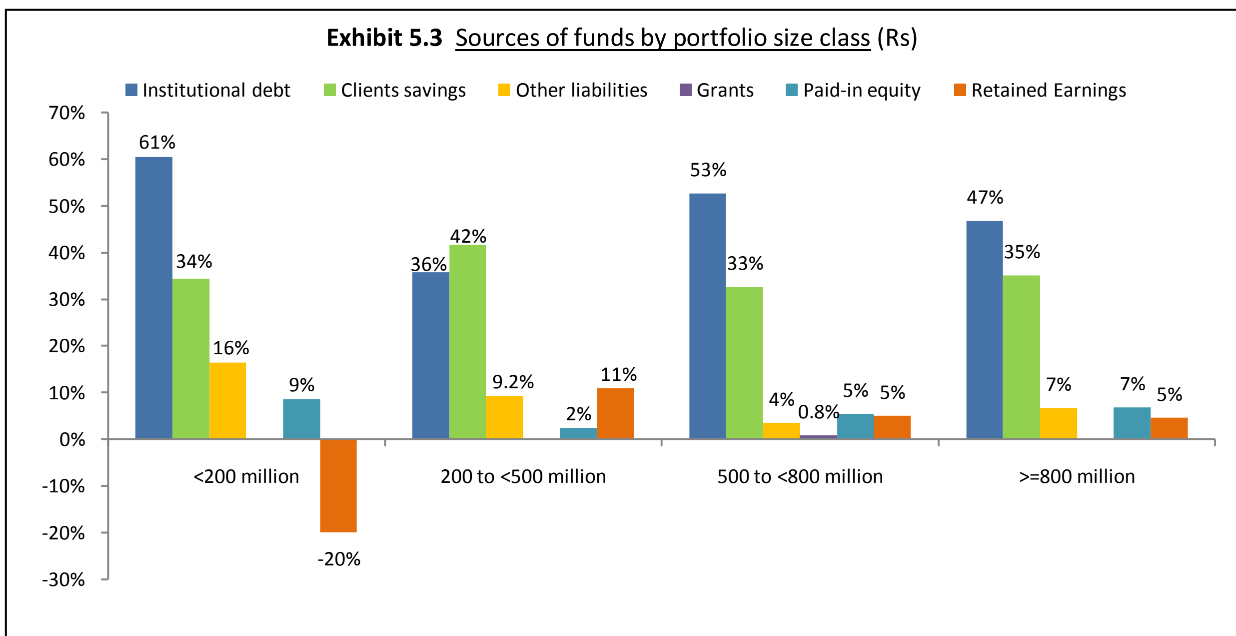
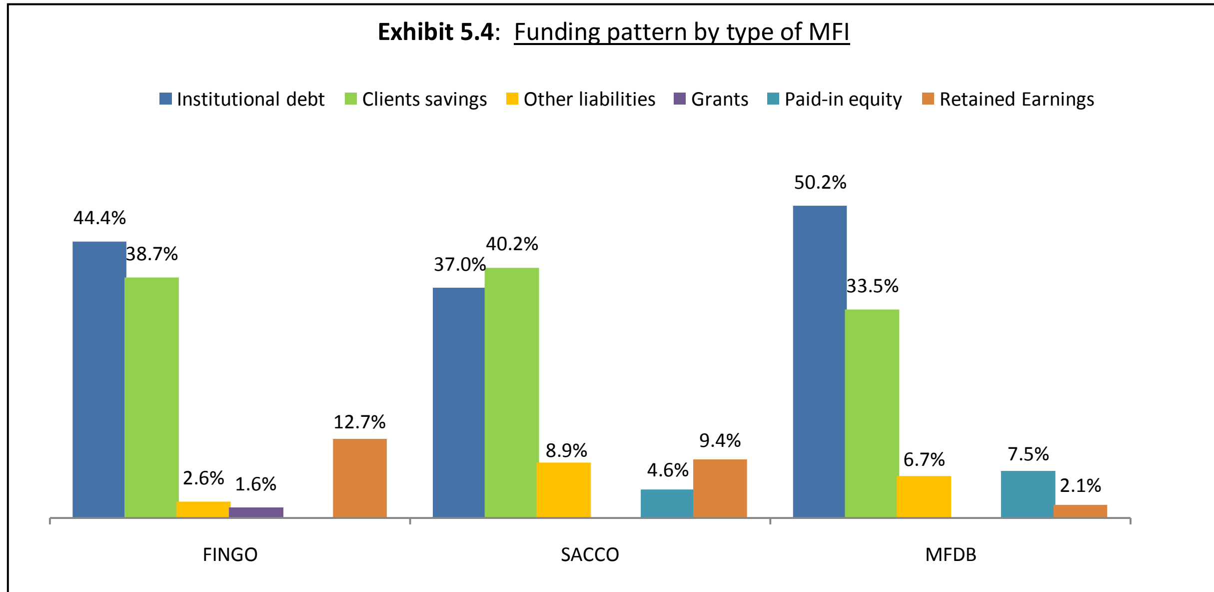


Exhibit 5.3 Sources of funds by portfolio size class (Rs)

The extent to which the type of institution makes a difference to the pattern of fund mobilisation of MFIs is apparent from the funding pattern depicted in **Exhibit 5.4** classified by form of legal registration. The MFDBs – seen as more professionally run institutions – generate over 50% of their funds from institutional debt while for SACCOs member savings are more important, albeit moderated by the availability of debt funding from RMDC in particular.

Exhibit 5.4: Funding pattern by type of MFI

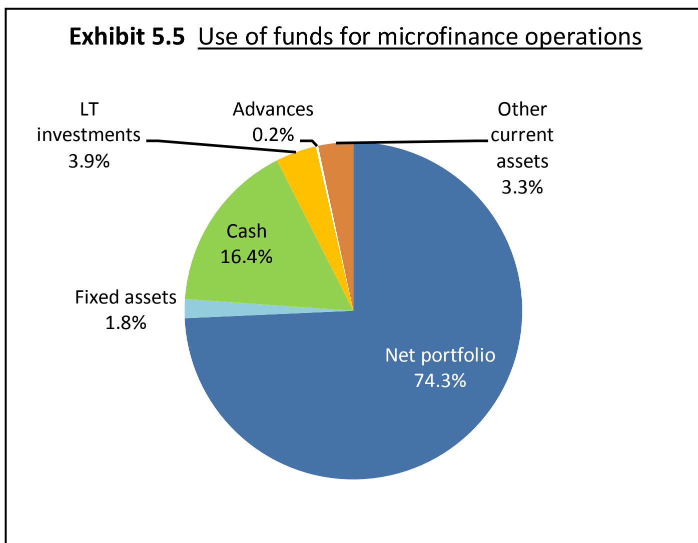


5.2 The use of funds has improved over the years

5.2.1 ...with a greater degree of professionalization of management

The allocation of funds by Nepal MFIs conforms fairly well to international best practice norms. Of the total resources of Rs18.5 billion ($261 million) deployed in microfinance by the 18 sample MFIs, nearly 75% was in loans to clients at the end of July 2011 (**Exhibit 5.5**). Six years ago this was of the order of 60%, at the low end of the 60-70% portfolio allocation range considered normal in international microfinance at the time.

Exhibit 5.5 Use of funds for microfinance operations



Category	Amount Rs million	July 2011
Net portfolio	13,708.6	74.3%
Fixed assets	335.7	1.8%
Cash	3,027.8	16.4%
LT investments	721.4	3.9%
Advances	40.7	0.2%
Other current assets	617.8	3.3%
Total sample	**18,452.0**	**100.0%**

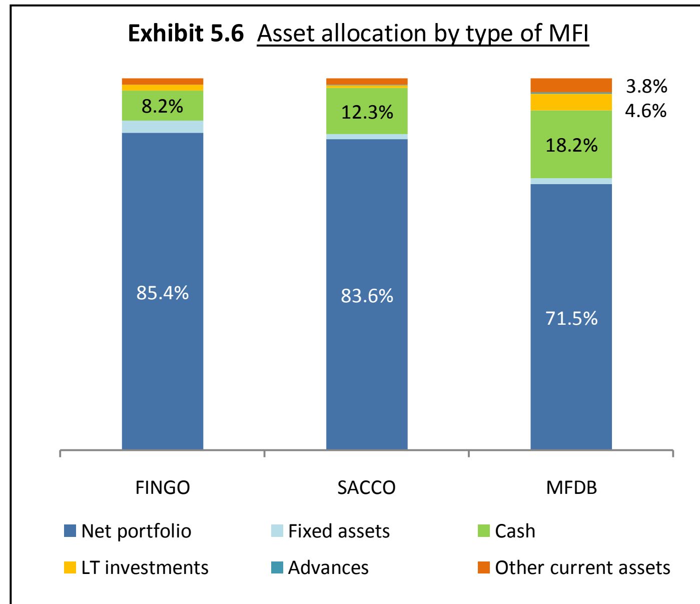
The cash holding of over 16% by Nepal MFIs, on the other hand, is significantly higher than the global standard of around 10%. A closer examination of recent rating data (for year 2009-10) of Nepali MFIs shows that, as in India, this is partly because of the release of a substantial amount of deprived sector lending funds by conventional financial institutions at the end of the financial year in order to comply with the requirements of the central bank. Up to one-third of this cash holding at the end of the financial year is of this type; re-

ducing this from the balance sheet would result in an average cash holding of 11% for MFIs, which seems a reasonable level.

The efficient, effective and prudential management of these assets is dependent on a number of factors including

- minimisation of the need for fixed assets relative to total assets
- maximisation of investment of financial resources either in the loan portfolio or, at least, in high return investments, and
- asset-liability matching in order to limit the risk associated with the MFIs' financial assets to levels consistent with the organisation's own funds or net worth.

Exhibit 5.6 Asset allocation by type of MFI



The allocation of assets varies to some extent between different types of MFIs (**Exhibit 5.6**). The much higher cash holding of MFDBs at the end of the financial year appears to validate the assumption that deprived sector funds are suddenly released by other financial institutions at this time. MFDBs are assumed to have more professional management and are therefore more favoured for lending by conventional financial institutions than are FINGOs and SACCOs.

5.2.2 …resulting in better prudential management as well

Most MFIs aim to mobilize long term sources of funds such as equity, long-term loans (repayable in 3-5 years), member deposits and (very occasionally), grants in order to finance their portfolios. On the other hand, the loans they extend are usually for a period of one year, sometimes less, thus becoming short-term assets.[1] This translates into short term assets (maturity less than one year) accounting for 94.2% of the total while over 50% of liabilities are long-term. This is an area in which traditional MFI fund management is highly appropriate to their financing structure and has contributed to the stability of microfinance funding.

For ensuring prudential management, banks in Nepal are expected by the NRB to maintain Capital Adequacy Ratios (CAR - net worth as a proportion of risk weighted assets) of 10% and other financial institutions are required to maintain a CAR of 11%. **Exhibit 5.7** provides information on the capital adequacy ratios (CAR) of MFIs covered by this analysis. While all private banks in Nepal have CAR comfortably above this level in July 2011, information published in the NRB's Banking and Financial Statistics shows that the two public sector banks have high levels of negative net worth, hence negative CAR. The MFIs are mostly

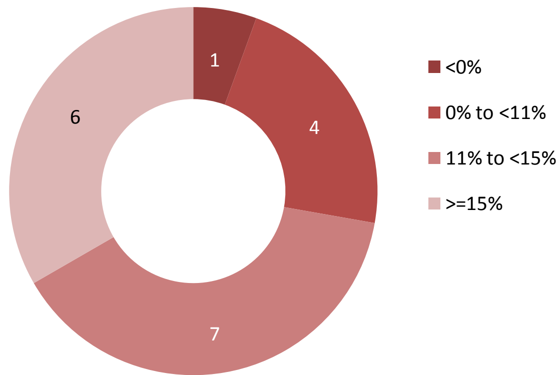
Exhibit 5.7
Capital adequacy ratios of Indian MFIs

Models	Weighted CAR (%)	Typical MFI (%)	Banks, 2012	Weighted CAR
FINGO	16.0	15.4	Development	22.9
SACCO	15.9	14.5	Commercial	10.6
MFDB	12.2	4.0	India MFIs, 2012	28.6
Nepal, 2011	**13.0**	**9.0**	Bangladesh	

[1] Though with regulation now requiring 2-year terms for loans disbursed amounts >Rs15,000, this is starting to change.

above the requisite 11% level with an average CAR of 13%. Only some of the older MFDBs – the formerly public sector "grameen development banks" (GBBs) – have lower levels of CAR resulting in the "typical" CAR for MFDBs looking uncomfortably low at 4% for this category.

Exhibit 5.8 Frequency distribution of MFIs by CAR



This picture is reinforced by **Exhibit 5.8**: just 5 MFIs have CAR below 11% while as many as 6 (of the 18 for which reliable data is available) have CAR greater than 15%. This is a substantial improvement on the situation in July 2005 when an analysis by M-CRIL showed that more than 50% of MFIs had CAR below 10%. The discussion of profitability in **Chapter 6** provides more information on this matter.

Chapter 6

...and financial performance is now attractive to investors

6.1 Yields have increased as MFIs have improved portfolio quality & collection efficiency

The income earned by an organisation's major asset – in the case of MFIs, the outstanding portfolio – is its main means of attaining viability. Portfolio yield measures the income actually earned by MFIs on their portfolios. It is apparent from **Exhibit 6.1** (and the information in **Chapter 3**, **Exhibit 3.14**) that, on a weighted average basis, this income has grown significantly over the past couple of years. The weighted average yield for Nepali MFIs has increased to 22% from around 18% a couple of years ago. These yields compare with the MIX median yield of 25.8% for East Asia Pacific and 26.8% for non-AP MFIs in India and 23.2% in Bangladesh in 2011. The average interest paid by Nepali microfinance clients is not exorbitant by global microfinance standards; nearly 86% of MFI borrower accounts are now with MFIs that have a yield less than 25% (**Exhibit 6.1**). These interest rates are comparable with those paid by users of consumer finance from commercial banks (financing costs of credit cards) and other conventional financial service providers.

Exhibit 6.1

Portfolio yield of Nepal MFIs, %

Models	Weighted avge yield	Typical yield
FINGO	23.8	23.6
Coop	20.5	15.9
MFDB	21.8	22.2
Nepal	**22.0**	**22.3**
India – non-AP	26.8	29.7
Bangladesh	23.2	24.0

Frequency distribution - number of MFIs

Interest (%)	Yield 2010-11	% of MFI borrowers served July 2011
<20%	5	22.1%
20% to <25%	10	63.8%
25% to <30%	3	14.1%
Nepal	**18**	**100.0%**

Compared to the 36-50% real cost of bank loans for small borrowers (including all transaction costs) and moneylender interest rates ranging from 60-120% in various parts of the country, average yields of 22% in Nepal represent a substantial benefit for low income MFI clients. This is significant in the context of the ever-present debate in Nepal and other parts of Asia about the suitability of interest rates charged by MFIs.

6.2 ...and returns to MFIs have improved as a result

The trend in the financial performance of Nepal microfinance over the past eight years is illustrated in **Exhibit 6.2** using information on the return on assets (RoA) available from the MIX website. It illustrates how financial viability of microfinance institutions in Nepal has improved over the past few years particularly over the past two years. **Exhibit 6.3** provides a comparison of the 3.0% weighted average Return on Assets of the M-CRIL sample of MFIs in Nepal with those in India, Bangladesh, regional benchmarks across the globe and the banking sector in Nepal. Even the typical MFI in Nepal earns around 2.0%. This is a great improvement over the 0.4% RoA of 2004-05 estimated by M-CRIL from a sample of rated MFIs at the time.

Exhibit 6.2

Trend in the return on assets over 2003-2011

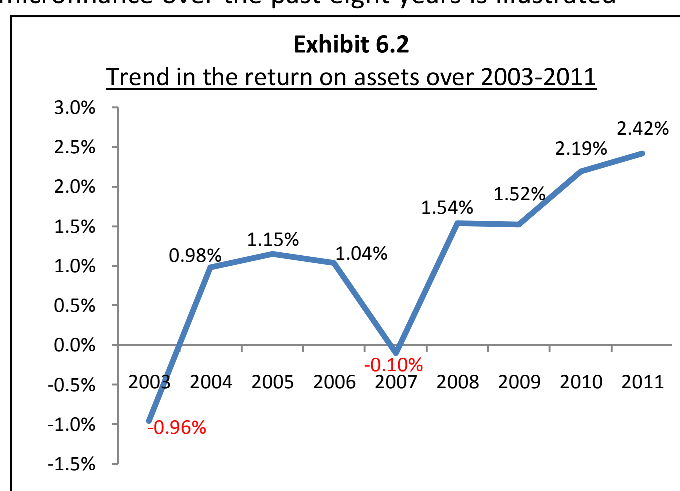


Exhibit 6.3
Return on total assets of MFIs

Models	Weighted Average, %	Typical MFI	Region/country		Frequency Distribution	2011
FINGO	5.4	5.1%	Bangladesh	1.5	<0%	1
Coop	4.0	3.3%	India – non-AP	3.9	0% to <2%	5
MFDB	2.6	-0.1%	East Asia/Pacific	0.8	2% to <5%	6
Nepal sample	**3.0**	**2.0%**	Africa	4.0	>=5%	6
Comm'l banks	1.87		Latin America	3.6	**Total**	**18**
Devt banks	0.71		Nepal Finance Cos.	-0.11		

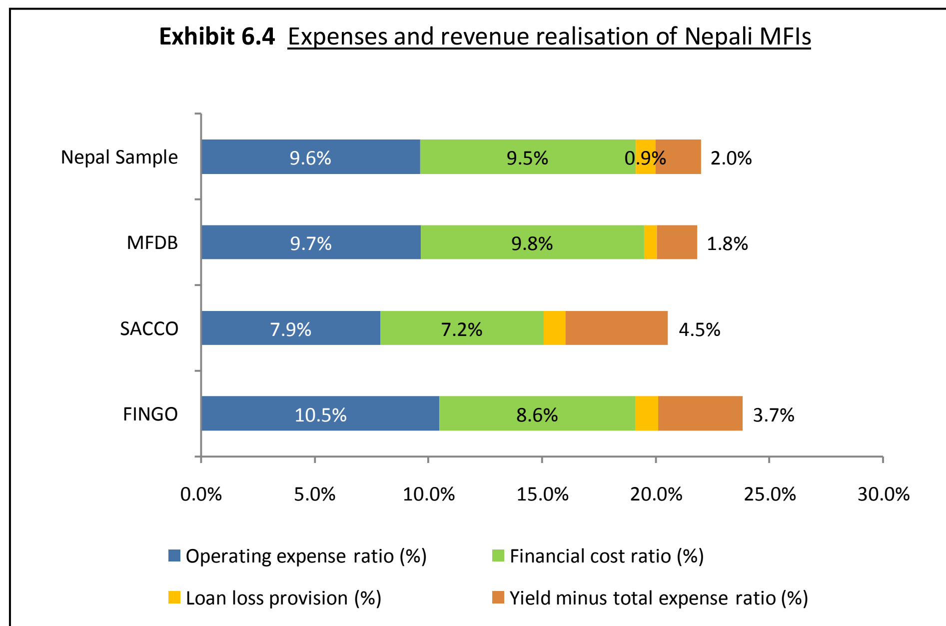
* Source: NRB, 2011. **Banking and Financial Statistics No.57 July 2011**. Kathmandu: Nepal Rastra Bank

With the 3.0% level of return on assets calculated for the sample used here, Nepal MFIs are now doing very well even in comparison with the commercial banking sector which, in turn, is very profitable relative to banks in India (RoA, 1.08%) and Bangladesh (1.37%). The Nepali conventional development banks do not do as well with just a 0.71% return on assets.

Yet, hardening inflationary conditions in the region have resulted in an increase in lending rates from banks and other financial institutions to MFIs over the past two years. Thus the traditionally high borrowing cost for Nepali MFIs has become even higher recently with the **financial expense ratio** (FER) at 9.5% for 2010-11 (**Exhibit 6.4**). These financial expenses are significantly higher than the 4.1% of East Asia/Pacific (according to the MIX database) though Indian MFIs have a still higher 10.2% FER (albeit partly on account of a substantially higher proportion of debt funding). The seemingly low average loan loss provisioning ratio of 0.9% is still a lot more than is strictly necessary (given the low PAR) as discussed in **Chapter 4**.

The 20% weighted average typical expenses of Nepal MFIs are still lower than non-AP MFIs in India (22-23% of portfolio) and well below global ratios of around 24-26%; subtracting total expenses from the yield results in a surplus for these MFIs of 2.0% on portfolio. Thus, Nepali MFIs deliver microfinance to low income clients at a very low operating cost by the standards of typical international MFIs.

Exhibit 6.4 Expenses and revenue realisation of Nepali MFIs

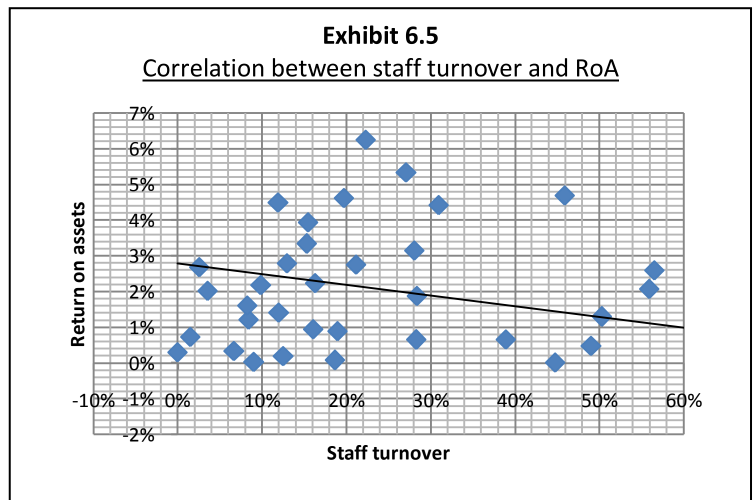


Models	Operating expense ratio (%)	Financial expense ratio (%)	Loan loss provision (%)	Total expense ratio (%)	Yield (%)	Yield minus total expense ratio (%)
FINGO	10.5	8.6	1.0	20.1	23.8	3.7
SACCO	7.9	7.2	1.0	16.0	20.5	4.5
MFDB	9.7	9.8	0.6	20.0	21.8	1.8
Nepal	**9.6**	**9.5**	**0.9**	**20.0**	**22.0**	**2.0**
India – non-AP	11.7	10.2	0.8	22.7	26.8	4.1
Bangladesh	13.6	7.5	4.3	25.4	25.1	-0.3
East Asia/Pacific*	15.0	4.1	0.6	19.7	25.8	6.1

As discussed in **Chapter 3**, **staff working conditions and remuneration** (as indicated by the staff turnover rate) can have an effect on the operating expense ratio. Though high turnover could be related to lower expenses through a lower remuneration, it is apparent from data available for India that the OER is actually higher with a high staff turnover as it imposes increased expenses on the employer due to the need for additional recruitment and training. The relationship of staff turnover to staff satisfaction is reflected in yield and portfolio quality resulting in a significant negative relationship between staff turnover and return on assets – presented in **Exhibit 6.5 using the India MFI data** (since Nepal data on staff turnover is not available). This shows the expected correlation between the two parameters.

Exhibit 6.5

Correlation between staff turnover and RoA

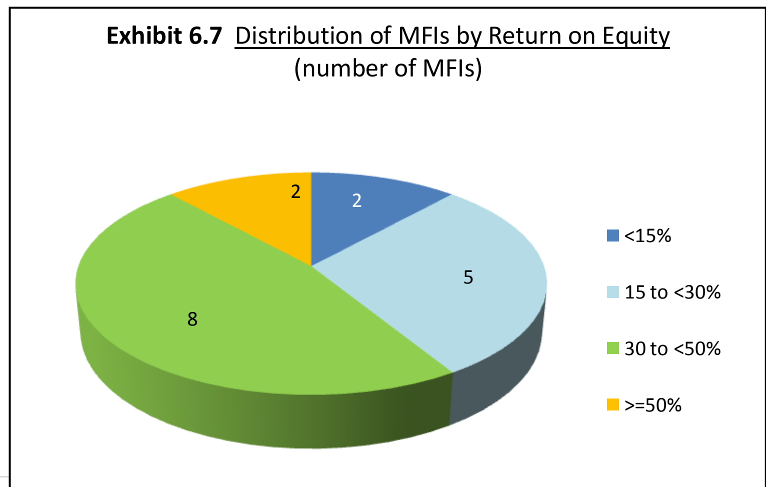


...with returns to equity now at attractive levels in the 20-40% range, 28.9% on a weighted average basis (**Exhibit 6.6**) for this 18 MFI sample in 2010-11. On a simple average basis, the typical MFI earned a higher 32.7% return on equity in 2010-11. This compares very well with 11-12% average levels in Bangladesh and non-AP MFIs in India. It is well ahead of the low returns earned by conventional non-microfinance development banks in Nepal and nearly matches the good average return, over 31%, registered by Nepali commercial banks As **Exhibit 6.7** shows, just 2 of the 17 MFIs (that have an RoE) earned less than the minimum 15% return on equity that investors regard as worthy of consideration. If this level of return can be sustained and widened across a larger cohort of Nepali MFIs it certainly bodes well for the future of microfinance in the country.

Exhibit 6.6 Returns on equity to Indian MFIs, 2011-12, %

Legal type	Weighted average	Typical MFI
FINGO	38.3	36.5%
Coop	28.7	22.2%
MFDB	26.7	32.4%
Nepal sample	**28.9**	**32.7%**
India – non-AP	12.1	7.4
Bangladesh	11.5	
Comm'l banks	31.3	
Devt banks	4.7	

Exhibit 6.7 Distribution of MFIs by Return on Equity (number of MFIs)



In sum, despite considerable scepticism about Nepal's early foray into microfinance regulation in the late 1990s, it is now apparent that this seemingly quixotic intervention sowed the seeds for the lessons that were learned during the early 2000s. Improvements in the regulation and the public confidence generated by supervision by the NRB over an extended period of time enabled the industry to withstand the challenges of political instability in the middle of the decade. All the indications are that a stable and responsible microfinance sector has now started to emerge in Nepal and that this is likely to have a significant positive impact on financial inclusion in the country during the current decade.

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Key references and data sources used for this review

Annual reports or **annual financial statements** of 18 leading MFIs in Nepal with more than 10,000 borrowers on 16 July 2011.

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Glossary of terms

Annual percentage rate (APR)	Expected earnings from a loan portfolio based on the stated terms of the financial institution's loan products
Capital Adequacy Ratio (CAR)	Ratio of net worth to risk weighted assets (Risk weights: 100% for all assets except fixed assets & interest bearing deposits: 50%; cash 0%).
Client retention rate	Rate as reported to MIX by MFIs – defined by MIX as active borrowers at the end of the period to (active borrowers at the beginning of the period + new borrowers during the period)
CRILEX Nepal	M-CRIL's index of growth of the microfinance sub-sector – the subsequent area name specifies the region covered
Financial expense ratio (FER)	Total interest expense for the year divided by the average portfolio
Financial inclusion ratio	Extent of coverage of the population of a region by financial services provided by formal financial institutions
GNI per capita	Gross national income per capita – ratio of the dollar value of a country's final income in a year divided by the population

Loan loss provisioning ratio	Total loan loss provision expense for the year divided by the average portfolio
Loan loss reserve ratio	Ending Loan loss reserve divided by ending gross loan portfolio.
Cost per borrower	Ratio of operating expenses to number of borrowers
Coverage ratio/MF penetration	Ratio of number of loans outstanding to estimated number of financially excluded families
Operating expense ratio (OER)	Sum of staff, travel, administration costs, other overheads and depreciation charges divided by the MFI's average loan portfolio.
Portfolio at risk (>=30 days) (PAR30)	Ratio of the principal balance outstanding on all loans with overdues greater than or equal to 30 days to the total loans outstanding on a given date
Return on assets (ROA)	Ratio of operational income/loss to average total assets
Return on Equity (ROE)	Ratio of operational income/loss to average total equity
Staff turnover rate	Rate as reported to MIX by MFIs – defined by MIX as number of exit during the period to average (number of employees at the end of the period + staff employed for one year or more)
Total expense ratio (TER)	Ratio of total financing expenses, loan loss expenses and operating expenses to the average loan portfolio
Yield on portfolio	Interest and fee income from loans to clients divided by the average loan portfolio for the year
Write off ratio	Ratio of write off amount to average gross loan portfolio

Micro-Credit Ratings International Limited
602 Pacific Square, 32nd Milestone NH8
Gurgaon 122 001 INDIA
Tel: +91 124 230 9497, 230 9707, 405 0739, 426 8707
Fax: +91 124 230 9520
e-mail: contact@m-cril.com ; website: www.m-cril.com