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Improving and Expanding Agricultural Lending in Nepal's Hills

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Introduction

Nepal continues to rank among the world's least developed countries and as a low income food deficit country. As of 2009, its income per capita ranked 148th out of 164 countries in purchasing power parity terms, just above Haiti.ⁱ Facing a difficult geography, recovering from conflict, and struggling with a frozen political establishment, Nepal confronts an array of challenges and significant uncertainty in its development path.

Despite the fact that nearly 80% of Nepal's population is dependent on agriculture, agricultural share of GDP is just 40%, due to the subsistence nature of farming.ⁱⁱ Malnutrition in Nepal, by some measures, is among the worst in the world.ⁱⁱⁱ Agricultural development to a commercial-based, high-productivity sector will play a critical role to Nepal's future growth.

Within the agriculture sector, there is a sharp disparity between the Terai and country's hills, where approximately 45% of the country's population lives. The mountainous geography makes the land less productive, landholdings smaller, markets harder to access, and illiteracy and subsistence practices common. Due to these challenges, financial institutions – necessary for agricultural input purchase, enterprise development and consumption smoothing – concentrate in the Terai and forego the hills. (The ten-year conflict also drove commercial banks and government support out of the interior). In the hills, only 11% of the population is thought to have access to formal savings, loans, and other financial products to better secure and promote their livelihoods^{iv}, compared to an estimated 90% in the Terai.^v

This study aims to evaluate modalities of improving and expanding credit access in Nepal's hills. It has four parts. Part 1 will describe the current needs and behavior of farmers in Nepal's hills and how well suited the financial service landscape is for them. Part 2 will describe and evaluate recent innovations in financial service provision in the hills. Part 3 will consider two new models for agricultural lending to the hills – wholesale lending to cooperatives by microfinance institutions and umbrella lending and capacity building firms. Part 4 will make recommendations and suggest areas for further exploration.

This study is based on 40 interviews with microfinance institution clients, client groups, branch managers, and chief executives, cooperative leaders and members, central bank officials, NGOs and development agencies, and other stakeholders. Interviews were conducted in Kathmandu and in Bhojpur, Dhankuta, Ilam, and Palpa districts, which have similar agro-climatic conditions and crop selection. A complete list of interviewees is found in the Appendix.

Just as there are dramatic disparities between agriculture in the Terai and Hills, so there are dramatic differences among low-, mid-, and high-hills and across the country from east to west.

Bhojpur, Dhankuta, Palpa, and Ilam were judged to respectively have low, medium-low, medium, and medium-high access to financial services, respectively, and with the exception of Bhojpur have higher-than-average market and road access. These districts cannot capture all the geographic variation critical to explaining financial service provision, and the author has kept this in mind regarding his recommendations.

Part 1: Problems of the Present Landscape

1.1 Farmer Agricultural and Credit Needs

Farmers in Nepal's hills are smallholders, owning typically between one and fifteen ropani (between 0.05 and 0.75 hectares), on which they typically plant subsistence crops – maize, wheat, and rice. More enterprising farmers with better market access have also moved into cash crops or a food-crop/cash-crop mix, including ginger, cardamom, tea, and potatoes, often with the assistance of NGOs. The land is usually unirrigated and dependent on rainfall, whose patterns have been recently shifting.

Households require multiple sources of income to spread risk and provide food and income throughout the year. Crops are harvested at different points (rice and maize in summer, wheat in winter), and livestock provides income year-round. Livestock and crops also serve as complementary investments, with crops providing feed for the livestock while the livestock provides manure fertilizer for crops.

However, food production is rarely sufficient to meet household need, and food is frequently the major spending item for smallholder households. A member of the household, typically the husband, will frequently supplement farm income with migrant labor income from India, the Persian Gulf, or Southeast Asia. This requires being away from several months to several years at a time, and the wife is responsible for raising the farm and family.

If there is surplus production or the farm is producing cash crops, selling produce is impaired by limited market access and market information. In areas with no market information or proper storage mechanism, crops are sold at the local *haat bazaar* for whatever price they can fetch, or sold to traders coming house to house during crop shortages. If markets can be accessed, farmers receive price information from these traders, friends and family who recently visited market locations, calling market locations by mobile phone, or in some cases by FM radio (such as Madan Pokhara FM Radio in Palpa). If storage is possible, farmers will wait for better prices or the need for cash before selling, but disease, frequent *bandhs* (strikes), and lack of proper storage techniques keep price risk high for these households.

Agricultural value chains are poorly developed in general. For inputs, farmers are usually self-reliant, setting aside a share of crops for seeds. Sometimes seeds can also be purchased at the district agricultural development office (DADO), but the process is cumbersome. Given the small scale of the farmer, there is little bargaining power with traders, who purchase crops often well below market price. Collective marketing by farmers is beneficial but challenging given the distances between households and the varying cash flow needs of each household.

Farmers face both productivity and business skill deficiencies. While farmers are eager to increase their productivity, they frequently lack knowledge in disease management, crop and varietal selection, proper storage techniques, irrigation methods, and other technical areas. Extension services are rarely available; district agricultural development and livestock service offices provide assistance to a small segment of farmers, but in practice do not do outreach. Most government extension offices closed sub-branches during the insurgency, so interior areas are underserved. Beyond agricultural techniques, business skills critical to the transition from subsistence to commercial farming – like recordkeeping, the concepts of profit and loss, and a movement to cash crops – are lacking and are undermined by illiteracy.

Farmers require credit for consumption smoothing, inputs, and enterprises. In the hills, however, only 11% of smallholder farmers have access to formal saving and credit products. Commercial and government banks have withdrawn from interior hill areas, largely as a result of the ten-year conflict. Farmers turn to family members, neighbors, and moneylenders as their most frequent source of credit, which is provided unreliably and at high rates of interest (often around 50-60%), paid in a lump sum at the end of the borrowing term. Moneylenders will often not allow early repayment of loans, and repayment often comes in the form of a share of harvest, which is purchased well below market prices.^{vi}

Loan requirements vary greatly based on both quantity and quality of crop or livestock investment. On top of productive credit, loans are often taken during lean seasons to finance consumptive needs, from medicine and children's education to festival and wedding needs.

1.2 Dominant Credit Products and Practices

In this landscape and with the end of the conflict, FINGOs, microfinance development banks, and government agencies have also begun to provide saving and loan products into the hills given farmer need and the availability of new clients. Additionally, numerous saving and credit cooperatives have organized in the hills to mobilize member savings for more reliable and cheaper loans than are otherwise available. The products and practices of these institutions will be explored.

1.2.1 Grameen Model Microfinance

Nepal was one of the first countries to adopt Grameen-model microfinance after it was pioneered by Professor Muhammad Yunus, with 18 microfinance development banks and 45 FINGOs now largely deploying this model.^{vii} Microfinance is heavily concentrated in the Terai, where clients are frequently members of multiple banks. Due to heavy competition in the Terai, microfinance institutions have begun expanding into the hills, keeping the Grameen model intact.

In the Nepali version of Grameen-model microfinance, groups of five farmers are organized into centers and trained. Collateral-free loans are issued to individuals up to Rs. 60,000 (\$800), the government-mandated loan ceiling for collateral-free loans, guaranteed by the client's group. The interest rate ranges from 15-25%, generally closer to 25%. Compulsory savings are also collected, with interest paid at 8%, on average. Loans are repaid usually in weekly or fortnightly installments, and repayment is usually close to 100%.

Grameen-model microfinance is a poor fit for Nepal's smallholder farmers, however. Developed in Bangladesh, both densely crowded and flat, Grameen-model microfinance is best suited for short-term credit needs in professions with high turnover, where groups are easily formed and monitored to compensate for the lack of collateral. This model is ill-suited for Nepal's geography, topography, and agricultural livelihoods strategies. Smallholder farmers are scattered and difficult to reach, in some areas days from the nearest road. They are consequently difficult to form into groups, monitor, and train. In hill areas where agricultural enterprise is weak and markets inaccessible (e.g. Midwest and Far West high-hills and mountains), loan sizes would be too small to justify the higher operating cost in the area. In other hill areas, where markets are established and agricultural enterprise developed, the short-term, small loan Grameen model is also a poor fit. Farmers in these areas (e.g. Ilam, Palpa) require loans large enough to finance a crop cycle and flexible enough to adapt to the income stream from their investments.

Farmers reliant on ginger and cardamom provide an illustrative example. Both cash crops are well-suited to Nepal's hills and their high value provides strong potential for movement from subsistence to commercial agriculture. Ginger is harvested twice; three to five months after planting and then nine to ten months after planting. Weekly, fortnightly, and even monthly installment payments are thus difficult for ginger farmers to make, unless there is reliable income from other sources.

Cardamom farmers are even more in need of long-term financing. Cardamom farmers require financing for crop medicine, labor, and crop expansion on a monthly basis beyond personal consumption needs, but their income is annual since cardamom is harvested once a year. Since cardamom is grown in the high hills, where other crops do not grow well, cardamom farmers have few other income sources to rely on, and are thus especially ill-suited for frequent installment payments and require a one year loan term.

1.2.2 Saving and Credit Cooperatives

Cooperatives have rapidly expanded throughout the country in the past decade. There are now some 2,300 financial cooperatives registered with the Nepal Rastra Bank, and likely tens of thousands of informal cooperatives throughout the country.^{viii}

Saving and credit cooperatives are formed to mobilize member savings at scale and provide loans for emergency and productive purposes. Saving and credit cooperatives also often operate in other activities, including collective input purchases, collective marketing, and land sharing. Cooperatives vary greatly in size, from just a few dozen to a few thousand members. Membership and voice are purchased through shares. Members are required to save a compulsory amount each month and are eligible for loans from this pool of savings based on their share level. Collateral for these loans ranges from guarantees by two other cooperative members, to share capital, to formal collateral evaluated by cooperative leadership. Monitoring is minimal for these loans, but repayment is generally very high as a result of the ownership and communal nature of the organization.

In many ways, cooperatives are well-suited for agricultural lending in the hills. Being generally based on location where the loans are utilized and employing few staff who often serve on a volunteer basis, cooperatives have very low operating costs and consequently lower interest rates (between 10-15%, in general). They are also taxed less (if registered) than microfinance institutions, which are taxed at the same rate as commercial corporations. Furthermore, the ownership nature of the institution in theory makes cooperative policies and products more suited for the needs of their members than those of external institutions. Finally, governed by the Cooperative Act (1992), cooperatives do not face the NRB loan ceilings for their products, and larger cooperatives are able to issue large loans with long installment periods needed to finance many agricultural investments.

Cooperatives, however, face a number of challenges that make the institutions as they currently exist inadequate for financial service provision in the hills. First and foremost, cooperatives lack enough liquidity to accommodate the financial needs of its members. Cooperative loans are drawn exclusively from members' savings, and compulsory savings rates would be prohibitively high in order to provide loans to all members who require it. As a result, many cooperatives issue loans on a rotating basis or require debate among members over who deserves or needs the loan more. Borrowing externally is extremely rare because of commercial banks' disengagement from the hills, collateral required for loans from commercial and government banks, and MFI unwillingness to work with cooperatives.

Furthermore, many cooperatives lack management skills and good governance. Cooperatives have little experience or training opportunities in managing finances and establishing productive policies accepted by members. The poor skill level leads often to poor governance.

While cooperatives are democratic in theory, in practice the leadership is often in permanent control, run by a certain family, and strongly influenced by local politics. Larger cooperatives often do not even mobilize savings into agricultural or productive enterprises but instead invest in Nepal's real estate markets. Talented or educated individuals in the community are often excluded by leadership out of fear of displacement.

External support or training is challenged again by the high operating cost of working in inaccessible areas with such small institutions. Because of these challenges, registration efforts by the Nepal Rastra Bank and external support from organizations like NEFSCUN and GTZ remain quite difficult, and benefits fall to accessible, larger cooperatives.

Finally, cooperatives often fail to provide finance to poor farmers. Cooperatives' membership saving and share requirements, typically higher than MFIs', lock out many individuals who cannot afford them. Cooperatives also attract more enterprising individuals who understand the benefits of savings and loans. Consequently, the average income of cooperative members is generally higher than that of microfinance clients, and a need for financial services among the poor thus remains in these communities.

1.3 Government and Central Bank Efforts

The Nepal Rastra Bank is extremely active in microfinance efforts and supports a number of efforts to promote finance to the poor. The government, through its National Planning Commission (NPC), has also stated its dedication to expanding financial access to hills. The NPC's current Three Year Interim Plan dedicates a chapter to agriculture and rural credit, which states the objective of increasing agricultural productivity and increasing the outreach of microfinance programs.

Government and central bank agricultural finance policies have primarily been directed through three programs: lending through the Agricultural Development Bank and Regional Rural Development Banks, mandating private financing through its deprived sector lending policy, and local support through District Agricultural Development Offices.

1.3.1 Public Lending

The Agricultural Development Bank Limited (ADBL) was formed in 1968 to provide credit to institutions and individuals involved in agriculture. Seven years later, the ADBL created the Small Farmers Development Program (SFDP) to focus on smallholder farmers, organizing them into groups and lending wholesale to them. The ADBL has more than 400 branches spread throughout the country, including the most remote areas, (e.g. Humla, Jumla), offering by far the largest rural bank network in the country. The Government of Nepal also established five Grameen Bikas Banks, one for each development region. These banks, currently being

transitioned to the private sector, are microfinance banks lending through the Grameen modality and also extend deep into the hills.

The government-sponsored development banks experienced severe problems, however. The mixture of politics and lending proved to be problematic, as a “loans-for-votes” culture emerged to accrue rural political support. Monitoring was poor, and default simply meant moving to another area for lending. On the borrower’s side, loan recipients questioned why they should repay loans from the government, as they felt entitled to its support. This attitude was supported by the Maoist insurgency, which encouraged non-repayment to garner political support. By 2003, the Small Farmers Development Program was facing nonperforming loans up to 40%, and was restructured with the assistance of the German Agency for Technical Cooperation (GTZ) into the Small Farmers Cooperatives Limited (SFCL).^{ix} For similar reasons, the Grameen Bikas Banks are being gradually privatized.

The attitude towards public lending persists, however. As recently as 2008, the Maoist-led government announced that government microfinance loans up to Rs. 30,000 from its banks (Nepal Bank Limited, Rastriya Banjya Bank, and ADBL) would be forgiven. Clients of the then-privatized Grameen Bikas Banks demanded the same treatment, hurting repayment in private sector finance as well. The conflict severely hampered government lending to the hills as well, as bank branches were often targeted, and government banks scaled back their hill operations to district headquarters.

1.3.2 Deprived Sector Lending

The government’s second major policy instrument is its deprived sector lending policy, introduced in 1990, which requires that a certain share of a bank’s loan portfolio be allocated to the “deprived” sector. This policy applies to commercial banks (3%), development banks (2%), and financial companies (1.5%). In practice, deprived sector lending includes small loans for microfinance, microenterprise, agriculture and livestock, housing, foreign employment, hydropower, youth and small entrepreneur projects, and community hospitals, each with an associated loan ceiling to keep the program focused on the disadvantaged. Critically, wholesale loans to microfinance institutions and cooperatives and equity investment in microfinance development banks, also qualify as deprived sector lending. The latter two approaches are the most favored method of lending by commercial banks (roughly 53% compared to 31% to direct lending), if they choose to participate in the program at all.^x As of July 2005, 11 of the 17 commercial banks chose to not comply with the 3% requirement and pay the fee instead.^{xi}

Deprived sector lending is very effective at directing liquidity to the microfinance sector, which consequently relies on borrowing from banks and other financial institutions for over 50% of total capital.^{xii} While the interest rate charged on deprived sector loans is not capped or

subsidized, MFIs have received financing at very low rates of interest (3-4%) due to the required loan portfolio quantity, until recently when a liquidity crunch elevated these wholesale loans to approximately 7-8% on average. The policy is seen as quite successful in promoting microfinance, but subsequent on-lending to clients has posed a problem. Nepal Rastra Bank is only now beginning to seriously monitor deprived sector loan use by microfinance institutions, and until recently microfinance institutions poured up to half of their financing into fixed deposit accounts, which provided a better return than expanding operations and lending on to more risky clients. The deprived sector lending policy, then, has led to a financially-robust microfinance sector (nearly all the institutions remain profitable despite the liquidity crunch) but an uncertain expansion in clients served.

The DSL policy's loan ceilings also have unintended consequences. The loan ceilings are intended to ensure the deprived sector loan funds are used for microenterprise and small-scale projects instead of larger and more commercial ventures. However, the loan ceiling is often restrictive for those smallholders it aims to assist. The Rs. 60,000 loan ceiling on collateral-free loans, the most common microfinance product was raised from Rs. 40,000 only two years ago but still does not meet the needs of poor smallholder farmers, who often require more than that for a single crop cycle, to say nothing of consumption needs during the lean season. In an inflationary agriculture sector, the cap affords smallholder farmers less and less purchasing power. In combination with MFIs' long graduation periods to the full loan amount, smallholders often sign up with multiple microfinance institutions and try to take loans from each, hiding this behavior from their lender.

1.3.2 District Agricultural Development and Livestock Offices

These offices are found in each district, mandated with providing agricultural extension and agrovet support to local farmers. Before the restructuring of the Ministry of Agriculture's district-level operations in the 1980s, district agricultural development offices (DADO) and district livestock service offices (DLSO) had multiple branches and sub-branches in the interior of most districts. As a result of the restructuring, however, they mostly relocated to the district headquarters, away from most of the smallholders, and transitioned to a service center model of working. As a result, the transactions costs of seeking technical advisory services from DADOs and DLSOs became prohibitive for most smallholder farmers located in the VDCs.

Furthermore, the services of these offices are ill-provided. Offices are frequently under-staffed and officials are often rotated out, unable to gain a relationship with the district and its farmers. Support processes, such as for seed provision, are lengthy, leading many farmers to forsake extension support entirely.

Part 2: Recent Innovations

In the last ten years, several new lending models and institutions have emerged, adjusting to the challenges of lending to Nepal's hills. Cooperatives, microfinance institutions, and Government of Nepal apex institutions have all made changes to improve loan products and expand coverage. This section will describe the experiences of these new innovations and evaluate their strengths and limitations.

2.1 Self-Reliant Group (SRG) Model

Model Overview

The Self-Reliant Group (SRG) microfinance model recognizes the challenges of lending to inaccessible areas and adopts a community-ownership approach. In some ways, the Self-Reliant Group model involves microfinance institutions creating a cooperative from scratch, and lending wholesale to it.

Pioneered by Nirdhan Utthan Bank Limited with support from Plan Nepal and Save the Children in 2003, the SRG model was first deployed in Terai district of Banke, where the insurgency made Grameen-based lending challenging. The following year, it was deployed to its first hill district, in Palpa, and as of this report is deployed in 8 districts (Palpa, Banke, Kailali, Ilam, Dhankuta, Panchthar, Bardia, and Dadeldhura). During this fiscal year, NUBL plans a dramatic expansion of twenty new branches, with ten in the hills and ten in the Terai. The profits of the Terai branches will subsidize the initial losses in the hill branches.

Under the SRG model, NUBL forms a group of ten to forty members drawn from NUBL's targeted population of smallholder, uneducated women. The group elects a chair, treasurer, secretary, and assistant leadership positions, and goes through a weeklong training in the program rules. For three months, the group gains experience collecting compulsory savings from their members, which can be mobilized for loans to the group members. Groups meet every twenty-eight days, and after three meetings and signing a contract with the bank can apply for wholesale loans from NUBL.

These wholesale loans are currently issued at a rate of 18% in an amount up to twenty times the group's total savings, with a ceiling of Rs. 1 million. Individuals are only eligible for Rs. 20,000 the first year, Rs. 40,000 the second year, and the maximum Rs. 60,000 from then on. The group then issues loans to its individual members from this pool at an interest rate of their choosing. Any spread between the 18% wholesale rate and chosen retail rate goes to the group's general fund, which members can borrow from for any purpose without NUBL supervision. All decisions are made through group consensus. NUBL staff support these group

meetings, aiding with recordkeeping, calculations, and procedures, with the aim of gradually scaling back staffing of the meetings.

SRG has also adjusted its model to the agricultural livelihoods of most of its members. Loan installments have been extended to a monthly or quarterly basis based on group preference. In certain branches, groups also have six month or even yearly balloon installment payments. Loan duration is one year for the first year and two years thereafter, and any installment amount repaid can then be taken out as a loan again without waiting for the loan term to finish. After one year, members are also eligible for a seasonal loan up to Rs. 10,000, though the total borrowing cannot exceed the Rs. 60,000 ceiling.

Strengths

Despite its innovative approach, NUBL's SRG model hearkens back to the ADBL's SFDP approach of group formation and wholesale lending beginning in 1975, which ended in significant non-repayment. The SRG model is unlikely to repeat this outcome, however. The principle problem with ADBL's program surrounded the mix of politics and lending, which resulted in a culture of non-repayment, non-monitoring, and non-collection of loans. Under a private institution, the SRG model has already shown promise and better repayment performance.

The SRG model is an improvement from Grameen-model microfinance for the hills in a number of ways. First, after the initial heavy cost of group formation and training, the reliance on group members for recordkeeping, savings collection, and individual loan disbursement, and staffing groups only on a monthly basis significantly lower operating costs. The lower operating cost allows NUBL to charge a lower interest rate than its competitors that use the Grameen modality. After requiring four to five years for its first hill branch in Palpa to break even, performance has improved, with more recent branches breaking even between 18 and 24 months, rivaling the profitability of Terai microfinance branches.

Second, group self-reliance and the training offered to group leadership promote literacy, business orientation, and numerical skills. It also affords more flexibility than traditional microfinance products, allowing members to decide group size, their retail interest rate, and meeting rules. The flexible retail rate (typically set at 24% to allow for a convenient 2 percent/month calculation) allows members to invest in their group members.

Third, self-reliant groups mimic many of the advantages of cooperatives while avoiding some weaknesses. Since self-reliant groups are formed from scratch and trained in group best practices with external assistance, their governance is consistent and of higher quality. Additionally, self-reliant groups are targeted at disadvantaged populations - poor, smallholder, and uneducated women – providing financial access to groups often excluded from

cooperatives. Finally, and most significantly, self-reliant groups have access to a reliable source of external finance, which cooperatives lack.

Limitations

While the SRG model is a definite improvement over Grameen-model microfinance in the hills, there remain limitations in its approach, and it is unsuitable in many areas of the country.

While self-reliant groups do perform a number of critical finance tasks on their own, the groups never become truly autonomous from NUBL support. Even groups formed for years continue to be supported by NUBL on a regular basis. NUBL correctly emphasizes that self-reliant groups are not required to borrow exclusively from their bank and may turn to other banks, though few other banks offer collateral-free loans at NUBL's interest rate. However, members will likely begin to demand salary for leadership positions, paid through the group fund, as compensation for their administrative jobs. Experienced SRGs could easily merge and form their own cooperative, otherwise. Salaried leadership can be managed under the existing model, but will need to be delicately handled.

The SRG model, while providing better access to the hills, will likely not be successful in all hill areas. Staffing in remote interior areas is simply not financially possible given the lack of road access. Presently, SRG branches cover a perimeter roughly three to four hours from the branch, which allows staffers to attend a meeting and return the same day. Staffing monthly meetings that are multiple days from the road would be too expensive.

The SRG model is also bound by literacy level. Strong self-reliant groups tend to have sufficient literate members to perform leadership duties: take meeting minutes, record transactions, and perform financial calculations. Groups that lack such skills require a heavy staff presence and capacity building, which requires intensive investment.

Finally, while self-reliant groups resemble cooperatives in a number of ways, the external financing comes at the cost of a higher interest rate than those of cooperatives or government and commercial banks, which limits participation and access. This higher interest rate is partly driven by a desire to break even as quickly as possible to facilitate further expansion as well as by the large upfront cost of branch establishment, group formation and training, and delayed wholesale lending.

NUBL has demonstrated that wholesale group lending can perform well and break even relatively quickly in areas with good road access and commercial orientation. The dramatic expansion this fiscal year into more interior areas with lower literacy and entrepreneurship will reveal its performance under more difficult conditions and the extent of the model's feasibility.

2.2 Small Farmers Cooperatives Limited

Model Overview

Similar to the self-reliant group model is the Small Farmers Cooperatives Limited program (SFCL), which was the restructured successor to the Small Farmers Development Program. Small farmer cooperatives organized and lent to by the ADBL were made autonomous and federated, and the first SFCL loan was issued in 1997. SFCLs are organized across three tiers – farmer groups, inter-groups, and federated cooperatives – and many have membership rolls over a thousand.

The SFCLs are trained by the Sana Kisan Bikas Bank Limited (Small Farmers Development Bank), which then provides external financing. There are 229 SFCLs as of January 2010, operating in twenty-one Terai districts and nineteen hill districts, with an average loan outstanding per SFCL of Rs. 4.5 million. SFCLs have a self-replicating expansion method, where an existing SFCL recommends a neighboring VDC for SFCL creation and then promotes and trains it in the best practices it has come to operate with.

Similar to self-reliant groups, SFCLs have a “saving-only” introductory period. After six months of collecting voluntary and compulsory savings, SFCLs are eligible to borrow from the bank at around 11-12%, and the SFCLs lend on to individual farmers at 14-15%, with the margin used to pay for operating costs.

Strengths

The SFCL program is the sole significant case of wholesale financing to cooperatives in Nepal. Its strengths thus mimic the strengths of cooperatives writ large. SFCLs are also owned and led by their members, which makes their loan products more tailored to smallholder farming needs. Loans are long-term (between 18 and 30 months), and installments quarterly or semiannually, based on the investment need. SFCLs are also the largest shareholder of the Sana Kisan Bikas Bank, owning 42% of the shares. SFCLs are staffed by small farmers, and recruitment and operations take place locally, minimizing operating costs. Most significantly, this allows for a low interest rate.

While preserving the strengths of cooperatives, SFCLs also critically have access to external finance and better governance than ordinary cooperatives. Since SFCLs are formed with the assistance of an experienced cooperative and have roughly standardized leadership structures and rules, members are generally active and engaged in the institution. Experience has shown that cooperatives that have access to training and external advising, whether from another SFCL or NGO, perform better.

SFCLs resemble self-reliant groups in their being formed from scratch and their access to external training and finance. However, SFCLs are technically accessible by everyone – even, in some cases, large farmers – while SRGs are only accessible to smallholder disadvantaged women. The universal accessibility broadens the savings base available for loans.

Limitations

A significant limitation of the SFCL model is its expansion rate. The replication method, which lowers operating costs and affords a lower interest rate, is also very slow and difficult to scale. Expansion takes place from one VDC to another, slowly. SFCLs still take roughly four to five years to break even, while the self-reliant group model allows a single branch to profitably cover several VDCs with one branch in an increasingly short amount of time.

More critically, the SFCL model is not self-sufficient, and still relies on government subsidies. In the four years it takes to break even, the government supports operating costs for two years, and two years of operating costs is borrowed by the cooperative. While the SFCL model has thus far avoided the repayment problems associated with government support (repayment is currently at 98%), the SFCL model must improve performance to become sustainable.

Finally, the ability for anyone to join SFCLs, while providing a broader liquidity base, can indirectly exclude disadvantaged farmers if compulsory savings rates are set too high. There is no formal mechanism to assure the target groups of microfinance institutions are gaining access to finance beyond encouraging SFCLs to adjust their policies.

2.3 MFI-NGO partnerships

It is rare to find a microfinance development bank without an NGO backstopping its efforts or providing supporting services. Nirdhan Utthan Bank Limited, DEPROSC Development Bank, Swabalamban Bikas Bank, and Nerude all have associated NGOs. Microfinance institutions also have partnered with unaffiliated international NGOs, including Plan Nepal, Save the Children, GTZ, Mercy Corps, and others. These NGOs engage in development assistance, from literacy, health and education interventions, to agricultural extension services and business training.

The MFI-NGO partnership emerged as Nepali NGOs began engaging in microfinance activities, and then branched off as MFDBs. In combination, the two institutions provide a valuable service, recognizing that financial service access was not the only, or even most critical, need of Nepal's poor. Moreover, recognizing that lack of access to financial services was a cause but also a consequence of poverty, pairing financial service provision with certain interventions were found to be significantly more effective than the interventions alone.^{xiii} In particular, financial service provision combined with extension training provides both the skill and financial capacity to improve agricultural production.

The partner MFI-NGO arrangement can thus provide a needed multifaceted intervention to address both market and productivity challenges that smallholder farmers face. However, the arrangement faces two significant weaknesses.

First, and most fundamentally, there is a mismatch between the financing of NGO and MFI. The MFI has access to low-interest loans from commercial banks and is, by and large, profitable. As a result we see MFDBs expand even in a time of strained liquidity and MFI shareholders benefiting. Among those shareholders is typically the partner NGO, but it must rely largely on donor support for its operations.

This mismatch results in a sustainability problem. NGOs are unable to match the pace of expansion that microfinance institution partners engage in, let alone maintain their existing operations. Thus, the frequency of these joint interventions declines. The lack of complementary technical service support undermines both a farmer's production and her willingness to utilize financial services. Irrigation techniques and storage mechanisms, for example, would be more frequently invested in if farmers understood their benefits.

Second, the MFI-NGO partnership leads to blurry lines between the missions of the organizations. Smaller NGOs contend that the partner NGOs simply serve a supporting role to microfinance activities and crowd out funding for more able NGOs with a more dedicated, focused development mission.

2.4 New Apex Institutions

The government and Nepal Rastra Bank have recently instituted two new apex institutions to finance microfinance institutions and cooperatives: the Rural Self-Reliance Fund and Rural Microfinance Development Centre.

The Rural Self-Reliance Fund provides wholesale finance to 450 cooperatives, NGOs, and MFDBs across 53 districts, with roughly Rs. 134 million outstanding. The financing is derived from a government endowment fund of Rs. 20 million, and it targets the smallholder poor and disadvantaged. The Rural Microfinance Development Centre also provides wholesale loans to microfinance institutions and cooperatives, and at a much larger scale, lending to 61 MFIs and cooperatives across 52 districts, with approximately Rs. 1.6 billion in loans outstanding.

The RSRF and RMDC provide a useful source of low-interest financing for the microfinance sector during the present liquidity crunch. With the inconsistent participation and questionable sustainability of the deprived sector lending policy, the RSRF and RMDC will play a more significant role. Until recently, these institutions did little to actively promote financial provision in the hills, but in December 2009, the RMDC announced a policy of providing loans at 2% annual interest for MFIs and cooperatives that expand into nineteen high-hill and mountain

districts. This policy was intended ease the initial losses associated with hill district branch opening. An MFDB charging 18% per annum would earn 16% spread on each loan.

While this policy does provide some incentive for expansion, it is quite limited. Institutions that qualify for the 2% interest rate are limited to a one-time Rs. 1 million loan, which is not sufficient to justify expansion into these most inaccessible of districts. Furthermore, given persistent political instability, microfinance institutions and cooperatives are understandably skeptical of how long the program will last.

Part 3: Potential New Directions for Agricultural Lending

The recent innovations in agricultural lending have promoted new mechanisms for delivering finance to the more inaccessible hills of Nepal, lowering operating costs and providing capacity building to smallholders for better financial service use. The models are also increasingly tailored to the needs of smallholder farmers, through either their ownership or loan terms. However, in sum, their models either remain limited to hill areas with road access and relatively strong capacity (in the case of SRGs), require subsidies (in the case of SFCLs), or cannot sustain the rate of expansion (in the case of the MFI-NGO partnership arrangement).

The landscape is still in want of a sustainable model that can allow low capacity, interior hill areas to have access to finance. A comprehensive new model proposal is beyond the scope of this study, but two proposals will be cursorily described and evaluated: MFI wholesale lending to cooperatives, and single-institution offering both financial service and capacity building.

3.1 MFI Wholesale Lending to Cooperatives

Wholesale lending to saving and credit cooperatives already takes place. As described earlier in this report, the SFCL program and RMDC and RSRF apex institutions are based around this strategy, and NEFSCUN also provides wholesale loans to its cooperative members. The SKBBL lends to its 229 cooperatives, the RMDC lends to approximately forty cooperatives, and the RSRF has outstanding loans to nearly two hundred of them. All three organizations are supported by the government or central bank, however.

Microfinance institutions' expansion into the hills has only proven suitable for hill areas with road access, existing capacity, and moderate loan sizes. One of the most significant challenges in lending to subsistence farmers is building client understanding about the uses and benefits of finance, without which no substantial transactions or enterprise takes place. Lending to interior areas without significant market access or enterprise familiarity would be prohibitively expensive for microfinance institutions, requiring a heavy and long-term staff presence. While the experience of the SFCL program, NGOs, and the self-reliant group model has shown that cooperatives built from scratch with external assistance have stronger governance and performance, the cost of creating and training a cooperative is too high in many interior areas.

Rather, the financial needs of these communities could be better served by partnerships with established and nascent local cooperatives, relying on their low operating costs and local knowledge of community member creditworthiness and needs. Under this arrangement, cooperatives could tap into a vital source of external capital, while microfinance institutions

would be able to find a destination for the excess liquidity they often receive through deprived sector lending.

There are a number of obstacles to such an arrangement, and indeed neither cooperatives nor microfinance institutions are generally receptive to the idea of partnering with the other. In fact, microfinance institutions frequently claim that such wholesale lending to cooperatives is prohibited by NRB regulation, which is not the case, but a useful way to deflect the proposal. Microfinance institutions hope, rather, to corner the retail market in these areas as well, particularly now that microfinance development banks are allowed to take deposits from non-members. Their reluctance to work with cooperatives goes beyond the desire to expand retail service, though. Microfinance institutions core strategy of working exclusively with women would be compromised by this arrangement, as women-only cooperatives are not especially common.

Cooperatives, meanwhile, see external assistance also as a violation of their ownership principle, relying on the standards and requirements set by others instead of their members. Furthermore, the interest rate generally offered by MFIs (20%, on average) significantly exceeds the rate cooperative members charge one another (14%). While MFIs should be able to charge a lower interest rate on wholesale loans to cooperatives since they would not be heavily staffed, the longstanding disparity between cooperative and MFI interest rates creates a sense that the two cannot be bridged.

Two additional obstacles are governance and monitoring. Cooperatives have varying qualities of governance and performance. For wholesale lending to cooperatives to be viable, monitoring and supervision would be much more limited than in either Grameen or Self-Reliant Group modalities. Its role would resemble the Nepal Rastra Bank's relationship to commercial banks, auditing records off-site on a quarterly basis and visiting location on a semiannual or annual basis. With this frequency, access to these areas, while difficult, would not be financially prohibitive.

Finding cooperatives that are reliable and amenable enough to work with on this loose basis would be time-consuming and require some degree of community introduction to build trust and familiarity between cooperative members and their external lender. Literacy, accounting practices, and governance can be evaluated on location during this introductory phase without requiring a nearby branch.

3.2 Combined Agricultural Lending and Capacity Building

The frequent partnership between MFIs and NGOs, as described in the previous section, provides a successful yet unsustainable model of financial services combined with complementary services. For agricultural lending to truly meet smallholder farmer needs, and in the absence of an outreach-based public extension service, financial provision should be joined with technical training in agricultural techniques as well as commercial practices. This combined effort both increases the utility of the finance provided and tailors the finance to the specific technology and input investments of the farmer. However, the mismatch in financing between the MFI and NGO will result in microfinance rapidly outpacing technical service provision.

The only way to deploy the complementary services is from under the same roof. Microfinance institutions presently dismiss the option. They note that microfinance is a specialized business and while supporting services are undoubtedly helpful, they are not in a position, financially or in expertise, to provide such a combination.

This point, however, neglects the productivity gains and greater loan utilization that come as a byproduct of technical service provision. One of the largest challenges facing financial service provision in the hills is the small scale of production, and as agricultural technical support accelerates production, accompanying financial transactions will expand. Combined financial services and capacity building has been proposed before, but it has yet to be deployed in any significant way.^{xiv}

Part 4: Recommendations and Next Steps:

Recent innovations have led to a variety of approaches to lending in the hills. This is no bad thing, as no single institutional approach is yet proven in an exceptionally challenging environment. Nonetheless, the agricultural lending landscape need not remain as fragmented as it is, and efforts should be made to foster collaboration among financial institutions. The Nepal Rastra Bank and government should consider revising existing policies to make them more conducive for agricultural lending, and through their supervisory role should focus on creating an enabling environment and competitive market for microfinance. Finally, NGOs and external actors should advocate for policy change and promote pilot ventures in wholesale lending to cooperatives and umbrella agricultural lending and capacity building. These recommendations are broken down and expanded as follows:

4.1 National Policy Level

- The Nepal Rastra Bank should increase the collateral-free loan ceiling from Rs. 60,000 to at least Rs. 100,000, and peg the ceiling to inflation. Rs. 100,000 is the minimum capital needed by some smallholder farmers for a single crop cycle.
- The government should promote the expansion and proper staffing of district agricultural development and livestock service office branches beyond district headquarters, providing farmers easier access to extension services.
- Deprived sector lending should be closely supervised and monitored, and the uses of the subsidized liquidity more specifically delimited.

4.2 Financial Institutions

- Microfinance development banks and FINGOs should revise the Grameen model for hill branches, offering longer installment periods, fewer group meetings, and longer loan terms, based on the activities of clients.
- Microfinance institutions and cooperatives can mutually benefit from collaborating to provide financial services to interior hill areas. Cooperatives based in these areas can locally organize, collect savings, and disburse loans, while microfinance institutions, with limited access to interior areas can provide needed liquidity. Microfinance institutions should begin pilot programs lending wholesale to a few cooperatives in a small area. A period of community introduction will be needed to build trust and evaluate cooperative governance and ability. Based on this experience, the MFDB can evaluate community needs, supervision and auditing requirements, and acceptable interest rates. If successful, the demonstration

effect on nearby cooperatives will encourage them to adopt better practices in hopes of attracting external finance.

4.3 NGOs and External Actors

- NGO partners of Microfinance Institutions should pressure their partners to establish wholesale cooperative lending pilot programs in exchange for financial support for the upfront operating cost of search and matching.
- Organizations like the Centre for Microfinance, which engages in policy advocacy, and GTZ, which has worked closely with Government of Nepal microfinance efforts, should advocate for the needed policy changes noted above.
- NGOs and donors should promote pilot microfinance operations offering both agricultural lending and capacity building services, providing financial support while the operation reaches scale. Support for new market entrants is necessary as shareholders of current MFIs with NGO partners are unlikely to overhaul operations.

APPENDIX: List of Interviews

Government/Central Bank

Nepal Rastra Bank

Kushal Kumar Sharma
Assistant Director, Microfinance Department
Kathmandu

Nepal Rastra Bank

Narahari Acharya
Deputy Director, Financial Supervision
Kathmandu

Apex Institutions

Agricultural Development Bank Limited

Ghan Shyam Awasthi
Section/Faculty Chief, Central Training Institute
Kathmandu

Rural Microfinance Development Centre

Pritha Bahadur Thapa
Senior Officer, Microfinance Services
Kathmandu

Sana Kisan Bikas Bank Limited

Jalan Kumar Sharma
Chief Executive Officer
Kathmandu

Financial Institutions

Centre for Self-Help Development (CSD)

Mukunda B. Bista
Executive Director
Kathmandu

DEPROSC

Pitembar Acharya
Executive Director
Kathmandu

Forward

Leknath Subedi
Branch Manager
Fikkal, Ilam

Grameen Bikas Bank

Jeewan Shivani
Area Manager
Tansen, Palpa

Nepal Investment Bank Limited

Shivanth Pande
Department Head, Research & Business
Development Communications & CSR
Kathmandu

Nerude Laghubitta Bikash Bank Limited

Mani Kumar Arjyal
Executive Director
Biratnagar, Morang

Nirdhan Utthan Bank Limited

Dr. Harihar Dev Pant
Chairman and Chief Executive Officer
Kathmandu

Nirdhan Utthan Bank Limited

Arjun Khanal
Branch Manager, Bans Tari
Bans Tari, Palpa

Nirdhan Utthan Bank Limited

Agni Poudel
Branch Manager, Fikkal
Fikkal, Ilam

Nirdhan Utthan Bank Limited

Shekhar Karki
Branch Manager, Hile
Hile, Dhankuta

Swabalamban Bikas Bank Limited

Tanka Acharya
Branch Manager, Hile
Hile, Dhankuta

Swabalamban Bikas Bank Limited

Gotendra Gelal
Branch Manager, Fikkal

Fikkal, Ilam

Cooperatives

Eco-Tea Cooperative

Shiva Aryal
Executive Member/Treasurer
Kolbung, Ilam

Nawajyoti Cooperative

Nagendra Basnet
Cooperative Member
Hile, Dhankuta

Pancha Kunya Agricultural Cooperative

Milan Rai
Manager
Fikkal, Ilam

Pathibara Multipurpose Cooperative Limited

Dalim Nepupone
Manager
Kolbung, Ilam

Pathibara Multipurpose Cooperative Limited

Gopal Niraula
Assistant Manager
Kolbung, Ilam

Sitaradevi Savings and Credit Cooperative

Manager
Bans Tari, Palpa

Women's Multipurpose Cooperative

Reena Shakya
Manager
Tansen, Palpa

Farmers

7 Interviews with Individual MFI Clients
3 Self-Reliant Group Interviews
2 Unaffiliated Farmers
1 Community Leader

Support Institutions

Agro Enterprise Center

Pradip Mahajan
Chief Executive Officer
Kathmandu

Center for Microfinance (CMF) Nepal

Tejhari Ghimire
Chief Executive Officer
Kathmandu

Nepal Federation of Savings and Credit Cooperatives (NEFSCUN)

Min Raj Kadel
Chairperson
Kathmandu

Nepal Federation of Savings and Credit Cooperatives (NEFSCUN)

Dilli Ram Adhikari
Chief Executive Officer
Kathmandu

Plan Nepal

Hem Poudyal
Livelihood and Microfinance Coordinator
Kathmandu

German Technical Cooperation (GTZ)

Roshan Shrestha
Microfinance Advisor
Kathmandu

German Technical Cooperation (GTZ)

Nibedan Baidya
Senior Programme Officer, INCLUDE
Kathmandu

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