

Achievements and Challenges of Non-banking Financial Institutions in Resource Mobilization

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Abstract

As a result of liberalized market-oriented economic policy since reinstatement of multi-party democratic system in Nepal, a rapid growth of banking and non-banking financial institutions is observed in the country during last one and half decade. In this paper, an attempt has been made to examine the growth of various types of non-banking financial institutions (NFIs) and their contribution to mobilization of financial resources for the development and expansion of modern economic activities. NFIs are found to have encouraging result on collecting saving from people, promoting banking knowledge and habit in the people and working as financial intermediary. However, a significant part of collected savings are invested on unproductive sector for urban dwellers while there is shortage of financial resources with the NFIs working in rural areas. At the same time, a large number of institutions are carrying out financial activities without the permission of the Rastra Bank, the Central Bank of Nepal. The regulatory and supervisory role of central bank, therefore, should be maintained to guarantee safety of people's saving and making this saving available for entrepreneurs and productive rural farmers.

Introduction

Mobilizing domestic financial resources is an important component of economic development as it induces individuals and organizations to smooth income and consumption over time. Financial institutions, both banking and non-banking, play a key role in facilitating savings and credit leading to investment in production and services. The experience of many developing countries has shown that non-banking financial institutions can contribute to a smoother flow of saving and credit transactions. Grameen Bank in Bangladesh and Bank Rakyat in Indonesia are two of many examples of such institutions.

The reason behind the growth of non-banking financial institutions is that the operating cost of commercial banks in small and scattered settlements is high. At the same time, the main objective of commercial banks is always to make profits rather than to work through

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the welfare approach in their business. This paper reviews developments in non-banking financial institutions in Nepal in the last one and a half decades first by reviewing its achievements, its challenges, and finally suggesting some policy changes.

Achievements

In Nepal's case, looking back to the history of non-banking financial institutions, the establishment of Cooperative Bank in 1963 was probably the first official initiation to mobilize rural saving through cooperative societies. In 1968, the merger of this cooperative bank with another agency, the then Land Reform Savings Corporation which was created in 1966, led to the establishment of Agricultural Development Banks of Nepal (ADB/N). ADB/N evolved as the largest institution with a large number of country wide branches as the saving and credit agency in the rural Nepal. Some other agencies like, Nepal Industrial Development Corporation, *Rastriya Bima Sansthan*, *Karmachari Sanchaya Kosh*, were established during the *Panchayat* regime as non-banking financial institutions (NFIs) in the capital market.

Due to a kind of controlled economic policy during the *Panchayat* rule, growth of financial institutions was very limited. Financial reform policy was adopted by the central bank in mid 1980s. However, overall economic policy of the government was not favorable to attract the private sector work in the financial market. At the beginning of 1980s there were only two commercial banks and two development banks performing banking activities in the country. As a result of financial reform policy adopted in mid 1980s, a few commercial banks with joint venture were established. During the *Panchayat* regime, however, there were no micro credit development banks, finance companies, cooperatives and NGOs working in financial market.

After reinstatement of multi-party democracy in 1990, economic policy of the government made a distinct departure placing emphasis on liberal market-oriented economy. The role of government and private sector was demarcated clearly at policy level. The government was assigned the four rules as, facilitating the economic activities, promoting private sector economic development activities, building physical infrastructure and sustaining social services by opening this sector for private sector as well (Shakya, 2004). After the liberalization of economy by the first elected Nepali Congress government, financial sector made a tremendous progress both in number of financial institutions and beneficiaries of financial services. By mid-July 2006, the bank and non-bank financial institutions, licensed by Nepal Rastra Bank totaled 194 (Table 1). Out of them, 18 were commercial banks, 29 development banks, 70 finance companies, 11 micro credit development banks, 19 saving and credit cooperatives, and 47 NGOs.

Table 1: Growth of Financial Institutions in Nepal

| Type of financial institutions | Number of institutions in mid-July | | | | | | |
|---|------------------------------------|----------|----------|-----------|-----------|------------|------------|
| | 1980 | 1985 | 1990 | 1995 | 2000 | 2005 | 2006 |
| Commercial banks | 2 | 3 | 5 | 10 | 13 | 17 | 18 |
| Development banks | 2 | 2 | 2 | 3 | 7 | 26 | 29 |
| Finance companies | - | - | - | 21 | 45 | 60 | 70 |
| Micro credit development banks | - | - | - | 4 | 7 | 11 | 11 |
| Saving and credit cooperatives | - | - | - | 6 | 19 | 20 | 19 |
| NGOs (performing limited banking activities) | - | - | - | - | 7 | 47 | 47 |
| Total | 4 | 6 | 7 | 44 | 98 | 181 | 194 |

Source: Nepal Rastra Bank, 2006.

After liberalization of economic policy, the private sector started to establish development banks aiming at mobilizing financial resources for development activities. Out of the 29 development banks in the country eight have their central offices in Kathmandu valley, and the rest are located outside Kathmandu. The finance companies which started to establish from early 1990s have been growing rapidly. These finance companies, established mainly in the urban centers of country, have been effective to collect the savings from people and provide resource for investment and consumption demand.

Out of 11 micro credit development banks (MCDBs), five are rural development banks. During the 1980s, Grameen Bank had been a successful banking system to reduce the poverty in Bangladesh. The rural development banks, established focusing in the rural areas and deprived section of population, are the replica of Grameen Bank of Bangladesh. These banks have been established in Nepal as one in each development region during the period between 1993 to 1996. Following the financial system of rural development banks, four micro credit banks, such as, Nirdhan/Utthan Bank, Swabalamban Vikash Bank, DIPROSC Vikash Bank and Chhimek Vikash Bank were established during the period between 1998 and 2001. These four replicating banks were created from the private sector initiatives.

Two of the MCDBs, namely, Rural Microfinance Development Centre (RMDC), created with the loan assistance from Asian Development Bank (ADB) in 1998, and Small Farmers' Development Bank (SFDB) in 2001 are functioning at national level as wholesale lending institutions. These two institutions do not have direct approach to the individual creditors, they provide wholesale loan to other micro credit development banks, cooperatives and NGOs.

The number of savings and credit cooperatives with license from Nepal Rastra Bank (NRB) had reached to 35 in 2000. After establishment of SFDB, some saving and credit cooperatives were shifted under it. Actually, the total number of saving and credit cooperative

societies as registered at the Department of Cooperatives is 2692 as of mid April 2006. Some details of the cooperative societies as registered under Department of Cooperatives is provided in the following pages. As recorded in NRB, the number of NGOs performing limited banking activities has stood 47 in mid-July 2006 from seven in 2000. It is assumed that a large number of NGOs are operating as financial intermediary and saving and credit agency in most of the districts. The data for all such institutions can not be collected easily.

Poverty is the major issue of Nepali economy. Poverty reduction has been a sole objective of Nepal's Ninth and Tenth Plans. Mobilization of capital resources for investment is an important factor for poverty reduction in the rural Nepal. In this context, there was need of financial institution to mobilize the financial resources by collecting small scattered savings and availing those investments in economic activities. The commercial banks would not like to go to villages because of high operating cost since they have profit motive rather than promoting social banking. From the view point of cost, flexibility, incentive and motivation, non-banking financial institutions (NFIs) are more effective in resource mobilization and promoting development activities. NFIs are involved with service motive rather than making profit. Since NFIs can keep close relation with people and work together, they can play an effective role in mobilizing the resources for production that help reduce the poverty.

With the numerical growth of NFIs in the last one and half decades, there has been tremendous progress in the scale of resource mobilization. From the observation of comparative data on the use of funds by the commercial banks and NFIs, it is demonstrated that five rural development banks have highest loan/deposit ratio followed by micro credit banks, cooperatives and finance companies respectively. The average of loan/deposit ratio of all NFIs under study is 110.3 while it is only 59.5 of the commercial banks (Table 2). The overall weighted average of loan/deposit ratio of all financial institutions which indicated 69 percent is not found satisfactory. However, this ratio is heavily affected by the low ratio of commercial banks.

It is revealed from Table 2 that nearly one fifth part of the total deposits of all types of financial institutions is contributed by NFIs. Out of these NFIs, development banks have occupied highest proportion (10 percent) and it is followed by finance companies. The contribution of rural development banks (RDBs) and replicating micro credit development banks (MCDBs) seems insignificant since both the number and volume of transaction of these banks are low.

The contribution of NFIs to the total loan disbursement seems significant (30 percent). Out of them, the development banks and finance companies have the share of more than 10 percent each to the total of all financial institutions under study.

Regarding the cooperatives societies, there are only 19 saving and credit cooperatives under the regulatory framework of central bank. There are, however, 2692 saving and credit cooperatives altogether registered under the Department of Cooperatives. Not only this, there are altogether 8045 cooperatives registered under the Department of Cooperatives in 47 districts. Most of these cooperatives are doing saving and credit business. If saving

Table 2: Comparison of resource use of commercial banks and ADB/N, and NFIs, mid-July, 2006 (Rs. in million)

| Components | Commercial banks and ADB/N (1) | Development banks (2) | Finance companies (3) | Rural development banks (4) | Micro credit devt. Banks (5) | Saving and credit cooperatives (No. 2692) (6) | Total of NFIs 2 to 6 (7) | Total of 1&7 (8) |
|---|--------------------------------|-----------------------|-----------------------|-----------------------------|------------------------------|---|--------------------------|------------------|
| Total deposit | 291245.6 | 35902.64 | 24332.5 | 499.8 | 418.0 | 6485.4 | 67638.3 | 358883.9 |
| Total loans | 173383.4 | 3122.5 | 27078.95 | 1616.5 | 1272.4 | 13392.6 | 74584.7 | 247968.1 |
| Total capital | -17742.1 | 4782.1 | 4314.8 | 316.3 | 181.8 | 297.6 | 9892.6 | -7849.5 |
| Loan/deposit ratio (%) | 59.5 | 87 | 111.3 | 323.4 | 304.4 | 206.5 | 110.3 | 69.1 |
| Contribution of NFIs to total deposit | 81.2 | 10 | 6.8 | 0.1 | 0.1 | 1.8 | 18.8 | 100 |
| Contribution of NFIs to total loans (%) | 70 | 12.6 | 11 | 0.7 | 0.5 | 5.4 | 30. | 100 |

Source: 1. NRB, 2006.

2. Department of Cooperatives, 2006

and credit amount of all cooperative societies are included, there will be drastic change in ratio proportion of NFIs.

The Table 3 exhibits the resource mobilization trend and share of commercial banks and NFIs in the eight years period from 1998 to 2006. It is noticed that the proportion of loan/deposit ratio of NFIs is increasing gradually in the last 8 years period. At the same time, the contributions of NFIs to the total deposit and total loan are also increasing. The contribution of NFIs to total deposit was 6 percent in 1998 and it increased to 18.2 percent in 2006. Notably, their contribution has been nearly one third (30 percent) in 2006 from 8 percent in 1998.

Table 3: Trend and share in resources mobilization by commercial banks and NFIs during 8 years period from 1998 to 2006. (Rs. in million)

| S.N. | Statements | Mid-July | | | | | | | | | |
|------|-------------------------------|----------|------|--------|-------|----------|---------|----------|---------|----------|---------|
| | | 1998* | | 2000* | | 2002# | | 2004 # | | 2006 | |
| | | Com. B | NFIs | Com. B | NFIs | Com. B | NFIs | Com. B | NFIs | Com. B | NFIs |
| 1 | Total deposit | 102540 | 6760 | 153290 | 11040 | 185144.7 | 40042.2 | 233811.2 | 52235.5 | 291245.6 | 67638.3 |
| 2 | Total loan | 71240 | 6260 | 99450 | 10670 | 113174.6 | 41963.9 | 140031.4 | 57379.4 | 173383.4 | 74584.7 |
| 3 | Loan/deposit ratio % | 69 | 92 | 64 | 96 | 61.1 | 104.8 | 59.8 | 109.8 | 59.5 | 110.3 |
| 4 | Contribution to total deposit | 94 | 6 | 94 | 6 | 82.2 | 17.8 | 81.7 | 18.3 | 81.2 | 18.8 |
| 5 | Contribution to total loan | 92 | 8 | 90 | 10 | 72.9 | 27.1 | 70.9 | 29.1 | 70 | 30 |

The data for micro credit development banks (MCDBs are not included).

Source: NRB, 2006, * Acharya, 2059

The Table 4 provides the performance of NFIs including ADB/N. It is indicated that there is total of 688 thousand borrowers of rural development banks, micro credit development banks and ADB/N. The data for cooperatives were not available on the number of borrowers. The total loan disbursement by these four categories of financial institutions is Rs. 339314 millions. The major share of total disbursement is of ADB/N followed by rural development banks.

Table 4: Performance of NFIs, mid-July, 2006 (Rs. in million)

| | RDBs | MCDBs | Coop. * | ADB/N | Total |
|-------------------------|---------|--------|---------|----------|---------|
| No. of centers | 5046 | 7054 | 2692 | | 14792 |
| No. of groups | 36403 | 36717 | | | 73120 |
| No. of members | 167886 | 185833 | 358312 | | 712031 |
| No. of borrowers | 149255 | 146402 | NA | 392289 | 687946 |
| Total loan outstanding | 1636.1 | 1261.9 | 10961.5 | 33393.4 | 47252.8 |
| Total loan disbursement | 14093.2 | 7387.9 | 13392.6 | 304440.5 | 339314 |
| Total loan repaid | 12457.1 | 6126. | 2431.2 | 28610.1 | 49624.3 |
| No. of Branches | 142 | 120 | | 242 | 504 |
| VDCs covered | 1038 | 1163 | NA | NA | |
| Districts covered | 47 | 40 | 47 | 47 | |

* As of mid-April 2006

NA – Not available

Source: 1. NRB, 2006 2. Department of Cooperatives, 2006 3. ADB/N database

The commercial banks and NFIs functioning in urban areas have normally excess liquidity over the demand for loan. NFIs functioning in rural areas do not have adequate supply of financial resources. NFIs can meet the credit demand of rural areas by borrowing from

urban banks and financial institutions. The urban banks and financial institutions, therefore, may have the opportunity to utilize their excess liquidity by wholesale lending to NFIs. The NFIs, thus, can act as financial intermediaries in transferring urban surplus into deficit rural areas. This could obviously help reducing poverty by increasing production and income of rural people. NFIs, therefore, are playing a catalytic role for balanced economic growth of the country.

The deposit system in the commercial banks is not encouraging for small savers. Commercial banks in urban areas have raised the minimum balance varying from Rs. 3,000 to 50,000 to be maintained in the depositor's saving account since they would like to reduce operating costs. Small savers of the urban centers, therefore, are not availed the services of commercial banks and a large number of small savers were forced to close down their account operating in the commercial banks. On the other hand, NFIs are inducing small savers in various ways. This system provides the opportunities to a large number of small savers. It has resulted that not only the member of institution but also other small savers, like, retailers, street vendors, tea shop operators, workers, students and other low income people can open their account to make their regular savings. NFIs, therefore, have been developing as an alternative to commercial banks in the rural as well as urban areas to mobilize the financial resources from the people of low income groups.

Further, this indispensable part of NFIs should be looked not only from economic point of view but also in view of promotion of banking knowledge and banking habit in the people. This practice gives the message that internal resources mobilization is possible from the poor people also to meet the local investment demands.

Many NFIs, such as, rural development banks and microfinance development banks perform not only saving and credit activities but also invest in identification of pre-investment sector and enterprise, entrepreneur training, literacy classes and the like. The objective of such NFIs is to mobilize financial and skill capacities of local people by providing banking facilities and other support services with the ultimate goal of reducing poverty. The micro credit services for the self employment micro enterprise development to the deprived section of population are an important contribution of NFIs to the social banking system in rural Nepal.

NFIs are playing considerable role in the development and expansion of agriculture, industry and trade sectors by providing financial resources and technologies for the establishment and enhancing of capacity and productivity of business. NFIs are, thus, found successful in contributing significantly to increase the employment and income, and improve livelihood of rural people.

Development and expansion of capital market is indispensable part of economic development of any country. NFIs are playing a vital role in enhancing of capital market in Nepal. Many of these NFIs have been distributed their ownership share in the general public, and listed in the stock exchange market. Some of them have issued various types of securities to collect the capital from financial market and also successfully accomplished responsibility of share issue manager.

Saving is the starting phase of capital formation for economic development. Without saving from the people, capital formation is not possible. A number of NFIs have made different kinds of saving schemes like personal saving, group saving, fixed saving, recurrent saving, old citizen saving, child education saving, to promote the savings from all classes of people. This has been proved from the significant proportion of deposit made in NFIs to the total savings (Table: 2). This has indicated that saving habit is being promoted in Nepali people. The interest rates on saving provided by NFIs are more attractive than the rates provided by the commercial banks. This has increased the propensity to save in the general people, and that ultimately leads to induce investment, and increased employment, production, income and poverty reduction.

As an impact of economic liberalization since 1990, there has been structural change in the Nepali economy. The proportion of share of employment and GDP contribution of agriculture has been declining gradually. The employment has increased mainly in industry, finance and business services (CBS, 2003) and share of GDP has increased in the sectors like, industry, finance, and real states (MoF, 2006). It indicates that there was an important contribution of non-banking financial institutions for the structural change in employment and GDP contribution. A study has revealed that there was a notable increase in employment in the service sector as an impact of liberalization of economy (Silwal, 2002). Banking and financial service sector is indicated to be one of the major sectors to create employment opportunities. Thus, the growth of NFIs in the country has resulted in the increase in employment opportunities for a large number of populations.

It is well known that the spread rate of interest on different types of loan of commercial banks has remained still high. They provide very low rate of interest to the depositors but charge higher rate to borrowers. The major proportion of profit of commercial banks is the difference between interest given to the depositors and the rate levied to the borrowers. On the other hand, the spread rate of interest of NFIs is maintained lower than commercial banks. After liberalization in economic policy, all the financial institutions have got liberty to fix interest rate by themselves. After the growth of financial institutions, competitive situation has been developed in the capital market. It has led to declining spread rates of interest of such institutions. This has resulted in benefiting both depositors and borrowers and inducing saving and investment.

It is obvious that development requires higher GDP and faster growth rate. The basic issue is not only to grow GDP but also who does contribution to grow, a few producers or many people. The traditional thinking of development as looking into GDP of GDP per Capita has been changed. The trickle-down theory of development has been failed to improve the standard of living of rural people. The main thrust of development, therefore, in today's developing countries is growth, equity and fulfillment of basic needs (Todaro and Smith, 2003). For this purpose, every citizen should have the opportunities and facilities to utilize his or her potentials and resources in production and increased income. The state should act as facilitator to induce people use their potentials and that will lead participate many people to grow GDP. From the growth of NFIs and expansion of their activities in the country, it has provided opportunities and facilities to a large number of populations to use their

potentials and local resources on their own initiations. It has, thus, helped contribute by many people to grow GDP.

Women Empowerment

Empowerment of women is one of the challenging issues in economic development of Nepal. The women, bound to household chores, have very low economic and social status. Making them engaged in economic activities is necessarily in order to uplift their social status and reduction of poverty in the family. NFIs have been effective agents in this field. NFIs are supporting in various ways making them affiliated to women groups, providing micro credit, supporting to initiate micro enterprise, promoting saving habit, family education, health and the like. After initiating activities by NFIs in rural areas women have been able to lead the household as an economic and social person, and felt capable to initiate enterprising activities and promote the community development.

Challenges

The major sources of financial resources of RDBs and MCDBs are wholesale lending institutions and commercial banks. They have to borrow loan at the high rate of interest. These financial intermediaries are reluctant to use such amount at high interest rate. An example is that RMDC has not been able to use of major portion of its fund as per stated objective. It has invested its major part of fund in government bond and deposited in fixed account (RMDC, 2005). The low proportion of lending resulted due to the high rate of interest levied on the loan to the financial intermediaries. Finding unfavourable and business of loss, DEPROSC repaid the wholesale credit of Rs. 5 million within a month and also Rural Development Bank of Central Region paid back Rs. 35 million to RMDC (Kunwar, 2005). On the other hand, many NFIs working in the rural areas have no sufficient capital to meet the demand of deprived population. Commercial banks, at the same time, also have excess of liquidity but RDBs, MCDBs, Cooperatives and NGOs are unable to use this resource.

Some of the registered saving and credit cooperatives have run away with the saving made by members and general public. In recent days, there have been emerging problems like fear about safety of savings made by members and general public, ineffective monitoring from the concerned department, increasing trend of institution opening, closing and running away and losing faith of general public on the saving and credit cooperatives. These problems have emerged due to the absence of provision of effective punishments and incentives in the Cooperative Act, functioning of institutions out of cooperative principles and process, absence of regular meeting and audit reporting, lack of coordination between central agencies, implicit licensing process, and absence of monitoring and supervision (Shrestha, 2061).

The Cooperatives Act has stipulated that the cooperatives can collect deposit from its members, and provide loan to them. It has also stated that such cooperatives must take permission from Nepal Rastra Bank and follow the rules and directives of it. Despite this

legal provision, almost all the cooperatives are doing saving and credit business without permission of NRB. Not only saving and credit cooperatives but also most cooperatives of other types also are doing saving and credit functions. They are actually running only under the Cooperatives Act.

Regarding the regulating and supervising of cooperatives which are doing saving and credit activities, the Department of Cooperatives has no coordination with central bank. These cooperatives, except a few licensed by the NRB, are not under the regulatory and supervisory framework of NRB. The regulatory and supervisory framework and implementation of Department of Cooperatives is weak. Due to such situation many saving and credit cooperatives have failed to make refund of public deposits (Timilsina, 2060).

Conclusion and Suggestions

The growth of financial institutions has positive impact on economic development process. The financial institutions create the inducing environment for the saving depositors and investors. With the process of economic liberalization, growth of NFIs is observed fast with the participation of private sector. It should be agreed that NFIs are serving in resource mobilization by collecting savings from people, promoting banking knowledge and habit in the people, providing financial and technological services to the farmers and enterprising people and working as financial intermediary. Their activities have helped in utilizing the local potentials, increasing employment and income, and reducing poverty in the country. The major characteristics of financial institutions are collection and mobilization of saving and work as financial intermediary. The success or failure of such institutions is directly related to the financial interest of people. The NFIs, therefore, should maintain faith of the people, safety of their savings, functioning in system and disciplined manner.

The geographical area, activities and resource volume of NFIs are expanding rapidly. Monitoring and supervision of such institutions has become a challenging task. Naturally, central bank is the overall responsible agency for monitoring and supervision of banking and non-banking financial institutions. It has created a separate department for the supervision of NFIs. But monitoring and supervision aspect of central bank is found unsatisfactory. A large number of NGOs and cooperatives are doing financial activities without permission of central bank. NRB is found unsuccessful to implement the rules and regulations that have provided the authority to it. The NRB as a regulatory and supervisory institution must play an active role to make the NFIs running within the regulatory framework.

There is shortage of financial resource with the NFIs working in rural areas. The saving deposits made by the members and general people are not sufficient to meet the excess demand from farmers and entrepreneurs. All such NFIs have no approach to the banks and financial institutions of capital city. The central bank, therefore, should allocate certain percent amount of its profit to the NFIs working in the rural areas annually for ten years.

The fund provided by Asian Development Bank to RMDC is not utilized as per its objectives. It is said that terms and conditions to get loan from RMDC is not favorable for

financial intermediaries. It has deposited its significant amount of money on fixed account and invested on purchasing securities. Most finance companies are concentrated in the urban centers. A significant part of their loan investments is made on unproductive sector like, buying vehicles, home appliances and the like for urban dwellers. Similarly, commercial banks are also doing the same to utilize their excess liquidity. To reduce this discrepancy, the central bank should adopt effective measures so that such resources could flow to the rural areas through NFIs.

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