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Poor People's Access to Formal Financial Services

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Abstract

Developed as well as stable financial system is essential for economic growth. Empirical evidences suggest that access to the financial services is still limited and declining in Nepal. The bottom 20 percent of poor households is not covered by the targeted programs because of their location in the remote areas and lack of knowledge. The paper briefly reviews financial sector development along with government's efforts to increase people's access to credit in view of the government's targeted programs and NRB initiatives on creating conducive environment for institutional credit in the form of micro finance. The paper concludes that three major areas, such as conducive environment, suitable financial base and proper institutional development should be enhanced for the propagation of MFIs.

Introduction

Access to financial, physical and social infrastructure are necessary complements to the efforts of the poor people for their better lives and cope with risk (World Bank, 2005, Zeller and Meyor, 2002). Over the years, people's access to physical and social infrastructure has increased to a great extent. But the access to the financial services is still limited and declining. The financial market is basically under the control of the informal credit providers (World Bank, 2007; NLSS I and II). Liberalization of financial sector has not been able to extend the expected outcome in terms of enhancing the access to the financial market for the poor.

Lesson learned from other countries has shown that developed as well as stable financial system is essential for economic growth whereby so reduce poverty. But for the positive impact of financial development on poverty alleviation, it should be inclusive. Micro finance is not only a tool for poverty alleviation but also a catalyst which can bring socio economic progress in the nation by putting those living in extreme poverty at the center of development agenda (*Global Report on State of the Micro Credit Submit Campaign*, 2006). Empirical evidences show that it is an instrument, which works in synergy with other development interventions (APROSC, 1997, ADB/M, 2003, Poudyal and Shrestha, 1998).

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Financial Sector Development

The financial sector witnessed remarkable growth in terms of number of financial institutions and beneficiaries after the liberalization of the financial sector. Various efforts have been made by the government to increase access of people, particularly of poor people, to financial services. Targeted and directed lending to the small business and low-income households has been implemented. Establishment of wholesale and retail lending institutions was another step. To open up and widen rural people's access to the system, the government has mandated to open branches outside Kathmandu valley. Nepal initiated financial reform measures since mid 1980s. Before that there were only two commercial banks (CBs) and two Development Banks (DBs). However, there were no non-banking financial institutions. Various reform measures were undertaken that resulted into stability in banking sector though partially.

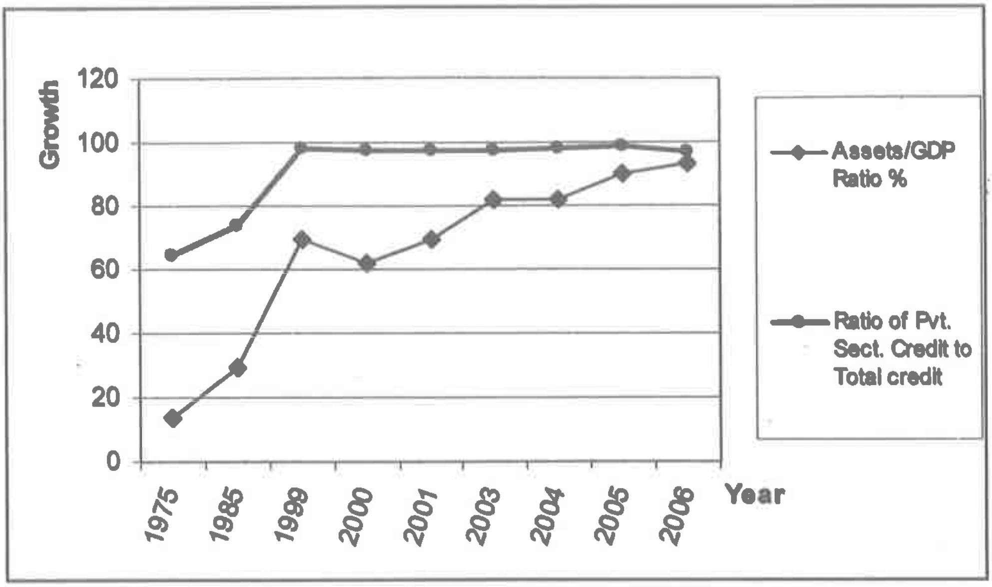
The financial reform measures include removal of entry barrier, provision of prudential norms like capital adequacy, loan classification, loan-loss provisioning, single borrower limits and establishment of credit information bureau. Introduction of Finance Company Act, Development Bank Act and Financial Intermediation Act is the milestone of financial sector development in Nepal. Amendment of Commercial Bank Act in 1984 made possible the establishment of private sector commercial banks. Following these measures, many foreign joint venture commercial banks were established. This has raised the competition among the commercial banks. With the establishment of new financial institutions, managerial know-how and innovative skill were infused in the banking sector. New financial instruments were introduced.

As of mid January 2006, NRB licensed and regulated bank and non-banking financial institutions were 186 in number (17 commercial banks, 29 development banks, 63 finance companies, 11 micro-credit development banks, 19 saving and credit cooperatives and 47 NGOs). It is estimated that about 2,500 cooperatives and 15,000 NGOs are involved in financial activities. Thus, the micro finance sector regulated by NRB represents only very small number of the overall micro finance sector operating in the country.

Financial Deepening

With the implementation of liberalization measures, Nepal witnessed positive trend towards financial deepening. Increasing role of financial sector in the Nepalese economy is indicated by ratio of all the financial assets to GDP. Commercial Banks' financial asset, deposit, credit and investment ratios to GDP are important measures of banking system within the economic system. All these indicators revealed the positive trend over the years (Figure 1).

Figure 1: Selected Indicators of Financial Sector Growth

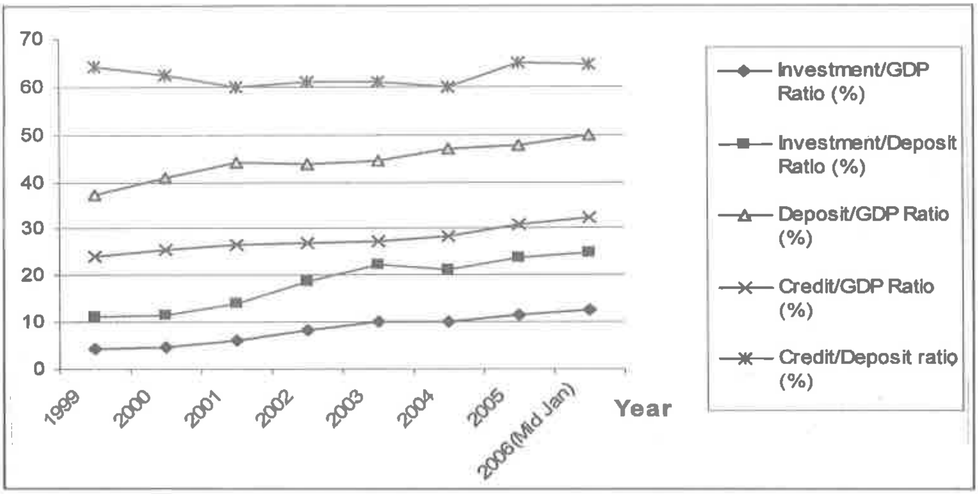


Source: Banking and Financial Statistics, 2006, Nepal Rastra Banks, Bank and Financial Institutions Regulation Department and Acharya, 2003 (NRB, Economic Review Occasional Paper, No. 15.

The financial assets-GDP ratio was only 14 percent in 1975 and within the decade it doubled. It was 62 percent in 2000 and reached 93 percent in 2005. The ratio of private sector credit to total credit also has increased significantly from 64 percent in 1975 to 97 percent in 2006 (Shrestha, 2007). Higher private sector credit ratio to total credit indicates degree of privatization of the organized sector economic activities. In the recent years, almost the total bank credit has been diverted to the private sector indicating higher degree of privatization of the economy.

Commercial Bank deposit and credit ratio to GDP also increased over the years, but the growth in credit GDP ratio was slower. This indicates that demand for credit is not expanding fast as a source of funding for economic activities in the country. The credit deposit ratio of commercial banking system also did not undergo a noteworthy change between 2000 and 2006 (Figure 2).

Figure 2: Trends in Financial Indicators [1], 1999 to 2006



Source: Banking and Financial Statistics, 2006, Nepal Rastra Banks, Bank and Financial Institutions Regulation Department.

M2/GDP, M1/M2 ratios, and the share of central bank to total banking assets, though reveal positive trend, however, the present status of these rates indicate inefficient financial sector development in the country as has been depicted in Table 1.

Table: 1 Financial Sector Development, 1975-79 to 200-05

Indicators	1975-79	1980-84	1985-89	1990-94	1995-99	2000-05
M2/GDP	17.7	26.1	27.7	32.3	39.6	52.9
M1/M2	45.3	34.5	30.3	29.6	28.8	24.0
Share in Total Banking Assets						
1. NRB	51.6	45.4	45.9	44.6	37.0	30.9
2. Commercial Banks	48.4	44.6	54.1	55.4	63.0	69.1

Source: Nepal Rastra Bank in Fifty Years, 2005, NRB, Kathmandu Nepal.

M1/M2 also reflects the financial deepening. Lower the ratio, the financial intermediaries will play more active role on mobilization of financial resources in terms of time and demand deposits. Nepal witnessed significant decline in ratio from 45.3 during 1975-79 to 24.0 during 2000-05 (Table 1).

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[1] Includes Commercial Banks and ADBN

People's Access to Formal Financial Sector:

Banking sector has increased both in size and number of intermediaries with liberalization of financial sector. But liberalization of financial sector has not been able to reap expected outcome in terms of enhancing the access to the people. The financial sector is not inclusive in terms providing access to poor. Foregoing analysis clearly indicates that despite numerous efforts made by the government and NRB, people's access to formal credit has not increased. World Bank's latest Survey on Access to Financial Services (2007) confirmed this. NLSS I, and NLSS, II (2004/05) and I (2003/2004) also indicate the trend towards declining access over the years.

Deposit has been growing faster despite very low interest on it. The credit to deposit ratio declined considerably to 64 percent in 2005 from 71 percent in 1976. The financial intermediation, that is the degree to which banking sector puts deposits, is stagnating. Declining annual growth of credit also indicates declining access.

Table 2: Major Indicators of Commercial Banks (1999 to 2006)

Description	1999	2000	2001	2002	2003	2004	2005	2006
Bank Branches (no)	511	484	430	413	447	423	422	428
Pop. Per branches (000)	36.1	38.1	53.8	56.1	51.1	54.7	54.9	59.1
Deposit Growth (%)	24.0	21.8	17.3	1.9	10.1	14.7	8.6	5.3
Credit growth(%)	19.2	17.8	13.3	3.7	10.0	12.5	16.9	4.8
Investment Growth (%)	31.3	26.1	41.6	34.4	32.7	9.4	21.2	9.7
Credit/Deposit ratio (%)	64.3	62.3	60.0	61.1	61.1	59.9	64.9	64.6

Note: * including ADB/N.

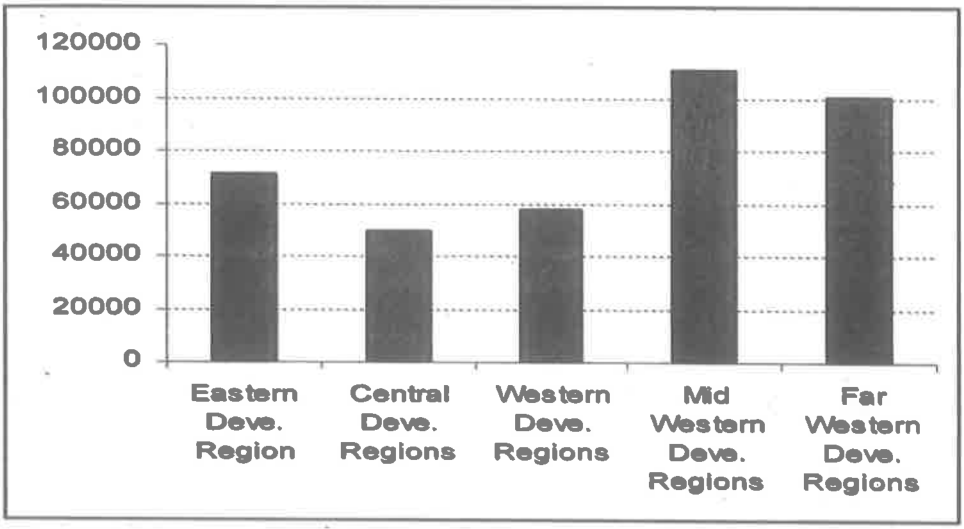
Source: Banking and Financial Statistics, 2006, Nepal Rastra Bank, Bank and Financial Institutions Regulation Department

Access to banking infrastructure measured in terms of number of inhabitants per bank branch has decreased considerably over the years. The branches of the two state-owned commercial banks have decreased since 1995 due to insecurity reasons and a process of rationalization. The branches decreased to 428 in 2006 from 511 in 1999. Due to increase in population and continued process of closing of bank branches, population per bank branch increased from 36,000 in 1999 to 59,000 in 2006 while in all South Asian countries the corresponding overall figure was 30,000 people. Average population served by a branch is a good indicator of people's access to financial infrastructure. According to report on Financial Performance and Soundness Indicators of South Asia Nepal performed worst than regional average in terms of average population served by a branch.

Time to reach a bank also increased to 3.5 hours from 3 hours between 1995/96 and 2003/2004 because of closing of rural branches due to worsening security situation and withdrawal of CBs compulsion for opening branches in the rural areas. After 1991 many loss-making branches are either closed or merged with another viable branch. ADB/N, which has large number of rural branches, has been continuously downsizing branches since 1999. It has created vacuum in the saving and credits activities in the rural areas and created further problems in flowing institutional credit the rural poor.

Wide disparity is noted in the number of inhabitants per branches in different development regions. Since most of the private banks are located in the Kathmandu valley, population per branch is less than 50,000 in the central region. The corresponding figure is more than double in far and mid western regions.

Figure 3: The Number of Population per Bank Branch, 2006



Source: Banking and Financial Statistics, 2006, Nepal Rastra Banks, Bank and Financial Institutions Regulation Department.

The number of bank deposit and loan account per 1000 people has decreased over the years. The number of deposit account per 1000 people decreased to 89.55 in 2005 from 112.71 in 2001. In the same manner, the number of loan account per 1000 people downsized to 10.49 in 2005 from 18.96 in 2001. This means the access to the banking services has narrowed down (World Bank, 2007). These all indicate declining access to financial services.

The findings of the empirical studies (NRB, 1991, NLSS I, 1996, NLSS II, 2004 and World Bank, 2007) suggest limited access of the people, particularly the poor people to credit. Proportion of household taking loan increased substantially between 1995/1996 to 2003/2004 (Table 3). The rural households particularly the poor ones, are more likely to borrow for consumption purposes (for health and education) while the urban people are more likely to borrow for business purposes (World Bank, 2005).

Table 3: Proportion of Households Taking Loans, 1995-96 and 2003-2004, (percent)

Description	1995/1996	2003/2004
All purposes		
Total	61.3	68.8
Urban	37.6	46.2
Rural	63.1	73.2

Source: NLSS I and NLSS II (1997, 2004).

There has been slight decrease in the borrowing from the banking system. Borrowing from moneylender decreased quite considerably. Increasing borrowing from friends and relatives suggests people's limited access to formal sources and also suggests the lack of good saving institutions to provide alternative opportunities for investment and resource pooling in the rural areas (World Bank, 2005). Majority of the households borrowing from the informal sources do not try to borrow from the formal financial institutions because later cannot meet their financial needs on time and formal sources requires higher level of physical collateral (World Bank, 2007).

Table 4: Household Borrowing and Access to the Bank Credit, 1995-96 and 2003-2004, (percent)

Description	1995/96	2003/04
Household with borrowing	61.3	68.3
Borrowing from bank[2]	16.1	15.1
Borrowing from relatives & friends	40.8	54.5
Borrowing from money lenders	39.7	26.0
Proportion of poorest quintile having access to bank borrowing	8.2	8.3
Proportion of richest quintile having access to bank borrowing	21.8	26.8

Source: NLSS I and NLSS II (1997, 2004).

The proportion of the richest quintile households having access to formal credit sources is almost three times higher than for the poorest quintile and it is on increasing trend. No increment was witnessed in the proportion of lowest quintile access to formal credit sources compared to 1995/96. In this respect the richer households are relatively better off.

Among the different formal sources, FINGOs and the cooperatives are the largest providers of credit for all quintiles except for the top one. They seem to prefer these

[2] Banks includes all the formal credit sources.

sourece because they are faster in issuing loans and accept the movable collateral. Reliance on FINGOs and cooperatives are relatively higher in rural areas and in the mountains and hills.

Banks are the second largest providers of loan mainly in urban areas and for the larger loan. Similarly, MFDBs and RRDBs are the third largest providers and serve twenty percent of the households with loans. Reliance on MFDBs and RRDBs are higher in Terai and rural areas. The least preferred are the finance companies and serve only 3.4 percent of the households with loans. They operate exclusively in the urban areas surrounding Kathmandu Valley and mainly in top quintiles.

Table 5: Households with credit from formal sources, by urban/rural, ecological regions and quintiles (in percentage)

	Banks	Finance Companies	MFDBs/RRDBs	FINGOs/Cooperatives
Kathmandu	43.2	43.2	4.5	9.1
Other Urban areas	56.1	9.6	10	9.1
Rural	31.7	1.4	22.4	44.6
Eco. Belts				
Terai	37.1	1.1	26.7	35.1
Hills/Mountains	29.3	5.9	4.5	59.1
Kathmandu	43.2	43.2	4.5	9.1
Income groups				
Bottom	29.2	0.3	26.2	44.3
2	21.1	0.0	40.5	38.4
3	36.6	0.7	24.0	38.7
4	38.0	2.4	15.6	44.0
Top	46.5	11.7	2.7	39.1
Total	35.1	3.4	20.4	41.1

Source: World Bank, 2007.

Thus, different indicators show that, despite government efforts, formal financial institutions have not been able to cater to the needs of Nepalese population at large and access is very limited for low income households. In fact the access is closely correlated to the household income. The AFS survey (2007) indicates informal sources are important for wealthy and urban households also. Half of the wealthiest households preferred informal providers because of their speed of delivery.

Government Efforts to Enhance Access to the Financial Services to Low Income Households:

Introduction of Branch Policy

The government has introduced Branch Policy to expand branches outside Kathmandu Valley. As per branch policy a bank is given permission to open branch in Kathmandu valley only if it opens a branch outside the valley. This leads to opening of more and more branches in some of the accessible areas like some district headquarters.

Priority sector and Deprived Sector Lending

NRB introduced the concept of compulsory priority sector[3] lending (PCL) for CBs (Commercial Banks) in 1974. In the year 1974, the CBs were required to invest 5 percent of their total deposit liability in priority sector and from 1985 the proportion of PSL is related to total loan portfolio of the CBs. The CBs are required to lend at least 12 percent of the total loan portfolio to PS and quarter of it (3 percent) must be invested for deprived sector (household below poverty line).

Government is gradually declining PSL program and decided to phase completely by 2007 but deprived sector- lending requirement for CBs will remain unchanged. As of 2006, banks are required to invest 4 percent of their total loan portfolio in priority sector.

Establishment of financial institutions to cater to the needs of undeserved people Introduction of new categories of financial institutions with lower minimum capital requirement is another step forward in this regard. Nepal.

NRB has been playing a crucial role in the promotion of rural financial institutions and making financial policy more rural and poor friendly. Numbers of financial institutions have been established to increase the financial services to the undeserved people. It has established cooperatives[4] and postal saving banks[5]. Development Bank Act, 1995 and Financial Intermediaries Act, 1998, has made possible private sector involvement in micro finance business.

In the past ten years, the government has increased these types of financial institutions by introducing two new categories with lower capital requirement (namely finance companies and the development banks. Center for Self-help Development, Nirdhan, Deprosc and Chhimek are the major micro finance operator in private sector. Regional Rural Development Banks (RRDBs) established in early 90s, is a major breakthrough in the micro finance sector development in Nepal. There are five RRDBs operating in each development regions and is the major micro finance operator in Nepal. In each RRDBs the government has major share participation (Rs. 195.0 million). One of the five RRDBs was privatized in 2005.

[3] Later it was redefined as priority sector lending (PSL).

[4] Cooperatives were created by executive order in late 50s.

[5] Created in early 70s for developing the saving habit and to mobilize the in rural areas.

Establishment of Apex Financial Institutions

Another major breakthrough in the financial sector development in Nepal is establishment of three financial institutions which can lend funds to financial NGOs, RRDBs, private MFDBs and cooperatives. They are NRB managed RSRF (1991) and autonomous institution RMDC (1999). SFCL has been initiated since 1993/94 to institutionalize SFDP. SFCLs are locally owned and managed and exclusively on-lends to small farmers cooperatives that has been created by ADB/N's "Small Farmer Development Program".

Deposit Insurance and Credit Guarantee Corporation (DICGC) established in1974 is another important financial institution,[6] which provides credit guarantee to CBs against default of the credit given. It provides guaranteed compensation up to 75 percent of the defaulted rural loans and also gives guarantee against loans for cattle since 1987/88.This will encourage the CBs to expand the rural branch network and wholesale lending to MFDBs on lending to poor clients. RDBs operated in Grameen Banking Model of Bangladesh, is a major breakthrough in the micro finance sector development in Nepal. There are five RDBs operating in each development regions and is the major micro finance operator in Nepal. In each RDBs the government has major share participation (Rs. 195.0 million)

Targeted Credit Programs

Collateral based lending practice of commercial banks and development banks (CBs and DBs) deprived the poor people from institutional sources of credit. Similarly institutional credit is also conditional to business types, location and the social status of the borrower.

Realizing that expansion of the financial system alone does not necessarily ensure poor people's access to formal credit, a number of targeted credit programs such as micro finance programs are initiated. The major programs implemented to benefit the disadvantaged groups with the objective of attaining sustainable livelihood of the rural poor households are as follows:

1. Small Farmer Development Program (SFDP)

SFDP, first targeted program was launched in 1975. SFDP is a new banking model for reaching the poorer section of the community. With the implementation of the program, the history of group based collateral free lending targeted to small and marginal farmers, was initiated in Nepal. Women component was also added in the program in 1981. SFCL has been initiated since 1993/94 to institutionalize SFDP. SFCLs are locally owned and managed.

2. Productive Credit for Rural Women (PCRW)

PCRW was introduced in 1982 with the objective of uplifting the socio economic condition of rural women. The program channels resources using existing banking channels. It was implemented by Women Development Division of the government.

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[6] It was created with the joint investment of NRB, Rastriya Banijya Bank (RRB) and Nepal Bank Ltd. (NBL).

The main source of fund was channeled through CBs and ADB/N. UNICEF supported the social component and cost of staffs and main source of fund was IFAD. Non-regulation of the program administration and overdue loans (18 percent) were the major problem. The program could not reach the poor and dalit women as targeted (ADB/M, 2003).

3. Micro Credit Program for Woman (MCPW)

It is another targeted program implemented by MLD to improve socio economic status of women and mainstreaming them in national development through credit. It is credit plus program, because it provides other support along with credit. The program was implemented with support of ADB/M. The program involves NGOs in delivery of credit. Social mobilization, institutional support of NGOs and training component is taken care by Department of Women Development. MCPW is aimed at lending to women micro enterprises on a larger scale than in PCRW and RRDBs.

Eighty two women saving and credit cooperatives were organized and 25 of them were registered at the Cooperative Department. Twenty-five saving and credit cooperatives have been able to become partner organization (POs) of RSRF. Similarly, 27 FINGOs formed by women groups under the MCPW have got limited banking license. The evaluation report of the programs reveals that it has been able to bring positive changes in social and economic life of the women and also brought synergic effect on other development intervention such as that promote health, nutrition and education. But the coverage of the program is very limited.

4. Cottage and Small Scale Industries (CSI) Project

Realizing the importance of CSI for employment generation, output and export promotion, CSI project was launched in 1981 with World Bank assistance (US $ 6.5 million) in Kathmandu valley and six other districts. Second phase of the project was launched in 1987 with additional components and wider coverage (27 districts). The project provided credit, product and skill development and commercial services to CSI. NRB provided refinance facility up to 80 percent of the eligible sub loans to the participating credit institutions NBL, RBB and ADB/N from the project funds. Along with this NRB provided credit guarantee up to 75 percent of the principal amount of the CSI. Due to very low loan recovery rate, the project was prematurely halted in June 30, 1992 (three years before the project period). Despite this problem, the project has been successful in creating favorable environment for growth of CSI and remarkable growth of export oriented woolen carpet industries (NRB, 2005).

5. Third Livestock Development Project

The project was launched in 1996 with loan assistance from ADB/M[7]. The primary objective of the project was to raise the living standard of the people through raising the livestock productivity and management and development of livestock market. The project period was completed in July 15, 2005. The government had provided the loan[8] to NRB at

[7] Launched in 26 districts in three different phases.

[8] SDR 2 million for the credit component.

4 percent per annum and NRB to PFIs at 6 percent per annum. Department of Livestock of Nepal government was responsible for components: improving livestock productivity and institutional development and organizational development.

6. Poverty Alleviation Project in Western Terai (PAPWT)

It was the first micro credit project that was based on credit plus approach of financing. The project was launched in 1997 with assistance from International Fund for Agricultural Development. The project was completed in December 2004. Poverty alleviation in eight western terai district was the primary goal of the project and 16 branches of PFIs comprising of RRDBs[9] and two private MFDBs (Nirdhan Utthan Bank and Centre for Self Help Development were selected for micro credit delivery. NRB was implementer of credit component and MoLD was responsible for project management. The project offices of the project areas are mainly responsible for mobilizing the groups, which later on get credit line. Based on the pre-financing model of payment the selected branches of PFIs will get resources from NRB for on lending to their clients. Financing was based on the viability plan of selected branches of PFIs approved by Credit Approval Committee of the project within NRB.

5. Recommendations

For more than four decades, the government has supported number of interventions for increasing access to financial services to the low-income households. But the outreach of micro finance sector to low income households is still limited.

Most of the MF models are finding it difficult to expand their services particularly in remote hills and mountains where the poor are concentrated due to cost constraints. Low population density, pattern of settlement and weak market conditions are the reasons for non viability of the existing MFIs to expand their services in these areas. It is necessary to develop appropriate operational modality for remote hills and mountains. Since government's main development agenda is poverty reduction subsidy should be provided to MFIs, CBs and DBs for expanding branch network in the remote hills and mountains.

Targeted credit programs should be implemented with wider coverage to compensate for closing of branches in the rural areas following the withdrawal of compulsion for CBs and DBs to open rural branches.

It is suggested to strengthen Deposit Insurance and Credit Guarantee Corporation for small credit and deposit insurance and providing support in livestock and cash crop insurance.

The government is suggested to support MFIs in different forms to reduce the operational cost like providing grant or soft loan through donor agencies to MFIs for initial period for social mobilization, strengthening institutional capacity building and technology transfer. Experience of Bangladesh, India and other countries shows how MFIs can pool risk, reduce

[9] Western, Far Western and Mid-Western RRDBs.

the operating cost and afford to lend at lower rate. MFIs need strengthening in internal control, management information system, human resource development, accounting, financial analysis and business planning

With the increasing demand for micro finance services in the rural areas, it is definite that there will be more and more new entrants in the micro finance market. It would be difficult for NRB to supervise and monitor MFIs with existing branch network and manpower. Thus NRB has to enhance it's capability to regulate, monitor and supervise all of them.

The government needs to continue restructuring the state owned micro finance providers (RRDBs) and apex institutions like RMDC and RSRF. These institutes should be professionally managed and operate independently to increase their outreach, flexibility and user focus in operation.

Despite various efforts on enhancing the access to the formal credit to the poor, very little impact has been made in this respect. The efforts made in this sector in the past did not work as expected. The ultimate challenge for government and NRB is to strengthening the existing MFIs and making them viable and sustainable along with creating conducive environment for more entrants in the micro finance market.

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