Chapter – I

INTRODUCTION

1.1 Background of the Study

Nepal is one of the 14 Least Developed Countries of the Asia Pacific Region and one of the poorest countries in South Asia. Over 31% Nepalese population are estimated to live below the national poverty line in 2003/04. Over 90% of the poor live in rural areas and a majority of them live in inaccessible hills and mountainous settings. The Poverty Reduction Strategy Paper/the 10th Plan and the on-going interim plan focuses on accelerating income and employment opportunities in rural areas and address the issue of social, economic and financial inclusion with microfinance as one of the targeted programmes experimented by the government in order to address poverty problems. The difficult topology, the feudal history and inequality in income and human development by-passed rural populations in remote areas and excluded indigenous and occupational groups from access to basic services and acted counterproductive to intended impact of poverty reduction efforts.

Nepal endorsed the Millennium Development Goals (MDGs) and set a target to reduce absolute poverty to 21% by 2015 from 42% in 1996. Poverty incidence decreased from 42% in 1996 to 31% in 2004 indicating significant progress on poverty reduction in the recent years. Nepal's performance on achieving has been mixed and well behind the goals in most of the targets set in the MDGs.

With approximately 25.6 million populations in 2006, administratively Nepal is divided into 5 development regions, 14 zones, 75 districts, 3,915 village development committees (VDCs) and 58 municipalities. Based on state of development as well as environment, people, economy, customs, culture and access, Nepal can be divided into four almost parallel regions viz. mountains, inaccessible hills, accessible hills and mountains.

There exist great variations across geographic regions with Tarai as the most potential region while the inaccessible hills and mountains are the least. Tarai and accessible hills possesses comparative advantage to expand access to financial services due to dense population, good transport network and more per capita high quality cultivated land. In Tarai, there exist MFI's presences among communities living in interior areas as well. Limited infrastructure and market access, remoteness, sparse population, climatic conditions, less arable land and limited but specialized economic potentialities have complicated provision of financial services in inaccessible hills and mountain areas where demand is higher compared to Tarai and accessible hills due to poverty and deprivation.

Nepal is the eleventh poorest country in the world and it is one of the least developed countries among South Asian countries in terms of key indicators of well being. Incidence of poverty is characterized by limited access to assets, education, health facilities, economic infrastructure, savings, paid employment and entitlements. It is predominately agrarian and rural economy, with over 66% population depending on agriculture sector for livelihood, which contributes over 39% in the GDP. Most people are subsistence farmers, managing to grow enough to feed their families and sell a small surplus, which buys a few necessities like salt, tea, and cloth. Rice, maize, mustard and wheat are grown in Tarai and accessible hills and millet, barley and potatoes are grown in more remote districts. The rural economy is characterized by stranglehold of low income, low savings and low investment where the infusion of credit can be a major key to break this structure. However provision of financial services embodied by different challenges such as scattered settlement, access, scale of operation, sustainability, limited credit absorptive capacity is not straightforward in inaccessible hills and mountain areas.

Nepal faces considerable development problems and challenges. Agricultural productivity is low and declining due to population pressure on marginal land. Limited resource base, rapid population growth and environmental degradation, low level of social development and widespread poverty reinforces Nepal’s development challenges. In the past expansion on cultivable land for sustainable crop production was at the cost of forest resources and such possibilities have been gradually diminishing overtime. Opportunities in non-agricultural sector remain largely unexploited due to lack of resources. Access to financial services is limited, more so among women and further hindered by geographic limitations in remote areas. Improvements in infrastructure, markets, communication facilities, skills training, information and financial services are required to increase the benefits of microfinance services, allowing micro-entrepreneurs, particularly women, to improve their economic status in those remote areas. This is on which background the research is focused and this study seeks to uncover the investment opportunities in micro-financing for the commercial and development banks of Nepal.

1.2 Focus of the Study

The interest in micro finance as a means of extending financial services to rural communities has seen a dramatic increase during the last decade. Furthermore, several donor agencies, development partners, government and non-government organizations (GOs/NGOs) have been providing support for developing microfinance. In addition, the directive of Nepal Rastra Bank mandates commercial banks, development banks and finance companies to provide 3%, 1.5% and 1% respectively of their outstanding loans to the deprived sector. As such, microfinance service has grown rapidly and has become a very powerful development tool in Nepal.

Furthermore, approximately 15,000 Community Forest User Groups (CFUGs) in the country are actively involved in managing local forest resources. One of the strong features of CFUGs is that these organizations are widespread and present in almost every corner of the country even where there are no financial institutions. Winrock International is working towards building capacity of CFUGs and promoting them to work as financial intermediaries for financing biogas plants. There exist possibilities that there could be more ways to expand the credit market for Clean Energy Development Bank Ltd. (CEDBL) and Bank of Kathmandu Ltd. (BOK). There is a need to explore the possibility and potential of the CFUGs to work as intermediaries for CEDBL's and BOK's rural finance initiative including the major attempts made by many development and commercial banks in Nepal.

Over the past decade, there has been tremendous growth in Nepalese financial sector both in the size and number of privately owned financial institutions. Despite increase in the number of bank branches and financial institutions, they have limited their services in Tarai and accessible hill areas and access of their services to people living in remote areas is very much limited. A lot of savings and credit cooperatives (SCCs) are emerging to fill this gap on these services. In general capacity of these MFIs, greatly varies and they are not only constrained with inadequate management capacity but also lack sufficient funds to service and meet the financial needs of their clients. Despite many efforts, directives, regulations and programmes aimed at injecting funds to rural areas and clients, the coverage of MFI services are less than satisfactory. Poor performance on operation is mainly attributable to three factors. First, the absence of a national level fund manager which can tap funds from various disaggregated sources such as a) the deprived sector lending facilities from commercial and development banks b) dedicated funds for micro finance made available by donors/development partners and c) funds from international sources for rural areas through a defined partnership arrangement with MFIs. Second, financial Institutions continue to be risk averse and also lack sufficient capacity to understand risks in rural financing and take appropriate mitigation measures. Third, the lack of an effective monitoring and networking mechanism, which may expedites rural financial access.

There are opportunities for both the development banks like CEDBL and other commercial banks to position themselves as a "National Fund Manager" to accelerate rural financing by using rural renewable energy projects as an entry point. This is possible by forming strategic alliance and partnerships with a wide range of MFIs. The mission and vision of the commercial and development banks should align well with the need of rural finance in Nepal but they lack sufficient outreach. It is imperative that CEDBL and BOK explore opportunities to channel funds dedicated to rural finance through MFIs and explore institutional capacity building needs of these institutions. Capacity building of MFI will make them effective and reliable partners and/or clients who can gradually expand services to cater to the diversified credit needs of the rural populace. To become a National Fund Manager the development banks like CEDBL should access funds from commercial/development banks, government, donors, development partners and international sources and channel it through an established network and partnership arrangements with rural financial institutions. CEDBL and all other commercial banks like BOK should also mobilize its own funds in rural financing.

In order to work as a national fund manager CEDBL and BOK require to gradually increasing their exposure; develop confidence, technical knowledge and capability to work as an active promoter of rural finance. This will eventually lead to an opportunity for CEDBL's partners in development, mainly Triodos Bank and FMO to invest funds in rural areas of Nepal. The banks like CEDBL and BOK need not only channel funds but be proactive in enhancing institutional capacities of its partner MFIs. They also need to develop an effective and reliable networking, monitoring and evaluation system that can provide accurate and periodic information on its rural finance portfolio. This monitoring and evaluation system will help all the banks and their partners mitigate risks associated with rural RET financing.

1.3 Statement of the Problem

Nepal has developed considerable history in the provision of financial services that has been evidenced by emergence and growth of a large number of financial institutions as well as design and implementation of programmes to support financial sector development over time. Along with the development of financial sector, there has been corresponding growth in microfinance sector as one of the interventions to address poverty problems in rural areas. History of microfinance movement in Nepal can be traced back to 1956 which started with the emergence of cooperatives that started providing savings and microcredit services to their shareholders. Government recognized the potential role of support to expand microfinance services on addressing poverty problems and this has been very effective for the expansion of Nepalese microfinance sector from mid-seventies (ADB and NRB, 1994). Government officially recognized the potential roles of microfinance sector on poverty reduction only in the Sixth Plan (1980/81 - 1984/85) and since early 1980's both government and non-governmental sector developed and implemented number of programs to ensure access to financial services to the poor; women and disadvantaged group. The microfinance sector gained momentum after 1990s wherein number of microfinance service providers (MSPs) increased exponentially with the entry of local Non Government Organizations (NGOs) and microfinance development banks (MDBs) and transformation of savings and credit groups (SCGs) into Savings and Credit Cooperatives (SCCs) as local MFIs with an increased support for the growth and development of the sector.

The Government of Nepal (GoN) has declared energy crisis in the country which was the result of the increasing use of unsustainable energy sources. The country is an overwhelming dependence on traditional fuels such as fuel wood, agricultural residue and animal dung and fossil fuels. This gives rise to adverse impacts regarding energy security, environment and human health. There is an urgent need to substitute these energy sources with renewable clean energy sources. Fortunately, Nepal has a huge potentiality for promoting renewable energy technologies (RETs).

The majority of Nepal's population lives in rural areas, and energy is viewed as a means of fulfilling social and economical objective of the rural population. In this context, the promotion of appropriate energy is essential to meet the basic needs of the communities for cooking, lighting etc. Energy is also essential to meet the social objective of alleviating human drudgery, and required to sustain and support economic activities.

Access to adequate, affordable, reliable, safe and environmentally benign energy is crucial for improving the lives of poor people across the world. Realizing the fact, the GoN has given priority to promoting RETs and also provides subsidies. However, rural poor are deprived of the benefits of the technologies and the government subsidy because they lack the ability to pay the upfront cost required to purchase such technologies.

Urban concentrated commercial and development banks can provide credit to rural poor for acquiring RETs. Proven technology, a strong quality control mechanism and favorable economics of the various RETs makes providing loans for them viable, reliable and bankable loan products. These banks are also looking for new investment opportunities, and can also partner with microfinance institutions (MFIs) to fulfill this demand.

Though four major types of MFIs namely Savings and Credit Cooperatives (SCCs), Small Farmers' Cooperatives Limited (SFCLs), Financial Intermediary NGOs (FI-NGOs) and Micro Finance Development Banks (MDBs) are active in Nepalese microfinance sector, there are still many opportunities to be explored for the commercial and development banks in Nepal. How can the banks like CEDBL and BOK explore new areas and opportunities for the further investment in the rural areas as done by Grameen Bank in Bangladesh, and ICICI Bank in India?

Banks should offer new services to cater to the changing needs and demands of customers to ensure growth and sustainability. The introduction of RET loan products provides an opportunity to integrate credit with other services for the socio-economic benefit of members and the society. Portfolio diversification also means risk diversification.

Despite significant efforts and innovations to expand financial services to the poor and excluded, access to financial services has still been confined to a small and relatively less poor segment of rural population living in Tarai and accessible hill districts. The study will address following basic questions:

- The possibility of CEDBL and BOK utilizing the services of MFIs working as intermediary, agents, franchisees, facilitators or wholesale borrowers;

- The issues pertaining to different working relationships and feasibility of such relationships; and

- The prospects of CEDBL and BOK undertaking the role of a National Fund Manager for rural financing aimed at accelerating and promoting the use of clean and RETs.

1.4 Objectives of the Study

The overall objective of the study is to define a feasible business model that specifies the commercial and development banks especially CEDBL's and BOK's working and partnership relationship with MFI to extend rural finance services and work as a national level fund manager. Specifically, the study will define:

(a) to identify working relationship and partnership of CEDBL and BOK with MFIs and CFUGs and;

(b) to explore the prospects of commercial and development banks undertaking the role of a national fund manager for rural financing aimed at accelerating and promoting the use of clean and renewable energy technologies (RET) in Nepal.

1.5 Significance of the Study

The study is aimed at developing a framework for the development and commercial banks and esp. CEDBL's and BOK's working relationships and the prospects of establishing CEDBL and BOK as a National Fund Manager. More specifically the scope of work of this study will be the following:

- Analysis of the legal and regulatory provision that govern the working relationship under the various partnership and relationship models.
- Analysis of demand and supply for rural finance and wholesale credit for micro/ rural financing in Nepal.
- The demand of credit for small scale rural clean and renewable energy systems. This will be based on the proposed national targets sourced from national five year plans, government agencies such as AEPC, development agencies and various secondary sources.
- Understanding rural finance institutions and their capacity needs and needs for various types of external loans they may require for RETs and their willingness to launch new and diversified financial products in rural areas.
- Review various models implemented in other developing countries such the ACLEDA and PRASAC model in Cambodia, Grameen model of Bangladesh, and the ICICI Bank model India, etc.

1.6 Limitations of the Study

This research paper is subject to the following limitations:

1. Altogether, there are 63 development banks and 25 commercial banks in the county. It is not possible to conduct research over all the commercial banks and development banks due to time constraint.
2. The study is based on analysis of Bank of Kathmandu as one of the leading commercial bank to invest in the micro-finance sector and on the extensive research made by the CEDBL in search of the investment opportunities in this sector and RETs.
3. This research paper is for partial fulfillment of the requirement of the degree in Masters in Business Studies under Tribhuwan University. It is assumed to be really handy for future researchers but not to be published in the form of books or any other form.

1.7 Organization of the Study

The study will be divided in to four chapters as under:

Chapter 1 INTRODUCTION

This chapter is an introduction chapter where the current micro economy situation of the country, major issues related to micro finance, focus of the study and limitation of the study are highlighted.

Chapter 2 REVIEW OF LITERATURE

Different literatures and product documents of Bank of Kathmandu Ltd. and Clean Energy Development Bank Ltd. have been reviewed in this chapter.

Chapter 3 RESEARCH METHODOLOGY

In this chapter the different financial tools used by BOK and CEDBL to assess the micro finance project is highlighted.

Chapter 4 DATA PRESENTATION AND ANALYSIS

In this chapter the data related to micro finance is highlighted and analyzed.

Chapter 5 SUMMERY, RECOMMENDATION AND CONCLUSION

In this chapter summery of the study, recommendation and conclusion of the study are highlighted.

Chapter – II

REVIEW OF LITERATURE

2.1 Introduction to Microfinance

Microfinance refers to small-scale financial services provided to low-income households. It includes programs that are solely credit-based or those that provide both savings and credit services, those that rely on group contracts and those that rely on individual contracts, those that cater only to women and those cater to both men and women, and those that are run by governments or those that are run by non-governmental organizations (NGOs).

Low-income households – like everyone else – need credit and insurance because their economic activities are often spread out over time. Productive activities require fixed and working-capital that needs to be invested before returns are obtained from them. Households also need credit to meet life-cycle needs such as marriage and illness to invest in productive opportunities, or to smooth consumption through time. They also want to save safely so they can use them in the future.

Despite the fact that the private sector does not cater to their financial needs, low-income households have devised strategies to meet their credit needs and provide them with risk-sharing mechanisms. Informal moneylenders, traders and landlords often end up as the source of credit for the poor because they not only have a lot of personal information about the poor but also use the inter-linkage with the poor through transactions in different markets such as credit, food, or labor. The problem, however, is that these lenders charge very high interest rates that often precludes borrowing large sums of money for investment in productive purposes (Robinson, 2001, p. 15). This, in turn, often hinders the ability of the poor to improve their standard of living and is the motivation behind microfinance.

2.2 Micro-Finance Institutions and Village-Banking: A Historical Background.

The idea of alleviating poverty through banking is not a new idea. In fact, cheap credit was the centerpiece of the development strategy of governments in low-income countries from the 1950s until the 1980s. The excitement about cheap agricultural credit, however, waned through time, because these programs had very low repayment rates, the costs of subsidies were very high, and credit was often diverted away from the targeted recipients (Von Pischke, et. al., 1998, p.1-7).

As criticism of subsidized agricultural credit was increasing, the 1970s and 1980s saw a wave of institutional innovations in Bangladesh, Bolivia and Indonesia. These institutions, which we now call *microfinance* institutions, share the commitment to provide financial services to clients that have been excluded from the formal sector.

These institutions are different from their predecessors in that they are generally run by the non-governmental sector (thus avoiding the corruption prevalent in government subsidized schemes), often focus on group-lending, and allow higher interest rates than existed in government schemes (Matin et. al., 2003, p.16).

Grameen Bank, the best-known of this new crop of MFIs, was founded by Muhammed Yunus, who had noticed that most villagers were unable to obtain credit at reasonable rates, so in 1974 began to lend them money from his own pocket, allowing the villagers to buy materials for projects like making bamboo stools and pots (Morduch, 2003, p.1575). Soon he had set up a bank which lent exclusively to groups of poor households. The groups consisted of 5 people each and were formed voluntarily. The unique thing about these groups was that although money was lent to an individual, everyone in the group was held responsible for repayment. In other words, only one or two members were given loans at a given time. If they defaulted on their weekly repayments, everyone else in the group would be denied subsequent loans.

Village Banks (VBs) are community-managed credit and savings associations that were pioneered in the mid-1980s by the Foundation for International Community Assistance (FINCA), a U.S.-based nonprofit organization that specializes in rural credit. The village banking model assumes that poverty, especially for women, exists because of a low perception of personal capabilities and opportunities, limited access to external resources, and low or nonexistent personal savings. Village banks provide the tools to enable people to break out of poverty, including loans for income-generating activities, incentives to save money, and a mutual support group of twenty to fifty members.

VB share have several features that are in common with other models microfinance institutions. Unlike the government-led credit programs in the 1950s-70s that emphasized rapid disbursement of cheap loans to targeted sectors, these programs insist on repayment. Like other MFIs, VBs charge higher interest rates than earlier government-led programs that so that they can cover the costs of credit-delivery. Perhaps most importantly, they provide financial services to the people who are not served by formal financial institutions. Those institutions are reluctant to serve low-income households partly because such households do not own collateral, and partly because there is imperfect information in rural credit markets. The biggest difference between VBs and other models of microfinance is that VBs are savings-led rather than credit-led. VBs do not get funding from outside sources, except for the seed money that sponsors lend some VBs at the beginning of the VB's formation. Savings mobilization has only recently been recognized as an important component – the "forgotten half" – of financial intermediation. Although financial institutions in the past thought that the poor had low capacity to save and thus did not demand deposit facilities, they are now recognizing that if the savings products are appropriately structured, low income households will save (Fiebig et. al, 1999, p.1). Incorporating savings is crucial for the sustainability of the microfinance institutions for they will not anymore need to rely on external organizations for their loan fund. Also, savings-led MFIs are more likely to have a better governance structure than credit-led MFIs because their leadership do not answer to a long chain of government officials and donors – but directly to their depositors and borrowers.

2.3 Major Issues in Micro-Finance

Much of the literature in microfinance revolves around the trade-offs and synergies between three overarching policy objectives – financial sustainability, outreach to the poor, and the welfare impact – also called the "triangle of microfinance" (Zeller et al, 2002, p.3). There has been as much debate about the meaning of these terms as there has been discussion about which of these goals is more important and how we can achieve them. I will borrow (Navajas et al, 2002, p.154) definition of *outreach* as the social value of the output of MFI in terms of depth (how poor are the clients), worth to users, cost to users (transaction costs and interests), breadth (number of clients), length (how long will the client be served), and scope (variety of financial products). *Sustainability* signifies how permanent the MFI will be. *Impact* measures the benefits to the clients of microfinance programs.

Once we recognize that outreach, impact, and sustainability are the three goals of microfinance programs, the more difficult task is to measure them. Impact-assessment studies have measured changes in consumption levels, income levels, school enrollment of children, assets, improved health outcomes, and women's empowerment. Assessing impact is challenging because of the difficulty of selecting rigorous control groups and selecting unbiased samples so that the perceived impact can be attributed to microfinance programs.

Participation in microfinance programs has been found to reduce poverty by significantly improving clients' incomes and reducing their vulnerability to consumption and income shocks. Clients of microfinance programs appear to have much better nutrition, health practices, and health outcomes than non-clients. Microfinance programs have also proven to make women more confident and more likely to participate in family and community decisions. Although these results are indeed encouraging, we should not take them with face value since we do not know what impact we would have received had we invested in other programs such as health and education.

2.4 Micro-Finance in Nepal

Microfinance in Nepal was started with the establishment of the government sponsored Small Farmer Development Program in 1975. This program organized farmers into small groups throughout the country and provided them with credit that was backed by group guarantee. Because of bureaucratic inefficiency and lack of training and motivation of its staff, this program was doing very poorly by the 1990s, with repayment rates falling to 58% (Conroy et al, 1995-6, p. 200). This program was transformed into the Small Farmer Cooperative Limited in 1997 with the hope of making them self-sustaining and more efficient by allowing them to be owned and managed locally.

The Intensive Banking Program introduced in 1981 by the central bank required commercial banks to devote 12% of their portfolios to finance the priority sector (defined as cottage industries, agricultural industries and services), including 3% which was supposed to go to the hard-core poor. The 1980s also saw the introduction of a gender based microfinance program called Production Credit for Rural Women in cooperation with the United Nations Children's Fund in 1982 that organized women's groups so that they could borrow under the Intensive Banking Program. This was the first government sponsored program that involved NGOs.

The 1990s saw an acceleration in microfinance activities in the country. Between 1992 and 1997, the government sponsored five replicas of the Grameen Bank called Regional Rural Development Banks. The government also passed the Cooperative Act in 1992 that allowed the formation of credit cooperatives. By 1998, more than 4,400 cooperatives were registered under the Act and were providing savings-only or savings and credit services in the country. The government also established the Rural Self-Reliance Fund in 1991 that provided funds to microfinance intermediaries.

Currently, every imaginable model of microfinance practiced in Nepal. INGOs and NGOs run both credit-only and savings-and-credit programs either as stand-alone programs or as parts of multi-faceted development programs including literacy, health, income-generation etc. Five regional Grameen replicas still operate under the government. Besides the Grameen replicas, the government also supports credit-only, savings-and-credit programs, women-only programs and programs geared for both men and women. Numerous private savings and credit cooperatives have also emerged all over the country, which are required to operate under regulation from the government.

Despite the variety of microfinance projects currently running in Nepal, VBs did not exist in Nepal until PACT (an international non-government organization headquartered in Washington, D.C.) introduced the Women's Empowerment Program (WEP) in 1999 with funding from USAID. The status of women in Nepal is very bleak, with only 14% who are literate, and have infant mortality, malnutrition, life expectancy, and maternal mortality that are among the worst in the world. PACT introduced WEP order to increase the influence of women in household decision-making, to increase women's spending on family well-being, and enable women to initiate collective action (Odell, 2001, p.2). In order to achieve this WEP had three components:

- Literacy program
- Legal advocacy
- Village banking

WEP lasted from 1999 to 2001 and the project involved, 125,000 women that included about 6,500 saving and credit groups all over Nepal. Those groups were categorized into VBs (the strongest of the groups), economic groups (weaker groups that received comparatively little support from WEP), and other groups that were associated with cooperatives and microfinance organizations.

The groups were not established by PACT but by 245 local NGOs. The process was competitive since proposals for many more than 6,000 groups were submitted to be included in WEP. The groups were narrowed down according to size, proximity to each other and commitment of local NGO to support them. In other words, many of the 6,000 groups had already begun to mobilize savings and loans by the time they joined WEP in 1999, although many of them had primitive record-keeping until then. Although all groups started with basic savings and credit programs, the 1,500 stronger ones among them were trained to become VBs that kept records according to VB standards. Some VBs were also formed by combining two or more groups.

2.5 Landscape of Financial Service Providers in Nepal

Landscape of financial service providers in Nepal comprises of informal financial sector, semi-formal sector and formal financial sector as they pertains to provision of microfinance services. The 'snap-shot' of landscape of financial sector are discussed hereunder.

2.5.1 Informal Financial Sector

Informal lenders provide credit without procedural complexities and are flexible regarding repayments and collaterals, which does not exist in formal sector. Nepalese informal financial sector comprises of individual lenders or informal groups / institutions.

Individual lenders comprise of landlords, merchants, farmer-lenders, goldsmiths, pawnbrokers, friends and relatives and exist in almost all the villages. They lend money with or without interest or collateral. It is only the moneylenders who charge interest and loan is highly secured. They lend either with collateral (gold or silver) or without collateral albeit linked with labor and/or land transaction as security. The interest charged by moneylenders is generally very high, ranging between 36% and over 100% per annum. In addition, they often receive either labor services or other small gifts as part of the loan request. Owing to high effective interest rate, loans from moneylenders are generally used mainly for emergency purposes such as medical crises or socio-cultural obligations like weddings and funerals.

Money lending informal groups/institutions comprises of traditional rotating credit groups such as dhikuties, dharam, bhakari, guthies, etc. and they are well established and widespread in Nepal and represent a truly local and indigenous response to credit needs. Savings mobilized and credit delivered through informal rotating credit mechanisms like dhikuties represent an enormous level of financial activity, indicating that the resources are not yet fully tapped by formal and semi-formal sectors.

Dhikuties are groups formed within villages for the purposes of savings and credit activities. Members are mainly business communities. They are particularly popular amongst Nepal's ethnic trading communities or in urban areas. They are based upon the collection of equal amounts of savings collected each month (or other period) which are then lent out to each member in a rotating sequence. The rotation is generally determined by a bidding process where the bid with the highest interest rate receives the loan. Dhikuties have an average membership of 20 to 30 people with individual savings amounts ranging from Rs. 100 to Rs. 1,000. At the end of the rotation, the surplus from interest paid is distributed equally to the members. The main risks are that those who borrow will not repay principal or interest due to business setbacks, or that a contributing member will drop out once he or she has received the group collection.

Dharam bhakari (literally, "religious storage") are group grain associations. Each member provides an equal contribution of grain at harvest. He may then "borrow" it in the off-season, repaying at rates between 1.25 and 1.5 times the borrowed amount at the next harvest. These exist among small to medium farmers, and are a good safeguard against starvation.

Guthi are cultural heritage associations, common amongst the Newari and some tribal groups. They are like dhikuti in their form of standard collections of amounts from the group members, but accumulated funds are largely used for funerals or community welfare activities such as festivals. The group decides whether the user pays interest or not on the funds, and whether they are a loan or grant, based on the relative wealth and situation of the person requesting funds.

2.5.2 Formal Financial Sector

The formal financial sector in Nepal includes the following institutions: NRB, commercial banks, development banks, finance companies, SCCs and financial intermediary (FI) NGOs. The NRB is Nepal's central bank established in 1956 and is responsible for regulating and supervising country's formal financial sector. NRB also mandated commercial banks (CBs) to lend directly to micro entrepreneurs through the Intensive Banking Programme (IBP) and Deprived Sector Lending (DSL).

As of July 2008, there are 25 commercial banks (A grade) of which two (two state-owned) namely Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB) were involved in microfinance sector since 1974 under priority sector lending programme, renamed as IBP in 1981. They were also implementers of large government microfinance programmes. Initially NRB imposed lending requirement to commercial banks on priority sector at 5% in 1974, which increased to 7% in 1976 and to 12% in 1990. Also NRB directed commercial banks to allocate at least 25% of these priority sector loans or 3% of the total portfolio to hardcore poor under DSL. These schemes were undertaken by all the commercial banks as mandatory requirements or pay the penalties for non-compliance. Recently, NRB has decided to phase out priority sector credit policy withholding 3% investment in deprived sectors. The outreach of microfinance services through IBP/DSL once reached in almost all the 75 districts of Nepal decreased gradually owing to poor portfolio quality, deteriorating security situation and management problems.

S.N.	Type of institutions	Number of institutions by location		
		Kathmandu	Outside	Total
1	Commercial Banks (A grade)	20	5	25
2	Financial Institutions (B grade)	9	49	58
3	Financial Institutions (C grade) – Finance Companies	53	25	78
4	Financial Institutions (D grade) – MDBs	2	10	12
5	Savings and Credit Cooperatives – limited Banking operation	5	11	16
6	NGOs – involved in microfinance operation	15	31	46
	Total	104	131	235

*Table **1**: Banks and Non-financial Institutions in Nepal as of July 16, 2008*

There are 58 and 78 financial institutions respectively of B grade and C grade with limited role to provide microfinance services.

There are 12 financial institutions (D grade) working as MDBs, of which two are wholesale lenders and 10 are retail lenders. Of the 10 retail lending MDBs, five are Regional Grameen Bikas Bank (RGBB) promoted by government in each of the development regions to replicate the Grameen Bank model of Bangladesh to provide microfinance services to rural poor (mainly women) and other five are the outcome of transformation of microfinance operation of leading NGOs into MFIs.

There are thousands of NGOs active in the microfinance sector both as promoters and practitioners. In their roles as promoters, these NGOs facilitate to group formation of poor and disadvantaged people that generate internal resources through members' savings and use the fund for on-lending to members. NGOs occasionally provide seed money to groups. The groups often disintegrate when the programs implemented by the NGOs come to an end and cease to provide technical support. NGOs have also supported to transform some promising groups into SCCs. Beginning from 2000, some NGOs transformed into FI after obtaining license from NRB to involve as practitioners MSPs. As of July 2008 there are 46 FI-NGOs active in Nepalese microfinance sector.

There are over 3,300 savings and credit cooperatives that operate in different parts of the Nepal. They exist in all the 72 out of 75 districts of the country. Sixteen savings and credit cooperatives have received limited banking license from NRB and are involved on deposit mobilisation from general public.

Most of the activities in formal financial sector are commercial in nature, characterized by large loan sizes and lending concentrated in industrial productive activities. In general, formal financial sector provide majority of loans to men, as women are not normally involved in larger businesses[1].

2.5.3 Microfinance Sector

Microfinance sector generally targets poor and excluded groups and focuses to address poverty problems. The sector comprises of MFIs and microfinance programmes.

2.5.3.1 Microfinance Institutions

[1]ADB and NRB (1994) estimates proportion of rural households reporting borrowing from formal sources during 1991/92 at 8%. Across regions, proportions are 4%, 8% and 9% for the Mountains, the Hills and the Terai regions respectively."

Nepalese MFIs comprise of MDBs, FI-NGOs, SCCs, and SFCLs. In addition, there are five refinancing organizations supporting the MFIs.

1. The Rural Self Reliance Fund (RSRF) established in 1991 by the government with secretariat in NRB to provide wholesale loan to SCCs and NGOs.

2. The Rural Microfinance Development Centre Ltd (RMDC) established in 1998 to provide wholesale funding to regulated MFIs.

3. The Sana Kisan Bikas Bank (SKBB) established in 2001 to outsource the wholesale funding to SFCLs and similar institutions.

4. The Cooperative Bank providing wholesale loans to member cooperatives.

5. Biogas Credit Unit (BCU) under AEPC that provides wholesale loans to member MFIs to provide access to financial services to MFIs.

Based on their ownership and nature of operations, these MSPs can be broadly grouped into two categories: commercial oriented and community based. The former includes CBs, MDBs and FI-NGOs while SCCs, SFCLs and SCGs falls on later category. Information of number of MFIs in Nepal is provided in Table 2.

S.N.	**MFI Type**	**Number of MFI as of 15 of**		
		July 2006	**July 2008**	**Growth**
1	**MDBs**	**9**	**10**	**1**
2	**FI-NGOs**	**47**	**46**	**-1**
3	**SCCs**	**2957**	**3309**	**352**
4	**SFCLs**	**205**	**228**	**23**
	Total	**3218**	**3593**	**375**

Table 2: Number of MFIs in Nepal

CBs are involved in providing microfinance service through their obligation to meet DSL requirements. In general, CBs meet the DSL requirements of NRB by providing block loans or investment as share capital to MFIs or pay penalties or a combination of all three. There exist instances where majority of the MFIs have parked such fund in the commercial banks. The effectiveness of entire deprived sector lending on increasing access to finance for the poor is therefore questionable. Some CBs like ADBN, RBB and NBL have extended microfinance services through their branches in all 75 districts. In cognizance to emerging distortions, NRB has phased out priority sector credit policy in 2007 while continuing DSL requirements.

The ten MDBs providing microfinance services are replicating grameen model exactly or through some modification. Five of the government owned RRDBs were established during 1992-1997. The remaining five are private MDBs with operational history back to early 1990. These private achieved MDB status between 1998 and 2007 (one in 1998, two in 2001, one in 2002 and last in 2007). All these MDBs share basic objectives to improve access to microfinance services among women for promoting income-generating activities (IGAs).

First FI-NGO was registered in 2001 and of the 48 FI-NGOs, as of July 2008, 27 are involved as practitioner to provide microfinance services. FI-NGOs mobilize savings and borrow loanable fund from three apexes - RSRF, RMDC[2] and BCU - and the DSL window of the commercial banks.

Cooperatives are formal body characterized by democratic and highly participatory decision-making process. The SCCs are community based organizations either self emerged or promoted by I/NGOs and have a history back to 1954. The cooperative sector gained momentum in 1990s with the enactment of a new Cooperative Act 1991 that focused on capturing the spirit of cooperative norms and values. SCCs have the largest presence (i.e. 69 out of 75 districts) and there are only six mountain districts without SCCs. In contrast, SFCLs are member-owned and controlled multi-service cooperative agency promoted under external influence to deliver both financial and non-financial services. It consists of three-tiered organization and plays an important role in the rural civil society, by pooling joint resources to meet basic needs and to defend members' interests. Formation of SFCLs started in 1993 and compared to SCCs, SFCLs are characterised by improved cohesion and communication within shareholders. Establishment of the SKBB, as an **apex body** has been quite innovative to provide wholesale funds to SFCLs.

2.5.3.2 Microfinance Programmes

Since mid 1970s Government and NRB implemented at least 17 rural development programmes with credit component to extend group approach to financial services delivery to un-served poor and dis-advantaged communities. These programmes focus to organize target people into SCGs with savings collection and loan operation as one of the key activities and are highly deep-rooted with hardly any clusters or villages in rural areas without SCGs. There are cases where member of the households have participated in more than one SCGs supported by different programmes.

S.N.	Particulars	Unit	Value
1	Rural Development Programmes	No	16
2	SCGs	No	55,742
	Male only	No	15,681
	Female only	No	21,705
	Mixed	No	18,356
3	Members	No	1261,309
	Male	No	602,049
	Female	No	659,260
4	Savings mobilization	Rs. '000	1,203,951

Table 3: Savings and Credit Groups in Nepal as of July 2008

SCGs are promoted by involving households below poverty line or using holistic approaches covering over 80% HHs in a settlement. Mainly SCGs are promoted adopting homogeneity and joint liability principles at village or settlement level. Numbers of member per SHG ranges between 9 and 60 with an average of 23 members. SCGs act as financial

[2]RSRF was established in 1991 and managed by NRB that provides wholesale loans up to NRs. 2.0 millions to SCCs/FI-NGOs while RMDC was established in 1998, owned by NRB and Nepalese banking sector that can on-lend up to NRs. 200.0 millions to MFIs.

and non-financial Service Delivery Unit (SDU) of most rural development programme. In most cases, SCGs are viewed as the body for the members to start their loan application process, pool monthly individual and other compulsory savings and carry out other activities viz. marketing, farming and community development.

World Bank (2006) has estimated over 400,000 informal groups active in rural areas. Number of SCGs promoted by 16 rural development programmes implemented by the government was 55,742 with over 1261,309 members. These SCGs mobilize members' financial savings and use them for lending to promote income generation, asset creation and social/economic development. In general, thousands of SCGs that exist in rural Nepal are under-utilized.

2.5.4 Micro-Finance and the involvement of NRB.

NRB mandate incorporates supervision, regulation and monitoring of all commercial banks, development banks, finance companies, and licensed NGOs and cooperatives engaged in microfinance. More specifically, the microfinance department of NRB supervises microfinance organisations, manages development finance projects and operates a refinancing window for MFIs. NRB imposes 'priority sector' lending to commercial banks, which entails lending a certain percentage of their deposit / loan portfolio to an underserved population, including typical microfinance clients. NRB has recently decided to phase out its priority sector credit policy by 2007, but the 3% deprived sector credit requirement will stay in place, and include microfinance.

Under the priority sector lending agenda, the central bank led different initiatives, such as the Intensive Banking Program, which introduced group guarantee mechanisms instead of formal collateral, the Production Credit for Rural Women (PCRW) and Micro-Credit for Women (MCPW), which targeted low-income women, and were supported by donor agencies such as IFAD and the ADB.

Between 1992 and 1996, NRB established five Regional Rural Development Banks (RRDBs), using the Grameen Bank methodology, each one operating in a separate development region. Being the main shareholders in the RRDBs, the NRB has initiated a restructuring program to improve the performance of RRDBs, which will result ultimately in their privatization. In the Western region, the most profitable RRDB will soon be a private entity, as already 90% of its shares are sold to private investors. NRB envisages of keeping only a 10% stake. A second RRDB, operating in the Eastern region, also profitable, should be privatized by the end of 2004. The three remaining RRDBs, operating at a loss, will continue to be restructured in the coming 2 to 3 years, before being privatized as well - the NRB only keeping a minority shareholder position (10%).

NRB holds a 26% participation in the Rural Microfinance Development Centre (RMDC), which provides wholesale funds to regulated microfinance organisations, mostly to Grameen Bank replications.

NRB manages the Rural Self-Reliance Fund (RSRF) established in 1990 by the government of Nepal, and supported financially by an allocation of public funds, completed by replenishments from NRB and occasional donor support. RSRF provides wholesale funds to organisations offering financial services in rural areas, such as, Savings and Credit Organisations (SCO), NGOs, and Grameen replications. Funds lent to SCOs and NGOs are charged with 8% interest rate, which is reduced to 2% in case of 100% repayment. Funds lent to Grameen replications are indexed on the lowest re-finance rate of NRB, i.e. 4.5%. A loan portfolio of Rs. 19.2 million is outstanding as of mid January 2004, with organisations working in more than 46 of the 75 districts of the country.

NRB also acts as supervisory body and coordinator for targeted development finance project funded by donor agencies such as IFAD, CIDA, or the ADB. It includes the ‘Poverty alleviation in Western Tarai’, the ‘Community Ground Water Irrigation sector project’ and the ‘Third Livestock Development Project (TLDP)’.

2.6 Micro Finance Product Paper of Clean Energy Development Bank Ltd.

Background

In the Nepalese financial sector, many financial institutions are opened and are initiating various programmes. Despite this, reports illustrate access to financial services in rural and micro finance sector has been declining. Clean Energy Development Bank Ltd. (CEDBL), as a development bank, aims to cross the threshold in rural and micro finance sector channeling various internal and external unutilized resources. To bring in such resources into the sector, CEDBL has started financing on the renewable energy and microfinance sector.

Introduction

Microfinance is the provision of a broad range of formal financial services to poor and low-income people who do not have access to formal financial services such as:

- ✓ Deposits
- ✓ Loans
- ✓ Payment services
- ✓ Money transfers
- ✓ Insurance
- ✓ Training

Microfinance services are provided by three types of sources:

- ✓ Regulated financial institutions, such as banks, credit unions, consumer finance companies, postal savings banks and cooperatives
- ✓ Nongovernmental organizations (NGOs)
- ✓ Informal sources such as money lenders, shopkeepers, and “traditional” savings groups

CEDBL has been exploring the options of investing in micro financing. Primary reasons being:

- ✓ To contribute to our vision and mission
- ✓ To prospect the rural market for financing and utilize the untapped resources
- ✓ To contribute to bank‘s as well as society’s profit
- ✓ To establish a link between stakeholders and MF sector
- ✓ To build up capacity of MFIs

Strategy

The area of coverage is large. After analyzing the environment of each sub sectors, it would be prudent to approach the sector gradually. CEDBL’s strategy would be to go by a step by step approach and through partnership with the third party. CEDBL will manage, administer and mobilize national/ international fund (e.g. from the government, donor agencies, commercial banks and other possible sources) for the participatory approach as the participatory approach to development is increasingly accepted.

The bank does not have the experience and expertise as required in this sector. Rather than investing huge amount at once, it would be practical to invest in pilot actions for few years with the help of external advisers.

Partnership with Third Party

The bank has to gain some experience in rural sector, therefore, joint effort would be made with various interest groups to develop modality to facilitate loan in micro financing. These partnerships would be tested as: guarantee fund mechanisms, co-finance, pre-selection, technical support, franchising model – contract, commission and fee base etc.

Definitions

Some of the popular definitions of micro finance activities are as under:

Micro Finance

MF in the whole word has the following definition:

- ✓ Financial services including Credit, Saving, Insurance, Payment Services, Remittance and Trainings specifically conceived for poor people (and women)for poor without access to formal financial institutions.

Micro finance according to global versions, Rural Banks and NRB regulation has the following characteristics:

- ✓ Usually very small, short term and progressive amount of loan (from Rs. 5,000 to Rs. 60,000)
- ✓ Secured saving product
- ✓ Simplified appraisal process
- ✓ High repayment rates
- ✓ Given after training and orientation

- ✓ Usually without collateral lending and using group mechanism instead of classical guarantee
- ✓ Quick disbursement and regular repayment to keep in touch with the client

Bank's Definition and Boundaries on MF

Below are some of the basic elements to help defining the category of loans under MF.

Objectives:

- ✓ Highlight upliftment in term of economic livelihood of marginalized group: farmers, women, poor, dalits etc.
- ✓ Highlight upliftment of sectors which are of immense potentiality but not exploited due to lack of access to financial services.
- ✓ Focus towards positive discrimination to bring equality in the society. However the geographical location will not be the prime criteria.
- ✓ Promote of environmental friendly projects.

Characteristics of loans:

- ✓ Can be community based or on individual basis.
- ✓ Can be to individuals (retail), to financial intermediaries having better access to the target groups (whole sale) or to other equivalent legally established institutions having regular satisfactory operation (commission/fee base).
- ✓ Low amount

Characteristics of procedure

- ✓ The first step would be a partnership with a third partner (mostly from development sector)
- ✓ Will be open to use different mechanisms for guarantee as the clients/ MFIs can not usually provide same collateral than those of corporate
- ✓ Will include client friendly procedure and language to be understandable from clients

Basic Characteristics and Procedures for Loans advanced for MF

Process

- ✓ Selection of partner organization
- ✓ Pre-lending study/ Site visit
- ✓ Appraisal of the project
- ✓ Loan disbursement
- ✓ Supervision/Monitoring
- ✓ Recovery of the loan

Eligibility Criteria

For Individual or Group

- ✓ Applicant (individual or group of individuals) must be a Nepali citizen.
- ✓ Applicant must be creditworthy and have definite sources of income for repayment of loan.
- ✓ Applicant must be a permanent resident in the service area of the financial institution.
- ✓ Existing clients should have no default loan. The main point is that the loan applicant has to verify reliable sources of income to pay back the loan. Applicants with existing overdue loans will not be eligible.
- ✓ The applicant's personality, inclinations and attitude towards the MFI also need to be taken into account.

For Micro Finance Institution (MFIs)/ Cooperatives/ NGO/ Clubs

- ✓ The MFIs, Co-operatives and NGOs should be legally registered under the prevailing legal framework and already implementing savings and credit programs.
- ✓ Non Governmental Organizations (NGOs) should be authorized by Nepal Rastra Bank under the "Financial Intermediary Act".
- ✓ Community-based organizations, associations and other equivalent institutions must be registered with concerned register's office, Department or Ministry.
- ✓ The MFI/Co-ops and NGOs should have a provision of collecting savings, mobilizing credit and borrowing loans from other institutions in their bylaws.

- ✓ Dairy cooperatives and forest user groups providing such services, although they may not be dictated in organizational by laws, are also entitled to a loan by submitting a recommendation letter from the central milk producers cooperative union, district milk producers cooperative union or the district forest office or any other entity who could give recommendation on their abilities.
- ✓ Other factors that would be taken into account for eligibility would be:
  - Institutional outreach
  - Portfolio quality
  - Efficiency
  - Productivity
  - Capital/Liability structure

<u>Loan Amount</u>

The loan amount required will vary with the nature and size of the micro finance.

For Individual or Group

- ✓ Minimum Rs. 10,000.
- ✓ At least 10 % of the total loan amount should be made as the borrower's contribution. Keeping in mind the circumstances of the rural population, the contribution can be in the form of kind, i.e. labor, materials etc.

For Micro Finance Institution (MFI)/ Cooperatives/ NGO/ Clubs

- ✓ Minimum Rs. 2,000,000 in first loan, Rs. 4,000,000 in second and Rs.5,000,000 in third loan.
- ✓ The amount will not exceed a ratio 1/10 with the savings or 30 times of the core capital (whichever less).
- ✓ Amount will depend on the purpose of the loans (micro credit/ finance, biogas, agriculture loans, etc.) and the business plan (how many loans does the MFIs plan to invest)
- ✓ 10% at least of the total amount required should be lended by the MFI on their own resources.

- ✓ For small cooperatives (less than Rs. 500,000 savings/equity), it is recommended to start with small amount and plan increase as soon as results in term of repayment and management are shown.

Pricing

For Individual or Group

Interest Rate	:	14.00% to 16.00% per annum
Processing Fee	:	0.50% to 2% flat upfront
Prepayment Fee	:	1.00% to 2.00% on the amount prepaid for remaining tenure
Loan Swap Fee	:	2% per annum on outstanding balance for outstanding tenure
Penal Interest Rate	:	Minimum of 3% on overdue amount
Restructuring Fee	:	0.50% to 1% flat

For Commission/ Fee based Organization

- ✓ Commission of 2.00% - 3.00% on the repaid amount from CEDB's customer.

For Micro Finance Institution (MFI)/ Cooperatives/ NGO/ Clubs

Interest Rate	:	9.50% to 11.00% per annum
Processing Fee	:	0.50% to 2% flat upfront
Prepayment Fee	:	1.00% to 2.00% on the amount prepaid for remaining tenure
Loan Swap Fee	:	2% per annum on outstanding balance for outstanding tenure
Penal Interest Rate	:	Minimum of 3% on overdue amount
Restructuring Fee	:	0.50% to 1% flat

- ✓ Interest rates are subject to review by the Management.
- ✓ Processing fee to be obtained upon review of all documents / processing of application. The fee is non-refundable unless CEDBL declines the request.
- ✓ Prepayment is allowed any time with a fee of 1.00% to 2.00% on the amount prepaid for the remaining tenure.
- ✓ Loan swap fee is allowed any time with a fee of 2% per annum on outstanding balance for outstanding tenure. Relationship Officers, however, may need to be proactive to retain the loan with excellent track records with CEDBL.

- ✓ Maximum amount up to 50% of the loan amount may be accepted as the partial prepayment for one time with a restructuring fee of 0.50% to 1% of the balance loan amount. The loan will thereafter be restructured considering the net due amount as the principle for the remaining period.

Interest Rate

- ✓ The interest rate has to be set with a view to support institutional operating costs and still has to stick in the market.
- ✓ Risk analysis of no repayment will be analyzed for each pilot and taken in account for interest setting.

Tenure

- ✓ Maximum 5 years
- ✓ Will be defined function of the lifetime of the investment for MF.

Security

- ✓ In case of loans to MFI, the bank won't go in retailing. It would be advanced through MFI so that wholesale conditions apply.
- ✓ In case of wholesale, own collateral from the MFI will be asked. If this does not exist or does not cover the amount of loan, 10 to 30 % of the required investment shall be deposited by MFI and corporate guarantee shall also be provided.
- ✓ In case of other institutions/mediators, corporate guarantee, project guarantee and other guarantees will be asked

Repayment

- ✓ Equated Monthly Installment (EMI) or Equal Quarterly Installment (EQI). Repayment to start from the subsequent month of disbursal if the loan is disbursed within 15th day of the month; if the loan is disbursed after 15th of the month, the repayment to start from the subsequent next month.

Disbursement

For Individual/ Group

- ✓ Once the investment done with bill/contract from the machine/investment provider like other business loans of the bank.

For Micro Finance Institution (MFI)/ Cooperatives/ NGO/ Clubs

- ✓ 30% of the loan amount required (not exceeding Rs.2,000,000) at the beginning.
- ✓ Next 30% after justifying the first installment and the repayment rate of this installment (not exceeding Rs. 4,000,000).
- ✓ Last 40% after justifying the second installment and the repayment rate of the first 60% (not exceeding Rs. 5,000,000).

Procedures

All institutions have their own criteria for loan investments. Particularly for these new loans, some special procedures will be followed. Others will be similar to standard retail or corporate loans.

1. Background on project: Choice of a partner and MOU

As third partner has been identified as a key success factor for this kind of project, no loan will be analyzed without an agreement with a third partner concerning the investment and the context in which it takes place.

In a MOU signed with the partners, the way of supporting the project from the third partner will have to be clearly detailed.

Different mechanisms will be used:

- ✓ Pre selection /selection of clients(direct or MFIs)
- ✓ Technical trainings and management skills provided by /through the partner
- ✓ Co financing of establishment of a guarantee fund from the third part
- ✓ Monitoring activities to the clients (direct or MFIs) from the third part after loan is issued.

All this mechanism can obviously be combined and will be amply discussed before drafting agreement.

All this process will be done at central level by the team in charge of innovative project in Kathmandu.

During this process, a first visit to future clients (MFIs) will be done with the third part where some data will already be collected. The regional office will already be involved in this visit so it will be able to take the application whenever needed.

2. Loan Application

The applicant (individual or MFI) should fill out and hand over the institutional application form, clearly indicating the preference for collateral or security to back the loan. A decision to place property as collateral has to be supported by including photocopies of the property rights papers along with the loan application form.

Beside the loan application form, other paperwork to be collected includes:

<u>For Individual/ Group</u>

- ✓ Photocopies of applicant's citizenship certificates.
- ✓ Document showing income source of the applicant or the format of the income source to be filled by the applicant prepared by CEDBL.

<u>For Micro Finance Institution (MFI)/ Cooperatives/ NGO/ Clubs</u>

- ✓ Photocopies of organization registration and renewal certificates.
- ✓ MoU and AoA of the organization if applicable.
- ✓ Income Tax Clearance Certificate if applicable.
- ✓ Copy of Board Minute.
- ✓ Photocopies of citizenship certificates of the board of directors.
- ✓ Business plan and other policies of the organization.
- ✓ Financial Statements of last 3 years.

Documents required as against security (if applicable)

- ✓ Title Deed of land.
- ✓ Building Construction Permission letter from competent authority.

- ✓ Payment Receipts of latest land revenue.
- ✓ Four boundaries certified Copies.
- ✓ Blue print of land.
- ✓ Drawing of the building to be constructed (where applicable).
- ✓ Oath and commitment letter of group guarantee
- ✓ Commitment letter of corporate guarantee

3. Analysis of Loan Application

- ✓ Check application form and paper

Upon receipt of the loan application form, the institution's loan officer/ subcommittee should assess whether the application has been filled out correctly and see that the necessary paperwork is complete.

- ✓ Visit to client

Once this is satisfactory, a visit to the client (MFI) to verify the technical, economic and financial viability of the client project and check all information got in the application or in previous visit. For that, specific procedure (check list and/or questionnaire) has to be answered.

- ✓ Approval process

Application with department/regional office recommendation/advice has to be sent to Kathmandu committee.

Preparation of formal agreement and additional Paperwork

- ✓ Once the loan has been approved, an agreement should be developed between the two parties.
- ✓ In the event of collateral on property, the original deeds to the property and authorization of freezing of property sale should be included in the formal agreement.
- ✓ In the event of individual/group security, the presence of guarantors and their compliance to the terms and conditions is mandatory before signing the agreement as guarantors. The deposit scheme indicating the expected dates

and amount of loan payment and interest should be made available to the loan applicant upon signing the formal agreement.

Monitoring and Control

- ✓ Maximum will be defined function of each subsector (herbs, dairy, agriculture etc.) but won't go up in specific sub sectors loans will go up to **Rs. 5,000,000.**

- ✓ For the MFI, there will be a control from CEDBL to ensure that the loan has been used in the mentioned purpose: this control could be entrusted to the third part as part as a strategy to reduce cost.

- ✓ Monitoring will be shared between the bank and the third party. However, even if the third party agrees to monitor and do regular support visits, frequent inspection visits to the work site to determine progress should be made by the loan officer in charge. This system of making onsite inspections offers the advantage of gathering feedback from the borrowers a firsthand, and also supports the loan repayment scheme.

- ✓ The frequency of visit as well as needed reports will be made clear to the borrower.

Risk Assessment

- ✓ Individuals with limited authentic data.
- ✓ Regulatory risk – impact of government regulation on tariff and other regulatory matters
- ✓ Collateral and Guarantee Risk

Mitigation

- ✓ Credit monitoring tools would be strictly adhered.
- ✓ Majority of the businesses require loan to manage the books and hence gearing is not a risk in those cases.
- ✓ Facility shall be secured by corporate guarantee (in case of institution) and credibility of the institution shall be strictly observed.

Loan Recovery Process

- ✓ In case of default of any interest continuing > 1 month, a follow up letter would be sent to the borrower.
- ✓ If the above default is not rectified within 3 months from the date of the follow up letter a legal notice of 35 days would be sent in similar manner.
- ✓ If the customer is not in contact during the annual review period for more than 2 months despite follow ups a legal notice of 35 days would be sent in similar manner.
- ✓ If the default is not rectified upon initiation of above processes, legal action to be initiated against the Borrower/ Guarantors and the security held for the loan.

Notes

- ✓ CEDBL reserves the right of refusal without explaining the reason whatsoever.
- ✓ Waivers in pricing may be allowed subject to approval from the CEO as specific case.
- ✓ Any account with delinquency of above 2 months shall be considered “Careful” and a note regarding follow-up and recovery action of such accounts needs to be placed at least once every week unless the delinquencies are cleared in full.
- ✓ Each loan document should be maintained in a flat file and held in the Business Unit in alphabetical order.
- ✓ Charge over assets should be released to the applicant upon full repayment of the loan including interest. Third party transfers are prohibited.

System

- A separate sector code to be defined in the system, which should be used as “Micro Finance Sector Scheme Code” while opening the loan account.
- The separate ML code should also be used for the purpose.

Chapter – III

RESEARCH METHODOLOGY

The prime objective of this research is to identify and analyze the opportunity of micro financing for the commercial and development banks of Nepal and the assessment of various risks associated with micro financing. There are opportunities for both commercial banks and development banks to position themselves as a "National Fund Manager" to accelerate rural financing by using rural renewable energy projects as an entry point.

Assessment of industry risk, business and management risk, facility structure risk, account performance risk and security risk are more of a logic based and are dependent upon judgmental and analytical ability of the credit analyst (RM/ARM). However, assessment of financial/cash flow risk involves utilization of various financial tools and techniques. These have been discussed in this section.

1. Research Design

In compliance with objectives of this research, descriptive and exploratory research design has been followed in order to assess lending opportunity in micro financing by analyzing various risk associated with micro financing in Nepal with special reference to Clean Energy Development Bank Ltd. and Bank of Kathmandu Ltd.

2. Population and Sample

There are twenty five commercial banks and fifty eight development banks currently operating in the country. Hence, our population size is 25 commercial banks and 58 development banks from which one/one sample has been taken for both the case i.e. BOK as the sample for commercial banks and CEDB as the sample for development banks.

Population size	Sample Size	Sampled Bank
25	1	Bank of Kathmandu Ltd
58	1	Clean Energy Development Bank Ltd.

Table 4: Population and Sample

Since, the components of risk assessed for a particular industry are practically similar in all commercial and development banks and differentiation exists only in the ability of the analyst, we have reduced the sample size to two and considered BOK's and CEDB's assessment as the basis for our research.

3. Sources of Data

This study is based on primary as well as secondary data. No particular questionnaire has been designed depending upon its irrelevancy with the objective of the research. However, personal interview with the credit analyst, Head of the Micro Finance Unit and Development Credit Unit at BOK and CEDB have been the major source of primary data collection.

Secondary data have been obtained from the following sources:

1. Internal documents regarding micro finance and credit risk assessment procedures of BOK and CEDBL
2. Website of BOK, CEDBL and NRB (mainly).
3. Published annul reports of BOK and CEDBL
4. Books, Magazines, newspaper and journals.
5. Unified directives of NRB for Banks and Financial Institutions
6. Training and Seminar papers
7. Others as relevant

4. Data Collecting Procedure

As mentioned above, primary data were collected through direct personal interview and discussion with the related personnel at BOK and CEDBL and the secondary data were collected by visiting the related sources as listed above.

5. Methods of Data Analysis

Assessment of industry risk, business and management risk, security risk, facility structure risk and account performance risk involves more of logical and judgmental expertise of the credit analyst. However, assessment of financial risks associated with the financing involve use of various financial and accounting tools, detailed as unde :

5.1 Financial Analysis

Financial analysis is designed to determine the relative strength and weaknesses of a business operation. It also provides the framework for financial planning and control. Financial analysis concentrates on analysis of the financial statement, which highlights the key aspects of the operation of micro financing activities.

Financial statement analysis involves a study of the relationship between income statement and the balance sheet accounts, how their relationship change over time and how a particular firm compares with other firm in the industry.

In this research report, following financial tools have been used to assess the key financial risk associated with the micro financing, as relevant to BOK and CEDBL under the assessment micro financing.

5.1.1 Profitability Ratios:

Profitability ratios are calculated to measure the operating efficiency of the Micro Finance Institutions and Micro Finance Project. Besides management of the borrower, shareholders, directors, depositors, creditors and other stakeholders are also interested in the profitability of the Micro Finance Institutions and the Micro Finance Project. The lending financial institutions would want to get interest and repayment of principal regularly. Shareholders want to get required rate of return on their investment. This is possible only when the Micro Finance Institution earns enough profit. Following ratios have been used to assess the profitability of micro financing activities:

1. Gross Profit Margin:

$$\text{Gross Profit Margin} = \frac{\text{Gross Profit}}{\text{Sales}}$$

Where,

Gross profit = Sales – Cost of goods sold

The gross profit ratio reflects the efficiency with which management produces each unit of product. A high gross profit ratio is sign of good management. A gross profit ratio may increase due to any of following factors:

- Higher sales sale prices, cost of goods sold remaining constant
- Lower cost of goods sold, selling prices remaining constant
- Combination and variation in sales price and costs, the margin widening, and
- An increase in the proportionate volume of higher margin items

The analysis of these factors will reveal to the management how a depressed gross profit margin can be improved.

The ratio will be low due to fall in prices in market, or marked reduction in selling price by the micro financing project in an attempt to obtain large sales volume, the cost of goods sold remaining unchanged. Financial manager must be able to detect the causes of failing gross margin and initiate action to improve the situation.

Gross profit margin is a key indicator of a company's ability to pass along its increased costs to its customers. The gross profit margin is related to the return secured for the risk taken in adding value to the product during the asset conversion cycle.

2. Net Profit Margin

$$\text{Net Profit Margin} = \frac{\text{Net Profit}}{\text{Sales}}$$

Where,

Net profit = Earning after tax

Net profit ratio establishes a relationship between net profit and sales and indicates management's efficiency in manufacturing, administering and selling the products

This ratio also indicates the firm's capacity to withstand adverse economic conditions. A firm with a high net profit ratio would be in an advantageous position to survive in the face of falling selling prices, rising cost of production or declining demand for the product. It would really be difficult for a low net margin firm to withstand these adversities.

The net profit margin in any company is dictated by the nature of its operation and cost structure, its operation in the market place and the ability of its management to control cost.

3. Return on Asset (ROA)

$$\text{Return on Asset (ROA)} = \frac{\text{Net Profit}}{\text{Total Asset}}$$

Where,

Net profit = Earning after tax

The return on asset is an important financial tool to assess the management's ability to utilize assets in generating higher return. A bank extends credit to a project in order to finance assets i.e. long term loans to create fixed assets and working capital loan to create current assets. And therefore, higher the return on the assets, the lesser will be the financial risk thereto.

4. Return on Equity (ROE)

Shareholders are the owners of the project who invest equity in order to finance the project. They are entitled to the residual profits. The rate of dividend is not fixed; the earnings may be distributed to shareholders or retained in the business. Nevertheless, the net profits after taxes represent their return. A return on shareholder's equity is calculated to se the profitability of owners' investment. The ratio is calculated as under:

Return on Equity (ROE) = Net Profit

Net Worth

Where,

Net profit = Earning after tax
Net Worth = Equity + reserves & surplus + Retained earnings + Current
years profit/Loss

ROE indicates how well the firm has used the resources of owners. In fact, this ratio is one of the most important relationships in financial analysis. The earning of a satisfactory return is the most desirable objective of a business. This ratio is, thus, of great interest to the present as well as the prospective shareholders and also of great concern to management, which has the responsibility of maximizing the owners' welfare.

5.1.2 Growth Ratios:

The most important term to express the success of any firm is its growth in its financial statement. A bank extends credit to a project with belief that interest and principal amount will be repaid on time. This belief comes with the viability of the project whereby growth is perceived.

Growth ratios occupy a very important role in assessing the financial risks associated with financing a project. On the basis of the past growth/decline trend and prevailing economic conditions, future growth trends can be projected.

At BOK and CEDBL following growth ratios are considered while assessing the financial risk under consortium lending:

- Sales growth ratio
- Gross profit growth ratio
- Net profit growth ratio
- Total assets growth ratio

- Total liabilities growth ratio

5.1.3 Cash Flow

The central equation bottom lined under financing a micro financing project is – will the interest and principal be paid in time by the customer? The entire complex system of risk assessment and concluding on the viability of the project to be financed revolve around the above question. When a bank extends credit, its first security is the cash flow to be generated from the project to be financed. No matter, collateral security (land, building, machineries etc) will be needed for advancing loan, its not the objective of the bank to recover loan by auctioning the property of the loan customer, if in case the customer is not able to repay the loan.

Further, NRB has issued strict directives regarding provisions to overdue interest and principal. If the interest is not paid on time, then the bank will have to create provision (interest suspense) for that amount from its (bank's) profit. Also, in case of term loan, if a single installment is not paid on time, then the bank will have to create some provision for that loan amount.

Therefore, if the loan project becomes failure, then the bank will have to compensate from its own profit. Thus the essence of cash flow in evaluating the financial risk associated in financing a particular project is very great. The most direct way of evaluating a firm's ability to generate sufficient cash to payback debt is the analysis of its cash flow statement. The cash flow statement, which is the summery of a firm's cash source and uses, is more than just another tool to assist in understanding a firm's business operation – it is the tool of credit analysis.

The cash flow statement provides a link between two balance sheets and the income statement and allows us to evaluate how much cash the firm generated during the period and how it used this cash. The cash flow statement is in short, an approximation of a firm's cash receipts and disbursements during the period.

The cash flow statement presents information on the sources and uses of cash during the period, as depicted in the diagram below[3]:

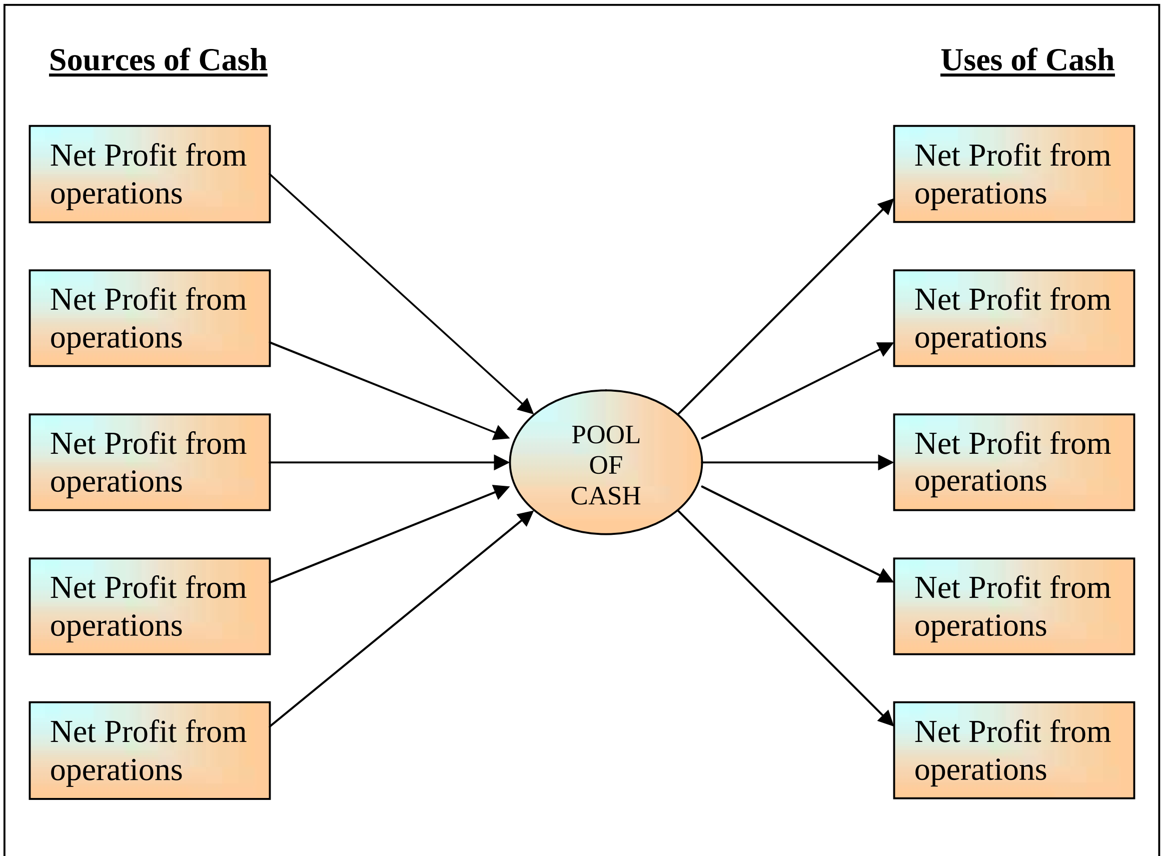

Figure 1 - sources and uses of cash

The following assessment points in the cash flow statement of micro finance borrower have been analyzed for assessing to reduce the cash flow risk:

I. Cash from trading activities
II. Gross cash from operation

[3] Lending and credit Analysis, a procedural approach – Bank of Kathmandu Ltd

III. Net Cash after operations
IV. Cash after debt amortization
V. Increase/decrease in debt
VI. increase/decrease in equity

5.1.4 Operating Cycle

The operating cycle or the asset conversion cycle is an important tool to analyze the working capital cycle of a business firm. It is the process by which a business invests in raw materials, converts these raw materials to finished goods, sells the goods, and collects cash. The asset conversion cycle describes the basic operations of a business operation. Each company has a unique asset conversion cycle, which is determined by the nature of the business and how it operates in the market place.

Studying what is involved in a particular company's asset conversion cycle provides a basis by which to understand and evaluate its financial statements. A company's asset investments and its financial structure, as reflected in its balance sheet, are determined, to a large extent by its asset conversion cycle.

Following financial tools are used to study and understand the working capital cycle of a firm:

Days Inventory

This ratio provides the average number of days the inventory is in hand before it is sold. This is calculated by dividing inventory by cost of good sold and multiplying it by 365 (i.e. days in a year).

$$\text{Days inventory} = \frac{\text{Inventory}}{\text{Cost of Goods sold}} \times 365$$

Days Debtors

This ratio provides the average number of days before the receivables are converted to cash. This is calculated by dividing account receivables by sales and multiplying it by 365 (i.e. days in a year).

$$\text{Days inventory} = \frac{\text{Account Receivables}}{\text{Sales}} \times 365$$

The total number of days by adding the days inventory (average number of days the inventory is held before it is sold) and the days debtors (average number of days before receivables are converted in to cash), gives the total period before final cash is collected from the whole production process.

Days Creditors

This ratio provides the average number of days before the payment is made to the supplier. This is calculated by dividing trade creditors by cost of good sold and multiplying it by 365 (i.e. days in a year).

$$\text{Days inventory} = \frac{\text{Trade Creditors}}{\text{Cost of Goods Sold}} \times 365$$

Net Cash Cycle Period

This is the number of days the firm remains out of fund (starting from the purchase of raw material till the collection of receivables via sale of goods). The firm requires working capital financing for this period only.

Net Cash Cycle Period = Days Inventory + Days debtors – Days Creditors

Calculation of net cash cycle period helps the bank to assess the period of working capital finance and control over the repayment of extended working capital loan.

5.1.5 Other Key Ratios

Other key ratios used in assessing the financial risk for extending credit to project by a commercial bank are:

Liquidity Ratio

It measures the firm's ability to meet current obligations. The failure of a company to meet its obligations due to lack of sufficient liquidity, will result in a poor creditworthiness, loss of creditors' confidence, or even in legal tangles resulting in the closure of the company. A very high degree of liquidity is also bad; idle assets earn nothing. The firm's fund will be unnecessary tied up in current asset. Therefore it is necessary to strike a proper balance between high liquidity and lack of liquidity. Most common ratios which indicate the extent of liquidity or lack of it are:-

a) <u>Current Ratio</u>

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current liabilities}}$$

Where,

Current asset include cash and those assets which can be converted into cash within a year, such as marketable securities, debtors and inventories.

Current liabilities include creditors, bills payable, accrued expenses, short term bank loan, income tax liability and long term debt maturing in the current year.

Current ratio is a measure of the firm's short term solvency. It indicates the availability of current asset in rupees for every one rupee of current liability. A ratio greater than one means that the firm has more current asset than current claims, against them.

As conventional rule, a current ratio of 2:1 or more is considered satisfactory. The higher the current ratio, the greater the margin of safety; the larger the amount of current asset in relation to current liabilities, the more the firm's ability to meet its current obligations, provided the quality of current asset is good (no inclusion of bad debts and non trading inventory)

b) Quick Ratio

$$\text{Quick ratio} = \frac{\text{Current Assets - Inventories}}{\text{Current liabilities}}$$

This ratio is often termed as acid-test ratio. It is the ratio of liquid assets to current liabilities. An asset is considered liquid if it can be converted into cash immediately or reasonably soon without the loss of value and therefore, the value of inventory is excluded while calculation of this ratio.

The quick ratio is a more severe indicator of short term liquidity in that it attempts to assess current creditors coverage without relaying on the sale of existing inventories. However, the reliability of quick ratio as an indicator of short term liquidity largely depends on the quality of receivables.

Generally, a quick ratio of 1:1 is considered to represent a satisfactory current financial condition of a firm.

Gearing Ratio

$$\text{Gearing ratio} = \frac{\text{Total Liabilities}}{\text{Tangible Net Worth}}$$

Where,

Total Liabilities = Current Liabilities + Loan Term Liabilities

Tangible Net Worth = Equity + reserves & surplus + Retained earnings +

Current years profit/Loss

Gearing ratio is commonly termed as financial leverage. It shows how much a company is relying on creditors to fund its assets at any point in time.

A bank will look in to this ratio with very keen interest as the smaller this ratio will be, more will be the equity portion and thereon more responsibility on the heads of the promoter/shareholders of the firm. For example – In case of long term loan, a bank will restrict lending up to a maximum of 70% of the total project cost, thereby ensuring injection of a minimum of 30% equity finance. This is because, the lower will be the portion of equity, the lesser will be the financial involvement of the promoters which may consequently lead to lack of proper responsibility.

Further, the greater will be the portion of eternal debt, additional burden of interest cost in the income statement. In general, the higher the gearing ratio, the greater the financial risk – that is the likelihood that the firm might be unable to meet interest and principal payments in the future[4].

Interest Coverage Ratio:

This interest coverage ratio is one of the most conventional coverage ratio used to test the firm's debt servicing capacity. It is calculated by dividing earning before interest and taxes (EBIT) by the interest charges.

$$\text{Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{Interest Charges}}$$

Debt Service Coverage Ratio (Cash flow Basis):

The debt service coverage ratio refers to the long term solvency of the firm. It shows the ability of a firm to meet its interest and principal payments on long term debts and similar obligations as they become due. This ratio is calculated on cash flow basis as the source of repayment for interest and principal amount is the net cash after operations.

$$\text{Debt Service Coverage Ratio} = \frac{\text{Net Cash After Operations}}{\text{Interest Charges + Principal due}}$$

This is one of the most important tools for assessing the financial risk involved in financing a project, specially a long term loan. This decides the viability of a business in terms to its ability to service interest and principal dues on time.

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[4] Lending and credit Analysis, a procedural approach – Bank of Kathmandu Ltd.

Chapter – IV

DATA PRESENTATION AND ANALYSIS

4.1 Background

The definition of micro-finance covers all mechanisms to provide financial services to the poor. This includes micro savings, micro loans, micro insurance and money transfer. The loans can be for immediately productive activities, the case for most micro-finance loans, or for quality of life improvements. Renewable energy technologies, such as biogas and solar home systems, can provide substantial improvements in the life of rural households.

Access to adequate, affordable, reliable, safe and environmentally friendly energy is crucial to achieving the Millennium Development Goals (MDGs) and for improving the lives of poor people across the world. However, two billion people globally cannot afford clean, safe cooking fuels and depend on traditional biomass sources – having negative impact to their health and the environment. Whilst micro finance services targeting the poor have been successfully promoted in many developing countries, such services for promoting clean energy technologies has not been widely tried out.

Energy services are essential for socio economic development. Renewable energy (RE) has significant potential to mitigate global climate change, address regional and local environmental concerns, reduce poverty, and increase energy security. The challenge is to provide appropriate policy framework and financial tools to enable RE to achieve optimum market potential from being a marginal source energy supply into the mainstream.

Renewable energy technologies (RETs) are best suited to supply the energy need of highly scattered remote rural households. Despite the huge potential of promoting renewable energy in Nepal, it is heading towards a crisis through its unsustainable energy use pattern. There is an overwhelming dependence on traditional fuels-fuel wood, agricultural residue and animal dung (accounting for 88% of primary energy use) and fossil fuels (accounting for 11.5% of primary energy use). This gives rise to adverse impacts regarding energy security, environment and human health. Therefore, there is an urgent need to substitute these energy sources with renewable clean energy sources.

Acknowledging the potential benefits of RETs, the Government of Nepal (GoN) subsidizes RET for rural households and communities in order to ensure wider and more equitable dissemination. However, the majority of rural poor remain unable to take advantage of government subsidies for RETs because they do not have ready cash on hand to purchase the system. This situation will become more acute in future since GoN plans to gradually phase out the subsidy scheme in RETs.

4.2 RETs and Financing Needs of the Consumer

As we look at the current RET installations, the majority of them are in more "affluent" and accessible rural areas. However to reach the RETs's primary target of reaching the poorest of the poor in rural Nepal, innovative approaches are essential. The cost of RET system escalates due to increased transportation costs to remote, scattered villages. Such subsistence-based rural communities lack disposable income to pay the upfront cost of installation. Furthermore, with ever-decreasing government subsidy, there is immense demand for affordable means of credit from communities with limited purchasing power.

Vital to this issue is the unfortunate reality that the period of maximum RET subsidy went unnoticed by poor households as they were unaware about the technology, and were unable to bear the risk of investing additional money for RET systems . Now, as the rural households have become more aware of the RETs, the cost of the systems are steadily going up; yet, just as the poor have accumulated enough confidence to purchase the technology, government has planed to reduce subsidy on RETs over time. The role of affordable credit, therefore, has become vital in making RETs accessible to poor households. RET potential in rural areas, strategic location of micro finance institutions (MFIs) and the energy needs of the rural poor serve as drivers to promote micro financing of RETs in rural Nepal. Hence adequate motivation of MFIs is expected to result in large-scale financing of RETs through MFIs.

The definition of micro-finance covers all mechanisms to provide financial services to the poor. This includes micro savings, micro loans, micro insurance and money transfer. The loans can be for immediately productive activities, the case for most micro-finance loans, or for quality of life improvements. Renewable energy technologies, such as biogas and solar home systems, can provide substantial improvements in the life of rural households.

It is widely acknowledged that micro finance can play an important role in enhancing the economic opportunities available to the poor. Most micro loans are provided for immediately productive activities which help farmers to increase their income. This is important to improve the financial status of poor people. RETs, on the other hand, improve the well-being of rural households by providing them modern forms of household energy, which in turn provide multiple benefits with respect to health, education etc. Poor households that can not pay the upfront cost of systems need credit so they can pay for systems over a longer period. MFIs can provide loans for systems cost-effectively in rural communities. For large numbers of poor people to receive access to modern energy services for cooking, lighting and television, MFIs must be convinced that the available technologies are appropriate for poor rural users. They must also be convinced that their clients can pay for systems either from increased income as a result of installation of systems or from other sources.

4.3 Financing Opportunities in RET Markets

With the aim of encouraging MFIs to view RETs as attractive loan products, studies have been carried out by Winrock International, Alternative Energy Promotion Centre (AEPC), Biogas Support Program (BSP) and Centre for Rural Technology/Nepal (CRT/N) to provide both technical and financial information about RETs. These studies have indicated a huge market potential in RET micro financing.

The following table presents the investment potential in various RET sectors.

Technology	**Potential**	**Installed**	**Annual Target**	**Total investment/year (NRS ,000)**	**Subsidy/year (NRS ,000)**	**Potential for loan/year (NRS ,000)**
Biogas	1.9 million	184,000	22,000	550,000	176,000	374,000
SHS	2.4 million	95,000	20,000	500,000	200,000	300,000
Solar Tuki	2.4 million	60,000	25,000	112,500	31,250	81,250
IWM	25,000	2800	1255	37,650	15,060	22,590
Micro Hydro		10 MW	3,250KW	650,000	276,250	373,750
Total				**1,850,150**	**698,560**	**1,151,590**

Table 5: Potential in Various RET Sectors

MFIs are strategically located in rural areas and have proved their easy access to rural population through their simple policy and procedures. Moreover, these institutions are mostly focused on financing income-generating activities. The studies have established RETs as a viable area of investment for MFIs, and suggest that increased MFI financing is justified because of the following reasons:

4.4 RETs are Creditworthy

4.4.1 Huge Market Potential:

The majority of Nepal’s population lives in rural areas, and energy is viewed as a means of fulfilling social and economical objective of the rural population. In this context, the promotion of appropriate energy is essential to meet the basic needs of the communities for cooking, lighting etc. Energy is also essential to meet the social objective of alleviating human drudgery, and required to sustain and support economic activities. In Nepal, RETs are the best means of supplying reliable, quality and cost efficient power to consumers in scattered remote rural households. In addition, the government, donors, INGOs and NGOs are presently all promoting RETs. With the right design, and products and services focusing on rural areas, RETs promise to be a very lucrative new market for MFIs.

4.4.2 Robust and Well- Proven Technologies in Nepal:

RETs, especially hydropower, biogas, solar thermal and solar PV, are tested and trusted technologies in Nepal. Around 10MW of power is being produced through pico and micro hydro power systems. More than 100,000 households have been electrified with solar PV systems. More than 184,000 biogas plants have already been installed in more than 66 districts. RETs have gained immense popularity, with the demand increasing day by day. RETs have been established as a robust and dependable technology. Trained technicians, operational support and advice and spare parts are easily available. The technologies are particularly suitable for the rural community as they utilize the natural resources, and the systems cost is directly proportional to the energy required.

4.4.3 Relatively Simple to Operate:

With the exception of hydropower, RETs do not have significant maintenance requirements. Manufacturers provide basic training to consumers to enable them to undertake routine repair and maintenance themselves.

4.4.3.1 Guarantee Mechanism:

Most RETs manufacturers and suppliers provide guarantees for their systems. In the case of solar PV, suppliers provide a 2 year guarantee from the date of installation for the complete module. Similarly, biogas suppliers provide a 3 year guarantee for construction.

4.4.3.2 Multiple Uses of the Technologies:

RETs have many end uses such as for cooking and lighting, and to power telecommunications equipments, entertainment (radio and television), household electrification, health clinics, water pumping, milling and grinding and many other productive uses.

4.4.3.3 Environment Friendly:

RETs are environment friendly technologies, and have various environmental benefits that depend upon the technology itself**.**

4.5 Portfolio Diversification

MFIs should offer new services to cater to the changing needs and demands of members to ensure growth and sustainability. The introduction of RET loan products provides MFIs an opportunity to integrate credit with other services for the socio-economic benefit of members and the society. Portfolio diversification also means risk diversification. The lending is distributed in small amounts among numerous micro entrepreneurs. In most countries, the main characteristics of microfinance institutions are their excellent repayment rate and thus their high solvability.

4.6 RETs can Provide Significant Benefit to Borrowers

Many MFIs are guided by social objectives that encourage them to work for socio-economic welfare of their members. One way to meet the social objectives is by financing

RETs in order to increase the access of the rural population to clean energy technologies. RETs have various direct and indirect benefits.

In Nepal, Winrock International is an organization that works to promote clean energy services to poor households through access to micro finance and supports additional livelihood enhancement by promoting small and medium enterprises using clean energy. Winrock has been working with rural poor households, the government, micro finance institutions, energy companies, other financial institutions to develop market mechanism to benefits all of these stakeholders. Winrock's microfinance support program in Nepal includes capacity building and building linkages between Microfinance Institutions (MFIs), energy companies, the Alternative Energy Promotion Centre and commercial banks. Winrock also managed to influence government policy to include energy sector as a priority investment sector for microfinance.

Winrock's Microfinance Capacity Building Program, funded by the USAID, has built capacity of 400 MFIs to support for clean energy promotion to poor households from 2003 and 2006. Winrock has developed several guidebooks and manuals, and published newsletters catering to MFIs and potential biogas adopters. This Program catalyzed 150 MFIs to provide loans exceeding one million US Dollars to 5000 poor households to construct biogas plants. An additional 700,000 U$ was also mobilized from these households' contributions and government subsidy for these biogas plants. A sample study of 100 of these biogas adopters in 2006 has shown that there has been an average increase of 8837 rupees per household per year from the sale of biogas slurry and the sale of increased vegetable production through the use of slurry. Winrock supported WWF Nepal to link microfinance and energy technology promotion based on the lessons from this Program.

Winrock also promoted micro-finance to help poor households connect to electricity supply and to develop small and medium enterprises through another USAID funded project entitled "Conflict Mitigation through Community Based Rural Electrification", from November 2005 to November 2006.Winrock worked with two Rural Electrification Community Organizations (RECOs) to build their capacity to also operate as a microfinance institution. They provided micro credit to 155 poor households connect to the national electricity grid and 189 households to establish small and medium enterprises and run income generating activities. These two RECOs provided the credit of total worth of $40,000. Winrock's enterprise development capacity building works with rural households to support them to analysis the total value chain from input suppliers to the end users.

Winrock supported the establishment of the Clean Energy Development Bank and its capacity building in Nepal through an USAID supported project entitled “Technical Advisory Services to the Clean Energy Development Bank. Winrock has helped the development of the Bank’s policy and procedures to work with rural micro finance institutions and other financial intermediaries to provide micro finance access for acquiring clean energy systems and for using energy for income generating activities.

4.7 Financing Models

Various countries have practiced different models of financing RETs based on the local conditions. The following are some models which are relevant in our country.

4.7.1 Micro-financing

The poor households in rural areas are heavily dependent on either traditional sources of energy, or on expensive and increasingly scarce fossil fuels. The majority of these communities lack the upfront capital to afford modern energy technologies. This does not only apply to decentralized renewable systems, but also the cost of connection to the grid line. Micro financing for RETs will therefore enable the poor access to such beneficial energy technologies.

As stated in the case above, MFIs in Nepal indicate a gradual progress in this direction. More than 150 MFIs have been financing biogas and other renewals. Nirdhan Utthan Bank, Purbanchal Grameen Bikash Bank, Sahara Savings and Credit Cooperative, Karnali Savings and Credit Cooperative are good examples of MFIs involved in RET finaning. Examples in the region include Sarvodaya Economic Enterprise Development Services (SEEDS) in Sri Lanka. SEEDS has pioneered a successful example of micro financing of solar home systems. In coordination with private solar companies, SEEDS has already financed over 70,000 solar home systems.

4.7.2 Franchising

MFIs in remote areas are strategically located close to the RET customer. However these institutions may not have adequate funds for financing such systems, and may also be viewed as not credit worthy by commercial banks. The franchising model can work effectively in such cases.

The MFI provides loan origination and administration services on behalf of the bank, and functions within a clearly defined guideline framework. It leverages its proximity to the client base and utilizes relevant methodologies and local staff. In this structure, the MFI facilitates the loan process by selecting clients and monitoring loans; the loan is carried on the bank’s books alone. Incorporation of the entity is uncomplicated since it functions as a service provider as opposed to a financial intermediary. Fees paid for the services rendered are linked to disbursements and recoveries.

ICICI bank in India has successfully practiced this model in generic micro finance schemes. With proper orientation to both commercial banks and MFIs, this can be replicated in financing RETs.

4.7.3 Revolving Funds

The “revolving fund” is a fund established to finance a cycle of operations through amounts received by the fund. The funds are designed in such a way that the interest income covers the management cost. Members of the group select the management committee for its efficient and effective management. A number of members obtain loans and pay back as per the rules and procedures established. The next set of members obtain loans as the former group pays it back, and it goes on revolving thus among the members. Such funds are generally used for financing income generating activities. With proper orientation and training, funds can also be used for financing modern energy services.

Revolving funds have been established to finance the purchase of small photovoltaic systems in developing countries. WWF Nepal has established a revolving loan fund for financing biogas plants in its program area. WWF is working through cooperatives and community forest users groups. In several parts of the country, many community forest users have established revolving funds for financing renewable energy systems mostly biogas plants. Solar

Electric Light Fund (SELF) has shown these funds can be very successful given a small amount of start-up funding for purchasing PV home lighting systems.[5]

4.7.4 Vendor Financing

In this model, energy service providers sell the system in credit and collect regular installments from users. Such models are appropriate in areas where the presence of financial institutions is negligible, or where the service provider coverage area is very high. This model has been used for financing solar home systems in many parts of the region.

Grameen Shakti in Bangladesh is an energy company that sells its products and services on credit, and collects regular installments. It has successfully installed over 100,000 solar home systems in rural Bangladesh. Few solar companies like Rural and Alternative Energy Pvt. Ltd, Tahanu Nepal has also started this model in a small scale. This company and some other solar companies are now planning to expand it in various parts of the country.

4.7.5 Leasing

This model of financing energy services allows consumers to pay monthly fee for the energy services rather than buying the system. The system service provider provides guaranteed maintenance and reliable energy services.

Grameen Shakti in Bangladesh has a leasing model called micro utility. It is targeted at communities unable to purchase the system at a single go. GS provides the system without upfront costs, on condition that users share the power with other neighbors within the technical limit of the SHS. The owner of the system pays a monthly installment to GS, and collects a load charge from the other users according to the load capacity used. 50% of installment generally comes from this power selling mechanism.

4.8 Process of Loan Disbursement

[5] Asia-Pacific Economic Cooperation, Guidebook for Financing New and Renewable Energy Projects, 1998

Economic down fall, political turmoil and insecurity within the country have narrowed the economic and business growth dimension since past few years. The country is experiencing a downward economic growth. With the very limited market to flow loan, the existing commercial and development banks have to compete in order to retain the existing good customer and get a potential good customer.

The process of evaluating the healthiness of a particular customer involves evaluation and analysis of the proposal at all dimension of risk. Thus, when a new proposal comes in to the micro financing unit of both banks, it passes the following management levels such that the final decision of wither or not to finance in micro finance activities is profitable and associated with less amount of risk. The standard process flows of both banks for a new micro finance proposal goes through the following management check points:

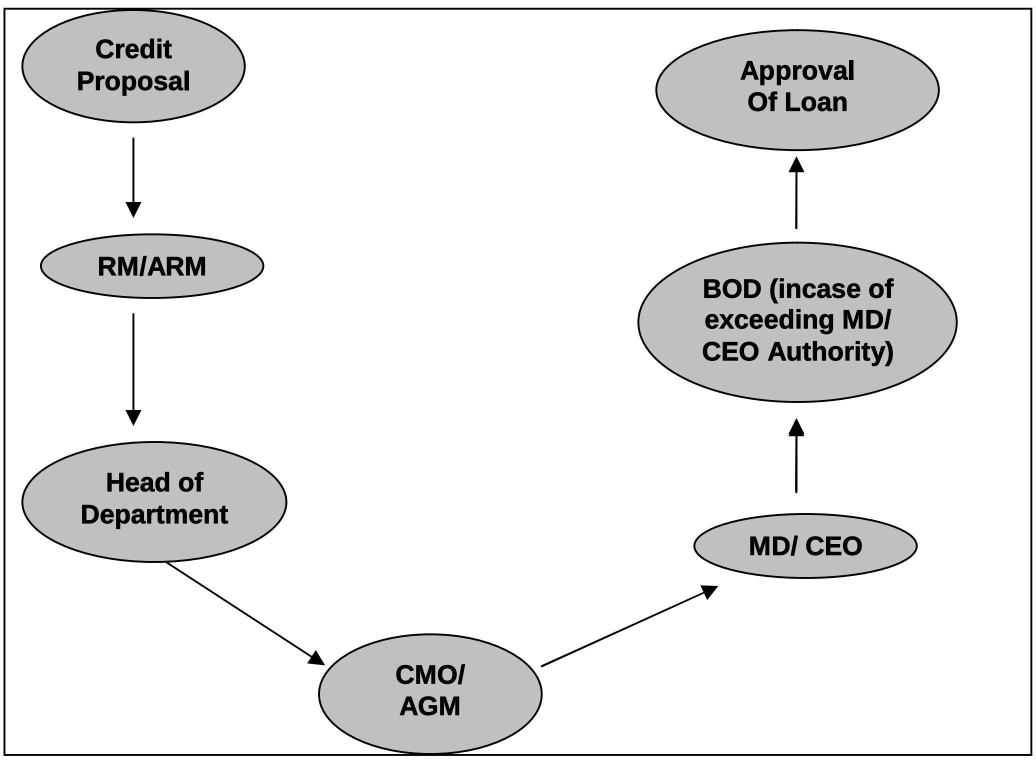

Figure 2: Credit Proposal Approval Process

The approving authorities are delegated with Credit Approval Discretion “CAD” in line with the current designation of the CAD holder. Depending upon the amount of loan requested, the credit proposal gets approved from the appropriate CAD holder. The final approving authority is the board of directors “BOD”.

When a customer enters the bank with a credit proposal, it is the relationship manager or the assistant relationship manager “RM/ARM”, who receives the customer and looks in to the proposal first. A RM/ARM occupies the junior level management (officer level) in the management hierarchy of a commercial and development bank. They are the first credit analyst. Their jobs relating to the evaluation of the new credit proposal can be numbered in the following points (in general):

1. Interviewing and evaluating the customer regarding nature of business (credit proposal), management quality and strength, credit worthiness of the micro financing borrower and security aspect. The customer is asked for a detailed write-up of the micro finance project (if not submitted) covering the tenure of loan requested, financial projection for the period etc.

2. A micro finance project synopsis is prepared covering brief risk assessment of the micro finance activities on the nature of business potentiality, security coverage, management quality and financial analysis.

3. Rejection of the proposal out right if the project is not worth financing at all. However, if there is some potentiality in the micro finance activities, the synopsis is forwarded with the decision of RM/ARM for decline or acceptance of the project for finance to the head of the department.

4. The head of the micro finance department adds/ supports his view on the synopsis and does necessary corrections, if any and forwards to Chief Business Officer/ Assistant General Manager and finally to the Managing Director/Chief Executive Officer.

5. The decision thereafter wither or not to finance the micro finance project is made. The formal confirmation of the bank to finance or not to finance the micro finance project is given to the customer. This whole procedure normally takes about one week.

6. If the proposal is accepted by the bank, then a credit proposal is prepared by the RM/ARM covering a detailed risk assessment in all dimensions of the project of the project and submitted for approval through the same management hierarchy. The proposal gets approved from the appropriate CAD holder and the loan is finally disbursed to the project.

4.9 Risk Assessment

Risk assessment of a particular project is a very detailed and minute process. The concerned RM/ARM has to collect the raw information from various sources before the assessment. The risk assessment procedure in BOK is divided in two forms:

4.9.1 Numeric Risk Grading

Under this system of risk assessment, the various risks associated with the project are given a combination of numeric and alphabetic representation/value such that the project is assigned a specific risk grade. The process and the components under this grading system are as under:

i. Industry Risk

Under this segment, numeric risk value is assigned to the project on the basis of evaluation of the industry components such as current market trend, level and intensity of competition, barriers to the entry of other firm in the similar business industry, market base (local market or export market), effect of change in the external environment factors in the business etc.

ii. Business Risk

Under this segment, risk value to the project is assigned on the basis of evaluation of the components associated with the business such as nature and quality of product, current market positioning of the product, number of suppliers of raw material used in the production of the product and number of buyers of the product, management quality, technology used etc.

iii. Financial Risk

Under this section, if the project is a running business then numeric value is assigned on the basis of financial evaluation on the components such as sales trend, profit trend, cash flow, liquidity, solvency (debt equity ratio) etc. However, if the project is a start-up venture then a standard numeric value is assigned.

iv. Account Performance Risk

Here, the numeric risk value is assigned on the basis of past account performance of the company (for a running business) with the bank such as number of years of relationship with the bank, timely repayment of interest and principal amount, utilization of the credit facility extended etc. However, if the project is a start-up venture, then a standard numeric value is assigned.

v. Security coverage

Under this section, numeric value is assigned to the project on the basis of security coverage for the amount of the loan to be extended. Here, security refers to the value of the tangible collateral security such as land & building, plant & machinery, other fixed assets, hypothecated (charge held by the bank) current assets like inventory stock and account receivable etc. If the value of tangible security is 100% of the amount of loan extended/to be extended, a standard numeric risk value is assigned and for greater or lesser than the 100% of the loan amount, a different numeric value is assigned to the project.

By adding the total of numeric risk value assigned to the project under industry risk, business risk, financial risk and the account performance risk, an alphabetic risk value is assigned to the project. The combined alphabetic risk value and the numeric risk value assigned for security coverage gives the credit risk grade for the project. By looking at this credit risk grade, one (in the above management hierarchy) can identify the quality of loan and the amount of risk associated with the project in wholesome.

4.10 CEDBL and BOK in Micro-Finance.

4.10.1 Overview

There is significant un-met demand for financial services in general and RETs financing in particular and most of the financial service providers have been used below potentials. The wholesale lending mechanism that are currently active in Nepal has not been able to expand their services to MFIs located in inaccessible hills and mountains and only few large MFIs are able to obtain wholesale loans from existing wholesale lending modalities due to their operation from head office in Kathmandu and inadequate focus to meet their lending requirements and build their institutional capacity. There exists huge market for CEDBL to involve on rural finance and act as a National Fund Manager for expanding frontier of rural financing as well as accelerating and promoting use of clean energy. There is tremendous prospects that CEDBL can be involved in mobilizing the deprived sector lending, however, this requires that it must build an environment of trust and confidence to properly mobilise this fund among under and unserved population living in inaccessible hills and mountain areas. Further, there exist serious distortions on deprived sector lending scheme which has been envisaged to expand the frontier of financial services in rural areas and most commercial banks and development banks are confining their services among few leading MFIs that are parking the fund which at times is counterproductive for the healthy growth and development of Nepalese rural financial market.

4.10.2 Clean Energy Development Bank Limited in Microfinance

Amount of Loan Operation

Since inception CEDBL has been involved on extending the microfinance services. At present it has working experiences on wholesale lending as well as individual lending. Amount of loan approved in NRs. 23.30 millions of which NRs. 21.30 millions has been disbursed. Amount of loan recovered is NRs. 0.5 million and there is outstanding loan balance of NRs. 20.8 million. As of October 2008, there is 100% on-time loan repayment rate on loan operation.

Lending Modalities

Loan has been provided to SCCs, FI-NGO, MDB and individual members of livestock groups. The products extended by CEDBL can be broadly grouped into two: wholesale loans and individual loans.

Wholesale loans:

CEDBL has extended wholesale loans to two SCCs (loan size Rs. 2.0 million), one FI-NGO (loan size NRs. 2.5 million) and one MDB (loan size Rs. 15.0 million). Loan term varies from one year to three years. Two modalities of loan repayment prevail. In case of SCCs and FI-NGO, loan should be paid on monthly equal installment while interest has to be repaid on quarterly basis. On the other hand, there is some difference on loan to MDB. In this case, interest should be repaid on quarterly basis while principal amount shall be repaid at the maturity date or loan shall be renewed for further period. Pre-conditions for this is that MDB should repay the interest on loan on quarterly basis.

Individual Loans:

CEDBL has also piloted the individual lending modalities to the members of the livestock groups. In this case, loan has been disbursed to the individual members of the livestock groups. A total of 15 members of the livestock group have received loans from CEDBL's individual lending modalities. The loan has been extended for promoting buffalo farming.

Interest on Loan

Interest on loan varies across lending methodologies as well as type of clients. Interest rate charged by CEDBL on loans ranges between 7% (case of FI-NGO) and 11% (case of individual lending). The rate of interest charged on loan clearly reflects on intensity of risk involved on loan portfolio, their capacity, stability and transaction cost involved on loan management in addition to amount cost of capital used for loan operation.

S.N.	Name	Interest rate	Amount Approved	Amount Disbursed	Amount Recovered	Outstanding loan	Due date
A	**SCCs**						
1	Shree Gorkha Gharwlu	10	2,000,000	2,000,000	130,000	1,870,000	1/8/2011
2	Bhimkul	10	2,000,000	1,000,000	92,500	907,500	1/8/2011
B	**FI-NGO**						
1	FORWARD	7	2,500,000	2,500,000	190,000	2,310,000	1/8/2011
C	**MDB**						
1	MGBB	8	15,000,000	15,000,000	-	15,000,000	15/6/2009
D	**Individual Loan to following member of Shanti Bagar Pashupalan Samuha**						
1	Rishi Ram Adhikari	11	59,500	59,500	6,768	52,732	1/8/2010
2	Ishwar Nepal	11	59,500	59,500	6,768	52,732	1/8/2010
3	Baikuntha	11	59,500	59,500	6,768	52,732	1/8/2010

	Nepal						
4	Narayan Adhikari	11	59,500	59,500	6,768	52,732	1/8/2010
5	Guna Kanta Aryal	11	59,500	59,500	6,768	52,732	1/8/2010
6	Ram Sharan Silwal	11	59,500	59,500	6,768	52,732	1/8/2010
7	Bishnu Nepal	11	59,500	59,500	6,768	52,732	1/8/2010
8	Shiba Kumari Nepa	11	59,500	59,500	6,768	52,732	1/8/2010
9	Sita Nepal	11	59,500	59,500	6,768	52,732	1/8/2010
10	Masina Gurung	11	29,750	29,750	3,384	26,366	1/8/2010
11	Bishnu Prasad Dhakal	11	29,750	29,750	3,384	26,366	1/8/2010
12	Rup Maya Pariyar	11	29,750	29,750	3,384	26,366	1/8/2010
13	Ram C. Poudel	11	59,500	59,500	6,768	52,732	1/8/2010
14	Ambika Adhikari	11	59,500	59,500	6,768	52,732	1/8/2010
15	Shyam Kumari N.	11	59,500	59,500	6,768	52,732	1/8/2010
	TOTAL		**22,303,250**	**21,303,250**	**503,872**	**20,799,378**	

Table 6: Clean Energy Development Bank Limited in Microfinance as of October 2008

Source: CEDBL, November 2008

Repayment Performance

Repayment performance of the loan disbursed by CEDBL on microfinance sector is quite encouraging. CEDBL has been able to recover the loans in time and on-time loan repayment rate is 100%.

4.10.3 Bank of Kathmandu in Micro Finance

Bank of Kathmandu Limited (BOK) is a culmination of a comprehensive vision of the promoters to take the Nepalese economy to a newer realm in the global market. Each promoter of Bank of Kathmandu has successfully demonstrated leadership skills, business acumen and entrepreneurial talents in his/her respective field.

BOK started its operation in March 1995 with the objective to stimulate the Nepalese economy and take it to newer heights. BOK also aims to facilitate the nation's economy and to become more competitive globally. To achieve these, BOK has been focusing on its set objectives right from the beginning. To highlight its few objectives:

- To contribute to the sustainable development of the nation by mobilizing domestic savings and channeling them to productive areas
- To use the latest banking technology to provide better, reliable and efficient services at a reasonable cost
- To facilitate trade by making financial transactions easier, faster and more reliable through relationships with foreign banks and money transfer agencies
- To contribute to the overall social development of Nepal

BOK's activities globe around deposit mobilization, advancement of various credits, international banking including trade financing, inward and outward remittances and funds and portfolio management.

Bank of Kathmandu is committed to providing products and services of the highest standards to its customers by understanding their requirements best suiting the market needs. In pursuit to deliver the products and services of the highest standards, Bank of Kathmandu has state-of-art technology for appropriate and efficient Management Information System (MIS) and rendering quality services, VSAT and Radio Modem for networking, SWIFT for international trade and transfer of funds around the world, correspondent banking relationships with over 200 banks worldwide for effective and proficient execution of international trade and remittance activities, gamut of corporate and retail banking products and services and centralized banking operations for better risk management, consistent service deliveries and lowering operating cost.

BOK has established a separate department called Development Credit Unit in order to lend in the micro finance activities. The goal of Development Credit is to provide quality financial services to marginalized groups and poorer sections of society through intermediaries e.g. Micro Finance Institutions, Co-operatives, Financial Intermediary Non Governmental Organizations, Development Banks, Community Based Organizations and other registered organizations. BOK has offer the following micro finance products to increase its micro finance activities:

General Micro Finance

This product has been devised for financing general micro finance loans to clients through partner institutions involved in offering Micro Finance services. A micro finance loan is defined as a loan used for various income generating activities including, but not limited to, purchase of livestock, loans for mini-grocery stores, vegetable loans, etc. Non-income generating loans such as installing bio-gas units shall also be availed but only with prior approval from Bank of Kathmandu.

Agriculture and Forest Based Product Loan

The product has been devised to allow farmers, agricultural cooperatives, community forest user groups and other registered institutions engaged in producing and processing agricultural and forest based products to have access to finance for funding working capital requirements, plantation expenditures and purchasing livestock and accessories.

Equipment Finance:

The product aims to finance the cost of equipments of various purposes to individuals, groups and institutions operating Small and Medium Enterprises with an objective to raise income in rural and urban areas of Nepal.

Vehicle and Accessories Finance:

The product has been devised for financing vehicles and vehicle related accessories to self-employed low income earning entrepreneurs. Loans will be of a Hire Purchase and on an owner-driver concept.

Constraints and Challenges

CEDBL and BOK have experienced some constraints/challenges on managing its loan portfolio on microfinance. Some of these constraints are outlined hereunder.

- Experiencing difficulties to monitor the micro finance loan portfolio of MFI and this is because of the fact that these MFIs are sources of funds from more than one wholesale service providers as well as development banks and commercial banks to support them to meet their deprived sector requirements.

- The third tier MFI lacks capacity to borrow and need capacity building training.

- There exist difficulties to monitor/ high monitoring cost; bank does not have enough outreach to monitor the MF loan portfolio.

- High monitoring cost reducing the profitability of the bank; therefore, reluctant to enter in the rural/remote area where CEDBL does not have the branch office.

- Security risk that arises due to the collateral free nature of the microfinance loan is clearly evident and there is lack of enough risk mitigation measures.

- There are difficulties to assess the income level of rural people etc. and eventually their credit absorptive capacity.

- Reluctance of the first tier MFIs to borrow at the commercial rate is clearly evident as they have a sufficient fund in their fixed deposit account and still willing to borrow the loan at cheaper rate where there is no need of financing. They intend to borrow at lower rate in order to ensure safety-net in their operation.

Chapter – V

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary and Conclusion

There is significant un-met demand and most of the MFIs are operating below potentials due to lack of funds. Currently active wholesale lending mechanism has not been able to expand their services to MFIs located in inaccessible hills and mountains. They have not been able to address the emerging demand for financial services for RETs. Few selected MFIs are able to obtain wholesale loans from existing wholesale lending modalities due to their operation from head office in Kathmandu and low capacity to meet their lending requirements. Deprived sector lending has not been properly used as envisaged.

Commercial banks in Nepal are required by the central bank to earmark a portion of their loan portfolio to priority lending (agriculture, cottage industry, services), which includes 0.25% to 3% to the deprived sector (poor population). Under this obligation, commercial banks can lend directly to individuals or self-help groups, charging a 6-7% interest rate, or provide wholesale funds or equity to microfinance providers serving the poor. Two thirds of the priority and deprived sector lending and investment are provided by the two public commercial banks, Nepal Bank Limited and Rastriya Banijya Bank. Until recently the priority lending was set at 12% of the loan portfolio. It is now being phased out, ending completely in 2007, while the 3% deprived sector requirement will stay in place, and therefore loan and investment in microfinance with it. As of mid July 2003, Rs.22,605 million were affected to the priority sector, while Rs. 3,563 million allocated to deprived sector lending, from which 132.6 million was in the form of equity. Under this requirement, investments made by commercial banks in the Rural Microfinance Development Center, an apex organisation providing wholesale fund to microfinance, can be seen as a new link between the formal finance sector and microfinance.

However, commercial banks are not seeing a commercial interest in lending to microfinance clients, directly or indirectly, as they are judged being too poor, without the necessary collateral to secure their loans. They have reduced their lending to microfinance over time. Some believe that banks need to see opportunities in microfinance for their banking business, instead of being forced to serve a population unknow Fulfilling their ‘deprived sector’ requirements, Nabil bank and Himalayan bank provide lending and equity capital to the two leading private rural microfinance banks, Swabalamban Bikas Bank and Nirdhan Uttan Bank. Everest Bank is also an investor in Nirdhan, while Nepal Investment Bank is a key shareholder of the Swabalamban Bikas Bank. In addition, the banking office of the Women Cooperative Society (an NGO) has a 12% share in Swabalamban Bikas Bank.

Self Help Groups, which have evolved into registered cooperatives, can access commercial bank lending if they gather at least 25 members and satisfy the bank borrowing criteria. However, there is often little interest from cooperatives to borrow from commercial banks as they can access funds at subsidised interest rates from the Rural Self-Reliance Fund (8% reduced to 2% in case of good repayment).

Nirdhan and BISCOL (a cooperative) collaborated during the last two years, with the leading insurance company in Nepal, National Life Insurance Company, on the implementation of a micro insurance product. Facilitated by the Center for Microfinance, the pilot project provided life insurance, health insurance and livestock insurance policies to the clients of microfinance providers. BISCOL is providing matching fund in the scheme, while Nirdhan has announced that it will now extend this product to all its clients.

There is significant demand for financial services for promoting RETs such as biogas, improved water mills, micro-hydro and solar home systems. There is lack of specialised FSPs involved on providing financial services for promoting RETs.

Nepal has a huge potential for promoting RETs as cost effective means to provide energy services to the poor in the remote villages. Once MFIs are convinced about the credit worthiness of RETs, they can provide affordable credit to rural clients to access these highly beneficial technologies. Commercial banks and other development banks can also take advantage of this enormous potential market by means of MFIs as their intermediaries.

5.2 Recommendations

The following recommendations can be drawn to accelerate RET micro financing in Nepal.

- RETs are bankable loan products for MFIs and there is huge market for financing RETs which not only improve the quality of life of the rural poor but also be a means for income generation through their productive uses.

- Capacity building is essential to attract MFIs into this sector. Capacity building efforts need to be done for MFIs as well as energy service providers so that they can complement each other to increase both their businesses.

- Related government agencies and program for RET promotion should give special attention towards increasing access of poor households in the RETs through facilitating micro finance access.
- Provision of guarantee fund and similar mechanism would be useful to build the confidence of commercial/development banks to provide wholesale loans to MFIs

- On the basis of the study findings, the report has provided some other following recommendations to enable the banks like CEDBL and BOK act as a national fund manager on RETs financing.

5.2.1 Awareness on Microfinance/Rural Finance for RETs

Awareness of the board of directors, management and key staff (including branch managers of CEDBL) on salient features of the microfinance/rural finance for RETs covering aspects such as strategic planning, operational planning, pricing, operational risk management, MIS, internal control requirements and benefits and costs associated with RETs financing under both model viz. (i) replication of existing wholesale lending modalities, and (ii) agent model to serve the need of the graduated clients.

5.2.2 Development of Operational Manual

CEDBL should be supported to develop operational manual for their involvement on RETs financing under both model. Each modality requires different operational system and manual and concerned staff should be trained on operational manual.

5.2.3 Access to concessional loan for financing RETs

One of the pre-requisite to enable CEDBL to work as national fund manager on RETs financing is the access to the concessional loan. Considering the existing financial market, in order to continue and sustain its operation, CEDBL should operate at 4% interest margin. Findings of the market analysis revealed that CEDBL can charge a maximum of 10% on wholesale loans and maximum 1% as service charge on loan disbursed. In this context, one of the pre-condition for CEDBL to operate as a national fund manager is access to sizable amount of concessional loans at 6% (maximum) interest rate.

5.2.4 Support to Develop Management Information System

CEDBL should be supported to develop the MIS to track the operational and financial performance of the partner MFIs on financing on RETs.

5.2.5 Strengthening/Capacity Building of Potential MFIs

CEDBL should be supported to identify and strengthen partner MFIs (cooperatives, FI-NGOs, MDBs) so as to prepare them to ensure access to finance for promoting RETs. Especially the capacity of these MFIs should be strengthened through following.

- Institutional audit/rating of partner MFIs (SCCs, SFCLs, MPCs, FI-NGOs and MDBs) and identify their strengths, weaknesses, opportunities and threats.

- Capacity building (based on their current status, institutional audit and ratings findings) of these MFIs on aspects such as
  - Governance,
  - New product development,
  - Business planning
  - Loan operation,
  - Accounting/book keeping,
  - Financial management,
  - Internal control,
  - Operational risk management,
  - Management information system,
  - Product diversification and
  - Service delivery mechanism.

The above areas are quite indicative and it is quite obvious that the types of strengthening and capacity building support required differs across typology of the partner MFIs and findings of the institutional audit/rating should provide basis for type of strengthening and capacity building support required for the partner MFIs.

- Support to these MFIs to comply with the requirement of CEDBL on RETs financing.

Staff Training

CEDBL need to recruit new staff with specialized skill and expertise on RETs financing, they must be adequately trained on various aspects of acting as a national fund manager on microfinance and RET financing. Some of the areas requiring such support on staff training include the following.

- Principles and practices of microfinance operation,
- Concept and challenges to act as national fund manager on rural finance and RETs.
- Preparation of operational manual,
- MIS system,
- MFI assessment, loan processing, follow-up and loan tracking,
- Operational risk management,
- Diversification of Products and Services
- Training on RETs,
- ToT training
- Interaction and discussion on national and regional best practices of micro finance and
- Other on-the-job trainings.

The above trainings are indicative only and other training should be designed on need basis for strengthening and capacity building of CEDBL staffs as and when required.

Development of operational system

CEDBL has been operating from branch level. Working relationship of the branch level rural finance staff, loan appraisal procedure, reporting at head office, MIS, internal control, loan processing and appraisal, quality control and assurance, etc. need to be worked out and concerned staff needs to be adequately trained to adopt this process.

Eligibility criteria and awareness on business opportunities from CEDBL

Eligibility criteria for the potential MFIs to be considered as a partner need to be worked-out and agreed. These criteria and emerging business opportunities for MFIs willing to involve on RET financing should be disseminated. A system of institutional audit as well as ratings of the selected MFIs should be done so as to enable CEDBL to ascertain which MFIs have potential to be the partner for RETs financing. Refer Annex 2 for proposed eligibility criteria for selecting partner MFIs.

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