NEPAL INCLUSIVE ECONOMIC GROWTH ASSESSMENT

MICROENTERPRISE DEVELOPMENT

JULY 2008

This assessment was produced for review by the United States Agency for International Development. It was prepared by Jason Wolfe and Carissa Page of the Microenterprise Development office in USAID/EGAT.

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ACRONYMS

ACCU	Asian Confederation of Credit Unions
ADB	Asian Development Bank
ADB/N	Agriculture Development Bank of Nepal
ADS	Automated Directives System
AIG	American Insurance Group
ASP	Application service provider
ATM	Automated teller machine
BDS	Business development services
BoK	Bank of Kathmandu
CECI	Canadian Center for International Studies and Cooperation
CGAP	Consultative Group to Assist the Poor
CGC	Credit Guarantee Corporation
CMF	Centre for Microfinance Nepal
CSD	Centre for Self-Help Development
DADO	District Agricultural Development Office
DCA	Development Credit Authority
DEPROSC	Development Project Service Centre
DLO	District Livestock Office
FINGO	Financial Intermediary Non-Governmental Organization
FNCCI	Federation of Nepal Chambers of Commerce and Industries
FSS	Financial self-sufficiency
GBB	Grameen Bikas Bank
GBNB	Grameen Bank Nepal Biratnagar
GDP	Gross domestic product
GTZ	German Technical Cooperation
ICT	Information and communications technology
IDE	International Development Enterprises
IIM	International Institute of Management
ILO	International Labour Organization
IME	International Money Express
IPO	Initial public offering
MDB	Microfinance Development Bank
MFI	Microfinance institution
MGBB	Madhyamanchal Grameen Bikas Bank
MIA	Micro Insurance Academy
MIS	Management information system
MOU	Memorandum of Understanding
MPGBB	Madhya Pashimanchal Grameen Bikash Bank
MSEs	Micro and small enterprises
MSMEs	Micro, small, and medium enterprise
MSP	Microfinance Service Provider
MTO	Money Transfer Operator
NACCFL	Nepal Agriculture Cooperative Central Federation Ltd
NEFSCUN	Nepal Federation of Savings & Credit Cooperative Unions
NGO	Non-governmental organization
NICB	Nepal Industrial Commercial Bank
NSSC	Neighborhood Society Service Center
NTFP	Non-timber forest product
OMB	Office of Management and the Budget
OSS	Operational self-sufficiency
PAR	Portfolio at risk
PDA	Personal digital assistant
PGBB	Western Region Grameen Bikas Bank
POS	Point of sale
PPP	Purchasing power parity
RBI	Reserve Bank of India
RMDC	Rural Microfinance Development Centre
ROA	Return on assets
RSRF	Rural Self Reliance Fund
SACCO	Savings and Credit Cooperative
SCG	Savings and Credit Group
SFCL	Small Farmers Cooperatives Ltd
SFDB	Small Farmers Development Bank
SHG	Self Help Group
SKBB	Sana Kisan Bikas Bank
SMEs	Small and medium enterprises
SPGBB	Sudur Pashimanchal Grameen Bikash Bank
SPS	Sanitary and Phytosanitary Standards
SRG	Self Reliant Group
SRO	Self Regulatory Organization
STI	Second Tier Institution
TA	Technical assistance
TOT	Training of trainers
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
VDC	Village Development Committee
VS&L	Village Savings and Loan
WDO	Women's Development Office
WEP	Women's Empowerment Program

EXECUTIVE SUMMARY

Microenterprise Development and Inclusive Economic Growth

Economic growth is a critical precondition for poverty reduction but may not be sufficient, by itself, to reduce poverty in a manner or timeframe that matches USAID objectives. A growing body of research shows that aggregate growth has a positive effect on poverty reduction but at different rates in different contexts. In countries with large gaps between the rich and the poor, evidence shows that the rich benefit more, earlier, and longer from economic growth than the poor. Where income gaps are relatively small, growth translates into poverty reduction much more quickly, efficiently, and sustainably. Broad-based growth reduces poverty, diminishing the burden on public resources to mitigate poverty's adverse effects. More importantly, broad-based growth increases the purchasing power of poor consumers who can then increase their consumption of goods and services that are more often produced locally. This demand for goods and services, in turn, creates demand for a larger workforce that is capable of producing those goods and services, which in turn increases employment, wages, and consumption. Broad-based, or inclusive, economic growth is thus a central strategy for achieving interrelated goals of economic growth and poverty reduction, particularly in contexts characterized by acute income disparities.

Focusing economic growth investments on those subsectors with a high participation of poor households can help to increase overall growth and reduce unequal income distribution. Most of Nepal's poor live in rural areas where there are very few possibilities for wage employment by SMEs and many more opportunities for casual or self-employment through MSEs (including smallholder agriculture). An inclusive economic growth strategy centered on MSEs can strengthen the channels by which the benefits of growth are transmitted to the poor as well as improve productivity and performance in key subsectors that drive overall growth. An auxiliary outcome of this approach is supporting USAID's congressional mandate for microenterprise development assistance.

Economic and Poverty Profile

Nepal's economy has performed well over the past 20 years, even through the prolonged Maoist insurgency, although average annual growth over this period has trended downwards. According to 2006/07 estimates, annual economic growth of 2.5 percent brought GDP to $29 billion PPP ($1,200 per capita PPP). Although Nepal continues to show a negative trade balance, its economy is kept afloat by substantial inflows of remittances from its large cadre of labor migrants (conservatively estimated at $1.5 billion in 2006/07 or 14 percent of nominal GDP). Remittances are solely responsible for Nepal's $58 million current-account surplus and the primary driver behind expanding domestic consumption. Agriculture dominates Nepal's economy, contributing some 38 percent to GDP compared to 20 percent for industry. Its effect on employment is even more substantial, with 80 percent attributed to agriculture. Yet agricultural GDP growth has remained relatively stagnant at just under 1 percent in 2005/06 and an estimated 0.62 percent in 2006/07 (in the four preceding years growth averaged 3-4 percent).

Poverty has decreased in Nepal over the past 15 years in both relative and absolute terms. With respect to the national poverty line, 31 percent of the population was characterized as poor in 2003/04, a decrease of more than 10 percentage points over the previous 10 years. During this same period, both income and consumption levels for Nepal's poorest quintile virtually doubled in nominal terms, a 22 percent increase when adjusted for inflation. While the poor have an undoubtedly better standard of living compared to the 1990s, data point to sharply growing inequality in income distribution. Annual income growth rates range from 2.5 percent for the poorest quintile to 6.4 percent for the richest quintile. The Gini index for Nepal grew from 34.2 percent to 41.4 percent between 1995/96 and 2003/04, indicating a widening disparity in income distribution and placing Nepal behind its South Asian neighbors.

Assessment of Enterprise Development in Nepal

Nepali export markets fall into two broad categories: mass-market exports driven by Indian markets and niche exports for markets in Europe and the United States. With a porous border and booming consumption, Indian markets easily absorb most of the agricultural and food products that Nepal can export. Competitive exports to Europe and the U.S. tend to have higher values per unit, to account for comparatively high transport costs, as well as higher degree of differentiation in terms of quality, branding, and marketing value. Domestic markets for most Nepali products and services are predominantly in urban areas, where per capita expenditure levels are growing and consumption patterns are shifting in response to rising middle and upper class incomes.

Nepal has a fairly enabling policy and regulatory environment for microenterprise. Due to the proliferation of cooperatives, business registration procedures have not visibly limited the creation, growth, and operations of microenterprise. Tax incentives for cooperatives and cottage industries further facilitate many types of enterprise formation and performance. Trade policies are generally conducive to the needs of many industries, although the perpetually precarious and mercurial relationship with India, Nepal's largest trading partner, is always a source of concern. The most significant constraint is the acute need for many industries, particularly in the agribusiness and food sectors, to better understand and conform to sanitary and phytosanitary requirements and other industry standards required for market access outside of Nepal. While many European and multilateral agencies are working with the Government to address this issue, USAID has a strong history of building private sector capacity in this area.

Vertical linkages between microenterprises and larger firms are woefully underdeveloped in Nepal and probably the single most critical constraint. Well-meaning donor and government strategies seeking to overcome the isolated and disadvantaged nature of rural microenterprises have in many cases empowered the producers but perpetuated their marginalization from the private sector at large. Cooperatives are continually formed for collective marketing of agricultural production but with few connections to buyers or end markets. These cooperatives are pushed to then take on more functions beyond bulking of member production: input and extension services, buying produce from non-members, transport, and retail. While cooperatives could be an appropriate vehicle in some cases to carry out these functions, they often do not take into account the presence of other private firms better equipped to do so and frequently crowd them out of the market. This worrying phenomenon has perpetuated a supply-driven mentality and, in many cases, demonized other private firms with whom they should be partnered. Improving vertical linkages in Nepali industries is critical for enhancing overall competitiveness and improving benefits to microenterprises.

Horizontal linkages among small and isolated producers are one of the biggest concerns for any market system in Nepal. Transport costs are already high in this country (due to poor road and transport infrastructure as well as Nepal's lack of sea access), so managing small transactions with large numbers of dispersed producers can easily make the difference between competitive and non-competitive pricing at the end market. Fortunately, horizontal linkages are already well developed in the form of cooperatives, especially in the agricultural and NTFP sectors. However, the performance of existing cooperatives is highly variable, and other means of horizontal linkages, which may be more informal or less participatory, are poorly developed.

Finance is an important support service for any business and is frequently the most pressing constraint expressed by microenterprises. Microfinance loan amounts are appropriate for many types of agricultural investments and working capital undertaken by microenterprises, though loan terms do not always meet their needs. However the large financing gap between microfinance (₨150,000) and commercial lenders (₨1,000,000) may stifle the emergence of traders and SMEs on whom microenterprises depend for market access. An underexplored source of finance relies on inter-firm relationships and often takes the form of embedded services (where the cost of providing the service is embedded in other commercial transactions between the firms). Beyond finance, other services required by existing microenterprises are fairly well established with agricultural extension services fairly available from the Government at the district level and a network of input and equipment suppliers fairly well established. As specific industries grow, however, the need for more diverse or specific services may outpace supply.

Assessment of Financial Services in Nepal

Nepal's microfinance sector is quite diverse. Microfinance service providers (MSPs) in Nepal can be roughly divided into "credit-led" providers and "savings-led" providers. Credit-led providers are professionally managed organizations in which the primary source of finance is from external sources rather than member savings. Savings-led providers are self-managed organizations that focus on the mobilization of member savings as a significant source of loan capital, as well as a service independent of credit.

Credit-led providers in Nepal enjoy easy access to cheap external capital to finance their operations. Indeed, not only are there three government-sponsored apex lending institutions in Nepal, but the commercial banks are also obligated to lend 3 percent of their portfolios to the so-called "deprived sector," which can include microfinance institutions. In fact, capital is so easy to access in Nepal that most credit-led institutions have become highly leveraged institutions and only invest a fraction of their portfolios in microfinance loans.

Despite easy to access capital and an enabling regulatory structure, the credit-led providers have had only limited success at reaching breadth and depth of outreach. This limited success is reflected in their slow growth, weak portfolio management, low profitability, artificially low interest rates and dependence on subsidies. Because credit-led microfinance relies on scale in order to be profitable, most of these institutions have concentrated their operations in more densely populated areas in the Terai. Financial access in the Hills and Mountain areas remain the frontier due to the higher transaction costs and higher risks of serving these populations.

There is also relatively little attention given within the credit-led sector to designing new financial products, like agriculture credit, insurance, and remittance-linked financial products, which could greatly increase assets and reduce vulnerability among poor households in Nepal. Remittances, in particular, are a huge overlooked opportunity given the fact that 80 percent are sent through informal means such as family or friends, and only 6 percent are saved in financial institutions.

Savings-led providers, also known as the cooperatives, are achieving much more breadth and depth of outreach than their credit-led counterparts. Cooperatives can be found in all five development regions of Nepal with relatively good coverage in places like the Hills. Additionally, many cooperatives are leveraging a wide spectrum of non-financial services, including literacy training, peace building activities, nutrition and reproductive health education, rural and agricultural development and the promotion of income-generating activities. They've also been successfully used as a mechanism for increasing people's access to the supply chain, capital markets, and appropriate production technologies

There are aspects of the cooperative movement, however, that call into the question the long-term sustainability of many of these institutions. In particular, there is a lot of anecdotal evidence that the quality of cooperatives is often quite low due to over-zealous government involvement, inadequate long-term incentives for NGOs to properly nurture groups and diminishing skill sets, particularly with regards to bookkeeping. Clearly it is important to balance expansionary goals with an increased attention to the quality of cooperatives.

While *commercial banks* are engaged in microfinance insofar as their deprived sector lending mandate requires, they are virtually absent from the small and medium enterprise sector, an underserved segment that arguably constitutes the single biggest constraint to subsector growth and upgrading in Nepal today. The credit gap between what microfinance providers and what banks will provide is particularly extreme between Rs. 150,000 and Rs. 20 lakh. The upper limit imposed by microfinance providers is due to the fact that their wholesale capital is largely earmarked as DSL capital, which is limited to loans under Rs. 150,000. Banks need to adapt their culture and operations to this market segment, a challenge which will be particularly difficult given regulatory challenges and the recent liquidity crunch.

At the *policy level*, the government in Nepal has long played an active, perhaps overzealous, role in promoting access to finance for the poor. While the government needs to get out of the business of being a direct provider of microfinance, it has, to its credit, provided the space for a diverse range of private microfinance providers to grow and flourish in the country. If anything, however, this permissive environment has resulted in too many institutions under the regulatory purview of the Central Bank. While some degree of regulation is important to prevent breakdown of the financial system, Nepal's Central Bank is so under-staffed that current regulation is not effective.

To rationalize the current policy framework, the Cabinet recently passed a "National Microfinance Policy" which proposes the creation of a second tier institution to regulate and monitor the activities of the entire microfinance sector, as well as a new apex wholesale fund which would distribute capital. While this policy was well-intended, the its authors clearly did not understand the inherent conflict of interest in having one institution be the regulator, promoter and finance wholesaler of microfinance. Now that the policy has passed the Cabinet, the Central Bank is being tasked with writing implementing regulations, and there is an opening to receive external assistance toward this end. The Central Bank is also in the midst revisiting a number of other policies which could have broad implications on the future of the microfinance sector in Nepal.

RESULTS	RECOMMENDED ACTIVITIES	CRITICAL ASSUMPTIONS
OBJECTIVE: Integrating microenterprises into growing and competitive market systems.		
1. Market systems objectively selected and prioritized for further analysis and possible intervention based on key criteria.	Selection and prioritization can be executed by USAID using internal expertise, by a contractor as an input to activity or procurement design, or by a partner as the first step to activity implementation. Major categories of criteria must include: potential competitiveness, probable participation of and benefits to microenterprises, and prospects for industry leadership. Additional crosscutting criteria might include potential impacts on the environment, women, or disadvantaged groups.	USAID provides leadership in defining key criteria. USAID takes into account the interest and activities of other donors, which may either complement or work at cross-purposes to USAID's objectives.
2. Opportunities for and key constraints to competitiveness identified and prioritized through opportunity-driven analysis.	Analysis should be executed by a partner as an initial phase of activity implementation. Analysis must examine both end-market opportunities and systemic constraints to supply response. Constraints should be filtered or prioritized by their importance to achieving identified opportunities for increasing competitiveness and benefits to MSEs.	USAID is clear about the purpose of such opportunity-driven analysis: to design strategic interventions and begin securing private-sector buy-in. Analysis is conducted in a participatory fashion that, at a minimum, vets findings with private-sector stakeholders.

RESULTS	RECOMMENDED ACTIVITIES	CRITICAL ASSUMPTIONS
3. Strategic interventions developed that address identified constraints, build on private-sector incentives, and contribute to competitiveness and MSE benefits.	Build off of previous donor and government investment in horizontal linkages. Focus on building and strengthening vertical linkages between microenterprises and lead firms. Facilitate and encourage firms to invest in upgrading in small, "riskable" steps. Link with opportunities for appropriate financing and other support services. Change uncompetitive behaviors and relationships.	Sound analysis and appropriate private-sector buy-in guide the design of strategic interventions.
4. Undertake a facilitative and adaptive approach to executing and managing strategic interventions.	Encourage firms to make new investments, change aspects of their operations, and engage in new relationships by understanding and helping to mitigate their risks. Avoid providing services directly to any type of firm, especially if such services are needed repeatedly over the long-term, in order to reduce dependency. Employ vigilant monitoring and a flexible intervention strategy to take advantage of emerging opportunities, address new constraints, and adjust approaches.	
OBJECTIVE: Building a diverse and inclusive financial sector serving the needs of microenterprises and poor households.		
1. Microfinance providers develop innovative, demand-driven financial products, reach out to underserved populations in the Hill areas, and introduce new delivery technologies that could help them reach scale more efficiently.	Create an Innovation Challenge Fund to develop new products like micro-insurance, remittance-linked products, and agriculture credit, etc.; to explore new delivery methodologies; and to test new business models for reaching hard to reach populations, vulnerable populations, and the very poor.	Grants are demand-driven and opportunistic. Donors base their investment decisions on social and financial criteria.
2. There exists a robust market for training and technical assistance support services that can meet the diverse and complex needs of microfinance providers at every phase of institutional development.	Increase the pool of qualified trainers through an internationally-accredited training of trainers (TOT) approach. Facilitate strategic "exposure visits" for key personnel within high growth institutions. Couple trainings to identified "high growth" institutions with a program of direct technical assistance on key constraints such as internal controls, MIS, human resources management, product development, accounting, financial analysis and business planning.	MSPs are willing to pay for TA and training, even if it is on a partially subsidized basis. The World Bank's Financial Access Initiative, which includes a capacity building component, remains on hold (at least for the next year) and complements project objectives.

RESULTS	RECOMMENDED ACTIVITIES	CRITICAL ASSUMPTIONS
3. The new National Microfinance Policy streamlines and rationalizes the former regulatory framework and enables the development of a diverse and inclusive financial sector in Nepal.	Place a long-term advisor within the Central Bank (NRB) to influence political decision-making during this critical juncture. Support existing efforts by the Center for Microfinance (CMF), the emerging Nepal Microfinance Network and any other sector-wide efforts to advocate for policy change	NRB continues to extend its invitation for technical assistance, and USAID can engage directly with the NRB. The policy that passed the Cabinet of Ministers has room for flexibility. The World Bank's Financial Access Initiative, which includes a policy component, remains on hold during this juncture. ADB/Manila is not providing TA to the Central Bank, and if it is, it will complement USAID assistance.
4. The cooperative movement increases its breadth of outreach in many underserved areas such as Hills, and its depth of outreach in terms of financial management and linkages to markets and non-financial services.	Build on past efforts to promote new cooperatives in underserved areas, while balancing these expansionary goals with an increased attention to the quality of cooperatives. Use a train the trainers (TOTs) approach in order to disseminate information and reach scale quickly. Leverage the cooperatives platform for the provision of non-financial services such as literacy training, peace building activities, rural and agricultural development and the promotion of income-generating activities.	There is a demand for savings and credit cooperatives in rural and remote areas that the movement has yet to reach. Economic opportunities exist to effectively link cooperatives in these areas to the supply chain.

1. MICROENTERPRISE DEVELOPMENT AND INCLUSIVE ECONOMIC GROWTH

In the newly revised ADS 219[1], USAID defines microenterprise as a very small enterprise owned and operated by poor people, usually in the informal sector. For USAID program purposes, the term is restricted to enterprises with 10 or fewer workers, including the owner-operator and any unpaid family workers. In FY2008 appropriating legislation, the U.S. Congress directed USAID to commit $250 million annually in foreign assistance for microenterprise development. ADS 219 further describes microenterprise development as any activity aimed at encouraging the formation of microenterprises or promoting the improved performance of existing microenterprises. USAID support for microenterprise development involves three types of activities: (1) microfinance to improve access to financial services tailored to the needs of poor households, including savings, credit, insurance, and remittances; (2) enabling environment improvements to reduce regulatory, policy and administrative barriers that limit the opportunities of MSEs; and (3) enterprise development to improve the productivity and performance of microenterprises. USAID may undertake activities exclusively to support microenterprise development in its own right or in a cross-cutting manner where microenterprise development serves to achieve other foreign assistance objectives.

Figure 1. Microenterprise Development at USAID

Economic growth is a critical precondition for poverty reduction but may not be sufficient, by itself, to reduce poverty in a manner or timeframe that matches USAID objectives. A growing body of research shows that aggregate growth has a positive effect on poverty reduction but at different rates in different contexts. In countries with large gaps between the rich and the poor, evidence shows that the rich benefit more, earlier, and longer from economic growth than the poor. Where income gaps are relatively small, growth translates into poverty reduction much more quickly, efficiently, and sustainably. Broad-based growth reduces poverty, diminishing the burden on public resources to mitigate poverty's adverse effects. More importantly, broad-based growth increases the purchasing power of poor consumers who can then increase their consumption of goods and services that are more often produced locally. This demand for goods and services, in turn, creates demand for a larger workforce that is capable of producing those goods and services, which in turn increases employment, wages, and consumption. Broad-based, or inclusive, economic growth is thus a central strategy for achieving interrelated goals of economic growth and poverty reduction, particularly in contexts characterized by acute income disparities.

Focusing economic growth investments on those subsectors with a high participation of poor households can help increase overall growth and reduce unequal income distribution. Most of Nepal's poor live in rural areas where there are very few possibilities for wage employment by SMEs and many more opportunities for casual or self-employment through MSEs (including smallholder agriculture). An inclusive economic growth strategy centered on MSEs can strengthen the channels by which the benefits of growth are transmitted to the poor as well as improve productivity and performance in key subsectors that drive overall growth. An auxiliary outcome of this approach is supporting USAID's congressional mandate for microenterprise development assistance.

2. ECONOMIC AND POVERTY PROFILE OF NEPAL

2.1. Structure and Performance of the Economy

Nepal's economy has performed well over the past 20 years, even through the prolonged Maoist insurgency, although average annual growth over this period has trended downwards. According to 2006/07 estimates, annual economic growth of 2.5 percent brought GDP to $29 billion PPP ($1,200 per capita PPP). Although Nepal continues to show a negative trade balance, its economy is kept

[1] The primary outcome of the 2008 revision to ADS 219 was to remove the previous exclusion on "crop production" as a microenterprise for USAID programming purposes.

afloat by substantial inflows of remittances from its large cadre of labor migrants (conservatively estimated at $1.5 billion in 2006/07 or 14 percent of nominal GDP). Remittances are solely responsible for Nepal's $58 million current-account surplus and the primary driver behind expanding domestic consumption.

Agriculture dominates Nepal's economy, contributing some 38 percent to GDP compared to 20 percent for industry. Its effect on employment is even more substantial, with 80 percent attributed to agriculture. Yet agricultural GDP growth has remained relatively stagnant at just under 1 percent in 2005/06 and an estimated 0.62 percent in 2006/07 (in the four preceding years growth averaged 3-4 percent). Topping 8 percent, the main contributors to growth in 2006/07 are predicted to be the transport, communications, storage, financial intermediation, and real estate sectors.

At 60 percent of aggregate trade value, India is Nepal's dominant trading partner followed distantly by China (13 percent), the United States (6 percent), and Germany (4 percent). Nepal's 76 other trading partners account for under 2 percent each of overall trade value. Roughly half of Nepal's exports go to India, with the United States (18 percent) and Germany (8 percent) the only other significant players. India also supplies more than 60 percent of Nepal's imports, with China (18 percent) the only other major partner. As might be expected, India accounts for more than 70 percent of Nepal's $875 million trade deficit.

2.2. Nature and Determinants of Poverty

Poverty has decreased in Nepal over the past 15 years in both relative and absolute terms. With respect to the national poverty line,[2] 31 percent of the population was characterized as poor in 2003/04, a decrease of more than 10 percentage points over the previous decade. During this same period, both income and consumption levels for Nepal's poorest quintile virtually doubled in nominal terms, a 22 percent increase when adjusted for inflation. Due to recent spikes in food and fuel prices (up to a 30 percent increase), purchasing power among the poor has certainly declined but the full impact is not yet known.

Figure 2. Income Distribution by Geographic Area

While the poor have an undoubtedly better standard of living compared to the 1990s, data point to sharply growing inequality in income distribution.[3] Annual income growth rates range from 2.5 percent for the poorest quintile to 6.4 percent for the richest quintile. The Gini index[4] for Nepal grew from 34.2 percent to 41.4 percent between 1995/96 and 2003/04, indicating a widening disparity in

2 Nepal calculates poverty lines for each region of the country based on the monetary value of a representative basket of food containing 2,124 kilocalories per day plus other normal household expenses. In 2003/04, the poverty lines of a typical six-person household equaled Rs. 5,500 per month in Kathmandu and Rs. 3,000 per month in the Terai.

3 While we refer to "income" in this section out of convenience, most of the data cited relate to "consumption." Statistical sources, such as the NLSS, rely on household consumption measures as a proxy for most poverty analysis since these data are generally more accurate and reliable than household income estimates.

4 The Gini coefficient is a measure of statistical dispersion commonly used to indicate inequality of income or wealth distribution. It is defined as a ratio between 0 and 1, with 0 representing perfect income equality (everyone has exactly the same income) and 1 representing perfect inequality (one person has all the income). Thus, lower Gini coefficients indicate less income inequality and high scores correspond to more inequality. The Gini index expresses the Gini coefficient as a percentage rather than a ratio.

income distribution and placing Nepal behind its South Asian neighbors (compared with 28 percent in Pakistan, 31 percent in Bangladesh, and 33 percent in India). Disaggregating this trend by income segment, recent analysis shows reduced inequality among the poorest segments (2 percent decline between "poor" and "very poor"), moderately expanding inequality in middle-income segments (6 percent increase between "middle class" and "poor" and 8 percent increase between "upper middle class" and "middle class"), and explosive growth in disparity at the upper ends (27 percent increase between "rich" and "middle class"). As might be expected, data also point to spatial disparities with 85 percent of the Kathmandu Valley falling into the highest (richest) quintile, while poverty is mostly concentrated in rural areas, particularly the Eastern Hills and Western and Eastern Terai.

2.3. Social Exclusion

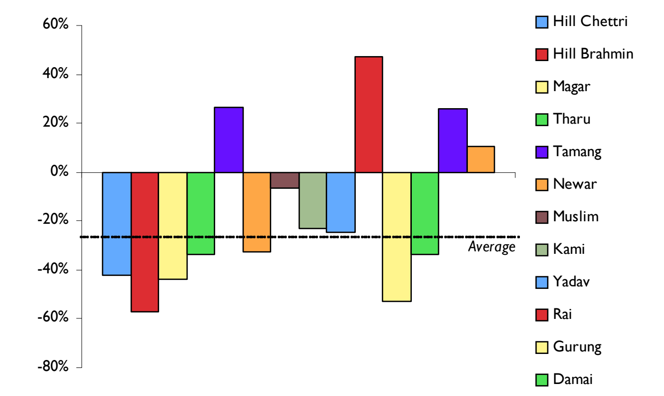

Figure 3. Change in Poverty Rates by Caste/Ethnic Group between 1995/96 and 2003/04

Nepal's social structure is influenced by a complex web of divisions that derives from caste, ethnicity, geography, and religion and corresponds with specific socio-religious status and expectations. Major divisions include Brahmins/Chettris, Janajatis, and Dalits, which are then often subdivided according to location (Hills or Terai). Persistent differences in poverty status according to these social divisions indicate the economic exclusion of disadvantaged groups. The more advantaged groups (Brahmins, Chettris, and Newars) exhibit lower poverty rates (14-18 percent), while nearly half of Hill Janajatis and Dalits are classified as poor. Even over time, poverty reduction among higher-caste groups has occurred at twice the national average while progress has been slower among the disadvantaged groups, with some actually experiencing higher poverty rates. Poverty seems to be deepest among the Hill Janajatis, particularly in the Eastern Hills, and among the Terai Dalits.

Traditional gender roles encourage households to invest more resources in education and nutrition for boys than for girls: 65 percent of Nepali women are illiterate compared to 33 percent of men and the gender gap is even higher for completion of various levels of education. While sociocultural norms continue to limit the economic opportunities available to women, the most acute barrier to economic empowerment appears to be women's lower education and skill levels. In rural areas, 90 percent of women working outside the home are either self-employed or casual laborers in agriculture (compared to 75 percent of men). Both agricultural and non-agricultural wages are significantly lower for women than for men, especially for unskilled jobs in which women's wages have actually declined in real terms and are half the rate earned by men. Growing labor migration is changing women's roles in the household and society as male heads of household are absent for long periods of time and women are left behind to manage the household, agricultural activities, and remittance receipts. Female-headed households exhibit poverty rates below the Nepali average and tend to either work from home or spend fewer hours working outside the home. While unskilled women in typical households may be forced to undertake suboptimal economic activities to make ends meet, remittances may provide a critical safety net that allows women to make more informed or longer-term decisions about their labor.

3. ASSESSMENT OF ENTERPRISE DEVELOPMENT IN NEPAL

3.1. Market System Approach

After decades of experimenting with varying approaches for understanding and intervening in microenterprise development, USAID now advocates a market system approach for its enterprise development assessments and assistance. Microenterprises are not homogenous: just because they share a similar size and serve a common development objective does not mean they share the same constraints and opportunities. Microenterprises do not exist in isolation but rather depend on a network of relationships with suppliers, service providers, and buyers to function. Limiting assessments only to firm-level factors affecting business operations risks overlooking key external drivers of enterprise performance.

This assessment accordingly employs a market system perspective to analyze microenterprise needs and opportunities and to ultimately prioritize programming options available to USAID. The analytical framework incorporates both structural and dynamic factors that affect the contributions microenterprises make to their market system and the benefits they derive from it. Ideally such an assessment would first select market systems according to key criteria before examining these factors. However, given time and resource constraints, the analysis makes general observations about each of these factors and then reviews the relative strengths and weaknesses of high-profile market systems.

3.2. Structural Factors

The structure of market systems includes all the firms involved in the system and is characterized in terms of the following elements:

- <u>End Markets</u> define opportunities for market systems by determining the characteristics—including price, quality, quantity and timing—of a successful product or service. Any assessment should begin with an understanding of end market dynamics, and end market competitiveness should provide the benchmark by which all other opportunities and constraints are prioritized.
- <u>Enabling Environment</u> circumscribes the limits of market opportunities. Norms and customs, laws, regulations, policies, international trade agreements, and public infrastructure (roads, electricity, etc.) at multiple levels can either facilitate or hinder the movement of a product or service through the market system. Useful analysis of the enabling environment will examine the implementation or enforcement of such policies and not just their existence.
- <u>Vertical Linkages</u> describe the relationships between firms performing different functions in the market system and are critical for moving a product or service from inception to the end market. Vertical linkages can increase the efficient flow of goods and services toward the end market as well as benefits, embedded services, and information in the opposite direction.
- <u>Horizontal linkages</u> describe relationships—whether formal or informal—among firms performing similar functions in a market system. Horizontal linkages can reduce the transaction costs for buyers to work with many small suppliers as well as help small firms to increase their market power and generate economies of scale.
- <u>Supporting Markets</u> include financial services, sector-specific services (e.g., irrigation equipment and product design services), and crosscutting services (e.g., business consulting, legal advice, and ICT) that firms need to operate, upgrade, and innovate. If these services are needed repeatedly or over the long term, they must be provided commercially: either by other actors in the supply chain or by independent service providers.

End Markets

In terms of exports, Annex C analyzes overall market growth and Nepal's market share for 3,089 products (using official trade statistics) to indicate Nepal's export competitiveness in select end markets. The results are dramatic. In the world market, Nepal's exports are highly uncompetitive, with only 9 percent demonstrating both rising market demand and market share and an astounding 80 percent showing falling demand, which may indicate that Nepali exporters are erroneously staying active in contracting markets. The U.S. market follows the world market trend, with 85 percent of Nepal's exports experiencing reduced demand. By contrast, Nepal's exports appear highly competitive with India, its largest trading partner, where 68 percent of exports enjoy rising market demand (more than half of which also show rising market share). This cursory analysis is not a condemnation of Nepal's export potential but rather a wake-up call for Nepal's export industries to better understand the dynamics of the markets in which they operate and to develop proactive strategies to regain or sustain competitiveness. For the purposes of this assessment, Nepali export markets fall into two broad categories: mass-market exports driven by Indian markets and niche exports for markets in Europe and the United States.

With a porous border and booming consumption, Indian markets easily absorb most of the agricultural and food products that Nepal can export. Nepal's varied geography gives it a comparative advantage to produce a range of agricultural products during Northern India's off-season or shoulder seasons. For higher-value products, such as non-timber forest products and tea, India has a history of augmenting its own production with supplies from Nepal. Two threats mitigate the remarkable opportunities offered by this end market. Trade relations between Nepal and India are complex and more or less constantly under strain. India is beginning to implement stricter sanitary and phytosanitary requirements on its agricultural and food imports, which Nepali firms need to understand and incorporate in order to maintain market share.

Competitive exports to Europe and the U.S. tend to have higher values per unit, to account for comparatively high transport costs, as well as higher degree of differentiation in terms of quality, branding, and marketing value. Many of these market segments exhibit a greater long-term resilience to demand fluctuations and desire long-term relationships with suppliers, which are highly valued attributes for poor producers. Nevertheless, these markets also tend to have very exacting standards, high degrees of collusion, and little transparency – all of which constitute formidable barriers for new entrants and suppliers in search of new markets for their products. Many of the NTFP exports prized in Nepal are destined for these markets, including an array of essential oils, handmade paper, and various gums and resins. These markets also demonstrate the highest demand for products bearing many types of certifications: organic, fair trade, and forest stewardship. Nepal has also been successful in developing commodity-based industries (e.g., coffee and tea) by targeting niche markets in these countries building on unique product characteristics (e.g., semi-washed processing for coffee and orthodox processing for tea) rather than the traditional price-based, mass-market appeal of these commodities.

Domestic markets for most Nepali products and services are predominantly in urban areas, where per capita expenditure levels are growing and consumption patterns are shifting in response to rising middle and upper class incomes. Consumer demand is increasing for higher-value agricultural products, such as year-round vegetables or dairy products. Foreign imports are feeding a large part of this domestic demand. While Nepal may not be able to compete with the likes of India and China for material goods, there are clear opportunities for import substitution in many agricultural products.

The tourism market merits a separate discussion as it involves the flow of people rather than products and payment generally occurs locally rather than in the country where the tourist originates. The Nepali tourism industry counted nearly 400,000 foreign arrivals in 2005 and estimates about 500,000 arrivals for 2007, with about 60 percent coming to Nepal for pleasure/holiday or trekking/mountaineering and roughly 25 percent coming for pilgrimages. International competitiveness has waned in recent years as heightened security consciousness among tourists after 9/11 coincided with expanded public awareness of the Maoist insurgency. Moreover, recent increases in fuel costs worldwide have contributed to a decline in airlines serving Nepal and an overall increase in air transport pricing. Increased competitiveness of Nepal's tourist industry must clearly focus on higher-end, niche markets for mountaineering, adventure tourism, and other nature and culture enthusiasts. While these market segments tend to be more resilient to price fluctuations and security concerns than mass-market tourists, their high standards and desire for unique experiences are more difficult to assess and satisfy. However, ongoing security concerns and unpredictable disruptions from *bandhs* and strikes continue to threaten the industry's appeal to end markets. The magnitude of domestic tourism is more difficult to measure, but motivation seems to be driven by holiday/pleasure, pilgrimages, and visiting relatives. More analysis is needed on this untapped market, as it may constitute a more attainable market for nascent tourism enterprises, provide an intermediate stepping stone to serving foreign clientele, and hedge against the notorious seasonality associated with foreign tourists.

Enabling Environment

Nepal has a fairly favorable business enabling environment affecting those classified as microenterprises. Firms with annual revenues under Rs. 2,000,000 ($29,411) are deemed microenterprises and exempted from taxation. Cooperatives, which tend to comprise microenterprises as members, are subject to reduced taxation levels of around 15 percent. Cooperative registration is also a straightforward process and can usually be accomplished in any district headquarters in about two days. The business enabling environment for small and medium enterprises may be more constraining.

Sector-specific policies and regulations can be problematic, especially where multiple ministries are involved. Policy coordination among ministries is notoriously difficult or completely absent. In particular the NTFP sector can require deft navigation through a series of ministries covering agriculture, cooperatives, commerce, forestry, and the environment to operate within the legal framework. Accordingly, substantial NTFP trade occurs through informal means or illicit channels. While most other sectors are less burdened by such dysfunction, the sizeable magnitude of informal commerce suggests that inappropriate policies, inadequate policy coordination, and/or weak policy enforcement abound; however, they do not seem to have a significantly negative effect on the performance of most sectors.

The most binding constraints in the enabling environment include poor transport infrastructure, an unreliable energy supply, weak access to justice, and a tenuous security situation. While improvement continues, Nepal's diverse and rugged topography gives it the least dense road network in South Asia, which adds significant cost to economic transactions. While access to electricity and fuel is quite widespread, even in rural areas, supply is not inadequate and load-shedding and fuel shortages are frequent. While many microenterprises often enter into contractual relationships with buyers and financiers, the crippled judiciary system gives neither party much recourse in the event of violations. Finally, the widespread violence associated with the Maoist insurgency has abated, yet the current political transition has kept Nepal under much instability and unpredictable disruptions (e.g., strikes and *bandhs*), which authorities seem incapable or unwilling to prevent.

Vertical Linkages

Vertical linkages between microenterprises and larger firms are woefully underdeveloped in Nepal and probably the single most critical constraint to inclusive economic growth. Well-developed vertical linkages are fundamental to price competitiveness as they reduce transaction costs and efficiently move products from inception to market. However, they are equally important for facilitating information transfer, innovation, and collective action within a market system. Typically lead firms at the top of the supply chain have the closest contact with end markets and the best position to understand the demand requirements and trends. Their ability to effectively and efficiently transfer this information to producers through backward linkages forms the basis of competitive supply response in the industry, which has implications for profitability for both the lead firms and their microenterprise suppliers.

Well-meaning donor and government strategies seeking to overcome the isolated and disadvantaged nature of rural microenterprises have in many cases empowered the producers but perpetuated their marginalization from the private sector at large. Cooperatives are continually formed for collective marketing of agricultural production but with few connections to buyers or end markets. These cooperatives are pushed to then take on more functions beyond bulking of member production: input and extension services, buying produce from non-members, transport, and retail. While cooperatives could be an appropriate vehicle in some cases to carry out these functions, they often do not take into account the presence of other private firms better equipped to do so and frequently crowd them out of the market. This worrying phenomenon has perpetuated a supply-driven mentality and, in many cases, demonized other private firms with whom they should be partnered. Improving vertical linkages in Nepali industries is critical for enhancing overall competitiveness and improving benefits to microenterprises.

Cooperatives' supply-driven mentality restricts their choice of market channels: lacking strong relationships with lead firms, they often do not understand and, accordingly, cannot meet product requirements for the end market. This phenomenon effectively bars them from access to more formal, differentiated, and high-value market channels and keeps them in informal markets where they have to compete on price and efficiency alone. Informal markets provide diminishing returns over time and do not constitute an effective strategy for growth or poverty reduction over the long term.

Lead firms in many sectors seem desperate to establish stronger and longer-term linkages with microenterprise suppliers. Such backward linkages are critical in a context like Nepal for lead firms to acquire marketable quantities, but they are also fundamental prerequisites for lead firms to pursue new market opportunities. With such strong incentives to establish backward linkages, many lead firms are beginning to provide a host of embedded services to attract and maintain these relationships (the section below on "Supporting Markets" provides greater detail). This is an ideal opportunity for many microenterprises, at least over the short term, if they are able to see value through the haze of the cooperative movement.

Horizontal Linkages

Horizontal linkages among small and isolated producers are one of the biggest concerns for any market system in Nepal. Transport costs are already high in this country (due to poor road and transport infrastructure as well as Nepal's lack of sea access), so managing small transactions with large numbers of dispersed producers can easily make the difference between competitive and non-competitive pricing at the end market. Fortunately, horizontal linkages are already well developed among clusters of producers throughout Nepal, especially in the agricultural and NTFP sectors.

Cooperatives comprising various sorts of small-scale producers are the primary form of horizontal linkages found in Nepal. The Ministry of Cooperatives estimates that 10,000 cooperatives are currently registered in two categories, single-purpose and multiple purpose, with the majority as single-purpose, meaning that they focus on one product, sector, or function. Their profusion is partly due to the relative ease in registering them (taking as little as two days in almost any district headquarters) and to decades of donor interest in promoting them. The promise of shareholder dividends from cooperative profits and the empowering sense of belonging to a group also provide substantial motivation and should not be undervalued. Other formal means of horizontal linkages, such as Community Forest User Groups and Private Limited Companies, have stricter requirements and may require a visit to Kathmandu to complete the registration process.

Other means of horizontal linkages, which may be more informal or less participatory, are poorly developed. Perhaps due to the influence of donors, many producers seem unwilling to undertake collective action until motivated by an outside party or formalized as a cooperative. Moreover, the frequently valuable agglomerating role provided by local traders seems to have been pushed aside by donor and government interest in cooperative formation.

The performance of existing cooperatives is highly variable. Some lead firms have characterized cooperatives as highly vulnerable to political influence or cooptation: examples abound where the individuals leading cooperatives (the executive committee) are selected for their social status rather than management ability, contribute and benefit less to the cooperative's economic activities than the average member, and control or distort information to maintain their own power. In other instances, cooperatives have formed for one purpose (for instance, savings and credit activities) and evolve or drift over time into other economic activities for which their membership and structure may not be ideally suited. Finally, many cooperatives formed for collective marketing of agricultural produce will typically buy or represent any producer regardless of whether s/he is a member. As these cooperatives effectively crowd out private traders but struggle to provide exclusive or value-added services to members, they often seek to take on other functions for which they are not capable or well suited.

Supporting Markets

Finance is an important support service for any business and is frequently the most pressing constraint expressed by microenterprises. The supply of certain types of finance is better in some parts of Nepal than is often encountered in other developing countries. A wide array of intermediaries provide various forms of microfinance, but coverage is generally restricted to urban areas and many rural parts of the Terai. Microfinance loan amounts are usually capped at Rs. 60,000 ($882) for uncollateralized loans (usually secured through solidarity groups) and Rs. 150,000 ($2,206) for individual loans secured with real estate collateral, though a handful institutions will lend up to Rs. 500,000 ($7,353) under certain conditions (see section 4.2 for a more thorough discussion of retail microfinance). Commercial bank loans do not typically come down below R1,000,000 ($14,705) and require real estate collateral. Microfinance loan amounts are appropriate for many types of agricultural investments and working capital undertaken by microenterprises, though loan terms do not always meet their needs. However the large financing gap between microfinance (Rs. 150,000) and commercial lenders (Rs. 1,000,000) may stifle the emergence of traders and SMEs on whom microenterprises depend for market access. Bank of Kathmandu (in potential partnership with IFC) is exploring entry into this market.

An underexplored source of finance relies on inter-firm relationships and often takes the form of embedded services (where the cost of providing the service is embedded in other commercial transactions between the firms). Many agrovets will offer credit to a small number of their most reliable clients on input purchases, which is then repaid in installments over the growing season or in one balloon payment at harvest. As the agrovet is often a member of the same community, strong social pressures guarantee repayment; providing this type of supplier credit can also help to strengthen the agrovet's relationship with key clients. Limited working capital is typically the main barrier to expanding the number of clients offered this service. A more innovative model is being piloted in the dairy sector involving a tripartite arrangement between farmers, a financial institution, and a dairy processor. The farmer enters into a loan agreement with the bank to purchase livestock with the condition that its milk will be sold to the processor, who withholds a small percentage from the farmer's payment to make loan payments directly to the bank. Embedded financial services are most common when independent services from the financial sector are not available or appropriate, or when lead firms wish to strengthen their relationships with suppliers or clients with added services. As industries mature or business models become more proven, embedded financial services tend to spin off or absorb into independent financial institutions.

Sector-specific support services are routinely required by microenterprises in the agricultural and livestock sectors. These consist of a range of extension services, input and production equipment supply, and veterinary assistance. Established service suppliers primarily include line agency staff in the districts (such as DADO and DLO extensionists) and private agrovets and paraveterinarians. Breadth of supply is generally good though not always very deep: service providers can be found in most every district headquarters but frequently do not extend into the VDCs. Though line agency staff are generally competent and well trained, insufficient staffing or funding may constrain their operations. Agrovets and paravets are often limited by a real or perceived lack of demand for their services, though proven models do exist for entering new and potentially weak markets with minimum risk exposure. Some cooperative also either provide support services directly to their members or act as a conduit for outside service providers. Embedded services from lead firms are not widely available, though several efforts (in particular with agrovets and dairy processors) have demonstrated great promise.

Those supporting services used by firms across different sectors are variably available in Nepal. Providers of accounting/auditing, human resources, and management consulting services can be found in urban centers but are generally geared to larger or mature businesses, and markets for such services have generally been weak among smaller or more rural firms. The supply of ICT and other telecommunications services are growing in Nepal, especially with the advent of competition in the mobile phone industry, and there is great potential to leverage these services to reduce transaction costs in many of Nepal's traditionally fragmented industries.

3.3. Dynamic Factors

Dynamic factors influencing market system performance characterize how firms in the market system respond to the opportunities and constraints described by the structural factors detailed above. These dynamic elements include:

- Upgrading refers to the investments made by firms to achieve higher levels of efficiency, increase product differentiation, or reach new markets, which results in a more competitive market system and greater benefits for its participants. Factors governing this process include a clear market opportunity, a supportive enabling environment and the availability of critical services including finance, technology and information.
- Inter-firm cooperation and competition describe the extent to which firms work together to achieve increased industry competitiveness and greater benefits while simultaneously competing for supply and market share. Nascent or immature market systems tend to demonstrate limited cooperation and a high degree of competition that erodes overall market share and stifles innovation. Cooperation in more mature industries facilitates action on common constraints, joint interests, and a shared vision for overall competitiveness, even as individual firms still pursue their own business strategies.
- Power Dynamics in market systems shapes the incentives that drive behavior and determines which firms benefit from participation in an industry and by how much. Relationships can range from highly dependent, where one party dominates, to balanced, where all parties involved have some power that they can wield. In any given industry, relationships can cover the full range, and these relationships can change depending on shifting market demands. Power in value chains typically translates into benefits. The firms able to wield power through branding or access to worldwide suppliers and those traders in a chain able to control information can often exact a larger share of benefits from producers and suppliers.

Upgrading

Upgrading entails a range of proportional risks and returns, both real and perceived, for firms in a market system. The five types of upgrading are described below in order from the lowest risk/return to highest:

- Process upgrading improves overall efficiency or productivity resulting in reduced cost or price per unit produced.

- Product upgrading enhances the marketability, quality, or differentiation of an existing product, such as producing a bigger tomato or acquiring organic certification.
- Functional upgrading occurs when a firm takes on or moves into a new function, such as farmers bulking their production at a common buying station or traders becoming exporters.
- Channel upgrading pursues new markets for products, such as moving from informal vegetable markets to formal supermarkets.
- Sectoral upgrading implies that firms enter into a completely new sector or market system.

Beyond understanding what kinds of upgrading are most needed, especially among microenterprises, in Nepali market systems, it is critical to examine why these kinds of investments are not already occurring on their own. When market systems are not performing well, microenterprises may not receive the right kinds of information or market signals to fully comprehend the potential returns on upgrading investments. Similarly market failures may limit the availability of supporting services (such as finance, inputs, equipment, or training) that any firm requires to invest in upgrading. Finally, smaller enterprises, especially those operated by the very poor, may perceive risks and returns very differently from larger, more mature, or more resource-rich firms.

The need for process upgrading is acute in many sectors, and the costs and risks are low especially in relation to the expected returns from such investments. Particularly in agricultural sectors, farmers need higher rates of productivity (i.e., increasing yields with comparatively little increase in inputs and labor) to become more competitive and increase their returns. Only about 20 percent of Nepal's land is arable, and the average farm size of 0.8 ha (15.75 *ropani*) continues to fragment and diminish. Agricultural expansion is generally not feasible, so higher returns to agriculture are only possible with more intensive agriculture. This is possible through cultivation of higher-value crops, productivity-enhancing techniques, and prolonged growing seasons. Returns to labor are also fairly low, whether in agriculture or in other sectors, which helps to justify low wage rates but is also a drag on competitiveness (the garment sector being a notable example). The means for investing in process upgrading are generally available in Nepal, so why is the uptake so low? This requires further investigation in target sectors, but two possible reasons are evident. Some support services, such as finance, are not appropriately designed for the needs of microenterprises: for instance, agricultural loans may not be large enough for necessary investments or may require immediate installment payments months before they begin generating revenue. Market signals may also not reach microenterprises to indicate the potential returns they could accrue from investing in process upgrading, which would be consistent with the weak vertical linkages observed in most sectors.

Product upgrading is very related to product or market differentiation, but the cause and effect is not always clear. As new markets show growing demand for differentiated products, suppliers will usually respond by upgrading their products to take advantage of these trends. Conversely, market saturation may prompt innovation among suppliers, who differentiate their products in the hope of segmenting the market. In either case, little product upgrading is occurring in Nepal, with the exception of high-value, niche industries like NTFPs where there is sizeable investment in quality upgrading, various certifications, and branding. Low investment in other sectors may be due to unsaturated markets (so that markets have no desire to pay for differentiation) or, again, lack of market signals reaching microenterprises due to weak vertical linkages.

The need for certain kinds of functional upgrading is pervasive throughout many market systems in Nepal. Weak or missing functions frequently occur where microenterprises need to interface with downstream firms or vice versa. The many cooperatives formed to facilitate product agglomeration have frequently undertaken additional functional upgrading (such as brokering sales with nonmembers or other cooperatives, quality control, storage, processing, and even retail), often in evident pursuit of vertical integration and with variable success. Often this functional upgrading is not a critical need, as other firms in the market system are already carrying out this function, and it only serves to crowd out other, more capable firms or distort the operations of the overall market system. In other cases, lead firms need upgrading to improve their ability to deal with existing and new microenterprise and cooperative suppliers.

Channel upgrading is not yet a tangible requirement for the majority of Nepali firms, as most markets remain fragmented, undifferentiated, and predominantly informal. For lead firms to identify and move into more formal and differentiated markets, they will undoubtedly require closer and stronger relationships with their microenterprise suppliers to meet these new market requirements.

There is no doubt that many firms in Nepal are currently involved in economic activities that are uncompetitive or have low economic returns. However, sectoral upgrading is only likely to occur when new opportunities emerge in other growing sectors. Such change will be driven by dynamic lead firms capable and willing to invest in new suppliers as well as by the demonstration effect from early adopters in the community.

Inter-Firm Cooperation

Competitive market systems are based on commercial relationships between firms and some degree of cooperation in areas of shared interest or constraints. These characteristics are not common features of the economic landscape in Nepal.

Among microenterprises, relationships are primarily driven by social, rather than commercial, considerations. The community and caste ties that bind individuals together in cooperatives are excellent catalysts for collective trust and action but not a sound basis for business decisions over the longer term, as evidenced by cooperative leaders chosen for their social status rather than business acumen. Even larger or mature firms have a reputation for collusion and nepotism in Nepal based on social and family connections. While social factors are absolutely critical entry points and for building and maintaining trust in an market system, commercial factors must form the basis of business decisions over the longer term to achieve competitiveness.

Nepal demonstrates a high degree of cooperation primarily among firms performing the same function, as demonstrated in the plethora of cooperatives and trade associations, or among broadly heterogeneous groupings such as the various chambers of commerce. It is rarer to find formal or informal networks of firms in the same sector that pursue collective action around common interests or constraints. This kind of cooperation is vital to, at a minimum, agree on a common vision for the industry that can rationalize its structure and practices as well as catalyze action. Such cooperation can often provide a highly effective constituency to advocate for changes in specific policies affecting the industry.

Power Dynamics

Power asymmetries between firms in Nepal generally result in nontransparent transactions and a pervasive lack of trust, which raise transaction costs, stifle upgrading and innovation, and are an overall drag on competitiveness. These dynamics conform to the following governance patterns:

- Market-Based: the majority of firms engage in arms-length relationships, where few firms know either where their supplies originate or which end markets receive their outputs. Few firms wield much power to influence the structure, performance, or direction of these market systems. This pattern is highly typical of the informal market channels that dominate much of Nepal's economic activities and is a strong disincentive to the product or market differentiation required for achieving competitiveness.
- Balanced: enterprises involved in Nepal's niche industries (like NTFPs, coffee, and tea) are more likely to exercise some degree of power to set conditions of trade. This accumulation of power may help firms to negotiate longer-term contracts, command some price premiums, and negotiate more favorable terms of payment or delivery.

- Directed: very few Nepali businesses appear to participate in directed relationships, where their buyers have a substantial degree of control over their operations. As this governance pattern encourages a great deal of investment in suppliers, many successful industries worldwide have been able to leverage these relationships to upgrade rapidly and achieve competitiveness.

3.4. Key Subsectors/Value Chains

The preceding assessment of structural and dynamic factors is a generalization of observed trends in Nepal. Actionable recommendations will require a selection of high-potential market systems and a closer examination of these factors in those specific contexts. This assessment did not include sufficient time, data, or resources to undertake such a sector selection process. Yet some level of overview and analysis of promising sectors may be useful, at a minimum to indicate the potential utility and impact of USAID interventions.

The SWOT analysis elaborated below indicates helpful and harmful elements of each industry's current attributes (strengths and weaknesses) as well as its competitive environment (opportunities and threats). The sectors reviewed below were identified based on their prominence in the export competitiveness assessment (Annex C), previous USAID intervention, and popularity among other donors, development practitioners, and government agencies. Their inclusion in the SWOT analysis does not imply endorsement.

Cardamom

	Helpful	**Harmful**
Internal	Strengths Large cardamom is only produced in the Himalayan region (cardamom produced elsewhere is a different species). An estimated 70,000 families produce cardamom in Eastern Nepal on 12,000 ha of land with an annual yield of nearly 7,000 MT. In recent years area under cultivation has increased by 29%, production by 100%, and productivity by 59%.	Weaknesses Little agricultural extension and technical assistance are available for cardamom producers. Suboptimal on-farm processing yields a poor-quality finished product. Village and wholesale traders have poor storage facilities. Exporters and other lead firms have low capacity and poor understanding of international markets and trends.
External	Opportunities Top large cardamom producers are Nepal, India (Sikkim) with 33%, and Bhutan. Indian (Sikkim) production is falling due to disease. Bhutanese production has also declined due to land tenure issues and widespread disease.	Threats Signs of disease have already appeared in Nepal and could threaten the Nepalese industry as in India and Bhutan. Nepal relies to a great extent on India for exports and is subject to nontransparent and asymmetrical market channels as well as tenuous trade relations.

Dairy

	Helpful	Harmful
Internal	Strengths The parastatal Dairy Development Corporation is privatizing its four processing plants for liquid milk (with one sale already concluded). Private dairies are making new investments in processing capacity, especially for powdered milk (in Pokhara and Chitwan). Livestock rearing is a widespread activity (estimated 80 percent of rural population). The sector has at least a few catalytic lead firms with demonstrated resources and incentives to invest in suppliers. Dairy cooperatives are very common (they are the second most common type registered with the Ministry of Cooperatives).	Weaknesses Nepal's poor transport infrastructure increases transaction costs. Producers have very low productivity, partly due to poor animal health, and many raise cattle for subsistence rather than off-farm sales. Milk supply is highly seasonal: the six-month lean season yields 70 percent less than the six-month flush season. Producers tend to raise only one or two animals, implying a strong need for agglomeration. Cooperative leadership may not make rational business decisions due to a lack of commercial orientation or business acumen. Producers and cooperatives have little experience with the contracts required by private dairies and demonstrate a high frequency of side-selling
External	Opportunities Nepal has a sizeable and growing domestic market for milk and other dairy products. Powdered milk is a critical input to Nepal's dairy industry in order to smooth its supply of liquid milk to the market throughout the year India recently banned powdered milk exports, putting pressure on the Nepali dairy industry to find alternative sources for powdered milk. There are possible opportunities for export to India, which is unable to meet domestic demand for dairy products.	Threats New powdered milk plants in Nepal may be overcapitalized, especially if they are unable to secure adequate supplies of raw milk. Domestic powdered milk production is nascent and unproven against imports, especially if India lifts its ban on exports.

Essential Oils

	Helpful	Harmful
Internal	Strengths Its unique topography and high levels of endemic biodiversity give Nepal a significant comparative advantage for producing essential oils from both collected and cultivated sources. High labor requirements, low financial returns on labor, high degree of seasonality, and small quantities of output make essential oils production highly appropriate for remote and very poor populations. Nepal has an established capacity and reputation for producing certain essential oils. Essential oils' high value per volume/weight is optimal for Nepal's high transport costs due to poor transport infrastructure and lack of sea access.	Weaknesses Initial capital investments in processing infrastructure may exceed producer expectations for returns on investment (though it is profitable, it may take several years to break even) and not match the availability of financing (in excess of $20,000) for this population segment. The bulk of returns for essential oil production comes from processing: limiting producer involvement only to raw material collection or cultivation does not typically provide sufficient financial returns to sustain their participation, yet the levels of functional upgrading required may require long-term support. Remote production centers are very vulnerable to poor transport infrastructure and information asymmetries. The need for strict quality control, certification/traceability schemes, and close relationships with foreign buyers often exceeds the capacity of producers and/or exporters.
External	Opportunities Essential oils are used in a plethora of products by a variety of industries depending on the individual oil (e.g., foods, cosmetics, perfumes), which diversifies risk exposure. Essential oil buyers tend to prefer close and long-term relationships with their suppliers. Nepal's progressive land use and economic tenure policies for ecologically sensitive areas can protect the resource base for collected raw materials and offer an additional opportunity for communities to benefit financially from essential oil production.	Threats Global trade in essential oils is notoriously nontransparent, collusive, and heavily driven by reputation; identifying and cultivating new buyers can be extremely difficult. Certain certifications (e.g., organic, FSC, fair trade) may be a prerequisite for accessing many of the niche market buyers that dominate the global essential oils market, even though these certifications may add little value, and often substantial costs, for producers. Nepal's land use policies require resource management and monitoring plans in order to secure access and economic tenure, which frequently surpass communities' capacities to develop and implement on their own.

Ginger

	Helpful	Harmful
Internal	<u>Strengths</u> Nepal has widespread comparative advantage for ginger production, with at least 15,000 farmers producing 16,000 MT per year in Palpa district alone. The ginger industry is taking advantage of growing opportunities for value addition and diversification through drying and other processing. Some functional upgrading and specialization is occurring in the ginger industry, especially among apex cooperatives, and at least one lead firm is entering the industry with strong export linkages. Farmers can reportedly earn up to $10,000 per hectare and also intercrop ginger with maize.	<u>Weaknesses</u> Relying on nontransparent and collusive Indian traders for accessing the Indian market leaves Nepal in a vulnerable position. The ginger industry is still predominantly informal and fragmented, which can limit incentives for quality improvement, understanding market preferences and trends, and investments in upgrading.
External	<u>Opportunities</u> Consumption of ginger appears to be growing both domestically and in nearby India.	<u>Threats</u> None observed.

Tea

	Helpful	Harmful
Internal	<u>Strengths</u> Tea production has grown in Nepal. Leveraging linkages to established Indian buyers/exporters is a good short-term strategy for capturing market share and a competitive edge. Clear industry competitiveness strategy focuses on higher-value market segments interested in quality (specialty tea) and niche markets interested in unique origin and various certifications. Comparatively lower labor costs supports industry focus on more labor-intensive cultivation and processing practices.	<u>Weaknesses</u> Continued reliance on Indian buyers and little domestic processing and marketing capacity puts Nepal in a highly vulnerable position and limits longer-term prospects for increasing market share and share of final retail price. Lack of brand identity and testing/validation facilities negates any potential value added by unique quality, origin, and certification attributes.
External	<u>Opportunities</u> Nepal's team imports have declined dramatically since the mid-1990s, implying an increase in market share for tea domestic production. Worldwide market for tea appears to be growing. While the specialty tea market is not well defined, the presumed market for specialty tea in Germany and other European markets is growing. SAPTA gives Nepal preferential access to South Asian regional markets over tea producers such as Kenya.	<u>Threats</u> Periodic and unpredictable trade restrictions with India disrupt access to Nepal's primary market channel for tea and create a climate of uncertainty within the industry. Reliance on India for market access inappropriately ties Nepal's tea competitiveness strategy (specialty, quality, and niche) to India's (blends, low-cost, and mass-market).

Tourism

	Helpful	Harmful
Internal	<u>Strengths</u> Nepal features a range of unique destinations and experiences. Nepal has extensive established tourism infrastructure. The tourism industry has moderately effective mechanisms for coordination, planning, and destination marketing. Tourism has a strong knock-on effect, with experts estimating that each tourist supports anywhere from one to nine jobs in Nepal.	<u>Weaknesses</u> Air connections to prime regions of tourist origin (Europe and North America) have been reduced. Government support is uncertain in light of the political transition and constant rotation of senior civil service staff in the Ministry of Tourism Major tour operators are content to sell the “golden triangle” of Kathmandu-Pokhara-Chitwan and unwilling to innovate or diversify into newer products. Foreign tourism is highly seasonal.
External	<u>Opportunities</u> Nepal’s tourists have a reputation for repeat visits. Nepal has traditionally sold well as an add-on to India and Thailand itineraries. Niche markets for adventure, nature, and cultural tourism are growing faster than other segments and also tend to be more resilient to price and security fluctuations than mass-market tourists Regional tourism is growing, particularly from India and Thailand, especially among younger segments and in the business/conference market.	<u>Threats</u> Negative viral marketing: generally, one bad experience can dissuade 1,000 tourists from choosing Nepal, while one good experience might encourage only 20 tourists to choose this destination. Domestic security: continued travel advisories create strong disincentives for certain market segments Unpredictable strikes and *bandhs* can severely limit or disrupt tourist mobility inside the country

Vegetables

	Helpful	Harmful
Internal	<u>Strengths</u> Its varied topography and microclimates give Nepal a comparative advantage for year-round vegetable production. The number of farmers cultivating vegetables in the off-season has nearly doubled since 1995/96, with 61% of farmers growing summer vegetables in 2003/04. Vegetable production can involve a wide range of farmers: from poor Hill farmers on marginal lands to more established Terai farmers with access to more resources. Fairly adequate and improving network of agrovets supplying equipment and inputs needed for vegetable production.	<u>Weaknesses</u> Inefficiencies abound in Nepal’s vegetable industry: highly informal and fragmented supply chains, poorly organized farmers producing individually small amounts, dysfunctional cooperatives with little knowledge of and few connections to markets, and poor transport and storage infrastructure unsuited to highly perishable products.
External	<u>Opportunities</u> End markets appear to be growing due to the growing urban middle class in Nepal and increased consumption in India. There are significant opportunities for off-season, shoulder-season, and niche-market vegetables from Nepali farmers. Potential opportunities for multiplying and exporting high-quality vegetable seed (requires further investigation and corroboration).	<u>Threats</u> Seasonal gluts from poorly timed agricultural calendars destabilize market prices and discourage farmers. Nepal’s climatic comparative advantages can be eroded by infrastructure investments in suboptimal locations (e.g., Indian farmers using greenhouses).

4. ASSESSMENT OF FINANCIAL SERVICES IN NEPAL

4.1. Financial System Approach

This assessment uses a "financial system" approach to assess Nepal's microfinance sector and to identify recommendations that can help a build a more inclusive financial sector. This approach is founded on the assumption that work is needed at three levels to ensure that large numbers of poor people have access to a diverse range of financial services: the micro level (retail financial institutions), the meso level (financial market infrastructure), and the macro level (policy environment).

4.2. Micro Level

The micro level of the financial system refers to the retail financial institutions in a country which have the potential to serve poor households. Retail institutions form the backbone of any financial system and include many types of institutions, including, but not limited to, private and state-owned banks, microfinance development banks (MDBs), Savings and Credit Cooperatives (SACCOs), Financial NGOs (FINGOs) and non-bank financial institutions such as postal banks, insurance and money transfer companies.[5]

Vision

Looking ahead, a vibrant and dynamic Nepalese microfinance sector should continue to develop the capacity of a broad range of financial institutions, as well as a range of delivery mechanisms (such as "branchless banking"), to ensure that diverse needs are met within the sector, including the desire to achieve both breadth and depth of outreach. The sector should also provide a diverse menu of products and services beyond microenterprise credit that meet the demands of poor households, including but not limited to savings, insurance, money transfer services, and housing and education credit.

Retail Institutions

There are currently four major types of microfinance service providers (MSPs)[6] in Nepal:

- Savings and Credit Cooperatives (SACCOs)
- Small Farmers' Cooperatives Limited (SFCLs)
- Financial Intermediary NGOs (FINGOs)
- Microfinance Development Banks (MDBs)

These institutions can be roughly divided into "credit-led" MSPs and "savings-led" MSPs. Credit-led MSPs, which include the FINGOS and MDBs, refer to professionally managed organizations in which the primary source of finance is from external sources rather than member savings.[7] Savings-led MSPs, which include the SACCOs and SFCLs, refer to self-managed organizations that focus on the mobilization of member savings as a significant source of loan capital, as well as a service independent of credit.

[5] See CGAP's *Good Practice Guidelines for Funder of Microfinance: Microfinance Consensus Guidelines*, October 2006 (2nd edition). http://www.cgap.org/p/site/c/template.rc/1.9.2746.

[6] "MSP" in this report is used an all inclusive term which refers to all types of providers in Nepal, including SACCOs, SFCLs, FINGOs and MDBs.

[7] In Nepal, credit-led institutions also offer savings facilities, but more as an ancillary service that is tied to the provision of credit.

Savings-Led Microfinance Providers

Savings and Credit Groups (SCGs)[8] have long existed in Nepalese society. SCGs are typically a group of five to sixty individuals, usually poor women, who regularly pool small amounts of thrift savings, ranging from Rs. 10 to 100 per month, into a common fund from which they can borrow when necessary. Sometimes NGOs promote and nurture SCGs, sometimes they are formed spontaneously or with the assistance from existing groups on a fee-for-service basis, and more and more frequently, the Nepalese government is promoting SCGs.[9]

As these groups have increasingly multiplied across Nepal, tens of thousands have opted to join the estimated 3,500 "Savings and Credit Cooperatives" (SACCOs) that are currently registered and monitored by the Department of Cooperatives. These cooperatives are typically a two, sometimes three, tiered structure, with many SCGs forming a federation. Not only does this structure provide a platform for SRGs to act collectively and leverage non-financial services, it also serves certain financial functions, such as enlarging the pool of capital that is collected within the individual SCGs and providing an institutional structure for SCGs to access external capital from commercial banks, NEFSCUN, or the Central Bank's National Self Reliance Fund (NSRF).

Even a cursory analysis of the cooperative sector in Nepal reveals that this movement is much more than a rural credit initiative. For many NGOs across Nepal, SACCOS are a means to provide financial services to the poor in a manner that lends itself easily to many other kinds of development and social empowerment. Indeed, the group lending setup itself requires that poor, often illiterate women develop leadership, conflict resolution, and financial management skills. Also, SACCOs provide a platform for the provision of a wide spectrum of non-financial services, including literacy training, peace building activities, nutrition and reproductive health education, rural and agricultural development and the promotion of income-generating activities.

For example, the Women's Empowerment Program (WEP), implemented by PACT and funded by USAID from 1996 to 2000, provided a small stipend to 240 NGOs, cooperatives and MSPs to train 6,500 groups in financial management skills, with literacy training as a fully integrated and central component.[10] World Education's program, which is currently funded by USAID, takes a similar approach, delivering a package of modules to SCGs on literacy, conflict mitigation and financial management through a network of local NGOs. By all accounts, including the beneficiaries themselves, these projects have been hugely successful at empowering women, promoting literacy, improving livelihoods and reducing vulnerability to income shocks.

Many SACCOs are organized around a single sector (so-called "single purpose cooperatives"), such as dairy or ginger, working cooperatively to disseminate information, negotiate favorable prices and hook into end markets. There are also many "multi-purpose cooperatives" that are working across several sectors, or have multiple objectives beyond savings and credit. For example, the Small Farmers Cooperatives Ltd. (SFCLs), promoted by the government's Agriculture Development Bank (ADB/N) and GTZ, have provided 219 SACCOs across Nepal a branded platform for farmers of all kinds to hook into agricultural extension services provided by the government, including veterinary services and various income generating skills training. There are also many other multi-purpose

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8 SCGs have many alternative names, including, but not limited to, Village Savings and Loans (VS&Ls), merry-go-rounds, Self Help Groups (SHGs), Savings and Credit Organizations (SCOs), and Accumulating Savings and Credit Associations (ASCAs).

9 There are many agencies and offices of the Nepalese promoting SCGs, including the Department of Cooperatives, the Agricultural Development Bank of Nepal (ADB/N), the District Development Office (DDO), the Village Development Committee (VDC) and the Women's Development Office (WDO), among others.

10 The WEP program promoted a "Village Banking" model which is related to the SACCO model. In this case, the cooperatives are not linked to external capital, groups total 25 members, mandatory savings tend to be higher, and loan cycles are 16 weeks long. At the end of each loan cycle, the profit from interest income is distributed as dividends, and members have the option to exit the group or reinvest their dividends and receive a larger loan.

farmers cooperatives (without the SFCL branding), including several currently promoted by the USAID-funded SIMI project, that are linking up with marketing and planning committees.

On top of the social and economic benefits provided by programs like WEP, World Education and the SFCL initiative, there are also real financial and efficiency advantages to this model of "microfinance" over more traditional Grameen-style microfinance. The process of institution building is not nearly as costly, and programs to promote groups generally require no additional subsidies once the groups have been formed.[11] For example, groups trained under WEP have organically promoted and formed thousands of new groups with no financial support from any NGO or government entity.

Also, unlike the Grameen-style microfinance approach, many SACCOs provide flexible loan terms and repayment schedules and issue loans with less delays (11 days on average once all documents have been provided).[12] In the case of the SFCLs, loan terms are as long as three years, loans are high as Rs. 50,000 and interest-only grace periods are often provided upwards of six months. Such terms are better suited for agricultural activities where cash flow tends to be intermittent and seasonal. While the SFCLs are unique because they have access to larger sources of long-term capital from the Small Farmers Development Bank (SFDB) (see Meso Level sub-section on "Access to Capital"), many other cooperatives also customize loans depending on the purpose for which the loan is intended.

Despite all these successes, much remains to be done to maximize the initiative's potential. While savings-led microfinance has successfully established operations in all the development regions (unlike credit-led microfinance), it continues to be mostly concentrated in the Hills and the Terai. The inaccessible Hills and the Mountain areas remain relatively underserved.

Additionally, there are aspects that of the cooperative movement that call into the question the long term sustainability of many of the SACCOs. While the formation of federations is a promising development to this end, there is a lot of anecdotal evidence that the quality of SACCOs is often quite low. This has been attributed to over-zealous government involvement, inadequate long-term incentives for NGOs to properly nurture groups and diminishing skill sets, particularly with regards to bookkeeping. The portfolio quality of cooperatives varies widely across the country, depending on literacy levels and the quality of training that the group received during its establishment. The director of NEFSCUN estimated that much as 10 to 20 percent of the total cooperative portfolio is now at risk of default, although, thanks to the group guarantee structure, default at the apex level is typically limited to 2 to 5 percent.

If the cooperative movement is truly to reach its potential, donors like USAID should ramp up efforts to promote new SCGs and SACCOs in underserved areas since these districts are home to many of the poorest in Nepal where there are no credit-led microfinance service providers. At the same time, USAID must be careful to balance these expansionary goals with an increased attention to the quality of SACCOs, particularly with regards to financial management. Train the trainers (TOTs) approaches, such as that employed by WEP and World Education, can be very effective at disseminating information and reaching scale quickly. Also key is time-limited support in which the NGO acts as a catalyst of group development to ensure that the movement is self-sustaining.

Finally, USAID needs to consider innovative ways that SACCOs can be used as a mechanism for increasing people's access to the supply chain, capital markets, and appropriate production technologies. For example, Winrock's microfinance program, funded by USAID, is linking SACCOs to the

[11] Wholesale capital provided from the Rural Self Reliance Fund (RSRF) is provided at concessional interest rates. However, most SACCOs do not access capital from this Fund and rely only on internal resources.

[12] See Aurora Ferrari, "Access to Financial Services in Nepal," *World Bank Directions in Development: Finance* (2007), Available from www.worldbank.org, pg 20.

government and energy companies to improve access to renewable energy technologies.[13] Once electrified, communities can then enhance the production of a variety of these income-generating activities such as poultry and dairy farming. Other enterprise development programs should similarly leverage the cooperative platform to overcome financing constraints and better meet project objectives.

Credit-Led Microfinance Institutions

In addition to the thousands of NGOs in Nepal which are promoting or leveraging the cooperative movement, there are also 47 NGOs that have obtained licenses under the Financial Intermediary Act of 1998 so that they can directly undertake financial intermediation. Known as FINGOS (Financial Intermediary NGOs), these institutions are replicating the Grameen model introduced in Bangladesh in which a centrally managed MSP organizes members into groups of five in a highly disciplined joint guarantee structure. The FINGOs' focus is mostly on credit, although a recent law passed in 1998, the Financial Intermediary Societies Act, now allows them to also collect savings from members of their groups. Generally speaking, FINGOs in Nepal tend to be characterized by loose governance, frequent changes in management, and lack of ownership, traits which have inhibited this sector from reaching scale.

The 1996 Development Banks Act allowed for the transformation of certain FINGOs into regulated microfinance development banks (MDBs) and resulted in the commercialization of four high-performing FINGOs: Nirdhan Utthan, DEPROSC, the Centre for Self Help Development (CSD, now Swabalaban), and Chhimek. This new regulatory structure established minimum capital requirements and provisioning norms, helped enhance the ownership and governance structure of these institutions, boosted institutional stability, and enabled them to raise capital for their operations on better terms. All of these institutions base their operations in the densely populated Terai, although increased competition is gradually pushing MDBs to reach clients in more sparsely populated areas as well. The recently piloted "Self Reliant Group" (SRG) model,[14] which relies on larger, self-managed solidarity groups that link directly to MDBs, has demonstrated initial success at cost-effectively reaching the Hill areas. However, it should be noted that it still takes about five years to reach break-even profitability in the Hills, as opposed to two years in the Terai.

In addition to the private sector MDBs, there are also five public sector MDBs which have been promoted by the government in the five development regions of Nepal. Known as Regional Rural Development Banks (RRDBs) or Grameen Bikas Banks (GBBs), these institutions have not been successful with regards to sustainability and portfolio quality. In the last couple years, two of these banks have been privatized, although time is yet to tell whether these privatizations will turn them around.[15] The RRDBs continue to face ongoing challenges, which have not been helped by the Maoists' recent declaration that they may forgive loans to the public banks.

Despite easy access to capital and an enabling regulatory structure, the MDBs, both public and private sector, have had only limited success at reaching breadth and depth of outreach in Nepal. This limited success is reflected in their poor outreach, slow growth, high liquidity, weak portfolio management, low profitability, and dependence on subsidies. Although the nine regulated MDBs only represent only a very small percentage of the entire credit-led sector, they are broadly representative of the issues faced by other credit-led institutions as well.[16]

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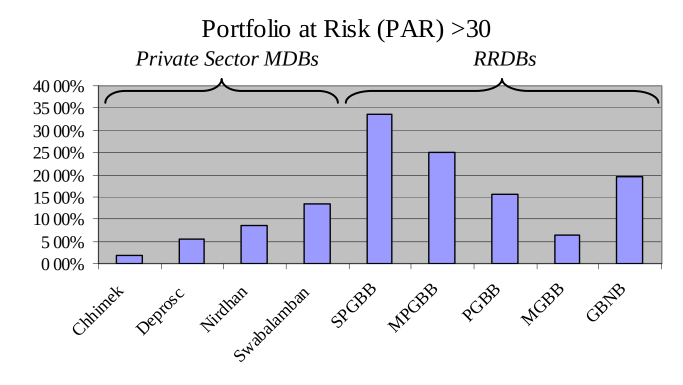
[13] Under this cost share model, the government pays 80 percent and the user pays 20 percent of the cost of connecting up to the grid.

[14] The SRG model is very similar to the Self Help Group (SHG) model in India in which SCGs link directly to banks.

[15] In the analysis below, the recently-privatized RRBs are lumped in with the remaining three public sector RRBs because sufficient time has not passed for management to turn around their portfolios.

[16] See Aurora Ferrari, *World Bank*, 36.



- Poor Outreach. [17] In addition to poor outreach to the Hill and Mountain areas, Nepal's MDB's are also not reaching 'very poor' populations. Using their average loan balance (expressed as a percentage of GDP) as a proxy for poverty, none of these institutions have reached below the 20 percent benchmark that is widely regarded as an indicator of depth of outreach. In 2007, the average loan balance as a percentage of GDP stood at 50 percent for the private sector MDBs and 41 percent for the RRDBs.
- Slow Growth. Over the 2006-07 financial year, the combined outreach of the four private sector MDBs grew by only 13 percent, a rate which registers well below global trends.[18] Even more disappointing, the combined outreach of the five RRDBs grew by only 5 percent.
- High Liquidity. Because of easy access to capital provided at highly concessional rates, many institutions prefer to save their capital in safe investments, where the spread is often quite large, rather than invest it as loan capital. In 2005, 15 percent of the portfolio of MDBs was kept as cash-on-hand or call deposits. Another 22 percent was parked in safe investments such as bonds or certificates of deposit.[19]

[17] A commonly used metric for depth of outreach is an estimate by which the average loan balance is used as a proxy for average income level. The assumption behind this indicator is that very poor people cannot afford large loans, and that relatively less poor people are not interested in small loans. For comparison across countries or regions, this indicator is most useful if it is expressed as a percentage of a country's per capita GDP.

[18] This statistic was heavily influenced by Nirdhan, which reduced its portfolio by 1 percent over this period. In contrast, DEPROSC and Chhimek's growth exceeded 25 percent.

[19] See Aurora Ferrari, *World Bank*, 66.

- Weak Portfolio Management. Portfolio management is perhaps the single biggest challenge to future MDB growth in Nepal. At 7.3 percent and 20 percent for private sector MDBs and RRDBs respectively, PAR >30 is among the highest in the region and creates a significant drain on revenue, profit and sustainability. (PAR below 5 percent is widely regarded as an indication of strong portfolio quality.) It should be noted, however, that writing off bad debt is considered a taboo practice in Nepal, so these numbers may be slightly inflated.

Figure 4. Portfolio at Risk

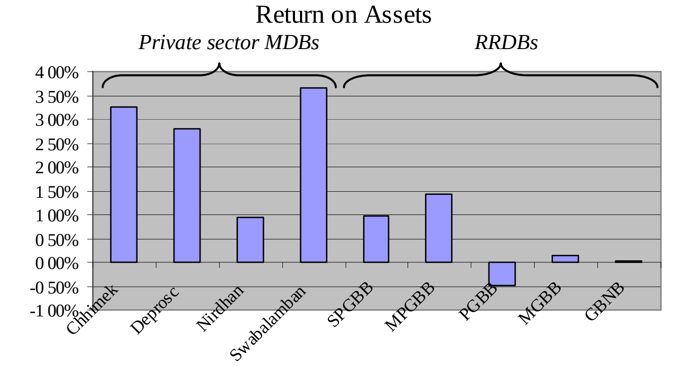


Figure 5. Return on Assets

- Low Profitability. While all but one of the MDBs are profitable, returns tend to be weak or bordering on break-even profitability. Over the 2006-07 financial year, the private sector MDBs averaged 2.66 percent Return on Assets (ROA), while the RRBs averaged 0.42 percent.
- Dependence on Subsidies. All but one of the nine MDBs have reached operational self-sufficiency (OSS). However, a better metric for sustainability, financial self-sufficiency (FSS), measures the extent to which an institution's financial revenue covers its costs, including indirect costs covered by subsidies. While sufficient data does not exist for this metric across the sector, it is likely that none of the MDBs have reached this benchmark since all depend heavily on wholesale capital provided at below market interest rates to sustain their operations. According to one source, Nirdhan (which is arguably the leading MDB in Nepal) has only reached 98 percent FSS.

Despite all of these challenges, operating expenses among the MDBs are actually quite due to low salaries, high staff productivity [20] and a concentration of activities in densely populated areas. The operating expense ratio for the nine MDBs averaged only 6.5 percent in 2007. To put this into perspective, 15 percent or below is widely considered an indicator that an institution is "operationally efficient." Given this cost structure, one way in which MDBs might consider increasing outreach, improving profitability and moving toward financial self-sufficiency is to raise their interest rate. Indeed at 15 to 24 percent, it is among the lowest in the region, if not the world.

Commercial Banks

There are no private commercial banks in Nepal that are currently engaged in retail microfinance. Instead, their role in this sector is limited to their obligations under the Deprived Sector Lending (DSL) mandate imposed by NRB (see Meso Level sub-section on "Access to Capital"). Banks generally meet their DSL requirements by providing wholesale loans to MSPs, investing share capital in these institutions, or paying penalties (or a combination of the three).

Additionally, ever since "priority sector lending"[21] phased out last year, commercial banks have for the most part ceased lending to small and medium enterprises (SMEs),[22] an underserved segment

[20] See Hari Dhakal, 23.

[21] In years past, commercial banks in Nepal were required to lend 12 percent of their portfolios to the "priority sector," which included SMEs, with 3 percent channeled to the very poor or "deprived sector." The government phased out the priority sector lending mandate in July 2007 but maintained the deprived sector lending mandate.

which arguably constitutes the single biggest constraint to subsector growth and upgrading in Nepal today. According to one World Bank study, 77 percent of small businesses have no outstanding loans and are entirely dependent on retained earnings or supplier credit to meet their financing needs.[23] The credit gap between what MSPs and what banks will provide is particularly extreme between Rs. 150,000 and Rs. 20 lakh, a segment which is served by virtually no financial institutions in the market.[24] The upper limit imposed by MSPs is due to the fact that their wholesale capital is largely earmarked as DSL capital, which is limited to collateral-free poverty loans under Rs. 60,000, or collateralized loans under Rs. 150,000.[25]

Unfortunately there are several policy challenges at the macro level which discourage the development of a robust SME finance sector in Nepal (see Macro Level sub-section on "Enabling Environment for Commercial Bank Downscaling"). Despite these regulatory challenges, there is at least one commercial bank, Bank of Kathmandu, which has shown interest in establishing first mover advantage in SME finance. BoK management believes that the SME segment is a vast untapped market and represents a new frontier which could help them expand and diversify their product portfolio. The bank also has good leadership in its General Manager, who recently visited Bangladesh and saw firsthand commercial banks which have successfully downscaled into this market.

Unfortunately, BoK's engagement in SME finance to date has not been met with much success.[26] The bank has found the operating expenses of evaluating risk and monitoring SME loans, particularly in the rural and remote areas of the Hill and Mountain areas of Nepal, to be prohibitively high. Management also observed that the country's past experience with state-owned banks has damaged the credit culture, with many rural borrowers not placing high value on timely payments.

In recent months, BoK signed an MOU with the International Finance Corporation (IFC) to provide advisory services, via an international consultancy firm, in developing an SME unit. The hope is that this TA will help BoK adapt its culture and operations to this new market segment. As part of the TA, the bank will likely streamline lending procedures, develop appropriate products and pricing policies, and learn how to do cash flow analyses for small businesses. Staff will also likely be trained on how to develop trust and better communicate with small business owners.

Although plagued by many challenges, many commercial banks around the world have managed to overcome these obstacles with proven models of profitable and effective small business lending. Often times, however, TA alone is not enough to encourage banks to take risks in untested frontiers like SME finance, particularly at a time when Nepal's financial sector is faced with a liquidity crunch due to capital flight surrounding the elections, an increase in remittances and two major Initial Public Offerings (IPOs). For this reason, USAID may want to consider leveraging IFC's TA to Bank of Kathmandu with a 50 percent Development Credit Authority (DCA) partial credit guarantee directed toward a particular subsector or value chain. Of course, because TA to BoK is still in the concept phase, it may make sense to wait a year or two to seriously consider this possibility.[27]

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22 It's important to note that there is no common definition, either within the government or the private sector, for what constitutes an "SME" in Nepal.

23 Aurora Ferrari, *World Bank*, 28

24 Between $2,206 and $29,411

25 The definition of "deprived sector lending" used to be under Rs. 40,000, but new regulations were passed about a year ago raising the limit.

26 BoK has lent Rs. 5 to 10 lakh for several essential oil distillation enterprises in collaboration with BDS-MaPS and has also worked with Practical Action to lend for dairy production.

27 Commercial banks in Nepal engaging in SME finance currently have access to 80 percent partial credit guarantees from the government-sponsored Credit Guarantee Corporation (CGC), but this scheme is unreliable since claims are issued on a first-come-first-serve basis as long as the fund is liquid. In contrast, DCA guarantees are legally binding commitments backed by the full faith of the U.S. government to share in up to 50 percent of a private lender's realized losses. One thing to keep in mind, however, is that Nepal's country risk rating, assigned by the Office of Management

New Financial Products

Mature microfinance sectors that are demand-driven and responsive to the diverse needs and demands of poor households offer financial products beyond consumption and microenterprise credit. Indeed, study after study across the developing world has shown that the demand among poor households for products like savings and micro-insurance which increase assets and reduce vulnerability are much greater than that for microenterprise credit.

Unfortunately, while there is a large focus on savings within the Nepalese microfinance sector, there is relatively little attention given within the credit-led sector to designing new products, like agriculture credit, insurance, and remittance-linked financial products, which could have a huge impact on poor households in Nepal. Additionally, products that are launched tend to be supply driven rather than demand driven, with almost no formal process for collecting market research, developing a marketing strategy and internal systems to launch a product, and understanding the factors that contribute to the product's success. USAID can help catalyze such innovations in product development by providing seed capital for the design, pilot and launch of new products.

Annex D, Annex E, and Annex F provide more information on agricultural credit, micro-insurance and remittance-linked products in Nepal and opportunities for strengthening the provision of these services.

Innovative Delivery Models

Because microfinance relies on scale in order to be profitable, most credit-led institutions have concentrated their operations in more densely populated areas in the Terai. Financial access in the Hill and Mountain areas remains the frontier due to the higher transaction costs and higher risks of serving these populations. Lower population density and the poor conditions of roads mean loan officers have to travel longer distances and spend more time in the field to reach their clients. There is also more security risk in carrying and transporting cash in rural areas; indeed, there are many stories of MSP loan officers in Nepal getting robbed during the insurgency. These factors, combined with the fact that clients are poorer so loan and deposit amounts tend to be smaller, make banking rural populations an unattractive proposition for most MSPs in Nepal to date.

Some commercial banks and MSPs in other countries have used information and communications technologies (ICT) as a potential solution for addressing these challenges. These approaches are often referred to as "branchless banking" because each uses technology and cash-handling non-bank agents to reduce the need for expensive branches.

The ICT approaches used can be categorized as follows:

- *Direct Banking*: having existing clients handle their transactions directly via Internet banking or Automated Teller Machines (ATMs) or their mobile phones.
- *Non-Bank Agent Networks*: using point-of-sale (POS) terminals in retail stores and outlets to provide banking services.
- *Mobile/portable banking*: taking the bank close to the customer by putting it on wheels or by equipping loan officers with portable devices (PDAs) to simplify loan processing and improve staff productivity.

So far, no MSPs in Nepal have engaged in direct bank or non-bank agent networks, although DFID is in the midst of conducting a feasibility study on the potential for mobile banking in Nepal. Also,

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and the Budget (OMB), is a nine (out of ten), which means that the subsidy cost of providing a DCA could be prohibitively high. This is another reason to revisit this intervention opportunity at a later date since the country risk rating is re-established each fiscal year.

one source suggested that ATMs in Nepal only require 125 to 150 transactions per day on average to reach break-even profitability (as opposed to 250 in India), suggesting that it may be viable for MSPs to leverage this platform in certain areas.

In terms of mobile/portable banking, Nirdhan is currently looking into the possibility of purchasing PDAs[28] as it continues its rural expansion plans.[29] These devices allow loan officers to download local collection and disbursement information in real time in the field, so that no manually-generated collection sheet is required, and then automatically upload information from the PDA to the computer, saving them the time required to re-enter meeting data. Particularly as MSPs like Nirdhan scale up operations in the Hills and other impoverished areas where break-even profitability at the branch level takes as long as five years (as opposed to two years in the Terai), PDAs could be a useful tool to improve efficiency and reduce the administrative burden of activities. Investing in the up-front costs of this technology can have huge pay-offs for donors and MSPs alike.

4.3. Meso Level

The meso level refers to the overall infrastructure of the financial system and the support services that are available to meet the needs of microfinance institutions. This infrastructure includes structures such as wholesale capital providers, a credit bureau or a rating agency, training institutes, research companies and universities, technical assistance providers, audit companies, associations or networks of microfinance retail institutions.[30]

Vision

Looking ahead, a vibrant and dynamic Nepalese microfinance sector should possess a sustainable market of financial infrastructure providers that can meet the comprehensive needs of an MSP at every stage of institutional growth. The sector should also have an independent and inclusive microfinance association/network that could unify the sector, and actively represent the interests of its members to external stakeholders, policymakers, and regulators.

Access to Capital

In most countries, MSP growth is contingent upon the continuing accessibility of funds for on-lending. This is not the case in Nepal where capital is readily available and at relatively cheap rates, at least for the credit-led MSPs. Capital is so easy to access that most credit-led MSPs are highly leveraged institutions and only invest a fraction of their portfolios in microfinance loans (40 percent for the FINGOs and 58 percent for the MDBs in 2005)[31]. The rest is often held as liquid funds or parked in safe investments.

Part of the reason why MSPs are so liquid is because commercial banks are required to invest 3 percent of their portfolios to the poorest sector, either as equity investments or wholesale loans to MSPs, or retail loans directly to clients.[32] Known as Deprived Sector Lending (DSL), this requirement is mandatory and punishable by fine if banks fail to meet it. In order to get around this requirement, many commercial banks lend to MSPs, but mandate that the funds be parked in safe investments. Other commercial banks are willing to reduce their interest rate to as low as 4 to 4.5 per-

[28] These are also sometimes called POS (point-of-service) devices, to be distinguished from POS (point-of-sale) terminals referenced above.

[29] A manager at Nirdhan estimated that the start-up costs of purchasing PDAs for all of its loan officers and implementing the new system would cost about U.S. $52,000.

[30] See CGAP's *Good Practice Guidelines for Funder of Microfinance.*

[31] See Aurora Ferrari, *World Bank*, 64 & 66.

[32] "Deprived sector" lending is defined as loans less than Rs. 60,000 without collateral, or less than Rs. 150,000 with collateral.

cent just so they can attract the small handful of institutions in Nepal with strong ownership structures and solid balance sheets.

In addition to capital provided by commercial banks, there are also three apex lending institutions sponsored by the government which provide capital at highly concessional rates: the Rural Self Reliance Fund (RSRF), the Rural Microfinance Development Centre (RMDC) and the Small Farmers Development Bank (SFDB). There is also a Central Finance Facility Program, which is managed by NEFSCUN, the national organization of cooperatives.

- *RSRF* is an NRB-financed fund which targets SACCOS and FINGOS and certain priority subsectors that serve the very poor or populations in underserved areas such as the Hills and Mountains. Because of the lack of qualifying institutions that meet RSRF's portfolio standards, the fund is quite liquid and mostly benefits the highly politicized tea growing sector.
- *RMDC* is a revolving loan fund, financed by the ADB via the government, which targets high-performing MDBs, FINGOs and cooperatives.[33] RMDC operates differently than the other funds because it couples capacity building support with its lending facility.
- *SFDB* is a fund housed within the Agricultural Development Bank of Nepal (ADB/N) which targets the SFCLs. To isolate the fund from political interference and maintain it for the long run, the SFCL federation NACCF has raised capital to purchase ADB/N's share and hopes to create a new institution in July which will be managed by the members themselves.
- The *Central Finance Facility Program* is managed by NEFSCUN, the apex association for the co-operative sector, and is owned and capitalized by its 539 member SACCOs. It is the only apex fund which lends at market interest rates.

See Annex G for more detailed information on each of these apex lending institutions.

Technical Assistance and Training

Microfinance is at its core a labor intensive business, and Nepal is no different with over 1800 personnel among the nine MDBs alone.[34] With ongoing expansion and turnover, MSPs need a constant supply of quality training to ensure that their staff know the basics of how to efficiently and effectively manage an MSP. Training is especially challenging in rural and dispersed countries like Nepal where it is difficult, if not impossible, for trainers to be in a wide variety of geographical locations at once.

Unfortunately there is a limited supply of microfinance trainings in the Nepalese market. The Center for Microfinance (CMF), which was established in 1998 by USAID/CECI and the Ford Foundation, has as its mission strengthening the capacity of MSPs in Nepal through training, technical assistance (TA), and consultancy services. However, CMF currently only offers seven annual retail courses aimed at middle management, as well as occasional workshops/roundtables for senior management. While other donors have occasionally subsidized the cost of staff from some small FINGOs and SACCOs to attend trainings at CMF, most participants, particularly those at the MDBs, pay on a cost-recovery fee basis.

Beyond CMF, the NRB also provides a couple microfinance courses within its bank training institute, although the quality is reportedly weak. Also, the RMDC's Institutional and Social Development Department provides assistance to institutions that it identifies as prospective borrowers, but this assistance is organized as peer-to-peer visits and on-site practical training, rather than retail courses that have the potential for scale.

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[33] RMDC currently has 69 partners: 7 MDBs, 25 FINGOs and 37 SACCOs.

[34] See www.mixmarket.org.

In addition to the limited supply, trainers are generally not accredited or certified by international organizations such as the Consultative Group to Assist the Poor (CGAP), the International Labour Organization (ILO) or microSAVE.[35] Other than Nepal's Microfinance Summit, which CMF hosted earlier this year, neither CMF nor any other organization in Nepal has much exposure to international best practices.

As a result of the low quality and high expense of trainings, most MSPs in Nepal have developed in-house training and mentoring capacity. Entry level staff are trained on the job, and middle management are promoted from the ranks of these field-level specialists. Some MSPs send their staff to Kathmandu to learn the basics of financial management, but most learning takes place through informal coaching. As a result of this ad hoc process, there are many capacity gaps, particularly in management, which prevent MSPs from reaching their growth potential. According to a CEO at one MSP, management training is the single biggest challenge that MSPs in Nepal face today.

One approach donors such as USAID have taken in other countries to increase institutional capacity is to directly deliver trainings through an international firm. The World Bank is currently contemplating a "Financial Access Initiative," which would include a capacity building component that would be implemented by a private contractor (via NRB).[36] However, when governments or donors do the training themselves and compete with existing providers, they often inadvertently inhibit the development of a private, sustainable market. Another approach promoted more recently within the donor community is to support the development of a private, internationally-accredited market of local trainers who are not affiliated with any microfinance institution. Training can be provided on a fee-for-service basis, or can be partially subsidized by the donor. Generally speaking, most MSPs, particularly second tier MSPs, cannot afford the full cost of training.

The availability of management training also continues to be a binding constraint, particularly given the reliance on internal promotion, and so USAID should also consider working with local academic institutions like the Administrative Staff College or Kathmandu University to build their capacity to provide management training geared toward MSPs. These particular institutions currently offer management courses that Nirdhan's staff is availing, but they are likely geared more towards civil servants than toward management in financial institutions.

Finally, there really are no TA providers in the market (other than RMDC's on-site practical training assistance). In addition to training, MSPs need customized assistance for their particular stage of institutional growth. Relatively mature institutions like Nirdhan and Chhimek are in particular need of specialized assistance that retail trainings cannot provide on issues such as internal controls, MIS, human resources management, product development, accounting, financial analysis and business planning. Such TA, if targeted and customized to their unique needs, could help move these institutions to the next level of institutional development.

ICT/MIS Providers

Only three MSPs in Nepal – Nirdhan, Chhimek and the Swabalaban – have computerized back-end systems (commonly known as Management Information Systems, or MIS). Nirdhan and Chhimek are using a locally-developed, Oracle-based software, while Swabalaban is using Mifos, an open source MIS developed by the Grameen Foundation. All other MSPs in Nepal continue to track and record their operations and accounting either in Excel sheets or manually, with maintenance of records in forms and ledgers. These primitive back-end systems cost a massive amount of time and resources, leave room for errors, and inhibit the ability of the sector to grow quickly and manage risk.

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[35] Chhimek has sent several middle managers to India to take some CGAP courses, and one of its staff is certified as a CGAP trainer on delinquency. However, there are no certified CGAP trainers available in the market.

[36] This project has been on hold the past nine months because of corruption charges in the Nepalese government.

Unfortunately, not enough information was collected during this assessment to establish the market and availability of local vendors in Nepal and their ability to implement and support Information and Communications Technology (ICT) solutions. However, Chhimek management did comment that it has taken the last three to four years to work out all of the kinks in their MIS software. Additionally, in most countries, even if there are vendors, MSPs often do not fully recognize the benefits of a fully automated and integrated MIS, nor do they have the organizational and human capacity to choose among different systems. There are also issues of the high cost of procuring ICT/MIS in countries where the largest MDBs, Nirdhan and Chhimek, serve a little over 50,000 active clients each. Most MSPs do not have the economies of scale to afford these kind of ICT solutions.

During the assessment period, one of the co-founders of Sevak Solutions, a U.S.-based not-for-profit company supporting ICT solutions for MSPs, visited Nepal as part of a World Bank mission to conduct a feasibility study on the potential for implementing an Application Service Provider (ASP)[37] model in Nepal. Under this approach, MIS services would be offered to MSPs over a shared, computerized network. An ICT provider like Sevak would develop the platform, and another provider like IBM would store data and manage the back-end system. The system's operational costs would be funded on a fee-for-service, or partially subsidized, basis, although its development costs would likely be funded by the World Bank.

Industry Networks and Associations

Strong microfinance association networks are an important platform to enable MSPs to exchange ideas and experience, establish common performance standards, and influence government policy to facilitate the development of a robust market for microfinance. In Nepal, CMF was established in 1998 as an apex industry association for the microfinance sector. Not only does CMF provide training, TA and knowledge management, it also has 25 members/shareholders representing institutions across the sector. CMF has good leadership in the Executive Director and has managed to accomplish a lot over the last decade. That being said, CMF does not have with any core grant support[38] and is not able to provide most of the services that networks in other countries provide.

Just this past February, CMF hosted the "Microfinance Summit Nepal," which enjoyed broad attendance from across Nepal, as well as from within the international arena. The Summit produced a "declaration"[39] in which summit delegates committed to form a separate "Microfinance Network Nepal," which would, among other functions, determine sector norms and standards for market discipline and self regulation and initiate the establishment of a Microfinance Credit Information Bureau to address overlapping microfinance services. The declaration also committed to form a task force that will consult with government and NRB on the new national microfinance policy (see Macro Level sub-section on "Enabling Environment for Microfinance").

This development suggests that the sector in Nepal is likely not characterized by unhealthy competition, politicization and infighting like microfinance sectors in many other countries. After the Network has been initially established and it is clear that sufficient political will exists to support its

[37] Through ASPs, the complexities and costs of MSPs acquiring such software can be cut down through economies of scale. Additionally, this system has the added benefits of allowing for standardized reporting to the Central Bank, as well as interoperability between MIS systems that would set the stage for various "branchless banking" solutions (see Micro Level sub-section on "New Delivery Models") such as ATMs, POS terminals and mobile banking. It would also enable the eventual development of an information sharing system between MSPs that would function similar to a credit bureau

[38] CMF has received grants for specific projects or activities, but does not have any grants for operational support.

[39] See. http://www.microfinancesummitnepal.org.

functions, USAID may want to consider providing grant funding to cover the Executive Director's salary and facilitate the hiring of staff as appropriate.[40]

In addition to CMF, which primarily represents the MDBs and FINGOs, the Nepal Federation of Savings and Credit Cooperative Unions (NEFSCUN) represents the SACCO sector in Nepal. NEFSCUN has 539 member SACCOs located in 54 districts. Among other services, it carries out training and educational services, promotes its Central Financial Facility Program (see Meso Level sub-section on "Access to Capital"), assists SACCOs in registering under the Cooperatives Act and provides business development support to SACCO members. NEFSCUN receives technical support from its umbrella industry associations: the Asian Confederation of Credit Unions (ACCU) and the World Council of Credit Unions (WOCCU).

4.4. Macro Level

The macro level refers to policies and regulations that enable a competitive and inclusive financial system, accommodating a broad range of institutional types and business models, including MDBs, FINGOs, SACCOs, finance companies, non-banking financial institutions and commercial banks. Competition will provide clients with more choice, will force finance providers to become more efficient and reduce interest rates to a degree, and more importantly, will offer more varied products to better match the needs of clients at all income levels

Vision

Looking ahead, the Nepalese government should move away from direct interventions in the microfinance sector and focus on playing an enabling role. A desired regulatory framework for Nepal would allow for expansion of microfinance to the Hill and Mountain areas, transformation of FINGOs into commercial institutions, upscaling and downscaling of MDBs, and downscaling of commercial banks into SME finance. It would also provide space for innovative partnerships and models such as the use of non-bank agents for payments, and alliances between financial institutions and national retail stores or mobile phone companies for delivery of financial services.

Enabling Environment for Microfinance

The government in Nepal has long played an active, perhaps overzealous, role in promoting access to finance for the poor. In recent decades, it has intervened directly through its five RRDBs, priority and deprived sector lending mandates, and three apex lending institutions. While the government has arguably overstepped its role as 'direct provider,' it has also, to its credit, provided the space for a diverse range of private microfinance providers to grow and flourish. Indeed, unlike many other countries around the world, cooperatives are promoted and encouraged, FINGOs have a mechanism to commercialize, and regulated institutions can capture member savings.

If anything, however, this permissive enabling environment has resulted in too many, rather than not enough, institutions under the regulatory purview of the NRB. Indeed, there are now 75 microfinance service providers (9 MDBs, 47 FINGOs and 19 cooperatives) that are regulated by Nepal's Central Bank. While some degree of regulation is important to prevent breakdown of the financial system, regulation is only appropriate where it's effective. Given that NRB only has the resources to conduct inspections every two to three years,[41] regulation in Nepal does little more than give deposi-

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[40] Objectives could include: (1) Developing a strategy and action plan for reaching out to new member institutions; (2) Conducting a survey to better understand the needs of the broader sector; (3) Enabling the network to organize sector-wide knowledge sharing events and discussion fora (e.g. a Policy Forum); (4) Establishing industry standards and benchmarking, and enabling the publication and dissemination of this information to members, regulators, funders, and investors; (5) Policy advocacy to the government; and (6) Institutional capacity building and technical assistance through the provision of market information.

[41] Aurora Ferrari, *World Bank*, 46.

tors a false sense of security that their savings are protected within these institutions. Clearly, NRB needs to revisit what it can effectively manage given these limited resources.

- There's also some confusion over the role of the Department of Cooperatives vis-à-vis NRB in regulating and promoting microfinance. While all SACCOs engaged in microfinance are supposed to register with NRB (in addition to the Department of Cooperatives), right now only 19 have taken this step.[42] This has created a regulatory muddle for these SACCOs since the two government bodies do not have syncronized policies.[43]

To address this regulatory muddle, the Cabinet of Ministers passed a "National Microfinance Policy" in early June. This policy (which is more a "concept note" than a "policy") proposes the creation of a second tier institution (STI) to regulate and monitor the activities of the entire microfinance sector, as well as a new apex wholesale fund (to be merged with the NSRF) which would distribute capital. There is some concern within the sector that the STI will bring all institutions – including the SACCOs – under one regulatory body, thereby increasing, not decreasing, the government's regulatory burden. Also, while this policy is intended to rationalize the current framework, its authors clearly did not understand the inherent conflict of interest in having one institution be the regulator, promoter and finance wholesaler of microfinance.

Particularly concerning to USAID, the policy seeks to have the new STI regulate the roles and responsibilities of donor agencies. While the details have yet to be worked out, the policy which passed the Cabinet proposes a central basket through which all donor funds would be channeled and managed. The World Bank has already voiced its opposition to such a plan.

In addition, the new policy places emphasis on expanding microfinance to underserved areas and allowing certain microfinance providers to accept public deposits. These priority areas could be implemented in a variety of ways, although there is some concern that it will result in the government increasing its role as direct provider and that the STI will not have sufficient resources to provide proper supervision of public deposits, a service which can have dire ramifications on the financial system if not properly managed.

Now that the policy has passed the Cabinet, NRB is being tasked with writing implementing regulations. Fortunately, the NRB has significant flexibility with regards to how it interprets this policy, and so there is still an opportunity to help craft a framework that rationalizes the current regulatory structure and enables the development of market-driven microfinance in Nepal. In addition to this policy, NRB's Microfinance Unit also intends take this opportunity to draft regulations on emerging issues such savings, micro-insurance and money transfer services. Furthermore, the Unit is contemplating extending a policy that allows banks to open a branch in the Terai only if they open one outside it to the MDBs. This policy should be discouraged since it may inadvertently inhibit growth of the sector.

There is an opening with the Executive Director of the Microfinance Unit to receive external assistance in drafting the new regulations. Mr. Gopal Prasad Kaphle is eager for help and said that he hopes USAID will partner with NRB during this critical juncture. Normally, the World Bank would provide technical assistance at such a moment, but the Bank's Financial Access Initiative, which includes a regulatory and policy component, has been held up for nearly a year now due to corruption charges within the Nepalese government. There is a possibility that the ADB is providing assistance to NRB since it did have a hand in drafting the policy, but USAID has a market-driven perspective that is unique from that provided by ADB and from which NRB could greatly benefit.

[42] Aurora Ferrari, *World Bank*, 2.

[43] For example, the Cooperatives Department requires that financial statements be recorded on an accrual basis, encourages low liquidity and does not allow write-offs. NRB, in contrast, requires statements on a cash basis, mandates minimum capital of 10 percent of mobilized savings, and encourages write-offs.

Enabling Enironment for Commercial Bank Downscaling

While the government has been very proactive in encouraging microfinance in Nepal, it has not been nearly as active in promoting SME finance. In fact, ever since priority sector lending phased out in 2007, there are virtually no private sector institutions in Nepal engaged in this sector. As mentioned earlier, commercial banks face several policy challenges which discourage them from downscaling into SME finance. The key challenges can be categorized as follows:[44]

- *There is no registry to record pledges on movable collateral.* Collateral registries are an essential tool for banks to be able to determine whether another lender already has rights over a particular asset. Unfortunately, the current registry only exists for real estate collateral.
- *The Credit Bureau only covers loans above Rs. 1,000,000 and entails high transaction costs to generate reports.* This renders the credit bureau nearly unusable for many small businesses and raises the cost of doing business with medium-sized businesses. In addition, the information that the credit bureau collects is extremely limited and generally outdated.
- *Loan loss provisioning requirements for loans secured with movable assets or personal guarantees are too high*, thereby raising the bank's cost of capital. While the provisioning requirements for loans secured by 100 percent real estate collateral are as low as 1 percent, the requirements for typical SME loans are about 21 percent. By tying up capital, the bank's cost of capital increases significantly, cutting into their spread.
- Penalties for banks failing to meet their deprived sector lending requirements discourage them from raising their interest rate for SME lending. The penalty is calculated as the shortfall times the bank's highest interest rate. This makes banks more reluctant to charge higher interest rates to SME borrowers to account for the higher transaction costs of serving them.

Enabling Environment for Money Transfers

It is estimated that 90 percent of all remittances come from neighboring India,[45] and that 80 percent of all remittances are sent through informal mechanisms, such as friends and family. In addition to cultural preferences for these familiar, time-tested mechanisms, there are also some policy issues which discourage formal sector transfers from India. A recent World Bank study found that special approvals are required from the Reserve Bank of India (RBI) (India's Central Bank) to send remittances from India to Nepal and that the process is "cumbersome."[46] These bureaucratic obstacles no doubt inflate the time and costs associated with sending remittances through formal mechanisms and encourage them to remain in the informal sector.

5. DONOR INVESTMENTS IN MICROENTERPRISE DEVELOPMENT

Asian Development Bank	Provided long-term loan to RMDC for on-lending to MDBs and FINGOs Advocated a new Second Tier Institution (STI) within the government to be merged with RSRF (It is unclear what ADB's role will be now that the National Microfinance Policy has passed the Cabinet.) Piloting community-based livestock micro-insurance scheme with a cooperative.
DFID	Considering interventions in migration/remittances such as financial literacy program for migrants and new loan products to fund the costs of migration. Planning to conduct a feasibility study on mobile banking and is considering replicating the Grameen Phone initiative introduced in Bangladesh.

[44] See Aurora Ferrari, *World Bank*, 34-36.

[45] See Aurora Ferrari, *World Bank*,12.

[46] See Aurora Ferrari, *World Bank*, 13.

GTZ	Building the capacity of the SFCLs' umbrella federation, the NACCF Launching new INCLUDE project that brings together previous efforts in rural finance and microenterprise development under one initiative; new enterprise development activities will follow a market system approach ("ValueLinks Approach" in GTZ terminology) with an emphasis on DDC or VDC involvement and public-private dialogue
SNV	Providing analytical and advisory services in the tea, cardamom, and NTFP sectors; continuing to follow a market system approach that begins with value chain analyses
UNDP	Funding phase 3 of the Micro Enterprise Development Programme (MEDEP) to provide training, technical assistance, and other services to rural microenterprises run by the very poor; phase 3 seeks to institutionalize this approach within the Ministry of Commerce, DDCs, and local NGOs established to provide these services on a subsidized basis. Planning a new youth livelihoods program, which has yet to be fully defined.
World Bank	Commissioned microfinance map which will be released in July 2008. Considering introduction of Application Service Provider (ASP) Model of MIS. In June, the World Bank hosted a mission to do a feasibility study of this approach.
World Bank / UNDP / UNCDF	Designed joint $30 million "Financial Access Initiative" ($27 million of which would be from the World Bank), which would be implemented through the NRB. The project has been held up for the last nine months because of corruption charges within the government. The project, if it goes forward, would include: (1) a Fund for Inclusive Finance (FIF) grants program implemented by an external body via the NRB; (2) Loan capital for commercial bank downscaling into SME finance; (3) Capacity building of pro-poor financial institutions, including MSPs and commercial banks; (4) Reform of the legal and regulatory framework

6. RECOMMENDATIONS

6.1. Integrating Microenterprises into the Private Sector

If well designed and implemented, microenterprise development can contribute to both economic growth and poverty reduction in Nepal. The most tangible need is to better integrate existing microenterprises, including smallholder farmers, into the private sector. The market system approach employed in this assessment can also guide the design and execution of strategic interventions to catalyze positive change. This strategy builds off of past investments and maximizes USAID's comparative advantages working with the private sector. Key recommendations include:

- Select target industries for further analysis and intervention based on the following minimum criteria: potential competitiveness, probable participation of and benefits to microenterprises, and the prospects for industry leadership.
- Consider balancing investments in domestic and export markets. Domestic markets show good growth and can be more attainable than, or serve as stepping stones to, export opportunities.
- Build off of previous donor and government investment in horizontal linkages (cooperative formation) but do not refrain from exploring other models.
- Focus on building and strengthening vertical linkages between microenterprises and lead firms – the most binding constraint observed in virtually every market system. This will involve upgrading on the part of both microenterprises and lead firms to achieve effective interactions and win-win relationships.
- Understand that a range of non-commercial factors are influential determinants of microenterprise performance and decision-making. Social drivers and relationships are key entry points for many interventions, but competitive industries are always based on commercial

behavior. Effective strategies for behavior change will be critical to achieving catalytic and sustainable impact.

- Facilitate and encourage firms to invest in upgrading, but pay attention to the commercial supply and appropriate design of the supporting services that enable upgrading.
- Pursue meaningful coordination with other likeminded donors adopting a market system approach, such as GTZ and SNV, and invest in advocacy and training for those donors and government officials that may not understand the characteristics and advantages of such an approach.

Transitioning from USAID's past support for livelihoods activities to a market system approach driven by the private sector requires further consideration and consensus around the following strategic questions:

- Who are the target beneficiaries? USAID/Nepal has most recently targeted the very poor, highly vulnerable, and/or socially excluded in its livelihoods programs. USAID needs consensus on whether to continue this emphasis or shift focus to the more mainstream poor (e.g., the second and third quintiles). In any event, a market system approach must involve a broad range of enterprise sizes and household types; the question is who does USAID want to intentionally and ultimately benefit?
- Where to start – communities or industries? USAID/Nepal's recent programs have employed an approach that first identified communities meeting certain requirements and then selected economic activities to promote based on comparative advantages and market opportunities. An alternative approach, as advocated in this assessment, is to begin by identifying sectors based on key criteria, which will then self-select individuals or communities for participation. USAID needs consensus on whether targeting specific communities is more important than selecting competitive industries in which large numbers of microenterprises participate.
- What level of economic impact is desired or acceptable? Depending on the ultimate beneficiaries targeted and sectors selected, USAID/Nepal can reasonably anticipate a range of economic impacts. Some combinations may yield results that are small in absolute terms but that represent a substantial proportional increase in household income. Others may yield results that are larger in absolute terms but smaller proportions of baseline incomes. USAID needs consensus on what levels of results are acceptable – or unacceptable – to establish effective parameters for future programming.

6.2. Building an Inclusive Financial Sector

This assessment recommends transitioning USAID's past emphasis on beneficiaries and institutions to a financial system approach. If well designed and implemented, a financial system approach can help catalyze a diverse and inclusive financial sector serving the needs of microenterprises and poor households. The approach employed in this assessment can also guide the design and execution of strategic interventions to catalyze positive change. Key recommendations include: .

Result: <u>Microfinance providers develop innovative, demand-driven financial products, reach out to underserved populations in the Hill areas, and introduce new delivery technologies that could help them reach scale more efficiently</u>.

Recommended Activities: Establish an Innovation Challenge Fund to encourage innovation and risk taking.

- In other countries, challenge grants have provided a powerful incentive for MSPs and other financial institutions to risk branching out into areas they might not have otherwise considered.
- Under this approach, the implementer would define criteria and objectives for grant awards, and ensure that the selection process is transparent, competitive, and demand-driven. Cost-sharing on the part of grantees, whether cash or in-kind, could be considered.
- Themes may include, but are not limited to:
  - Reaching the very poor and other hard-to-reach populations such as the rural poor in the Hills or Mountain areas;
  - Developing new products such as micro-insurance, remittance-linked microfinance products and credit for agriculture; and
  - Introducing new delivery technologies such as point-of-sale (POS) devices and other means of branchless banking to build scale and broaden outreach.

Critical Assumptions:

- Grants are demand-driven and opportunistic.
- Donors base their investment decisions on social and financial criteria.

Result: <u>There exists a robust market for training and technical assistance support services that can meet the diverse and complex needs of microfinance providers at every phase of institutional development</u>.

Recommended Activities: Develop the capacity of a broad range of retail financial institutions with promising potential to serve poor people through internationally-accredited, fee-based training and technical assistance.

- CGAP, the ILO and microSAVE have scaled up their trainings worldwide through a trainer of trainers (TOT) model. So called "master trainers" train local trainers through an accredited certification process. The high quality modules provided through these trainings are generic, but easily adapted and customized to local country contexts. After receiving the TOT, accredited trainers go back to their home country where they can provide events for multiple institutions in one central location, which can then be disseminated among local staff.
- Building a pool of internationally-accredited local providers requires technical assistance initially to provide ToTs for local capacity building providers, adapt and translate modules, and create a market for the courses. It's also extremely important that accredited trainers develop the capacity to follow up trainings with TA visits to focus in on issues specific to that institution.
- The implementer may also consider working with local academic institutions like the Administrative Staff College or Kathmandu University to build their capacity to provide management training geared toward MSPs
- For higher level training required by relatively mature institutions, the service provider should couple trainings with a program of direct technical assistance on key constraints such as internal controls, MIS, human resources management, product development, accounting, financial analysis and business planning. This should be provided on a fee-for-service basis, even if it is partially subsidized.
- The implementer should also facilitate a few strategic "exposure visits" for key personnel within high growth institutions.

Critical Assumptions:

- MSPs are willing to pay for TA and training, even if it is on a partially subsidized basis.

- The World Bank's Financial Access Initiative, which includes a capacity building component, remains on hold (at least for the next year) and complements project objectives.

Result : The new National Microfinance Policy streamlines and rationalizes the former regulatory structure and enables the development of a diverse and inclusive financial sector in Nepal.

Recommended Activities: Place a long-term policy advisor within the Nepal Rastra Bank.

- To promote a more conductive policy environment in Nepal, a long-term advisor should engage key government staff within the Nepal Rastra Bank to influence political decision-making during this critical juncture.
- Another USAID partner may also support existing efforts by the Center for Microfinance (CMF), the emerging Nepal Microfinance Network and any other sector-wide efforts to advocate for policy change (for example, through a policy forum).

Critical Assumptions:

- NRB continues to extend its invitation for technical assistance, and USAID can engage directly with the NRB.
- The policy that passed the Cabinet of Ministers is flexible and can be implemented in a manner that comports with international best practice.
- The World Bank's Financial Access Initiative, which includes a policy component, remains on hold during this juncture.
- ADB, Manila is not providing TA to the Central Bank, and if it is, it will not directly conflict with USAID assistance.

Result 4: The cooperative movement increases its breadth of outreach in many underserved areas such as Hills, and depth of outreach in terms of financial management and linkages to other services.

Recommended Activities: Build on past efforts to promote new SCGs and cooperatives in underserved areas, while balancing these expansionary goals with an increased attention to the quality of cooperatives, particularly with regards to financial management.

- Train the trainers (TOTs) approaches can be very effective at disseminating information and reaching scale quickly. Also key is time-limited support in which the NGO acts as a catalyst of group development to ensure that the movement is self-sustaining.
- These cooperatives should also be used as a platform for the provision of non-financial services such as literacy training, peace building activities, nutrition and reproductive health education, rural and agricultural development and the promotion of income-generating activities.
- In addition, the implementer should leverage the cooperative platform as a mechanism for increasing people's access to the supply chain, capital markets, and appropriate production technologies.

Critical Assumptions:

- There is a demand for savings and credit cooperatives in rural and remote areas that the movement has yet to reach.
- Economic opportunities exist to effectively link cooperatives in these areas to the supply chain.

ANNEX A. INDIVIDUALS AND INSTITUTIONS CONSULTED

Aanandvan-Rupendehi Small Farmers Agricultural Cooperatives Limited *Butwol*	Chandra Mani Neupane *Bank Manager*
Asia Network for Sustainable Agriculture and Bioresources *Kathmandu*	Bhishma Subedi *Executive Director* Ram Hari Subedi *Director of Operations* Sushil Gyawali *Program Officer*
Bank of Kathmandu *Kathmandu*	Ajaya Shrestha *Chief Business Officer* Kamal Pokharel *Relationship Manager, Development Credit Unit* Vijay Kumar Gurung *Development Credit Unit*
Centre for Micro-Finance Nepal *Kathmandu*	Tejhari Ghimire *Chief Executive Officer*
Centre for Self-help Development *Kathmandu*	Shanker Nath Kapali *Deputy Director*
Chetanshil Women's Savings Group *Gulmi*	Mina BK *Secretary* Suntali BK *Member*
Chhimek Bikas Bank *Kathmandu*	Ram Chandra Joshee *Executive Director*
Coffee processor *Harthok*	Umar Khadka *Entrepreneur*
Development Project Service Centre (DEPROSC-Nepal) *Kathmandu*	Pitamber Acharya *Executive Director* Kailash Rijal *Deputy Director*
District Cooperative Office, Palpa and Gumli Districts *Tansen*	Sri Krishna Nepal *District Registrar*

Federation of Nepalese Chambers of Commerce & Industry *Kathmandu*	Suraj Vaidya *Senior Vice President* Deva Bhakta Shakya *Executive Director, Agro Enterprise Centre* Megh Nath Neupane *Director General* Krishna Tamrakar *Vice President*
Federation of Woman Entrepreneurs Associations of Nepal *Kathmandu*	Pramila Acharya Rijal *President* Ananda Shova Tamrakar *Executive Member* Sharda Rijal *Treasurer*
GTZ *Kathmandu*	Shameer Khanal *Advisor, Subsector Promotion* Ujjwal Raj Pokhrel *Advisor, Subsector Promotion* Roshan Shrestha *Advisor, Microfinance and Conflict*
Harthok Vegetable Collection Center *Harthok*	Min Bahadur Thapa *Secretary, Marketing and Planning Committee*
Hasara Women's Savings Group *Gulmi*	Kamala Bhandari *President*
Himalayan Bio Trade Pvt Ltd *Kathmandu*	Khilendra Gurung *Sales Manager* Saraswoti Rai *Production Manager*
International Development Enterprises *Kathmandu*	Luke Colavito *Country Director*
Laligurans Women's Savings Group *Gulmi*	Yem Kala BK *Treasuer*
Marsayangdi Multipurpose Cooperative *Mugling*	Jay Lal Shrestha *Chairman* Shree Prasad Kandel *Secretary*
Milijuli Women's Savings Group *Gulmi*	Pratibha Palli Magar *President* Raj Kumari Gandharba *Member*

National Planning Commission *Kathmandu*	Jagadish Pokharel *Vice-Chairman*
Nawa Prativa Savings and Credit Co-operative *Nawalparasi*	Ram Prasad Kafle *Program Officer*
Nawa Yug Women's Savings Group *Gulmi*	Tika Aslami Magar *President*
Neighborhood Society Service Centre *Kathmandu*	Krishna Kaj Pant *Senior Officer*
Nepal Agriculture Cooperative Central Federation Ltd (NACCFL) *Kathmandu*	Rudra Bhattarai *General Manager* Khem Bahadur Pathak *Chairman* Meena Pokhrel *Program Manager*
Nepal Federation of Savings & Credit Cooperative Unions (NEFSCUN) *Kathmandu*	Babu Ram Neupane *Program Officer* Bhola Shrestha *Program Officer*
Nepal Life Insurance Company *Kathmandu*	?
Nepal Ministry of Industry, Commerce and Supplies *Kathmandu*	Shiv Raj Bhatt *National Programme Manager & Trade Policy Analyst* Thierry Noyelle *Consultant*
Nepal Rastra Bank *Kathmandu*	Gopal Prasad Kaphle *Executive Director, Microfinance Department*
Nepal Tourism Board *Kathmandu*	Hikmat Singh Ayer *Officiating Director, Research, Planning & Monitoring*
New Thapa Engineering Works *Bhairahawa*	Moti Lal Thapa *Owner*
Nirdhan Uttham Bank *Bhairahawa*	Harihar Dev Pant *Chairman and CEO* Bhoj Raj Bashyal *Deputy Director* Prabin Dahal *Senior Manager*
NPYS *Gulmi*	Dhata Nanda Bhusal *Motivator, Gulmi* Nilam Devkota *Trainer, Integrated Pest Management*

Pharjong Women's Savings Group *Gulmi*	Indra Rana Magar *President*
Pipaldanda Women's Savings Group *Gulmi*	Til Kumar Uchhai *Secretary*
PlaNet Finance Nepal *Kathmandu*	?
Practical Action *Kathmandu & Chitwan*	Achyut Luitel *Country Director* Deepak Doj Khadka *Team Leader, Markets and Livelihoods* Sharad Rai *Senior Project Officer, Markets and Livelihoods* Jivan K. C. *Project Manager, Access to Infrastructure Services*
Rural Development and Awareness Group (RUDAG) *Gulmi*	Khadgabir Thapa *Motivator, Gulmi* Khim Lal Rahadi *Motivator, Gulmi*
Rural Economic Development Association (REDA-Nepal) *Tansen*	Lila Bahadur Karki *Executive Director*
Rural Enterprise Developer's (RED) Group Nepal *Kathmandu*	Sichan Shrestha *Executive Director*
Rural Microfinance Development Company (RMDC) *Kathmandu*	Shankar Man Shrestha *Chairman*
Sagarmatha Women's Savings Group *Gulmi*	Shanta Pandey *Member*
Samjhauta Nepal *Kathmandu*	Usha Jha *Chief Executive Officer*
Sarsoti Women's Savings Group *Gulmi*	Parbati Taramu *Treasurer* Bhima Sinjali *Member* Dhan Maya Kunwar *Member*
Satyabati Women's Savings Group *Gulmi*	Parbati Taramu *Member*
Save the Children – United States *Kathmandu*	Ganga Thakali *Economic Opportunity*

Shikhar Women's Savings Group *Gulmi*	Kopila Pandey *Member*
Singdi Women's Savings Group *Gulmi*	Lilia Taramu *President*
SmartChoice Technologies *Kathmandu*	Vivek Rana *CEO*
SNV – Netherlands Development Organisation *Kathmandu*	Subarna Rai *Deputy Country Director* Rajan Kumar Kotru *Senior Advisor, Forest Policy & Institutions* Rik van Keulen *Value Chain Advisor, NTFPs*
Sujal Foods Pvt Ltd *Kathmandu*	Mahendra Shrestha *Brand Manager*
U.K. Department for International Development *Kathmandu*	Matthew Greenslade *Economic Advisor*
U.S. Mission to Nepal *Kathmandu*	Beth Paige *USAID Mission Director* Anthony Chan *USAID Deputy Mission Director* Carla Bachechi *Pol/Econ Section* Amy Paro *USAID Program Officer* Anita Mahat *USAID Economic Opportunity Advisor* Sribindu Bajracharya *USAID Program Specialist* Mera Thompson *USAID Education Team Leader* Kishore K.C. *USAID Program Economist* Bishnu Adhikari *USAID Democracy and Governance Specialist* Shanker Khagi *USAID Program Development Specialist* Margot Welk *Program & Project Development Specialist* Karen Kaplan *OTI Deputy Country Representative* Santosh Gyawali *USAID Computer Management Specialist*

United Nations Development Programme *Kathmandu*	Lazima Onta-Bhatta *Assistant Resident Representative, Livelihoods* Lakshmun Pun *National Programme Manager, Micro Enterprise Development Programme*
USAID Conflict Assessment Team *Kathmandu*	S. Tjip Walker *Senior Conflict Advisor*
USAID Democracy and Governance Assessment Team *Kathmandu*	David Timberman *Team Leader* Julie Werbel *Governance Specialist* David Garner *Consultant*
USAID Economic Growth Assessment Team *Kathmandu*	James Walker *Economist* Danielle Dukowicz *Economist*
Winrock International *Kathmandu, Bhairahawa & Tansen*	Binod Sharma *Team Leader, CRRN* Bibek Chapagain *Acting Director, Renewable Energy Project Support Office* Shailendra Kumar Shrestha *Regional Program Coordinator* Rudra Thapa *Regional Program Coordinator*
World Bank	Sabin Raj Shrestha *Senior Financial Sector Specialist*
World Education *Kathmandu & Ridi*	Helen Sherpa *Programme Coordinator* Ram Chandra Khanal *Field Coordinator* Laxmi Prasad Ghimire *Program Officer* Bhagawati Shrees *Motivator, Gulmi*
World Trade Organization *Kathmandu*	Christiane Kraus *Chief Coordinator, Programme Implementation Unit for the Integrated Framework Development Division*
Yekata Women's Savings Group *Gulmi*	Indra Thapa *Member*
Yeti Travels Pvt Ltd *Kathmandu*	Manohar SJB Rana *Chief Executive Officer*

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ANNEX C. NEPAL EXPORT COMPETITIVENESS IN SELECT END MARKETS

Data from UNCTAD/WTO International Trade Centre, 2006, with authors' own calculations.

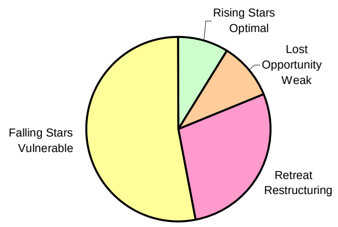
Market Share Proxy examines the extent to which Nepal's exports in 3,089 products have grown faster than global exports for each product (World) or national imports of each product (India and USA) during the period 2002-2006.

Market Growth Proxy examines the extent to which global exports in 3,089 products have grown faster than overall global imports (World) or the extent to which national imports in 3,089 products have grown faster than overall national imports (India and USA) over the period 2002-2006.

World

MARKET GROWTH PROXY

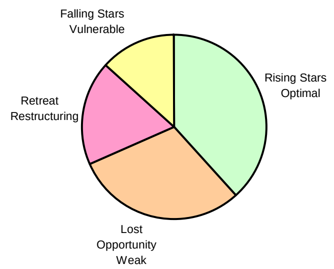
MARKET SHARE PROXY	Shrinking	Growing
Growing	Falling Stars :: Vulnerable 52.31%	Rising Stars :: Optimal 8.67%
Shrinking	Retreat :: Restructuring 27.70%	Lost Opportunity :: Weak 10.03%



India

MARKET GROWTH PROXY

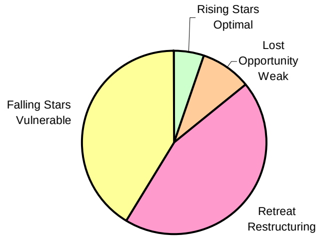
MARKET SHARE PROXY	Shrinking	Growing
Growing	Falling Stars :: Vulnerable 13.42%	Rising Stars :: Optimal 38.31%
Shrinking	Retreat :: Restructuring 18.14%	Lost Opportunity :: Weak 30.03%



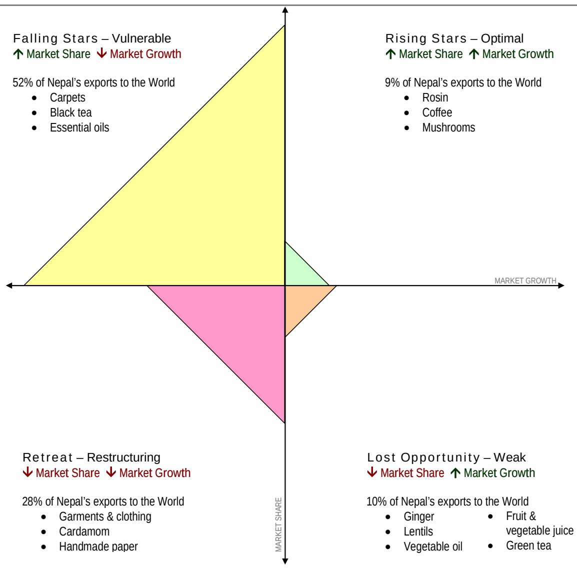
USA

MARKET GROWTH PROXY

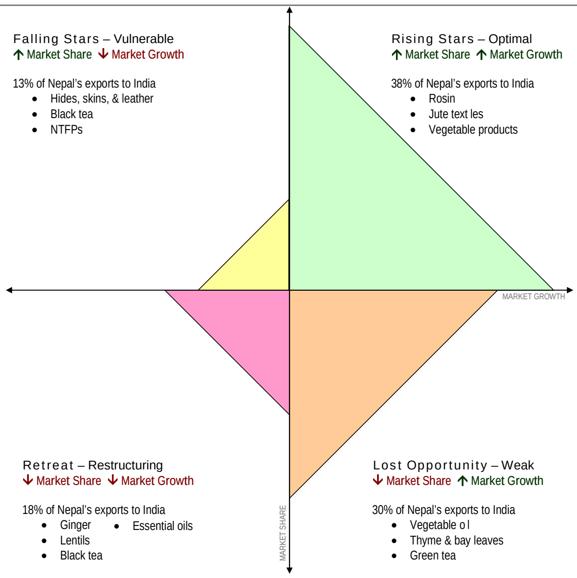
MARKET SHARE PROXY	Shrinking	Growing
Growing	Falling Stars :: Vulnerable 41.13%	Rising Stars :: Optimal 5.20%
Shrinking	Retreat :: Restructuring 44.30%	Lost Opportunity :: Weak 9.03%



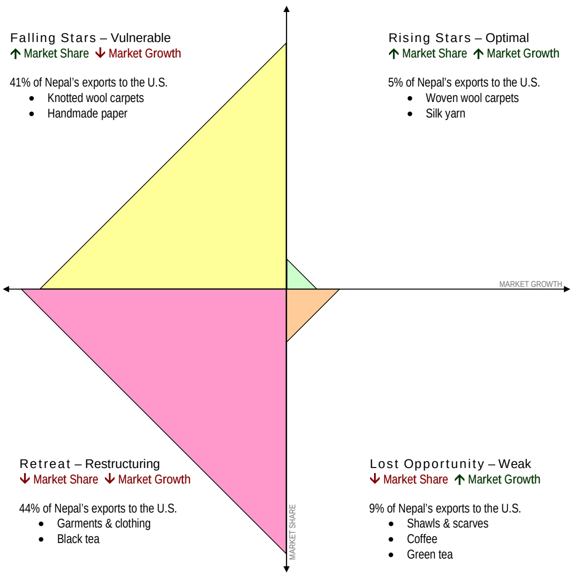
World



India



USA



ANNEX D. RURAL AND AGRICULTURE CREDIT

With over 82 percent of Nepalese engaged in agriculture for their livelihoods, there is a huge demand for agriculture credit. Unfortunately, rigid loan terms, short tenors and regular installments promoted under traditional Grameen-style microfinance in Nepal do not accommodate the bulky investments and cyclical cash flows that characterize this sector. Most MSPs, including MDBs, FINGOs, and SACCOs, that claim to have an "agriculture" credit product within their menu of services are not designing their loan terms to meet these unique needs.

There are some agriculture cooperatives, such as the SFCLs promoted by GTZ, that offer farmers loans with longer tenors coupled with three to six month grace periods or interest only installments. Many of these agriculture cooperatives, however, are highly politicized since they were established or capitalized by the government and are now plagued by unsustainable subsidies and poor loan repayment. Further complicating matters, the Maoists recently announced that they are considering forgiving loans to the public financial sector.

For these reasons, it is important that Nepalese MSPs that are isolated from political interference also develop agricultural products that meet the needs of poor farmers. Agricultural lending is admittedly risky, particularly in a country like Nepal where prices are unpredictable and the biggest factor affecting yields is the level of rainfall. Successfully engaging in this sector therefore means that MSPs must diversify their portfolios across many sectors and that character-based lending techniques be combined with technical criteria in selecting borrowers. Additionally contractual arrangements and rainfall-based index insurance can help protect against the risks of lending. The development of these linkages is an area where USAID can engage to catalyze sustainable agriculture finance.

ANNEX E. MICRO-INSURANCE

Although micro-insurance is still a nascent industry in Nepal, it has made significant inroads in recent years. An inventory of micro-insurance schemes published in 2004[47] estimated that there were 21 schemes operating in Nepal at that time. Based on anecdotes collected in interviews of new schemes being piloted or contemplated, that number has surely increased significantly in the past four years. MSPs recognize that losses due to natural disasters, death or health calamities can drive clients into destitution and that micro-insurance can mitigate their losses, while reducing their clients' vulnerability to shocks.

There are four basic models of micro-insurance currently being implemented or contemplated in Nepal. Under the most popular model, the "community-based" or "mutual" model, clients and policyholders are in charge and manage and own the operations. This model dovetails particularly well with the cooperative structure in Nepal. For example, NEFSCUN, the industry association for the cooperative sector, is currently piloting a life insurance scheme among several of its cooperatives. Under this setup, each member pays Rs. 35 for a 10 year benefit. In the case of death, the family receives a fixed benefit: either Rs. 5,000 or Rs. 10,000, depending on whether the death was an "accident." Another common scheme is to tie insurance to the loan. For example, many of the SFCLs charge an upfront five percent fee on their livestock loans. This scheme similarly provides a fixed benefit – 80 percent of the loan value – upon death of head of livestock.

Unfortunately, these schemes often entail high risk, particularly in small communities where covariant risk is high. To address this issue, the Micro Insurance Academy in India (MIA) and Save the Children recently created a consortium to introduce micro health insurance to cooperatives in Nepal. The unique feature of this project is that the cooperatives will partner with an international reinsurance company to protect themselves against the risk of loss. The consortium is planning to hold a workshop in July 2008 in Kathmandu to work out all the issues leading to implementation.

Another model piloted in Nepal is the "provider-driven model." Under this setup, an MSP or other financial institution directly provides the insurance. For example, Chhimek recently launched a pension scheme in which clients pay Rs. 200 per month and are offered the option of receiving either a lump sum consisting of double the invested premium after 14 years, or waiting until 16 years to receive a fixed monthly income of Rs 1,000.

A third model operating in Nepal is the "full service model." In this case, one provider is in charge of everything: designing, delivering and insuring the product, as well as providing services. The 2004 inventory report surveyed three health care providers offering micro-health insurance in Nepal. Unfortunately, this model entails extremely high risks and often times is not sustainable.

Finally, several MSPs are contemplating offering micro-insurance under a "provider agent model." Under this set-up, an MSP acts as an agent for a professional insurance company such as Alico or the American Insurance Group (AIG). The MSP agent delivers and markets the product to clients, while the insurance company, designs, develops and insures the product. This model can be quite advantageous for MSPs because their risk is limited and because they can gain a relatively predictable stream of revenue from a fee-based product. Also, this scheme enables MSPs to offer products like weather index insurance[48] in which co-variant risk is high. Nirdhan is currently in discussions with Alico to launch a micro-insurance partnership. Also, an article written Dr. Ghosh, CEO of the Na-

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[47] See "An Inventory of Micro-Insurance Schemes in Nepal," *International Labour Office (ILO)* (2004), Available from http://www.ilo.org/public/english/protection/socsec/step/download/714p1.pdf.

[48] Index-based insurance is different from indemnity-based insurance because payouts are triggered by a physical event, such as rainfall measured at a regional weather station.

tional Insurance Company Ltd., in the June 1, 2008, edition of "The New Business Age" suggests that this Indian-based company may also be interested in establishing such a partnership.[49]

USAID should encourage MSPs to continue to experiment with micro-insurance, particularly with the partner-agent model and innovative products like weather index insurance which is a relatively simple product (unlike micro-health, for example) that could provide a huge benefit to Nepalese farmers. (To the author's knowledge, such a product has yet to be piloted in Nepal.) Also, the majority of the schemes that have been introduced could benefit from technical assistance. For example, in the case of Chhimek's pension plan, it is unclear (despite questions to this effect) how this scheme was a designed, an observation which is particularly troublesome given its long term, the fact the scheme is not linked to a reinsurance company and that it is operating outside the regulatory purview of Nepal's Insurance Act. Similarly, there are several schemes (such as NEFSCUN's life insurance scheme) which refund the entire premium if there is no claim, a trait which does not comport with universal insurance principles.

[49] See http://www.newbusinessage.com/index.php?option=com_content&task=view&id=226.

ANNEX F. REMITTANCE-LINKED PRODUCTS

An estimated 80 percent of the remittances sent to Nepal are sent through informal mechanisms, rather than through formal mechanisms such as banks, MSPs or money transfer operators (MTOs).[50] With about 90 percent of all remittances coming from neighboring India,[51] most remitters prefer to carry their money back in person or send it through friends and family than used untested mechanisms with which they are not familiar. Given that remittances amount to 14 percent of Nepal's GNP, this suggests a huge opportunity to entice more Nepalese to enter the formal and semi-formal financial sector, not only to leverage the impact of these flows, but also to provide migrants a means for faster, more frequent, and more reliable remittance delivery.

The business of remittances has a lot to offer MSPs, particularly at a time when many are seeking to reach financial self-sufficiency. To MSPs, remittances represent a means to generate income from a fee-based product and attract savings deposits for intermediation, as well as an opportunity to cross-sell other microfinance products such as microenterprise credit.

At least two MSPs, Chhimek Development Bank and Nirdhan Utthan Development Bank, as well as several cooperatives, have partnered with MTOs as a means to engage this market. Due to a change in the regulatory framework in 2001, MTOs like Western Union, Prabhu, Money Gram and International Money Express (IME) have entered Nepal and have expanded to the point where they now cover thousands of service points across the country, including in many rural and remote areas. MTOs work on an agent model that can include anything from grocery stores, beauty parlors and travel agencies to banks and MSPs. The startup cost for agents includes a fax machine, Internet, and branding materials, and, in return, agents earn commissions on each remittance payment. For example, Marsayangdi Multipurpose Cooperative promoted by Winrock International receives a commission of Rs. 100 per transaction from IME and Rs. 150 to 500 per transaction from Western Union.

Another way in which MSPs can engage this market is to partner with a commercial bank, either in the home country (Nepal) or the host country (likely India), which is located in close proximity to a large population of migrants and/or their families. In addition to their MTO partnerships, both Nirdhan and Chhimek have several such relationships with banks in Nepal. This model has several benefits, especially if MSPs choose a partner endowed with the resources to absorb much of the up-front costs. Commercial banks can share their data system, provide access to international payment networks, and absorb much of the marketing costs. If done properly, this option has the potential to be the cheapest mechanism for receiving remittances.

USAID can help encourage more MSPs to tap the remittance market in order to encourage informal flows to move through formal channels. Once this linkage exists, MSPs can design products that link remittances to savings accounts to increase the liquidity of the financial system and enable financial institutions to intermediate deposits for productive investment. Indeed, studies in Nepal have shown that while a large portion of remittances are spent on consumption, poor households' propensity to save can be as high as 40 percent,[52] although only 6 percent are currently being saved in financial institutions.[53] Unfortunately, most clients who currently receive remittances at Nirdhan are not credit clients and cannot legally save their remittance income with the institution. However, the new National Microfinance Policy, which just recently passed the Cabinet, will allow licensed MDBs to accept public deposits, a change which will enable MSPs like Nirdhan to bank a larger share of the remittances received through its MTO partnerships.

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[50] See Aurora Ferrari, *World Bank*, 11.

[51] See Aurora Ferrari, *World Bank*,12.

[52] See Bhubanesh Pant, "Make Remittances Productive," *The Kathmandu Post* (June 23, 2008).

[53] See Aurora Ferrari, *World Bank*, 25.

MSPs can also design specialized financial products that link remittance income directly to productive and/or developmental investments. For example, families with a demonstrated history of receiving remittances might quality for larger microenterprise loans on better terms.[54] MSPs could also work through returned migrant associations in Nepal or so-called hometown associations located in India or the Middle East to finance community development projects.

[54] Under this approach, the history of remittance income would be factored into the client's risk profile.

ANNEX G. APEX WHOLESALE LENDING INSTITUTIONS

Rural Self Reliance Fund (RSRF)

RSRF is an NRB-financed fund, established in 1991, which targets SACCOS and FINGOS and certain priority subsectors that serve the very poor or populations in underserved areas such as the Hills and Mountains. Wholesale loans have a tenor of three years and carry an interest rate of 8 percent, with the provision that 6 percent will be returned as a rebate in the case of timely payment. Beneficiaries are only eligible for up to three loans: the first for Rs. 1 million, the second for Rs. 1.5 million and the third for Rs. 2.5 million. However, in practice, RSRF rarely approves more than five to seven lakhs.

RSRF is a challenged institution. SACCOs have to send representatives to Kathmandu to apply to the fund, and the process is reportedly long with many delays. Because of the lack of qualifying institutions that meet RSRF's portfolio standards, the fund is quite liquid and mostly benefits the highly politicized tea growing sector, rather than the SACCOs and FINGOs.[55] In addition, RSRF is facing a huge delinquency problem that is compounded by RSRF's lack of professional expertise in microfinance. The institution is not sustainable (it does not have a balance sheet) and depends on NRB for capitalization.

Rural Microfinance Development Centre (RMDC)

RMDC, which has been operational since 2000, is a revolving loan fund that targets high-performing MDBs, FINGOs and cooperatives.[56] It is financed through a 20 year loan provided by the Asian Development Bank (ADB) via the government, as well loans provided by commercial banks seeking to satisfy their DSL responsibilities. Wholesale loans have a tenor of two to five years with a six month grace period and carry an interest rate of 5 to 6 percent. RMDC's interest rate used to be higher, but it recently negotiated a reduction in its cost of capital with ADB and NRB (down to 2percent) because it was finding it difficult to compete with the banks. The maximum loan size provided by RMDC is Rs. 160 million, which is significantly larger that that provided by any other apex fund.

RMDC operates differently than the other funds because it takes a supply-driven approach to placing its capital. Rather than having prospective partners apply to the fund, RMDC has teams in the field which identify potential institutions and then work with them over several months to shore up their accounts, build their capacity and prepare them for RMDC funding. RMDC claims to have 0 percent PAR, a success which it attributes to this intensive approach. Almost all of RMDC's partners are currently located in the Terai, but the fund is actively seeking new partners in the Hills and other underserved areas.

Small Farmers Development Bank (SFDB)

The SFDB, also known as the Sana Kisan Bikas Bank (SKBB), is a fund housed within the Agricultural Development Bank of Nepal (ADB/N) which targets the SFCLs promoted by GTZ and ADB. Wholesale loans have a tenor of one to five years and carry an interest rate of 10 percent. SFCLs that seek external capital are required to secure it from this fund, unless they receive specific approval from the Board to seek external capital elsewhere.

The SFDB has a joint stock ownership structure, with 19 percent of its Rs. 120 million in share capital owned by the SFCLs themselves, 58 percent by the ADB/N, 6 percent by the commercial banks

[55] According to one person interviewed, three-fourths of the 16 crore fund has gone to a long term loan to ADB/N for tea planation; only one-fourth, or 4 crores, is benefitting the SACCOs and FINGOs.

[56] RMDC currently has 69 partners: 7 MDBs, 25 FINGOs and 37 SACCOs.

and 17 percent by the government. As an entity that is majority owned by ADB/N, the institution is highly politicized and plagued by poor repayment. According to recent estimates, 30 percent of a Rs. 1 billion external loan from ADB/N is currently at risk of default, largely because of a culture of non-repayment to public sector banks. To isolate the fund from political interference and maintain it for the long run, the SFCL federation NACCF has raised Rs. 60 million to purchase ADB/N's share and hopes to create a new institution in July which will be managed by the members themselves. It is still unclear, however, whether ADB/N will forgive the Rs. 300 million in delinquent debt, allowing this fund a new beginning.

NEFSCUN's Central Finance Facility Program

NEFSCUN, the apex association for the cooperative sector, sponors the Central Finance Facility Program, which is wholely owned and capitalized by its 539 member SACCOs and is the only apex fund which lends at market interest rates. This Facility lends out over Rs. 2 crore annually with a Rs. 15 lakh loan maximum. The tenor of its loans range from one to three years and carry an interest rate of 11 percent. According to NEFSCUN's management, all loans are paid back on time and PAR stands at 0 percent. Savings earn an interest rate of 7 percent, with all profit distributed to membership organizations on an annual basis according to their share capital.

While the interest rate on these loans is higher than any other apex organization in Nepal, the fund is often the only source of external capital for SACCOs that don't have the capacity or financial wherewithall to access RMDC funding and don't meet the qualifying standards for RSRF funding (very poor, or located in underserved areas). NEFSCUN is currently working to enlarge its share capital to meet increasing needs within the cooperative sector.