Governance in Microfinance Institutions in Nepal

Ragab Kayastha

Abstract

Microfinance is an effective tool for poverty reduction of rural areas in Nepal. Especially from 1990s, the development of microfinance institutions (MFIs) has contributed to diminish the poverty of the country comparatively than previous days, by providing microfinance to the poor people. But still more than 25% of the total population is under poverty (Microfinance Summit Nepal, 2010). To make these microfinance institutions more sustainable as well as more accessible to the poor is a crucial agenda for the country. There are several factors affecting the sustainability of MFIs, and governance is one of them. In this paper, there are the explanations of 2 types of governances. One type of governance is the governance inside the MFIs, which is distinguished as corporate governance. The other is governance as a policy body, the system of the Government regarding microfinance policy in Nepal. It can also be distinguished as good governance. Governance inside the MFIs is also meaningful essence to attempt the security of the customers of microfinance. The microfinance act and regulations are complicated in Nepal so as customers' point of view it's hard to deal with the process while using microfinance. Microfinance institutions in Nepal are governed by Banks and Financial Institutions Act 2006 (BAFIA) whereas there are lots of Savings and Credit Cooperatives (SCCs) and Small Farmer Cooperatives Ltd (SFCLs), those are handled by Cooperative Act (1992). There is also Financial Intermediary Act 1998 to control the activities of Financial Intermediary Non-government Organizations (FINGOs). The procedures for getting services from the different modalities of MFIs differ. So there is a need of one umbrella act to make the regulatory system of microfinance simple, and easy to understand and get the access with.

Keywords: Poverty Reduction, Microfinance Institutions (MFIs), Governance, Act, Regulation

1. Introduction

Nepal is one of the least developed countries in the world having US$ 392 GDP per capita income (ADB, 2007). The Nepalese economy is predominantly an agricultural economy. Around 80 percent of the population lives in the rural area of the country engaging in the agricultural sector. GDP growth of Agricultural sector is 1.0 percent (ADB, 2007). Although more than 80% of the population is involved in agricultural sector, the growth rate is comparatively low. By the end of Tenth Plan, in 2007, about 31 percent of the population was found to be living below the poverty line which was 42 percent before the Ninth Plan[1]. At the declaration of Microfinance Summit Nepal 2010, the average number of

1) Sigdel, Bamdev (2007)

the poor people has come around 25 percent. But it could not be distinguished as the real aspect of poverty reduction, it might also the result of the income gap between the rich and poor people in Nepal.

Nepal has been witnessing planned development efforts since the last more than five decades. The objectives envisaged in most of the plans aim at reducing poverty. However, the intensity of poverty in the country calls for massive and genuine efforts. Microfinance is one of the effective tools for poverty reduction.

Microfinance is termed as the financial services rendered to the deprived groups of the people and small enterpreneurs in savings, credit, remittance, rural insurance, etc. to help them in developing self-employment opportunities and various income generating activities. Small size of loan, group savings, small-scale enterpreneurs, diversified utilization and simple and flexible terms on credit (without collateral) are the determining characteristics of its definition.

2. The Development of Microfinance Sector in Nepal

The microfinance sector in Nepal has expanded considerably in recent years. The earliest initiatives for establishing microfinance services in Nepal can be dated back to the early 1960s when the first credit cooperatives were established and primarily intended to provide credit to the agricultural sector[2)]. So the cooperative movement became the first vehicle of microfinance in Nepal, as 13 cooperatives provided flood victims access to financial services adapted to their specific needs. In parallel, rural finance institutions were established such as the Agricultural Development Bank of Nepal (ADBN)[3)], which aimed at providing credit and marketing support to agriculture.

In 1974, the two state-owned commercial banks, Nepal Bank Ltd. and Rastriya Banijya Bank were directed by the central bank, Nepal Rastra Bank, to invest at least a portion (first 5% to increase as high as 12%) of their deposit liabilities in the ‘small sector’. This marked the beginning of the directed credit system in Nepal. In 1976, the scope of the small sector was broadened to include agriculture, cottage industry and services, and has since then been called the ‘priority sector’. The credit didn’t reach the poor, as only influential and well-connected people, with collateral, were able to access the program. This led to the development of targeted initiatives, such as the Intensive Banking Program (IBP) in 1981, initiated by the government and the central bank, through partnerships with commercial banks. Under this approach, group guarantee for loan repayment were used instead of physical collateral.

Starting in 1975, the Small Farmers Development Program, implemented by the Agricultural Development Bank of Nepal, mobilised farmers groups using a credit plus approach, and was the first experience of group-based lending in Nepal. Unfortunately, It failed due to political pressure for a fast expansion, overemphasis on credit, high delinquency levels and the overall not satisfactory performance of the system.

In 1982, the Cottage and Small Industries Project and the Production Credit for Rural Women all provided new directions to priority sector lending, focusing on project viability rather than collateral, and therefore provided a financing window to the poor through commercial banks collaborating with local development organizations. The commercial banks perceived this program as more of an obligation towards the central bank than a business interest.

In 1990, the government of Nepal established the Rural Self-Reliance Fund (RSRF), with the objective of providing wholesale loans to NGOs, cooperatives and other financial intermediaries for on lending to the poor. The Microfinance Department of NRB acts as the secretariat of the RSRF and management committee headed by the NRB

2) Sinha, Sanjay (2001)

3) According to the Banks and Financial Institutions Act (BAFIA) 2006, ADBN is also classified as Type A, commercial bank. So after classified as a commercial bank, the new name of ADBN is Agriculture Development Bank Limited (ADBL). However, I have mentioned the old name, as ADBN in this paper.

deputy governor oversees the fund.

In 1992, the government of Nepal, following a recommendation from the NRB, established Regional Rural Development Banks (RRDB) in each of the five development regions of Nepal, modelled on the Grameen Bank methodology. It is called Grameen Bikash Bank (GBB). The majority of the ownership is in the hands of government, Nepal Rastra Bank (the central bank) and public commercial banks, while other private commercial banks have small equity stakes. During the same period, private initiatives led by NGOs, such as Nirdhan and the Center for Self-help Development, also used the Grameen Bank methodology, resulting in a generally more efficient and successful replication. In the 1990s, with technical assistance from GTZ, local branches of ADBN under the Small Farmer Development Program, started to be reorganized into federations of small farmers groups, the 'Small Farmer Cooperatives Ltd (SFCL); each operating as an autonomous cooperative.

With the promulgation of the Development Bank Act in 1995, Nirdhan was the first NGO (1998) to transfer its microfinance portfolio into an autonomous microfinance rural bank (Nirdhan Utthan Development Bank). Since 2000, three other microfinance rural banks were created through the same process first initiated by Nirdhan, with DEPROSC Development Bank in 2000, Swabalamban Bikas Bank Ltd and Chhimek Bikas Bank in 2001. Acknowledging the poor performance of the GBBs under public ownership, the central bank started a restructuring program, which will lead ultimately to the privatization of the five GBBs.

With the view of providing a source of wholesale fund to regulated microfinance institutions (MFIs), the Rural Microfinance Development Center (RMDC) was established in 1998, and later on opened its lending to other MFIs. In 2001, the Small Farmer Development Bank (SFDB) was established under the Development Bank Act to provide wholesale funds to Small Farmer Cooperatives Ltd. (SFCLs), which were formed after the transformation of Small Farmers Development Projects, promoted under the Small Farmers Development Project, into cooperatives. SFDB is owned by ADBN, the Ministry of Finance, two commercial banks, and a group of SFCLs. It is envisaged that SFCLs majority ownership will grow over time.

Generally, the microfinance institutions (MFIs) in Nepal can be divided into two types: i) Community Based MFIs, such as SCCs and SFCLs; ii) Commercial Oriented MFIs, such as MFDBs, GBBs, FINGOs, etc. So there are several modalities of MFIs in Nepal.

There are several factors which affect the sustainability of Microfinance Institutions (MFIs). Governance is one of them. The objective of this paper is to discuss theoretically how the microfinance governance looks like and give the practical insight of the governance in Nepal.

3. Review of Relevant Literatures

3. 1 What is Governance and Good Governance Relating with Microfinance?

3. 1. 1 Microfinance Governance

The need for governance exists anytime a group of people called stakeholders come together to accomplish an end result. It is the process through which this group of people make decisions that direct their collective efforts. Stakeholders are the people and groups with an interest, or 'stake', in the success of the institution.
Depending on the legal status of the institution, stakeholders may include[4]:

・Donors
・Government

4) Ruth Jacobs, Ruth Dueck Mbeba, Bill Harrington (2007).

・Other financial institutions
・Regulatory bodies such as a country's Central Supervisory Bank
・Other Stakeholders, including clients, employees, and shareholders

Governance is the process by which a board of directors, through management, guides an institution in fulfilling its corporate mission and protects the institution's assets over time[5]. A board of directors is established to provide oversight and give direction to the managers of an institution. The board carries out this function on behalf of a third party, referred to as shareholders in the case of for commercial oriented corporation. But, there are no owners in non-profit corporations, third party is not easily identified and had been defined to include the corporation's clients, staff, board and donors[6].

3. 1. 2 Good Governance[7]

Good Governance is about both achieving desired results and achieving them in the right way. Since the "right way" is largely shaped by the cultural norms and values of the institution, there can be no universal template for good governance. Each institution must tailor its own definition of good governance to suit its needs and values.

There are, however, some universal norms and values that apply across cultural boundaries. The United Nations published a list of characteristics of good governance. The principles those Good Governance models[8] include are:

1. Legitimacy and Voice
2. Direction
3. Performance
4. Accountability
5. Fairness

3. 2 Why Need to Focus on Good Governance?

In the microfinance field, good governance has assumed increasing importance for several reasons[9].

- As microfinance institutions grow in their outreach, the size of their assets, as reflected in their portfolio, also grows to considerable size. Ensuring effective management of this growth requires added input and involvement from the board of directors.
- The increasing numbers of MFI's are becoming regulated and assuming the responsibilities and challenges of a regulated entity. Capturing deposits from savers and investors is an important challenge and requires the greatest oversight.
- MFI's are operating in increasingly competitive markets, and maintaining or increasing market share has become an important component of their strategic objectives.

3. 2. 1 Types of Boards[10]

There are some types of boards and conditions exist to achieve effective governance. Not all types of boards will have the same level of involvement in operation of the institution. For a successful microfinance bank, there is one clearly preferred board structure. Those structures are:

---

5) Rock, Rachel, Otero, Maria and Saltzman, Sonia (1998).
6) *Ibid*.
7) Ruth Jacobs, Ruth Dueck Mbeba, Bill Harrington (2007).
8) *Ibid*.
9) Rock, Rachel, Otero, Maria and Saltzman, Sonia (1998).
10) *Ibid*.

i. The Rubber-Stamp Board that only reacts to and supports management;
ii. The Hands-on Board that engages directly in operations taking on some of management's role;
iii. The Representational Board made up of highly influential individuals with access to sources of power and funds;
iv. Multi-Type Board that balances representational members with microfinance expertise, and are generally better equipped to make informed decisions on a timely and efficient basis. This is the recommended board structure for a good MFI wishing to convert and be regulated.

3. 2. 2 Relationship between Board and Management

Board and management deal with the same issues, but at different levels. The board deals with policies while management deals with practical implementation. The relationship between the board and management is defined by partnership, particularly between the board chair and managing director[11)]. This partnership must be based on mutual support, trust and respect forged them. Overall, the Board governs management. A good microfinance institution boards understands its role and responsibilities, and maintains a clear separation with management of the organization, if it cannot effectively assess management's performance, the role of oversight suffers.

Effective governance requires boards to focus on three major areas of responsibility: i) management accountability, ii) strategic planning and policy-making, and iii) self-regulation.

4. Analysis and Interpretation

Microfinance regulation in Nepal is mainly governed by the Banks and Financial Institutions Act (BAFIA) 2006 and the Financial Intermediary Act. BAFIA has classified the financial institutions into four groups, in which the financial institutions providing microfinance service are located in Type D and prudential norms are designed in line with normal financial institutions. Moreover, capital requirement is lower for MFIs. 13 microfinance banks, 2 wholesale MFIs and 16 co-operatives are regulated under this act[12)].

Commercial banks are in Type A, which are supposed to be more contributing all kinds of people as customer throughout the country. Commercial banks operate in a completely different environment from what one would witness in case of microfinance sector wherein the needs, policies, capabilities, reach etc. very different[13)]. The products and facilities offered by commercial banks are significantly large and primarily targeted at commercial business and individuals allowing the former to yield higher return on the capital employed. The smaller clients and those belongings to the poor rural mass are not entertained as the general perception exists that they do not have stable and viable source of income so as to substantiate cash flow for servicing their loans. Similarly, subsistence farmers also do not form the target market of commercial banks as they lack adequate collateral to guarantee their loans.

On the other hand, MFIs capitalize on their local branch network and close proximity with their clients. The range of services offered by them includes loans, saving facilities, insurance, transfer payments, and even micro-pensions to poor who cannot afford to enter the formal system of commercial banking[14)]. MFIs employ staff from local population, possess extensive data about the clientele, have deeper relationship with the clients and can operate much efficiently than commercial banks in those areas.

As governance concerns, BAFIA states following features[15)]:

- Expedient to amend and consolidate forthwith the current legislation relating to banks and financial institutions

11) *Ibid*.
12) Microfinance Summit Nepal, 2010.
13) *Ibid*.
14) *Ibid*.
15) Mathema, Vijaya Ram (2008).

and thus make it suitable to the times in order to promote the trust of the public in the overall banking and financial systems of the country.

- Protect and promote the rights and interests of depositors.
- Provide reliable and quality banking and financial intermediary services to the public through healthy competitions among banks and financial institutions.
- Minimize risks relating to the banking and financial sectors.
- Liberalize the banking and financial sectors and further boost and consolidate the economy of the country.
- Make necessary legal provisions relating to the establishment, operation, management and regulation of banks and financial institutions.

For the establishment of banks and financial institutions, the concerned person must apply for registration in Nepal Rastra Bank (NRB) under Company Act (2005), with all the documents as specified in the BAFIA for prior approval as public limited company according to the current law. There are 15 MFDBs under this Act. In addition, there are Co-operative Act (1992) and Financial Intermediary Societies Act (1998) for governing SCCs, SFCLs and FINGOs respectively.

Later in 2007, Government of Nepal (GON) promulgated Microfinance Policy (2007) with the slogan of sustainable microfinance service to the poor and make easy to access to them.

5. Key Findings and Conclusions

The legal procedure of MFIs in Nepal is quite complicated. Even BAFIA has distinguished the MFIs as Type D, the legal framework is divers. As client's point of view, it is bit confusing for getting microfinance services because of the various legal procedures. It may cause difficulty in sustainability of microfinance services and institutions.

In Nepal, the legal framework of microfinance is bit strange. Generally, there should be need of microfinance policy to make act, rules and directive related to microfinance. But, several acts have made before the establishment of Microfinance Policy (2007). It is quite interesting.

Government of Nepal (GON) has made commitment about the policy of poverty reduction and promotion of microfinance in paper, but lack in the practice.

Sometimes Government arbitrarily announced the policy considering the poor people i.e. exemption of loan, Biseshwor with the Poor, Jagriti, Youth Employment Programme, etc which are not encouraging the MFIs and affect their management system.

6. Recommendations

As governance inside MFIs, it is necessary to have good governance in MFIs to have efficient microfinance service among the poor. On the other hand, as governance outside MFIs, it needs good governance to create and guide the appropriate operating environment for the MFIs.

Effective governance strikes the appropriate balance in the relationship between a board of directors and management in their combined efforts to move the institution forward. Moreover, a clear articulation of the function of microfinance boards is essential for their effective governance.

References

Balkenhol, Bernd (2007) Microfinance and Public Policy—Outreach, Performance and Efficiency, International Labour Organization, Palgrave Macmillan

Hulme, David and Arun, Thankom (2009) *Microfinance – A reader*, Routledge Studies in Development Economics

Kunwar, Krishna Bahadur (2006) *Rural Development in Developing Countries*, Mina Publications

Ledgerwood, Joanna and White, Victoria (2006) *Transforming Microfinance Institutions: Providing Full Financial Services to the Poor*, The World Bank

Mathema, Vijaya Ram (2008) *Microfinance in Nepal*, Variety Printing Press

Mersland, Roy and Storm, R. Oystein (2009) "Performance and Governance in Microfinance Institutions", *Journal of Banking & Finance,* 3, 662–669

Microfinance Summit Nepal, 2010 < http://microfinancesummitnepal.org/>

Nepal, Govind (2008) Development Planning in the Era of Globalization, Himalaya Book Stall

Rock, Rachel, Otero, Maria and Saltzman, Sonia (1998) "Principles and Practices of Microfinance Governance", ACCION International

Ruth Jacobs, Ruth Dueck Mbeba, Bill Harrington (2007) "Board and Governance Training for Microfinance Institutions Toolkit", *MicroSave—Market-led Solutions for Financial Services*

Sigdel, Bamdev (2007) "Poverty and Inequality: Micro Finance on Gradual Poverty Reduction in Nepal", Socio-Economic Development Panorama, 1–2

Sinha, Sanjay (2001) "Nepal", *The Role of Central Banks in Microfinance in Asia and the Pacific*

［カヤスト　ラガブ　横浜国立大学大学院国際社会科学研究科博士課程後期］