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Louis Berger

Access to Finance for the Poor Programme

Political and Economic Analysis

Inception Phase Deliverable A0.4– Political and Economic Analysis

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Contents

LIST OF ACRONYMS

AFP	Access to Finance for the Poor
AusAID	Australian Agency for International Development
BFI	Bank Financial Institution
CA	Constituent Assembly
CO	Community Organisation
CPDCC	Constitutional Political Dialog and Consensus Committee
DFID	Department for International Development
DSL	Deprived Sector Lending Prgoramme
FAO	Food and Agriclture Organisation
FINGOs	Financial Intermediairy Non- Government Organisations
FMDB	First Micro-finance Development Bank
FSAP	Financial Sector Assessment Programme
FSPs	Financial Sector Providers
GDP	Gross Domestic Product
GoN	Government of Nepal
HDI	Human Development Index
HLPC	High-Level Political Committee
IMF	International Monetary Fund
MFDB	Micro-Finance Development Bank
MFI	Micro-Finance Institution
MWFWR	Mid- and Far- Western Region
NC	Nepali Congress
NCP UML	Communist Party of Nepal Unified Maoist Leninist
NRB	Nepal Rastra Bank
PAF	Poverty Alleviation Fund
RMDC	Rural Micro-finance Development Center
RSRF	Rural Self-Reliance Fund
SACCOs	Savings and Credit Cooperatives
SCCS	Savings and Credit Cooperatives
SCG	Savings and Credit Groups
SFDB	Small Farmers Development Bank
SMEs	Small and Medium Enterprises
SHGs	Self-Help Groups
SRGs	Self-Reliance Groups
UCPNM	Unified Communist Party of Nepal Maoist
UN	United Nations
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Fund
USAID	United States Agency for International Development
WUPAP	Western Uplands Poverty Alleviation Project

Political and Economic Analysis

Introduction: Background and Context

Enhancing financial inclusion in Nepal is confronted with political, economic, financial, social and topographical challenges, all unique in nature and structure. This means that a normative approach to an access to finance programme will have limited traction. Furthermore, it is critical to fully understand the history of Nepal – its political, economic and security evolution; the remoteness of targeted communities, its cultural norms and practices -- when charting a course for the Access to Finance for the Poor (AFP) programme in the priority regions (mid-west and far-west). Specifically, the following constraints need to be carefully considered as the AFP Programme enters its implementation phase:

- Complex political transformation;
- Potential for hartals/strikes given the political impasse over the drafting of the constitution;
- Significant poverty incidence in the Far-Western and Mid-Western regions;
- Significant vulnerabilities within the financial sector, including the largely unsupervised cooperatives sector;
- Increase in client over indebtedness among lending institutions;
- Significantly low participation of poor and disadvantaged groups in the decision making of community-based cooperatives- which are the mainstay in the Mid-West and Far-West regions
- Methodological rigidity adapted by lending institutions in rural and scattered communities
- Social stratification is such that poor and disadvantaged groups feel far removed from access to finance sources
- Women usually do not have title, thereby preventing them from using physical assets as collateral

Part I of this assessment provides an overall analysis of the political environment, national and local economic considerations, financial sector developments, social and cultural implications and gender; youth and disadvantaged population imbalances.

Part II looks at the implications of each of the above on the overall AFP programme and the mitigation approaches to minimize implementation risks. **Deliverable B0.5** (AFP Programme Risks and Strategy) provided separately will be updated on a periodic basis.

Part 1- Assessment

1. Political Environment

The people of Nepal elected representatives to the Constitution Assembly (CA) in November 2013 for the second time[1] after the Comprehensive Peace Agreement (CPA) was signed between mainstream political parties and the Maoist Party in 2006. In the 2013 election, the Nepali Congress (NC) emerged as the largest party followed by Communist Party of Nepal Unified Maoist Leninist (CPN UML) and Unified Communist Party of Nepal Maoist (UCPNM). Communist Party of Nepal (Mohan Baidhya Group), a breakaway faction, of the UCPNM, didn't participate in the election. **Figure 1** provides the division of seats among the various parties in the CA.

[1] The first election to the CA was held in 2008.

Figure 1 - Seat Distribution in the Constituent Assembly		
S. No	Name of the Political Party	Seats in the CA
1	Nepali Congress (NC)	196
2	Communist Party of Nepal (NCP UML)	175
3	Unified Communist Party of Nepal Maoist (UCPNM)	80
4	Rastriya Prajatantra Party Nepal (RPP N)	24
5	Madhesi Jana Adhikar Forum, Nepal (Loktantrik)	14
6	Other Parties and 2 Independents	86
7.	Nominated by Government	26[2]
	Total	601

None of the parties had a clear majority to stake a claim to government formation. It took 4 months following the election for the two largest parties in the CA--NC and NCP UML—to finally form a government with the support from fringe parties. Since its inception, the coalition government has struggled to maintain consensus on key issues of governance. This has been largely attributable to factionalism within the main parties of the coalition.

The main task of the CA is the drafting of the Constitution. After more than 5 years (including the tenure of the last CA), the three main political parties--NC, NCP UML and UCPNM--are yet to come to a common understanding on four main contentious issues:

i. Type and form of Federalism (the number and names of federal states based on identity and economic viability, availability of natural means and resources, administrative accessibility, physical infrastructure/geography, ethnic mix, etc.)
ii. Form of Government (Presidential System or Parliamentary model or some hybrid form)
iii. Electoral system (seats with proportional representation in the federal Parliament; distribution of political power among centre and states, etc.)
iv. Judicial system (separation of the judiciary from the control of the Parliament with the appropriate checks and balances among judiciary, legislature and executive functions or the placement of the judiciary within the executive and/or the Parliament, as well as the central and state structure of judiciary etc.)

The political parties in the CA continue to deliberate on these above-mentioned key issues, thereby further delaying the entire constitution writing process. It is generally observed that views of UCPNM on these issues are very radical and some of them are against the spirit of democracy whereas the views of NCP UML and NC do not fully capture the changed aspiration of Nepalese people. Both NC and NCP UML continue to blame the obstructionist approach of the Maoist leaders. The Maoist and other opposition parties claim that the ruling parties are trying to force issues on the strength of their majority status rather than taking all into confidence. Meanwhile, the opposition parties under the UCPNM umbrella have launched nationwide protests to press for identity-based federalism among others.

On the other hand, there are many political parties (outside the CA) that subscribe to the view of the breakaway faction of UCPNM, the CPNM, which posits that the constitution should be drafted through a round table conference involving all the political parties and stakeholders and not through CA. CPNM has formed a 33 party alliance to take their agenda forward. This matter seems to have become more complex by the dual positions of some of the political parties who want to be on both sides.

Figure 2 summarizes the different proposals/positions of the political parties on the above-mentioned issues.

[2] Out of 26 positions only 17 were nominated on August 30, 2014 with 9 yet to be nominated.

Figure 2 – Differing Proposals Among Political Parties

Issues	NC	NCP UML	UCPNM	Others
Type and form of Federalism	-a six or seven state model based on clear criteria -three tier federal structure-central federation, provinces and local bodies -Names of provinces to be decided through 2/3 majority of the first provincial assembly	- Flexible in number - five – seven state/province model most likely - multiple identity-based federalism -based on economic viability - north south divided	-delineation of federal states based on ethnic identify -not clear on (single ethnic, multi ethnic) or economic viability -Ready to accept 6 state/province model with identity based names decided beforehand or leave to concerned provinces to finalise names provided the number of provinces is 14 or 11	-Terai based parties want 1 Pradesh for Terai -Some are ok with 2 Pradesh -based on geography of Terai -many ethnic based parties propose caste and ethnicity based federalism
Form of Government	-Parliamentary/ Westminister form with the executive to be elected through majority votes in Parliament -Election of ceremonial President and Vice President through electoral college	-Parliamentary system with provisions/changes aimed at ensuring stability -Directly elected PM (Left this stand in agreement with NC recently) -ceremonial President -three-tier government	-Westminister form not acceptable -directly elected president -parliament appointed PM	-not clear -mostly parliamentary form
Electoral System	-Bicameral Parliament with 175-member Lower House and 75-member Upper House -20-250 members in provincial assemblies	-bicameral Parliament -State legislature to be smaller in size	-bicameral system	
Judicial System	-Besides courts in each province, one Supreme Court with the authority to interpret the constitution A separate constitutional court for 10 years since the promulgation of the new constitution to settle disputes related to federalism	- Constitutional Council to appoint Supreme Court chief justice -the Judicial Council to appoint the remaining justices.	- Federal Supreme Court at the centre -Earlier stand on Judges to be nominated by Legislature, but ready to other form	

A recent effort by the 3 large political parties in the CA to establish a High-level Political Committee (HLPC) with rotational leadership to take on the remaining tasks related to the peace process as well as hold dialog with forces outside the CA has been hailed as a positive step. However, recent assertions of the Maoist leaders that HLPC and constitution making have no direct relationship (and that their protests for identity-based federalism continues) makes matters more difficult.

The recent one-week extension of the CA's Constitutional Political Dialog and Consensus Committee's (CPDCC) mandate for resolution of the above disputed constitutional issues may lead to the shortening of time accorded to other important tasks such as seeking public comment on the new draft and further deliberations within the CA on the proposed changes. If the CPDCC is unable to resolve the issues, it has been asked by the CA to submit a questionnaire on those issues for a vote on the floor of the CA. This could further aggravate the situation and lead to a chaotic situation in the political environment of the country.

When the political parties went to electorate in the last election, they promised that the constitution writing process will be completed in a year's time. The time is ticking and there is increasing disenchantment among the people on the pace of progress. The main political parties are treading on a risky path and continuation of this impasse could not only backfire on them but also serve as a detriment to Nepalese nascent democracy. Given the pace of progress to-date, it is highly unlikely that a resolution is likely by the deadline dates announced by the CA.

The AFP Programme will have to closely monitor developments on the above over the next 2-3 months, as the outcome of the deliberations on the constitution can have an impact on the delivery of our programme in the priority districts in the medium to long-term.

2. National and Local Economic Considerations

The most recent analysis on the Nepalese economy done by the IMF[3] indicates that the Nepalese macroeconomic situation remains broadly favourable despite the uncertain political situation, and that growth is projected to recover owing to the good monsoon, robust growth in services and increased public spending. The assessment also notes that while high remittances inflows are expected to continue to support the external position, the outlook for growth will depend largely on improving the environment for private investment as well as resolution of political issues (described above). A decisive boost in public spending and structural business enabling reforms to create a more conducive environment for business formation and expansion needs to be expedited to capture the positive sentiment generated through the recently announced power and hotel deals with the GMR Group and Sheraton Hotels.

Nepal also recently went through its' first-ever FSAP assessment with the IMF/World Bank. The assessment has brought to light the significant vulnerabilities within the financial sector that include deteriorating asset quality and interconnectedness, an underdeveloped financial sector infrastructure—including the legal/regulatory framework, and preparedness to deal with major financial crisis. Concerns remain with the largely unsupervised cooperatives sector that is growing rapidly as well as multiple lending. Key policy recommendations are also calling for a recalibration of the monetary policy to control the volatility and level of excess reserves in the financial system and further reforms to strengthen regulation and supervision, improvement of the financial sector infrastructure to reduce systemic risk and a uniform microfinance policy to increase access to finance.

A further developed and inclusive Nepalese financial sector requires increased economic opportunity and growth and vice versa. In the past decade, Nepal has averaged 4.1% annual GDP growth and is estimated to have grown just 3% in 2013[4]. The structure of Nepal's GDP (**Figure 3**) reflects a low contribution of an industrial sector that supplies goods largely for local consumption. Exports lag significantly behind while import costs continue to rise, creating a large trade deficit and spurring inflation, although newly completed trade negotiations with bordering countries should expand trade opportunities in the upcoming years. The service industry continues to grow with wholesale and retail trade as the largest contributor followed by transport, storage, communications and real estate. While workers' recorded foreign remittances constitute an estimated 23% of GDP, they are largely used for consumption and not put into productive sectors. Microenterprises still constitute the largest source of employment, especially in more rural areas, and a recent census of small manufacturing establishments employing less than 10 people but registered in relevant government offices showed just 32,326 establishments, with only 8% in the Mid-Western Region and 4% in the Far-Western Region[5].

[3] IMF Article IV consultation mission's press release, July 2014
[4] IMF World Economic Outlook, April 2013
[5] Central Bureau of Statistics (CBS) Census (2008-2009)

Figure 3: Gross Domestic Production by Sectors in Billion Rupees[6]

Year/Sector	2006/7		2011/12		2012/13		2013/14 (Estimated)	
	Value (in bn. NR)	Share %	Value (in bn. NR)	Share %	Value(in bn NR)	Share %	Value(in bn NR)	Share %
Agriculture	184.8	34.7%	224.7	33.5%	227.2	32.6%	237.9	32.4%
Industry	86.8	16.3%	98.1	14.6%	100.6	14.5%	103.3	14.1%
Service	243.5	45.8%	318.5	47.5%	335.1	48.1%	355.6	48.4
Total	532.0		670.3		696.1		734.2	
% change over previous year	3.4%		4.8%		3.8%		5.5%	

Additionally, there is limited trust between the GoN and the private sector. There is a general lack of national and regional economic forums and channels to influence long-term economic policies that encourage an environment for investment and enterprise, and effectively mainstream people into economic advancement programmes, especially in the more remote and poorer Mid- and Far-Western Regions (collectively known as the MFWR). This has largely been attributed to the political instability and decade long conflict attributed to the indecisiveness among the main political parties on clear roles towards development policies and practices.

In the initial years, after the overthrow of partly less Panchayat System in the 90s, the GoN adopted free market policies but later moved towards more socialistic policies and also acted as market interventionist at times. The government has been accused of discouraging private sector participation and expansion.

Economic activity varies significantly between Nepal's development regions and ecological zones. The country is split into five administrative regions and three ecological zones: the Terai, comprising 42% of the land and 50.2% of the population, is the most productive region with agriculture as its base. With a larger population and a more moderate climate in the Terai, industry and services are also greater here. In comparison, the Mountain zone, comprising 35% of the land area but just 6.7% of the population, and the Hill zone, comprising 42% of the land area and 43.1% of the population, is more remote with rough terrain, low rainfall and poor-quality soil. As shown in **Figure 4**, the MFWR has a higher percentage of Hill and Mountain land.

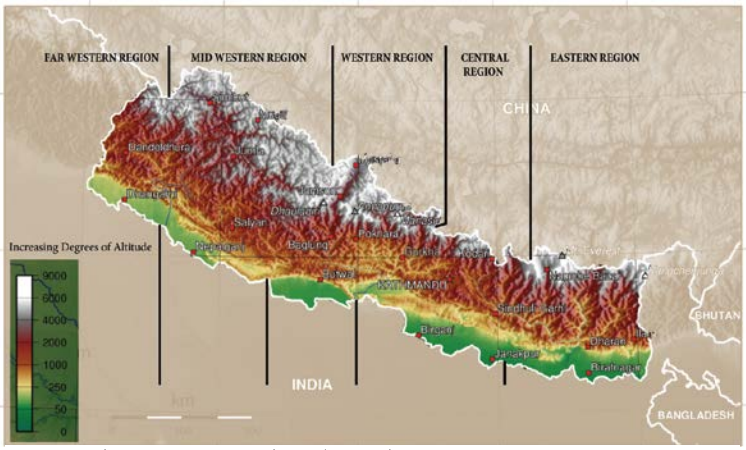

Fig 4- Administrative and Ecological Zones

Therefore, it is not surprising that the poverty level[7] rises in the regions where economic activity is limited largely to subsistence agriculture (see **Figure 5** for main value chains). The percentage of those people living below the poverty level is estimated to be 31% in the Mid- Western Region and 45% in the Far-Western Region. Determining viable microenterprises and appropriate financial products and delivery mechanisms in the MFWR, given the geographic terrain, poor communication ns and infrastructure contributing to higher poverty, will be one of the greatest challenges of the AFP programme and will require strong networks, economic incentives and technology.

[6] Economic Survey 2013/14, Ministry of Finance Nepal Government)

[7] Estimated at 25% of the population and 30% of the population living on less than £8.5 per month (2011 Population Census and NLSS, 2009/10; IFAD Rural Poverty Portal-Nepal)

Figure 5. Main Value Chains in the MFWR

Far Western Region

- High value agriculture products like non-seasonal vegetables, ginger including dried, lentils, apples, walnuts, vegetables seed, herbs, etc.
- Animal husbandry

Mid-Western Region

- Non-seasonal agricultural products, lentils, cotton, vegetable seeds, ginger, apple, walnut, pear, dairy
- Herbs including CORDYCEPS (locally termed Yarsagumba), a high value product grown only in the alpine areas
- Paper and paper products
- Animal husbandry

HDI ranking among the 15 eco-development regions, the Central Hills has the highest HDI score at 0.571, and the Far Western Mountains the lowest at 0.386. In the Tarai, the Eastern Tarai has the highest value at 0.485; the Central Tarai the lowest at 0.443. Among the Hill regions, the Far Western Hills has the lowest HDI score, at 0.409. For the Mountains, Western Mountain region fares better at 0.529 by virtue of higher incomes in Manang and Mustang. Far Western Mountains lags behind at 0.386, largely due to low educational level and per capita income.[8]

3. Financial Sector Developments

Nepal's financial sector comprises a variety of institutions. Bank and Financial Institutions (BFIs) are classified into four categories (A, B, C and D) by BFI Act 2063 BS. Category 'D" is the micro finance development banks (MFDBs/MFIs). As part of the Deprived Sector lending (DSL) guidelines of NRB (discussed in more detail below), all Class A, B and C BFIs also lend directly or provide wholesale fund to whole sale and retail MFIs. Other financial institutions are regulated by various agencies as mentioned below. (**Figure 6**)

Figure 6 – NRB Regulated BFIs and other FIs in Nepal

SN	Types of Institutions	No (As of Mid-July 2014
NRB Regulated BFIs		
1.	Class A (Commercial Banks)	30
2.	Class B (Development Banks)	84
3.	Class C (Finance Companies)	53
4.	Class D (Micro Finance Dev. Banks)	37
	Total	**204**
Other Financial Institutions		
1.	Financial Intermediary NGOs (FINGOs)	29[9]
2.	Licensed Cooperatives (Limited Banking License by NRB)	15[10]
3.	Insurance Companies	25[11]
4.	Other NGOs involved in MF (Estimated)	15000
5.	Cooperative Societies	31177[12]
6.	Among Cooperative Societies SACCOs & Saving Credit Cooperatives (Estimated)	18000[13]
7.	Postal Saving units	117

Class D-Micro finance Development Banks (MFDBs) include NIRDHAN, CHIMEK, DEEEPROSC Development Bank, Swabalamban Bikas Bank, NERUDE, and FORWARD, etc. Several of these institutions were transformed from FINGOs to their current status. Other MFDBs are being established as subsidiaries of some of the BFIs. Three of the MFDBs are wholesale financing

[8] Nepal Human Development Report 2014, GoN and UNDP
[9] Regulated by NRB under Financial Intermediation by Societies Act 2055 BS
[10] Regulated by NRB and DOC under Cooperatives Act 2048 BS
[11] Regulated by Insurance Board under Insurance Act 2049BS
[12] Regulated by Department of Cooperatives under Cooperatives Act 2048 BS
[13] Regulated by Department of Cooperatives estimate (Saving Credit, SFCLs, Multipurpose doing Saving Credit) under Cooperatives Act 2048 BS

institutions: a) Rural Microfinance Development Centre (RMDC), b) Small Farmers Development Bank (SFDB) and c) First Microfinance Development Bank (FMDB). NRB also manages the Rural Self Reliance Fund (RSRF), a whole sale fund that has provided funding to 940 FIs (including 826 cooperatives and 53 NGOs) spread over 68 districts. As of April 2014, the RSRF had extended wholesale loans of Rs 1.52 billion with an outstanding loan portfolio of Rs 0.61 billion. These FIs mostly use the Grameen Bank (Bangladesh) style lending methodology.

Savings and Credit Cooperatives (SACCOs) are small, indigenous savings and credit groups, which lend funds from group savings. SACCOs are registered under the Cooperative Act and are largely funded through contributions from local community members. FINGOs, registered under Financial Intermediary Act, have limited licenses to carry out financial services and act as intermediary groups that provide financial services (usually savings and loans) for end clients through MFIs. The FINGOs have been mandated by the NRB to transform to MFDBs by mid July 2015 or otherwise their operations will be closed down. Many of them are in process of transformation and it is expected that they will fully comply with NRB guidelines using NRB issued incentives to do so.

Additionally, the government established a Poverty Alleviation Fund in 2004 which is working in 49 districts and facilitated through over 22,000 community organisations (COs) and 1,600 village development committees (VDCs). In 2008, the GoN established the Youth and Small Entrepreneurs Self Employment Fund which provides collateral free credits to Dalit, janajati and conflict-affected youth. As of June 2013, an estimated Rs. 963.3 million had been disbursed to youths to start small and medium-sized enterprises (SMEs).

Finally, in addition to the above, there are large numbers of formal Saving and Credit Cooperatives (SCCS) and informal SACCOs including Savings and Credit Groups (SCG), Self-Reliance Groups (SRG) or Self Help Groups (SHG) that provide financial services to the poor.

Among the above-mentioned financial institutions licensed by NRB and other financial intermediary instructions, commercial banks hold the largest market share, with roughly 75% (NRB) of total loans. Banks have reported sizeable profits over the past few years. Commercial banks also have excess liquidity, which is largely attributable to a lack of new investment avenues, limited lending products and services and slow progress in capital expenditure. Credit to the private sector as a percentage of GDP stood at 56.8% in Mid April 2014 as against 52% in 2011[14]. Despite the large number of FIs, penetration has remained low (see **Figure 7**), especially as one moves towards the West and into the Hill and Mountain zones. A majority of the financial entities are located in the Central and Terai regions. Overlap of borrowers among institutions is also a large problem, and as mentioned above, linkages with viable microenterprises by ecological zone is lacking.

Figure 7- Population per BFI branch[15]

Region	Population	Branches of BFIs 2014	Population per branch (Average)
Eastern	5,811,555	415	14004
Central	9,656,985	1205	8014
Western	4,926,765	617	7985
Mid-Western	3,546,682	216	16420
Far-Western	2,552,517	115	22196
Total	26,494,504	2568	10317

Over the past few years, the number of commercial bank branches has increased significantly and population per branch has decreased in the same manner. The deposit base and credit of commercial banks has increased, and has resulted in increase of per capita deposit and credit. But the per capita deposit (Rs. 38978) is relatively higher than per capita credit (Rs. 31299) based on March 2014 numbers

[14] Economic survey 2013/14, Ministry of Finance, GoN
[15] Source: Economic Survey, 2013/2014

(see **Fig 8**). This explains the high liquidity levels discussed above and opportunities for further enhancing access to finance.

Fig 8- Indicators of Financial Expansion and Deepening[16]

	Mid-July 2010	Mid-July 2011	Mid-July 2012	Mid-March 2013	Mid-July 2013	Mid-March 2014
Commercial Bank Branches	966	1111	1425	1472	1486	1514
Population per Branch	27184	23960	15892	17998	17830	17500
Domestic Deposits of Commercial Banks (Rs. In Billion)	569.0	680.2	867.98	915.28	1020.83	1032.71
Per Capita Deposit (Rs.)	21668	25500	32760	34546	38530	38978
Commercial Banks Lending (Rs. In Billion)	472.3	544.2	622.57	708.51	757.21	829.25
Per Capita Credit (Rs.)	17985	20400	23498	26741	28580	31299

Nepal's MFIs have been largely funded through borrowing from BFIs under the Deprived Sector Lending Programme (DSL), apex institutions such as Rural Microfinance Development Centre and members' savings. The NRB mandated DSLP requires Class A, B, C institutions to devote a percentage of their credit portfolios (4.5%; 4.0%; and 3.5% respectively) to deprived sector lending. Some banks have established microfinance subsidiaries and specific programme packages to meet the requirement and deepen financial services among clients. Others have chosen to lend to MFIs (wholesale lending) who in turn, lend to its deprived clients. MFDB/MFIs and various community based institutions have been instrumental in increasing financial inclusion by reaching out to the less advantaged population through their programs. MFDBs had reached to over 1.0 million poor people through their micro credit program by Mid April 2014[17] while FINGOs had reached an additional 485,064[18] people from similar program. Other programs, projects cooperatives etc. also have targeted many rural poor households. This shows that expansion of MF services with a modification in approach can further increase financial services and enhance access of finance to the poor communities in the priority regions.

But several challenges still remain, including those related to the efficacy of the DSL programme. While meant to increase to lending to the poor, some have also argued that it has largely made MFIs richer, as they are able to lend the money at a low rate and then lend it to borrowers at a much higher rate[19]. In the absence of robust system for tracking of the scheme to determine if the loans are actually reaching the neediest borrowers, questions are being raised about the programme's efficacy. Further, most FSPs are located in the urban and Terai areas, remote rural areas are not prioritised. Instead excessive focus on market expansion and profit as well as reluctance for sharing information have resulted in overlaps of clients and products among banks and MFIs, contributing to client over indebtedness.

In view of the highly diversified and segmented market, it has been found that no single type of BFIs presents an optimal solution to reaching all market segments with all type of financial services. In remote rural areas like the mid and far western hills and mountains, the low cost structure and

[16] Ibid
[17] NRB MFD
[18] Rudra Dahal, MIFAN Nepal
[19] A 2011 report found that Return on Assets (RoA) of the typical MFI is 2-3%, exceeding that of commercial banks, and an average of 32.7% return on equity (RoE). (Sanjay Sinha, Micro-Credit Ratings International Limited, *Nepal Microfinance: Rising above the turmoil – a financial and social analysis*, Nepal Microfinance Review, 2011).

proximity of user-owned and managed providers constitute significant advantages over more structured BFIs. However, commercial oriented BFIs have the advantage of being able to offer a wider variety of products or a broader spectrum of terms and conditions, and may be more reliable then community based providers. While recent years have witnessed a considerable increase in the commercial provisions of access to finance and the emergence of public listed microfinance companies, semi-formal and informal providers remain the main source of financial services for the vast majority of the poor.

As part of its current 5-year financial strategy, the NRB has announced several new initiatives in expanding financial inclusion and access, especially: 1) giving additional interest free funds for institutions to work in remote districts; 2) giving women up to Rs. 700,000 as credit under deprived sector credit; 3) having banks invest up to 20 per cent in the productive sector by 2015, 4) expanding the outreach of the Rural Self Reliance Fund (RSRF) in un-served areas; and 5) launching a programme for financial literacy. The NRB also works through its Microfinance Promotion and Supervision Department to promote, monitor, and supervise MFIs licensed by NRB and other projects. The department coordinated the Enhancing Financial Services Project supported by UNCDP and UNDP (2008-12) with 18 partner institutions. The programme reported that it increase financial access to 281,313 people with a complete focus on women and Terai. NRB is also undergoing a reengineering phase during the last decade under the World Bank support as part of Financial Sector Reform strategy. Under this strategy its organization structure, human resource management system, regulation and supervision system improvement and enhancement of overall capacity is being revamped.

The GoN resorted to a liberal financial sector policy in early 1990s which led to establishment of numerous private BFIs. Following decades of unrestricted growth, the sector began experiencing over crowdedness as well as growing incidences of malpractices within financial institutions. This resulted in some BFIs being liquidated (Nepal Development Bank) and some placed under the management control of the Nepal Rastra Bank (Nepal Bank Ltd., Nepal Credit & Commerce Bank Ltd., etc.). The Nepal Rastra Bank (NRB) eventually issued a new policy aimed at strengthening the banking system. As per the newly articulated policy, the NRB has granted no licenses (for the last five years) for the opening of new Class A, B & C Financial Institutions (FIs). Further, it has limited the granting of new licenses to Class D Micro-finance Development Banks (MFDBs) in the underserved areas of the country. Further, the NRB promulgated a policy on Mergers and Acquisitions, thereby paving the way for consolidation in the industry. Several BFIs have responded positively to this policy with 25 M&As (60 BFIs merged to form 25 institutions)[20] already completed and several others on the cards. NRB has also largely been able to maintain its autonomy and is also regarded as the most effective regulator in the country. However, as shown above, besides the institutions which are licensed and regulated by NRB, there are various other institutions licensed by different government entities which are involved in deposit collection and loan granting activities. It has been observed that these institutions lack sound governance practices are weak in credit grating process with little adherence to prudent practices.

International donors including the DFID, ADB, GIZ, USAID, FAO, Save the Children, UN, UNCDF, and AusAid have supported financial sector access and inclusion in selected areas. While there are several donor initiatives, there is limited coordination among programs and synergies can be expanded. *Finally, t*he approach to financial sector development to-date continues to be fragmented, among the various state and on-state actors, and there is noticeable disagreement on the roles, responsibilities and accountability for developing, coordinating and monitoring monetary and banking affairs. The legacy and prominence of the GoN in shaping the financial sector and thus, the inherent political pressure affecting the financial sector, has also been at times an area of contention and slowdown, especially for the donor-funded programmes that have specific objectives.

4. Social and Cultural Implications

Nepal possesses a rich culture with an estimated 40 different races and tribes. Within each of these are particular social norms and constraints that must be fully understood and interventions designed around.

[20] Source: Nepal Clearing House

The outcome of the current political and economic policies has been evident in terms skewed distribution of the access to finance in Terai and accessible hills and with little or no services in inaccessible hills and mountains. Even in more developed areas, access to financial services is limited to middle-class village people. A major barrier to financial inclusion often occurs due to low educational qualifications, cultural backgrounds, and lack of confidence. This is more prevalent with poor and disadvantaged groups (see **Figure 9**) who lack basic academic or vocational qualifications. In contrast, educated people have greater access to information and knowledge of their rights and available opportunities.

Figure 9. Nepal's Rural Poor

The rural poor in Nepal include:

- **Destitute people** including those that are sick, disabled or displaced, and abandoned
- **Extremely poor people** including illiterate or landless people
- **Moderately poor people** who have small farms but are heavily indebted
- **The 'nearly poor'** including small farmers who are at risk of falling back into poverty as a result of factors such as conflict, debt and land degradation

Source: IFAD, Enabling poor rural people to overcome poverty in Nepal, 2013

In general, poor and disadvantaged groups face more constraints for financial inclusion, which is related to a lack of voice and representation. There is significantly low participation of poor and disadvantaged groups in the decision-making of community-based cooperatives, and their participation on decision-making is virtually none in commercial-oriented MFIs. Additionally, poor and disadvantaged groups face a number of other socio-economic constraints that restrain their time and/or require them to seek employment outside of their home village. Women also generally face more constraints than men. These barriers relate to lack of mobility and time. Women are prevented from joining the community-based MFIs by their husbands or family members. Even if a woman is associated with a financial cooperative, she largely cannot make financial decisions independently. Many times, the husband uses the loan amount borrowed by his wife. Women also have competing household and child upbringing responsibilities that limit their time and ability to join and actively participate in these groups.

There are numerous physical, economic, and social barriers to reaching the most deprived groups:

4.a Physical Barriers

The wide majority (90%) of Nepal's poor lives in rural areas where there is little or no access to financial services. Generally, the hills and mountains areas present very challenging geographical settings with people living in scattered villages. Poverty is more severe and intense in theses remote areas. Reaching poor and disadvantaged groups in these rural areas means higher transaction costs for Financial Sector Providers (FSPs). Such areas are often characterized by poor infrastructure, low population density, low levels of literacy and relatively less economic opportunities. Additionally, the rural economy in these areas is based on agriculture and it has low profitability and prone to high risk. Even if some FSPs are present in those areas, they often lack well-trained professionals and have insufficient support from other sectors to extend finance. Programmes like PAF, WUPAP have promoted a few saving and credit groups but these groups are mainly poor performing and lack institutionalization.

Geographical location of FSPs is another major factor for accessing financial services. Considering the geographical constraint, people from far areas are in a distinct disadvantaged position in terms of availability of financial services.

4.b Economic Barriers

Economic barriers to access to finance emerge due to methodological rigidity adopted by the MFIs on rural lending. Grameen model or group based lending is the main lending methodology adopted by most MFIs for rural lending which requires clients attend a weekly or fortnightly or monthly meeting to comply various process required for access to financial services. Further, the Grameen methodology requires clients/members to divert some per cent of the loan to a savings account. Such criteria for eligibility for group and continued group process, prevents the participation of poor people due to socio cultural barriers and limits their access to financial services. Even the savings first type micro-lending methodologies such as informal savings and credit groups and credit union tend to reach a smaller proportion of the poorest people and have a limited impact on poverty reduction.

One of the main obstacles to financial inclusion of disadvantaged group in MFIs is the household poverty with a wide range of associated hardships for livelihood and survival. Size of land holding of many poor and disadvantaged groups is too small to be operationally viable particularly in hill areas. The financial sector's primary objective is to safeguard deposits and to invest entrusted funds into low risk and high yield projects, which implies that they traditionally avoid risky clients such as poor and disadvantaged groups.

Rural households are often not acquainted or comfortable with formal financial channels and rely heavily on family, friends or community-based institutions and/or cooperatives for lending needs. Many of these households lack traditional collateral and the very poor have few if any assets at all. They are currently over indebted and need savings rather than credit products. Productivity levels are low, limiting the financial viability of many microenterprises. Rural agricultural activities are vulnerable and deteriorating as a result of natural disasters (e.g., floods, thunderstorms, earthquakes) ecological and climate changes (e.g., glacial melting, landslides) perpetuated by poor agricultural techniques. Finally, high illiteracy in these areas inhibits understanding and uptake of financial services and products.

Other problem to cater to the poor of the Hills and remote location is dispersed and small population cluster making financial service very costly to MFIs. One of the prerequisites to be the member of financial cooperatives is mandatory regular meetings, compulsory savings, and timely repayment of loans. Many vulnerable people are unable to meet these requirements due to their irregular and poor earning capacity.

Further, resources of financial cooperatives are limited in remote areas. These take the form of members' savings and share contribution is very much limited and at times insufficient to meet the financial need and demand of their shareholders. Limited managerial capacity of these cooperatives precludes them from having access to finance from wholesale financial service providers. All these factors work as a barrier for financial inclusion to members who are essentially poor and disadvantaged groups.

4.c Socio-Cultural Barriers

Even when poor people are not actively excluded by the community, they often opt out of community-related projects because they are socially intimidated, believing that the services offered by such projects is not suited to their needs. Living in absolute poverty for a prolonged period of time strongly affects people's dignity and hope for the future, as well as their ability to take initiative and overcome stigma.

Ethno-caste based social structures are the main hindrances of inclusion of poor and disadvantaged groups due to discrimination they face in society. In many cases, the so-called upper caste people intentionally exclude these groups under the garb of capacity deprivation[21]. As a result, these disadvantaged groups isolate themselves as they do not feel comfortable working with the so-called higher casts.

Social stratification is such that poor and disadvantaged groups may find it difficult to gain access to finance. The sharp contrast of participation in financial market further reveals that the caste system continues to be a major hindrance to one's opportunity to access financing. Poor and disadvantaged groups are most excluded in all sectors of life including the financial sector due to their lack of awareness and caste-based discrimination. Language is also a significant barrier as the trainers mostly speak Nepali and published materials are in Nepali, despite the fact that in some areas—especially in the Terai—most beneficiaries find it difficult to understand Nepali.

[21] Capacity deprivation relates to illiteracy, poor health, chronical illness, lack of entrepreneurship and money management capacity.

A limited number of financial products and services offered by FSPs for productive and social purposes is another barrier to financial inclusion. Most FSPs have limited saving and loan products with the current offering providing low interest rates for savers and high interest rates for borrowers. Most of the FSPs have concentrated in financial intermediation and not in social intermediation.

Building and maintaining level of trust in all circumstances can improve financial inclusion, and it is particularly important when different ethnic or religious groups are involved. Caste, which is not solely an ethnic factor, can pose cultural barriers similar to ethnic differences. In areas where caste systems or religion are central to communities' social organization, individual may be systematically denied access because they are from a lower caste or a difference religion.

Religion and ethnicity can also affect the ability of women to access financial services. For example, in some cultures women are homebound for religious reasons, and unable to meet with providers outside the home or to form a group with other women. Similarly, some cultures prohibit male staff visiting female clients. Gender based rules and norms can have a significant impact on both financial service needs of women and their ability to access and use services.

4.d Institutional Barriers

BFIs and other type of FSPs find it difficult to expand services in remote and hilly areas due to high cost of operation initially. Another reason is their own management philosophy is restrictive as they are unaware of future market after crating synergy through developing a network of services that work for the poor.

Nepalese BFIs do not have policy and practice to have appropriate products suitable to the poor in the remote areas and hills. First of all there are not enough BFI branches in such areas and where ever there are they lack the product. MFIs are also expanding slowly in such areas. This is the main constraint for financial exclusion to the poor and disadvantaged groups in such areas. Even if they become a member in the MFI, they do not get supportive policy to promote their participation.

5. Gender, Youth and Disadvantaged Population Imbalances

5.a Women:

Women often suffer a double burden of oppression due to their caste/ethnicity and their gender. While comprising 51% of the population, Nepalese women are less educated and skilled than their male counterparts but contribute more in labour-especially in the agricultural sector where they comprise 76% of labour workforce.

Nepalese women have both a lower social status and heavier workload than men. Women, especially from rural communities, typically lack access to and control over resources, including property rights and accessibility to health and education services. For example, Nepal is one of the few countries in the world where women have a lower life expectancy than men, which directly reflects the underprivileged status of women. Socially, traditional family expectations of early marriage and children continue to determine life options for women. Other traditional practices have been reinforced, such as dowry/tilak, male child preference, social acceptance of domestic and public violence against women, polygamy, and other associated exclusion. Further, practices like Chaupadi, Deuki, and Badi in the MFWR continue to cause suffering to women.

Nepal has had a long history of discrimination based on caste system. The Hindu orthodox beliefs, values and practices that segregate Dalits and Non-Dalits based on the notion of purity and impurity are still prevalent in the MFWR. The manifestation of the aforementioned structural differences between Dalits and Non-Dalits are visible in different practices such as the prohibition of inter-caste marriage and segregation in public places like temples and public taps. Dalits have not been able to live a dignified life – they are dehumanised as "untouchables". Discrimination regarding employment opportunities has hampered the growth of Dalit communities outside of their traditional jobs and small scale enterprises. In addition, the issue of Haliya and Baadi of the Far West and Mid-west has also received national level attention.

Inequality and exclusion are cross cutting and cumulative. Gender equality and social inclusion are fundamental to poverty reduction and social development in the Nepalese context. Following ten years of violent conflict and the subsequent social and political turmoil, it has become clear that central to peace and poverty reduction are enhanced gender equality and social inclusion. The long-term journey of peace and poverty reduction requires more inclusive opportunity structures and decision-making processes.

Violence against women is the outcome of long-standing practices establishing unequal power relations between men and women in all aspects of life. These practices result from established socio-political, politico-economical and socio-cultural practices. Without addressing this unequal power relation, the elimination of violence against women is unthinkable.

Women and girls in rural areas are disproportionately suppressed by socio-cultural norms and values largely limiting their mobility to household activities and denying them access to health, education and job opportunities let alone adequate representation in the political system. Women and girls have been excluded from access to, and control over, resources. Even the discriminatory legal system has denied women from accessibility to justice.

Additional obstacles in Nepal's traditional patriarchal society that the AFP programme will need to understand and address to further reach Nepalese women include:

- Women usually do not have titles, preventing them from using physical capital as collateral.
- Women socially usually do not travel alone, limiting them from travelling to FSPs.
- Women are more likely to be illiterate, unable to read or understand financial terms or concepts and/or making them less confident with such.
- Women tend to work in lower paid, informal sectors.
- Women tend to have less decision-making ability in Nepalese households, especially in more rural areas.

Most of the community based financial institutions such as MFIs and cooperatives have focused on married women, often older, in their groups thereby excluding younger unmarried women.

In order to reach its objectives of reaching the poor and marginalized, the AFP programme must prioritise women who are disproportionately poor, live in rural areas, and work in informal sectors. Not only will targeted gender initiatives bring more women into the financial sector, but studies show that empowering women economically also yields beneficial external impacts as women reinvest 90% of their income in their families and communities, compared to men who reinvest only 30 to 40% of their income[22].

5.b Youth:

Nepal's youth (ages 15-29) represent another opportunity for development. Young people currently face limited viable employment and self-employment opportunities, especially in the Western Regions. A recent study[23] found that there is a 'youth bulge' in Nepal in which youth unemployment is correlated to conflict. At best, without skills or capital, many Nepalese youth are forced to migrate to neighbouring Indian States for work. The same study found that many young people would instead like to stay in Nepal and open a business but lack the capital to do so. Currently, most MFIs including small scale cooperatives see youth as too risky for loans, unable to pay the security deposit. Specialised collateral free loans need to be further developed and accessible. Financial schemes could also link remittance income from youth abroad into starting their own businesses.

Part II - Implications for the Overall AFP programme and Mitigation Strategies

In this section, we look at the implications of the discussion in the preceding section on the AFP Programme and our proposed mitigation strategies.

[22] Phil Borges (2007), Women Empowered: Inspiring Change in the Emerging World. New York.
[23] The British Council, *Youth Survey of Nepal.*

Fluidity of the Political Environment

The fluid political situation is likely to impact all walks of life and the AFP programme is unlikely to remain immune to its consequences. Infighting within the ruling parties and intransigent opposition parties is likely to make it difficult for the government to take tough decisions which are needed to accelerate economic growth. Further, the country may see large scale protest and disturbances if the constitution is not drafted on time or the drafted constitution doesn't satisfy the aspiration of many. In order to maintain AFP programme momentum, the AFP leadership team will undertake the following:

1. Closely monitor the political development by working with various government agencies and donor communities and recalibrating its interventions accordingly based on evolving circumstances
2. Robust engagement and dialogue with the AFP Steering Committee
3. Work closely with local stakeholders and get their early buy in. If the programme is able to get early buy in from all the stakeholders, especially local communities, then notwithstanding the constraints as mentioned above, the programme can achieve its objective. Prior experience has shown that--except during the time of violence and intimidation--the local communities are quick to embrace such programmes once they see the benefits accruing to them.
4. Use opportunities/platforms to apprise policy makers including prominent members of Constituent Assembly of programme development
5. Ensure that international experts maintain a low profile, keeping visits to counterpart organisations to a minimum, and using local staff to maintain programme momentum during protests/hartals
6. Utilise priority district locations and regional office staff to a maximum for implementing planned local interventions

National and Local Economic Situation

Even though the broader economic indicators are favourable there are various risks which need to be closely monitored as the ability of economy to absorb big shocks brought about by internal and external events is yet to be tested. Further, the unstable political situation will have negative impact on the economy as a result of paralysis in decision making, and implementation of populist measures and quick fixes, etc. that are likely to have a negative impact in the long run.

AFP programme's demand driven value chain interventions in priority districts (selected through a pre-determined set of criteria) will help unleash potential of the local economy by supporting various income generating activities that have a higher probability for success, will positively contribute to enterprise formation and expansion and employment generation. Further, AFP will provide support for improving financial sector architecture, enhancing institutional capabilities of regulators and policy makers and improving overall regulatory and legal environment, thereby making the economy more resilient.

Financial Sector Implications

Despite improvements in financial inclusion in the country, access to financial services for the very poor as well as for not so poor population in geographic regions such as the Far and Mid-Western Nepal remains dismal. Large concentration of FIs in over-served areas has resulted in client indebtedness, excessive consumerism, duplication, unhealthy competition, etc. The AFP programme will encourage FIs to expand their network in the underserved/unserved area through various incentive schemes.

Large number of unregulated or under regulated financial intermediary pose a huge risk to financial sector. Failure of community based institutions will erode faith in the local populace. And in many of the situations, these community based institutions are the best medium to provide financial services. To overcome this risk, the AFP programme will carefully select and work closely with these institutions to further develop their capacity. The AFP programme will also work closely with NRB and other stakeholders to expedite promulgation of necessary acts for the establishment of a 2nd tier Regulator.

FIs are going through a consolidation phase and many are in different stages of the merger or acquisitions process. During this period, these FIs priority may not be in increasing their outreach or committing resources for new products or delivery channel. This is likely to limit the pool of eligible potential partners for the AFP programme. However, since the process has been underway for some time, there are many institutionally sound and financially strong partners with whom AFP can partner with.

Social and Cultural Implications

Financial exclusion is a complex and dynamic process. Some people experience short periods of exclusion, maybe more than once in their lives. For a small number, however, it can be long-term, perhaps even life-long. The majority of people without financial products are excluded by a combination of marketing, pricing and inappropriate product design. Focus group discussion and consultative meetings conducted by the AFP programme in some of the priority districts has uncovered that many poor and disadvantaged group feel disengaged from banking. As a consequence, in many places self-exclusion by poor and disadvantaged groups is far more important than direct exclusion by banks refusing to open accounts. In some places, psychological and cultural barriers impede the use of banking services in the indigenous populations. The social cultural implications for the AFP programme will be high. The programme needs to address the problem inherent to financial exclusion to expand the frontier of the financial service delivery in the project districts using innovative delivery channels.

The AFP Programme will also work with like-minded FIs to innovate and design services that maintain high standards of financial performance as well as set new standards in poverty impact by focusing on following:

- Understanding costs (smaller loan size, increased demands on staff time, smaller portfolios, remote areas, etc.) and benefits (lower exit rates and arrears, higher penetration rates) of working with the very poor.
- Basing institutional self-sufficiency on client self-sufficiency and success. Where their vulnerability can be overcome, very poor clients can achieve significant growth and changes.
- Innovation through the use of technology to make poverty-focused microfinance more cost-effective; and
- Improving the impact of microfinance.

Figure 9 provides AFP Programme strategies for design and delivery poverty focused products and services working closely with partner FIs.

Figure 9 – AFP Programme Strategies to Better Address Social and Economic Implications

Focus area	Strategies
Improving outreach	▪ Understand who BFI do reach or exclude and why. ▪ Target poorer areas through rigorous geographic targeting. ▪ Motivate poorer people to be the target of BFI work ▪ Develop a system to work with the very poor based on vision.
Ensuring impact	▪ Undertake market research to understand clients' underlying needs and not just listen to the loudest voices. ▪ Modify the products and services and ensure proper delivery. ▪ Understand negative impacts of the access to finance and take required steps to reduce these.
Appropriate products	▪ Design and improve microfinance products and services based on their potential to reduce poverty, risk and vulnerability, not their attractiveness to clients. ▪ Diversify financial products and services required by the very poor ▪ Link the access to credit with ability to repay[24] and financial literacy ▪ Introduce a range of products such as emergency loans, insurance or educational inputs to help poor clients cope with emergencies, seasonal migratory patterns, smooth consumption, and reduce their risk and vulnerability. ▪ Ensure a balance between flexibility and a range of products that clients' requires with BFIs' capacity to manage an increasingly complex and diverse portfolio.
Delivery	▪ Support very poor clients in coping with vulnerable and other problems experienced rather than coercing them into making loan instalments. ▪ Don't compel clients to take a loan. ▪ Encourage client support and skills-sharing. ▪ Introduce an organizational culture of poverty-focus and impact in an MFI for achieving positive impact. ▪ Learn from community-based organizations and other models of access to finance. ▪ Integrate gender awareness into BFI practice at the level of field staff-client relations, and within organizations' procedures and culture.

The AFP Programme will encourage innovation, experimentation, and improved understanding on possibilities for poverty-focused access to finance for the poor and disadvantaged groups through the following:

- Providing financial incentives through the AFP Challenge Fund towards achievement of certain goals on depth of poverty outreach and impact
- Creating space for BFIs to improve their effectiveness by creating pilot schemes, or exploring different time-frames for achievement of different objectives
- Establishing clearer industry standards for good practice in poverty-focused access to finance
- Promoting greater transparency in reporting on poverty outreach and impact
- Funding research, particularly the one focused on improving operational effectiveness and understanding trade-offs involved in a poverty-focus

Finally, even though the financial industry has established best practices for measuring and reporting financial performance, it has yet to establish comparable standards for performance in poverty outreach and impact. The AFP Programme will help develop systems for transparent reporting of such data. Industry standards and reporting guidelines will need to be developed using performance measures that take into account both efficiency and effectiveness.

[24] Where loan repayment is made *from existing income sources* there is a need for flexibility in savings and loan repayments. Savings in particular should be easily accessible, both for deposits and withdrawals. Loans do not need to be tied to a particular activity. Likewise, where repayment is made *from business profits*, regular repayments and pressure from the BFIs are important to encourage focus on the business activity and to develop business management skills.

Gender, Youth and Disadvantaged Group Imbalances Implications

Successful implementation of the AFP Programme will be contingent on a firm commitment by its implementing partners to the principles of gender equity, social inclusion, and empowerment. In practice, these principles will need to guide the development of programme initiatives and be fully integrated into every aspect of the AFP programme. The AFP programme will focus on mitigating these issues using the following strategic actions during the Implementation Phase:

- Provide guidance for gender mainstreaming across all AFP Programme components and the implementing partners
- Hold implementing partners accountable for addressing the GESI concerns, making sure the organizations are more responsive to female clients' needs when designing ad launching new products and/or services
- Build the capacity of stakeholders/partners including the GoN on the mainstreaming of GESI indicators in planning, monitoring and evaluation and reporting systems
- Supporting partner organizations to develop a gender analysis framework/gender checklist to assess gender impact of their programmes and to incorporate gender situation analysis and improve overall programmatic and organizational performance
- Integrate GESI dimensions in all thematic, cross-cutting components, affirmative action and quality implementation as per the research, feedback from partners and beneficiaries and lesson learnt by the project
- Sensitization and empowerment of GESI target households for equitable benefit sharing through meaningful participation- i.e., compliance of GESI with project communication strategy, massive outreach of GESI in the project districts, ensuring that target groups are informed about opportunities and developments, provision for business counselling, coaching and mentoring to the disadvantage groups
- Ensure target group friendly economic empowerment training to women and disadvantage groups for improved income from their agricultural enterprises so as to address the social hazard and minimize discrimination
- Seek possibilities to collaborate with relevant government and nongovernment organizations working with rural women (in agriculture), dalit, Janjati, Muslim, disabled and unemployed youth, and seek mechanisms whereby effective participation can be ensured and improved in access to finance.