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Innovations in Nepal's Microfinance Sector and Benefits for Asia –
A Review of the Lessons Learned from the
Small Farmer Cooperatives Ltd. System

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1. Introduction

The Small Farmer Cooperatives Ltd. (SFCLs) network is next to the Grameen Banks the largest provider of microfinancial services in Nepal. SFCLs are reaching out to 80,000 poor households with an estimated total outreach of 480,000 people. Despite the adverse effects of the present armed conflict in Nepal, the number of SFCLs is still growing. The Consultative Group to Assist the Poorest (CGAP) together with the International Fund for Agricultural Development (IFAD) awarded in early 2002 the Rural Pro-Poor Innovation Challenge (RPPIC) to the SFCL model. The purpose of this paper is to outline some of the innovations that emerged from this network with a particular view of potential benefits for the MF sector in Asia.

It is important to note that in Nepal, as in other parts of the world, there is no one-best or one-fit-for-all approach in microfinance. Nepal has often been described as the laboratory of microfinance based on its geographical diversity that brought forward a multitude of different approaches. Readers who are interested in the microfinance sector of Nepal should look into the Centre for Microfinance's (CMF) directory of MFIs in Nepal (CMF, 2003) to get an overview on the microfinance sector.

Many innovations have been produced by various MF actors in Nepal, which go beyond the SFCL model. Unfortunately, these innovations have not yet been sufficiently uncovered due to the lack of resources. The reasons to identify innovations from the SFCL model in this paper are the comprehensive availability of facts and figures and the significance that the SFCLs present today to Nepal's microfinance sector.

Finally, it seems appropriate to clarify what is meant by "innovation". The term innovation, in general, and in the world of microfinance, in particular, has entered into our day-to-day vocabulary. Many MF scholars and practitioners use the term without much thinking about the real meaning. This paper will adopt the definition of Greve and Taylor (2000) who define innovation as "activities that differ significantly from current or recent practice".

The remaining part of this paper will first give in chapter two a brief introduction into the SFCL model. Readers, already familiar with the SFCLs in Nepal can directly enter into Chapter three that presents five innovations that emerged over time from the SFCL system. Chapter four attempts to identify some of the lessons learned from the SFCL model for the MF practitioners and scholars in Asia. The paper concludes with a brief summary in chapter five.

2. About the Small Farmer Cooperatives Ltd.: A brief profile

In 1975, ADBN started to form joint liability groups of small farmers through its Sub-Project Offices (SPOs). In line with the prevailing development thinking of that time, "cheap" money, meant for productive purposes, was channeled to group members. The high overheads and low collection rates of the SPOs, however, led experts to question the sustainability of this approach. In 1987, the ADBN introduced an action research Institutional Development Programme (IDP) with the support of GTZ. The objective of the new direction taken was to transfer the ADBN-run SPOs into fully

self-administered and managed cooperatives of small farmers (Lamsal, Sejuwal & Shakya, 2001).

In 1993, as a result of the IDP, the first four SPOs were transformed into Small Farmer Cooperatives Ltd. (SFCLs). Since then, 143 SFCLs have been established in 36 districts of the country. Currently, the Small Farmer Cooperatives Ltd. in Nepal comprise a total of 80,000 rural households with outstanding loans of USD 11.5 million and internally generated resources of USD 2.5 million. Female membership stands at 40% and is increasing.

A Small Farmer Cooperative Ltd. is a multi-service cooperative designed to deliver primarily financial, but also non-financial services to its members in rural areas. SFCLs are civil society organizations that pool their joint resources to meet basic needs and to defend their members' interests. They are member-owned and controlled and have an open membership policy towards "poor" farmers.

By July 2000, SFCLs had captured a significant share of the formal/semi-formal rural financial market, serving 6% of the total borrowers¹. The market share of SFCLs is estimated to have increased since then by another 2-3%. For many years the SFCLs followed a strong path towards profitability with impressive growth rates in terms of deposit mobilization and increases in revenue. An ADBN/GTZ study in 2001 (Wehnert & Shakya) showed that from a sample of 33 SFCLs, the average financial self-sufficiency ratio had increased from a poor 39% by mid-July 1997 to 118% by mid-July 2000, putting SFCLs in the category of successful microfinance institutions. Over the last couple of years, however, the business climate and security situation have deteriorated due to the Maoist conflict, adversely affecting the performance of SFCLs. Thirty four SFCLs have so far been attacked by extremists, and documents, furniture and buildings have been burnt down. The average financial self-sufficiency ratio therefore dropped to 89% by July 2001 and further decreased to 83% by July 2002 (Wehnert & Shakya, 2003).

Studies agree that SFCLs have a substantial positive impact on the socio-economic situation of their members (ADBN, 2002; Sharma, Bhattachan & Shrestha, 2001). Living conditions have improved for a large majority (above 80%) of SFCL members, largely due to the access to credit. Independence from moneylenders was mentioned as an important change after joining the cooperative. Many cooperative members diversified their economic activities after joining the cooperative, in many cases including non-agriculture income opportunities. Most cooperative members make productive and rational use of the additional income they gained. Literacy levels, food consumption habits, sanitation and health conditions as well as social cooperation have improved. The mortality rate of children decreased while access to safe drinking water increased. Savings habits also increased, thus insuring the families against risks. Furthermore, the use of modern agricultural inputs increased. Even ecological aspects are better than before with the installation of biogas plants, construction of low cost latrines, more scientific use of organic manures and multi-service tree planting / maintenance.

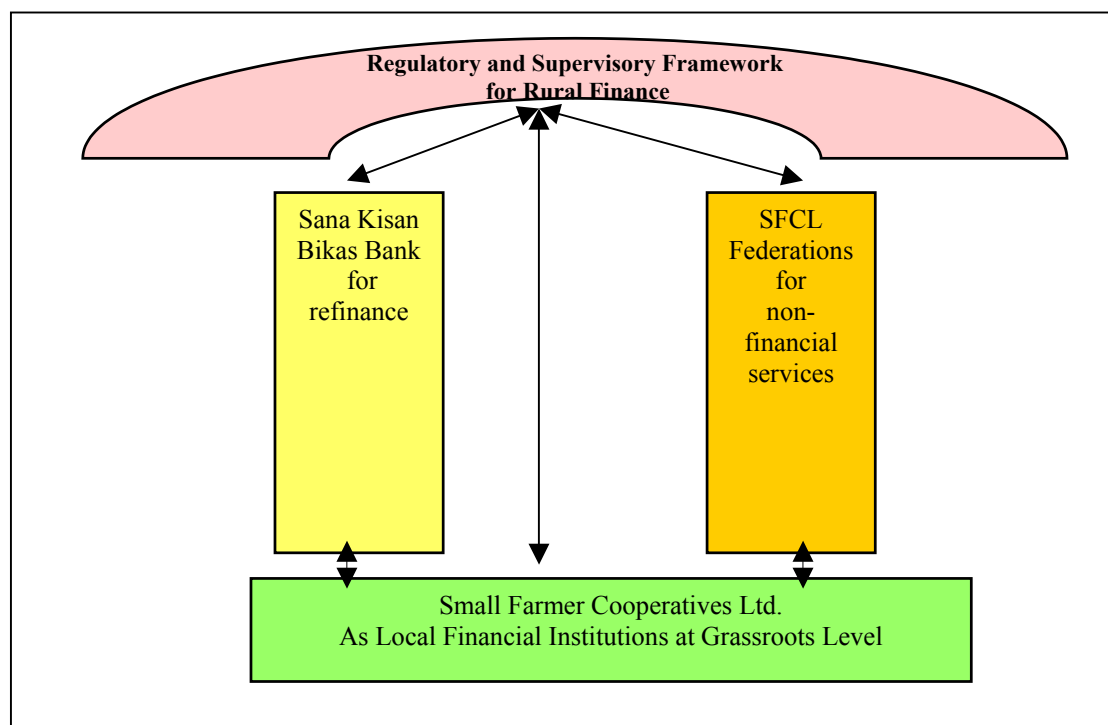
¹ Calculated from data provided by ADB (2001).

3. Innovations that emerged from SFCLs

3.1 A systemic approach: Rather a guiding principle than an innovation

There are numerous examples of failed efforts in promoting MFIs since they focused on the institution only. MFIs are part of the financial system that needs to be taken into account, too. Identifying and promoting linkages to financial and non-financial support institutions as well as the regulatory environment is a necessity that often is underestimated by the promoting institutions. Even worse, sometimes, with good intentions in mind, parallel structures are created next to the banking system just to provide services to the poor. This, of course, will not have long lasting effects but might work in the short term.

Figure 3 summarizes the financial systems development approach to SFCLs with the three pillars i.e. the local financial institutions on the grassroots level, the Sana Kisan Bikas Bank at national level for refinance facilities and federations/networks of SFCLs to provide non-financial i.e. technical support services to SFCLs.



Some of the innovations that emerged from this system will be presented in the remaining part of this chapter.

3.2 Three tiered structure: Reaching out effectively to members

Small Farmer Cooperatives Ltd. in Nepal, the organizations and their products, have been comprehensively researched (e.g., Acharya, Shrestha & Shakya, 2002; Lamsal, Sejuwal & Shakya, 2001; Staschen, 2001). An interesting feature that distinguishes

SFCLs from other MFIs in Nepal and beyond is their unique three-tiered structure with *small farmer groups*, *inter-groups* and the *main-committee* as the three pillars.

Small farmer groups are formed as joint liability groups at the village level, usually consisting of 5 to 12 members. These bodies allow members to start and operate financial and non-financial services required by the group and/or group members. From each small farmer group within a defined area, one representative joins the so-called inter-group. The inter-group further validates specific group requests and gives approval recommendations to the main committee. It also functions as an intermediary between the groups and the main committee. One representative of each inter-group joins the so-called main committee at the VDC² level. The nine member main committee approves the programme of the SFCL and decides on the implementation of any other projects such as office building construction, livestock insurance schemes, consumer stores, etc. To handle the daily operations of the organisation, a chief manager, an assistant manager and a helper are employed by the SFCL. Either the chief manager or the assistant manager should be female.

SFCLs deliver various financial and non-financial services. Financial services include various forms of voluntary and compulsory savings products, a variety of loan products as well as a livestock insurance scheme. Non-financial services include the construction of irrigation channels, establishment of milk collection centers, nursery programmes or women empowerment programmes. New products are continuously added. A prominent example is the design of a savings product addressed to children and their parents.

Through this unique organizational set-up, SFCLs deliver their services to the members. Important messages from the main committee can be effectively delivered through the inter-group representatives without calling in an assembly. Particularly for hill and remote areas, the three-tiered structure appears to be appropriate since the small farmers will be able to do the majority of their activities within their groups on the local level.

3.3 Replication: Creating new MF institutions at a discount rate

The process of institution building in microfinance is generally considered as very costly. The lack of capacity building measures for MFIs is probably the single most important factor that many MFIs in Asia and elsewhere are still struggling for survival. Against this background, SFCLs have initiated a farmer-to-farmer replication with support of ADBN and SKBB. The core idea of replication is to minimize the institution building costs of a community based organization through the exclusive involvement of mature and highly experienced SFCLs. Being the real practitioners, the small farmers appear to be more knowledgeable than staff from public banks or NGOs. This approach leads to a significant reduction in the institution building costs of up to 50%.

The process of replication takes about three to four years. In this process the replicators provide microfinance services and training (social mobilization, capacity building, financial and accounting management) to the rural poor (mostly women) in order to establish a sustainable MFI to be registered in the form of a SFCL. SFCL Chatreaurali, for example, started a replication initiative in 1998. It took 3.5 years to form the SFCL Kewalpur with about 350 members, NRs. 2.8 million outstanding

² Village Development Committee (the smallest administrative unit in Nepal.)

loans, Nrs. 1 million mobilized internal resources and a 93% financial self-sufficiency ratio.

The following table shows the completed and ongoing replication initiatives. The prime promoters of replication next to the SFCLs themselves are ADBN and SKBB with technical and financial support from GTZ and CGAP. It is hoped that replication becomes the prime tool to support the establishment of new SFCLs all over the country.

Table 1: Status of the SFCL replication

Name of new SFCL and district	Start of replication	Status
Kewalpur (Dhading District)	January 1998	Completed
Khairahani VDC (Chitwan District)	January 2004	Replication has just started.
Inaharwashira (Bara District)	January 2004	Replication has just started.
Jabda (Rupandehi District)	January 2004	Replication has just started
Khaduwanaganai (Rupandehi District)	January 2004	Replication has just started
Pashupatinagar (Illam District)	January 2004	Replication has just started
Kathar (Chitwan District)	Dec. 2000	Registration expected in March 2004
Karaiya (Rupandehi District)	Dec. 2000	Registration expected in March 2004
Geta (Kailali District)	Dec. 2000	Registered as SFCL in January 2004
Bauwadi (Jhapa District)	Dec. 2000	Registered as SFCL in January 2004
Kumarwati (Nawalparashi District)	Sept. 2002	Registered as SFCL in January 2004

3.4 Sana Kisan Bikas Bank: A bank for and by the poor

The Sana Kisan Bikas Bank (SKBB) was registered in July 2001 with the company registrar office. The bank received its operating license from the Nepal Rastra Bank in March 2002 and started its lending operations from three area offices in November 2002.

The objectives of the Sana Kisan Bikas Bank (SKBB) are:

- to act as a specialized, professional and lean rural finance institution to refinance SFCLs and similar institutions in rural and remote areas
- to encourage SFCLs to become majority shareholders of this bank in a 5-10 year time frame.

Thus, the vision of the new bank is not to create merely a subsidiary of ADBN, but to establish a refinance institution which should be driven and guided in the long run through its members, i.e. SFCLs and similar organizations. However, in the start-up phase, ADBN assumed the role of a strong promoter and main shareholder. The total paid-up capital at present is almost NRs 105 million (USD 1.4 million). The biggest shareholder is ADBN with NRs 70 million (USD 959,000), followed by the Ministry of Finance with NRs 20 million (USD 274,000) and two commercial banks with a total share holding of NRs 7 million (USD 96,000). All together 99 SFCLs have already invested NRs 8.1 million (USD 111,000). This amount is expected to increase significantly over the coming years. Despite being the second smallest shareholder, SFCLs are represented on the seven-member board with two representatives. The remaining seats are shared by ADBN with three representatives and by the Ministry of Finance and the Nepal Bank Ltd. with one representative each.

3.5 Federations: The future pillar of non-financial support services

Besides the refinance facilities provided through the SKBB, SFCLs will still need technical assistance and guidance in the future. In order to achieve full autonomy from external support, SFCL federations will provide non-financial services to their members such as training, consultancy, supervision and auditing.

From the start, a guiding principle was to separate financial and non-financial services at the apex level. While SKBB was established to meet the financial requirements of the SFCLs, a federation system was to be set up for the non-banking services. In addition, as more and more SFCLs are emerging, a well functioning vertical structure is needed to provide those non-financial services to SFCLs, which ADBN was no longer in a position to deliver.

The federations at the district level will be business and services oriented. Income generating services, such as stationary management, cooperative audit, management consultancy and marketing support are to be launched. Business plans have already been prepared. Since the present cooperative act does not yet allow the registration of SFCL federations, the SFCLs have established ad-hoc committees to be operational. These ad-hoc committees operate in the same areas as the Sana Kisan Bikas Bank.

4. Are there microfinance lessons to be learned for Asia?

Having presented these five innovations that emerged from the SFCL system in Nepal over the years, are there any lessons to be learned for both MF practitioners and scholars in Asia? In this concluding chapter a number of lessons will be suggested for discussion related to a) guiding principles and b) the break-up with traditional MF thinking.

At this point, it is repeated again that there are many more MF innovations in Nepal beyond the SFCL model that could unfortunately not be considered in the framework of this paper.

4.1 Two guiding principles for innovation and sound MF operations

In retrospective, among the many factors that influence the generation of innovations, two guiding principles have been of particular importance to the SFCL emergence, that is *vision* and *people's ownership*. To many readers, the two aspects will sound like platitudes with no degree of additional value to existing MF knowledge. Let's take a close look at these aspects, first.

A vision can be seen as a powerful inspiring long-term perspective, which gives direction, creates a strong identity, motivates and - of course - should lead to appropriate activities. The vision of the SFCL stakeholders can be described as "creating a system of self-sustained institutions for financial and non-financial intermediation to successfully fight poverty". The importance of a vision is to develop it in an early stage and to stick to it. A vision is the glue that holds all stakeholders together, in good *and* bad times.

The second aspect, people's ownership, is a well-acknowledged principle in microfinance. However, successful and less successful microfinance programmes can be distinguished by the degree to which they have implemented this principle. Too often, people's ownership is taken for granted by MF promoters. The SFCL innovations such as the establishment of SKBB and the farmer-to farmer replication approach are truly based on the people's participation. Thus, the people have become the actors and promoters of the programme at the same time.

4.2 Breaking with some traditional MF thinking

Multipurpose can work – many services, many customers

The present cooperative ideology is largely in favor of single-purpose cooperatives, simply because this type of cooperative has a long and successful track record. In contrast, multi-purpose cooperatives (MPCs) appear to have encountered many failures. MPCs are more complex to manage – the management needs to be well educated and must have good market knowledge. In the past, MPCs were a prime target of supply-oriented government programmes. This did not only make them unmanageable, but spoiled their character and made the representatives easy to be affected by corruption and selfish behavior.

As the SFCL model demonstrates, there are specific rural conditions that are in favor of a multipurpose approach. It will require the absence of government interference, the establishment of a profitable core business (such as financial services), a sound and experienced management and a demand oriented approach. Under these circumstances, MPCs will be attractive for their members and will have a fair chance to be successful and prosper.

SFCLs represent premier self-help poverty reduction initiatives in that they provide savings opportunities and credit access to poor farmers. In addition, they promote a range of other financial and non-financial services. Other services offered are dairying, livestock insurance, veterinary services, various income generating skill training as well as social development activities such as literacy and awareness about family planning. They all directly contribute to the enhancing of income opportunities and quality of life of the members. Thus, one may argue, that SFCLs are successful because they offer not only credit (at market and above-market interest rates!), but also provide other advantages for the members.

Big is beautiful – one village, one cooperative

In building MFIs, promoters often forget to think a priori about certain minimum criteria to ensure an institution's future economic viability. In the case of the SFCLs, the promoters developed at the beginning some minimum standards such as number of members (around 350) and minimum loan portfolio size (around NRs 3 million, USD 40,000). These standards should ensure that an organization is in a position to derive a margin from its loan portfolio to pay for administrative and financial costs.

Particularly in the hill and remote areas of Nepal, there is less room for a variety of service providers that could compete for clients. Thus, the concept of establishing one service provider that offers a variety of services in a professional manner has proved to be successful.

Cold money or hot money - the magic of the AND

Cold money destroys the spirit of savings and self-help. This is well-accepted knowledge in microfinance since the end of the supply led rural credit paradigm in the 1980s. The experience gained from the SFCL network building shows that low savings can be effectively complemented with high external loans.

The major advantage of accessing external loans is a faster take-off of the institution. Each institution needs a minimum turnover to safeguard covering of fixed costs, which would include - among others - the salary of a professional manager. The initial spirit of the founding members may be spoiled if the working capital needed to be provided through savings alone. These initial benefits may outnumber the negative effects, which are usually associated with the provision of cold money.

In the case of SFCLs the right blend between cold and hot money proved to be a success factor. It should be stressed, that this method is a special version of the linkage approach. Sustainable and economically successful financial institutions are linked to refinancing sources in order to increase their business volume and their benefits for the economy and their customers. These experiences plus the additional income generated would help them to develop more institutional strength and enable them to play an increasing important role in the development process of their community and the society itself.

NGOs only? - Government can be effective, too

There has been a strong movement in the last decade to rely on NGOs for the provision of financial and technical services to the MF sector, particularly in Latin America. That government could be a reliable development partner, too, had almost been forgotten. Successful institution building in the rural finance sector requires powerful capable and professional institutions, with a good political standing and backing, while the cooperation itself has to be built on trust.

The emergence of the SFCL system had not been possible without the leadership and determination of a public bank that has a potential to reach out to even the most remote areas. Thus, it is not a question of either or. Rather, it needs a careful evaluation of each case to see whether the competitive advantages of NGOs or a government institution would best serve the purpose of any microfinance project.

5. Summary and Conclusion

The purpose of this paper was to outline some of the innovations that emerged from the SFCL system in Nepal. With the understanding that innovations are "activities that differ significantly from current or recent practice", the following five innovations were proposed:

(1) The SFCL systems approach as a guiding principle, (2) The unique three-tiered structure of the SFCLs that ensures good communication and accessibility to members, (3) The Sana Kisan Bikas Bank as an emerging apex bank to be owned by its clients, (4) The farmer-to-farmer replication approach that cuts institution building costs into half, and (5) The business oriented SFCL federations that provide non-financial support services only.

Vision and people's ownership have been reconfirmed as important success factors for innovation and sound MF operations. Other lessons learned from the SFCL system suggest that (1) multi-service cooperatives can work under certain conditions, (2) larger cooperatives have advantages over several smaller ones, (3) cold money can serve to quickly scale-up MF programmes, and (4) that government institutions can be effective and efficient partners, too.

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