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SUSTAINABILITY OF MICROFINANCE INSTITUTION FROM SMALL FARMERS' PERSPECTIVE: A CASE OF RURAL NEPAL

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This paper is based on empirical research and reports about the local understandings of small farmers about sustainability. The performance of microfinance institutions in terms of institutional sustainability in Nepal seems not encouraging despite the fact that international and national development programs have been giving high priority on sustainable microfinance for poor for many years. In response to low repayment rate and the question of sustainability of microfinance schemes, many proposals have been forwarded for initiating small farmers' development program and encouraged their participation in sustainable microfinance projects. Nevertheless, the repayment rate - the crux of sustainability - of farmer-run organizations is significantly low and is unable to reach the required level. Yet, little research has been done to understand and ascertain small farmers' local understandings of sustainability. The main research questions in this study are: How do small farmers think of sustainability? What is their frame of reference, and what are the views that small farmers hold about the factors that contribute towards sustainable microfinance in rural areas? The findings of the study demonstrate that small farmers generally do not think in terms of 'institutional' sustainability when they obtain loans from cooperatives. They define the term 'sustainability' in terms of personal benefits. Their frames of reference are more utility-focused and directly connected to their lives and livelihood, the level of benefit, income, and economic survival of the family. In other words, what is sustainability for a banker is not so for small farmers. It is our argument that without a strong understanding of the divergence between the perspectives and interests of rural small farmers and those of bankers and policymakers microfinance programs are likely to continue to struggle to fulfil their mission of poverty alleviation and sustainability of microfinance.This study is a case of rural Nepal. Our data came from in-depth individual interviews, and focus group discussions carried out in three farmers' cooperative organizations (the most successful, the least successful and the median) from the same geographical area and demonstrate how local understandings and views of rural small farmers can contribute towards sustainable microfinance and poverty alleviation in rural Nepal.

Field of Research: Finance

1. Introduction

Various researchers have argued that in democratic societies, small farmers have a right to a participatory role (process approach) and full ownership of microfinance organizations including planning, management, and decision-making (Weitz, 1982: 30-33; Wehnert and Shakya, 2003: 25; Shah, 1999; Sharma and Nepal, 1997:75). The basis of the argument is that farmers have access to local knowledge, which is unknown to official experts. The supporters of this school of thought have argued that microfinance institutions should not be run by public sector organizations; it should rather be handed over to small farmers in order to generate a sense of ownership among small farmers (Weitz, 1982: 30-33; Shah, 1999; Sharma and Nepal, 1997:75) and to attain institutional sustainability of microfinance institutions (MFIs).

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The Agricultural Development Bank of Nepal (ADBN) is a public sector development finance institution in Nepal that started Small Farmer Development Program (SFDP) in 1975 as part of its poverty alleviation responsibility. Under SFDP, more than 400 sub-project offices (SPOs) were initiated under the 'project approach'. Due to unbearable high transaction costs and low repayment rate, ADBN later on, decided to handover the SPOs to the small farmer by initiating their own organization - 'Small Farmer Cooperatives Limited (SFCL)' - at local level aiming at financial viability and institutional sustainability of the microfinance scheme. ADBN initiated the Small Farmer Cooperatives Limited (SFCLs) with technical collaboration from the German Agency for Technical Cooperation (GTZ) in 1987.

The innovation of the Small Farmer Cooperative Limited (SFCL) is the result of the Institutional Development Program (IDP) in Nepal. The Consultative Group to Assist Poorest (CGAP) has considered SFCL as one of the best models for poverty alleviation in 2002. Wehnert and Shakya (2003) argue that the SFCL won an international award in 2002 from CGAP because it was a successful farmer-run microfinance organization. Nevertheless, the repayment rate of SFCLs was significantly low and could not reach the required level of at least 70% that the ADBN necessitates. The overall financial and development indicators proved to be sub-standard and questioned the sustainability of the institution (ADBN, 2003). It is, therefore, imperative to understand the views of small farmers about sustainability and verify whether knowledge of sustainability is responsible for the high credit defaults amongst small farmers. These questions were explored through an in-depth study conducted in 2003.

The overall aim of this paper is to examine the understandings of sustainability held by small farmers involved in microfinance institution in rural Nepal. The main objective of this study is to document the small farmers' views on 'sustainability' (including the views on the conversion of SPOs into SFCLs), their frame of reference about sustainability, and record the views about the factors that contribute towards sustainable microfinance in rural areas from small farmers perspectives. The paper presents some definitions of the term 'sustainability' followed by the method adapted. The results and discussions of the study are presented in Section 4 and 5. Summary conclusions are highlighted in Section 6.

2. Sustainability: Some definitions

From bankers' perspective, a microfinance institution is said to have reached sustainability when the operating income from the loan is sufficient to cover all the operating costs (Sharma and Nepal, 1997). This definition adopts the bankers' perspective and sticks to 'accounting approach' of sustainability. However, Shah (1999) adopts for an 'integrated approach' in defining the term sustainability as the 'accounting approach' to sustainability that takes into account the financial aspect of the institution is too narrow for him. For Shah, the concept of sustainability includes, amongst other criteria, - obtaining funds at market rate and mobilization of local resources. Therefore, his performance assessment criteria for the financial viability of any microfinance related financial institution are: repayment rate, operating cost ratio, market interest rates, portfolio quality, and 'demand driven' rural credit system in which farmers themselves demand the loans for their project. From banker's perspective, sustainability of microfinance institution includes both financial viability and institutional sustainability (self-sufficiency) of the lending institution (Sharma and Nepal, 1997). The frames of reference in banker's definitions are therefore, more financial, administrative and institution focused. Small farmer communities are also expected to embrace these definitions.

3. Method

The study was conducted in Chitwan district of Nepal. The study took place in three SFCL of the most successful, least successful and median performance. These SFCLs were taken from

Kumroj, Meghauli and Piple Village Development Committee (VDC). The performance assessment criteria and the basis for grading were: repayment rate, profit, number of inactive groups, women's participation, share distribution, internal resource generation and social programs, such as community dairy center, community irrigation, and local bridge construction. Maximum Variation Sampling Technique (MVST) was used for selecting the most successful and the least successful organizations in the region. The study followed the constructivist research paradigm to examine the understandings and views of small farmers about sustainability of microfinance institutions. The research has used multiple case study method as its research design, and a qualitative approach (inductive approach) as research strategy. Combinations of research tools from the social sciences, such as focus group discussions, in-depth individual interviews, and participatory rural appraisal (PRA) were used. A total of 36 small farmers of different category (low castes, high castes, scheduled castes (so-called 'untouchables' and tribal/indigenous community) were interviewed. The small farmers interviewed included: executive committee (EC) members and general members including the landless and the ultra-poor. Grounded theory was used both as a research strategy and as a tool for data analysis.

4. Results

The results of research presented hereunder are some of the main themes that emerged from data gathered through individual interviews and focus group discussions. The understandings and views expressed by the small farmers of the three different organizations in relation to sustainability and sustainable microfinance were often consistent. Most respondents expressed that they never thought in terms of institutional sustainability when they obtained loans from the SFCLs.

The majority of general member-small farmers, except landless, held a view about sustainability. However, their opinion about sustainability and the frames of reference were entirely different than that of microfinance professionals. More than 80% of the small farmers interviewed mentioned that they did not think about 'institutional' sustainability. For them, 'individual' sustainability came first rather than the institutional. They believed prosperity of individuals as the foundation of sustainability of microfinance institution that resulted in "trickle-up" effect. However, almost all Executive Committee (EC) members were concerned about institutional sustainability. Ironically, they were the main defaulters. Theoretically, EC members' definition appeared to be similar to those of microfinance professionals, whereas other farmers defined it in entirely different way. For 80% small farmers, livelihood, personal economic benefits and relief from local indebtedness and sharecropping were the frame of reference to define the term 'sustainability'. In contrast, EC members gave more emphasis to institutional benefit.

Small farmers who never thought in terms of institutional sustainability when they obtained the loans viewed that 'sustainability' was simply a "show off" and a "fashionable buzz" of 21st century that imposes liability on poor, frees government out of responsibility, and makes government "politically" right in the name of people's participation.

Sustainability is utility-based

The majority of general members from the SFCL viewed that their direct personal true economic benefit was sustainability. Small farmers – particularly general members - had to obtain the loans either from local moneylenders, sell their livestock, land or any other assets, or re-borrow the loans from the SFCL to repay old debts on time. The farmers believed that such actions could not make the institution better off in the long run. Instead, they thought that such pressure on farmers to repay on time through any possible means would impact negatively on the financial situation of the farmers. The farmers (general members) viewed that institutional sustainability was the part of management responsibility. The Executive committee (EC) members spoke in favor of institution and focused their views on repayment rate.

In expressing the views about sustainability, one of the respondents asserted, *'I love my land and do not want to lose my land through auction. I need it for the future of my family'*. His view of sustainability was to protect his land from being auctioned, and satisfying the sustenance needs of his family. He further stated, '*…However, I am bound to sell my land to repay overdue debt, if I don't sell it, it will get auctioned*'. Small farmers viewed the idea of sustainability and conversion of public sector projects into cooperatives (SPOs) as a "burden of development" on small farmers rather than the way to self-reliance.

Survival of own family is sustainability

More than 50% of respondents were deeply hostile to the idea of institutional sustainability. They viewed sustainability and profitability as the same issue and saw it as added pressure to socialise losses and underwrite private gains. The general feeling was that sustainability was counterpoised to the survival of their families. The statement made by one small farmer, '*I love my land and do not want to lose it through auction… survival of my family is more important than profitability or sustainability* [of the institution]', was commonly reiterated by many other small farmers.

A small number of landless respondents with no collateral who belonged to a highly disadvantaged socio-economic and caste group were not concerned about institutional credit, ownership and sustainability. This was because they did not believe that the microfinance institution that requires collateral and charges, what they believed were high interest rates, had any immediate benefit for them. Most people from this category either worked as day labourers or carried on with their traditional skills, such as tailoring and fishing that earned little wage.

Farmers who perceived themselves as "very poor" (ultra-poor) were indifferent to institutional credit since they could not gain access to formal credit without any collateral and credit history. These farmers had very little knowledge about institutional credit and sustainability compared to other borrowers.

Frame of Reference

From banker's perspective, the term 'sustainability' in microfinance refers to 'the ability of a microfinance institution to develop a methodology that ensures loans successfully reach the poor while covering all of its costs *without subsidy*' (Unitus, 2005: 4). Despite the fact that subsidized loan is not issued under sustainability, nearly 80% of small farmers expressed that loans to small farmers should be either in the form of grant or in a subsidized form. The landless and the ultra-poor defined institutional credit as "seed money" (as a grant).

The attitudes of small farmers towards sustainability of their microfinance institution (SFCL) appeared to be shaped mainly by their perception of immediate benefits they could receive from it. For instance, local indebtedness and sharecropping were the crucial problems of small farmers in three study areas. Many small farmers were primarily concerned with getting out of their debts, and emancipation from sharecropping (*Adhinya*), fixed contract cultivation (*Bandaghi*, *Thekka)* and land leasing. The lending institution's definition of sustainability had little meaning to small farmers since the frame of reference of small farmers was based on livelihood and family benefit, or utility.

5. Discussions

Microfinance professionals, bankers, governments and donor agencies consider sustainability as the benchmark in evaluating the performance of microfinance institutions (Brau and Woller, 2004; Baumann, 2004). However, we found that small farmers generally do not think in terms of 'institutional' sustainability when they obtain loans from the cooperatives. Small farmer's frame of reference regarding sustainability is more utility-focused and directly connected to their

lives and livelihood, the level of benefit, income, and economic survival of the family. From a small farmer perspective, the ability of a local institution to abolish local indebtedness, share-cropping, and bondage labor primarily leads the institution towards institutional sustainability. The literature shows that millions of the poorest and most vulnerable small farmers and workers in South-Asia are bonded to their formal or informal sector employers as they try to repay loans (Daru et al., 2005). The results of the study conducted by Rondinella (2005) in India clearly show how access to guided institutional credit can lead to increases in household income, savings, and diversification of income generating activities.

The high credit default rate by executive members indicates a lack of sense of ownership towards the organization. This has resulted in low degrees of loan recovery due to the fact that nearly most of the loan funds distributed are externally obtained (from the ADBN). Bennett et al. (1996: 271) state that the degree of sense of ownership towards organization (which is the crux of institutional sustainability) is relatively high if funds are internally generated by the cooperatives itself.

As noted previously, small farmers used utilitarian approach and defined sustainability in terms of direct economic and social benefits to small farmers; whilst the banking and lending institutions and microfinance professionals generally prefer institutional benefits first. Chambers (1983) subscribes to the view that last should be put first and prosperity of poor is a sine-qua- non for institutional sustainability. Rao (2001: 226) claims that maintaining a socioeconomic benefit of poor is one of the criteria for sustainable policy.

The most important attribute of the results of this study is the wide range of views and understandings expressed by small farmers involved in the management and use of credit. The term 'institutional sustainability' was totally new and unknown to many small farmers at group (village) level, who were therefore, not in position to give their views on its meaning. However, they offered an opinion on sustainability (not the institutional one) in their own way using their own frame of reference. The understandings and frames of reference held by general members were different than bankers and the views expressed by EC members. In many cases, the views expressed by the EC members were consistent to bankers, because they were in direct contact with lending institutions (bankers) and microfinance professionals, and were influenced by them. EC members perceived that sustainability of the institutions was the prosperity of small farmers, but it was not so for general members. Likewise, what is 'productive' (use of fund) for lending institution was not so for general member-small farmers. For example, use of loan for food consumption and daily household expenses was the 'most productive', efficient, and sustainable use of fund from small farmers' perspectives. For bankers, it is the misuse of loan.

The review of literature showed that Bankers' frame of reference to sustainability is more financial (such as repayment rate), administrative (such as overhead cost) and institution focused. However, small farmers' references were focused on direct economic and social benefits connected to small farmers' livelihood, such as income generation and emancipation from local indebtedness and sharecropping. Dhakal (2002:9) supports this finding and puts forward the statement in the same way. He argues that financial viability of the institution is dependent on client satisfaction.

With the current interest rate (15-19%) of SFCL, it seems that the institution is not going to be financially sustainable even from the bankers' perspective because its overhead cost goes up to 27 % if all the costs (such as cost of group formation and supervision) are taken into consideration. From bankers' perspective, it could be argued that the SFCLs need to charge higher interest rate to attain financial sustainability of the institution. Unfortunately, the current interest rate is already viewed by the small farmers as "too high". In such circumstances, it seems that both the lending institution and the small farmers may not be sustainable in the long run. The World Bank (1993) revealed that the small farmer development program in Nepal to be financially sustainable have to increase its lending rate to 42.5%, which is higher than the prevailing moneylenders' rate of 36%.

It seems that microfinance service to small farmers at cost plus (cost + profit) interest rate without any subsidy is too expensive. In this situation, it seems appropriate to provide employment opportunities to small farmers rather than unsupervised credit.

Conversion of public sector projects into SFCL: A burden of development

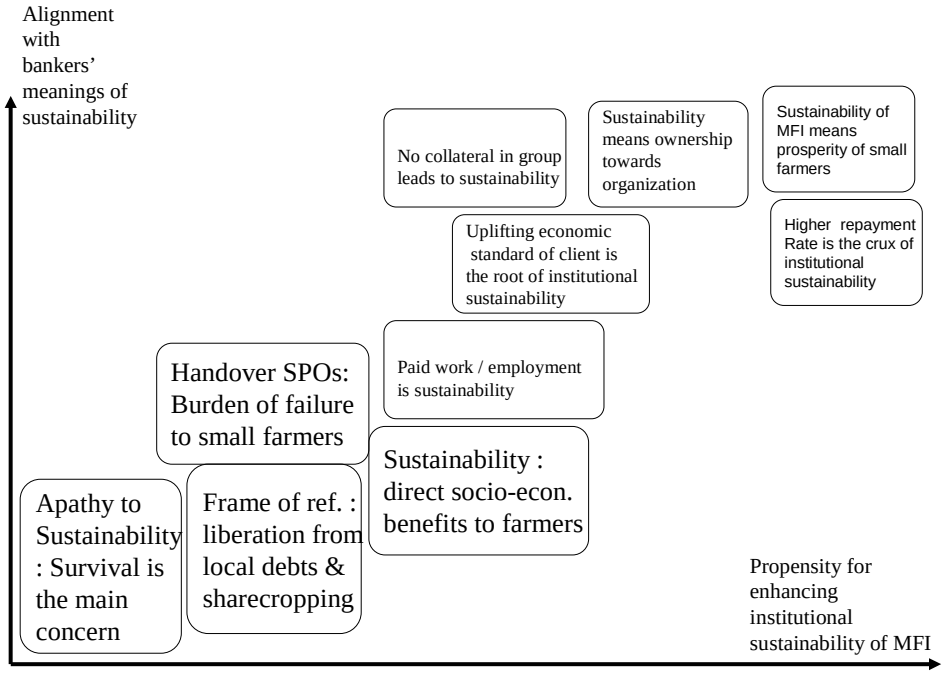
Small farmers viewed the conversion of public sector projects into cooperatives as the transfer of costs and responsibilities from the centre to the periphery rather than the way to sustainability. The question of public involvement in development process is defined and interpreted in different ways, and challenged by some writers. For instance, Buchy, Ross and Proctor (2000) state that it is difficult to understand whether governments see people's participation as opportunity to transfer costs and responsibilities from the centre to the periphery or whether government agencies sincerely believe in long-term value on involving people in managing their programs. They claim that the effect of government's withdrawal from rural areas in particular on the capacity of local communities to run their own affairs is not sufficiently studied and understood by same agencies promoting local involvement. Rural development professionals (Dale, 1998; Kamarah, 2001) argue that improving the quality of life of rural people, and paying special attention to the needs of the poorest is the foundation to build or strengthen local institutions.

Small farmers asserted that the responsibility of running an independent autonomous microfinance institution in a sustainable way is not possible in isolation without addressing their needs, without providing support system (such as market) and infrastructure, and without imparting the knowledge of cooperatives. Fisher (2002) argues that the crucial reason why local people often fail to "participate" in local organization is that they do not feel that these organizations meet their needs. Similarly, the IFAD (2000: 1) states, 'policy cannot be mechanically applied. It needs to be adapted to the socio-economic setting of each area'. It appears that institutional sustainability does not benefit small farmers directly. Therefore, the sustainability of these cooperatives was none of their interest and priority. The national progress report substantiates this fact - the nationwide progress report of the cooperatives shows that there is a remarkably low percentage (16.52%) of internally generated resources (such as savings) and substantially low percentage of share capital (1.08%) against outstanding loan in 2002/03 (ADBN, 2003). The percentage of external source of overdue loan (SPO source) is higher (19.95%) than the internal (14.99%) in 2003 (ADBN, 2003). Theoretically, the SFCL is supposed to have at least 20% capital fund (internally generated) to its total deposits, which is the "entry point level requirement" for institutional sustainability (RUFIN, 2003: 5). Bennett et al. (1996: 271) state that the degree of sense of ownership towards organization is relatively high if funds are internally generated by the cooperatives itself.

The range of views encountered about sustainability amongst small farmers across the three study areas is broadly depicted in Figure 1. Again, the views are arranged on two axes (X and Y), namely 'alignment with bankers' meaning of sustainability', and 'propensity for enhancing institutional sustainability of microfinance institution (MFI)'.

The figure depicted below clearly states that there is remarkable variation among small farmers of different positions (within the same organization) about the understanding of 'sustainability'. The executive level of farmers (EC members) who manage the cooperatives viewed the term closer to the bankers. However, the paradox is that EC members themselves were the main defaulters despite such views. It appears that, while some of the views sticked to the term by EC members are likely to enhance institutional sustainability in a bankers' way, other views might work against it. Although some small farmers viewed 'no physical collateral in group' as the way to sustainability, direct economic benefit, emancipation from local debts and day-to-day survival were their main concern and were observed to be a quite common meaning of sustainability. It is also observed that transformation of old debts (SPO's debts) through conversion of SPOs into

SFCL was named by 80% of our participants as "burden of failure" to illiterate small farmers. The most common view was that what is 'sustainability' for bankers was not so for small farmers. However, some uncommon views offer potential for designing programs that are attractive to bankers and will also enhance sustainability of microfinance business from bankers' way.



Note: Boxes with larger fonts represent views that are more common.
Figure 1: Range of views on sustainability encountered amongst small farmers in three study areas of Chitwan district in Nepal. Figure adopted from (Acharya et al., 2004)

The literature review reveals that financial institutions, bankers and microfinance professionals adopt the definition of sustainability that largely ignore the local understanding and meaning attached to the term by small farmers. While bankers are aware that there might be disagreement between small farmers' and lending institutions' interpretations of sustainability, there is little evidence of effort to overcome the obvious blockages and constraints that these differences are resulting in the demotion of high credit defaults. The views high on both axes in Figure 1 tended to be held by EC members who had strong contact with bankers, lending institutions, and policy makers. This implies that there is hope that through awareness programs small farmers' views towards formal credit can be changed over time. However, institutional sustainability seems not possible unless the more common views of small farmers are considered and the repayment capacity of majority of village level of small farmers is promoted through locally appropriate income generating opportunities.

Factors contributing to increased income, sustainable microfinance and poverty alleviation in rural areas

The small farmers also viewed that the economic prosperity of poor is the crux for sustainable microfinance. The literature also shows that the sustainability of community level organization largely depends on the economic prosperity and well being of local people (Chambers, 1983; Chambers, 1993).

Dale (1995) notes that only rural industrialization can transform subsistence economy into a market economy. Also, Bajracharya (1999) states that agriculture should be commercialized and modernized and the financing should be made jointly by the government and the farmers

with the bulk share provided by the former. Commercialization therefore, should involve farming under cooperatives or companies injecting commercial inputs.

The introduction of small-scale industries within rural areas seems fruitful for many reasons: First, to encourage the process of farm diversification by creating a market for agricultural products - raw material for processing and perishable foodstuff for consumption by industrial workers - and by the provision of inputs; second, to provide employment (Weitz, 1982). So far, industrialization of developing countries like Nepal has not produced the expected results, mainly because it copies the process which has taken place in the developed countries (United Nations, 1975: 102).

Weitz (1982) subscribes to the above view and states that the industrial enterprises capable of being integrated into rural areas should be classified as per small farmers' needs and their production. This encourages them to produce more and generates both on-farm and off-farm employment opportunities. He classifies these industrial enterprises into three categories, namely, "processing", "coordinated" and the "neutral". The processing industry transforms the primary agricultural products into the finished products intended for direct consumption. The processing can consist of a single stage, like sugar refining, or number of stages like the cotton industry (Thieme, 1963: 287-97), or making *Khudo* or *Sakhar* from sugar-cane. Coordinated microenterprises, on the other hand, are industries that help improve the small farmers' income and hence repayment capacity.

6. Conclusions

The small farmers who involved in executive committee for more than a year were more concerned about institutional sustainability than others. It is revealed that small farmers generally do not think in terms of institutional sustainability when they borrow the loans. The majority of non-executive small farmers had a little concern about 'institutional' sustainability. They defined sustainability in their own way. Their definition and frame of reference to sustainability was entirely different to those of bankers and microfinance professionals. The lack of sense of ownership towards organization and apathy towards institutional sustainability were some of the reasons for high credit defaults amongst small farmers. It is confirmed that what is "sustainability" for lending institution, microfinance professionals, and bankers was not "sustainability" for small farmers. Their frame of reference is more livelihoods focused, and linked to the level of benefit, income, and economic survival of the family.

The findings revealed that a divergence between the interests of professionals and small farmers, differing expectations between lenders and borrowers, difference in frame of reference of sustainability, conflict between executive and non-executive committee members (small farmers) caused the problems in repayment of the loan resulting in high credit defaults. The majority of small farmers viewed that some economic programs and projects need to be initiated for sustainable microfinance in the remote areas. Rural industrialization, introduction of massive commercial farms and rural market centers are the preferred strategies for sustainable microfinance scheme from small farmers' perspective. The basic demand of small farmers was the introduction of local industries or factories that could provide them shift work (day and night) so that the industries could utilize the abundant (surplus) labor force at low-priced rate.

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