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**From Informal to Formal Finance:
The Transformation of an Indigenous Institution in Nepal**

by

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From Informal to Formal Finances: The Transformation of an Indigenous Institution in Nepal

Abstract:

Rotating savings and credit associations (RoSCAs) are, next to moneylenders, the most prevalent type of informal finance around the world. In 1988, Seibel & Shrestha traced the evolution of the dhikuti, as RoSCAs are called in Nepal, and published the results under the title *Dhikuti: The Small Businessman's Informal Self-Help Bank in Nepal* in *Savings and Development* (XII, 2:183-200). Ten years later, a remarkable institutional innovation had occurred, benefiting from a change in the legal framework: the transformation of an organization of dhikuti origins into the *Himalaya Finance & Savings Company*. No subsidy or technical assistance was involved. HFSC provides doorstep savings collection services to low-income people throughout the country, shifting at the same time from group to individual technology. Matching assets and liabilities, it combines two categories of term finance: medium-term savings contracts and medium-term loans. Continuing its morphogenesis, HFSC is now ready to transform itself into a bank and to pursue an even more vigorous course of internal resource mobilization.

Sommaire:

Dhikuti réexaminé: De tontine à compagnie financière

La tontine, à côté du prêteur d'argent, est le type de finance informelle le plus répandu au monde. En 1988, Seibel et Shrestha ont tracé l'évolution des dhikuti, les tontines Népalaises, et ont publié le résultat sous le titre *Dhikuti: The Small Businessman's Informal Self-Help Bank in Nepal* dans *Savings and Development* (XII, 2:183-200). Dix ans après, une innovation institutionnelle remarquable a eu lieu, grâce à un changement du cadre juridique: la transformation d'une organisation d'origine dhikuti en *Himalaya Finance & Savings Company*, et cela sans avoir reçu ni de subventions ni d'assistance technique. Partout dans le pays, HFSC collecte quotidiennement de l'épargne des pauvres à leurs maisons, changeant en même temps de la technologie de groupe à une approche individuelle. Deux catégories de financement à terme ont été combinées pour équilibrer l'actif et le passif: des contrats d'épargne de trois ans et des prêts d'un à trois ans. En continuant le processus d'évolution, la compagnie financière se prépare maintenant à se transformer en une banque pour suivre un cours de mobilisation d'épargne encore plus vigoureux.

Dhikuti origins

The Himalaya Finance and Savings Company (HFSC) traces its origins back to an age-old institution, the dhikuti or dhukuti as it is called in Nepalese, or dhikur (lit. *storage box for valuables or food grains*) among the Thakali from which they originated in the course of the trans-Himalayan trade centuries ago (Fürer-Haimendorff 1975; Bista 1971; Messerschmidt 1972, 1978, 1981; Dolebel 1985; Schrader 1988). There is only scant information on the earlier period, but like among a number of rotating savings and credit associations (ROSCA; see Bauman 1994; Schrader 1991) its first form was probably that of a social reserve fund with contributions in grain for assistance to members in case of emergency. By the middle of this century, cash had replaced kind, and the dhikuti had turned into ROSCAs among Thakali businessmen with the purpose of capital formation. Groups were usually small, 20-30 members, though sometimes above 100 (Von der Heide 1985). The cycle of rotation was usually annual; access was principally open, without caste, gender or ethnic restrictions. The allocation of the fund was generally on the basis of drawing lots.

During the past half century dhikuti spread as informal financial institutions all over the country and became *the small businessman's self-help bank* (Seibel 1988). This was mainly due to the extension of the money economy, the increase in business opportunities, an upsurge in the demand for money and, at the same time, the lack of formal financial institutions with convenient savings deposit facilities and broad access to credit. During that process of expansion, the dhikuti underwent two major changes: the cycle of rotation changed from annual to monthly, and fund allocation by lots was replaced by secret bidding¹.

Weaknesses of the dhikuti

The dhikuti studies by Seibel & Shrestha in 1988 seemed to function reasonably well. There was no evidence of a transformation into regular credit institutions. The authors proposed to introduce permanent funds from which members could obtain loans at market rates of interest whenever needed and not only through a singular chance of successful bidding. To build up such funds, the balance between the agreed-upon total amount of contributions and the actual bidding amount was first to be deposited in a permanent fund; in a second step the institutions were to be linked to banks (Archarya, Shrestha and Seibel 1990). This sounded like an expert idea; however, this was not the course history took.

During the 90s word spread in Kathmandu that ROSCAs were a risky venture. In spite of a number of risk management precautions such as personal guarantees and immediate allocation of the fund, auctioning posed a particular moral hazard problem. More and more people placed bids of unreasonably low amounts to capture the fund immediately, speculating on exceptionally high returns on their investment. When these expectations fell through, they found themselves unable to abide by their obligations and dropped out of the dhikuti before its conclusion. In 1995 it was estimated that roughly one-third of the dhikuti in Kathmandu came to such a premature end (Bodhi 1995). Redress to litigation was difficult as the dhikuti is an informal institution beyond the protection of the law.

Organizing dhikuti became something like a profession, and many dhikuti were headed by organizers in charge of several dhikuti at the same time. As a reward, the organizer had the privilege of obtaining

¹ The fund is allocated to the lowest bidder, with the balance redistributed among the members. E.g., with a fund size of \$1200 and a lowest bid of \$800, \$400 are turned back to the members.

the first round in a cycle; but he was also liable for its proper conclusion. It is not clear how they actually managed the risk of dhikuti failures.

From monthly rotating savings accumulation to daily deposit collection

H. B. Pradhananga, (H.B.P.), then a government employee, detected several weaknesses in the dhikuti system as it had evolved: the lack of instant access to credit; the speculative nature and moral hazard of bidding; the rigidity of fixed monthly contributions; the failure of the system to mobilize savings as they occurred; and the drop-out risk of early recipients of the fund. He also saw that the vast majority of people in Nepal make their money in the informal sector, where income is irregular and daily, rather than regular and monthly. If small excess incomes are not collected on the spot, they are consumed and fail to be converted into savings. Furthermore, he realized that the craving for access to credit was largely due to the absence of savings deposit facilities. As people wasted their daily income, they recurrently needed credit to finance their investments or working capital requirements.

In 1989, as an organizer of three dhikuti of 25 members each, H.B.P. introduced a new financial technology. Employing a deposit collector, he provided daily doorstep collection services to the amount of Rs 10 (appr. US\$0.16 at the 4/1998 exchange rate of US\$1 = Rp63) each. The start was slow, as people were distrustful. Groups met every month to check whether their money was still safe. As confidence grew, word spread, and within a year, in 1990, the number of groups had risen to 200, comprising a total of 5,000 participants. At a rate of Rs 10 per day, the daily collection amounted to Rs 50,000, corresponding to about Rs 18 million annually.

Institutional Upgrading: from Dhikuti to Finance Company

Attempts to register the groups or the overall business had failed as there was no appropriate legal status for that kind of money business. The operation was too small to be registered as a commercial bank. And cooperative status did not suit H.B.P.'s profit motive.

In 1992 the Government passed a Finance Company Act. H. B. P. then took a giant step on the evolutionary scale of organizational morphogenesis and registered his business as the Himalaya Finance & Savings Company Ltd., HFSC. The existing groups continued to maintain their group structure but switched to annual meetings. In the acquisition of new business, however, H.B.P. abandoned the group approach and went into straight daily savings collection on an individual basis, with annual meetings for participants. In their eyes, legal status with its inherent supervision by the central bank is a substitute for direct monthly control. By May 1996, HFSC had established 49 branch offices all over the country, in addition to its head office in Kathmandu. It employed 600 collectors, with each serving between 125 and 400 clients a day by bicycle, motorcycle or on foot; and a monthly salary around Rs. 3,000.

By April 1998, after a change in legislation, H.B.P. changed the structure once again, reducing the branch network to five (Biratnagar, Birganj, Janakpur, Lalit Pur, Kathmandu-Sundhara), plus a head office in Tahachal, Kathmandu, and converting the remaining 43 branches into collection offices. HFSC covers 43 of the 75 districts of Nepal. Excluding deposit collectors, the total number of employees is around 300. Bookkeeping reports are faxed daily to the head office for electronic processing. Computerization of the branch offices is expected in the near future.

By changing from a fixed salary to a commission of 3% of deposits collected, the collection system has become immensely more efficient. The number of collectors decreased from 600 to 98: with higher incomes for the remaining collectors and a lower wage bill for HFSC. They serve as many as 52,000

savers all over South Nepal, the Kathmandu and Pokhara valleys. As of April 1998, daily deposits were increased to amounts ranging from Rp 10 to Rp 500.

Savings products

Participants enter into a savings contract for a period of three years after which their savings are returned to them including interest. They have a choice between having their savings collected or depositing them directly at the branch or collection office. On collected savings, the annual interest rate was 9% in 1996 and has now been lowered to 7%; on deposited savings the interest rate has remained stable at 11%. There are thus two savings products: one of collected savings at 7% interest; and one of deposited savings at 11% interest. If participants break their savings contract within the first three months, they receive no interest payment.

Doorstep services

We accompanied a senior collector, around 35 years old, on his tour, who has been working for the company for six years. He starts work at ten o'clock in the morning, leaving the head office of the company by bicycle. Close by, on his way to his collection area in Chabahil, Manankal, Bouda and Jorpati - about three quarters of an hour away - he stops at the houses of four customers. The first customer is a 50-year old woman, owner of a small food store. She has a three-year contract and pays 100 Rs per day into her savings account. The collector signs the receipt in her savings book which she keeps in her shop. The first page gives the name of the customer and his account number and bears a photograph. The following pages provide columns for the date, remarks, the savings amount and the signature of the collector. In return the customer has to sign the collector's list. The whole transaction took some 15 to 20 seconds.

One shop to the left are the next two customers, both from the same family: a young mother who runs a small shoe stall and her six-year-old child. The mother pays 100 Rs per day into her savings account and 50 Rs per day into the child's, amounting to a total of 4,500 Rs per month: a considerable sum. She says she opened the child's account to save for its education. The third customer is also female, a middle-aged woman in a small food store depositing 20 Rs per day, the same as the fourth customer, a man with a shoe stall.

It takes about half an hour to get to the main collection area. The first customer there runs a small communication centre, but he is presently away. This means that the collector has to return later. Then comes a 30-year old male with a small food shop who saves 25 Rs per day, which seems to be the most common amount. Altogether this collector has around 300 customers, which is 100 more than on average. As he cannot serve them all within one day, he covers half of them every day, collecting the double amount. On average he comes back to the office around 5 o'clock in the evening with total savings amounting to 8,000 Rs. He has no fear of being robbed on his tour. Settling his account at the head office takes 10 minutes. 3 percent of the total savings collected are his salary: around Rs 240 per day or roughly Rs 7,000 per month. Depending on the amount of daily savings, customers fall into one of the following categories: very low-income people with daily collections of Rs 10; low-income people with tiny shops contributing Rs 20-50; and small businessmen with daily savings of Rs 100-500.

Loan products

Loans may be granted to participants and nonparticipants. However, members have priority and can get a loan at any time without collateral. Loan processing takes about two days. Nonmembers have to undergo thorough loan examination procedures and provide tangible collateral. The maximum loan size

is Rs 3 million (\$48,000) for both members and nonmembers. There are thus two major loan product categories: collateral-free loans for members; and collateralized loans for nonmembers. There are six loan products: (1) business loans of Rs 100,000 – 2,000,000 for two years at 21% interest; (2) industrial loans of Rs 100,000 – 2,000,000 for two years at 21%; (3) agricultural loans of Rs 10,000 – 500,000 for 2-5 years at 15-19%; (4) housing loans of Rs 100,000 – 3,000,000 for two years at 21%; and (5) hire-purchase loans of Rs 50,000 – 150,000 for two years at 24%; and, for saving scheme participants only: (6) savings and fixed deposit loans up to 50% of the amount deposited, from Rs 10,000 – 100,000, at 14-17% interest.

Repayment modalities vary according to loan product from daily instalments to lump-sum repayment at the end. Interest payments are due at least quarterly. Delayed payment of instalments is fined at 10% on the interest due. About 2-3% of total loan instalments are in arrears. Bad loans amount to no more than 1%.

Insurance products

In addition, HFSC offers two insurance products with automatic coverage for every saver, at no extra cost to the saver: (1) accident insurance up to a maximum amount p.a. of Rs. 50,000; and (2) health insurance up to a maximum amount p.a. of Rs. 5,000.

Organizational data and future perspectives

HFSC is headed by a board of nine members, three of them women. H.B.P., the organizer-founder of HFSC, is its chairman and majority shareholder. HFSC is largely a family affair; the dhikuti group character has been abandoned. The share capital of HFSC as of 4/1998 is Rp100m (\$1.6m): all earned within a 10-year period. As savings mobilization in finance companies is limited to ten times the share capital, H.B.P. plans to transform his finance company into a bank for which no such restrictions exist.

There are some 45 finance companies in Kathmandu; but none has copied HFSC with its focus on deposit collection from low-income people. Committed to his mission, H.B.P. plans to expand into the hilly regions where to date microfinance is virtually non-existent. He argues that with his financial services he contributes to the growth of microenterprises and small farmers: a market segment which in the long run will contribute to the growth of HFSC.

Is there something to be learned from the upgrading of the dhikuti in Nepal to a finance company and of similar institutions elsewhere, such as the *paluwagan* in the Philippines, the *arisan* in Indonesia, or the *hui* in Vietnam and *Laos*? The answer is not a matter of expert opinion. Blind replication would certainly not be advisable. Too much depends on the cultural background and the legal environment in each country. But if practitioners are inspired by what has happened in Nepal, we would welcome an exchange of experience, either through this journal or directly with the authors.

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