

# Unlocking key constraints in the supply side of access to finance for the growth of SMEs in Nepal

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## Abstract:

The missing middle problem is one that affects a lot of developing countries, including Nepal. This paper aims to shed light to the existing financial structure in Nepal and the major challenges in supply-side of access to finance for the growth of SMEs. It includes an introduction section which describes the relevance of the missing middle problem in Nepal, followed by a financial structure mapping of the country in Part 1; which primarily describes key players in the formal financial structure. Part 2, of the paper focuses on identifying and analyzing the existing challenges in the supply side of SME financing and provides recommendations to tackle the said challenges. The need for a unified national definition of MSMEs and stronger, well defined policies and directives for SMEs; taking advantage of credit guarantee facilities; expanding the role of Credit Information Bureau to mitigate the risks associated with SME lending and improving SME lending through diversifying credit facilities to meet the needs of unique businesses as well as MFI upscaling are some of the ideas and solutions discussed in the paper.

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## Abbreviations:

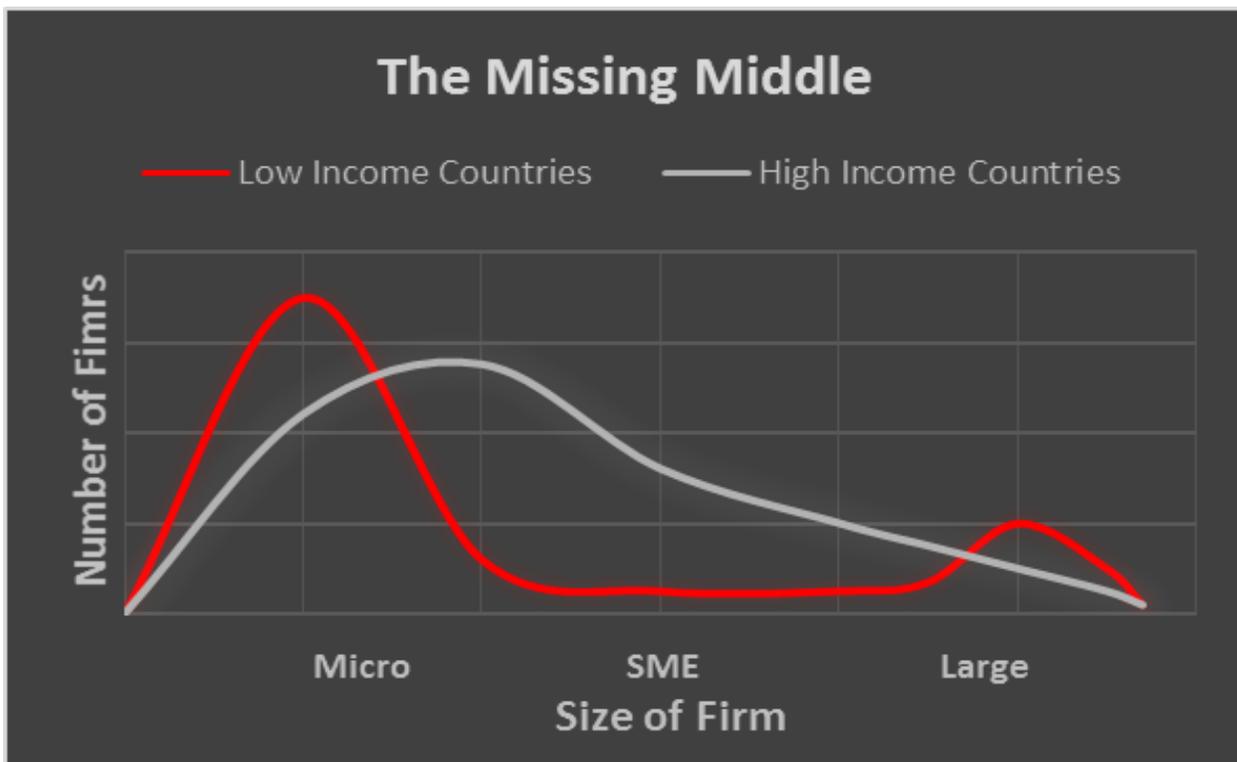
BFI	Banks and Financial Institutions
CBS	Central Bureau of Statistics
CIB	Credit Information Bureau
CIT	Citizen Investment Trust
DCGC	Deposit and Credit Guarantee Corporation
DEOC	Department of Co-Operatives
EPF	Employee Provident Fund
FINGOS	Financial Intermediary Non- Governmental Organizations
GDP	Gross Domestic Product
MFI	Micro Finance Institution
MOI	Ministry of Industry
MSMEs	Micro Small and Medium Enterprises
MTO	Money Transfer Operators
NEFSCUN	Nepal Federation of Savings and Credit Cooperative Unions Ltd
NEPSE	Nepal Stock Exchange
NPC	National Planning Commission
NRB	Nepal Rastra Bank
SACCOS	Saving and Credit Co-operatives Society
SEBON	Securities Board of Nepal
SME	Small and Medium Enterprise

## Methodology:

This study was conducted primarily through secondary research on existing literature, policy reviews and exploring Nepal government websites. Interviews with relationship managers in some commercial banks were also conducted. Finally, regular discussions and consultations with Nepal Rastra Bank personnel in the micro-finance and supervision department and regulation department were also crucial in shaping the content of this research paper.

## Introduction:

SMEs in developed countries have a much larger and impactful presence than that in developing countries. While SME's are accountable for over 50% and 60% GDP and employment respectively in high-income countries, they account for only 17% GDP and 30% employment in low-income countries.<sup>i</sup> Data show that developing countries have a huge presence of microenterprises and some large enterprises, however the number of operating SMEs is far fewer in comparison. Lack of access to finance has consistently been identified as a key reason for this.<sup>ii</sup> Since SMEs are crucial drivers of innovation and economic growth, tackling the missing middle problem is particularly important for inclusive economic growth in a developing economy like Nepal. Thus, identifying and finding solutions to the key challenges that obstruct the supply of financial access to this promising sector is extremely critical and urgent.



*Image Source:* Weichert, Josh. "The Missing Middle." (2015). ASTAGO.

Nepal faces a missing middle problem whereby SMEs that require financing - greater than that provided by micro-finance institutes and lower than that required by BFIs' large corporate clients - face challenges in accessing finance to launch and grow their businesses. While NRB places a lot of focus on the microfinance sector and has clear provisions for the deprived and productive sector lending, limited policies geared towards SME financing are vague at best with no directives defining clear action steps for both BFIs and monitoring agents. The lack of a uniform definition for SMEs and the dearth of data and information on the sector is extremely problematic. Additionally, stringent collateral and documentation requirements from BFIs discourage enterprises from acquiring the financing they need. Therefore, clear progressive policies focusing on SME development, better data collection, along with an enhanced role of the Credit Bureau and Credit Guarantee Agency are crucial to help SME's realize their potential and consequently contribute to the nation's prosperity and development.

## Mapping Nepal's Financial Structure:

Post financial liberalization in the 1980s, Nepal's financial system has been rapidly evolving by adopting efficient methods to increase and improve its reach and output. The on-going progress and growth of banks and financial institutions as well as other financial service providers paints an encouraging picture for the goal of achieving financial inclusion and economic growth. However, with only 61% of the Nepali adults formally banked, 21% using informal methods and 18% financially excluded, both the public and the private stakeholders have a long way to go.<sup>iii</sup> Understanding how the system works is the first step towards finding solutions for better financial inclusion.

## Financial Structure Mapping Overview:

### Formal Channels:

#### ➤ Banking & Financial Institutions

- Commercial Banks
- Development Banks
- Finance Companies
- Micro-Credit Development Banks
- SACCOS – Saving and Credit Co-operatives Society
- \*FINGOS – Financial Intermediary Non- Governmental Organizations

\* In the process of either converting into MFIs or discontinuing their services

- NEPSE – Nepal Stock Exchange
- Ministry of Finance
- Credit Information Bureau
- Deposit and Credit Guarantee Corporation
- Citizen Investment Trust
- Employee Provident Fund
- Department of Cooperatives

- Insurance Board
- Nepal Rastra Bank
- SEBON – Securities Board of Nepal
- ICRA Nepal: Credit Rating Agency Nepal
- MTO- Money Transfer Operators (Remittance)
- Post Office

Semi-Formal Channels:

- Consumer Group
- Aama Samuha
- Savings Groups
- Ban Samuha

\*Registered or recognized under Ministry of Education or Local Development Committees

Informal Channels:

- Dhukuti
- Hundi
- Networking/Unity
- Money Lenders
- Friends and Family

## A Brief Introduction of Key Players in Nepal's Formal Financial Structure:

**Nepal Rastra Bank (NRB)** - the central bank of Nepal - was established in 1956. Being the apex policy making body and monetary, regulatory and supervisory authority of banks and financial institutions; some of its key objectives are to ensure financial, price and balance of payments stability as well as promote financial services and manage liquidity. Currently, NRB directly governs the following:

**Commercial Banks** – Classified as Class A financial institutions, the number of commercial banks as of January 2016 stands at 30 with a total of 1806 branches all over the country. The eastern region has 339 branches, Central 868, Western 326, Mid-Western 168 and the Far-Western has the lowest 105 branches. This class has the largest number of deposit accounts amounting to 12093683 and has a deposit/GDP ratio of 72.96%. It also has the largest number of loans at 702721, a credit/GDP ratio of 55.34% and a deprived sector loan/total loan ratio of 5.33%.<sup>iv</sup>

**Development Banks** – The total number of Class B financial institutions, development banks is 73. It has 856 branches comprising of 110 in the Eastern Region, 324 in Central, 310 in Western, 82 in Mid-Western and 30 in Far-Western. This class has the second largest number of deposit accounts at 3098936 and a deposit/GDP ratio of 11.61%. It has 285647 loans, a credit/GDP ratio of 9.31% and a deprived sector loan/total loan ratio of 6.38 %.<sup>v</sup>

**Finance Companies** – There are 47 Finance Companies; Class C financial institutions with a total of 202 branches out of which 23 are in the Eastern Region, 113 in Central, 55 in Western, 8 in Mid-Western and 3 in the Far-Western Region. It has 563238 deposit accounts, 49798 number of loans, 3.55% deposit/GDP ratio, 3.15 credit/GDP ratio, and 4.02% deprived sector loan/total loan ratio.<sup>vi</sup>

**Micro-Credit Development Banks** – Class D financial institutes, Micro Finance Institutions (MFIs) play a crucial role in financial inclusion by providing access to finance for the underprovided masses. Currently, there are 40 MFIs with a total of 1183 branches, however given the dangers of duplication and weak regulation and supervision, NRB will only allow new MFIs to operate in financial services deficient areas. The Monetary Policy 2015/16 has also increased the limit of micro finance loans up to NPR 300,000 for group based non-collateral loans and up to NPR 700,000 for collateral based enterprise loans.<sup>vii</sup>

**Financial Intermediary Non- Governmental Organizations (FINGOS):** As of January 2014 there were 31 FINGOs that operated in over 50 districts in Nepal. However, due to difficulty in regulations, NRB brought the policy that required FINGOs to either convert into a Class D MFI, or to close down its operations by Mid-2015. Although some FINGOs are still in the transition phase, they will no longer exist in the near future.

**NRB licensed Cooperatives** – There are only 15 cooperatives which perform limited banking activities that are licensed under NRB. As of July 2014, the total deposits amounted to NPR 15.9

billion and total loans to NPR 11.8 billion. All remaining cooperatives are licensed under the Department of Cooperatives.<sup>viii</sup>

**Securities Board of Nepal (SEBON)** – SEBON, the apex regulator of security markets, was established in 1993. Some of its major functions are to register securities of public companies and mutual funds, issue securities directives and licenses to operate stock exchange, stock broker, dealer, merchant bankers, depository company and credit rating agency. It also regulates the issue, transfer and exchange of registered securities as well as approves the bye-laws of stock exchange.

**Nepal Stock Exchange (NEPSE)** – NEPSE which was established under the Securities Exchange Act in 1983, is administered under SEBON. It opened its trading floor in January 1994 with the objective of imparting free marketability and liquidity to government and corporate securities by acting as a facilitator for trade transactions among market intermediaries. Currently there are 240 companies listed in Nepal Stock Exchange Ltd. As of mid-July 2015, the stock market capitalization stood at NPR 989.40 billion, and the ratio of market capitalization to GDP was 46.6%.<sup>ix</sup>

**Insurance Board** – Beema Samiti, or Insurance Board is the Insurance Regulatory Authority of Nepal which was established to develop, systemize and regulate the insurance business in the country. Its main objective is to create a healthy and developed insurance market in Nepal. As of July 2015, there are 26 insurance companies of which 9 are life insurance, and 17 are non-life. The total asset/liabilities of these companies grew in 2014-2015 by 22.1% to NPR 124.3 billion.<sup>x</sup>

**Deposit and Credit Guarantee Corporation (DCGC)** – The Deposit and Credit Guarantee Corporation is sponsored and administered by the government, but it is a separately functioning entity. Its major function is to act as an insurer and take responsibility for deposit and credit guarantee. In case of an unlikely failure of a bank or financial institution, depositors are protected by the DCGC whose coverage is limited to NPR 200,000 per individual depositor per member institution. It is mandatory for commercial banks, development banks, finance companies and Micro-Finance Institutions to be part of a deposit guarantee scheme which has a fixed 0.20% premium rate. This was done to increase public confidence towards BFIs. The government also subsidizes credit guarantee for micro finance and deprived sector credit, small and medium enterprises and livestock credit to a certain level; up to NPR 150,000 for loans without collateral and NPR 400,000 for loans with collateral, up to NPR 1.5 million per loan, and up to NPR 90,000

respectively. As of mid-June 2015 deposits of NPR 284.25 billion from 164 BFIs has been guaranteed and a premium of NPR 561.6 million has been collected for the deposit guarantee. Similarly, NPR 1.05 billion under micro and deprived sector, and NPR 168.4 million under SMEs has been insured under the credit guarantee scheme, and NPR 2.95 premium has been collected. <sup>xi</sup>

**Citizen Investment Trust (CIT)** – Nagarik Lagani Kosh or CIT was established on 18<sup>th</sup> March 1991 under the Citizen Investment Trust Act 2047. The trust operates various kinds of retirement and unit schemes as well as mutual fund programs. Not only does the trust expand investment opportunities for its investors but it also contributes to capital market development. The trust focuses its efforts in three areas: Saving Program, which aims to increase the trust funds through savings and mutual fund program; Investment Management, which aims to diversify investment portfolio but through secure priority sectors; and lastly Capital Market Service which aims to accelerate the development of the Nepali capital markets. A number of private and government entities share the ownership of the trust; whereby, the Government of Nepal owns 10%, Nepal Rastra Bank owns 13%, NEPSE owns 10%, Rastriya Beema Sansthan owns 27%, the general population owns 20% and BFIs own the remaining 20%. <sup>xii</sup> As of mid-April 2015, the asset/liabilities of the trust was NPR 63.68 billion which had increased by NPR 9.06 billion since last year. The trusts major liability, fund collection was at NPR 60.43 billion on April 2015. <sup>xiii</sup>

**Employee Provident Fund (EPF)** – The EPF or Karmachari Sanchaya Kosh (KSK) operates under the Ministry of Finance and on behalf of the Government of Nepal, manages the Provident Fund. Its function is to provide financial security to member individuals upon retirement or separation from their jobs. Members of the EPF includes all army and police personnel, civil servants, employees of all government organizations, including schools as well as private organizations who have more than ten employees and want to enroll in the service. All member employees contribute 10% of their salaries to the fund, which is matched by their employers. Accident Indemnity, Funeral Grant, Employees Welfare Scheme (Insurance), Medical Assistance and Participation in Profit are additional social security benefits of EPF. According to KSK's website, they had 28000 offices with 4, 66,000 individual members as of November 2012. The Fund's asset/liabilities amounted to NPR 189.14 billion as of mid-April 2015 which was an almost \$20 billion increase from the previous year. The depositors' provident fund stood at NPR 182.30 billion. <sup>xiv</sup>

**Department of Co-Operatives (DEOC):** The department of co-operatives operates under the Ministry of Cooperatives and Poverty Alleviation. Its function is to register, promote and regulate all cooperatives in the country. Saving and Credit, Multipurpose, Dairy, Agriculture, Bee Keeping, Tea, Energy and Consumers are some of the several kinds of cooperatives operating in Nepal.

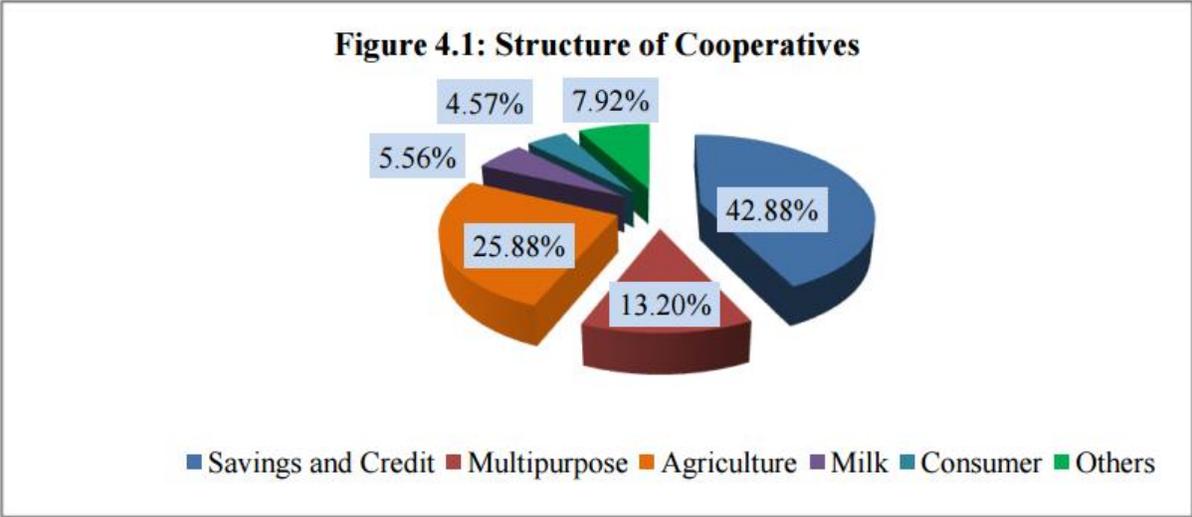


Image Source: Nepal Rastra Bank. "CHAPTER 4: COOPERATIVES, FINGOS AND OTHER FINANCIAL INTERMEDIARIES." *Financial Stability Report*, no. 5 (July 2014): 74.

Cooperatives are seen to be one of the three foundation pillar of Nepal’s economy given its vast rural reach as well as economic impact. According to the Department of Cooperatives, there were 32,663 serving 5 million people and employing more than 57,894 people as of 2015.

The Nepal Federation of Savings and Credit Cooperative Unions Ltd (NEFSCUN) is an organization that overlooks the development, promotion and strengthening of Saving and Credit Cooperative Societies (SACCOS) and their District Unions (DUs). According to NEFSCUN their reach covers 73 districts and 21, 00,000 individuals. As of mid-June 2015, the number of saving and credit co-operatives was 13,413 and they collectively held deposits of NPR 131.29 billion and lent out NPR 121.69 billion. <sup>xv</sup>

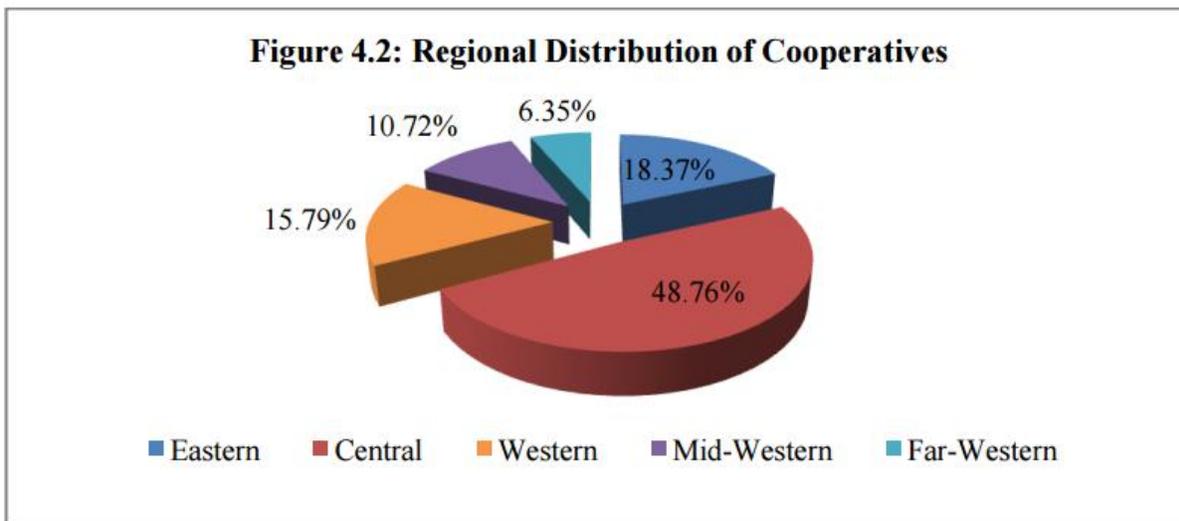


Image Source: Nepal Rastra Bank. "CHAPTER 4: COOPERATIVES, FINGOS AND OTHER FINANCIAL INTERMEDIARIES." Financial Stability Report, no. 5 (July 2014): 74.

Despite its rural reach, co-operatives are still mostly concentrated in urban and easily accessible areas. Therefore, efforts in further expanding its reach is still important. Furthermore, due to the large number of these cooperatives regulation and monitoring has become difficult. To strengthen the regulation and supervision of the increasing number of saving and credit cooperatives and micro credit institutions, the 2015-2016 monetary policy has a provision for submitting a draft of an act for establishing a strong institution for the above purpose.<sup>xvi</sup>

**Credit Information Bureau (CIB)** – CIB or Karja Suchana Kendra Limited (KSKL) was established in 1989 to curb the alarmingly increasing Non Performing Assets of BFIs during the period. It started operating under the NRB Act 2058, Article 88 as an independent public limited company since March 2005. The ownership of the organization is spread between BFIs with Commercial Banks holding 65% shares, Development Banks holding 10%, Finance Companies 15% and the Nepal Rastra Bank holding 10%. Its major function is to collect and organize credit information of all individual consumer and commercial borrowers of all BFIs. NRB has made it mandatory for BFIs to be a member of KSKL and to report the credit records of all borrowers amounting more than or equal to NPR 2.5 million. Credit reports of loan requesters are thus disseminated to BFIs upon request. NRB regulation also required all BFIs to obtain the credit

information of a borrower, “before the new credit extension, renewal, restructuring, and / or rescheduling of NRS 1 million or above facility”.<sup>xvii</sup>

The benefits of CIB are widespread. The borrowers will get easier and faster access to credit and they may also be eligible to pay lower interest rates if they remain in good credit standing. SMEs also benefit in the same ways as individual borrowers and their high risk perception will also be reduced. BFIs can receive comprehensive risk profiles of their clients which will help them shift to information based lending and also increase market penetration. Lastly, regulators will have access to a comprehensive risk monitoring mechanism, reduce non-performing loans levels in the economy as well as increase credit levels and reach without having to increase risk.<sup>xviii</sup>

# Identifying major challenges and their potential solutions in the supply side for improving access to finance for SMEs

### 1) The need for redefining MSMEs:

The Industrial Policy 2010 defines a cottage industry as one that is related with national tradition, art and culture or which uses specific skills, local resources or local raw materials; a micro enterprise as an enterprise that has fixed assets up to NPR 200,000 among other factors; a small enterprise as that with fixed assets between NPR 200,000 and NPR 50 million; and a medium enterprise as that with fixed assets between NPR 50 million and NPR 150 million. However, with the newest monetary policy allowing micro-finance institutions to lend up to NPR 10 lakhs in areas where BFIs do not exist, it is evident that this definition needs an upgrade. Moreover, this definition mostly applies to the industrial enterprises and the government itself promotes isolated policies and laws referring to discrete segments of the sector.<sup>xix</sup> The need for a new uniform definition of MSMEs has been highlighted time and again in existing literature, and was an apparent conclusion from conversations with officials at NRB, an analysis of missing data on its reporting as well as interviews with BFIs. The astounding difference in the maximum SME loan amount between different financial institutes ranging from 50 lakhs to 4 crores among the interviewed banks show the inconsistency of the understanding of an SME in Nepal.

The lack of a proper uniform definition not only makes it challenging to measure the size and contributions of MSMEs, but also consequently makes it extremely difficult to come up with productive policies for the improvement of the sector as well as to implement and monitor those policies in the absence of proper data. Hence, a clear unified national definition for MSMEs that is applicable to all the sectors of the economy is very important.<sup>xx</sup>

In coming up with the definition, it is crucial that the Ministry of Industries along with other relevant ministries, the National Planning Commission, and Nepal Rastra Bank collectively in consultations with relevant agencies working in the field, analyze the little existing information on the nature of MSMEs in Nepal as well as consider a number of factors such as employment, annual turnover, value of investments, ownership structure and choose a combination which will best reflect the characteristics of each category. While all of these factors may not be considered in the national definition, different ministries and agencies

might want to use those criteria while developing their target programs. Lastly, the national MSME definition should exclude state and public enterprises as well as the subsistence agriculture sector.<sup>xxi</sup>

## **2) Improving information on MSMEs for better policy making :**

The lack of information on MSMEs is a major hurdle for effective policy making geared towards its development. There is no mechanism to properly report, collect and analyze information related specifically to SMEs. The data available is extremely limited and scattered and dissecting the data according to size, sectors and other necessary distinctions to properly understand the challenges and needs of the SME sector is impossible.<sup>xxii</sup> Thus creating proper regulatory and policy framework in the absence of such crucial information and statistics becomes extremely difficult.

The Ministries of Industries, Commerce and Supplies as well as the National Planning Commission, Central Bureau of Statistics and Nepal Rastra Bank should collectively ensure improved and integrated data collection and a maintenance of an up-to-date national database for MSMEs. The database should include relevant classifications.

Specifically, in the context of access to finance the only information collected currently by NRB in terms of SMEs in the Banking and Financial Statistics is the amount of Small and Medium Industrial Loans given by Class A Commercial Banks. This reporting is not mandatory and the accuracy of the limited available data is also questionable given the discrepancies in the definitions of SMEs among commercial banks. In addition to adhering to a uniform definition whilst reporting total Small and Medium Industrial loans, sub-categorization of loans to Small and Medium and further to amount ranges within those sub categories will help uncover what the distribution of finances actually look like in the lower, mid and upper tiers of small and medium enterprises and which categorical sector among those need targeted support. Moreover, information on number of loan enquiries in the SME category, number of actual applications and number of approvals with categorization according to loan amount ranges will provide powerful insight into the dynamics of supply and demand in financial access for SMEs. Thus NRB should require not only commercial banks but all BFIs including development banks and financial companies to collect and report the above mentioned categorical data.

Lastly, an annual report on the contributions, challenges and policy reforms on MSMEs should be published.<sup>xxiii</sup>

### **3) The need for stronger policies, directives or better yet a separate SME act:**

Monetary Policies from the past several years contain points to improve financial access to SMEs, however its implementation has been extremely disappointing. The 2013/2014 policy included an implementation status update on the 2012/2013 Monetary Policy which stated “In coordination with programs adopted by government, an arrangement for availability of credit easily to small and medium enterprises (SMEs) will be made.”<sup>xxiv</sup> The update mentioned that NRB “made a provision of providing 10 percent of total credit to agricultural and energy sector by BFIs” and that “definition of SMEs has been clarified”<sup>xxv</sup>. There are two problems in the implementation update. While provision for credit to agricultural and energy sectors is important, this does not necessarily improve access to finance for the target which is SMEs. Secondly, the “clarified” definition of SMEs has not surfaced till date which is still a major problem that has been discussed above.

This year’s 2016/2017 monetary policy includes a point to make SME desks in BFIs more effective and monitoring stronger to address the problem of the missing middle.<sup>xxvi</sup> Some version of this point has been circulating for the past 3 years but no directives have been issued to address this yet. The language in the policy is very vague with no clear definition of the missing middle and no mention of what exact steps will be taken to make the SME desks more effective. Conversations with NRB revealed that much thought has not been put into this policy and there is no clarity for further implementation, hence we cannot expect directives to address this in the near future.

SME financing seems to be neglected in comparison to the Microfinance sector. While there is an entire department in NRB dedicated to microfinance, strong provisions in deprived sector lending for BFIs, and clear directives for MFIs, such attention to SMEs seem to be lacking. While provisions for a productive sector lending exists which might benefit SMEs, this is not guaranteed as an enterprise need not be an SME to qualify as a productive sector entity.

Thus, it is important that NRB take steps to further clearly define “the missing middle” and “SMEs” and formulate clear guidelines for BFIs and action plans for monitoring by the NRB in a directive. Many countries have a separate SME act, and similarly creating an SME act might be an important step in recognizing the need and urgency for supporting our SME sector, clarifying definitions and action plans for all interested private entities and BFIs, setting up stage for finally implementing previous SME policies as well as planning and creating a proper monitoring and

evaluation mechanism. This might be a much needed boost for improving financial access to SMEs.

#### **4) Taking advantage of Credit Guarantee facilities:**

One of the major hurdles for small enterprises to access finance is the lack of acceptable fixed collateral. Partial credit guarantees are a good way to manage the high risks associated with SME lending without requiring massive collaterals and poor terms of credit. While a Deposit and Credit Guarantee Corporation (DCGC) does exist in Nepal it is more focused on deposit guarantee, despite starting off initially with the purpose of only credit insurance.<sup>xxvii</sup> A Small and Medium Enterprise Guarantee Product is offered with the following criteria:

- “1. The loan advanced by the member institutions to the sector of service and industry up to Rs. 3 million per loan compulsorily and the investment up to Rs. 10 million per loan under DCGC's approval is guaranteed by DCGC.
2. The premium rate is 0.15% up to Rs. 10 million and 0.175% up to Rs. 3 million on the basis of outstanding balance of each half-year i.e, 0.30% and 0.35% respectively per annum.
3. The bank can file the claim of the unrecovered outstanding loan till the due date of payment within two years of the due date of payment.
4. The compensation rate is 80% up to Rs. 3 million and 70% up to Rs. 10 million of the outstanding balance of the loan at due date.”<sup>xxviii</sup>

As of 2013 only 4 banks were using the product, rendering it unpopular.<sup>xxix</sup> However, the total amount insured over the years have increased from NPR 65.2 Million in 2013 to NPR 168.4 Million in 2015.<sup>xxx</sup> The limited success of this program is attributed to higher “emphasis on Deposit Guarantee, majority ownership by Government, inefficient guarantee review processes, limited uptake and interest from Commercial Banks, high premiums, slow pace of reviews, guarantor of the last resort type mentality and inordinate delay with the Draft Act”<sup>xxxi</sup>.

#### **5) Expanding the role of Credit Information Bureau:**

It has been established through multiple conversations with Banks and Financial institutions’ officials and previous literature that loans to SMEs are considered to be high risk investments, which does not make this sector very lucrative for these for-profit institutions. The CIB has played a crucial role in reducing non-performing assets and its role could be extended to reduce the risks

that are pertained to SME lending. Currently only BFIs are required to report the credit records of all borrowers amounting more than or equal to NPR 2.5 million. Thus, borrowers who borrow less than that amount and through other financial mediums are excluded from the database. Many microfinance institutions and co-operatives maintain their own individual records of lending. Incorporating that information in the master database for CIB by requiring all financial institutions to report their lending, will help build a credit history for a lot of individuals and SMEs who borrow any amount of loans, regardless of the size. Additionally the role of the credit bureau can further be expanded to collect and disseminate information on utility and rent payment patterns of entrepreneurs, hence building a credit history for SMEs who have not taken out loans previously to help BFIs evaluate their credit worthiness. Easy accessibility to information about SME and proprietor credit patterns will not only reduce the risk of non-performing assets but also make background analysis of borrowers easier for financial institutions, thus subsequently reducing the time for loan approval as well as potential increases in the number of loans.

Currently, the CIB reports are just used as a yes-no tool for loan approval by BFIs. Using a standard identity measure such as citizenship number to associate a credit score for each individual can be extremely helpful for BFIs in determining interest rates and credit line amounts.

#### **6) Improving SME Lending services:**

SME lending has yet to be a priority for BFIs. According to NRB, SMEs received only 2.6% of the total loans from commercial banks in 2015.<sup>xxxii</sup> Although the accuracy of the data is questionable given the fairly limited data collection on SMEs and discrepancies in the definitions of SMEs among commercial banks, the figure is staggeringly low even as just a wide estimate. Banks and financial institutions have a much lower interest rate as compared to their MFI counterparts. While the interest rate for SME loans in banks ranged from 8%-14%, the average interest rate of MFIs is 18%<sup>xxxiii</sup> and goes much higher in many cases. However, rigid requirements and standards make it difficult for a budding enterprise to receive approval for a loan in a BFI. Proper book-keeping is one of the key requirements for SME lending in BFIs. This is a challenge for many small businesses, even in the urban areas. Thus, many proprietors prefer to take out personal loans to forego this requirement, despite higher interest rates. While financial literacy is an important aspect to tackle this problem, more flexibility and/or support by BFIs is also crucial. Successful SME lending models have shown that a dedicated SME staff force trained to help small

business owners to transform their unofficial business records into an acceptable book-keeping form can be helpful.

Furthermore, almost all of the BFIs' SME lending services require collateral and the business should either have minimum two years of profitable operations or the business owner should have 2 years of experience in a similar business. The lack of innovative and flexible tools and options is crippling to budding enterprises as this excludes any new comer who might have a brilliant business idea but limited experience and/or resources. There have been some venture funds established in the recent years but those are fairly new and have very limited reach. Although the socio-economic conditions of SME owners are vastly different in rural and urban areas, BFIs do not have any diversity in their product and service offerings to meet the unique needs of their diverse clientele. As discussed above, analyzing CIB reports to offer competitive interest rates to clients while managing risk can also be an effective way to handle SME lending.

Moreover, upscaling MFIs by increasing their lending limit much higher than NPR 1 million can also be an effective tool to cater to the needs of the missing middle enterprises. The argument against doing so earlier was the danger of exploitation of small enterprises through exorbitant interest rates. However, with the introduction of a 7% spread for MFIs in the new monetary policy, that danger can be mitigated.<sup>xxxiv</sup> Utilizing the existing network and reach of these MFIs that the BFIs lack, can be very helpful to increase access to finance for rural SMEs.

## Limitations:

This paper could have benefitted with an extensive review of all existing policies, acts and directives issued by various government agencies. Additionally, interviews and consultations with more related stakeholders like the Ministry of Industry, Department of Cottage and Small Industries as well as more BFIs, MFI, Co-operatives and Micro, Small and Medium entrepreneurs could also have provided more depth to parts of the analysis. Regretfully, given the limited time-frame for the study, these limitations could not be addressed.

## Summary of existing challenges and recommendations:

Below is a brief summary of the major existing challenges and the supply-side recommendations for increasing access to finance of SMEs.

### **The major challenges identified by the research were:**

- Lack of unified national definition of SMEs has made data collection and policy initiatives difficult. It seems BFIs and government use vastly different standards for SMEs.
- SMEs received only 2.6% of the total loans from commercial banks in 2015. SME loans offered by financial institutions are largely collateral based requiring stringent documentation and make no distinction between rural and urban clients. Thus, entrepreneurs either want to avoid BFIs or prefer to take personal loans with higher interest rates.
- While points for improving access to finance for SMEs have been mentioned in monetary policies year after year, there seems to be a lack of specific action plan since no directives or acts follow the policy. The current monetary policy mentions tackling the missing middle problem by making SME desks more effective. However, the definition of the target missing middle or SMEs remains undefined.

### **Recommendations:**

- MOI and NRB collectively in consultations with relevant agencies need to create a unified national definition for MSMEs. Additionally, The MOICS, NPC, CBS and NRB should collectively ensure improved and integrated data collection and a maintenance of an up-to-date national database for MSMEs.
- The reporting of total Small and Medium Industrial loans, should be sub- categorized into loans to Small and Medium and further to amount ranges within those sub categories to help uncover what the distribution of finances actually look like in the lower, mid and upper tiers of small and medium enterprises and determine which categorical sector among those need targeted support. NRB should mandate all BFIs to report the above mentioned categorical data.

- The role of the Credit Bureau can be further expanded to collect and disseminate information on utility and rent payment patterns of entrepreneurs, and even loans given out by co-operatives and BFIs that are lower than the current NPR 2.5 million mark; hence building a credit history for SMEs who haven't yet taken out loans to help BFIs evaluate their credit worthiness.
- Policies geared towards improving financial access for SMEs should have clearly defined terms such as what amount constitutes the “missing middle” and also have immediate implementable action steps laid out for both BFIs and the monitoring officials to follow.
- A separate Credit Guarantee Agency needs to be established which specializes on credit insurance and does not deal with deposit guarantee.
- Banks and Financial Institutions should take advantage of the flourishing SME sector by diversifying their loan service offerings to meet the needs of a diverse clientele. This can be achieved by training and appointing specific SME staff to look after the unique needs of small business owners.
- Nepal Rastra Bank along with the government should look into tapping the network, resources and reach of MFIs by increasing their maximum lending limit and allowing for an upscale. An adequate spread requirement should be maintained for MFIs to keep the interest rates in check.

## Conclusion:

In conclusion, the SME sector in Nepal has tremendous potential and improving financial access to grow and expand budding enterprises, especially in rural Nepal will help increase employment, improve standards of living and can play a major role in the country's economic development. It is therefore imperative that the government and private stakeholders divert their attention to SMEs and come up with stronger and well defined policies and initiatives to improve their access to finance in order to collectively reap the benefits and ripple effects of flourishing enterprises in Nepal.

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## Endnotes:

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## Appendix:

### Questionnaire for Banks and Financial Institutions July 2016

1) Do you offer any services that caters specifically to SMEs?

Yes  No

2) If yes, what kind of services do you offer?

3) If no, why not? Are there any alternative financing options for entrepreneurs? (Personal loans?)

4) What kind of clients do you usually deal with? What kind of businesses are they involved in?

5) What is the range for loan demand for SMEs? (What amount do they ask for?)

6) What is the amount range for actual SME lending?

7) Describe the processes involved in securing an SME loan/ entrepreneur loan? Is there any flexibility in the requirements?

8) On average what is the level of loan enquiry for SMEs? Out of those who enquire, what percentage apply for a loan? Out of those who apply what percentage are successful in getting a loan?

9) Are most of the SME loans dispersed collateral based? What kind of alternatives are there for collateral lending? How effective are they?

10) How do you fulfill your deprived sector lending and productive sector lending requirements issued by NRB? What kind of industries do the funds go to? (Also look at NRB data)

11) Do you face any policy or regulation challenges that prevents or discourages you to lend to SME entrepreneurs?

12) What infrastructure or other challenges do you face in this regard?

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13) Do you have data on rural lending vs. urban lending? What are the biggest differences in the type of clients and demand? Is there a difference in the way you provide services?

14) How helpful is the Credit Information Bureau? Do you think there is any way it could be better? Do interest rates for specific clients vary according to their credit worthiness or is it a standard range for all clients. How flexible are the rates? What are factors that determine the interest rates for particular clients?

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