

United Nations Economic and Social Commission for Asia and the Pacific

MSME Financing Series No. 3

Micro, Small and Medium-sized Enterprises' Access to Finance in Nepal



Unlocking Public and Private
Finance for the Poor

Copyright © United Nations, 2020. All rights reserved.

The views expressed in this publication are those of the author(s) and do not necessarily reflect the views and policies of the United Nations or other international agencies. Mention of any firm does not imply endorsement by the United Nations.

Links contained in the present publication are provided for the convenience of the reader and are correct at the time of issue. The United Nations takes no responsibility for the continued accuracy of that information or for the content of any external website.

Reproduction and dissemination of material in this publication for education or other non-commercial purposes are authorized without prior written permission from the copyright holders, provided the source is fully acknowledged.

Enquiries on this report can be sent to:

Director
Macroeconomic Policy and Financing for Development Division
United Nations Economic and Social Commission for Asia and the Pacific
United Nations Building, Rajadamnern Nok Avenue
Bangkok 10200, Thailand
Escap-mpdd@un.org

How to cite this report:

United Nations, Economic and Social Commission for Asia and the Pacific, *Micro, Small and Medium-sized Enterprises' Access to Finance in Nepal*, MSME Financing Series No. 3 (Bangkok: United Nations, 2020), available from: <https://www.unescap.org/resources/micro-small-and-medium-sized-enterprises-access-finance-nepal>.

Photo credit: UNCDF Nepal

About this series

Micro, small and medium-sized enterprises (MSME) make a significant contribution to economic growth and job creation across Asia and the Pacific. However, they often encounter difficulties in accessing finance. Women-headed MSME's are particularly underserved by financial institutions due to economic, regulatory and socio-cultural factors. In recent decades, governments and related agencies have set up mechanisms to facilitate the flow of finance. The result has been an increase in financial inclusion but the extent to which the financing gap has been reduced is not well known.

To gain more understanding about this issue, key questions need to be addressed, including the following: Is finance still a constraint, including for certain classes of enterprises, such as medium-sized ones? What mechanisms, such as credit guarantees, collateral support, and directed credit, have been the most beneficial in closing the gap? Is there gender disparity in access to finance? And are there public and/or private sector measures to overcome any existing regulatory, normative and contextual barriers to women entrepreneurs' equal access to finance? How have demand-side programmes, such as financial literacy, aided MSMEs? And how have FinTech and digital finance helped to increase access to finance?

To seek answers to these and other important questions, the Economic and Social Commission for Asia and the Pacific (ESCAP) developed *A Framework for Country Studies on MSMEs Access to Finance in Asia and the Pacific*. The Framework provided direction for the preparation of detailed national studies on MSMEs' access to finance in selected countries of Asia and the Pacific. The studies were prepared by researchers and specialized consultants under the guidance of a lead country agency with policy responsibilities in MSME financing. In some of the studies, an advisory committee composed of representatives from departments, agencies, financial institutions, and organizations involved in MSME promotion and financing provided direction and support to the authors.

This series presents the Framework along with national studies that were prepared following its guidelines. Each national study is expected to contribute, through policy analyses and recommendations, to policy discussions on how to improve access to finance by MSMEs. The preparation of national studies based on a common framework is also expected to facilitate comparisons across countries to share experiences, identify good practices, and understand common challenges.

Some of the studies contributed to ESCAP capacity building projects. The studies for Cambodia and Nepal were funded by the United Nations Regular Programme of Technical Cooperation, and the studies for Bangladesh and Samoa were funded by the Government of Canada, through Global Affairs Canada, in the context of ESCAP's Catalysing Women's Entrepreneurship Programme. The preparation of these four studies benefitted from a partnership between ESCAP and the United Nations Capital Development Fund (UNCDF). The latter contributed financial support for the Nepal study through UNNATI-Access to Finance (A2F) Project funded by the Government of Denmark. In addition, the Task Force on Banking and Finance of ESCAP's Sustainable Business Network funded a comparative study of MSME financing in Singapore and Hong Kong, China.

About this report

This report was commissioned by the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP). The report was prepared by a study team led by Achyut Hari Aryal, a member of the Board of Directors of Nepalese microfinance institution Vijaya Laghubitta, licensed under the Central Bank of Nepal. The other team members included Madan Sharma, Binisha Nepal, and Dharmendra Lekhak. Alberto Isgut, from ESCAP, provided an extensive revision and additional research to the report.

This report was financially supported by ESCAP, through the United Nations Regular Programme of Technical Cooperation, and UNCDF, through UNNATI-Access to Finance (A2F) Project, funded by the Government of Denmark. The preparation of the report was guided by the High Level Financial Inclusion Roadmap Implementation Committee of Nepal Rastra Bank, the central bank of Nepal, as well as by ESCAP and UNCDF, which has been a partner of ESCAP in the production of studies on MSMEs access to finance in Asia and the Pacific. The preparation of the report was based on ESCAP's *Framework for Country Studies on MSMEs Access to Finance in Asia and the Pacific*, MSME Financing Series No. 1, Bangkok: United Nations, 2020. Key informant interviews were conducted to gain a better understanding of the financing environment from the perspectives of both the demand and the supply sides of the market. Secondary data collection involved extensive reviews of intergovernmental reports. The bulk of the data was gathered between July and December 2018, with an update to the quantitative analysis in 2019 in order to include recently published data from the National Economic Census 2018.

To gather information on the demand side, the study team conducted interviews with entrepreneurs in agriculture and manufacturing industries based in different areas of the Eastern and Mid-Western Regions of Nepal. Critical information was also received from the Municipality of Ilam and from the Mayor of Suryodaya Municipality.

On the supply side, the study team conducted interviews at six major financial institutions in the Central Region, including microfinance institutions (MFIs) Nirdhan Utthan Laghubitta Bittiya Sanstha, Laxmi Laghubitta Bittiya Sanstha and Chhimek Laghubitta Bittiya Sanstha. The small and medium enterprise (SME) departments of several commercial banks in the region, including Siddhartha Bank, Nepal Investment Bank and Nabil Bank, were also interviewed. In the Eastern Region, the team interviewed the Ilam Bazaar branch manager of local microfinance bank Nirdhan Utthan Laghubitta Bittiya Sanstha and at the commercial Sunrise Bank. In the Mid-Western Region, SBI Bank's Dhangadhi branch manager participated in the study. To gain clarity on the role that financial technology (FinTech) and digital finance play in expanding MSME access to finance, the team conducted interviews with UK Aid-Nepal's Sakchyam's Access to Finance Program and UNCDF's UNNATI Access to Finance (A2F) Project.

Contents

About this series.....	i
About this report.....	ii
Abbreviations.....	v
Acknowledgements.....	vii
Overview and key messages.....	viii
1. Introduction.....	1
Definitions.....	2
MSMEs in Nepal.....	2
Challenges of Women-led MSMEs.....	4
2. Financial Access and Gaps.....	5
The financial gap.....	6
Understanding the gap.....	8
The “Missing Middle”.....	9
Collateral.....	10
Additional supply-side and demand-side issues.....	11
3. Policy and Regulatory Framework.....	12
Variable interest rate loans.....	12
Enhancing MFI and commercial banks’ portfolios to promote MSMEs.....	13
MSME Registration and Tax Compliance.....	13
4. Lending Infrastructure and Support.....	14
MSME Loan Guarantee Mechanism.....	14
Credit Information Bureau.....	15
Insurance schemes for MSME.....	16
5. Dedicated Banks and Funds.....	17
6. Venture capital and private equity.....	20
7. FinTech.....	21
Digital Financial Services in Nepal.....	22
Recent FinTech Initiatives in Nepal.....	24
8. Business Membership Organizations.....	26
9. Financial and Business Literacy.....	26
10. Recommendations to improve MSME financing in Nepal.....	28

Promote a conducive ecosystem for MSME financing	29
Expand FinTech services for MSMEs	31
References.....	34

Abbreviations

ADB	Asian Development Bank
ADBN	Agriculture Development Bank of Nepal
BFI	Banks and Financial Institutions
BLB	Branch Less Banking
BS	Bikram Sambat
CBS	Core Banking System
CGFTSM	Credit Guarantee Fund Trust for Small and Medium Enterprises
CHGTMSE	Credit Guarantee Fund Trust for Micro and Small Enterprises
CIB	Credit Information Bureau
CSR	Corporate Social Responsibility
FDI	Foreign Direct Investment
FI	Financial Institutions
FinTech	Financial Technology
FNCSI	Federation of Nepal Cottage and Small Industries
GDP	Gross Domestic Product
GESI	Gender Equity and Social Inclusion
GoN	Government of Nepal
IFC	International Finance Corporation
IME	International Money Express
IVR	Interactive Voice Recording
KYC	Know Your Customer
MCSI	Micro, Cottage and Small Industries
ME	Micro Enterprises
MEDEP	Micro Enterprise Development Programme
MEDPA	Micro Enterprises Development for Poverty Alleviation
MFI	Micro Finance Institutions
MIS	Management Information System
MoI	Ministry of Industry
MSME	Micro, Small and Medium Enterprises
NRB	Nepal Rastra Bank
PAN	Permanent Account Number
POS	Point of Sales
RSRF	Rural Self Reliance Fund
SBI	State Bank of India
SME	Small and Medium Enterprises
SMS	Short Message Service
SSI	Small Scale Industries
TV	Television
UK	United Kingdom

UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
UNESCAP	United Nations Economic and Social Commission for Asia and Pacific
UNNATI	Unnati Access to Finance
USD	United States Dollar
VAT	Value Added Tax
VL	Vijaya Laghubitta

Note: Conversions from Nepalese Rupees (NPR) to USD in the text are for illustrative purposes only. They are based on the average exchange rate for 2019 of NPR 112.64 = USD 1.00.

Acknowledgements

ESCAP would like to thank the author of this report, Achyut Hari Aryal, for his comprehensive review of the Nepalese financial context and the pragmatic proposals for action presented hereafter. We also would like to acknowledge other members of the study Team – Madan Sharma, Binisha Nepal and Dharmendra Lekhak – for their contribution to this report.

The author of this report would like to express their gratitude to the High-Level Financial Inclusion Roadmap Implementation Committee (HLFIRIC), chaired by Deputy Governor of Nepal Rastra Bank, Chinta Mani Shiwakoti, and other distinguished committee members as well as Alberto Isgut, ESCAP, Paul Vandenberg, ESCAP advisor, and Saroj Nepal, National Programme Coordinator at United Nations Capital Fund (UNCDF) Nepal.

ESCAP would like to extend its appreciation to the Small, Micro and Medium Enterprise (SME) Departments of Nepal Investment Bank Limited, Siddhartha Bank Limited, Nabil Bank Limited, Sunrise Bank Limited, for providing key quantitative data. Special thanks to the CEOs of Nirdhan Utthan Laghubitta Bittiya Sanstha, Laxmi Laghubitta Bittiya Sanstha in Kathmandu, and the managers of the Ilam and Dhangadi offices of Chhimek Laghubitta Bittiya Sanstha, who have also been instrumental in providing feedback regarding micro enterprises.

ESCAP would like to express sincere thanks to Sakchyam Access to Finance Programme and UNCDF for providing information on FinTech; Suryodaya Municipality and Ilam Municipalities for lending their valuable time and visions for MSMEs in their areas; and the beneficiaries of the MEDPA unit for sharing their experiences.

Furthermore, ESCAP would like to acknowledge and appreciate all the interviewed MSME entrepreneurs, who shared their perspectives and provided critical qualitative insight to support the report's findings. An additional thank you to all stakeholders who participated in the stakeholder consultation meeting, held in Kathmandu on 30th November 2018.

The authors would like to express their sincere gratitude to Nepal's Institute for Integrated Development Studies (IIDS), particularly to Bishnu Dev Pant, Executive Director, for his support in the preparation of this study.

This report was edited by Dana MacLean. Patchara Arunsuwannakorn, Beini Liu and Zeinab Elbeltagy provided effective research assistance.

Overview and key messages

The Micro, Small and Medium Enterprises (MSME) sector has emerged as a dynamic and highly vivacious sector of the Nepalese economy. It has contributed significantly to the economic and social development of the country by promoting entrepreneurship and generating employment opportunities. The development of MSMEs and changes in their structure over time contribute to employment generation, market expansion and economic growth. This study assesses their access to finance from various sources and the effectiveness of the existing financial infrastructure, policies and mechanisms to provide a conducive ecosystem to harness their full potential to contribute to the national development.

Key findings

In Nepal, the Industrial Enterprises Act of 2020 classifies enterprises as micro, cottage, small, medium and large based on their number of employees and capital. Nepal lacks an appropriate credit infrastructure to support MSME growth, including credit guarantee mechanisms and insurance schemes. Insufficient venture capital financing, stringent collateral requirements, and the “missing middle” problem — in which small enterprises have difficulties accessing larger volumes of credit but are too big to benefit from microloans — are other obstacles for MSMEs to access appropriate financing.

According to the 2018 National Economic Census, there were 923,356 establishments operating in Nepal in 2018, roughly half of which were registered. The MSME sector employed 2.74 million people, 69.3 per cent of which are micro enterprises, 25.2 per cent small enterprises, and 5.5 per cent medium-sized enterprises. Employees are predominantly men, with a male-female employment ratio of 62:38. However, the gender disparity is higher for ownership and managerial positions, in which the male-female ratio is roughly 70:30.

The study estimates that the financing gap for MSME in Nepal is USD 3.6 billion.¹ A study by Nepal Rastra Bank (NRB) found that only 16 per cent of start-up enterprises have access to capital from banks and financial institutions (BFIs). Nepal’s ‘missing middle’ problem is clear from the gap that exists between the sizes of loans offered to micro enterprises and to SMEs. While the average size of micro enterprises loans offered by MFIs is less than NPR 0.5 million (USD 4,400), the average minimum loan size for small and medium-sized enterprise loans offered by commercial banks is more than NPR 2.5 million (USD 22,200). A recent NRB study, however, revealed that nearly 59 per cent of small enterprises need loans of less than NPR. 2.5 million. Although the Nepalese government’s monetary policy for fiscal year (FY) 2016-2017 encouraged commercial banks to strengthen their SME units to provide adequate loans for the missing middle segment, most commercial banks interviewed for this report in the second half of 2018 indicated that the share of loans less than NPR 2.5 million in their portfolios is insignificant.

The monetary policy documents published every year by Nepal Rastra Bank have been introducing various schemes to promote MSME financing. To encourage women entrepreneurs, the monetary policy for 2014/2015 introduced project-based financing schemes for up to NPR 0.7 million (USD 6,200) for women-managed enterprises, but this does not appear to have been effective, as none of the commercial banks have implemented this policy or disbursed any such loans. Similarly, the

¹ This MSME financing gap is in line with the Asian Development Bank’s (ADB) 2018 Comprehensive Assessment of the Small and Medium-sized Enterprise Sector in Nepal. For details, see <https://www.adb.org/documents/support-small-and-medium-sized-enterprises-2005-2017>

monetary policy for 2018/2019 allowed commercial banks to grant loans up to NPR 1.5 million (USD 13,300) to women entrepreneurs without the need for collateral security and with a 6 per cent interest subsidy. However, at the beginning of 2019, only 170 women nationwide had benefited from this scheme and the average loan size was less than NPR 0.6 million (USD 5,300).

Another significant barrier to SME financial inclusion identified during the study is related to collateral. Most banking and financial institutions (BFIs) accept only tangible collateral with high liquidity from SMEs. Nepal lacks specialized banks or financial institutions dedicated to MSMEs, although certain funds — such as the Women’s Enterprise Development Fund (WEDF) initiated in 2015 — are available to support this sector.

Venture capital and private equity are emerging as new sources of MSME financing, but this remains marginal, with private equity contributing only 0.5 per cent to total MSME financing. The use of financial technology (FinTech) to support MSMEs is increasing among financial institutions in Nepal, with most banks facilitating banking services for customers through increased digitalisation of services. However, regulations to safeguard customer privacy, guarantee the security of transactions and ensure a user-friendly interface are needed.

Business networks and associations such as the Federation of Nepal Cottage and Small Industries (FNCSI) and the Federation of Women Entrepreneurs Associations of Nepal (FWEAN) have the potential to play meaningful and effective roles to boost the financial inclusion of MSMEs through strategic social capital and information resources, but this needs to be backed up by a nationwide financial literacy campaign as well as broadened credit access.

Key recommendations

The key recommendations in this report are as follows:

1) Improving Financial Access through

- Easing physical collateral requirements by introducing project-based financing, on the basis of borrowers projected cash flow, and allowing MSMEs to pledge collateral assets, such as land and buildings, at market price value rather than at official administrative prices.
- Considering SME financing as one of the priority sectors, to which banks are mandated to allocate a minimum of 25 per cent of their portfolio, and encouraging all MFIs to increase their micro enterprise portfolio from the current 13 per cent to 33 per cent — the maximum share allowed by Nepal Rastra Bank.²
- Introducing a simplified VAT reporting system for MSMEs to improve their compliance with tax laws.³

2) Boosting Lending Infrastructure Support through

² The justification for SMEs to be considered a priority sector is that, according to the Ministry of Industry, they contribute 22 per cent of Nepal’s annual GDP and employ 1.75 million people.

³ Registered enterprises are required to report VAT transactions each month or face penalties. The system is expensive for small enterprises, which do not have the resources to maintain accounting books or issue invoices for each transaction.

- Promoting an ecosystem for MSMEs to grow by introducing a credit guarantee mechanism, expanding micro-insurance schemes for MSMEs, and strengthening the Micro Enterprise Development for Poverty Alleviation (MEDPA) program to enable local level units to cater to the needs of small and medium-sized enterprises as well as those of micro enterprises.
- Establishing a separate MSME department at NRB to establish a regulatory environment conducive to their expansion.
- Linking MSMEs to commercial chain retailers, such as Bhat Bhateni Supermarket and Big Mart, to improve their access to markets and value chain finance.
- Strengthening the capacity of the Credit Information Bureau to include credit histories of MSME loan applicants in their database to reduce risks to lenders.

3) Promoting the Financial Technology and Literacy through

- Expanding FinTech for MSMEs through multiple technologies, including an open source system, with application programming interface that can serve multiple institutions and millions of people.
- Encouraging banks and financial institutions to invest part of their Corporate Social Responsibility funds in financial and business literacy programs for MSME entrepreneurs. Programs could be both delivered digitally, through online videos and mobile apps, and broadcasted through TV programs.⁴

⁴ Nepal Rastra Bank circular no. 11/073/74, dated January 25, 2017, mandated banks and financial institutions to set up corporate social responsibility (CSR) funds and deposit at least one per cent of their net profit each year. The CSR funds must be used in total during the subsequent fiscal year.

1. Introduction

Micro, small and medium-sized enterprises (MSMEs) play a vibrant role in the economic growth and employment of any country. Globally, MSMEs account for more than 50 per cent of jobs and contribute to at least 35 per cent of GDP.⁵ In emerging markets, seven out of 10 formal jobs are created by SMEs, and this figure rises to nine in 10 jobs in some low income countries.⁶ Given the fact that the global economy needs to generate 600 million new jobs over the next 15 years to absorb the growing workforce and reduce unemployment, MSME development is a high priority for governments in both developing and developed economies.⁷

The Government of Nepal (GoN), like most governments worldwide, recognizes the important role MSMEs play in economic development and employment generation. While the Nepalese economy has grown at an annual average of about 4 per cent over the last two decades, such growth has been insufficient to generate enough jobs, resulting in an increasing number of Nepalis seeking employment abroad. Nepal's economic growth has also underperformed compared to that of its South Asian peers, and the country's import-export ratio doubled from 2.6 to 5.2 between 2008 and 2018.⁸

To boost Nepal's development, the importance of businesses as primary contributors of growth cannot be overstated. For businesses to reach their full potential and contribute to overall national economic growth, it is fundamental to ensure an enabling environment for them to prosper. In this regard, it is particularly important to facilitate the development of institutions that provide affordable and suitable financial services and products to micro, small and medium-sized enterprises (MSMEs).

In Nepal, there is a considerable gap between MSMEs financing needs and their access to credit. Both supply side factors, which result in an insufficient flow of finance from financial institutions to MSMEs, and demand-side factors, including inadequate business skills among MSME entrepreneurs, contribute to this gap.^{9,10} While the banking sector has untapped liquidity which could be allocated to loans for this sector and there is a strong rationale for scaling up the credit flow to MSMEs, the feasibility of doing so requires a deep analysis of the key characteristics of the MSME financing market. It is also important to understand the extent to which the policy and regulatory framework in Nepal is supportive of MSME development, particularly their access to financing.

The overall objective of this study is to understand the difficulties and constraints MSMEs experience in gaining access to finance in Nepal. Specific objectives include the following: (i) estimate the financing gap between MSMEs' financial needs and the access required to harness their full growth potential; (ii) detail the difficulties faced by MSMEs on the supply side of finance; (iii) suggest beneficial mechanisms to decrease or close the gap; (iv) outline the usefulness of

⁵ World Bank Group, *What's Happening in the Missing Middle?: Lessons from Financing MSMEs* (Washington, DC., 2017) Available at: <https://openknowledge.worldbank.org/handle/10986/26324>

⁶ Ibid.

⁷ Ibid.

⁸ World Bank, World Development Indicators (accessed on 13 March 2020).

⁹ Ibid.

¹⁰ Chaulagain, Ramesh Prasad, "Financial Literacy for Increasing Sustainable Access to Finance in Nepal," paper prepared for the Nepal Rastra Bank (Kathmandu, Nepal, December 2019).

demand side programs, such as financial literacy programs; (v) investigate the difficulties faced by women-led MSMEs to access finance, explore the availability of special provisions for women entrepreneurs, and suggest additional means of support; and (vi) discuss how FinTech and digital finance can be used to increase access to finance.

Definitions

There is no common global definition for MSMEs. Many countries use three criteria: assets, employment and annual turnover, whereas others use only two of these or a single criterion. For example, India, Philippines, Rwanda, Thailand, Bolivia, and Mozambique use a single criterion, such as annual turnover in the case of India or employment in the other countries.¹¹ In the case of Nepal, the Industrial Enterprises Act of 2020 defines micro enterprises using four criteria (capital investment, employment, annual turnover, and energy consumption) while it uses the single criterion of capital investment to define SMEs. The Act also includes the category of cottage industries. The definitions of micro, cottage, small, medium and large enterprises are as follows:

- i) Micro industries are enterprises that meet the following conditions: a) have a fixed capital not exceeding NPR 2 million (USD 18,000) apart from land and buildings, b) are run by the proprietor himself, c) work at the local level and utilize local raw materials, d) have an annual turnover of up to NPR 10 million (USD 89,000), e) employ not more than nine workers, and f) consume less than 20 kilowatts of electrical power when they run in full capacity.
- ii) Cottage industries are enterprises that use local workers and raw materials, are engaged in traditional labour-intensive industries that reflect the country's indigenous art and culture and consume less than 50 kilowatts of electrical power when they run in full capacity.
- iii) Small scale industries (SSI) are enterprises other than micro and cottage industries with fixed capital not exceeding NPR 150 million (USD 1.3 million).
- iv) Medium industries are enterprises with fixed capital between NPR 150 million and NPR 500 million (USD 4.4 million).
- v) Large industries are enterprises that have over NPR 500 million in fixed capital.¹²

MSMEs in Nepal

According to the Economic Census conducted between April and June 2018, the country had 923,356 establishments.¹³ With regards to the geographic distribution of the establishments, Bagmati Province — which includes Kathmandu — has the highest share with 30.6 per cent of all establishments based here., Meanwhile, Nepal's largest and least populated province, Karnali Province, is home to the least number of MSMEs, with only 4.6 per cent of the national total.

¹¹ Raju, Yerram, "Reclassifying MSMEs," The Hindu Business Line, 31 July 2018.

¹² The use of fixed capital as a main criterion to distinguish between small, medium and large enterprises has been questioned by the Asian Development Bank, which alternatively suggests the use of annual turnover and employment. Commercial banks and SME entrepreneurs consulted for this report agree that these are more accurate measures to determine firm size.

¹³ The census covers all the economic activities in the International Standard Industrial Classification (ISIC) revision 4, except the following: Unregistered establishments in A. Agriculture, forestry and fishing; O. Public administration and defence, compulsory social security; T. Activities of households as employers; undifferentiated goods- and services-producing activities of households for own use; and U. Activities of extraterritorial organizations and bodies.

Nepal's establishments employed 3,228,457 people, with Bagmati Province employing the highest share of more than 1.2 million (Table 1). The table also shows the percentage of unregistered establishments per province, which is highest in Province 2.

Table 1
Distribution of establishments, employment and unregistered enterprises by province

Name of the Province	Establishments		Employment		Unregistered Establishments (percentage)
	Number	Percentage	Persons	Percentage	
Province 1	168,518	18.3	544,079	16.9	46.5
Province 2	117,670	12.7	354,994	11.0	64.7
Bagmati Province	282,920	30.6	1,218,497	37.7	49.9
Gandaki Province	100,684	10.9	332,472	10.3	44.6
Province 5	147,789	16.0	474,264	14.7	47.7
Kamali Province	42,807	4.6	118,951	3.7	51.2
Sudurpashchim Province	62,968	6.8	185,200	5.7	44.9
Total	923,356	100.0	3,228,457	100.0	49.9

Source: Nepal, CBS, National Economic Census 2018.

Because the 2018 National Economic Census lacked all the information required to categorize enterprises by size in accordance with the definitions in the Industrial Enterprises Act of 2020 described above, the analysis below is based on a classification of establishments based on the number of persons engaged.¹⁴ According to this classification, 95.4 per cent of the enterprises are micro enterprises, 4.2 per cent are small, 0.24 per cent are medium-sized, and 0.19 per cent are large. See Table 2.

Table 2
Registered and non-registered establishments by establishment size

Establishment size	Establishments		Registered	Unregistered		Unregistered / Total
	Number	Percentage	Number	Number	Percentage	Percentage
Micro	880,254	95.37	421,996	458,258	99.53	52.1
Small	38,737	4.20	36,705	2,032	0.44	5.2
Medium	2,253	0.24	2,165	88	0.02	3.9
Large	1,783	0.19	1,739	44	0.01	2.5
Total	923,027	100.00	462,605	460,422	100.00	49.9

Source: Nepal, CBS, National Economic Census 2018.

Note: The table excludes 329 establishments that lack information on number of persons engaged.

¹⁴ Micro enterprises are enterprises engaging up to 9 persons, small enterprises engage between 10 and 49 persons, medium enterprise between 50 and 99 persons, and large enterprises engage 100 or more persons. Persons engaged include employees, owners and unpaid family members working in the establishment.

The table also shows that 99.5 per cent of the unregistered establishments are micro enterprises. The percentage of unregistered enterprises is 52 per cent for micro enterprises, 5.2 per cent for small enterprises, 3.9 per cent for medium-sized enterprises and 2.5 per cent for large enterprises.

Regarding sectors of the economy, most of the micro enterprises, 56.2 per cent, are engaged in wholesale, retail and repair services, followed by 14.5 per cent in accommodation and food services and 11.2 per cent in manufacturing. Education services is the main sector for both small enterprises (39.7 per cent) and medium-sized enterprises (37.4 per cent), followed by manufacturing (10 per cent for small enterprises and 20.4 per cent for medium-sized enterprises).

Of the 3,228,457 persons employed in 2018, over 2.5 million or 84.7 per cent are employed by MSMEs. Most of the employed at MSMEs, 69.3 per cent, are employed in micro enterprises, followed by 25.2 in small enterprises and 5.5 in medium-sized enterprises. The percentage of women employed in MSMEs is 37.9 per cent, ranging from 38.5 per cent in micro enterprises to 36.5 per cent in small enterprises and 35.9 per cent in medium-sized enterprises. The percentage of women employed as managers of MSMEs is 26.7 per cent, ranging from 30.6 per cent for micro enterprises, to 11 per cent for small enterprises and 8.9 per cent for medium-sized enterprises.

Challenges of Women-led MSMEs

Globally, the rates of female entrepreneurship are on the rise with near gender parity in some regions. In East Asia and the Pacific, women own 50 per cent of micro enterprises and 59 per cent of small and medium-sized enterprises. However, in South Asia, these rates drop to 10 per cent for micro enterprises and 8 per cent for SMEs.¹⁵ Nepal is renowned in South Asia for its high rates of female labour force participation, and the International Labour Organization estimates that 55.7 per cent of the total workforce in Nepal is comprised of women, mainly in the agricultural sector.¹⁶ Women's participation as business owners or managers in the private sector remains an under-tapped source of economic growth, with national statistics indicating an upward trend.

As noted above, 26.7 per cent of the MSMEs are managed by women. Nepal also saw the proportion of female limited liability company (LLC) proprietors almost tripled from 4 per cent in 2012 to 11 per cent in 2016.¹⁷ However, the widespread practice in Nepal of surrogate entrepreneurship — in which a woman registers her husband's company in her name or takes out a loan on behalf of a male family member — creates challenges for capturing and interpreting quantitative data on female participation in the private sector.¹⁸

The ease of opening a business in Nepal is improving overall — Nepal now ranks 94 out of 190 countries, according to the World Bank's Doing Business report in 2020 — yet women continue to face significant gender-specific hurdles that impede their entry into the economy at the business level. “A volatile market, lack of adequate capital and the absence of effective business policies

¹⁵ SME Finance Forum, 'MSME Finance Gap', available at <https://www.smefinanceforum.org/data-sites/msme-finance-gap>.

¹⁶ International Labor Organization, “Ratio of Female-Male Labour Force Participation Rate - Nepal,” ILOSTAT, Available at: <https://data.worldbank.org/indicator/SL.TLF.CACT.FM.ZS?locations=NP> (Accessed on 14 May 2020).

¹⁷ World Bank Group, “Women's Entrepreneurship: How to Measure the Gap between New Female and Male Entrepreneurs?” Policy Research Working Paper 8242, Development Economics Global Indicators Group (November 2017).

¹⁸ Upasna, Acharya et al., “Women's Entrepreneurial Ecosystem in Nepal: A Study Based on Kathmandu Valley,” study prepared for Westcliff University (Irvine, California, 2018).

make entrepreneurship a tedious process for women,” according to the Yang-Ward Foundation, a US-based non-profit that works in Nepal.¹⁹ The challenges that women face in securing the start-up funding necessary to launch a business are exacerbated by traditional sociocultural norms, in which women generally do not manage the household income and are expected to seek permission from family members and spouses to access and use money.²⁰

To correct socio-historical gender imbalances in land and resource ownership, in 2016 the Government of Nepal put in place policies by offering between 25 per cent and 50 per cent tax reduction on land registered to women as well as a 35 per cent waiver on fees to register a business. The Industrial Enterprises Act also allows women-owned micro enterprises to register free of charge. These measures recognize the importance of incentivizing women to improve their economic status through personal enterprise, though the impact of the policies has yet to be felt on a national scale.²¹

2. Financial Access and Gaps

As of August 2019, there were 28 commercial banks, 28 development banks, 22 finance companies and 89 MFIs with a total of 8,970 branches across all 77 districts of the country. In 2018, Nepal Rastra Bank instructed all banking and financial institutions (BFI) to establish at least one branch of any of the commercial banks in each of the 753 municipality units of all 77 districts of Nepal, both rural and urban. As of August 2019, 749 municipalities have been covered. Table 3 shows the total number of BFIs by type.

Table 3
Number of Banks and Financial Institutions

Financial institution	2013	2014	2015	2016	2017	2018	Aug 2019
Commercial Banks	32	31	30	30	28	28	28
Development Banks	88	86	84	76	67	40	28
Finance companies	70	59	53	48	42	28	22
Micro Finance Institutions	24	31	33	38	42	53	89
Infrastructure Development Bank	0	0	0	0	0	0	1
NRB Licensed Cooperative with Limited Banking Transactions	16	16	15	15	15	14	NA

Source: NRB, *Banking and Financial Statistics* (October 2019)

With regards to access to credit, the 2018 National Economic Census found that only 35.5 of the MSMEs have access to credit. This percentage is lowest for small enterprises (32.5 per cent), followed by micro enterprises (35.6 per cent) and medium-sized enterprises (52.9 per cent). See Table 4.

¹⁹ Yang-Ward Foundation, “Empowering women through entrepreneurship in Nepal,” The Asia Dialogue, University of Nottingham, Asia Research Institute, 22 August 2018.

²⁰ Upasna, Acharya et al., “Women’s Entrepreneurial Ecosystem in Nepal: A Study Based on Kathmandu Valley,” study prepared for Westcliff University (Irvine, California, 2018).

²¹ In 2018 Nepal ranked 118 out of 165 countries in the UN Development Program’s Gender Inequality Index (GII).

Among the MSMEs that have access to credit, bank credit is the most important source, although its importance diminishes from 88.6 per cent for medium-sized enterprises to 72 per cent for small enterprises, and 33.4 per cent for micro enterprises. In contrast, the importance of cooperatives as a source of credit diminishes from 32.2 per cent for micro enterprises to 11.9 per cent for small enterprises and 4.6 for medium-sized enterprises. The third most important source of finance is personal loans, which ranges from 8.1 per cent for micro enterprises to 8 per cent for small enterprises and 3.8 per cent for medium-sized enterprises. The table also shows that the share of microfinance institutions (MFI) in the sources of credit of micro enterprises is rather low, especially in view of the mandate for MFIs to provide one-third of their loan portfolio to micro entrepreneurs, which is further discussed below.

Table 4
Distribution of sources of credit among MSMEs that have access to credit

Source	Micro-enterprises	Small enterprises	Medium-sized enterprises	MSMEs
Banks	33.4	72.0	88.6	35.2
Cooperatives	33.2	11.9	4.6	32.2
Personal loans	14.6	8.0	3.8	14.3
Finance companies	8.1	4.8	1.4	7.9
Microfinance institutions	8.1	0.8	0.4	7.8
Other	2.6	2.5	1.2	2.6
Memo item: Access to finance	35.6	32.5	52.9	35.5

Source: Nepal, CBS, National Economic Census 2018.

The financial gap

A recent NRB study on SME financing in Nepal reveals that small enterprises' loan size varies between NPR 1 and 5 million (between USD 8,900 and 44,400) and medium enterprises require a loan size between NPR 5 to 150 million (between USD 44,000 and USD 1.33 million).

With regards to micro enterprises, MFIs offer two types of loans: group loans and micro enterprise loans. These loans are subject to a ceiling imposed by NRB which varies between MFIs, from NPR 500,000 to NPR 700,000 (USD 4,400 to 6,200).²² To be eligible to access these loans, micro entrepreneurs need to have a good record of repayment of group loans. Based on interviews conducted for this study, the average loan required by micro entrepreneurs is around NPR 0.5 million (USD 4,400).

Several recent studies reveal that barriers to financial access and gaps in provision for MSMEs in Nepal are significant. The SME Finance Forum estimated in 2018 that the financing gap for unserved MSMEs is USD 3.6 billion, and a 2018 ADB study reached similar conclusions.²³

²² The NRB ceiling for individual loans goes up to NPR 1 million (USD 8,900) in remote areas where other banks are not available.

²³ SME Finance Forum, 'MSME Finance Gap', available at <https://www.smefinanceforum.org/data-sites/msme-finance-gap>; ADB, Comprehensive Assessment of the Small and Medium-sized Enterprise Sector in Nepal (2018).

A calculation using data from the 2018 National Economic Census and assuming – based on the information above – that the average financial needs per establishment are NPR 500,000 for micro enterprises, NPR 2.5 million (USD 22,200) for small enterprises and NPR 50 million (USD 444,000) for medium-sized enterprises, the total gap is similar to the one estimated by the SME Finance Forum: NPR 402 billion or USD 3.57 billion. See Table 5. However, given the larger percentage of micro enterprises in the Census data compared to the SME Forum data, the share of the financial gap attributable to the micro enterprises' financial gap is significantly larger in the current estimate: over 70 per cent compared to 21 per cent in the SME Finance Forum estimation. Further research will need to be conducted to validate these results.²⁴

Table 5
Estimation of the financial gap of MSMEs

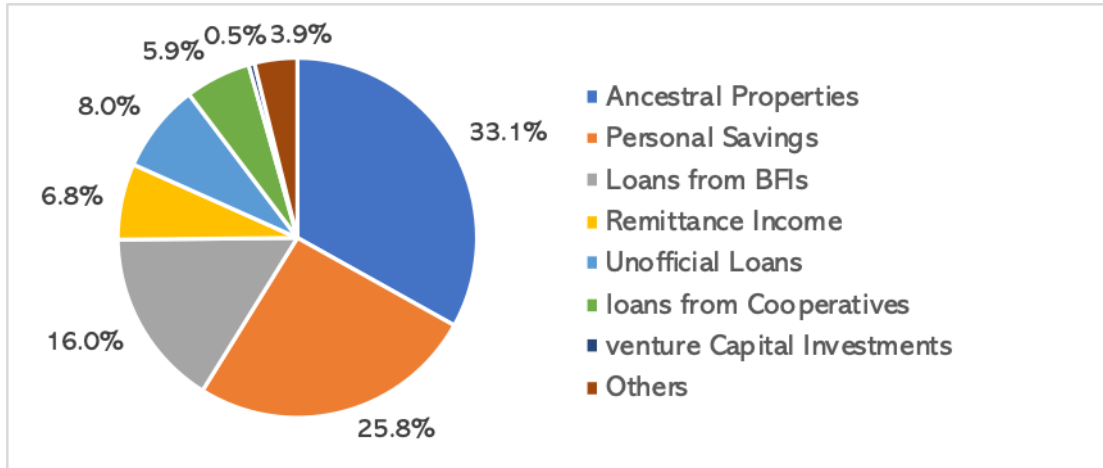
	Micro enterprises	Small enterprises	Medium-sized enterprises	Total
Number of establishments	880,254	38,737	2,253	921,244
Percentage of establishments with no access to credit	64.4	67.5	47.1	
Number of establishments with no access to credit	566,884	26,147	1,061	594,092
Estimated financial needs per establishment (NRP, million)	0.5	2.5	50.0	
Estimated financial needs per establishment (USD)	4,439	22,195	443,892	
Estimated financial gap (NRP, million)	283,442	65,369	53,058	401,869
Estimated financial gap (USD, million)	2,516	580	471	3,568
Share in the MSME financial gap (percentage)	70.5	16.3	13.2	100.0

Source: Authors' calculation based on data from Tables 2 and 4 above and estimates of the financial needs for establishments of different sizes.

Access to financing is particularly limited for MSME start-ups. One of the biggest constraints to MSME development is the lack of financial resources to start, sustain and grow businesses. Almost three-quarters (74 per cent) of MSME start-up entrepreneurs use parental properties, savings, informal sources, or remittances to invest in their businesses. Bank financing facilities are available to only 16 per cent of all start-up MSMEs in Nepal, and among the BFIs, nearly 85 per cent are commercial banks and the rest are development banks, finance companies and MFIs. See Figures 1 and 2.

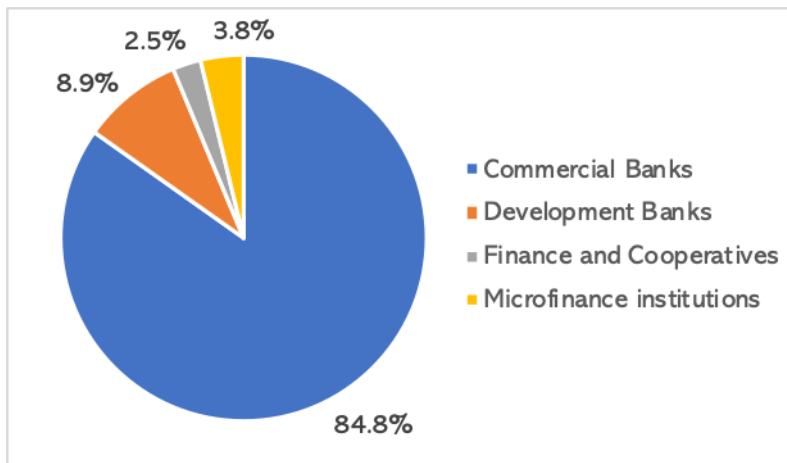
²⁴ In particular, it would be useful if future censuses or surveys collect the information required to classify MSMEs according to the definitions of the Industrial Enterprises Act of 2020.

Figure 1
Sources of Capital to Finance for Start-up SMEs



Source: NRB, SME Financing Study Report 2019

Figure 2
Proportions of SME Loans from Various Banks and Financial Institutions



Source: NRB, SME Financing Study Report 2019

Understanding the gap

This financial gap for MSMEs is believed to be due to severe information asymmetries, the prevalence of informal business practices, the high costs of underwriting relative to available margins, heterogeneity of the market, impediments to MSME growth and productivity, lack of adequate skills and capacities at the entrepreneur's end and regulatory constraints. These issues have starved the MSME segment of the capital needed to grow and improve productivity, affecting

the majority of the workforce that MSMEs employ. Such problems have also deterred financial institutions from tapping into this market as a source of long-term business value.²⁵

Among the MSMEs, those located in rural areas face more severe credit constraints because of two main reasons: (i) physical access to a bank branch and (ii) difficulties meeting collateral requirements. Despite the NRB's efforts over the past two decades to mandate bank branches to open in all Nepalese districts, most BFI branches remain concentrated in cities,²⁶ and financial institutions are more interested in operating in areas with infrastructural accessibility.²⁷ Meanwhile, the collateral requirements of formal banks similarly stress the importance of accessibility, which is problematic for MSMEs located in remote areas. Acceptable collateral is required to be located within a bank's catchment area, and have adequate road access, so that assets can be easily liquidated in the event of default. Rural MSMEs tend to suffer from either a lack of sufficient tangible collateral (land and buildings) or collateral that is located in remote or mountainous areas. Inaccessible collateral ends up being valued extremely low by formal banking institutions in order to justify loan provisions.

Location also has an impact on the capital needs of micro and small enterprises. Based on the studies of several agricultural enterprises in central Nepal's Dhading district, the average loan size demanded by rural businesses ranges between NPR 1 million and NPR 1.5 million (between USD 8,900 and USD 13,300), whereas those located in urban areas require more than NPR 2 million (USD 17,800). Similarly, a study by the Asian Development Bank found that most urban SMEs needed at least NPR 3.67 million (USD 32,500) to establish and grow their businesses successfully.²⁸ Part of the reason for the higher financing requirements of urban MSMEs is that expenditures for sourcing raw materials, supply chain logistics and other fixed costs including rent are higher in urban areas.

The “Missing Middle”

Limited access to finance, is a major hindrance to the growth of MSMEs. However, the problem does not affect all enterprises equally. There are many microfinance programs catering to smaller micro enterprises, while commercial banks generally finance larger firms. Between these two groups there is a ‘missing middle’ of enterprises with financial needs that are not met by the current market.

Based on our study, most of the commercial banks' minimum loan size is NPR 2.5 million (USD 22,200). There are only a few banks, such as the Nepal Investment Bank, which disburse loans smaller than this amount. However, most of these small loans are for non-funded facilities, in the form of either loan guarantees or letters of credit. A recent NRB study also reveals that nearly 59 per cent of small enterprises have a loan below NPR 2.5 million.²⁹ This clearly indicates the significant gap in funding for the ‘missing middle’ among both small enterprises and micro enterprises that aspire to grow and become small or medium-sized enterprises.

²⁵ Wyman, Oliver, “Harnessing the FinTech Revolution,” Inter-American Investment Corporation (September 2016).

²⁶ Banks that open in Kathmandu are required by NRB regulations to also open branches in underbanked areas. See IMF, *Nepal 2014 Article IV Consultation*, Country Reports 14/214 (2014)

²⁷ Ramesh Prasad Chaulagain, “Financial Literacy for Increasing Sustainable Access to Finance in Nepal,” *NRB Economic Review*, vol. 27, no.2 (2019)

²⁸ ADB, *Comprehensive Assessment of the Small and Medium-sized Enterprise Sector in Nepal* (2018).

²⁹ NRB, *SME Financing Report* (2019)

To support the financial needs of micro enterprises, NRB allowed MFIs to allocate up to 33 per cent of their portfolio to micro enterprise loans. Currently, most MFIs make these loans available for individual borrowers, in addition to their traditional group loans. Individual members of an MFI that have successfully repaid their group loans are eligible for individual micro enterprise (ME) loans, provided that they have adequate collateral. However, as of 2019 only 14.9 per cent of the MFIs portfolios were allocated to micro enterprise loans. Although the trend has been on the rise since 2017, progress has been slow. See Table 6.

Table 6
Micro enterprise loan portfolio of MFIs

	December					
	2014	2015	2016	2017	2018	2019
Micro Enterprises portfolio over total Portfolio of MFI (percentage)	10.7	9.4	8.0	11.2	13.3	14.9

Source: Nepal Rastra Bank, Microfinance Progress Report, various years.

In addition to the underutilization of micro enterprise loans by MFIs, the average loan size for individual members has been less than NPR 300,000 (USD 2,700), the same size as the typical loan disbursed to regular group members, even though these individual members can afford to put up the collateral for a NPR 700,000 loan, MFIs are reluctant to lend more, regardless of adequate collateral. The MFIs interviewed during this study noted they have limited capacity to monitor large loans and, therefore, prefer to offer small loans with a low risk factor. In addition, interviews revealed that the average loan size of banks loans to micro enterprises is also less than NPR 300,000.

Collateral

Inability to pledge appropriate and adequate collateral is one of the major obstacles that MSMEs face to improve their access to loans in Nepal. While more than 85 per cent of the assets pledged by MSMEs as collateral are land and buildings, as noted above BFIs, including MFIs, tend to accept as collateral only land and commercial properties with road access, which excludes entrepreneurs located in remote or less accessible areas.³⁰ The main reason for this is to ensure that it can be easily liquidated in case of a loan default.

The NRB has recently clarified the criteria for BFIs' valuation of immovable assets, such as land and buildings, pledged as collateral. It stipulated that it should be based on the fair value of such assets, with less 5 per cent for realization costs — such as brokerage fees — and 25 per cent for the possible drop in price due to a forced sale.³¹ While fair value should be measured on the basis of the market price, the NRB stipulates that “in case of assets which are not dealt with in active markets, up-to-date valuations shall be taken for measurement”.³²

³⁰ NRB, *SME Financing Study Report* (2019).

³¹ See NRB, *Guideline on Recognition of Interest Income* (2019).

³² *Ibid.* p. 5.

Despite this regulation, commercial banks and MFIs interviewed for this study noted that land and buildings with limited road access are still considered unattractive as collateral, while entrepreneurs interviewed considered that this creates a major obstacle for them to obtain loans. Entrepreneurs pointed out that even if banks and MFIs follow the NRB's directives about the use of fair values for collateral assets, in the absence of active markets for those assets, they often resort to government valuations — which tend to be significantly lower than the market price.

In addition, some of the MFIs interviewed mentioned that clients who have land and buildings with road access are often not willing to use such assets as collateral because the size of their required loans is much smaller than the value of the assets. In those cases, borrowers prefer to obtain uncollateralized group loans, and keep their assets unencumbered in case they need a large loan in future. When the size of loan required is higher than the usual group loan size, applicants frequently join and borrow from more than one MFI.

Some MFIs have recently started to accept as collateral land and houses without road access using the local price, if the property is found to be as good as regular collateral. However, more than 99 per cent of MFIs' micro enterprise borrowers are women, and in Nepal, women do not traditionally own land or buildings. The women entrepreneurs interviewed identified difficulties obtaining consent from their male counterparts to use the property as collateral since the value of loan will be significantly less than the value of the collateral to be pledged.

Additional supply-side and demand-side issues

Other supply side issue MSMEs face include the following:

- MSMEs require small loans, which may be too expensive to serve by commercial banks. In particular, the credit appraisal tools used to assess the risks associated with larger loans may not be appropriate for the evaluation of MSMEs' loan applications. Commercial banks will not be inclined to develop and use separate appraisal tools for the MSME segment unless it is mandated by a regulatory body.
- Based on the enormous variation between enterprises in the MSME segment, banks should consider (apart from the regular financial appraisal criteria), the business' levels of innovation, commercialization and willingness to repay the loans.
- Commercial banks in Nepal have not developed the adequate expertise towards understanding MSME business propositions, sustainability, growth potential or cash flow. During the evaluation of an MSME's ability to repay a loan, these factors also need to be strongly considered.

Expanding financial access for MSMEs in Nepal also requires addressing certain issues in the demand side, including the following:

- Due to a lack of expertise and capacity in the internal control systems of MSMEs, most fail to meet the documentation requirements and do not maintain the accounting records required by commercial banking facilities. According to the 2018 National Economic Census only 47 per cent of the MSMEs record their transactions. However, this number is heavily influenced by the micro enterprises, among which only 46 per cent have proper accounting systems. Among small and medium-sized enterprises the percentages are, respectively, 93 per cent and 97 per cent. The percentage of establishments not keeping accounting books is larger in unregistered enterprises.

- As per the Monetary Policy 2018/19, all borrowers — including SMEs — seeking credit from banks are required to submit their tax clearance certificates and the income and expenditures in the tax clearance certificate will be the basis for the loan appraisal. Most SMEs do not possess the certificates as they do not have the financial resources to keep detailed transaction accounts.³³

3. Policy and Regulatory Framework

Many governments have developed legal frameworks, policies and institutions dedicated to the promotion of MSMEs. One example is India's MSME Development Act of 2006 and the Ministry of MSMEs, which oversees the entire ecosystem of MSMEs in India and promotes their growth. However, at the time of writing, Nepal does not have a dedicated national MSME development policy or framework. With regards to institutional arrangements, Nepal's Department of Cottage and Small Industries (DCSI), under the Ministry of Industry, Commerce and Supplies, has the mandate to promote and foster various kinds of cottage and small industries, but it lacks the authority and/or capacity to support their access to finance.

MSME financing in Nepal is the responsibility of the NRB, which is guided by several directives and laws, such as the Bank and Financial Institutions Act 2073 (BAFIA) of 2017, Directives 2075 for Microfinance Institutions, Unified Directive 2075 of Nepal Rastra Bank for commercial banks, and the Monetary Policy 2017/18. To improve micro enterprises' access to finance, the NRB has mandated all commercial banks to allocate at least 5 per cent of their portfolio to deprived sector loans, which includes extending wholesale loans to MFIs.³⁴ In addition, NRB established priority sectors which should receive a minimum of 25 per cent of the total loan portfolio of banks. The sectors include agriculture (10 per cent), energy and tourism (15 per cent).

While Nepal lacks a dedicated MSME promotion agency, the government recently institutionalized into its own structure a successful donor program. In 1998, the UNDP started the Micro Enterprise Development Programme (MEDEP), with the aim of reducing poverty and generating employment through the creation of micro enterprises by those living below the poverty line. In 2017, MEDEP was renamed the Micro Enterprise Development Programme for Poverty Alleviation (MEDPA) and came under the jurisdiction of the Ministry of Industry, Commerce and Supply. The MEDPA is now working to establish units in all municipalities across 77 districts of Nepal, with the objective to promote and assist micro enterprises. Between 1998 and July 2018, the project successfully created 142,437 entrepreneurs. Out of the 142,593 micro enterprises it created over 20 years, 37,304 were graduated, 29,417 became resilient, and 1,317 were able to convert their enterprises into SMEs.³⁵

Variable interest rate loans

³³ Mukunda Dev Adhikari, "The tax plights of micro SME," Nepal Tax Online, 2 January 2016.

³⁴ The NRB uses the term deprived as a broad category for low income groups or economically excluded segments of the population, including socially disadvantaged women, ethnic minority groups, persons with disabilities, small farmers, craftsmen, labourers and informal settlers. Deprived sector lending consists of microcredit loans extended to self-employed individuals and micro enterprises to facilitate socioeconomic empowerment and mobility.

³⁵ Government of Nepal, Ministry of Industry, commerce and Supplies, Industrial and Investment Promotion Division. <https://medpa.moics.gov.np/Home/About?infoId=1018> [accessed 23 August 2020].

Commercial bank loans to SMEs are often set at variable interest rates, even in the case of short-term loans for working capital. SMEs interviewed for this study noted that in their experience, interest rates almost always increased during the loan contract, in some cases as much as 50 per cent, from an initial interest rate of 8 per cent to 13 per cent, effective at the time of repaying the loans. While this substantial variability is due to monetary conditions that affect the interest rate at which banks can borrow funds, such increases in the interest costs of loans have been extremely detrimental for many SME borrowers, some of which have been forced to borrow informally to repay the loans. This underscores the importance of monetary stability to create a stable environment for the financial inclusion of SMEs.

Enhancing MFI and commercial banks' portfolios to promote MSMEs

MFI and commercial banks share the perspective that there is significant scope for allocating a larger share of their portfolios to MSMEs. As noted above, as of December 2019 the share of micro enterprise loans was only 14.9 percent.³⁶ MFIs interviewed for this study said that they had high demand for micro enterprise loans of NPR 300,000 (USD 2,700) or more, but were reluctant to increase either the numbers of micro enterprise loans or the loan sizes due to their inability to monitor the loan utilization.

SME loans by commercial banks represent, on average, less than 5 per cent of the banks' loans portfolios.³⁷ Though commercial banks interviewed for the study expressed interest in increasing their SME portfolios, potentially up to 10 per cent of their total portfolio, they currently do not have plans to do so. NRB regulations can support an increase in commercial banks' SME portfolios up to 10 per cent of the total amount of loans.

If it were possible for MFIs to allocate 33 per cent of their portfolios to micro enterprise loans and for commercial banks to increase the share of SME loans to 10 per cent of their total loan portfolios, an additional NPR 182 billion (USD 1.6 billion) would be available to finance MSMEs. This amount, which could be broken down into NPR 32.1 billion in new micro enterprise loans and NPR 150 billion in new commercial bank loans, would lower the estimated financial gap by 44 per cent.³⁸

MSME Registration and Tax Compliance

Currently, MSMEs seeking access to financial services are required to register either at the company registration office, the GoN's Department of Cottage and Small Industries, or at the local government municipalities. They are then required to enrol the enterprise at the tax office to obtain a Permanent Account Number (PAN) or, if their annual turnover is over NPR 5 million (USD 41,384), they need to register for value added tax (VAT). Once they are registered in the tax system, enterprises are required to submit a regular tax return and an annual income statement. If they are registered for the VAT, they need to report their financial transactions every month.

The NRB's monetary policy for 2018/2019 tightened these requirements by requiring all enterprises, including MFIs, to produce documents related to their tax clearance and annual turnover in order to obtain a loan from any bank or financial institution. As a result, banks started

³⁶ NRB, *Microfinance Progress Report* (December 2019)

³⁷ NRB, *SMEs Financing in Nepal* (2019)

³⁸ The total portfolio for Nepal's 28 commercial banks is NPR 2,497 billion, according to the NRB, *Financial Indicators Report* (July 2019)

processing loans based on borrowers' sales volumes and incomes shown in their tax returns, replacing the previous practice of accepting provisional and projected financial statements without tax returns. This additional requirement created another obstacle for MSMEs to access loans of the size they require, particularly for business expansions leading to a higher expected future income compared with the income stated in their income statement.³⁹

These tax compliance requirements apply to all firms, which puts micro and small enterprises at a large disadvantage due to their relatively small volume of operations and capacity constraints. Furthermore, tax compliance requires firms to maintain appropriate records of their transactions, but as noted above, according to the National Economic Census only 47 per cent of the country's MSMEs do so. The general perception among entrepreneurs interviewed for this study is that complying with tax requirements is cumbersome, especially for micro and small enterprises. They also pointed out that the annual transactions of such enterprises may vary significantly on a year-to-year basis. As tax liabilities for the current year are based on the previous year's profits, such liabilities can be excessive if profits drop significantly from the previous year. This problem is exacerbated when tax officers estimate tax liabilities based on sales volumes rather than calculating them based on profits, as the latter vary over time more than the former. This estimation is common in cases when the quality of the firm's accounting records is poor, which is often the case for micro and small enterprises.

MSME entrepreneurs interviewed for the study agreed that the new requirement, mentioned above, of presenting tax returns as a condition to apply for bank loans is appropriate for medium and large enterprises that have a large volume of transactions and who can afford to hire appropriate staff to help comply with financial and tax policy. But they pointed out that micro, small and even lower-medium sized enterprises, whose transactions are small, cannot afford to hire skilled staff to prepare the documentation required by the tax laws, which creates further difficulties for them to obtain loans. Part of the solution to this problem could be a simplification of tax compliance requirements for micro and small enterprises, along with the provision of special facilities and tax rebates to encourage their compliance.

4. Lending Infrastructure and Support

A comprehensive ecosystem for MSME financing is critical to improve financing opportunities for MSMEs in Nepal. In developing such an ecosystem, it is important to establish effective institutional arrangements, including specific schemes such as credit guarantees, insurance for projects, and avenues for MSMEs to seek information, advice and assistance on issues such as debt resolution and management.⁴⁰ Commercial banks, development banks and MFIs have significant potential to improve their MSME portfolios if a proper MSME financing ecosystem can be developed. Banks interviewed during the study emphasized the importance of establishing key infrastructure, such as a loan guarantee mechanism and micro or regular insurance schemes to reduce exposure to risks.

MSME Loan Guarantee Mechanism

Nepal's Deposit and Credit Guarantee Fund (DCGF) provides deposit insurance to all banks and other financial institutions and has a few credit guarantees programmes, including one for SMEs. The latter guarantees 80 percent of the outstanding balance of loans of up to NPR 5 million (USD

³⁹ Income statements are also likely to understate the actual income, further constraining firms' access to finance.

⁴⁰ Bank Negara Malaysia (BNM), *Developing the SME Financing Ecosystem* (Kuala Lumpur, BNM, nd.)

44,400). To access this program, banks pay half of an annual premium of 0.6 per cent, with the remaining half being subsidized by the government of Nepal.⁴¹

A few years ago, the Sakchyam Access to Finance for the Poor Programme implemented a pilot partial loan guarantee scheme in the context of a challenge fund to support MSMEs access to finance.⁴² The scheme guaranteed a percentage of the total amount disbursed for a period of up to two years. Although the performance of the pilot was found to be good, participating banks did not continue providing the guarantees after the financial support from Sakchyam ended.

Based on the current legal and regulatory framework and current financing context in Nepal, Sakchyam suggests three options for an MSME credit guarantee fund:

1. Scale up the DCGF and strengthen its capacity to work as MSME credit guarantee fund
2. Establish a guarantee fund within Nepal Rastra Bank
3. Establish a separate and independent MSME credit guarantee fund

As a part of the feasibility study of these three options, Sakchyam recently conducted two sub-studies: (i) An assessment of the legal and regulatory aspects of such a guarantee fund; and (ii) an MSME financing gap assessment.⁴³

Credit Information Bureau

In Nepal, where taking out multiple loans is a common practice for MSMEs, the consequences of default are naturally more severe since several financial institutions are affected by one business failure. In fact, the trend of multiple borrowing is widespread enough to create risk for the entire economy. One woman interviewed for this study in Kawasoti, Nawalparasi, admitted being a member of 17 different microfinance institutions, and was indebted to at least eight separate loans.

One reason that multiple borrowing has become so rampant in Nepal is that financial institutions, and particularly MFIs, face significant challenges when trying to assess the level of uncertainty of customer repayment. Microfinance institutions are often unable to access customers' credit history for evaluation. In January 2019, it became mandatory for all banking and financial institutions to register loan clients with the Credit Information Bureau (CIB) and report on a regular basis. In an ideal situation, when a BFI is registered in the CIB and regularly reports all approved loans amounting to NPR 50,000 (USD 444) or more, the institution is also able to digitally access the credit histories of loan applicants in the management information system.

To regulate the microfinance industry and impose more rigorous controls on lending, registered MFIs which fail to report regularly to the Credit Information Bureau face the penalty of a 2-per cent loss in loan provisions from the NRB. During interviews with registered MFIs which regularly report to the CIB, the MFIs expressed dissatisfaction with the level of support provided by the CIB, which

⁴¹ Loans of up to NPR 20 million are guaranteed, with prior permission, by the DCGF. In these cases, the Fund guarantees 70 per cent of the outstanding balance, or approximately NPR 5 million. See <http://www.dcgf.gov.np/en/services/sme-guarantee>.

⁴² Sakchyam is an initiative funded by UKaid as part of an agreement between the Governments of Nepal and the UK. The 5-year program, valued at £20.5 million, works with the public and private sectors to leverage access and facilitate financial sector development in Nepal for micro, small and medium enterprises.

⁴³ Sakchyam, *Developing a Robust Credit Guarantee Facility: Unleashing Access to MSME Finance in Nepal* (November 2017), Available: <https://sakchyam.com.np/knowledge-hub/reportanalysis/>

they note is inadequate to maintain reporting standards. In addition, the Core Banking System (CBS) and Management Information System (MIS) used by MFIs are unable to sync information or interface with the CIB system for reporting, which BFIs are required to do for all new applicants as well as loans that have defaulted for more than 90 days.

MFIs that have not registered with the CIB might be using the 2-per cent loss in loan provisions as a cushion to avoid having to report. The CIB needs to strengthen its capacity to extend necessary support and mentoring to all financial institutions, particularly MFIs, to help them comply with registration and timely reporting requirements. A common digital platform that will allow the information management systems of financial institutions to be compatible with that of the Credit Information Bureau will greatly facilitate automatic reporting in real time to ease the burden of reporting on MFIs.

In addition, customers and financial institutions in Nepal are struggling to update Know Your Customer (KYC) information in a convenient way. Therefore, CIB should also automatically allocate an identification number to each borrower when their name is entered into the system by a BFI. The identification number should be linked to the customer's credit history and accessible to all BFIs. The digitization of customer identification cards is the first necessary step towards implementing this concept. Given the current context of Nepal, there is immense scope and potential for digital financing to facilitate greater inclusion while exerting more stringent and appropriate regulations to the microfinance sector.

Although FinTech, KYC and other management information systems now being mainstreamed in the Nepalese financial sector are not geared specifically towards MSMEs, start-up and expanding business ventures can capitalize on the ease that these new technologies can bring to financial transactions including loan applications. Particularly at the MFI level, multiple borrowing issues are becoming a serious threat to the stability of the financial system, not to mention the negative impact that over indebtedness has on individuals in the community. Strict rules to report to CIB for all loans will help reduce instances of multiple borrowing and create pressure on MFIs to establish regulatory institutional mechanisms and seek appropriate clients to maintain their portfolios.

Insurance schemes for MSME

Designing appropriate insurance products for MSMEs is also an important factor in enterprise growth. According to various Finscope surveys, MSMEs — particularly micro and small enterprises — face a wide spectrum of risks including: illness or death of the proprietor or a member of his or her household; drought, harvest failure or flooding; and theft or loss of property.^{44, 45} Appropriate insurance to cover those scenarios can result in lower risks to lenders and lower financing costs.

Global insurers, such as Allianz, offer low-income family insurance that specifically caters to household needs. Forty-five million people in 11 countries in Asia, Africa and Latin America are already covered by Allianz micro-insurance. In the context of Nepal, insurance for the MSME sector offers global insurers a potential untapped market in the country's estimated 183,000 businesses,

⁴⁴ FinScope surveys are nationally representative surveys on the demand, access and use of financial services developed by FinMark Trust, an independent non-profit trust based in Johannesburg, South Africa, that aims at "making financial markets work for the poor". FinScope surveys have been conducted in more than 30 countries. For further studies, see <http://finmark.org.za/>.

⁴⁵ See Christiaan Loots, *Understanding the opportunity for MSME insurance* (2016).

which would benefit from an insurance scheme tailor-made for the specific risks that they face. The success or failure of an MSME can hinge upon the quality of its risk management⁴⁶.

Realizing the importance of insuring low-income individuals, including micro and small enterprise entrepreneurs, through micro-insurance schemes, the Insurance Committee of the Government of Nepal mandated all insurance companies to allocate a minimum of 10 per cent of their insurance portfolios to micro-insurance products. These products cover both the enterprise and the entrepreneur. However, the current normative provides no clear guidelines for insurance companies to promote micro-insurance, and none of the micro or small entrepreneurs interviewed for this study were aware of any existing micro-insurance schemes.

To promote the uptake of micro-insurance policies by micro and small entrepreneurs, the Government of Nepal offers a subsidy of up to 75 per cent of the premium for agriculture and livestock insurance. This subsidy could be extended to micro and small entrepreneurs in the services and manufacturing sectors as well. Since risk management strategies, such as insurance, provide protection against a wide spectrum of hazards that increase the probability of business failure, banks can consider insured businesses more likely to succeed and repay loans on time. “Higher creditworthiness of MSMEs with sound risk management systems should be recognized, even for those still lacking proven experience, through cheaper loans and ease of access to those loans,” according to the ADB.⁴⁷ This would also provide greater incentives for MSMEs to be willing to pay for insurance costs.

Alternatively, BFIs can promote the uptake of micro-insurance by using their Corporate Social Responsibility (CSR) Funds.⁴⁸ This could be justified by the fact that CSR funds can be used for several social activities including client protection, a category which can also encompass insuring MSMEs and entrepreneurs.

5. Dedicated Banks and Funds

Nepal does not have specialized banks for MSMEs, but each commercial bank has a department that looks after SME financing. In some banks it is a full-fledged department, and, in some cases, it is a unit in a department. Similarly, there are no specialized financial institutions in Nepal with a strong mandate to work for the promotion of MSMEs. However, the GoN has launched several initiatives to create funds for start-up enterprises to obtain access to capital.

Micro, Cottage and Small Industries (MCSI) Development Fund

The Department of Industry (DoI) established a Micro, Cottage and Small Industries Development Fund in 2003, with the objective of stimulating infrastructure development, building local crafts skills, and facilitating technology transfer and product marketing. The MCSI Fund is dedicated to supporting MCSIs in Nepal, which contribute 70 per cent of exports, generate both urban and rural self-employment, and balance agro-industrial growth by adding value to locally-sourced raw

⁴⁶ Asian Development Bank, *Insurance for Micro, Small and Medium-sized Enterprises*, ADB Briefs No.78 (April 2017), Available at: <https://www.adb.org/publications/insurance-for-msme>

⁴⁷ Ibid.

⁴⁸ As per the NRB circular on 2073/10/12 BS, it is mandatory that all BFIs, including MFIs, allocate 1 per cent of their net profits to a CSR fund.

materials.⁴⁹ Enterprises with a minimum fixed capital of NPR 100,000 (USD 890) can register with the Cottage and Small Industry Offices in each district. According to the Department of Cottage and Small Industries, 80 per cent of MCSI ventures have an income of between NPR 300,00 (USD 2,700) and 600,000 (USD 5,400).

Women Entrepreneurship Development Fund (WEDF)

The Women Entrepreneurship Development Fund (WEDF), established in 2015, helps women entrepreneurs to access the finance needed for enterprise growth. WEDF is an initiative by the Ministry of Industry (MOI), offering collateral-free loans up to NPR 500,000 (USD 4,440) at a 6-per cent interest rate. Women entrepreneurs apply at the district office of Department of Cottage and Small Industries (DCSI) by submitting their business plans, which are later sent to the DCSI centre office in Kathmandu. Enterprises that meet the conditions of the WEDF Procedural 2065, receive a loan. Women-led enterprises must have been in operation for at least two years and have a recommendation from any one of the umbrella organizations in their local district. As shown in Table 7, the coverage of the fund expanded to 75 districts in 2018. The cumulative number and volume of loans approved until that year amounted to 1,888 loans and NPR 332.8 million (USD 3 million), respectively.

Table 7
Progress of Women Entrepreneurship Development Fund until 2018

Year	2014/15	2015/16	2016/17	2017/18	Total
Number of districts covered	10	21	42	75	
Number of loans approved	119	229	765	775	1,888
Total amount of loans approved (NPR Million)	14.3	27.05	165.86	125.6	332.8

Source: Nepal Rastra Bank Progress Report 2018

The Federation of Women Entrepreneurs' Associations of Nepal (FWEAN) pointed to three problems of the WEDF: (i) lengthy application procedures that can take up to one year, many female candidates can be automatically disqualified if they lack a credit history, (iii) and a restrictive loan ceiling that is insufficient for business expansion given the costs of raw materials in the domestic market. FWEAN also noted that WEDF has not been able to attract women entrepreneurs from remote areas, possibly as a result of their significantly lower access to financial institutions, which tend to be concentrated in urban areas. One of the recommendations made by FWEAN is to create widespread awareness and clarity about WEDF eligibility and the steps required for the application process.⁵⁰

The government also pledged interest subsidies on loans for various social programs, including the WEDF. This scheme, initiated in 2018, allows banks and financial institutions (BFI) to provide loans up to NPR 1.5 million (USD 13,300), with the business itself posing as the collateral, and a subsidy of 6 percentage points of the annual interest rate provided by the government. However, the uptake of the scheme by BFIs has yet to gain momentum. In explaining this apparent lack of

⁴⁹ Institute for Integrated Development Studies, *Nepal Economic Outlook 2018-19* (IIDS, Sopan Press, Kathmandu, 2019)

⁵⁰ <https://www.cipe.org/blog/2018/11/26/womens-economic-empowerment-improving-business-loans-can-create-opportunities-for-women-entrepreneurs-in-nepal/>

interest, the commercial banks interviewed for this study mentioned that they lack the capacity and tools to appraise the applications and other documents for non-collateralized loans. Therefore, there exists a gap in tools, skills and proper regulation that have hampered the promotion of this product. Banks also noted limited demand for the loan, which could be due to a lack of awareness on the demand side about the existence of the credit facility. In order to improve the uptake of WEDF, in November 2019 Nepal Rastra Bank mandated commercial banks to provide subsidised loans to at least 500 eligible beneficiaries by the end of fiscal year 2019-2020 across different sectors other than agriculture and livestock.⁵¹

Youth and Small Entrepreneurs Self-Employment Fund

The Youth and Small Entrepreneur Self-Employment Fund (YSEF) was established by the GoN in 2009 with the aim of generating self-employment and providing vocational and skills development training to individuals over the age of 18. YSEF helps unemployed youths to access collateral-free loans from banks, cooperatives and financial institutions to expand their opportunities for self-employment. Applications are directed to the YSEF Secretariat, which works under the Ministry of Cooperatives and Poverty Alleviation. The main objective of YSEF, which has helped 55,333 small entrepreneurs establish businesses since its launch 11 years ago, is to improve the livelihoods of economically disadvantaged groups. Loans up to NPR 200,000 (USD 1,770) are disbursed for individual-owned businesses, and up to NPR 5,000,000 (USD 44,400) for groups of a maximum of 25 persons, at a low interest rate under 6 per cent.

Poverty Alleviation Fund

The GoN, with the support of the World Bank, established the Poverty Alleviation Fund (PAF) in 2004. One of the objectives of PAF is to provide impoverished populations with access to finance for income-generating activities. Loans are disbursed through a revolving fund that is managed at the community level. So far, more than NPR 14 billion (USD 124 million) has been distributed to 32,000 community organizations reaching almost one million households across 60 districts.

The following initiatives promoted by Nepal Rastra Bank have targeted MSME entrepreneurs:

Rural Self-Reliance Fund (RSRF)

The Rural Self-Reliance Fund (RSRF) provides wholesale credit for on-lending purposes to deprived or marginalized groups through loans to MFIs, Cooperatives, and NGOs. RSRF also provides long-term loans to agricultural product sectors such as tea, cardamom, and cold storage through the Agricultural Development Bank and permitted MFIs. The target group of the fund is individuals from rural households, holding less than 15 ropanies (7,631 square meters) of land in the hills or less than 1 bigha (1,619 square meters) of land in the Terai, Southern Nepal, or families who cannot meet their minimum consumption needs. Additionally, the fund provides micro credit in places where BFIs do not exist.

Re-financing Facilities

The Nepal Rastra Bank can also provide refinanced loans to crisis-hit industries related to tourism, hydropower, agriculture, real estate, small and cottage industries, and productive sectors. Eligible individuals must apply to the relevant BFIs, and the institution refers the case to the Nepal Rastra

⁵¹ Sujan Dhungana, "NRB sets subsidised loan threshold", The Himalayan Times, 29 November 2019. The NRB also mandated development banks and finance companies to provide subsidized loans to 200 and 100 beneficiaries, respectively.

Bank through another application. Upon approval, the Nepal Rastra Bank channels the loan amount through the BFI for them to lend to the borrower. One of NRB refinancing programs is for SMEs. In its monetary policy for 2019/2020, the bank lowered the refinance rate from 5 per cent to 3 per cent, and it reduced the maximum rate that BFIs can charge to SMEs from 10 per cent to 7 per cent. The beneficiary SMEs need to provide usual collateral for such loans.⁵²

6. Venture capital and private equity

There are increasing opportunities in Nepal to mobilize much-needed financial resources towards MSMEs through venture capital. Recently several venture capital firms registered as private companies, with some also investing abroad. On average, each venture capital firm has invested in eight burgeoning enterprises, of which four are start-ups. Their equity contribution in such enterprises runs as high as 36 per cent. The following are some of the venture capital firms or private equity funds currently operating in Nepal.

Business Oxygen (BO2) is a climate-focused equity fund that aims to reduce the negative environmental impact of industry and create equitable social systems. The World Bank's International Finance Corporation (IFC) has committed USD 7 million of this USD 14-million venture fund. With a motto of "Investing in Change," the fund has provided capital to a variety of MSME industries ranging from clean energy and ecotourism to dairy farms.⁵³ Its services include risk capital financing with advisory support for accounting, quality-assurance standards, and corporate governance frameworks. Business Oxygen is managed by WLC Ventures, a subsidiary of the local business and development consultancy White Lotus Centre.

Lotus Holdings is a venture capital firm that seeks to promote private sector growth through local and overseas investments. Since its founding in 1998, Lotus Holdings has been dedicated to supporting struggling entrepreneurs with financial backing. The company offers financing to new ventures for marketing, research and development, and improved administrative capacity. The firm's mission is to expand opportunities in the local workforce to promote economic inclusion.⁵⁴

M&S holdings was established in 2016 with investments primarily in media, technology and tourism industries. M&S Next offers entrepreneurial education, mentorship, guidance, a shared workspace, resources, market exposure and access to networks and funding to fledgling businesses.

The almost decade old Biruwa Ventures consulting firm offers free mentoring sessions and serviced office spaces for aspiring entrepreneurs and early stage start-ups. Biruwa aims to be a catalyst for aspiring entrepreneurs to gain market expertise, financial resources and private sector contacts to grow their businesses. The firm also assists new operations seeking to refine their business plans and investment proposals to connect with avenues of financing and has helped more than 500 entrepreneurs since 2011.

Gazaab Social Ventures is a micro social venture capital fund with a three-pronged approach of providing start-up capital, training courses and consulting services to incipient smallholder businesses. The enterprise was founded in 2009 by a Singaporean university student and has been

⁵² NRB, *Monetary Policy for 2019/2020*. https://www.nrb.org.np/contents/uploads/2020/04/Monetary_Policy_in_English-2019-20_Full_Text-new.pdf

⁵³ BO2, *Investing in Change*, see <https://bo2.com.np>

⁵⁴ For more details, see <http://www.lotusholdings.com/>

described as a “business accelerator and incubator in Nepal.”⁵⁵ Gazaab works to create socially minded entrepreneurs who are motivated to solve problems for their community through business means. The organization primarily focuses on youth and can be contacted through social media. It has faced financial issues in the past and is currently minimally operational as its founder, Jamon Mok, is now working with a new business venture for sustainable tourism.⁵⁶

The non-profit Dolma Foundation works to alleviate poverty by working as an impact advisor to help communities learn how to generate income. The UK-headquartered charity uses a Community Partnership Model to develop environmentally sustainable enterprises in rural and remote communities. The Dolma Foundation also conducts outreach for education programs and health.

Venture capital funds as a source of MSME financing in Nepal remain incipient with currently minimal contributions to sectoral growth. Given the barriers to formal financial access that MSMEs frequently face, venture capital and private equity can play a significant role in filling this gap, if the policies to create an environment conducive to mobilizing private equity towards MSMEs is explored further. Equity firm capital backing for MSMEs does not need to be limited to firms with social welfare missions, as small and medium-sized businesses with high growth prospects have the potential to provide venture capital firms with high returns on investment.⁵⁷ But firms need to be willing to commit to long-term finance since the gestation period for a start-up or MSME expansion prior to revenues may be significant. Secondly, since equity firms share both the risks and rewards of business outcomes with entrepreneurs, value-added services — such as mentorship and supplier linkages — are likely a necessary component to accompany any capital support and this might limit private equity interest in the sector without regulatory incentives to attract either domestic or foreign investors to this area.

7. FinTech

The rapid spread of digital technologies over the past decade among MSMEs and their customers is sparking a transformation in the dynamics of MSME finance globally. Massive amounts of data generated and processed by FinTech tools can be used to better understand the MSME market, assess creditworthiness, and increase capacity and efficiency in risk management. The emergence of new technological solutions presents a unique set of opportunities and challenges for financial institutions. Several specialized financial technology companies have made waves in recent years by developing solutions targeting the bottlenecks afflicting traditional financial mechanisms. Advanced analytics platforms are leveraging Big Data drawn from digital footprints to conduct credit assessments at faster and lower costs than ever before. Non-traditional sources of information available through digital technologies are also helping to create more robust credit risk profiles and enhance the understanding of complex MSME markets. Digital automation can streamline underwriting processes, as well as organizational decision-making, further lowering costs for financial institutions. In Nepal, financial technology in the form of digital banking started during the mid-1990s.

⁵⁵ Patricia Ordonez de Pablos, *Management Strategies and Technology Fluidity in the Asian Business Sector* (IGI Global, Hershey, PA, 2018).

⁵⁶ Ibid.

⁵⁷ Meena Kumari, “The Financing of MSMEs — Role of Venture Capital,” *The International Journal of Business and Management*, vol. 3, No. 5 (May 2015).

In Nepal, as of June 2017, the internet penetration rate had reached 60 percent of the 28-million population — nearly on par with the country's 67.9 per cent adult literacy rate in 2018. Moreover, according to the Nepal Telecom Authority there were an estimated 250 new internet users every hour in Nepal in 2017.⁵⁸ Given that the majority of MSME entrepreneurs are among the literate population in Nepal, and are undoubtedly benefitting from the accelerated expansion of internet services, they have the potential to introduce financial technology to their businesses and increase their capacity to participate in the digital economy.

Digital Financial Services in Nepal

The introduction of credit cards in the early 1990s by Nabil Bank (then Nepal Arab Bank) marked the first digital financial service established in Nepal. The subsequent arrival on the banking scene of other mechanized financial services — including ATMs, internet banking, mobile banking and other technologies — are rapidly revolutionising monetary transactions while increasing the potential for financial inclusion. Table 8 and what follows provides details. However, it is important to keep in mind that as of 2017 only 45 per cent of people in Nepal owned a bank account, and only half of them used their accounts that year to withdraw money even one time.⁵⁹

Table 8
Digital Services in Offered by Nepal's Commercial Banks

	Mid-July					
	2013	2014	2015	2016	2017	2018
Number of Internet customers	286,732	328,434	396,362	489,835	766,958	810,674
Number of mobile banking customers	452,909	768,424	997,463	1,604,578	2,438,222	4,711,097
Number of Debit card holders	3,193,137	3,641,960	4,146,237	4,142,390	4,694,066	5,307,970
Number of ATMs	1,239	1,303	1,483	1,661	1,874	2,252
Number of credit card holders	38,587	57,898	43,895	52,014	68,966	104,721
Number of prepaid card holders	57,453	66,204	69,322	82,797	101,458	96,816
Number of Branchless Banking centres	205	504	503	812	1,008	1,248

Source: Bank and Financial Institutions Regulation Department, NRB Annual report 2018

Internet Banking. Kumari Bank introduced internet banking to Nepal in 2002. Currently, all the commercial banks offer internet banking services to their customers. Between 2017 and 2018, the

⁵⁸ Nepal, *2018 Digital Nepal Framework: Unlocking Nepal's Growth Potential*, Ministry of Communication and Information Technology (2018)

⁵⁹ Ibid.

number of people using internet banking services doubled to 810,674 persons. So far, internet banking is primarily limited to commercial banks' utility payments services, fund transfers within and between selected banks, and the generation of account statements. There is the potential for digital financial expansion to encompass — and create much greater ease for — transactions such as online tax payments, loan applications and repayments and receiving remittances, in line with the GoN's strategic priority to leapfrog the financial sector from conventional banking into digitalization in the upcoming decade.

Mobile Banking. Nepalese banks provide mobile banking services that include balance inquiry, mini statements, transactions information, withdrawal alerts, cheque book inquiries and requests, inter-bank and intra-bank fund transfer, utility bill payments and other related functions. In 2018, there were more than 4.7 million mobile banking users — representing more than 400 per cent growth compared to the previous two years. In addition, according to the 2018 Nepal Digital Framework, mobile penetration in the country now exceeds 100 per cent, and the GoN aims to facilitate Telecom operators (such as Nepal Telecom and Ncell) to offer digital financial services, effectively expanding overall access to financial services, including for MSMEs.

Debit Cards. All Nepalese commercial banks provide debit card services to their customers. There are approximately 5.3 million debit card users nationwide, which represents nearly 30 per cent growth since 2016, but still only encompasses 9 per cent of the total population.

Automated Teller Machines (ATMs). Himalayan Bank introduced the first ATM in Nepal in 1995 and the country's 28 commercial banks have now installed a total of 2,252 ATMs nationwide, but these are primarily concentrated in urban areas despite that 81 per cent of the population (22.47 million people) lives in rural areas. The absence of financial infrastructure outside of cities remains a key obstacle to improving levels of financial inclusion and supporting rural MSMEs. While insufficient funds are the main reason that people remain unbanked, according to the Global Findex Database, the second most significant barrier is the distance that people in Nepal must travel to reach a banking service.

Credit Cards. While the numbers of bank account holders and credit card users in Nepal have both been increasing since 2013 — with the number of credit card holders surging by more than 270 per cent between 2013 and 2018 (from 38,587 to 104,721) — the use of debit cards continues to outstrip credit card adoption rates.

Prepaid Cards. The use of prepaid cards in banking is now starting to decline. The number of prepaid card holders in July 2017 was 101,458 and has since waned to 96,816 in 2020. This may be attributed to the increasing traction of debit and credit cards as a replacement for prepaid cards.

Branchless Banking. Branchless banking (BLB) delivers financial services through agent-based point of transaction (POT) machines, avoiding the need to establish a traditional brick-and-mortar bank branch. The services, accessed through a smart card or mobile phone, include deposit, withdrawal, balance enquiry, and fund transfer. As of mid-July 2018, there were 1,248 branchless banking centres in Nepal. A significant growth of branchless banking occurred in the wake of the devastation of Nepal's April 2015 earthquake, when victims of the 7.8-magnitude disaster required rapid aid delivery, particularly in remote and hard-to-reach areas. BLB facilitated the ease of cash payments to earthquake-affected people in the 14 hardest-hit districts of Nepal. BLBs were set up by at least seven commercial banks in partnership with the GoN and aid agencies to help people

rebuild their livelihoods without needing to travel to an urban centre to collect monetary assistance.

Recent FinTech Initiatives in Nepal

The use of FinTech in Nepal is gradually increasing even though most of the population continues to rely on informal financial channels as the preferred mode of conducting monetary transactions. Within the formal economy, only 15 per cent of salaried employees receive wages through an official bank account. Nevertheless, commercial banks and financial institutions have recognized the potential of FinTech to increase financial distribution channels and provide more user-friendly and efficient services to customers. Internet banking, mobile banking, and mobile wallets are now common interfaces offered to customers by most commercial banks in Nepal. Recently, mobile wallets have become popular among educated youths in urban areas, and they are also gaining traction among middle- and higher-income households in cities. However, the penetration of these technologies in rural areas, and among MSME entrepreneurs, remains limited. Government-imposed ceilings on maximum digital payments, hefty fees associated with formal banking transactions and low levels of digital and financial literacy among a majority-unbanked population are the main challenges for the nascent FinTech sector to become widespread in Nepal.

Commercial Banks

In order to increase financial access in rural areas, some key initiatives have been established over the past half-decade. As noted earlier, part of the post-earthquake recovery efforts in 2015 involved guidance from the NRB for all commercial banks to expand their national outreach, particularly to earthquake-affected populations. With initiative and support from organizations such as Sakchyam Access to Finance and UNCDF, most commercial banks have been able to open up BLB units in rural areas. Local people are trained and employed as agents to manage the units, dozens of which are scattered throughout Nepal's 34 most remote districts that previously had no bank access. "Agents are becoming the face of banks in many of the communities," notes the Centre for Financial Inclusion.⁶⁰

This has helped not only rural earthquake-affected populations, but also MSME entrepreneurs. By making cash more readily available at the local level, the overall environment has become more conducive to MSME start-ups and expansion. BLB units were initially equipped with point of sale machines that could only be used for cash in (deposit) and cash out (withdrawal). However, since the system was updated under the Know Your Customer (KYC) banking guidelines implemented in 2012, all POS units were replaced with tablets to allow real time system updates on customer activities. The tablets can also be used to upload other necessary documents and photos required for the KYC process, which reduces banking costs and provides a digital solution to customer profile management.

Several banks also allow agents to carry out a portion of loan processing work. The BLB agent helps the borrower to prepare all the necessary documents to forward to the bank branches for a loan application. Once the loan is approved, the borrower is informed via SMS, and the approved amount is deposited into his or her account and easily withdrawn from any BLB unit. According to Sakchyam and UNCDF, MSME entrepreneurs can significantly benefit from this BLB service development.

⁶⁰ Center for Financial Inclusion (CFI), *UKaid Nepal Sakchyam Access to Finance*, in an article prepared for Financial Inclusion Week, October 2016.

MFIs

A number of financial access programs, including the BLB system implemented by Sakchyam noted earlier, are now providing MFIs with the resources to implement tablet banking at their service centres. The tablet transactions are carried out by a loan officer, and transactions take place and are recorded in the MFI's databases in real time, with the only caveat being the need for reliable internet connectivity. When there is no internet available, transactions must be carried out in offline mode and sent to the main system at a later date.

One local MFI, Chhimek Laghubitta Bittiya Sansathahas, has taken the process one step further and now trains one member from each group, which are mainly women, to act as an agent for recording the group's financial transactions on the tablet. Chhimek has found this method successful and efficient, leading the organization to adopt tablet banking in all its 126 branches in 63 districts nationwide. With support from UNCDF, Chimek Laghubitta Bittiya Sansatha has also established BLB units.

In addition, mobile wallets and other online transactions are gradually penetrating rural areas. IME Pay has started offering mobile wallet services, including transfers and withdrawals from linked bank accounts, utility payments, and even purchasing airline tickets. While such services are aimed at consumers, MSME entrepreneurs are also benefitting from the increased efficiency of digital payments systems. IME Pay has developed a vast network of 15,000 agents across the country. Recent information shows that over the past two years more than 40,000 transactions were made through this system. Similarly, with UNCDF support, Prabhu Bank and Global IME continue to expand mobile wallet services in Nepal.

Going Forward: Open Source System for Financial Services

Nepal can connect all BFIs through a common open source platform for core banking services which can be used not only for financial transactions but also for conducting credit ratings for borrowers, submitting reports to the NRB and CIB, and other activities. While developing such an open source platform, it is essential to ensure the system is the following:

- Safely and reliably accessible from connected devices, such as feature phones, smartphones, tablets and other specialized devices.
- Customer-friendly, allowing seamless connections using a crowd sourced and flexible KYC operating system.
- Customer-centred, enabling users to flexibly open and operate accounts, or nominate third-party operators, without the assistance of an agent.
- Based on an open application program interface (API) so new service providers (for payments, insurance, loans, etc.) can be easily added to payee lists.
- Established using an open-ended API to enable customers to set up and modify services on the platform according to their unique set of preferences.⁶¹

⁶¹ There are various open source software products that Nepal could use and adapt. An example is the Mojaloop Foundation, which offers open source software solutions to create interoperable digital payment systems to increase financial inclusion. See <https://mojaloop.io/>.

8. Business Membership Organizations

Nepal has a number of business membership organizations (BMO) representing MSMEs. One of them is the Federation of Nepalese Chambers of Commerce and Industries (FNCCI), an umbrella organization of 960 businesses representing 103 commodity sectors which caters to the needs of medium-sized enterprises by providing sector-specific projects and hubs to catalyse their innovation and expansion. The FNCCI's goal of driving economic growth through private sector enterprise is aligned with the GoN's 2018 vision of "Prosperous Nepal, Happy Nepali," which identifies rising economic opportunities and job creation as critical levers for national socioeconomic development. The FNCCI has a presence on almost all national councils, boards and policy advisory bodies concerned with business and industry, representing the interests of the private sector.

The Federation of Women Entrepreneurs Association of Nepal (FWEAN), headquartered in Kathmandu and with 74 chapters nationwide, provide effective support to women owned and managed MSMEs. Established in 2003 as an apex body for the Women Entrepreneurs Association of Nepal (WEAN), FWEAN provides opportunities for women to market their products at fairs and expos, offers training for women to upgrade their skills and expand businesses, and functions as a collective advocacy voice for the country's thousands of women entrepreneurs. For example, the FWEAN campaign for greater access to finances for women contributed to the government's establishment of the WEDF loan in 2015 and paved the way for the NRB in 2018 to establish guidelines for a similar subsidized, collateral-free loan for women.

The Federation of Nepalese Cottage and Small Industries (FNCSI) is a non-profit umbrella organization for cottage and small industries in Nepal. It is an apolitical business membership organization (BMO) with nationwide outreach through 74 branches and autonomous district chapters, all of which espouse the FNCSI constitutional ideology of recognizing the value of and promoting indigenous crafts such as carpet-making, metalworks and handloom garments of raw wool, silk and cotton. FNCSI works to strengthen competitiveness of its 35,000 members, which include 20 national level commodity associations which work at the district, regional and national levels to promote Nepali suppliers and assist with quality product development to upgrade the capacity of institutions within the MCSI sector.

District Micro Entrepreneur Group Associations (D-MEGA) have been set up in the context of the UN Development Programme's Micro Enterprise Development Program (MEDEP) to provide support to micro entrepreneurs at the district level. The D-MEGA aim at advancing the sustainable development of micro enterprises through local level resource generation, advocacy, and B2B linkage creation. As umbrella organizations operating at the district level for micro enterprises, D-MEGAs provide a common platform for budding micro-entrepreneurs to learn how to improve their crafts, access finance and materials, and eventually expand their enterprises. The presence of D-MEGA at the local district level allows the provision of immediate and hands-on support to the entrepreneurs.

9. Financial and Business Literacy

Financial and business literacy among MSME entrepreneurs affects the ability of an entrepreneur to obtain a formal loan. Moreover, such knowledge is needed by entrepreneurs to be able to process, understand, and analyse new information accurately in order to make good business decisions. These reasons explain why interest in financial and business literacy have increased in recent years,

and why many countries, including Nepal, have embarked on programs and initiatives to introduce and enhance financial literacy among their populations. Financial and business literacy have gained the attention of a wide range of institutions in Nepal, including the Central Bank, government agencies, educational institutions, consumer boards, and various community interest groups.⁶²

The NRB has highlighted financial literacy as a key component of developing an inclusive financial sector, as outlined in the GoN's 2017 Financial Sector Development Strategy Paper. Financial literacy is defined as "a combination of awareness, knowledge, skill, attitude, and behaviour necessary to make sound financial decisions and ultimately achieve individual financial well-being".⁶³ The NRB's March 2020 Financial Literacy Framework (FLF), which will run for four years, targets salaried workers, students, women, remittance receivers and farmers/entrepreneurs through mass media programs that cover topics ranging from household budgeting and loan management to capital market operations. The FLF is still in the initial stages of implementation, however, and rural populations have yet to benefit from its educational agenda.

Meanwhile, the local level reach of MFIs places them in a good position to conduct activities related to financial literacy. Sakchyam Access to Finance is currently helping several MFIs, including Vijaya Laghubitta (VL), to implement a financial literacy training program. The program covers basic financial literacy topics, such as savings, loans, and credit appraisal, and it uses mobile messages as well as short video clips and local FM Radio messages to reach the MFI members, who are mostly women. The message in one call lasts up to 2 minutes in length. The program has been very effective in terms of helping members to understand financial terminology and basic concepts.

Programs such as this are much needed given the uneven financial knowledge among MSME entrepreneurs. During the study team field visits, most business owners were found to have limited business and financial literacy, especially regarding the documentation, analysis and presentation required for a loan application. As a result, the documents required by banks and financial institutions to secure credit could not be properly produced. The entrepreneurs also seemed to lack adequate business development skills such as those related to pricing, packaging, and marketing.

Both men and women entrepreneurs interviewed lacked the knowledge and skills needed to meet the requirements of financing institutions, indicating a significant need for programs to empower people and build their capacity to consume available financial services in a sustainable way. Many of the major skills gaps identified in entrepreneurs during this study were related to the following: preparing a business plan, applying for a loan, being aware of updated bank policies, maintaining books of accounts and records, preparing financial statements, and complying with tax requirements.

⁶² Eresia-Eke Chuks, "SMME Owners Financial Literacy and Business Growth," *Mediterranean Journal of Social Sciences* Vol.4 (November 2013).

⁶³ NRB, *Financial Literacy Framework* (Central Office Baluwatar, Kathmandu, March 2020)

10. Recommendations to improve MSME financing in Nepal

Prioritize the local value of assets over road access to ease collateral requirements. For financial institutions, the value of tangible collateral assets is more significant than road access. Most small and micro entrepreneurs based in remote and/or mountainous areas own limited assets which are also likely to be located on rugged terrain that does not meet banks' collateral requirement of being linked to a road. Because of this, banks need to evaluate assets pledged as collateral according to their local value in relation to the size of the loan being applied for, regardless of the transport infrastructure available in the area. Although the NRB has already revised collateral requirements to allow for this, very few banks or MFIs have adopted the new policy due to a lack of flexibility in their internal policies. Strong directives from the NRB are required to ensure that all commercial banks and MFIs conduct uniform policy revisions for collateral assessments in the MSME loan approval process.

Develop a national framework for SME loan approvals based on cash flow and potential profits. In order to ease access to finance for micro and small business owners, including women entrepreneurs, who often do not possess adequate collateral, enterprises should be assessed for loans based on their cash flow and profit potential. In Nepal, BFIs have not provided project-based financing for industries other than hydropower. An important recent precedent, however, is the 2018 NRB initiative to develop collateral-free loan provisions for women entrepreneurs. In this context, the NRB has required commercial banks to prepare guidelines and assessment tools to launch such loans, and to report their progress to the NRB in their quarterly reports. During interviews conducted for this study, all banks interviewed expressed their willingness to mobilize credit based on assessments of MSME's cash flows and profits. However, they are reluctant to implement project-based financing models for the MSME sector in the absence of detailed guidelines and a credit guarantee. It is, therefore, recommended that the NRB prepare a detailed guideline, appraisal tools and the necessary guarantee mechanism to back up collateral-free loans to women entrepreneurs. More on credit guarantees below.

Increasing the size of micro enterprise (ME) loans provided by MFIs. The current loan ceiling of NPR 300,000 (USD 2,700) customarily imposed on credit applications of micro enterprises to microfinance institutions stymies their further growth and expansion. In order to overcome this obstacle, it is recommended that the NRB issue a circular mandating that only loans for more than NPR 300,000 with physical collateral will be counted as ME loans, and all loans less than NPR 300,000 will be considered group loans, regardless of collateral. This circular would also encourage MFIs to increase their ME portfolio to closer to the maximum allowable limit of 33 per cent of their total portfolio. It will be expected that this limit would become the industry standard for micro enterprise loans. If the NRB can give MFIs a reasonable time period, such as five years, to meet the 33 per cent target for ME loans in their portfolios, institutions will be able to adjust to the new policy without the need to limit regular group loans.

Mandate all banks to dedicate at least 10 per cent of their portfolios to SME loans. As noted above, commercial banks have been required to dedicate 25 per cent of their portfolios to priority sectors, including agriculture (10 per cent), energy and tourism (15 per cent), as well as 5 per cent to deprived sectors. Commercial banks need similarly mandatory conditions to incorporate more SME loans into their portfolios. Expanding BFIs' mandatory portfolio quotas to include the SME sector would not require any significant policy revisions on behalf of the NRB and has the potential to address the 'missing middle' problem. In interviews for this study, the majority of commercial banks expressed a willingness to increase their SME portfolios by up to 10 per cent, but noted that they would need to upgrade their internal capacity — through improved human resources and management skills — and require several years to reach that target.⁶⁴ The NRB can also encourage banks to use part of the SME portfolio for project-based or cash-flow based financing with quotas for female entrepreneurs.

Record and publish MSME portfolios. The NRB publishes a quarterly report on MFI lending, and includes quantitative data on micro enterprise loans disbursed in relation to the institution's total portfolio. However, information regarding SME loans is notably absent. The NRB should mandate all banks to maintain proper records of MSME loans, including collateral-free loans, and include the figures in their quarterly reports, in order to monitor any progress or stagnation in loans distributed to businesses in this subsector. Such reports should use the criteria established by the Industrial Enterprises Act of 2020 to classify enterprises into micro, small, and medium-sized.

Simplify tax requirements for MSME entrepreneurs. Tax policies are currently the same for all enterprises irrespective of their size and location but complying with the Nepalese tax system is cumbersome for small and micro enterprises. To bring them on board into the national tax system, it is strongly recommended that they are subject to simplified tax compliance procedures during a few years for micro and small enterprises as well as start-ups. A possible solution could be for micro and small enterprises to enrol only in the new Permanent Account Numbers (PAN) taxpayer ID system, rather than registering for value-added taxes, regardless of their sales.

Promote a conducive ecosystem for MSME financing

It is the time for Nepal to create a conducive environment for the expansion of the MSME sector. Establishing favourable policies, programs and mechanisms to support the growth of MSMEs will not only facilitate the flow of credit, but it will also create forward and backward linkages to improve their profitability. The following recommendations can promote a supportive MSME ecosystem in Nepal.

⁶⁴ To respond to the economic crisis caused by the COVID19 pandemic, Nepal Rastra Bank's Monetary Policy 2020/2021 mandated commercial banks to allocate a minimum of 15 per cent of their portfolios to loans of NPR 10 million or less to MSMEs by mid-2024. See <http://www.nbsm.com.np/assets/kcfinder/upload/files/Publication/Highlights%20of%20Monetary%20Policy%202020.pdf>.

Develop a credit guarantee mechanism. A credit guarantee mechanism like India's Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) can be established to support lending based on cash flow to micro and small enterprises in Nepal. The GoN can explore the possibility of creating a single guarantee mechanism that works to support existing funds — such as the Micro, Cottage, and Small Industry Development Fund, WEDF or the Youth & Small Entrepreneur Self Employment Fund. Integrating the various MSME funds under the guarantee mechanism would function to maximize its impact and effectiveness while reducing the risks of fragmentation and overlap in financial provisions.

Promote micro-insurance for MSME entrepreneurs. Considering the significant risks associated with starting or expanding an MSME, appropriate insurance schemes for MSMEs are necessary to reduce the vulnerability of entrepreneurs. Beema Samity, the Insurance Regulatory Authority of Nepal, currently requires all insurance companies to dedicate 10 per cent of their portfolios to micro-insurance. Under this policy, MSMEs should be categorized as micro-insurance. Since many insurance companies also find it difficult to meet this target, it is in their interests to provide MSME coverage through micro-insurance schemes. Similarly, the GoN's current policy of providing up to 75 per cent of the premium to subsidize agriculture and livestock insurance should also be expanded to MSMEs given their significant numbers and contribution to the economy.

Establish MEDPA units in village councils and municipalities to build MSME capacity. During the meetings with entrepreneurs in the eastern and western parts of the country, it became clear that preparing the necessary documents to obtain loans from formal banking institutions is a challenge for MSMEs nationwide. This impediment was also mentioned by most of the BFIs consulted for the study. Both the demand and the supply side are looking for institutional arrangements that can help MSME borrowers prepare the required documents for loan applications and appraisal.

Under the Ministry of Industry, the MEDPA program is establishing units in all 753 local government offices. The units aim to help local micro entrepreneurs strengthen their skills and capacity to apply for loans and manage their enterprises. The units will also fill an advocacy and promotion role to create awareness surrounding new schemes and other offerings for micro entrepreneurs, including financial literacy-related activities.

Municipality officials interviewed in the course of the study noted that broadening the role of MEDPA to serve the MSME sector, instead of just micro entrepreneurs, would be far more beneficial for local employment creation in their municipalities. Therefore, it is recommended that the Ministry of Industry strengthen the capacity of MEDPA in subnational bodies support MSMEs in their loan applications and provide them with information about new products and services. Both MSME borrowers and BFIs would welcome such support.

Explore the possibility of setting up an MSME division within the NRB or MOI. Neighbouring countries of Nepal with similar economic profiles, such as India, have ministries specifically dedicated to MSMEs. In the context of Nepal, further study is necessary to assess the feasibility and benefits that such a ministry could bring to the sector and economy as a whole. In the medium-term, creating an MSME department at either the NRB or the Ministry of Industry is a viable option. A separate MSME department with the NRB or MOI is an appropriate measure.

Find commercialization pathways for smallholders. Based on consultations with BhatBhateni supermarket, a prominent supermarket chain and department store retailer in Nepal, there are very good possibilities to link MSMEs with large firms in order to expand access to a stable consumer base, a range of inputs and business knowledge. These linkages can also help smallholders to obtain financial services from commercial banks, according to BhatBhateni representatives, who explicitly expressed an interest in assisting partner vendors to obtain loans from commercial partner banks, based on exclusive sales agreements between suppliers and the shop. This type of agreement is also possible as a commercialization pathway for other MSMEs through other large retail firms operating in Nepal.

Strengthen Credit Information Bureau (CIB)'s MIS to interface with BFIs. Establishing a robust management information system that can provide an accessible interface to all banking and financial institutions and the Credit Information Bureau will be key for creating transparency among credit applicants. A regulatory environment that prevents multiple borrowing and the heightened risk of loan default will create a climate of greater confidence among financial institutions. It will also encourage BFIs to register and submit reports on a regular basis. The disciplinary fine of a 2-per cent loss in loan provisions for late reporting and failure to register has proven to function as a deterrent to enrolment and has not worked as an impetus for financial institutions to comply with the regulations. In this context, it is important to remove the penalty and ease access to the system instead, as a means to strengthen institutional engagement and compliance.

Expand FinTech services for MSMEs

FinTech should be used to offer financial services to MSME borrowers. The following activities are being tested in Nepal or elsewhere and can be replicated on a wider scale. The NRB, through its directives, can encourage BFIs to capitalize on new technologies.

Tablet/Smartphone banking. Sakchyam Access to Finance successfully piloted using tablets for financial transactions in real time at the MFI level in the post-earthquake recovery efforts. This can become a universal feature of branchless banking activities in Nepal to expand the benefits to the wider population, including MSME entrepreneurs. The NRB should encourage all banks and MFIs to offer tablet banking services and formulate the necessary guidelines and policy to ensure safe, reliable transactions.

Internet Banking. The growing popularity of internet banking can contribute to enhance financial inclusion. Internet banking can significantly reduce the logistical burden of obtaining a loan and making payments for entrepreneurs, particularly those located in remote or rural areas without proximity to a commercial bank branch. MSME staff should also be able to conduct other regular business-related transactions, such as payments for raw materials and utility bills, through internet banking. The NRB can mandate commercial banks to provide loan services through internet banking and provide financial literacy training as part of the loan approval process, to teach borrowers how to use the system.

Open source system for financial services with application programming interface to serve multiple institutions and millions of people. As mentioned earlier, Nepal can connect all BFIs through a common open source platform for core banking services. The platform should function to facilitate not only financial transactions, but also to allow BFIs to view individuals' credit histories, submit regular reports to the NRB and CIB, and other activities. Any government-led initiative should work in synergy with currently existing initiatives, such as the tablet banking system run by Sakchyam Access to Finance and take the necessary steps to avoid overlap or discrepancies. Adequate support from NRB is needed to establish such open source system for financial services.

Using technology for financial literacy. The expansion of digital technology and internet penetration in Nepal can be capitalized to implement large-scale financial literacy programs. The growing popularity of social media among the youth has been a main driver in the increased demand for internet. Nepal is home to at least 9.3 million Facebook users and 6.4 million registered Youtube users, according to January 2018 statistics, while Nepal Telecom Authority observed a boost in 2.25 million new users the previous year alone.⁶⁵ Any financial education program can take advantage of this enormous appetite for social media in parallel with increased financial services on offer for the population. "The key opportunity [for financial literacy] lies in moving in tandem with the improving trend of financial access by the presence of BFIs in all local units of the government," notes the GoN's 2020 Financial Literacy Framework. These measures can significantly assist MSME entrepreneurs. If technology becomes a mainstream financial education tool for BFIs, it will strengthen the capacity of banking customers to manage their own financial needs and eventually reduce/minimize supervision costs for banks.

Develop short videos in mass media for financial literacy. MFIs which have created short educational video clips to impart financial information to members have received positive feedback. However, the current reach of the clips is limited, as only a few MFIs have implemented this type of training and without a coordinated national media campaign. Given the significant needs for MSME entrepreneurs to gain financial literacy in order to successfully start up and manage their businesses and obtain and service loans, the importance of this type of training cannot be underestimated, and it should engage a much wider audience through the and social mass media.

It is necessary to engage in a variety of mass media mechanisms to maximize the reach of financial literacy programs. Since 2003, private broadcasters have been operating alongside the state-owned Nepal Television, and currently there are at least 117 licensed TV channels with coverage to nearly 95 per cent of the country. A 2017 Sharecast Initiative survey noted that 75 per cent of households own a television and 60 per cent of people watch daily, effectively highlighting the potential of a TV-based financial literacy campaign to reach a significant portion of the population. Leveraging the power of mass media and digital technology to promote and upgrade MSME

⁶⁵ Nepal, *2018 Digital Nepal Framework: Unlocking Nepal's Growth Potential*, Ministry of Communication and Information Technology (2018)

ventures on a macro-level will also contribute towards the government's long-term goal to empower, protect and educate consumers while fostering their financial inclusion.

Under the 2020 Financial Literacy Framework, the responsibility for promoting and disseminating financial literacy lies with the NRB, which can initially take the lead to prepare educational video clips for telecasting. However, to ensure the long-term sustainability of the program, the GoN can mandate TV stations, under corporate social responsibility policies, to telecast a full series of financial literacy video clips. The NRB can also explore the possibility of using Facebook and other social media applications to disseminate the financial literacy video clips.

References

- Adhikari, Mukunda Dev. (2016). The tax plights of micro SME. Nepal Tax Online, 2 January 2016.
- Asian Development Bank (2018). Comprehensive Assessment of the Small and Medium-sized Enterprise Sector in Nepal. Kathmandu, Nepal.
- Bhusal, Ramchandra. (2015). SME Finance in Nepal: Relevance of Bootstrapping Finance. Kathmandu, Nepal
- Bogers, Marcel, Agnieszka Radziwon, and Arne Bilberg. (2014). Open Innovation in SMEs: Exploring the Ecosystem.
- Brethenour, Julia. (2016). Financing Missing middle SMEs in Emerging Markets: Insight about Small Cap Mezzanine Finance. SME Finance Forum Blog. 11 August 2016.
- Central Bureau of Statistics. (2019). National Economic Census 2018 – National Report. National Planning Commission. Government of Nepal. July 2019.
- Center for Financial Inclusion (CFI). (2016). UKaid Nepal Sakchyam Access to Finance. Article prepared for Financial Inclusion Week.
- CEPAL. (2013). Commercial Bank Financing for Micro enterprises and SMEs in Mexico.
- Dhungana, Sujana. (2019). NRB sets subsidised loan threshold. The Himalayan Times, 29 November 2019.
- Emerge. (2016). A review of Micro, Small and Medium Enterprises in the ICT Sector. ITU Publications.
- European Parliament. (2017). Competition Issues in the Area of Financial Technology. Document IP/A/ECON/2017-20
- International Monetary Fund. (2014). Nepal 2014 Article IV Consultation. Country Reports 14/214 (2014)
- Industrial Business Act 2015 (NP).
- International Finance Corporation. (2017). MSME Financing Gap- Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets. Kathmandu, Nepal
- Khatri, Navaraj. Solution to Problems of Micro, Cottage and Small Industries. The Rising Nepal.
- Kumari, Meena. (2015) The Financing of MSMEs — Role of Venture Capital. The International Journal of Business and Management. Vol. 3, No. 5 (May).
- Lamsal, Basanta and Sharma, Prakash Raj. Current Risks in the Microfinance Industry in Nepal. Nepal Microfinance Bankers Association, Nepal
- Loots, Christiaan. (2016). Understanding the opportunity for MSME Insurance: Evidence on MSME's risks and how they cope in 6 countries. Mombasa, Kenya.
- Nepal Rastra Bank (2018). Bank Supervision Report. Government of Nepal.

- Nepal Rastra Bank. (2019). Financial Indicator Report. Government of Nepal
- Nepal Rastra Bank. (2019). Progress Report of Microfinance Financial Institutions. Government of Nepal
- Nepal Rastra Bank. (2019). SME Financing in Nepal (in Nepali). Government of Nepal.
- Nepal Rastra Bank. (2020). Financial Literacy Framework. Government of Nepal.
- Ordonez de Pablos, Patricia. (2018). Management Strategies and Technology Fluidity in the Asian Business Sector. Hershey, Pennsylvania: IGI Global.
- Pant. Bhubanesh. (2016). Financial Inclusion in Nepal. Policy Review and Prescription. Kathmandu, Nepal
- Raju, B Yerram. (2018, July 31). Reclassifying MSMEs. The Hindu Business Online.
- SAWTEE. (2010). Promoting Women's Micro, Small and Medium Enterprises (WMSMEs) in Nepal. Kathmandu, Nepal
- Saxena, Niti and Singhal, Ruchi. (2017). Status of Women Entrepreneurs in India–A Study of Challenges Faced & Future Prospects an Article published on Advances in Economics and Business Management (AEBM).(4th Issue, Vol. 4).
- UNCDF (2019). Is lack of access to finance impeding the growth of female led small businesses in Nepal? 26 February.
- UNDP. (2017/18). MEDEP Annual Progress Report. Nepal
- UNESCAP. (2019). New UN project in Nepal to advance women entrepreneurship. 25 August.
- Upasna, Acharya, and Chittaranjan Pandey. (2018). Women's Entrepreneurial Ecosystem in Nepal: A Study Based on Kathmandu Valley. Irvine, California: Westcliff University.
- Wayman, Oliver. (2016). Harnessing the FinTech Revolution-How Digital Innovation revitalizing MSME Finance in Latin America and the Caribbean.
- World Bank Group, International Finance Corporation, SME Finance Forum. MSME Finance Gap-Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets.
- World Bank Group. (2017). What's happening in the Missing Middle? Lessons from Financing SMEs.
- World Bank Group. (2017) Women's Entrepreneurship: How to Measure the Gap between New Female and Male Entrepreneurs?