

CONSTRAINTS TO INCREASED ACCESS FOR SMALL BUSINESSES AND LOW-INCOME HOUSEHOLDS

This chapter identifies the main obstacles—institutional, legal, and regulatory—that hamper access to financial services for small businesses and low-income households in Nepal. The analysis is based on the data presented in chapters 1 and 2, case studies of two banks and detailed discussions with several others on how they serve small businesses, six focus group discussions with small entrepreneurs, and ratings of seven microfinance providers.

GOVERNMENT POLICIES HAVE NOT TACKLED THE ROOT CAUSES OF LOW ACCESS

Since the late 1950s the government has tried to increase access with a series of policies and direct market interventions. Yet 50 years later, 63 percent of households with accounts in formal financial institutions prefer to save elsewhere, 38 percent of households borrow only informally, and another 16 percent borrow both formally and informally. Although access to and use of financial services are limited in general, the problem is more acute for low-income households and for small, household-based businesses (box 3.1). Indeed, both access and use are closely correlated with household income and business loan size.

Government policies have not achieved the desired outcomes because they have addressed only the symptoms of limited access to financial services—not the root causes. For example, priority sector lending has not considered the sustainability of banks' lending to this market segment, while deprived sector lending has not taken into account the microfinance sector's capacity to generate large volumes of loans. Achieving both goals depends on financial institutions being able to serve these segments in a financially sustainable way. But lending profitably to small businesses requires a high degree of efficiency, while operating a growing micro-

TABLE 3.1

Small businesses with formal loans by type of lending institution, 2006

(percentage of small businesses)

Loan size (NRs)	Bank	Finance company	MFDB or RRDB	FINGO or cooperative
Total	45.5	17.8	11.5	25.2

Source: Access to Financial Services Survey 2006

TABLE 3.2

Small business loans by type of lending institution and loan size

(percentage of small businesses for each type by row)

Loan size (NRs)	Bank	Finance company	MFDB or RRDB	FINGO or cooperative
Less than 10,000	0.0	9.7	0.0	90.3
10,000–50,000	19.2	16.7	25.6	38.5
50,001–100,000	70.3	9.9	0.0	19.8
100,001–250,000	68.9	26.4	0.0	4.7
250,001–500,000	67.1	25.7	0.0	7.2
More than 500,000	94.7	5.3	0.0	0.0
Average	45.5	17.8	11.5	25.2

Source: Access to Financial Services Survey 2006.

finance institution is not easy and requires a certain level of specialization.

In the short to medium term, increasing access to financial services in Nepal will require tackling obstacles in both the banking and microfinance sectors. International experience shows that banks are better suited to serving small businesses—due to the size of the transactions involved—and microfinance institutions are more suited to serving low-income households. In the near term, based on the performance of the microfinance sector, banks are better placed to serve small businesses needing loans larger than NRs 100,000, while microfinance institutions should serve low-income households and microenterprises (that is, those with loan needs under NRs 100,000). The rest of this chapter analyzes the obstacles to increased access in these two market segments. It also briefly assesses potential obstacles to formalizing remittances, which primarily benefit low-income households.

WHY DON'T BANKS SCALE UP LENDING TO SMALL BUSINESSES?

Banks provide nearly half of formal loans to small businesses (table 3.1) and are by far the largest providers of loans larger than NRs 50,000 (table 3.2). Still, most small businesses meet their financing needs through internal sources and supplier credit. Indeed, 77 percent of small businesses say that they have no outstanding loans, while 72 percent say that they regularly buy on credit for lack of cash at the time of purchase (see box 3.1).

In Nepal small businesses have very different features from large corporations—

BOX 3.1

HOUSEHOLDS WITH SMALL BUSINESSES

Among the households interviewed by Nepal's 2006 Access to Financial Services Survey, 33 percent had a small business (defined as sole proprietors and partnerships). Of these households, 82 percent said that income from the business was one of their two main sources of income. Just over 77 percent of small businesses seem to finance themselves through internal sources (box table 3.1). If they do borrow, the loans tend to come from formal financial institutions (17 percent).

Still, 72 percent of the small businesses interviewed said that they usually buy on credit from their suppliers due to lack of cash at the time of purchase. This is true for both urban and rural small businesses, and for small businesses owned by members of the top and bottom quintiles. This discrepancy is probably due to the fact that buying on credit is such a routine business practice that it is no longer considered borrowing—although technically, it is informal borrowing. Suppliers are preferred over formal financial institutions because they are faster at providing loans.

BOX TABLE 3.1

Small businesses with loans by area and type of lending institution, 2006

(percentage of small businesses in each area)

Area	None	Formal	Informal	Both
Urban	70.8	24.5	3.5	1.2
Rural	80.4	12.4	6.4	0.8
Average	77.1	16.6	5.4	0.9

Source: Access to Financial Services Survey 2006

Among formal financial institutions, banks play a larger role in providing loans to small businesses than to households. Although financial NGOs and cooperatives compete strongly in rural areas, banks are the largest providers because business loans are larger than household loans, and financial NGOs and cooperatives often have limited equity—constraining their capacity to provide large loans. In the segment where there is competition among the various formal financial institutions (that is, for loans under NRs 50,000), banks are not the preferred providers—even though they charge lower interest rates and fees than do financial NGOs and cooperatives or microfinance development banks. This is probably because banks take almost twice as long to issue a loan, require physical collateral in almost all cases, and rarely accept movable collateral. And though the direct costs of borrowing from banks (interest and fees) are lower, the indirect costs are higher (such as the costs of preparing financial statements and of registering and evaluating collateral).

the traditional clients of banks. Small businesses are often young companies with unsophisticated accounts and low assets. Business and household finances may not be clearly delineated and are often strongly interdependent. Most small businesses have minimal or no banking relationships, work primarily with cash, and finance their operations through profits or informal financing. They are usually family businesses, run and managed by one or two people who take full, hands-on responsibility for all aspects of the business. Although these individuals typically know their business, they are weaker at producing written business and financial plans and are discouraged by the documentation requirements of banks. Moreover, management rarely plans their operations far in advance—so when they do require financing, they usually need it immediately.

To serve small businesses profitably, banks need to minimize transaction costs and generate large volumes of high-quality loans. As in other activities with small profit margins, commercial banks need to increase revenue by making many loans while lowering expenses—for example, by making loan officers more product and avoiding bad loans.

Nepalese banks find it difficult to serve small businesses profitably. When lending, banks—including those that have tried to create dedicated loan products for small businesses—make little or no distinction between large corporate and small business clients in terms of the products they offer or the demands and procedures they apply. The main obstacles to increasing bank loans for small businesses are complex lending procedures, inappropriate products, pricing policies that do not appear to allow cost recovery, little use of movable collateral, and no measures of small business performance—despite the capacity to do so with existing management information systems. These obstacles are discussed in more detail below and summarized in box 3.2.

COMPLEX LENDING PROCEDURES

Bank procedures for lending to small businesses are too complex for the market segment—making such lending unnecessarily time-consuming and costly for both the businesses and the banks. Banks require the same documents and information (such as business plans, financial statements, and collateral valuation and registration) from small businesses as they do from large corporations. Because small businesses often do not have the in-house resources required to produce such documentation, they must hire outsiders. This adds extra costs, time, and meetings for the businesses and the banks.

Producing such documents for a NRs 500,000 loan costs about NRs 15,000, or 3 percent of the loan amount. Given the complexity of the documentation required, a small business owner normally has at least five meetings with the bank to obtain a loan (for the initial application, site visit, collateral evaluation, signing of the required documents, and loan disbursement). Because small businesses have limited staff, any time that management spends dealing with a bank is time taken

BOX 3.2

**BEST PRACTICES FOR LENDING TO SMALL BUSINESSES
AND CURRENT NEPALESE PRACTICES**

Best practices	Current Nepalese practices
Loan approvals should take one to five days	Loan approvals take three to four weeks
The application process should be simple, requiring no financial statements or business plans	Financial statements—and sometimes business plans—are required
Products should be standardized, repaid in monthly installments	Overdrafts are widely used, and principal repayment rare
Each loan officer should process 15–20 loans a month	Each loan officer processes 3–4 loans a month
Collateral requirements should be flexible, including allowing movable assets as primary collateral	Real estate collateral is mandatory
Interest income should exceed lending costs	Interest income does not cover lending costs
Portfolio at risk above 30 days should be monitored	Portfolio at risk measurements are meaningless due to de facto bullet loans and perpetual overdrafts
Individual staff performance should be closely monitored and rewarded	Individual staff performance is not monitored or rewarded

Source: Case studies and interviews on how Nepalese banks serve small businesses.

from business activities—increasing the indirect costs of applying for a loan. In addition, Nepalese banks often have very centralized credit decision processes, further lengthening loan approvals. As a result it takes a new client a minimum of one month to get a loan once all the required documents have been submitted.

Banks, on the other hand, need to generate large loan volumes to make such small transactions profitable. But given the lengthy procedures, it is difficult for loan officers to approve more than three or four loans a month—well below what is required to break even.

INAPPROPRIATE PRODUCTS

The most popular bank product—overdrafts, or lines of credit—is inappropriate for many small businesses, which tend not to deposit their revenues in banks. In Nepal overdrafts come in two forms. The first are one-off overdrafts, typically approved for terms of 3–12 months, with clients paying monthly or quarterly interest payments on the outstanding amount. Clients can draw down and make principal repayments as they see fit during this period, as long as they remain

within the approved limit. The entire outstanding amount is then due at the end of the term. This type of overdrafts (or credit lines) resembles bullet loans, where clients typically draw down up to the approved limit shortly after approval and are then faced with a large repayment at the end of the loan period—and often have to borrow from informal sources or another bank to repay.

More popular, and even more risky, are perpetually revolving overdrafts. These are approved for 12-month terms. At the end of this period they are reviewed, with a view to revolving or extending for another 12-month term. Most banks make no demands on clients to make principal repayments. As a result many clients pay only interest, without repaying any principal, year after year. Analysis of both the supply and demand has found that this product accounts for the vast bulk of small business lending in Nepal. According to the 2006 Access to Financial Services Survey, 40 percent of bank loans to small businesses have a maturity of five years or more.

Neither type of overdraft is appropriate for small businesses, as they neither instill discipline in clients who have limited experience with formal borrowing nor test their capacity to repay or cope with increasing debt. Even if a client repays interest on time, the bank has no way of knowing whether the business could repay the debt and what the real quality of the loan is. This, understandably, also discourages banks from increasing financing—even after many years of working with a client.

From a risk management perspective, it is not a good idea to extend overdrafts to small businesses whose turnover does not pass through the account. Under term loans with monthly installments, the lending bank quickly realizes if a business is deteriorating—as evident from smaller repayments—and can take immediate appropriate action. With credit lines, where businesses only have to repay interest, the bank is unlikely to realize that there is a problem until later, at which point it may be too late to take appropriate action and collateral may have disappeared. Furthermore, when problems develop with credit lines, the entire amount is usually outstanding and at risk—while with standard loans, clients have usually made a number of principal repayments, lowering losses to banks.

PRICING POLICIES THAT IMPEDE COST RECOVERY

Bank loans to small businesses do not seem to adequately reflect the cost of serving this market segment. To serve this segment on a sustainable basis, banks must be able to make a profit. While profitability analysis is bank-specific, the interest rates that Nepalese banks charge to small businesses appear too low to make this segment profitable. Banks charge almost the same interest rates to small businesses as they do to large corporations: 8–10 percent a year, with application fees of 0.5–1.0 percent of the loan amount and annual renewal fees of about NRs 1,000 for loans of NRs 1 million. With annual inflation running at about 5 percent, loans to small businesses do not provide banks with a very strong income stream. Profits are

further eroded by the relatively high portfolio at risk for such loans.

The costs of making small loans will always be higher (in percentage terms) than the costs of making larger loans—even if banks substantially lower transaction costs. Accordingly, in countries where small business lending is profitable, interest rates on small loans are usually higher than rates on large loans, given that retail purchases are more expensive than bulk purchases.

By offering low interest rates to small businesses, Nepalese banks make lending to them unprofitable—leading to their exclusion from the formal financial sector. The 2006 Access to Financial Services Survey found that small Nepalese businesses consider faster service and lower collateral requirements more important than lower interest rates. As noted, 72 percent of small businesses regularly buy on credit from the informal sector, despite its much higher interest rates, because they prefer its faster lending. But if banks were able to lend profitably to small businesses, they could also contribute to their development by giving them access to the formal financial sector and its wider array of loans and services.

LITTLE USE OF MOVABLE COLLATERAL

Banks require high levels of immovable collateral, yet small businesses tend to have only movable assets. The high-risk structure used by Nepalese banks for small business lending and the absence of appropriate lending products encourage banks to focus on collateral. Although banks will accept a mix of collateral, including inventory, collateral that is not real estate is generally accepted only as additional collateral.¹ In fact, securing a loan with movable collateral is not technically secure in Nepal. Because there is no secured transactions registry for movable assets, it is virtually impossible for a bank to verify whether another lender has a priority claim over the same assets.

Given the risky loan structure and the difficulties that banks face in seizing the collateral of defaulting borrowers, banks not only demand high levels of collateral, they are also very restrictive on what constitutes acceptable real estate collateral. Typically, real estate used for collateral must be within city limits and have direct road access—meaning that only prime urban real estate is accepted. This approach both greatly restricts the pool of small businesses with sufficient collateral to obtain loans and limits the amount of financing they can obtain. Most small businesses do not own enough high-quality urban real estate to provide as collateral for bank loans. The only real estate owned by many small businesses is their family home, which is often located in areas that banks are unwilling to accept. Potential female borrowers are at a particular disadvantage because they are usually not the legal owners of the family home. But small businesses do have movable assets that could be used as collateral, including vehicles, machinery, equipment, generators, inventory, and other personal goods.

LIMITED MEASUREMENT OF SMALL BUSINESS LENDING PERFORMANCE

Although Nepalese banks have sophisticated management information systems, they generally do not use them to measure the performance of small business lending. Given the lower profit margins on each small business loan, it is crucial to monitor the efficiency and portfolio quality and ensure that staff incentives are aligned with these goals. Most Nepalese banks have sophisticated information systems that allow them to monitor the efficiency of individual staff members and lending departments, yet such efficiency is rarely monitored—and staff rewards are usually unrelated to efficiency or the quality of the portfolio that they manage.

BANKS NEED TO SERVE SMALL BUSINESSES—NOT THE OTHER WAY AROUND

Lending to small businesses requires profound changes in the culture of banks and their staff. Private banks focus on sophisticated corporate clients and wealthy individuals. To be successful small business lenders, private banks need to adapt to this market segment—which is not used to working with banks. In particular, private banks need to understand the needs of small businesses. They also need to learn how to communicate with small business owners and build trust.

Public banks need to become more customer-oriented. In addition, the levels of efficiency and productivity needed for profitable small businesses requires that banks, whether public or private, significantly change how they do business. This can be a challenging and painful process, as changes are required at every level of the institution—from loan officers to lawyers to top managers. Managing the needed cultural changes is a major challenge for banks that embark on lending to small businesses.

LAWS AND REGULATIONS SHOULD FACILITATE LENDING TO SMALL BUSINESSES

Although Nepal's legal and regulatory framework is not necessarily a binding constraint on small business lending, it could be improved to facilitate bank loans to this market segment. An analysis of this framework has found that it is not hampering small business lending. But the lack of a secured transactions registry for movable collateral, limited functions of the credit bureau, and certain loan loss provisioning rules do not facilitate lending to these businesses:² The main obstacles in the legal and regulatory framework are that:

- **Nepal has no registry to record pledges on movable collateral.** Although pledges on immovable assets are registered in the land registry, there is no registry to register liens on movable assets. Nepal's parliament approved a secured transactions law in 2006, but the law cannot be implemented because no registry has been created. Such a registry is crucial for ensuring that lenders that want to use an asset

as collateral can ascertain what rights other lenders may have over the same asset. A centrally held, public registry also provides a convenient method for determining the hierarchy of competing claims on the same asset by different lenders.

■ **The credit bureau covers only loans above NRs 1 million and is slow in generating credit reports.**³ Because the credit bureau requests information and keeps records only for borrowers with loans above NRs 1 million, it is not useful for small business lending. And although the bureau is supposed to generate credit reports within three days, in practice it generally takes a week for banks to receive them. This delay slows the growth of loan portfolios for small businesses. In addition, the credit bureau provides limited information on borrowers—for example, its reports do not provide historical information on borrowers, whether they have other loans, and the number of days other outstanding loans have been overdue.⁴ Finally, because banks provide the bureau with information only on a quarterly basis, it takes a long time for the bureau to update its records. As a result credit bureau reports are often up to six months out of date.

■ **Loan loss provisioning rules—especially for short-term loans—are too lax and do not create the right incentives for stringent monitoring of small business lending.** Nepal Rastra Bank regulations for loans less than a year require that only principal repayments be considered when calculating arrears. Moreover, if a loan is secured with tangible collateral registered in the appropriate office, provisioning is calculated as shown in table 3.3.⁵ Given that small business lending is usually short term, that banks need to test the capacity to repay of previously unbanked clients, and that to achieve profitability on small business lending the portfolio at risk above 30 days has to be very low, current low provisioning requirements could encourage banks to undertake lax supervision of their small business loan portfolios.

TABLE 3.3

Loan loss provisioning requirements

Indicator	Pass	Substandard	Doubtful	Loss
Length of arrears (months)	Less than 3	3–6	6–12	More than 12
Amount of provision (percent)	1	25	50	100

Source: Nepal Rastra Bank.

■ **On the other hand, provisioning requirements for loans secured only with personal guarantees are too stringent—discriminating against small businesses that cannot offer immovable assets as collateral.** Most small businesses can offer only movable collateral and personal guarantees as collateral. But because Nepal has no registry for liens on movable assets for the purpose of calculating provisioning, such loans are considered secured only with personal guarantees. As such the loans are subject to an additional 20 percent provisioning requirement even if they are serviced on time—making small business lending more costly for banks.⁶ Although

it is generally prudent to require tangible and registered collateral, this discourages lending to small businesses. Priority sector loans insured with the deposit insurance and credit guarantee corporation are exempt from this higher provisioning requirement, but such lending is expected to be phased out in 2007.⁷

■ **Penalties for priority and deprived sector lending discourage banks from charging appropriate interest rates for small business lending.** Although banks can set their own interest rates, those that do not lend 4 percent of their portfolios to the priority sector and 3 percent to the deprived sector are subject to fines—which are calculated by multiplying the shortfall amount by the highest interest rate that the bank charges its clients. This approach obviously discourages banks from charging appropriate interest rates to small businesses.

WHY HAVEN'T MICROFINANCE INSTITUTIONS PROVIDED MORE FINANCIAL SERVICES TO LOW-INCOME HOUSEHOLDS?

Microfinance institutions play a key role in providing financial services to low-income households (those in the bottom three spending quintiles). Yet many microfinance clients prefer to save and borrow with the informal sector. Financial NGOs and cooperatives, followed by microfinance development banks and regional rural development banks, are the largest providers of financial services for low-income households. Still, many microfinance clients prefer to use the informal sector for deposit accounts and loans (see chapter 2).

The reason is that informal providers offer products and services better suited to the needs of low-income households—that is, with quick availability and no requirement for immovable collateral. Low-income households are much more likely than wealthier ones to have irregular incomes. In addition, many of their non-routine expenditures are for health care. Thus they often require quick access to financial resources. Moreover, half of Nepal's low-income households cannot use their homes as collateral because they do not have the required documents and because their dwellings are in a bad area, in poor condition, or both. Informal providers better serve the needs of such clients by offering faster service and requiring no collateral. A third of the bottom three quintiles (the largest proportion) said that they borrowed informally because formal financial institutions take too long to provide loans. Moreover, less than 10 percent of informal loans are secured with collateral, compared with 64 percent of formal ones.

The limited ability of formal microfinance institutions to adequately serve low-income households is reflected in their poor outreach, sluggish growth, high liquidity, and low profitability. Although regulated microfinance institutions represents only the tip of the iceberg of Nepal's microfinance sector, they are broadly representative of the sector—if not better performing.

Several factors explain the poor state of the formal microfinance sector in Nepal, including the complicated geo-political environment, weak technical capacity, lack

of commercial orientation, and distortions arising from deprived sector lending policies. These factors affect the sector's profitability and are discussed below.

COMPLICATED GEO-POLITICAL ENVIRONMENT

The geo-political environment of Nepal—a mountainous country that has been experiencing conflict in recent years—poses significant challenges. The performance of many small farmers cooperatives and financial NGOs and cooperatives has been severely affected by the insurgency.⁸ The conflict has affected all formal microfinance providers, though to different degrees depending on their location and ownership structure.

Although microfinance development banks have faced difficulties, they have been able to keep looting under control by maintaining good relations with clients and with insurgents in their areas. Regional rural development banks are perceived by the general public as being government institutions, making them particularly vulnerable to the insurgency. As a result their operations have been badly affected. These banks have experienced frequent thefts of cash, physical threats to their employees, and damages to their properties. To mitigate risks, microfinance providers have developed a number of strategies, including minimizing cash transfers and disbursing loans immediately after collecting repayments. Microfinance providers have also spent time explaining to Maoists that their microfinance activities benefit the population.

WEAK TECHNICAL CAPACITY

Formal microfinance institutions suffer from limited capacity in key technical areas such as accounting and auditing, strategic planning, financial analysis, and human resource management. This weak technical capacity clearly slows the sector's growth. Most microfinance providers face similar challenges: a lack of professionally trained staff in technical areas, weak internal control systems, no internal or external audit mechanisms, inadequate management information systems, and low capacity for product development.⁹

Although the Rural Microfinance Development Center has provided crucial capacity building and “hand holding” support to its borrowers, it has limited resources for such activities. Significant additional efforts are required to build capacity in the sector—both for providers of technical assistance to microfinance providers and for the sector itself.

LACK OF COMMERCIAL ORIENTATION

Lack of commercial orientation and slow professionalization of the sector hamper its profitability; many still consider microfinance a charitable activity. By design, NGOs do not have a commercial orientation. In addition, they tend to have weak governance structures, due to lack of clear ownership. That is why the NGO legal form is inappropriate for providing sustainable microfinance. Accordingly, many

NGOs in other countries aiming to evolve into strong microfinance institutions have chosen to transform themselves into companies.

This transformation has also occurred in Nepal with the creation of Nirdhan Utthan Bank Limited, the Development Project Service Center Development Bank, Chhimek Bikas Bank, and Swambalamban Bikas Bank from their respective NGOs. Government ownership of the five regional rural development banks also undermined their commercial orientation (which explains efforts to privatize them; see box 1.4). Similarly, the four private microfinance development banks do not have a strong commercial orientation.

DISTORTIONS ARISING FROM DEPRIVED SECTOR LENDING POLICIES

Deprived sector lending has led to high liquidity and distorted capital adequacy ratios among formal microfinance institutions. The balance sheets of Nepal's licensed microfinance providers have extremely high levels of liquidity, with investments and liquid funds accounting for more than 20 percent of assets in all these institutions (see figure 1.4). This situation is particularly striking for microfinance and regional rural development banks (with this figure approaching 40 percent) and financial NGOs (with this figure approaching 50 percent). This high level of liquidity is matched by high loans, which account for more than 60 percent of liabilities for financial NGOs, regional rural development banks, and microfinance development banks. (In contrast, loans represent only 2 percent of liabilities for financial cooperatives.) Not surprisingly, the Rural Self-Reliance Fund has large undisbursed amounts of loans, while the Rural Microfinance Development Center has committed the full amount available only after nine years of operations.

Such high levels of liquidity and loans are a result of the deprived sector lending window. In some cases, because commercial banks are uncertain about the capacity of some microfinance providers they lend to, they ask the providers to invest these low-cost funds (with annual interest rates of 3–5 percent) in fixed deposits. The microfinance providers earn a profit on these investments; the interest rate margin is usually 2–3 percent. In other cases commercial banks trust microfinance providers to onlend the funds, but the provider might not have the retail capacity to do so. Deprived sector lending also has a perverse effect on the capital adequacy ratios of microfinance providers, because it inflates the ratios for institutions (particularly financial NGOs) that receive high levels of deprived lending and entrust these funds to banks or financial companies instead of onlending them to their clients.

LOW PROFITABILITY

These various obstacles translate into low profitability in the formal microfinance sector. In 2005 only 8 of 20 financial cooperatives and 4 of 47 financial NGOs recorded profits over NRs 1 million. And despite Nepal Rastra Bank's reform program, just two of the five regional rural development banks recorded profits that year. Moreover, the one privatized regional rural development bank made a

profit only due to income from its investments in deprived sector lending by other financial institutions. Still, all four microfinance development banks are profitable, though historical data indicate that this profitability is fragile. For example, Nirdhan Utthan Bank Limited recorded losses until July 2004, with its financial performance improving only recently.

OTHER OBSTACLES AND ISSUES

Other obstacles in the formal microfinance sector are more specific to the type of institution. For instance, financial cooperatives do not properly manage delinquency, which is often blamed on their self-governance structure. Regional rural development banks also face difficulties linked to their governance structures. These banks generally do not have active boards of directors; their boards are made up of government officials who are not in a position to give adequate attention to the performance of the banks' management and who lack understanding of and technical expertise in microfinance. In addition, it is questionable whether the strategy chosen by Nepal Rastra Bank to privatize regional rural development banks—selling their shares to their clients—will allow for the best governance structure. Overall, microfinance development banks perform better than other microfinance providers. But they also have weaknesses that hamper their growth. Their management systems have not improved in line with their outreach and experience, and their accounting and internal controls should be strengthened. Accordingly, microfinance development banks have not been able to keep pace with international best practices in microfinance.

Still, even though the current regulatory framework is convoluted and confusing, especially for consumers (who often do not know which microfinance institutions are regulated and which are not; see appendix A), it does not appear to be hampering the growth of the formal microfinance sector. An assessment of the legal and regulatory microfinance framework has found that none of the prudential requirements are a binding constraint.

Looking ahead at the potential growth of Nepal's formal microfinance sector, a major source of confusion in the legal and regulatory framework involves the possible participation of foreign institutions (including for-profit ones). Different texts make contradictory statements. The Bank and Financial Institution Act (2006) says that licensed microfinance institutions can obtain loans or grants from any licensed institution or domestic or foreign organization or association. But a recent publication from Nepal Rastra Bank says that foreign institutional investors (except foreign individuals, who are barred altogether) can hold a minimum of 10 percent to a maximum of 51 percent stake in microfinance development banks (Golden Jubilee 2005). Such stake should not effect the public allocation (30 percent).

For regional rural development banks the same publication says that, under the government's five-year restructuring program, Nepal Rastra Bank is restructuring the banks and divesting its majority shares of profitable ones—maintaining 10

BOX 3.3

RWANDA'S MICROFINANCE CRISIS

Hundreds of savings and credit cooperatives have emerged in Rwanda over the past decade, building a base of depositors three times that held by commercial banks. In June 2006 the Central Bank of Rwanda announced the immediate closure of eight of these cooperatives—citing gross mismanagement, significant losses incurred due to poor credit management, failure to meet minimal conditions for licensing, and loss of customer confidence. These closures resulted in massive withdrawals of deposits from many of the county's savings and credit cooperatives, and discouraged new deposits.

In explaining the closures, the governor of the central bank said that it could not “remain indifferent to the situation currently prevailing in the microfinance sector, where people risk losing their savings placed in some of the microfinance institutions, and therefore compromising the future of this sector in Rwanda.” This announcement led microfinance stakeholders to wonder whether the measure taken by the central bank would serve as a warning to other savings and credit cooperatives engaged in improper dealings to clean up their acts—or further lower confidence in the sector, leading to a rush by clients to withdraw their savings and resulting in the bankruptcy and eventual closure of many others.

The central bank later announced that it would pay back half the money owed to depositors in the closed cooperatives at the branches nearest them. It also promised to sell the assets of the closed cooperatives and enforce payment of their default loans before reimbursing the remaining amounts owed to depositors.

This crisis originated in November 2005, when the central bank closed a savings and credit cooperative for gross mismanagement and poor credit management that led to bankruptcy. At that time the central bank also issued several warnings to other institutions cited to have improper dealings. These actions caused many people to lose confidence in the microfinance sector and rush to withdraw their savings, leading to the bankruptcy of a number of cooperatives. Deposits in the nine cooperatives closed by the central bank totaled about \$6 million.

Source: Nshuti 2006.

percent of the banks' equity while selling 40–50 percent to clients and employees (see box 1.4). That publication says that to make the financial sector attractive to foreign investors, the 50 percent ceiling on ownership by foreigners has been increased up to 75 percent. Yet Save the Children US expressed interest in buying shares of Nirdhan Utthan Bank Limited and Nepal Rastra Bank denied it, without clear reason. Allowing international microfinance investors could have a positive impact on Nepal's formal microfinance sector, providing crucial equity capital and possibly new dynamism.¹⁰

Moreover, supervision of the microfinance sector is not robust: institutions that pose no systemic risk are supervised while large ones are not, and supervisory capacity is very weak. Of the 76 microfinance institutions that Nepal Rastra Bank

currently supervises, 47 are financial NGOs, which account for only 3 percent of the deposits of regulated institutions. Some of these NGOs have fewer than 200 clients. Moreover, as noted, the regulated microfinance sector only represents the tip of the iceberg; there are a lot more microfinance players about which little is known. In addition, the institutions currently regulated are not adequately supervised. In fact, inspection visits take place only once every two to three years, and inspection teams lack sufficient understanding of and experience with microfinance. This is partly due to the lack of relevant skills in Nepal Rastra Bank's Financial Institutions Supervision Department, as well as the constant rotation that the bank's staff undergo (changing positions every three to four years). This rotation is intended to stem corruption, but it prevents specialization and supervisory expertise.

Because of the haphazard way in which microfinance institutions have been licensed and the legal and regulatory framework is applied, microfinance consumers find it difficult to understand which institutions are supervised. In addition, the fact that many small institutions are supervised while large ones often are not does not allow supervisors to have a pulse on the sector and foresee possible crises. Crises can occur in the microfinance sector just as in the banking sector (box 3.3).

WHY DO INFORMAL CHANNELS DOMINATE THE REMITTANCE MARKET?

Bringing remittances into the formal financial sector offers considerable benefits for Nepal and its migrants. Using formal channels reduces the risk of money laundering and financing of illegal activities. Formal channels also present benefits for migrants and their families, as they can gain access to other financial services and eventually save.

Yet formal remittance services are scarcely used in Nepal, because money transfer operators—by far the most popular formal channel—have a limited presence on the India-Nepal corridor, Nepal is primarily a cash economy, and low-income and rural households have limited familiarity with the financial sector (see chapter 1). The 2006 Access to Financial Services Survey found that only 31 percent of households receiving 0 most preferred channel.

Analysis of the remittance market has shown that since money transfer operators entered the market in 2001, remittance services have improved substantially, with remittances being delivered in a day or two at relatively low cost, even in remote areas (see boxes 1.5 and 1.6). Still, money transfer operators are not very active in the India-Nepal corridor due to legal and regulatory constraints in India. The proximity and ease of entry for migrants (no visa is required) also explain some of the reasons for the widespread informality of remittances in the India-Nepal corridor. And as noted, informal channels are used less due to limited familiarity with the financial sector—especially by low-income and rural households, which tend to emigrate more—and a perception that family and friends are safer delivery

mechanisms, rather than to a lack of alternatives.

Large shares of remittance transfers are used to repay loans (most likely incurred during the immigration process), reducing the potential impact of remittances on household welfare. Evidence from the Access to Financial Services Survey and an analysis of migration between Nepal and Qatar shows that, for lack of pre-migration financing schemes, many migrants end up borrowing from staffing agencies at high interest rates. The migrants' families then use large portions of the remittances to repay interest and principal.

CHAPTER 3 NOTES

1 Notable exceptions include consumer loans for buying vehicles, which are secured with the vehicles themselves. For such loans the bank is registered as the owner of the vehicle until the loan is fully repaid, which effectively makes such loans capital leases. But because there is no register for pledging vehicles or other movable assets as collateral, even if a borrower has a vehicle that could be used as collateral for a working capital loan, banks do not accept such items as primary collateral.

2 This report does not analyze the regime for immovable collateral, because this is a complex topic that requires separate analysis. But a recent World Bank analysis of creditor rights identifies the weak institutional capacity of the land registry (where mortgages are also registered) as the main obstacle to a well-functioning banking system.

3 Nepal Rastra Bank, Unified Directive 12, 16 July 2005.

4 Such data are reported if the borrower has a loan larger than NRs 2.5 million or has been blacklisted—that is, the borrower has loans overdue for more than six months, is bankrupt or has disappeared, and the like.

5 The number of months of arrears is the most important criterion for assets classification, and loan loss provision is based on the entire amount outstanding (that is, without deducting the value of collateral).

6 Nepal Rastra Bank, Unified Directive 2, 16 July 2005.

7 Nepal Rastra Bank, Unified Directive 2, 16 July 2005.

8 A Rural Finance Nepal (2004) study of 125 small farmers cooperatives found that 34 had been attacked by Maoists. Six lost their offices through fires, destroying important documents. In addition, the study found that local Maoist commanders put pressure on the cooperatives to lower their loan interest rates and encouraged farmers not to repay loans. Maoists are thought to have become more hostile toward community and development work in general, and consider the cooperatives an extension of the Agricultural Development Bank—an institution that, since the conflict began in 1996, has been a prime target. By destroying the loan records of Agricultural Development Bank branches, Maoists assume that farmers will not have to repay their loans.

9 This weak capacity is confirmed by ratings provided by Micro-Credit Ratings International Ltd. (M-CRIL) of 7 microfinance providers: Bindabasani Savings Cooperative Society Limited (BISCOL), Forum for Rural Women Agency Development (FORWARD), Jeevum Vikas Samaj (JVS), Nirdhan Utthan Bank Limited (NUBL), Pashchimanchal Grameen Bikas Bank Limited (PGBB), Swabalamban Bikas Bank Limited (SBB), and VYCCU. The ratings are available at <http://www.themix.org>, and range from alpha minus for BISCOL and SBB, to beta for FORWARD, PGBB, and VYCCU, to beta plus for JVS and NUBL. On a scale of 1 to 10, alpha minus represents 5, beta plus 6, and beta 7.

10 <http://www.mix.org> provides example of such investors, including Responsibility and Unitus.