

MAKING THE FINANCIAL SECTOR WORK FOR SMALL BUSINESSES AND LOW-INCOME HOUSEHOLDS

This chapter provides some conclusions and offers suggestions for improving access to financial services for small businesses and low-income households. Efforts should focus on strengthening the enabling environment and institutions with the potential to expand such access.

KEY PRINCIPLES FOR SUCCESSFUL GOVERNMENT INTERVENTION

Empirical international evidence has shown that stable, privately owned financial sectors do not necessarily create inclusive financial systems. Hence governments have a reason to be concerned about expanding access. Yet there is limited understanding of the issues that are important to expanding access.

Although this is a relatively new area of economic development, general consensus has been reached on two principles:

- Government is better placed to act as a facilitator rather than a direct provider of financial services.¹ Facilitation involves creating an enabling environment and, if needed, supporting initiatives that can help private institutions increase access.
- Any effort to expand access should address sustainability issues among providers of financial services—that is, help them profitably reach their desired market segments, rather than require them to lend to specific sectors or open branches in specific areas.

These principles have already been proven true in Nepal. Despite government efforts, regional rural development banks are the worst-performing microfinance institutions, and their branches remain concentrated in the Central region. Meanwhile, as priority sector lending requirements have been reduced, banks have withdrawn from the sector. And despite its high liquidity, the microfinance sector's loan portfolio is stagnating.

HELPING BANKS EXPAND LENDING TO SMALL BUSINESSES

Priority sector lending, which sought to increase access to credit by small businesses, is considered a burden by banks. Almost 40 years after such lending was introduced, banks are reducing it as Nepal Rastra Bank lowers requirements for it. Banks perceive priority sector lending as a sort of annual tax that they must pay to do business, as they are not equipped with the right products, procedures, and lending technologies to serve small businesses profitably.

Public banks are struggling with negative equity, and profitable private banks have few incentives to seek out new markets or develop products for new market segments. If left to their own devices, banks would probably develop appropriate lending methods for small businesses—but only after a few years, as competition increases in the corporate and consumer segments. Nepal's government could undertake two initiatives to expedite this process: encourage financial institutions with potential to move the market frontier forward and develop an appropriate enabling environment.

INITIATIVE 1:

Create a technical assistance fund to help banks with potential develop appropriate products and procedures for profitable lending to small businesses.

With help from its development partners, the government could support grant-funded technical assistance programs to help selected banks adapt their lending procedures to significantly increase small business lending.² This technical assistance should focus on removing the key obstacles to increasing such lending, identified in chapter 3.

Not every bank will be a suitable candidate for small business lending, so technical assistance should be given only to those fully committed to it. Profitably serving small businesses is not just about introducing new products and procedures: it also requires changing the entire corporate culture and the way that banks operate. Hence technical assistance should go only to banks whose investors' mandates fit these changes. While it may seem unfair to target technical assistance to a small group of banks, long-term effects are rarely achieved when such assistance is spread too thinly. Similarly, when technical assistance is spread among a lot of institutions, it ends up including those whose managers are not fully committed to the intended outcomes—often with disappointing results. Moreover, focusing on a small group of banks and helping them achieve profitable small business lending will force the rest of the market to take note and follow suit.

Banks with large branch networks and a focus on retail lending usually have a comparative advantage in entering this market segment (box 4.1), but smaller private banks can also be targeted to serve as catalysts. In Nepal, Nepal Bank Limited and possibly the Agricultural Development Bank could serve as the large banks.³ But

while Nepal Bank Limited has already undergone major changes, the Agricultural Development Bank still needs to prove that it can be turned around.

Although small business lending programs have been very successful in state-owned banks with large networks in the medium term, these banks are often slow in implementing the required changes at the beginning. This is why technical assistance should also be given to a few other banks—including smaller, faster-moving private banks. But while such banks are faster in implementing changes at the beginning, acting as a catalyst for the state-owned banks, they reach a plateau after a few years due to their smaller networks.

The technical assistance program should be comprehensive and cover the entire loan cycle. The program should last at least two years and involve resident advisory teams. It should include a redesign of bank products to meet client needs, a robust management information system, and a scheme to ensure that staff incentives are aligned with banks' efficiency targets.

Finally, the technical assistance program should include performance agreements identifying minimum targets, signed by the partner bank and the technical assistance provider (and its funder, if a different institution). These agreements should specify the number and volume of loans disbursed and outstanding to be achieved by a given date, as well as an indicator of portfolio quality (such as keeping

BOX 4.1

CAPITALIZING ON A LARGE BRANCH NETWORK: KHAN BANK

In 1991 Mongolia created Khan Bank from the assets of a former state bank, with the goal of serving rural areas. After being placed under receivership in 2000, Khan Bank was recapitalized and put under a restructuring plan. A large component of the restructuring involved downsizing.

The bank was privatized in 2003. Between December 2001 and June 2006 its loan portfolio grew from \$9 million to \$149 million. In 2006, 76 percent of its loan portfolio was in rural areas, business loans accounted for 45 percent of all loans, customer loans for 28 percent, and agricultural loans for 26 percent, and the portfolio at risk over 30 days was just 2.5 percent. In June 2006 Khan Bank had 410 branches—all of them profitable.

Early in its restructuring, Khan Bank implemented a technical assistance program to increase lending to small businesses, which helped the bank refocus on its comparative advantage (having Mongolia's largest branch network). The program started by developing simple, standardized products with simplified, decentralized approval processes. The new products and procedures were piloted in a few urban branches, then soon rolled out to the entire branch network. This quick rollout was facilitated by the gradual delegation of authority and a training of trainers approach. Over time Khan Bank has increased its product range, and now offers a wide array of loan, deposit, and fee services. Loan products range from express micro loans, loans to small and medium-size enterprises, and crop and herder credits to pension advances, consumer loans, and large corporate loans.

the portfolio at risk over 30 days to less than 3 percent). These targets should be monitored monthly, and remedial actions should be taken if they are not met.

INITIATIVE 2:

Develop an enabling environment that makes small business lending safer, cheaper, and faster

Although the creation of an enabling environment will not move forward the market frontier per se, it would facilitate small business lending. A supportive environment would enable banks to lend profitably to small businesses—a market segment that usually lacks traditional collateral. It would also cut the costs of such lending and reduce information asymmetries. Although Nepal’s legal and regulatory framework does not impose any binding constraints on small business lending, the government could take a number of steps to facilitate it.

Creating a secured transaction registry would empower small businesses with movable collateral (box 4.2). The government could create a registry for charges over movable assets, allowing any small business with movable assets to use them as collateral. Before creating the registry, the government should conduct a thorough analysis to decide which institution should operate it. The registry should be based on the following principles:

- The system should permit charges on all kinds of assets, and should be centrally administered.
- A regime for secured credit should provide for effective publicity of charges on assets, enabling lenders to ascertain existing charges and enabling third parties to discover such prior rights.
- The registry should provide an easy method for determining the order of ranking between competing rights claimed on the same asset.
- Failure to publicize a charge should mean that no security right can be effective against third parties.
- The system for registering and accessing information should be simple, fast, and inexpensive. Modern technology should make it possible to obtain searches within a few minutes of the request.
- The register should be accessible by all citizens and businesses. Various contact points should be made available throughout the country.
- The system and its method for recording, storing, and accessing information should protect against error, abuse, and fraud.
- The registry should be managed transparently, and independent audits should be conducted regularly.
- The registry, whether public or private, should be required to report regularly to a supervising authority (EBRD 2004).

BOX 4.2

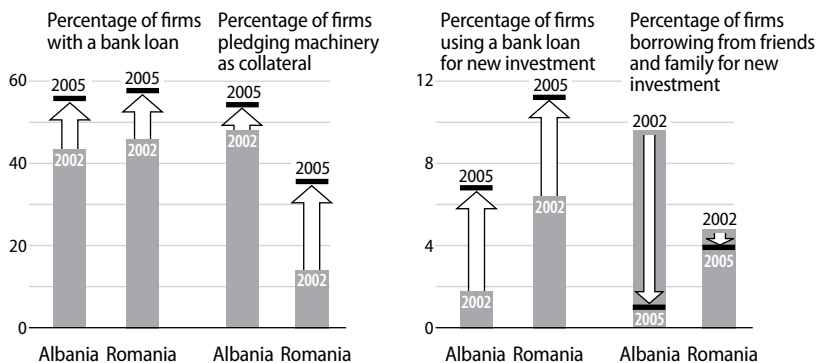
SECURED TRANSACTIONS AND SMALL AND MEDIUM-SIZE ENTERPRISE LENDING IN ALBANIA AND ROMANIA

In Albania, after a new law governing the use of collateral was passed and a pledge registry created in 2001, bank lending to small and medium-size firms increased by 10 percentage points between 2002 and 2005 (box figure 4.1). Romania had a similar experience. After reforming operations in its pledge registry in 2000, the number of small and medium-size enterprises with loans increased by 10 percentage points.

Although not all of the increase in small business lending can be attributed to reforms of secured transactions, the number of small and medium-size enterprises pledging machinery as primary collateral increased substantially between 2002 and 2005, from 40 to 45 percent in Albania and from 12 to 30 percent in Romania. At the same time, small and medium-size enterprises firms increasingly relied on commercial sources of finance (bank loans, financial leases) and less on informal sources (family, friends, moneylenders; box figure 4.2).

BOX FIGURES 4.1 & 4.2

Small and medium-size enterprise borrowing and sources of finance for new investments in Albania and Romania, 2002 and 2005



Source: Adapted from Safavian, Fleisig, and Steinbuks 2006.

Nepal Rastra Bank should strengthen its monitoring of small business lending and lower the costs of lending to this segment. It could do so by increasing overall loan loss provisioning requirements in line with international standards that make no distinction between short- and longer-term loans. It could also allow financial institutions to lend to small businesses (say, for loans under NRs 500,000) without registered movable collateral and without requiring extra provisioning, as banks become familiar with the functions of the new secured transactions regime and the registry is established and begins to function smoothly.

To reduce information asymmetries between lenders and borrowers, Nepal's credit bureau should be strengthened. A well-functioning credit bureau can greatly reduce such asymmetries—especially for small businesses, which often have limited credit histories. As a shareholder, Nepal Rastra Bank could upgrade the services provided by the bureau by:

- Ensuring that the bureau's data are electronically accessible by financial institutions, as this will shorten delivery times for credit reports and ensure that the bureau's information is up to date.
- Lowering the reporting threshold to the credit bureau to cover loans larger than NRs 100,000 (down from the current NRs 1 million).
- Requiring the bureau to include more information in its reports, such as historical data, information on how many days payments are in arrears, and information on other businesses of borrowers even if they are not blacklisted.

HELPING MICROFINANCE INSTITUTIONS SERVE MORE LOW-INCOME HOUSEHOLDS

For the past 40 years Nepal's government has supported a number of interventions aimed at increasing access to financial services for low-income households (defined here as those in the bottom three spending quintiles). First the government established financial cooperatives, then it introduced deprived sector lending, then it created regional rural development banks, and finally it sponsored the three apex microfinance institutions. In all these attempts the government either acted as the direct provider or required the private sector to lend to these households.

Yet few of these attempts have been successful, and the outreach of the microfinance sector remains limited. The root causes appear to be the sector's low capacity in technical areas and a charity mindset among many microfinance providers. The sector and the government should recognize that low-income households do not need charitable institutions, but instead service providers that meet their needs on time. To do so, microfinance institutions need to be professionally managed and profitable. The financial sector is not unlike other industries, where some companies focus on the low end of the market (such as Hindustan Leaver in India, Grameen Phone in Bangladesh, and McDonalds and Wal-Mart in the United States).

The government could be instrumental in promoting this new approach by undertaking initiatives that strengthen technical skills and reenergize the microfinance sector (including reforms of state-owned providers), and create a legal and regulatory framework that promotes consumer protection and stability.

INITIATIVE 3:

Promote the microfinance industry by upgrading technical skills, reenergizing the sector, and reforming state-owned providers

The government should articulate a vision for the sector by finalizing its microfinance policy. This policy should provide a roadmap on how to improve access to financial services for low-income households and identify that the shift in the sector is a priority. The government's role as a facilitator should increase, and its role as a direct provider decrease. The policy should also recognize that microfinance is not an appropriate tool for serving the poorest of the poor, as they do not have enough income to repay loans (box 4.3). Rather, dedicated grant programs should be established for the poorest to raise their living standards until they “graduate” to regular microfinance services. In formulating the policy, institutional consultations should occur at various levels, with a working group involving ministries, Nepal Rastra Bank, and microfinance institutions.

With the assistance of its development partners, the government could also create a technical assistance fund to upgrade the capacity of microfinance institutions in key technical areas and expand access to safe, microfinance services outside the Terai.⁴ Nepal's microfinance institutions need to be strengthened in several areas, including internal controls, management information systems, human resource management, product development, accounting, financial analysis, and business planning. Currently, microfinance institutions have neither the resources nor the incentives to buy such services. As a result there are no providers—such as information technology providers or accountants specializing in microfinance—of these types of services to the microfinance sector. To increase access to safe, professional financial services in less densely populated areas, new delivery mechanisms should be piloted. These could include linking community savings and loans associations to formal microfinance institutions and using technology to deliver financial services to such areas. As it stands microfinance institutions have no incentive to expand outreach because doing so would require investing in new products, and they have a more easily accessible market in the Terai.

The technical assistance fund should aim at strengthening the capacity of microfinance providers in key technical areas, working with service providers (auditors, information technology providers, consultants, trainers, the credit bureau, and so on) to build capacity to service the sector, supporting initiatives to increase microfinance outreach outside the Terai and help community savings and loans

BOX 4.3

MICROCREDIT—NOT THE ANSWER FOR SEVERELY DISADVANTAGED RURAL AREAS AND THE CHRONICALLY DESTITUTE

Microcredit is one of many interventions designed to alleviate poverty, generate income, and promote employment. But it is not a one size fits all solution. In choosing the most appropriate intervention for a specific situation, microcredit should be carefully evaluated against alternatives. In many cases savings and insurance services, microgrants, infrastructure improvements, employment and training programs, and other nonfinancial services may be more effective for reducing poverty and creating jobs. Microcredit is generally most appropriate for individuals or households that are already engaged in economic activities and have sufficient cash flows. Otherwise it may create an excessive debt burden.

Microcredit may also be inappropriate in immediate post-emergency environments, severely disadvantaged rural areas, and as an intervention for the chronically destitute. Moreover, microcredit is not recommended where there is dependence on a single economic activity or barter transactions; high risk of civil violence, natural disaster, or hyperinflation; or in the absence of law and order.

Grants, rather than microcredit, can best be used to overcome the social isolation, lack of productive skills, and low self-confidence of extremely poor people, preparing them for eventual use of microcredit. Microgrants and other financial entitlements can work well as first steps of comprehensive programs designed to move the poorest people from vulnerability to economic self-sufficiency.

An example of a graduated strategy is the Income Generation for Vulnerable Groups Development Program, offered by the Bangladesh Rural Advancement Committee. The program combines free food, skills training, health care, and savings creation in an 18-month program designed to graduate clients to the committee's mainstream microcredit program. Most graduated programs should, however, be implemented by multiple organizations working together.

Other interventions to strengthen the livelihoods of poor people include investments in public infrastructure (including roads, communications, and education), community-level investments in commercial and productive infrastructure (such as market centers or small-scale irrigation infrastructure), and nonfinancial services (from literacy and business training to business development services).

Source: Adapted from CGAP 2002.

BOX 4.4

XACBANK MONGOLIA: PROVIDING MICROFINANCE IN REMOTE AREAS

XacBank Mongolia, founded in 1998, is developing an interesting approach to reach remote villages and nomadic herders: the “franchise” service. Through this service the bank provides technical assistance to savings and credit cooperatives to help them become sustainable financial providers in remote rural areas. The service involves four main activities: organizing extensive training for the creation and establishment of rural savings and credit cooperatives, building the capacity of existing rural cooperative to enhance financial services, providing basic office equipment for new cooperatives, and giving cooperatives advisory and other technical support.

XacBank aims to offer rural clients the safety of a bank and the convenience of a local cooperative—at a cost that enables the bank to reach rural clients on a sustainable basis. By March 2006, 58 savings and credit cooperatives had received the franchise service. The portfolios of these cooperatives totaled \$351,000 in loans and \$73,800 in deposits. The cooperatives have more than 3,200 members, who have invested \$182,400 in total share capital.

Source: Adapted from CGAP 2006c and USAID 2005.

associations link up with microfinance institutions, and increasing the monitoring capacity of microfinance networks—for example, by promoting voluntary disclosure and collecting data on financial performance.

To speed up reforms, the government could facilitate the entry of a new demonstration institution in the microfinance sector. Such an institution should challenge the sector by introducing new ways of doing business and rapidly increasing its client base. This new player should have a sound track record in microfinance and a strong, committed board. To attract such an institutional investor, the government should first clarify whether foreign institutions—including equity funds—are allowed to hold shares in Nepalese financial institutions. A number of well-regarded institutional investors in microfinance have created equity funds that have invested in microfinance institutions in South Asia, Eastern Europe, Latin America, and Africa.⁵ To raise investor awareness of Nepal’s microfinance sector, the government could sponsor a fair for foreign microfinance investors.

The government also needs to continue restructuring state-owned regional rural development banks. Although the government’s reform program is a step in the right direction, given the six years since it began, it is appropriate to learn from its achievements to date. Two issues in particular need to be revisited: whether enough information was provided on the banks to be privatized, to ensure that the best privatization method was designed; and whether selling most of the government’s shares to clients was conducive to the best governance outcome—especially given the possible future growth of these institutions. Based on such an assessment

a program to improve the financial performance of these institutions, without decreasing their outreach, should be formulated and implemented.

Finally, management of the Rural Self-Reliance Fund should be professionalized, and the institution given greater independence. Since its creation in 1990 the fund has had mixed performance at best; a substantial portion of its loan portfolio is in arrears and, partly due to the high liquidity in the microfinance sector, it has disbursed just over of its available funds (see box 1.3). To improve the fund's performance, it is imperative that its management be professionalized and that it operate independently from Nepal Rastra Bank Professional management will also ensure that no conflicts of interest arise between the fund and its regulator (Nepal Rastra Bank).

INITIATIVE 4:

Create a legal and regulatory environment that protects microfinance consumers and promotes stability

The legal and regulatory framework for microfinance should be simplified to reduce confusion and strengthened to increase stability. Although the framework is not a major constraint to the sector's growth, the haphazard ways in which microfinance institutions have been licensed and the framework has been applied have led to confusion and weak supervision. First, microfinance consumers do not know which institutions are supervised and which are not. Second, supervision of the sector is weak, so supervisors rarely foresee or recognize the problems facing it. Finally, the fact that small institutions are often supervised while large ones are not does not allow supervisors to guarantee the sector's stability. To improve the legal and regulatory framework, the government should:

- Prioritize the institutions that should be supervised, to target only those that can pose a threat to the microfinance sector's stability. The 2006 Access to Financial Services Survey found that regulated microfinance institutions are only the tip of the iceberg in terms of service providers. To understand which institutions matter, the government should map the entire sector and develop quantitative criteria for licensing institutions. For institutions that do not meet these criteria and will not be regulated—and especially for financial cooperatives—the government should explore the possibility of auxiliary supervision (such as by the Nepal Federation of Savings and Credit Cooperatives).
- Develop a business plan for stronger microfinance supervision. Once there is agreement on which institutions need to be prudentially supervised, a business plan should be developed for the supervisory agency. This should address issues such as work plans (onsite supervision, offsite supervision), human resource requirements (number of staff, skills, training), and budgets. If the microfinance supervisory

agency is not the central bank, additional issues will need to be addressed, such as accountability and the legal nature of the agency.

- Review microfinance regulations and prudential requirements to simplify and clarify a number of points for industry participants. This would involve an analysis of the inconsistencies between different texts (for example, on foreign ownership of microfinance institutions) and possibly a rationalization of the different legal forms of microfinance institutions (for example, whether different legal forms are needed for regional rural development banks and microfinance development banks).
- Draft new legislation or amend existing legislation. This process should not be rushed, and should happen only once consensus has been reached on the regulatory and supervisory framework for microfinance institutions.

MAKING REMITTANCES MORE EFFECTIVE

The government should also take steps to increase the use of formal financial remittances, and to make such remittances more effective.

INITIATIVE 5:

Enhance the financial literacy of migrants and tackle legal and regulatory obstacles in the India-Nepal corridor to increase formal remittances.

Formal remittances could be increased by enhancing the financial literacy of migrants. Although migrants are required to undergo a two-day training course before departure, the course does not cover financial literacy. By introducing such a module, the government could raise awareness about the potential channels for sending remittances and the different costs, advantages, and disadvantages of each, and provide training on financial literacy.

In addition, the use of money transfer operators on the Nepal-India corridor could be expanded by lobbying India's central bank to address the legal and regulatory constraints involved. First, though, Nepal's government needs to map the legal and regulatory constraints facing money transfer operators. After doing so, it should initiate a dialogue with the Reserve Bank of India on this subject.

INITIATIVE 6:

Promote a viable loan scheme for migrants—one that reduces the share of remittances used to repay loans.

Finally, the proportion of remittances used to repay loans could be reduced by developing a viable loan scheme for migrants. To promote sustainable pre-emigration finance, the government should reform the existing scheme (see box 2.1) to ensure that formal lenders can select their clients and loans are linked to remittance

flows. These changes might help reduce reliance on the high-interest loans provided by the informal sector and staffing agencies. Such an arrangement would require cooperation from migrants' employers and lenders to deduct loan payments from wages at the source and transfer them to the borrower's account in Nepal, which could be under the name of the migrant worker or a beneficiary.

CHAPTER 4 NOTES

- 1 Notable exceptions are Brazil's Banco de Nordeste, Indonesia's Bank Rakyat, and Thailand's Bank for Agriculture and Agricultural Cooperatives.
- 2 A number of countries, including China and several in Eastern Europe and the Commonwealth of Independent States, have adopted similar schemes for both state-owned and private banks—generally with very successful results.
- 3 Rastriya Banijya Bank and the Postal Savings Bank could have the outreach to become retail banks. But Rastriya Banijya Bank appears to be too insolvent to fulfill this mandate. And despite its large branch network, the Postal Savings Bank is an insignificant player in the financial sector, and its staff lack even basic training in banking. The Agricultural Development Bank is included despite its poor financial performance because it has just been recapitalized and is undergoing changes in management.
- 4 Several countries have designed capacity building initiatives for their microfinance sectors. The Small Industries Development Bank of India provides funds for onlending coupled with capacity building funds (<http://www.sidbi.in/Micro/aboutus.htm>). Afghanistan's Microfinance Investment Support Facility provides similar support (<http://www.misfa.org.af>), and its approach is being replicated by Sierra Leone's Microfinance Investment and Technical Assistance Facility (<http://mitaf.esglobal.com/index.htm>).
- 5 For example, the Bangladesh Rural Advancement Committee (<http://www.brac.net>) created a new institution in Afghanistan and is expanding its activities in East Africa. Similarly, ACCION International (<http://www.accion.org>) and FINCA International (<http://www.villagebanking.org>) are developing networks of microfinance institutions in Africa and Latin America.