Executive Summary

Over the past 20 years Nepal's financial sector has become deeper and the number and type of financial intermediaries have grown rapidly. In addition, recent reforms have made banks more stable. Still, access to financial services remains limited for many people in many parts of Nepal and in recent years has been declining. This report examines the country's supply of and demand for financial services and the constraints to increasing access to them, and offers recommendations for making the financial sector work for all of Nepal's people, especially the poor.

The Supply of Financial Services

For much of the past 50 years Nepal's government has tried to increase access to formal financial services for small businesses and low-income households. (This report defines low-income households as those in the three bottom spending quintiles.) The government has introduced directed lending programs for small businesses and low-income households, required banks to open branches outside the Kathmandu valley, created specialized wholesale and retail institutions, and lowered market entry requirements to foster the development of different types of financial institutions.

Despite government efforts, access to formal financial services is declining. Financial intermediation is stagnating, the number of bank deposit and loan accounts per inhabitant is falling, and lending targets for low-income households have generated excess liquidity among microfinance institutions without significantly increasing their outreach. And despite 40 years of government mandates to lend to small businesses, banks have been withdrawing from this segment as these requirements have been lowered. Access to bank infrastructure has also decreased. Moreover, as a result of the government's efforts to increase access, the central bank (Nepal Rastra Bank) now has to supervise 180 institutions.

Even the large foreign remittances received by Nepalese households—mostly from migrant workers—seem to be a missed opportunity for increasing access to formal financial services. Despite the entrance of money transfer operators and the growth in formal remittance flows they have generated, the bulk of remittances enter the country informally.

The Demand for Financial Services

The findings of the 2006 Access to Financial Services Survey—conducted by the World Bank and Total Management Services in cooperation with Solutions Consultant as background for this report—confirm that use of banks is limited, financial NGOs and cooperatives play a large role in providing both deposit accounts and loans, and informal borrowing far exceeds formal borrowing.

Only 26 percent of Nepalese households have a bank account, and banks' procedures are perceived as being the most cumbersome among financial institutions. Accordingly, clients prefer not to save in them. Banks dominated in urban areas and among the wealthiest.

Financial NGOs and cooperatives run a close second as largest provider of deposit accounts, serving 18 percent of households. These institutions are the preferred provider for low-income households, but are close to banks even for wealthier households. Microfinance and regional rural development banks are a distant third provider of deposit accounts, serving only 4 percent of households—mainly poor, rural ones.

About 38 percent of Nepalese households have an outstanding loan exclusively from the informal sector, 16 percent from both the informal and formal sector, and 15 percent from only the formal sector (that is, a bank, finance company, financial NGO or cooperative, or microfinance or rural regional development bank). Family and friends are by far the largest informal providers of loans to households—and, contrary to common belief, family and friends often charge interest. Most households who borrow from informal providers do not bother trying to borrow from financial institutions, mainly because formal institutions cannot meet their financial needs on time. Informal providers also require less physical collateral. Even among the wealthiest households, half of those with a bank account prefer informal lenders because of their rapid delivery. Similarly, informal lenders are the preferred providers of working capital for small businesses, again because they are faster at sanctioning loans than are formal financial institutions.

Of households that borrow from the formal sector, financial NGOs and cooperatives are the largest provider of loans (except for the wealthiest households). They dominate the market for loans under NRs 50,000, even for households with a bank account. Banks are the second largest provider—mainly in urban areas and for loans larger than NRs 50,000. Microfinance and regional rural development banks are the third largest providers, serving mainly in rural areas and in the Terai. Finance companies are the least preferred formal lenders, and operate mainly in the Kathmandu valley.

Nepal's payment system is virtually unused for retail domestic transactions and little used for international ones. An estimated 69 percent of foreign remittances come through informal channels—usually family and friends—even among households with a bank account. Just 6 percent of remittances are saved in financial institutions. The bulk of foreign remittances are used for consumption and to repay loans—loans most likely incurred by workers to migrate to other countries.

In sum, both supply and demand indicators show that, despite government efforts, formal financial institutions do not serve the needs of most of the Nepalese population. And while access to and use of formal financial services are limited in general, the problem is more acute for small businesses and low-income households. Indeed, both access and use are closely correlated with business loan size and household income.

Why Have Government Efforts to Increase Access Failed?

Government efforts to increase access to formal financial services have not achieved their goals because they have focused on the symptoms of limited access—not the root causes. For example, the priority sector lending program, requiring banks to make loans to small businesses, has not addressed the sustainability of such lending. Similarly, the deprived sector lending program for low-income households has not addressed the microfinance sector's capacity to extend large volumes of loans.

Increasing financial access for small businesses and low-income households requires that financial institutions be able to serve these segments in a financially sustainable manner. Lending profitably to small businesses requires a high level of efficiency, while operating microfinance institutions with large outreach requires high levels of professionalism and technical skills. Nepal's financial institutions have struggled to meet these requirements.

Why Don't Banks Scale up Lending to Small Businesses?

Small businesses have very different features from large corporations—the traditional clients of Nepalese banks. To serve small businesses profitably, banks need to minimize transaction costs and generate large numbers of high-quality loans. But for many reasons, Nepal's banks find it difficult to serve small businesses profitably:

- Bank procedures for small business loans are too complex, making such lending unnecessarily long and expensive for both the businesses and the banks.
- The most popular bank product, overdrafts (lines of credit), is inappropriate for many small businesses, which do not deposit their revenues in banks.
- The interest rates that banks charge on loans to small businesses do not adequately reflect the costs of serving them.
- Banks require high levels of immovable collateral, while small businesses tend to have only movable assets.
- Although Nepalese banks have sophisticated management information

systems, they generally do not use them to measure staff and loan performance—which is crucial for profitable small business lending.

Although the legal and regulatory framework is not a binding constraint on bank lending to small businesses, it could be improved to facilitate such loans. Obstacles include:

- The absence of a registry to record liens on movable assets, which makes such assets almost unusable as collateral.
- The credit bureau only covers loans larger than NRs 1 million, and does not provide accurate and timely information.
- Loan loss provisioning rules—especially for short-term loans—are too lax and do not provide the right incentives for stringent monitoring of small business loans. At the same time, provisioning requirements for loans secured only with unregistered movable collateral and personal guarantees are too stringent, discriminating against small businesses that cannot offer immovable assets as collateral.
- The method used to calculate fines for not meeting priority and deprived lending targets discourages banks from charging appropriate interest rates for small business loans. (Fines are calculated by multiplying the shortfall amount against the highest interest rate that the bank charges its clients.)

Why Haven't Microfinance Institutions Provided More Services to Low-income Households?

Nepal's formal microfinance institutions could play a key role in delivering financial services to low-income households. Yet many potential clients of microfinance institutions prefer to save with and borrow from informal sources. The microfinance sector's limited ability to serve low-income households is reflected in its narrow outreach, sluggish growth, high liquidity, and low profitability.

Several factors explain the disappointing state of Nepal's microfinance sector, including:

- A complicated geo-political environment.
- Weak technical capacity in key areas, such as accounting and auditing, strategic planning, financial analysis, and human resource management.
- Lack of commercial orientation and slow professionalization—mainly because microfinance is often considered a charitable activity.
- Distortions arising from the government's deprived sector lending program that generate high liquidity among many microfinance institutions, as these institutions are encouraged to borrow beyond their needs and invest these low-cost funds in other financial institutions.

Although often cited as an obstacle, Nepal's legal and regulatory framework is not a binding constraint on the growth of the microfinance sector. Still, the framework for microfinance is convoluted and confusing. Although this framework is not hampering microfinance growth per se, supervision of the sector is problematic. Small institutions that pose no systemic risk are supervised, while larger ones are not—and supervisory capacity is weak. As a result microfinance consumers can be misled, and supervisors cannot ensure the sector's stability.

Why Do Informal Channels Dominate the Remittance Market?

Since 2001, when money transfer operators were allowed to enter Nepal's remittance market, formal remittance payments have increased and improved considerably—with formal remittances being delivered in a day or two at relatively low cost, even in remote areas. Thus it seems that the widespread use of informal channels is due to limited familiarity with the formal financial sector and a perception that family and friends are a safer delivery mechanism, rather than to a lack of alternatives. Moreover, India is the largest source of migrant remittances and, given its proximity and ease of entry, migrants tend to move quite often between it and Nepal. Finally, there appear to be legal and regulatory constraints in the India-Nepal corridor for money transfer operators.

How Can the Government Increase Access for Small Businesses and Low-income Households?

Although there is little theoretical knowledge of what expands access, several approaches have worked in practice, based on two principles. First, government should not require financial institutions to lend to specific sectors or open branches in specific areas. Rather, it should support financial institutions with potential to increase access sustainably, by helping providers profitably reach their desired market segments. Second, government must develop an enabling environment—for example, by promoting institutions that reduce information asymmetries between borrowers and lenders.

To help banks increase small business lending, the government could undertake two initiatives:

Initiative 1:
Create a technical assistance fund to help banks with potential develop appropriate products and procedures for profitable lending to small businesses.

Initiative 2:
Develop an enabling environment that makes small business lending safer, cheaper, and faster. Efforts should include:

- Creating a registry for secured transactions.

- Increasing loan loss provisioning requirements overall while reducing them for small loans without registered movable collateral.
- Strengthening Nepal's credit bureau.

To help microfinance institutions serve a large number of low-income households, the government could undertake two initiatives:

Initiative 3:

Promote the microfinance industry by upgrading technical skills, reenergizing the sector, and reforming state-owned providers. Efforts should include:

- Articulating a vision for the sector.
- Encouraging professionalization of the sector by supporting a technical assistance fund to upgrade capacity in key technical areas.
- Attracting a demonstration institution—that is, a commercially oriented microfinance player—to expedite change.
- Restructuring state-owned microfinance providers and apex institutions.

Initiative 4:

Create a legal and regulatory environment that protects microfinance consumers and promotes stability. Efforts should include:

- Reviewing the legal and regulatory framework for microfinance, with a view to simplifying it.
- Determining which institutions should be supervised, to target only those that could threaten the microfinance sector's stability.
- Developing a business plan for a stronger microfinance supervisor.
- Drafting new legislation or amending existing legislation.

To make remittances more effective, the government could undertake two initiatives:

Initiative 5:

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

Initiative 6:

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