

ECONOMIC ANALYSIS

A. Introduction

1. The Rural Enterprise Financing Project will increase subsistence small farmers' incomes by helping them engage in rural enterprises. The project will finance rural enterprises comprising collective enterprises that are jointly owned and operated by small farmers, and individual enterprises. The project will address rural enterprises' limited access to finance, which is currently unmet by private commercial banks and other formal financial institutions. By providing access to finance and value chain development support to small farmers, the project will generate rural employment opportunities, increase small farmers' incomes, and contribute to rural poverty reduction in Nepal.

B. Rationale

2. In Nepal, financial institutions are categorized into formal and semiformal institutions. Formal institutions are financial intermediaries that are licensed and supervised by Nepal Rastra Bank (NRB)—the central bank—and include commercial banks (class A), development banks (class B), finance companies (class C), and microfinance institutions (MFIs) (class D). The class D MFIs include formal MFIs (licensed microfinance development banks, microfinance nongovernment organizations [NGOs], and savings and credit cooperatives) and semiformal MFIs (unlicensed microfinance NGOs, and savings and credit cooperatives that provide financial services without an NRB license). In addition to those formal and semiformal financial institutions, informal financial services, such as loans from friends and relatives, are widely used in rural Nepal.

3. Despite the diversified financial institutions, access to finance is limited, especially in rural areas. Access gaps are most acute in the eastern, midwestern, and far western regions, which are sparsely covered by formal financial institutions. Also, financial services are concentrated within the urban and male populations. Of the total adult population, 61% are formally financially included. However, while 71% of urban adults are formally financially included, only 58% of rural adults are serviced by formal financial institutions (Table 1). Similarly, a persistent gender gap exists: while about 30% of Nepalese adult males have a bank account, only 21% of females do. Savings and credit cooperatives are important financial service providers, especially among members of the rural population who do not have access to banks. Of the total population, 29% of adults are members of formal or semiformal savings and credit cooperatives, and 9% borrow from them.

Table 1: Key Access to Finance Indicators in Nepal

Indicator	Share of Total Population (%)
Adults who have access to formal financial services	61
Urban adults who have access to formal financial services	71
Rural adults who have access to formal financial services	58
Adults who have access to semiformal financial services only	21
Adults who are financially excluded	18
Men who have bank accounts	30
Women who have bank accounts	21
Adults who take loans from financial institutions	46
Adults who belong to savings and credit cooperatives	29
Adults who take loans from savings and credit cooperatives	9

Sources: Nepal Rastra Bank; United Nations Capital Development Fund. 2014. *Making Access Possible: Nepal Financial Inclusion Country Report 2014*. Kathmandu.

4. Among the formal financial institutions, commercial banks (class A) dominate the sector. Of the total financial sector loan portfolio, commercial banks' share was 80.47%, followed by development banks (class B) (10.56%), finance companies (class C) (2.15%), and MFIs (class D) (6.82%). While finance companies operate in rural areas, their outreach is insignificant. Commercial banks' (class A) and development banks' (class B) loan portfolios are concentrated in the corporate sector in urban areas. Further, construction and trade are the dominant sector, comprising over 30% of banks' total loan portfolio. Banks' rural loan portfolio was estimated at 27% of their total loan portfolio as of March 2019.¹ Banks are not required to disclose their portfolios by loan size, and data on banks' loans to micro, small, and medium-sized enterprises (MSMEs) are not available. However, it is estimated that about 25% of the commercial banks' portfolios fall under the category of small and medium-sized enterprise loans (i.e., loans above NRs1 million and below NRs100 million).²

5. Because of the government's policy of enhancing access to finance for the poor, deprived populations, and the rural areas, Nepal has a relatively dense network of MFIs, including formal and semiformal savings and credit cooperatives (para. 2). Those formal MFIs, semiformal microfinance NGOs, and savings and credit cooperatives collectively reach over 5 million poor and low-income populations, the majority of which are in rural areas. MFIs mainly provide short-term microcredit (i.e., loans below NRs700,000) without collateral but based on group guarantee. Also, NRB allows MFIs to provide loans above NRs700,000 and up to NRs1 million for microenterprises with collateral.

6. Banks' portfolio concentration in the corporation in urban areas and MFIs' loan ceiling of below NRs1 million have created a vacuum of access to finance for rural enterprises. Commercial banks have limited interest in providing rural enterprise financing because of the high cost associated with serving rural clients with small-size loans. Because of their proximity to rural clients, MFIs, including savings and credit cooperatives, can be a significant source of rural enterprise financing. However, MFIs are constrained by their limited capacity and access to funding.

7. To address the rural enterprise financing gap, the project will provide a fund for wholesale loans for rural enterprise financing to the financial intermediary, Small Farmers Development Bank (SFDB), which is a class D MFI. The project will also provide capacity development support to develop SFDB's capacity in rural enterprise financing, including business appraisal, due diligence, risk assessment, financial management, and safeguards. For the project, a regulatory concession by NRB will be obtained for SFDB to extend loans above NRs1 million.

C. Rural Enterprise Finance Demand and Supply Gap

8. For the project's purpose, rural enterprises are defined as MSMEs in rural areas, and they include both on-farm and off-farm enterprises.³ In Nepal, there is no unified definition of MSMEs. The Industrial Enterprise Act of 2016 defines a microenterprise as an entity with fixed assets up to NRs500,000, a small enterprise as an entity with fixed assets up to NRs100 million, and a medium-sized enterprise as an entity with fixed assets of NRs100 million–NRs200 million. NRB

¹ Commercial banks' and development banks' rural portfolio is defined as the loan portfolio outside of metropolitan cities and sub-metropolitan cities.

² Beed Management Pvt. Ltd. 2018. *Demand Study on MSME Financing – Submitted to UKaid Sakchyam Access to Finance Program*. Kathmandu.

³ On-farm enterprises produce crops and livestock for commercial sale, and off-farm enterprises encompass all types of economic activities excluding subsistence agriculture and on-farm enterprises.

defines small and medium-sized enterprises as entities with fixed assets up to NRs50 million. However, these definitions do not match with the practices of actual rural enterprise financing. For this project, the target MSMEs are defined as microenterprises with fixed assets from more than NRs1 million to NRs10 million, small enterprises with fixed assets from more than NRs10million to NRs100 million, and medium-sized enterprises with fixed assets from more than NRs100 million to less than NRs150 million (Table 2).

Table 2: Definitions of Micro, Small, and Medium-Sized Enterprises

Entity	Industrial Enterprise Act, 2016	Nepal Rastra Bank Unified Directives	Project Definition
Microenterprise	Annual financial transactions up to NRs5 million; maximum fixed assets of NRs500,000		Fixed assets from NRs1 million to NRs10 million
Small enterprise	Maximum fixed assets of NRs100 million	Paid-up capital up to NRs5 million	Fixed assets from more than NRs10 million to NRs100 million
Medium-sized enterprise	Fixed assets between NRs100 million–NRs200 million	Fixed assets up to NRs50 million	Fixed assets from more than NRs100 million to less than NRs150 million

Sources: Industrial Enterprise Act, 2016; Government of Nepal, Ministry of Industry. 2010. *Industrial Policy 2010*. Kathmandu; Nepal Rastra Bank; Asian Development Bank.

9. The credit demand and supply gap for the whole MSME sector in Nepal as of March 2019 is estimated at NRs397 billion, and the one for rural enterprises is about NRs106 billion (Table 3). However, this is considered an underestimate because the credit demand from unregistered MSMEs is not included in the analysis because the data is not available.

Table 3: Rural Enterprises Credit Demand and Supply Gap

Type	Total No. of Enterprises		Total Loan Demand		Total Credit Supply		Demand Supply Gap	
			(NRs billion)		(NRs billion)		(NRs billion)	
	All	Rural	All	Rural	All	Rural	All	Rural
MSME	216,000	57,845	1,080	289	683.40	183.03	396.60	106.19

MSME = micro, small, and medium-sized enterprise.

Source: Asian Development Bank.

10. The demand and supply gap was assessed based on the following assumptions:
- (i) The total number of MSMEs was estimated at 300,000 based on the number of micro, cottage, and small industries registered at the Department of Small and Cottage Industries (290,459) and the number of small and medium-sized enterprises registered at the Department of Industry (5,952) in 2018. However, the estimate is considerably lower than the actual number of MSMEs because in Nepal, there are a significant number of unregistered micro and small enterprises. No data are available for the unregistered MSMEs.
 - (ii) Based on the Demand Study on MSME Financing, of the 300,000 estimated MSMEs, 72% are estimated to have credit demand. The remaining 28% either plan to avail themselves of informal sources of financing or do not require credit (footnote 2).
 - (iii) The number of rural MSMEs was estimated based on commercial banks' and development banks' portfolio outside of metropolitan cities and sub-metropolitan cities. However, this is also considered to be an underestimate because there are a substantial number of rural MSMEs that are unserved by banks.
 - (iv) The average size of MSME loans is estimated at NRs5 million.

- (v) The total credit supply is the formal financial institutions' aggregate total loans outstanding as of March 2019. The rural loan portfolio is estimated at 27% of the total commercial banks' and development banks' loan portfolio (para. 4).

D. Sustainability and Other Risks

11. SFDB was established in July 2001 and licensed by NRB as a class D MFI.⁴ It is an apex microfinance bank of cooperatives; small farmers agriculture cooperatives (SFACs) own 44% of the shareholding, the general public owns 30%, the state-owned Agriculture Development Bank Limited owns 22%, and commercial banks own 4%. As of 2018, SFDB had 680 member SFACs in 68 districts with 670,866 members, of which 75% were women.

12. SFDB is financially sound as indicated by its satisfactory capital adequacy ratio, low nonperforming asset ratio, and high return on equity and assets (Table 4). SFDB's capital adequacy ratio was 10% in 2018, above the statutory requirement for class D MFIs (8%). SFDB's total loan outstanding to SFACs amounted to NRs17 billion, with an on-time recovery rate of over 99%. SFDB's net income in 2018 was NRs393 million. Its return of equity is 22% and its return on assets is 3%. Under SFDB's lending policy, the individual borrower exposure limit is set at 25% of SFDB's core capital.

Table 4: Small Farmers Development Bank Key Financial Indicators

Particular	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
Net worth (NRs million)	883.12	987.55	1,301.86	1,607.54	1,970.6
Outstanding loans (NRs million)	5,305.81	7,981.44	10,850.51	13,775.83	16,633.25
Capital adequacy (%)	11.53	9.75	10.07	10.15	10.38
Recovery rate (%)	99.89	99.83	99.93	99.10	99.96
Net interest margin (%)	4.42	4.90	4.70	4.69	4.42
Portfolio at risk (%)	0.11	0.17	0.01	0.10	0.04
Return on assets (%)	2.75	2.72	2.95	3.53	3.21
Return on equity (%)	14.63	16.80	19.50	22.74	21.97

FY = fiscal year.

Note: The FY of Small Farmers Development Bank ends on 15 July. "FY" before a calendar year denotes the year in which the fiscal year ends, e.g., FY2019 ends on 15 July 2019.

Source: Small Farmers Development Bank.

13. An SFAC is a member-owned and member-managed community-based organization that provides savings and credit services to its members. SFAC members are small farmers whose landholding is less than 0.76 hectares in the hill areas and 0.67 hectares in the Terai (a lowland area in southern Nepal). Each SFAC has 300–5,000 members, with an annual loan disbursement ranging from NRs2 million to NRs400 million. SFACs' loans to their members are mainly short-term microcredit, with loan sizes below NRs1 million. In FY2018, SFACs' total loan outstanding to members stood at NRs436 billion. SFACs' aggregate recovery rate was 97.63% in FY2018. SFACs show strong credit demand and SFDB's loan outstanding with SFACs grew from NRs3.6 billion in 2013 to NRs17 billion in FY2018.

14. SFDB's and SFACs' financial performances are satisfactory. Under the project, only mature SFACs with sufficient credit experience and satisfactory financial performances will be financed. However, based on the financial management assessment, some financial

⁴ Sana Kisan Bikas Laghubitta Bittiyasanstha Ltd or commonly called SFDB.

management risks were identified, including the following: (i) outdated management information systems; (ii) heavy reliance on short-term borrowing; (iii) weak financial management capacity; (iv) limited human resources in internal audit; (v) limited capacity for rural enterprise financing; (vi) inadequate internal control mechanism at SFDB and SFACs; and (vii) lack of policies on know-your-customer, risk management, and information technology at SFDB.⁵ The attached technical assistance will address these issues by developing rural enterprise financing operational policies and guidelines, and providing training to SFACs.

E. Poverty Reduction and Other Economic Benefits

15. **Poverty reduction.** The project's target beneficiaries are small farmers who are subsistence scale of primary producers with limited linkages to value chains for their agricultural produce. Accordingly, their sources of income are limited only to the sales of their primary produce and some supplementary income, such as by migrating to other area and working as a laborer. Interviews with selected SFAC members revealed that the income of an average SFAC member was about NRs84,581, while the incomes of SFAC members who engage in rural enterprises range from NRs90,000 to NRs150,000.⁶ By participating in rural enterprise activities, SFAC members can sell their primary produce at better prices than the price offered by traders and, by participating as shareholders, gain dividend from their rural enterprises.

16. **Employment generation.** The project will finance at least 500 individual enterprises owned and operated by small farmers. Based on an assessment of SFAC members' individual enterprises, it is estimated that each individual enterprise employs on average five persons. The investment in 500 individual enterprises will therefore translate into 2,500 employment opportunities for small farmers. In addition, the project expects to involve at least 30,000 small farmers in rural enterprises' production activities.

17. **Women's empowerment.** The project will contribute to the economic empowerment of women by providing them access to finance and developing their entrepreneurship skills. The project aims to organize at least 6,000 women as the shareholders of collective enterprises as well as finance at least 150 women individual entrepreneurs. The project will include value chain and business facilitation support focusing on women.

18. **Financial intermediary capacity development.** SFDB is an MFI with primary experience in short-term microcredit. The project will develop SFDB's skills in wholesale lending for rural enterprise financing by developing its rural enterprise financing policies, guidelines, and business processes. In addition, the project will enhance SFDB's skills in credit appraisal, risk management, portfolio monitoring, and safeguards for rural enterprise financing. SFDB's capacity development will have a sustainable leverage effect in enhancing access to finance for rural enterprises.

⁵ Financial Management Assessment (accessible from the list of linked documents in Appendix 2).

⁶ ADB. Impact Study of Microcredit Component of Disaster Risk Reduction and Livelihood Restoration for Earthquake-Affected Communities Project (ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Administration of Grant to Nepal for Disaster Risk Reduction and Livelihood Restoration for Earthquake-Affected Communities Project*. Manila.). Unpublished.