

SECTOR ASSESSMENT (SUMMARY): FINANCE (RURAL ENTERPRISE FINANCE)

A. Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. **Financial sector overview.** The financial sector in Nepal is governed by the Banks and Financial Institutions Act (2006). Under this act, the formal financial institutions—i.e., institutions that are licensed and supervised by Nepal Rastra Bank (NRB), the central bank—are classified into four categories based on the minimum capital requirements and functions: commercial banks (class A), development banks (class B), finance companies (class C), and microfinance institutions (MFIs) (class D). Class D MFIs include microfinance development banks, microfinance nongovernment organizations (NGOs), and savings and credit cooperatives (Table 1). In addition to the formal financial institutions, there are semiformal financial institutions, including savings and credit cooperatives and microfinance NGOs, that provide financial services without NRB licenses. Further, informal financial service providers such as self-help groups, money lenders, traders, friends, families and relatives are used extensively, especially in rural areas.

Table 1: Financial Institutions in Nepal

Category	Institution	Number of Institutions ^a	Minimum Capital (NRs million)	Function
Formal	Commercial banks (class A)	28	8,000	All banking activities
	Development banks (class B)	33	500–2,500 ^c	All banking activities except letter of credit
	Finance companies (class C)	24	800	Retail and consumer lending
	Microfinance development banks (class D)	15	20–640 ^b	Microfinance
	Microfinance NGOs (licensed) (class D)	16		
	Savings and credit cooperatives (licensed) (class D)	45		
Semiformal	Microfinance NGOs (unlicensed)	Over 200 ^b		Microfinance
	Savings and credit cooperatives (unlicensed)	Over 3,000 ^b		
Informal	Self-help groups, money lenders, friends, families, relatives			

NGO = nongovernment organization.

^a As of March 2019.

^b Estimates.

^c Varies by geography or operation.

Sources: Asian Development Bank; Nepal Rastra Bank.

2. In March 2019, the financial sector's total loan portfolio amounted to NRs3,002 billion, with commercial banks accounting for 80.47%, development banks for 10.56%, finance companies for 2.15%, and MFIs for 6.82%. However, in terms of outreach, MFIs have the largest number of clients. As of March 2019, formal MFIs served 2.4 million borrowers, while other classes of institutions served 1.4 million (Table 2). In addition, there are over 3 million estimated clients served by semiformal microfinance NGOs and savings and credit cooperatives. While clients of banks and finance companies are mostly corporates and individuals in urban areas, clients of formal MFIs and semiformal MFIs are mainly poor and low-income households in rural areas.

Table 2: Financial Institutions Loan Portfolio, Branch Network and Client Outreach

Category of Institutions	Formal Financial Institutions				Semiformal Financial Institutions
	Class A: Commercial Banks	Class B: Development Banks	Class C: Finance Companies	Class D: Microfinance Institutions ^b	Savings and Credit Cooperatives/ Microfinance NGOs
Total loan portfolio (NRs billion) ^a	2,416.51	317.10	64.58	204.66	240.00 ^c
Share of total formal sector loan portfolio (%)	80.47	10.56	2.15	6.82	
Number of branches	1,682	823	216	1,143	
Number of borrowers	987,942	331,233	41,139	2,441,621	3,000,000 ^c

NGO = nongovernment organization.

^a As of March 2019.

^b Class D microfinance institutions include licensed microfinance development banks, microfinance NGOs, and savings and credit cooperatives.

^c Estimates.

Source: Nepal Rastra Bank.

3. **Rural enterprise finance.** Rural finance is a subsector of the finance sector and is defined as financial intermediation in rural areas. Rural finance is further divided into microfinance and rural enterprise finance (Table 3). Microfinance in Nepal refers to loans below NRs1 million for subsistence agriculture activities and cottage-sized income-generating activities.¹ Although a growing number of commercial banks and other classes of institutions have started providing microfinance, the majority of microfinance is extended by formal and semiformal MFIs.

Table 3: Rural Finance Categories

Item	Microfinance	Rural Enterprise Finance
Intermediary	(i) Class D MFIs (ii) Unlicensed Savings and Credit Cooperatives (iii) Unlicensed microfinance NGOs	(i) Class A and B institutions (ii) Unlicensed savings and credit cooperatives
Loan size	Below NRs1 million	Above NRs1 million below NRs100 million
Collateral	Not required but based on group guarantee	Required for class A and B institutions
Activities for financing	(i) Subsistence agriculture (ii) Cottage-sized income-generating activities	MSMEs (on-farm and off-farm)

MFI = microfinance institution, MSME = micro, small, and medium-sized enterprise, NGO = nongovernment organization.

Source: Asian Development Bank.

4. Rural enterprise finance is generally defined as loans above NRs1 million and below NRs100 million for rural-based enterprises.² Rural enterprises are micro, small, and medium-sized enterprises (MSMEs) in rural areas and include both on-farm and off-farm enterprises.³ On-farm enterprises undertake farming and livestock production for commercial purposes. Off-farm

¹ In a broader context, microfinance refers to all types of financial services for poor and low-income people and can include loans, savings, insurance, remittances, and other services. Although microfinance serves urban clients, the majority of microfinance clients are rurally based. Accordingly, microfinance is considered a subset of rural finance.

² In Nepal, there is no official definition of rural enterprise finance. This definition is based on current financial institutions' practices in Nepal.

³ The government's Industrial Policy, 2010 defines (i) microenterprises as business entities with investments of up to NRs200,000, annual transactions of less than NRs2 million, and up to nine workers; (ii) small-scale enterprises as entities with fixed assets up to NRs50 million; (iii) medium-scale industries as entities with fixed assets of more than NRs50 million to NRs150 million. Government of Nepal, Ministry of Industry. *Industrial Policy, 2010*. Kathmandu.

enterprises encompass all types of economic activities other than subsistence production and on-farm enterprises.⁴ Under the current regulatory requirement, only banks and finance companies can provide loans above NRs1 million. However, because semiformal financial institutions are outside NRB's purview, some semiformal savings and credit cooperatives provide loans above NRs1 million to their members.

5. Commercial and development banks' loans to rural borrowers accounted for 27% of their total loan portfolio as of March 2019.⁵ Finance companies provide rural loans, but their outreach is insignificant. Further, commercial and development banks' total MSME portfolio is estimated at about 25% of their total loan portfolio.⁶ As of 2019, the rural enterprise finance demand and supply gap is estimated to be at least NRs106 billion.⁷

6. **Issues and problem analysis.** Rural enterprise financing is limited because banks and MFIs are unable to meet rural enterprises' financing needs. Commercial banks and development banks are reluctant to extend financial services to rural enterprises because of higher risks and costs associated with small loans in rural areas. Further constraints include (i) banks' limited rural branch network and outreach, (ii) banks' limited knowledge and risk assessment capacity in rural enterprise financing, and (iii) rural enterprises' difficulty in securing valid loan collateral.

7. MFIs can be a potential major source of rural enterprise financing. However, MFIs' rural enterprise financing is constrained because of (i) a regulatory ceiling on MFIs' loans of NRs1 million, (ii) MFIs' limited sources of funding, and (iii) MFIs' limited knowledge and capacity in rural enterprise financing. Further, in addition to finance, developing rural enterprises in Nepal also require external support for value chain development and business facilitation, including linkages to suppliers, processors, transport, and markets; and the development of business plans, accounting, financial management, registration, and certifications. Financial intermediaries' abilities to appraise rural enterprises and undertake financial intermediation as well as provide nonfinancial support services are also limited.

8. **Small Farmers Development Bank and Small Farmers Agriculture Cooperatives.** Small Farmers Development Bank (SFDB), a class D MFI, started rural enterprise financing in 2016.⁸ SFDB was established and licensed by NRB in July 2001. It is an apex microfinance bank owned in part by small farmers agriculture cooperatives (SFACs). Its main objective is to improve the lives of the rural poor and promote small farmers' access to finance, especially those in the hills and mountain areas. SFDB provides wholesale loans to SFACs for microfinance, and technical and training support for SFAC members' income-generating activities. SFACs are the major shareholders of SFDB (44%), followed by the general public (30%), the state-owned Agriculture Development Bank Limited (22%), and commercial banks (4%). In 2018, SFDB had 680 affiliated member SFACs in 68 districts with a total 670,866 members, of which 75% are women. SFDB's total loans outstanding to SFACs amounted to NRs17 billion in July 2018.

⁴ Subsistence production is production mainly for own consumption.

⁵ Nepal Rastra Bank. 2019. *Banking and Financial Statistics Mid-March 2019*. Kathmandu. Rural portfolio includes loans provided in municipalities, national park or reserves, and rural municipalities.

⁶ Beed Management Pvt. Ltd. 2018. *Demand Study on MSME Financing – Submitted to UKaid Sakchyam Access to Finance Program*. Kathmandu. The estimate is based on the assessment of eight class A and B financial institutions. Among these banks, the definition of MSME loans varies, ranging from NRs40 million to NRs200 million.

⁷ Further details on the rural enterprise finance demand and supply gap are in the Economic Analysis (accessible from the list of linked documents in Appendix 2 of the report and recommendation of the President).

⁸ Sana Kisan Bikas Laghubitta Bittiyasanstha Ltd or commonly called SFDB.

9. SFACs are community-managed, community-based organizations that provide savings and credit services to their 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*.⁹ Each SFAC has 300–5,000 members with an annual loan volume ranging from NRs2 million to NRs400 million. In July 2018, SFACs' total loan outstanding to their members stood at NRs435 billion. Over 95% of SFACs are operating at a profit.

10. To increase the gains from farming, some SFACs initiated rural enterprises that engage in production, processing, and marketing of agriculture produce and are jointly owned by SFACs and their members. SFACs have organized five such collective enterprises in the following areas: milk collection center, two rice mills, seed processing factory, and tea processing factory. The project will support SFDB and SFACs to promote collective enterprises owned by small farmers with financing and value chain development support. The project will also finance micro and small enterprises owned by individual SFAC members who have graduated from microcredit and wish to scale up their cottage-sized income-generating activities.

2. Government's Sector Strategy

11. Rural employment generation and poverty alleviation is a key government policy priority. The government's 14th Three-Year Development Plan, FY2017–FY2019 has the goal of, among others, generating dignified and gainful employment opportunities.¹⁰ Further, the government's Agriculture Development Strategy, 2015–2035 promotes the agriculture sector's profitable commercialization to transform the sector from subsistence farming to agribusiness enterprises for commercial purposes.¹¹ NRB's Monetary Policy, 2018–2019 states that banks and financial institutions are encouraged to provide credit to small and medium-sized enterprises.¹² Further, the government has several policy schemes to improve the credit supply to the deprived sector, the agriculture sector, and other priority sectors.¹³

B. Major Development Partners: Strategic Foci and Key Activities

12. Multiple development partners support Nepal's inclusive finance and small and medium-sized enterprise (SME) finance subsectors. Key development partners include the Department for International Development (DFID) of the United Kingdom, the International Finance Corporation (IFC), the International Fund for Agricultural Development (IFAD), and German development cooperation through KfW.

13. DFID's 5-year Sakchyam Access to Finance for the Poor Programme aims to create a favorable regulatory and institutional environment for equity investment in SMEs, develop a Nepali challenge fund to help deliver innovative financial services to MSMEs, develop appropriate financial products for small farmers, and stimulate economic activities in lagging regions by

⁹ The *terai* is a lowland region in southern Nepal.

¹⁰ Government of Nepal, National Planning Commission. 2017. *14th Three-Year Development Plan, FY2017–FY2019*. Kathmandu.

¹¹ Government of Nepal, Ministry of Agricultural Development. 2015. *Agriculture Development Strategy, 2015–2035*. Kathmandu.

¹² NRB. 2018. *Monetary Policy for 2018–2019*. Kathmandu.

¹³ The government currently imposes on banks a productive sector lending scheme and a deprived sector lending scheme. The productive sector lending scheme mandates commercial banks to allocate at least 10% of the total lending portfolio to the agriculture sector. The deprived sector lending scheme requires banks to lend at least 5% of the total portfolio to poor, low-income, and marginalized populations.

providing increased microfinance support.¹⁴

14. IFC supports the private sector in Nepal, including agribusiness, transportation, trade finance, small businesses, and private equity and venture funds. IFC initiated the Business Oxygen venture fund, which will make equity investments in Nepal's high-growth SMEs. Also, IFC, together with the Private Sector Window of the Global Agriculture and Food Security Program, is working to enhance poultry farm productivity to increase incomes in rural Nepal.¹⁵

15. KfW recognizes that SMEs (i) represent the missing middle between a functioning financial market for the smallest microloans and investment loans for larger, well-established companies; and (ii) are especially important for Nepal's economic development. In its program for sustainable economic development, KfW is supporting Nepal's financial sector by expanding its financial services and making them more accessible for SMEs.¹⁶

16. IFAD finances the Samridhhi Rural Enterprises and Remittances Project. The project objective is to reduce poverty and achieve sustainable peace through employment-focused, equitable, and inclusive economic development. The project will diversify the economic activities accessible to poor rural households by (i) promoting self-employment and small businesses and microenterprises through on-farm and off-farm activities, (ii) carrying out vocational training and apprenticeships for gainful job placement, and (iii) developing mechanisms specifically targeting migrant households and returnees.¹⁷

17. IFAD also initiated the Agriculture Sector Development Program (ASDP) to increase access to economic opportunities for poor farmers and small producers. The program will target smallholder producers and landless rural people interested in engaging in targeted value chain activities. Women will constitute two-thirds of beneficiaries and disadvantaged households will be specifically targeted for inclusion (footnote 17).

Table 4: Major Development Partners

Development Partner	Project Name	Duration	Amount (million)
ADB	Rural Finance Sector Development Cluster Program (subprograms 1 and 2)	2006–2016	\$112.00
ADB	Disaster Risk Reduction and Livelihood Restoration for Earthquake-Affected Communities Project	2016–2019	\$15.00
DFID	Sakchaym Access to Finance for the Poor Programme	2013–2020	£37.00
IFAD	Agriculture Sector Development Program	2017–2023	\$68.09
IFAD	Samiddhi Rural Enterprise and Remittance Project	2015–2022	\$68.15
IFC	Business Oxygen venture fund	2015–	
KfW	Sustainable Economic Development	2017–	€3.50

ADB = Asian Development Bank, DFID = Department for International Development of the United Kingdom, IFAD = International Fund for Agricultural Development, IFC = International Finance Corporation.

Source: ADB.

¹⁴ Sakchaym Access to Finance for the Poor Programme. <https://sakchaym.com.np/>

¹⁵ The Global Agriculture and Food Security Program is a multilateral mechanism to fund country and regional agriculture and food security strategic investment plans. The program is implemented as a financial intermediary fund for which the World Bank serves as a trustee.

¹⁶ KfW. Nepal. <https://www.kfw-entwicklungsbank.de/International-financing/KfW-Development-Bank/Local-presence/Asia/Nepal/>

¹⁷ IFAD. Nepal. <https://www.ifad.org/en/web/operations/country/id/nepal>

C. Institutional Arrangements and Processes for Development Coordination

18. Instead of overlapping or conflicting, the developing partners' projects in inclusive finance and SME finance have complemented and enforced each project's impact. Development partners' activities address different segments of inclusive finance and SME finance. DFID, KfW, and IFC support financing and business capacity development for commercial banks' SME financing, and IFAD focuses on microcredit for small and marginal farmers. The proposed project's focus is on the missing middle in rural finance: those who are engaged in MSMEs but have yet to be serviced by commercial banks or other formal financial intermediaries. Further, the proposed project's focus on SFDB, which is an apex cooperative bank and an MFI, is complementary to KfW's and IFC's support for commercial banks, and contributes to overall financial sector development in Nepal.

19. SFDB is currently implementing two development partners' projects: IFAD's ASDP and DFID's Sakchyam Access to Finance for the Poor Programme. Under the ASDP, SFDB extended microcredit to small farmers through 83 SFACs. Under the Sakchyam Access to Finance for the Poor Programme, SFDB is participating in the digitization of SFACs and expansion of access to finance in Karnali Province. The project will work with IFAD and DFID to ensure coordination with their activities. In addition, the project will conduct regular information sharing and discussions with the key development partners to ensure synergy among different development partners' interventions.

D. ADB Sector Experience and Assistance Program

20. The project is based on ADB's successful rural finance project experiences in Nepal. ADB financed the Rural Finance Sector Development Cluster Program (RFSDCP) (subprograms 1 and 2) during 2006–2016.¹⁸ The RFSDCP carried out (i) legal and regulatory framework reform for rural finance, (ii) restructuring and reform of key rural finance institutions including SFDB, and (iii) expansion of access to finance to the hills and mountain areas. The RFSDCP's program completion reports (PCRs) rated subprograms 1 and 2 *successful*, and recognized the program's contributions to the improved efficiency, soundness, and outreach of rural finance in Nepal.¹⁹ With respect to lessons learned, the PCR for subprogram 1 suggested enhancing financial product development and diversification in areas where enhancing access to financial services had been a challenge. The PCR for subprogram 2 recommended a survey of women credit beneficiaries to determine economic impacts and empowerment of women beneficiaries.

21. ADB approved the Disaster Risk Reduction and Livelihood Restoration for Earthquake-Affected Communities Project on 7 October 2015. The emergency assistance project was prepared in response to the earthquake in Nepal on 25 April 2015, and it comprises a \$15 million grant financed by the Japan Fund for Poverty Reduction.²⁰ The project provided microcredit for livelihood restoration to 15,700 affected households.²¹

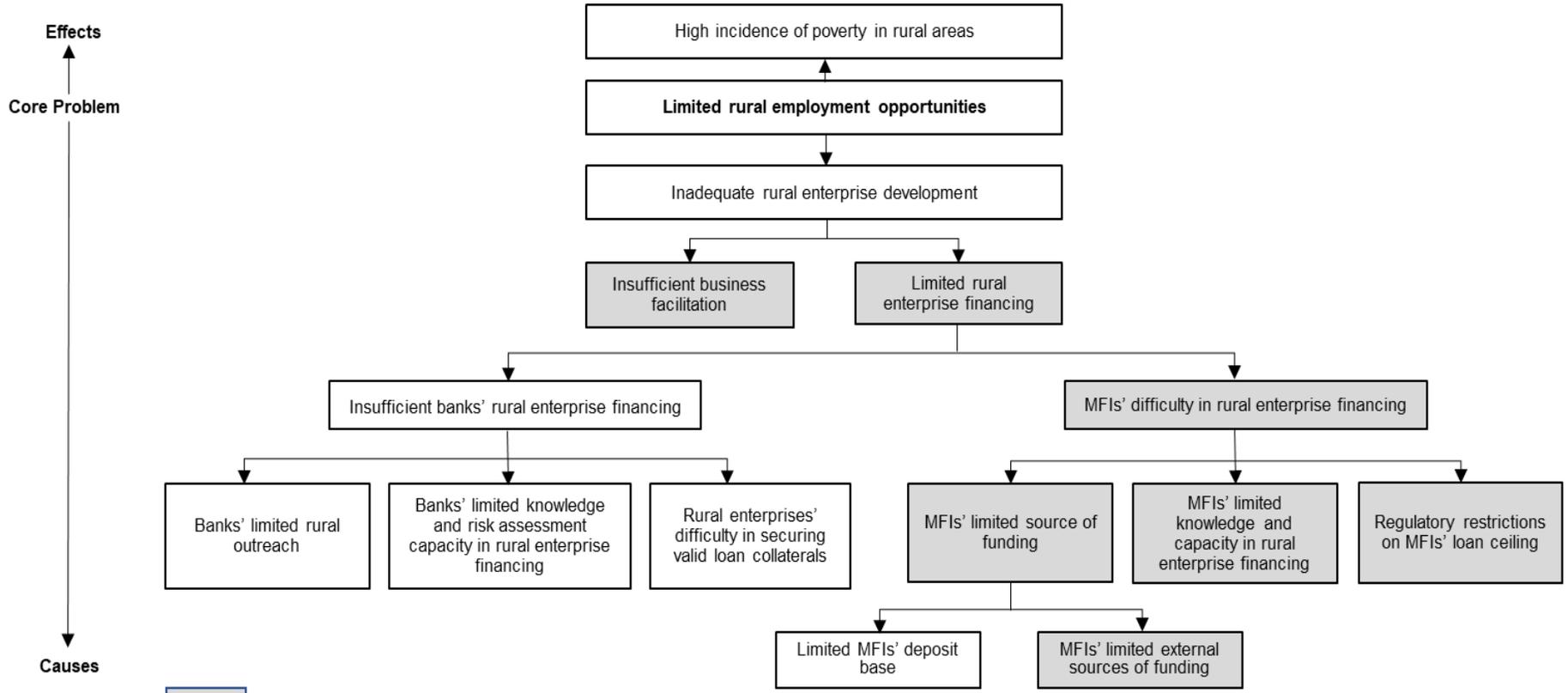
¹⁸ ADB. 2006. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Nepal for the Rural Finance Sector Development Cluster Program*. Manila; and ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan for Subprogram 2 to Nepal for the Rural Finance Sector Development Cluster Program*. Manila.

¹⁹ ADB. 2012. *Completion Report: Rural Finance Sector Development Cluster Program in Nepal*. Manila; and ADB. 2016. *Completion Report: Rural Finance Sector Development Cluster Program (Subprogram 2) in Nepal*. Manila.

²⁰ Funded by the Government of Japan.

²¹ ADB. 2015. *Report and Recommendation of the President to the Board of Directors for the Proposed Administration of Grant to Nepal for the Disaster Risk Reduction and Livelihood Restoration for Earthquake-Affected Communities Project*. Manila.

Problem Tree for Finance (Rural Enterprise Finance)



To be covered under the project.

MFI= microfinance institution.