

SME Financing Problems and prospects

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Kathmandu



SME FINANCE
CONSTRAINTS
AND
RESPONSES



INNOVATIVE
APPROACHES
CAN EASE
CONSTRAINTS



IMPLICATIONS
FOR POLICY
AND
REGULATION

To get answers to three basic business questions

1. Should we do it (aligned with business strategy, risk appetite, culture, values, and ethics)?
2. Can we do it (people, processes, structure, and technology capabilities)?
3. Did we do it (assessment of expected results, continuous learning, and a robust system of checks and balances)?

Outlook of SMEs Sector

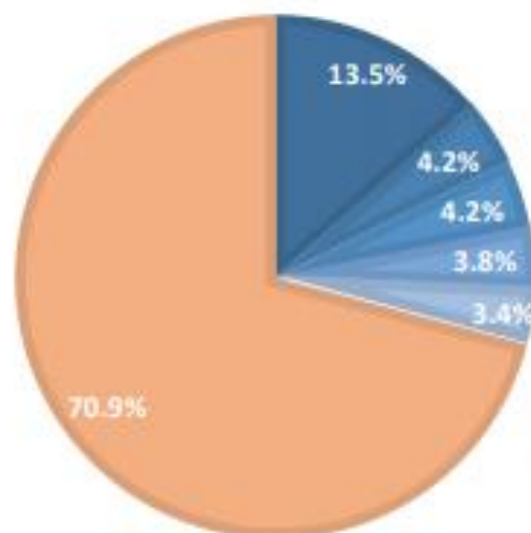


Final Results of National Economic Census 2018 of Nepal



Number of Establishments : 923,356

- Kathmandu
- Jhapa
- Rupandehi
- Morang
- Sunsari
- Others



(Total Number of Establishment)
923,356

(Registered)
462,605
(50.1%)

(Not Registered)
460,422
(49.9%)

Not Reported
329
(0.04%)



Establishment density

6.3 per km²

Establishments per 1,000 persons

31.6 establishments

Number of persons engaged per establishment

3.5 persons

- Number of Establishments 923,356
 1. Registered 462,605 establishments 50.1 %
 2. Not registered 460,422 establishments

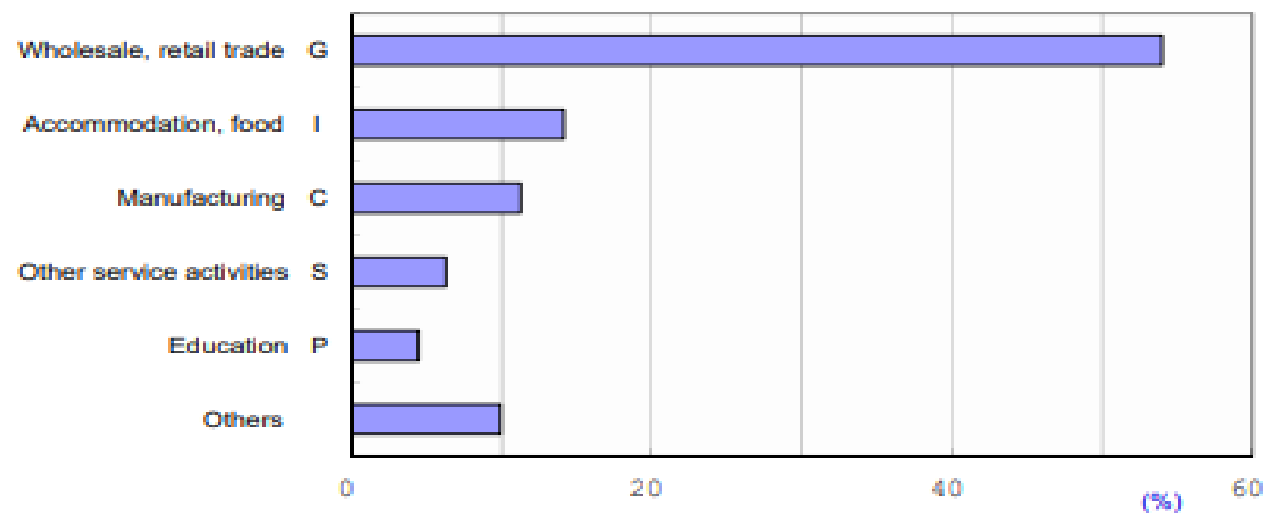
- Ownership
 1. Female manager 273,436 persons 29.6 %
 2. Female owner 247,880 persons 29.8 %
 3. Young manager 498,646 persons 54.0 %
 4. Young owner 450,464 persons 54.5 %
 5. Foreign owner 10,265 persons 1.2 %

- Number of Entities 900,924 entities
 - A. Owned (Building/Room) 400,848 establishments 46.7 %
 - B. Rented (Building/Room) 426,380 establishments 49.7 %
 - C. Street business 34,101 establishments 3.7 %
- Home business 386,323 establishments 41.8 %
- New establishments 394,219 establishments 42.7 %
- Area of business place (building/room) Under 100ft (9.3m²) 172,985 establishments 20.8 %
- Single unit 898,996 establishments 97.4 %
- Number of Persons Engaged 3,228,457 persons
- No accounting record 472,350 entities 52.4 %
- New establishments mean which started business between April 2015 and April 2018

SMALL AND MEDIUM SIZED ENTERPRISES

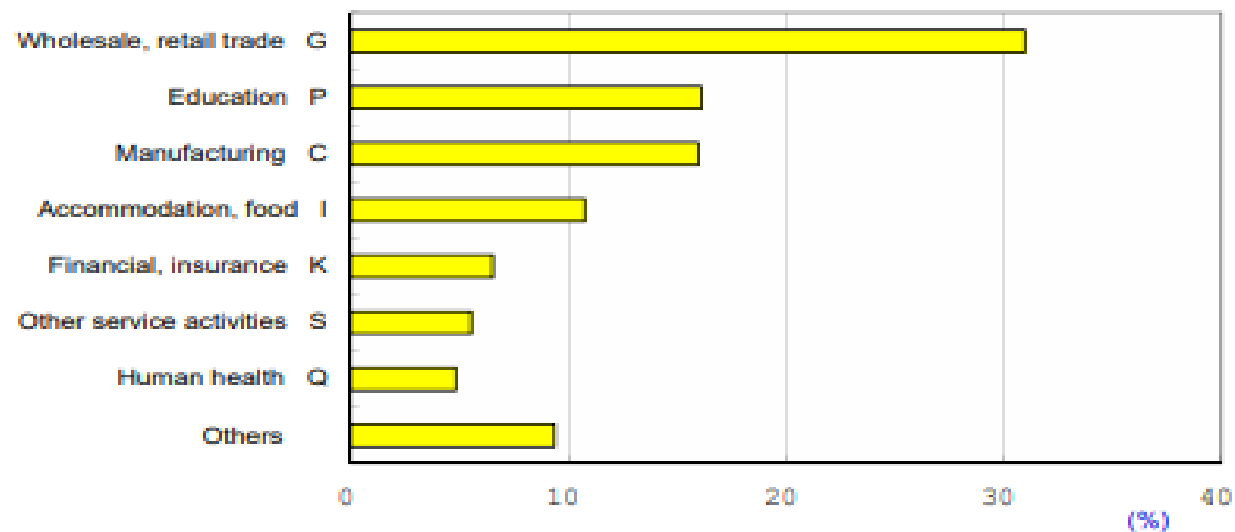
- Small and medium-sized enterprises (SMEs) are a very heterogeneous group of businesses usually operating in the :
 - Service,
 - Trade,
 - Agri-business, and
 - Manufacturing sectors.
- They include a wide variety of firms such as:
 - Village handicraft makers,
 - Small machine shops,
 - Computer software firms that possess a wide range of sophistication and skills.
- Some are dynamic, innovative, and growth-oriented while others are satisfied to remain small and perhaps family owned.
- In Nepal, SMEs usually do not operate in the formal sector of the economy and employ mainly wage-earning workers.
- SMEs are often classified by the number of employees and/or by the value of their assets.

Graph 1. Percent Distribution of Establishments by NSIC - Nepal (2018)



* NSIC stands for Nepal Standard Industrial Classification.

Graph 2. Percent Distribution of Persons Engaged by NSIC - Nepal (2018)



* NSIC stands for Nepal Standard Industrial Classification.

Importance of SMEs – Banking & Economy

- Small and Medium Enterprises (SMEs) are vital for development of a country
 - Helps reshaping the productive sectors
 - Generates employment
 - Creating an environment for entrepreneurship
 - Promotes innovation
- Globally, SMEs contribute over 90% of Business Enterprises and 50-60% of Total Employment.

Importance of SMEs – Banking & Economy

Small and medium-sized enterprises (SMEs) are the backbone of the Asian economy.

They make up more than 96% of all Asian businesses that provide two out of three private sector jobs in the continent.

Employment investment ratios in Nepal

Larger unit 10 Million = 1 employment

SMEs 1 million = 3 employment

Table 5: Industries Registered by Scale (Up to 2074/75)

SCALE	NO. OF INDUSTRY	PROPOSED TOTAL CAPITAL*	PROPOSED FIXED CAPITAL*	PROPOSED WORKING CAPITAL*	PROPOSED EMPLOYMENT**
LARGE	1,030	1,452,564.28	1,353,803.92	98,760.36	149,263
MEDIUM	1,640	149,426.37	102,456.94	47,450.94	152,504
SMALL	4,859	78,929.22	49,054.29	30,021.83	273,729
TOTAL	7,529	1,680,919.87	1,505,315.15	176,233.12	575,496

* in million Rupees

** in Number

A lack of early-stage finance and business incubation support constrains start-ups.

A lack of financing for SMEs is a cross-cutting constraint that poses specific challenges to IT start-ups. In interviews conducted for the Country Private Sector Diagnostic program of Worldbank, some IT-services firms noted that they are at a point where they typically require US\$500,000 to US\$1 million to scale up. But accessing long-term bank loans or equity investment of this size is difficult for them. In part, this could be due to a lack of advisory support, which could help IT start-ups become better prepared to seek such funding.

According to Industrial Enterprise Act 2073

1. Categorization of the industries as per their fixed capital
 1. Large Industries: Fixed capital having more than Rs.25,00,00,000
 2. Medium Industries: Fixed capital upto Rs 25,00,00,000 and more than Rs 10,00,00,000
 3. Small Industries: Fixed Capital upto than Rs 10,00,00,000
2. Categorization of the industries based on their nature of production :

There are eight categories of industry which are:

 1. Agro Based and Forestry
 2. Construction
 3. Information, Communication and Transmission (ICT)
 4. Energy Based
 5. Manufacturing
 6. Mineral
 7. Service
 8. Tourism

Financing SMEs

1. There are several gaps in Nepal's financial infrastructure, limiting its ability to extend credit to firms.
2. Most Nepalese firms are Medium and Small and Medium Enterprises (MSMEs).
3. Major assets of SMEs are moveable assets. **Banks prefer nonmoveable collateral.**
4. Legal, regulatory, and institutional framework **for movable asset-based financing needs to be strengthened.**
5. The ***Secured Transactions Act*** was adopted in 2006 with the aim of strengthening the institutional framework of this sector. However, no rules, regulations, or operational procedures have been established to enable its efficient functioning.

Credit Information status in Nepal

1. Credit Bureau does not have its own statute and *its credit information reporting and sharing is limited, providing only negative information and covering a mere 1.7 percent of the adult population.*
2. *Nepal scored 10 on the index measuring strength of legal rights.*
3. *The depth of the credit information index is zero.*
4. *Currently NRB has introduced Credit rating of high value loans*
5. *In Nepal's current business environment, risk-adjusted returns for lending to SMEs may simply be too low to be profitable.*

SME Financing - CONSTRAINTS

SME Financing - CONSTRAINTS

- Approx. 95% of SMEs in Nepalese economy suffer from credit constraints,
- Approx. 70% of all Nepalese Economy SMEs do not use any formal credit,
- Informal sector meets SMEs financial requirements with stringent conditions,
- Nearly 15% of SMEs disappear in two years and nearly 40% of SMEs exit the market in four to five years due to business failure, bankruptcy, or other reasons,
- Lack of successful track record of SMEs creates a perception of greater credit risk among the banks,
- SMEs lack the substantial asset base (collateral) to provide as security against bank loans.

SME Financing - CONSTRAINTS

SMEs are typically managed by

- One or two entrepreneurs mostly related as family members or
- Members from the known community.
- Rarely managed by qualified professionals,
- Performance dependent **on the experience and expertise** of the entrepreneur.

These parameters are mostly not acknowledged by SMEs

- Understanding legal or environmental issue,
- **Enhancing disaster management capacity,**
- Impact of subsidies/tax waiver by the government,
- Impact of sudden business loss,
- **Impact of non insurance or inadequate insurance of assets,**
- Extraordinary or windfall gains and losses,
- Impact of the monetary or fiscal policies and
- **Impact of significant development in the industry.**

SME Financing - CONSTRAINTS

A significant number of SMEs are doing their business as the forward and backward operation of the formal sector; hence,

- Rarely have control over pricing or
- **Fully market dependent.**
- Market competition is very high due to large number of **SMEs in the same business.**
- Loan structure **Long term Vs short term loan**

BFIs need to enhance the existing credit assessment system with additional features:

- a) Complying with Standardized approach of Basel III requirements
- b) Create Risk Rating System
- c) Automate
 1. Credit Origination,
 2. Credit approval process,
 3. **Risk administration and monitoring functions**
 4. Management of Non Performing assets
 5. Provide data feeds for management reporting

Challenges Faced by SME in Nepal

1. Lack of proper infra-structure.
2. Regulatory complexities – relaxation in prudential rules and easy access to loan.
3. Shortage of skilled manpower.
4. Quality control problems.
5. Lack of entrepreneurial expertise.
6. Shortage / irregular availability of financing facilities.
7. Shortage of equity sources.
8. Inability to meet credit criteria / credit conditions.
9. Inadequate bargaining skills / options.
10. Lengthy documentation procedure.
11. Unwillingness of BFIs to finance SMEs
12. Collaterals issue

SMEs Issues Identified (Sample Size 1,000)	Percentage
Lack of finance	70%
Shortage of skilled labour	40%
Getting business site	60%
Bribes	30%
Orders/Marketing of Product	80/%
Lack of Knowledge	70%
Government interference	45%
Raw Material	60%
License for work	90%

SMEs constraints can be summarized as under

Cashflow

Regulation

Profitability

Process

Productivity

Time

Connections

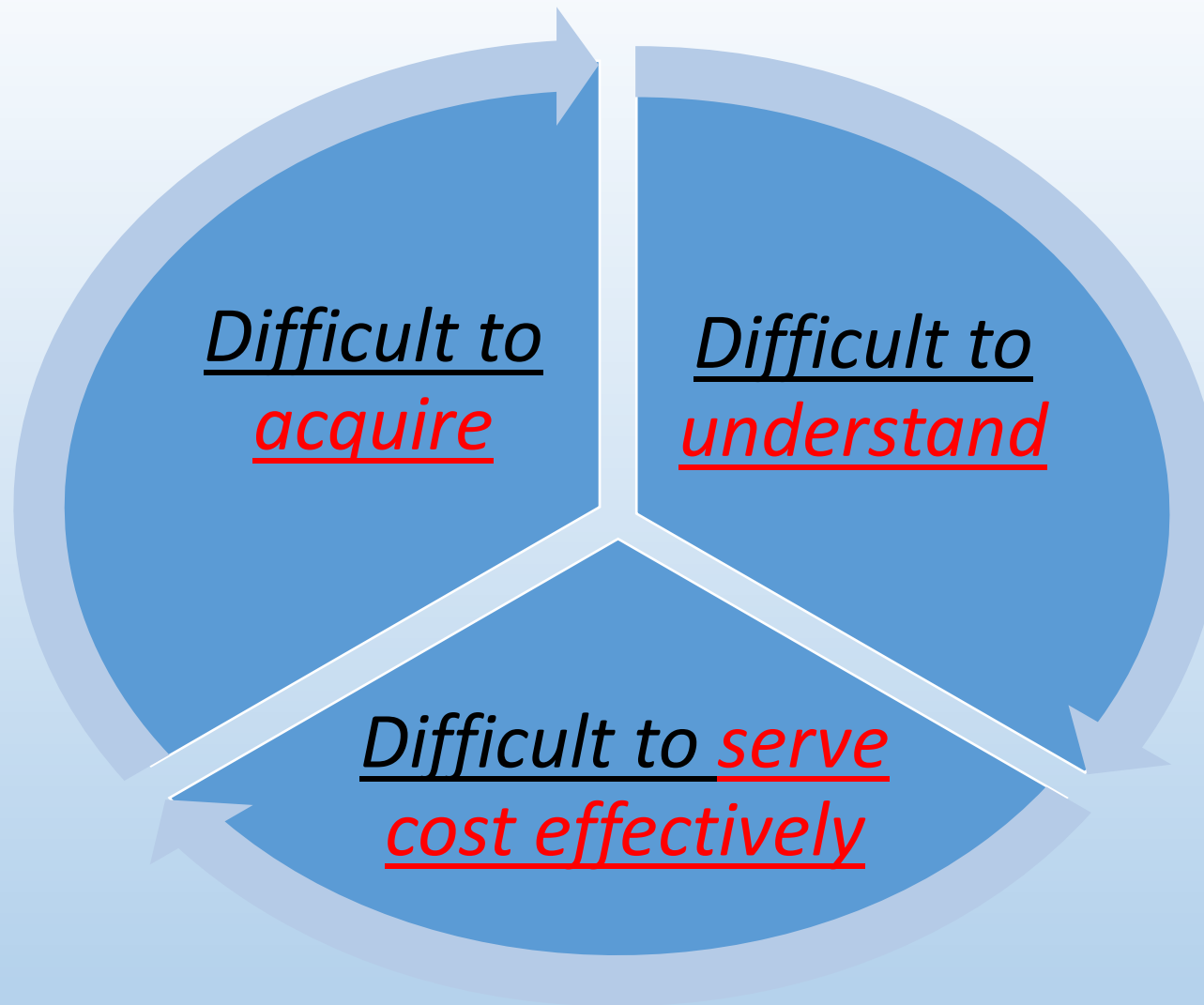
Marketing

Customers

Research & Development



SMEs



But,
SME's Current
Account deficit is
much greater
than of our trade
deficit. Therefore
BFIs have big
opportunities to
finance the
deficit of SMEs

Nepal need to conduct a comprehensive diagnosis to develop a
financing strategy for SMEs, possibly including alternative finance
models such as leasing

SME Finance Constraints – Responses

<i>Constraints</i>	
Information asymmetry	
Usable collateral	
Lack of Financing Sources and Products	
Lack of Access Points	
SME Financial Capability	

SME Finance Constraints – Responses

<i>Constraints</i>	<i>Response</i>
Information asymmetry	Credit Reporting Systems
Usable collateral	Secured Transactions Frameworks (including movable assets registries)
Lack of Financing Sources and Products	Credit lines, Guarantee Schemes, Government Banks, SME Funds, NBFIs for Competition, Reforms to encourage leasing, factoring
Lack of Access Points	Branch Expansion, Non Availability of Alternative Financing, Agent Networks
SME Financial Capability	Financial Education, Training, Awareness Campaigns

Information asymmetry

Information asymmetry

- There is an asymmetric information problem between suppliers and demanders of funds in general.
- Information infrastructures are necessary to remedy this problem.
- Lack of institutional information-sharing schemes of SMEs have limited the ability of BFIs to assess the creditworthiness.
- Strengthen the creditor information base and explore approaches to covering more SMEs in credit information systems.

Information asymmetry

Unstructured method applied by BFIs to evaluate risk of SMEs limits BFIs ability to:-

1. Check the effectiveness of Internal Rating Systems,
2. Apply appropriate loan pricing policies,
3. Apply adequate credit risk mitigation strategies

In many economy BFIs do not obtain Credit Rating Report to evaluate creditworthiness of SMEs

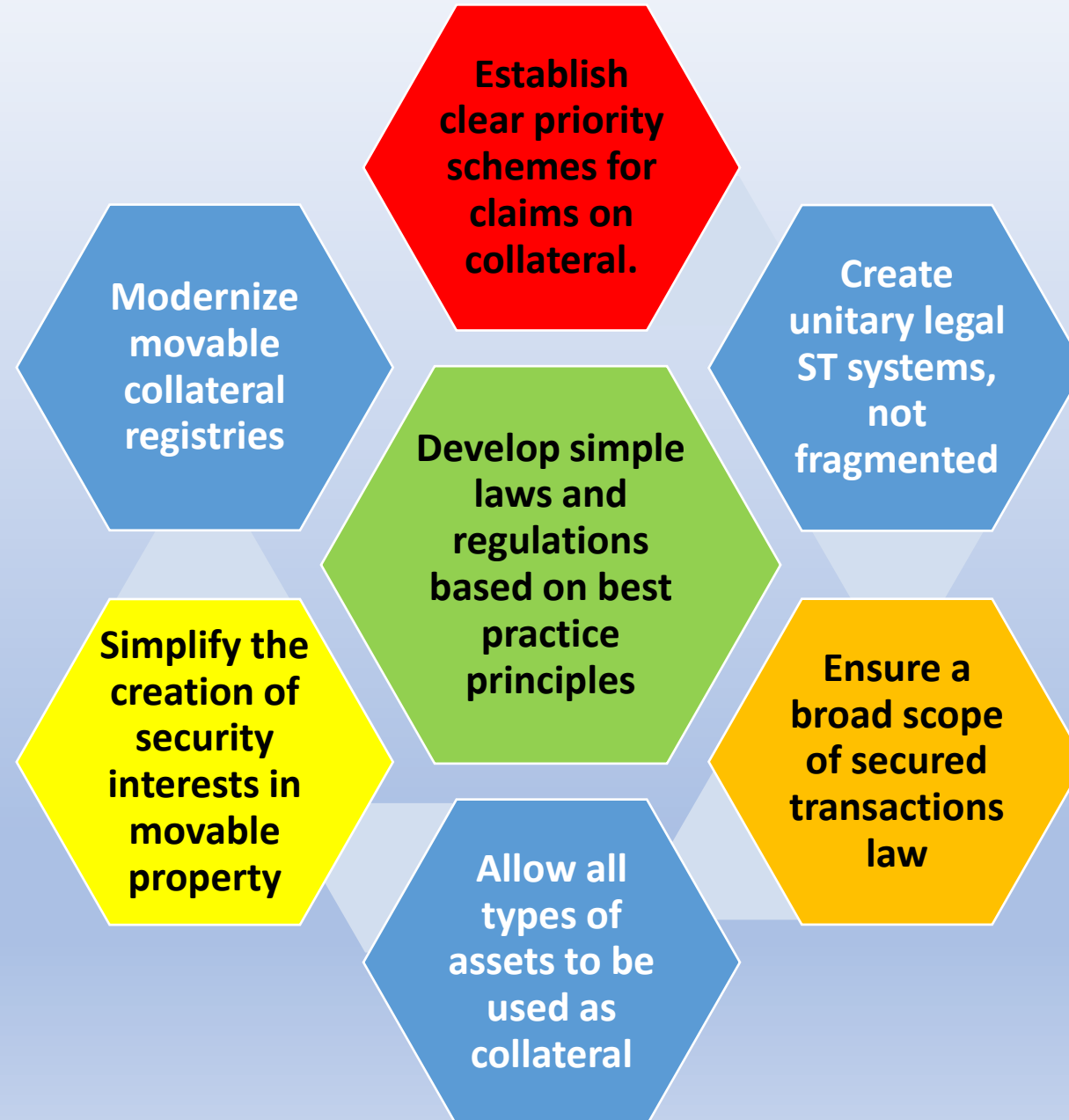
Information asymmetry

The remedies include

1. The development of Credit Information Infrastructures for SMEs
2. Utilization of Credit Rating techniques for SMEs,
3. The development of a sustainable credit guarantee scheme,
4. The development of specialized private banks for SME financing,
5. The introduction of new ways of providing community-based financing
6. Improve the capacity (skills, systems, products) to provide SMEs finance and evaluation mechanism to measure
 - Cost Efficiency: Automating the process
 - Additionality: Capacity to stimulate financing and
 - Sustainability: Reducing default risk.

Lack of Usable Collateral

Lack of Usable Collateral Secured Transactions (ST) (Financial Infrastructure)



Lack of Usable Collateral

- Coverage ratios should ensure sufficient protection against
 - Default risk,
 - Should provide incentives for sound lending and
 - credit risk management

(LONA TO VALUE RATIO OF 1:3.75 HAS DISCOURAGE SMEs TO APPROACH BANKS)

- Repayment scheme should take into account effectiveness of collateral and operational issues of SMEs.

Lack of Usable Collateral

- **NRB needs**

- **Redefine SMEs and**
- **Simplify the regulatory process and**

- **BFI needs to**

- **Increase their capacity evaluate the risk associated with SMEs**
- **Design products to fit SMEs requirements**

Lack of Usable Collateral

- In collateral-based lending, the collateral is the simplest way for SMEs and financial institutions **to reduce the risk premium in loan.**
 - SMEs do not have proper or dependable collateral
 - **SMEs cashflows are not dependable**
 - SMEs do not have adequate accounting system.
- Basel requirements for risk management require **financing SMEs** to
 - Develop comprehensive information infrastructure
 - **Develop efficient and lower-cost credit risk evaluation tools**

Lack of Usable Collateral

Design Features of Partial Credit Guarantee (PCG) Schemes

Additionality

Capacity to stimulate financing for SMEs that would not otherwise have been available: In Canada, 75% of guarantees are used by firms that would not have been able to obtain a loan otherwise. In Chile, the guarantee scheme increases the probability of small firms to get a loan by 14%.

Leverage

Ability to 'leverage' PCG endowment on lending activity: Good practice for ratio of outstanding guarantee commitments to the underlying funds of the PCG scheme is 6-7 times.

Transparency

Clear and reliable procedures for claims and payments. Critical for building trust with financial institutions and ensuring high uptake of guarantees.

Cost Efficiency

Appropriate fee level, sound risk management, efficient operational procedures.
Sustainability not essential, but many inefficient and ineffective schemes.

Ability to Stimulate Markets

Stimulate the SME lending business and the creation of new financial products; Counter-cyclicality.

Lack of Financing Sources and Products

Lack of Financing Sources and Products

- Start-up companies, in particular, are finding it increasingly difficult to borrow money from banks
- Basel III capital requirements have made the situation more difficult.
- Riskier SMEs also face difficulty in borrowing money from banks.
- It is difficult for banks to evaluate SMEs since they often do not have solid accounting systems and their credit risk is not obvious for lending institutions.

Lack of Financing Sources and Products

- Many SMEs in Nepal borrow money by
 - Paying high rates of interest or
 - Offering costly collateral, which hinders their growth.
- Many banks prefer to lend to large enterprises rather than SMEs.

The main reason behind such behavior is for large enterprises financing, the financial statements are clear and audited.

Lack of Financing Sources and Products

- To increase SME financing requires range of interventions including:
 - Improvements in disclosure and governance of SMEs
 - Improvements in SMEs operating standards,
 - Create Guarantee or accelerator fund
- SMEs financial and nonfinancial accounts are often difficult to assess BFIs should start using
 - Credit Risk Database (CRD)
 - Credit Bureaus, and
 - Credit Rating Reports
- Banks are cautious about lending to SMEs even though such enterprises account for a large share of economic activity.

Accelerator Funds active in Nepal

	BO ₂ (Private Equity (SME Venture) Impact Fund)	Dolma Impact Fund	Rockstart
Year started	2015	2012	2014
Investors	IFC SME Ventures \$7 mn DFID \$4 mn Pilot Program for Climate Resilience (PPCR) \$3.6 mn	Dutch, Finnish and Austrian development finance funds, family offices and High Net Worth Individuals	Rockstart funded through a revolving fund (funded entrepreneurs refund pro-rated program costs out of investment received) International impact investors fund SMEs
Support provided	Capital (equity) and technical assistance	Capital and expertise	Intensive coaching from local and international professionals
Size of investment	\$100,000-\$500,000; up to 49% of total equity	\$500,000 to \$4MN; larger amounts are possible through co-investment partners 20% to 49% equity	SMEs attain EUR 100,000 to EUR 500,000 investment
Criteria	SMEs (< 50 staff; < US\$ 3M turnover; < US\$ 3M assets) in operation for > 2 yrs) Meets environmental, social & governance (ESG) criteria; no child labour.	Business generates annual revenues > USD 500K; management team has expertise and track record; open to working with active investors	Company should show high potential in scaling to reach larger population in the bottom of the pyramid and to make a larger impact on their surroundings
Expected impacts	IRR – minimum 20% Investment used for top or bottom line growth that is job creating.	Business able to generate competitive rates of return with identifiable exit options. Investment used to scale up capacity, increase skills and competitiveness, and meet market demand Generates employment and stimulates further FDI	

INNOVATIVE APPROACHES CAN EASE CONSTRAINTS

<i>Constraints</i>	<i>Traditional Responses</i>	<i>Innovative Responses</i>
Information asymmetry	Credit Reporting Systems	Psychometrics, “big data” analytics, Credit Rating
Usable collateral	Secured Transactions Frameworks (including movable assets registries)	Development of key financial products supporting SME growth (warehouse receipts, leasing, secured registries), Supply chain relationships, contracts.
Lack of Financing Sources and Products	Credit lines, Guarantee Schemes, Government Banks, SME Funds, NBFIs for Competition, Reforms to encourage leasing, factoring	Crowdfunding, P2P lending, Supply Chain relationships
Lack of Access Points	Branch Expansion, Non Availability Alternative Financing, Agent Networks	Cards, Mobile Phones (through PoS, ATMs, Agents)
SME Financial Capability	Financial Education, Training, Awareness Campaigns	Personal financial management, automated advice

Lack of Usable Collateral, Financing Sources, Products

Innovative Approaches: Supply Chain Finance - Big Data

Data (on SME payments, contracts behavior) can be used to lower the cost and risk of financing MSMEs.

Electronic payments enable data to be collected instantly and more comprehensively.

Financial Service Provider



Production loans

Factoring, working capital loans, trade finance.

Supplier



Suppliers can provide inputs on credit

SME



Buyer
(processor, exporter, wholesaler)



Buyers can provide credit to help secure production

How factoring can work:

**SME sells to
a large firm**

**In 30 days, the factor receives
the full payment from the
large firm, and the SME
receives the remaining ... % of
the total, less interest and
service fees**

**The SME needs working capital to produce
more inventory and uses its accounts
receivable as collateral. The factor
purchases the accounts receivable. The SME
receives a % of the face value of the
accounts receivable**

- **Policy Response: Enabling Regulatory Frameworks for Factoring**
- Clear laws governing contracts between parties and assignment of receivables, are needed
- Further challenges include:
 - Tax regime,
 - Enabling regulation of BFIs ,
 - Weak legal environment for enforcing contract compliance.
- Factoring can provide working capital finance to sellers.
- *Giving the money can be very easy but getting it back can be very difficult*

SME Financing - *Innovative Responses*

The **credit risk assessment of SMEs requires a specific approach**, as the factors affecting the creditworthiness differ from those compared to large corporate entities.

BFI are **migrating from**

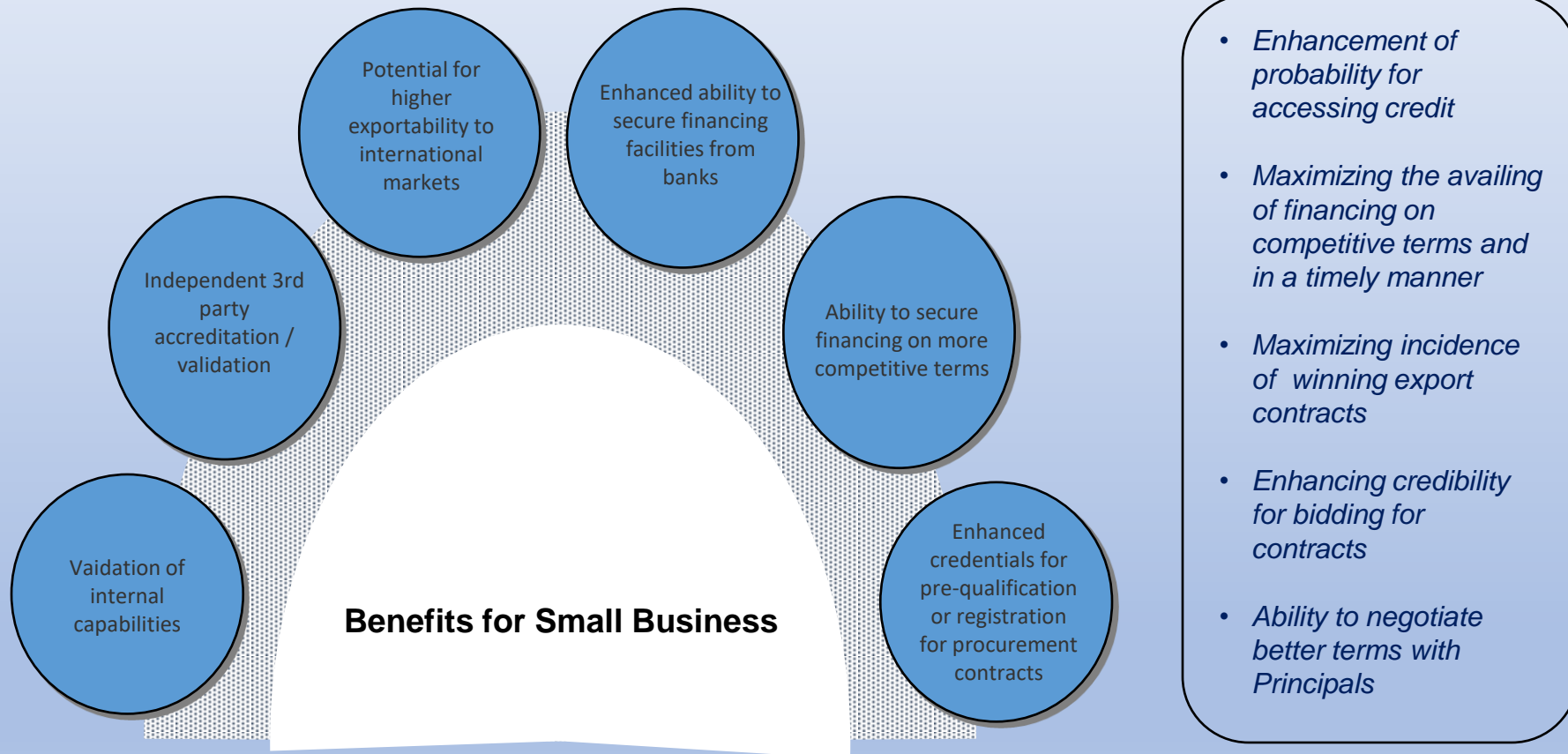
- **From individual's opinion based credit review process**
- **To Systematic and scientific process** with an emphasis on **objective inputs**.

The main reason for this shift is the need for faster, more accurate, uniform and timely credit decisions.

This can only be possible when **highly productive and easy to use tools are provided to them to help them in their decision-making.**

Therefore, many Central Bank across the region had mandated SMEs Rating

Benefits of Rating – For Small Business



Research has shown that enhanced information coverage on SMEs increases credit approvals by 88% and reduces defaults by 41%

Lack of Access Points

Lack of Access Points Innovative Approaches

- *Point-of-sale Innovations*
- *Mobile-based KYC*
- *Automated Financial Advice*
- *SME Financial Management*

IMPLICATIONS FOR POLICY AND REGULATION

<i>Constraints</i>	<i>Innovative Responses</i>	<i>Policy Considerations</i>
Information asymmetry	Psychometrics, “big data” analytics, Credit Rating	Consumer Protection, Data Accuracy/Privacy
Usable collateral	Development of key financial products supporting SME growth (warehouse receipts, leasing, secured registries), Supply chain relationships, contracts	Legal Framework for factoring, electronic signatures. Public procurement from SMEs
Lack of Financing Sources and Products	Crowdfunding, P2P lending, Supply Chain relationships	Supervisory capacity to understand and monitor risks of new financing models?
Lack of Access Points	Cards, Mobile Phones (through PoS, ATMs, Agents)	Bank vs Telco roles, regulation & supervision of payments services providers, interoperability...
SME Financial Capability	Personal financial management, automated advice	How best to leverage, content, also consumer protection

New Regulations

- Credit restriction on personal loan (loan limit reduce to Rs. 5 million)
- Verification of document related to tax payment (linking credit with IRD)
- Increment of transaction through internet Banking
- Credit Rating
- VAT refund to individual if payment is made through electronic media
- Reduction of refinancing rate for SMEs and other business
- Agriculture loan subsidy
- Introduction of Income to loan ratios
- Requirement of PAN for transaction and wages/salaries payment

Credit restriction: Personal Loan and its impact on SMEs

- SMEs having turnover of 2 million and annual taxable income of 200K don't need to submit tax return based on books of account.
- **Opting T/O tax SMEs less likely or do not have to go through tax assessment process**
- Some of the taxpayer are utilizing this provision to avoid tax.
- **Even having best intention to pay tax they can not prepare financial statement**
- Due to difficulty faced by SMEs, even majority of SMEs having turnover more than 2 million has to take personal loan
- **Credit restriction imposed by NRB to restrict personal loan to Rs 5 million will likely to hit SMEs as they are not yet prepared to upgrade their accounting system due to lack of knowledge.**
- Due to lack of adequate man power it will be very difficult for authority to even to conduct rapid assessment of such tax payer

Regulatory response and Impact on Economy

- For BFIs:-
 - Difficult plan credit growth
 - Difficult manage deposit mix
 - Difficult to call loan before maturity (Personal loan utilized by SMEs. It may encourage informal banking or increase banking from non regulated sources)
 - Base Rate mechanism and Interest spread management
- For Borrower:-
 - Difficult to conduct business
 - Difficult to manage relationship with bank (Paying loan before maturity)
 - High Loan to collateral ratio:-
 - For real estate Loan to collateral is more than 1:3
 - For Capital Market Loan to collateral more than 1:4
 - Credit restriction:-
 - On Vehicle Loan
 - On Personal Loan

Questions

?