

Challenges to SME Financing: A Case of Nepal

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Abstract: The objective of this study is to analyze the challenges faced by SMEs in need of financing in developing countries, with a focus on Nepal. In Nepal, the SME sector is a major economic player and therefore, reinforcing the responsibility of this sector in the national production is a major strategy of the country. High loan rates and high collateral requirements remain a big obstacle in the access to finance to SMEs and hence in the development of the economy. However Nepal's expedited license and permits grant system and the contribution of female workforce in the SME sector remain its strong points that can be exploited for a faster growing SME sector. Recent policy reforms helped in the creation of an environment in which the SME sector can flourish. However, efforts for promotion of SMEs are confined to the urban centers in regional headquarters and lack the ability to carry out their mission. The increasing numbers of branches, opened in rural areas, by the commercial banks have also been lukewarm because these financing institutions are more focused on transferring rural savings to urban sectors than using them for improving the local entrepreneurial efforts. A lot needs to be done for the promotion of Nepal's troubled SME sector, which, if properly taken advantage of, can offer a lifeline to its difficult economy.

Keywords: SME Innovation; SME Financing; Intellectual Property Protection; Developing Countries.

1. INTRODUCTION

Nepal is a small land-locked country located between two economic giants, China and India. Nepal's geography is mainly mountainous. The economy is most dependent on a large agricultural based rural sector and a smaller industrial urban sector subsisting primarily on manufacturing, trade and tourism. Nepalese economy is heavily dependent on imported goods and in order to maintain a favorable balance of payments, the country needs healthy exports. A robust SME sector can fuel Nepal's exports as carpets dominate the manufacturing industry besides ready-made garments and hides; all of which show an export potential.

1.1 SME OVERVIEW

SMEs are a vital part of the economy of developing countries. The United Nations Industrial Development Organization UNIDO stresses that poverty and inequality can be tackled successfully with the integration of developing countries in the global economy through economic liberalization, deregulation and democratization. This can be achieved with an active private sector, pushing the economy forward accelerated by the contribution of SMEs (Fida, 2008).

Ninety five percent of all the industrial establishments in Nepal are SMEs and they employ 80 percent of the national industrial workforce and contribute around 80 percent to the GDP of the country. According to the Industrial Enterprise Act of 1992, with amendments in 1997, a micro enterprise is defined as a business establishment with assets worth up to two hundred thousand Nepalese Rupees (NPR 200,000), a small enterprise is defined as a business concern with total assets up to 30 million Nepalese Rupees and a medium-sized enterprise is defined as a business establishment with total assets worth between 30 million to 100 million Nepalese Rupees.

In Nepal, SMEs clearly play an important role. In a country where the advantages of economic growth are restricted to the metropolitan urban centers and benefit only a small percentage of the population, SMEs are major drivers of creating opportunities for self-employment, mobilization of local resources and bringing economic growth to the rural populace. There is a lack of developmental strategies in Nepal to advance the inter-relationship between different economic centers so that economic gains can benefit a wider range of population.

Since 1980s, Nepal has seen a shift to open market regime that lowered the barriers to international trade. This policy change has affected Nepal's SME sector with the influx of foreign imported goods that are seen to pose a threat to the growth of its domestic industry. Nepal's SMEs have suffered in the battle for quality and unless the government sets quality standards for its main exports, the damage is expected to increase. The government has recently announced commercial policies and export related incentives to encourage the SME sector but a number of factors have contributed to the continued state of struggle for the country's SME sector. The lack of awareness among the entrepreneurs is a big factor as most of the SME owners have business operations in rural areas, the outreach and awareness of policies is equally as important as the formation of new policies, just as the timely formulation and implementation of a policy. Any lapse in policy declaration sets back SME sector recovery.

2. SME FINANCING

According to the legal definition as described in the Industrial Enterprise Act of 1992, SMEs in Nepal comprise of establishments having total assets worth up to NPR 100 million. Business concerns falling under this specified limit of total assets owned in the country form a huge 98 percent of the total manufacturing concerns of the country. This shows the importance of manufacturing SMEs in contributing to employment generation and value added.

Since SMEs form such a big part of the manufacturing industry in Nepal, their financing is an important driver of economic growth. However, despite claims by banking institutions of SMEs being prime customer target, the SMEs in Nepal have been forwarded fewest loans of all established businesses. According to the central bank of Nepal, the Nepal Rastra Bank (NRB), SMEs receive only about 2.6 percent of the total financing offered by commercial banks.

What characterizes Nepalese economy is the presence of a substantial rural sector and a smaller industrial sector that is mainly concentrated in manufacturing, trade and tourism areas (Thapa and Poudel, 2006). As typical of a developing country, most small businesses in distant areas and on their less accessible mountainous terrain face difficulty, not only in accessing finance (UNDP, 2009) but also in having information about the financing options available to fulfill their needs of their business.

Nepal suffers from a lack of both internal and external investment (Ghimire, 2011). This stems from low domestic savings, a small domestic market, a severe shortage of skilled labor, chronically corrupt and inefficient public administrations, high transport and operating costs, the inadequacy of power resources and, increasingly, political instability. There have been recent attempts to encourage investment and privatization through the Industrial Policy 2010 and the creation of industrial centers with governmental land and buildings on lease for private ventures. Recent increase in the lending to services sector shows potential of growth and indicates a positive potential for the SMEs in Nepal.

2.1 FINANCING CONSTRAINTS

According to the research department of Nepal Rastra Bank, lack of sufficient collateral is the main obstacle to SMEs access to financing in Nepal. Nepal Bankers Association is of the opinion that while lack of collateral does play a role refusal of financing, it is not the biggest issue. The major difficulty faced by entrepreneurs is the lack of documentation. SMEs looking for financing do not maintain proper account books of their businesses and the informal documentation and record keeping and so fail to meet the criterion that is required by commercial banks for financing an enterprise.

A high cost of borrowing is also an important hurdle in the growth of SMEs in Nepal. SMEs have to currently pay the high loan rate of around 16%, which is even higher than the interest charged on auto loans and home loans (Joshi, 2018). A high lending rate like this affects business owners not only by raising their cost of debt servicing but also by forcing them to keep their operating costs low and discouraging any steps toward undertaking innovations.

The lack of sufficient collateral to obtain a loan by SMEs is a major hindrance in boosting financing to the sector and NRB has addressed the issue by announcing the necessity of establishing a secured transaction registry office in an effort to realize the implementation of the Secured Transaction Registry Act. This special step gives the banks the leverage to issue funding to entrepreneurs with grain and livestock as collateral, thus widening the scope of what is traditionally considered suitable collateral and gives the rural entrepreneur base an option to avail funding without land and property based collateral needed. The plan seems lucrative in funding the hard to reach rural SMEs.

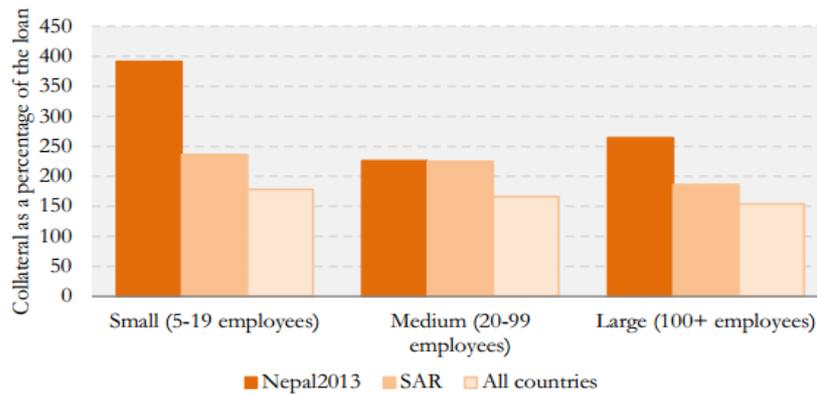


Figure np.1 Small firms in Nepal require higher collateral compared to larger firms

The chart above from the World Bank’s Enterprise Survey clearly shows the problem faced by Nepalese firms when it comes to getting funding. The chart compares collateral requirements relative to the amount of loan applied for by small, medium and large firms in Nepal, the rest of South Asian countries and the global collateral requirement threshold. Nepalese collateral requirement for all sizes of firms is higher than the rest of the south Asian and even the world average. Not only is this an alarming situation in a country where SMEs play such a big part in the domestic economy but also the increase in collateral requirement with the decrease in firm size is a troubling statistic. Every firm starts small and high collateral requirement indicates an entry barrier essentially which can be interpreted as a discouragement for startups.

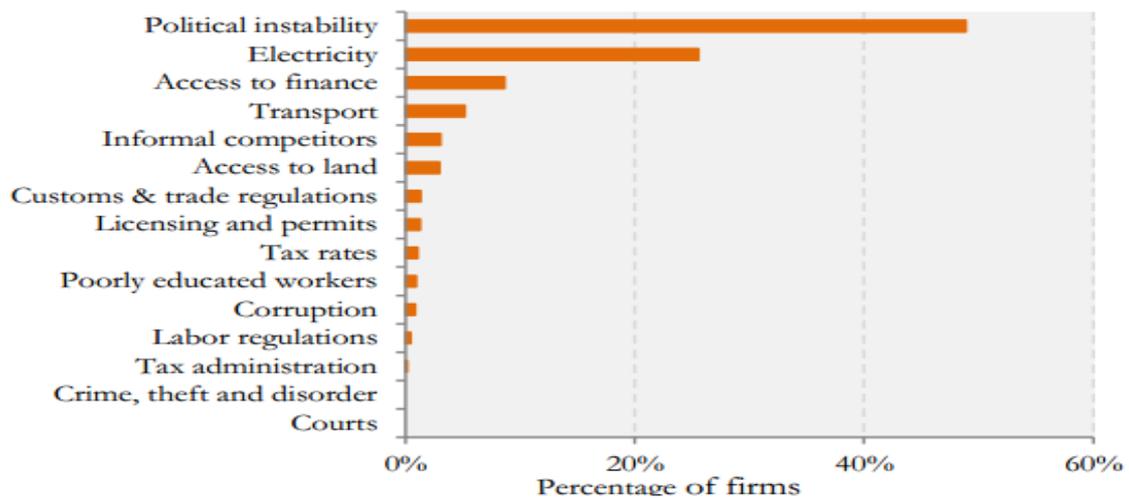


Figure np.2 Obstacles to business for firms in Nepal

The enterprise survey data clearly shows the three biggest obstacles to business in Nepal being political instability, lack of electricity and access to finance. Almost ten percent of the businesses identified access to finance as the biggest obstacle faced by them in the development of their businesses and combined with political instability, it is a lethal combination for the survival of businesses. This figure is instrumental in identifying the areas that need key focus if the SMEs sector in Nepal is to flourish.

Figure np.3 shows the strength of Nepal in the area of issuance of licenses and permits for operating or importing activities of businesses. It is an area that needs analysis so other countries can benefit from the Nepalese model of expedite and efficient permit/license issuance. Especially noticeable is the efficient issuance of a construction-related permit which needs considerably less time when compared to the regional and even global average time. In Nepal, it only takes a mere 6 days to get an import license issued as compared to the 27 days needed on a global average and the gap between the time taken to issue a construction license is a staggering 49 days on average. The example of Nepal offers good insight in making the license/permit issuance more efficient for the world.

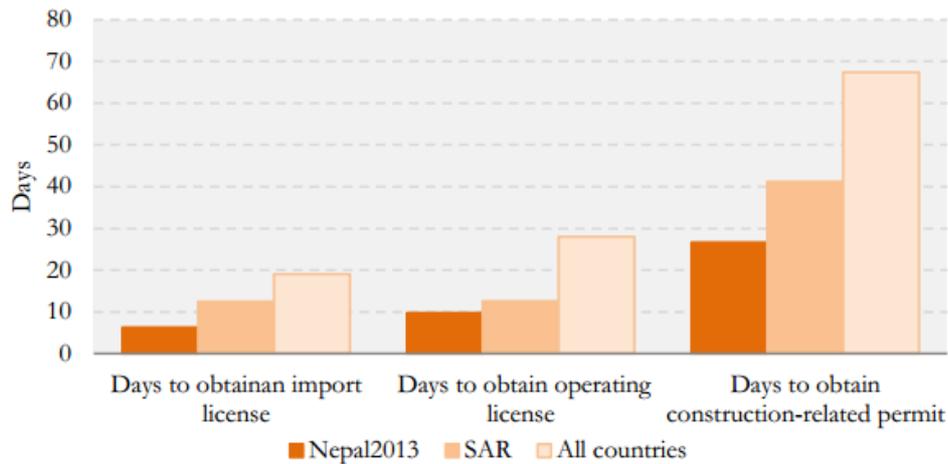


Figure np.3 Average wait times for obtaining permits and licenses in Nepal

The figure below shows the statistics regarding female participation in businesses and entrepreneurship in Nepal as compared to regional average. Nepalese women seem to play a higher role in both the ownership as well as management of businesses in Nepal in comparison to the neighboring South Asian countries. About 17 percent of Nepalese women are top managers and over 22 percent own their own businesses. This shows higher workforce participation by the female population of the country that is surrounded by conservative South Asian neighbors where, the female role seems to be limited.

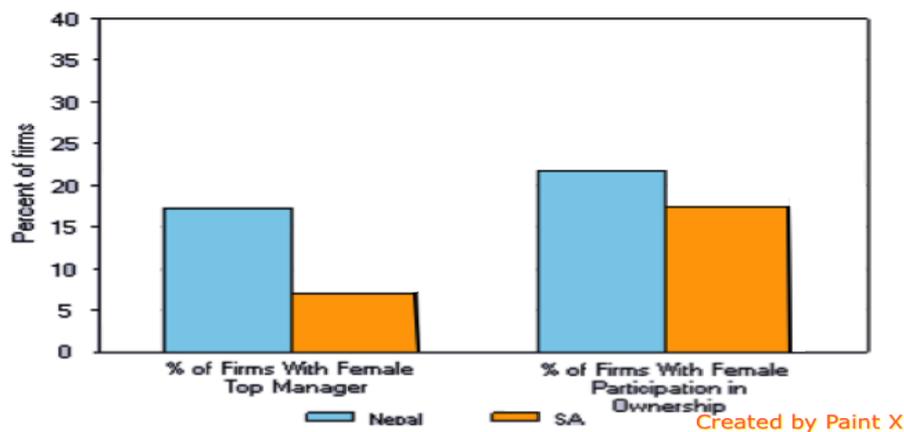


Figure np.4 High rates of female participation in Nepalese firms

3. SME PROMOTION STRATEGY

In the early nineties in Nepal, trade and investment were liberalized, a unified exchange rate was established and the tariff and tax structure was rationalized. All this was done in effort to bolster the exports of the country, reinforce the financial and capital markets of Nepal and promote the growth and development of private sector. The result of the reforms was a positive change in the economic environment with regard to the emergence of a market-oriented economy. The private sector was revitalized and its role in the manufacturing industry, health sector, finance sector and almost all other sectors saw a boost with the share of non-agri sector rising 8 percent. The overall impact of this on the economy was the increase in employment and other opportunities for income generation. The growth rate of manufacturing, trade and tourism sector showed remarkable hikes from 1990 to 1995 but unfortunately, this positive trend was short lived and took a downward turn in the late nineties and plateaued in the year 2000. The political turmoil in the country has contributed a fair share to the stagnation and even worsening of the SME sector.

Policy reforms, like relaxation of trade policies, privatization at national level, deregulation and de-licensing, unification of exchange rate and rationalization of tariff and tax structure have played a major role in the minimization of market distortions and helped in the creation of an environment in which the SME sector can flourish. A major step taken by the

government at the time was including the SME sector in the discussion of economic policy. This inclusion of the SME sector in the dialogues for policy formulation, and SME input in reform activities, helped in the identification of developmental hindrances in the promotion of this sector, like presence of benefits for bigger companies in trade, which they subcontract to SMEs instead of SMEs getting the benefit first hand. Due to the inclusion of SMEs in policy dialogue, the small firms and cottage industries are exclusive for national participation and foreign involvement in these sectors is prohibited.

These reforms, though involved the participation of SME sector, were far from flawless and offered a lot of room for improvement. This was felt in the lack luster improvement and performance of SME sector in the following years in Nepal. The continued political instability was a major fact in the recurrent change in policies, policy makers, interference in policy formulation and continued delay in policy implementation. This chaotic power struggle over the formulation, implementation and administration of policies was fueling the fire of corruption. The annual budgets became a complicated mess of procedural announcements with continued variations in trade and taxation policies. To further damage the situation was the circulation of confidential circulars outlining the hampering of growth of SME sector, in departments of organizations established mainly for SME promotion. Besides the problems of trade policy, the lack of proper infrastructure in Nepal has been a basic obstacle in the growth of this sector, which has led to the aggravation of another major problem of the lack of access to inputs and markets by small and medium entrepreneurs.

The location of Nepal, sandwiched between China and India has also contributed to its problems. The biggest advantage of its neighbors is their massive economies of scale and the small nation of Nepal faces increasing competition, especially from its southern neighbor. The raw material used in the local industry is imported from India and the domestic cost of production using that raw material increases the final cost of Indian finished goods from the same material because the tax on raw materials is more than that on finished goods. Besides the tax disadvantage, the permeable Nepal-India border is a threat to domestic competitiveness in Nepal.

Recently, in order to provide support services to SMEs and promote domestic cottage industry, the government has established a number of institutions that are involved in the training of unskilled labor, guiding entrepreneurs in accessing funds and inputs. Efforts for promotion of SMEs are confined to the urban centers in regional headquarters and even those were either under-staffed or lacked skilled staff to carry out its mission. The increasing number of branches, opened in rural areas, by the commercial banks have also been unsuccessful in reviving SMEs because these financing institutions are more focused on transferring rural savings to urban sectors than using them for improving the local entrepreneurial efforts. There is no doubt that a lot needs to be done for the promotion of Nepal's troubled SME sector, which, if properly taken advantage of, can offer a lifeline to its difficult economy.

4. CONCLUSION

Nepal has realized significant development by cutting the percentage of people living on less than \$1.25 a day by more than half. Even though its social indicators have also upgraded but Nepal still has a long road ahead of it in realizing its economic potential. Poor infrastructure: unreliable electrical power and low-quality transportation networks are among the country's important economic bottlenecks and hinder job creation and the delivery of services. A difficult regulatory environment constrains the private sector as businesses are required to comply with 130 processes from over 41 ministries and government agencies. A high degree of informality, characterized by reluctance toward taxation, regulation and inspection, also prevails and diminishes the quality of goods and services.

Some financial institutions remain at risk of insolvency, due to inadequate risk management practices, poor corporate governance and high credit exposure compounded by under-resourced supervision and weak enforcement of prudential norms. The regulatory framework remains weak; operational capacity to manage the fiscal costs of a financial crisis is limited; and so the capacity to prevent and manage potential crises remains a concern.

All of this, combined with the reining political turmoil and a big dose of natural catastrophes in recent years took its toll however, the SME sector has been getting more attention and has taken a front seat in the ongoing situation. Increased lending to the services sector shows potential of growth. In Nepal, the SME sector is a major economic player and therefore, reinforcing the responsibility of this sector in the national production needs to be a major strategy of the country.

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