

## ECONOMY AND POLICY

# Realising the Potential of Micro and Small Enterprises

*Time has come for the government and stakeholders to support endeavours of microfinance companies to uplift the MSEs to the national economic mainstream.*



BY JANARDAN DEV PANT

**D**eveloping micro and small enterprises (MSEs) opens the doors of opportunity for poverty reduction and enhances the country's overall development. This is because such enterprises enable people at the bottom of the pyramid to get the opportunity to realise their potential.

for MFIs. Currently, MSEs in Nepal are struggling just to survive rather than to excel and grow. A resultant solution is possible for this situation at a time when the coverage of MFIs has expanded to all districts and commercial banks have reached all the rural municipalities of the country.

3.36 million households across Nepal to engage in livelihood activities. The members of the households strictly follow microfinance activities such as attending monthly meetings, availing credit and related services, crops, livestock and health insurance alongside health and sanitation awareness programmes. The target groups of MFIs are the people earning below USD 2 per day.



MSEs need capital to grow. But in Nepal's context, such businesses are the "missing middle". They are considered as 'too big' by the microfinance institutions (MFIs) and 'too small' for mainstream financial institutions- 'too big' for MFIs because of the size of the loans to such businesses which exceed the ceiling for non-collateralised loans set

As a pioneer MFI in Nepal, Nirdhan Utthan Laghubitta Bittiya Sanstha Limited started collateral-free lending in 1993 to meet the dual objectives of women's empowerment and lifting people who are at the bottom of the socio-economic pyramid people out of poverty. Presently, about 91 MFIs provide microfinance services to

### What are MSEs?

As per the Industrial Enterprises Act, 2016, a micro enterprise is a firm with investment in plant, machinery and equipment not exceeding Rs 0.5 Million (land and building not included) and with a yearly turnover not exceeding Rs 5 million. Meanwhile, in a small enterprise, investment in fixed assets is usually more than Rs 0.5 million with a cap at Rs 100 Million. Similarly, the Act has categorised a medium enterprise as a firm having investment in fixed assets of more than Rs 100 million but not exceeding Rs 250 million.

In Nepal, most of MSEs are running informally; some of them do not want to register their firms to

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avoid government taxes. The country's GDP does not represent the value added by those MSEs as their businesses are operated without being registered with the government authorities concerned. A majority of them do not have bankable land and buildings, particularly in rural areas, where land with eight-foot road access (which is a normal collateral requirement of BFIs) is limited. Normally, MSEs lack proper documentation about their business plans and projections and don't have financial and business literacy about basic accounting, taxation, compliance, management skills and marketing.

#### **Campaign to Upgrade**

As of April 13, 2019, Nirdhan Utthan has 347,530 active clients covering 77 districts and an estimated 3.36 million total MFI clients across Nepal. If we can help these clients to start micro and small entrepreneurial activities at a rate of five percent per annum, about

168,000 new entrepreneurs will start micro and small businesses on a yearly basis. Presently, it is estimated that there are about 75,541 MFI financed micro and small enterprises in Nepal (as of January, 2019) and microenterprise (ME) loans outstanding at Rs 22.66 billion. As per the existing arrangements, MFIs are required to allocate a minimum of one percent of their profit to the client protection fund for skill development and financial literacy programmes. Therefore, during FY 2018/19 there was an 83 percent ME loan growth in the country's MFI industry. In January 2018, the total ME loan outstanding was Rs 12.35 billion which increased to Rs 22.66 billion by January 2019.

#### **Creating Jobs**

Nirdhan Utthan has developed a "tailor-made client graduation strategy" which is aimed at shifting graduated clients to MSE portfolios i.e. upgrading the status of clients from

nano to micro and small entrepreneurs. This strategy helps to promote new entrepreneurs in large numbers who will be able to contribute to the country's GDP and create more jobs. Nepal's GDP does not represent the value added by nano enterprises (MFI clients) as most of these businesses are operated without being registered. Once we help them to upgrade to micro and small enterprises, they have to register at government authorities. Assuming that 3.5 individuals are engaged per MSE, the microfinance sector can create an additional 588,000 jobs per annum.

#### **Access to Source of Finance**

Bank and financial institutions haven't been providing sufficient funds to MSEs because access to finance of newly established firms and MSEs is relatively limited than big business establishments. Basically, it is due to the inability of MSEs to guarantee land and building and other property as collateral, low level of financial literacy, and in many cases absence of suitable loan products. All these increase risk factors to BFIs to invest in such firms.

Currently, there is a large MSEs funding gap in Nepal. The total credit gap is estimated at USD 2.1 billion. The basis of this estimation is according to the assumption of the average loan size of USD 30,000 multiplied by 300,000 registered MSEs in Nepal. The total loan demand is estimated at USD 9 billion. Assuming 30 percent of credit worthy MSEs, the total loan required is at USD 2.7 billion. Presently, the total loan outstanding of banks in MSEs stands around USD 0.6 billion. After deducting the loan outstanding USD 0.6

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### Way Forward

1. Enhance micro and small enterprise loans from the present maximum one third of total loans and advances outstanding to one half from MFIs.
2. Establish a credit score mechanism that can assess the credit worthiness of all Nepalis who are aged 18 or above after providing them the unique identification number in a sequence.
3. A course related to business literacy should be made mandatory for grade 8, 9 and 10 students. It should cover budgeting, financial basics such as the effects of compound interest on loans and savings, insurance, investments and government schemes.
4. Strengthening of existing infrastructures and the establishment of a credit guarantee fund to reduce the risk for MSEs.
5. Leveraging MFIs to be able to increase the number of loans to Micro Enterprises.
6. Revise and refine the priority sector lending regulatory requirements for commercial banks adding small enterprises at a reasonable percent to their lending portfolio.
7. Deepen the collaboration between MFIs and commercial banks.
8. Enhance the capabilities of staffers in MFIs and commercial banks to provide better services to MSEs.

billion from loan demand of USD 2.7 billion, the net credit gap is estimated to be at USD 2.1 billion.

To support the growth of MSEs, there is a need to bring a Micro and Small Enterprise Credit Guarantee Act. Under this, when the loans become unrecoverable, banks and financial institutions extending the loans can receive compensation from credit guarantee companies and hence the loans will be paid. However, there should be a provision for the uniform credit scoring. Credit scoring

will help to standardise policies, processes and procedures, increase productivity of loan officers of the financial institutions and improve the portfolio quality by quantifying risks.

### Central Bank Directives

Currently, the class 'A', 'B' and 'C' BFIs are required to lend at least five percent of their total outstanding loan and advances (including bills purchased and discounted) to the deprived sector.

As of March 15, 2019, the total deposits and loans and

advances of BFIs stood at USD 28 billion and USD 25 billion respectively. From this figure, we can infer that the total minimum loanable funds to the deprived sector, as of March 15, 2019, stands at USD 1.25 billion. However, the loan and advances of commercial banks in the hydropower projects (up to 1 MW), in cooperatives up to Rs 30 million and in non-dividend hospitals up to 5 percent of BFI core capital are also considered deprived sector loans.

Nevertheless, the total loans and advances outstanding of MFIs as of January 14, 2019 is at USD 1.58 billion and their deposits at USD 0.55 billion. It is high time that the central bank give similar additional lending directives to A, B and C class BFIs to lend to MSEs once the infrastructure, such as uniform credit scoring, is created by the Credit Information Bureau and credit guarantee insurance companies.

### Sustainability, Specialisation and Scale

MFIs are locally rooted, have deeper connections with bottom of the pyramid clients and have a good distribution capacity.

Commercial banks have funding strength and are globally connected. The government has various schemes such as Direct Benefit Transfer (DBT). DBT removes the middlemen and money will reach the accounts of the target group directly. Therefore, DBT and monitoring of welfare schemes through digital banking can be an effective tool when it comes to good governance. ■

*The author is CEO of Nirdhan Utthan Laghubitta Bittiya Sanstha Limited.*

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