

Expanding Access to Finance for Small and Medium Enterprises: An Analysis of Demand and Supply Side Constraints of Nepal

Jeebanath Adhikari¹

Abstract

The objective of this article is to analyze the constraints on expanding access to finance with a special reference to Small and Medium Enterprises (SMEs) in Nepal. Following explorative research design, tools like review of literature, field observations, key informant interview with Banks and Financial Institutions (BFIs), and a quick questionnaire survey with SMEs in hilly districts of Nepal were deployed to collect data for this article. The descriptive statistics showed the financing gap very clearly. The constraints of SMEs on access to finance are found in policy and operational levels on both the demand and supply sides. There is a huge scope of modern technology to reduce the constraints towards expanding access to finance for SMEs in rural areas. The major constraints area includes the policy measures, lending approach and use of technology, rate of interest, availability of collateral with SMEs, risk-mitigating measures, the position of financial literacy, stage of SMEs' market development and their business incomes, regulatory compliances, general price level, and development of the physical infrastructures.

Keywords: Financial Institution and Services, Access to Finance, Financing Obstacles, Small and Medium Enterprises, Finance in Urban and Rural Economies

1. Introduction

The share of SMEs in employment generation and economic development is growing over time in developing countries. ADB working papers have also reported that SMEs comprise a large share of employment and output in Asian countries. The leadership of the Federation of FSMEs Nepal claims that SMEs' contribution to industrial development is at 83 percent. However, expanding access to finance the SMEs in Nepal has policies and institutional constraints on top of geographical complexities and economic development challenges. Understanding the business environment and contexts of SMEs, an appropriate design of the SMEs' loan product, processing efficiencies of the loans, policy and regulatory reform to support an effective implementation as per the diverse environmental contexts, etc. are the key issues to promote access to finance the SMEs in Nepal. Having a look at the current guidelines for improving access to finance including the ideas from the Constitutions of Nepal, graduating context of Nepal into the developing country, sustainable vision 2030, etc., we find that the Government of Nepal (GoN) is trying to increase the branches of commercial banks, increase the share of deprived sector lending, priority sector lending, refinance, etc. In the last few years, BFIs branches increased rapidly and they reached 11650 branches (NRB, 2022). However, SMEs' share of access to finance has found still difficult and the financing gap is clearly observed.

¹ Researcher, Innovative Circle and Lecturer, Public Youth Campus, Tribhuvan University, Kathmandu, Nepal, Email: adhikarims06@gmail.com.

Yet nearly after 80 years of the banking industry, government policies have not focused on the root causes of access to finance in Nepal. Despite the efforts of the Central Bank of Nepal (Nepal Rastra Bank, NRB) to flow credit to priority sectors, BFIs have shown somewhat reluctance to disburse credit even at a high rate of interest (NRB, 2014). Therefore, this article tries to explore and analyze the most crucial constraints impeding access to finance for SMEs in Nepal. SMEs are classified mainly according to the size of capital utilized in business².

SMEs are often too small to attract commercial banks' or investors' interest, and too large to be benefited from the loan products financing from microfinance. To date, few scalable solutions to support this "missing middle" tier of business are found. SMEs are hindered by various factors such as a lack of business skills, financial access, and a sound legal and regulatory environment, among other things. One of the biggest constraints faced by SMEs is the lack of access to financial services that hinder their establishment and growth. BFIs tend to believe that SME lending has a poor risk/return ratio due to weak and large asymmetric information which leads to complexity in underwriting. This may or may not be the correct hypothesis.

2. Literature Review

Kharel and Dahal (2020) argue that onerous collateral requirements and high-interest rates are the major challenges to accessing credit for manufacturing SMEs, besides the lack of concrete policy framework, the poorly targeted fiscal stimulus package for their institutional development, and other needs. UN ESCAP (2018) claims that Nepal lacks the credit infrastructures, financing policies, and credit guarantee mechanisms to create a conducive eco-system, and the stringent collateral required to support the SME's growth and full potentialities. As a result, small enterprises have difficulties in accessing an appropriate amount of credit and the financing gap is still large. The survival and success, growth and development, and productivity and innovation of SMEs largely depends on access to finance, where small and young business generally face tight resource constraints due to unfavorable financial market (Bakhtiyari and et. al 2020). OECD (2018) report informs the demand and supply side financing barriers that included market failures and structural challenges such as information asymmetries, collateral shortage, high transaction cost in serving SMEs, poor financial skills and knowledge of the SMEs, limited supply of and poor access to financing instruments to address the diverse financing needs, fragile credit market environment, and changing contexts.

A national survey conducted by the NRB (2022) showed that the usage of credit products among its respondents was below average population, 46.34 percent only, where the largest proportion of loans was with the collective saving loan (26.02%) followed by the Cooperatives loans (21.26%), bank loan (17.6%), Microfinance (12.11%), the loan without collateral (11.09 %), government concessional loan (2.35%) in general. In addition, the survey claimed that the financial literacy of Nepal at the end of 2022

²As per the industrial classification of Nepal, a small enterprise is an enterprise that is other than micro and small enterprises and has fixed assets up to NRs. 100 million of fixed capital and medium enterprises are the enterprises that have fixed assets of amount from NRs. 100 million (10 Crore) up to NRs. 250 million.

Except for the land and buildings, micro-enterprise has a fixed asset amount of up to NRs. 0.5 million, along with a provision for the entrepreneur by himself/ herself in business operation and management, 9 employees including the entrepreneur, less than NRs. 5 million's annual business transactions, and less than 20 KW energy consumption for the use of machinery or equipment.

was just above average score of 57.9 percent and financial inclusion varies across the provinces, rural and urban clusters, occupation, age, financial products, etc.

Despite the comprehensive policy measures and the initiatives of policymakers and regulators of Nepal, improving the financial access to MSMEs is a challenging issue. Some of the policies and enabling initiatives include the establishment of microfinance institutions, formulation of the National Financial Inclusion Strategy and its roadmap, frequent mandates and measures of fiscal and monetary policies, increasing branches of BFIs, financial literacy programs, the offer of digital financing service such as branchless banking, Biometric card system/POS, etc., cooperatives financing, SMEs Development Funds, Challenge (seed) Funds, concessional interest rate policies and refinance for SMEs, priority and deprived sector lending, etc. The review of documents available in the literary landscape showed that the financing gap is overwhelmingly observed in Nepal.

3. Methodology

As an explorative research design, the methodology of the study includes both quantitative and qualitative approaches. The review was done on a few relevant literature, policy briefs, and other published documents available in the literary landscape. The whole lending policy and the process considered by the BFIs were taken into consideration to analyze the financing situation. Both primary, as well as secondary data, were considered to internalize the issues and cover the broader business environments. The approach administered a critical observation throughout the lending process and an overview of the stakeholder's situations and provisions. Primary data were purposively collected from two districts, Dhading and Nuwakot, and clustered the districts into urban and rural municipalities. The samples were randomly selected from the urban and rural municipality clusters and explored the local financing issues with those respondents. Four urban and six rural municipalities were visited to reveal SMEs' situation and analyze the local context of the supply of loan products. The study broadly covered both demand and supply-side constraints towards access to finance. On the demand side, 116 SMEs were surveyed through a quick assessment where SMEs were selected by using the simple random sampling approach to identify the financing gap for SMEs.

On the supply side, the author conducted a key informant interview with 20 branches of BFIs that covered 4 different aspects: (a) availability of SMEs loan products, (b) measures of credit risk assessment, (c) the proportion of SMEs loan flow and (d) rural financing approach. A workshop was organized to discuss access to finance with most of the stakeholders- representatives of the central (bank's) authority, commercial banks, and SMEs. The findings are presented in the form of descriptive statistics and discussed in the local context.

4. Results

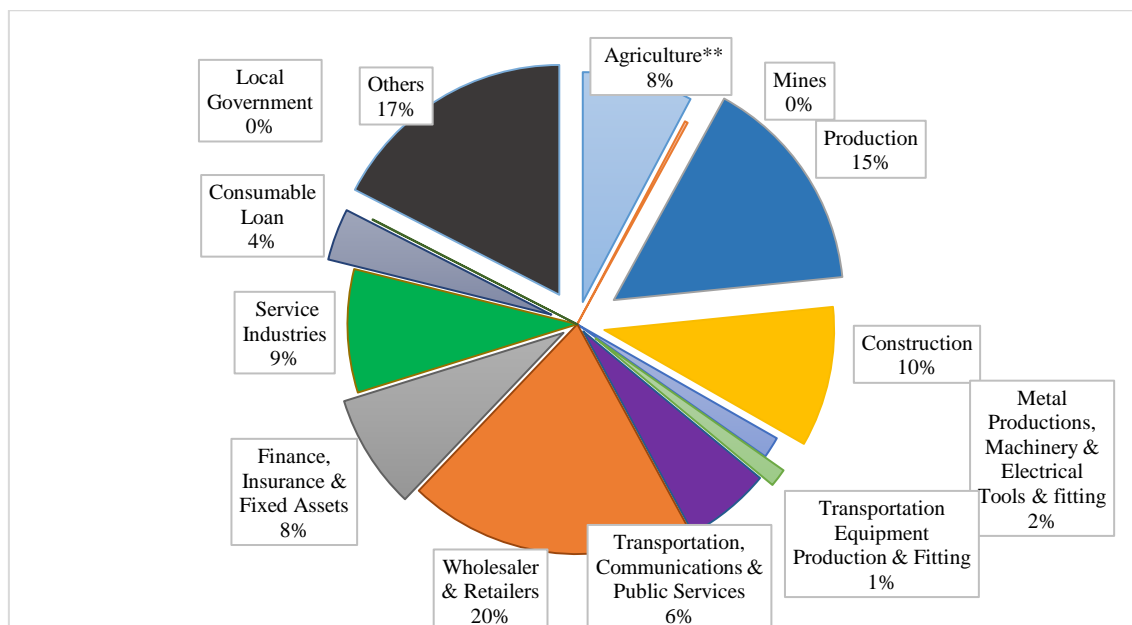
The analysis and discussion broadly cover the area of national lending statistics, SME policy measures, regulatory compliances, weak governance, under-developed physical infrastructures, and rising price levels. On the supply side, this article assessed the lending approaches, use of technology, and risk mitigation measures. On the demand side, it analyzed the collateral constraints, low level of financial

literacy, phase of SMEs business development, high cost of capital, and irregular business income among SMEs.

4.1 Policy Measures and Lending Statistics

Since the late 1950s GoN tried to increase access to finance through numerous policies. The initial measures broadly established the financing access under the government regimes and later on it was designed through the market intervention approaches. The early phase policies were focused to expand credit to low-income households. A large number of state-owned institutions were established for poor and rural households' access to finance. Opening of more branches outside the Kathmandu Valley, establishment of cooperatives, postal saving banks (1970), regional rural development banks (in the early 1990s), small farmers development bank, rural self-reliance fund (1990s), and rural microfinance development centers were the major initiations at the hand. In the early stage, deprived and priority sector lending was initiated mainly after the 1990s. A large number of Finance Companies and Development Banks were licensed in the last two decades. Priority sector lending and deprived sector lending have been provisioned as mandatory on the total loan portfolio. The expansion of bank branches was focused to establish within as well as outside of Kathmandu valley. The commercial lending status of commercial banks, development banks, and finance companies as per the new call reports of sectors showed that the largest share lending was received by wholesale and retail trade (20.05%) followed by production (15.42%), construction (9.86%), service industries (8.67%), finance, insurance, and fixed assets (8.08%), agriculture (7.77%), etc. (figure 1).

Figure 1: Commercial Lending by Sector in Nepal (July 2021)

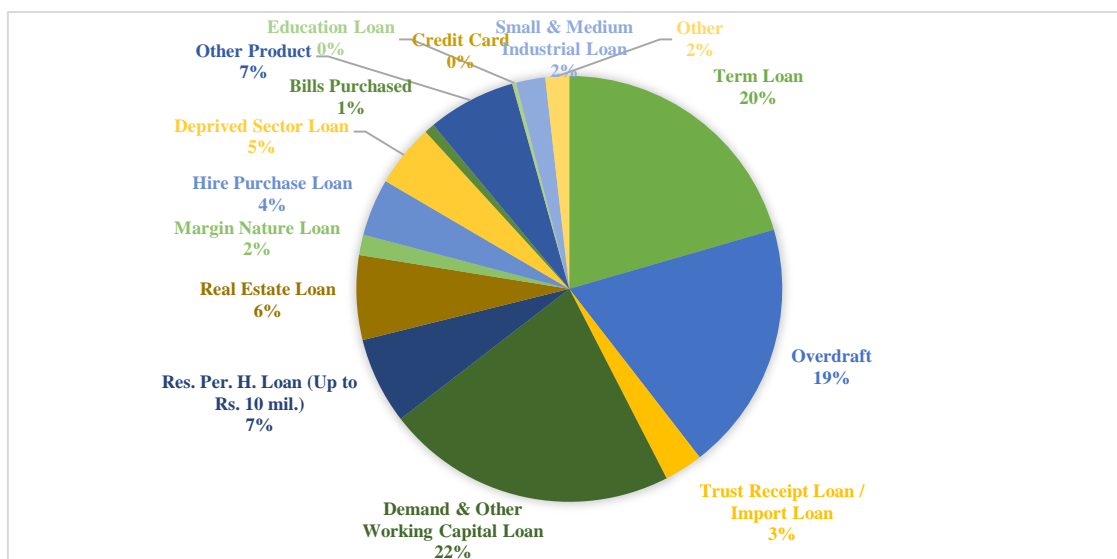


NRB has already ruled its directives for the opening of at least one branch in each rural municipality in the current federal structure. As a result, a large number of bank branches are being established especially in the rural part in the last few years.

The formal financial structure of the country as shown by the NRB (data of 2015) revealed that commercial banks hold 54.9 percent of total financial resources followed by resources holdings of the central bank- NRB itself (22.3%), development bank (5.9 %), employee provident fund (5.3 %), insurance companies (4 %), microfinance (2.3 %), citizen provident fund (2.1 %), finance companies (1.7 %) and cooperatives and financial NGOs (1 %). Under the licensing of NRB – the major credit suppliers for SMEs are commercial banks, development banks, finance companies, and microfinance and financial NGOs which in total account for 65.8 percent of financial resources (of 2017/18). Economic Survey, 2018 reported that financial services were disproportionately distributed among the 7 provinces- a financial branch serves 4839 to 18360 population. Compared to the other 6 provinces, the financial indicators of hilly Karnali Province showed poor performance. Overall broad money supply, private sector lending, and the deposit GDP proportion showed positive remarks on monetization and access to finance (Economic Survey, 2018).

However, Small and Medium Industrial Loan had only a 2 percent share on the statement of product-wise loans and advances of the commercial banks (2015) in Nepal³. SMEs loan, in fact, was more than the Small and Medium Industrial Loan which was not in the special accounting records of commercial banks. Therefore, the proportion of SME loans from commercial banks was not publicly available. Similarly, the deprived sector lending was limited to 5 percent only (Figure 2).

Figure 2: Statement of Product Wise Loans and Advances of Commercial Banks, 2015



Source: Nepal Rastra Bank, Banking and Financial Statistics, No. 61 (2015)

Overall deprived sector lending was composed largely of the share of indirect investment followed by direct lending and youth self-employment loan. The trends of direct lending were being reduced, while the recent trends of indirect investment were increasing in the country. The share of youth self-employment loans had the lowest proportion. Here, components of direct lending include agriculture,

³ The shares of loan and advances show an average figures of 14 commercial banks of Nepal.

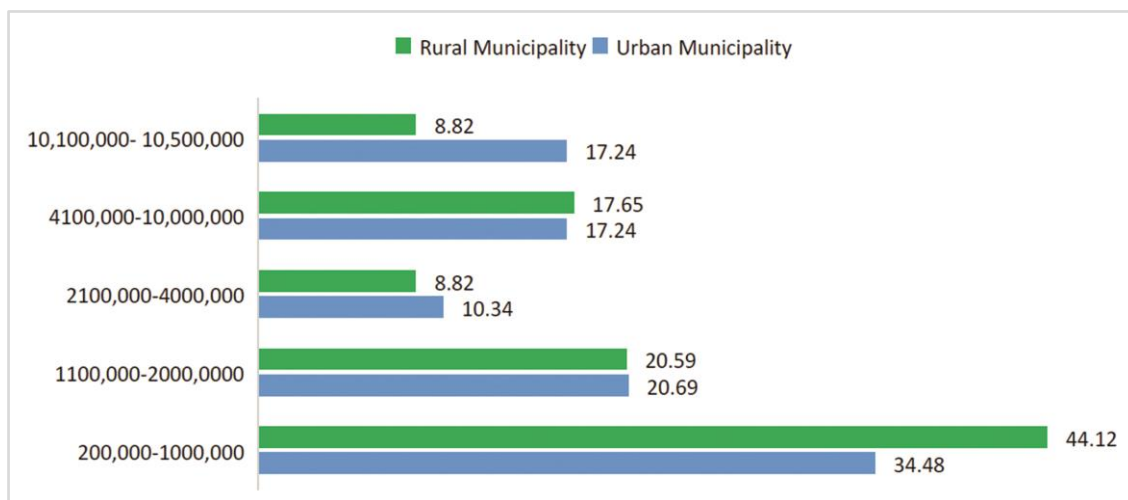
cottage industries, services, and others and components of indirect investment were institutional lending (wholesale) and share investment. The NRB statistics showed a large proportion of loans and advances in demand and other working capital (22%) followed by term loans (20%) and overdrafts (19%) on average.

4.2 The Financing Gap

Despite the aforesaid financing provisions, most of the SME respondents who were asked in sample districts demanded a smooth financial arrangement that would leverage them in their business operations and expansions. Most of the SMEs respondent (96%) who were in need of financial support had a bitter fact that they were ready to borrow even from informal lenders. The reasons behind their readiness were utilizing funds for purchasing additional raw materials, managing stocks, equipment, and other various needs. Overall 82 percent of SMEs had such wishes to expand their business, while 18 percent did not. An overwhelming proportion of respondents also reported that they didn't have their own capital to expand their business. Those respondents who did not have their own capital were obviously more in rural areas compared to the urban and semi-urban areas in the survey districts.

A large proportion of SME respondents (77%) reported loan requirements for more than NRs. 1 million⁴, while 23 percent of respondents reported between NRs. 0.6 -1 million for expanding its business in the near future. However, the majority of the respondents have demanded a loan size below NRs. 2 million (Figure 3)

Figure 3: Average Size of Loan Demand for MSMEs in Rural and Urban Municipalities (%)



Source: Field Data, Dhading and Nuwakot (2019)

4.3 The Supply Side Constraints

Most of the commercial banks had gradually developed their loan products for SMEs. However, an aggregate share of the supply of such loans and advances was found to emerge. Throughout a quick assessment survey and key informant interview with 20 BFIs, this study found that the proportion of SME

⁴ 1 million NRs. Is equivalent of US \$ 9091 at the current exchange rate of NRs. 110 = US \$ 1

loans was roughly estimated to be around 20 percent and ranged between 10 -30 percent. Loan products had limited accessibility for SMEs though they were available with most of the BFIs. The reasons behinds while discussed with the representatives of several commercial banks revealed the following facts behind their current lending situation and practices.

Loan Products and Issues

A large number of SME loan products were available BFIs branches with similar features. These products largely lack innovation, carry out high transaction costs, and are meant for a few implications. The problems are well noted in that BFI's loan products were designed without systematically assessing the needs and institutional capacity of SMEs and the broader economic environment of the local area. The product designs were operating under such mistakes that there was limited scope to resetting the interest rate and improvement practices for review. The pilot testing and the iteration for scale after receiving the feedback were not in practice. Likewise, there was a lack of supportive mechanisms and help desks for communicating with SMEs about SME loan products and supportive linkages for SMEs' business development. There was no proper mechanism to collect, record, analyze, and use feedback on SME loan products. All these make the products rather 'stiff' in a one-size-fits-all provision even without taking nuances and contexts into consideration. Commercial banks have flown a few proportions of their resources to SMEs but the loan was largely going under the caption of consumer basis loan rather than the business loan. Actually, SMEs had not been recognized as any business entity in terms of loan flow out. While asking about the criteria of loan requirements, a consumer loan was found much easier than a business loan in the whole loan process. Compared to business loans, the interest rate charged on consumer loans was found almost higher. The compliance required for business entities had not been covered by SMEs for various reasons. On the other hand, commercial banks including the regulatory bodies had seen not to be serious enough to reform these issues.

Cost of Loan Operation

BFIs are normally profit-driven entities that always try to reduce their cost, given their business management activities. Most of the BFIs respondents agreed that operational and service cost increases with the increasing number of SMEs. This is the reason BFIs prefer large-size enterprises to expand credit. However, SMEs' loan itself is more diversified at a broader level to minimize the risks. The operational cost of BFIs largely depends on the efficiency parameter derived out through technological advancement. However, commercial banks settle the payment based on individual dealing and do not go through advanced digital technologies. Accessing loans from a bank was found a lengthy and cumbersome process for SMEs in terms of requirements, verification, and paperwork. The process involves a significant upfront cost like the credit information charge (CIC), the cost for the valuation of the collateral, registration of collateral, insurance of the collateral, and other associated fees and charges. Generally, BFIs doubt the reliability of project banking documents produced by SMEs. As a result, loan transaction costs and processing time increase for evaluation.

The Risk Mitigation Measures

Before any loan process, BFIs ask SMEs a few questions about the risks. BFIs mostly want to be convinced of major three basic questions: (a) what is the purpose of the loan? (b) How shall the loan be paid back? (c) What could be done in case of loan default? These three questions broadly cover their risk

mitigation measures. Actually, BFIs observe the repayment capacity of SMEs. Most of the commercial banks' branches have developed a simple scoring model to evaluate several risk factors such as financial risk, management risk, industry risk, security risk, relationship risk, etc. For loan decisions, they usually rate SMEs through all their financial indicators assigned with aforesaid risk factors. Therefore, BFIs usually prefer to understand liquidity position, repayment capacity, debt-equity ratio, profitability, managerial quality and strength, performance record, sector of loan, market competition, size of the loan, quality of collateral security, etc. Broadly BFIs branches take loan decisions based on the size of the credit- the branch itself takes a decision, if the size of the loan is relatively smaller, the branch puts forward the documents to the loan committee of its head office, if the size of the loan is big, and it puts forth on board of directors through the head office in case of the largest loan size. The process may vary based on the size of loans and the financial capacities of BFIs.

Overall the risk management policies and procedures of BFIs were found at the primitive stages. Advanced forms of loan grading and credit portfolio were not used by the BFIs. BFIs had their Risk Management Committee (RMC) which was found usually not in operation. BFIs usually analyze the weighted exposure of credit and operational risks, while few commercial banks look more for market risk too. Internal Risk-Based Provisioning Model (IRBPM) was hardly found for the decisions on loans and loan losses (Khanal, 2007). Actually, providing credit to SMEs at a broader level is product diversification, a less risky position for any BFIs. However, this reality was not realized by the branches of the BFIs through their lending practices.

Use of Collateral and Valuation Approach

The branches do not necessarily consider rating the cash flow of SMEs to support their loan decisions rather they put up collateral as a major consideration. The majority of small and micro enterprises in rural areas do not have bankable assets. BFIs require a parcel of land connected to a motorable or gravel road as collateral. Fulfilling this requirement was difficult for most SME owners in rural municipalities. As a result, a large segment across the country is inaccessible to credit. Non-collateral lending was found in very small in size (NRs. 0.1 - 0.3 million) relatively with a higher interest rate and low payback period (2 years as maximum). The outreach of these non-collateral lending was very limited. Actually, BFIs demand primary as well as secondary collaterals in lack of proper trust, and SME-proposed collaterals usually happen insufficient for several reasons. The collateral-based loan products used to have a longer payback period with a relatively smaller interest rate. Mostly BFIs do not want to evaluate SME assets as collaterals when properties are from a rural area.

Evaluation of assets usually limits fixed assets and underestimates the cash flow of SMEs. The valuers judge the SME's collateral. They demand primary as well as secondary collaterals in lack of proper trust, and SME's collaterals usually happen insufficient for several reasons. The major proportion of collaterals are found to be tangible securities and fixed assets such as land and house, plant and machinery, and other moveable assets and these assets are not much more found in rural and hilly communities. In most cases, valuers serve their clients from urban areas with a single field visit. It also implied rural access difficulties of evaluators who can consider the rural context and ethics of SMEs in valuation. Unfortunately, valuers evaluate collaterals based on available physical infrastructures, context and time value, and financial position of SME business. SMEs from rural areas were found with limited scope and

poor quality collateral. But evaluators did not consider higher ethics and degree of commitment to loan payback. Compared to urban municipalities, rural municipalities had poor physical infrastructures that significantly play a negative impact on the inaccessibility of credit through the evaluation process.

The Lending Approach and Technology

The lending approaches designed to finance SMEs could be explained in 3 different aspects- collateral based, group-based, and cooperative-based. Mostly, BFIs follow a collateral-based approach, while the last two approaches were found less effective in a lack of practices. BFIs have largely emphasized collateral as an effective and safe means to finance clients. The major proportion of collaterals are found to be tangible securities and fixed assets such as land and house, plant and machinery, and other moveable assets and these assets are not much more found in rural and hilly communities.

Almost BFIs followed an internet-based banking approach. BFIs deal individually for payment and clearance which usually consumes a few minutes of time and effort. But the problem found in the rural area is the lack of internet. BFI has not used faster, more efficient, and more convenient technology such as cloud computing, distributed ledger technology, and artificial intelligence to improve financial access. The lower levels of institutional capacity, the higher initial cost to adopt the technology, and the high trustworthiness and traditional mindset on paper work ultimately result in BFIs being far away from the latest digital technology in the SME financing approach.

Documentation and Lengthy Procedures

SMEs faced difficulties to develop their financial documents. Actually, SMEs felt onerous mainly due to cumbersome bureaucratic and complicated procedures in the unfriendly environment of documentation. SMEs had to collect their tax certificate, audit report, business proposal development, and others that take a lot of effort and time. Therefore, SMEs prefer simple procedures of consumer /mortgage loan in comparison to SMEs' business loan. The loan process takes a few weeks depending on the size of the loan. Assessing SMEs and collaterals, BFIs branches normally take charge of very small size SMEs loan. Actually, BFI branches forward whole SME documents to their head office for approval and it generally takes 15 – 30 days for final credit decisions on behalf of SMEs. The credit department of the head office collects SME's documents and takes decisions on an individual basis which generally consumes a week. The distance between the loans processing branch and head office, customer bases, and other factors also matter for processing time. The larger the size of an SME loan the more process barriers exist.

4.4 The Demand Side Constraints

High Cost of Capital

The cost of capital was found very high mainly due to a higher rate of interest. While asking with BFIs representatives⁵, the interest rate charged for clients was found as per their classes between 12 to 20 percent. Respondents were asked to view problems of access to funding for their businesses. Forty-three percent of respondents reported that the interest rate was high, while 15 percent, 11 percent, and 5 percent of respondents reported that they had no reliable source of the loan, difficulty paying loan installment, and high cost of loan processing respectively. One-fourth of the SME respondents (25%) reported that

⁵ BFIs representatives include commercial banks, development banks, finance companies, micro-finance and cooperatives

they had other internal problems. While discussing with SMEs, they also reported a lengthy banking process for taking a loan. Therefore, the operational cost of loan products including the interest rate was a big challenge.

Market Struggles for Sustainability

The situation of SMEs was confronted by several issues, while BFIs look for large-size capital and immediate business sustainability. Competition among SMEs was increasing in those emerging markets. Sometimes, SMEs compete even at negative profits for no more loss or addition to the customer base. SMEs had not only faced issues with capital access but also frequent labor shortages. Most of the local youths had gone abroad for foreign employment opportunities. The shortage of labor was also due to the very high dominance of unskilled and semi-skilled laborers. Moreover, these laborers were available only in seasonal periods. The rent, wage, and interest rate records showed increased figures over the decades. Actually, these factors were taken into consideration in the lending decisions. Usually, large-size firms were dominating in product pricing practices. Compared to small ones, large enterprises possess a high financial capacity. Influenced by the large size capital, BFIs therefore mainly preferred the large size enterprises.

SMEs had weaknesses in documentation skills, business planning and development, and business professionalism. They hardly could produce papers that chart out their demand projections and financial planning. SMEs were found largely ad-hoc in terms of their business set-up, operations, and management. In the absence of proper documentation, BFIs were reluctant to provide loans to MSMEs. The coverage of business insurance was limited in the local urban area. Very limited SMEs had used insurance services.

Financial Literacy

Financial literacy was found weak among SMEs. Participants of BFIs had reported underdeveloped knowledge and information among SMEs. A large number of SMEs including educated ones too had financial literacy problems. The weak educational background, lengthy hours of business involvement, poor bank visits, low visibility of SMEs products, and lack of SMEs loan marketing were found responsible for low literacy among SMEs. In addition, SMEs were not aware of the provisions and policies developed on their behalf of themselves.

In many cases, real SMEs were not found to benefit from immunities and exemptions of existing government policies and provisions. NRB provisioned several exemptions and immunities including the deprived sector lending, and refinance opportunities. The more surprising was that both BFIs and SMEs were not aware of several policy support provisions for SMEs.

One more important fact is that SME loans could be proceeded to establish a new business. However, a prior business loan was not generally considered by both SMEs and BFIs for providing the SME loan. In several cases, SMEs were not aware of the available SME business loan products across the banks, their loan procedures, documentation, loan payback systems, etc. SMEs had to collect their tax certificate, audit report, business proposal development, and others that take a lot of effort and time. According to the BFIs' representatives, SME information is sometimes misleading and put in controversy in terms of

business transactions, account keeping, debt–equity position, etc. One interesting thing was that SMEs frequently ask for a formal loan from BFIs to pay back their earlier informal loans.

Not knowing about the finances formally hinders their knowledge of what was available from the banks, how they could negotiate for better terms, and how they could put their business in order so that they could get better rates. The more they know about formal savings, investments, best practices, and negotiation techniques, the better they were able to use finance for their benefit.

Local Market Context and Governance Situation

The SMEs faced several market and governance-related problems. Local governments were more at the juncture of federal restructuring. Some rural municipalities had promulgated few tax exemption provisions, while others had imposed a high tax for their revenue generation for SMEs. BFIs were aware of taking charges against SMEs. As a result, BFIs seemed to be reluctant to flow out credit to typical SMEs such as Brick kilns, crushers, etc. A prior business loan to establish a new business was not generally considered. However, BFIs were found happy with registration initiations taken by local-level governments, appropriate policy decisions, and regulatory measures on behalf of SMEs.

The retail price fluctuates with the change in import price. Consumers usually complain about rising price levels. The relative increase in income was very less compared to the increase in the local price level. Therefore, SMEs were facing difficulties to increase their sales. In the lack of proper stocks, the operation cost of SMEs used to increase, and financial strength used to decrease. SME respondents and government officers used to blame each other. The local level private sectors had argued on the poor service delivery including professional ethics, accountability, roles, and responsibilities, while arguments of government sides were taking the wrong charge through under invoices practices. Local-level offices such as the district administration, district police administration including the district judiciary office- had frequently ruled for some typical activities of construction enterprises such as the extraction of sand and concrete materials from rivers.

Credit Transaction and Irregular Business Incomes

One important thing was that BFIs usually ask for an existing source of income prior to starting any SME business. In rural areas, SMEs' customers don't necessarily have the kind of regular source of income but frequently with seasonal incomes from agriculture-related sources, such as horticulture crops and vegetables, livestock sales, etc. As a result, SMEs were used to sell their goods and services on a credit basis. SMEs generally trust on payback capacity of customers. Sometimes, SMEs sell their products in credit even due to the very high competition between the entrepreneurs. Such trading practices gradually increase their size of credit over business years. As a result, SMEs face liquidity problems which eventually impacts negatively on dealing with dealers/whole sealers and their business expansion. SMEs customer cannot pay back the credit in time. Such type of trading practices put SMEs with irregular business incomes and risky business environments which were not usually in favor of the existing commercial lending.

Business Registration, Audit Report and Tax Compliance

For loan purposes, BFIs usually ask for a business registration certificate, audit report, tax certificate, etc., and these documents were found difficult to develop for SMEs for several reasons. The study also

revealed that SMEs were rampantly registered between several government and private agencies as they were involved. Some SMEs were running out of their business informally. In some cases, they had not registered their business to just avoid government taxes. SME's registration process generally takes place at the District's Small and Medium Enterprise (SME) Office, a line agency of the Ministry of Industry (MoI). For the purpose of tax, MSMEs had also been registered at the district line agency of the Inland Revenue Department. However, registration processes, after the implementation of the federal structures, were found dual. SMEs were being registered at the municipality level too. Compared to local urban areas, SMEs from rural municipalities had found less registered with such government agencies. Therefore, SMEs prefer consumer loans instead of the cheaper business loan though it was more costly.

Development of Physical Infrastructures

The credit-enabling environment and entities for SMEs were lagging behind in the local marketplace. Constraints had been more clearly observed in rural municipalities. The outreach of BFIs was also found in a very good position mainly in headquarters cities and road access areas, while poor access was observed in the rural areas. The poorly developed physical infrastructures impeded SMEs to expand their business operation. In addition, there were several transportation barriers in the lack of local road networks and connectivity. The supply of electricity and internet facilities were found inconsistent. The product market governance was weak as observed in the shortages of raw materials, supply chain irregularities, fluctuating prices of goods and services, unsupportive district administration, etc. Sometimes they faced problems related to their business securities. SMEs faced other barriers such as education and information for business proposal development, estimation of market demand, and expand the size for market expansion, etc. Credit Information Bureaus, Credit Guarantee Agencies, National Payment Gateway, and Warehouse facilities – all these institutional arrangements were not available in the local area that could add value to expand SME loans for income generation. There were no credit-enabling entities to add value to expand SME loans for SMEs in the local marketplace.

5. Conclusion

Most commercial banks are gradually increasing their loan products for SMEs. However, an aggregate share of the supply of such loans and advances was found emerging and roughly estimated to be around 20 percent and ranged between 10 - 30 percent. Of the SME loans, the proportion of business loans was very low. An overwhelming proportion of SME respondents (82%) from this survey reported that they had the wish to expand their business. However, they did not have as many funds as their own. Those who had the wish to expand their business were almost in need of financial requirements. However, SMEs hesitated to take credit at high-interest rates (43% of respondents), had difficulty paying the installments and loan processes, etc.

Actually, business loan products had limited accessibility for SMEs. There was a clear gap between the supply of and demand for business loans for SMEs through the policy and operational levels. The barriers that limit the supply of credit were not only due to the topographical difficulties but also depended on government policies and market incentives. The presence of government, market structures, and the development of roads and other infrastructures. In fact, SME loan products largely lack innovation that carried out high transaction costs and are meant for a few implications. There was no proper mechanism

to collect, record, analyze, and use feedback on SME loan products. All these make the products rather 'stiff' in a one-size-fits-all provision even without taking nuances and contexts into consideration. Accessing loans from a bank was found a lengthy and cumbersome process for SMEs in terms of requirements, verification, and paperwork. The overall process involves a significant upfront cost. The risk management policies and procedures of BFIs were found at the primitive stages - advanced forms of loan grading and credit portfolio were not realized with the risk diversification perspectives, instead mostly preferred the large-size enterprises. BFIs also do not necessarily consider rating the cash flow of SMEs to support their loan decisions rather they put up collateral as a major consideration. BFIs have largely emphasized collateral as an effective and safe means to finance clients. Actually, BFIs require a parcel of land connected to a motorable or gravel road as collateral. Non-collateral lending was found in very small in size (NRs. 0.1 - 0.3 million) relatively with a higher interest rate and low payback period (2 years as maximum). The outreach of these non-collateral lending was very limited.

BFI has not used faster, more efficient and more convenient technology such as cloud computing, distributed ledger technology, and artificial intelligence to improve financial access. SMEs felt onerous mainly due to cumbersome bureaucratic and complicated procedures in the unfriendly environment of documentation that generally takes a total of 15 – 30 days for final credit approval decisions.

On the demand side, SMEs mostly feel the rate of interest is very high which usually remains between 12 to 20 percent. The operational cost of loan products including the interest rate (sum of the base rate and premium charge) were big challenges. The situation of SMEs was confronted by several issues, while BFIs look for large-size capital collateral, source of income, and immediate business sustainability. The competition of the emerging markets, business profitable situation, credit basis in business, business incomes, size of credit over business years, liquidity problems, prospects of business expansion, etc. are taken into consideration for a lending decision. SMEs had not only faced issues with capital access but also frequent labor shortages. The rent, wage, and interest rate records showed increased figures over the decades. In the lack of proper stocks of SMEs, operation cost tends to increase and financial strength tends to decrease.

The poor financial literacy of SMEs had several professional reasons. SMEs frequently ask for a formal loan from BFIs to pay back their earlier informal loans. SMEs were found largely ad-hoc in terms of their business set-up, operations, and management. The coverage of business insurance was limited in the local urban area. Very limited SMEs had used insurance services and other policy measures to get benefitted from immunities and exemptions of existing government policy and provisions such as deprived sector lending, refinance opportunities, etc. Sometimes SMEs' information misleads and puts in controversy in terms of business transactions, account keeping, debt-equity position, etc. The issue of business registration, exemption of taxes, under invoices, etc. were also prevalent. BFIs usually ask for a business registration certificate, audit report, tax certificate, etc. and these documents were found difficult for SMEs for several cost reasons. Local governments were more on federal restructuring processes and gradually ruling over SMEs through registration, taxation, and other operational measures though they blame each other for the existing level of public service delivery, roles and responsibilities, and professional ethics, accountability, etc. but do not feel comfortable enough to collaborate in their common needs and issues.

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