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Supporting Micro entrepreneurs (ME's) for scaling up their enterprise with better access to finance

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Abstract

This paper attempts to explore the micro enterprises sector in Province 5 of Nepal. It has focused on the growth oriented Micro enterprises and, have done exploratory analysis of available financing tools for the current ME's to scale up their enterprises. It has utilized qualitative research tools i.e. Focus group discussions (FGD's) and key information interviews (KII) to understand the current financing tools being used and, identify the attributes the ME's prefer to smoothen their process. Based on the results, this paper has offered a recommendation to the provincial government regarding setting up a Credit guarantee scheme with joint involvement of government as well as private investors/lenders. The identified limitations in current financing model were higher interest rate being charged and, requirement of strict financial documents as well as good quality collateral. This paper has found that the best way to address this limitation is through the recommended mode of Credit guarantee scheme as it will share the risk of credit default among many participants allowing the investors or lenders to take higher risk or, work with lower level of return requirement parameter.

Introduction:

Industrial Policy 2010 of Nepal has redefined classification system of Industries in Nepal and, as per the revised classification system, Industries in Nepal can be classified into five different types: i) Micro enterprises ii) Cottage Industries iii) Small Industries iv) Medium Industries v) Large Industries (Ministry of Industry (MOI), 2010). Micro enterprises has been defined in different terms by different agencies or authors giving priority to different element. For Nepal, the definition offered in Industrial Policy, 2010 by Ministry of Industry can be considered standard which has defined it as: Micro enterprises refers to enterprise having following features i) Fixed investment up to NRs. Two Lakhs except land and, building ii) Self-managed by entrepreneur himself/herself. iii) Employment of less than 9 people including entrepreneur iv) Amount of annual transaction of enterprise less than NRs Twenty Lakhs. v) Use of power less than 10 KW if used.

Micro enterprises is considered to be the beginning step of an entrepreneurial journey. This type of enterprises play a major role in underdeveloped country like Nepal where entrepreneurial system is not so developed along with lack of necessary infrastructure and, other relevant system. As creation and, operation of Micro enterprises requires very low amount of capital, and, it encourages use of local people's skills and, knowledge rather than creating something very innovative so, it can be a best starting point for a new venture. In a long run, creation of micro enterprises will have a positive impact on Nepalese economy and, its entrepreneurial system. This has been verified and, trusted technique of achieving economic prosperity by country like Nepal so, there are many international organizations working on creating and, promoting micro enterprises in Nepal i.e. Micro enterprise development for poverty alleviation (MEDEP) and, Nepal government has also realized the importance of micro enterprises so, they have also launched several government funded programs which work on this frontier i.e. MEDPA.

Micro-Enterprise Development Program (MEDEP) is a flagship enterprise development program of the Government of Nepal (GON) and United Nations Development Program (UNDP). The goal of the program is to alleviate poverty by incubating micro-enterprises and helping them become self-sustainable. The program was initiated in July 1998 in 10 districts of Nepal. As it completes its fourth phase of implementation in 2018 it has spread its work area to 55 districts and has successfully incubated more than Seventy Three thousands entrepreneurs. MEDEP's target population consists of the poor and ultra-poor individuals and families who are below the poverty line according to the Nepal Living Standard Survey (NLSS-III). Unemployed youths, women, and socially marginalized groups from the target population are prioritized for the program. Apart from UNDP, Australian Government Overseas Aid Program (AUSAID) and Canadian International Development Agency (CIDA) are the major supporters for this program. Its major implementing agency is the Ministry of Industry (MOI) and the co-implementing agencies are Ministry of Forest and Soil Conservation (MOFSC), Ministry of Federal Affairs and Local Development (MOFALD) and Ministry of Agriculture Development (MOAD) (MEDEP, 2010).

The Government of Nepal, under the name of Micro-Enterprise Development for Poverty Alleviation (MEDPA), also runs the MEDEP model of enterprise development in various districts in Nepal.

MEDEP Model:

The credit to MEDEP being one of the few successful poverty alleviation programs in Nepal goes to its comprehensive enterprise development model. The MEDEP model is very strategically implemented from the very first step of social mobilization for opportunity identification and creating motivation in public to making them self-sustainable graduate entrepreneurs. Each step of MEDEP model is briefly described below.

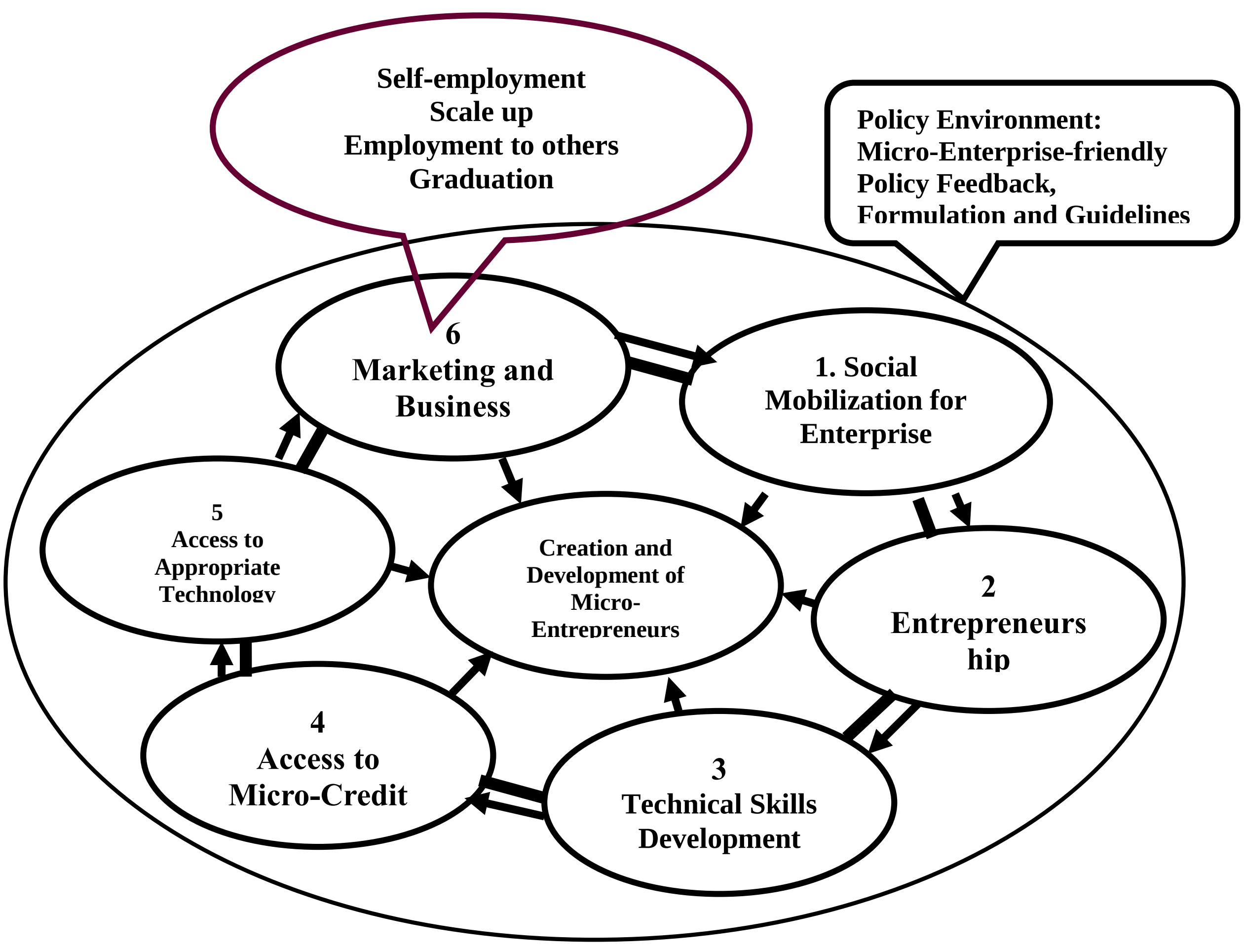


Figure 1: MEDEP Model,

Source: Dr. Lakshman Pun, National Program Manager, MEDEP

1. Social Mobilization for Enterprise Development:

In the MEDEP districts, communities with lower HDI (HDI) index are selected for the implementation of the program. After a community is selected MEDEP launches awareness raising programs there. It organizes various community meetings, orientations and networking with partner agencies. MEDEP assesses the resources availability of the area, market demand of the vicinity then assesses potential entrepreneurial competencies of the target population and selects the ones who can best benefit from the program (MEDEP, 2010).

2. Entrepreneurship Development:

MEDEP uses 'Start and Improve Your Business' (SIYB), a step by step entrepreneurship development package developed by International Labor Organization (ILO) and UNDP for rural setting. The SIYB provides a gradual capability development opportunity to the entrepreneurs by acquiring knowledge and skills for business development.

3. Technical Skill Development:

Technical skill development is the most crucial part of MEDEP's capability building process. It is these skill sets with which the entrepreneurs can create marketable value in the form of product and services. Several kinds of training program are conducted for developing technical skills depending on the nature of the entrepreneurship MEs are involved. The trainings enforce the knowledge base of the MEs after they go through SIYB. These skill sets can be immediately used for product development or for providing service and can be source of income (MEDEP, 2010).

4. Access to Finance:

Since the target population of MEDEP program live below the poverty line they are non-bankable and have limited access to finance at their capacity. MEDEP facilitates the MEs to have easy access to small-scale loans or micro credits by collaborating with various micro-finance institutions such as Rural Development Bank, Nirdhan Utthan Bank and cooperatives. According to immediate need MEDEP also facilitates financing from district and local level government institutions such as Local Development Fund, District Development Committee and NGOs. MEDEP also trains and encourages establishing saving and credit groups, co-operatives from among MEs. It teaches them how savings from such groups can be reinvested to improve their enterprise (MEDEP, 2010).

5. Access to Appropriate Technology:

The enterprises are usually based on product development or service providing which require appropriate simple technology. MEDEP facilitates the MEs in accessing to such technology at low or subsidized cost. Where access to finance and resources such as availability of land and building facility for installing the technology is unaffordable for the MEs, MEDEP helps them by establishing the Common Facility Centers. MEDEP facilitates by directly investing in such CFCs and/or by collaborating with other resources. Such technology and CFCs are tested and transferred for the ultra poor MEs (MEDEP, 2010).

6. Marketing Linkage and Business Counseling:

Marketing is another crucial aspect of enterprise development process where MEDEP helps the MEs with its expertise. MEDEP operates a demand driven marketing strategy for the MEs. It prepares the MEs for stepwise and gradual marketing that aims to expand sales potential from local to district level and ultimately national and international level. Encouraging and helping the MEs with resources for opening outlets at local, district, regional, and national level is part of that strategy. As MEs mature MEDEP helps them with labeling, branding and copy right protection matters where necessary. MEDEP mobilizes Enterprise Development Facilitator (EDF) at district level to facilitate the MEs with sales side of the business. EDF's task is to stay up to date with the market and counsel the MEs with perceived problems and opportunities in the market place. Such counseling is done through the Micro Enterprise Group Association (MEGA) meetings. EDFs also counsel them with credit and saving procedures. Whenever required new and/or refresher workshops and trainings are also organized for MEs (MEDEP, 2010).

Every support programs who have created and, helping to operate micro enterprises expects that the created entrepreneur would take a path of achieving growth instead of remaining in the same initial level. They want the micro enterprise to learn and, take these learnings to next level by scaling up their enterprise to higher level of industrial chain i.e. from micro enterprises to small enterprises.

Micro enterprises and, industrial status in Nepal

Background on Province 5:

Province 5, with 12 districts includes 109 local communities including 4 sub metropolitan city, 32 municipalities, and 73 gaaupalika. With area of 17,810 sq. km, this province is 6th largest in area. 54% of area lies in terai region so, province has rich possibilities in agriculture. Census of 2068 has indicated that there are almost 885,203 households in this province with average household size of 5.08 members. Thus, there is enough labor supply from their own family. As per the Nepal Human Development Report 2014, only 41% of population is active economically and, Province GDP on 2067/68 was 210 Billion which just 14.8% of total country's GDP is.

Province situation paper states that agriculture contributes 45.6% in total production of province which is further strengthened by the fact that 22.7% of total area is fertile in the province. This further presents a huge potential in this sector. Per capita income of the province calculated to be 1,007 is still below national average which further illustrates the need to offer the people of the province to increase their income. In terms of financial availability, province 5 has almost 900 branches of financial institutions but, still only 66 out of 109 has reach of commercial bank which is just 60% reach. Situation paper has further highlighted the fact that province is rapidly growing so, there is huge prospect for creation & further enhancement of micro entrepreneurs.

Literature Review:

Hundreds of millions of people in developing countries earn their living through small-scale businesses (World Bank, 2004). A study that combined data from 13 countries revealed that a quarter of households who are living below the poverty threshold of USD 2 per person per day have at least one household member who are self-employed (Banerjee and Duflo, 2007). These enterprises usually have a small scale size, most of them don't have any employees other than the owner and, very low levels of working capital (Liedholm and Mead, 1998). Enabling such small-scale entrepreneurship has long been identified as a potential mechanism for poverty alleviation.

Results from many studies have pointed to the importance of these kind of small scale self-employing enterprises coined as Micro Enterprises (ME's) in developing economies as it helps in enhancing employment and income, and thereby leading to broad-based poverty reduction. In many East Asian economies, for example, these ME's has been the driver of overall economic growth during the early stage of development (Estudillo et al., 2012). Income from ME sources seems to have a greater effect on poverty reduction as revealed by many authors in their research. For instance, Deininger et al. (2007) used cross-sectional data from Sri Lanka and, found that self-employment in the rural enterprise sector has a significant impact on poverty reduction and, this type of ME's are not only used by those unable to find gainful employment elsewhere. Most of the households who adopt microenterprise activity have additional sources income from farm activities. Khandker et al. (2013) through his research revealed that household adoption of a microenterprise activity causally increases both income and expenditure, and thus reduces poverty in Bangladesh. Particularly, they found that involvement of any household members in any ME's increases by around 50 percent the per capita expenses of a household.

However, scaling-up ME's has not been forthcoming as expected. Different academic papers and, case reports by International organizations has mentioned that growth in microenterprises seems to suffer from a variety of factors, of which lack of access to finance, infrastructure, and markets, and poor quality technology and regulatory barriers appear to be most common (World Bank, 2007). Further, they have also documented that access to better finance (in terms of better terms and conditions of loans as well as a reliable source of finance) is an essential tool for improved productivity and growth for any economy.

Though different obstacles had been identified which has been hindering growth of ME's but, access to finance has been consistently mentioned to be the most important and robust underlying factor. Better access to finance fosters greater firm innovation and dynamism, entrepreneurship, more efficient asset allocation and the ability to exploit growth opportunities, and growth of incumbent firms to a larger size (Beck, Demirguc-Kunt and Honohan, 2006).

Scaling-up microcredit to support progressive ME's with diversified loan and competitive products has not helped to achieve the result thus, access to finance may still be a major hurdle for microenterprise growth. Studies in varied settings show that better access to finance also promotes a firm's entry into the market and thus contributes to growth. For example, Sawada and Zhang (2012) find that nonfarm entrepreneurs perceive access to finance to be a constraint for nonfarm enterprise growth in Yemen. Wang (2008) finds that an exogenous shock/loosening of credit constraints allowed households in urban China to switch from salaried state employment to self-employment.

Banerjee et al. (2009) study the expansion of a microfinance institution (MFI) to new neighborhoods in urban India, and his results find that this expansion led to an 8.3 percentage point increase in likelihood of MFI borrowing. While the expansion may have been highly beneficial for the relatively small fraction of individuals who chose to take out loans to start a new business, the credit expansion left the great majority of people totally unaffected. In urban Philippines, Karlan and Zinman (2010a, b) also exploit randomized access to credit, but estimate the impact of loans made at much higher interest rates to relatively richer individuals. They see no effect of microcredit access on business investment; rather, they find some evidence that the size and scope of businesses shrink when their owner gets a loan. Furthermore, many banks that target the poor realize low or negative profits (Morduch, 1999). Consequently, microfinance has been moving increasingly towards for-profit ventures that focus on relatively richer clientele (Malkin, 2008). In addition, since the size of the average loan given out by microfinance banks is small, even the most pro-poor microfinance banks must charge relatively high interest rates in order to recoup operating expenses, and such rates may exceed the returns to capital for many entrepreneurs. From this, it is not clear that it will ever be profitable for banks to dramatically increase their lending to the poorest of the poor, which means that access to such credit may never come.

In this context, some papers have argued that enabling savings instead of credit can offer better result since most of the poor people lack access to formal banking services of any kind (Banerjee and Dufio, 2007). Johnston and Morduch (2008) have shown that over 90 percentage point of Bank Rakyat Indonesia clients only save but, don’t borrow. Bauer, Chytilová, and Morduch (2010) argued that some women in India subscribe to microcredit schemes only as a way to force themselves into saving habit as that requires regular installment payments rather than use credit for a business.

Most of the ME’s financed largely through informal sources of investment i.e. individual savings and, informal loans from friends and, relatives. Institutional credit can play a role, but it has until recently been marginal. This paper intends to explore different investment tools for ME’s currently being used up in Nepalese context and, offer a better investment model for Nepalese scenario for scaling up ME’s.

Research Methodology:

This paper intends to explore the existing investment tools available for Micro entrepreneurs of Province 5 in Nepal along with their critical analysis and, policy recommendation for Province 5 government on developing an investment model that can address the raised issue and, fill the investment gap for scaling up the interested ME’s. This research is more inclined towards applied research as it intends to make recommendations to fill the existing gap between investment demand of existing ME's and, supply constraints thus, it requires the use of qualitative research method.

As this paper intends to fill the gap existing between supply and, demand side of investment so, data collection will involve two set of respondents i.e. participants from demand side and, participants from supply side. Supply side participants include:

- ✓ A, B, C class Financial institutions,
- ✓ D class Micro credit institutions,
- ✓ Private equity firms,
- ✓ Venture capital firms,
- ✓ Angel investors,
- ✓ Non-governmental agency funded programs i.e. Sakshyam – Access to Finance, MEDEP.
- ✓ Governmental agencies

Demand side participants will include Micro entrepreneurs of Province 5. The total population of Micro entrepreneurs is considered to be the ME's nurtured by MEDEP in Province 5 which will include ME's registered and operating within 12 districts of Province 5. Thus, we will be taking a sample out of this population. As paper of this topic intends to study ME's who wants to scale up so, we will be considering ME's who have been operating since 2+ years within Province 5.

As this paper intends to do a qualitative research, so data collection method to be employed is unstructured individual interviews for both supply side and, demand side data collection. In addition, focus group discussions were held to incorporate more responses in the group in few of the locations. FGD participants included local ME owners.

Data:

Demand side participants will include Micro entrepreneurs of Province 5. As paper of this topic intends to study ME's who wants to scale up so, we will be considering ME's who have been operating since 2+ years within Province 5.

Data Analysis:

The data collection for analysis and decision making was classified as per 2 channel partners: 1) Supply side 2) Demand side.

From the demand side; following investment tools are most popularly being used by the Micro enterprises in current scenario in Nepal:

1) **Women's Local Group:**

These local groups usually are named Local sister's group or, Local Mother's group where, the local ladies come together informally, deposit small amount of money each periodically and, the member who needs the cash most will take it as a loan at certain rate of interest. For small level of enterprises like Micro Enterprises, this tool is found to be widely popular as it doesn't require complex documentation, or procedures required in banks. Each member usually know each other properly so that they are confident to lend each other without requiring any collateral or, analysis of payment capacity of lending member.

2) **Cooperatives:**

Compare to local groups, the cooperatives might consist of more members and, are more official than local groups. These cooperatives are usually registered in some government bodies and, thus can be supported by either any government, or local government agency or, by International organizations. These cooperatives also follow the same procedure where they collect specific fund from each member which is then lend to the member who require the fund most at specific rate of interest. These cooperatives usually provide other technical, skills enhancement support to the members and, all members also work together to create market for their product. These cooperatives are usually established around a specific product that members are interested in like: Honey Manufacturers Cooperatives, Organic vegetable farming cooperatives etc.

3) Micro Finance Institutions:

The other type of institutions frequently used by the Micro enterprises are Micro finance institutions which usually follows the investment model suggested by Grameen Bank (Mohammed Yusuf). These lending are more popular among the small level Micro enterprises because they require less documentations to borrow. Usually, these institutions lend small amount of money NRs. 50,000 in Nepalese scenario which is equivalent to around 400 euros without requiring any collateral from borrowers and, without assessment of borrowers paying ability. For granting these loans, no collateral is taken as well as no credit assessment is done. In some cases, usually group guarantee is required to provide loan. Usually, a group of people will offer personal guarantee of creditworthiness of borrowers. The borrowed amount is usually broke down into monthly equal monthly installments (EMI) and, loan is usually granted for a year only.

Case of Sabitri Kurmi from Taulihawa Nagarpalika:

M/s. Sabitri Kurmi has been involved in different business since 2065 B.S. She started with sweets in the beginning then moved to production of "Dhungra" and currently she is operating a retail store and tent house in her own neighborhood. She had moved into different business and failed but, she again started a new one. She has faced failure several times but she has been confident and started with new one. She has received several business skill development training and other skills training from MEDEP and has been an active member of District Micro enterprise group association (DMEGA). She has been living in distant village of taulihawa nagarpalika which is close to small Indian border and is far from basic amenities to maintain a living standard.

There are only two "A" class commercial banks in the neighborhood but there are several micro finance institutions operating in the locality. These MFI's easily fulfil their financial requirement so, she feels that there is no problem of access to finance to her but there are certain limitations that has affected her access to finance status. These MFI's provide small amount of loan without any collateral. The loan amount starts from NRs. 20,000 for first time borrowers and depending on the behavior in those initial lending the amount of loan offered can reach up to NRs. 1,50,000. The loans are issued with group collateral of all the members of the women's group.

As per her these loans are easy to get but interest rate and service fees charged by these MFI's make them too expensive. For e.g. If a person has requested and got approved a loan amount of NRs. 50,000 then MFI's initially charge around 6,000 as service fees and, only NRs. 44,000 is actual cash receipt of MFI's. The loan amount along with applicable interest rate at 18% is then converted into Equal monthly installment (EMI) for a period of 1 year payable every 15 days. This makes the access to finance too difficult despite its wide availability.

4) Subsidized Interest Loans:

The other financing tool widely popular in Nepal is subsidized interest loans targeting small borrowers to promote their local entrepreneurial venture. Usually, interests are substantially subsidized by the Government of Nepal to promote small entrepreneurs and, in a way attempt to reduce poverty. In case of Nepal, Government of Nepal has asked Nepalese banks and, financial institutions to allocate at least 10% of their loan portfolio in agriculture sector and, the loans issued in this sector have interest rate of 5% only. Usually rate of interest on loans from banks in

Nepal is 13-14% but, borrowers taking subsidized loans have to pay only 5% and, remaining amount is borne by government of Nepal. The only problem with this lending is it requires sufficient level of collateral to be kept in banks but, usually borrowers living below poverty line doesn't have any assets to keep as collateral.

Case of Lilapati from Banganga Nagarpalika:

Mr. Lilapati has been operating0 his own bee farm since 2053 B.S. He had started with a single bee hive which has now reached 70 in number. During this period, he has only received around NRs. 2,25,000/- from Prime Minister Agriculture Grant in 2074 B.S. which has allowed him to expand his business. Before starting his venture, he took a 15 days training program in Kathmandu organized by a government agency. He has received loan from local saving and credit association to setup his business and also to extend his reach. The amount of loan he has received was 20 lacs with minimal requirements and documentation required as he was also the active member of the local institution. Interest rates were fairly competitive in compare to other local financial institutions. He then heard about the loan which he can obtain from the local branch of Rastriya Banijya Bank with subsidized interest rate. While approaching to local bank branch, he was asked to wait for next fiscal year as that year's loan quota with subsidized interest rate has already been issued. He is planning to issue loan worth 50 lacs with subsidized interest rate next year and further expand his business.

During the conversation, he mentioned that there is no problem with market as he can sell his product immediately without any risk. There is no any issues of financial availability as there are many different types of financial institutions available to provide credit provided the person can submit required documents. As per him, his only issue was high interest rate and high service fees being charged by financial institutions which increases their cost of production and make them less competitive.

5) Financial Institutions-NGO's:

There are few non-governmental institutions who work to smoothen financial access to micro enterprises in Nepal. They usually identify themselves as FINGO's who provide micro enterprises with required seed capital for establishment or, scaling up their enterprises either in terms of loan, or seed capital, or grant. They provide funds for specific purpose as per their strategic objectives and goals. In my sample case few of the respondents were provided with funds to purchase and install simple equipment to automate the manual jobs so that, productivity can be improved, production can be enhanced and, higher income can be achieved so as to uplift the low level people out of poverty. E.g. Bee farmers were provided with funds to buy honey processing machines, doll makers were provided with funds to buy stitching and, cutting machines.

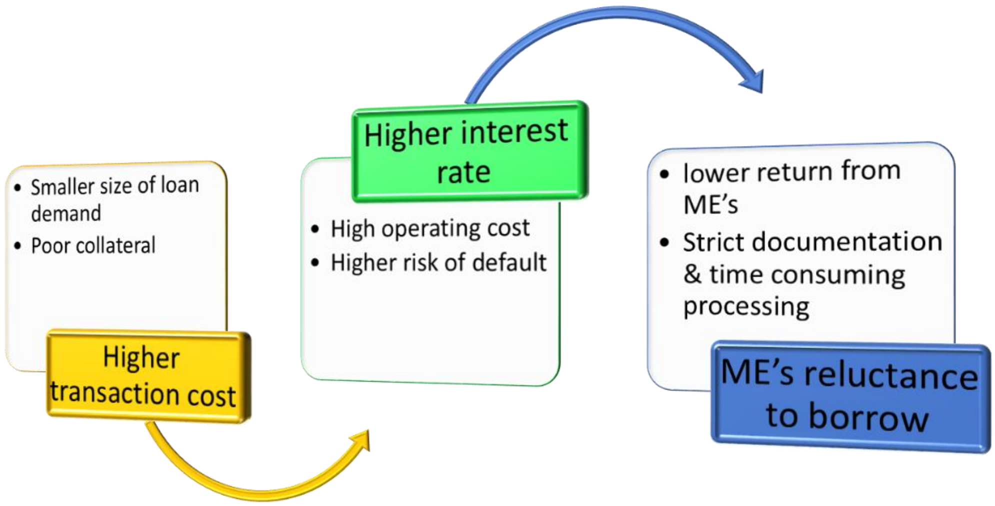
6) Personal borrowings:

The other prominent source of financing found to be used widely was personal borrowings through which micro entrepreneurs borrow funds from their family members, relatives, friends or, people from closed circle to finance their enterprise. Usually, these borrowings are interest free and, doesn't require any collateral to be kept. This also doesn't require any documentation procedures and, usually performed through informal medium. This lending is based on personal trust and, it involves close trusted members as participants at either side so, there is less chance that either party involved might cheat each other in one way or, another.

7) Banks and, other financial institutions:

Finally, less preferred but, still widely available source of financings was lending through retail banks. Unsurprisingly, this financing tool was found to be less preferred by the micro enterprises. As this is formal channel of lending so, it requires the submission of all necessary documents, fulfill all strict procedures as per the guidelines of Central bank of Nepal. This tool requires compulsory collateral from the borrower which usually involves keeping personal lands, house and, other property as collateral in the bank so, low level people usually fear that they might lose their house as well which is basic necessity of living. In addition, requirements of banks are very strict in sense of credit appraisal, documents submission and, timely periodic payments so, people usually don't prefer this medium of borrowing.

Problems identified with formal banking channel:



It has been revealed that these small scale micro enterprises prefer formal banking channel very less for borrowing and, several reasons has been identified for such behavior which are closely inter related to one another. As these micro enterprises operate in very small scale so, they also need to borrow very small amount as well and, usually banks don't prefer to issue loans of small amount. As the credit assessment and, documentation procedures for all scale of loans issued by banks has to follow same strict procedure which keeps transaction cost almost at same level for all scales of loan. Transaction cost of issuing small scale loans or large scale loans remain almost same so, rate to issue smaller loans became quite expensive for small borrowers. In addition, collateral valuation is inconsistent, not scientific and, collaterals are not so good. This both lead to higher cost of interest for small borrowers.

The higher rate of interest which in Nepalese case goes up to 18% p.a. is primarily due to higher operating cost and, higher risk of default. The banks need to reach rural locations which don't have proper infrastructure such as roads, internet, security, employees etc. along with lower scale of lending and, deposit collection makes the operating cost higher for these locations. In addition, the default risk is higher with these loans. The borrowers are very poor without sufficient level of insurance to protect against default so, if their venture fails to provide return then, it will lead to failure and, loans lent to them defaults. Both of these reasons keep the rate of interest high with these scale of lending.

With higher lending cost, the borrowing becomes too risky and, in most cases unfeasible for the small scale of micro entrepreneurs. Thus, these micro enterprises prefer other non-banking sources more than formal banking channels.

Several other points were also raised by the respondents that has been hampering growth of micro enterprises in the country. They can be listed as:

High Collateral requirement:

Collateral requirement to raise loans in Nepal is high in compare to world's average. In Nepal, to raise a loan of $1 from financial institutions borrowers are required to provide at least $3.6 worth of collateral to the financial institutions which are very high in compare to the world's average. World's average shows that to raise $1 loan, borrowers just need to keep $2 worth of collateral. Nepalese financial institutions are taking ultra-safe mode which makes borrowing through financial institutions highly improbable source to raise funding for businesses especially to micro enterprises.

Microfinance institutions has been popularly targeted to increase financial access towards the lower class of people. This model has been widely practiced in many developing nations and, also in many closely aligned economies of Nepal like Bangladesh. This model has also been widely popular in Nepal and, it has reached to different corners of our country as well. These microfinance institutions follow different investment models.

Different models of Microfinance institutions in Nepal:

With the history of quite a few decades, MFIs in Nepal have been following a few prominent microfinance models. These comprise of Cooperative model, Small Farmer Cooperative Limited (SFCL) model, Grameen Bank model, and Community based organizations (COs) or Self-Help Groups (SHGs) model. In addition, Village Bank (VB) is also considered a separate program/model of microfinance in Nepal. Brief descriptions of these models are as follows:

Cooperative Model:

This model is generally used by the Saving and Credit Cooperatives (SCCs). Under this model, SCCs has been offering a wide variety of savings and loan products to its members. These SCCs offers are open for all people within certain locality disregarding this social and economic status. It attempts to bring in people from different level of social status and economic status within a single roof. There exist a small number of SCCs which are established by the development partners whose primary focus is people from disadvantaged group. These SCC's in Nepal are established under Cooperative Act, 1992 which mentions that a group of at least 25 members from a community can come together and decide to establish a SCC. They are registered with the Department of Cooperatives under Ministry of Agriculture and Cooperatives but, under new federal structure of government of Nepal these SCCs supervisor has been transformed to local level. Thus with new structure local government either Municipality, Gaaupalika etc. is the supervising authority of these SCCs. These SCCs accept the money from its members as deposits which can be of current, savings or fixed nature and these deposits along with the shares can be invested to the members who need the money as loan. These SCCs are available all over Nepal from rural locations to modern cities like Kathmandu but, it was conceptualized mostly for the people of hilly and mountainous region to avail them with access to finance without much bureaucratic hassle.

Small Farmer Cooperative Limited (SFCL) Model:

SFCL Model, simply a multi-service cooperative whose objective is to offer financial as well as non-financial services to its members. The non-financial services include social mobilization, training and technical support services with primary target area as rural regions of the country. It is also membership based institution which is managed by selected few members of the institution. Its operation area is usually confined within a single village i.e. gaaupalika which serves around 500 householders who are primarily rural farmers.

It generally has a three tier structure: i) Village Level: Promoter members organize the local household members and encourage them to form groups ii) Ward Level: Initially formed farmer groups which are close in distance and have common interest are combined to form inter-group associations. iii) VDC Level: The smaller groups and then formed inter-groups represent to construct an Executive Committee who are elected by the General Assembly. The general assemble hire the Manager and other operational staffs to execute the objective of the institution. Individual members meet regularly and collect compulsory savings, loan repayments and application for loan demand. Inter-group associations meet to assess the loan applications and Executive Committee make the final decision.

Grameen Bank Model:

Grameen Bank Model, a popular model was founded in 1976 by the Nobel Laureate Professor Muhammad Yunusin from Bangladesh. It was introduced since 1990 in Nepal which is considered to be most appropriate for the Terai region of Nepal due to its developed market and road infrastructure. The group meetings are regularly scheduled where members make their savings and demand for loan. Peer groups comprising five members are formed and three to ten such peer groups form a cluster focusing a certain location – close to a village where periodic meetings are held regularly. A chairperson and center chief is elected in each group and each center respectively who oversee the activities of group members, maintain group discipline, check loan utilization and ensure loan amount with periodic installments are paid regularly. Loans are made initially to two members, then to two others and finally to the last member, with a four to eight week interval between each disbursement. Such loans do not require collateral security. However, group guarantee for repayment is mandatory. Subsequent loans can be accessed only upon the successful repayment of existing loans by all group members. The MFI field staff facilitates the group meetings and also verifies the utilization of disbursed loans.

Nirdhan Utthan Bank Limited, Chhimek Bikas Bank Limited and Swabalamban Bikas Bank Ltd. are some Nepalese MFIs operating under the Grameen Bank Model.

Self-Help Groups (SHGs)/Community Organizations (COs) model:

Based on the concept of “self-help”, SHG’s are small groups of individuals formed into groups of ten to twenty and operating a savings-first business model whereby the member’s savings are used to fund loans. In a SHG usually women from a similar class and region come together to form a savings and credit organization. They pool financial resources to make small interest bearing loans to their members. The terms and conditions and accounting of the loan are set by designated members in the group. The ‘Dhukuti’ system is one such example of a very old form of self-help group in Nepal which has been in operation for over four decades.

Community Organizations (COs)/ SHG's are formed at the VDC level with the assistance of the Local Development Fund (LDF) under Participatory District Development Project (PDDP) and Decentralized Local Governance Support Program (DLGSP). Similar to other MFI's, the CO's too mobilize mandatory and other types of savings. Their lending schemes generally offer loans at 10-12% interest per annum to the borrowers. Members apply for loans and collect due installments during a CO's regular meetings. The interest rates and other terms and conditions of loans are determined by the CO's if they lend money using their own savings. However, if the member seeks a loan amount that is more than what the CO can provide from its savings, the member would have to fill a separate application form addressed to the Local Development Fund (LDF). The CO recommends the loan and forwards it to the LDF for approval. Similarly, Poverty Alleviation Fund (PAF) too organizes the local groups of the target families called CO's with the help of local NGOs. They are informal groups and not linked up with any financial institutions. These groups are provided with seed fund at the rate of Rs. 3,000 per family member and are charged about 10% interest per annum.

Village Bank (VB) Model:

Village banks are credit and savings associations that are managed and run by the community members. Established by NGO's with an objective to provide members with access to financial services, VB's build community self-help groups and help members accumulate savings. A typical village bank consists of 25 to 50 members, who are low-income individuals, seeking to improve their lives through self-employment activities. Aiming to enhance the social status and intra-household bargaining power of women, VB's mostly seek more female participation.

VB lends loan to the members from the loan capital extended to it by the sponsoring MFI. All members sign a loan agreement with the village bank to offer a collective guarantee, thus providing moral collateral for each extended loan. A member generally gets Rs. 3,000 to 10,000 at a time, depending on the amount of savings available in the bank. The loan cycle must end and all loans must be paid back at the end of the 16th week to get new loans released. Members are usually requested to save twenty percent of the loan amount per cycle. New loans or collective income generating activities are funded using members' savings, thereby ensuring that the money stay within the village bank. In a VB, loans are generally charged at 24% interest per annum and interest is collected on upfront basis.

Recommended Investment Model for Provisional Government:

Based on all the data collection during the research period supported with different success stories from similar economies, this research would recommend the formation of a Credit guarantee scheme (CGSs) with the support of provincial government where further private partners can be invited and included to make it more inclusive and, sustainable. This model will address the current problem of very high interest rate being charged by the financial institutions to the lower category borrowers based on the high risk associated with them. This higher risk has been mentioned as a primary reason for charging higher interest rate and, this higher risk was primarily due to higher credit risk. Through this research paper, I have proposed a new model to address this issue and, description of model along with how it will work has been described hereafter.

Credit Guarantee Scheme (CGSs) Model:

Growth oriented Micro enterprises can make a substantial contribution to economic growth, job creation and economic restructuring. For these ME's financial issues are compounded by the technological and market risks associated with requirement to compete with big multinational companies coming in after Nepal's membership in WTO. Growth oriented ME's may find it particularly difficult to present a robust business case to potential finance providers with acceptable levels of investment risk. Guarantee schemes can increase lender confidence in making growth oriented investments by supporting through debt finance.

For the vast majority of growth oriented ME's different forms of debt has remained the primary form of external finance for funding growth and innovation. International experience and evaluation evidence suggests that Credit guarantee schemes can play a significant part in the debt financing of growth. Target specific guarantee measures on supporting ME's growth – a dual approval process (technological/financial) can help to reduce chances of business failure. Government needs to create a market for guaranteed loans. This can reduce their borrowing costs and attract more lenders ready to invest to the micro entrepreneurs. Government should play a critical role – co-ordinate partners, set agendas, underwriting initial capital needs to establish credibility. Furthermore, we should establish commercially rigorous and independent guarantee approval mechanisms.

Why CGSs will be helpful for promoting growth oriented ME's:

1) Overcoming information asymmetry:

Lack of reliable information to back the credit decision is a core reason commercial banks are generally reluctant to provide loans to ME's. In most of the situations, ME's are unable to provide credible proof on their creditworthiness as their enterprise lack appropriate accounting records and in addition, they lack collateral to provide. With the lack of credible documents to assess the credit, it leads to uncertainty on the project's expected return and the credibility of the borrower. Gathering such information on ME's can be challenging and costly. This needs additional scrutiny from the lenders' side i.e. field visit, close observation etc. thus, administrative costs of lending tend to be higher for smaller firms. Obtaining information requires more resources as a percentage of the underlying loan. Visiting borrowers and monitoring their activities is expensive and not always economically rational when a loan size is small.

Higher lending administrative costs can result in a selection process based only on firm-size and collateral. As a consequence, profitable projects that don't meet this condition may be unable to obtain financing, resulting in a suboptimal allocation of credit. CGSs can help banks overcome information asymmetries by aiding accurate identification of lending risk and improving banks' ability to make appropriate lending decisions.

2) Diversifying or transferring risk:

As mentioned earlier, commercial banks often have a difficult time assessing smaller firm risk due to a lack of information. Moreover, ME's are more vulnerable in the wake of harsh economic conditions, and their mortality rates are relatively high. The situation is likely compounded in developing economies by weak creditor and property rights, the informal economy and non-existent or ill-enforced collateral registration. Thus, lending to ME's may carry higher risks.

CGSs can be a mechanism of risk transfer and diversification. By covering part of the default risk, a lender's risk is lowered – guarantees secure repayment of all or part of the loan in case of default. In essence, CGSs absorb an important share of borrower risk. CGSs can also compensate for factors such as insufficient collateral and weak creditor rights.

3) Lower collateral requirements:

Due to lack of credible credit scoring system, almost all the lending decision of banks in Nepal is based on the valuation of available collateral. Collateral reduces lending risk and, lenders in Nepal usually prefer to have collateral worth almost 2.5 times more than the loan offered to the client. The point being for this is a borrower who is willing to offer a higher level of collateral, particularly personal collateral such as a house, has a higher intention of repaying the underlying loan. Additionally, collateral provides insurance to a bank – if the firm defaults on its loan, the bank has recourse to the collateral used to obtain the loan. Selling the collateral allows the bank to recover part or all of the value of the defaulted loan. As the owners of ME's usually belong to lower level without any personal property to keep as collateral thus, deficient collateral is one of the main reasons small firms are unable to obtain credit.

CGSs can alleviate the high collateral requirements demanded by banks. ME's as can't offer credit financial document or good property as a collateral so, they are categorized as high risk credit which further compels the lenders to get higher level of collateral to lend loan to ME's. In this situation, CGSs allow firms with insufficient collateral to access the lending market. Since these firms would be otherwise excluded from the lending market, the result is higher overall lending.

Credit guarantee schemes are thus designed to diminish the risk associated with lending to ME's. As already mentioned, they can reduce information asymmetry and alleviate high collateral requirements. Therefore, CGSs can improve loan terms and facilitate access to formal credit for small firms. Additionally, by allowing loans to be made to borrowers that otherwise would have been excluded from the lending market, these firms are now able to establish a repayment reputation that itself can, in the future, act as a type of collateral. Finally, by extending more loans to smaller businesses, lending institutions gain experience in managing these types of loans, encouraging further development in this market segment. Experience suggests that credit guarantee schemes do play a role in expanding credit to ME's.

Different forms/types of CGSs:

Further exploration of literature and, different case studies in the world has revealed that there are different types of CGSs based on their structure of capital, ownership status, delivery of credit guarantee. To categorize among different types, we need to ask few questions such as: “How has the fund been capitalized? What is the ownership structure? How are the guarantees delivered?” we can identify four major types of guarantee funds: public guarantee schemes, corporate funds, international schemes and mutual guarantee associations (Green, 2003).

1) **Public Guarantee Schemes:** They are established by public policy which usually involve state subsidies, especially initially. Typically, they are managed by a private organization or an administrative unit of the government. An advantage of this system is that, in case of loan default, the guarantee is paid out directly from the government budget. This gives such a scheme higher credibility within the banking sector.

Box 1. The Small Business Development Fund (SBDF)

Slovenia’s Small Business Development Fund (SBDF) was established in 1992 by the Government of Slovenia to promote the establishment and development of small business units. It guarantees both long-term and short-term loans, in collaboration with banks. All forms of support are provided on the basis of a public invitation to lenders to participate in the program. First, a loan must be accepted by a bank. Then the board of directors, which consists of representatives from banks and government, takes the final decision on which applications to guarantee under the fund. In 1997, 28 banks had signed an agreement to offer guarantees with the SBDF. For long-term loans the SBDF guarantees up to 80 percent of the purchase price of the equipment or plant bought with the loan.

The SBDF also has a series of regional guarantee funds (RGF) that operate through Regional Business Centers. RGFs receive funds from both the SBDF and from local resources. At the end of the 1990s, the fund provided a 50 percent guarantee of credit for amounts between USD 6,000 to USD 60,000. Repayment periods span from one to five years and interest rates are generally around 6%.

In the late 1990s, RGFs operated with a fund of USD 2 million and the SBDF maintained a fund of USD 23 million. In 1996 and 1997, the SBDF fund benefited from an influx of capital coming in from the privatization program following the Privatization Law of 1995. 9.5 percent of funds coming from these privatizations were allocated to the SBDF.

Source: OECD, 2000, Financing Newly Emerging Private Enterprises in Transition Economies.

2) **Corporate Guarantee Schemes:** Corporate guarantee schemes are generally funded and operated by the private sector, e.g. banks and chambers of commerce. Corporate guarantee schemes have the advantage of being managed by experienced corporate leaders, and generally benefit from the direct involvement of the banking sector.
3) **International Schemes:** International schemes are typically bilateral or multilateral government or NGO initiatives, e.g. ILO, UNIDO or the European Investment Fund. Often, international schemes combine both a guarantee fund with technical assistance to firms.

Box 2. USAID's Loan Portfolio Guarantee Scheme (LPG)

USAID's Loan Portfolio Guarantee Scheme (LPG) does not provide funding to any particular organization. Instead, it facilitates public-private partnerships. This is done through a series of international bilateral commercial guarantee agreements between USAID's Centre for Growth and privately-owned commercial banks.

USAID uses the Development Credit Authority (DCA) to stimulate lending through the use of credit guarantees. DCA was established in late 1999 and now has more than 225 partial credit loan and bond guarantees. The DCA has enabled approximately USD 1.8 billion of private capital to be loaned in over 60 countries. The DCA offers four guarantee products: loan guarantees, loan portfolio guarantees, bond guarantees and portable guarantees, all of which cover up to 50 percent of the default risk. Loan amounts typically range between USD 5 million to USD 10 million, but loan guarantees have been as low as USD 1 million and as high as USD 40 million. USAID also combines technical assistance with the DCA.
Source: www.usaid.gov

4) **Mutual Guarantee Schemes:** Mutual guarantee schemes are also sometimes known as mutual guarantee associations, societies or funds. They are private and independent

organizations formed and managed by borrowers with limited access to bank loans. Although they are largely funded from membership fees, etc., in many instances, they operate with some form of government support. Mutual guarantee schemes benefit from the active involvement and experience of their members.

A 2008 World Bank study of 76 guarantee schemes across 46 developed and developing countries has shown that mutual guarantee funds tend to operate in high-income countries while most middle and low-income countries have publically operated funds. In Nepalese scenario, Mutual Guarantee Scheme fund seems to be a good type to go forward. The study also suggests that mutual guarantee schemes tend to be financially more sustainable due to the ownership and involvement of their members. So, I am recommending to follow this type of guarantee scheme.

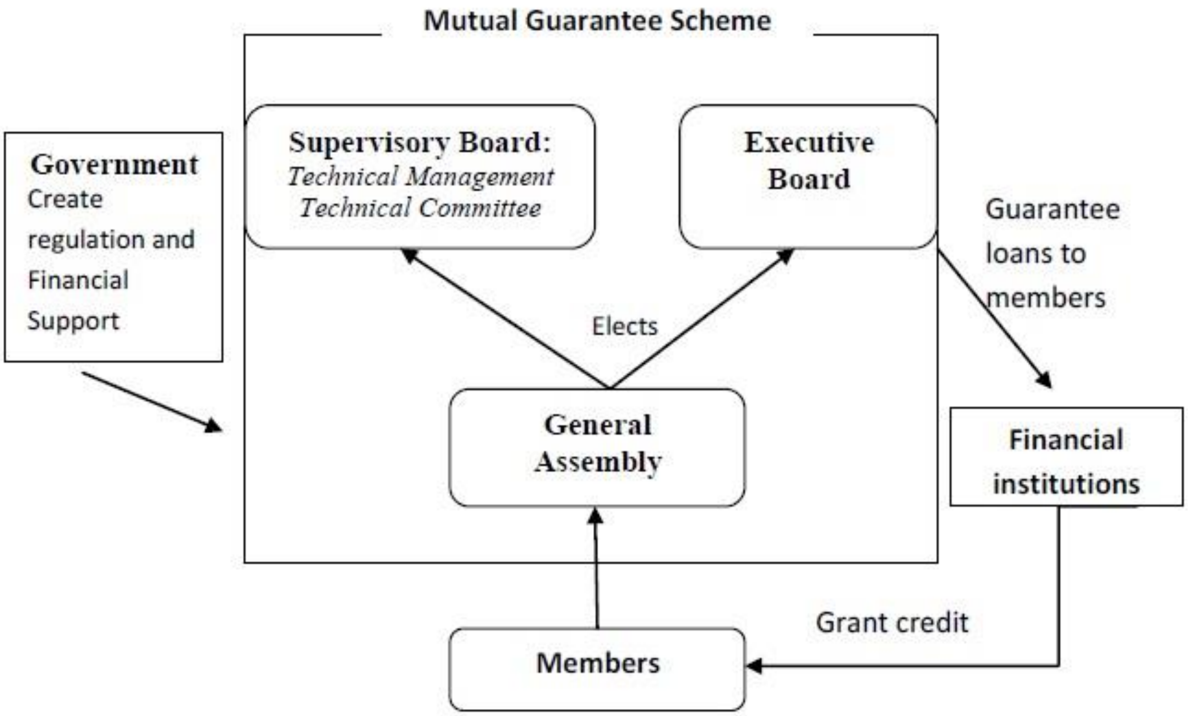
Recommended structure of mutual guarantee scheme (MGS) for Province 5:

The MGS aims to bridge the gap between lenders and borrowers i.e. Micro enterprises. Each member contributes to a common fund that is used to make guarantees on loans procured by its members. An essential feature of an MGS is that it also relies on social capital, i.e. the fund creates social norms and positive peer pressure to encourage repayment amongst its members. "They provide guarantees for one another, benefit from [them] and become liable for each other's debt" (De Gobbi, 2002). They typically share some common characteristics, for instance they generally have:

- ✓ A General Committee composed by all members. The General Committee determines the regulations for issuing guarantees and elects members to the Executive and Supervisory Boards. It can approve or veto actions planned by the Boards.
- ✓ An Executive Board that monitors and supervises the technical management of the fund and takes the decision on which guarantee applications to accept. The Executive Board also decides whether to admit new members to the fund.
- ✓ The Supervisory Board that monitors the guarantee contracts and the fund's financial situation.

Thus created MGSs are usually independent but, they should be supported by the Provincial government. Provincial government need to provide the appropriate legal and regulatory framework within which MGS can operate. Additionally, MGS need to be provided with the initial funding by the provincial government so as to encourage private partners to tuck in without any doubt.

Proposed Structure of Mutual Guarantee Scheme



Source: *Green. A, (2003), Credit Guarantee Schemes for Small Enterprises: An Effective Instrument to Promote Private Sector- Led Growth? UNIDO*

One of the main advantages of MGSs is their expertise and knowledge of the private business sectors covered by the fund, the region in which the MGSs is based and the market trends and production techniques of the enterprises whose loans are guaranteed by the fund. Thus, they are often in a better position to evaluate the feasibility and risk of a project. This knowledge advantage possessed by MGSs can decrease information gathering costs and therefore reduce overall transaction costs.

Moreover, MGSs will create social capital from peer monitoring and peer pressure, increasing loan repayment which has already been validated by the credit repayment history in group lending tool. However, for this social capital to be fully exploited, some conditions are necessary (Tschach, 2000):

- ✓ Members should have full knowledge of the economic and social situation of borrowers. This enables them to easily identify the credit capacity of borrowers.
- ✓ It should be difficult for members to leave behind a debt, e.g. by moving away suddenly.
- ✓ Loan default should be accompanied by social repercussions from other group members. In essence, there should be negative social factors which encourage members to make good on their loans.

MGSs can also give members a more powerful bargaining position. This is particularly important for ME's. MGSs play the role of a quasi-borrower vis-à-vis banks and are a more influential negotiating partner than a single small firm. Members are thus able to obtain loans with better conditions and possibly lower costs.

Box 3. Confidi

Modern MGSs appeared in Europe in the 1940s and since then they have grown in both size and number. In 2000 MGSs provided guarantees worth over EUR 14 million to more than 2 million SMEs (De Gobbi, 2003)

Confidi, the first Italian MGS, was created in the late 1950s. Today it operates over 700 individual MGAs in many different sectors and has over 940,000 SMEs as members (De Gobbi, 2002). Confidi has gradually spread from central Italy to northern Italy and now exists throughout the country. Each MGS operated by Confided has on average 2,000 members. The membership structure is based on the principle of equality: each member has one vote regardless of its size. In some cases, Confidi has also benefited from government assistance and money from the EU. However, subsidized credit is only a small proportion of overall lending and has heavy and expensive procedures.

Some important characteristics that have made Confidi a success are its:

- High quality technical management;
- Focus on risk sharing and strengthening of SMEs: the large size of the MGAs under Confidi has led to decreased levels of peer pressure and social capital. Despite this drawback, Confidi has been able to maintain its success because of the principle of equality amongst its members. By empowering vulnerable SMEs, it has strengthened the links between SMEs, SME associations and the MGAs. This has given the MGAs in Confidi a strong negotiating position and allowed them to obtain more favorable loan conditions (De Gobbi, 2003).

Source: De Gobbi, M. (2002), Making Social Capital Work: Mutual Guarantee Associations for Artisans,

Design of credit guarantee schemes: identifying good practices:

The main objective of a credit guarantee scheme is to ensure that firms can obtain financing for solid investment projects. In particular, CGSs aim to assist ME's that are otherwise creditworthy but don't have adequate collateral to obtain a loan at a reasonable interest rate. A successful scheme needs to be able to help riskier ME's obtain financing by reducing the risk of a loan extended to them, limiting transaction costs and guaranteeing payment in case of default. The question, however, is whether such requirements can be translated into a CGS that is sustainable. Self-sustainable funds exist in many different countries, e.g. Italy's Confidi schemes or Canada's SBLA scheme. In the next section, we analyze good practices that can contribute to a successful guarantee fund that will be sustainable. Hence, we consider three main challenges for CGSs:

Following factors need to be considered for designing effective CGSs:

1) Risk sharing

Inappropriate designed guarantee scheme can inflate moral hazard among borrowers. Guarantee scheme reduces the chances of default risk they otherwise would incur by providing part of the collateral required in order to obtain the loan. This will lead to more so called strategic defaults from borrowers because part of the collateral does not belong to the borrower which incentivizes borrower to default as they have less to lose. However, properly designed guarantee scheme helps limit moral hazard. If loan risk is shared amongst the lender, the borrower and the guarantors, risk is minimal.

The magnitude to which each party should share in the risk is a delicate balancing act. The guarantor should accept enough risk to be able to persuade banks to participate in the scheme. In fact, 100 percent coverage exists in countries such as Canada, Japan, and Luxembourg. A World Bank study from 2008 revealed that among the 76 schemes in 46 developed and developing countries, 40 percent of them offer this option (World Bank, 2008). However, total coverage will make the lenders entirely risk-free and, will lead to greater moral hazard. Not only does it increase the strategic default option of borrowers, but it also reduces banks' incentives to properly assess and monitor risk.

Coverage rates below 50 percent reduce the potential for moral hazard and exhort adequate assessment and monitoring of loans. On the other hand, a coverage rate below 50 percent reduces banks' incentives to participate in the guarantee program, especially because loan administration costs is on the higher side. Countries with low coverage rates are able to maintain attractiveness of their scheme by using other financial incentives. The national guarantee fund in Egypt, despite having a low coverage rate, still managed to guarantee USD 85 million in loans in 1995 after only four years in operation. In part, this was achieved by offering other financial incentives in addition to guarantees. In Thailand, however, a similar scheme with the same coverage rate as that offered in Egypt only managed to secure USD 51 million in loans after 10 years in operation. One reason contributing to their lower usage levels was a lack of other financial incentives (Levitsky, 1997).

Such experiences suggest that coverage rates should generally be between 60 and 80 percent (Levitsky, 1997). Rates in this interval are high enough to encourage lender participation and yet low enough to limit moral hazard. From the 76 schemes studied by the World Bank, the median coverage rate was 80 percent. The study also found no correlation between a country's economic and financial development and maximum coverage ratios (World Bank, 2008).

Some countries offer more complex coverage rates. For example, Italy and Mexico offer an array of guarantee rates. Rate levels depend on the risk assessment and the type of loan. In another interesting example, the Chilean fund FOGAPE determines coverage rates based on an auction.

Box 3. The Auction System of the Chilean Fund FOGAPE

A main feature of the Chilean guarantee scheme FOGAPE is the auction system used to distribute guarantees and set coverage rates. In fact, in 2005 a similar system, modelled after the FOAGPE auction system, was adopted in Mexico. The bidding takes place four to six times per year. Only supervised financial institutions can participate. Financial institutions participating in the system are responsible for analysing the risk of loans and respecting the conditions set forth by FOGAPE.

In every auction FOGAPE distributes resources for three types of credit guarantees: (i) 50 percent of total resources go to short-term loans; (ii) 30 percent go to long-term loans, exporters and emerging companies; and (iii) the remaining resources go toward other credit. Tenders are selected based on the coverage rates proposed by lending institutions – lower coverage rates are selected before higher coverage rates. Once the tenders have been accepted, FOGAPE establishes a contract with the winning financial institution fixing the coverage and commission rates, and outlining the contractual obligations of both parties in the case of default. Interestingly, the auction system has led to decreasing coverage rates – average coverage rates have fallen from 80% when initiated in 2000 to 65% in 2004.

Once the contract is concluded between FOGAPE and the lending institution, loans based on the guarantees must be distributed to borrowers within a two month time frame. If during that period, the guarantee is not used, FOGAPE calls for a new bid. In 2005, lending institutions typically used 85 percent of the resources available to them. In order to increase usage, FOGAPE recently required that the contracting financial institution must use 90 percent of the guarantees awarded to them.

Another weakness in the FOGAPE system was recently fixed. In 2005 one financial institution obtained the majority of the resources distributed by FOGAPE. As a result, FOGAPE recently established a cap of 66 percent of total resources that one single contracting financial institution can receive.

Source: Llisterri. J., Rojas. A., Mañueco. P., López. V., Garcia. A., (2006); Sistemas De Garantía De Crédito En América Latina, Banco Interamericano de Desarrollo, Washington, DC 2006.

Fees

The fees charged by CGSs act as blueprint that impact not only the incentives lenders and borrowers have in participating in the programme, but they also play a pivotal role in determining the financial sustainability of the fund. Fees must be high enough to cover administrative costs, but low enough to ensure adequate lender and borrower participation. Experience has shown that it is unrealistic to expect a CGS to cover its full costs through fees, however the administrative costs of running the scheme should be covered by the same (De Gobbi, 2002).

Generally, the percentage and the way fees are applied vary among different schemes. There are schemes where a registration fee for processing the application is required. In Europe as well as in developing countries, the fee is typically about 1 percent of the loan amount. Others schemes usually impose an annual or a per-loan fee that ranges from 1 to 2 percent. According to Levistky, fees above 5 percent render the scheme too expensive for adequate lender and borrower participation.

Among the 76 countries studied by the World Bank, 56 percent of fees were paid by borrowers and 21 percent were paid by the financial institution receiving the guarantee. Only 15 percent of schemes impose a membership fee, while 30 percent impose an annual fee and 48 percent of the 76 schemes charge a per-loan fee. 57 percent of the schemes base the fee on the amount of the guarantee; 26 percent of them base it on the loan amount (The World Bank, 2008). A risk-based pricing structure is only available in some countries, e.g. Colombia – the Fondo Nacional de Garantía (FNG) charges different fees according to risk. Low risk applications with guarantees up to 40 percent are charged a 3 percent fee. Higher risk applications with a 70 percent coverage rate are offered a 4 percent fee (Levistky, 1997).

1.5.3 Types of loans

Another important element that policy makers must take into consideration is whether a scheme should provide individual or portfolio loans. A loan-level or individual model applies when applications are approved by the guarantor. In this case, there is a direct link between the borrowers and the lenders since the application assessment is done on case-by-case basis. This allows for a more careful risk management and likely reduces the probability of moral hazard.

Such a scenario probably results in a higher quality loan portfolio. However, this method can also be more costly for the fund to manage. According to the World Bank, 72 percent of credit guarantee schemes use this selective or individual loan approach (World Bank, 2008).

If the objective of the scheme is to increase guarantee and credit volume, the portfolio model might be a better approach. Under this approach, the guarantor negotiates the criteria of the portfolio. For example, a fund can specify that loans made with its guarantees are targeted to the SMEs sector, a particular location or a specific loan size. However, the portfolio model does have some disadvantages. Because the screening process is less meticulous, default rates tend to be higher. Moreover, since the portfolio is based on specific lending objectives, there is less risk diversification. Managers are thus confronted with a trade-off between lending volume and portfolio quality.

International experience has shown that only 14 percent of the 76 schemes studied by the World Bank use the portfolio model. 9 percent of schemes use a combination of the loan-level/individual model and portfolio model. The study did not find any indication that country income level or financial development played a role in determining which model was used by the guarantee schemes in different countries (World Bank, 2008)

1.5.4 Defaults

The default rate is an important indication of a scheme's endurability. When applications are appropriately assessed and monitored, an adequate default rate is possible. Levistky considers that a sustainable scheme should aim to have a default rate between 2 and 3 percent. Newly established schemes in developing countries might consider a higher default rate (i.e. over 5 percent) in their early years of operation. However, prolonged high default rates should be avoided.

A scheme's credibility is also based on how defaults are handled. Guarantee payouts should only be used as a last resort. Before it comes to this, guarantors (or lenders) should negotiate rescheduled payments. This, however, requires experienced staff in the guarantee scheme able to handle the subjective nature involved in renegotiating payment plans. In fact, many schemes have failed due to unqualified and inexperienced personnel and unclear management criteria. For instance, in Côte d'Ivoire, 250 applications were considered by the fund between 1968 and 1981.

Due to the unavailability of clear selection criteria, 90 percent of them (221 requests) were accepted by the management committee. Most of the firms which receive a guarantee eventually stopped business activity, and 37 defaults crippled the financial health of the fund. In 1989, the fund was required to repay almost 850 CFA franc to lenders (Balkenhol, 1990).

The Japanese Credit Guarantee Corporation has had success decreasing the amount of guarantee claims it must pay out by vigorously pursuing borrowers when they default on loans. Through their efforts, they have achieved a 53 percent recovery rate (World Bank 2008).

1.5.5 Risk management

In order to reduce the exposure of schemes to default and diversify risk, funds might use risk management mechanisms such as reinsurance, loan sales or portfolio securitisations. However, these mechanisms require relatively well developed local capital and financial markets. Nevertheless, the World Bank study revealed that 76 percent of the schemes studied use risk management tools. 20 percent purchase some form of loan insurance, 10 percent securitize the loans portfolio and 5 percent use risk management strategies (World Bank, 2008).

An example of a reinsurance mechanism is a counter- or co-guarantee. Counter-guarantees are provided by the government or an international financial entity. They provide indirect protection – the counter-guarantor assumes part of the risk associated with guaranteeing a loan. One negative consequence of a counter-guarantee system is that moral hazard increases. For this reason, it is advisable to have a counter-guarantee cover only a limit amount of the risk. However, a positive consequence of the counter-guarantee system is that it helps increase private sector confidence in the guarantee scheme.

Box 3. Portugal Mutual Counter-Guarantee Fund

The "Fundo de Contragarantia Mutuo" (FCGM) was created in association with the European Investment Fund (EIF) in 1998. The Counter-Guarantee Fund was created to both leverage the capacity of mutual guarantee companies and ensure the solvency of the mutual guarantee system. By law, the fund must reinsure all guarantees provided by mutual guarantee companies. The fund itself benefits from risk coverage provided by the European Investment Fund (EIF) on guarantees of bank loans lasting over three years granted to companies with less than 100 employees. The FCGM has provided EUR 29 million in counter guarantees.

The maximum counter-guarantee of each extended guarantee allowed by the FCGM is 80%. Whenever a mutual guarantee society is required to pay all or part of a guarantee, the FCGM pays the percentage of the sum paid equal to the percentage of the counter-guarantee.

Source : www.portugalglobal.pt, www.eif.org, Minister of Finances, Ministerial order no. 1354-A/99 (II Series), Decree-Law no. 229/98, of 22 July

Counter-guarantee systems are mostly found in developed countries. Applying counter-guarantees in developing countries has proven to be difficult due to inadequate financial development and legal conditions. An attempt was made in Chile to introduce counter-guarantees; however, the project was eventually abandoned. Recently, some insurance companies owned by banks in Latin America have begun providing counter-guarantees to their mother-banks, but such initiatives are new and their impact and feasibility are not yet certain (World Bank Partial Credit Guarantee Schemes Conference, 2008).

1.5.6 Involving donors, the public sector and the private sector

The primary role of the public sector in facilitating credit guarantee schemes is to create the appropriate regulatory environment. Public funding, especially initially, could also be considered e.g. as in Colombia or Chile. However, it is important that state subsidies do not interfere with market mechanisms determining the supply and demand, and therefore the price and quantity, of credit. In many cases, national or regional governments have provided guarantee schemes with subsidies to target guarantees at SMEs or to help a guarantee fund expand operations. In other cases, governments have stepped in to provide initial capitalisation. While government initial capitalisation spreads risk between lenders, borrowers and the government, it can often also cloud the real operational costs. Many studies have shown that the role of the government should be limited to setting-up the appropriate legal environment and contributing to technical assistance. Subsides should only be given over a short-term period, and the eventual aim of a guarantee scheme should be independence and self-sufficiency (Commission of the European Communities, 1991). The government should have a much more limited role in the management and risk assessment of the scheme (The World Bank, 2008).

Donors play an integral role in funding guarantee schemes and aids in bringing creditability to the scheme. Donors closely examine and research guarantee schemes they are looking to fund. It is imperative that donors define the responsibility of each actor and determine payment conditions based on key milestones and outputs to encourage adequate risk allocation.

Without the active involvement of the private sector, schemes are unlikely to flourish. Private sector funds are important to ensure a fund’s sustainability. In fact, banks and other private institutions can have a direct stake in a fund’s capitalisation. Other options include private funding through equity. Mutual guarantee associations pool resources from their members. Private funds reduce the guarantee fund’s dependency on public funds, which can sometimes be volatile. In many West African countries, public resources were not rapidly injected into the guarantee schemes. As a result, the schemes faced delays in disbursing their guarantees. Lenders were therefore reluctant to apply to the guarantee schemes. The end result was that many of the schemes, including those from Burkina Faso and Cote D’Ivoire, were forced to close (Balkenhol, 1990).

Box 3. Korean Scheme

Despite the success of the Korean Credit Guarantee Scheme, it maintains a default rate of 4 percent which is considered high by international standards. This is because the main goal of the scheme is to improve the credit environment for SMEs. Indeed, the fund provides credit to 230 SMEs and the total amount of credit guaranteed surpasses USD 33 million. The government only contributes USD 100 million to the scheme. The remaining USD 700 million in the scheme comes from commercial banks. The financial involvement of the private sector has enabled the fund to remain financially stable over time, despite its relatively high default rate.

In the 1980s while the Korean economy was growing rapidly, the fund issued many credit guarantees. However, in the late 1990s Korea experienced a very serious economic crisis and a financial downturn. To contribute to the normalisation of the financial market, the fund decided not to stop distributing guarantees. As a result, the default rate increased and still remains relatively high. However, the fund expects it to decrease over time – starting in the early 2000s the economy began improving and the fund quit expanding its credit portfolio; now it is putting more emphasis on improving the quality of the portfolio.

Source : World Bank Partial Credit Guarantee Schemes Conference, 2008

Regulatory and institutional framework

Many guarantee funds, especially mutual guarantee funds, have not had tremendous success in developing countries. Reasons for this include a weak legal framework and a non-competitive banking sector (Levitsky, 1993). For instance, in Senegal the National Craft Association (UNCM) and the Dakar Chamber of Commerce have both attempted to create a mutual guarantee scheme. However, minimum capital requirements prevented the funds from setting up shop – both funds aimed to operate on a smaller scale, and the minimum capital requirements were too high for them to either achieve or even need. The legal environment did allow the MGSs to establish as non-profit organisations, but most banks prefer dealing with a profit-making entity (Balkenhol, 1990). In contrast, a competitive banking sector and growing domestic capital market contributed to the success of the Chilean guarantee scheme.

Governments need to construct the conditions to enable the creation of MGSs and the growth of state-funded credit guarantee schemes. In particular, they need to minimise obstacles to their creation and growth and promote their use among the financial sector and the general public. A 2005 study by the London International Development Department identified a number of micro and macro factors that can contribute to the success of guarantee schemes. Included amongst their suggestions is the need for an open, competitive environment with independent banks and a framework that will support SME creation and growth. Additionally, guarantees need to be regulated – however this is a slow process. For instance, Latin American countries only began regulating guarantees in the early 2000s.

Regulators can improve the environment for issuing guarantees in numerous ways. In particular, they can establish minimum capital requirements, the appropriate solvency ratio and transparency criteria. Such controls help improve banking sector confidence in the guarantee schemes and can help prevent any major crisis stemming from poorly issued guarantees. Additionally, these controls can contribute to higher liquidity among guarantee schemes, improving the ability of banks to recover the cost of their loans in instances of default.

One final question to consider is: who should take on the role of the regulator? Engaged external supervision can have a positive effect on the guarantee system, since it will reduce the risk of fund mismanagement. Guarantee scheme regulation contributes to the credibility of the schemes, and in the case when the scheme is supported by public resources, regulators can ensure the protection of those resources. In countries where the private financial market is well developed, regulation can be achieved, in part, with private sector actors. However, when this is the not the case, public entities such as the central bank, should take over the task.

Conclusion:

This paper has performed exploratory analysis of ME's operating within Province 5 of Nepal. The population for the study has been the growth oriented ME's or, intention to scale up has been identified in the population. Initial research had identified several setbacks on scaling up of ME's and among which access to finance has been identified to be one of the major one. This study has thus focused on availability of access to finance to ME’s of Province 5 who have an intention to scale up. Exploratory study of available access to finance tools within the region has identified many different tools ranging from Savings and Credit Cooperative to “A” class financial institution. The survey results has shown that access to finance has been identified by the ME’s with intention to scale up as their primary restraining factor. Despite wide availability of different financing tools with different systems, the ME’s with intention to scale up were not being able to utilize it primarily for these reasons: i) Strict requirements make the access difficult to reach ii) strict requirements with high collateral requirements raises the cost of lending. With these setbacks the desired results has not been achieved. Thus, I have recommended a new model to address these issues which is Credit Guarantee Scheme (CGS). With this scheme the setbacks can be addressed and access to finance can be made available and obtained with ease.