Making Access Possible 2021

Nepal

Financial Inclusion Refresh

SUSTAINABLE DEVELOPMENT GOALS
17 GOALS TO TRANSFORM OUR WORLD

UNCDF
Unlocking Public and Private Finance for the Poor

Making Access Possible

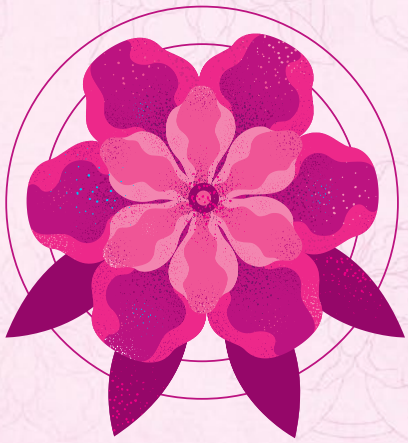
Making Access Possible (MAP) is a multi-country initiative to support financial inclusion through a process of evidence-based analysis feeding into a financial inclusion roadmap jointly implemented by a range of local stakeholders. Through its design, MAP seeks to strengthen and focus the domestic development dialogue on financial inclusion. In each country, MAP brings together a broad range of stakeholders from within government, the private sector and the donor community to create a set of practical actions aimed at extending financial inclusion tailored to that country.

This report was prepared by beed management Pvt. Ltd, lead by Sudip Bhaju, Raju Tuladhar, Rojesh Shrestha, Sarik Koirala, Sujeev Shakya, Sugam Bajracharya, and Tanushree Agrawal. We would like to express our appreciation to all stakeholders that provided information and insights, and in particular to Nepal Rastra Bank (NRB), Central Bureau of Statistics (CBS), National Planning Commission and the Ministry of Finance, as well as to the UNCDF country team, especially Saroj Nepal, for assisting with coordination and the organisation of interviews as well as invaluable inputs provided to the report.

MAP Series Editor: Kameshnee Naidoo
Technical review and oversight: Christiaan Loots
Editor: Jacquie Withers
Layout and Design: Hybrid Creative

The cover symbol and artwork

Through the MAP programme, we hope to effect real change at country level and see the impact of financial inclusion on broader national growth and development. The cover graphic features a Rhododendron, the national flower of Nepal. The flowering plant is noted for its many clusters of large flowers and the design symbolises growth and development while the circle represents inclusive growth. Each flower is an example of the successful growth in a unique environment.



Working together to support implementation of Agenda 2030

Countries are seeking new ways to address complex and interconnected challenges. Fulfilling the promise of the UN Sustainable Development Goals (SDGs) requires multisectoral approaches that bring together expertise from a range of perspectives. By harnessing our comparative advantage and working within the context of our respective mandates, we can collectively make significant progress towards realising the vision of the SDGs.

Financial inclusion is increasingly positioned as an enabler of broader development goals, in support of the SDGs. More and more countries are including an inclusive financial sector as a key objective in their national development plans, and this tendency is further underpinned by the G20 leadership of financial inclusion, which highlights the ongoing relevance of the SDGs and nationally led financial inclusion efforts. Furthermore, financial markets play a vital role in creating a sustainable future. Access to finance for individuals, small and medium enterprises (SMEs) and governments is important to a number of the SDGs, helping to facilitate secure payments, including for basic services and trade; smooth cash flows; offer financial protection; and improve allocation of capital while also enabling investments in many areas.

This MAP refresh, in supporting country efforts, increases the focus on inclusive growth (especially through SMEs and agriculture), access to basic services (energy, health and education), and improving household resilience, as well as gender equality. Increased reliance on technological innovation and digital financial services will help to improve the scale and efficiency of financial inclusion interventions.

This refresh was undertaken by the United Nations Capital Development Fund (UNCDF) to jointly address the United Nations Development Programme's (UNDP's) Signature Solution 1, which seeks to work with countries to keep people out of poverty, relating directly to SDG 1: eradicate all forms of poverty, wherever it exists.

The core focus of Signature Solution 1 is helping people get out of – and stay out of – poverty; and hence the analysis and interventions identified help eradicate poverty, such as by creating decent jobs and livelihoods, providing social safety nets, and ensuring access to services such as water, energy, healthcare, credit and financing support for investment in productive assets.

Partnering for a common purpose

By combining inspiration, ideas, knowledge and resources with our partners, we become more than the sum of our parts.

We are committed to empowering investors—public and private alike—with the clarity, insights and tools they need to optimise the positive impact of their investments, closing the gap between high-level principles and financial performance to make a positive contribution to society.

Note on the use of household data

Within this document (unless otherwise referenced), demographic, income and financial usage data is obtained from the 2014 FinScope Nepal Consumer Survey. A summary report and presentation of FinScope is available as a separate deliverable, and the FinScope dataset is available for future research at https://uncdfmapdata.org. Analysis meant to feed into this report will be provided to stakeholders separately once the upcoming Access to Finance survey becomes available in 2022.

Our technical response

Access to affordable finance for all by 2030, with increased access to formal financial services.

In 2014, UNCDF assisted the Government of Nepal with the preparation of a Financial Inclusion Roadmap and Action Plan, which set out the above vision. This called for a MAP study in Nepal, which follows an approach adopted in a range of countries, including Botswana, eSwatini, Democratic Republic of Congo, Lao PDR, Lesotho, Malawi, Mozambique, Myanmar and Thailand.

The 2016 MAP diagnostic report for Nepal considered the country context, demand and supply for financial services, and the regulation of these services. The report highlighted the need for interventions in accordance with those opportunities that best meet the national objectives for growth and improved livelihoods. Such interventions were then documented in the form of the 2017–2022 Nepal Financial Inclusion Action Plan, which provided the structure for defining, prioritising, coordinating, measuring and tracking the interventions.

The report identified practical recommendations for overcoming barriers to greater financial inclusion, including (i) unlocking constrained credit and savings market; (ii) improving the payment system; (iii) bolstering risk-mitigation capabilities; (iv) enhancing and leveraging locally based financial service providers; (v) enhancing financial inclusion support in national governance; and (vi) strengthening consumer empowerment, protection and education.

In this MAP refresh report, we review the implementation of the 2016 MAP diagnostic recommendations and the 2017–2022 Nepal Financial Inclusion Action Plan, consider key market changes and identify financial inclusion interventions that can grow the economy and benefit society.

Nepal at a glance

Data sources as referenced in remainder of document.

GDP (2019)
USD30,6 bn

GDP per capita (2019)
USD1,071.05
USD 792.60 (2015)

Exchange rate
1USD= NPR117.30
January–June 2021
6 months average

Average annual growth rate
7.3%
2016–2019

CPI inflation
3.6%
2020/21

Global COVID-19 pandemic pressure
1.9%
GDP actual contraction
2020

2.7%
GDP projected growth
2021

3.9%
GDP projected growth
2022

Contribution to GDP
Agriculture, forestry and fishing
27.7%
2020

Contribution to GDP
Wholesale & retail
13.9%
2020

Contribution to GDP
Manufacturing
5.7%
2020

Contribution to GDP
Foreign direct investment
0.54%
2019

Human Development Index
0.602
2020
0.583
2015

Contribution to GDP
MSMEs
38%
2019

Contribution to GDP
Remittances
22%
2019/20
27%
2019

Global Food Security Index
77/113 countries
2021

Nepal at a glance

Data sources as referenced in remainder of document.

Total population
28.6mil
2019

Urban 20.2%
Rural 79.8%
2019

16.7% 2019/20
Population below international poverty line
18.7% 2018/19
(PPP USD 1.90/day)

Population in multidimensional poverty
17.4%
2021

2018
67.9%
Adult literacy rate
cf. South Asian average literacy rate: 72.2%

59.7%
Female adult literacy rate

92.4%
Youth literacy rate
cf. South Asian youth literacy rate: 89.9%

Labour force
16.9 million
2019

28.6%
2018
Female-headed households in multidimensional poverty

Informal employment
% of total labour force
61%
2020

MSME establishments
923,356
2020

Gender Gap Index
101/153 countries
2020

Male-female employment ratio
62:38
2020

MSME jobs
3.2 million
2020

Tele-density mobile
128%
2020

Broadband Internet access
84%
2021

1

The changing environment

1.1 Economy, population and growth

Tenfold GDP increase since 1990 – but infrastructure, economic growth and export levels remain a challenge. With the restoration of multi-party democracy in 1990 and opening of the economy, Nepal's GDP increased tenfold: from USD 3.4 billion in 1990 to USD 34 billion in 2020.[1]

This has been possible through private sector-led growth, migration of Nepali people to other countries for work creating remittance inflows to the country, and overall improvement on social metrics as indicated in Nepal's achievement of the millennium development goals. However, the country still faces challenges around infrastructure development, inclusive growth, and leveraging its position for trade and commerce between its two large neighbours.

Nepal achieved an average growth rate of 7.3% per year for the period 2016–2019, and its GDP in 2019 was USD 30.6 billion. GDP per capita in 2019 was USD 1,071.

Economic lift-off hampered by pandemic. Nepal achieved an average growth rate of 7.3% per year for the period 2016–2019,[2] and its GDP in 2019 was USD 30.6 billion.[3] GDP per capita in 2019 was USD 1,071[4] (see Figures 1 and 2 for GDP per capita growth).

The country aimed to graduate from least developed country (LDC) status to developing country status by 2022. To do so, the Government of Nepal (GoN) set an ambitious GDP growth rate target of 9.6% per year (at basic prices) for the period from 2020 to 2024.[5] However, the global COVID-19 pandemic caused the country's GDP to contract by 1.9% in 2020 and is only expected to grow at a rate of 2.7% in 2021 and 3.9% in 2022.[6] This has put a severe dent in the GoN's ambitions of attaining developing country status by 2025 and middle-income country status by 2030.

Decrease in poverty and increase in quality of life. Nevertheless, the increased economic growth in the period from 2016 to 2019 resulted in Nepal's per capita income catching up with the per capita income of the world's LDCs, increasing by almost 38% to USD 1,071.05 over the period.[7] As a result, the proportion of the population living in poverty has declined: from nearly 24% in 2014/15, to nearly 19% in 2018/19, and falling further to nearly 17% in 2019/20.[8]

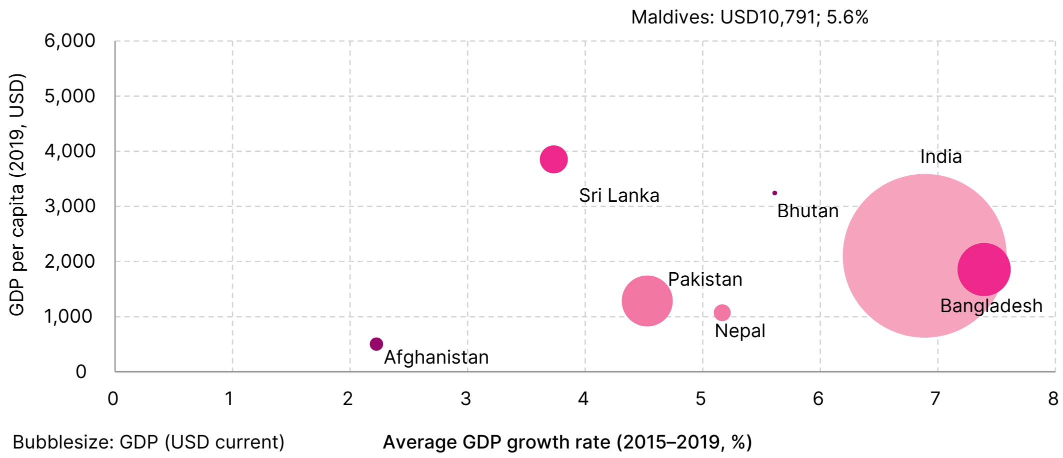


Figure 1: GDP per capita growth in % (2015–2019, in USD)

Source: World Bank Development Indicators 2020

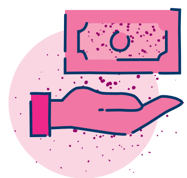
At the same time, the country's UNDP Human Development Index (HDI) rating increased from 0.583 in 2015 to 0.602 in 2020.[9] Per capita health expenditure went from just under USD 48 in 2015 to just under USD 58 in 2018, while the net primary school enrolment rate was just over 96% in 2019.[10]

The increase in the quality of living and decrease in the poverty level can be largely attributed to an increase in remittance flows into the country, post-earthquake reconstruction efforts, and increased levels of public spending on large infrastructure projects.

Increasing labour pool remains predominantly rural. The population of Nepal increased to 28.6 million in 2019, and the proportion of the population of working age is increasing (currently almost 65% of the total population are in the 15–64 age bracket) due to a decreasing fertility rate (1.9 per 1,000 in 2019) and a decreasing crude mortality rate (6.4 per 1,000 in 2019).[11] As a result, the country's total labour force increased by 12%: from almost 15 million in 2015 to almost 17 million in 2019.

Although the urbanisation rate stands at 3.3% per year, just under 80% of the population remain rural[12] and Nepal will therefore remain predominantly rural in the foreseeable future.

Nepal economy characterised by high levels of remittance inflows. Nepal received remittances amounting to NPR 665.1 billion (almost USD 5.7 billion) in 2015/16, growing to NPR 875.03 billion (almost USD 7.5 billion) in 2019/2020: an increase of almost 32% in the five-year period. However, despite the nominal increase, remittances have been declining relative to GDP, from just over 25% of GDP in 2015/16 to just over 22% of GDP in 2019/20.[13]



The increase in the quality of living and decrease in the poverty level can be largely attributed to an increase in remittance flows into the country, post-earthquake reconstruction efforts, and increased levels of public spending on large infrastructure projects.

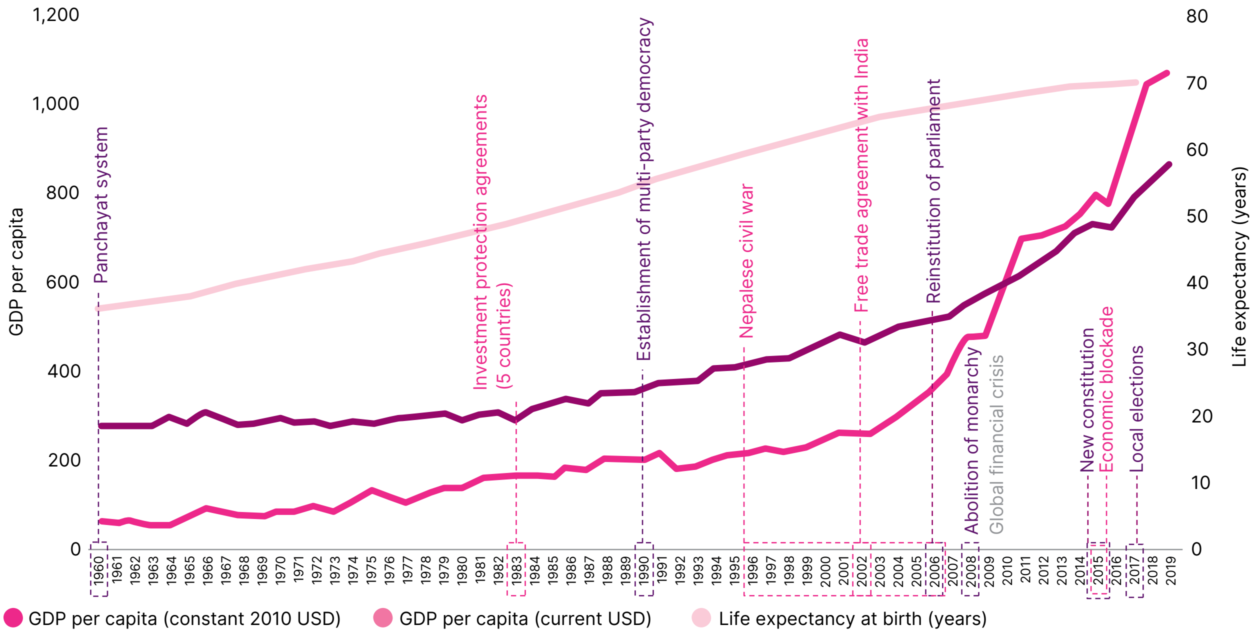


Figure 2: GDP per capita versus life expectancy (1960–2019)

Source: Author, using World Bank Development Indicators 2020

Remittances contributing to a low-growth, high-migration trap. While migration and remittances have been a key factor in reducing poverty in Nepal, remittance-fuelled consumption coupled with the country's low industrial output has led to high import volumes, contributing to a widening trade deficit and a downward pressure on the country's foreign exchange reserves. This has led to a steady loss of competitiveness through the appreciation of the real exchange rate and growth of low-productivity services in the country.[14] Furthermore, the fact that government derives a large chunk of its revenue from taxation of such imports means there has been little incentive to tackle this problem.

Low levels of economic growth and high levels of migration feed into a further reinforcing cycle: with insufficient domestic job creation to absorb new entrants to the labour market each year, workers continue to migrate in large numbers for employment abroad. From FY 2015/16 to 2018/19, the government issued 1,376,870 labour permits, averaging 344,217 permits a year.[15] A high proportion of the labour force migrates to other countries (to work on mostly low-skill assignments), and the number of new permits per year almost equals the yearly entrants into the country's labour pool.

Remittances not feeding into inclusive growth. At the same time, and despite government's pro-poor policies and critical reforms targeted at reducing poverty, little has been done to improve public service delivery and access to basic services for the general population. As a result, the country's education, healthcare and infrastructure remains subpar. Hence, Nepal has found it increasingly difficult to escape its low-growth, high-migration trap. Effectively, this is a missed opportunity to leverage remittances to invest in inclusive growth.

Financial access has expanded rapidly. The period post-MAP 2016 has seen rapid expansion in the availability and uptake of financial services, with banks and financial institutions (BFIs) reaching 750 of the 753 local areas in the country:

- By mid-June 2020, the percentage of the population having at least one bank account ('banked') had increased to an estimated 67%, compared to an estimate of almost 61% in mid-July 2019,[16] and to a figure of 40% in 2015.
- In 2019, 26% of the population had access to formal insurance, compared to 11% of the population in 2015.[17]

Furthermore, to accommodate the new structure of government since 2015 (three levels: federal, state or province, and local), the central bank has transformed its previous regional branch offices into provincial offices, while commercial banks have started to establish provincial headquarters with provincial management structures, in efforts to enhance and facilitate financial services at the provincial and local levels. Provincial- and local-level commercial bank branches are currently working directly with the provincial and local governments to promote and increase access to financial services.

Tertiary sector contributing to increased GDP, while primary sector declines and secondary sector stagnant. In terms of sectoral contribution to GDP, Agriculture (27.7%), Wholesale and Retail (13.9%) and Real Estate Services (11.9%) continue to be the largest contributors, while Education, Construction, and Financial Intermediation also contributed 7%–8% each (see Figure 3).[18]

In terms of sectoral contribution to GDP, Agriculture, Wholesale and Retail and Real Estate Services continue to be the largest contributors.

However, some sectors are declining in contribution to GDP, despite showing nominal growth, while others are increasing in contribution due to their higher respective sectoral growth rates. For instance, Agriculture's contribution has been steadily decreasing, as has that of Transport, Communication and Storage, and Manufacturing. By contrast, Real Estate and Business Services, Education, and Financial Intermediation are all contributing an increasing share. That is to say, the tertiary sector (driven by services), is contributing to an increasing share of GDP (just over 58% in 2020 vs 53% in 2014), while the primary sector's contribution is declining and that of the secondary sector has remained stagnant during this review period.

The higher-growth sectors are mostly not high-employment sectors. The key issue to note is that the higher-growth sectors are not as labour intensive as the lower-growth (and declining) sectors (for example, agriculture remains the highest source of employment at 66% of the population),[19] and this has the effect of pushing more people into the informal sector and away from agriculture – increasingly also in urban areas. At the same time, the agriculture and manufacturing sectors are not yet contributing optimally in terms of their crucial potential role in growing Nepal's economy, while the transport and energy sectors in particular are contributing very little to growth while being critical to unlocking broader and sustainable growth in the economy.

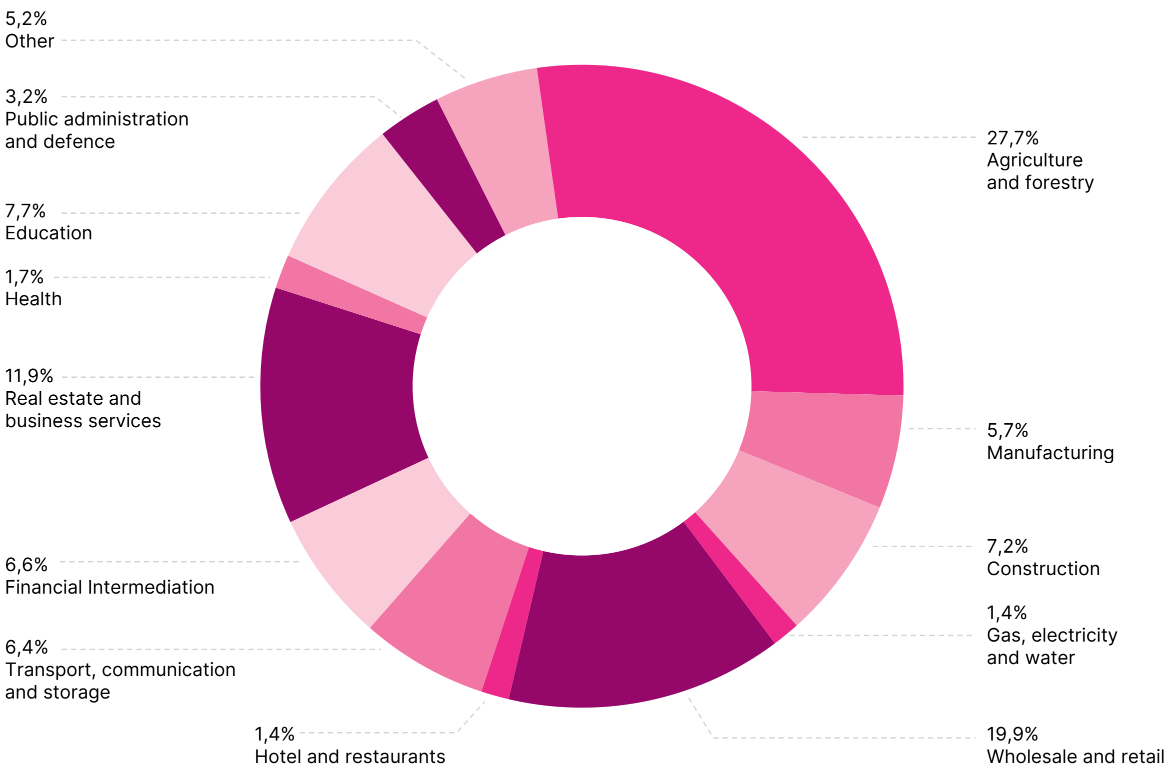


Figure 3: Sectoral contribution to GDP as of FY 2019/20

Source: Nepal Macroeconomic Update 2020, ADB (2020b)

Persistent trade deficit due to high import levels. Nepal's fiscal expenditure has seen progress through continuous reforms which have contributed to an increase in revenue sources for the government.[20] Nevertheless, the country's fiscal deficit has grown over the years. The country also has a consistent current account deficit, largely due to a massive imbalance between imports and exports, fuelled by both remittances and increasing levels of importation of capital goods. For instance, from 2015 to 2019, the country's trade deficit increased significantly due to the combination of increased importing of industrial and capital goods for high investment and stagnant levels of exports.[21] However, the balance of payments is buffered against the trade deficit to some degree by the country's high remittance inflows, and recently (first six months of FY2020/21)[22] turned to a surplus, as a result of a decline in imports due to COVID-19. Consumer price index (CPI) inflation stood at 6.15% in 2019/20 and 3.6% in 2020/21.

1.2

Policy and regulation

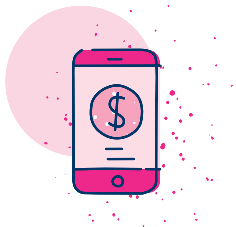
Since 2015, in terms of its new Constitution, the Federal Democratic Republic of Nepal has been organised into three levels: federal, provincial and local. The legislative structure accordingly has three tiers: a bicameral federal parliament, unicameral state assemblies for the seven provinces, and unicameral municipal or village assemblies for the 753 local government levels.

With the implementation of this structure, sub-national governments, as granted by the Constitution, are essential stakeholders with powers to implement pro-growth policies in cooperation with the private sector.

Significant number of key policies and regulations drafted, amended, introduced. With the successful completion of a national election under the new federal structure, many policies and regulations that had been pending or outstanding were introduced during the period (see Table 1).

Reforms have had positive implications for financial services. In tandem with the new federal structure in place, the reforms have resulted in an increase in the number and coverage of physical bank branches across the country. The series of laws and regulations related to digital payments along with the development of the country's payment infrastructure has also led to exponential uptake of digital payment transactions post-MAP 2016. And the central bank is in the final stages of introducing the National Payment Gateway via Nepal Clearing House Limited, which will consolidate the various systems of online payment.

New federal structure leading the financial inclusion agenda. The government introduced the Financial Sector Development Strategy (FSDS) 2017–2022, which has identified financial inclusion as one of the guiding principles for achieving government's vision and objectives. To increase financial access, the federal government introduced campaigns such as 'One Household One Bank Account'. Likewise, the new provincial and local governments, via their annual plans and polices, have come out with various programs in partnership with local financial institutions (BFIs operating in the local area), which is driving financial inclusion across the country, especially in the semi-urban and rural areas.



The central bank is in the final stages of introducing the National Payment Gateway via Nepal Clearing House Limited, which will consolidate the various systems of online payment.

Financial Literacy Framework introduced. The central bank introduced its Financial Literacy Framework, which is an implementation priority under the area of strengthening consumer empowerment, protection and education in the MAP action plan 2016. The framework aims to enhance and systematise the current fragmented financial literacy activities, to facilitate monitoring and evaluation as well as regular assessment.

Central bank has increased accountability and transparency. The central bank has established a financial consumer protection unit to manage depositors' and creditors' grievances and generally to improve consumers' trust in the financial sector, including in financial service providers. The central bank has also established a financial inclusion online portal, which publishes a range of key financial inclusion indicators. The portal was established by the central bank as a transparency mechanism and makes specific metrics available publicly on a periodic basis, allowing the public and key stakeholders to monitor financial inclusion progress and declines over time.

The central bank has established a financial consumer protection unit to manage depositors' and creditors' grievances and generally to improve consumers' trust in the financial sector.

BFIs do not yet view financial literacy initiatives as business strategy. BFIs have yet to incorporate financial literacy into their business strategies and governance. Financial literacy activities are carried out as part of corporate social responsibility (CSR) and are still generally viewed as representing compliance with philanthropic imperatives rather than as strategic business investments.

National financial inclusion agenda currently driven by multiple stakeholders. Various stakeholders are currently driving the financial inclusion agenda. The Ministry of Finance (MoF) has the overall policy formulation, regulation and coordination mandate related to the financial sector. The financial sector management and corporation coordination division of the ministry carries out various financial sector activities. Currently the ministry is directly implementing the five-year Financial Sector Development Strategy (FSDS) 2017/18–2021/22, in which financial inclusion is one of the outlined activities. The ministry is also working to roll out the next five-year FSDS. In addition to this, both the central bank and the Insurance Board (IB) carry out financial inclusion activities, with the central bank's focus on driving the financial inclusion agenda being more explicit: it has a dedicated financial inclusion unit under the Microfinance department. The current 2017–2022 Nepal Financial Inclusion Action Plan activities are also being spearheaded by this central bank unit, which has also recently conducted a rapid assessment of the Action Plan in 2020.

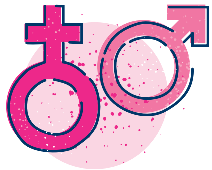
Table 1: Key policies and regulations in Nepal (post MAP-2016)

POLICY/REGULATION	OVERVIEW
FINANCIAL SERVICES	
Banks and Financial Institutions Act (BAFIA), 2006, Amendment, 2017	This is the act that governs all the activities of BFIs in the country. Key amendments were: cooling period for chief executive and deputy CEO; two-term limit for bank CEO, chairperson and directors of the bank; provision allowing conversion of promoter shares into public shares after the lock-in period of 10 years.
Cooperative Act 1991, Amended, 2017	After 26 years, the Act was amended, with key changes including the following: provision for creating a cooperative development fund; provision for creating a loan collection jurisdictional authority; additional penalties to ensure safety of cooperative members' savings; conflict of interest for board members defined; interest rate spread introduced.
Payment and Settlement Act, 2019	The Act provides for 'development, expansion, promotion, oversight and regulation of overall payment and settlement system of the country'. It provides the legal framework governing the payment and settlement systems in Nepal, including retail payment systems, payment service providers (PSPs) and payment system operators (PSOs).
Real Time Gross Settlement (RTGS) System Rules, 2019	These are rules applicable to all the participants in the RTGS system provided by the NRB. RTGS is owned by the NRB (i.e. the central bank), which is the legal system operator.
Licensing Policy for Payment-related Institutions, 2016	This policy is to: (i) issue licenses for the establishment of institutions/ mechanisms operating payment-related functions and their related instruments and transactions; (ii) classify licenses on the basis of the nature of the function, namely: payment service provider (PSP) and payment service operator (PSO). The policy resulted in the operation of 17 PSPs (apart from BFIs) and 9 PSOs (as of mid-November 2020).
Retail Payment Strategy, 2019	The strategy introduced by the central bank is focused on creating an enabling framework for the development and widespread use of digital payment services in Nepal. The key components of the strategy are: (i) strengthening the legal and regulatory framework; (ii) deepening digital retail payment systems; (iii) enabling government and remittance payments to transaction accounts; (iv) strengthening retail bank clearing systems by allowing settlement of net clearing obligations in central bank money (NRB cash or book entries); (v) increasing financial awareness; (vi) increasing oversight covering endpoint security; and (vii) coordination with relevant authorities.
Nepal QR Standardization: Framework and Guidelines, 2021	This standard has been introduced to bring in uniformity and provide equal opportunity for all players in the payment space. The standard makes provision for three major payment principles: interoperability, scalability and security.
Specialized Investment Fund Rules, 2019	The rules introduced by the Securities Exchange Board of Nepal (SEBON) facilitates the operation of alternative investment funds such as: private equity, venture capital, hedge fund and others funds.
Moneychanger License and Inspection Regulation, 2020	The amended regulation has increased the annual fee, deposit amount, capital requirement and annual renewal fees for the licensed moneychangers from the central bank. Furthermore, the regulation makes provision for onsite and non-onsite inspection and supervision of the moneychanger, and actions for violations of the conditions outlined in the regulation.
Foreign Exchange Trading License and Inspection Regulation, 2020	Along with BFIs, other firms, companies or institutions such as department stores, supermarkets, hotels, tourism services, travel agencies, cargo companies, aviation services and casinos will be allowed to conduct foreign currency exchange transactions.

Microinsurance Directive, 2020	Life and non-life insurance companies alike are required to operate microinsurance business as per the direction of IB. If microinsurance is sold directly, without agents, 8% discount can be provided in the premium of the life microinsurance and 10% in that of the non-life microinsurance policy buyer. Furthermore, the companies are barred from charging any extra fees on microinsurance premiums.
Agriculture and Livestock Insurance Directive, 2020	The directive defines the roles, duties, qualifications and code of conduct of insurers, insureds, technical experts, agents and surveyors involved in agriculture and livestock insurance. The procedures regarding claim settlement are also provided. Likewise, the directive sets out provisions regarding minimum area of land for eligibility of insurance, provisions regarding transfer of policy, formulation of a manual and use of software, and procedures for inspection.
Economic, social policy	
Foreign Exchange (Regulation) Act, 2019, Amendment	Section 12 of the Act empowers the central bank to issue directives, bylaws and notices to implement the provisions of the Act. It also provides the central bank with the power to take action, sets out provisions related to payment for sale of goods and services to foreigners, stipulates restriction on import or export of certain currency and bullion, includes provisions relating to lending and borrowing of a loan in a foreign exchange, and makes provision for repatriation, investment and transfer of right in foreign exchange.
Social Security Fund Act, 2017	All (formal) employers and employees are required to register under the Social Security Fund (SSF). Employees and employers are required to deposit 11% and 20% respectively of the employee's basic salary to the fund every month. This includes the employee's provident fund, social security tax, gratuity and medical insurance. The Act stipulates which Nepali citizens are entitled to receive a social security allowance. Social security protection is provided for maternity, sickness, employment injury, old age and retrenchment in accordance with internationally accepted principles. A medical scheme in addition cover payments for treatment of medical conditions The Act mentions the procedures for distribution of the allowance, as well as offences and punishments, and various other provisions.
Health Insurance Act, 2018	The Act sets out the eligibility criteria for the National Health Insurance Program (NHIP), including the required contribution, provisions on payment, health services covered by the program, services excluded by the program, and provisions on revocation of the agreement. The Act also defines the roles, duties, authority and qualifications of executives of the board.
Health Insurance Regulation, 2020	The NHIP offers cover up to a maximum of NPR 100,000 (USD 853) to up to five members of a family. Each family is required to contribute NPR 3,500 (USD 30), with NPR 700 (USD 6) required as a contribution for every additional member. Each member gets coverage of NPR 20,000 (USD 171). The formal sector's payroll contribution is 2%. Subsidy of 100% is provided to ultra-poor families, HIV-positive people, and the elderly population over 70 years.
Consumer Protection Act, 2018	The Act is intended to protect the interests of consumers regarding the quantity, quality and price of consumer goods and services. The new Act has revised the definition of 'services' and added various new services such as banking. The Act also outlines prohibited activities and relevant authorities for consumer rights and protection.
Public Private Partnerships and Investment Act, 2020	The Act makes provision for approval of investments, project implementation and investment boards.
Digital Nepal Framework, 2019	This provides a roadmap to how digital initiatives can contribute to economic growth in Nepal as well as solving major challenges facing society and identifying opportunities for Nepal to participate in the global economy.
Agriculture policy	
National Agroforestry Policy, 2019	The objectives set out in the Act are: to increase the production of agricultural, livestock, and forest products; to conserve the environment and biological diversity; to create opportunities for livelihoods, employment and income generation, along with food security, commercialisation and facilitation of investment opportunities in agroforestry; and to conduct research and capacity enhancement in agroforestry subjects.

With all of the recent reforms, there is a pervasive feeling of a shift in the policy environment that favours financial services expansion. Nonetheless, there are a number of gaps or areas for improvement in order to better align these regulations for the delivery of financial services and products (see Table 2). These developments will ultimately aid in the creation of more suitable products and services, thereby promoting financial inclusion.

Gender-neutral polices should be revisited to encourage greater gender equality. The majority of Nepal's legislation and policies are largely gender neutral, although there are a few exceptions: for instance, the central bank's concessional loan program includes a special category for assisting female borrowers; and microfinance institutions (MFIs) are urged to lend to female borrowers without requiring collateral. Even though there are no explicit gender-specific rules prohibiting women from accessing formal financial services, access is frequently difficult due to ingrained social norms and cultural barriers, particularly in rural areas; and a lack of financial literacy and the strict documentation requirements only make the situation more challenging. This has resulted in a greater reliance on informal financial services by rural women.



The majority of Nepal's legislation and policies are largely gender neutral, although there are a few exceptions.

Moving forward, with an understanding of the ground-level challenges and gender gaps that women face in accessing formal financial services, upcoming policies and regulations should ensure that gender issues are adequately captured and provisioned to close any existing gender gaps.

A number of key policies and regulations in the pipeline. The key acts that are currently under approval or discussion or in the development phase are listed in Table 2; they are all under review in the lower house.

Table 2: Key policies and regulations currently under approval, discussion or development in Nepal (2021)

POLICY/REGULATION	STATUS	
Nepal Rastra Bank Act, Amendment	ALL UNDER REVIEW IN THE LOWER HOUSE	The bill proposes restructuring of the NRB into a federal structure, in which it would have the right to operate offices in any province as the banker and financial advisor of the federal government, the provincial government and local levels as well. Likewise, the bill proposes the establishment of a financial stability fund into which the government and BFIs would deposit certain amounts, which would be used to help BFIs during times of financial crisis.
Banks and Financial Institution Act, Amendment		The bill proposes new provisions on the academic qualification and experience of the board of directors. Likewise, the bill requires BFIs to get approval from the NRB before hiring or firing CEOs. The bill includes a provision that prevents businesspersons who take loans over a certain limit from a BFI becoming a board member of the BFI.
Credit Information Act		The bill aims to create mechanisms to govern the credit information business through a separate law. The law would enable new companies specialising in credit information-related services to enter the market and would allow them to receive credit information from lending agencies, maintain records and share such information with BFIs.
Insurance Act, Amendment		The bill defines fees charged by the IB to insurance companies on premiums collected on normal policies and on microinsurance policies. It also defines the priority of payment by insurance companies in case of liquidation. Provisions allowing foreign companies to operate in Nepal are also proposed.
Securities Act, Amendment		The bill includes provisions for the establishment of an Indemnity Fund to protect investors from risk, provisions for the operation of central depository services, and provisions for the operation of specialised investment funds. The bill also proposes criteria regarding the eligibility of CEOs of listed companies. It describes the right of the SEBON to issue bylaws.

PART 1 NOTES

1 IMF, 2021
2 WB, 2021c
3 WB, 2021a
4 WB, 2021a
5 NPC GoN, 2020
6 WB, 2021c
7 WB, 2021c
8 MoF, 2021
9 UNDP, 2021
10 WB, 2021a
11 WB, 2019a
12 WB, 2021a
13 NRB, 2021c
14 WB, 2017a
15 MoLESS, 2020
16 NRB, 2021a
17 MoF, 2020
18 ADB, 2020b
19 ILO, 2019
20 MoF, 2020
21 As per the mid-term review report of the monetary policy for 2020/21, exports stood at NPR 60.8 billion (just over USD 518.3 million), while imports amounted to almost NPR 661.3 billion (just over USD 5.6 billion), the latter down from just over NPR 949.1 billion (just over USD 8 billion) mid-March 2018/19.
22 NRB, 2021b

2

Financial inclusion and its links to social and economic questions

2.1 Introduction

To stimulate growth, the country's government is focusing on increasing energy output and transmission, irrigation, industrial jobs, Internet access, primary and secondary education levels, and access to safe drinking water.

However, to further grow the economy, Nepal requires investment in physical infrastructure; credible public management and governance reform; transformation in key sectors of the economy (such as agriculture, energy, transport, and manufacturing/exports); and human and social development contributing to job creation.

Local streams of capital will be crucial. Given the GoN's fiscal constraints and low levels of foreign direct investment (FDI), the financing agenda needs to identify local streams of capital that could be leveraged for development objectives. Households already spend money that can contribute to investment in physical infrastructure, setting up or expanding businesses in key sectors of the economy and human and social development contributing to job creation.

It will be important to tap into the power of 'people's money'. If existing household expenditure can be formally intermediated, financial inclusion effectively supports the achievement of broader growth objectives in Nepal. However, this requires formal financial inclusion that aggregates and mobilises money flows, and ultimately increases the availability of domestic capital as a source of investment. In this way, financial inclusion has the potential to contribute to funding government's development objectives, as well as contributing to SDG achievement at the household level, and inclusive economic development in the process.

Nine strategic areas for government action – including 'the four crucial needs'. Based on international frameworks for inclusive growth, UNCDF has identified nine areas that governments can influence to make growth and economies more inclusive. Of these, one is financial inclusion in itself, and an additional six can be supported through financial inclusion. These additional six areas include education and skills development; basic services provision and the infrastructure needed for basic service delivery, health, and human development; asset building and entrepreneurship; fiscal transfers and social protection; and unemployment and inequality. UNCDF also found that households already prioritise these areas in their own household spending, although the majority of this spending happens informally. Four areas in particular – what UNCDF has termed 'the four crucial needs'[1] – stand out most in household spending: education, basic services, healthcare, and entrepreneurship.

Nepal requires investment in physical infrastructure; credible public management and governance reform; transformation in key sectors of the economy; and human and social development contributing to job creation.

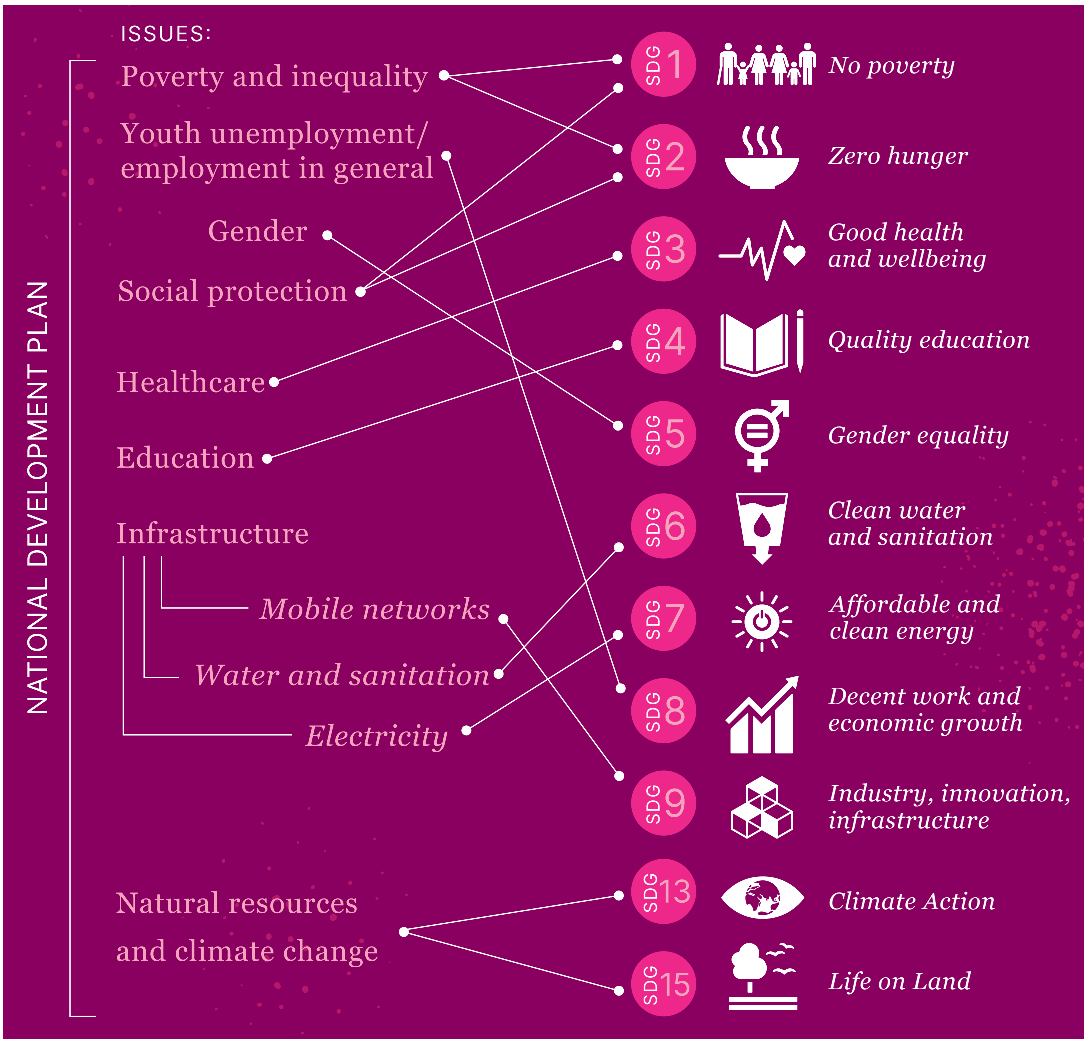
In order to understand how financial inclusion can support inclusive growth objectives, it is therefore necessary to understand key social issues in Nepal relating to these areas, while locating them within the context of government's objectives.

To create stronger linkages between financial inclusion (as an enabler) and inclusive growth, the MAP refresh report therefore takes a deeper look at the main social and economic trends, issues and opportunities in Nepal and their relation to financial inclusion. The topics reviewed in this section were identified and selected based on (i) their impact on individual human development, (ii) their impact on sustainable growth in society and (iii) their relationship to government policies (as captured in Table 3).

Focusing on an inclusive financial sector in particular has a strong impact on poverty alleviation, with links between financial sector development and more equitable growth, on the one hand, and broadening access to economic opportunities – especially for the poor, rural communities and women – on the other. An inclusive financial sector contributes to increased equality and equity in society, with more equitable consumption patterns.

This section relates major current socio-economic trends and events in Nepal with financial inclusion, to provide elements of answer to the question: *Where and how can financial inclusion support inclusive economic growth?*

LINKS BETWEEN
Issues considered, policies in Nepal and UN SDGs



2.2

Poverty and inequality

Substantial proportion of the population remain poor and vulnerable despite improvements. As of 2019, 39% of the Nepali population lived on less than USD 3.5 per person per day, while 8% of the population were estimated to be living on less than USD 1.90 per person per day.[2]

This section of the population is rendered highly sensitive to any vulnerability in the local economy, with any economic disruption likely causing this section of the population to fall below the poverty line (daily income less than USD 1.25 per person). Furthermore, as per the Nepal Multidimensional Poverty Index 2021 for Nepal, 17.4% of Nepal's population is still vulnerable to multidimensional poverty.[3] The value stood at 59% in 2006 and 29% in 2014, which does signify a marked improvement in poverty reduction in Nepal, but still falls behind regional peers India and Bangladesh.[4] The major contributing indicators to overall poverty in Nepal were malnutrition and insufficient years of schooling.

35%

Nepal's GDP per capita increased by over 35% in the period from 2015 to 2019.

Poverty driving Nepalis to migrate for income-earning opportunities. During the same time period, the GoN issued over 1.3 million new labour approvals (certificates that allow Nepali citizens to work abroad) and issued just over a further 1 million labour renewal approvals.[5]

Despite enduring poverty, GDP per capita increased and absolute poverty declined. Nepal's GDP per capita increased by over 35% in the period from 2015 to 2019: from USD 792.60 to USD 1,071.05.[6] From 2015 onwards, Nepal has received remittances worth almost USD 7.4 billion per year on average.[7] This high foreign employment rate and influx of remittance income in households has contributed significantly to a reduction in the rate of poverty in the country. The absolute level of poverty in Nepal decreased from nearly 24% of the population living in poverty in 2014/15, to nearly 19% in 2018/19 and falling further to nearly 17% in 2019/2020.[8]

Food security remains a major issue due to land shortage and subsistence farming. Nepal's agriculture sector has been classified as being an integration of subsistence agriculture and crop-livestock.[9] Agricultural land accounts for 29% of the country's land area. The country's agriculture sector has, however, remained underdeveloped with the sector marred by low productivity owing to high dependence on monsoon rainfall, insufficient irrigation facilities, labour shortages, unavailability of seeds and fertilisers, and insufficient production of key crops such as rice and maize to meet domestic demand. The agriculture sector has seen an increasing trend of land fallowing and abandonment.[10] As of 2021, Nepal ranks 77th out of 113 countries in the Global Food Security Index.[11] Although there has been marked improvement in Nepal owing to efforts made by the government to improve food security in the country, there are still 4.6 million people who are food insecure. In the 2021 World Global Hunger Index, Nepal ranked 73rd out of the 107 countries under survey.[12]

High rural vs urban disparities. As of 2019, just under 80% of the total population of Nepal resided in rural areas of the country. The country's rural population has been characterised by high outbound migration and low population growth rate: the rural growth rate and urban growth were 1.3% and 3.9% respectively in 2019.[13] The urban–rural divide in the country is also very evident through the fact that only 7% of the urban population lives in multidimensional poverty whereas the number stands at 33% for the rural population of the country.[14]

Employment-generating activities in Nepal are primarily concentrated around the urban areas, making rural–urban migration not a choice but a necessity. According to the Nepal Labour Force Survey 2017/18, the employment-to-population ratio in urban areas was 36.9%, while the ratio was only 29.3% in rural areas.[15] With fewer employment opportunities available in the rural areas, the population is highly dependent on subsistence agriculture, which in itself is a low-productivity sector, leaving the population highly vulnerable to any economic shocks and forced to emigrate to urban areas or to other countries for income-earning opportunities.

Employment-generating activities in Nepal are primarily concentrated around the urban areas, making rural–urban migration not a choice but a necessity.

COVID-19 has deepened poverty, could weaken human capital accumulation, productivity for years to come. Nepal had 39% of its population living below USD 3.50 a day before the start of the pandemic.[16] Increasing domestic market layoffs and uncertainty around foreign employment in the short and medium term are likely to have a severe impact on employment numbers in Nepal. With low domestic employment opportunities and the inability of the domestic market to absorb returning migrants, many economically vulnerable Nepalis face the risk of falling below the poverty line.

Nepal's informal economy accounts for more than 61% of the total labour force, and almost 50% of the business establishments in the country are unregistered.[17] The economic fallout that has ensued as a result of the pandemic has affected the informal establishments and workers the most. This has led to concerns over long-term economic disparities and the erosion of decades of positive growth in the country. Furthermore, the economic hardships brought on by the pandemic might result in many families opting to withdraw their children from schools to aid in subsistence household economic activities; if this were to happen it would have long-term consequences for human capital accumulation and productivity growth in the country.

RELATIONSHIP BETWEEN FINANCIAL INCLUSION AND POVERTY AND INEQUALITY

Financial sector development has a significant impact on poverty alleviation and is inextricably linked to economic growth. This can include better ability to smooth consumption, increased access to income-earning opportunities, increased human capital development, and improved health. A more inclusive financial sector has both direct and indirect effects on poverty reduction, including links between financial sector development and more equitable growth, as well as the effect of expanding access to financing, particularly for the poor, rural areas, and women.

2.3 Employment

Low official unemployment but high levels of informal and foreign employment. While the country's official unemployment rate is relatively low, at just over 11%,[18] in reality much of the employment is either in the informal sector or abroad. The labour market pool sees on average about 378,000 new entrants each year. The country's inability to absorb the influx has forced large numbers of workers to emigrate abroad: since 2010, 4.2 million workers have left Nepal for foreign employment, which means that nearly 22% of the country's working-age population are working abroad.[19]

Difficulty in sustaining informal employment and non-farm micro businesses. According to the National Economic Census 2019, there are 923,000 business establishments in the country, out of which only 50% are registered[20] (i.e. are formal businesses). The major issues plaguing micro businesses in Nepal are the high cost of capital and the non-availability of highly skilled staff. A collateral-backed financial lending system and higher-paying foreign employment opportunities have meant that starting and sustaining micro businesses in Nepal is already constrained and it is further exacerbated by the requirement to comply with excessive regulatory and tax burdens. Some areas of conflicting policies include: a bankruptcy rule that leads to directors being blacklisted; the Foreign Investment and Technology Transfer Act (FITTA), which imposes a minimum investment of NPR 50 million (USD 500,000), thereby constraining investment in SMEs; and the Electronic Transaction Act making it hard to transfer funds out of Nepal.

According to the National Economic Census 2019, there are 923,000 business establishments in the country, out of which only 50% are registered.

Not enough incentive offered for formalisation. Furthermore, the government has not incentivised the process enough for informal enterprises to incorporate themselves into the formal economy. In addition, the tax rebate incentives that the government does provide have turned out to be either counterproductive or not marketed enough to reach the intended target audience.

Prime Minister's Employment Program has thus far had limited effectiveness. With the aim of addressing unemployment in the country, the Ministry of Labour, Employment and Social Security (MoLESS) decided to provide 100 days of employment to 200,000 unemployed people aged between 15 and 59 through the Prime Minister's Employment Program.

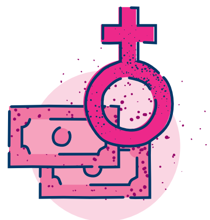
The GoN allocated a total of NPR 11.6 billion (almost USD 98.9 million) for the program, which comes on the back of the government's target of creating 500,000 jobs in the public and private sectors and also through other special programs.[21] However, the program has failed to achieve its target since its launch, with projects remaining incomplete and some even failing to generate enough days of work for the locals.[22] Despite the program being short on its 100-day employment objective, though, it has set a precedent by institutionalising the required mechanisms for its implementation at the local levels.

RELATIONSHIP BETWEEN FINANCIAL INCLUSION AND EMPLOYMENT
Financial inclusion contributes significantly to the reduction of unemployment in developing nations by providing income-generating options through access to credit or improved risk mitigation mechanisms.

2.4

Gender equality and women empowerment

Women's participation in the labour market lower than men's. In 2020, females reported an unemployment rate of 13.1%, which was 2.8 percentage points higher than that of males.[23] There were also huge disparities in other labour market indicators between females and males, in that female employment-to-population ratio (EPR) was almost 23%, which was just over 25 percentage points lower than that of males. Female participation in the labour force was just over 26% compared to male (just under 54%). The 2020 Gender Development Index study conducted by UNDP found that women were more likely to be involved in activities such as the manufacturing of household goods, fetching of water, collection of firewood and construction of or major repairs to own dwelling: about 66% of females were involved in such activities compared to about 51% of males.[24]



Discrimination in wages has been found to put severe stress on the finances of female-headed households in the country; nearly 24% of Nepal's population live in female-headed households, nearly 29% of which are multi-dimensionally poor.

Gender disparities exist in income. As per the 2017/18 Labour Force Survey prepared by the Central Bureau of Statistics (CBS), women earn on average 29% less than their male counterparts, even when the level of education for both genders is the same.[25] This discrimination in wages has been found to put severe stress on the finances of female-headed households in the country; nearly 24% of Nepal's population live in female-headed households, nearly 29% of which are multidimensionally poor.[26] This is higher than the national average multidimensional poverty figure of just over 22%. Furthermore, the government's policies and laws have been inadequate to promote gender equality: for instance, there are no laws in Nepal to prevent workplace discrimination based on gender and no law against rape in the workplace.

Nepal society characterised by significant gender gaps. Nepal ranked at 101 on the list of 153 countries in the Global Gender Gap Index 2020. The index suggests that Nepal lacks significantly in the areas of Female Education Attainment (133) and Female Economic Participation and Opportunities (131). However, one sector where there has been marked improvement in terms of gender equality has been political empowerment, in which the country ranked 59th out of the 153 countries.[27] On the UN's Gender Development Index, which measures gender gaps in human development achievements, Nepal ranked 142nd out of 189 countries around the world. According to the statistics provided by the study, women fared worse than men in the areas of expected years of schooling, mean years of schooling, and expected gross national income per capita.[28]

Representation of women requires ongoing concerted effort. Article 84 of the 2015 Nepal Constitution outlines that each political party must ensure a third of its elected members in the Provincial Assemblies or House of Representatives are women. In the local elections held in 2017, out of 35,041 elected representatives, 41% (14,352) were women.[29] The election commission had also issued a rule mandating that the chief and deputy chief nominations put forward by each political party in each local unit be gender even. While the election results were a monumental victory for female representation, the fact that 91% of the deputy positions were won by females but the chief positions were predominantly won by males (98%) paints a picture that there is still room for improvement with regard to proportionate gender-based representation in the country. The 2017 elections also ensured 18% of the total representatives were Dalits and other minorities,[30] as mandated by law. In terms of financial inclusion, various innovative initiatives have been undertaken by the government to increase the representation of women: such as subsidised loans for women entrepreneurs, and free bank accounts for daughters. Likewise, BFIs have special accounts targeted towards women.

In the local elections held in 2017, out of 35,041 elected representatives, 41% (14,352) were women.

RELATIONSHIP BETWEEN FINANCIAL INCLUSION AND GENDER EQUALITY AND WOMEN EMPOWERMENT

Gender gaps in access to finance are marginal in Nepal (as reflected in MAP 2016), and uptake of financial services by women is mostly driven by MFIs and Savings and Credit Cooperatives (SACCOs). The government has prioritised and put in place measures to help extend women's access to financial services.

2.5 Social protection

Social assistance offered to many of the most vulnerable. Given the high rates of poverty and vulnerability in the country, the GoN offers a range of social assistance schemes in order to uplift those who are most vulnerable. The schemes comprise mainly government pensions, senior citizen allowances, support to widows and single mothers, support to under-5 Dalit children and under-5 children from the Karnali region, a disability protection system, and protection for endangered communities. Currently, the monthly rates are: NPR 2,000 (USD 17) for single mothers and widows; NPR 1,000 (± USD 9) for senior citizens; and varying from NPR 1,600 (± USD 14) to NPR 3,000 (± USD 26) for disabled people.[31] There are also provisions currently in place for housing programs for Dalits and people affected by the 2015 Nepal earthquake. The government also introduced the SSF through the Social Security Fund Act of 2017. The fund, through a contribution payment system, is expected to provide protection for maternity, sickness, employment injury, old age and retrenchment. However, this scheme currently only covers people in the formal sector (for whom it is mandatory), meaning that the majority of the labour force (who are in the informal sector) are excluded.

Growing elderly population inadequately provided for. This inadequate coverage and an increasingly ageing population might have long-term consequences for Nepal. As of 2019, 9% of Nepal's population were aged over 60 and this segment is estimated to be growing at a rate of almost 4% per annum. The government's social protection programs have in particular been left wanting in the case of senior citizen protection. The country lacks a universal old-age pension system and the social pensions are provided to only those citizens who are over 70 and are from lower-income strata – a loosely defined term in itself. Currently, the old-age allowance is NPR 4,000 (± USD 34) a month. While this amount might be adequate in rural areas of the country, the amount is not sufficient for urban older people to meet their basic needs. Inadequate income protection has meant senior citizens are dependent on ineffective Rural Community Public Health Programs, Senior Citizen Welfare Committees and Senior Citizens Welfare Funds during health ailments. Unavailability of adequate safety nets in the country has meant that the almost 4% of the population who are elderly people living alone have been left particularly vulnerable.[32]

The government's social protection programs have in particular been left wanting in the case of senior citizen protection.

RELATIONSHIP BETWEEN FINANCIAL INCLUSION AND SOCIAL PROTECTION

The government's social security allowance and health programs, which aim to assist vulnerable and excluded groups in meeting their basic needs, are encouraging; yet, they have not been implemented effectively and public awareness of their benefits is limited. Financial inclusion policies can support improved efficiencies in distributing social security allowances, while social protection programs create additional needs for financial services among the poor, and such financial services must be provided in order for the social protection programs to have the desired impact.

2.6 Healthcare

COVID-19 aside, the country faces significant healthcare challenges. Nepal faces an enormous challenge in delivering healthcare to its population. The COVID-19 pandemic further highlighted the existing weaknesses of the country's health system. Nepal has a shortage of health workers, medical doctors, nurses, and paramedics, with only 3.15 health professionals per 1,000 population. Government data from 2020 shows Nepal had only 1,395 Intensive Care Unit (ICU) beds and 480 advanced respiratory support (ventilators) before the COVID-19 crisis.[33] The country faces the following healthcare-related challenges: shortage of healthcare professionals; security concerns of healthcare workers; lack of proper health infrastructure; inadequate health insurance policies; geographic challenges for the operation of health centres; and ineffective government policies coupled with poverty, illiteracy and negative attitudes towards medical workers.[34]

Most Nepalis fund their own healthcare. Only 5% of Nepal's population are covered by health insurance.[35] As a result, the majority of the country's population depend on personal financing for their health expenses. Nepal's health expenditure per capita increased from almost USD 48 in 2015 to almost USD 58 in 2018: it has increased by 21% post-MAP 2016. Positively however, Nepal's out-of-pocket health expenditure (as a percentage of current health expenditure) decreased from just over 59% in 2015 to just under 51% in 2018. This has been compensated for by government's general health expenditure per capita increase of 82% in the same period.[36]

Financing of healthcare. Healthcare financing in Nepal is currently done either through premiums from members who have the ability to pay or tax fund provisions financed by the MoF as annual block grants. The tax fund provision funds are currently directed to the Health Insurance Fund to subsidise premiums for senior citizens and the poor and to cover expenses of health insurance administration. The government has also introduced the NHIP, with the aim of ensuring quality health services and providing universal health coverage to its citizens.[37] However, since there is no accurate and efficient mechanism for targeting the intended beneficiaries (e.g. to distinguish the ultra-poor from the poor), the full implementation of the NHIP through the Health Insurance Fund is likely to be delayed. As of mid-March 2020, health insurance had been extended to 505 local levels of 55 districts. A total of 2,687,810 people had received health cover and services under the program, of which just over 25% were ultra-poor and 300,000 were senior citizens.[38]

Only 5% of Nepal's population are covered by health insurance. As a result, the majority of the country's population depend on personal financing for their health expenses.

Government support under the critical illness support program includes cardiac valve replacement for senior citizens, antenatal care services for pregnant women, treatment finance for children under 14 years with acute non-communicable diseases, and free vaccination of infants. The government introduced the *Bipanna Nagarik* (chronic diseases support program) in the aftermath of the 2006 *Janandolan* (People's Movement) to provide financial relief to people with debilitating and expensive diseases and conditions such as head and spinal injuries, cancer, cardiovascular diseases, Alzheimer's disease, Parkinson's disease and sickle cell anaemia.[39]

RELATIONSHIP BETWEEN FINANCIAL INCLUSION AND HEALTHCARE
Financial inclusion can assist households to cope with unexpected medical expenses, including reducing out-of-pocket expenses.

2.7 Education

Increase in education levels of the population, including females. Nepal's adult literacy rate in 2018 stood at nearly 68%.[40] While this has been a steady improvement from the nearly 60% reported in the 2011 census,[41] it still stood below the South Asian average literacy rate of just over 72% in 2018.[42] The youth literacy rate, by contrast, stood at just over 92% in 2018, higher than the South Asian youth literacy rate of just under 90%, indicating Nepal is enjoying a demographic dividend in the form of a well-educated youth population.

Similarly, in 2018 the female adult literacy rate was only about 60% while the female youth literacy rate stood at nearly 91% as a result of literacy initiatives by government and other development partners.

With educating a child in Nepal estimated to cost USD 300 per year, for many families, education remains unfeasible.

Poor education accessibility and affordability. The government ensures free education up to grade 10 in community colleges; scholarship programs; midday school meals; school uniforms; and stationery provision in community schools. However, education in Nepal is still inaccessible to a high proportion of poor communities, especially in geographically remote areas: for instance, 770,000 children aged 5-12 years remained out of school in 2017, and children from the lowest wealth quantile are worse affected.[43] With educating a child in Nepal estimated to cost USD 300 per year,[44] for many families, education remains unfeasible.

Financial inclusion can support financing and contribute to affordability of education. To address issues of accessibility and the quality of education, the GoN has redoubled its efforts to increase the number of classrooms, secondary schools and special and integrated schools.[45] However, while the establishment of new schools and provision of better resources in existing schools is a step in the right direction, the government needs to do more to make education more inclusive and accessible. The country's challenging geography, social and cultural structures, and overall socio-economic environment will require concentrated efforts with many stakeholders – national and international – partnering to ensure that children in the most rural areas of the country get access to education. This will also require extensive financing, to which financial inclusion can contribute in terms of mobilising capital availability. In addition, financial inclusion can assist at the household level to help with affordability issues in accessing education.

RELATIONSHIP BETWEEN FINANCIAL INCLUSION AND EDUCATION
Financial inclusion can help households deal with the cost of education, through appropriately targeted savings, credit and educational insurance products.

2.8

Natural resources and climate change

Nepal has a mountainous geography, a diverse natural ecosystem, abundant water resources and fertile lands, but remains extremely vulnerable to environmental degradation and the impacts of climate change and disaster risks, due to government's lack of capacity and lack of financial, technical and human resources to combat climate change, exacerbated by weak governance. For instance, despite the country's abundance of water resources, widespread water pollution has resulted in water scarcity, reduced agricultural yields and a declining quality of aquatic life in lakes and rivers.

Role for financial inclusion in reducing forestland encroachment. Nepal has a total forest cover of almost 45% of the total land mass, of which about 23% is protected areas (natural parks, conservation areas and wildlife reserves). However, forestland has been encroached on for the expansion of farmlands, settlements, and infrastructure projects and for mining activities, in addition to being affected by forest fires (an increasing issue). Rural communities rely extensively on the forests for their livelihoods, including the collection of firewood (Nepal's forests are estimated to provide over 70% of rural energy needs in the country),[46] and, for example, reliance on the forest for timber, to forage, and for medicinal and aromatic plants.

Forestland has been encroached on for the expansion of farmlands, settlements, and infrastructure projects and for mining activities, in addition to being affected by forest fires.

Use of firewood for energy correlates with poverty. As per UNCDF's clean energy diagnostic studies,[47] the use of firewood as the major source of energy has a direct correlation with poverty in these areas. The study found that despite the population having access to electricity grids, the high cost of electricity means the population still prefers firewood for cooking purposes as it is the cheapest alternative. The provision of clean stoves such as solar cooking stoves, which can be facilitated through financial inclusion, could benefit both forest-protection efforts and human livelihoods by decreasing the rural areas' reliance on firewood and ultimately reducing unsustainable collection of firewood in these areas.

RELATIONSHIP BETWEEN FINANCIAL INCLUSION AND NATURAL RESOURCES AND CLIMATE CHANGE

Financial services tailored to the poor may enable them to make affordable investments in environmentally beneficial practices, thereby mitigating environmental damage. The poorest people are most vulnerable to the threats to their health and livelihoods posed by climate change, and they lack the tools necessary to cope.

2.9

Infrastructure

Poor road quality hampers safe, efficient and affordable transport. Despite continual increases in the total length of roads in Nepal, the country still has the lowest road density in South Asia, with about 34 kilometres of road per 100 square kilometres and just under 2 kilometres of road per 1,000 people. By comparison, South Asia has 141 kilometres of road per 100 square kilometres;[48] while the road density for Europe is 2,800 kilometres of road per 100 square kilometres. Since FY 2015/16, more than 6,000 kilometres of road have been constructed in different parts of Nepal. However, with the majority of the country's roads being mud roads and a low prevalence of blacktopped roads, travel in Nepal is highly unsafe, resulting in transport being costly.[49]

Nepal permitted to transport commercial goods via Indian waterways. Nepal has made progress in renewing the transit treaty between Nepal and India, in terms of which Nepal will now be able to transport commercial goods through Indian inland waterways.[50]

Drinking water and infrastructure for its distribution remain challenges. As of mid-March 2020, access to drinking water was available to 90% of the population, of which 21% of the country had access to high- and medium-quality drinking water. Nepal has struggled to provide high- and medium-quality drinking water to all of its citizens, and this will likely remain a major challenge in the immediate future.

Plans to increase power generation, including hydro. In recent years, Nepal's energy production has increased substantially and as a result 90% of people now have access to energy. This has also resulted in fewer imports from India, and fewer power cuts. Nepal has further plans to increase power generation, though, with a focus on exports as well. For instance, it has massive hydro power potential, despite current low levels of hydro power usage, and new power generation licenses are substantial. Given the country's historical reliance on traditional sources of energy (as opposed to clean/alternative sources), exploiting hydro could have a positive environmental impact. But focusing on household-level clean energy products like clean energy cooking stoves could also help to effect positive change.

Access to drinking water was available to 90% of the population, of which 21% of the country had access to high- and medium-quality drinking water.

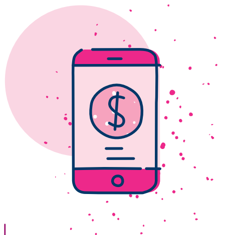
High tele-density and high uptake of mobile Internet services. As of February 2021, the total number of telephone users (both fixed and mobile phone) was almost 40 million. The tele-density of the country is currently at 128% for mobile and nearly 3% for fixed line. Similarly, access to broadband services (Internet) increased from 72% in February 2020 to 84% in February 2021. The growth in uptake of the broadband service is driven by mobile broadband, which accounts for almost 62%.[51]

According to a report made public by the Nepal Telecommunication Authority, the number of 4G users in Nepal reached 7,668,181 as of February 2021. The number increased by 107% compared to the same period in the previous year when the number of 4G users stood at 4,839,194. Ncell has the highest number of 4G customers, followed by Nepal Telecom and Smart Cell.

Mobile data expensive in Nepal. Nepalis paid on average NPR 256.53 (USD 2.18) for 1 GB of mobile data until 2019, which, although it had reduced by over 50% by 2020 to NPR 104.53 (USD 0.89), is still more expensive than in other countries.[52] The high tele-density and increasing uptake of mobile broadband services provide increased opportunities for increasing access to finance through extending digital financial services (DFS).

RELATIONSHIP BETWEEN FINANCIAL INCLUSION AND INFRASTRUCTURE

As access to basic services like water, energy, transport and ICT is essential for inclusive growth, financial inclusion should ensure increased access to such services, while leveraging aggregated financial flows towards investment in infrastructure required to expand the delivery of basic services. Access to financial services, in turn, requires the presence of roads, the availability of public transport systems and so on, while access to (and the reliability of) electricity, ICT, and the Internet, is critical for the adoption of DFS in particular.



The high tele-density and increasing uptake of mobile broadband services provide increased opportunities for increasing access to finance through extending digital financial services.

PART 2 NOTES

1 UNCDF MAP, 2020
2 WB, 2021b
3 NPC GoN, 2021
4 NPC GoN, 2018
5 MoLESS, 2020
6 WB, 2021a
7 WB, 2021a
8 MoF, 2021
9 FAO, 2020
10 CIAT, et al., 2017
11 Economist Impact, 2021
12 Global Hunger Index, 2021
13 WB, 2021a
14 NPC GoN, 2018
15 NPC and ILO, 2018
16 WB, 2021b
17 UNDP, 2020b
18 CBS and NPC, 2020
19 WB, 2021a
20 WB, 2020
21 MoLESS, 2021
22 Mandal, 2020
23 WEF, 2020
24 UNDP, 2020a
25 NPC and ILO, 2018
26 NPC GoN, 2018
27 WEF, 2020
28 UNDP, 2020a
29 The Asia Foundation, 2017
30 The Asia Foundation, 2017
31 MoF, 2020
32 HelpAge Global Network, 2021
33 MoHP, 2020
34 Rai, et al., 2001
35 Ranabhat, Subedi, and Karn, 2020
36 WB, 2018b
37 Social Health Security Development Committee, 2017
38 WB, 2020
39 MoHP, 2021
40 WB, 2018d
41 NPC GoN, 2012
42 WB, 2019b
43 UNICEF, 2021
44 Room to Read, 2020
45 NRB, 2021c
46 ADB, 2020a
47 UNCDF, 2020
48 IRF, 2019
49 MoF, 2020
50 MoF, 2020
51 NTA, 2021
52 My Republica, 2020

3

National financial inclusion strategy achievements

It is important to reflect on progress against the 2016 MAP project and the ongoing 2017–2022 Nepal Financial Inclusion Action Plan, in order to gauge the current scenario, identify remaining gaps and inform prioritising of future interventions. There are a number of ways in which the financial services sector is now much better positioned to expand financial inclusion, particularly by means of low-cost, branchless banking (BLB), physical bank branches, and DFS. At the same time, there are a number of areas where limited progress had been made, especially where inter-regulatory coordination and approvals are required.

3.1 Progress on the MAP 2016 diagnostic study

There has been considerable progress since 2016 on the various recommendations set out in the previous MAP diagnostic study. The FSDS 2017–2022 adopted by the MoF has also aided progress as many of its activities and implantation issues and recommendations support and promote activities outlined in the Financial Inclusion Action Plan.

The 2017–2022 Nepal Financial Inclusion Action Plan adopted by the central bank synthesises the main findings and recommendations from the comprehensive demand-side, supply-side and regulatory analysis and presents a way forward on the recommended action areas for financial inclusion in Nepal.

Among the targets set out in the 2017–2022 roadmap is increasing formal financial inclusion to 75% by 2022 (from 60% in 2014), and reducing the financially excluded as a proportion of the population from 18% to 3%, so as to create economic empowerment. As of mid-2020, NRB estimates the population with at least one account is just over 67%, but an upcoming nationally representative demand-side survey will provide further updates on the level of inclusion. These targets would be achieved through implementing six action areas.

Targets set out in the 2017–2022 roadmap include increasing formal financial inclusion from 60% to 75% by 2022, and reducing the financially excluded as a proportion of the population from 18% to 3%.

Priority 1: Unlock constrained credit and savings markets

The main objective here was to mobilise widescale saving and unlock credit, as ways to improve people's ability to efficiently invest in assets and productive capacity.

Priority 2. Improve payment system

The emphasis was on developing a cost-effective, reliable and accessible payment system to benefit the vast majority of the population.

Priority 3. Bolster risk-mitigation capabilities

The focus here was on improving people's capability to face risk events that would have a significant impact on their financial situation, whether current or future.

Priority 4. Enhance and leverage locally based financial service providers[1]

The primary objective here was to note a key group of supply-side players in the financial inclusion space and explore options for expanding their impact.

Priority 5. Enhance financial inclusion support in national governance

Given that implementing financial inclusion initiatives requires support from within national governance, and that policy and legislative frameworks are key determinants of action in the market by public and private actors alike, the emphasis here was on consolidating and supporting effective financial inclusion efforts across the board.

Priority 6. Strengthen consumer empowerment, protection and education

Financial capability is critical to enabling consumers to extract optimal value from financial services, and so the focus here was on prioritising consumer empowerment as a key driver of uptake of financial services.

For the implementation of the roadmap, the Nepal Financial Inclusion Action Plan was developed; it broadly outlines both the short- and long-term strategies and identifies specific activities that can be undertaken to achieve the priorities outlined in the roadmap.

A high-level implementation committee was established with representation by senior officials from the central bank as well as the government. The six-member committee comprises: the senior deputy governor of the NRB (as coordinator); the deputy governor of the NRB; the joint secretary (Financial Sector Management Division) of the MoF; the department chiefs of the NRB's Microfinance Promotion and Supervision department and Payment Systems department, respectively, as members; and the department chief of the NRB's Financial Institutions Regulation Department as member secretary. The Action Plan is anchored within the Financial Inclusion Unit – Microfinance Institutions Supervision Department of NRB.

Of the 53 activities outlined in the Nepal Financial Inclusion Action Plan under six priorities and 15 interventions, 10 activities have clearly been completed. The majority of activities – i.e. about 38 activities – have seen some level of progress. There are also instances where some level of progress has been achieved but without the desired outcome having been clearly realised. Around five activities have not seen any progress thus far. This 2021 refresh report identifies a number of activities (18) from the 2017–2022 Action Plan for continued implementation as key priorities, based on their continued relevance.

One of the notable achievements during the implementation phase has been the rapid adaptation and development of digital payments and banking services. Introduction of timely and favourable regulations that are now in place has resulted in the proliferation of PSPs and PSOs, and even the Class D MFIs have been allowed to operate as PSPs. Similarly, the area of quick response (QR) code retail payments is seeing aggressive growth and bringing a larger number of SMEs into the formal banking sphere. The push by the government for the settlement of financial transactions through digital means, with the objective of minimising cash transactions following the spirit of the 2019 Digital Nepal Framework,[2] has been instrumental. Similarly, the operation of the RTGS system has made possible the transfer of funds between banks in real time, and has facilitated high-value and urgent transactions along with liquidity and risk management.

Despite their importance, certain activities failed to achieve the intended development outcomes. For example, the Secured Transaction Registry (STR), which is critical for promoting non-collateralised loans, has not been adopted by the MFIs due to a lack of clarity regarding claims settlement. Furthermore, the intended results for non-collateralised credit products have not been realised. On the positive side, about five commercial banks have piloted personal credit products for their customers, based not on collateral but on their own electronic credit appraisal system.

Despite their importance, certain activities failed to achieve the intended development outcomes.

The regulatory agencies and frameworks that regulate financial service providers differ, and it is necessary for an overarching agency such as the MoF to oversee the implementation of activities under the Financial Inclusion Action Plan. Financial inclusion is covered under the FSDS and also falls under the government's mandate, with the MoF responsible for ensuring that activities to accomplish the goals are implemented. The MoF, in the light of its mandate and convening authority, should direct the process, with active participation from other stakeholders, such as the central bank and the IB.

Table 4: Nepal Financial Inclusion Roadmap and Action Plan (2017–2022) progress highlights and challenges

INTERVENTION/ ACTIVITY	PROGRESS HIGHLIGHTS AND CHALLENGES
ACTION PLAN PRIORITY: UNLOCK CONSTRAINED CREDIT AND SAVINGS MARKET	
Develop and market non-collateralised loans	Currently the MoF has mandated the Credit Information Bureau (CIB) to operationalise the Secured Transaction Registry (STR). Nonetheless, various legal issues raised by the lenders (SMEs, MFIs, corporates) on the provision of the Secured Transaction Registry Act have made them sceptical of lending against movable assets. Thus, the service is currently only being used only the commercial banks. Lack of awareness is another major reason for the failure of non-banking institutions to link with the STR. Although the government had announced via its fiscal policy for FY 2020/21 that the Secured Transaction Act, 2006 would be amended, thus far this has not happened.
Affordable and relevant credit products	Since FY 2013/14, it has been compulsory for Class A, B and C BFIs to lend to the priority sector. And from FY 2020/21 onwards, the concept of priority sector lending was redesigned: it now includes agriculture, energy, tourism, and the SME sector. Commercial banks will now be required to invest at least 15% of their total credit in the agriculture sector by FY 2022/23, and invest 15% of their total credit in the SME sector with loan values amounting to less than NPR 10 million (USD 85,251) by FY 2023/24. Likewise, the central bank has introduced concessional loans up to NPR 1.5 million (USD 12,788) for the agriculture sector and SMEs. The CIB is currently working with a vendor to develop an individual credit scoring system for existing borrowers from Class A, B and C financial institutions. The intention was to do a pilot run in May 2021 and launch it by November 2021. The NRB has made it mandatory for all BFIs, including Class D (MFIs), to share credit information of all existing borrowers with the CIB, in order to obtain credit records for new credit applicants from the CIB. As of 2021, most MFIs had joined the CIB. At least five commercial banks have introduced innovative credit products as an alternative to the otherwise homogeneous and generic range of products. Commercial banks have introduced credit products based on the outcome of on an individual credit scoring model, as well as SME credit products that take credit guarantees, project viability, and cash flow streams into account.
Long-term savings products with real returns Relevant affordable savings products	Similarly, commercial banks have gradually introduced various recurring, term and long-term savings products as an alternative to traditional one-year fixed deposits; however, banks have not yet introduced market-driven low-cost commitment savings products, and fixed-deposit savings accounts longer than a year are still not popular with bank customers. In an effort to promote long-term savings, the central bank has made it mandatory for commercial banks to issue debentures worth at least 25% of their paid-up capital by mid-July 2021. The Foreign Employment Savings Bond continues to be unpopular and hugely undersubscribed. No policy has been drafted yet for implementing the 'One Household One Bank Account' campaign; nonetheless, the government has been driving the 'Let Us Open Bank Account' campaign.
Enabling regulation	The government, via fiscal policy for 2019/20, announced that bankruptcy and secure transaction laws would be enacted, amended and implemented. However, no progress in this regard has been made thus far.

ACTION PLAN PRIORITY: IMPROVE PAYMENT SYSTEM	
Develop retail payment infrastructure	A number of key regulations and policies were introduced by the central bank to facilitate payment systems and uptake of digital payments. The Payment and Settlement Act, 2019, along with the Retail Payment Strategy, 2019 and the Nepal QR Standardisation: Framework and Guidelines, 2021, were introduced.
Increase usability of digital payments	The RTGS system has been put into operation and MFIs have been allowed to operate as PSPs. A directive on BLB for its sustainability and wider coverage was introduced; as a result, prior approval is no longer needed for opening a BLB centre in a rural area. Work has commenced on establishing a national payment switch at Nepal Clearing House Limited (NCHL).
Enabling regulations	Settlement of financial transactions through digital means has been encouraged. Following the spirit of the 2019 Digital Nepal Framework implemented by the government, the emphasis is on promoting a sound and secure electronic payment system in order to minimise cash transactions. Likewise, the Retail Payment Strategy, 2019 is in place with the vision of unlocking the potential of digital payments and moving towards safe and efficient payment systems in Nepal. Furthermore, the NRB has issued a notice aimed at easing the receipt of payment from abroad for e-commerce transactions. Non-banks have also been granted licenses to operate retail payment systems. As per the licensing policy for payment-related institutions, currently there are 14 PSPs and 9 PSOs. In addition, all 27 commercial banks, 12 development banks, and 7 finance companies have been granted licenses to provide payment services. Connect IPS, an e-payment system/ Internet payment gateway, has been established as a single payment platform, and allows bank customers to transfer funds and process payments from various channels. In terms of collaboration and interoperability, one of the key PSPs has started to provide interest-earning wallets in terms of which the wallet is virtually linked with a bank account. Similarly, remittance companies have started to provide the option of transferring remittance funds to a mobile wallet. Some PSOs and PSPs are already integrating QR code technology on their payment platforms; however, QR technology will need to be interoperable through appropriate standards and policies. Nepal Telecom, the country's largest telecommunications (telecom) company, in collaboration with a commercial bank, has soft-launched the first mobile digital wallet, it will also enable Unstructured Supplementary Service Data (USSD) based payment.

ACTION PLAN PRIORITY: BOLSTER RISK-MITIGATION CAPABILITIES	
Facilitate awareness generation on insurance as risk-mitigation tool	The government launched two ambitious programs: the 2017 SSF, with insurance as one of the major services, and the 2020 NHIP. The NHIP offers affordable healthcare to families/ households, and 100% subsidised (i.e. free) healthcare for ultra-poor families, HIV-positive people, and people older than 70. The SSF, which also includes medical insurance for its participants, currently only covers people in the formal sector (which is a minority of the population), for whom it is mandatory. Through the SSF, the government also provides up to 75% subsidy on agriculture. A recent directive requires insurance companies to have at least 10% of their total portfolio in microinsurance.
Improve insurer business models	The review period saw the establishment of 10 new life insurance companies, 2 non-life insurance companies, and 1 reinsurance life insurance company. As a result, competition in the industry has increased drastically, and there is new room for growth and innovation. Nonetheless, regulatory limitations continue to block product innovation. Furthermore, as a response to unhealthy practices in the sector, the central bank has restricted BFIs from selling credit-linked life insurance products, which has limited the penetration of life insurance policies. There is limited coordination and interaction between the IB and the central bank. Insurance Institute Nepal Limited was established through joint investment between the IB and insurance companies, and provides insurance-related training for employees of insurance companies, financial institutions and the general public. Online digital payment of insurance premiums is now available to consumers. A few companies – mainly non-life insurance companies – have started to sell insurance products online; uptake of such policies online is, however, minimal.
Institutional capacity building of the IB	The government has announced its intention to carry out Institutional and systematic reforms of insurance service providers in a bid to expand the reach of insurance services. In 2018, a World Bank technical assistance team prepared the Off-site Financial Analysis and Reporting Process manual under the Nepal Insurance Sector Strengthening program supported by the Financial Sector Reform and Strengthening Initiative (FIRST Initiative). The manual was prepared in order to assist the IB to enhance its supervisory off-site surveillance and reporting processes.

ACTION PLAN PRIORITY: ENHANCE AND LEVERAGE LOCALLY BASED FINANCIAL SERVICE PROVIDERS	
Strengthen MFIs	Directives are being issued annually aimed at ensuring best practices in compliance and transparency among BFIs. The providers' landscape has been dramatically altered as BFI numbers have been reduced and MFI numbers increased, primarily as a result of mergers and acquisitions of Class A, B and C institutions, and the central bank's awarding of operating licenses to long-standing MFI applicants. The number of MFIs as a result increased from 38 in 2015 to 76 in 2020. As of mid-July 2020, the total number of MFI members was about 4.7 million – a 147% increase from the almost 1.9 million members in 2016. The central bank has introduced measures on the interest rate spread and ceilings on lending rates for greater effectiveness, transparency and consumer protection.
ACTION PLAN PRIORITY: ENHANCE FINANCIAL INCLUSION SUPPORT IN NATIONAL GOVERNANCE	
Consolidation of all ongoing access to finance project in Nepal	The central bank has adopted the Nepal Financial Inclusion Action Plan, which was approved by the NRB Board on 26 December 2017. A high-level Financial Inclusion Action Plan Implementation Committee was established with representation of senior officials from the central bank as well as the government. However, a high-level Access to Finance Coordination Committee has not been established, and limited progress has been made on developing an overarching national financial inclusion strategy.
ACTION PLAN PRIORITY: STRENGTHEN CONSUMER EMPOWERMENT, PROTECTION AND EDUCATION	
Develop consumer protection framework	The central bank has established a Financial Consumer Protection Unit to manage depositors' and creditors' grievances and to improve the public's levels of trust in the financial sector. The central bank website has a separate portal for queries, grievances and suggestions from the general public related to banking services. Likewise, the Financial Consumer Protection and Grievance Management Manual 2077 has been introduced by the central bank. As per the central bank directive to handle customer dissatisfaction and grievances, each bank should establish an Information and Grievance Handling Desk. In terms of DFS, a separate circular on 'consumer rights protection' applicable to all PSPs and PSOs has been released. It covers areas such as digital financial literacy, grievance handling, confidentiality and data protection. To expand the deposit guarantee coverage, the previous deposit guarantee limit of NPR 200,000 (USD 1,705) at a premium rate of 0.20% has been enhanced to NPR 300,000 (USD 2,558) at an applicable premium rate of 0.16%. Furthermore, work is ongoing to enhance the deposit guarantee limit to NPR 500,000 (USD 4,263) with an applicable premium rate of 0.12%. The Deposit and Credit Guarantee Fund has rolled out various credit guarantee products. Currently the uptake of such guarantee is for subsidised credit as per NRB guidelines on livestock, SME credit, agriculture, education, and deprived sector credit.
Consolidate financial literacy and educational programs	The central bank has carried out various financial literacy activities and programs, including financial literacy book, articles and even songs. Financial Literacy Day is celebrated every year. A financial inclusion portal dashboard has been launched by the central bank in association with UNCDF, and provides key financial inclusion indicators, access to financial services, data on usage of financial services, credit and deposits, and BLB agents' figures and information. To drive financial literacy, the central bank now requires BFIs to allocate at least 5% of their net profit for financial literacy programs under their CSR. The NRB has also been working closely with the Ministry of Education to incorporate financial literacy in formal educational curriculum. So far, financial literacy materials have been incorporated in various courses under the grade 8, 10 and high school curriculum. A comprehensive financial literacy course has yet to be developed.

Source: Compiled by the author

PART 3 NOTES

1 Licensed financial institutions such as BFIs, financial cooperatives and insurance companies operating in Nepal

2 GoN, Ministry of Communication and Information Technology, 2019

4 Demand- and supply-side analysis and findings

4.1 Banking

Providers' landscape dramatically altered as BFI numbers reduced and MFI numbers increased. Apart from Class D financial institutions (i.e. MFIs), the number of BFIs has decreased significantly, especially Class B (development banks) and Class C (finance companies), as a result of the central bank's mergers and acquisitions effort since 2012. Since the central bank upped the capital requirement for BFIs by four times in FY 2015/16, consolidation has accelerated. The central bank also provided incentives through its monetary policies to encourage mergers and acquisitions. By contrast, in recent years the number of MFIs has increased, primarily as a result of the central bank's awarding of operating licenses to long-standing applicants (see Figure 4).

Since the central bank upped the capital requirement for BFIs by four times in FY 2015/16, consolidation has accelerated.

Cooperatives have decreased in number – but increased in terms of members, as well as savings, deposits and credit. As of July 2020, there were around 29,886 cooperatives operating in Nepal, with over 7.3 million members, compared to 32,663 cooperatives with 5.1 million members in July 2015. That is to say, in the period from 2015 to 2020, SACCO membership increased by over 40%.

These cooperatives have collected NPR 478 billion (just over USD 4 billion) in savings and deposits,[1] and have mobilised total credit of NPR 426 billion (over USD 3.6 billion). As of July 2018, the number of SACCOs stood at 13,917 (compared to 13,460 in July 2015), while the number of SACCO members stood at 3.4 million (compared to 2.7 million in July 2015).[2]

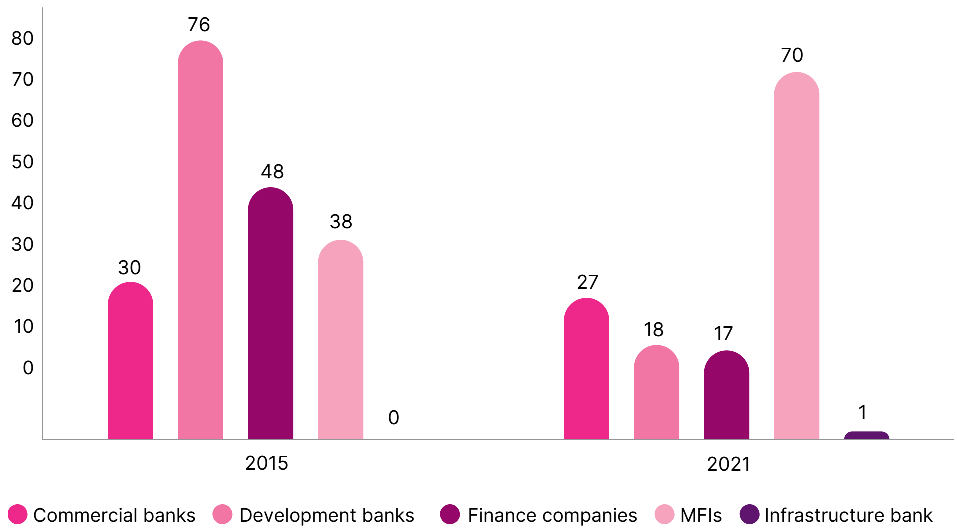


Figure 4: Change in the number of BFIs (2015–2021)

Source: NRB (2021c)

Figure 5: Number of branches of BFIs, by province

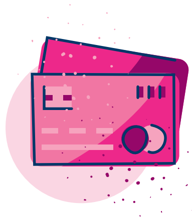
Source: NRB Monthly Statistics, July 2021

Significant increase in number of financial access points since MAP 2016 – though rural areas still underserved. Bank branches, ATMs, and BLB centres have expanded in number since the previous MAP assessment, with expansion across all provinces and local levels.

By mid-January 2021, BFIs had opened 10,187 branches in 750 of the 753 local areas (see Figure 5). According to NRB data, rural municipalities have roughly 22% of the total branches, while sub-metropolitan and metropolitan areas have the rest. The number of BFI ATMs has also expanded by 114% in the past five years: from 1,985 in 2017 to 4,254 in 2021. Out of this, the rural municipalities have just over 200 ATMs in total and municipalities have 1,850 ATMs, while sub-metropolitan and metropolitan areas account for over 2,150 ATMs. ATMs processed about 6.8 million withdrawals. Despite progress, there are far fewer physical access points in rural areas where the bulk of the country's population still live.

According to the 2017 Findex Survey,[3] although only 31% of rural adults had a bank account in 2014, 43% had one in 2017; despite the improvement, though, as of 2017 20% of adults did not have a bank account due to distance.

MFIs and SACCOs have seen a surge in member numbers. Post-MAP 2016, the number of people with access to the services of MFIs in Nepal has increased dramatically. As of mid-July 2021, the total number of MFI members was about 5.2 million – a 173% increase from the almost 1.9 million members in 2016 – with a compound annual growth rate (CAGR) of 22.3%. Similarly, the total number of MFI savings members during the period increased by 177%, from almost 1.9 million in mid-July 2016 to 5 million as of mid-July 2021, while the total number of borrowers saw a 131% increase, from almost 1.3 million in 2016 to almost 3 million in 2020. The total number of groups that borrowed with MFIs also increased: from 366,547 in 2016 to 1,183,364 in 2021 – a 223% increase.[4]



Bank branches, ATMs, and BLB centres have expanded in number since the previous MAP assessment, with expansion across all provinces and local levels.

Similar increase in access to financial services could be observed in cooperatives, including SACCOs, since the previous MAP study. In mid-July 2015, the total number of members affiliated to cooperatives was around 5.1 million, while by mid-July 2018 this had increased by 27% to 6.5 million. Out of the total cooperatives' members, 2.7 million people were members of SACCOs in 2015, while by mid-July 2018, the total number of SACCO members had increased to almost 3.4 million – a 26% increase.

SACCOs play critical role in expanding financial services, particularly in rural areas. SACCOs are vital for providing access to financial services in rural areas, although product offerings have remained stagnant since the previous MAP survey. SACCOs' savings options include mandatory savings, recurring deposits, and 'piggy banks'. These products instil a saving habit in all age groups. SACCOs also allow members to borrow against their savings.

SACCOs have traditionally been popular with depositors because not only do they offer higher interest than BFIs[5] but their products are better suited to low-income people and small depositors, allowing them to save small sums regularly. The outcome has been higher volumes of deposits for SACCOs than BFIs. The Department of Cooperatives recently prohibited cooperatives from charging more than 14.75% on loans: SACCOs may not have interest spreads above 6% and they can offer up to 8.75% return on deposits. This could have the effect of limiting their capacity to raise deposits, as hitherto most people deposited with SACCOs to take advantage of their higher deposit rates than those of BFIs.

The Department of Cooperatives recently prohibited cooperatives from charging more than 14.75% on loans: SACCOs may not have interest spreads above 6% and they can offer up to 8.75% return on deposits.

BFIs employing various strategies in attempt to bring down costs. According to the 2017 Findex Survey, 17% of the population lack access to a bank account because of the cost of having one, while 4% lack access to a bank account due to having insufficient funds. In other words, it is very much in BFIs' interests to make bank account ownership more affordable. To this end, BFIs are turning to technological advancement and digitisation for solutions, and the volume of clients using mobile and online banking has surged. Likewise, commercial banks have tried to expand BLB, a low-cost alternative to establishing full-fledged banks in rural areas, as a strategy for increasing financial inclusion.

Complementarity between digital and more traditional financial services. There is a complementarity in Nepal between digital and more traditional financial services, unlike in other countries where increasing digital banking usually implies decreasing traditional physical access locations. Lack of major technological advancement in Nepal's rural areas continues to hinder the expansion of DFS. Both inaccessibility to the Internet and the lack of reliable mobile networks (along with their high costs) pose a barrier to formal saving. A lack of skilled human resources with an understanding of digital technologies can be seen as a further obstacle to offering affordable financial services.

BLB centres increased as attempted financial inclusion strategy. Financial services such as account opening, withdrawals, payments, and fund transfers are available through a network of agents in BLB centres equipped with POS machines. Until now, only commercial banks have been involved in BLB. As of mid-July 2020, there were 1,574 BLB centres, up from 812 in mid-July 2016 (see Table 5). In Nepal, 14 out of the 27 commercial banks have BLBs. A BLB point opens an average of 188 accounts per month. The average deposit collected by these banks per BLB point amounts to almost NPR 2 million, while the average number of transactions per day is 9.[6]

Table 5: Number of BLB centres (2016–2020)

	MID-JULY				
	2016	2017	2018	2019	2020
No. of BLB centres	812	1,008	1,285	1,530	1,574

Source: NRB Annual Reports

BLB strategy has had limited success. Despite the developments in terms of BLB centres, over the past five years BLB customers have actually declined in number: from 229,317 in January 2017 to 201,676 in January 2021. The number of customers reached a low of 111,670 in January 2019, although the initiative picked up thereafter, with customer numbers increasing to 201,676 in 2020/21.

A number of factors account for the limited success of the BLB strategy. For one thing, it presents the branchless banker/agent with few incentives: BLB takes up a lot of time for the agent, who is also running a grocery store (kirana pasal), and the volumes are low. Agents face the additional risk of safeguarding the money and transporting it to the bank branch. BLB is further constrained by weak rural network access and inadequate BLB agent training.

Local financial services partnerships another option for BFIs. By partnering with local financial service intermediaries such as remittance agents, eSewa, and agricultural veterinarians, the commercial banks could increase micro-level financial inclusion of the marginalised and previously excluded.

Surge in uptake of digital banking services. Over the past five years, uptake of digital banking services has shown exponential growth in Nepal (see Figure 6). Between 2017 and 2021, the number of registered mobile banking customers went up as much as 432%: from 2.7 million in mid-July 2017 to 14.2 million in mid-July 2021. The CAGR for mobile banking customers in the five-year period was 40%. Similarly, the number of customers subscribing to Internet banking services increased by 48%: from 783,751 in mid-July 2017 to almost 1.2 million in mid-July 2021.

More than 8.8 million debit cards had been issued as of mid-July 2021 – a 77% increase on the almost 5 million cards that had been issued as of mid-July 2017.

Proliferation of digital banking services post-COVID-19. The COVID-19 pandemic has dramatically expanded use and acceptance of digital banking in Nepal.[7] BFIs had previously avoided digitising their procedures due to the high cost of doing so. However, COVID-19 made digitisation no longer a choice, as customers demanded convenience and easy access to their funds, and banks did not want to lose out.

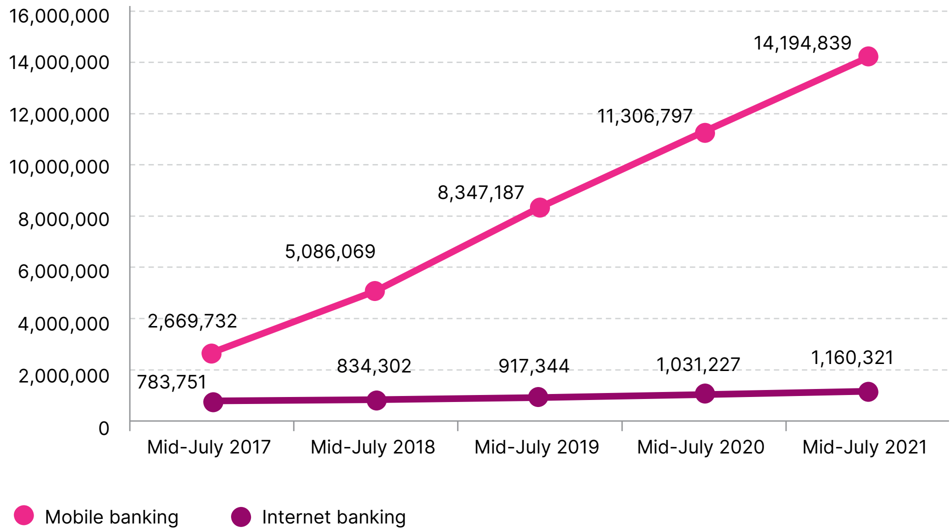


Figure 6: Number of mobile and Internet banking customers (2017–2021)

Source: NRB Monthly Statistics

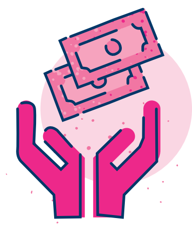
The pandemic has also opened doors for collaboration between banking institutions and fintech and digital payment firms. For example, mDabali, a platform for digital access to cooperative and finance companies, was created.

A clause in the Payment and Settlement Regulation 2077 allows digital wallet providers wanting to provide interest on their customers' wallet balance to do so after obtaining approval from the central bank, and payment service providers have expressed interest in this option. IME Pay's 'Super Wallet' offers customers interest on their wallet balance equal to the Global IME Bank's minimum savings account rate.

However, the general public's response to these PSPs as savings providers is not yet clear, while the regulations that will govern these PSPs are still under development.

4.2 Market for savings

Government initiatives driving formal saving in banks. Over time, the GoN has made a concerted effort, through various policies and regulations, to increase the culture of saving in formal institutions; and, given that people already associate saving in banks with low risk, government efforts have increased levels of trust in the banking system. Furthermore, the federal government's campaign 'One Household One Bank Account' and the requirement to have a bank account in order to receive social security allowances have increased people's access to banking services and helped to foster saving habits. The NRB directive regarding free reactivation of deposit accounts or exemption from penalties for not maintaining minimum balances has also made it easier and encouraging for the low-income earning population to maintain savings. Furthermore, the FY 2021/22 budget provides additional interest of 1% if remittances are deposited into fixed-deposit accounts; this measure has been introduced with the aim of inculcating a habit of saving remittances rather than spending them mostly on consumption.



The provincial and local governments are also making an active effort to promote banking and access to finance by partnering with BFIs.

Provincial and local governments partnering with providers to increase rate of saving. The provincial and local governments are also making an active effort to promote banking and access to finance by partnering with BFIs. Such initiatives should definitely raise awareness regarding savings in remote communities and help the banking sector increase its reach:

- The government of Karnali Province launched the 'Bank Account for Daughters, Life-long Security' scheme, with the aim of uplifting girls in the region.
- In Bajura district, the 'One Household One Bank Account' drive with the support of Himalayan Bank has increased the municipality's reach to financial services, freeing consumers from the exorbitant interest rates charged by local lenders.[8]
- The Solu Dudhkunda Municipality and Rastriya Banijya Bank (RBB) have entered into an agreement to provide concessional loans to locals, as the government had made concessional loans available for various programs: commercial agriculture and livestock, educated youth self-employment, youth returning from abroad, women entrepreneurs, Dalit community business development, higher and technical and vocational education, and construction of private houses for earthquake victims.[9]

Share of fixed-deposit savings accounts increased. As of mid-July 2020, total deposits in commercial banks amounted to NPR 3,930 billion – almost 30% higher than at the end of FY 2017/18. Of the total deposits, fixed deposits accounted for almost 49%, savings deposits for almost 32%, demand deposits for 10% and other deposits for almost 10%.[10] Table 6 shows that over the years the share of savings deposits has been decreasing while the share of fixed deposits has been increasing.

Table 6: Deposits at BFIs (in %, 2016–2020)

DEPOSITS	MID-JULY				
	2016	2017	2018	2019	2020
Demand	9.1	8.7	9.3	9.7	10.0
Savings	43.3	35.4	34.5	32.8	31.9
Fixed	30.5	43.2	44.8	46.3	48.6
Other	17.1	12.7	11.3	11.2	9.5

Source: NRB (2020b)

Central bank intervening to increase long-term saving. To encourage long-term saving, the NRB has prohibited commercial banks from accepting short-term fixed deposits below a three-month-period financial commitment. The NRB has also mandated that the interest rate differential between savings accounts cannot exceed 2%; banks will have to find new ways to attract customer deposits based on being more competitive. Although BFIs are increasingly attracting one-year fixed deposits, the popularity of longer-term fixed deposits (i.e. beyond a year) remains low. Due to substantial interest rate fluctuations arising from banks' customary practice of using interest rates in order to attract customers, banks rarely advertise these accounts.

Savings products limited in range, and giving decreasing returns. Both lack of innovative savings options (i.e. savings products that meet consumers' actual needs) and low deposit rates have hampered BFI depositor retention. During the pandemic-induced lockdown, commercial banks dropped their deposit rates to 2%–5% (from as much as 6.5% during the 2018/19 liquidity crunch), meaning depositors received near-zero actual returns. Banks' interest rates on savings fluctuate, and banks change the interest rate arbitrarily. In the absence of new products, BFIs battled for depositors by introducing new savings accounts and manipulating interest rates.

Central bank intervention on interest rate differentials helpful to depositors and borrowers. The NRB intervened through its unified directives, asking BFIs to keep interest rate differentials between savings account products to a maximum of 2%. The NRB's mandate also capped commercial and development bank interest margins to 4% and 5%, respectively, to discourage banks from creating excessive rate spreads. This new rule helps depositors and borrowers alike: depositors are enticed to save in SACCOs because of the relatively higher interest rates available, while the low interest rates offered by banks have forced people to invest their money in the stock market in the hope of receiving much higher returns.

Directive issued to reduce duplication of savings accounts. As of mid-January 2021, the number of deposit accounts with BFIs had reached nearly 34.7 million, which is more than the total population of the country. However, duplication of account holders definitely exists, as an individual may have multiple accounts with different BFIs. Although the NRB should be able to identify duplicate accounts with different banks using the newly implemented National ID, the bank has issued a new directive, prohibiting an individual from having more than one savings account with the same bank. The NRB's objective in this regard is to reduce account duplication and discourage banks from offering varying interest rates on different saving accounts.

Proximity to a bank branch improved through requirement that banks prioritise municipal and rural areas. Improvements in physical access to banking infrastructure have been achieved since MAP 2016 by the requirement that banks open three branches outside Kathmandu valley before opening one in Kathmandu, with two of the three required to be located in a municipality or rural municipality. As a result, 89% of the population in urban areas and 27% of rural people are within 30 minutes (on foot) of a commercial bank branch.

Improvements in physical access to banking infrastructure have been achieved since MAP 2016 by the requirement that banks open three branches outside Kathmandu valley before opening one in Kathmandu.

Participation in the capital market has increased as a means of savings and investment. The stock market has attracted a large number of new investors, most of whom are small investors channelling their funds through the capital market, particularly during the COVID-19 outbreak. A sizeable portion of the public has begun participating in main (initial public offering) and secondary capital markets (stock market). The total number of depository participant (DP) account holders (mandatory account to participate in the capital market transactions) increased to 4 million account holders at the end of FY 2020/21 – up from only about 1.8 million accounts at the end of FY 2019/20. The number of investors in the secondary market is also on the rise. At the end of FY 2020/21, the total number of registered traders and online traders in the secondary market had increased to 877,000 and 791,000 respectively (compared to only 245,000 and 35,000 respectively at the end of FY 2019/20).

As of mid-2021, the market was offering high profits as a result of the widespread participation of investors during the pandemic owing to ample liquidity and a lack of alternative investment outlets. The initial public offering market has been attractive because it offers more attractive returns than bank savings do. However, these investments are sensitive to market risks, and a lack of proper understanding and speculative behaviour makes them increasingly risky.

Pension and retirement funds increasingly used as saving mechanisms. Pension and retirement funds are increasingly playing an important role in mobilising savings. Previously only available to salaried employees, these funds are now available to self-employed individuals as well. A new pension program for Nepalis who work in any institution, profession or business and generate a monthly income has also been launched under the Citizen's Investment Trust. It covers employees, self-employed people, and migrant labour. The increased uptake of pension and retirement saving plans is also related to the fact that online registration and enrolment are available.

Response to SSF underwhelming despite scheme's potential to support saving. The SSF is another important government-sponsored saving tool; it is a contribution-based social security scheme, aimed at protecting public- and private-sector employees under four categories of support: medical treatment and health protection; accidents and disability plan; dependent family plan; and old-age security plan. The vision of the government is in time to provide comprehensive social security coverage to the population; however, the SSF currently only covers people employed in the formal sector. An amount equivalent to 31% of a worker's basic salary – 11% deducted from the worker's monthly salary and 20% in the form of the employer's contribution – is deposited into the fund. The SSF had 13,074 employers and 184,999 contributors by mid-January 2021, and by 2020 had collected NPR 3.7 billion (around USD 31.5 million) and paid out around NPR 28.5 million (around USD 2.4 million). However, the scheme has had a lukewarm reception due to companies' unwillingness to incur increased costs and workers' general lack of awareness of the scheme.

The vision of the government is in time to provide comprehensive social security coverage to the population.

Directive has enabled monetisation of savings in commodities. As per a new provision in the 2019/20 annual budget, the NRB issued a directive on gold deposit schemes allowing citizens to deposit gold in banks as an interest-earning deposit. As per the directive, banks can accept a deposit of 25 grams of gold (minimum) for a duration of at least three years and up to five years. The gold deposit scheme might turn out to be a very attractive product for people who prefer saving in such commodities as well as a beneficial product for banks. Moreover, banks can deposit the gold in the central bank, which will help to maintain that bank's cash reserve ratio.

General public reluctant to save through advanced products like bonds/debentures. Bonds and debentures offer fixed-rate savings. The NRB's monetary policy for FY 2019/20 required commercial banks to issue debentures worth at least 25% of their paid-up capital by mid-July 2021. Commercial banks have issued 22 debentures thus far (and a further 9 were due by November 2021). Debentures provide a higher interest rate than fixed deposits or savings accounts, although the interest rate differential is not very large. Members of the public have generally not been attracted to debt instrument investments. They may be hesitant to tie up their money for a long time when they can move it around in fixed deposits for one to two years. Even more discouraging for private investors are debenture expenses. Despite the instrument's continued undersubscription, marketing attempts to promote its benefits are minimal, and bonds/debentures as investment or savings vehicles are poorly understood. While remittance commissions are waived for subscribing bonds, acceptance of these bonds and debentures is still limited. The Foreign Employment Savings Bond, for example, continues to be unpopular and hugely undersubscribed.

Eligibility still a significant barrier to uptake of formal savings products. Proving eligibility remains one of the biggest barriers to access to formal financial services. The requirement arises mainly from the fact that only physical paperwork can be recognised as evidence by the judiciary in the event of a dispute. However, a quarter of Nepal's citizens lack citizenship certificates, rendering them ineligible to access formal banking. Not having the necessary documents accounts for the fact that 10% of the country's adults lack bank accounts. The hassles of account opening, particularly the know your customer (KYC) forms and other forms of documentation, thus discourage people from entering the banking system.

Proving eligibility also a barrier to digitisation of savings. Despite remarkable progress in digitising financial services, the country's digital product offerings have been limited to payments and remittances. In attempts to expedite bank account opening, the process has been digitised and KYC requirements can be fulfilled via video, but in order to be fully functioning such accounts still require submission of physical documentation (including KYC).

4.3 Market for credit

Steady growth in credit as percentage of GDP. Credit distribution through formal channels (BFIs) has steadily increased since MAP 2016. While total domestic credit as a percentage of GDP was just over 74% in mid-July 2016, it had increased to almost 87% by mid-July 2020 (see Figure 7). As of January 2021, 60% of total credit deployed from Class A, B and C banks had been dispersed in metropolitan areas, 26% in sub-metropolitan areas, almost 11% in municipalities, and just over 3% in rural municipalities.

Uptake of bank credit has increased. Uptake of credit through formal banking channels has increased, with BFIs reporting an increase in the number of loan accounts. As of January 2021, the number of loan accounts in Class A, B and C BFIs was at 1.6 million, compared to almost 1.2 million in January 2017, indicating a growth of just over 38% in the period 2016 to 2021, with a CAGR of 7%.

Increased consumption, entrepreneurship and corporate expansion are among drivers of increased credit usage. Reasons for increased reliance on bank credit include increased levels of consumption, increased entrepreneurship levels, and corporate expansion. The credit expansion has also been continuously supported by annual monetary policy measures and targets outlined by the central bank.

Uptake of credit through formal banking channels has increased, with BFIs reporting an increase in the number of loan accounts.

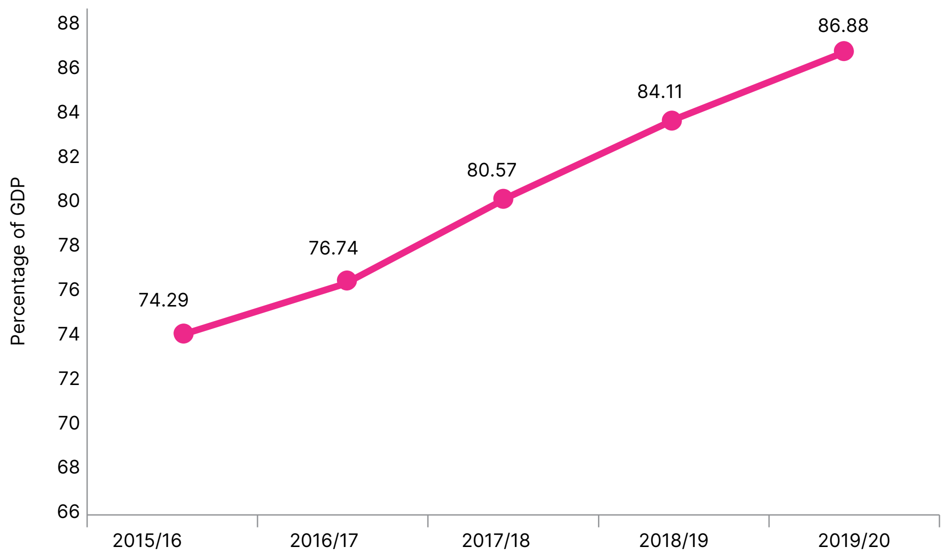


Figure 7: Domestic credit as percentage of GDP (2015/16–2019/20)

Source: NRB Financial Stability Reports

According to the 2017 Findex Survey, while 8% of Nepal's adult population had outstanding home loans in 2014, by 2017 the figure had jumped to 14%. Similarly, while 20% borrowed money for health and medical needs in 2014, this had risen to 24% in 2017; and in that same year, 14% took out formal credit to start, operate, or grow a farm or business (up from 8% in 2014):

- Commercial banks' total loan accounts increased by 54% in four years, and the loan values have more than doubled, with an average loan size of NPR 2.6 million (USD 22,165) as of January 2021 – up from NPR 1.9 million (USD 16,197) in January 2017.
- By contrast, development banks saw a mere 0.5% rise in loan accounts over the four-year period, with the total number of loans disbursed increasing by 33%. The average loan size was NPR 790,000 (USD 6,734) in January 2017 and NPR 1.05 million (USD 8,951) in January 2021.
- The number of loan accounts from finance companies increased by 25% from 2017 to 2021, with the total loan value increasing by 35%, and the average loan size increasing from just under NPR 1.5 million (USD 12,361) in January 2017 to almost 1.6 million (USD 13,384) in January 2021.

The low growth in the number of loans and loan amounts from development banks and finance companies can be attributed to the decline in their numbers owing to mergers and acquisitions with commercial banks.

The low growth in the number of loans and loan amounts from development banks and finance companies can be attributed to the decline in their numbers owing to mergers and acquisitions with commercial banks.

Surge in uptake of credit from MFIs and cooperatives. MFIs and cooperatives have played an essential role in providing loans to those unable to obtain loans from commercial banks (e.g. because of the strict loan application process including proving eligibility). MFIs have seen a surge in the number of borrowers since MAP 2016: the total number of borrowers increased by 131% in the period from 2016 to 2020, with the total loans disbursed increasing by over 200%. The average size of the loans also increased: from NPR 289,000 (USD 2,463) in 2016 to NPR 485,000 (USD 4,134) in 2020.

Despite the number of cooperatives operating in Nepal decreasing (from 32,663 in 2015 to 29,886 in 2020), the total number of cooperative members increased by over 40% during the period, with the total credit mobilised reaching NPR 426 billion (over USD 3.6 billion).

Overall level of formal borrowing increased – but decreased for males and increased for females. According to the 2017 Findex, 13% of adults borrowed from a formal financial institution in 2017, representing a slight increase from 12% in 2014. In 2017, just 13% of the male adult population borrowed from a formal financial institution, down from 15% in 2014. By contrast, the number of female adults borrowing from a financial institution grew: from 10% in 2014 to 14% in 2017.

Informal borrowing increased significantly. In the period from 2014 to 2017, informal borrowing increased significantly: while, in 2014, 35% borrowed from family and friends, by 2017 the figure had risen to 53%. The percentage of men and women borrowing from family and friends grew from 37% and 34% in 2014 to 57% and 49%, respectively, in 2017.

Similarly, in 2017, 8% of the population borrowed via savings groups: 6% of males and 11% of women borrowed from such organisations. The prevalence of informal sources of credit can be linked to the fact that they have low barriers to entry despite having high interest rates; people (especially low-income people) prefer borrowing from informal sources to avoid the inconveniences associated with official banking institutions, such as the demand for lengthy documentation and collateral. The local nature of informal providers offers additional benefits in many cases (e.g. knowing the borrower, being known to the borrower, and being in convenient proximity).

Surge in consumer credit demand. Consumer credit demand has been on the increase, as evidenced by the widespread uptake of consumer credit products such as credit cards, residential home loans, automobile loans, and consumer loans.

Stunning increase of almost 200% in credit cards issued. The number of credit cards issued by commercial banks in January 2021 was 176,414 – up from 58,932 in January 2017. This represents a stunning increase of just over 199%. The significant demand for credit cards was supported by higher consumption spending. The number of credit cards issued per 1,000 adults has increased year on year: from 2.44 in 2015 to 6.11 in 2019.

Demand for automobile loans has increased significantly. People spend significant sums of money on vehicles as a result of the country's poor public transport system.

Number of home loans has also increased significantly. In January 2021, residential home loans totalled just over NPR 263.8 billion in value, which represents an increase of almost 62% on the total value of almost NPR 163.3 billion of January 2017. Despite a dip in 2018, there has been an absolute increase post-2018 in total home loan values, with a CAGR of almost 12.8%.

Poor public transport systems have contributed to increased uptake of auto loans. Demand for automobile loans has increased significantly. People spend significant sums of money on vehicles as a result of the country's poor public transport system. The NRB cut the loan-to-value ratio for auto loans from 65% to 50% in a bid to discourage rampant vehicle purchases due to the easy availability of auto loans from BFIs.

Lending (still) heavily based on collateral. The credit market in Nepal is extensively collateralised, and the absence of assets that match the collateral requirement makes it difficult for people with low incomes to obtain credit. The majority of BFI loans and advances are secured by collateral in the form of immovable assets. As of January 2021, just over 88% of BFI loans and advances were collateralised by property. Similarly, just over 1% of credit was backed by gold and silver, while a little over 4% was backed by guarantees such as institutional guarantees, government guarantees, or personal guarantees. This also indicates the strong reliance on immovable assets such as real estate as collateral.

Furthermore, over the past few years the NRB has tightened the computation of distressed value. In the case of personal loans, banks are only permitted to disburse up to 50% of the distressed value of the loan or up to NPR 5 million (USD 42,625), whichever is lower – as opposed to 80% previously. In the case of business loans, BFIs are permitted to lend up to a maximum of 83% of the distressed value and this needs to be backed by a strong cash flow.

Collateralised credit market keeps NPL levels low. The fact that lending is highly collateralised has contributed significantly to the low level of non-performing loans (NPL) of BFIs. The overall NPL to total loans ratio stood at 1.84% in January 2021, which was down from 2.13% in January 2017. This is also significantly lower than is the case in other countries in the region, in spite of the fact that Nepal's is a smaller economy. Despite the decreasing trend, 2021 saw a small increase in BFIs' NPL ratios, mainly attributable to the country's COVID-19 pandemic-induced lockdowns.

The establishment and functioning of the Secured Transactions Registry in accordance with the Secured Transactions Act (2006) will enable the issuing of movable asset-secured loans. The process has been stalled for a long time due to the absence of regulatory clarifications and policies, and this prevented BFIs from providing loans against movable assets.

Provision for loan loss increased by 60%. With an increase in the number of people taking out loans through formal banking channels and an increase in the volume of credit disbursed by formal BFIs over the period from 2017 to 2021, the provision for loan loss also increased: the overall loan loss provision for commercial banks, development banks, and finance firms was just under NPR 51.8 billion (USD 441.5 million) in January 2017, but increased to just under NPR 82.7 billion (around USD 704.9 million) in January 2021 – a 60% increase.

Period January 2020 to January 2021 saw a very significant loan loss increase. The sharp increase in loan loss provision from almost NPR 66.9 billion (just under USD 570 million) in January 2020 to almost NPR 82.7 billion (around USD 704.9 million) in January 2021 is likely an outcome of the disruptions caused by the COVID-19 pandemic.

Banks increasing fixed-value non-collateralised lending levels. Nepal is slowly but steadily transitioning to a lending market with no collateral. Previously, the NRB had limited the provision for non-collateralised loans to a maximum of NPR 1.5 million (USD 12,788) and 5% of BFIs' overall loan portfolio. However, this provision was not widely practised by the banks as there was always a preference on their part for collateral.

Banks considering cash flow and earnings to assess credit risk, and adopting credit-score based lending. There is evidence that banks are gradually transitioning to innovative lending processes. Banks are now expanding their lending depending on borrowers' cash flow and earnings. Furthermore, with the assistance of development programs and partners, a few banks have adopted the notion of credit-score based lending.

Nabil Bank, for example, has created Nabil Sajilo Xpress Karja, which employs credit scoring in making credit approval and pricing decisions for SME client credit; charging reasonable interest rates, the initiative caters to loan sizes up to NPR 7.5 million (USD 63,938). Prabhu Bank has launched a similar scheme.

Nepal is slowly but steadily transitioning to a lending market with no collateral.

Priority and deprived sector lending increasing the scope and accessibility of credit. Since FY 2013/14, the NRB has mandated BFIs to lend a particular percentage of their loan portfolio to selected sectors of the economy to assist in sustainable economic growth. From FY 2020/21, the definition of priority sector loans was revised to include agriculture, energy, tourism, and SMEs, which were formerly excluded. The Priority Sector Lending Program (PSLP) requires BFIs to lend 15% to agriculture by FY 2022/23; and 15% to SMEs and 10% to hydropower by FY 2023/24. Similarly, the central bank has made concessional loans of up to NPR 1.5 million (USD 12,788) available to the agriculture sector and SMEs.

Deprived sector lending has increased significantly. A deprived sector is defined by the NRB as low-income families and women; indigenous communities; Dalits; individuals with disabilities; marginalised communities; small farmers; labourers; and landless people. Deprived sector lending has risen considerably in recent years, partially as a result of the central bank's decision to broaden the definition of the poor to include more organisations and communities eligible for borrowing.

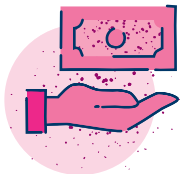
In January 2021, deprived sector lending reached almost NPR 243.3 billion (about USD 2.1 billion) – up by just over 41% from the 2017 figure. BFIs' lending portfolios in the deprived sector have grown at an 11.26% CAGR over the past five years.

Flow of concessional loans increased to encourage entrepreneurship. The disbursement of concessional loans surged after the NRB, with the objective of promoting entrepreneurship in the country, made it mandatory for BFIs to issue such loans under various categories. The banks receive a 6% concession from the government for the 'Women Entrepreneurship Loans' and 5% for other categories. Under this initiative, farmers are eligible for loans of up to NPR 50 million (USD 500,000) per person at 5% interest rate.

Not surprisingly, the mandatory issuance of concessional loans has significantly increased credit uptake. As of January 2021, BFIs had disbursed a total of almost NPR 100.4 billion (around USD 855.7 million) in the form of concessional loans to 60,879 borrowers, compared to a total of NPR 47 billion (around USD 400.7 million) disbursed to 23,978 individuals in January 2020. Over three-quarters of the concessional loans have been provided as commercial agriculture and livestock loans.

Need for SME and startup credit hitherto not well served by BFIs. According to the NRB's 2019 report SME Financing in Nepal, of the initial funding provided to SMEs, only 16% came from BFIs. SMEs were found to source startup funding in the form of informal loans (6%), from cooperatives (6%), and in the form of venture capital (5%).

The study also found only about half of operating SMEs borrowed from BFIs. Of those SMEs, almost 85% borrowed from commercial banks, almost 9% from development banks, almost 3% from finance businesses, and almost 4% from MFIs. The average interest rate was just over 12.5%, plus a 1% service charge, and obtaining a BFI loan takes about 38 days.



Deprived sector lending has risen considerably in recent years, partially as a result of the central bank's decision to broaden the definition of the poor to include more organisations and communities eligible for borrowing.

Although traditional banking channels provide access to funding for SMEs, difficult processes (e.g. onerous documentation requirements), high interest rates, and collateral requirements deter SMEs from seeking credit from BFIs and prompt them rather to borrow from MFIs and SACCOs.

Entrepreneur funding support prioritised in 2021/22 national budget. The government in its budget for FY 2021/22 made provision for loans to entrepreneurs of up to NPR 2.5 million (USD 21,312) at 1% interest; NPR 1 billion (around USD 8.5 million) was set aside for this purpose.

The central bank plans, by mid-July 2024, to channel 15% of directed sector financing to SMEs in the form of loans of less than NPR 10 million (USD 85,251).

With regard to COVID-19, for FY 2021/22 the NRB announced refinancing facilities and concessional interest rates, with 80% of the funds to be disbursed via commercial banks, development banks, finance companies, and MFIs. The SMEs refinancing rate was set at 2%.

Local governments are increasing access to credit. Provincial as well as local governments in Nepal have been partnering with BFIs to make available easy and affordable credit facilities in support of promoting the growth of agriculture and SMEs at local level. The governments have been coming up with various concessional credit programs:

- Through agricultural cooperatives the Karnali state government provides farmers who cannot pledge collateral with concessional interest subsidies of up to 11% on loans of NPR 50,000 (USD 426) to NPR 500,000 (USD 4,262). The state government has also partnered with Agriculture Development Bank and RBB to provide farmers with interest subsidies.
- Thulung Dudhkoshi Municipality of Solukhumbu district and Laxmi Bank reached an agreement to run a concessional loan facilitation program to promote entrepreneurship and self-employment among migrant returnees.
- On the recommendation of the local government, Global IME Bank and Naukunda rural municipality signed an agreement to make agricultural subsidy loans available to farmers engaged in goat rearing, dairy, vegetable farming, poultry, pigeon rearing, fishing, and the production of various fruits.

The state government has also partnered with Agriculture Development Bank and RBB to provide farmers with interest subsidies.

BFIs, cooperatives directed to lower interest rate spread and base rates. Interest rate spread is one of the major indicators that determine the cost of access and usage of credit, as it helps BFIs fix the lending and deposit rates. The NRB, through its unified directives, directed Class A banks to bring down their interest rate spread to a maximum of 4.4% (from 5% previously), and Class B and C banks to bring their interest rate spread within 5%. As of mid-July 2020, the overall interest rate spread of the commercial banks stood at 4.1%. Issuing new regulations, the Department of Cooperatives barred cooperatives from charging more than 14.75% on loans. The regulations also barred SACCOs from having interest rate spreads exceeding 6%.

Base rate system part of NRB strategy to increase transparency, protect consumers, promote competition. The overall base rate came down to 8.5% in July 2020 from 9.3% in July 2019. This drop in base rate can also be attributed to the decrease in demand for credit during the COVID-19 pandemic. The NRB introduced the base rate system to enhance transparency in interest rate determination, protect clients' interests, promote healthy competition among providers and improve the sustainability of BFIs; the latter have also been directed to publish their interest rate spreads on a monthly basis.

Credit rating process and procedures still in their infancy. In Nepal, credit rating is a relatively new concept. Through its monetary policy in 2018, the NRB made credit rating mandatory as a foundation for loan appraisal for loans of NPR 500 million (about USD 4.3 million) or more. Furthermore, credit ratings are required for public issuing of shares worth NPR 30 million (USD 255,755) or more. Currently, Nepal has two credit rating agencies, ICRA Nepal Limited and CARE Nepal Limited, and between them they have granted over 250 ratings, the majority of which have gone to banks, hydropower firms, insurance companies, steel and cement enterprises, and hotel industries. Such achievements aside, the credit rating system still needs much improvement.

Recommendation to decrease rating fees, and to regulate to encourage credit rating in SME lending. Obtaining a credit rating is currently costly. In order to encourage corporate entities to use credit ratings, the regulatory body should enact regulations that impose a low fee for credit rating. Furthermore, the NRB, in collaboration with concerned ministries such as the Ministry of Industry, Commerce, and Supplies, should enact regulations that encourage banks as providers and SMEs as customers to use credit rating to increase access to SME credit.

Credit vetting and reporting by MFIs made mandatory. As per the latest directives issued by the NRB for MFIs, it is mandatory for MFIs to access borrowers' credit information from the CIB before they disburse loans, renew old loans, or restructure or reschedule loans. Similarly, the MFIs are required to become members of the CIB and to share their updated credit information (details of borrowers and their loans, including identifying borrowers that default on payments) within 15 days of the end of each quarter.

Improved access through PE/VC. Access to credit is being improved through alternative sources such as private equity (PE) and venture capital (VC). As per the monetary policy of 2020/21, PEs and VCs, in coordination with the concerned agencies, will be allowed to extend credit for restructuring in cases where the conventional measures for restructuring and rescheduling loans remain inadequate. Furthermore, the proliferation of PE/VC is significantly increasing the amount of credit being extended to micro, small and medium enterprises (MSMEs) and startups, particularly those enterprises that are too small for BFIs to serve.

INNOVATIVE CREDIT PRODUCTS

Recently, the country has seen some creative approaches to the rollout of credit products – measures aimed at credit provision and disbursement:

- **FoneLoan:** As consumers' demand for convenience and digital banking increases, many Class A commercial banks in Nepal have also started offering 'FoneLoans': small, short-term, pre-approved loans to individual customers instantly, through the bank's mobile banking platforms. Different banks have different thresholds for the credit disbursed through this mechanism. For example, Nabil Bank through Nabil FoneLoan service provides virtual credit card loans using the bank's mobile banking for loan amounts up to NPR 1 lakh (USD 852). Mega Bank allows customers to make available short-term loans up to NPR 200,000 (USD 1,705) to salaried individuals for a period of 30 days. These pre-approved loans are available to banking customers deemed eligible by an automated analytics system as per the criteria set by the bank.
- **COVID-19 recovery fund for SMEs:** With the aim of helping SMEs sustain and survive the pandemic, One To Watch, in partnership with Nabil Bank, NMB Bank and Laxmi Bank, and with support from the Swiss Agency for Development and Cooperation (SDC) and FMO Development Bank, has launched the COVID-19 MSME Fund Nepal. The fund will support SMEs by providing them with interest- and collateral-free loans (bridge financing) to meet their short-term working capital needs. The loan size can range from NPR 1 million to NPR 2 million with zero interest/collateral for a maximum period of 18 months. In addition to short-term financing, the fund will provide business advisory/development services to help the businesses improve their managerial and operational capabilities.

4.4 Market for insurance

Insurance penetration and uptake significantly increased. Uptake of insurance has increased significantly: from the 11% reported in FinScope 2014[11] to an estimated 26% (including foreign employment insurance coverage) by mid-March 2020.[12]

In the past four years, the number of life insurance policies sold increased by 247%: from 2,729,974[13] in 2016/17 to 9,484,303 in the third quarter of 2020/21.[14] Life insurance companies' branches expanded from 1,253 in FY 2017/18 to 1,969[15] in 2020/21, allowing more people to access their products.

Non-life insurance policies have also surged in popularity, rising in number from 1,743,572 in 2016/17 to 2,122,007 in the third quarter of 2020/21. Non-life insurance company branch numbers expanded from 730 to 936 in FY 2017/18.[16]

The total premium collection (both life and non-life insurance companies) during FY 2019/20 stood at just under NPR 121 billion (just over USD 1 billion),[17] while the total premium collection during the first eight months of the fiscal year up to March 2021 stood at more than NPR 102 billion (USD 870 million).

Uptake of insurance has increased significantly: from the 11% reported in FinScope 2014 to an estimated 26% by mid-March 2020.

A plethora of new developments and regulations driving increased insurance uptake. Key drivers of insurance growth include the following: the opening up of insurance licenses in 2017 (both life and non-life); mandatory opening of branches in rural areas;[18] extension of the NHIP in 75 districts;[19] mandatory contribution to the SSF for those employed in the formal sector; mandatory life insurance for foreign employment; third-party liability vehicle insurance; asset insurance for mortgage finance; uptake of the COVID-19 insurance policy; the introduction of affordable microinsurance products (life and non-life) with low premiums, which provide maximum coverage with a VAT waiver; and tax exemption provision against life insurance premiums from NPR 20,000 (USD 171) to NPR 25,000 (USD 213).

The establishment of new insurance companies and the IB's allocating of districts to each insurance company and making it mandatory for life and non-life insurance companies alike to establish branches in all 77 districts of Nepal have increased access to insurance.

Establishment of new local insurance companies has expanded provision. The IB's 2017 directive on Insurer Registration and Operation of Insurance Business permitted the registration of new insurance businesses. Table 7 illustrates the current distribution of insurance companies. In 2019, the IB also established the Insurance Institute Nepal Limited, to provide insurance training to workers of insurance firms, financial institutions, and the general public. In future, the institute could also examine research and development on insurance products.

Table 7: Distribution of insurance companies

DETAILS	2017	2021
Life insurance	9	19
Non-life insurance	17	20
Re-insurance	1	1

Source: IB (2020b)

Minimum capital requirement for insurance companies increased. The minimum capital requirement for non-life insurance companies has been increased from NPR 250 million (just over USD 2.1 million) to NPR 1 billion (more than USD 8.5 million), while the minimum capital requirement for life insurance companies has been increased from NPR 500 million (almost USD 4.3 million) to NPR 2 billion (just over USD 17 million). The IB also raised the capital requirement for international insurers operating in Nepal to NPR 2 billion and NPR 1 billion for international life insurance and international non-life insurance respectively.[20] The key rationale for increasing the capital base was to improve the financial strength and integrity of insurance companies, by ensuring that enough capital is available to sustain their operations, that they are able to increase their risk-taking capacity and provide wider coverage of risks, and that they are able to honour their policy obligations when claims are triggered.

Microinsurance made mandatory for insurance companies. Prior to the adoption of the Microinsurance Directive in 2014, groups such as MFIs, cooperatives and NGOs offered low-income households informal insurance products. These institutions administered social protection funds that provided coverage for predefined illness, the client's or spouse's death, maternity, and property damage caused by natural disasters. In terms of that 2014 directive, insurance companies (life and non-life) were required to commit a minimum of 5% of their portfolio to microinsurance. This was subsequently revised to 10% by FY 2019/20.

Microinsurance policies comprise significant portion of insurance market. In total, 15,023,450 microinsurance policies were issued during FY 2019/20, accounting for just over 16% of all insurance policies issued.[21] The GoN, in the budget for FY 2020/21, waived VAT on microinsurance products. Table 8 details the microinsurance products available in Nepal in 2020.

Table 8: Microinsurance products available in Nepal (2020)

TYPE OF PRODUCTS	MAXIMUM SUM ASSURED IN NPR	PREMIUM
Term life microinsurance	300,000	As per the rules of the insurance policy
Endowment life microinsurance	300,000	As per the rules of the insurance policy
Asset (wealth) microinsurance	500,000	0.20% of sum assured
Household microinsurance	500,000	0.05% of sum assured
Personal accident microinsurance	300,000	0.10% of sum assured
Health microinsurance (coverage of max. 5 family members)	50,000	4.00% of sum assured
Critical illness microinsurance	100,000	As per the rules of the insurance policy
Crops and livestock microinsurance	200,000	As per the rules of the insurance policy

Source: Microinsurance Directive, 2020

Insurance companies collaborating with MFIs for issuance of microinsurance. The Nepal Insurers Association (NIA) created a microinsurance risk pool for non-life microinsurance products, following which a memorandum of understanding was signed between the NIA and the Nepal Microfinance Banks Association (NMBA) to ensure distribution of microinsurance policies through MFIs. The NIA established a microinsurance pool (MIP), which consists of 20 non-life insurance companies in Nepal, with Shikhar Insurance Company Ltd as the pool manager. All 20 non-life insurance companies have equal value of seed money in the MIP. Insurance companies are working with the MFIs operating in their 77 allocated districts. The NIA has begun to offer a variety of microinsurance and crop insurance products. It also intends to develop other tailored microinsurance solutions in response to MFI clients' feedback in order to suit their insurance needs.

The increase in uptake is being driven by the implementation of the Agricultural and Cattle Insurance Directive 2020, which requires non-life insurance companies to allocate 5% of their insurance portfolio to agricultural and cattle insurance products.

Life insurance continues to be the most popular product. The IB reports that insurance uptake is largely driven by demand for life insurance products. One of the key drivers for uptake of life insurance is that it has been made mandatory for foreign employment workers.

Market for life insurance highly concentrated in Nepal. Two life insurance companies account for almost 50% of gross premium market share: Nepal Life Insurance holds the largest gross premium market share (approximately 29%), while Life Insurance Corporation (Nepal) holds 16% of the gross premium market share.[22]

Regulations have driven increase in uptake of agricultural insurance. The uptake of agricultural insurance increased from NPR 625 million (just over USD 5 million) in 2014 to just over NPR 22 billion (USD 190 million) in 2019.[23]

The increase in uptake is being driven by the implementation of the Agricultural and Cattle Insurance Directive 2020, which requires non-life insurance companies to allocate 5% of their insurance portfolio to agricultural and cattle insurance products, and allocates 77 districts among the 20 non-life insurance companies for purposes of expanding agricultural insurance coverage and area of operation. Furthermore, in order to encourage the purchase of agricultural insurance, the government increased the subsidy: from 50% in 2014 to 75% in 2019. Insurance companies have begun to take the initiative to provide services that go beyond what the IB prescribed in the directive: for example, Shikhar Insurance Company introduced weather index insurance for the first time in Nepal for apple farmers in Jumla and other apple-producing districts.

In microinsurance, agricultural is dominating – and within that, livestock insurance is predominant. In terms of uptake, agricultural insurance is dominated by livestock insurance products, with livestock insurance policies comprising 95% and crop insurance 5% in 2019.[24] Given a general lack of technical skills and appropriate monitoring methods among insurers for evaluating risks in crop insurance, insurance providers have been prioritising provision of livestock insurance.

Crops and livestock microinsurance are classified as microinsurance; nevertheless, insurers record these products as agricultural insurance in order to qualify for a government subsidy of 75% on agricultural insurance premiums, which is not available for other microinsurance products. As a result, agricultural microinsurance (crop and livestock microinsurance) has outperformed other microinsurance products in terms of uptake.

Agricultural microinsurance (crop and livestock microinsurance) has outperformed other microinsurance products in terms of uptake.

Migrant workers now benefiting from improved terms for foreign employment life insurance. Previously, migrant workers were required to purchase a three-year insurance package, despite the fact that the permit for migrant workers was for only a two-year period. The IB has made changes in the policy that now requires migrant workers to pay only for an additional six months, which will cover workers for three months prior to departure in Nepal as well as providing coverage in labour destination countries for up to three months after their tenure is over.

GoN driving a number of social security/insurance program innovations. In Nepal, social security schemes are administered by the Department of Civil Registration (DoCR), which is part of the Ministry of Federal Affairs and Local Development (MoFALD). The DoCR is currently implementing 11 different cash transfer programs for various groups of people; benefits from such social security schemes are available to senior citizens, single mothers, and members of marginalised communities. Beneficiaries receive cash every four months from the local government authority. In some cases, banks have been used to disburse social security payments, while in others cash is disbursed directly by a local government authority.

Low-income population targeted for dedicated social security safety net. The GoN also intends issuing identity cards to low-income households. The identification of poor households and the distribution of identity cards are expected to result in the establishment of a dedicated social security system for the poor.

Pilot health insurance scheme scaled from 3 to 75 districts from 2016 to 2021. The NHIP, a cash-free health insurance program, was introduced by the GoN in 2016 in three districts: Kailali, Baglung and Ilam. Under the program, the health services and drugs are provided at affordable cost, with only a minimum payment required from recipients. Individual enrolment in the NHIP increased from 12,623 individuals in three districts during 2016 to 3.9 million individuals covering 75 districts in 2021.[25]

High dropout rate on health insurance scheme attributable to supply-side shortcomings. The Health Insurance Board reports a high dropout rate of just over 38% during FY 2018/19[26] from the NHIP. The high dropout rate is attributable to a number of supply-side failings that have the effect of undercutting the quality of service offered to individuals, including: insufficiency of drugs and other essential supplies; long delays in receiving health services; poor infrastructure and maintenance of registered healthcare facilities; and unfriendly behaviour on the part of health workers.[144] Furthermore, health service delivery on the NHIP has been hampered by a lack of coordination among the different levels of the system – health insurance offices, federal government, local government, and healthcare facilities – which has also contributed to the high dropout rate.

Delay in policy maturation time a disincentive for consumers. The three-month delay (maturation time) to activate the policy is a significant time gap, which is tending to discourage consumers from joining the NHIP.

Efforts to serve formal private sector employees hampered by lack of clarity on benefits. In 2017 the GoN introduced the contribution-based Social Security Fund Act to protect and secure employees working in the formal private sector. The SSF scheme provides medical, health, and maternity benefits, as well as accidental and disability benefits, benefits for dependent family members, and old-age benefits (see also Section 5.2). The fund has collected almost NPR 4 billion (almost USD 32 million) and has paid more than NPR 28 million (USD 242,541) under various categories.[27] As of February 2021, 13,261 employers and 189,234 contributors had been listed under this scheme.[28] The overall coverage of the SSF scheme is low despite the mandatory requirement for formal sector employers to register with the scheme. Employers and employees have found transitioning to the new contribution-based system difficult, partly because of companies' unwillingness to incur increased costs and employees' general lack of awareness of the scheme. Low levels of clarity about the scheme and an ambiguous scheme design have meant that before committing to the scheme, employers and employees alike have requested clarity from the appropriate government ministry and the SSF on contribution rates, perks, and administrative requirements.

Some progress achieved in digitisation of insurance sector. The increase in the number of Internet users in the country has prompted many insurance companies to collaborate with digital financial service providers, digital wallet providers and BFIs (Internet banking, mobile banking) to facilitate online digital payment of insurance premiums. The agreement between the Foreign Employment Department and Internet payment gateways such as eSewa, Khalti's digital wallet, and Connect IPS will make it easier for migrant workers to pay for insurance, welfare, and re-entry work permits from labour destination nations.

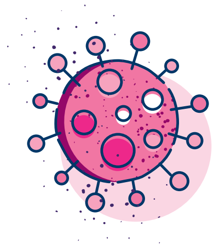
Online insurance sales still in their infancy, with applicants required to provide physical documentation. While the COVID-19 pandemic has acted as a catalyst in prompting the majority of insurance companies to promote digital payment of insurance premiums, issuing of new insurance policies digitally is still extremely limited as applicants are required to submit documents physically and use of digital signatures has yet to be implemented. Shikhar Insurance is one of the first companies to start selling insurance policies online.

Significant barriers to expansion of insurance services. These include consumer awareness, agent limitations, undifferentiated product offerings, and absence of 100% digital application procedures. Lack of awareness on the part of consumers is among the biggest impediments to broadening the uptake of insurance; because insurance is seen as an expense rather than a risk-mitigation tool, many people still rely on credit and savings to protect themselves. Furthermore, for the most part agents are themselves not well educated and rather than trying to educate the public tend to focus their sales pitch on returns or discount rates.

Insurance product offerings are homogeneous. Partly due to IB oversight, insurance companies continue to sell the same insurance products without much differentiation, and innovation is sorely needed: for example, MSMEs would benefit from policies customised to the risks they face and, by using CSR money, BFIs could promote microinsurance uptake. CSR financing could also be used to achieve a number of social goals, such as customer protection, which includes insuring MSMEs.

In rural areas, infrastructure limitations limit possible insurance services. Lack of the auxiliary infrastructure required to develop insurance services also contributes to low insurance uptake. Healthcare providers, agricultural technicians and weather stations are expected to help expand insurance services in rural areas.

Investment required for digitisation – but road ahead not yet clear. To move towards digitisation, the industry needs to invest in technology and information technology (IT); especially during the COVID-19 outbreak, for example, premium payments via digital channels increased. Furthermore, as already mentioned, some insurance companies are offering sign-up for new insurance policies online although uptake is low as physical documents (KYC document, signature verification) are still required before the policy can be activated. Another barrier to issuing insurance policies online is the commonly expected practice of discounting on premiums (offered by agents out of their commissions), and the negotiability of terms and conditions.



The COVID-19 pandemic has acted as a catalyst in prompting the majority of insurance companies to promote digital payment of insurance premiums.

4.5 Market for payments

Significant increase in digital financial service usage, especially after the onset of COVID-19 pandemic. The number of DFS users has risen significantly in the post-MAP 2016 period. For instance, the number of mobile banking users has seen a CAGR of 42% in the past five years: in mid-January 2021, the number of mobile banking users stood at almost 13 million, compared to 468,000 in mid-July 2014.

Similarly, the number of Internet banking users has risen by an impressive 14% CAGR over the past five years, to just over a million users in mid-January 2021, compared to 328,000 in mid-July 2020.

The COVID-19 pandemic acted as a catalyst for DFS usage: within a year of the onset of the pandemic – i.e. between mid-March 2020 and mid-March 2021 – the number of mobile banking users increased by a staggering 30%.

With the increase in the number of DFS users has come a significant increase in the number and volume of electronic transactions.

Huge increase in electronic transactions. With the increase in the number of DFS users has come a significant increase in the number and volume of electronic transactions. Within the last 10 months of the current FY 2020/21, the number of transactions carried out by Connect IPS increased by approximately 165%: debit card transactions were up by almost 119%, while mobile banking services were up by almost 100%.

In terms of the volume of electronic transactions during the same period, Connect IPS saw a staggering growth of just over 175%, while mobile banking also saw an impressive growth of almost 160%. The total amount of transactions via debit cards also increased by more than 134%.

New QR-based payments increased. The year 2021 saw the introduction of the Nepal QR Standardization-Framework and Guidelines, designed to bring about uniformity and provide equal opportunity for all players in the payments space. Within a short period of time an encouraging number of QR-based transactions have already been carried out.

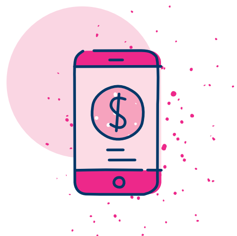
Healthy increase seen in RTGS volumes. The volume of payments via RTGS also saw a positive growth: just over 26% since MAP 2016.

Education level and geographic location are factors in uptake of DFS. According to the 2017 Findex Survey, only 3% of the adult population used a mobile phone or the Internet to access a financial institution account in the previous year. However, education seems to be a significant factor: the survey found that 36% of those with a secondary education and higher were DFS users – the highest of any group. In addition, 10% of those with a secondary education had used the Internet to pay bills or buy something online in the previous year, compared to only 1% using such services in 2014.

The survey also found that the population of debit card users had increased to 9% of the adult population – from 7% in 2014 – although the proportion owning a credit card remained low, at 1%. In terms of debit card ownership, the highest uptake was among those with at least a secondary education (23%). In total, 16% of the adult population had made or received digital payments in the previous year, compared to 9% in 2014. Of those in rural areas, however, only 14% used digital payment services.

Access to DFS and digital client onboarding is limited in rural areas. Efforts to expand agent networks and expand BLB seem to get mixed reviews from stakeholders. On the one hand, recent development sector-led programs in Nepal's banking sector have increased the footprint of physical bank branches and increased the number of trained agents for expanding BLB models. On the other hand, while PSPs seem grateful for agent networks with the potential to extend DFS to rural clients, there is awareness among the providers that often the service provided by such agents is sub-optimal, which then serves as a barrier to attracting new clients: client onboarding is still low in rural areas. According to service providers,[29] low levels of client onboarding are due to a lack of confidence in digital platforms.

Digital transactions less profitable for PSPs in rural areas. Since customers are unable to engage directly with digital platforms, PSPs cannot directly cross-sell them high-value financial products/services. Given the relatively low volume of transactions in rural areas, serving rurally based clients is not as profitable for PSPs as doing business in urban centres.



With the new regulations in place, the third-party managed payment infrastructure has evolved.

Enabling and timely regulations have increased the number of DFS providers. Over the past five years, enabling developments in terms of policy and regulation, mainly initiated by the central bank, have enabled traditional financial institutions and new participants to enter the market, which has increased money flows and settlements. For example, the NRB Act of 2002 and the Nepal Payment System Development Strategy, 2014, define large-value payments, retail payments, overseas remittances, and inter-bank transfers, among other development pathways. The NRB also formed an internal Payment Systems Department. Payment-related institution licensing policies were added in 2016, a Payment and Settlement Act was enacted in 2019, and Payment and Settlement Bylaws were enacted in 2020 (see also Section 2.2).

PSOs and PSPs have proliferated over the past five years. With the new regulations in place, the third-party managed payment infrastructure has evolved. There were 18 non-bank PSPs and 9 non-bank PSOs licensed by the NRB as of mid-January 2021. Aside from these, the NRB has licensed all 27 commercial banks, 19 development banks, and 7 financing businesses to function as payment institutions. NCHL, a PSO, offers a wide range of technology-based payment options for BFIs, with more and more of these solutions being made available via application programming interfaces (APIs). White-label solution[30] providers that provide user-facing platforms for BFIs, on the other hand, have relied on putting on-site servers at BFIs to manage payment solutions and address infrastructure and database difficulties in-house.

Providers are actively pursuing digital innovations and technological integration, often through partnership. The major white-label solution supplier still relies on on-site servers at the client BFI, while NCHL has only recently begun releasing its technological solution as APIs to others. PSOs like the Nepal Payment System (NPS) are looking at more capital-light solutions and integrating API engines into BFIs. Local card networks are also looking for technology enhancements so that they can offer APIs to paying BFI clients[31] for information switching, processing, settlement, reconciliation, and other services. One of the PSOs, Nepal Electronic Payment Systems Ltd (NEPS), is developing a digital payment interface that will provide API rails for KYC and other functions, as well as a digital banking system, which will be an API marketplace for banks' front-end operations.

The technology currently available is limiting provider options: partnership between PSPs and BFIs to provide banking services is limited to payments. PSPs are currently connected to banks for limited functions such as bank transfers, equated monthly instalment (EMI) payments, and fee payments. Currently it is not possible to buy banking products through PSPs, or conduct other banking functions. These constraints reflect the technology available currently: basic payment services are available as APIs from NCHL or the white-label solution provider. The NRB has begun issuing many PSP licenses by lowering the threshold for paid-in capital. However, there is a high transaction threshold requirement and there are strict cyber-compliance requirements to retain the license. Ideally, these conditions will push PSPs to explore highly valuable and profitable business models sooner rather than later.

QR code standards and policies have only recently (2021) been introduced in Nepal. Some PSOs and PSPs are already integrating the QR code technology as a payment option on their platforms. Proactive PSOs have begun expanding this option by waiving fees, and have also been able to develop interoperability with standards in India.

Adoption of digital technology among MFIs (Class D), cooperatives, and savings groups is poor. No MFI yet has a PSP license and MFIs must rely on existing infrastructure of PSOs and PSPs to improve their internal processes and extend some digital transaction channels to their clients. For example, some MFIs are using NCHL's Corporate PAY service to effect management/settlement of their accounts, or allow their clients to make loan payments through eSewa. However, SACCOs, given their existing structures, present too high a compliance risk for PSOs and PSPs to systematically onboard them and their clients; that is to say, a number of regulatory and structural issues need to be addressed before PSOs and PSPs can successfully onboard cooperatives and savings groups. The NRB could do more to help MFIs develop digital services.

Use of digital payments for other sectors is limited. More people have started to use DFS for making payments to financial institutions (e.g. fees, EMIs, loan payments, insurance premium payments), for conducting brokerage transactions, and even for paying government taxes. However, in e-commerce, levels of adoption of payment are not high. Even the biggest e-commerce player in the country does aggregated settlements. There is not enough banking sophistication in the market to allow for escrow-based settlement, which could perhaps accelerate e-commerce adoption and digital payment. In addition, among other limitations, businesses are still unable to make pull payments (triggered by the payee rather than the payer).

Payment ecosystem has hugely benefited from participation of new players. Subsequent to MAP 2016, many new players have entered the payment ecosystem, and the value chain has strengthened as a result. For instance, Fonepay is the dominant white-label solution provider to banks (rather than an issuer processor), that has also been trying to acquire merchants with QR codes. On the other hand, mobile wallets such as eSewa, Khalti and other PSPs are largely customer facing. Remittance players largely serve retail customers, unless they are part of a bank. A POS gateway would provide a single gateway for merchants to accept payments from different service providers, and could therefore benefit all ecosystem players:

- NCHL is fast becoming the central network for all BFIs and external card networks to plug into, and as part of the process the central bank is developing a National Payment Gateway.
- PSOs such as NEPS started with a consortium of banks to provide customers with readymade solutions for card issuance, connectivity, and settlement.
- POS gateway providers such as SCT Nepal provide a shared network of ATMs and POS machines to BFIs. They also issue SCT-branded cards in partnership with commercial banks.
- Along with SCT, NIBL, a commercial bank, maintains a proprietary network of ATMs and POS machines. The National Payment Network is also issuing its own brand cards. With the recent merger of NIBL and Himalayan Bank, a commercial bank with a powerful payments network is set to emerge.

PSPs mention the need for support in customer onboarding. There is a strong affinity for cash among Nepalese people, and DFS providers mention consumer trust levels, and transaction limits by the NRB, as crucial factors for increasing transaction volume and value. While the issue of transaction limits must be addressed by the NRB's payment department as it starts building more capabilities and sophistication, the issue of consumer trust will need to be addressed by business sophistication and evolution; whoever offers the lowest customer acquisition cost will win.

Digital KYC and authentication services are still slowing customer onboarding and network security. DFS service providers highlight lack of robust digital KYC and authentication options as impediments to digitisation in financial services. For example, full virtual bank account opening is not yet possible. Additionally, there

There is not enough banking sophistication in the market to allow for escrow-based settlement, which could perhaps accelerate e-commerce adoption and digital payment.

are regulatory limits on digital/online transactions. Some PSOs are introducing more solutions for banks to make more of their payment and banking functions virtual; eKYC and authentication systems are among the solutions being explored.

Improving use of digital payments rests on several supply- and demand-side factors. Stakeholders emphasise the supply-side improvements needed for lowering customer acquisition costs: for example, expanding digital literacy levels, improving consumer trust in digital transactions, allowing operationally cheaper e-KYC options, and removing restrictions on wallet providers. Stakeholders also highlight demand-side bottlenecks that need addressing, such as paying out interest on wallet balances, allowing sale of financial products through e-wallets, introducing features and regulation for B2B payments and pull payments, and introducing digital signature for authentication.

The NRB has mandated NCHL to explore the feasibility of introducing a national switch to allow interoperability between local card networks. NCHL will then focus on establishing interoperability of PSPs and QR code providers. However, this mandate on interoperability doesn't seem time bound.

Removing physical cash from Nepal's economy will take time because of the extent of the informal sector, especially among lower-income people. The agent-based banking model, though useful for reaching customers in remote regions, still does not seem profitable for banks or PSPs. Using the social capital of MFIs, cooperatives, and savings groups could theoretically lower customer acquisition costs; in reality, though, as already mentioned, the compliance risks remain too high. Consolidating the network of 40,000 cooperatives through DFS could be a worthwhile task. Yet, with the national payment gateway (for cards, PSPs and QR) being introduced through NCHL, new DFS providers may be able to explore business models that cheaply expand their customer base.

PSPs have limited capabilities. Though mobile payments levels have increased during the pandemic, and QR codes have been introduced for merchant payments, PSPs still face challenges in onboarding more users and improving transaction volumes. For example, many e-wallet operators face restrictions on transaction sizes and volumes. PSPs are also not permitted to provide banking services, while FDI is not allowed in finance companies, even if they are non-deposit taking. Furthermore, very few banks have yet adopted an open API back-end architecture or are considering partnering with PSPs beyond payments. PSPs are not yet helping banks on the asset side of their balance sheet such as helping extend product reach.

The payment ecosystem is in its infancy. Existing regulations and the relatively undeveloped state of the payment ecosystem are hindering PSPs in introducing higher-value DFS services that resemble more of a BFI's product range. PSPs mostly facilitate payments, yet there are few options in this regard given limits on BFIs, merchants and vendors in terms of making B2B payments and sending pull payments. Solution providers have introduced some B2B payment-related products but pull payments have not yet been introduced anywhere in Nepal.

4.6

Market for remittances

Despite its small size, remittance receivers group in MAP 2016 were third wealthiest target market segment. In the previous MAP study, remittance receivers were one of six target market segments considered. While this group constituted only 11% of the adult population, making it the second smallest of the target groups, and comprised mainly women with relatively low education levels, it was remarkable for being the third wealthiest of the six segments.

Growth in remittance income post-MAP 2016 has decelerated. While remittance income showed a significant annual growth rate of 22% during the last MAP study review period (from 2010/11 to 2014/15), during the past five years remittance income has seen marginal average annual growth of almost 6%: remittances have been declining relative to GDP, from just over 25% of GDP in 2015/16 to just over 22% of GDP in 2019/20 (see Figure 8).[32]

The US Dollar's appreciation by almost 13% against the Nepali Rupee in the same five-year period has had the effect of increasing the total value of remittance amounts flowing in – but in the context of actual remittance stagnation. The contraction in the Indian economy has also dampened remittance in Nepal: the average contribution of remittances from India over the past five years is almost 13%.

Remittance income showed a significant annual growth rate of 22% during the last MAP study review period.

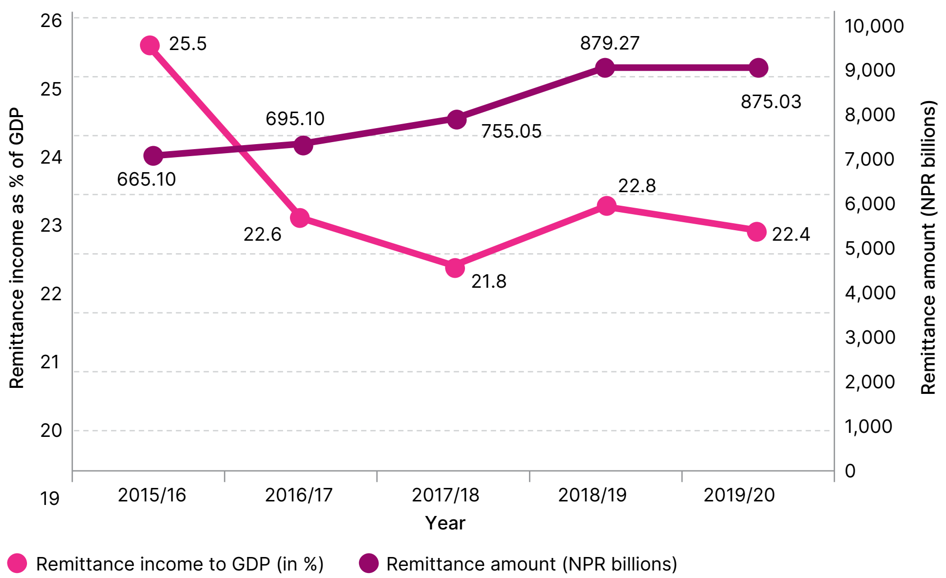


Figure 8: Remittance growth and income as percentage of national GDP (2015/16–2019/20)

Source: Constructed by author using NRB data (2021c)

Given already stagnant remittance growth post-2016, the COVID-19 crisis only marginally affected remittance growth: in FY 2019/20 remittances fell only marginally, by less than 1%.

Lower departing-migrant numbers have put downward pressure on remittance. A gradual decline in the number of outbound migrants has been the primary factor in the remittance growth deceleration; in the period from 2016 to 2020, the number of outbound migrants showed a cumulative decline of 5%. In the context of already decreasing migrant numbers, the COVID-19 pandemic caused the number of departing migrants to fall by 36% in FY 2019/20. By the end of the first eight months of FY 2020/21, only 33,161 migrants had been approved for foreign employment.

Domestic remittance receiver numbers have also decreased. According to the 2017 Findex Survey, just 26% of the adult population had sent or received domestic remittances in the preceding year, compared to 29% in 2014. Furthermore, in 2017, only 33% of remittance users with a secondary education and above had sent or received domestic remittances in the previous year – down from 42% in 2014.

According to the 2017 Findex Survey, just 26% of the adult population had sent or received domestic remittances in the preceding year, compared to 29% in 2014.

The 2017 study also found that only 19% of the adult population had received domestic remittances in the previous year – down from 24% in 2014; and the percentage of rural residents receiving domestic remittances had similarly decreased: from 24% (2014) to 19% (2017).

More than a quarter of remittances used for savings. According to a study[33] conducted by the NRB in 2019, of the remittance received: 28% is used for savings; just over 25% is used for loan repayments; almost 24% goes on daily consumption; almost 10% is used for healthcare and education; 3% goes on social activities; and just over 1% is used for productive activities. In 2011, the Nepal Living Standards Survey 2010/11 indicated that 56% of Nepali households receive remittances.[34] The NBR's 2019 study indicates at least 64% of the households receiving remittance have a formal bank account. The higher savings mobilisation due to remittance correlates with an increase in formal deposit mobilisation: the total deposit mobilisation by banks had risen to 94% of GDP in FY 2017/18, compared to just over 79% of GDP in FY 2015/16.

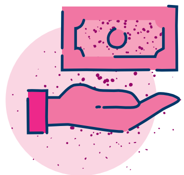
Central bank's 'Retail Payment Strategy' aims to reduce cost of remitting and improve digital payment services. In 2019, the central bank introduced its Retail Payment Strategy, which focuses on creating an enabling framework for the development and widespread use of digital payment services in Nepal. A key component of the strategy is facilitating digital payment channels so that a remittance receiver can receive the funds directly into a transaction account. The proposed measures are expected to reduce the cost of remitting funds and also facilitate migration from cash to non-cash modes of payment.

Mobile wallet providers have started to roll out remittance services. Major mobile wallet companies (e.g. Prabhu Pay, Ime Pay, and eSewa) have begun to offer remittance services. These platforms now enable mobile wallet users to instantly receive money transfers (local and international) into their mobile wallets. In addition, in an effort to encourage and maintain wallet balances, some digital wallets now offer interest on wallet balances, and wallet holders can now easily link their bank accounts to their mobile wallets. These services are projected to draw remittance receivers into using formal financial services, particularly in remote rural areas with limited access to physical banking services.

Agents and full cash-out still favoured over bank accounts. Currently, almost 80% of remittance receipts are through formal agents, while only about 20% of remittance is received via bank accounts (of which only about 1% is received via mobile wallets). The remittance received via agents is immediately cashed out, which means the funds are not retained in the formal channel (bank account).

As per the 2017 Findex, the number of users who received or sent domestic remittances using an account increased to 28% (from 16% in 2014). And the usage of in-person and in-cash remittance decreased significantly, from 65% in 2014 to 42% in 2017, indicating increased reliance on formal channels for sending and receiving remittances. Nonetheless, in 2017 only 2% of domestic remittance receipt was via mobile phone (and this had obviously not existed as an option in 2014).

Remittance cost gradually decreasing but cost of remitting lower amounts should be reduced. The global cost of remittance was 6.8% in the first quarter of 2020, which is far higher than the SDG goal of 3%. For Nepal, the average cost of remitting up to USD 200 is 4.3%, while the cost of remitting up to USD 500 is 2.9%.[35] The cost of remitting is slightly higher to Nepal compared to remitting to the country's neighbours India and Bangladesh. As per the central bank,[36] if the cost of remitting up to USD 200 can be decreased (especially from the Gulf countries), this will further support formal remittance transactions. Remittance inflow from India has seen a positive growth as the cost of remitting in the India–Nepal corridor is among the lowest in the world and below the SDG target of 3%.



80% of remittance receipts are through formal agents, while only about 20% of remittance is received via bank accounts.

PART 4 NOTES

1 Department of Cooperatives, 2020
2 NRB, 2019a
3 WB, 2017b
4 NRB, 2021d
5 MAP Refresh Nepal 2021 stakeholder consultations
6 Sakchyam Access to Finance Nepal, 2020
7 Investopaper, 2021a
8 Singh, 2021
9 The Rising Nepal, 2021
10 NRB, 2020b
11 FinMark Trust, 2014
12 MOF, 2020
13 IB, 2019
14 IB, 2021a
15 IB, 2019
16 MoF, 2021
17 MoF, 2021
18 IB, 2020a
19 IB, 2021b
20 Ghimire, 2017
21 Merolagani, 2021
22 Investopaper, 2021b
23 MEFIN, 2020
24 MEFIN, 2020
25 IB, 2021b
26 Ranabhat, Subedi, and Karn, 2020
27 SSF, 2020
28 New Business Age, 2021
29 MAP Refresh Nepal 2021 stakeholder consultations
30 A white-label product is one produced by one company that other companies (i.e. marketers) rebrand to make it appear as if they had made it. The name derives from the image of a white label on the packaging that can be filled in with the marketer's own branding. White-label products are sold by retailers with their own trademark but the products themselves are manufactured by a third party.
31 NEPS is building a digital payment interface (to provide API rails for KYC and other functions) and a digital banking system (an API marketplace for front-end function for banks).
32 NRB, 2021c
33 Bista, 2020
34 CBS, 2011a
35 WB, 2019c
36 NRB, 2019a

5

Economic sectors that can drive growth and employment

5.1 Introduction

Financial inclusion can only do so much in directly supporting the alleviation of Nepal's key social challenges. Ultimately, economic growth is needed to address employment creation, which in turn positively impacts on most of the social issues highlighted in this refresh report. Nevertheless, financial inclusion has a vital role to play in supporting the real economy, thereby contributing to growth.

Such support should be targeted at sectors considered to have the potential to amplify employment creation and economic growth, thereby maximising financial inclusion's impact on poverty reduction.[1]

Services sector now Nepal's largest economic sector. Nepal's structural economic change has consisted of a shift from agriculture to services, rather than from agriculture to manufacturing as shown by many countries that have experienced transformational growth. For instance, South Korea, Thailand and, more recently, Viet Nam, demonstrated a sustained acceleration of investment and export expansion, and an increased share of high-value-added goods in the export basket, resulting in exponential growth in per capita income. The tertiary sector (services) in Nepal is now the largest sector in the economy: its share of GDP rose from 26% in 1980 to over 58% in 2019.[2]

Nepal's structural economic change has consisted of a shift from agriculture to services, rather than from agriculture to manufacturing as shown by many countries that have experienced transformational growth.

Stagnation of secondary sector has severely hindered real economic growth and exports. In its growth process, the services sector has leapfrogged over the secondary sector (which includes industries and manufacturing), and this has had a negative impact on real growth in the economy and on exports. Nepal's exports are concentrated on a narrow and low-value product base and rely on a limited number of trading partners, which has made the country vulnerable to changes in global demand. Declining export levels combined with increasing import levels have led to a staggering trade deficit that continues to widen.

Agriculture and manufacturing selected as priority financial inclusion focus sectors. Agriculture and manufacturing have been selected as sectors where financial inclusion can support real economic development (see Table 9). The selection of agriculture (primary sector) and manufacturing (secondary sector) as focus sectors is based on: (i) their current and potential contribution to GDP,

(ii) their current or potential contribution to employment creation and livelihoods support, (iii) their inclusion in the periodic plans of Nepal, including the Fifteenth Five-year Plan and (iv) their links to the UN SDGs.

Table 9: Key economic sectors that can drive growth and employment

SECTOR[3]	CONTRIBUTION TO GDP (2019/20)	AVERAGE GROWTH RATE (2016–2020)	PROPORTION OF TOTAL FORMAL BUSINESS ESTABLISHMENTS	FIFTEENTH FIVE-YEAR PLAN	UN SDGs
Agriculture	27.70%	3.85%	2.62%	Yes	2 Zero Hunger 8 Decent Work and Economic Growth
Manufacturing	5.70%	5.86%	11.27%	Yes	8 Decent Work and Economic Growth 9 Industry, Innovation and Infrastructure

Source: Author

Lower-growth agriculture is highest contributor to GDP and highest-employment sector. As shown in Table 9, the agriculture sector is the highest contributor to the country's GDP, despite having a lower growth rate. In addition, the majority of rural adults remain employed in this sector. Supporting this sector, therefore, means not only strengthening the largest sector in terms of contribution to GDP but also helping to safeguard the livelihoods of a large proportion of the vulnerable population.

Stagnant manufacturing is low contributor to GDP. By contrast with agriculture, the manufacturing sector's contribution to GDP stands at a mere 5.7%.[4] However, given the structural composition of Nepal's economy, strategic intervention in this sector has the potential to make a big and positive impact on both economic growth and employment creation.

Both the agriculture and manufacturing sectors have been prioritised by government's five-year plans (among other policies).

SMEs identified as priority financial inclusion segment based on ubiquity and employment contribution. SMEs in Nepal span the different sectors, including the agriculture and manufacturing sectors, but the majority of SMEs (54%) are in the wholesale and retail trade sector[5]. Financial exclusion is often cited as the biggest constraint for SMEs; therefore, including SMEs as a priority segment based on both their existing and potential economic and employment contribution increases the potential for achieving real economic impact.

Investment in infrastructure and utilities has vital support role for agriculture, manufacturing and SME development. The priority sectors (agriculture and manufacturing) and segment (SMEs) will be unable to achieve significant growth unless the supporting infrastructure (e.g. transportation, energy) is improved; thus, it will be necessary to invest in improving supporting infrastructure and services.

5.2 Agriculture

Agriculture sector of vital importance – including for livelihoods support from informal employment. As of 2019, just under 80% of Nepalis lived in rural areas,[6] with agriculture serving as their primary source of income. Although the agriculture sector is declining, as already discussed, Nepal remains a predominantly agrarian country, with agriculture still contributing almost 28% to GDP,[7] and remaining the highest source of employment at 66% of the population.[8]

However, the agricultural employment figure includes an extremely diverse array of quality of employment: everything from subsistence to (small-scale) enterprise farming, and wage-employment that is seasonal and part-time to permanent.[9] As a result, only a fraction of those employed in the agriculture sector are included in the official labour force. This explains why, despite the proportion of the population that is formally employed in agriculture decreasing over time, the absolute number of people employed in the sector continues to grow. The agriculture sector also contributes to social welfare and human development and is an important source of food security. Agriculture is thus a key sector both for alleviating poverty and supporting survival and livelihoods at the individual and household levels, and as part of the primary sector with the potential to feed into long-term economic growth by contributing more substantially to GDP and employment creation.

As of 2019, just under 80% of Nepalis lived in rural areas, with agriculture serving as their primary source of income.

Land is a challenging factor in improving agriculture and boosting the economy. Given the availability of agricultural land, and the high number of people involved in farming in Nepal, increasingly the majority of farms are fragmented, tiny smallholdings. In fact, almost 53% of Nepal's land holdings were less than half a hectare, compared to just over 40% in 1995.[10] Such land fragmentation undermines productivity.

Declining agricultural production attributable to land fragmentation and continued prevalence of subsistence farming. The prevalence of land fragmentation, the high number of small land holdings and the predominance of small-scale subsistence farming make increasing agricultural production very challenging. For example, land fragmentation militates against achieving economies of scale, while the predominance of subsistence farming means it is very difficult to improve agricultural inputs (seeds and fertilisers) and mechanise farm operations to any meaningful extent. The small size of land holdings means that traditional wooden tools and implements (e.g. wooden ploughs and sickles, and animal-drawn implements) are still being used.

Land fragmentation and subsistence farming trap people in reinforcing cycles of poverty. Land fragmentation and subsistence farming are coping strategies in response to circumstances in Nepal, rather than representing pathways out of poverty.[11] Land fragmentation (driven by population growth), the division of land between siblings as a result of inheritance (or the division of land during conflicts), and the country's unadjusted land tenure system all result in different people owning fragments of land. Given the lack of alternatives for generating a livelihood, people are essentially locked into farming despite this fragmentation, although it results in additional time spent on farming, which has the effect of raising labour and fertiliser costs and limiting the use of agricultural machinery. This, in turn, has led to a decline in productivity while deterring people from making further investments to potentially improve yields in the future.[12] Furthermore, low productivity results from primitive farming practices that include reliance on favourable weather, a lack of mechanisation, a lack of high-quality inputs such as seeds and fertilisers, and practices of land fallowing and land abandonment.

Agricultural imports at all-time high, despite local production. Despite the population's high levels of involvement in farming, the country displays high levels of dependence on food imports, which exceed exported food commodities by a factor of six.[13] Spending on food imports increased by 62% in the five-year period from 2016 to 2021, and the trend is alarming: 80% of the grains consumed in Nepal are imported, and even crops like rice, dal and vegetables that are farmed extensively in the country are imported. Despite the abundance of livestock and aquaculture in the country, substantial amounts of poultry are imported as well. Similarly, Nepal imports tea and coffee in spite of producing world-renowned tea and coffee. Increases in agricultural imports are attributed to insufficient domestic production and consumers' changing consumption patterns away from traditional staple food items to more quality products.

Diverse cash crops and livestock used to hedge against uncertain weather conditions. Nepal's agricultural sector is heavily dependent on the annual monsoon rains. Nepali farmers grow diversified crops in order to hedge against erratic and uncertain weather and other unfavourable agronomic conditions. Rice, maize, millet, wheat, barley and buckwheat are the major staple food crops. Cash crops (e.g. potatoes, oilseeds, tobacco, sugarcane, jute and cotton), and pulse crops (e.g. lentils, gram, peas and soybeans) are cultivated in Nepal. The country is also famous for its orthodox tea, large cardamom (also known as 'Nepal cardamom'), turmeric and ginger. Farmers grow a variety of fruits and vegetables: apples, walnuts, oranges, limes, lemons, peaches, cucumbers and leafy vegetables. Livestock is also an important source of cash income for farm households, where farmers sell milk, cheese, chhurpi (sundried cheese), ghee, meat, eggs and poultry. Roughly 70% of households in Nepal keep some type of livestock, including cows, buffaloes, pigs and chickens.[14]

Government prioritising agricultural productivity through subsidies and policies. Agriculture remains a focus area for government and international donors alike. The GoN is developing policies and programs and increasing spending on agriculture, with the aim of stimulating employment creation, boosting productivity/efficiency, supporting profitable commercialisation, and increasing the country's economic competitiveness. Government is also subsidising inputs such as seed, agricultural tools and equipment, and fertilisers, and in remote areas has been providing subsidies for food transportation as well. Related policies include installation of weather radars, establishment of land banks and promotion of cooperative farming. Through engaging with the private sector and contract farming, the government aims to move towards commercialisation of agriculture, which has been on the increase in recent years. Mechanised and commercially oriented farming can absorb significant amounts of labour and transform agriculture into a lucrative employment opportunity.

Local agricultural products being supported by private sector markets, but exports not yet leveraged. With the aim of providing a marketplace for local agricultural products, homegrown chain stores such as Bhatbhateni Supermarket and KK Mart have started getting into the agricultural supply chain. They engage with traders to provide local artisanal products on the shelves of the department stores. This at least allows farmers to promote their products in the country's urban markets, if not in international markets. Furthermore, multiple buyers are pursuing joint ventures and partnerships with farmers and agricultural cooperatives to co-invest in joint storage and processing facilities.[15] However, given the growing global demand for agricultural exports – thanks to a growing middle class as well as the impact of climate change – Nepal can do more to leverage favourable trade agreements to increase agricultural exports.

Multiple buyers are pursuing joint ventures and partnerships with farmers and agricultural cooperatives to co-invest in joint storage and processing facilities.

Climate-smart agricultural practices and mechanisation can support growth. Promoting climate-friendly agriculture practices is one of the strategies set out in Nepal's Nationally Determined Contribution (NDC).[16] Policies related to climate change adaptation focus primarily on the implementation of better agricultural practices and technologies, livelihoods diversification and capacity-building activities, in addition to promoting green technologies and reducing carbon emissions. To leverage the green revolution as a way to increase food production and its related processing, there is a need to improve the quality of seeds and to mechanise agriculture by increasing reliance on advanced technology. In addition, there is a need to develop processing capability and manufacturing hubs, develop infrastructure to bring products to market, tackle trade barriers and improve tax incentives, gain clarity on land rights, and increase access to financing for farmers.

Sources of finance for agricultural practices

Finance is a key driver of agricultural development, as it allows farmers and agribusinesses to improve production efficiency and adopt improved technologies. Realising the importance of investment in the agriculture sector, the central bank initiated the PSLP, which requires BFIs by FY 2022/23 to allocate 15% of their loan portfolio to the agriculture sector.

Formal and informal sources used for agricultural credit. In Nepal, the credit source for agriculture includes both the formal and the informal. The main sources of non-institutional financing are moneylenders, landlords, traders, and private borrowings (e.g. family and friends). In rural areas, it is often seen that moneylenders and landlords are the key providers of credit to farmers, due to the combination of ease of access and minimal documentation requirements.

The main formal sources of credit include commercial banks, MFIs and cooperatives. NGOs and other financial institutions such as private equity firms also sometimes lend to the agriculture sector. The central bank encourages banks to open rural branches through providing them with an interest-free loan for that purpose.

The central bank encourages banks to open rural branches through providing them with an interest-free loan for that purpose.

Farmers and agricultural service providers struggle to access formal credit. Despite credit services being widely available in principle, actually accessing a formal loan remains a challenge for a number of reasons, including smallholder farmers' lack of technical skills to produce a product that would allow them to apply/pay back the loan, and the ways loans are structured. Most farmers and agricultural service providers fail to access financial services and instruments because of BFIs' lack of understanding of the sector, poor quality of collateral on the part of applicants for credit, and inadequate documentation, and BFIs' unwillingness to lend to small borrowers due to high transaction costs. In addition, many loan products have payment terms (e.g. payment schedules and maturity) that do not match with the agricultural crop calendar and, hence, can create cash flow problems for smallholder producers.

Government subsidy driving agricultural insurance provision. In Nepal, agricultural insurance is recognised as a specialised scheme that falls under the purview of the non-life insurance business and now comprises 10% of total insurance business.[17] As discussed in Section 5.4, livestock insurance policies comprise 95% of the total sum insured and the remaining 5% is crop insurance. To stimulate low-income farmers to participate, the government subsidises 75% of the premium (an increase from 50% in 2014). The development of agricultural insurance, including revisions in processes for crop and livestock policies and developing production-oriented insurance policies, has been successful in increasing the uptake of agricultural insurance. There have also been increasing interactions between various local-level institutions and related organisations, as part of awareness campaigns aimed at increasing the uptake of agricultural insurance.

Support and coordination between development and financial inclusion projects. An integrated interest subsidy guideline was published in 2018 by the MoF to provide loans to multiple target audiences, with the provision being that if the loan is paid back in time the government will reimburse 6% of the amount. Development programs such as SAMRIDHI and Sakchyam also work with cooperatives and MFIs to improve loan provision. They have played pivotal roles in introducing innovative financial products like warehouse receipt financing, thereby encouraging farmers to increase their agricultural production.

5.3 Manufacturing

As the scope of labour absorption in agriculture is limited, it is important to diversify to a strong manufacturing base to improve productivity and generate more and higher-paying jobs.[18] The manufacturing sector represents a major portion of industry in Nepal, making its development crucial for generating employment, promoting value-added trade, enhancing income growth and alleviating poverty.

The manufacturing sector also offers economies of scale, technological progress, output growth, productivity, positive spill-over effects and efficiency in terms of use of resources (compared to the agricultural sector, for example).[19]

Manufacturing sector characterised by low-technology, labour-intensive manufacturing products. The manufacturing sector has a gross-value added (GVA) of 5.09%, with an average growth rate of 5.86% for the period from 2016 to 2020, and can be broadly classified into three sub-sectors: fast-moving consumer goods (FMCG), industrial goods and consumer goods. The sector is characterised by low-technology, labour-intensive manufacturing products – e.g. fabricated metal products, grain mill products, vegetable oils and fats, food products, non-metallic mineral products, plastic, beverages, tobacco, and textiles – which account for more than 80% of manufacturing value-added.[20]

Special trade agreements in place – but limited benefits for Nepal thus far. The country is part of bilateral and multilateral trade agreements, including the South Asian Free Trade Area (SAFTA), Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC), and Indo-Nepal Trade Treaty. The Nepal-India bilateral trade agreement grants Nepal preferential market access, including zero tariffs on all products except for tobacco, zinc, vegetable ghee and acrylic yarn. The agreement also sets a lower value addition of 25% compared to the World Trade Organisation's 30%, to comply with country-of-origin requirements, often resulting in a trade preference to export to India. This is further solidified with additional incentives Nepal gives to increase exports to India, which include cash incentives of almost 5% on total export value for all fabricated skills and metal products, and indirect subsidies such as tax rebates, discounts on purchase of raw materials and discount on operating expenses (e.g. electricity) to manufacturing industries. However, even though Nepal is part of these special trade agreements, it has not been able to extract the full benefit from them.

Nepal is part of bilateral and multilateral trade agreements, including the South Asian Free Trade Area, Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation, and Indo-Nepal Trade Treaty.

Manufacturing sector's contribution to GDP has steadily declined. Nepal's manufacturing sector has not performed as the engine of growth that it should be. The country's manufacturing base seems to be vanishing, with manufacturing's contribution to GDP steadily declining from 8.8% in 2000/01 to 5.7% in 2019/20.[21]

High levels of remittance and imports have crippled the manufacturing sector. By contrast, other sectors – transport, storage and communications, and financial intermediation – increased their shares in the economy over the years. This pattern could be attributed partly to remittance-fuelled investment in construction and services such as real estate. In recent decades, growth in total factor productivity (TFP) has accounted for a minuscule fraction of GDP growth. Given diminishing returns to capital, such accumulation-led growth is not sustainable in the long term. Moreover, Nepal has a low rate of investment, and a particularly low rate of public investment.[22] The remittance-driven nature of the economy and the high levels of imports have crippled the manufacturing sector, with key focus shifting towards wholesale and retail trade.

The country's manufacturing base seems to be vanishing, with manufacturing's contribution to GDP steadily declining.

Development of special economic zones for export-oriented industries. The GoN has developed special economic zones (SEZs) to cater to export industries that intend to export at least 75% of production.[23] Such industries can be established in an SEZ once the prescribed capital has been invested and permission obtained from the Special Economic Zone Development Committee under the Ministry of Industry. Industries that operate in SEZs are eligible for 50% tax exemption for the first five years. In addition, company registration, tax registration, banking, insurance, freight forwarding, issuance of a certificate of origin for export, and other administrative formalities are provided in these zones through a one-window service. Furthermore, in the SEZs, manufacturing firms enjoy incentives such as zero VAT rates available for goods or services traded among entrepreneurs operating within the SEZ; exemption from tax on dividends for the first five years; exemption from customs duty on raw materials; and discount of 50% (year one), 40% (year two) and 25% (year three) on rent or lease payments for the first three years of establishment.

The country's few large manufacturing enterprises are focused on construction materials. A mere 0.7% of Nepal's manufacturing enterprises can be categorised as large enterprises, in terms of number of people employed.[24] The larger manufacturing enterprises are concentrated in the production of construction materials like metal and metal products, cements and bricks. Mainly due to the country's increased infrastructure projects, the cement industries have reported a surge in sales. In addition, Nepal Trade Integration Strategies (NTIS) has identified iron and steel products as export-priority products having competitive advantage.

In manufacturing, small firms dominate. The manufacturing sector is dominated by small firms, which account for almost 98% of manufacturing establishments. Furthermore, almost 53% of the employees employed in the manufacturing sector are employed by small industries.[25] In Nepal, small enterprises are crucial to improving the productivity and capacity of the industrial sector, given that most of the larger enterprises are in the construction sector. It is safe to say that the creation of quality employment in the manufacturing sector is more likely to come from the development and promotion of small-scale industries.

Manufacturing is a lucrative sector for employment. In terms of employment generation, the manufacturing sector ranks the highest.[26] In a country where the contribution of agriculture to total GDP is fast decreasing (from 37% in 2000 to almost 28% in 2020), manufacturing jobs are considered ideal for workers transitioning out of agriculture, as service jobs require a higher level of educational qualification.

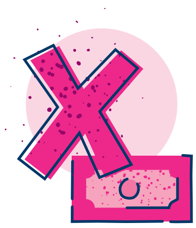
In terms of employment generation, the manufacturing sector ranks the highest.

Export-focused manufacturing is prioritised. The manufacturing sector in Nepal is undergoing a structural change, moving towards more basic, export-oriented industries.[27] To graduate to lower middle-income country status, Nepal must accelerate trade and investment by diversifying into higher value-added export products (e.g. promoting the manufacturing industries) and by diversifying export destinations.[28] The GoN's developing of SEZs aims to cater for export-oriented industries and develop the competitive advantage of products in the country's export basket. In addition, the country's Industrial Policy 2010 lists agriculture, forest-based industries, ayurvedic and homeopathic medicine manufacturing, minerals, and handicrafts as priority industries, which also constitute the majority of the country's exports, while the Special Economic Zone Act, 2016 aims to promote export-oriented industries and increase the competitiveness of export-oriented goods and services.

A 2016 research report[29] suggested focusing on the following nine major industries in order to support the industrial base and boost the export potential of Nepal: cardamom, ginger, tea, herbal plants, fabrics (including yarn), leather, footwear, pashminas, and knotted carpets.

Need to commercialise and strengthen agricultural value chains – especially with regard to the potential of NTFPs. Nepal is endowed with non-timber forest products (NTFP), also known as Jadibuti, which are increasingly being used as vital ingredients in items such as cosmetics, herbal medicines, and health foods. However, the full potential of NTFPs has not yet been realised, as most of these products are collected and exported to India in an unprocessed form and then resupplied to other countries by the Indian traders. Proper certification mechanisms in terms of setting the quality standard, and enhanced branding and packaging and other aspects of commercialisation through private sector participation could improve the agricultural value chains. Agricultural commodities and agricultural processing have high export potential, and targeted support to agricultural manufacturing could, therefore, improve the entire value chain while increasing the contribution of the agriculture sector.

Light manufacturing thriving – but competitiveness limited by economy-wide cross-cutting constraints. Light manufacturing, which is usually characterised by higher customer orientation and less capital-intensive businesses, is thriving in Nepal. Aside from small-scale food processing, light industry, largely concentrated in southeastern Nepal, includes the production of footwear, tanned leather, instant noodles, jute goods, refined sugar, cigarettes, matches, spun cotton and synthetic fabrics, wool, and tea.[30] Light manufacturing has grown significantly on the back of relatively inexpensive labour, government's favourable policies, and the existence of a domestic markets as well as export potential.[31] However, the light manufacturing sector has not been able to effectively leverage its huge low-wage advantage (minimum wage of USD 90 compared to USD 138 in Bangladesh and USD 239 in Viet Nam); the ease of migration has added to the number of workers migrating to other countries, resulting in a limited supply of labourers in Nepal. Migration is further fuelled by better economic opportunities available to blue-collar or semi-skilled workers when they migrate: for example, a semi-skilled Nepali worker has the chance of becoming a floor manager when they migrate to neighbouring countries or Middle Eastern countries, whereas back home their scope remains limited. Further constraints on light manufacturing include low firm-level productivity, the country's poor basic infrastructure, difficulty accessing land and finance, and the low availability of basic and managerial skills. Furthermore, Nepal's restrictive investment climate and inward-focused industrial policy limit interest from foreign manufacturers in investing in an otherwise lucrative sector.[32]



Nepal's restrictive investment climate and inward-focused industrial policy limit interest from foreign manufacturers in investing in an otherwise lucrative sector.

Development of industrial infrastructure on the rise. Industrial infrastructure is the backbone of manufacturing sector development. A paradigm shift is evident in Nepal in terms of strategies for sustainable development, with the government prioritising infrastructure and development projects across all provinces of the country in the previous two budgets.[33] The budget of 2020/21 allocates 9.41% of the national budget to infrastructure development, which is in line with economists' predictions of a requirement of government spending of 8%–12% of GDP in public infrastructure to bridge the infrastructure gap.[34] The government has prioritised the development of strategically important new infrastructure projects and the completion of ongoing ones, including the construction of roads, civil aviation systems, education, healthcare systems, rail systems, waterways, and telecommunication, information and broadcasting (including electronic media). A notable improvement in terms of industrial infrastructure has been the normalisation of the power supply by Nepal Electricity Authority.[35]

Introduction of Nepal one-window services and e-customs significant progress – but further integration and digitisation required. However, to enable significant growth in the manufacturing sector, border posts need to be improved, as low-quality customs/ports increase the cost of doing business. Investments in border posts need to extend beyond infrastructure upgrades and include improvements to processes through digitisation and automation. The GoN has invested in infrastructure in integrated check posts and an Inland Clearance Depot, as well as digitisation of trade processes at borders. In January 2021, it introduced the Nepal National Single Window (NSW) system that allows the Department of Customs and several government agencies as well as stakeholders involved in foreign commerce to integrate trade procedures and move towards paperless trade: submission of declaration, invoices, and packing list is now done electronically, under e-customs. However, challenges persist, including non-utilisation of digital signatures as these are not yet considered legally binding, and difficulties in synchronisation due to differences in countries' digital platforms. Addressing these challenges would accelerate clearing and reduce risk/losses in the process. Digitisation of value chains and their related processes would undoubtedly significantly improve the manufacturing sector and play a big part in unlocking its potential.

A key obstacle in providing financing to the manufacturing sector is the absence of an effective credit information infrastructure.

Links to financial inclusion

Manufacturing firms' access to financing remains inadequate. Though the vast majority of manufacturing firms in Nepal have access to at least some finance, high interest rates and hefty collateral requirements, among other constraints, prevent firms from obtaining the required financing. Furthermore, the majority of the finance provided is short-term credit, despite the widespread presence of a range of lending institutions: commercial banks, MFIs and cooperatives.

Pressing need to strengthen credit information infrastructure and increase access to long-term credit. Commercial sources are the primary source of external credit to the manufacturing sector. A key obstacle in providing financing to the manufacturing sector is the absence of an effective credit information infrastructure. This has resulted in dependence on immovable assets, particularly land and buildings, as collateral. The lack of a framework for use of movable assets as collateral is also negatively impacting on SMEs. Access to long-term credit is still constrained by limited financial product offerings and the shallowness of the capital market, and access to credit generally is highly correlated with the size of the firm: smaller manufacturing firms' access to finance is much more constrained than is the case for larger firms, in various fields including credit, overdraft facilities, collateral-to-loan ratio, and cheque/savings accounts. Smaller firms rely less on bank credit and more on internal funds to fund their capital requirements. Credit from suppliers and advances from customers are also more important for smaller firms than for larger ones in financing working capital needs.

5.4 MSMEs in Nepal

MSMEs make a significant contribution to the country's poverty alleviation, employment generation, and GDP growth – and with the right support their contribution could have an even greater impact.

The role of MSMEs is also more crucial than ever given the current economic need to increase domestic production of goods and services to avoid the need for high imports, which produced the country's trade deficit. Strengthening the MSME sector is considered central to government's objective of achieving higher levels of economic growth and reducing poverty by generating employment, and is in line with Nepal's vision of graduating from LDC status.

In the context of Nepal, under the Industrial Enterprise Act, 2020, industries are classified into micro, cottage, small, medium and large enterprises on the basis of number of employees and fixed assets, as summarised in Table 10.

Table 10: Definition of industries in Nepal as per the Industrial Enterprise Act, 2020

SIZE	DEFINITION
Micro Industry	• Maximum of nine employees including the investor • Annual financial transaction of maximum amount of NPR 5 million (USD 42,625) • Maximum application of 20 kilovolts of energy • Maximum fixed assets of NPR 2 million (USD 17,050)
Cottage Industry	• Based on traditional skill and technology • Maximum application of 10 kilovolts of energy
Small Industry	• Apart from micro and cottage industry, maximum fixed assets of NPR 150 million (almost USD 1.3 million)
Medium Industry	• Fixed assets of NPR 150 million to NPR 500 million (almost USD 1.3 to just over USD 4.3 million)
Large Industry	• Fixed assets of more than NPR 500 million (just over USD 4.3 million)

Source: Industrial Enterprise Act, 2020

In Nepal, there are 923,356 MSME establishments, employing 3.2 million people and contributing 38% to GDP.[36] Employees are predominantly men, with a male-female employment ratio of 62:38.

SMEs in Nepal are cross-cutting across sectors. SMEs in Nepal are a heterogeneous group of businesses usually operating in the service, trade, agri-business and manufacturing sectors. Most Nepalese SMEs are involved in processing and manufacturing food items, consumer and household goods, and textiles and related products, both for exports and for the domestic market. Agro-food processing attracts a high concentration of SMEs: tea, rice, pulses, oil and flour mills, dairy and milk products, aerated soft drinks, fruit juices and processed products, noodles, biscuits and light snack products. SMEs are also involved in forest fibre-based industries, wooden and metal handicrafts, handmade paper and products, apparel and garments, woollen carpets, pashmina shawls, rugs and leather, as well as in industries such as metal processing, manufacturing of wooden, plastic and metal furniture, polythene pipes, utensils, and jute products. In other words, SMEs are prominent across a wide range of sectors, and vital for private sector growth in the economy. A significant portion of SMEs – approximately 54% – operate in the wholesale and retail trade, which entails reselling activities rather than value-addition.[37]

54%

Approximately 54% of SMEs operate in the wholesale and retail trade, which entails reselling activities rather than value-addition.

Majority of SMEs operate informally, outside official regulated systems. Most SMEs in Nepal are informal enterprises that use simple and traditional technologies and serve limited local markets, employing mainly wage-earning workers. While this informality undeniably offers some short-term benefits (e.g. supporting livelihoods and survival, avoiding administrative hassles including paying taxes), it also comes with many significant disadvantages, which prevent such businesses from accessing resources, information and markets, and undermine their incentive to invest in the skills of their employees. At the same time, the informality of businesses reduces the value added to the economy and the wider society; the tax that would otherwise be derived from these economic activities would be invested back into local administration, infrastructure and services.

Numerous traditional SMEs exists but face significant challenges. In Nepal, SMEs are usually small, family-level enterprises, set up with family savings and run by family members. With 54% of SMEs in Nepal predominantly focusing on the wholesale and retail trade and reselling of goods, their expansionary capacity is limited. In addition, most SMEs produce for and cater only to the local market, with export-oriented SMEs being few in number: most firms' non-labour inputs are sourced domestically and only 1 in 10 firms export. Obstacles to expansion of small businesses include poor quality control systems, inability to meet timely delivery, and limited production capacity. Nepal's relatively small market size, geographical challenges that limit connectivity and market integration, and the low average incomes of Nepali consumers together translate into only modest increases in domestic demand. This stalls expansion plans.

Value-added export products and diversified export destinations key areas for improvement. To graduate to lower middle-income country status, Nepal must accelerate trade and investment by diversifying into higher levels of value-added export products and by diversifying export destinations.[38] However, the country's diversification to date has largely been characterised by manufacturers switching to related products that were within the same garments and agriculture community of products. As a result, Nepali enterprises have failed to build a cumulative mastery of activities needed to diversify into more complex and high-value export products.

Transformative small-scale enterprises can be key growth drivers. Transformative (high-potential/high-impact) SMEs are firms that employ 10 or more people and experience average annual growth in employment or turnover of 20% or more over three years. Compared to subsistence enterprises, transformative enterprises are generally characterised by higher levels of human capital, and higher willingness to take risks,[39] and are innovation driven, creating wealth through expansion. While subsistence/'survivalist' small enterprises are vital for livelihoods support for low-income households, it is the transformative SMEs – often labelled 'aspirational' SMEs – that are able to have a significant positive impact on a country's economic growth.[40]

Experimentation will allow entrepreneurs and enterprises to acquire mastery over a broader range of activities, which will allow Nepal increasingly to diversify and develop innovative products, as a result of which the economy will benefit from enhanced trade and productivity; ultimately this will support the country's efforts to achieve economic transformation. Transformative enterprises in sectors like IT, telecommunications, financial intermediation, transportation, and manufacturing can fuel economic development. They also will facilitate business generation for other companies in the local economy, as they usually start out small with a large part of their cost of goods sold going to other domestic businesses.

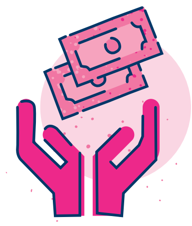
Capital restrictions are obstacle to SME growth. Transformative SMEs in Nepal are handicapped by capital restrictions, particularly in terms of foreign exchange. For example, as a result of capital restrictions, IT companies in Nepal struggle to benefit substantially from the significant outsourcing trend that is playing an important role in bridging the digital as well as economic divides between developed and developing countries.

Dramatic and encouraging changes in the entrepreneurship ecosystem. Over the past five years (from 2016 to 2021), the entrepreneurship ecosystem in Nepal has developed rapidly, with organisations like One to Watch, Anterprerana, NEXT Launchpad Program, the Enterprise Business Accelerator Program, and Slush Global Impact Accelerator all running regular programs. Large private companies like NCELL regularly also support startup weekend events. Increasing access to the Internet and smartphone usage has increased Nepalis' exposure to global business innovations and solutions that are disrupting traditional business models, and global innovative solutions are being replicated and adapted to suit Nepal's context and solve local problems.

Entrepreneurship and digitisation symbiotic and growing. As political stability increases, a paradigm shift can be seen in the number of young people considering entrepreneurship as a career path. A mapping study indicates that more than 400 companies have undergone startup incubation or acceleration programs in Nepal. Furthermore, the startup ecosystem has been propelled onwards by the wave of digitisation resulting from improved access to the Internet and digital payment infrastructure. Sectors across the country are adopting and integrating technology, with the 2019 Digital Nepal Framework having identified eight key sectors: agriculture, health, education, infrastructure, energy, tourism, finance and connectivity.[41]

Links to financial inclusion

Constrained access to finance a significant obstacle to SME development. The total credit requirement of small enterprises (i.e. only SMEs) in Nepal is estimated to be NPR 478 billion (USD 4.3 billion). SMEs' access to finance tends to be more constrained than is the case for larger firms, across services like account holding, credit and overdraft facilities, and collateral-to-loan ratio. The dominance of collateralised lending is a significant obstacle; in the absence of adequate financial infrastructure and lack of credit information in the market, BFIs rely mostly on conventional immovable collateral to extend credit. The provision of granting loans up to only 50% of the collateral value also affects the availability of finance.[42]



Only 16% of startup enterprises have access to capital from BFIs, with the total supply of credit towards the entire MSME sector being only USD 5.4 billion.

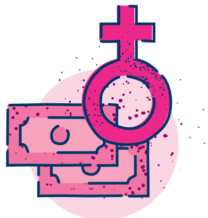
In addition to these mandatory, stringent collateral requirements, insufficient alternative sources of financing and the 'missing middle' problem – in which SMEs have difficulty accessing larger volumes of credit but are too big to benefit from micro loans[43] – are significant obstacles, which usually apply to the transformative SMEs because they tend to fall into the small and medium categories. A study by the NRB found that only 16% of startup enterprises have access to capital from BFIs, with the total supply of credit towards the entire MSME sector being only NPR 605 billion (USD 5.4 billion).[44] Transformative SMEs can benefit from the startup investor ecosystem, which is starting to flourish in Nepal.

Nepal has seen the development of alternative sources of financing. Entrepreneurs in Nepal can benefit from encouraging growth in the startup ecosystem, in which impact investors, private equity and VC funds are steadily becoming more of a feature. In terms of investments in the startup ecosystem, a few offshore PEs and VC firms – Dolma Impact Fund, Business Oxygen, and One to Watch – have been operational in Nepal for the past few years. The number of domestic funds has also grown: True North Associates, I-Capital, Team Ventures, and Safal Partners. And the younger generation of investors, belonging to large business houses with sizeable capital, business knowledge, and risk-taking capacity, are turning into angel investors and investing in such startups. Finally, development partners are also active in this domain and have a number of initiatives aimed at creating conducive frameworks and conditions for developing the entrepreneurship ecosystem in Nepal. Though the development of alternative sources of finance is commendable, their role in boosting SMEs can be further enhanced.

Role of MFIs and SACCOs in promoting MSMEs. Nepal's microfinance sector has been servicing micro-entrepreneurs and the poorer segments of the population. MFIs have been working to fill the gap of credit available to MSMEs, particularly in rural areas, through the deprived sector lending directive. MFIs and SACCOs, both of which tend to focus on serving their immediate local community, are widespread. These institutions, particularly SACCOs, provide credit to members and have a broader scope of collateral than is the case with BFIs. SACCOs are more lenient in terms of eligibility and collateral requirements and are more immediate with their processing. They also offer flexible repayment schedules, which is another reason for their popularity, especially in the rural areas (given the constraints of the agricultural crop calendar). However, SACCOs often turn out to be costly, as they charge exorbitant interest rates from their borrowers.

Village savings groups support low-income saving and borrowing. Rural areas also benefit from village savings groups, which are self-selected groups of people who belong to a particular community. Members pool their money into a fund on a regular basis, often daily. The amount and frequency of contribution is determined by mutual consent among members. Members of the group can borrow from the savings fund, and the money is repaid with interest, causing the fund to grow. Village savings groups fulfil the need for small, local pools of capital to satisfy households' cash management needs.

Lack of gender-disaggregated data serves as a barrier to affordable credit for women-led SMEs. As per the NRB, BFIs are required to submit data pertaining to the number of clients, outstanding loans, total savings, capital and assets, among others – but not on the basis of gender. This prevents the identification of gender-related issues, recognition of women's needs (as per their social and economic background) and the impact of existing products on them. As it is not a common practice among BFIs to collect and analyse gender-disaggregated data, there is a paucity of information to influence the design of women-centric and/or gender-sensitive products. Likewise, the tedious internal procedures, poor digital infrastructure and limited technical capacity of BFI employees for data analysis and understanding of gender-based needs and differences make it difficult to ascertain gender-disaggregated data. This is a major constraint to designing policies that respond to the limitations placed on women in accessing credit. Currently, the financial institutions are not prepared to develop products for low-income segments due to the lack of information about women's financial needs and financial behaviour.[45]



The tedious internal procedures, poor digital infrastructure and limited technical capacity of BFI employees for data analysis and understanding of gender-based needs and differences make it difficult to ascertain gender-disaggregated data.

PART 5 NOTES

1 UNCDF MAP, 2020
2 NRB, 2020b
3 Categorised as per the National Standard Industrial Classification (NSIC)
4 ADB, 2020b
5 UNESCAP, 2020
6 WB, 2021a
7 ADB, 2020b
8 ILO, 2019
9 ILO, 2019
10 MoF, 2014
11 Banskota and Sing, 1991
12 ILO, 2019
13 Prasain, 2020
14 FAO, 2020
15 USAID, 2015
16 Other relevant policies that the GoN has adopted include the National Adaptation Program of Action (NAPA), the Agricultural Development Strategy, the national Climate Change Policy in 2011 (CCP), and the Local Adaptation Plans of Action (LAPAs).
17 MEFIN, 2020
18 ADB, DFID and ILO, 2009
19 IBN, 2017
20 Basnett and Pandey, 2014
21 ADB, 2020b
22 WB, 2018c
23 Special Economic Zone Act, 2016
24 Dahal and Kharel, 2020
25 Dahal and Kharel, 2020
26 MoF, 2020
27 CBS and UNIDO, 2014
28 ADB, 2017
29 MoCIS, 2016
30 Nations Encyclopedia, 2021
31 IBN, 2017
32 WB, 2018c
33 New Business Age, 2020
34 Setopati, 2018
35 New Business Age, 2018
36 UNESCAP, 2020; UNCDF, 2019
37 UNESCAP, 2020
38 ADB, 2017
39 Olafsen and Cook, 2016
40 UNCDF MAP, 2020
41 GoN, Ministry of Communication and Information Technology, 2019
42 beed management, 2019
43 The ‘missing middle’ are those small businesses that are the most significant contributors to economic and employment generation yet struggle to access affordable finance.
44 beed management, 2019
45 AFI, 2016

6 Conclusions and recommendations

6.1 Conclusion and recommendations

While the COVID-19 pandemic has significantly slowed Nepal's economic growth rate, in the period 2016–2019 the country's GDP grew by an average 7.3% annually,[1] mainly as a result of remittance inflow, post-earthquake (2015) reconstruction efforts, and increased public spending on large infrastructure projects.

The strong GDP growth – in combination with government's pro-poor policies and critical reforms targeted at reducing poverty, sustaining economic growth and improving income distribution – contributed significantly to poverty reduction and HDI improvement: the country's absolute poverty rate decreased, literacy rates increased, gender gaps narrowed, and HDI improved to 0.602 in 2020 (2015: 0.583).[2] All of these metrics suggest an improvement in the quality of life of the country's population.

Agriculture, which is the country's largest source of employment in the form of subsistence activity, has seen its GDP contribution steadily declining.

Nevertheless, the pandemic's impact on economic growth in 2020 and the predicted impact in 2021/22 are not the only obstacle to the government's goal of achieving middle-income status by 2030: the country's poor infrastructure and low levels of investment in productivity enhancement remain significant obstacles. Nepal will need to achieve economic growth that is rapid, sustained, and led by exports. But this is a challenge given the sectoral composition of the economy.

The highest-growth sectors (the services sectors), while being where most of the country's small businesses operate, are not otherwise creating employment on any significant scale. Agriculture, which is the country's largest source of employment in the form of subsistence activity (over 80% of the population are in rural areas), has seen its GDP contribution steadily declining. And the industrial sector is underdeveloped and stagnant, meaning there are insufficient market opportunities to stimulate investment, which is detrimental to the creation of trade commodities.

Thus, the agriculture sector requires commercialisation and mechanisation: strengthening the agricultural value chain and delivering competitively priced products in the domestic market will reduce dependence on agricultural imports.

And in order to boost productivity levels and create more and better-paying jobs, the country's manufacturing base also needs strengthening, including by means of products that provide a competitive advantage (primarily in higher value-added export products).

FDI would help to stimulate economic growth, but as a percentage of GDP was only 0.54% in 2019[3] – one of the lowest levels in South Asia. Attracting foreign investment requires a business climate that is friendly to investment, whereas Nepal currently ranks 151st out of 190 nations in this regard.

The country's total labour force has increased post-MAP 2016 but unemployment and labour migration data indicate an oversupplied labour market. While the official unemployment rate is relatively low at just over 11%,[4] nearly 22% of the country's working-age population are working abroad,[5] while 61% of the total labour force are in informal employment.[6]

Attracting foreign investment requires a business climate that is friendly to investment, whereas Nepal currently ranks 151st out of 190 nations in this regard.

The country's small businesses operate across a broad range of economic sectors and contribute significantly to job creation, poverty alleviation and GDP growth in the country. The country's manufacturing sector is dominated by small firms, which account for almost 98% of manufacturing establishments, while almost 53% of the employees employed in the manufacturing sector are employed by small industries.[7] While MSMEs play a critical livelihoods and survival role for the country's population, SMEs – and in particular the transformative SMEs – are central to building up the country's manufacturing base, boosting national productivity and output and increasing employment opportunities. For these reasons, entrepreneurship and the strengthening of SMEs are prioritised both by the GoN and in this study.

Financial inclusion can make a significant contribution to Nepal's growth aspirations at this critical juncture. Financial inclusion mobilises household spending to assist governments in funding development objectives, aggregates and mobilises money, and ultimately increases the availability of domestic capital as a source of investment. It thereby contributes to SDG achievement at the household level, and inclusive economic development in the process.[8]

Financial inclusion is also crucial for addressing the 'missing middle' challenge that often stymies the attempts of even the transformative (i.e. high-potential/ high-impact) SMEs to access finance: they are too large to benefit from micro credit but too small to be a worthwhile business proposition for BFI lending.

While a 2019 study[9] conducted by the central bank estimated financial access (in the sense of having at least one bank account) to be at almost 61% of the adult population (mid-July 2019), by mid-June 2020 financial access had expanded to just over 67%.[10]

Driven by the central bank's commitment to providing at least one financial institution at each local level (i.e. in each of the 753 local areas across Nepal), by mid-January 2021, BFIs had opened 10,187 branches in 750 of the 753 local areas (compared to 3,465 bank branches in 2014). The number of BFI ATMs has also expanded by 114% in the past five years: from 1,985 in 2017 to 4,254 in 2021.

Despite progress, there are far fewer physical access points in rural areas where the bulk of the country's population still live.

Interventions to increase financial inclusion further will need to connect Nepal's high-level financial inclusion aspirations and objectives to individuals' and small businesses' activities and needs in the real economy – in ways that foster job creation and expand opportunity. It will be important to focus on increasing affordability of financial access, including by capitalising on digital opportunities, and on expanding product offerings to meet consumers' – and SMEs' – real needs. At the macroeconomic level there will need to be improved linkage between the high-growth/high-impact formal sectors of the economy and SMEs that are identified as transformative (high-potential/high-impact).

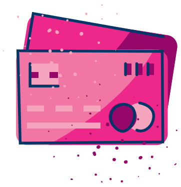
Savings

The savings market in Nepal has improved substantially since MAP 2016. Formal banking service providers have been increasing their provision of financial services through significant expansion of bank branches, ATMs, and BLB centres, as well as through digitisation, resulting in a rise in the number of bank accounts and increase in deposit amounts. While commercial banks dominate the savings market, their services are mostly centred around urban and semi-urban areas. SACCOs have proven to be more suited for catering to the low-income and rural population.

Although the reach of BFIs has been increasing, not much change has been observed in their product range. BFIs had been competing to attract depositors by providing higher interest rates on new savings accounts, but since the NRB intervened, the BFIs have focused on bundling products such as free dematerialised accounts, free insurance products, cheaper loan processing fees, free mobile/Internet banking and debit cards and the like, in an effort to attract deposits. However, despite the apparent variety, these product offerings are actually quite homogeneous across the industry. While medium- to long-term savings products such as one to two year fixed deposits have been growing in popularity, long-term savings instruments have been fairly unpopular with the general public, and uptake of advanced products such as bonds and debentures has been low, due to factors such as low awareness of the benefits they could offer, higher prices, limited trading in the secondary market, and hesitance to lock in savings for longer periods.

Nevertheless, through various policies, regulations and campaigns the federal, provincial and local governments have been playing a huge role in increasing the culture of saving in formal institutions. The government made it mandatory for all government social benefits to be paid out through bank accounts. Government campaigns such as the 'One Household One Bank Account' are also helping to promote the use of formal banking channels. Different banks have partnered with local governments to improve financial access and awareness. Furthermore, the NRB has issued directives to promote fair treatment of depositors by capping interest rates and has forced BFIs to expand to rural areas in order to improve financial access.

Credit



The credit market in Nepal has seen remarkable improvement since the previous MAP study. Credit disbursement through formal financial service providers has seen significant growth over the past five years, while the number of borrowers and the uptake of credit from MFIs and cooperatives has seen a massive surge. At the same time, borrowing from informal sources such as savings groups as well as from family and friends appears to have become more prevalent. The rise in uptake of credit can be attributed to a number of factors, including entrepreneurship, corporate expansion and increased consumption. With the latter, demand for consumer credit products such as credit cards, residential home loans, automobile loans and consumer loans has skyrocketed.

The increase in BFI access points, including branches and BLB centres, and the proliferation of digital banking services can also be credited for the increase in volume of credit disbursement through formal channels.

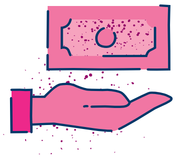
There have also been interventions from the government and from the NRB to increase the scope and accessibility of credit through various programs, policies and directives. The NRB's requirement for BFIs to lend a particular percentage of their loan portfolio to priority sectors and deprived sectors has contributed to increased credit access and assisted in sustainable economic growth. The uptake of concessional loans has also significantly increased after the NRB made such lending mandatory with the objective of promoting entrepreneurship. Refinancing facilities and concessional interest rates were also made available to SMEs. To enhance transparency in interest rate determination, protect consumers' interests and promote healthy competition, the NRB lowered the interest rate spread of commercial banks as well as the base rates of BFIs. In a bid to increase access to credit to promote agricultural growth and entrepreneurship, provincial and local governments have also been partnering with BFIs to increase the availability of concessional interest subsidies as well as guarantees.

Despite the improvement in credit uptake, lending is still heavily collateralised, mostly in the form of property, which makes it difficult for the low-income population to access credit facilities. The requirement of collateral has continued to be a challenge for SMEs needing to access credit from banks. However, BFIs have been gradually transitioning towards non-collateralised lending such as credit-score based lending. To enhance non-collateralised lending, the adoption and development of credit rating, which is currently in its infancy, would be beneficial for BFIs and borrowers alike. The proliferation of alternative financing sources such as PEs and VCs has also contributed to the extension of credit facilities to MSMEs and startups, particularly those enterprises that are too small for BFIs to serve.

Insurance

The insurance market has improved since MAP 2016, as evidenced by an increase in the uptake of insurance from 11% (in 2015) to 26% (in 2019). The uptake of insurance is higher if the NHIP offered by the government and the informal insurance provided by cooperatives and community groups are taken into account. The growth in insurance uptake has not been organic but rather has been partly driven by government regulations that make it mandatory for individuals to purchase insurance for foreign employment and for accessing concessional loans or loan mortgages. Access to insurance services has also improved significantly with the issuance of new licenses to both life and non-life insurance companies as well as the IB's allocating districts to each insurance company and making it mandatory for life and non-life insurance companies alike to establish branches in all 77 districts of Nepal. Similarly, insurance companies adopted the institutional agent model and entered into agreements with MFIs and SACCOs. Both of the latter have been instrumental in increasing access to formal insurance in rural areas but their reach is limited to their clients or members.

In terms of insurance product offerings, both life and non-life insurance companies continue to offer homogeneous products with limited product differentiation. Since the previous MAP study, the uptake of agricultural insurance has increased as the government has been providing subsidies on the premium, which has encouraged farmers to insure their farm products. The mandatory provision for non-life insurance companies to allocate 5% of their insurance portfolio for agriculture and cattle insurance has been a key driver for increasing agricultural insurance, which has further been bolstered by the introduction of affordable microinsurance products. The introduction of the NHIP and the SSF, and the extension of microinsurance products and credit guarantee products have also increased the uptake of insurance. However, the lack of awareness about insurance and its benefits and the fact that insurance is still widely perceived as an expense rather than a risk-mitigation tool is seen as a major issue to be tackled in attempts to increase uptake. The introduction of the COVID-19 scheme in April 2020 saw uptake of more than 1.4 million policies, which indicates a demand for medical-related insurance. Currently, medical insurance is limited to group medical insurance and very few insurance companies offer individual medical insurance schemes.



Payments and remittances

Post-MAP 2016, Nepal's digital payments landscape has transformed dramatically, with considerable increases in both uptake and usage of DFS such as mobile and Internet banking and also in terms of the number of electronic payment transactions and their volume. Notably, the Central Bank has introduced key regulations and supporting infrastructure, while private sector banks and technology service providers have worked to expand access to DFS. The third-party managed payment infrastructure has evolved as a result of the new laws. The use of digitisation in wholesale and retail payment services has been implemented, and uptake has been positive. The COVID-19 pandemic has forced the acceleration and the evolution of the digital payments ecosystem. Despite all the progress, however, crucial aspects of the ecosystem need further development. Technological hurdles such as a lack of high-speed Internet and mobile network connections, as well as a shortage of competent human resources, have proven to be a bottleneck in the digitisation of financial services in rural areas, while also limiting their adoption and use in big cities. There are also some limitations (both practically in terms of connectivity and legally/judicially) to digitising KYC standards.

While remittance income showed significant average annual growth in the period 2010/11 to 2014/15, post MAP-2016, with a gradual slowing of outward migration, remittances have been declining relative to GDP, from just over 25% of GDP in 2015/16 to just over 22% of GDP in 2019/20.[11] That said, the COVID-19 pandemic only marginally affected already stagnant remittance growth (in FY 2019/20 remittances fell by a marginal 0.5%), and remittances mainly stayed strong despite steep drop projections. If the pandemic continues, however, remittance income will almost certainly be impacted. Remittances are a major consumption smoothing mechanism for remittance receivers, and thus any significant drop in the future would likely have long-term consequences.

On the positive side, the use of formal remittance channels has been on the increase, and the introduction of remittance via digital or mobile wallets has further broadened the scope of services available to consumers. To encourage use of formal remittance channels and ensure a smooth flow of remittances, a number of further improvements will be important: lowering remittance costs; providing a variety of suitable products (including digital functionality) to attract and divert remittances to saving and investment mechanisms; and increasing awareness/literacy about and trust in formal remittance services (particularly digital options as they become more available).

Based on the findings of this diagnostic refresh research, the following recommendations are made across financial product markets and areas:

Savings

Support infrastructure development to reduce the cost and increase usage of digital financial transactions:

- The high cost of Internet in Nepal as well as connectivity issues in rural areas make using Internet and mobile banking challenging; telecom companies and BFIs should explore partnerships as a way to make mobile data and Internet accessible to the larger public.
- Encourage regulation and competition in the correct amounts in order to lower the cost of mobile data and services, particularly in rural and remote areas.
- Expand both the ATM network and the agent network, particularly in rural areas.

Enable a coherent and cohesive payments ecosystem that fosters innovation, to attract more users to formal banking channels:

- Simplify the process of account opening, aiming for end-to-end digitising of the entire process. In particular, accelerate the digitisation of documentation and the KYC process.
- Introduce a centralised National ID card, to simplify the documentation process and streamline verification.
- Draw in all stakeholders, including the judiciary, to acceptance of digitisation of banking services.
- Allow customers to have separate labelled savings facilities (e.g. naming a bank account or product with a specific savings goal), as a strategy for increasing usage of formal financial services (particularly within the unbanked population).
- Allow customers to save in digital wallets, and allow them to receive interest on the same.

Credit

Implement the Secured Transaction Registry:

- The NRB should prioritise the establishment of the STR Office to eliminate multiple borrowing and also allow for the granting of loans secured by movable assets.

Develop credit scoring-based lending:

- Formulate adequate legislation along with broadening the scope of the CIB, to create a system that captures integral credit information, whether good or negative, in order to progress towards a market with more non-collateralised lending.
- Introduce individual credit scoring, which will allow people with no prior credit history to access formal credit.

Increase providers' financial literacy initiatives aimed at borrowers:

- Financial institutions should invest in financial literacy activities as part of their loan origination and repayment processes.

Develop value chain financing:

- Secure a coordinated effort by BFIs and proactive investments from PE/VCs into local agribusinesses, with the aim of developing value chain financing; this will enhance access to finance as well as infrastructure like warehouses and cold storage for farmers.

Credit guarantee:

- Improve credit guarantee schemes to help BFIs minimise their risk and develop new products based on the needs of MSMEs.

Insurance

Organise awareness-building programs:

- One of the significant problems in low uptake of insurance products is the lack of awareness of the benefits and value thereof.
- Insurance companies should take the initiative to promote insurance to the general public by organising awareness campaigns, social media promotions, road shows and customer meetings.
- Given that the goal is to raise insurance awareness, rather than to promote a particular brand or advertise a specific product, introduce insurance into the curriculum as part of children's early education.

Promote digital insurance:

In Nepal, the use of the Internet and mobile phones has increased dramatically. The insurance business is starting to embrace digitisation, and it is likely to become one of the industry's mainstays.

- Introduce policies that allow for electronic/digital signatures, change the provisions on wet signatures, remove default paper document/hard copy requirements, and introduce electronic acknowledgement of document receipt.
- Promote collaboration between insurance companies and fintechs to accelerate digital transformation within the constraints of the current regulatory and policy frameworks.
- Advocate with regulators and policymakers on digital issues to increase understanding and pave the way for the removal of barriers to digitisation.
- Incentivise insurance companies to invest in backend technologies[12] to facilitate not only online premium collection but also online application. Thus, invest in mobile applications that will allow would-be customers to calculate how much insurance cover they need, and to buy a policy online.
- Leverage the existing network and reach of telecom companies to increase the uptake of insurance products (especially low-cost, microinsurance products) by developing polices that allow telecom companies to use their existing databases to market insurance.

Promote MSMEs with risk management system:

- Provide cheaper and easier access to loans for MSMEs that have implemented effective risk management systems (in the form of insurance products) even if they have no proven track record; this could incentivise MSMEs to pay for insurance.

Promote easier access to loans for MSMEs with risk management system:

- Develop and market appropriate low-cost insurance products based on the varying needs of low-income customer segments. Explore options for combining insurance products with other financial and non-financial items to enhance insurance penetration. Adopt consumer-centred, demand-driven approaches in an effort to identify and serve different segments' real-economy needs, thereby increasing the odds of increasing the uptake of the insurance products being offered.

Payment

Introduce digital KYC:

- Introduce policy measures to accelerate adoption of digital KYC and authentication measures; support existing PSOs to introduce population-level eKYC and authentication services with a strong focus on security and privacy, which can also improve the public's trust in the payments ecosystem.

Continue to support PSPs to expand their product range and depth:

- Support PSPs to expand partnerships with BFIs, and allow PSPs to sell financial products in addition to facilitating payments. Advocate for FDI into PSPs, as currently these institutions have very limited capabilities.

Create regulatory provisions and provide technical support for PSOs and PSPs:

- Onboard more rural customers leveraging the digital services they've already investing in; and extend the reach of shared infrastructure, such as the services of the NCHL and F1soft – which are currently available to the Class A, B, and C banks – to MFIs and cooperatives as well.

Leverage telecom networks:

- These networks have excellent rural coverage and have recently been granted licenses to offer DFS. Incentivise partnerships of telecom companies with existing BFIs, PSPs and PSOs. Encourage improvement in the KYC procedures of telecom companies' sales processes.

Evaluate the potential of third-party providers of POS and point of transaction (POT) machines:

- Consider an expanded role for the POS gateway provider SCT, which could help to create a more efficient and cost-effective network.

Develop clear policy for interest payments on idle cash in e-wallets and mobile money accounts:

- As has been done for QR code payment standards, issue guidelines to standardise digital wallets.

Without delay, introduce the National Payment Gateway:

- As soon as possible, accelerate the introduction of the National Payment Gateway – for the card payment network, PSPs, and QR codes.

Increase public awareness and trust in digital options:

- The regulator should carry out awareness and digital literacy initiatives focusing on digital financial products and services and should conduct exercises aimed at increasing the public's trust in the digital payments ecosystem.

Remittances

Work towards reducing the cost of remittance:

- The cost of making lower-value remittances (up to USD 200) needs to be decreased in order to attract remitters currently opting to use informal channels to remit.

Create conducive environment to facilitate remittances via digital platforms:

- Undertake thorough research into facilitating cross-border remittances and settlement (with appropriate risk mitigation measures) by accepting in Nepal digital wallets that have been issued overseas.

Increase innovation of products and services to attract and retain remittances:

- Financial institutions and digital wallet providers need to innovate products and services that truly cater to consumers' remittance needs, in order to attract and retain remittances in the financial system and increase the rate of saving.
- Allow digital wallet providers to cross-sell other financial products.
- To retain the remittances received via digital wallets, PSPs should be allowed to offer various financial products apart from payment services, such as micro lending and insurance (i.e. cross selling).

Increase awareness of and build trust in products and services:

- Carry out awareness and trust-building exercises aimed at enhancing awareness levels with regard to available products and services and their benefits, and ensure availability of essential information for users of remittances.

Leverage the extensive network of remittance companies and their user base to promote financial inclusion:

- As remittance service providers complement the payment infrastructure, the existing agent network of the remittance companies (i.e. the money transfer operators) could be leveraged to offer various bundled financial products and services.

6.2 Implementation and evaluation

NEPAL FINANCIAL INCLUSION ROADMAP AND ACTION PLAN AREAS FOR IMPLEMENTATIONS: 2017 VS 2020	
PRIORITY 1. UNLOCK CONSTRAINED CREDIT AND SAVINGS MARKET	
1. Expand and promote non-collateralised loans	**2017 Recommendations outstanding or relevant** • Develop and promote value chain financing. • Streamline processes for effective operation of credit guarantee schemes. **2021 additions** • Amend the Secured Transaction Act and the Regulation. • Implement individual credit scoring by the CIB.
2. Affordable and relevant credit products	**2017 Recommendations outstanding or relevant** • Leverage the network of MFIs to ensure the implementation of a revised modality of deprived sector lending provision.
3. Relevant affordable savings product	**2017 Recommendations outstanding or relevant** • Adopt an innovative approach to formal banking by leveraging digital payment channels, agency model and mobile financial service providers. • Introduce market-driven low-cost commitment saving products. **2021 additions** • Allow customers to save in digital wallets, and allow them to receive interest on the same.
4. Enabling regulation	**2017 Recommendations outstanding or relevant** • Undertake legal review of insolvency law and commercial bench. • Establish a supervision mechanism for cooperatives. **2021 additions** • Speed up the process of amending and enacting bankruptcy and secure transaction laws. • Introduce the centralised National ID card, to simplify the documentation process as well as making verification streamlined. Accelerate the digitisation of the KYC process.
PRIORITY 2: IMPROVE PAYMENT SYSTEM	
1. Develop retail payment infrastructure	**2017 Recommendations outstanding or relevant** • Encourage PSPs to invest in digital infrastructure. • Develop and implement a national payment switch. **2021 additions** • Support infrastructure development to make mobile data and Internet accessible and affordable to the wider public.
2. Increase usability of digital payments	**2021 additions** • Fully implement the Retail Payment Strategy, 2019. • Reduce the cost of digital financial transactions by collaborating with telecom companies. • Support PSPs to expand their product range and depth.
3. Enabling regulations	**2021 additions** • Introduce policy measures to accelerate adoption of digital KYC. • Allow FDI into PSPs to enhance their technical and financial capacity.
4. Improved business model	**2021 additions** • Work towards reducing the cost of remittances. • Create a conducive environment to facilitate remittances via digital platforms. • Innovate products and services to attract and retain remittances.

PRIORITY 3: BOLSTER RISK-MITIGATION CAPABILITIES	
1: Facilitate awareness generation on insurance as risk-mitigation tool	**2017 Recommendations outstanding or relevant** • Expand and promote microinsurance. **2021 additions** • Organise awareness campaigns to promote insurance uptake.
2: Improve insurer business models	**2017 Recommendations outstanding or relevant** • Support research and development within the insurance sector. • Explore financing options for insurance. **2021 additions** • Digitise the insurance business, and invest in technology. • Introduce low-cost insurance products.
PRIORITY 4: ENHANCE LOCALLY BASED FINANCIAL SERVICE PROVIDERS	
1: Improve business models of MFIs and SACCOs	**2017 Recommendations outstanding or relevant** • Encourage remote financial service providers to work with MFIs and SACCOs, leveraging their local knowledge. • Leverage existing distribution network of MFIs and SACCOs.
PRIORITY 5: ENHANCE FINANCIAL INCLUSION SUPPORT IN NATIONAL GOVERNANCE	
1: Consolidation of all ongoing access to finance projects in Nepal	**2021 additions** • Need for flexibility to establish a separate unit/department to oversee and implement financial inclusion activities.
PRIORITY 6: STRENGTHEN CONSUMER EMPOWERMENT, PROTECTION AND EDUCATION	
1: Develop consumer protection framework	**2017 Recommendations outstanding or relevant** • Create awareness of grievance-handling calls. • Expand deposit insurance coverage.
2: Consolidate financial literacy and education programs	**2017 Recommendations outstanding or relevant** • Use multiple delivery channels for financial literacy campaigns. **2021 additions** • Invest in financial literacy activities as part of BFIs' loan origination and repayment processes. • Educate BFIs on organising financial literacy activities as strategic business investments instead of simply CSR activities.

PART 5 NOTES

1 WB, 2021c

2 UNDP, 2021

3 World Bank Development Indicators 2019

4 CBS and NPC, 2020

5 WB, 2021a

6 UNDP, 2020b

7 Dahal and Kharel, 2020

8 UNCDF MAP, 2020

9 NRB, 2019a

10 NRB, 2021a

11 NRB, 2021c

12 In software engineering, the terms ‘frontend’ and ‘backend’ (sometimes spelled ‘back end’ or ‘back-end’) refer to the separation of concerns between the presentation layer (frontend), and the data access layer (backend) of a piece of software, or the physical infrastructure or hardware.

Acronyms and abbreviations

API	Application Programming Interface
B2B	Business to Business
BAFIA	Banks and Financial Institutions Act
BFI	Bank and Financial Institution
BLB	Branchless Banking
CAGR	Compound Annual Growth Rate
CBS	Central Bureau of Statistics
CIB	Credit Information Bureau
CSR	Corporate Social Responsibility
DBS	Digital Banking System
DFS	Digital Financial Services
FDI	Foreign Direct Investment
fintech	Financial Technology
FSDS	Financial Sector Development Strategy
FY	Fiscal Year
GDP	Gross Domestic Product
GoN	Government of Nepal
HDI	Human Development Index
IB	Insurance Board
ICT	Information and Communication Technology
IT	Information Technology
KYC	Know Your Customer
LDC	Least Developed Country
MAP	Making Access to Financial Services Possible
MFI	Microfinance Institution
MoF	Ministry of Finance
MoLESS	Ministry of Labour, Employment and Social Security
MSME	Micro, Small, Medium Enterprise
NHCL	Nepal Clearing House Limited
NHIP	National Health Insurance Program
NIA	Nepal Insurers Association
NPL	Non-Performing Loan
NPR	Nepali Rupee
NRB	Nepal Rastra Bank
PE	Private Equity
POS	Point of Sale
PSLP	Priority Sector Lending Program
PSO	Payment Service Operator
PSP	Payment Service Provider
QR	Quick Response
RBB	Rastriya Banijya Bank
RTGS	Real Time Gross Settlement
SACCO	Savings and Credit Cooperative
SDG	Sustainable Development Goal
SEBON	Securities Exchange Board of Nepal
SEZ	Special Economic Zone
SME	Small and Medium Enterprise
SSF	Social Security Fund
STR	Secured Transaction Registry
telecom	telecommunications
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
USD	United States Dollar
VAT	Value Added Tax
VC	Venture Capital

References

ADB (Asian Development Bank) (2017). *Nepal's Development Context and the Role of Trade Facilitation.* Asian Development Bank. Available online.

ADB (2020a). *Country Integrated Diagnostic on Environment and Natural Resources in Nepal.* Asian Development Bank. Available online.

ADB (2020b). *Nepal Macroeconomic Update*. Vol. 8 No. 2 September 2020. Asian Development Bank. Available online.

ADB, DFID and ILO (2009). *Nepal Critical Development Constraints.* Asian Development Bank. Available online.

AFI (Alliance for Financial Inclusion) (2016). *AFI Annual Report.* Alliance for Financial Inclusion. Available online online.

Banskota, M., and Sing, R. V. (1991). *Watershed Management Experience in the Hindukusha – Himalayan Region*. Theme Papers, MEM Series (2). Kathmandu: International Centre for Integrated Mountain Development.

Basnett, Y., and Pandey, P. R. (2014). *Industrialization and Global Value Chain Participation: An Examination of Constraints Faced by the Private Sector in Nepal.* Asian Development Bank. Available online.

beed management (2019). *Demand Study on MSME Financing.* UKAID Sakchyam Access to Finance. Available online.

Bista, I. (2020). While Nepal's remittance keeps increasing, it mostly gets spent in unproductive areas, *Nepal Economic Forum,* 6 March. Available online.

CBS (Central Bureau of Statistics) (2011a). *Nepal Living Standards Survey 2010/11.* Government of Nepal. Available online.

CBS (2011b). *National Population and Household Census 2011.* Available online.

CBS and NPC (Central Bureau of Statistics and National Planning Commission) (2020). *Nepal Labour Force Survey.* Government of Nepal. Available online.

CBS and UNIDO (Central Bureau of Statistics and United Nations Industrial Development Organization) (2014). *Development of Manufacturing Industries in Nepal: Current State and Future Challenges.* Government of Nepal. Available online.

CIAT, WB, CCAFS and LI-BIRD (2017). *Climate-smart Agriculture in Nepal.* CSA Country Profiles for Asia Series. International Center for Tropical Agriculture (CIAT); The World Bank; CGIAR Research Program on Climate Change, Agriculture and Food Security (CCAFS); Local Initiatives for Biodiversity Research and Development (LI-BIRD). Washington, D.C.

Dahal, K., and Kharel, P. (2020). *Small and Medium Sized Enterprises in Nepal: Examining Constraints on Exporting.* Asian Development Bank. Available online.

Department of Cooperatives (2020). *Sahakari Jhalak.* Ministry of Land Management, Cooperatives and Poverty Alleviation. Available online.

Economist Impact (2021). *Global Food Security Index.* Available online.

FAO (Food and Agriculture Organization) (2020). *Nepal at a Glance.* Available online.

FinMark Trust (2014). *FinScope Consumer Survey Nepal 2014*. Available online.

Ghimire, S. (2017). Paid up capital requirement for insurance cos hiked by 4 times, *My Republica*, 1 April. Available online.

Global Forest Watch (2020). *Nepal.* Available online.

Global Hunger Index (2021). *Nepal.* Available online.

GoN (Government of Nepal), Ministry of Communication and Information Technology (2019). *2019 Digital Nepal Framework. Unlocking Nepal's Growth Potential*. Available online.

HelpAge Global Network (2021). *Ageing Population in Nepal.* Available online.

ILO (International Labour Organization) (2019). *Eight Ways to Grow Nepal's Agriculture Sector.* International Labour Organization. Available online.

ILO (2021). *Employment Promotion in Nepal.* International Labor Organization. Available online.

IB (Insurance Board) (2019). *Annual Report.* Insurance Board.

IB (2020a). *Agriculture and Livestock Insurance Directive 2020.* Insurance Board.

IB (2020b). *Namelist: Insurance Companies.* Insurance Board. Available online.

IB (2021a). *Consolidated Financial Statements of Third Quarter 2020/21.* Insurance Board. Available online.

IB (2021b). *Districts with Health Insurance Implemented.* Insurance Board. Available online.

IRF (International Road Federation) (2019). *IRF World Road Statistics 2019: Assessing the Global Road Network, South Asian Countries Report Highest Road Network Density, whilst North Africa Scores Lowest as a Region*. International Road Federation. Available online.

IBN (Investment Board of Nepal) (2017). *Manufacturing Sector Profile.* Government of Nepal. Available online.

IMF (International Monetary Fund) (2021). *World Economic Outlook. Nepal Dataset*s. International Monetary Fund. Available online.

Investopaper (2021a). Current Status of Banking in Nepal, *Investopaper*, 17 September. Available online.

Investopaper (2021b). Top Life Insurance Companies in Nepal, *Investopaper,* 24 August. Available online.

Mandal, C. K. (2020). Prime Minister Employment Programme has so far proved to be a let-down for jobless citizens, *The Kathmandu Post*, 9 August.

Merolagani (2021). What are the reasons for the inability of Micro Insurance to expand*? Merolagani*, 27 May. Available online.

MoCIS (Ministry of Commerce, Industries and Supplies) (2016). *Nepal Trade Integration Strategy 2016.* Government of Nepal. Available online.

MoF (Ministry of Finance) (2014). Nepal growth diagnostic. Available online.

MoF (2020). *Economic Survey 2019/20.* Ministry of Finance. Available online.

MoF (2021). *Economic Survey 2020/21.* Ministry of Finance. Available online.

MoHP (Ministry of Health and Population) (2020). *Health Sector Emergency Response Plan COVID-19.* Government of Nepal.

MoHP (2021). *Medical Treatment of Deprived Citizens.* Available online.

MoLESS (Ministry of Labor, Employment and Social Security) (2020). *Nepal Labour Migration Report.* Government of Nepal.

MoLESS (2021). *Prime-minister Employment Program*. Available online.

MEFIN (Mutual Exchange Forum on Inclusive Insurance Network) (2020). *The Status of Agriculture Insurance In Nepal*. Mutual Exchange Forum on Inclusive Insurance Network. Available online.

My Republica (2020). Nepalis pay Rs 104.53 for 1GB mobile data use: Report, *My Republica*, 15 September. Available online.

Nations Encyclopedia (2021). *Nepal-Industry*. Nations Encyclopedia. Available online.

New Business Age (2018). Experts Views on Manufacturing Sector in Nepal, *New Business Age,* 23 January. Available online.

New Business Age (2020). Experts Views on A year After Nepal Investment Summit, *New Business Age,* 19 March. Available online.

New Business Age (2021). Government Amends Social Security Fund Operation Guidelines, *New Business Age,* 15 February. Available online.

NPC GoN (National Planning Commission, Government of Nepal) (2012). *National Population and Housing Census 2011.* Central Bureau of Statistics.

NPC GoN (2018). *Nepal Multidimensional Poverty Index. Analysis towards Action. 2018*. Central Bureau of Statistics (CBS), Nepal with Oxford Poverty and Human Development Initiative (OPHI) University of Oxford. Available online.

NPC GoN (2020). *The Fifteenth Plan (2019/20–2023/24)*. National Planning Commission, Government of Nepal.

NPC GoN (2021). *Nepal Multidimensional Poverty Index. Analysis towards Action. 2021*. Central Bureau of Statistics (CBS), Nepal with Oxford Poverty and Human Development Initiative (OPHI) University of Oxford. Available online.

NPC and ILO (2018). *Report on the Nepal Labour Force Survey. 2017/18*. National Planning Commission Central Bureau of Statistics (Government of Nepal) and International Labour Organization. Available online.

NRB (Nepal Rastra Bank) (2015). *Situation of Financial Access in Nepal.* Nepal Rastra Bank.

NRB (2019a). *Situation of Financial Access in Nepal*. Nepal Rastra Bank. Available online.

NRB (2019b). *SME Financing in Nepal.* (Also known as *SMEs Financing in Nepal 2076*). Nepal Rastra Bank.

NRB (2020a). *Current Macroeconomic and Financial Situation. Based on Annual Data of 2020/21. Statistical Tables 2020/21*. Nepal Rastra Bank. Available online.

NRB (2020b). *Current Macroeconomic and Financial Situation (based on Annual Data of 2019/20)*. Nepal Rastra Bank. Available online.

NRB (2021a). *Financial Access in Nepal*. August 2021. Nepal Rastra Bank. Available online.

NRB (2021b). *Current Macroeconomic and Financial Situation of Nepal.* Nepal Rastra Bank.

NRB (2021c). *Current Macroeconomic Situation: Based on 6 Months Data*. Nepal Rastra Bank.

NRB (2021d). *Progress Report of Microfinance Financial Institutions 2078*. Nepal Rastra Bank. Microfinance Institutions Supervision Department. Available online.

NRB (2021e). *Monthly banking and financial statistics, mid-Jan 2021.* Available online.

NTA (Nepal Telecommunications Authority) (2021). *MIS Report Magh 2077.* Nepal Telecommunications Authority. Available online.

Olafsen, E., and Cook, P. A. (2016). *Growth Entrepreneurship in Developing Countries.* World Bank Group. Available online.

Prasain, S. (2020). Nepal's overall imports have gone down but agriculture import continues to expand, hitting record Rs 250 billion, *The Kathmandu Post,* 27 July. Available online.

Rai, S. K., Rai, G., Hirai, K., Abe, A., and Ohno, Y. (2001). The Health System in Nepal: An Introduction. *Environmental Health and Preventive Medicine,* Volume 6, pp. 1–8.

Ranabhat, C. L., Subedi, R., and Karn, S. (2020). Status and Determinants of Enrollment and Dropout of Health Insurance in Nepal: An Explorative Study. *Cost Effective Resource Allocation*, 18, 40. Available online.

Room to Read (2020). *Covid-19 Response: Education Resilience Fund.* Available online.

Sakchyam Access to Finance Nepal (2020). *A Brief on Branchless Banking (BLB) Initiative*. Sakchyam Access to Finance Nepal. Available online.

Setopati (2018). Disappointing in transformative projects, reforms; good in infrastructure development, plugging revenue leakages. *Setopati*. 29 May. Available online.

Singh, P. B. (2021). Every household in this remote Bajura village has a bank account, *The Kathmandu Post*, 15 March. Available online.

Social Health Security Development Committee (2017). *Social Health Security Program (Health Insurance).*

SSF (Social Security Fund) (2020). *Third Quarterly Report.* Ministry of Labour, Employment and Social Security. Available online.

The Asia Foundation (2017). *Nepal's Locally Elected Women Representatives Exploratory Study of Needs and Capacity Assessment.* Available online.

The Rising Nepal (2021). Concessional Loans to Solu Dudhkunda Locals. *The Rising Nepal*, 29 January.

UNCDF (2019). *Is Lack of Access to Finance Impeding the Growth of Female-Led Small Businesses in Nepal?* UNCDF. 26 February. Available online.

UNCDF (2020). *Energy and the Poor: Unpacking the Investment Case for Clean Energy*. Diagnostic Series. Available online.

UNCDF MAP (2020). *Note 5. Cracking the Code: Opening up Pathways out of Poverty*. Global Insights series – Volume 3. United Nations Capital Development Fund Making Access to Financial Services Possible.

UNCDF MAP (2021). MAP. *Countries*. United Nations Capital Development Fund Making Access to Financial Services Possible. Available online.

UNDP (2020a). *Gender Development Index (GDI).* Available online.

UNDP (2020b). *Rapid Assessment of Socio Economic Impact of COVID19 in Nepal.*

UNDP (2021). *Human Development Indicators.* Available online.

UNESCAP (2020). *Micro, Small and Medium-sized Enterprises' Access to Finance in Nepal.* United Nations. Available online.

UNICEF (2021). *Education.* Available online.

USAID (2015). *USAID/Nepal Private Sector Engagement Assessment: Agriculture Sector.* USAID. Available online.

WB (World Bank) (2017a). *Climbing Higher: Toward a Middle-Income Nepal.* World Bank. Available online.

WB (2017b). *The Global Findex Database 2017*. World Bank. Available online.

WB (2018a). *Creating Markets in Nepal.* World Bank. Available online.

WB (2018b). *Current Health Expenditure per capita (current US$): Nepal.* World Bank. Available online.

WB (2018c). *Footwear Sectoral Analysis: Nepal.* World Bank. Available online.

WB (2018d). *Literacy Rate, Adult Total (% of people ages 15 and above): Nepal*. World Bank. Available online.

WB (2019a). *Death Rate, Crude (per 1,000 people): Nepal.* World Bank. Available online.

WB (2019b). *Literacy Rate, Adult Total (% of people ages 15 and above): South Asia*. World Bank. Available online.

WB (2019c). *Remittance Prices Worldwide*. World Bank. Available online.

WB (2020). *Market Study to Understand Job Growth Potential in SMEs in Nepal.* World Bank.

WB (2021a). *Nepal Data.* World Bank. Available online.

WB (2021b). *Understanding Poverty*. World Bank. Available online.

WB (2021c). *World Development Report 2021: Data for Better Lives.* World Bank.

WB (2021d). *Nepal Development Update, April 2021: Harnessing Export Potential for a Green, Inclusive and Resilient Recovery.* World Bank. Available online.

WEF (World Economic Forum) (2020). *Global Gender Gap Report 2020.* World Economic Forum. Available online.