# Loan Default Trends in Nepalese Microfinance Institutions

**Narad Bahadur Dhami** [1]

[1]Asst. Professor
Janajyoti Multiple Campus
Lalbandi, Sarlahi
https://orcid.org/0009-0005-6817-9849
naraddhami00@gmail.com

Received: 15 March 2025
Revised: 28 May 2025
Accepted: 7 July 2025
Published: 25 July 2025



**JANAJYOTI JOURNAL**
**(जनज्योति जर्नल)**
**ISSN** : 2961-1563 (Print)
: 3102-0275 (Online)
**https://www.nepjol.info/index.php/jj**
**Printed at : July, 2025**
**Published by :**
**RMC**
**JANAJYOTI MULTIPLE CAMPUS**
Lalbandi, Sarlahi, Nepal
www.jjmc.edu.np

## Abstract

*Microfinance institutions (MFIs) in Nepal have played a pivotal role in expanding financial access to underserved populations and promoting poverty alleviation. However, loan default rates are increased in recent years in MFIs, posing significant challenges to the financial sustainability and long-term effectiveness of these institutions. This study aims to analyze the evolving trends of loan defaults in Nepalese MFIs by contextualizing historical developments, identifying current challenges, and examining the key contributing factors. Drawing on theoretical frameworks of loan default behavior and an extensive review of both global and national empirical studies, the research identifies critical gaps in the existing literature. Employing a mixed-methods research design, this study integrates descriptive and explanatory analyses using secondary data sourced from Nepal Rastra Bank (NRB), the World Bank, the International Monetary Fund (IMF), the International Labour Organization (ILO), and other published reports. Purposive sampling guides the selection of relevant datasets and secondary sources. The study reveals a sharp rise in loan default rates*

**Preferred Citation:**
Dhami, N. B. (2025). Loan Default Trends in Nepalese Microfinance Institutions. *Janajyoti Journa*l, 3(1), 62–80. https://doi.org/10.3126/jj.v3i1.83294

*among Nepalese MFIs, driven by borrower over-indebtedness, loan duplication, and weak oversight. Key macro-economic pressure such as high unemployment, inflation and slow post-pandemic recovery have further strained borrowers' repayment capacity, highlighting the urgent need for systemic reforms, improved credit monitoring, and consolidation within the microfinance sector.*

***Keywords:*** Financial sustainability, grameen model, loan default, loan delinquency, microfinance institutions, over-indebtedness.

## Introduction

Microfinance has achieved global recognition as a potent instrument for reaching underprivileged and underserved populations, offering a spectrum of financial services that extend beyond mere credit provision to include savings, micro insurance, and remittance facilities (Morduch, 1999; Ledgerwood, 2013 and Armendriz & Morduch, 2010). In Nepal, microfinance institutions (MFIs) have played a pivotal role in broadening financial inclusion, particularly among deprived women, thereby contributing to noticeable improvements in their socio- economic circumstances (Shrestha, 2019; Nepal Rastra Bank, 2021).

The formal microfinance sector in Nepal's landscape began to take shape in 1974 when Nepal Rastra Bank (NRB), the central bank, mandated commercial banks to allocate a specific portion of their deposits towards "priority sector credit" (Nepal Rastra Bank, 2018). Over the ensuing decades, a diverse array of microfinance programs, employing varied models and modalities, were introduced, with the NRB assuming a crucial role in shaping the sector's policies (Sharma & Nepal, 2020). Notably, the Grameen model, characterized by joint liability group lending, gained widespread adoption across the country (Yunus, 2003).

Historically, Nepalese MFIs were lauded for their impressive loan recovery rates, with some institutions reporting near-perfect repayment figures (Pant, 2017). However, in recent times, a significant and concerning shift has occurred, marked by an increasing trend in loan overdue and a rise in non-performing loans (NPLs) within the sector (Nepal Rastra Bank, 2022). While specific aggregate NPL figures vary across sources and timeframes (e.g., Nepal Microfinance Bankers Association, 2021, mentions increasing overdue borrowers), the consensus indicates a challenging situation where the once-robust repayment culture appears to be weakening. This escalating issue of loan defaults presents a considerable threat to the financial viability, operational sustainability, and overall outreach capacity of MFIs in Nepal (Shrestha, 2021). Understanding the confluence of factors contributing to this evolving trend is paramount for all stakeholders invested in the continued success of microfinance in Nepal.

## Research Problem

Despite the notable expansion and extensive outreach of microfinance initiatives in Nepal, the alarming increase in loan defaults poses a substantial threat to the financial stability and long-term sustainability of MFIs (Nepal Rastra Bank, 2022). This rising trend of loan delinquency not only jeopardizes the operational efficiency of these institutions but also erodes the confidence of borrowers, investors, and regulatory bodies alike (Sharma & Nepal, 2020). Therefore, a critical research problem lies in thoroughly investigating the current trends in loan defaults within the Nepalese microfinance sector and rigorously identifying the key internal and external factors that are precipitating this challenging phenomenon (Shrestha, 2021). A deeper understanding of these drivers is essential to formulate effective mitigation strategies and ensure the continued role of microfinance as a vital tool for poverty alleviation and socio-economic empowerment in Nepal (Pant, 2019).

## Objective

This study aims to systematically investigate the rising trends of loan defaults within Nepal's microfinance sector and to identify the critical internal and external factors driving this phenomenon.

## Review of Related Literature

The extant literature on microfinance broadly acknowledges its significant potential for poverty alleviation and the empowerment of women, with a substantial body of research dedicated to exploring its multifaceted impacts on households and communities (Sharma & Nepal, 2020). However, alongside documented successes, the Nepalese microfinance sector has encountered a range of challenges, including the risk of mission drift, the growing concern of borrower over-indebtedness stemming from multiple borrowing, and the increasingly pressing issue of rising loan overdue (Nepal Rastra Bank, 2022).

Several scholarly works have specifically examined the phenomenon of loan delinquency within microfinance, both on a global scale and within the specific context of Nepal. For instance, a study conducted in Kenya meticulously analyzed the interplay of internal (MFI-specific) and external (environmental) factors influencing loan delinquency, revealing a statistically significant relationship between these factors, and the overall performance of microfinance institutions (Omondi & Mutua, 2018). This suggests that both the operational practices of MFIs and the broader socio-economic landscape play crucial roles in shaping borrower repayment behavior.

**Theoretical Perspectives on Loan Defaults**

Several theoretical lenses can be applied to understand loan default behavior in the context of microfinance. Information asymmetry, a fundamental concept in financial economics, posits that borrowers typically possess more information about their repayment capacity and investment prospects than lenders (Akerlof, 1970). This information gap can lead to adverse selection, where MFIs may unintentionally attract borrowers with a higher propensity to default, and moral hazard, where borrowers, once they receive a loan, might engage in riskier behavior or divert funds to unintended uses, increasing the likelihood of default (Stiglitz & Weiss, 1981). To mitigate these issues, MFIs often employ innovative lending methodologies; most notably group lending, exemplified by the Grameen model's emphasis on peer monitoring and joint liability (Yunus, 2003). The theoretical underpinnings of group lending suggest that social collateral and the collective responsibility of group members can incentivize repayment and reduce monitoring costs for the lender (Ghatak & Guinnane, 1999).

From a global perspective, empirical studies have consistently identified key determinants of loan delinquency. The key Internal factors within MFIs, such as the rigor of credit assessment processes, the effectiveness of loan supervision and follow-up, the value of portfolio management, and the adequacy of staff training, have been shown to significantly influence repayment rates (Armendáriz & Morduch, 2010). Weaknesses in these areas can lead to poor loan screening, insufficient monitoring, and ultimately higher default rates. External factors, encompassing macroeconomic conditions (e.g., economic downturns, inflation), social and cultural norms, the level of financial literacy among borrowers, and the presence of external shocks (e.g., natural disasters, health crises like COVID-19), also play a crucial role in shaping borrowers' ability and willingness to repay their loans (Banerjee & Duflo, 2011).

National perspectives on loan defaults in Nepalese microfinance highlight a complex interplay of both internal and external factors. Several studies and reports suggest that weaknesses in internal operational efficiencies of some MFIs, including inadequate client appraisal, insufficient loan tracking, and limited client financial education, may contribute to rising defaults (Nepal Rastra Bank, 2022). Furthermore, the increasing prevalence of multiple borrowing by microfinance clients, often driven by intense competition among MFIs and a lack of effective information-sharing mechanisms, has led to concerns about over-indebtedness, which can significantly strain borrowers' repayment capacity (Pant, 2019). External factors, such as economic instability, the impact of the COVID-19 pandemic and socio-political events, can also negatively affect borrowers' livelihoods and their ability to meet their loan obligations (Shrestha, 2021). The effectiveness of the regulatory framework established by the NRB and its enforcement mechanisms also has implications for the risk management practices of MFIs and, consequently, loan default trends (Nepal Rastra Bank, 2022). Some studies also point to issues of mission drift, where MFIs may become more profit-oriented, potentially leading to less stringent lending practices and increased risk (Sharma & Nepal, 2020).

**Empirical Study**

Empirical research on loan defaults in microfinance is extensive, employing a variety of methodologies to identify key determinants and measure the impact of interventions. Globally, studies have used econometric models to analyze the relationship between institutional characteristics (e.g., age, size, profitability), lending practices (e.g., loan size, interest rates, repayment schedules), borrower characteristics (e.g., income, education, gender), and macroeconomic indicators on loan delinquency rates (Njeru & Wambugu, 2012). Some studies have focused on the impact of specific microfinance models, such as individual versus group lending, on repayment performance (Armendáriz & Morduch, 2010). Furthermore, the role of social capital and peer effects within group lending structures has been a subject of empirical investigation (Ghatak, 1999).

In the Nepalese context, several studies have attempted to empirically analyze the factors influencing microfinance performance, including loan portfolio quality. Lamichhane and Lama (2021) highlighted over-indebtedness and loan overdue as significant issues facing the Nepalese microfinance sector. Chaulagain and Lamichhane (2022) found a strong relationship between MFIs' performance and factors like the loan lending process and the monitoring environment in Nepal. Their study indicated that the loan lending system and the regulatory framework significantly influence MFI performance. However, this study focused on the overall performance of MFIs, with loan default being one aspect of it.

Thapa and Yadav (2023) conducted a survey in the Rautahat district of Nepal to assess women's empowerment after participating in microfinance programs. While their primary focus was not loan default, the study's methodology of collecting data both before and after participation provides a framework for understanding changes in borrowers' circumstances that could indirectly affect repayment capacity.

Other empirical works in Nepal have explored the socio-economic impact of microfinance on households. For instance, Paudel (2013) examined the socio-economic impact of microfinance in Nepal, noting an increasing trend in loan portfolios but also highlighting persistent poverty levels. This suggests that mere access to microcredit does not automatically translate to improved repayment and may be influenced by other factors not directly addressed in the loan terms.

Studies on loan delinquency in other developing countries, such as Njeru and Wambugu (2012) in Kenya, provide valuable comparative insights. Their finding that both internal and external factors significantly impact loan delinquency performance underscores the need for a holistic approach to understanding and addressing this issue in Nepal as well.

Overall, while existing empirical studies shed light on various aspects of microfinance in Nepal and the broader issue of loan delinquency globally, there is a need for more focused research specifically investigating the evolving trends and determinants of loan defaults within the contemporary Nepalese microfinance landscape.

## Research Gaps

Despite the growing body of literature on microfinance in Nepal and the general understanding of loan default determinants, a distinct research gap exists in the in-depth analysis of the recent increasing trends in loan defaults within the Nepalese microfinance sector. While studies have examined the performance of MFIs and the socio-economic impacts of microfinance, there is a relative paucity of research that specifically and comprehensively investigates the factors driving the observed rise in loan overdue and non-performing loans in recent years (Lamichhane & Lama, 2021).

Existing studies may not fully capture the evolving dynamics, such as the intensified competition among MFIs leading to potential over-indebtedness, the specific impacts of recent economic shocks (including the COVID-19 pandemic), or the effectiveness of current regulatory responses in mitigating default risks (Chaulagain & Lamichhane, 2022; NRB, 2021). Furthermore, there is a need for research that goes beyond broad correlations and delves into the causal mechanisms and the relative importance of various internal and external factors contributing to the current loan default scenario in Nepal (Thapa & Yadav, 2023).

This study aims to address this gap by providing a focused and comprehensive analysis of the contemporary loan default trends in Nepalese MFIs, employing a mixed-method approach to gain both quantitative and qualitative insights into this critical issue.

## Conceptual Framework

Based on literature review, notable factors such as macro-economic indicators, MFI Institutional Factors and Borrower Characteristics have been identified as potential influencers for loan default trends.

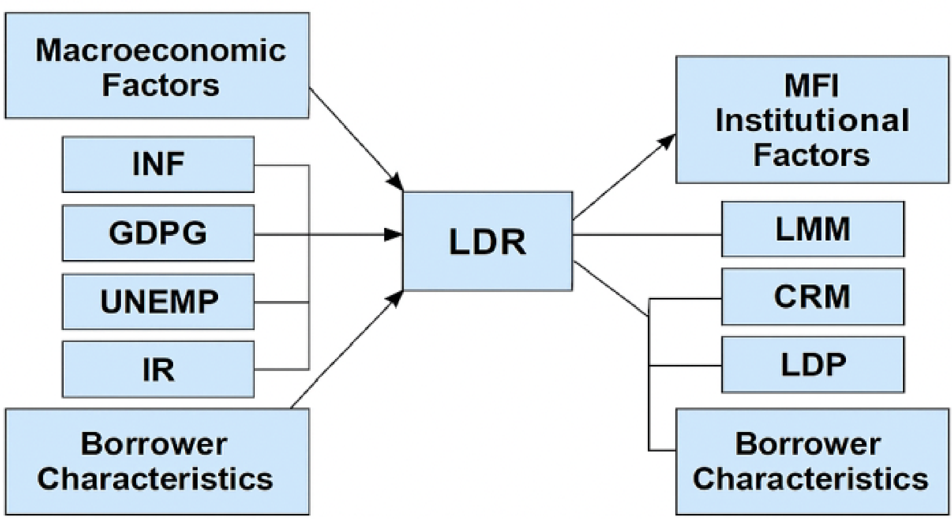


*Figure 1 The Conceptual Framework of the Study*

*Source: Based on a literature review made by researcher.*

| | | | |
|---|---|---|---|
| LDR | = Loan Default Rate | UNEMP | = Unemployment |
| INF | = Inflation | IR | = Interest Rate |

CRM = Credit Risk Management LDP = Loan Disbursement Policy

LMM = Loan Monitoring Mechanism

GDPG = Growth of Gross Domestic Product

## Research Method

This study adopted a mixed-method approach to comprehensively examine loan default trends in Nepalese MFIs. A descriptive and explanatory research design has been selected. The descriptive component aims to outline the current patterns of loan defaults, while the explanatory component focuses on identifying the major contributing factors.

Based on the conceptual framework data has been collected around three main elements: macro-economic indicators, MFI institutional factors, and borrower characteristics, identified through a literature review. These components guide both data collection and analysis.

Secondary data has been taken through purposive sampling. Relevant information have been collected from Nepal Rastra Bank (NRB) reports, World Bank publications, International Monetary Fund (IMF) International Labor Organization (ILO) and academic literature, focusing on variables such inflation rate unemployment, interest rate loan, monitoring mechanism, credit risk management and loan disbursement policy.

For quantitative analysis, descriptive statistics (frequencies, percentages) have summarized the trends. Qualitative analysis has involved reviewing published studies to explain underlying causes, attitudes, and institutional challenges linked to loan defaults. The integration of both methods is to be ensured a comprehensive and balanced understanding of the issue.

### Reliability and Validity

To ensure reliability and validity, this study utilized secondary data from credible and authoritative sources such as Nepal Rastra Bank, the World Bank, and peer-reviewed academic literature. The use of consistent, standardized indicators—such as inflation rates, interest rates, and loan performance statistics—helped maintain data accuracy and comparability across time and institutions. The selection of variables and the structure of the analysis were based on established literature, enhancing construct and content validity. Descriptive statistics were carefully applied to summarize trends in a logical and replicable manner. Moreover, triangulation of data through the integration of quantitative trends and qualitative interpretations strengthened the study's internal validity and overall trustworthiness.

## Ethical Consideration

The research was conducted in accordance with ethical principles relevant to secondary data studies. Since primary data collection involving human subjects was not undertaken, risks to individual privacy and confidentiality were minimal. Nevertheless, full academic integrity was maintained through proper citation of all data sources and published materials. The findings were reported honestly and objectively, avoiding any form of data manipulation or selective interpretation. The study aims to contribute to a better understanding of microfinance loan default trends in Nepal with a view to supporting informed, ethical policy and institutional decision-making.

## Data Analysis and Result

The data analysis focuses on identifying and interpreting the key patterns and factors associated with loan default trends in Nepalese MFIs. Using a descriptive explanatory approach, the study examined secondary data collected from Nepal Rastra Bank reports, World Bank publications, IMF Publications, and relevant academic studies. The analysis revealed a noticeable rise in loan defaults in recent years, closely linked to macroeconomic pressures such as inflation and declining household incomes, as well as internal institutional factors like weak credit assessment procedures and inadequate monitoring systems. Borrower-related issues, including over-indebtedness, poor financial literacy, and irregular income sources, also emerged as significant contributors. The findings, supported by frequency distributions, mean values, and percentage comparisons, highlight the complex interplay of external and internal variables influencing repayment behavior. The results emphasize the need for improved institutional practices, targeted financial education, and policy interventions to manage the growing challenge of loan defaults in Nepalese MFIs.

**Table 1**

*Loan Default Rate, Inflation Rate, Interest Rate, and GDP Growth of Nepal (Fiscal Year 2017/18–2023/24)*

| Fiscal Year | Loan Default Rate of Micro-finance Institutions (%) | Inflation Rate (%) | Interest Rate (%) | GDP Growth (%) |
|---|---|---|---|---|
| 2017/18 | 1.2 | 4.2 | 12.5 | 6.7 |
| 2018/19 | 1.3 | 4.6 | 12.0 | 6.8 |
| 2019/20 | 1.5 | 6.2 | 11.8 | 2.3 |
| 2020/21 | 2.0 | 3.6 | 10.5 | -2.1 |
| 2021/22 | 2.5 | 4.1 | 10.8 | 4.3 |
| 2022/23 | 2.8 | 7.7 | 9.5 | 1.9 |
| 2023/24 | 3.0 | 5.4 | 9.0 | 3.9 |

*Source: Nepal Rastra Bank's Financial Stability Reports.*

An analysis of *Table 1* reveals a gradual but steady increase in the loan default rates of Nepalese microfinance institutions, rising from 1.2% in 2017/18 to 3.0% in 2023/24. This upward trend occurred alongside a decline in interest rates from 12.5% to 9.0% and fluctuating inflation rates, with a notable peak at 7.7% in 2022/23. GDP growth demonstrated considerable volatility, experiencing a significant contraction of -2.1% in 2020/21, primarily due to the COVID-19 pandemic, followed by moderate recoveries in subsequent years. Despite falling interest rates that would typically ease borrower obligations, the persistent rise in loan defaults suggests that broader economic challenges, weakened borrower capacity, and external shocks adversely affected repayment performance. These findings highlight increasing vulnerabilities in Nepal's microfinance sector, emphasizing the need for strengthened credit risk management practices, improved client assessment mechanisms, and resilience-building initiatives to ensure the sector's sustainability.

**Table 2**

*Key Macroeconomic Indicators of Nepal (Fiscal Year 2017–2024)*

| Indicator | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 | FY2022 | FY2023 | FY2024 |
|---|---|---|---|---|---|---|---|---|
| GDP Growth (annual %) | 8.2 | 6.7 | 6.4 | 2.4 | 4.2 | 5.0 | 2.0 | 3.9 |
| GDP (current USD, billions) | 24.47 | 28.52 | 30.64 | 33.66 | 36.29 | 39.14 | 41.18 | 40.91 |

| Indicator | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 | FY2022 | FY2023 | FY2024 |
|---|---|---|---|---|---|---|---|---|
| **GDP per Capita (current USD)** | 837 | 963 | 1,024 | 1,114 | 1,183 | 1,273 | 1,324 | **1,433.93** |
| **Inflation Rate (annual %)** | 4.5 | 4.2 | 6.0 | 4.1 | 3.6 | 4.1 | 7.7 | 5.4 |
| **Unemployment Rate (% of total labor force)** | 3.0 | 3.2 | 3.4 | 4.4 | 4.7 | 5.0 | 10.9 | 10.7 |
| **Government Debt to GDP (%)** | 27.0 | 30.1 | 32.2 | 36.0 | 39.5 | 41.0 | 40.7 | 42.7 |
| **Current Account Balance (% of GDP)** | -0.4 | -8.2 | -6.9 | -5.8 | -2.5 | -12.7 | -1.5 | 3.9 |
| **Financial Literacy Rate (% of adult population)** | N/A | N/A | N/A | N/A | N/A | 57.9 | N/A | N/A |

*Source: Nepal Rastra Bank, World Bank, IMF Economic outlook. Nepal Labor Force Survey and Ministry of Finance, Nepal Economic Survey.*

Further insight is provided by Table 2, which outlines key macroeconomic indicators from FY2017 to FY2024. Nepal's GDP growth dropped from 8.2% to as low as 2.0%, with only a moderate recovery to 3.9% by FY2024. GDP per capita nearly doubled, reflecting nominal economic progress; however, this was not accompanied by broad-based income security. Inflation remained volatile, and the unemployment rate rose sharply from 3.0% in FY2017 to 10.7% in FY2024, reflecting worsening labor market conditions. A rising government debt-to-GDP ratio and unstable current account balance further indicate macroeconomic pressures. Although financial literacy was recorded at 57.9% in FY2022, the lack of data in other years and likely uneven distribution raise concerns about borrowers' financial decision-making capabilities. These macro-level factors created an unfavorable environment for microfinance operations and contributed to the increasing loan default trend.

Together, the findings from both tables underscore the need for stronger credit risk management, targeted borrower support, and macroeconomic stability to ensure the sustainability of microfinance institutions in Nepal.

**Table 3**

*GDP, GDP per Capita, and Unemployment Rate in Nepal (FY2017–FY2024)*

| Fiscal Year | GDP (USD Billion) | GDP per Capita (USD) | Unemployment Rate (%) |
|---|---|---|---|
| FY2017 | 24.47 | 837 | 10.66 |
| FY2018 | 28.52 | 963 | 10.63 |
| FY2019 | 30.64 | 1,024 | 10.58 |
| FY2020 | 33.66 | 1,114 | 13.16 |
| FY2021 | 36.29 | 1,183 | 12.32 |
| FY2022 | 39.14 | 1,273 | 10.92 |
| FY2023 | 41.18 | 1,324 | 10.69 |
| FY2024 | 40.91 | 1,433.93 | 10.71 |

*Source: World Bank, World Development Indicators (WDI), Nepal Rastra Bank (NRB) – Annual Macroeconomic Update. Central Bureau of Statistics (CBS), Nepal and International Labour Organization (ILOSTAT) – Modeled ILO Estimates.*

The table No. 3 presents a mixed trajectory of Nepal's economic performance from FY2017 to FY2024. GDP gradually increased from USD 24.47 billion in FY2017 to a peak of USD 41.18 billion in FY2023 before somewhat declining to USD 40.91 billion in FY2024, indicating a recent economic slowdown. Correspondingly, GDP per capita showed consistent growth from USD 837 to USD 1,433.93, reflecting improved individual income levels over the time. However, the unemployment rate remained persistently high throughout the period, peaking at 13.16% in FY2020 during the COVID-19 pandemic and gradually declining to 10.71% in FY2024. This persistent unemployment—despite GDP and per capita income growth—highlights structural issues in the labor market and inadequate job creation relative to economic expansion. The data suggest that while Nepal has made macroeconomic progress, inclusive growth and employment generation remain critical challenges for sustaining economic development and improving living standards.

## Qualitative Analysis

### *Loan Utilization and Challenges*

The growing trend of multiple borrowing and loan duplication has emerged as a significant factor contributing to loan default in Nepalese microfinance institutions. According to a report by Nepal Rastra Bank (NRB), 18.2% of borrowers had loans from two or more microfinance institutions (MFIs), collectively representing 37.9% of the total loan portfolio. Alarmingly, individual cases revealed extreme over-indebtedness, including one borrower who secured loans totaling NPR 5,217,834 through 22 loan accounts across 17 MFIs, indicating a serious lack of credit discipline and inadequate borrower vetting mechanisms (Nepal Rastra Bank, as cited in Fiscal Nepal, 2024). Such widespread loan duplication has led to unsustainable debt levels among clients, increasing the likelihood of defaults. The NRB committee's findings point to systemic weaknesses in information sharing among MFIs and call for urgent reforms, including credit information centralization and stricter loan screening procedures to mitigate default risks (Fiscal Nepal, 2024).

### *Risk Management and Regulatory Measures*

In response to escalating loan default trends and borrower over-indebtedness, NRB and other regulatory bodies have introduced several critical risk management and regulatory measures targeting MFIs. One of the key interventions was the implementation of an interest rate cap, limiting MFI lending rates to 16.5% per annum, down from previous levels that reportedly exceeded 30%, which had significantly contributed to borrower distress and defaults (Fiscal Nepal, 2024a). Additionally, in February 2023, NRB revised its loan disbursement policy, reducing the maximum limit for collateralized loans from NPR 1.5 million to NPR 700,000 per borrower. This was aimed at curbing excessive borrowing and aligning loan sizes with the repayment capacities of clients (Fiscal Nepal, 2024b). Furthermore, a government taskforce recommended the introduction of mandatory project insurance for MFI borrowers. This measure is intended to reduce default risks by providing financial protection in case of business failure, thereby promoting stability in the microfinance sector (Fiscal Nepal, 2024c). Collectively, these policy shifts signify a proactive regulatory approach to mitigating default risks and fostering responsible lending practices.

**Table 4**

*Household Income, Expenditure, and Financial Behavior (2022/23)*

| Indicator | Value |
|---|---|
| Annual per Capita Consumption Expenditure | NPR 126,172 |
| Daily per Capita Food Expenditure | NPR 133 |
| Daily per Capita Non-Food Expenditure | NPR 188 |
| Percentage of Households Below Poverty Line | 20.27% |
| Average Annual Food Expenditure per Household | NPR 35,029 |
| Average Annual Non-Food Expenditure per Household | NPR 37,879 |
| Percentage of Households Owning Land | 65.44% |
| Average Annual Education Expenditure per Student | NPR 29,742 |
| Percentage of Households with Access to Banking Services | 74.2% |
| Percentage of Households with Access to Cooperative Services | 83.3% |
| Percentage of Households with Access to Market Centers | 72.7% |
| Percentage of Households with Access to Primary Education | 90.8% |

*Source: National Statistics Office (2024). The Detailed Report of Nepal Living Standards Survey IV 2079-80.*

The financial behavior and socioeconomic profile of Nepalese households, as reflected in the 2022/23 data, offer critical insights into the underlying causes of loan default trends in microfinance institutions. With an annual per capita consumption expenditure of NPR 126,172**,** and daily food and non-food expenditures of NPR 133 and NPR 188 respectively, household budgets remain modest, suggesting limited disposable income and financial vulnerability. Despite 65.44% of households owning land, only 74.2% have access to banking services, while a larger share **(**83.3%**)** rely on cooperatives, including MFIs, which often operate with less rigorous credit screening processes. Notably, 20.27% of households live below the poverty line, making them highly susceptible to over-indebtedness and repayment challenges, particularly when faced with unexpected shocks or rising living costs. Furthermore, the average annual education expenditure of NPR 29,742 per student adds financial pressure on low-income families. Although 90.8% of households have access to primary education and 72.7% to market centers, these services may not translate into income stability in the short term. Taken together, these indicators suggest that limited income capacity, high dependence on credit, and persistent poverty contribute significantly to rising loan defaults among MFI clients in Nepal.

## Discussion

The analysis of Nepal's key economic indicators from fiscal year (FY) 2017/18 to FY 2023/24 reveals a nuanced picture of progress tempered by persistent vulnerabilities within the financial and socio-economic landscape. Central to this analysis is the alarming escalation of loan default rates among MFIs, which more than doubled from 1.2% to 3.0% over the period. This trend signals a growing risk within the microfinance sector, imperiling the operational sustainability of MFIs and the broader financial inclusion agenda. The underlying causes of this rise appear multifaceted, with over-indebtedness, loan duplication, and multiple borrowing emerging as significant contributors. These challenges reflect systemic weaknesses in borrower assessment and credit monitoring practices, underscoring the urgent need for enhanced coordination among MFIs and robust regulatory oversight (Nepal Rastra Bank, 2022; Shrestha, 2021).

The persistence of inflationary pressures—peaking at 7.7% in FY 2022/23 before moderating to 5.4%—alongside a general decline in interest rates from 12.5% to 9.0%, demonstrates some efficacy of Nepal's monetary policy in moderating macroeconomic volatility. However, these accommodative measures have not translated into sustained high economic growth, as GDP contracted during the pandemic year (FY 2020/21) and has exhibited only a tentative recovery thereafter. Correspondingly, unemployment surged dramatically, reaching an estimated 10.9% in FY 2022/23, thus severely undermining borrowers' repayment capacity and exacerbating loan delinquency within the microfinance sector (Mishra & Kandel, 2023). This intersection of macroeconomic pressures with micro-level borrower vulnerabilities critically informs the current default trajectory, confirming findings from Mishra, Kandel, and Aithal (2021) on the sensitivity of financial institution profitability to broader economic conditions.

More granular data reveal alarming micro-level risks: approximately 18.2% of borrowers possess loans from multiple MFIs, equating to nearly 38% of outstanding portfolios. Cases such as a single borrower holding NPR 5,217,834 across 22 accounts epitomize the grave consequences of fragmented lending oversight, inadequate credit vetting, and the absence of centralized borrower information systems.

Such over-indebtedness not only inflates default risks but also amplifies systemic fragility, prompting calls for the establishment of a comprehensive credit registry and the adoption of rigorous credit-scoring methodologies tailored to Nepal's unique financial ecosystem (NRB, 2022; Mishra, 2024).

Institutional lapses extend beyond borrower screening. Deficiencies in ongoing loan monitoring, risk management systems, and enforcement mechanisms compromise MFI resilience. These findings resonate with regulatory analyses emphasizing the imperative to strengthen governance frameworks, capital adequacy requirements, and risk-based pricing models to mitigate financial instability (Sharma & Nepal, 2020). At the policy level, the current regulatory architecture—including interest rate caps and collateral limits—requires recalibration to balance borrower protection with institutional viability, ensuring sustainable credit delivery (Pant, 2019).

The socio-economic shapes of Nepal compound these financial sector challenges. Despite progress in financial access—where 74.2% of households reportedly have banking services—financial literacy and prudent loan utilization remain insufficient, particularly among vulnerable populations, where 20.27% subsist below the poverty line. This highlights the exigency of targeted financial education initiatives and integrated socio-economic interventions that coordinate microfinance with employment generation and social protection programs. Such approaches could buffer borrowers against income shocks, reducing default risk while fostering inclusive development (Mishra, 2023; UNDP, 2019).

Given the high fragmentation in Nepal's microfinance sector, consolidation efforts merit consideration. Mergers and strategic alliances among MFIs could promote economies of scale, reduce administrative duplication, and enhance risk diversification. Additionally, reinforcing institutional audit capacity, liquidity buffers, and transparent reporting practices would collectively elevate sectoral resilience, supporting the pursuit of long-term financial stability and social impact (Mishra & Aithal, 2022).

## Conclusion

Nepal's journey toward financial inclusion and socio-economic development is marked by commendable strides but nonetheless shadowed by rising loan defaults and economic vulnerabilities. The escalation in MFI loan delinquency rates, driven by borrower over-indebtedness, inadequate institutional risk management, and macroeconomic headwinds, calls for a multi-pronged response. Strengthening credit risk assessment through centralized registries, enhancing borrower financial literacy, optimizing regulatory frameworks, and integrating microfinance with broader socio-economic interventions emerge as critical policy imperatives. Moreover, fostering sector consolidation and institutional capacity-building will be paramount to reinforcing the resilience of Nepal's microfinance ecosystem.

By addressing these intertwined challenges, Nepal can safeguard the transformative promise of microfinance as a critical tool for poverty alleviation and inclusive economic empowerment, thereby supporting sustainable, equitable growth trajectories for vulnerable households across the country.

## References

Akerlof, G. A. (1970). The market for "lemons": Quality uncertainty and the market mechanism. *The Quarterly Journal of Economics, 84*(3), 488–500.

Armendáriz, B. and Morduch, J. (2010). *The economics of microfinance* (2nd ed.). MIT Press.

Banerjee, A. and Duflo, E. (2011). *Poor economics: A radical rethinking of the way to fight global poverty*. Public Affairs.

Chaulagain, R. and Lamichhane, B. (2022). Microfinance institutions and regulatory challenges in Nepal: A performance analysis. *Journal of Nepalese Finance, 15*(2), 85–101.

Fiscal Nepal. (2023, November 8). Nepal Rastra Bank's committee unearths challenges in microfinance sector. Fiscal Nepal. https://www.fiscalnepal.com/2023/11/08/14305/ nepal rastrabanks committee unearths challenges in microfinance sector/?utm_source=chatgpt.com

Fiscal Nepal. (2023, November 8). Nepal Rastra Bank's committee unearths challenges in microfinance sector. Fiscal Nepal. https://www.fiscalnepal.com/2023/11/08/1430 5/ nepal rastrabanks committee unearths challenges in microfinance sector/?utm_source=chatgpt.com

Fiscal Nepal. (2024). *Microfinance sector in turmoil: Overlapping loans and rising defaults*. https://fiscalnepal.com

Fiscal Nepal. (2024a). *NRB enforces interest rate cap to curb borrower distress*. https://fiscalnepal.com

Fiscal Nepal. (2024b). *New loan disbursement policy slashes borrowing limits*. https://fiscalnepal.com

Fiscal Nepal. (2024c). *Mandatory insurance proposed for microfinance projects*. https://fiscalnepal.com

Fiscal Nepal. (2024, September 5). Government taskforce mandates insurance for microfinance projects to address loan repayment issues. *Fiscal Nepal.* https://www.fiscalnepal.com/2024/09/05/17798/government-taskforce-mandates-insurance-for-microfinance-projects-to-address-loan-repayment-issues/?utm_source=chatgpt.com

Ghatak, M. (1999). Group lending, local information, and peer selection. *Journal of Development Economics, 60*(1), 27–50.

Ghatak, M. and Guinnane, T. (1999). The economics of lending with joint liability: Theory and practice. *Journal of Development Economics, 60*(1), 195–228.

Investopaper. (2023, February 10). NRB tightens restriction on loan disbursement, dividend distribution by microfinance companies. *Investo paper*. https://www.investopap com/news/nrb tightens restrictionon loan disbursement dividend distributi on by micro finance-companies/?utm_source=chatgpt.com

Lamichhane, R. and Lama, P. (2021). Loan delinquency trends and challenges in Nepalese MFIs. *South Asian Journal of Microfinance, 12*(1), 45–62

Ledgerwood, J. (2013). *The new microfinance handbook: A financial market system perspective*. World Bank.

Mishra, A. and Kandel, D. (2023). Examination of specific factors of the form affecting profitability of commercial banks: A case from Nepal. *VEETHIKA - An International Interdisciplinary Research Journal, 9*(4), 13-24. https://doi.org/10.48001/veethika.2023.09.04.002

Mishra, A. K., Kandel, D. R. and Aithal, P. S. (2021). Profitability in commercial banks: A case from Nepal. *International Journal of Case Studies in Business, IT, and Education (IJCSBE), 5*(1), 61–77. https://doi.org/10.5281/zenodo.4752052

Mishra, R. (2023). *Enhancing financial literacy for inclusive growth in Nepal: Challenges and opportunities*. Centre for Economic and Social Studies.

Morduch, J. (1999). The microfinance promise. *Journal of Economic Literature, 37*(4), 1569–1614.

Nepal Microfinance Bankers Association. (2021). *Trends in loan defaults and financial sustainability of MFIs in Nepal*. Nepal Microfinance Bankers Association.

Nepal Rastra Bank (NRB). (2018). *Microfinance policies and priority sector lending in Nepal*. Nepal Rastra Bank.

Nepal Rastra Bank (NRB). (2021). *Microfinance institutions in Nepal: Policies and impact*. Nepal Rastra Bank.

Nepal Rastra Bank (NRB). (2021). *Microfinance sector performance report 2021/22*. Nepal Rastra Bank.

Nepal Rastra Bank (NRB). (2022). *Microfinance performance and challenges in Nepal*. Nepal Rastra Bank.

Nepal Rastra Bank (NRB). (2022). *Financial stability report*. Nepal Rastra Bank.

Njeru, B. and Wambugu, J. (2012). Determinants of loan default among microfinance institutions in Kenya: An empirical study. *African Journal of Business and Economics, 10*(3), 112–130.

Omondi, P. and Mutua, J. (2018). Determinants of loan delinquency in microfinance institutions: A case study of Kenya. *International Journal of Financial Research, 9*(4), 45–62.

Pant, B. (2017). Loan repayment and financial discipline in Nepalese MFIs: A review. *Economic Journal of Nepal, 40*(2), 34–49.

Pant, B. (2019). Loan default challenges in Nepalese MFIs: Causes and consequences. *Economic Journal of Nepal, 42*(1),67–85.

Paudel, K. (2013). Socio-economic impact of microfinance in Nepal: Challenges and opportunities. *Economic Review of Nepal, 41*(2), 67–90.

Sharma, R. and Nepal, B. (2020). Evolution and impact of microfinance in Nepal: A policy perspective. *South Asian Journal of Development, 25*(1), 78–92.

Shrestha, P. (2019). Women's empowerment through microfinance in Nepal: A case study approach. *Economic and Political Weekly, 54*(3), 45–56

Shrestha, S. (2021). Rising NPLs and challenges for microfinance in Nepal: An empirical analysis. *Nepal Economic Review, 43*(3), 56–72.

Stiglitz, J. E. and Weiss, A. (1981). Credit rationing in markets with imperfect information. *American Economic Review, 71*(3), 393–410.

Thapa, S. and Yadav, N. (2023). Empowerment through microfinance: A case study of women borrowers in Rautahat district, Nepal. *Nepal Development Journal, 22*(1), 56–73.

United Nations Development Programme. (2019). *Human development report 2019: Beyond income, beyond averages, beyond today – Inequalities in human development in the 21st century*. UNDP. https://hdr.undp.org/sites/default/files/hdr 2019.pdf

Yunus, M. (2003). *Banker to the poor: Micro-lending and the battle against world poverty*. Public Affairs.