Nepal’s potential for blended finance: A country-level study

Achyut Wagle
Nepal’s potential for blended finance: A country-level study

Achyut Wagle
Preface

Southern Voice is a network of 50+ think tanks from Africa, Asia and Latin America.

Since its inception in 2012, it has served as an open platform. It provides structured inputs from the Global South into the debates on the 2030 Agenda, and the SDGs, with a view to addressing the ‘knowledge asymmetry’ and ‘participation deficit’ that usually afflict such global discussions.

In 2017, Southern Voice started to explore the use of blended finance as part of the strategies to finance the 2030 Agenda in Least Developed Countries (LDCs). It is a joint effort with the United Nations Capital Development Fund (UNCDF) and the United Nations Foundation. In this context, four country case studies, along with a synthesis paper, were carried out in Bangladesh, Nepal, Senegal and Uganda. These were inputs also for the UNCDF’s report “Blended Finance in the Least Developed Countries,” published in November 2018.

The present study constitutes the analysis of the limitations and possibilities of blended finance in Nepal. This work explores in depth the use of blended finance to close the financing gap as well as to achieve the Sustainable Development Goals (SDGs). The study also includes the impact of the application of several models of resource mobilisation and management throughout time.

Debapriya Bhattacharya, PhD
Chair, Southern Voice and Distinguished Fellow, CPD

Dhaka, Bangladesh
Abstract

The concept of blended finance as an emerging tool for development financing, particularly towards meeting the SDGs in least developed countries (LDC), is seen with substantial optimism in Nepal, especially by the private sector. Albeit, the incumbent government in Nepal sees blended finance as one option among several models of development finance. Development practitioners see it as an opportunity to unlock private financing to meet a significant financing gap to attain the country’s development goals, including the SDGs. This paper takes an exploratory research approach to weigh on possibilities and constraints for blended finance in Nepal. Its findings are based mainly on three strands of research: analysis of available data on public, private, and commercial funding trends and potentials, review of policies and institutional frameworks related to development finance and, extensive group (roundtable) or individual interviews with a wide range of stakeholders including representatives from the Ministry of Finance and the Central Bank, private sector leaders, and international development partners. The study finds that in Nepal, the blended nature of finances has been particularly helpful in the hydropower sector and that the country is likely to encourage blending in specific areas like power generation, transportation, infrastructure and to improve existing mechanisms for SME financing.

Author

Achyut Wagle holds a PhD in Economics and currently is an Adjunct Professor at Kathmandu University School of Management (KUSOM), Kathmandu, Nepal. He can be reached at achyutwagle@gmail.com.
# Content

Preface .................................................................................................................. iv  
Abstract ................................................................................................................. v  
List of figures ......................................................................................................... viii  
List of tables .......................................................................................................... ix  
List of acronyms ..................................................................................................... x  
Overview ................................................................................................................ 12  
Financial flows ..................................................................................................... 17  
SDGs in context ..................................................................................................... 20  
Development finance in Nepal ............................................................................. 22  
  Financial intermediation model ........................................................................... 22  
  PPP model ........................................................................................................... 24  
  Impact fund model ............................................................................................... 29  
Blending potential ................................................................................................. 32  
  Caveats ................................................................................................................ 33  
  Challenges .......................................................................................................... 34  
  Risks .................................................................................................................... 40  
Summary of findings ............................................................................................... 42  
  Understanding blended finance .......................................................................... 42  
  Policies, institutions and capacities ................................................................... 44  
  Blended finance alignment with SDGs ................................................................. 45  
  Investments in the missing middle ...................................................................... 46  
  Possible support of blended finance to domestic private sector and local market .............................................................................................................................. 47  
  Remittances ......................................................................................................... 48  
  Investment by non-resident Nepali (NRN) .......................................................... 48  
  Checking the capital flight ................................................................................... 48  
  Promotion of private equity and venture capital markets .................................... 49
# References

References  ................................................................. 50

# Appendix I

Appendix I ................................................................. 53

# Appendix II

Appendix II ............................................................... 56
List of Figures

Figure 1. FDI flow into Nepal 17
List of Tables

Table 1. Capital formation by private investment ......................................................... 16
# Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAAA</td>
<td>Addis Ababa Action Agenda</td>
</tr>
<tr>
<td>ADB</td>
<td>Agriculture Development Bank</td>
</tr>
<tr>
<td>CIT</td>
<td>Citizen Investment Trust</td>
</tr>
<tr>
<td>DFIs</td>
<td>Development Financial Institutions</td>
</tr>
<tr>
<td>DFID</td>
<td>Department for International Development</td>
</tr>
<tr>
<td>EPF</td>
<td>Employees' Provident Fund</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>FITTA</td>
<td>Foreign Investment and Technology Transfer Act</td>
</tr>
<tr>
<td>FNCCI</td>
<td>Federation of the Nepalese Chamber of Commerce and Industry</td>
</tr>
<tr>
<td>GEF</td>
<td>Global Environment Facility</td>
</tr>
<tr>
<td>GoN</td>
<td>Government of Nepal</td>
</tr>
<tr>
<td>IBN</td>
<td>Investment Board of Nepal</td>
</tr>
<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
</tr>
<tr>
<td>INFFs</td>
<td>Integrated National Financing Frameworks</td>
</tr>
<tr>
<td>KSUTP</td>
<td>Kathmandu sustainable urban transport project</td>
</tr>
<tr>
<td>MCPW</td>
<td>Micro Credit Project of Women</td>
</tr>
<tr>
<td>MM4P</td>
<td>Mobile Money for the Poor</td>
</tr>
<tr>
<td>NIDC</td>
<td>Nepal Industrial Development Corporation</td>
</tr>
<tr>
<td>NRB</td>
<td>Nepal Rastra Bank</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>PCRW</td>
<td>Production Credit for Rural Women</td>
</tr>
<tr>
<td>PAF</td>
<td>Poverty Alleviation Fund</td>
</tr>
<tr>
<td>PPP</td>
<td>Public-Private partnership</td>
</tr>
<tr>
<td>RISMFP</td>
<td>Raising Income of Small and Medium Farmers Project</td>
</tr>
<tr>
<td>RDBs</td>
<td>Rural Development Banks</td>
</tr>
</tbody>
</table>
Nepal's potential for blended finance: 
A country-level study
Occasional Paper Series 48

Rural Microfinance Development Centre
Saving and Credit Cooperatives
Sustainable Development Goal
Sector-Wide Approach
Securities Board of Nepal
Nepal's Sustainable Development Goals Status and Roadmap
The Currency Exchange
Third Livestock Development Project
Town Development Fund
UNNATI Access to Finance Project
Viability Gap Fund
Youth Self-Employment Fund
Nepal’s potential for blended finance: A country-level study

Achyut Wagle

Overview

A recent effort made by the government of Nepal to assess development finance prospects for the country has estimated that the average (yearly) financing requirement to achieve the SDGs by 2030 would be of about USD 17.70 billion (Government of Nepal, 2018a). This accounts for approximately 50% of the GDP for the period 2018-2030. This amount exceeds the entire annual national budget (USD 12.7 billion) by USD 5 billion and is about five times larger than the allocated capital expenditure of USD 3.5 billion for the fiscal year 2017-2018. This explains the extent of the funding gap that Nepal, as a least developed country, faces towards meeting its development objectives, including the SDGs by 2030.

The government, in its latest budget speech for the fiscal year 2018-2019 (beginning July 15), indicated that it intends to adopt and mobilise blended finance resources selectively, mainly to generate resources for power generation projects (Government of Nepal, 2018a). Similarly, the government highlighted the need to create ‘special purpose’ development financial institutions (DFIs) and to undertake policy reforms. In 2018, the government also indicated that the Infrastructure Development Bank, which is in the process of establishment, will be brought into operation with the joint effort of the government and the private sector. Policy measures will be introduced to incentivise the financial sector to invest in infrastructure through the instruments of blended financing (Government of Nepal, 2018a).
The private sector leaders and private fund managers see blended finance as a tool with the potential to bridge the funding gap. According to Shekhar Golchha, Senior Vice-president of the Federation of the Nepalese Chamber of Commerce and Industry (FNCCI), the ‘shared liability and risk’ notion rooted in the concept of blended finance, has the potential to attract private actors to invest in priority areas such as the achievement of the SDGs. According to Golchha, the government must be ready to change both, the policy and institutional frameworks, to enable direct private sectors engagement in areas such as the social sector, where the private sector has seen more risk in attaining effective results in the past.

Siddhant Raj Pandey, Chairman of Business Oxygen (B02) a venture SME fund, considers that blending would be possible in the Nepalese context if two main challenges are addressed. On the one hand, the private sector must be able to utilise the grants that come as technical assistance without recipients having to pay taxes on them. On the other hand, a legal reform is required to enable a profit-oriented company to receive (lend) funds, including grants from (to) another company, including international financiers. Currently, the Nepalese legal regime only allows public entities to receive such funds.

A large portion of the population in Nepal has limited access to formal financial services and this remains one of the biggest bottlenecks in mobilising domestic financial resources required to achieve the SDGs. Only 40% of the adult population in Nepal has access to formal banking services. From this group 73% lives in urban areas. About 60% of Nepalese do not have access to financial services, mostly because they reside in rural areas where financial institutions have limited or no presence (Finmark Trust & UNCDF, 2015). The gap between the ownership of bank accounts between adult males and females is more than 8% and the gap between the rich and the poor is 12%. The gross national saving rate is only 3.82% of GDP, which severely constraints the mobility of domestic financial resources (Demirgüç-Kunt, Klapper, Singer, Ansar, & Hess, 2018). This indicates the importance of achieving the SDGs despite all odds.
With the exception of small microfinance tickets, all loan disbursements are invariably based on collateral evaluation rather than project evaluation. This represents an important constraint to those borrowers who do not own physical property. To facilitate the commercial financing of large projects through direct lending, the monetary policy (fiscal year 2017-2018) for BFIs, has defined hydropower, agriculture, tourism, exports, small and cottage industries, pharmaceuticals, cement and garment as priority sectors (Nepal Rastra Bank, 2018a). Commercial banks are required to allocate a minimum of 25% of total credit to priority sectors, which include a minimum of 10% to agriculture, 5% to hydropower, 5% to tourism, and the remaining percentage to other priority sectors. However, the existing provision for development banks and finance companies to extend a 10% and 15% of their total credit to the priority sector remains unchanged (Nepal Rastra Bank, 2018b).

Nepal’s financial architecture lacks DFIs. The decision to transform two former DFIs (the Agricultural Development Bank and the Nepalese Industrial Development Corporation) into regular commercial banking institutions as part of the financial sector reform in late 1990s, is now seen as a missed opportunity (see Annex 1). Other institutions were created. The Town Development Fund (TDF) was established in 1989 and is an effectively functional DFI with a small portfolio of USD 50 million that provides concessional financing to municipalities (see Box 1). It is largely a donor driven initiative and its public-private partnership (PPP) model fits into the emerging definition of blended finance. The TDF focuses mainly on SDGs 6 (clean water and sanitation), SDG 9 (industry, innovation, and infrastructure), and SDG 11 (sustainable cities and communities). Its administrative structure and jurisdiction might be redefined.
soon to expand its services to provincial jurisdictions due to the country's restructuration into a federal set-up.

Box 1. Town development fund, objectives and activities

The Town Development Fund (TDF) is an autonomous financing institution established by the Government of Nepal (GoN) in 1989. Its long-term institutional objectives are:

1. To improve basic urban infrastructure and services through long term financing for priority sector projects (social, basic utility and revenue generating) through its loan and grant funding.
2. To strengthen technical, managerial and financial capability of municipalities; to identify, implement and evaluate urban development projects; including promotion of institutions working for urban development.
3. To improve financial and managerial capacities of emerging institutions in urban sectors aiming for social development through the provision of long-term financing.

The TDF is the only autonomous financial intermediary institution in the country providing debt financing to local governments. Several donor agencies, including the GiZ, the KfW, the ADB, and the World Bank have worked with TDF since its inception in Nepal. Local governments in Nepal, especially municipalities and fast-growing emerging towns, are its main clients. The GoN, especially, the MoF and the NPC, consider TDF as a key institution with a significant role to play in the urban infrastructure development of the country.

Another relatively new DFI is the Hydroelectricity Investment and Development Company Limited (HIDCL), set up by the Government of Nepal in July 2011 as a special purpose vehicle (SPV) to address the country’s energy crisis through aggressive hydropower development. It is a public investment company, with a USD 100 million capital (80% equity from the Government of Nepal; the remaining 20% is planned to be generated through IPO).

The Central Bank of Nepal (Nepal Rastra Bank-NRB) provides licenses and currently supervises four types of financial intermediaries. As of January 2018, there were 28 class ‘A’ commercial banks, 67 class ‘B’ development banks, 42 class ‘C’ finance companies, and 42 class ‘D’ microfinance institutions. The total number of branches of these BFIs has reached 5,600. Even though Nepal federates into seven states (provinces) and 753 local governments, the distribution of major bank branches is highly skewed towards big cities. About 47% of these branches is still concentrated in Kathmandu (the capital), and three out of six metropolitan cities located in it. Similarly, commercial bank branches are present only in 352 out of 753 local government jurisdictions (Nepal Rastra Bank, 2018e). The skewed access to financial services in different geographical regions of the country might pose additional challenge in attaining SDGs across the country.

There are two large pension funds: Employees’ Provident Fund (EPF) and Citizen Investment Trust (CIT). In addition, there are 20 insurance companies whom BFIs depend on as the main institutional deposit base. EPF alone manages a USD 2.5 billion portfolio. The EPF has financed several small to medium-sized hydropower projects and it has also bought aircrafts for national flag carrier in accordance with the government’s
requirements. Some of this financing has elements of concessionality. EPF sees the potential for blended finance but mainly in areas of government priorities, where ticket sizes are relatively large and other BFIs are ready to co-finance as it doesn’t directly manage the individual project-based credit.

Similarly, CIT also sees possibility in implementing the blended approach in Nepal. CIT plans to set up one of the consortiums of hedge funds, a bill to authorise this function to the new institution is already being drafted. CIT has also planned to be a mutual fund manager that can provide concessional funding. The main preference of both EPF and CIT, are hydropower, tourism infrastructures like hotels with medium-time horizon (5-8 years), and relatively larger investments. Their financing decisions are often dictated by the government rather than by risk-return analysis.

The availability of alternative sources of funding within the country is limited. There are about 13,500 saving and credit cooperatives (SACCops). They now have a Rs 250 billion (USD 2.5 billion) deposit base, which is roughly equivalent to about 10% of the aggregate deposits mobilised by the BFIs (National Planning Commission, 2017). Nepal’s capital market, including the bonds market is still incipient and dominated by the financial sector. Very recently, some hydropower companies are being listed. Most investment-related rules restrict foreign individual or institutional investors to invest through the secondary or bond market. For example, one of the major restrictions is that the FDI investors must form a partnership with local investors even to open a bank account in the name of their company. The capital gain tax to foreign investors in the secondary market is 25% against 7.5% to the domestic investors. The policy and institutional arrangements necessary to enable blended finance in the country are yet to emerge.

Financial flows

Nepal has suffered from chronic underinvestment almost in every sector, from power generation to major infrastructure and manufacturing projects. In more than a decade,
private sector investment in gross fixed capital formation has barely grown by 10% (see Table 1). The capacity of the private sector to finance large projects remains very limited. The banking sector lending to the private sector is currently estimated to be close to 90% of the total disbursement, which is about 70% of the GDP (now estimated in USD 30 billion). This means that the financing capacity of the country’s banking sector has already been exhausted, especially considering that similar disbursements in developed economies are often above 200% of the GDP.

Table 1. Capital formation by private investment.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Investment in Gross Fixed Capital Formation (% of GDP)</td>
<td>16.9</td>
<td>17.7</td>
<td>16.7</td>
<td>16.1</td>
<td>18.1</td>
<td>18.7</td>
<td>22.8</td>
<td>21.7</td>
<td>25.4</td>
<td>26.3</td>
</tr>
<tr>
<td>Share of the private sector credit in the banking sector credit (%)</td>
<td>78.9</td>
<td>80.2</td>
<td>79.9</td>
<td>81.4</td>
<td>83.5</td>
<td>87.6</td>
<td>90</td>
<td>93.7</td>
<td>90</td>
<td>90</td>
</tr>
<tr>
<td>Private sector credit (% of GDP)</td>
<td>44.4</td>
<td>53.5</td>
<td>52.9</td>
<td>52.7</td>
<td>57.4</td>
<td>58.6</td>
<td>64.5</td>
<td>75.1</td>
<td>75.6</td>
<td>79.7</td>
</tr>
<tr>
<td>Private sector credit (annual % change)</td>
<td>29</td>
<td>14.2</td>
<td>13.9</td>
<td>11.3</td>
<td>20.2</td>
<td>18.3</td>
<td>19.4</td>
<td>23.2</td>
<td>18</td>
<td>20</td>
</tr>
</tbody>
</table>


Similarly, foreign direct investment (FDI) in Nepal has remained low. According to Nepal Rastra Bank, Nepal received USD 142 million as FDI in the current fiscal year (2018-2019) compared to USD 8.3 million in the previous fiscal year. The stock of FDI in Nepal reached USD 1.5 billion in mid-July 2017, which is about 5% of the GDP. Compared to Nepal’s neighbouring countries, the FDI inflows in Nepal are substantially low with shares of 0.01% of total FDI in the world while the South Asia region received over 3% in 2017. It is worth mentioning that Nepal did not even receive the committed amount of FDI (see Figure 1).
The GoN introduced a new foreign investment policy in 2015 with the objective of attracting foreign investment, technology, skills and knowledge. However, it did not change the bleak scenario. The new policy incorporates the changing context of investment portfolios, non-resident Nepalese investment, special economic zones, labour relation issues, and mobilisation of debt instruments in domestic and foreign currencies.

Figure 1. FDI flow into Nepal

Source: Author’s calculations based on the data published by the Department of Industry/GoN, various years.

A recent study from the Nepal Rastra Bank (2018f, p.11) indicates:

The legal arrangements that govern FDI in Nepal include the Foreign Investment and Technology Transfer Act (FITTA), 1992; the Foreign Exchange (Regulation) Act, 1962; the Investment Board Act, 2010; the Industrial Enterprises Act, 2016; the Company Act, 2017; the Investment Board Act, 2011; the Contract Act, 2000; the Arbitration Act, 1999; the Income Tax Act, 2002, the Labour Act, 2017; and the Privatisation
Act, 1992. DOI, the Investment Board of Nepal (IBN), and NRB are the agencies for administration and implementation of rules and regulations related to FDI. This in essence shows that Nepal's policy governing the FDI is highly fragmented.

According to UNCTAD's World Investment Report (2017), the introduction of these new policies has contributed to the improvement of the country's investment climate since the devastating 2015 earthquake. From a low base, FDI in Nepal almost doubled to a record high of USD 198 million in 2017 (Figure 1), mostly driven by Chinese investments in infrastructure, cement products, and mining. In an earlier version of the same report, UNCTAD already mentioned that Intra-Regional FDI, especially from China and India, was likely to grow in Bangladesh and Nepal, facilitated by India through its shared membership in the South Asian Association for Regional Cooperation and from China by bilateral agreements (UNCTAD, 2017).

### SDGs in context

Since the implementation of the 14th periodic plan (2016-2017 and 2018-2019) in July 2016, the government has mainstreamed the SDGs into the national planning and budgeting systems. After the adoption of the SDGs, the budgets of fiscal years 2016-2017 and 2017-2018 were aligned with the 2030 Agenda (National Planning Commission, 2017). In face of the SDGs, Nepal's objective is to build on the important development milestones related to education and maternal health achieved in the framework of the MDGs.

In line with the recommendations of the Addis Ababa Action Agenda (AAAA) regarding the use of national development strategies and plans to achieve the SDGs and to adopt Integrated National Financing Frameworks (INFFs) to manage funding needed to meet the goals by 2030, the Government of Nepal carried out a Development Finance Assessment in 2017. Even though the report highlights and assesses Nepal's financing gap (USD 17.7 billion are needed annually to meet the SDGs), the analysis does not address the potential of blended finance meeting the demands of the 2030 Agenda (Nordby et al., 2017).
After Nepal's recent political transition after the 2017 elections, the new government is tasked with adopting institutional structures, policies and strategies required to operationalise the Integrated National Financing Framework with the SDGs as a priority. Along with the new federal governance structure, several SDG-related functions have also been displaced from the central governments to subnational and local governments. For example, the achievement of the goals related to agriculture (SDG 2), health (SDG 3), education (SDG 4), or water and sanitation (SDG 6) are now under the mandate of local governments. These adjustments demand different strategies of resource allocation, mobilisation and public financial management to enable both subnational and local levels to align their finances as well as their project implementation strategies with the priorities of the 2030 Agenda. However, severe vertical and horizontal fiscal imbalances between the central government and the provinces might pose additional challenges to mobilise public funds in the new federalised structure (Wagle, 2018).

The latest progress reports "Development Finance Assessment, Final Report" (2017) and “Nepal's Sustainable Development Goals Status and Roadmap (SDGsSR): 2016-2030” (2017), have recognised the need for a full-scale mobilisation of potential investment of public and private sectors, both domestically and internationally, to bridge the funding gap that rises to 50% of GDP by 2030. This recognition provides with a policy basis for collaboration of the different sectors and positions blended finance as a mechanism to articulate collaboration to generate additional development financial resources. The DAF estimates that approximately USD 250 million per year would be available for the SDGs from 32,000 cooperatives, including SACCops, spread across the country. This would have the potential to complement...
public and private investments and initiatives towards the SDGs. To complement this potential source of funding, Nepal aims to explore other potential sources of finance for development such as the inbound remittances from migrant workers abroad, which currently represent about 30% of GDP. Nepal can also benefit from its own financial architecture and institutional setup, specifically if the country is able to draw from its experience with initiatives that are already in place and have a ‘blended’ nature.

**Development finance in Nepal**

Nepal has adopted several models of resource mobilisation and management throughout time. In the process, several dedicated financial institutions were created, recreated, and dissolved in some case. Some major models that have been adopted are discussed below.

**Financial intermediation model**

Nepal’s development finance has historically been led by the public sector. In 1959, Nepal Rastra Bank NRB, created the Nepal Industrial Development Corporation (NIDC) as a special purpose vehicle for providing longer term financial services to private industrial enterprises. NRB participated in equity, extended reﬁnance services and subscribed its debentures (which lead up to 30% stake). NIDC, in turn, participated in equity, provided loans and facilities for private sector enterprises, particularly in the tourism and manufacturing sector. Similarly, the Agriculture Development Bank (ADB) was set-up in 1968 to provide agricultural credit to farmers and agro-based enterprises. NRB was the promoter of this bank and it also provided required reﬁnancing to the projects it originally ﬁnanced. Until 1995, the ADBN remained the single largest rural ﬁnancial institution (Pradhan, 2006). Now, converted into a public sector commercial bank, it still has the largest rural branch network in the country.

---

1 Article 51 (d)3 of Nepal’s Constitution mentions the special role of cooperatives seeking to promote the cooperative sector and mobilise it in national development to the maximum extent.
In 1974, the Priority Sector Credit Policy was introduced as a mandatory lending instrument for commercial banks, mainly to address the problem of access to formal financial services in the poorer and downtrodden sections of the population. This policy was later enhanced as an Intensive Banking Program in 1981. In 1990, the Deprived Sector Credit Program was introduced to address the growing demand for microcredits, particularly in poverty-stricken rural areas. After several modifications, the commercial banks still needed to extend 5% of their total loan disbursement to the deprived sector (Nepal Rastra Bank, 2017). The government created a Rural Self-Reliance Fund in 1991 with the objective of providing institutional wholesale credit to smaller financial intermediaries like SAC Cops and financial non-governmental organizations (FINOGOs). This fund was created since financial service providers at the grassroots level often lacked adequate amount of loanable funds to meet the borrowing demands.

Following the Grameen Bank model of Bangladesh, rural microfinance development banks were established in two development regions in 1992 and in 1996. Other three were added to cover all five development regions. Initially, NRB had the majority stake in all these five Rural Development Banks (RDBs), but they were later privatised and merged into one in order to consolidate its resources and to reduce the management costs. It currently has the most extensive national network and serves mainly to the rural population. In 1999, with a loan from the Asian Development Bank, the Rural Micro Finance Development Centre (RMDC) was created as an implementing agency of a rural microfinance project that aimed to improve the socio-economic status of poor individuals, mainly, women, through wholesale credit to FIs. The Rural Self-Reliance Fund was established in 1991 and provides wholesale credit to target groups. Its capital has reached USD 8 million, with funding of USD 5.5 million from the Government of Nepal and USD 2.53 million from the Central Bank. The Fund disburses seed capital credit to its affiliated organisations based on their capacity and primary capital. It has disbursed credit in the amount of USD 23 million to about 1,200 smaller FIs. It has a recovery rate of 95%.
To sum up, Nepal’s development finance policy has been implemented mainly in six models, namely the Bangladesh ‘Grameen’ model, the guided lending model, the wholesale microfinance model, project-based microcredit model, the FINGOs model and the cooperative model. International development partners have also financed and promoted project-based micro financing. These include IDA, ADB, UNDP, UNICEF, UNIFEM, EU, IFAD, USAID, CIDA, GIZ, DFID, and UNCDF. Some of the major donor-funded projects carried out in Nepal include the Production Credit for Rural Women (PCRW), the Micro Credit Project of Women (MCPW), and the Third Livestock Development Project (TLDP). Ongoing projects include the Raising Income of Small and Medium Farmers Project (RISMFP), the UNNATI Access to Finance Project (UNNATI-A2F), Mobile Money for the Poor (MM4P) and Making Access Possible (MAP) (Pant, 2016, p.10).

**PPP model**

Public-private partnerships (PPPs) in Nepal are mainly concentrated in hydropower development and, to some extent, in transport services and infrastructure (see Table 2). According to the IMF, Nepal has 12 sizable PPP projects with an investment of USD 1.18 billion per year (see Table 2 for latest 10 largest PPP projects).

The Public–Private Partnerships for Urban Environment Project, which started in 2002 with the support of the United Nations Development Programme, has worked towards raising local and national awareness of the potential of public–private partnerships (PPPs) and creating a joint financing mechanism through PPPs for local urban service delivery with continued capacity building and policy and legislative interventions.
The Council for Technical Education and Vocational Training and the Federation of Nepalese Chambers of Commerce and Industry have established a PPP to develop nine trade schools. These schools provide training to develop employment-oriented skills (National Planning Commission, 2011).

Education and health sectors are not only two key goals under SDGs but also represent a substantive share of Nepal’s public (as well as private) investments. PPPs in Nepal’s education sector have not been entirely successful due to regulatory provisions related to fees and salaries. However, according to ADB (2016), training facilities substantially grew in Nepal. The number of accredited private institutions grew from three in 1991 to 110 in 2000 and crossed 450 mark in 2014. There is also a fresh PPP initiative in the health sector, the impact of which is yet to be seen. It is important as PPP with added component of concessionality is deemed as one of the models for blending the project financing.

A Public-Private Partnership (PPP) Policy was introduced in October 2016 by the government. The policy seeks to enhance private sector participation in public sector projects mainly related to infrastructure and services. The PPP policy and the proposed bill states that a global bidding process is necessary for projects exceeding USD 10 million. The policy identifies six main potential areas for PPP projects (PPP Policy, Para. 11.3(2)):

- Physical infrastructure and transport (roads, bridges, airports, railways, cable cars, ropeways and all kinds of ports).
- Power sector (singly or jointly related to production, transmission and distribution) and other types of energy-related projects.
- Information and communication sector.
- Urban and rural environment sector (for example, solid waste management, drinking water, sewerage and sanitation).
- Infrastructures related to education, health and all aspects of tourism including infrastructure and facilities (except for hotels and residences).
- Urban infrastructures related to services and facilities.
One of the most contentious issues in Nepal's PPP policies and projects has been the establishment and operationalisation of an effective viability gap fund (VGF), which mobilises capital grants to make the project financially viable. The PPP projects with some degree of concessionality are implemented by the Town Development Fund Nepal (see Box 2). The main argument against PPPs is that the profit is unidirectionally directed to the private partners while the public sector only bears the responsibilities of the projects.

Box 2. Kathmandu sustainable urban transport project (KSUTP)

**Project Area:** Kathmandu Valley Transport System improvement and urban public transport financing

**Total Project Cost:** USD3.8 million (GEF&ADB Grant)

**Project Concept:**

TDF has received a grant from the Asian Development Bank (ADB) and the Global Environment Facility (GEF) under the Kathmandu Sustainable Urban Transport Project (KSUTP) for financing the implementation of the Public Transport in S5 Pilot Route (Gongabu to Sinamangal) and the establishment of Sustainable Urban Transport Fund within TDF.

TDF shall use the repayment from the new Bus Operating Company to establish a revolving fund that may be used to finance subsequent public transport sector, which possess huge business potential for TDF. Hence, this pilot case is considered a good business opportunity which will pave the way for new business portfolios for TDF in the urban public transport sector.

**Project Objectives:**

The main objective of KSUTP is to improve the overall quality of urban life in the Kathmandu Valley. The specific objectives of the project are:

- With the aim of reducing the use of private vehicles in the future, KSUTP will investigate effective measures to significantly enhance the existing
public transport services by providing more convenient, comfortable, reliable, and safe public transport system.

- The project will take effective measures for the enhancement of road network operations by improving traffic management and traffic safety in the valley.
- The project also aims to declare pedestrianisation zones (car free zones) in the Kathmandu City core area. A total of 8 km heritage pedestrian walkways and 15 km of sidewalks improvements are part of the pedestrianization programs.
- Improving air quality monitoring and reduction in air pollution within the Kathmandu City.

TDF's involvement in KSUTP includes only the financing for Public Transport fleet with low emission or electric vehicle by setting up of financing mechanism. Out of the two pilot routes selected for the implementation by KSUTP, only the S5 pilot route was found commercially viable according to the operation and business plan prepared KSUTP / PMCBC.

**Financing Modality:**
TDF will receive a grant of USD 3.8 million (USD 2 million from GEF and 1.8 million from ADB) to implement the pilot route and the revolving fund.

Approval Date: July 22, 2010 (signing date: October 26,2010; effectiveness date: January 05, 2011)
Closing Date: June 30, 2018 (Revised)

**Blended Financing Model**
TDF loan financing =80% of project cost
Equity investment by private entity (M/s Digo Sarbajanik Yatayat (P) Ltd.) =15% of project cost
GoN grant as decongestion reward (for designing the project that reduces the traffic congestion is about 5% of total project cost.)
Project Beneficiaries:
In accordance with the business plan, the total number of 61 private operators, comprising of 26 micro-bus 25 Safa Tempo, operating in the S5 Route, had established a new operating company, M/s DigoSarbajanikYatayat (P) Ltd., which is 100% owned by the private sector. It signed a Service Level Contract with DoTM for 12 years.

The project will directly benefit 15,027 daily local commuters. It would also have a significant impact on the urban environment due to the use of low emission vehicles. Most importantly, it will help to abolish existing ‘syndicate’ (price cartel) in public transport, which is seen as bottleneck for improvement of the sector.

Expected Output:
The specific planned outputs of the projects are as following:

- In Kathmandu, public transport services and walkability are improved, favouring a modal shift from private vehicles and improving traffic conditions.
- Public transport is improved and upgraded, and a revolving fund established within TDF for PT financing.

Project Status: Active/ ongoing

Way Forward: Scaling-up the promotion of the public transport fleet with low emission or electric vehicles in other pilot routes through established revolving fund within TDF is a major way forward of the project. The project considers that identifying improved modes of mass transportation in the city are important to cope with the increasing population and urbanizations.


Practitioners and potential private sector investors advocate for a mechanism to address the viability gap according to differentiated project structures and considering
the progress and return-base of the PPP project in question. The practice of preparing a detailed project report (DPR) before the project’s launch is critical since the DPR can only distribute risk between the public and private sectors.

The policy has also acknowledged the fact that there is an absence of VGF, therefore, private investors are reluctant to invest in medium and large projects. Challenges persist due to the absence of a policy framework to distribute risks while implementing projects of national importance and large infrastructure development under the PPP concept, absence of appropriate arrangements to address the issue of VGF, inability to make project selection transparent, inappropriate feasibility studies, lack of independent project appraisal, lack of investment-friendly atmosphere, and persistence of problems related to security and land acquisition (Para. 4.5, p.2).

A separate act on Private Financing in Building and Operation of Infrastructures (2006 and its ensuing regulation, 2007) are in place. The objective of the act is to involve the private sector in the building, operation, and transfer of infrastructures in consistency with the liberal economic policy pursued by the country.

Impact fund model

Nepal has experimented with several approaches to encourage private participation in social projects or to canalise private investment and entrepreneurship to small commercial start-ups. Concessional funding arrangements have been adopted with the objective of making the products of micro and small entrepreneurs competitive in the market. Among them, three funds are briefly mentioned below.

- Poverty alleviation fund (PAF)
  This Fund was established in 2004 and enacted in 2006. The World Bank currently provides the required funding, while private parties access credit by directing a percentage of the counterpart fund to initiate the business. This is one of several
other customized financing models promoted by the PAF. To improve the living conditions of poor communities, the fund identifies communities in need and works with community organisations.

The PAF approach encourages beneficiaries to form community organisations and provides seed fund. Community organisations design and implement projects and manage revolving funds. According to K C (2018) the PAF also identifies the poorest of the poor in communities throughout Nepal and then partners with local governments and civil society organisations to provide community mobilisation and facilitation services. The transparency of the projects is evaluated by both PAF and directly by the community organisations receiving the support based on performance evaluation scoring. This model has often been cited as successful case in poverty reduction. The PAF claims that about 2 million people have been lifted out of abject poverty through this initiative. This endeavour could be linked to SDG 1.

- Challenge fund
  Between 2016 and 2017, the government set-up a Rs 1 billion (USD 10 million) fund to support start-ups. The main objective of the Challenge Fund is to provide seed capital to support innovative and entrepreneurial projects lead by young people. The fund supports business innovation initiatives of private parties that can prove that they are prepared to partially finance their projects. The Challenge Fund supports Nepal’s objective of becoming a middle-income country by 2030. Budget for this project has been allocated for the current fiscal year; however, the disbursement of funds has been limited due to ambiguous regulatory framework, lack of proper information and access, and procedural barriers. There are several similar funds also set-up by development partners.

- Youth self-employment fund (YSEF)
  The fund, later renamed as the Youth Self-Employment and Small Entrepreneur
Fund, was established by the government in 2009. It provides unemployed youths with collateral-free, low interest loans from financial institutions. The main objectives of the YSEF are to facilitate the improvement of livelihoods of economically disadvantaged groups, including women, Dalits (untouchables), indigenous nationalities, conflict victims, people living with disabilities, members of the injured and martyrs’ families, and the youth. It provides collateral-free periodic loans of up to NPR 200,000 (USD 2,000) for an individual and up to NPR 5,000,000 (USD 50,000) against a group guarantee for commercial farming, agro-based industry or service-oriented self-employment programs.

This fund has deemed to be politically biased in picking its borrowers and has been considered largely ineffective in meeting its objectives since its investments have been far lower than its outcomes. It could generate self-employment only for 50,000 youths against the target of 200,000. For this reason, the government has proposed to evaluate the possibility to merge it with other funds such as the Rural Self Reliance Fund and the Economic Revival Fund in order to create a larger resource base. The government has also proposed to assess the impacts of the projects in the future.

- SWAp model
  The Sector-Wide Approach (SWAp) was implemented in 2010. The government and international development partners, both multilateral and bilateral, agreed to create a sector specific fund and manage it through a single government’s budgetary mechanism. A joint financing arrangement to create this consolidated fund was signed in 2009 by GAVI, USAID, World Bank, AusAid, DFID, KfW, UNICEF, WHO and UNFPA.

This project has been particularly effective in two sectors: education and health. This initiative has achieved important outcomes in primary school enrolment rates, and child and maternal health care. The coordination efforts among the
development partners through SWAp proofed to be effective during the rescue and relief efforts after the 2015 earthquake in Nepal. Despite these tangible results, expansion towards sectors like the transportation sector are not yet a reality. To achieve this, policy coordination and clear jurisdiction guidelines for the central and provincial governments could be valuable for similar initiates in Nepal and other countries.

**Blending potential**

Recent literature on both development finance and SDGs, recognise the importance of adopting Integrated National Financing Frameworks (INFFs) to manage the funding needed to meet the SDGs in Nepal. The public sector seems equally determined to put all possible efforts to achieve the SDGs. The government of Nepal acknowledges that the funding needed to achieve the SDGs can be met by attracting private and commercial capital from domestic and international sources (see Appendix 1). The private sector has also shown interest in the concept of blended finance and has raised its commitment to achieve the SDGs through blended finance mechanisms.

According to widespread definitions of blended finance (OECD, 2017), Nepal has undertaken several policies, institutional and project level initiatives to allocate public funds with the objective of leveraging private and commercial investments. There are several examples of successful PPPs. The government's willingness to design and implement specific PPP policies also vindicates PPP's potential in Nepal's future economy.

---

2 SWAp is implemented in Tanzania and Bangladesh. Both countries have been considered for this research.

3 The engagement of the private sector was demonstrated when the Confederation of Nepalese Industries (CNI), an umbrella organization of Nepali businesses, chose to be one of the co-hosts, along with the International Finance Corporation, the Investment Board of Nepal, and the Standard Chartered Bank, of the first national conference on blended finance, organized in April 2008 in Kathmandu.

4 According to the OECD (2017), blended finance is defined as the strategic use of development finance for the mobilization of additional finance towards sustainable development in developing countries.
SWAps in the public sector may serve as other forms of blended financing. Experiences with impact funds and microfinance show that development financing, mainly in the form of loans, is still mostly concentrated in small businesses and/or livelihood support schemes rather than in industrial scale economic outputs. This has exacerbated the ‘missing middle’ scenario in Nepal. In this scenario, it is possible to say that the effective adoption of blending finance in Nepal is not at all without caveats, challenges and risks.

Caveats

Government's recent reports such as the Development Finance Assessment (2017) and SDGsSR (2017) point to the fact that there is a huge financing gap to achieve the SDGs. Interestingly though, these reports fail to recognize the importance of blended finance. International organisations such as the OECD and several UN agencies have underlined the emerging importance of the blended finance to bridge the financing gap in countries like Nepal. This exposes the extent of the information and knowledge gap about the topic in the country's policy-making circles. The need for theoretical and technical skills about blended finance in the policy-making circles is pressing.

As Nepal transforms into a federal system, the extent of devolution of public financial authority in new federal set up to provincial and local governments is yet to be defined, legally. Whether state governments would be allowed to negotiate directly with a potential foreign investor or development partners are contentious and await an appropriate legal framework. Equally questionable is the capacity of both state and local governments to absorb the available resources and optimize their output; commensurate to the constitutionally vested decision-making authority on them.

With the formation of a communist government with very strong parliamentary majority at the centre and in six out of seven states, the much-awaited political stability seems to have arrived. But at the same time, confidence of private investors is apparently flickering. Since the communist party started to perform better in local elections, the
The country's stock exchange has dropped by more than 400 points. Similarly, there are concerns over ensured private property rights in the longer term and uncertainty in key policy like taxation and profit repatriation.

Challenges

Availability, access and cost of funding

Availability of public funds to allocate as the seed or primary equity in SDG-linked projects and to attract commercial and private investment for blending remains the biggest challenge. The current macroeconomic situation also portrays a rather bleak scenario. Net transfer receipts of workers' remittances from abroad has been declining. Some of these economic trends like Nepal's dependence on imports for consumption, thereby desiccating the productive sector and globally increasing volatilities on remittances originating particularly in the Arabian Gulf region seem unlikely to reverse anytime soon. The country is likely to face tight financial condition, at least in the short run. The SDGs Report (UNDP, 2017) estimates that the financing gap to achieve the SDGs in the public sector will be high in infrastructure (58%), while such gap in the social sector will comprise 31%. In view of the increased size of the government while transitioning into the federal structure, this gap is only likely to widen.

In an interview conducted as part of this study, an equity fund manager stated: "In the reports that are circulated abroad, I only mention the abbreviation, UML and MC, of the name of the major two ruling parties, namely the Communist Party of Nepal, the United Marxist-Leninist party (UML), and the Communist Party of Nepal- Maoist Center (MC) to avoid the potential alarm to be created by the word ‘communist’." Another interviewee also discussed his deliberate effort to avoid referring to Nepal’s “socialist oriented economy.”
Nepal faces another paradox as its inability to expend available resources including its own budget earmarks. Nepal’s absorptive capacity of official development financing has remained historically low. For the last two decades, Nepal has been able to spend only 25% of disbursements and below 17% of total commitments. Even the government’s allocation of available budget is not spent timely. For example, only about 26% of the allocated capital expenditure of USD 3.35 billion has been spent in the first three quarters of the current fiscal year. Although the issue warrants much deeper investigation, some aspects that can explain this situation include ad hoc budgeting and planning processes, highly fragmented portfolios, chronic institutional inefficiencies leading to belated disbursement and bidding process and, odd size budgeting, among some of the most important.

Regarding commercial funding, Nepal’s financial system suffers from loanable funds. Average rate of commercial banks is now at approximately 11%. Even a consortium of the entire banking industry would not be in a position of generating enough funds to finance even a 200 MW hydropower project (i.e. USD 300 million). The effective cost of funds in commercial lending, including the processing and service charges, now exceeds 20%. Such cost in microfinance-type of lending has long been remained at around 30%. This has been the most inhibiting factor for private sector to set-up businesses making use of the BFI loans. Limited access to formal financial services, credit remains an issue of serious concern. According to a study, only 9% of the country's adults have access to credit from BFIs and cooperatives combined. Self-employment is thus very limited and increasing the income level of the population remains a challenge.

Policy regime

With the exception of some laws regulating impact funds and PPP Policy (2015), there are no policies that authorize public funds to be loaned or invested in equity to enable blending them with commercial or private financing. This is a priority in order to turn blended finance into a reality. Blended finance is a fresh paradigm and therefore,
the creation of new legislation is inevitable in order to allow the investment of public funds and ensure convincing risk-free returns to attract adequate private investment. Despite this and due to current legislative procedures, the existing monetary and fiscal policy would not be substituted entirely by the newly drafted laws in Nepal.

Despite several concessional financing arrangements (for commercial agriculture and woman entrepreneurship), the actual disbursement is very limited due to the lack public awareness on these issues and the bureaucratic limitations involved. There is need to customize several existing and upcoming laws, for example, the ones related to cooperatives and PPPs, to enable both public and private sectors to blend financing for development projects and achieve the SDGs. Due to the differences between sectors (for example, education and infrastructure projects), it would be useful to have separate legislations following SDGs categorisation in accordance with the required funding. In addition, several laws related to taxation and profit repatriation need an update. Regulatory environments, and monitoring and evaluation frameworks, now extended to the sub-national and local level, also need urgent improvement.

Institutions and their efficiency

Nepal suffers from a chronic institutional deficiency both in the public and private sector. Existing institutions related to budgeting, planning, public procurement, project implementation and overall regulation are highly inefficient as evidenced by its limited ability to manage capital expenditure. According to NRB periodic review (October,
(2018), in the first quarter of the current fiscal year, only 6% of the allocated budget for development had been spent. There are problems of compliance and transparency in the private sector as well. Price and supply cartels undermine the private sector’s credibility.

Institutions that help reduce investment risks by ensuring credible credit rating and quality financial literacy are not yet present in the country. There are about a dozen capital funds licensed by the Securities Board of Nepal (SEBON), but their role is practically limited to issue managers of stocks. Existing mutual funds are unable to expand their portfolio, primarily because the public knowledge about such investment instruments is very limited.

The domestic public and private sectors and, international development partners (IDPs) require an autonomous economic research institute to fill the data gaps and facilitate evidence-based policy formulation and project planning necessary for SDGs and blended finance initiatives. The private sector proposes to operationalise sizable venture capital funds, set up a VGF to distribute the risks in PPPs and TCX (The Currency Exchange) Fund to hedge the risk arising from the exchange rate volatility, particularly in FDI.

Public institutions such as the Investment Board Nepal (IBN), which oversees and facilitates the implementation of larger investment projects (for example, hydropower of more than 500 MW capacity), is also keen to be the focal institution to manage finances of blended projects. In an interview, Maha Prasad Adhikary (see list of interviewees in the Appendix 1), CEO of IBN, indicated: “We are the obvious choice for the job given our experience, institutional capacity and objectives.” He also thinks that the concept of blended finance comes just at the right moment: “[Blended finance] reduces the burden to the public coffers, manages risk for the private sector and ensures fair price of products due to attached concessionality.”
The government is also willing to set up the required institutional framework with the purpose of mitigating and distributing investment risks. The new budget speech (2018) proposes:

All productive sector companies having capital of one billion (rupees) or more will be required to convert them into public limited companies and get listed with Stock Exchange. New institutions like private equity, venture fund and hedge fund will be introduced in to the capital market. Credit rating assessment of Nepal will get conducted with the objectives of easing the process of foreign investment and credit placement (Government of Nepal, 2018a, p. 199).

The Central Bank is adjusting the monetary policy to facilitate the establishment of these institutions and to adopt the regulatory framework. In an interview, Dr. Chiranjivi Nepal (see list of interviewees), Governor of Nepal Rastra Bank, stated: “We realize that if we can put appropriate policy framework in place, the blended finance mechanism can unlock new private sector resources […]. The monetary policy for the next fiscal year (beginning July 15) will reflect these needs.” He also sees the need of financial education for all stakeholders focused on tailor made knowledge products according to differentiated financial and investment needs.

Operationalising the blended finance concept

Both, blended finance and the SDGs, need to be implemented in Nepal’s changing political context. The Development Finance Assessment (Nordby et al., 2017) has proposed
to frame the SDGs and Vision 2030 within the federal policy at the national and local levels. These changes require massive capacity enhancement and adequate resources. IDP representatives expressed the need for policy reform as a starting point. According to their views, blended finance can stimulate policy change and meaningful cooperation between the private and the public sectors in financing and achieving the SDGs (see Box 3).

**Box 3. Outcome of a roundtable meeting of IDPs held in Kathmandu on 31 May, 2018**

- The involvement of international development partners (IDPs) depends mainly on how their respective headquarters view and treat it. However, the solutions often may have to be customised, yet it is not clear what is exactly evolving and how that would be coordinated across the agencies, both bilateral as well as multilateral.
- The Government of Nepal and its development partners can play a major part in meeting the SDGs as they did with the MDGs. In accordance with the Addis Ababa Action Agenda, the structure of the strategies outlines the role of financing institutions and has shown how the private sector could contribute.
- Several things are going to change in this decade. The biggest change is going to be the shift from financing using highly concessional resources to the financing with risk mitigation. That can be the core element in making blended finance work.
- Major challenges to implement the blended finance in Nepal include:

---

6 These proposals were made by several stakeholders in the ISET-N round table (o) and in course of individual interviews with private sector leaders representing the Federation of Nepalese Chambers of Commerce and Industry (FNCCI), the Confederation of Nepalese Industries (CNI), and the Nepal Chamber of Commerce (NCC).
- There is no clear policy on blended finance or public private partnerships.
- There is lack of clarity in the government’s vision, especially in relation to the private sector.
- It is not clear how bilateral, trilateral or tetra lateral agreements will take place.
- Articulation within the government of Nepal (at the state, province and municipality level) is limited.
- There is no clear mechanism for risk management.
- Inter-ministry cooperation and coordination is missing.
  • Availability of capital would not be an issue if there is transparency within the government.
  • The perspective of LDCs and their connections with the SDGs must not be lost.
  • The understanding of blended finance among stakeholders should be an immediate priority
  • Nepal has so far failed to establish a functional development finance institution.
  • Sizable mutual funds and venture capital market are not created. Credit rating is a key. IDPs should support to create these key institutions as prerequisite to initiate ‘blending’.

Risks

Regardless of any policy or institutional arrangement, private sector investment is unlikely to flow in unless political risk is convincingly reduced by government policies. Stakeholders, and potential private investors have identified three types of risks’.

The fund managers, particularly those managing foreign equity requested complete anonymity. Therefore, their names and affiliation have been left out of this study.
Policy risk

Nepal's new government has adopted a concept of 'selective privatisation' and has made a commitment to revive closed or dilapidated public enterprises (PEs). Annually, the government disburses an average of USD 300 million to cover the losses of about three dozen PEs, out of which only a few are profitable. These public resources are perceived to be a loss of funding that could otherwise been utilised for development projects or 'blending' initiatives with commercial and private partners.

Another widespread concern is that the communist government might go back to control economy. Policy predictability is certainly an issue in this scenario. Some fear that the private sector would have no incentive to invest in left-out areas due to the crowding out of lucrative sectors because of public investment.

Country risk

Since Nepal is not yet in a sovereign credit rating, investors do not have a clear understanding of the nature of the risks of investing in Nepal. Private actors worry about security risks faced by large hydropower projects located in secluded areas of the country. Land acquisition and community forest clearance procedures are extremely time-consuming and often disproportionately costly. Risk return ratio is another concern. Nepal's current rate of return on investment is around 12%. International private investors maintain that this rate must be of at least 16% for a substantial amount of FDI to enter the country.

Currency risk

The exchange rate of the Nepalese currency is closely dependent with the Indian currency. However, the existing fixed exchange rate mechanism has provided limited stability to Nepal's monetary system. Foreign investors argue that volatility in the Indian
economy might cause unexpected risk in forex rates regardless of how good or bad Nepalese economy performs.

Foreign currency payment to investors is also a politically sensitive issue in Nepal due to exchange rate volatility. Therefore, mechanisms like The Currency Exchange Fund or TCX Fund have been advocated for. These mechanisms can provide a certain level of protection against exchange rate volatility, mainly in the event of domestic currency devaluation while projects with a longer completion period are being implemented in the country.

**Summary of findings**

**Understanding blended finance**

The understanding of blended finance in Nepal, at the conceptual, definitional, and operational levels is extremely limited and is often vague even at the highest policy and decision-making levels. More than 80% of the decision-making elites we interviewed for this study (see Appendix 2), heard the term "blended finance" for the first time during these interviews. About 12% of the interviewees consider that blended finance is no different to PPPs, a concessional SMEs loan, or some other form of joint financing. The remaining 8% had a better idea about this topic. Many interviewees considered that any project of mixed financing nature (public DPs, private DPs, and public-private projects), could be considered as 'blended finance'. It was also identified that different sectors have their own priorities and reasons to adopt, advocate
or resist the adoption of blended finance. There is an apparent lack of understanding about two key components of blended finance: concessionality, and additionality.

There is not a uniform approach from the government to grasp and utilise the potential of blended finance. As evidenced during an interview with the Minister of Finance, Dr. Khatiwada (See Appendix 1), decision-makers within the government perceive blended finance as one among many alternative mechanisms of development financing. In stark contrast, Investment Board functionaries believe blended finance is the only available alternative to unleash private sector investment and close the development financing gap. This is an urgent task since state funding is limited, official development assistance is rapidly shrinking, and the country is facing difficulties catching up with emerging global trends to attract FDI.

The private sector is particularly enthused about blended finance. Public stimulus funds and sovereign or corporate guarantees present in the blending schemes not only distribute risks but provide with much-needed credibility for private sector equity in the projects traditionally financed only by the public sector. The private sector advocates for that policy changes and institutional arrangements that are needed for the private sector to be able to finance larger projects, whether blended or not.

Development partners, particularly bilateral ones, have their own priorities to advocate for traditional financing models. For example, some support SMEs and poverty reduction while other focus on inclusion strategies for the most disadvantaged. Very few have plans for large project financing. Policy consistency, public sector institutional efficiency and transparency are major causes of concern for development partners.

There is widespread belief among all stakeholders, particularly in the private sector, that blended finance, though it is only adopted in small ticket size and a few hydropower

---

8 These inputs are based on views expressed in the round table meeting of Nepal’s international DPs organized by UNCDF on 31st May 2018 in Kathmandu.
development companies\(^9\), it has the potential to mobilise additional financing for SDG-related investment in Nepal.

### Policies, institutions and capacities

The legislative process is slow and existing legal frameworks related to blended finance in Nepal are inadequate. Potential investors, both domestic and foreign, highlight the need to adopt or modify the following legal instruments\(^{10}\):

- Laws to progressively open the capital market to the foreign investment.
- Amendment of the FITTA to open an automatic FDI route for priority development sectors.
- Laws to enable government’s financing of an ecosystem for financial intermediation that incorporates practices of loss equity, hedging, credit, and country risk mitigation.
- Policy calibration to expand listings of real sector companies in the capital market (85% of listed companies are BFIs).
- Law to develop and regulate the local currency bond market.
- Law to allow insurance companies to invest in infrastructure bonds.
- A dedicated blended finance act that incorporates blending elements of the laws related to PPP, BOOT, BOT, priority sector lending, concessional lending etc.
- The Secured Transaction Act (2006) could collateral-free financing in sectors such as agriculture and related commodity markets.
- Laws that allow international credit rating agencies to operate in Nepal.

---

\(^9\) According to Kul Man Ghising, Managing Director of the Nepal Electricity Authority (NEA), hydroelectricity projects like Upper Tamakoshi (PPP), Chilime, Salleri-Chyalsa, have been financed using a blended model.

\(^{10}\) This listing has been compiled using the outputs from the multi-stakeholder blended finance conference held in Kathmandu on 20th April and the DPs roundtable held on 31st May 2018.
As for the institutions, there is no domestic DFI effectively present in Nepal (see Appendix 1). The small ticket (microfinance type) concessional lending practices are highly fragmented across several ministries, donors, and NGOs. The private sector emphasises the need of a professional and independent intermediary institution (between the government and the private sector) to manage the funds to be allocated by the government as stimulus for blending and to make the financing objectively viability-based which can be free of politically favoured self-selection of the projects.

A sovereign credit system is deemed a prerequisite to signal country risk and credibility. The need of a domestic credit rating is also considered necessary. The government plans to set up a hedge fund, which currently does not address the need of introducing institutional mechanism to mitigate the exchange rate risk. There is no sizable presence of mutual funds. Current capitalization is barely USD 150 million where the market potential is estimated to be at least USD 15 billion. This has been an impediment for investors to invest through secondary markets.

Capacity constraints, both in terms of institutional efficiency and resource mobilisation are real bottlenecks in Nepal. The ability of the government to undertake project selection, financing, implementation, and sustaining is limited. In terms of financial resources, there is very limited investible funds available in the domestic financial system and the government is always cash-starved. On the other extreme, the ability to spend available funds is so limited that governments capital expenditure barely exceeds 50% of the allocation due to capacity constraints at various levels of administration.

**Blended finance alignment with SDGs**

The 17 SDGs cover almost all areas of socio-economic development of the nation-states. However, alignment of the SDGs with blended finance schemes remains a challenge. This is due to the fact that the concept of blended finance is currently emerging, and its definition still needs to be adapted to country-specific contexts.
Concessional microfinance practices are contributing to reduce poverty (SDG1) and eliminate hunger (SDG2). Financing in hydropower is contributing to increase access to clean energy (SDG7) and reduce climate change effects (SDG13). TDF financing for urban infrastructure and services contributes to create sustainable cities and communities (SDG11). Similarly, joint financing mechanisms of development partners, government and local users (deemed private parties) through SWAs are helping to meet health (SDG3) and education (SDG4) targets.

As mentioned by the Minister of Finance, the proposed budget for the next fiscal year would prioritise the SDGs through the allocation of seed money for blending finance. Instead of dispersing potential FDI and private finances across all the SDGs, the government’s immediate focus is on attracting private for hydropower and large infrastructure projects such as airports, roads, rail, and health and educational institutions.

Private equity funds, like Biruwa Ventures, are working with NGOs to achieve the SDGs by helping entrepreneurs to enhance opportunities, innovation, and profit through the mobilisation of local resources. Business Oxygen, another private fund supported by DFID (UK) and IFC of the World Bank Group, have similar objectives.

**Investments in the missing middle**

The definition of the missing middle can be relative to the structural stratification of the economy. In terms of financial access to business, the mainstream financial institutions usually concentrate on larger investments and in governments’ social uplifting schemes. They focus, for example on poverty reduction and livelihood support by targeting the bottom-end of the population. As such, businesses find it hard access smaller amounts of funding ranging from EUR 100,000 to EUR 300,000 (OECD, 2018).

According to the CEO of the Business Oxygen about 111,442 SMEs, which employ 1.75 million people and account for 22% of the gross domestic product are unquestionably
the missing middle in Nepal. Only 39% of Nepal’s SMEs have access to finance. IFC’s USD 7.3 million investment available as part of IFC’s SME ventures programme to Business Oxygen in June 2017, is expected to focus on this particular group. This would make finance available for start-ups with high risk profile and difficult operating conditions (The Kathmandu Post, June 13, 2017).

Nepal’s lending from the formal financial sector is entirely collateral-based and banks usually finance only 50% of the market value of the property. According to the private sector in order to address the missing middle, Nepal needs to change the following aspects of its lending practices: a) Nepal’s conservative approach towards lending must be changed in order to finance projects based on their viability and risk-return due diligence; b) individual, as well as corporate credit worthiness should be made additional basis of financing, c) appropriate legislation should be introduced to enable BFIs to finance without collateral security; d) responsible banking habits amongst borrowers should be developed through financial education and entrepreneurship training. Stakeholders agree that blended finance can be a useful tool to address the needs of the missing middle.

Possible support of blended finance to domestic private sector and local market

The average growth of deposits and private sector credit between 1960 and 2016 was 19.7% and 22.1% respectively; the average growth during the period 2011-2016 was 22.3% and 22.9% respectively (Nepal Rastra Bank, 2018f, p.70). Private savings and credit currently constitute approximately 80 and 70% of the GDP in current dollar price which as the sum is not very large but growth is impressive.

Besides the financial resources available through traditional markets like BFIs and pension funds, the private sector has at least five major sources of funding: workers’ remittances, investment by non-resident Nepalese, checking the capital flight, mutual and venture capital, and FDI. These that can be channelled to meet the development financial needs given the stable political climate, suitable policy regime and appropriately designed instruments for investment.
Remittances

According to the Economic Survey of the Government of Nepal (2017-2018), the inflow of remittances from Nepalese migrant workers has constituted more than 85% of total foreign exchange inflow into the country during the past years. The inflow has remained approximately equivalent to 30% of the GDP for last five years. More than 80% of the remittances is used for household consumption and less than 3% is used for savings and/or investment in productive assets (Nordby et al., 2017). If the challenges related to the business climate, the entry of new financial intermediaries, and the need for more diversification of financial sector products and services are addressed, remittances can play a significant role as an additional source of finance for development (Nordby et al., 2017, p.58).

Investment by non-resident Nepali (NRN)

Nepalese businesspeople who live abroad are often considered in Nepal as references of capital, technology and management skills that could be invested in the country. There are some sporadic middle-sized investments by this group in areas like the financial sector, health services and hydropower. They are also substantially involved in community level charities of different types. A joint pledge made by NRN Association to create a USD 1 billion fund to invest in Nepal was decided five years ago but it is yet to be materialised.

Checking the capital flight

Net outflow of money from Nepal has fluctuated between 6 and 10% of GDP from 2004 to 2013 (Kar & Spanjers, 2015). If tax rates are rationalized and private property rights are unequivocally ensured, investors' confidence will be increased. Consequently, at least 50% of the estimated USD 2.5 to 3 billion, could be retained and invested in Nepal.
Promotion of private equity and venture capital markets

Private sector leaders believe that the lack of sizable and well-managed financial intermediaries, platforms, and instruments are a bottleneck for those who have the capital to invest in Nepal. The establishment of credible private equity and venture capital funds, the market expansion of mutual funds and merchant banking could greatly facilitate investments. A few new private equity funds like Dolma, BO2, and Biruwa have shown positive trends, but they are still in their infancy. The inflow of FDI to Nepalese is less than 0.02% of GDP. Some of the reasons include bureaucratic hurdles, an uncertain business environment, and risks arising from policy uncertainty related to taxation, lack of clarity in defining the capital gains, and repatriation of profits.

The private sector has viewed the possible adoption of the blended model as a vehicle to support the domestic private sector. This enthusiasm was demonstrated when CNI along with Standard Chartered Bank became co-host of the first blended finance conference held in Kathmandu in April 2018. The government of Nepal is convinced of the benefits of blended finance and this should help accelerate the necessary policy reforms to channel remittances towards productive investment, materialise NRN's committed investment, create demand for the fund's investment, facilitate the establishment of equity funds and venture capitals, among others.

When the government itself becomes an equity-holder through blending, the bureaucratic impediments in various stages of the project's implementation are expected to decrease. This would reduce the cost and execution period of the projects. Several foreign investors still look for some form of government assurance before making investments in the country, and blended finance can become a key mechanism to achieve this goal.
References


Appendix I

List of interviewees (including actors who participated in roundtable discussions)

1. Dr Yubaraj Khatiwada
   Minister of Finance
   Government of Nepal
2. Dr Chiranjivi Nepal
   Governor
   Nepal Rastra Bank (the Central Bank of Nepal)
3. Mr Kebal Bhandari
   Joint Secretary
   Ministry of Finance
4. Mr. Narayan Khatiwada
   PPP Expert
   National Planning Commission
5. Mr Maheshwar Lal Shrestha
   Executive Director
   Nepal Rastra Bank
6. Mr Maniram Singh Mahat
   Executive Director
   Town Development Fund
7. Mr Maha Prasad Adhikary
   CEO
   Investment Board Nepal
8. Mr. Shekhar Golchha
   Vice President
   Federation of Nepalese Chamber of Commerce and Industry
9. Mr. Saurabh Jyoti  
   Chairperson, Bank, Finance & Insurance Committee  
   FNCCI
10. Mr Hari Bhakta Sharma  
    President  
    Confederation of Nepalese Industries (CNI)
11. Mr Gyanendra P. Dhungana  
    President  
    Nepal Bankers' Association
12. Mr Bharat Raj Dhakal  
    President  
    Development Bankers' Association Nepal
13. Mr Ramchandra Joshee  
    President  
    Nepal Microfinance Bankers' Association
14. Mr Tim Gocher  
    CEO  
    Dolma Investment Private Equity Fund
15. Mr Siddhant Raj Pandey  
    Chairman  
    Business Oxygen Private Equity Fund
16. Mr. DruvaTimilsena  
    Chairman  
    Merchant Bankers’ Association of Nepal
17. Mr. Jyoti Chandra Ojha  
    Chief Executive Officer  
    Rural Microfinance Development Centre
18. Mr Tulasi Prasad Gautam  
    Administrator (CEO)  
    Employees’ Provident Fund (EPF)
19. Mr Ram Krishna Pokharel  
   Executive Director  
   Citizen Investment Trust
20. Mr Sanam Chitrakar  
   Partner  
   Biruwa (Venture Investment) Advisors
21. Mr Kul Man Ghising  
   Managing Director  
   Nepal Electricity Authority
22. Mr Chhabi Raj Pokharel  
   Chief Executive Officer  
   Hydroelectricity Investment and Development Company Ltd. (HIDCL)
23. Dr Suresh Balkrishnan  
   UNCDF, Nepal Office
24. Dr Chandramani Joshi  
   Embassy of Finland, Kathmandu
25. Keshav Kumar Acharya  
   GiZ, Nepal Office
26. Raj Kumar Dhungana  
   Norwegian Embassy, Kathmandu
27. Namaraj Adhikary  
   JICA, Nepal Office
28. Bal Ram Paudel  
   UNDP, Nepal
# Appendix II

## Table A1. Town Development Fund

<table>
<thead>
<tr>
<th>Name of the project</th>
<th>Implementation period</th>
<th>Implementing agency</th>
<th>Sources of finance (primary, supplementary)</th>
<th>Total Amount</th>
<th>Status</th>
</tr>
</thead>
</table>
| Kathmandu Sustainable Urban Transport Project (KSUTP) | • Date of approval: July 22, 2010  
• Signing Date: Jan 05, 2011  
• Closing Date: June 30, 2018 (revised) | Town Development Fund (TDF) | Asian Development Bank (ADB) And Global Environment Facility (GEF) | US$ 3.8 million (US$ 2 million from GEF grant account and US$1.8 million from ADB grant financing) | Active/ongoing |

## Table A2. Salleri Chyasa Hydropower Plant

<table>
<thead>
<tr>
<th>Name of the project</th>
<th>Implementation period</th>
<th>Implementing agency</th>
<th>Sources of finance (primary, supplementary)</th>
<th>Pre-feasibility</th>
<th>Intended Outcome</th>
<th>Completion status</th>
</tr>
</thead>
</table>
| Salleri Chyalsa Hydropower (400 KW initially; 200 KW turbines installed in 2015) | 1982-1993 | Swiss Agency for Development and Cooperation (SDC) And Nepal Electricity Authority (NEA) | Promoter share: 50% SDC 50% NEA  
Ordinary share: 33% SDC 33% NEA 34% Public | ca. 1982 | Electricity efficiency | Electricity supply started in 1988  
Project runs until 2050 |
Table A3. Solu Hydroelectric Project

<table>
<thead>
<tr>
<th>Name of the project</th>
<th>Implementation period</th>
<th>Implementing agency</th>
<th>Sources of finance (primary, supplementary)</th>
<th>Total Amount</th>
<th>Pre-feasibility</th>
<th>Intended Outcome</th>
<th>Completion status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Solu Hydroelectric Project (23.5 MW) (run-off-river/ in SoluKhola, Solukhumbu district.)</td>
<td>January 2015 to June 2018 (possibly going to be extended)</td>
<td>Upper Solu Hydro Electric Company Pvt. Ltd.</td>
<td>Rs. 3.075 billion (75%) lenders and Rs. 1.025 billion (25%) promoters.</td>
<td>Rs. 4.1 billion</td>
<td>n/a</td>
<td>to contribute with app. 132.52 GWH of energy</td>
<td>About 80% completed</td>
</tr>
</tbody>
</table>