SAKCHYAM ACCESS TO FINANCE

from the British people

Implications of Decentralization on the Nepalese Financial Sector

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In Collaboration with

Monetics

Contents

Decentralization

The term "decentralization" embraces a variety of concepts, which must be carefully analyzed in any particular country before determining if projects or programs should support reorganization of financial, administrative, or service delivery systems.

1. Types of Decentralization

Types of decentralization include political, administrative, fiscal, and market decentralization. Drawing distinctions between these various concepts is useful for highlighting the many dimensions to successful decentralization and the need for coordination among them. Nevertheless, there is clearly overlap in defining any of these terms and the precise definitions are not as important as the need for a comprehensive approach. Political, administrative, fiscal and market decentralization can also appear in different forms and combinations across countries, within countries and even within sectors.

1.1 Political Decentralization

Political decentralization aims to give citizens or their elected representatives more power in public decision-making. It is often associated with pluralistic politics and representative government, but it can also support democratization by giving citizens, or their representatives, more influence in the formulation and implementation of policies. Advocates of political decentralization assume that decisions made with greater participation will be better informed and more relevant to diverse interests in society than those made only by national political authorities. The concept implies that the selection of representatives from local electoral jurisdictions allows citizens to know better their political representatives and allows elected officials to know better the needs and desires of their constituents.

Political decentralization often requires constitutional or statutory reforms, the development of pluralistic political parties, the strengthening of legislatures, creation of local political units, and the encouragement of effective public interest groups.

1.2 Administrative Decentralization

Administrative decentralization seeks to redistribute authority, responsibility and financial resources for providing public services among different levels of government. It is the transfer of responsibility for the planning, financing and management of certain public functions from the central government and its agencies to field units of government agencies, subordinate units or levels of government, semi-autonomous public authorities or corporations, or area-wide, regional or functional authorities.

1.3 Fiscal Decentralization

Financial responsibility is a core component of decentralization. If local governments and private organizations are to carry out decentralized functions effectively, they must have an adequate level of revenues – either raised locally or transferred from the central government– as well as the authority to make decisions about expenditures. Fiscal decentralization can take many forms, including a) self-financing or cost recovery through user charges, b) co-financing or co-production arrangements through which the users participate in providing services and infrastructure through monetary or labor contributions; c) expansion of local revenues through property or sales taxes, or indirect charges; d) intergovernmental transfers that shift general revenues from taxes collected by the central government to local governments for general or specific uses; and e) authorization of municipal borrowing and the mobilization of either national or local government resources through loan guarantees. In many developing countries, local governments or administrative units possess the legal authority to impose taxes; but the tax base is weak and the dependence on central government subsidies so ingrained that no attempt is made to exercise that authority.

1.4 Economic or Market Decentralization

The most complete forms of decentralization from a government's perspective are privatization and deregulation because they shift responsibility for functions from the public to the private sector. Privatization and deregulation are usually, but not always, accompanied by economic liberalization and market development policies. They allow functions that had been primarily or exclusively the responsibility of government to be carried out by businesses, community groups, cooperatives, private voluntary associations, and other non-government organizations.

Deregulation: Deregulation reduces the legal constraints on private participation in service provision or allows competition among private suppliers for services that in the past had been provided by the government or by regulated monopolies. In recent years, privatization and deregulation have become more attractive alternatives to governments in developing countries. Local governments are also privatizing by contracting out service provision or administration.

2. Decentralization in the Context of Nepal

In March 2017, the Government of Nepal (GON) restructured local government and started the process of transferring responsibility for many important public services (including primary and secondary education, health clinics and some hospitals, local development, and some agricultural programs) to the 7 State and 753 Local Governments (LGs). The funding of these services is being changed from the funding that earlier came from appropriations to Central government ministries to fiscal transfers or grants made directly to the States and LGs. In the 2017/2018 budget, grants to States/LGs and social services will constitute roughly 37% of total spending, up from an estimated 30% in 2016/2017, and 35% (actual) in 2015/2016. Changes in the flow of funds through the newly established States and Local Governments will require development of new approaches to PFM to ensure that funds are used for their intended purpose, and the Federal government is able to report accurately from a "whole-of-government" standpoint on how revenues from all sources—federal, State, and LG—are coming together to provide basic services and meet Nepal's development needs.

Given that many aspects of this new federalism (including key pieces of legislation such as The Intergovernmental Fiscal Transfer Bill; The Local Level Governance Bill; and The National Natural Resources and Fiscal Commission Bill, among others) are still at an evolutionary stage, the programme's year 4 work plan activities have been flexibly designed in close cooperation with the MoF, and other stakeholders.

3. Constitutional Changes

The promulgation of the Constitution of Nepal in 2015 declared Nepal as a Federal Democratic Republic and the unitary system of governance is replaced with a decentralized federal form of governance. As per the Constitution, Nepal has started to exercise a three-tier federal government structure from March 2017, with a re-structured governance system at Federation (national), State (provincial) and Local level. The local level governance system is comprised of 753 new Local Level Governments (LLGs) comprising of metropolitan cities, sub-metropolitan cities, Municipalities (Nagar Palikas) and Rural Municipalities (Gaon Palikas).

Until local elections were held, civil servants deputed by the Ministry of Federal Affairs and Local Development (MoFALD) headed the new local governments. However, after the first second and third round of elections on 14 May 2017 in states 3, 4 and 6, on 28 June 2017 in states 1,5 and 7, and on 18 September State 2 the newly elected local governments are responsible for planning and implementing their own budgets.

The Constitution has provisioned that each Local Government will have its own Local Consolidated Fund from which all income and expenditure of the respective government will be mobilized and that the Office of the Auditor General (OAG) will audit its accounts. Local government accounts will need to be maintained in the format prescribed by the Auditor General. Along with the formats of accounting approved by OAG, the central government is supposed to provide a model law for financial operations of the local governments.

Nepal's Constitution 2015 Articles 228 – 230, elaborates local financial procedures. The municipal executives from LLGs are required to present annual estimates of revenue and expenditure for approval before the municipal assembly. The budget must mention estimates of revenue from all sources during a fiscal year. The municipal executives are also required to present detailed expenditure estimates, with heading and subheadings classified for every fiscal year. Expenditures must also be classified as capital and revenue expenditures. The accounting system of LLGs shall be maintained in the format prescribed by the Office of Auditor General (OAG) as per Nepal's constitution, article 241. The specified financial reports must be submitted to local, federal and provincial governments on a quarterly and annual basis. The reporting format at local government level will facilitate its consolidation at provincial and federal level.

4. Guidelines on Planning and Budget Formulation provided by the Ministry of Federal Affairs and Local Development (MOFALD)

As per the MOFALD guidelines issued recently, every LLG should formulate their annual plan and budget through a participatory process in a result-oriented manner. Before formulating the plan and budget, a profile, as per MOFALD's prescribed format, exhibiting the real status of the areas including geographical, social, economic and infrastructure should be prepared. The LLGs may revise this format as required, by including additional details, and make the profile available for public use through its website.

While formulating the annual budget and programs, the LLGs should use the revenue and expenditure headings as stipulated by the Ministry of Finance, Government of Nepal. Every LLG should formulate and pass its annual budget and program for the forthcoming fiscal year through its assembly, as prescribed in the law, before the start of the forthcoming fiscal year. The LLGs are required to constitute the following committees:

- **Revenue Advisory Committee**: Abiding to the Constitution of Nepal and prevailing laws, the LLGs must form a revenue advisory committee to estimate the revenue that can be collected in the forthcoming fiscal year, and also include analysis of revenue source, scope and rate of mobilization within its working area.

- **Resource Estimation and Budget Ceiling Fixation Committee**: This committee shall be formed for the projection of total revenue to be collected and the preparation of a framework for the balanced distribution of such revenues.

- **Budget and Program Formulation Committee**: Based on the estimation and allocation framework prepared by the Resource Estimation and Budget Ceiling Fixation Committee, and pursuant to Article 230 of the Constitution of Nepal, this committee shall formulate annual programs and budgets for their LLG.

5. Planning and Budgeting Process

Once these committees are established, the following processes shall be followed:

- Prioritization and Formulation of Plans / Projects - Before formulating the annual plans / projects and budget, LLGs should prepare the basis and standards for the selection and prioritization of plans and projects. While preparing the basis and standards, different standards may be prescribed for settlements, communities and wards.

- Annual Budget and Program Formulation Process - While formulating the annual budget and programs of the local level, the following processes must be followed:

    a) Obtain fiscal transfer and budget and program formulation guidelines from the Federation (national) and province;
    b) Resource Estimation and Budget Ceiling Fixation;
    c) Settlement/community level project/program selection;
    d) Ward Level Project/Program Prioritization. Provisions regarding projects and programs should be prepared in collaboration with non-governmental organizations and the private sector.

- **Budget and Program Implementation, Monitoring and Evaluation Process** - After the annual program and the budget is approved by the rural municipal/ municipal council, the rural municipality / municipality executive office shall prepare the implementation plan. While preparing the action plan for implementation, the implementation modality, timeframe, agency or official responsible for implementation, the standards for monitoring and evaluation, and the process must be defined. While implementing the project / program, prevailing laws must to be complied with, including the Public Procurement Act. The LLG must make adequate provisions for regular monitoring of the projects being implemented.

6. Directives Relating to Formulation and Implementation of Budget and Financial Management and Handover of Assets at LLGs

The Ministry of Finance, GoN, has issued directives to all the new LLGs to implement the budget, systematize the budgeted expenditures against grants received from Federal Government and income generated through internal resources, and maintain uniformity between LLGs. Some of its key provisions are:

6.1 Grants and Budget Releases

Pursuant to the Appropriation Act, 2017, the Act prescribes the transfer of the grant amount under Grant Number 801 to the local consolidated fund. Pursuant to the provision prescribed therein, the concerned District Treasury Controller's Office (DTCO) shall in three instalments transfer the amount to the Consolidated Fund and the transfer shall be made on 16th July 2017, 17th November 2017 and 4th March 2018.

Where the equalization grant received from the Government of Nepal is unconditional by nature for the current fiscal year, the grant can be used for salary, allowance and other administrative expenditures and can be used, keeping in mind programs handed over, for any programs approved by the Rural Municipal Assembly and Municipal Assembly.

With regards to conditional grants, coordination shall be maintained with the concerned local level line agency or office located at the district and the grant shall be used against prescribed works. MOFALD, in coordination with the concerned ministry, shall provide a detailed description of the grant usage. Such budget amounts shall be approved by the LLG Assembly.

6.2 Formulation and Implementation of Annual Plan, Program and Budget

The LLG shall prepare the budget by including the following resources and shall table it before its Gaonpalika Assembly and Municipal Assembly. The budget shall be implemented only upon approval by the Assembly. However, for the current fiscal year (2017 – 2018), the budget can be formulated and submitted based on the following resources: grant received from Nepal government, balance available in the consolidated fund and revenue that can be recovered.

While preparing the budget for the coming year, programs shall be finalized within the limited estimated income and shall also contain the estimated expenditure.

Programs implemented through foreign assistance at the local level shall be pursuant to the agreement made by MOF at the central level and between donor agencies and shall be implemented in coordination with the concerned unit of Nepal government.

6.3 Sources of LLG Revenues

The main sources of financing and revenue for LLGs are elaborated below:

- Equalization Grants: Central government releases funds under the Equalization Grant to the LLGs. The funds are used for various purposes including for paying staff salaries and making planned expenditure on selected activities.
- Conditional Grants: Funds released by government for specific earmarked activities. LLGs can use the funds only for the specific activities for which the grant has been provided.

- Special Grants: Special Grants are released by the government for special purposes. They are normally provided for emergency situations like earthquakes etc.
- Grant from State / Provincial Governments: States also release funds for LLGs which may be general or conditional in nature. These grants should be based on the state law and according to the guidelines of Natural Resource and Fiscal Commission.
- Matching Grants: LLG may receive matching grants from federal government or from state government to implement projects related to infrastructure.
- LLG Own Sources: These revenues are generated locally by LLGs, such as, but limited to property tax, parking charges, advertisements and other charges.
- Loans: LLGs may obtain domestic loans after obtaining agreement from the federal government.

7. Fund and Expenditure Bank Accounts

Pursuant to Article 229 of the Constitution of Nepal, the local consolidated fund shall be provided for in Rural Municipality and Municipality. The following amount shall be included in the fund and other than that prescribed by law; the fund cannot be used for any other purpose. To use the (cash) amount of the consolidated fund, a separate expenditure (bank) account shall be opened.

The cash amount collected from the local consolidated fund shall be transferred to this bank account and the expenditure shall be made accordingly:

The Consolidated Fund bank account is required to be opened only in an "A" category commercial bank that has received permission from Nepal Rastra Bank. Separate recurrent and capital expenditure accounting records need to be maintained to spend the cash amount deposited in the local consolidated fund. The description of the account of the consolidated fund shall be provided to the concerned District Treasury Controllers' Office. The concerned District Treasury Controllers' Office shall transfer the grant amount within a prescribed period.

Other than the consolidated fund, LLGs are required to open an expenditure (bank) account, deposit (bank) account and any other (bank) account deemed appropriate. Such bank accounts too should be opened in an "A" category commercial bank or any other bank and financial institution recognized by Nepal Rastra Bank.

Accounting: The accounting system of revenue and expenditure of LLGs is required to be maintained in the format prescribed by the Office of Auditor General (OAG), as per Nepal's Constitution, Article 241.

Financial Reporting: The LLG executive must submit the financial reports quarterly and annually, in formats as prescribed by the OAG, to the DTCO along with federal and provincial governments. It is imperative to maintain consistency in budget formulation, accounting and reporting for all LLGs to enable consolidation of information / reports at the provincial and federal level. For this, the FCGO has developed a preliminary framework for accounting and reporting. This was facilitated by the MOF and in co-operation with MOFALD.

8. Implications for the Nepalese Financial Sector

For the past few years, decentralization has been a main focus of discussion for reform in Nepal. It is expected that decentralization will vest greater decision-making authority with the local level policy and decision makers. As with other types of decentralization, financial decentralization is expected to lead to organizations using local information by establishing their presence to make better decisions. It is also assumed that decentralization will result in expansion of outreach of financial services as it becomes inevitable for banks and financial institutions (BFIs) to establish a presence should they wish to pursue the local market. It is therefore assumed that this will improve local information thereby allowing the banks and the programme to make informed decisions.

In recent years, Nepalese financial institutions - including those operating in remote, rural regions have been commercially motivated. At the same time, amongst the cooperatives that mostly operate in regions where regulated financial institutions are absent, there is little or no policies that regulates the lending. Thus, the lending relationships between rural financial institutions and their clients are more likely to continue to be driven by commercial purposes rather than central bank and or government policies.

It is assumed that financial inclusion programmes in Nepal will continue to work in the underserved districts in Nepal to expand access to finance for the unbanked population. This is likely to be achieved through partnerships with the regulators, the Nepalese private and public sectors to determine innovative products, cost effective means and methods to expand outreach, including in the rural, remote regions of Nepal. In regions such as these, it has been observed that while the Central Bank's policies such as 'opening of two branches in rural region required for a permit to open one branch in an urban region' encourages BFIs to look beyond the traditional concept of establishing their presence only when they determine the market size is feasible; the expansion of bank branches/ presence, similar to those of the cooperatives, continue to be driven by a profit motive.

However, and because of the information advantages of local bank branches, BFIs might now find it efficient to decentralize authority within the organization. Unfortunately, agency problems and commitment failures can undermine the ability of local bank branches to look out for the bank's greater interests. To avoid these problems, the banks headquartered at the capital and other main cities may instead choose to limit the authority of its local bank branches by setting up rules and regulations that constrain their actions and which centralize authority. The banks at the local level are therefore likely to be restricted on the loan approval and loan size restrictions, thereby effectively continuing to centralize decisions on large scale investments.

In the meantime, the Central Bank will continue to be the institution tasked with formulating policies and regulations to determine the smooth functioning of the Nepalese financial sector.

9. Interpretation of the Challenges and Opportunities for the Nepalese Financial Sector

The following section has been derived as an interpretation of Nepal's Constitution 2015 that advocates for minimum rights translated into services, including financial inclusion among others, and the likely repercussions on the Nepalese financial sector. This section also highlights Sakchyam's ambitions on addressing some of these challenges in partnership with the regulators and the Nepalese financial sector.

Lack of Capacity: The most frequently cited problem at the local level in Nepal is the lack of capacity at sub-national levels of government to exercise responsibility for public services. At the moment, the lower tiers of government and the private sectors, especially those in the remote regions lack the ability to assess viability of programmes, and to make proper investment decisions. They also lack expertise and experience in managing public finances and maintaining proper accounting procedures. Since these are a requirement for transferring money (social security payments, reconstruction and housing grants, etc.) to the disadvantaged, affected population, it is likely that distribution may be worse than before decentralization. However, it is stated in the constitution that the "Economically poor, physically incapacitated and helpless person, helpless single women, persons with physical impairment, children, persons who cannot look after themselves and the citizens who belong to communities that are on the verge of extinction, shall have the right to social security as provided for by law." It is therefore imperative that the government find solutions for better delivery of these services.

Sakchyam will work with the central and the local governments to address this challenge by partnering with Nepalese financial institutions to establish presence in the region, thereby creating a secure infrastructure for enabling G2P payments, among others. Further, the programme will continue to advocate for a sustainable model by working with the government and the industry to determine a viable pricing solution for delivery of these services thereby ensuring a creation of a partnership and a business model that will continue after the programme has come to an end.

Monitoring and Evaluation: Decentralization can lead to misaligned responsibilities because the process and criteria for monitoring and regulation of local cooperatives is incomplete, possibly for political reasons. Although there is a delegated responsibility for the Central Bank to oversee the financial sector reforms in the country, it may have a limited role and authority. While decentralization was in some cases intended to strengthen the political power of lower tiers of government vis-à-vis the center, it has also increased the possibility of political capture within these lower tiers. Often, "village heads" influence selection of members of the council that are elected to represent the nest interests of the local communities; and therefore, accountability to the villagers can be weak. This may affect Sakchyam and the financial sector as it pursues new, innovative financial products and services.

A component of the programme currently works with progressive cooperatives that have the appetite for reforms. Sakchyam's experience of working with the local institutions in the past have resulted in restructuring of management principles of these organizations, thereby creating a bankable institution that are capable of attracting investments from other financial institutions and their own members. Therefore, creating an ownership in parallel to making local institutions accountable and bankable will reduce the element of risk of political capture.

At the same time, Sakchyam has invested heavily into a non-traditional M & E system that enables real time monitoring. This is done through an active reporting and participation of the programme's partners who in turn rely on this process for course correction, if any, that is required during the implementation of their projects.

Strengthening national economy through the participation and free development of public sector, cooperative sector and private sector: The programme will continue to advocate for greater participation of the public and private sector. This has been enabled through investments in large scale projects that have brought innovation and displayed sustainable business models while enhancing financial inclusion in Nepal. This has in turn helped achieve economic prosperity by creating income generating opportunities for the programme beneficiaries, and maximum utilization of available resources through leveraging private sector investments while offsetting some element of the risks to encourage participation beyond the usual geographic regions and demographics.

Diversifying and expanding markets for productions and services through the development and expansion of industries: In the last three years, financial inclusion programmes have brought innovations to the forefront by introducing financial products such as Invoice Discounting, and Warehouse Receipt Financing aimed at expanding services to create benefits to the actors along the value chain. As a result, Nepalese businesses have been able to directly source their raw materials from the smallholder farmers who in addition to receiving a fair price of their produce, now have access to formal financial services including credit. This has offset the informal lending market generating savings and reducing dependency on the money lenders. In the fourth year, similar initiatives will be scaled up by the programme as it looks to bank on the market's confidence which translates into profit for the financial institutions and demand for the product for the smallholder farmers.

Encouraging and mobilizing foreign capital and technology investment for infrastructure development in the areas of export promotion, and import to suit national interest: Sakchyam will actively seek to identify better practices in the region, and encourage international, experienced companies to consider Nepal as means of investment. This will be done through catalyzing on Louis Berger Group's experience of working with international companies in the region, and by brokering partnerships with the Nepalese private and public sector to deliver financial products and services to the Nepalese population. The programme will aggressively pursue big ticket partnerships such as mobile insurance that is likely to bring a revolution in the insurance sector, while building resilience amongst the communities most vulnerable to diseases and disasters.

Foreign aid shall be based on national needs and priority, and it shall be made transparent: Sakchyam welcomes this initiative as part of its engagement with the Government of Nepal, and the Nepalese line ministries. The Steering Committee chaired by the Ministry of Finance will continue to endorse and approve the strategic vision and work plan of the programme. Meanwhile, the activities of the programme will continue to be reported at the Steering Committee and other meetings, while partnerships and investments with the Nepalese private and public sector made public through press releases, annual reports and other deliverables published by the programme.

Providing mobility to economic development by establishing coordination among provinces and between province and federation regarding industrial corridors, special economic zones, national projects and foreign investment projects: The programme will be keen to participate in and contribute to generating linkages between different actors through financial inclusion initiatives that will unlock investments, including foreign investments, into large scale projects. This will be achieved by working alongside DFID other development policy programmes with a mandate to enabling investments in Nepal through create of a favorable investment climate.

Formulating strategies and programs for sustainable socio-economic development under regional development plans for balanced and inclusive regional development and to implement them in a coordinated manner: The Year 4 work plan, together with some of the initiatives identified as part of the cost and time extension actively seeks to advocate for regional development by partnering with the Nepalese private and public sector to provide formal financial services to the underserved, including those in the unbanked, remote regions of the country.

Developing and expanding information technology as required by the nation, and making its access easy and simple for the general public, while also making its maximum use for national development: Introduction and advancement of proven technology to further goals of financial inclusion is a key element of Sakchyam Programme. In its fourth year, the programme will actively seek to introduce and implement large scale technology-driven partnerships such as the RTGS, and the IME Mobile Banking initiatives. These partnerships are solely driven by the agenda to serve the general public, while generating sustainable returns.

Making appropriate arrangements of livelihoods by prioritizing employment for single women who are in helpless conditions on the basis of skill, capability and merit. Making women self-reliant who are vulnerable, victims of conflict, excluded by family and the society, by making necessary arrangements of rehabilitation, protection and empowerment for them: The programme works with local women groups and cooperatives while actively seeking to include the disadvantaged individuals and poor communities to embrace livelihood opportunities through financing of their small business initiatives. As the programme moves onto its 4th year, this is likely to increase given the successes generated through identification of the correct financial products and services that have been made available to these communities. In addition, ancillary products such as insurance that will be introduced in the fourth year will provide a safety net for the disadvantaged communities that are vulnerable to natural and other disasters.

10. Response to Needs of Decentralization

Alignment with Federalisation/Decentralization

For the past few years, decentralization has been a main focus of discussion for reform in Nepal. It is expected that decentralization will vest greater decision-making authority with the local level policy and decision makers. As with other types of decentralization, financial decentralization is expected to lead to organisations using local information by establishing their presence to make better decisions. It is also assumed that decentralization will result in expansion of outreach of financial services as it becomes inevitable for banks and financial institutions (BFIs) to establish a presence should they wish to pursue the local market. It is therefore assumed that this will improve local information thereby allowing the banks and the programme to make informed decisions.

In its fourth year and into the extension, Sakchyam will continue to work in the underserved districts in Nepal to expand access to finance for the unbanked population. This will continue to be achieved through partnerships with the regulators, the Nepalese private and public sectors to determine innovative products, cost effective means and methods to expand outreach, including in the rural, remote regions of Nepal. The programme will continue to work with local women groups and cooperatives while actively seeking to include the disadvantaged individuals and poor communities to embrace livelihood opportunities through financing of their small business initiatives. As the programme moves onto its 4th year, this is likely to increase given the successes generated through identification of the correct financial products and services that have been made available to these communities. In addition, ancillary products such as insurance that will be introduced in the fourth year will provide a safety net for the disadvantaged communities that are vulnerable to natural and other disasters.

A challenge of decentralisation is the lack of capacity at sub-national levels of government to exercise responsibility for public services. Sakchyam will work with the central and the local governments to address this challenge by partnering with Nepalese financial institutions and other donor funded projects to establish presence in the region, thereby creating a secure infrastructure for enabling disbursement of funds to local governments, which are likely to include the following types of grants:

- Equalization Grants: Central government releases funds under the Equalization Grant to the local governments. The funds are used for various purposes including for paying staff salaries and making planned expenditure on selected activities.
- Conditional Grants: Funds released by government for specific earmarked activities. Local governments can use the funds only for the specific activities for which the grant has been provided.
- Special Grants: Special Grants are released by the government for special purposes. They are normally provided for emergency situations like earthquakes etc.
- Grant from State / Provincial Governments: States will also release funds for local governments which may be general or conditional in nature. These grants would be based on the state law and according to the guidelines of the to-be-formed Natural Resource and Fiscal Commission.
- Matching Grants: Local governments may receive matching grants from federal government or from state government to implement projects related to infrastructure.

All the above-mentioned grant amounts will be channelled to local governments through a consolidated fund bank account to be opened at a Class "A" commercial bank branch in the local area. "A" category commercial bank that has received permission from Nepal Rastra Bank. Separate recurrent and capital expenditure accounting records need to be maintained to spend the cash amount deposited in the local consolidated fund. The description of the account of the consolidated fund shall be provided to the concerned District Treasury Controllers' Office. The concerned District Treasury Controllers' Office shall transfer the grant amount within a prescribed period. Other than the consolidated fund, local governments will be required to open an expenditure (bank) account, deposit (bank) account and any other (bank) account deemed appropriate. Such bank accounts too should be opened in an "A" category commercial bank or any other bank and financial institution recognized by Nepal Rastra Bank.

Additionally, Government-to-Person (G2P) payments will also need to be distributed through formal banking channels. Further, the programme will continue to advocate for a sustainable model by working with the government and the industry to determine a viable pricing solution for delivery of these services thereby ensuring a creation of a partnership and a business model that will continue after the programme has come to an end.

Create Eco-system for Bank Agents

Activity Summary including Market Analysis: Agent-based banking also called branchless banking (BLB) is a relatively new concept in Nepal. Nepal's topography is geographically difficult, creating additional challenges for FSPs—especially commercial banks—to provide financial services in the most remote outposts of the country. Establishing physical branch offices in these areas is often not feasible for commercial banks due to the low population density and lack of basic infrastructure (i.e., roads, electricity, etc.) Instead, BLB makes banking services available to smaller markets that are closer to the communities. It becomes an attractive, cost-effective alternative delivery channel to bring a range of financial services to the rural poor rather than requiring customers to travel to major market centres.

Sakchyam has partnered with FSPs, mainly commercial banks, to establish 450 BLB touch points in 34 districts. Out of the total 450 BLB touch points, 173 are being established in earthquake-affected districts, whereas 277 are being established in the Mid and Far Western Development Regions (MFWDR). As of April 2017, 212 BLB touchpoints have been successfully launched. There are a number of services currently available through the touch points including deposit and withdrawal facilities, balance enquiry, money transfer, printing of mini statements, mobile phone top-up, and utility bill payments. As of April 2017, 24,640 new customer accounts had been opened by Sakchyam's partner banks. The total amount of deposits outstanding is NPR 158 million while the BLB touch points have performed over 136,000 transactions. Five partner banks have also leveraged the BLB touchpoints to disburse NPR 42 million in loans.

Despite the huge market potential, there are challenges to scaling the BLB business. One of the main ones is the lack of expertise in agent network management (ANM). Banks know financial services, but lack the expertise or time to recruit and train agents. Furthermore, monitoring and motivating agents should be an ongoing activity, but bank staff, with several other responsibilities, is not routinely in touch with the agents after they have been recruited. The KPIs (Key Performance Indicators) of branch staff normally do not cover the growth and progress on the BLB agent business. Even if the banks of Nepal would like to take this seriously and it a make part of KPIs, the cost of operation is still too high and the expertise is lacking.

Globally, other countries have also faced this challenge, spurring the market to develop specialised third parties to provide agent management for cost efficiency, scale of operation, and expertise. In India, Sub-K is an ANM company that has created a self-propagating eco-system for profitability and sustainability of the agent, Bank, and Sub-K. Sub-K partners with the bank to recruit, vet, and manage the agent while still allowing the bank to book the financial transactions. In doing so, it offers an affordable, accessible, and scalable digital payment solution to rural and urban areas while also promoting a more financially-included society.

Sakchyam has put a lot of its resources to BLBs and is keen to make these BLBs commercially sustainable while at the same time expanding people's access to finance. The recent announcement of GON through the budget is going to put more pressure on banks to expand their outreach to remote locations. The banks now need to establish branch or BLBs in the newly formed Village Councils as part of implementing federal government structure.

Sakchyam believes that Nepal's BLB business is ready for this next step. Some of the joint venture banks have seen growth and sustainability of large number of BLBs in other countries and are already in talks with a few Agent Network Managers (ANM). Sakchyam has initiated talks with Sub-K an Indian ANM as an option to come into Nepal to manage the ANM for banks, and Nepalese banks have also shown interest in this model. The introduction of ANM will not only help better manage the existing BLBs for the banks but by lowering the associate time and costs, will also enable the banks to take more aggressive strategy in deploying new BLB agents. Additionally, with the increased monitoring through the ANM model, this should further allow banks to design and offer small ticket-sized loans with the majority, if not all, of their BLB networks.

Estimated Inputs and Results: Financial and technical support from the S-CF would be used to help a 3rd-party ANM Company and partner Nepali banks to establish the ANM system, including the costs of recruiting, training, and managing agents. With the introduction of ANM in Nepal, 50% of the BLB's (including Sakchyam supported) is expected to be managed by ANMs. Further, the initiative will encourage FIs to add more BLBs on their own and bring more people into formal banking channels and also support the GoN's initiatives to promote formal banking at the provincial level. More than 90,000 individuals are expected to benefit with this support[1].

Key Risks: Key risks include poor network connectivity in Nepal's rural areas. However, ANM can help better scope the best places for BLBs to reduce this risk. This model can also better provide support to agents who need to troubleshoot technology issues. Also, as the agent network grows, increased demand for connectivity from BLBs could also be used to lobby telecom regulators. Second, banks might take time to adopt the use of ANM as they initially see it as an additional cost. However, there is a business case to be had in that by better investing in and retaining their agents, banks should see an increase in customers and transactions. Finally, a foreign ANM company might find the Nepal market smaller, and their overhead cost may not be as efficient as compared to India or other countries. Getting a large number of banks to adopt the model will help reduce this risk.

Provide targeted support for Grant Payments to Local Governments and G2P payments through formal banking channels

Activity Summary including Market Analysis: Government to Person (G2P) payments have traditionally been made through cash, resulting in high delivery costs and ghost (fraudulent) beneficiaries. This issue was again highlighted following the 2015 earthquake when the government set to distribute housing reconstruction grants. Sakchyam has worked closely with the NRA and other government authorities to devise a safer and more efficient way to distribute payments to citizens.

Sakchyam has since contributed to work with the Department of Civil Registration (DOCR), an entity of the Ministry of Federal Affairs and Local Development (MoFALD), to develop a way in which to distribute social security allowances through banking and alternative delivery channels (i.e. BLB touch points and mobile phones). This will require various activities ranging from integration to the banking system, providing technical support to DoCR, MoFALD and Ministry of Finance (MoF) on the payment process and modality of secure transaction and communication across multiple stakeholders, financial literacy campaign management, etc. DOCR intends to appoint one bank/consortium in every province to distribute the social grants. Sakchyam has been working with DOCR in developing the TOR for bank selection; and, review of an electronic payment strategy etc.

Mid-west and Far-west Development Regions are the Sakchyam focused areas and as per the new provincial system these will become Provinces 6 and 7. Sakchyam shall make focused efforts in these two provinces and also other rural parts of Nepal. It will continue to extend its support to banks and financial institutions to expand outreach in the deeper, remote rural areas. The outreach expansion will include targeted openings of new branches, extension counters, and branchless banking (BLBs) touch points alongside implementation of MFS through IME and one of the Telco providers.

[1] This is a projected number of beneficiaries from this intervention and may change depending upon funding and other circumstances. Please see Section 3.4 for more information.

To support the movement of grants monies to local governments, NRB has been asking banks to have branches in all 753 local governments and so far, no bank has shown interest to have a branch in 161 local governments. The mapping of such 161 locations is yet to be done but most fall in Provinces 6 and 7. The support of the Sakchyam CF to the banks will be extremely important to increase outreach in these unserved areas. Sakchyam will also coordinate with the central bank and other donor funded projects like UNNATI to incentivise banks to serve the remaining locations.

Sakchyam will also work on creating an information repository needed to prevent duplication and to allow for interoperability. Sakchyam will work with other projects in collaboration to make the G2P happen through banking channels like currently working with World Bank/UNCDF. Sakchyam has been working closely with Economic Policy Incubator (EPI) in fostering e-commerce in Nepal. Similarly, the coordinated efforts with DFID funded other projects like KEP, GWS will be continued.

Estimated Inputs and Results: Support from the S-CF would be used to support local governments and launch the G2P programme with partner banks in Provinces 6 and 7 to directly benefit an estimated 165,000 people by August 2020[2]. DOCR would have complete documentation on the bank selection criteria, basis, evaluation and TOR. In the first phase, they will start serving 1.4 million beneficiaries with social allowances through formal banking channels. Another 0.9 million will be served in the second phase. P2G payments will be implemented in conjunction with a MFS platform, and the general public will have ease in paying different fees/service charges at the same time. Also, NRB will have prioritized form among the 161 local government locations that are still devoid of any Class "A" commercial bank branch presence. Sakchyam will work to help establish physical bank presence in a select number of these local governments.

Key Risks: The GON might delay the use of banking channels as the number of local bodies and provinces issues have not been settled yet. The database created by DOCR might conflict with the database available with local bodies due to change in the local body structure. Finally, there might be difficulty of connectivity for banks and service providers in rural areas and use of banking channels might not be as effective as proposed. Sakchyam is working closely with the DOCR to establish a plan that mitigates these risks.

11. Social and Cultural Implications

Financial exclusion is a complex and dynamic process. Some people experience short periods of exclusion, maybe more than once in their lives. For a small number, however, it can be long-term, perhaps even life-long. The majority of people without financial products are excluded by a combination of marketing, pricing and inappropriate product design. Focus group discussion and consultative meetings conducted by Sakchyam in some of the priority districts have uncovered that many poor and disadvantaged group feel disengaged from banking. As a consequence, in many places self-exclusion by poor and disadvantaged groups is far more important than direct exclusion by banks refusing to open accounts. In some places, psychological and cultural barriers impede the use of banking services in the indigenous populations. The social cultural implications for Sakchyam will be high. The programme will address the problem inherent to financial exclusion to expand the frontier of the financial service delivery in the project districts using innovative delivery channels.

[2] This is a projected number of beneficiaries from this intervention and may change depending upon funding and other circumstances. Please see Section 3.4 for more information.

Sakchyam will continue to work with like-minded FIs to innovate and design services that maintain high standards of financial performance as well as set new standards in poverty impact by focusing on following:

- Understanding costs (smaller loan size, increased demands on staff time, smaller portfolios, remote areas, etc.) and benefits (lower exit rates and arrears, higher penetration rates) of working with the very poor.
- Basing institutional self-sufficiency on client self-sufficiency and success. Where their vulnerability can be overcome, very poor clients can achieve significant growth and changes.
- Innovation through the use of technology to make poverty-focused microfinance more cost effective; and
- Improving the impact of microfinance.

Table 1 below provides Sakchyam strategies for design and delivery of poverty focused products and services working closely with partner FIs.

Focus Area	Strategies
Improving outreach	Understand which BFI do reach or exclude and why. Target poorer areas through rigorous geographic targeting. Motivate poorer people to be the target of BFI work Develop a system to work with the very poor based on vision. Encourage use of alternate delivery channel
Ensuring Impact	Undertake market research to understand clients' underlying needs and not just listen to the loudest voices Modify the products and services and ensure proper delivery Understand negative impacts of the access to finance and take required steps to reduce these
Appropriate products	Design and improve microfinance products and services based on their products potential to reduce poverty, risk and vulnerability, not their attractiveness to clients Diversify financial products and services required by the very poor Link the access to credit with ability to repay[3] and financial literacy Introduce a range of products such as emergency loans, insurance or educational inputs to help poor clients cope with emergencies, seasonal migratory patterns, smooth consumption, and reduce their risk and vulnerability. Ensure a balance between flexibility and a range of products that clients requires with BFIs' capacity to manage an increasingly complex and diverse portfolio.

[3] Where loan repayment is made from existing income sources there is a need for flexibility in savings and loan repayments. Savings in particular should be easily accessible, both for deposits and withdrawals. Loans do not need to be tied to a particular activity. Likewise, where repayment is made from business profits, regular repayments and pressure from the BFIs are important to encourage focus on the business activity and to develop business management skills.

Focus Area	Strategies
Delivery	Support very poor clients in coping with vulnerable and other problems experienced rather than coercing them into making loan instalments. Don't compel clients to take a loan. Encourage client support and skills-sharing. Introduce an organizational culture of poverty-focus and impact in an MFI for achieving positive impact. Learn from community-based organizations and other models of access to finance. Integrate gender awareness into BFI practice at the level of field staff-client relations, and within organizations' procedures and culture.

Table 1: Sakchyam Strategies

Sakchyam will encourage innovation, experimentation, and improved understanding on possibilities for poverty-focused access to finance for the poor and disadvantaged groups through the following:

- Providing financial incentives through the Sakchyam Challenge Fund towards achievement of certain goals on depth of poverty outreach and impact.
- Creating space for BFIs to improve their effectiveness by creating pilot schemes, or exploring different time-frames for achievement of different objectives.
- Encouraging BFIs to use alternate delivery channels and alternate credit assessment tools such as psychometric test to reach to new segment of unserved/underserved customer
- Establishing clearer industry standards for good practice in poverty-focused access to finance.
- Promoting greater transparency in reporting on poverty outreach and impact.
- Funding research, particularly the one focused on improving operational effectiveness and understanding trade-offs involved in a poverty-focus.

Finally, even though the financial industry has established best practices for measuring and reporting financial performance, it has yet to establish comparable standards for performance in poverty outreach and impact. Sakchyam will help develop systems for transparent reporting of such data. Industry standards and reporting guidelines will need to be developed using performance measures that take into account both efficiency and effectiveness.

12. Recovery – reconstruction efforts post April 2017 Earthquake

Two years on from Nepal's Great Earthquakes, up to 23% percent of the population are still living in self-constructed temporary shelters. In the most affected districts (those categorized as severely hit in the government's Post-Disaster Needs Assessment), 62% are still in temporary shelters. The figure is highest in Sindhulpalchowk district, where 84% remain in shelters (Table 2). A qualitative research by The Asia Foundation found that many people in shelters continue to struggle with shelters not suited to hot or cold weather, too small for families to live in, and people suffering from smoke from cooking areas situated in the same areas where they sleep. 17% of people in shelters said they got sick during the winter due to problems with their accommodation.

District	Proportion in Temporary Shelters
Sindhupalchowk	84%
Dhading	66%
Nuwakot	63%
Ramechap	55%
Gorkha	44%
Okhaldhunga	22%
Bhaktapur	13%
Solukhumbu	5%
Kathmandu	3%
Syangja	2%
Lamjung	1%ß

Table 2: District wise Proportion in Temporary Shelters

Source: Briefing note, April 2017, The Asia Foundation

Progress in rebuilding and the NRA reconstruction grant

Two years on from the earthquakes, most people have not started rebuilding. The marginalized are much less likely to have started rebuilding.

Across all districts, 56% of those whose house was significantly damaged or destroyed report that as of April 2017 they had not started to rebuild. The figure is highest for Sindhulpalchowk and Dhading (69% each) and is over 50% in every district except for Gorkha (48%) and Syangja, (33%). Solukhumbu stands out as an exception: despite the housing grant not being disbursed at the time of the research, 91% of people whose house was damaged have started rebuilding.

61% of low caste people whose house was majorly damaged or destroyed say they have not started rebuilding, compared to 57% of Janajati and 52% of high caste people. Those with a low pre-earthquake income are 4 percentage points less likely than those with a high income to have started rebuilding and the difference is the same for widows compared to other women. Those whose current monthly income had declined since the earthquake are 14 percentage points more likely to say they have not started rebuilding than those who say their income has improved.

People have not rebuilt because of a lack of money. The housing reconstruction grant has had some impacts in helping people rebuild but these have been minor so far.

Those who have not started rebuilding overwhelmingly say a lack of funds is one of the primary reasons (93%). The second most common reason (49%) was that people were waiting for government reconstruction grants followed by the high price of the construction materials.

Receiving the first tranche of the housing reconstruction grant has a slight impact in shaping whether people have started to rebuild. A majority of those whose house was damaged or destroyed have done nothing to rebuild, regardless of whether they received the grant or not. Fifty-eight percent of those who received the grant have done nothing compared to 66% of those who have not received the grant. Those who received the grant are slightly more likely to have started to rebuild but are less likely to have fully rebuilt their house.

Most people believe the NPR 300,000 grant will cover less than half of the cost of rebuilding their house. On average, people believe rebuilding will cost NPR 1,310,854, similar to the NPR 1,396,030 people said it would cost in the IRM-3 survey. Forty-five percent of people who said they have been declared eligible for the grant said it would cover less than 25% of their rebuilding costs while another 35% said it would cover 25-50%. Only six percent said it would cover 75% or more of their costs.

Banks and Financial Institutions Update:

The earthquake exacerbated Nepal's already complex financial sector challenges. In the years prior to the earthquake, important successes had been made in expanding the reach of the financial system, in restructuring of state-controlled financial institutions and improving legal frameworks. Nonetheless, a significant proportion of the population lacks access to financial services, and the banking sector remains exposed to several vulnerabilities, including concerns over asset quality. The framework for financial crisis management is still in the development stages and the depositor safety net is still in the early stages of implementation. Work to reform the insurance sector is now underway but will not be completed for some time, and the frameworks for supervision of the largely unregulated microfinance sector is very weak.

Thanks to a decisive policy response, operational disturbances in financial infrastructure caused by the earthquake was short-lived outside the affected areas and the overall financial sector remains sound aftermath the earthquake. This is a remarkable achievement, given the serious physical damage to the NRB' premises, and the absence of a Disaster Recovery Site (DRS) and Business Continuity Plans (BCPs). Although retail electronic banking holds considerable promise for expanding access and enhancing efficiency and speed in the delivery of financial services, it has not yet reached a stage where it can substitute for damaged bank branches.

Nonbanking financial sector is more affected than the banking sector. Particularly the microfinance and cooperatives are heavily impacted by the earthquake. Preliminary impact assessments point to a very large number of affected members. Most of the affected borrowers will see their income flow severely affected and lack alternative income generating activity. This could translate into liquidity and solvency pressures on the microfinance sector, impacting their capacity to assist their communities' in times of need.

1.5 Introduction to financing for housing reconstruction

This note has been prepared for discussions on the financial sector's potential contribution to the housing reconstruction. The same has influenced by Sakchyam's experience of working with the Nepalese financial institutions since the last three years to enhance financial inclusion in Nepal.

- With the current proposed interest free loans through financial institutions by the government, it is anticipated that easier access to loans for reconstruction of houses will lead to an increase in the demand for housing, construction materials and labor. This will in turn result in a higher cost of rebuilding, and is likely to result in insufficient funds for those who would begin to rebuild with the initial loan amount.
- The total bank loans in Nepal amount to $19 Billion. Historically, credit has expanded at annual average rate of 20%. As per the document, should the banks be directed to lend $3,000 for reconstruction, it will require BFIs to invest $1.5 Billion (500,000 beneficiaries) in this sector. Assumption that Nepalese financial institutions will invest 40% of their portfolio in one year for reconstruction when $3.8 Billion is intended for the entire economy is highly unlikely.
- In Nepal, there is already a shortfall of labor since there exists very less opportunities for employment. With training programmes, this gap can be addressed to some extent, but is likely to take time to overcome. Therefore, with the anticipation of increase in demand, a skills training programme can increase the numbers of skilled personnel in time for the reconstruction activities to begin.
- From the financial access point of view, a better assessment of the supply constraints (particularly the market distortion and MFI constraints) and why the demand is not taking up as needed is likely the next step. At present, the document lays out different solutions but does not explain why there is a market failure - why are the HHs are not borrowing from banks? Or, why are banks are not lending to the HHs?
- If the Government of Nepal is considering disbursing the housing loans thorough private sector BFIs, it is imperative that the BFIs are convinced on the repayment of the loans. Credit guarantee can be a substitute to collateral but not repayment capacity. Further, BFIs fear that government will come out with populist measure like 'loan waiver scheme' in future, which will penalize non-delinquent borrowers, risking future servicing of loan portfolio.
- Subsidy schemes such as the insurance premium and interest that are to be repaid to insurance companies and banks have remained pending for over months. Government has to drastically shorten turnaround time to gain private sectors' confidence.

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