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TASK ORDER 3.5 - NEPAL S³IDF SOCIAL MERCHANT BANK (SMB) MODEL

REVOLVING FUND CONCEPT NOTE

USAID SOUTH ASIA REGIONAL INITIATIVE FOR ENERGY
(USAID SARI/ENERGY)

CONTRACT NUMBER 386-C-00-07-00033-00

November 9, 2009

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List of Acronyms

ACEF	Asia Clean Energy Forum
ADB	Asian Development Bank
ADB/N	Agricultural Development Bank of Nepal
AEPC	Alternative Energy Promotion Center
BAU	Business as usual
CEDB	Clean Energy Development Bank
CRT/N	Centre for Rural Technology, Nepal
DCGC	Deposit and Credit Guarantee Corporation
ESCO	Energy Services Company
FF	Fact-Finding
FI	Financial Institution
GOA	Ghatta Owners Association
GHG	Green House Gases
IFI	International Financial Institution
IWM	Improved Water Mill
IWMP	Improved Water Mill Program
LS IWM	Long Shaft Improve Water Mill
MBM	S ³ IDF's Social Merchant Bank Model
MFI	Microfinance Institution
MSME	Micro Small Medium Enterprise
MOU	Memorandum of Understanding
NGO	Non-governmental Organization
NUBL	Nirdhan Utthan Bank Ltd.
PV	Photovoltaic
RBB	Rastriya Banijya Bank
RETSC	Rural Energy Technology Service Center
RMDC	Rural Microfinance Development Center
RF	Revolving Fund
S ³ IDF	The Small-Scale Sustainable Infrastructure Development Fund, Inc.
SACCO	Savings and Credit Cooperatives
SARI/E	South Asia Regional Initiative for Energy
SMB	S ³ IDF's Social Merchant Bank Model
SNV	Netherlands Development Organization
SS IWM	Short Shaft Improved Water Mill
USAID	United States Agency for International Development
SARI/Energy	South Asia Regional Initiative for Energy

A. BACKGROUND AND READERS GUIDE

1. This Concept Note explores various issues and options with regard to the transfer and application of the S³IDF's Social Merchant Bank (SMB) model to Nepal starting in the context of the Improved Water Mill Program (IWMP). The exploration of these issues and options are follow-on to the Reconnaissance Study prepared last year.¹
2. As in the case with the aforementioned Reconnaissance Study, this Note was prepared with support from USAID (US Agency for International Development) and its' South Asia Regional Initiative for Energy (SARI/Energy) via a Task Order with the PA Consulting Group which is the institutional contractor for USAID SARI/Energy. SARI/Energy and S³IDF co-financed the Reconnaissance Study.
3. A key element of S³IDF's SMB is the provision of "gap filling" financing that facilitates the provision of co-financing from local financial institutions (FIs) - banks and other formal sector financing institutions such as leasing companies and micro-finance institutions. The SMB model includes the provision of financing from a revolving fund (RF) or analogous "gap filling" mechanism (primary and secondary debt, equity or quasi-equity, partial risk guarantees, and/or other credit conditioning mechanisms) so small investments that benefit the poor and are financially viable but not bankable under FI's differing BAU (business-as-usual) practices, can become bankable. This aspect of the SMB model achieves its critical *leverage* criteria by using development and/or philanthropic capital to bring commercial capital to explicitly pro-poor investments and to use development capital more effectively.

A.1 Discussions in Manila, Post Fact Finding Conference Call and Reader's Guide

4. The preparation schedule of the draft version of this Note was accelerated when it became clear there would be an opportunity to hold discussions with the ADB, and other pertinent parties in Manila, in June when the author was invited to participate in the ACEF (Asian Clean Energy Forum) 2009². To take advantage of face-to-face meetings with ADB colleagues and to do further preparatory work on this Note, the author traveled to Manila earlier than was required for his participation in ACEF 2009. Prior to his travel to Manila the ADB provided a copy of the Bank's draft Concept Paper for the author's review. While in Manila, the author had a series of discussions with ADB staff and consultants directly involved in the preparation of the ADB project and also at his request, an ADB staff person with extensive knowledge of the Nepal financial sector and in particular some of the candidate RF "hosts" that are discussed below (Section C). Some of these discussions were held prior to the arrival of individuals from Nepal to the ACEF. Also, a brief exchange was held with an ADB staffer involved in the ADB's Carbon Fund as it may be a candidate source of non-conventional future donor funding for the RF and/or the overall IWMP.

¹ deLucia, Russell J. September 2008. *Nepal S³IDF Social Merchant Bank (SMB) Model Reconnaissance Study*. USAID SARI/Energy, P.A.Consulting Group, PA Government Services Inc. Cambridge, MA: S³IDF

² His travel expense was co-financed by USAID, an ACEF co-sponsor, as the recipient of a Top Innovation Award in the previous year.

5. During the Manila ACEF meeting period, there was also opportunity for discussions with representatives of the primary Government entity that will be involved in the project -AEPC (Alternative Energy Promotion Center) including the new executive director Dr. Narayan Prasad Chaulagain and his colleagues. Discussions were also held with Dr. Govinda Pokharel now with SNV (The Netherlands Development Organization) which up to now has been the IWMP's primary international supporter. Dr. Govinda Pokharel is very knowledgeable about the issues as he was until recently the long-time executive director of AEPC. At one of the author's multiple meetings with the ADB, AEPC and SNV representatives were also present.

6. At the time of the Manila meetings, the author had completed almost all of his research, much of his thinking and some draft writing (in internal memo form) for the paper including a set of working notes for other points to be covered in this Note requiring further examination. In his meetings with the ADB staff for comments on the ADB Concept Paper (much based on the aforementioned Reconnaissance Study) and related matters, the author also shared the essence of his preparatory work for this Concept Note with one or more of the ADB team members working on the project. And with the understanding that it was on an informal and preliminary basis he shared copies of both his internal memo and notes on points/issues yet to be written with the individual responsible for much of the revision of the ADB's Concept Paper.

A.2 Reader's Guide

7. Section B focuses on the functions of the RF and the team that will execute its transactions. Section C examines selection criteria for the RF host and briefly discusses candidates for the hosting. Section D outlines some of the major issues that deserve priority attention in the next steps of development and implementation of the ADB proposed project. Section E outlines suggested next steps.

B. ISSUES PERTAINING TO THE FUNCTION OF THE RF AND THE TEAM EXECUTING ITS TRANSACTIONS AND RELATED MATTERS

8. This Section focuses primarily on functional activities that are to be the assumed responsibilities of the RF and the operating team.

9. For the promotion of IWM investments (both long shaft (LS) and short shaft (SS)) the Revolving Fund (RF) should reflect not just the findings of the Reconnaissance Study but also incorporate successful experience elsewhere in solving the financing constraints of financially viable small, fixed asset investments, especially those that are pro-poor and "not bankable" under BAU (business as usual) practices of local banks and other formal financial institutions (FI). Such experience is found in facilitating the financing of the fixed assets of micro-small-and medium sized enterprises (MSME) not just elsewhere but also in other sectors.³

³ Since the early 1990s the author has been a student of the lessons and experiences of MSME financing and financial intermediation operations of donors in support of such financing. This lead to an consulting

10. The design and operation of the RF should take note of this broader experience but it must in particular reflect and take into account: the particulars of Nepal including its financial sector; the IWMP (and its future evolution); the possible scope and size of proposed IFI funded projects⁴; and, the financing constraints faced by the many existing Ghatta owners who are potential LS and SS IWM investor-owner-operators and the suppliers of the technology and know how that go into these investments.

11. It is assumed that initially the RF and the functions that its team will perform will operate as complementary but integral components of at least some geographical area of the IWMP program activities. And, as argued below (paragraph 27, III.a) initially this should be in a few selected districts in which the IWMP is already operating. But it could and should ultimately be an integral component of the whole IWMP program as and when other investors/funders capitalize the RF.

12. And it is further assumed that the activities of the IWMP program of bringing technology and know-how for IWM investments and the complementary institutional developments such as creating and strengthening the GOAs will continue, as will the IWM investment subsidies. And these activities will be funded by the Government and some mix of donors. In effect this means that much if not all of the pre-investment “deal flow” information will come from regular IWMP activities. It will then be the responsibility of the RF team and the IWMP implementing team (presumed to be CRT/N) to collaborate in further pre-investment work to bring both local bank/FIs and as necessary RF co-financing to the financially viable IWM investments.

13. Taking into account the points made immediately above, and prior to obtaining donor funded capitalization, the following, preliminary comments with regard to the RF should in principle hold for its design and implementation:

- i) It should operate in accordance with commercial/quasi-commercial principles earning risk adjusted yields on the financing support it provides. This is to make it attractive for non-conventional investors (e.g. “green” and social investment entities) as well as traditional development oriented donors and investors to provide its capital. Of course the phrase commercial/quasi-commercial principles earning risk adjusted yields can mean somewhat different things to different investor/donors depending on their appetite for risk and weighting financial versus social/development and/or environmental returns.

assignment with the World Bank Group (WBG) that produced the 1998 report to the WBG *Financial Intermediation in Support of Small-Scale Energy Investments*; deLucia and Associates, Inc. The thinking behind this report with the added pro-poor focus influenced in part the author’s conception of S³IDF as its principal founder a few years later. He has remained a student of examinations of financing MSME and initiatives in support of such financing.

⁴ One of the factors influencing the design of the RF, in particular its “institutional host/home” (examined in the next section) is the issue of size and duration of an IFI project. Unless the funding is very large and there is a commitment to long-term support there should be no consideration of the creation of a “new institution” that could, for example, be incorporated as an investment company.

- ii) The RF’s primary function is to leverage the financing support (and possible non-financing support) it provides to IWM investments such that other financial institutions (FI) in Nepal (e.g. commercial banks, MFIs, SACCOs, leasing companies, investment firms or groups) provide the primary debt or other (e.g. lease-towards-purchase) finance for such IWM deals (investments).⁵ The idea is to make use of the *development* capital that is supporting the many activities of the IWMP and to leverage this with the mix of *development* capital (from a Donor) and *non-conventional investment* capital (from others –see below) such that *commercial* capital from FIs ⁶comes into the financing of IWM investments.
- iii) It must be in a position to provide all types of financing support instruments (e.g. debt: primary and secondary, equity: passive, and partial risk guarantees or other credit conditioning) in order to “fill the financing gap” for financially viable IWM investments.
- iv) Given the footprint of Nepal FIs –or lack thereof (more in Section D) - as part of this aforementioned leveraging and facilitation of bank/FI participation in IWM investments, it may need (alone or with other parties) to become involved – directly or indirectly – as an agent or correspondent of bank/FI to help bring financing (both the bank/FIs and its own) to the IWM investments. While “agent/correspondent” role might best be performed by knowledgeable people or institutions based in the field (such as the GOAs or some of their members), the RF team may have to have some passive or more likely active role.
- v) The RF should be prepared to invest along the supply chain as well as in IWM investment deals. Thus it should be able to provide financing to an SME whose business includes providing the technology for IWM investments should these entities need facilitating financing in order to access bank financing.⁷ In principle this could also encompass support to such supply chain entities so that they could themselves become involved in supplier credit, leasing and/or ESCO type deals.
- vi) The RF should be of a certain size (investment corpus) that will make it worthwhile for its establishment on more than a pilot basis under the proposed ADB project. It is likely that seed financing in the hundreds of thousands of dollars or more will be required to make this sufficiently attractive for a formal sector FI to become involved in being the institutional host of the RF. The ADB’s Concept paper proposed RF seed financing of \$500,000. It is assumed that this will be provided on grant or very soft terms –unlikely the terms of future investors. The “spread” on the deployment of this RF seed capital can be used to absorb some of the early RF fund operations costs. But

⁵ Selected FIs will be discussed in the next Section in terms of their relevant transaction experience and various characteristics, building on work during the Reconnaissance Study and ongoing research. While Nepal has a history of bank/FI participation in other RE investments such as PV and small hydro, there is as relative paucity of bank financing of IWM investments..

⁶ As emphasized elsewhere especially important will be tapping the required deprived sector financing for the IWM investments.

⁷ This probably should be limited to suppliers who have been vetted by the IWMP. But this could be an open issue to be address as the RF-IWMP collaboration goes forward and additional technologies are vetted by the IWMP.

this matter is something for discussion and consideration by potential Donors and the host of the RF.⁸

- vii) In the context of the IWMP, and assuming sufficient capital, the RF should be prepared to invest (and as always facilitate formal FI financing) in linked (energy and non-energy) investments at selected IWM investment if these are financial viable investments that can markedly improve the economic and social impact of the community surrounding the IWM investment. In that manner some IWM sites might become providers of other energy, infrastructure and/or productive use services.
- viii) Again, assuming the RF has sufficient capital and after its initial transactions under the umbrella of the IWMP, the host of the RF should build on the partnerships (formal and formal) to invest in other viable energy/infrastructure that can similarly make a significant impact on poor households, communities and micro-enterprises.⁹
- ix) Taking note of point vi) it is underscored that if the RF is to become a major force in the future of the IWMP, it should not depend only on the initial capitalization by a potential Donor and the reflow that will happen as it follows its detailed procedures (to be defined as part of a Donor capitalization project) and is, hopefully successful not just in aiding more IWM investments to happen but being replenished by the interest, etc it earns. However, it should seek other investors and do so both through its own efforts -focused internally on Nepali investors and on its own and through partnerships with entities such as S³IDF that it and CRT/N put in place to bring in external investors.
- x) Many of the incremental IWM investments will likely only happen as a result of the support from the RF hence as noted in the Reconnaissance Study it is logical that some part of the carbon assets (GHG offsets) should be property of the RF and its investors. These carbon assets will likely be helpful in attracting other investors (see immediately below). The RF should be in a position to negotiate with Government and the donors supporting the IWMP for an equitable sharing of the ownership of these assets.
- xi) Within the norms of its detailed procedures (to be defined as part of a Donor capitalization project) and the general standards of commercial principles (see point i. above) it should be prepared to be flexible enough to operate “multiple” windows reflecting different investor preferences with regard to different types of investment

⁸ For some FIs with experience in large financial intermediation projects, a project with RF seed capitalization of only \$500,000 may not be very attractive. This was noted in some of the feedback the ADB received in its FF mission however due to the nature of the project there was still interest expressed by that FI candidate under consideration. Strong interest and appreciation of the innovativeness of the project’s pro-poor objectives, its *Action Research* modality and/or other characteristics will be necessary if the selected RF host is to make the critical institutional commitment discussed below (see point II, paragraph 15).

⁹ An obvious candidate is possible household hydro investments that would build on the partnership with CRT/N which has an affiliation with RETCS (Rural Energy Technology Service Center) which produces technologies for household sized hydro investments (and other technologies).

support (e.g. debt versus equity or guarantees) and perhaps target returns and other criteria (e.g. investments in remote areas or investments that yield carbon assets).

- xii) Depending on the “division of labor” between operation of the RF and the other “main” activities of the IWMP and who is responsible for these other IWMP activities, between them they must have the capability to provide more than financing support. This includes, for example, a range of technical and business development services in particular pre-investment analysis to determine the financial viability of the deals it supports, and analysis sufficient for itself and the FI co-financiers it will seek.¹⁰

C. CRITERIA AND CANDIDATES FOR HOSTING THE RF AND RELATED ISSUES

14. Against the background of the RF functions outlined in the previous section, this section examines criteria for institutions to host the RF and a select set of candidates for hosting organized by category. Comments are made on a select number of these candidates.

C.1 Criteria for Hosting a Donor/IFI Project’s RF

15. There are many criteria that can be identified as appropriate for selecting the RF host. However, S³IDF’s and the author’s experience as well as experience from donor financial intermediation experience in support of micro and small investments, suggest various criteria for the context of a Donor funded Project and in particular the role of the RF as articulated above. Some of the criteria judged more important and relevant are noted below. While no absolute ranking can be easily constructed, the order of the listing and comments on the criteria does reflect some judgment regarding their priority.

- I. *Financial soundness, transparency and good governance* are all important. All three characteristics are intertwined with a review of past and current financial transaction capability and track record. Transparency should be exhibited by audited financial reports prepared to the appropriate local and/or international standards. If these audits are not available as part of annual reporting to public shareholders, they should be available to any donor or its representative considering the entity as a RF host. Any entity and/or specific project evaluations should also be made available. Entity governance and structures should be clear with regard to functional responsibilities and staff, management and if appropriate independent directors should be available for interview.
- II. *Multi-dimensions of Institutional (especially Senior Management) Commitment and Flexibility* are of importance that simply can not be emphasized enough,

¹⁰ If these pre-investment and various business development activities are not covered by operation of the IWMP, or the “spread” earned on deployment of the RF (see point vi, in paragraph 13 above) it may be necessary for the RF team to seek grant support for these efforts. Otherwise the financial returns it will be able to offer investors will be much lower as it will have to absorb these costs and it will not be leveraging the development capital of the IWMP as stated in point ii, paragraph 13 above.

especially for a project of the proposed small size in terms of financial resources involved and the many challenges to be faced even with the modality of learning by doing. Assuming relevant transaction experience in one or many of the useful dimensions (see Criteria III below), and given the many functions to be performed (Section C) without such **Commitment**, it is unlikely that a transaction record will be built such that a Donor funded project would be a success. A few elaborating comments are warranted.

- a) Senior management should be both interested and committed to making this project work and they must communicate this to the staff that will be involved in the project. And as management judges it appropriate to organize their staff for RF operations (with a specific set of people or even a small unit for the project) they should be engaged with the other project players including a project consultant to develop the details of the RF investment criteria etc.
- b) As part of the management commitment it is critical that the project staff and the RF operation understand that this as a “mainstream” activity and that their work on this project will not hinder their carrier development in the institution.
- c) A commitment by the host to co-finance the RF with some funds from its own resources (even if a relatively small amount) would be a clear and strong statement of the host’s position to all the players involved in the project and to future possible funders.
- d) Management must also be willing to support the staff if the learning by doing leads to a need to modify procedures or requires some other flexibility. No better indication of support and commitment is for the senior management to periodically make themselves available to the staff for review and consultation, so they can benefit from their experience and some of this should happen on an informal basis. Obviously, getting the necessary commitment and flexibility will be more feasible if the RF hosts’ transaction experience includes small investments as a core service or at least an important part of their business.

III. *Transaction Experience* is also very important given the nature of this project. Relevant transaction experience can mean less training for the staff (involved in the RF operation) and the existence of inter-institutional relationships upon which to build. At least three dimensions of transaction experience are relevant:

- a) Experience with small investments of similar size, pertinent type and similar classes of borrowers/users of financing support are all relevant. Elaborating: i) Typically the size of IWM “hard” investments costs¹¹ range from hundreds of dollars to a few thousands of dollars. ii) These investments need multi-year tenure financing support, so common one-year/crop cycle financing

¹¹ The term “hard” costs encompasses all equipment, materials and construction services to implement an investment, but excluding pre-investment costs which may be considerable.

experience is much less relevant. iii) While transaction experience with Ghatta owners would be very helpful, in lieu of this, having experience with similar small investors would also be acceptable. For example, investors like the rural poor with little or no collateral or collateral that is not considered acceptable (under BAU practices) such as an unregistered traditional Ghatta.

- b) Elaborating further on the points immediately above, in certain circumstances this pertinent experience could take a direct or retail form in which the institution is the direct provider of the financing to the beneficiary. Or it could be an indirect form or “wholesale down stream to retail” if the nature of the transaction is such that the wholesaling institution has responsibility of assessing the retail institution and the ability and willingness to effect (reform) their procedures, including if necessary strong actions – stopping wholesale finance provision, a management take over or the like.
- c) In the context of this particular project, two other transaction experiences are pertinent both of which entail having regular transaction relationships with other financial institutions aside from the “downstream to retail” wholesaling noted above. One is co-financing of transactions with other FIs, experience that is common in large investments but rare in small investments. The other is collaborative wholesale funding whereby one FI serves as a channel for funding support to other/smaller FIs who are responsible for retail transactions.

IV. A FIs *Footprint (presence in many areas)* can be very important. This is the case if the FI has branches that are close enough to investment sites and is combined with transaction experience (see above) such that the BAU practices (or limited modification of these) and the catalyzing support from the RF will allow these branches to undertake Ghatta financing transactions. Unfortunately even the major FIs with the larger numbers of branches (especially ADB/N) do not have branches close enough to potential sites where transactions could be routine. In cases, often exceptions, in which there are formal FIs near Ghatta sites, they are MFIs, or SACCO whose footprints are generally confined to a limited area (e.g. one or two districts).

16. Other criteria could be added to the list above. Examples include:

- i) Experience in capability up-grading for “downstream” FI partners such as MFIs and SACCO;
- ii) An existing agreement with the Deposit and Credit Guarantee Corporation (DCGC) and;
- iii) Financial intermediation experience on behalf of international donors. The first can be particularly important as it is likely that in many cases the retail financing transaction in support of IWM investments will be done by MFIs and/or SACCO. The second can be quite useful to the proposed project and is such that if it is not in place it can be put in place without dialogue and negotiation which is less difficult for a major FI with

presence in Kathmandu where the DCGC has its only office as opposed to smaller FIs without a Kathmandu presence. In the case of intermediation experience for international donors, this can be viewed as a special case of the transaction relationships noted above.

C.2 Categories and Selected Candidate RF Hosts

17. Nepal's financial sector has developed significantly in the last decade or so with growth in multiple segments – commercial and development banks (some banks holding both commercial and development banking authorization), financing companies and other non-bank financial institutions, and MFI, SACCO and Grameen Banks. In addition there are formal institutions whose legal organizational structure put them outside the formal financial sector but are providing some financial services in particular intermediation of government and/or donor funding. AEPC is such an institution.

18. Despite the growth of the financial sector, still many households and micro/small enterprises in the rural hills of Nepal are unbanked in terms of access (or easy access) to formal FIs. Many sites for IWM investments are located in areas where the only source of financial services is the informal sector of moneylenders and other local entities operating in an un-licensed and unregulated mode. Hence, as implicitly suggested in earlier comments, for a Donor's project application of S³IDF's SMB approach to succeed, in many instances it will require some innovative approaches to extend the reach of the formal financial sector to these unbanked sites (see comments with regard to agents or bank correspondents above). Nonetheless, the host of the RF must be in the formal sector and in principle should have a brief that allows it to operate on an all-Nepal basis either directly or via its partnerships with other formal FIs.

19. The following paragraphs touch on a few categories of formal institutions and examples often taking note of the presence or absence of one or more of the criteria for hosting outlined above in Section C.1. But before beginning this discussion it should be noted that one hosting option, the creation and licensing of a new non-bank formal FI was ruled out for multiple reasons. Among these are: the limited size in funding amount, the “action research/learning-by-doing” characteristic, and the likely limited timeframe of the project. However, assuming that the project is a success, and other investors/donors show interest in joining, the RF host may examine the possibility of “spinning off” the RF capital and its operations team into a new non-bank formal FI that is wholly or partially owned by the host.

C.3 Categories, Selected Examples and Comments

20. Prior to this discussion, a few preface comments are in order. First, any systematic examination of even just the commercial and development banks of Nepal which together number well in excess of fifty was well beyond the limitations for the research for this Note. As a consequence considerable judgment was exercised with regard to the number

of FIs and non-FIs that are considered and touched upon in the discussion below. Second, this judgment was exercised based on:

- i) The background of the issues presented above;
- ii) Research of various documentation of both the financial sector and specific institutions;
- iii) Familiarity the author had with some institutions and the sector from prior work in Nepal and of course the preparation of the Reconnaissance Study which included interactions with more than twenty of these institutions; and;
- iv) Comments and feedback from the ADB and others as mentioned earlier. Third, and very importantly it must be underscored that while institution-specific information with regard to Criteria I, III and IV above (paragraph 15.) can be researched and examined using the just mentioned sources for judgments used in this Note, this can only be partially done in the case of Multi-dimensions of Institutional (especially Senior Management) Commitment and Flexibility. In the final analysis information and judgments about this criteria must include interviews and discussions at some length with the candidate RF host including the senior management if the institution of choice could (and should) lead to a MoU. Returning to the categories, examples and comments, these are addressed in the paragraphs below.

21. *Commercial Banks* - Nepal has more than 20 commercial banks and some of these such as the ADB/N (Agricultural Development Bank of Nepal) overlap with the development bank category as they have Central Bank licenses for both commercial and development bank operations. But only the commercial banks bear the deprived sector lending requirement. Originally the few/initial commercial banks were in the public sector,¹² but in the last two decades as market entry regulations evolved the number of private banks has grown and this includes a few banks whose partners are foreign banks. Aside from mandatory deprived sector lending (most wholesale) and prior to that priority sector lending, only a few of the commercial banks have particularly relevant transaction experience as outlined in the criteria. A few of the commercial banks provide support for other small renewable energy loans such as biogas and PVs via direct or wholesale mechanisms but apparently only ADB/N has supported IWM investments and this in very few instances.

22. In terms of footprint, few of the commercial banks have significant presence outside the Kathmandu Valley. But there are a few banks headquartered elsewhere. In terms of the IWMP only three of the commercial banks have extensive networks including some presence in districts where the IWMP currently operates- ADB/N, RBB (Rastriya Banijya Bank) and Nepal Bank Ltd. ADB/N has by far the largest branch network in Nepal – reportedly more than 600 branches. All three banks have had some history of poor

¹² Nepal Bank Ltd. the first commercial bank dates from 1937.

performance and in the last decade have been the subject of various reform initiatives. The ADB/N is currently the focus of one element of another ADB project which encompasses its restructuring. In principle, all three of these banks might be on a “short list” of candidates for RF hosting, with the ADB/N given its footprint and transaction experience perhaps the strongest candidate. But its involvement in the ADB project and restructuring probably argues against it undertaking the hosting responsibility given the requirements of the Criteria emphasized above.

23. *Development Banks* - Nepal has more than fifty development banks and as mentioned above some of these also have commercial bank licenses. A particular example of note is the CEDB (Clean Energy Development Bank). Many of these development banks are small in terms of capitalization and have distinct and limited area or sectoral focus, nonetheless, this group of the formal FI segment offers some of the most interesting possible candidates for hosting the ADB project’s RF. Even though some of these banks have very limited footprints (with a few exceptions), their missions, transaction experience and financial soundness suggest they would be candidates. The aforementioned CEDB would be a candidate but based on the view of recent contacts¹³ it has its “hands full” with the new Hydro Equity Fund it is already managing. Nonetheless, dialogue with CEDB should continue as it is a prime possibility for co-financing some IWM investments if the RF host organizes the appropriate relationship.

24. Two organizations in this category are of particular interest,¹⁴ the Nirdhan Utthan Bank Ltd. (NUBL) and the Rural Microfinance Development Center (RMDC) both of which began doing financial transactions while organized under the Companies Act and were subsequently granted a license to operate as development banks. At this preliminary stage, both should be considered. RMDC is an APEX micro-finance organization that is owned by the Central Bank and a number of Nepal’s banks and its general body members include a number of other formal financial sector players. Nirdhan Utthan Bank Ltd. is an explicitly microfinance bank with focus on the poor and some 40+ branches. Despite its footprint and the fact that it operates in the retail transaction space it does not cover all the districts in which the IWMP is currently operating. Nirdhan Utthan Bank Ltd. might be better in a partner FI role with RMDC in the host role as an APEX institution for the RF.¹⁵ RMDF is a particularly strong candidate to host the RF as it currently supports numerous (more than 40) partner MFIs and SACCOs with both wholesale funding and various capacity building services. RMDC has considerable experience as an intermediary, channeling both domestic and international resources to MFIs and its history as a “creation” of the Central Bank and the ADB under of an earlier ADB project may help facilitate the dialogue regarding hosting the RF.¹⁶

¹³ These contacts were made at the author’s request by SARI/E.

¹⁴ These two organizations were judged the most appropriate to highlight in this category given the limitations of the research undertaken for this Note.

¹⁵ Nirdhan Utthan Bank Ltd. is a shareholder in RMDC although its shareholding is a very small percentage.

¹⁶ RMDC is not the only institutions/mechanism providing wholesale financing to MFIs and other local FIs, other “wholesalers” for example include the Rural Self-Reliance Fund and Sana Kisan Bikas Bank Ltd. which funds small farmer cooperatives.

25. *An Ad-Hoc Category of FIs and non-FIs* - It would be strongly preferable for a RF host to come from one of the two categories outlined above. However, if the ADB's dialogue with the potential hosts noted above is not successful several fall-back options could be considered. These ad-hoc options could be ones where there is at least a RF host even if it is a second best solution. Such options might be made feasible by catalytic actions by the players very much involved in the IWMP; in particular AEPC and its primary implementing NGO Centre for Rural Technology/Nepal (CRT/N) assisted as appropriate by the ADB and S³IDF if it is further involved. Two private sector options that CRT/N may be able to facilitate are a non-financial corporate or a financing company with which CRT/N principals have strong formal or informal working relationships. In the case of the former, the possibility of the Rural Energy Technology Service Center (RETSC) as host for a small RF was explored by the author and his CRT/N colleagues during the Reconnaissance Study. A flexible financing company could likely be identified through CRT/N and the author's networks.

26. AEPC could also be a fall back option to host the RF. It operates channeling mechanisms for donor funds currently. But the structure of these mechanisms are such that the donors of necessity exercise much every day-to-day control and it would likely require hiring and training a new unit with special governance. If the AEPC were a host for the RF, arranging one of the ad-hoc fall back options such as a non-FI corporate or financing company would be a preferable solution. And if it is necessary to go this route and it appears successful, the possibility of this option morphing into an entity with more independent status should be feasible.

D. SOME MAJOR ISSUES FOR CONSIDERATION IN ADB PROJECT DEVELOPMENT

27. The primary objective of the ADB's project should be to transfer S³IDF's SMB model to successfully achieve its critical *leverage* criteria so the ADB's development capital brings commercial capital to explicitly pro-poor IPWM investments and there is more effective use of both the ADB's development capital as well as the other development capital going into the IWMP whether that capital comes from the Government or other donors. To increase the likelihood of this success there are a number of corollary objectives and important issues and options that the ADB and other key players (e.g. AEPC) should keep in mind as the ADB's Project is further refined in its development stage and into implementation. Some of the more important of these include:

- I. Think of the ADB Project as a large *Action Research Project* that will have to try different innovative administrative and institutional mechanisms to achieve the Project's primary objective and will empower those implementing the project to "learn by doing" as actions are undertaken that have either not been done in Nepal (as opposed to India) and/or have very little analogous precedent.
 - a) As an Action Research Project some mistakes will be made but they should lead to lessons that can be documented along with lessons from success.

- b) The need for learning by doing and the time involved argues for as long a project period as is administratively feasible under the ADB guidelines. A period of three to four years would be desirable. If significant successes can be achieved more quickly the entire better, but having the time to learn is critical.
 - c) At least in thinking and learning, if not in early actions, consideration should be given for thinking about applying the SMB model for small scale pro-poor energy and infrastructure investments that are “beyond the umbrella of ” the IWMP particularly for other “green” technology investments. And if there is good progress with IWM investments in the early stages of the Project, building on these experiences and players involved (especially the co-financing FIs) consideration should be given to extend the action research modality to some other small-scale pro-poor investments especially ones that bring various synergies or complementarities to the same geographical areas/districts of focus.
- II. The characteristics of this Project suggest there is a need for ADB pro-activism, not just in finalization of the design and development but also in the early stages of implementation. This pro-activism will be especially important with the dialogue with the Government, AEPC, candidate FI hosts of the RF (see Sections C and E) and possibly the Nepal Rastra Bank (Central Bank) –see point IV.a. Regarding this point it is worth underscoring that while this is an ADB energy sector project the essence of much of its implementation modalities are ones more common to financial sector projects and projects with innovative financial intermediation elements. For these reasons, as part of the ADB pro-activism it will be helpful if the ADB project team includes some active inputs from ADB financial sector expertise with expertise with Nepal experience.
- III. One corollary of Action Research in which success is critical to pave the way for future growth (see point VI below) is that the ADB’s project details not be too ambitious, but be very flexible in multiple ways. These points to at least two aspects of the Project details that should be adhered to:
- a) Implement the project in only a few very select districts at least until significant success has been demonstrated and lessons have been derived. The districts should be those where the Ghatta Owners Associations and Service Centers are better developed and where there are a number of IWM investments. Even if they have not have accessed bank financing and are owned by better-off Ghatta owners able to self-finance, there will be technical and organizational experience to build on.
 - b) Be very selective when developing the initial pipeline of IWM investments to foster. While aiming to have a mix of long shaft (with various linked productive use investments) and short shaft investments, “cherry picking” is recommended in the select districts (III.a above) with the following terms:

- (ii) Avoid sites with significant flood risk (the insurance program for all renewable energy investments that AEPC is working on is not yet in place);
- (iii) If possible develop investments in clusters” so that servicing them in both pre-investment and operations phases are some what easier in physical access for transactions - see point V.b below.

IV. Another corollary of an Action Research approach to the project, and in which success is critical, is to focus on the multi-dimensional “additionally” of the immediate source of local commercial funds so that the aforementioned emphasis on leveraging is achieved. Here there is need to be focused both on the sources/types of funds and the types of transactions through which these funds flow, specifically:

- a) Take actions to ensure that commercial bank lending requirements for the deprived sector reaches the targeted IWM investments. This should influence the choice of the RF host (see Section C) but also may require dialogue by the ADB with the Central Bank such that it reminds the commercial banks of the fact that such IWM investments owned by the poor clearly qualify for such lending.
- b) Enable the flow of deprived sector financing via wholesale/bundled mechanisms and/or retail deal specific transactions to the FIs who have the appropriate footprint and/or outreach to make such transactions feasible and not unduly expensive in terms of transaction costs.

V. Tough but also innovative execution is likely to be key to ensure the success of the ADB’s Project implementation. And the success is critical not just for this ADB initiative but to develop a track record that will hopefully in the near future attract other supporters/investors to both the IWMP and the RF itself. A few elaborating comments are warranted:

- a) Even with a learning by doing modality that builds lessons and experience, all transactions should undergo a necessary due diligence that follows tough (but fair) procedures requiring their viability to be documented and followed through. And with adherence to such tough procedures, there should be no transactions made due to favoritism or interference of a political nature or biases of one or other members of the team (organization and/or individuals) responsible for project execution.
- b) Even with the most cooperative and committed FIs to host the RF and to provide co-financing and execute transactions, the often remote geographical locations of the candidate IWM investment sites will likely require innovative mechanisms to facilitate the transactions on a fee-for-service basis. In the Reconnaissance Study there was discussion of involving the GOAs/Service Centers or their members in an alternative “agent or “bank correspondent” model (as is in India with S³IDF). This and other mechanisms could be envisioned. In any case, innovation will be

needed and it will likely require testing a few logically designed variations for such a mechanism as part of the learning by doing modality.

VI. A more future looking corollary for this Action Research approach is to be sure that the key players agree on RF structure and operation that will be welcoming for infusions of funds from “other” donors/investors. If feasible, once the project is established and early RF transactions are being made such that viable but un-bankable IWM investments become bankable, dialogues should begin with other classes of potential RF funding sources both domestic and international. Examples of such classes of investors include:

- a) Nepalese living overseas who might have particular interests compatible with certain aspects of the IWMP such as investments in the districts of their origin?
- b) International trusts and philanthropies who do program related investing and have existing program areas compatible with the IWMP and the RF’s approach.
- c) Nepal corporations (or international corporations with a presence in Nepal) who have CSR (corporate social responsibility) investing programs compatible with one or more aspects of the IWMP or a presence in the selected districts.
- d) Select non-conventional/social investors with particular interest in aspects of the IWMP such as the carbon assets (greenhouse gas displacement) it generates. A special example of such an investor may be the ADB’s Carbon Fund but it may also be a candidate for supporting the overall IWMP not just the RF.

For the last of these classes of investors, and perhaps for other investor/funders, the Government needs to rethink and modify its policy regarding carbon assets (as discussed in the Reconnaissance Study). The Government should be willing to offer ownership of some of these assets reflective of the additionality (additional financing support) brought by such investors.

E. REGARDING NEXT STEPS

28. This brief section makes a series of comments and suggestions about next steps. It includes steps, not just with regard to the ADB, but also SARI/E and USAID, AEPC and S³IDF. However, there is a particular focus on steps by the ADB in light of the fact that the ADB management has approved the ADB Project Concept Paper and the next stages of ADB procedures have proceeded. Some of the ADB Project team has completed a FF Mission in Nepal and as noted in Section A.1 this Note reflects post-FF communications with the ADB. Taking note of the FF mission results, following are some comments and suggestions with regard to next steps and in particular for consideration by the author and the ADB team.

- I. S³IDF’s explicitly pro-poor SMB was designed to be widely applicable. Its’ dissemination and transfer so that others might leverage commercial financing and

make more effective use of development financing has always been one of S³IDF's mission objectives. This Note, when taken together with the Reconnaissance Study cited above, provides a detailed discussion of many of the "devil in the details" to be addressed in such a transfer of S³IDF's SMB. And while this Note and the prior Reconnaissance Study are focused on Nepal, much of the discussion is applicable for thinking about the details of such a transfer elsewhere. Moreover, in the case of this Note, the discussion in the early section on RF matters (Sections B and C) would hold with little change to any developing country where the minimum conditions for the S³IDF's SMB held. Thus it would be useful if, in addition to posting on the SARI/Energy web page, SARI/E and USAID bring the two documents to the attention of USAID offices in the region and other agencies in the region with which they think it may be appropriate.

As part of its ongoing dissemination activities, as soon as this Note becomes public, S³IDF will also circulate the two documents in its dialogue with others as it judges appropriate.

And it would be useful if the ADB staff involved in the proposed ADB Project for Nepal, also circulate both documents to selected colleagues in the ADB who might benefit from considering application of the S³IDF's SMB elsewhere in Asia.

- II. In certain ways as supporters of both the Reconnaissance Study and this Note, USAID has already made possible and supported the proposed ADB Project. It is thus logical that with regard to the proposed ADB Project, USAID and/or SARI/E at the regional or country level should consider supporting some complementary, parallel or co-finance activities of the Project.
- III. In light of the near term likelihood of the ADB Project going forward, AEPC should pro-actively inform potential IWMP donors of the ADB involvement to help assure the future financing of the IWMP. And to the extent that USAID and/or SARI/E is in dialogue with other donors on various matters, they might also highlight the IWMP and the proposed ADB Project.

In S³IDF's dialogue with donors, social investors and philanthropists with regard to support for its India operations, it shall also seek support when appropriate, of applications of the SMB model in Nepal to build on the proposed ADB Project.

- IV. The ADB has decided to postpone final decisions with regard to hosting the RF until the actual start of the Project with this decision being part of the inception stage of the project.
 - a) During the interim period the author will be prepared to discuss (via email and conference calls) any matters in this Note, or to the best he can other project matters, that the ADB or other Donors/IFIs may wish to discuss.
 - b) The author will endeavor to make a short trip to Nepal to explain the SMB model to the primary RF host candidates (discussed above) that were met with during the

ADB's FF Mission. He will attempt to do this by integrating it with his forthcoming travel to India, and as part of S³IDF's SMB dissemination activities. This visit will be coordinated with CRT/N and will include if possible, a meeting with AEPC.

- (i) Assuming the author is able to travel to Nepal in the coming months before the project begins, the ADB and/or other Donors/IFIs, would provide introductions to the candidate host FIs.
- (ii) Prior to the visit the candidate RF host FIs will be provided (by the author or his CRT/N colleagues) a copy of the Reconnaissance Study.

V. ADB, and/or other Donors/IFIs may consider many issues to be internal and decide to discuss these with AEPC, the ADB's Project executing agency/implementing agency. Hopefully these discussions will be further informed by matters raised in this Note as they were a result of the draft version. It is the author's judgment that as the ADB project preparation progresses, dialogue with the AEPC takes place and recruitment of a project consultant is underway, the ADB should continue to address the following critical matters:

- a) The matters outlined in Section B above should be kept in mind and in so doing it would useful if there is agreement in principle on the districts that the ADB project will focus on even if this is only tentative¹⁷. This will allow the ongoing IWMP activities to begin laying the groundwork for the project and perhaps even some initial work on a pipeline of IWM investments.
- b) The matters regarding the roles of the RF team and the IWMP team so the issue of local staff/consultant time covered by the ADB project versus the IWMP is understood as well as the roles and responsibilities of the international consultant.

VI. It is the author's understanding that the ADB is not planning any other Nepal missions specific to this Project until an inception mission after the Project has begun. However, if members of the ADB team should have reason to be on mission in Nepal for other projects, it is suggested that further discussions with AEPC and the primary host FIs continue so contacts not made in the FF mission can be made. For example, a contact (if not detailed discussions) with the Central Bank could be helpful. This would inform them of the project, and the importance of accessing deprived sector financing as sources of the primary debt for the IWM investments and to seek any suggestions the Central Bank may have with regard to this matter.

¹⁷ The Reconnaissance Study suggested focus on Kavre and Sindhupalchok districts and the ADB's FF Aid Memoire indicated that based on its consultations these two districts could be two potential pilot districts.

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