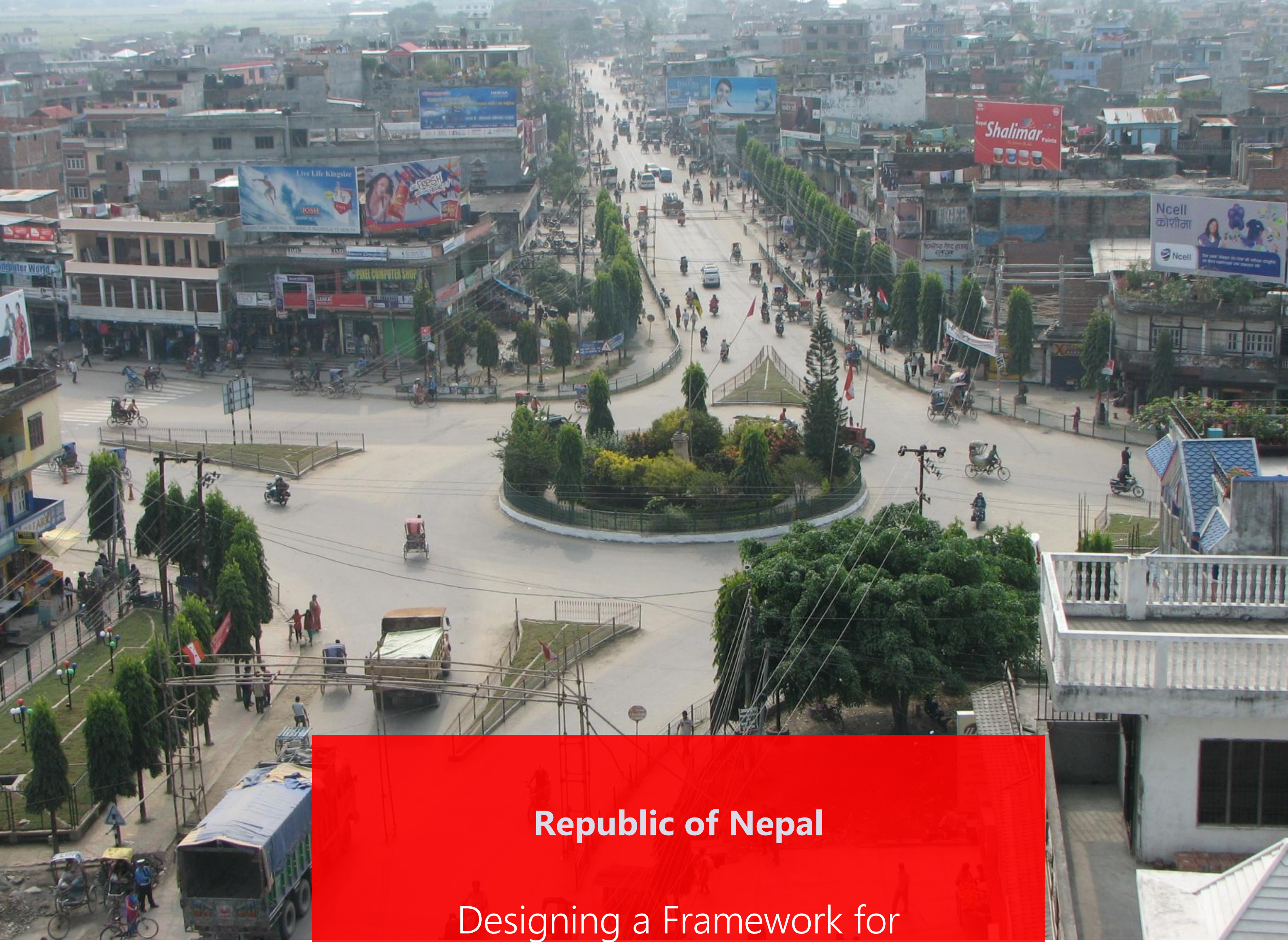


Republic of Nepal

Designing a Framework for Subnational Government Financing through Borrowing in the Context of Fiscal Federalism in Nepal

May 2017

Prepared for Local Body Fiscal Commission and
Town Development Fund
with the support of the Local Governance and
Community Development Programme (LGCDP: PPSF UN)

FINAL REPORT

1966
2016
UNCDF

Republic of Nepal

Designing a Framework for Subnational Government Financing through Borrowing in the Context of Fiscal Federalism in Nepal

May 2017

Prepared for Local Body Fiscal Commission and
Town Development Fund
with the support of the Local Governance and
Community Development Programme (LGCDP: PPSF UN)

FINAL REPORT

1966
2016

UN
CDF

Cover photo: Ithaki, Sunsari, Nepal

Photographer: LRP Photo by Santosh Yadav, UNDP Flickr

Report authors: Arun Regmi, National Consultant, and Priscilla M. Phelps, International Consultant, supported by members of the UNCDF team in Nepal, Pragyan Joshi, Programme Officer, and Bishnu Puri, Senior Advisor

The team involved in the preparation of this report would like to thank the staff of MoUD, MoFALD, LBFC and all those individuals who agreed to be interviewed, provided information, participated in consultation activities, reviewed drafts of the report or supported the work in other ways.

Designing a Framework
for Subnational Government Financing through Borrowing
in the Context of Fiscal Federalism in Nepal

EXECUTIVE SUMMARY

Nepal is entering a historic period, as its governance structure transitions from that of a unitary state to a federal system under the 2015 Constitution. With the first election of local officials in twenty years taking place in May 2017, expectations are that a new era of national development is underway.

The Local Self Governance Act (LSGA), 1999 gave Nepal's local bodies fiscal autonomy and authority to generate, collect and mobilize resources from various sources, but LGSA was never fully implemented. With the number of responsibilities delegated to very small and weak local governments (village development councils), local elections in suspension and a lack of human and financial resources, the promises of the decentralization under the LGSA were never fully realized.

The federal system places more responsibility for governance and service provision at the local level. The new configuration of subnational governments (SNGs) creates fewer, larger jurisdictions that have the potential to be stronger organizationally and more financially viable.

Increased accountability between citizens and SNGs will increase expectations and change the dynamic of governance. One of the hopes is that the autonomy and accountability provided by the federal system will create the impetus for development to flourish at the local level. Therefore, with local elections in process and the federalization process underway, conditions are favorable to assess the need for a sustainable, market-based subnational borrowing system.

The Four Dimensions of Fiscal Decentralization

The Constitution allows the federal government, the states and local governments to borrow funds to meet expenditure needs that cannot be met through regular resources. When borrowing, SNGs must maintain fiscal discipline and be able to develop financially viable projects.

It is appropriate to be considering subnational borrowing while policies are being defined to support the federalization process. A complete fiscal decentralization policy should address four dimensions:

- **Expenditures**: Assignment of functions and expenditure responsibilities to different levels of government
- **Revenues**: Assignment of taxes and other local revenue sources to different levels of government
- **Intergovernmental fiscal transfers**: Allocation of central government resources through intergovernmental fiscal transfers (IGFTs) or grants
- **Subnational borrowing**: Terms and arrangements under which local governments can borrow to finance capital investment or revenue shortfalls

There are important interdependencies among these pillars. For instance, subnational borrowing is not advisable if SNGs do not have sufficient revenue sources to support debt repayment. Various efforts are underway in Nepal to analyze the policy framework for pillars 1-3. The present report focuses in particular on pillar 4.

Designing a Framework for Subnational Government Financing through Borrowing

The present consultancy was initiated to provide a framework for developing a subnational borrowing system in the context of the federalization process in Nepal. The general objective of the consultancy is to provide a framework for development of a subnational capital financing system in Nepal that can finance projects and investment plans.

The specific objectives include identifying (i) the strengths and weaknesses of existing local government finance practices and institutions in Nepal, (ii) capacity requirements and other requirements for subnational borrowing and (iii) needed reforms in legal and institutional arrangements and (iv) proposing the steps to establish a subnational capital financing system. Lastly, the potential role of the Town Development Fund (TDF) in expanding local governments' access to financial markets was to be analyzed. The report seeks to answer the following questions:

- Is the current national context supportive of subnational government borrowing?
- Is an institutional framework in place or being put in place that will make subnational borrowing feasible?
- Is there an effective demand for subnational borrowing in Nepal and can subnational governments and related entities become good borrowers?
- Can the Nepali financial market or other local sources respond to demands for subnational government financing?
- What is the best vehicle for giving SNGs access to market finance?
- How should the subnational market development effort be organized?

Government counterparts for the consultancy included the Town Development Fund (TDF), the Local Body Fiscal Commission (LBFC), and the Ministry of Federal Affairs and Local Development (MoFALD). The work was supported by the UN Capital Development Fund under the Local Governance and Community Development Program.

The consultancy was carried out by a team composed of one national consultant and one international consultant. Beginning in November 2016, the consultants have interviewed key stakeholders (Annex 2 is a list of those consulted); reviewed legal, financial and technical information (Annex 4 is bibliography of material reviewed); conducted an original assessment of 16 municipalities and helped to conduct a series of consultation meetings, culminating in a national workshop held in Kathmandu on 18 March 2017. This report is the final deliverable of the consultancy.

As in least-developed countries (LDCs) generally, there are many impediments in Nepal to the timely delivery of capital investment projects. In fact, these impediments are part of what keeps LDCs on the lower rungs of the development ladder. The service deficits that result from inadequate capital investment then affect both productivity and quality of life of citizens. Service deficits in urban areas--where residents expect higher living standards--are particularly conspicuous in Nepal. One of the impediments is the lack of efficient means to raise financing for local infrastructure projects.

Background and Context for Subnational Borrowing

In countries where the option is available, borrowing can provide several advantages to SNGs, all of which can contribute to local economic development. These advantages include: (i) expanded resources for capital investment purposes; (ii) ability to match the useful life of the investment project to the term of the financing; (iii) greater autonomy to plan and implement investment projects.

Goals for the subnational borrowing system. This study recommends the development of a subnational borrowing system that is based on commercial principles. The alternative--a system based on entirely on guarantees, subsidies and flexible rules—will never be sustainable and is not beneficial to its clients in the long run. The proposed system should be:

- Efficient and transparent, able to finance bankable projects of creditworthy SNGs
- Aimed at mobilizing domestic financial resources and able to blend various resources (grant and loan, own-source and external funding, etc.)
- Not dependent on guarantees from higher levels of government

- Developed with input from key stakeholders including the financial sector and SNG officials
- Offering financing alternative (borrowing directly, through an intermediary, via public-private partnerships (PPPs), etc.), using standardized approaches to increase efficiency

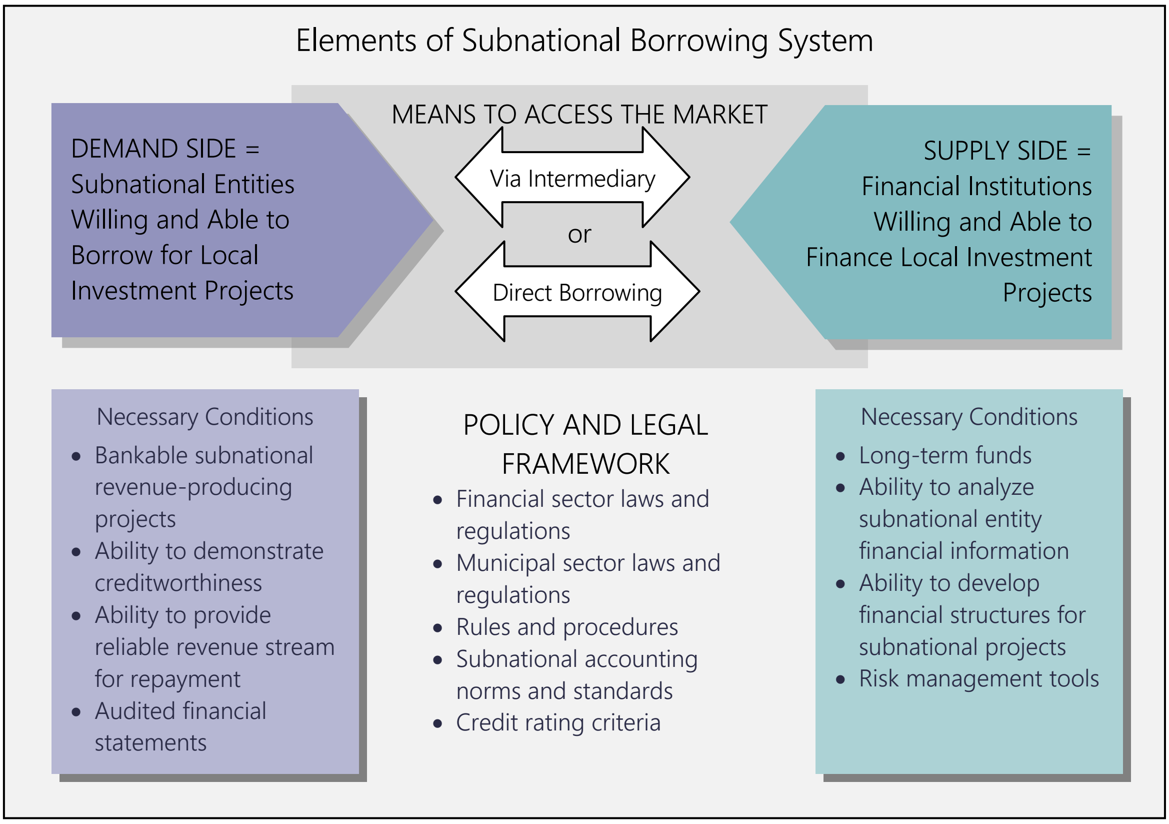
These goals might change over time as experience is gained and the feasibility of the proposed approach is tested on the ground.

Who Would Borrow? Both states and municipalities are allowed to borrow domestically under the Nepal's Constitution. Under certain circumstances, they may be able to borrow internationally as well. To do so, they should be in sound financial condition and have bankable investment projects.

With enabling legal provisions in place, companies formed by SNGs for service provision, special purpose vehicles (SPVs) created for PPPs and other purposes, and association of SNGs acting collectively to provide a service should also be able to borrow. Rural and small SNG may also borrow, although making their projects bankable may prove more difficult. One reason to create a financial intermediary is to provide better access to these borrowers. Community and user groups may also have a demand for credit, and there are some good experiences in Nepal with loans of this type. However, this consultancy did not analyze the provision of credit to these groups.

Elements of the subnational borrowing system. A successful market is one in which there is both an effective demand for financing and a sustainable supply of financing that can be delivered in a cost-effective manner. Figure 1 summarizes the key elements of the subnational borrowing system as they are discussed in the report.

Figure 1: Elements of the Subnational Borrowing System



Policy and Legal Framework for Subnational Borrowing

Subnational finance is complex because subnational development has political, institutional and territorial dimensions. Policies in sectors as diverse as social development, financial markets, land use, agriculture and transport, among others, affect local governments and their residents. Even macroeconomic policy has an impact at the local level.

Policy framework. There are several documents recently published in Nepal that collectively were useful for analyzing the policy context for fiscal decentralization. These include: *National Urban Policy* (2007); *National Urban Development Strategy* (2015) (NUDS); *Municipal Finance Framework for the National Urban Development Strategy of Nepal* (2015) (MFF) and *Inclusive Cities: Resilient Communities* (Nepal national report for Habitat III).

Together, these documents present a picture of the development challenges facing Nepal and her SNGs. These challenges include: urbanization that is accelerating, an unbalanced urban structure that favors the capital, weak rural-urban linkages, environmental deterioration, lack of clarity in national policy about subnational development, increasing urban poverty and weak local governments.

The NUDS defines a qualitative vision for future urban development in Nepal that is guided by five principles: sustainability, inclusion, resilience, efficiency and green growth. It also proposes development benchmarks for key sectors.

Legal framework. Subnational borrowing requires a well-designed legal and regulatory framework. The exact configuration of laws matters less than that borrowing is an integrated part of the intergovernmental fiscal system.

There are both public and private aspects of subnational borrowing regulation. The public finance dimension helps ensure social equity and macroeconomic stability. In particular, the Government of Nepal (GON) should define rules that prevent over-borrowing by local governments. The IMF identifies four approaches that governments can use to control subnational borrowing, which are explained in the report.

The private market dimension has to do with the safe and transparent operation of the financial and capital markets. Regulations address disclosure of information, financial reporting, protection of investors and prudential regulation.

Various agencies will have a role in regulating subnational borrowing, including the Nepal Rastra Bank (as regulator of banks and financial institutions), Securities Board of Nepal (as regulator of capital markets), and the Ministry of Finance (MOF) (in its role of managing public finances and borrowing). While not a regulator, the National Natural Resource and Fiscal Commission (NNRFC) is also expected to have a role in the development of the borrowing system.

The report contains a number of conclusions and recommendations regarding the policy and legal framework.

The policy framework for subnational borrowing is largely in place. The policy documents reviewed have been extensively consulted and carefully developed over the past several years, even in the absence of democratic institutions at the local level.

A regulatory framework must be put in place. SNGs need sufficient autonomy to increase revenues, expand the pipeline of bankable projects and try different financing approaches. Regulations should build on the experience of Nepal and other decentralizing countries to address both the public finance and the private market aspects of borrowing. Laws governing lenders and subnational borrower also need to be harmonized. A challenge will be to avoid developing a regulatory framework that protects the macroeconomy but completely discourages borrowing.

Laws and regulations must be carried through to implementation. The lesson from the LSGA and LSG Regulation is the need to carry through after approving laws and regulations to operationalize them fully. Implementation includes developing procedures, tools and systems and providing the technical support to implement and support them.

Demand for Financing and Capacity to Borrow

There is a huge need for local investment in Nepal. However, borrowing must be based not on the need for investment, but on effective demand for financing, which is a function of financial capacity.

The report assesses whether there is an effective demand for financing of subnational investments. Data available from policy documents, the national census, and the NUDS point to significant underinvestment in public services. The NUDS and the MFF provide estimates of investment needs and funding sources, which are summarized and recalculated to show investment per SNG per year over a 15-year period.

Assessments of SNG management and financial capacity are useful in judging capacity to borrow. Evidence from the minimum conditions and performance measures (MC/PM) system and findings from the recent Subnational Public Expenditure and Financial Accountability (PEFA) analysis were both reviewed. The results of the analysis of 16 municipalities conducted for the study also provide useful insights on municipal borrowing capacity.

For the 16 municipalities, the annual average investment each for the past three years was NPR 142 million. This is above the annual average range of NPR 82-90 million of the original 58 municipalities between FY 2011/12 and FY 2013/14. But it is well below the average Priority Investment Requirement of NPR 311 million estimated to be needed by the 191 municipalities in the NUDS and also well below three investment scenarios of annual Average Adjusted Investment per municipality in the MFF of NPR 429 million to NPR 644 million.

The report presents conclusions and recommendations regarding SNG demand for investment financing.

Demand for credit is hard to measure. It is difficult to prove whether SNGs are willing to make the reforms needed to use credit or to quantify the effective demand. Efforts to expand credit should focus on financing revenue-producing projects and reducing transaction costs by using standardized project designs and financing structures.

Creditworthiness is a function of willingness to pay. Ability to pay is an important concern in building the financial system, but willingness to pay is a more binding constraint. SNGs wishing to borrow need to have the ability to convince citizens to pay higher taxes and fees in return for receiving improved public services.

Municipal strengthening is a prerequisite to borrowing. Technical assistance is needed to build SNG capacities such as project preparation and revenue mobilization. Approaches such as joint borrowing by two or more subnational entities and public-private partnerships require special forms of technical assistance. A strategic view of organizational strengthening is called for, and should include seeking the support of academia and an effort to professionalize the field of local government finance.

Credit will not be an appropriate form of financing for all SNGs in the medium term. Borrowing needs to be part of a larger fiscal decentralization strategy that encourages bankable SNGs to borrow but provides other means of financing for those that cannot.

Financial administration must be standardized and upgraded. The Government of Nepal (GoN) should urgently promulgate subnational accounting and auditing norms and standards based on international norms and parameters for financial management systems, and provide assistance to implement them.

A major financial commitment is required for technical assistance. The development of the country now depends on the successful implementation of the federal system and strengthening of subnational entities. Making subnational government fully functional should be seen as a challenge similar to earthquake reconstruction, and equivalent resources need to be committed to the project.

Supply Side of Subnational Borrowing System

The constraints on the supply side of the borrowing equation include: (i) a shortage of savings and longer-term funds; (ii) the underdeveloped bond market, including the lack of a yield curve, (iii) the inexperience of lenders with SNGs; and (iv) the lack of financial information and means to evaluate SNG creditworthiness.

Capital market. The capital market in Nepal is underdeveloped. There are currently 230 companies listed on Nepal Stock Exchange Ltd. with a combined capitalization of NPR 1.7 trillion, which is low relative to gross domestic product (GDP). Short-term government debt dominates the bond market. In 2010, corporate bonds were only 5 percent of the market. There are few investors; Treasury instruments are bought largely by banks to satisfy statutory liquidity requirements. No SNG has ever issued debt in the Nepali capital market, even though it is permitted.

Banking sector. Banks are probably the most likely source of funding for SNG projects. Nepal's financial system has grown impressively in the past decade. Domestic credit to the private sector increased from 33 percent of GDP in 2005 to 75 percent in 2016. Savings and lending are both dominated by the commercial banks.

Municipalities handle significant financial resources, but mostly do business with state banks. Only one bank-financed municipal project was identified in the course of preparing this report –a bus park in Itahari municipality that was financed by Nabil Bank, Ltd.

The GoN has made a concerted effort over the past decade to strengthen the financial sector through legal reforms, improved financial reporting and strengthening bank risk management capacity and internal controls. Savings and financial inclusion are growing in Nepal. More savers should lead to more long-term savings instruments, which should, in turn, make it easier for banks to lend long-term. Interest rates in Nepal are relatively stable and should be affordable for SNGs.

Other financing options. The report discusses other potential sources of financing. These include: mutual funds, pension funds such as Citizen Investment Trust (CIT) and Employee's Provident Fund (EPF), private placements and public-private partnerships (PPPs). PPPs are considered a type of financing since the private partner may have access to borrowing, even if the SNG partner does not.

***Other financing issues**.* Below-market interest rates are often used to subsidize local investment. Justifications for this subsidy include the social benefits and the poor financial condition of borrowers. However, subsidized interest rates are detrimental to the long-term establishment of the subnational borrowing system, and should be avoided to the extent possible.

Tax exemption of income from municipal financial instruments is an incentive used to attract more investors in some countries. There is nothing inherent in SNG borrowing that requires interest to be tax exempt. The pros and cons need to be carefully analyzed before any decision is made to make municipal interest tax-exempt.

There are now two credit rating agencies registered in Nepal: ICRA and CARE Ratings. Credit rating agencies have supported subnational market development in some countries. They can develop ratings criteria and produce "shadow" (non-public) ratings that point out financial weaknesses that SNGs should address before financing in the market. In the short run, the GoN could consider engaging the credit rating agencies to develop a simpler self-assessment tool for SNGs.

The major conclusions and recommendations regarding the supply of financing are summarized below.

Financial market weaknesses are significant. Reforms taking place in the financial sector bode well for future subnational market borrowing, although they will take time. Subnational credit market development should be identified as a goal within the overall financial sector reform agenda.

SNGs might borrow from other sources in the medium term. SNGs may find financing through private placements; transactions with institutional investors such as CIT and EPF; and PPPs. TDF or another intermediary may also be able to gain market access in the next few years.

Private stakeholders should be involved in subnational market development. Financial sector stakeholders lack experience designing subnational transactions, but they understand the market in which they operate. A public-private working group should be created to (for example) validate the work plan and other information in this report, evaluate options for a financial intermediary and advise the GoN on specific initiatives related to market development.

The temptation to take shortcuts should be resisted. The financial weaknesses of SNGs and their poor standards of financial administration and reporting are the most critical constraints on municipal borrowing, and resolving these issues will take time. Even so, shortcuts that undermine long-run market development, such as the overuse of guarantees and subsidies, should be avoided.

Facilitating Market Access for Subnational Borrowers

Creating a sustainable market-based subnational financing system in Nepal is a major transformation from the financing system for municipal investment that exists today, which consists of IGFTs financed by the GoN and very limited credit financed by international donors and channeled through the TDF. Developing the market-based system requires creating several critical functions and capacities, including coordination of the market development process, a system of regulation, technical support to borrowers and facilitating access to financial resources.

Regulation is a central government function, as previously discussed. In addition, it is highly recommended that the GoN create a Subnational Borrowing Unit in MoF, the Local Body Fiscal Commission (LBFC) or the NNRFC to provide coordination. Technical and legal support will be needed by The GoN (in its roles of market development and regulator), borrowers and lenders.

Financial intermediary. The most complex task in the short run is the design and creation of a financial intermediary. Few SNGs are likely access the financial or capital market directly, so a financial intermediary can facilitate market access. This could be a reformed TDF or a new entity. The report suggests several intermediary models that should be considered. These include the Tamil Nadu Urban Development Fund (India), FINDETER (Colombia), Development Bank of South Africa and Viet Nam Provincial Local Development Investment Funds.

The principal role of the intermediary will be borrowing and on-lending to SNGs and related entities. The goal should be for the intermediary to borrow in the local financial market. An important consideration in deciding on the structure of the intermediary is the sources of funding it would want to access. Since being founded in 1989, TDF has received loans and grants from the GoN, the German Development Bank--KFW and German Technical Institution–GIZ, the Asian Development Bank and the World Bank. But funding sources should be expanded and could also include mobilizing savings, borrowing, local capital market transactions (bond issues or private placements of equity or debt).

Many have proposed creating a municipal bank in Nepal, and this option could be considered. However, organizing the intermediary as a bank may restrict its access to certain resources. Even if the intermediary is not legally a bank, it can still be managed like a bank, and run according to commercial principles.

The intermediary could take on other roles as well, including: facilitating PPPs, providing credit enhancement other forms of risk management and administrating donor projects.

Administration of donor projects is currently TDF's principal function. This role will continue to be needed, but it should not be the main purpose of the intermediary. Whatever form the intermediary takes, its various business lines should be managed and accounted for separately, to help ensure its financial sustainability.

Restructuring TDF. The option of restructuring TDF to serve as the intermediary is examined in detail in the report. TDF is subject to many of the same challenges that all municipal development funds (MDFs) confront, such as poor repayment by its borrowers. Through the implementation of its Business Plan, TDF has begun to overcome a number of these problems.

With its Board of Directors, TDF is already considering structural changes that would allow it to access the financial market. Even if TDF's functions are absorbed by a new entity, the lessons learned in its nearly 30 years of existence are important to understand.

The reputation of TDF with its borrowers is quite mixed. Its technical expertise is appreciated, but there are complaints about customer service and the lack of presence on the ground. Some borrowers expressed a desire for SNGs to own stock in the TDF, have more representation on the Board or both. These preferences must be considered in evaluating intermediary models**.**

Several conclusions and recommendations are made in the report regarding the options for giving SNGs access to market financing and the organization of market development activities.

Market development will entail several interdependent activities. The integrated nature of these activities calls for a motivated lead agency, proposed to be the Subnational Borrowing Unit housed in the NNRFC (or the LBFC) or the Ministry of Finance, but other lead agencies could be considered.

Specific technical assistance is needed to facilitate borrowing. Support to the borrowing process includes orientation on borrowing and transaction-specific legal and technical advice. Lenders cannot be expected to shoulder all these costs; instead, they will need to be funded from other sources until the market develops and expands, whereupon transaction costs should drop.

An intermediary is needed to link SNGs to the market in the medium term. The public/private working group should undertake the task of evaluating intermediary models and proposing the most suitable approach. The report explains issues to consider in designing the intermediary. All functions assigned to the intermediary should be financially sustainable and directly related to lending.

TDF's extensive experience should be carefully considered. The lessons of TDF include the need for discipline with borrowers, the importance of profitability and the conflict entailed in having a lender also dispense grants. The new intermediary (and TDF) should not have grant-making responsibility. It is also advised, based on MDF experience in building credit markets, that financial institutions be given access to any advantages available to the intermediary, such as lines of credit from the GoN or ability to intercept fiscal transfers.

Recommendations and Plan of Work

Neither the subnational sector nor the financial sector is prepared today for a subnational financing system based on commercial principles. Significant work is needed to strengthen both sectors and to establish the regulatory framework for subnational borrowing. Yet, the timing seems right to begin this process. The federalization process is underway, local elections are about to be held and key stakeholders are committed to the task.

The report includes a consolidated list of recommendations and a work plan based on these recommendations. The work plan is divided into the principal topics of the report (policy and legal framework, strengthening demand, expanding supply and supporting market access), with activities that correspond to the numbered recommendations in the chapters.

There are three phases of activities in the work plan:

- Phase 1: Improving enabling conditions (years 1-3)
- Phase 2: SNG strengthening and piloting of financial innovations (years 2-4)
- Phase 3: Scaling up the financing system (year 5 and after)

The work plan should be further refined, and updated on an annual basis as the feasibility of various recommendations is validated. Also, as it becomes clearer how stakeholders are responding and how long various activities will take to implement, the work plan can be modified.

Designing a Framework
for Subnational Government Financing through Borrowing
in the Context of Fiscal Federalism in Nepal

Table of Contents

Tables

Figures

ACRONYMS

ADB	Asian Development Bank
BAFIA	Bank and Financial Institutions Act
BRAP	Business Reorganization Action Plan
CBO	Community-Based Organization
CIT	Citizen Investment Trust
DDC	District Development Committee
EPF	Employee's Provident Fund
FSDS	Financial Sector Development Strategy
GDP	Gross domestic product
GoN	Government of Nepal
IFI	International Financial Institutions
IGFT	Inter-government Fiscal Transfers
IMF	International Monetary Fund
KfW	German Development Bank
LAA	Land Acquisition Act
LB	Local body
LBFC	Local Body Fiscal Commission
LBRC	Local Body Restructuring Commission
LDC	Least Developed Country
LGCDP	Local Governance and Community Development Program
LSGA	Local Self Governance Act
MC	Metropolitan City
MC/PM	Minimum Conditions / Performance Measures
MDF	Municipal Development Funds
MFF	Municipal Finance Framework
MOF	Ministry of Finance
MoFALD	Ministry of Federal Affairs and Local Development
MoFALD	Ministry of Federal Affairs and Local Development
MoUD	Ministry of Urban Development
NEPSE	Nepal Stock Exchange Ltd
NGO	Non-governmental organization
NNRFC	National Natural Resource and Fiscal Commission
NPC	National Planning Commission
NPR	Nepal Rupee
NUDS.	National Urban Development Strategy
OSR	Own source revenue
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PIR	Priority Investment Requirement
PPP	Public Private Partnership
SEBON	Securities Board of Nepal
SMC	Sub-Metropolitan City
SNG	Subnational Government
SPV	Special Purpose Vehicle
TDF	Town Development Fund
TIR	Total Investment Requirement
UNCDF	United Nations Capital Development Fund
VDC	Village Development Council
WB	World Bank

I. INTRODUCTION

A. Background

The Local Self Governance Act (LSGA), 1999 gave Nepal's local bodies (LB) fiscal autonomy and authority to generate, collect and mobilize resources from various sources. The LSGA allowed LBs to borrow to meet expenditure needs from a bank or any financial institution with or without a pledge of assets or a guarantee from the Government of Nepal (GoN). However, nearly the only debt that municipalities have taken on since approval of the LSGA has been from the Town Development Fund (TDF).

TDF was established under the Town Development Fund Act, 1996. Its mandate is to alleviate economic and social poverty in urban sectors through long-term financing of social infrastructure and revenue generating projects. TDF has received technical and capital support from the German cooperation (KfW), the Asian Development Bank (ADB) and the World Bank (WB), but its coverage and its capacity to meet the growing needs of LBs for investments funds to expand and improve local public services have been limited.

The Local Body Fiscal Commission (LBFC) was established by Article 137 of the LSGA. LBFC uses the Minimum Conditions and Performance Measures (MC/PM) system to conduct annual performance assessments of LBs. Based on this assessment, LBFC recommends to the Ministry of Federal Affairs and Local Development (MoFALD) the amount of the annual block grant transfers to LBs.

Nepal is now converting from a unitary government to a federal system under the 2015 Constitution. The Constitution allows the federal government, the states and local governments to borrow funds to meet expenditure needs that cannot be met through regular resources.[1] When borrowing, subnational governments (SNGs) must maintain fiscal discipline, which means developing financially viable projects.[2] According to the common interpretation of the Constitution, they can borrow domestically or internationally under specific conditions.

The first elections of local officials in 20 years are now planned for May 2017. Rules and regulations for fiscal decentralization are being drafted or revised to support the framework provided by the new Constitution.

In addition to these advances, there is also a need for a strategy based on a shared vision of how a sound credit system for SNGs should develop and function, which includes a plan of work. Such a strategy should define the role of ministries, local governments and other agencies in both the development and operation of the credit system.

B. Objectives of the Subnational Borrowing Study

The specific objectives include identifying (i) the strengths and weaknesses of existing local government finance practices and institutions in Nepal, (ii) capacity requirements and other requirements for subnational borrowing and (iii) needed reforms in legal and institutional arrangements and (iv) proposing the steps to establish a subnational capital financing system. Lastly, the potential role of the Town Development Fund (TDF) in expanding local governments' access to financial markets was to be analyzed. The report seeks to answer the following questions:

- Is the current national context supportive of subnational government borrowing?

[1] Some documents refer to the middle level of government in Nepal as the "province." Except when quoting documents that use "province," this document uses "state" to refer to the middle level, based on the official translation of the Nepal Constitution, 2015.

[2] The phrase "subnational governments" or SNGs is generally used in this report to include both states and local governments. The phrase "local bodies" or LBs is used when quoting laws or documents or when referring to arrangements in the past.

- Is an institutional framework in place or being put in place that will make subnational borrowing feasible?
- Is there an effective demand for subnational borrowing in Nepal and can subnational governments and related entities become good borrowers?
- Can the Nepali financial market or other local sources respond to demands for subnational government financing?
- What is the best vehicle for giving SNGs access to market finance?
- How should the subnational market development effort be organized?

C. Methodology for the Consultancy

The consultancy was carried out by a team composed of one national consultant and one international consultant. It included interviews with government officials and other stakeholders, desk research, detailed analysis of 16 municipalities, stakeholder workshops and delivery of written reports.

Government counterparts for the consultancy included the Town Development Fund (TDF), the Local Body Fiscal Commission (LBFC), and the Ministry of Federal Affairs and Local Development (MoFALD). The work was supported by the UN Capital Development Fund under the Local Governance and Community Development Program.

1. Consultation with key stakeholders

The consultancy included two technical missions, including an Inception Mission and a Technical Mission.

a. Inception Mission

The Inception Mission was held from November 3-11, 2016. During this time, the consultants: (a) met key stakeholders with an interest in the development of the subnational credit market in the public, private, nongovernmental and subnational sectors; (b) gained an overview of the lending, borrowing and institutional situations in Nepal; (c) gathered data and other technical inputs relevant to the consultancy; and (d) reached agreement on the outputs required and developed a work plan for the consultancy.

On November 11, the consultants made a presentation to the LBFC, TDF, and MoFALD on the results of the Inception Mission.

b. Technical Mission

The consultants held a technical mission in February, 2017, following submission of the draft Technical Report to GoN for review. The consultants held additional meetings with stakeholders and two stakeholder workshops to present and review the draft Technical Report.

c. Stakeholder Workshops

Two stakeholder workshops were held February 10 and 17, 2017 to review and receive comments on the draft Technical Report and present the proposed work plan.

The GoN organized a meeting with the consultants at the end of the mission to discuss the feedback received on the draft report and review anticipated changes in the final Technical Report.

2. Desk study and literature review

Laws, policy and project documents, technical studies and municipal data were analyzed, including data from the assessment of municipalities conducted as part of the consultancy. The consultants also reviewed numerous policy studies prepared recently in the context of the federalization process, and analyzed current municipal finance practices in Nepal and other countries whose experiences are relevant to Nepal. Annex 4: Bibliography includes a list of the material reviewed.

3. Assessment of municipalities

Data were collected from 16 municipalities to provide an overview of management practices and financial conditions in the municipal sector. The process involved (a) selection of municipalities, (b) field visits, and (c) gathering and analysis of data, based on an agreed information matrix. [3]

The municipalities included TDF borrowers, municipalities working with UNCDF and three new municipalities. The group is politically and geographically distributed. The municipalities, selected in consultation with the Municipal Management Division of MoFALD and LBFC, are listed and shown on the map below.

State 1: Damak (1) and Itahari Sub-Metropolitan City (SMC) (2)

State 2: Janakpur SMC (3), Birgunj SMC (4) and Chandrapur (5)

State 3: Lalitpur SMC (6), Heatuda SMC (7), Dapcha-Kashikhanda (8) and Bharatpur SMC (9)

State 4: Byas (10) and Pokhara SMC (11)

State 5: Butwal SMC (12) and Kohalpur (13)

State 6: Birendranagar (14)

State 7: Dhangadhi SMC (15) and Bhimdutta (16)

Assessment results are summarized in Section V.D.3. Data tables are included in Annexes 3 and 5.

4. Delivery of written outputs

The consultants delivered two reports: (a) an Inception Report, and (b) the present Technical Report, in draft and final versions. The final Technical Report reflects feedback received on the draft report and from the stakeholder workshops.

[3] It is important to acknowledge that data limitations affected the scope of the municipal assessment and may have an effect on the reliability of the results.

II. BASIC CONCEPTS IN SUBNATIONAL BORROWING

A. Why Subnational Governments Borrow

Access to credit provides SNGs with several advantages in the pursuit of their developmental purposes that are not enjoyed by those without access to credit.[4]

- Borrowing expands the resources available for capital investment purposes
- Using credit, SNGs are better able to match the useful life of the capital investment to the term of the financing
- Access to credit provides SNGs with more autonomy and ability to plan strategically (employing long-term investment plans rather than financing only occasional capital projects)
- Ultimately, SNGs are better able to promote local economic development

B. What Are the Goals of the Subnational Borrowing System?

As Nepal considers undertaking development a debt market for SNGs, it is useful to define the goals of the effort. Discussions with stakeholders confirmed the following goals.

- A sustainable, efficient, transparent system based on the ability of SNGs to demonstrate creditworthiness and to prepare "bankable" projects
- A system that mobilizes domestic financial resources and is based on commercial principles, which can blend various sources of funding (grant and loan, own-source and external funding, etc.).
- A system that *is not* dependent on guarantees from higher levels of government
- A system that offers alternative ways to access the market (direct borrowing, through an intermediary, public-private partnerships (PPPs), etc.), while standardizing approaches for the sake of efficiency

These goals may be modified over time, as the feasibility of this approach is tested on the ground.

C. Who Would Borrow?

This analysis assumes that both states and municipalities would borrow in Nepal. It recommends that companies formed by SNGs for service provision and special purpose vehicles (SPVs)[5] created by SNGs should be able to borrow, as should groups of SNGs acting collectively to provide a service.

It did not specifically consider whether rural municipalities or gaunpalika, very small municipalities or community groups should be able to borrow. In theory, any SNG in sound financial conditions with bankable revenue-producing projects should be able to borrow if the risk and return are acceptable to the lender.

Economies of scale and additional transaction costs can make rural and small SNG projects less attractive to lenders, as TDF is well aware. Rural and smaller SNGs may also have skills gaps that increase risk and needs for technical assistance. These impediments must be carefully analyzed when analyzing the structure and sustainability of the proposed financial intermediary.

---

[4] The remainder of this report uses the phrase "subnational government" or SNG rather than "local body" or LB in order to make it clear that the issues analysed and proposals made are meant to apply to both states and municipalities.

[5] Special purpose vehicles (SPVs) are structures that allow specific activities of a corporation or government to be legally, operationally and financially separated (usually into a limited corporation). SPVs are useful when an activity needs an autonomous management or governance structure or separate financial operations, or when the enterprise wants to attract investors or lenders, such as in the case of a PPP. SPVs go by various names including "special purpose entity" and "financial vehicle corporation."

Community and user groups may also have a demand for credit. There are successful experiences in Nepal of loan funds run by municipalities for community user groups. An argument can be made that creditworthiness is stronger at the local level due to greater familiarity and social pressure to pay fees; however, a number of factors contribute to sustainability and there are many loans to user groups that have not been repaid. Lending to community groups was beyond the scope of this report.

D. Subnational Finance Concepts Relevant To the Study

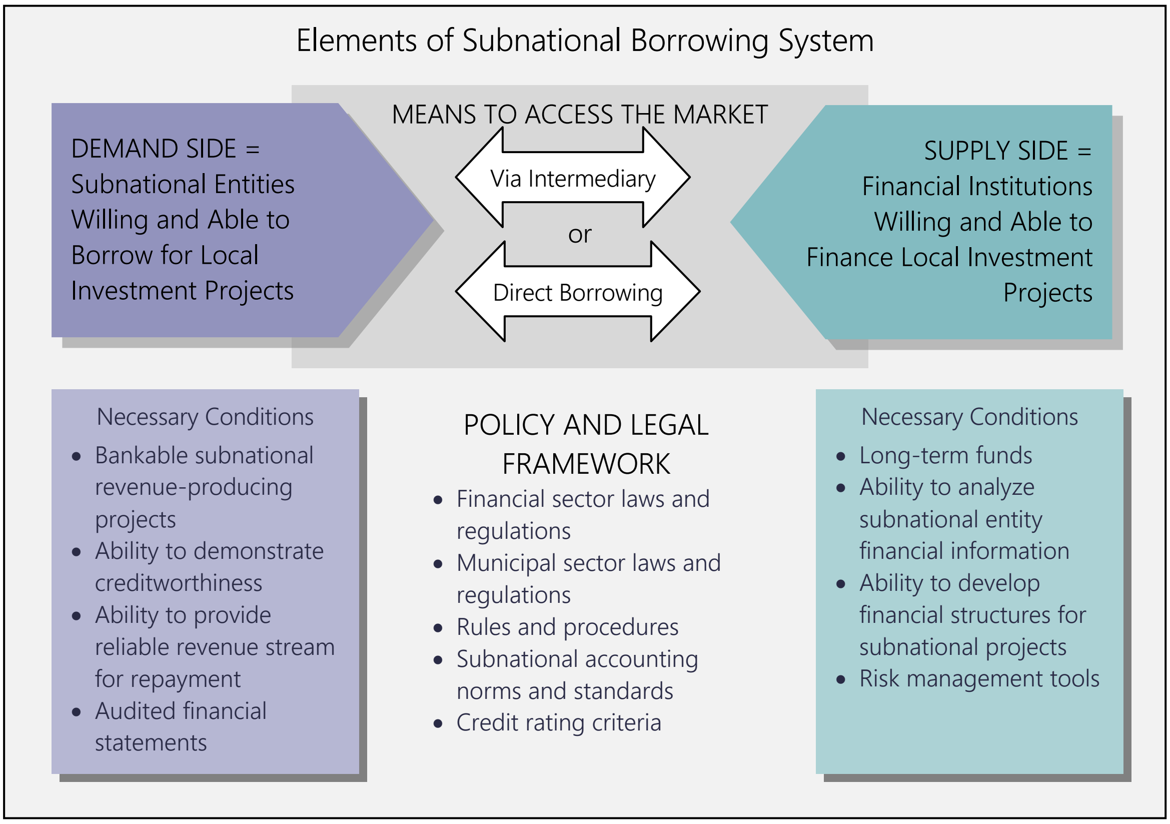
1. Supply and demand

A successful market is one in which there is both an effective demand for financing and a sustainable supply of financing, delivered in a cost-effective manner.

In the case of a subnational debt market, this implies that (a) local governments can prepare creditworthy projects and repay the debt, and (b) financial market actors can supply financing on a sustainable basis with terms (interest rates and other conditions) that potential borrowers find attractive.

The creation of such a market will depend on putting in place an enabling environment that allows the market to operate in a sustainable and transparent manner. For example, the market should require subnational financial reports prepared according to standards sanctioned by the GoN. By establishing this and other aspects of the policy and legal framework (as shown in Figure 1), the GoN plays a crucial role in helping to ensure both the supply of and demand for financing.

Figure 2: Elements of the Subnational Borrowing System



2. Project versus general obligation financing

Project financing and general obligation financing depend on different arrangements to repay the debt. Project financing depends on having one or more dedicated revenue streams to cover project operations and debt repayment. The revenue stream is generally directly related to the project investment (water tariffs in the case of a water and sanitation project, for example) and is dedicated to the investment project through a legal arrangement that is sometimes called "ring-fencing." An SPV may be set up to own and manage the project.

With general obligation financing, the sponsoring entity does not have to commit to using any particular revenue source. Projects financed with general obligation debt are normally balance sheet assets of the sponsoring organization (state or municipality).

In developed markets, financing arrangements include variations on these two approaches, depending on the needs of the issuer/borrower and investor/lender. The relative risk of these two approaches depends on the financial condition of the sponsor and the characteristics of the project. External credit enhancements such as insurance and guarantees can be used with either approach, although they are used more often with project financing.[6] When borrowers cannot provide reliable financial information or there is political uncertainty, a properly structured project financing can lower lenders' risks.

3. Recourse versus non-recourse financing

Non-recourse financing provides repayment to a lender from the cash flows of the project the loan is funding, but not from other collateral or revenue flows of the borrower. Revenue bonds are generally structured as non-recourse financing as are many financing arrangements in PPPs.

In order to ensure that the lender will get repaid, projects with non-recourse financing generally have longer terms and higher interest rates than projects that allow recourse to the owner's assets. The revenues from the project usually are segregated from other municipal revenues.

Lenders may demand certain rights with non-recourse financing, such as being able to take over management of the project if it is not producing revenues. While non-recourse financing is often considered to be higher risk, this depends on the project and the sponsoring entity.

4. Bonds versus loans

The choice of borrowing by issuing bonds or taking out a bank loan is largely an economic decision that takes into consideration interest rates, transaction costs and the capability of the financial and bond markets.

Both loans and bonds are contracts between lenders and borrowers. In a developed market, the benefits of bonds for issuers include lower costs and longer-term financing. An advantage for investors is that bonds are liquid – that is, they can be traded in the secondary market prior to maturity. The option to trade lowers risks for investors and should produce lower interest rates.

5. Risk management

Risks in credit markets affect both borrowers and lenders. These include changes in market conditions and interest rates, mismatches between the term of the source of funds and the loan, and credit (repayment) risk. In international lending, changes in exchanges rates create additional risk. Measures internal to the financial transaction (reserve funds, for example) or external to it (bond insurance) can be used to reduce risks.

---

[6] For example, bond insurance can be bought for both revenue (project) bonds and general obligation bonds.

In Nepal, conditions in the nascent subnational finance system (such as lack of information) create additional risk. Development of the credit system consists largely of identifying and addressing these risks. However, some measures used to counter risk in emerging markets--such as the use of government guarantees--can actually impede market development. Risk management is discussed further in Section VI.E.3.

6. The four dimensions or "pillars" of fiscal decentralization[7]

A complete fiscal decentralization policy should address all four dimensions:

- **Expenditures**: Assignment of functions and expenditure responsibilities to different levels of government
- **Revenues**: Assignment of taxes and other local revenue sources to different levels of government
- **Intergovernmental fiscal transfers**: Allocation of central government resources through intergovernmental fiscal transfers (IGFTs) or grants
- **Subnational borrowing**: Terms and arrangements under which local governments can borrow to finance capital investment or revenue shortfalls

There are important interdependencies among these pillars. For instance, subnational borrowing is not advisable if SNGs do not have sufficient revenue sources to support debt repayment.

In the context of the federalization process, various efforts are underway to analyze options for pillars 1-3. The present report focuses on pillar 4.

7. Options for structuring and financing subnational investment projects

There are many ways subnational projects could ultimately be financed. Table 1 lists the six most likely options.

SNGs may use their own resources, whether IGFTs or own-source revenue (OSR) (Option1), borrow directly from a bank (Option 2) or borrow directly from the bond market (Option 3).

The table also shows two different forms of indirect borrowing via a financial intermediary. The first involves traditional borrowing of an intermediary's own resources, which it has acquired from donors or by issuing debt in the market (Option 4). (This is how TDF operates.)

The second intermediary option entails the issuance of debt secured by a portfolio of loans (Option 5). This approach has been used successfully in the Water and Sanitation Pooled Fund by the Tamil Nadu Urban Development Fund (see Section VII.D.3).

Lastly, PPPs are shown as a financing method (Option 4), since they provide an SNG with access to the market via the borrowing of the private partner.

These financing options are discussed throughout the report.

---

[7] United Nations Development Program, 2005, UNDP Primer: Fiscal Decentralisation and Poverty Reduction, http://www.undp.org/content/undp/en/home/librarypage/poverty-reduction/fiscal-decentralization-and-poverty-reduction/.

Table 1: Options for Financing Subnational Investment Projects

	Form of Financing	Issuer or Borrower	Instrument	Security	Backup Security	Investor	Level of risk	Transaction Cost
1	**IGFT or OSR**	NA	Federal government or SNG revenue	NA	NA	NA	Very low	Low
2	**Direct market borrowing (bank)**	SNG	Loan	SNG assets, pledge of project revenues and/or pledge of general revenues	To be determined	Private bank	Medium	Medium
3	**Direct market borrowing (capital market)**	SNG	Public issue or private placement of bonds	SNG assets, pledge of project revenues and/or pledge of general revenues	Other SNG revenues, insurance, guarantee	Private investors	High	Medium
4	**Borrowing through financial intermediary**	TDF or another intermediary	Loan	SNG assets, claim on IGFTs	Intermediary balance sheet and revenue pledge	Donors, private banks or investors	Low	Medium
5	**Pooled financing via financial intermediary**	TDF or another intermediary	Public issue or private placement of bonds	Revenues from pool of loans	Intermediary balance sheet and revenue pledge	Private investors	Medium	High
6	**Public-private partnership**	Both private company and public entity	Loan and/or equity investment	Project revenues through SPV	Combination of public and private security	Private partner, private bank	Medium	High

III. THE CONTEXT FOR SUBNATIONAL BORROWING IN NEPAL

Key Question: Is the current national context supportive of subnational government borrowing?

A. Stakeholder Analysis

The GoN, civil society and the private sector are all stakeholders for the development of a subnational borrowing system. Stakeholders include (i) those affected positively or negatively by the effort to establish the system, and (ii) those able to influence the activity or program in a positive or negative way. Stakeholders are a broader group than partners (those who participate directly to support the development of the subnational financing system).

Knowing the points of view of stakeholders is beneficial to determining whether and how to proceed with development of the subnational borrowing system. In preparing this report, a broad cross-section of stakeholders were contacted. Annex 2 includes a list of contacts made.

Table 2: Stakeholders for Development of the Subnational Government Financing System

Stakeholder	Interest in the Subnational Borrowing System
Nepali citizens	▪ Improved services at a reasonable cost
Subnational governments	▪ Autonomy in accessing infrastructure finance ▪ Ability to improve local services
Ministry of Urban Development **Ministry of Federal Affairs and Local Development**	▪ Promoting local economic development ▪ Provide more financing options to SNGs ▪ Ensuring that subnational lending is properly regulated
Ministry of Finance	▪ Leveraging public funds ▪ Maintaining fiscal and macroeconomic control
Banks and capital market actors	▪ Develop new markets while avoiding excessive risk
Institutional investors (pension funds, investment companies, insurance companies) and individual investors	▪ Having new options for investment of long-term funds ▪ Contributing to national development
Financial advisors and other technical experts	▪ New source of clients ▪ Contribute to diversification in the financial markets
Private firms doing business in subnational jurisdictions	▪ Improvement in business conditions, including reliable quality public services and facilities
Private construction firms and other contractors	▪ Business opportunities constructing subnational infrastructure and operating public facilities
Town Development Fund	▪ Fulfill its mission while keeping its clientele ▪ Access the financial market
International financial institutions and donors	▪ Contribute to national develop goals ▪ Maintaining a role in subnational sector development

B. Organization of Subnational Government

Under its 2015 Constitution, Nepal is organized into federal, state and local levels. The country now has seven states and 744 local governments. Local level entities include Municipalities and Villages.

State and local governments are autonomous, corporate bodies, each with a unicameral legislature (state, municipal or village assembly). Districts, which before served an administrative function, will serve coordination function among Municipalities and Villages in the new system. Districts are also autonomous, corporate bodies. District Assemblies are composed of municipal officials. Municipalities are divided into at least nine wards. The GoN can also create Special, Protected or Autonomous Regions. States and local governments are governed by elected officials.

There are three levels of municipality: Metropolitan City (MC), Sub-Metropolitan City (SMC) and Municipality. Rural local governments are now gaonpalika, also called Village or Rural Municipality.

Until recently, Kathmandu was the only MC, and there were eleven SMCs, 217 municipalities and 3,157 Village Development Committees (VDCs).

The number of municipalities in Nepal has grown significantly in the past few years. Municipalities were formed by merging VDCs or redrawing their boundaries. Until 2014, there were 58 municipalities. In May 2014, 72 new municipalities were established, for a total of 130. Another 61 municipalities were designated in December 2014, for a total of 191. In September 2015, 26 more municipalities were created, for a total of 217. At that time, the administrative level of 7 municipalities was also raised to SMCs to reach a total of 11 SMCs.

Recently, the GoN has approved a new classification of SNGs for the federal system based on a proposal prepared by the Local Body Restructuring Commission (LBRC). Using criteria such as population, infrastructure and service levels and distance to services, three SMCs were raised to MCs, increasing the number of MCs from one to four, and the number of SMCs was increased to 13. The number of municipalities now stands at 246.[1] The number of rural municipalities approved is 481.

The distribution by category and the criteria used to classify local governments are shown in Table 3 and Table 4, respectively.

Table 3: Nepal Local Government Structure Approved in 2017

Local Governments	Total Number of Units
Metropolitan City	4
Sub-Metropolitan City	13
Municipality	246
Gaunpalika / Rural Municipality	481
Total	**744**

[1] Note that because the policy documents reviewed in Section IV.A were written at different points in time, they refer to different numbers of municipalities. Investment needs estimates were also based on differing numbers of municipalities.

Table 4: Criteria Used to Categorize Local Governments and Establish Boundaries

Criteria	Metropolitan City	Sub-Metropolitan City	Municipality	Gaunpalika (Rural municipality)
Population				
Mountain	300,000	150,000	17,000	13,000
Hills	300,000	150,000	31,000	22,000
Terai	300,000	150.000	60,000	40,000
Walking distance to service center				
Mountain				8hrs
Hills				6 hrs
Terai				4 hrs

Under the new Constitution, relations among the federal, state and local governments are to be based on the principles of "cooperation, co-existence and coordination." The federal government can intervene for a number of reasons in state and local government affairs, as can states in local government affairs. The concept of subsidiarity (i.e. where matters are handled by the lowest competent authority), which prevails in most federalized systems, is not mentioned in the Constitution.

C. Population and Urbanization in the 2011 Census

Nepal's population grew to 26.5 million in 2011 from 23.2 million in 2001, while its growth rate declined from 2.25 percent to 1.35 percent, due to the emigration of youth and a decline in fertility.[2] Twenty-seven Mountain and Hill Districts experienced negative growth during this period. Kathmandu had the highest growth rate at 4.78 percent.

Population growth is higher in urban areas than in rural areas, although the relative rates of change are difficult to compute due to changes in the number of municipalities and municipal boundaries, and the automatic classification of population in municipalities as urban. At the time the 2011 Census was conducted, there were 58 municipalities. By the time it was issued, 72 additional municipalities had been declared (for a total of 130 municipalities).

Urbanization varies by region; the Kathmandu Valley and the Tarai are more urbanized than other regions. Of the 130 municipalities, the Census Bureau characterized only about 40 as having urban qualities. Key urban development attributes in the others--such as levels of services and infrastructure, literacy, and labor composition--are similar to many rural areas.

The best measure of urbanization is to compare changes in an identical area. Population growth in the original geographic areas of the 58 original municipalities increased from 3,227,879 in 2001 (or 14.2 percent of the national population) to 4,511,244 in 2011 (17.1 percent of the total population), an annual growth of 3.4 percent or about 40 percent over the decade. These areas also showed an increase in density during the 2001-11 decade of more than 30 percent (985 persons/sq km to 1282 persons/sq km).

Including the 72 additional municipalities brought the urban (municipal) population to 27 percent of the total population in 2011, and the urban growth rate to 8 percent between 2001 and 2011, but this reflects changes in classification more than actual urbanization.

[2] Government of Nepal/Central Bureau of Statistics, 2014, Population Monograph of Nepal Volume III (Economic Demography). http://cbs.gov.np/image/data/Population/Population%20Monograph%20of%20Nepal%202014/Population%20Monograph%20V03.pdf.

Among all municipalities, those with populations between 20,000 and 49,999 predominate in both number and share of population; however, the original 58 municipalities had average populations of nearly twice that of the additional 72 municipalities (75,967 versus 38,798) and lower densities in some cases than areas that were not awarded municipal status.

The Census Bureau characterizes urbanization in Nepal as low but accelerating, and concludes that several factors are driving it:

- Increased rural to urban migration (Rural to urban migration accounted for 33.4 percent of all migration in 2012 versus 25.5 percent in 2001.)
- The tendency of those returning from living abroad to settle in urban areas (The census identified nearly 2 million people in 2011 as "absentee abroad.")
- Growing trend of investing remittances (received by 56 percent of households) in urban areas
- An occupational shift away from agricultural work

For social and economic reasons, the Census Bureau considers it likely that urbanization will accelerate in Nepal. In theory, municipalities are subject to higher infrastructure and service standards, which raise the quality of life for residents.[3]

However, the Census Bureau expresses the opinion that in classifying jurisdictions as municipalities, government officials should consider the country's capacity to mobilize the necessary resources to improve environmental conditions and provide the level of facilities expected in urban areas. Doing so would imply focusing available resources on adequately equipping fewer urban areas, rather than underinvesting in a large number of municipalities.

This challenge will become particularly acute with the recent designation of 246 municipalities and 17 cities. An effort may be needed to identify where to target investment in the urbanized municipalities and urbanized areas within municipalities.

D. Land and Urban Development

A complicated land acquisition process impedes the development of Nepal's cities for both local governments and (to a lesser extent) the private sector. The Land Acquisition Act (LAA) is one of several laws that govern land ownership and land transactions in Nepal. It was approved in 1977 and has not been updated since.[4]

In 2015, the National Planning Commission introduced the Land Acquisition, Resettlement and Rehabilitation for Infrastructure Development Project Policy in an attempt to clarify and modernize policies and procedures related to land acquisition for infrastructure projects. The policy modernized Nepal's approach to land acquisition somewhat, including strengthening procedures for compensation and resettlement, but it was criticized for adding complexity to the process. Moreover, since the LAA has not been updated, the policy created inconsistencies with prevailing law.

The National Natural Resource and Fiscal Commission (NNRFC), once it is operational, is expected by some to undertake a process to update land acquisition laws and procedures, although the Constitution does not mention this responsibility.

The current land acquisition process creates uncertainties that affect project costs and timing. Until the process is streamlined, land acquisition will make SNG infrastructure projects riskier and more

---

[3] The practice of creating municipalities by redrawing boundaries, rather than to respond to urbanistic or functional characteristics, presents challenges for capital financing. Low population density makes higher levels of investment difficult to justify or to pay for. Even among the 58 old municipalities, population density varies widely from 362.4 ppha in Kathmandu to 2.57 ppha in Kamalamai municipality.

[4] Land Acquisition Act, 2034 (1977). http://www.lawcommission.gov.np/en/documents/2015/08/land-acquisition-act-2034-1977.pdf.

difficult to finance. Updating this aspect of the legal framework for SNG financing should be a priority.

E. Conclusions: The Context for Subnational Borrowing

Key Question: Is the current national context supportive of subnational government borrowing?

The context in which development of a subnational borrowing system will take place is undergoing significant change. These changes can both facilitate and impede development of the subnational borrowing system, but in general, the conditions appear favorable for the work discussed in this report.

Several aspects of Nepal's changing context are positive, including:

- Local elections being held for the first time in 20 years
- Significant revision to laws and regulations are underway, which present an excellent opportunity to put in place a consistent set of enabling conditions for borrowing
- Steady increase in urbanization, which is strengthening the demand for urban capital investments and should make them more feasible
- High stakeholder interest in the development of the subnational finance system
- The new organization of local governments, which significantly reduces the number of local jurisdictions, and could improve their creditworthiness

There are always risks in an environment that is changing as described above. Some of these factors could undermine the development of the subnational financing system, for instance:

- New states and municipalities, run by newly elected officials who will require time to get fully oriented and organized
- Risk of political conflicts that could delay approval of fiscal decentralization laws and regulations
- Long-standing impediments to borrowing such as difficulty in accessing land, poor information systems and records, inadequate own-source revenues and turnover of staff

This report addresses these issues and provides advice on how to take advantage of the positive factors and mitigate the risks while developing the financing system for SNGs that is so greatly needed.

IV. POLICY AND LEGAL FRAMEWORK FOR SUBNATIONAL BORROWING

Key Question: Is an institutional framework in place or being put in place that will make subnational borrowing feasible?

The policy and legal framework for subnational development and finance is complex in every country because subnational development has political, institutional and territorial dimensions. Policies and rules in sectors as diverse as agriculture, transport, social development, financial markets, land use and land ownership, among others, affect the operating environment for local government and the expectations of citizens. Even national macroeconomic and development policy decisions trickle down to the local level.

Nepal's policy context is uniquely complex. Constitutional reforms, a new configuration of SNGs, increasing urbanization and the country's changing economy affect local development, as do high migration levels and Nepal's relationships with its Asian neighbors. On top of these challenges, the GoN has established a goal to make Nepal a middle-income country by 2030.

This chapter focuses on those laws and policies directly related to urban and subnational development. As a follow-up, it might be useful to conduct a scan of other sector policies and laws to identify synergies and inconsistencies with the concepts in this report.

A. Subnational Policy Framework

The legal and regulatory framework for subnational development and finance should reflect agreed policy directions. Nepal does not have a fiscal decentralization policy *per se*. However, several policy documents collectively provide a useful framework for the elaboration of a fiscal decentralization policy. These include the *National Urban Policy* (2007) (NUP); the *National Urban Development Strategy* (2015) (NUDS); the *Municipal Finance Framework for the National Urban Development Strategy* (2015) (MFF) and *Inclusive Cities: Resilient Communities* (Nepal national report for Habitat III). The 14th Three-Year Plan is discussed briefly, although there was limited documentation available to review.

These documents and their relevance to subnational financing are discussed below.

1. National Urban Policy, 2007 [5]

Prepared by	**Ministry of Physical Planning and Works, Department of Urban Development and Building Construction in 2007**
Key Objective	Present an integrated and coordinated policy for responding to the challenges posed by haphazard urbanization going on in the country, and to provide a roadmap to the urban sector.
Issues Identified	▪ Unbalanced urban structure ▪ Weak rural-urban linkages ▪ Environmental deterioration ▪ Lack of clarity in the national policy ▪ Urban poverty ▪ Weak municipal institutions

The NUP identifies the key urbanization-related issues in Nepal listed above, each of which remains a priority and has implications for capital financing. The NUP proposes three principal local and

[5] Ministry of Physical Planning and Works, Department of Urban Development and Building Construction, 2007, National Urban Policy, 2064 BS.

regional development objectives for the country, along with their corresponding policies and strategies. Table 5: National Urban Policy 2007, Local and Regional Development Objectives, Policies and Strategies contains a list of policies and strategies associated with each objective.

Objective 1: To achieve a balanced national urban structure through proper guidance to development of and investment in the infrastructural facilities

Objective 2: To raise the living standard of the urban residents through development of clean, secure and economically vibrant urban environment.

Objective 3: To achieve effective urban management through institutional strengthening and legal empowerment of LBs and coordination with other institutions involved in urban development

The NUP refers to estimates of an investment requirement of US$ 8.5 billion between 2001 and 2011 to provide adequate basic urban infrastructure services and facilities to the municipalities. The source of this estimate is not identified, and it was later updated in the NUDS.

Table 5: National Urban Policy 2007, Local and Regional Development Objectives, Policies and Strategies

Objective 1: To achieve a balanced national urban structure through proper guidance to development of and investment in the infrastructural facilities	***Objective 2: To raise the living standard of the urban residents through development of clean, secure and economically vibrant urban environment.***	***Objective 3: To achieve effective urban management through institutional strengthening and legal empowerment of LBs and coordination with other institutions involved in urban development***
Policies and Strategies		
▪ Regional urban centers for industrial, trade and export promotion ▪ Secondary urban centers along the north-south and east-west highways ▪ Development of North south highways to link the Himalayan belt (high mountains) and the Terai (southern plains) in every development region ▪ Prioritization of the backward development regions for industrial promotion and urban infrastructure investment ▪ Support rural economic development through transportation linkages ▪ Transferring economic activities detrimental to the long term development vision of Kathmandu valley outside the valley	▪ Develop an operational system in local bodies to support the implementation of programs and projects identified in development plans ▪ Develop environment-friendly public transportation systems ▪ Conservation of natural resources and cultural heritage ▪ Institutionalizing the 'healthy city' concept at the operational level ▪ Minimizing the risk of natural disasters ▪ Increasing the access of the low income groups to housing ▪ Promoting economic development based on local potentials and opportunities ▪ Exploitation and management of economic opportunities in the informal sector	▪ Creation of central body to formulate urban policy and guidance and monitor urban plans and programs ▪ Conferring municipal status only to those urban areas which have developed physical infrastructural facilities and economic activities ▪ Giving local bodies the prime executing role in urban development plans and programs ▪ Promoting cooperation among central government agencies, local bodies, non government organizations, private sector and financial institutions for the planning and execution of infrastructures and the provision of urban services and economic activities

2. National Urban Development Strategy, 2015[6]

Prepared by	Ministry of Urban Development (MoUD), published in February 2015
Key Objective	▪ Develop a medium and long term strategic vision of a desirable national/regional urban system based on existing trends and regional resource potentialities. ▪ Assess existing conditions of infrastructure, environment, economy and governance; establish benchmarks and desirable standards and identify prioritized strategic investment initiatives.
Issues Identified	The NUDS defines a qualitative vision for future urban growth in Nepal, as well as for physical development. It is guided by five basic principles, namely that urban centers should be sustainable, inclusive, resilient, green and efficient. The NUDS identifies the need for development benchmarks and proposes benchmarks in a number of key sectors, including: Major milestones by 2031 include annual investment of 2 percent of gross domestic product (GDP) in urban infrastructure development, and benchmarks for piped water, sewerage, electrification, road density, housing and land development, solid waste collection, internet availability, open space, disaster risk management plan and municipal capacity.

The NUDS uses the NUP as a starting point. It estimates investment needs under various scenarios and argues that urban infrastructure is needed to “unleash” the country’s economic potential. Urban areas are increasingly important contributors to economic growth. Urban GDP is as much as 33.1percent of national GDP, not counting peripheral VDCs. However, new infrastructure is needed to make the economy more efficient (especially power and water) and increase the commercialization of output (through transportation and communications). Investments such as water and sanitation, solid waste management, and public space improve work productivity and quality of life in urban areas.

The NUDS is relevant to the present study in that it estimates investment needs in the 58 “old” municipalities as well as in the 133 “new” municipalities. These estimates are discussed further in Section V.A.

[6] Ministry of Urban Development, 2015, National Urban Development Strategy.

3. Municipal Finance Framework for the NUDS, 2015[7]

Prepared by	**Town Development Fund (TDF) with the support of other organizations and published in 2015.**
Key Objectives	▪ To analyze own-source revenue and IGFTs and suggest enhancements that would provide municipalities with more financial autonomy ▪ To propose how to expand borrowing options for municipalities ▪ To outline a business plan that would give TDF a more central role in expanding borrowing options for municipalities.
Issues Identified	▪ Need for local elections so that there are elected officials in municipalities who can drive local development and engage citizenry ▪ Need to provide IGFTs on a predictable basis ▪ Need to strengthen municipal revenue efforts ▪ Ways to address technical and administrative gaps to prepare capital improvement plans and undertake capital spending jointly with other public agencies ▪ Strengthening capacity for transparent procurement processes ▪ Strengthening capacity to implement, operate and maintain urban infrastructure facilities and to work with the private sector to do so

While not a policy document *per se*, the MFF builds on the NUDS to lay out policy and operational directions to support the capital financing of subnational investment requirements, using a range of financial sources, including borrowing.

The MFF complements the NUDS by focusing on financing needs and issues that--if addressed—would provide borrowed funds to support the urban strategy. It envisions a borrowing system with the following characteristics:

- Appropriate macroeconomic and regulatory policies, including those that encourage long-term savings and permit private banks to lend to local governments
- Sufficient powers are devolved to local governments
- Fiscal transfers allow for more municipal autonomy in planning and use of funds
- Municipalities have urban development strategies and multi-year capital improvement plans
- Municipal own source revenues and surpluses are greatly increased
- Social marketing is used to improve willingness to pay
- Municipal financial management and accounting practices are improved
- Sustainable partnerships are established between municipalities and communities, private sector, and non-governmental organizations (NGOs)

The MFF also states that little of this is possible until local elections are held and the federalization process begins in earnest. The MFF financial projections are summarized in Section V.B

4. Inclusive Cities: Resilient Communities, Nepal National Report for Habitat III[8]

In 2016, a national report was prepared for the Third United Nations Conference on Housing and Sustainable Urban Development (Habitat III), held in Quito, Ecuador, entitled "Inclusive Cities:

---

[7] Khatiwada, Yuba Raj, et al, 2015, Town Development Fund, Municipal Finance Framework for the National Urban Development Strategy-Nepal: Final Report. http://www.tdf.org.np/new/custom/uploads/notice/5727.pdf.

[8] MoUD, 2016. Third United Nations Conference on Housing and Sustainable Urban Development (Habitat III) – Nepal National Report. Kathmandu: Government of Nepal, Ministry of Urban Development. http://moud.gov.np/?p=536#

Resilient Communities," in line with the theme of the event. Preparation of the National Report included consultations with various stakeholders and experts.

Prepared by	Ministry of Housing and Urban Development, 2016
Key Objectives	The **Habitat Agenda** of Istanbul (1996) set twin goals of achieving adequate shelter for all and ensuring sustainable human settlements development in an urbanizing world. ▪ Review Nepal's progress on the Habitat Agenda ▪ Identify key issues and challenges ▪ Presents Nepal's New Urban Agenda The **New Urban Agenda** is guided by national and international commitments, in particular to the Sustainable Development (SDG) Goal 11 ("make cities and human settlements inclusive, safe, resilient and sustainable") of the 2030 Agenda for Sustainable Development.
Issues Identified	The issues identified in this document echo many of those in the policy documents mentioned previously. At the same time, the report provides useful grounding in the 2030 Agenda for Sustainable Development, the SDGs and other national and international commitments. It also puts the New Urban Agenda in the context of Nepal's federalization process. Selected issues covered in the report include: ▪ Managing rural-urban linkages ▪ Ensuring sustainable urban planning and design ▪ Fostering ecological and resilient cities and human settlements ▪ Promoting safer and resilient communities ▪ Improving urban legislation ▪ Improving municipal/local finance ▪ Improving access to sustainable means of transport ▪ Ensuring sustainable access to basic sanitation and drainage ▪ Adequate and safe housing and shelter

5. 14th Three-Year Plan

The National Planning Commission's (NPC) Approach Paper for the 14th National Development Plan, identifies "balanced and inclusive development through infrastructure development at the provincial (state) and local level" as a national priority.[9]

According to Approach Paper, Nepal's goal is to increase access of citizens to socio-economic opportunities through infrastructure development that is coordinated between the state and local level. This infrastructure should increase income generation and employment opportunities at local level.

The two strategies proposed to support this goal are: (1) developing environment-friendly local infrastructure by utilizing local skills, resources, and technology; and (2) increasing local infrastructure services through participation and local ownership. Specific objectives include the following.

- Protecting rivers and other natural resources from pollution by developing a solid waste management facility in each municipality.

[9] Government of Nepal, National Planning Commission, Approach Paper of 14th Plan (2016/2017-2018/2019), pp. 165-168.

- Developing Integrated Urban Infrastructure master plans and implementing them by phase.
- Developing safe and secure two-lane local roads based on municipal road network master plans, updated periodically using GIS systems.
- Completing all large-scale infrastructure projects within two years.

B. Subnational Legal Framework

With the new Constitution, and the approval of new laws and regulations on the horizon, Nepal has a rare opportunity to put a legal and regulatory framework in place that is fully harmonized with the policy prescriptions contained in the policy documents reviewed in the previous section.

1. New Constitution

Nepal approved a new Constitution in 2015, based on which the country will transition from a unitary state to a federal system of government.[10] This reform will have political, administrative and fiscal repercussions at both the national and local level.

The new Constitution ascribes significant autonomy to states and both urban and rural municipalities. Districts will now serve a coordination function, rather than a governance function, and there is expected to be a reduction in deconcentrated ministry offices at the local level.

New laws, regulations and procedures are being developed to support the federalization process, covering all aspects of subnational governance including local government finance. National committees are working to draft legislation and other legal instruments. National and international advisors are supporting the process.

Schedules 5-9 list federal, state and local government powers and jurisdictions, as well as shared powers and jurisdictions between and among the various levels of government. There is considerable overlap among the powers and jurisdictions listed; forthcoming laws, regulations and procedures will need to provide clarification.

The Constitution contains various clauses that point to the right of states to borrow and receive guarantees from the federal government and for local level entities (municipalities and villages) to borrow and receive guarantees from the federal and state governments. The following clauses have been identified as supporting the right to borrow.

- Article 228 states that states and local government can take a loan only after a law is approved. This implies that the federal government will prepare an organic law that allows state and local governments to borrow internally. (Similar language referring to states is found in clause 203.) States and local governments will also need to pass their own ordinance following the spirit and essence of the federal law.
- Article 229 states that every local government will create a consolidated fund where all income and expenditures--including loan proceeds--are recorded.
- Article 59.7 states that federal law that will dictate how state and local level budget deficits will be covered. Article 230 states that if local governments present a deficit budget, they must propose how they will cover the funding gap. This suggests that borrowing will be allowed.
- Article 251.1.f delegates to the National Natural Resources and Fiscal Commission the responsibility for making recommendations about the internal loans the federal, state and local governments may take.

---

[10] Ministry of Law, Justice and Parliamentary Affairs, 2015, Constitution of Nepal 2015, Official Translation. http://www.constitutionnet.org/sites/default/files/nepal_constitution_-_official_translaiton_eng_mljpa.pdf.

There is also a widely-shared interpretation of the Constitution that states can borrow internationally with prior approval from the federal government, although no text was identified that clearly states this.

Laws and regulations are needed to define the meaning and implications of these clauses for all levels of government. It is understood that the right to borrow is made explicit in the draft Local Level Governance Act 2017 with an allowed repayment period of up to 25 years, as well as provision for of joint borrowing, according to limits imposed by the National Natural Resource and Fiscal Commission.

2. Existing legislation and regulations related to subnational borrowing

Because the existing laws and regulations that govern subnational finance and borrowing are expected to be replaced or updated soon, it is worthwhile to point out some of their strengths and weaknesses as far as how well they have served to support these activities in the past. The key legal and regulatory instruments include:

- Local Self-Governance Act, 1999
- Local Self-Governance Regulation, 1999
- Town Development Act, 1997
- Local Body Financial Administration Rules, 2007
- Local Body Resource Mobilization and Management Procedures, 2009

a. Local Self-Government Act 2056 (1999) [11]

The LSGA provided significantly greater fiscal and administrative autonomy to Districts, Municipalities and Village Development Councils than what they were granted under the previous laws that the LSGA repealed. As such, it defines a number of municipal powers and responsibilities relevant to subnational borrowing:

- Establishes the principle of devolution of powers, responsibilities, and provides means and resources
- Encourages private sector participation in local service provision
- Gives local bodies the power to levy and collect taxes, charges, levies, etc. and to borrow
- Lets local bodies undertake activities that generate income
- Gives local bodies and consumer groups the power to construct works and implement projects in a range of sectors
- Directs local bodies to prepare annual and periodic plans, in consultation with stakeholders
- Identifies the royalties, fees, taxes and levies that local bodies can mobilize and permits fines on those who do not pay
- Allows local bodies to borrow from banks or other agencies, in accordance with local policy
- Requires local bodies to create a single fund and to keep books and records
- Encourages local bodies to request assistance and not undertake tasks for which they are not qualified

[11] Local Self-Government Act 2056 (1999), http://www.undp.org/content/dam/nepal/docs/reports/governance/UNDP_NP_Local%20Self-Governance%20Act%201999,%20MoLJ,HMG.pdf.

b. Local Self-Governance Regulations 2056 (1999) [12]

The Local Self Governance Regulations provide procedures and guidance on various administrative practices, such as human resource management and preparation of plans. The Regulations contain little additional information relevant to subnational borrowing except for annexes that establish the rates of taxes and fees, which are to be periodically updated by the GoN.

c. Local Body Financial Administration Rules, 2007 [13]

The Local Body Financial Administration Rules provide detailed financial procedures that allow municipalities and VDCs to comply with the LSGA and the Public Procurement Act, 2063 (2007).

The subnational Public Expenditure and Financial Accountability (PEFA) analysis (see Section V.D.2, below) found that frequently the financial information prepared by LBs was not consistent with these Rules, and more importantly that subnational public financial management (PFM) needs to be updated to reflect modern standards and practices.

d. Local Body Resource Mobilization and Management Procedures 2069 (2012)

The processes and procedures described in the Local Body Resource Mobilization and Management Procedures support the programming and expenditure of capital investment funds, primarily the IGFTs provided by the GoN. They cover the preparation of Integrated Development Plans and the selection and preparation of projects.

Formally, the Procedures do not apply to borrowed funds, although they could be applied, especially with respect to project selection and feasibility analysis. As such, the Procedures would help provide initial evidence to a lender or investor of stakeholder support for the project. The Procedures should be updated and expanded as part of the process to update the regulatory framework for fiscal decentralization.

3. Lessons learned from existing laws and regulations

Several lessons emerge from analyzing experience from the LGSA and its regulations that may be useful in developing a new institutional framework for borrowing.

- The LSGA and its regulations were designed to be carried out in a democratic context that would promote accountability to the public and public participation in decision making. The extended suspension of local government elections that began in 1997 undermined the fundamental principle on which the LSGA and its regulations and procedures were based.
- Without concerted follow-through on the part of the GoN, new laws and regulations may never be fully implemented. Implementation may include the elimination of pre-existing laws and regulations that contradict the new law. While the need for these modifications was understood, they were not carried out after the LSGA was approved.[14] As a result, the current system represents a confusing hybrid of LSGA reforms, previous decentralization arrangements and ad hoc policy decisions.

  For example, most municipalities (except new ones less than five years old) should be reporting their financial operations on an accrual basis. However, local bodies were never provided the necessary standards and technical support to effect this transition.
- Even well-considered laws are likely to need modifications as time goes along. Some flaws in the original design of LSGA were never corrected (for example, overlapping of expenditure

---

[12] http://www.mofald.gov.np/sites/default/files/Resources/docs_25.pdf.

[13] http://www.lawcommission.gov.np/en/documents/2015/08/local-body-financial-administration-rules-2064-2007.pdf.

[14] Boex, Jamie, 2016, Intergovernmental Fiscal Design in the Context of the Federal Constitution of Nepal. Submitted to Ministry of Finance, MoFALD and Ministry of General Administration.

responsibilities and unclear procedures for revenue sharing). Nor was any formal process set in place to monitor the impact of the law. This should be done with the new laws, particularly those for borrowing, given the lack of prior experience.

The GoN should also be prepared to modify regulations and procedures promptly if they are not producing the desired results and to do so in consultation with stakeholders. For example, changes in accounting rules should take effect at the end of a fiscal year, in order to simplify financial reporting.

- Certain rules and standards need to be adjusted to the size and complexity of the local governments, based on experienced in both Nepal and other countries. While the objective may not change (local borrowing, for example), the requirements need to be tailored to the resources and capabilities of the locality.

  For example, having central government set tax rates, rather than individual SNGs, is a risk for investors and lenders. Central government involvement may be a logical safeguard for small or organizationally weak local governments but is unnecessary for more sophisticated SNGs. Instead, the GoN should consider providing mandatory guidelines for setting rates and taxes. Conversely, the responsibility for setting user fees–a likely source of revenues for many SNG projects–is left to the SNGs, but may not be employed by small SNGs without adequate technical assistance.

C. Parameters of the Legal Framework for Municipal Borrowing

Subnational borrowing requires a well-designed legal and regulatory framework. The subnational borrowing law can be a separate law or part of a larger fiscal decentralization, fiscal responsibility or subnational financial management law. The important consideration is not so much the configuration of the laws, as much as that borrowing fits well into the larger intergovernmental fiscal architecture.

In particular, the right for SNGs to borrow needs to be supported by a fiscal decentralization system designed to provide adequate and stable revenues to repay the debt and a clear delegation of responsibilities in the sectors being financed.

The revenue source can be dependable transfers or own source revenue, or some combination of the two. Using transfers as the source of debt repayment adds a level of risk, since national governments can reduce transfers for fiscal or political reasons, putting both the borrower and the lender in jeopardy.

In addition to the law and regulation, SNGs will need guidance on borrowing-related procedures such as project preparation, financial analysis, financial disclosure, and the preparation of contracts and other documentation.[15]

1. Scope of borrowing law and regulation

The legal and regulatory framework for private subnational borrowing must address both the public and private aspects of this activity. The government's interests are somewhat different along these two dimensions, as are the legal and regulatory references. The two dimensions can be characterized as: (i) the public finance dimension, and (ii) the private market dimension.

a. Public finance dimension

The new federal system grants significant autonomy to SNGs, but the delegation of fiscal powers still rests with the federal government (Clause 58). The principal interests of the GoN in the public finance dimension of subnational borrowing have to do with the management of the macro economy and the

[15] A list of proposed procedures and tools is included in Section VIII.B.

exposure of the federal government (and possibly of states) to the risk of SNG default, as well as with social considerations.

In the law and regulations, the GoN should set strict limits on its financial exposure and define rules that prevent over-borrowing by individual SNGs and by the local government sector as a whole (without discouraging borrowing under appropriate circumstances.) Therefore, the law and regulations would cover such matters as:

- Administrative and legal requirements to borrow (characteristics of SNG, implementation of accrual accounting, nature of legal arrangements, approvals by city council, etc.)[16]
- Financial and economic conditions SNGs must meet to borrow (SNG financial performance or indebtedness levels, debt service coverage of loan, economic return of projects, etc.)
- Social requirements (consultation with users, conditions for public approval of borrowing, affordability, etc.)
- Approval process (see discussion of options, below)
- Debt monitoring requirements (lenders will require disclosures, but government may have its own requirements, for instance, to be informed of any default of loan conditions)
- Liability limitations for upper levels of government and workout arrangements in the event of default on a loan or other credit arrangement

b. Private market dimension

The interests of government in the private market dimension of subnational borrowing are associated with the safe and transparent operation of the financial and capital markets, and do not differ greatly from those associated with other market borrowing.[17] Regulations should establish:

- Requirements for issuer (borrower) disclosure of information for capital market transactions (For banking transactions, the financial institutions should dictate what information is required.)
- Definition of sophisticated investor (Sophisticated investors can purchase or invest in securities issued with limited information disclosure.)
- Reserve requirements and concentration limits for financial institutions (This is already covered by the Banking and Financial Institutions Act (BAFIA) for lending to the private sector, but the regulations do not consider subnational borrowing, and may need to be added.)
- Financial reporting standards (Private equity issuers are required to report their financial information based on national/international accounting standards and lenders increasingly require the same of borrowers. The GoN should provide the standards that allow SNG borrowers to do the same.)

Given that the conduits for subnational borrowing still need to be developed, the borrowing law should be quite general, leaving the specifics to be defined in regulations and procedures. Existing laws, such as the BAFIA may also need some modifications, although the consultants identified no specific issues in preparing this report.

The borrowing law should allow for both borrowing from financial institutions and the issuance of debt securities, with separate regulations issued for each as needed. For subnational debt issuance, the most likely scenario in the medium term would be to use private placements (negotiated

[16] It is critical that the legal arrangements associated with the borrowing ensure that the obligation to repay the loan passes from one SN administration to the next.

[17] The relevant capital regulations in English could not be located, so their suitability was not assessed as part of this analysis.

borrowing from one or more sophisticated investors) rather than a public bond issuance. For that reason, regulations might be prepared initially only for private placements.

2. Approval of borrowing

Governments commonly impose conditions and limits on borrowing by SNGs. The goals in doing so include ensuring fiscal responsibility at the subnational level and maintaining the country's macroeconomic stability.

The International Monetary Fund (IMF) identifies four approaches that governments can use to control subnational borrowing, which are not mutually exclusive. [18]

Table 6: Approaches to Central Government Control on Subnational Borrowing

	Approach	Explanation	Drawbacks
1	Reliance on market discipline	Lenders decide whether an SNG is a good credit risk using information such as credit ratings.	Poor financial information and lack of credit ratings make this approach nearly impossible in underdeveloped markets.
2	Rules-based controls	SNGs free to borrow as long as it is only for investment, or conforms to fiscal indicators such as for expenditures, repayment capacity, etc.	SNGs sometimes find ways to circumvent or game the calculations behind these controls.
3	Administrative controls	Central government sets borrowing limits, approves each loan directly or carries out all borrowing which is then on-lent to SNGs.	While this seems the most conservative approach, it increases moral hazard by creating the impression that government has "approved" the borrowing.
4	Cooperative approach	SNGs and central government negotiate borrowing amounts and share responsibility for maintaining limits.	Requires a high level of technical understanding and political good faith.

To limit its liability, the GoN should avoid the appearance that it has "approved" the borrowing since this increases the expectation that the government will repay in the event of default.

3. Regulatory responsibility

Various agencies will have a role in regulating aspects of subnational borrowing. These include the Nepal Rastra Bank (NRB) (as regulator of banks and financial institutions), the Securities Board of Nepal (SEBON) (as regulator of capital markets), and Ministry of Finance (MoF) (in its role managing public finances and public borrowing). In addition, the NNRFC, while not a regulator, will have a critical role to play in the development of the borrowing system given its role in fiscal decentralization and the distribution of revenues between the federal, state and local governments.

In order to ensure that the borrowing system develops in a systematic and well-coordinated manner, it would be advisable that a dedicated Subnational Borrowing Unit be created in either MoF or NRB to coordinate the various regulators and other agencies, conduct research and make policy proposals,

[18] Ahmad, Ehtisham, Maria Albino-War and Raju Singh, [2006], "Subnational Public Financial Management: Institutions and Macroeconomic Considerations," Chapter 16 in Ehtisham Ahmad and Giorgio Brosio, eds, 2006, Handbook of Fiscal Federalism. http://www.untag-smd.ac.id/files/Perpustakaan_Digital_1/FEDERALISM%20Handbook%20of%20Fiscal%20Federalism.pdf.

and monitor borrowing activities and the progress of policy reforms. It could also review and facilitate the approval of borrowing transactions, if this function is needed, using agreed criteria and procedures.

It is not recommended that MoFALD, MoUD or the Municipal Association of Nepal (MuAN) be directly involved in these activities, particularly the approval of borrowing. Instead, they can ensure that technical assistance is available and serve as advocates and advisors on market development and policy reform efforts.

4. Debt management policy

Loans taken on by an SNG should conform to its debt management policy. The new Constitution requires the passing of ordinances in order to borrow, which ensures that obligations undertaken by one SNG administration are assumed by the next. However, ordinances should also reflect SNG borrowing or debt management policy. The GON should develop advice and models of SNG borrowing policies and ordinances.

Text Box 1: Definition of Debt Management Policy

Debt management policies are written guidelines, allowances, and restrictions that guide the debt issuance practices of state or local governments, including the issuance process, management of a debt portfolio, and adherence to various laws and regulations. A debt management policy should improve the quality of decisions, articulate policy goals, provide guidelines for the structure of debt issuance, and demonstrate a commitment to long-term capital and financial planning. Adherence signals to rating agencies and [lenders] that a municipality is well managed and therefore is likely to meet its debt obligations in a timely manner.

Source: Government Finance Officers Association (U.S.)

D. Conclusions: Policy and Legal Framework for Subnational Borrowing

Key Question: Is an institutional framework in place or being put in place that will make subnational borrowing feasible?

Policy framework is largely in place. Nepal has a solid policy framework on which the federalization process can take place. It has been extensively consulted and carefully developed over the past several years, even in the absence of democratic institutions at the local level.

Legal and regulatory framework is still developing. What is lacking now is the legal and regulatory framework that backs up the federal structure, as well as a clear path for implementation of the federal system.

To make subnational borrowing feasible, SNGs need sufficient autonomy to increase revenues, expand the pipeline of bankable projects and try different financing approaches. For instance, larger and better-managed SNGs should have more flexibility to set taxes and user fees.

The federalization process is a rare opportunity to develop a modern legal framework for subnational borrowing that builds on the experience of Nepal and other decentralizing countries. Laws and regulations should address both the public finance and the private market aspects of the SNG borrowing process. Laws governing lenders and subnational borrower also need to be in sync.

Balancing risk and return. Another challenge will be to avoid developing a regulatory framework for borrowing that is so conservative, it will actually discourage any borrowing from taking place. Lenders and borrowers need the flexibility to develop lending arrangements that properly balance risk and return (cost) for both parties. Having bank and financial institution officials involved in the development of the legal and regulatory framework will help mitigate this risk.

Need to avoid past mistakes. Nepal has an unfortunate pattern of passing laws affecting local governments that are never fully implemented. When the LSGA was approved, prior laws were not repealed, nor were many supporting rules and procedures put in place. The lesson from this experience is the need to carry through until laws and regulations are not only approved but fully operationalized.

E. Recommendations: Policy and Legal Framework for Subnational Borrowing

The following recommendations reflect the analysis presented in this chapter and the conclusions reached concerning the policy and legal framework for subnational borrowing.

	Recommendation	Action Required
1	**Approve fiscal federalism framework that incorporates option for borrowing**	Approve a fiscal decentralization strategy or policy and a fiscal decentralization law to support the federalization process that addresses revenues, expenditures, fiscal transfers, and borrowing.
2	**Evaluate options for control of subnational borrowing**	Establish borrowing limits and other controls and procedures for workouts, should they be necessary.
3	**Draft and approve subnational borrowing law and regulations**	Appoint a regulatory body for subnational borrowing and adopt regulations that address both the public finance and private market aspects of subnational borrowing. Ensure the laws governing lending and borrowing are mutually consistent.
4	**Update financial sector regulations**	Review financial sector regulations and remove any impediments to banks lending to or conducting other business with SNGs while defining prudential rules for financial institution lending to SNGs.
5	**Draft and approve new SN accounting norms and standards consistent with IPSAS**	Establish subnational accounting norms and standards that require accrual accounting and reflect international accounting standards. Require existing systems be updated to reflect the standards.
6	**Develop prototype accounting software and guidelines and approval process for DP and 3rd-party accounting software designs**	Develop a prototype accounting system for small SNGs. Establish a review process to ensure compliance of accounting systems being financed by DPs. Establish a review process for systems being procured by SNGs from the private sector.

V. SUBNATIONAL GOVERNMENT DEMAND FOR FINANCING AND CAPACITY TO BORROW

Key Questions: Is there an effective demand for subnational borrowing in Nepal and can subnational governments and related entities become good borrowers?

There is a huge need for local investment in Nepal. However, borrowing must be based not on need for investment, but on effective demand for financing, which is a function of financial capacity. This section compares various estimates of investment requirements to current and future expenditures and analyses the potential borrowing capacity of subnational governments.

A. Capital Investment Requirements in the Nation Urban Development Strategy[1]

Population growth in cities and the unregulated development that has resulted are key factors contributing to the current infrastructure deficits in Nepal. The NUDS describes and attempts to quantify these deficits. In the absence of consolidated data from municipal investment plans, these projections are helpful to define the scale of subnational financing needs.

1. Urban underinvestment and service deficits

The NUDS identifies urban development "red flags" that indicate investment deficits, including: incoherent land uses, traffic congestion and declining environmental conditions. It points out how deterioration in the urban environment is affecting the physical, natural, and social environment of cities. It also explains how underinvestment reduces both the quality and supply of critical urban services such as water, sanitation, solid waste management, housing, transport and energy, which ultimately undermines peoples' health and productivity.

These infrastructure gaps vary widely with the country but are clear from data such as the following.

- Quality and quantity of urban drinking water is insufficient. In Kathmandu, average water consumption of 35 liters per day (lpd) is well below WHO standards of 112-150 lpd.
- In urban Tarai, only 32.9% of households have piped water supply versus 81.2% in urban hill.
- Only 56.1% of urban households have access to sanitation system and 88.2% to toilets.[2]
- Access to toilets is 47% in rural areas overall, but sanitation and toilet access are as low as 0% and 20% respectively in smaller towns.
- Inadequate transport infrastructure makes
- travel inefficient. The average urban road density is low: 3.26 km/sq km.
- Only six of the original 58 municipalities have sanitary landfill sites. Forty-five of them are still using open dumping on riversides and roadways for solid waste disposal.
- Open space in cities is being encroached upon. The proportion of open space is only 0.48% in Kathmandu and 0.06% in Lalitpur, compared to 20% in New Delhi.
- Most lifeline facilities such as bridges and water supply are not being constructed to seismic standards.

---

[1] Ministry of Urban Development, 2015, National Urban Development Strategy.

[2] MoUD, 2016. Inclusive Cities: Resilient Communities: Nepal National Report. Third United Nations Conference on Housing and Sustainable Urban Development (Habitat III) Kathmandu: Government of Nepal, Ministry of Urban Development. http://moud.gov.np/wp-content/uploads/2016/10/Nepal-Habitat-III-National-Report.pdf.

2. Vision 2030 and its milestones

The NUDS presents a vision for urban development called "Vision 2030: Balanced and Prosperous National Urban System." Vision 2030 pictures Nepal achieving milestones for physical and institutional development that greatly enhance the quality of urban living.

Vision 2030 seeks an urban system characterized by efficiency, sustainability, inclusivity, resilience, and green development ("green, cool, and wet"). Achieving Vision 2030 depends on a coordinated effort among government agencies in many sectors.

The 5-year, 10-year, and 15-year milestones in Vision 2030 are ambitious, as shown below, but appropriate for a country aspiring to reach middle income status.

- 100 % of households with own toilets and access to piped water
- 50% of new residential area to be developed through land readjustment process
- High speed internet available at competitive prices in 80% of large and medium towns
- 100 % urban household waste collected
- 100 % of municipalities with own or shared sanitary landfill
- 80% of roads paved in existing municipalities and 50% paved in new ones
- Storm water drainage in 60% of road network
- 50% of population using public vehicles as main mode of transportation
- Walkability in urban cores and business districts with cycle lanes along major intra-urban arteries
- 7.5 km/sq.km of road density in existing municipalities and 5 km/ sq km in new municipalities

The NUDS focuses on new infrastructure requirements, while also identifying the need for urban regeneration programs.[3] Given the economic and social benefits of urban regeneration, which include the restoration and protection of cultural assets, it would be valuable to develop specific financing strategies and borrowing programs for this purpose.

In the Habitat III report and elsewhere, new urban development concepts have been recently introduced in Nepal that will also require investment. These include the SMART City initiatives proposed by Kathmandu Metropolitan City[4] and the Minister for Science and Technology.

3. Investment requirements in the NUDS

The NUDS estimates two levels of financing needs: (1) to bring all 58 existing municipalities and 133 new municipalities to a "minimum desirable state," as reflected in the Planning Norms and Standards and (2) to implement Vision 2030. Projections based on the 58 municipalities and numerous planning assumptions, unit and per capital costs for various types of infrastructure, and a 2.8percent net annual rate of population growth. The investments are apparently uninflated; that is, based on 2015 currency values.

---

[3] See National Urban Development Strategy, Section 4.3.6 S57."Documentation and development of heritage sites, routes, museums tied with local economy of historical areas, in visitor friendly way," page 95.

[4] The Himalayan Times, 3 December 2016, "Kathmandu to be transformed into 'smart city," https://thehimalayantimes.com/kathmandu/kathmandu-transformed-smart-city and The Rising Nepal, 11 May 2016, "Seven smart city as per provincial structure." http://therisingnepal.org.np/news/11215.

Text Box 2: Planning Norms and Standards, 2013

Nepal is one of only a few countries that have developed minimum national norms and standards for infrastructure for towns and cities of different sizes. The "Planning Norms and Standards 2013" incorporates local government standards, national standards in related sectors (such as the Nepal Urban Road Standard, 2011) and in some cases borrow benchmarks from other developing countries, such as South Africa and India.*

The main objective of the Planning Norms and Standards are:
- To facilitate urban designers, planners and policy makers to identify and forecast essential infrastructure need of urban areas as well as help prepare urban plans and programs.
- To enrich understanding of urban form and land use and ensure a balance between them.
- To guide the development and management of physical, social and economic infrastructure services in a planned manner.

While the Nepal standards may be perceived as unrealistic, they are useful for defining what is considered a minimum quality of life and estimating the investment needed to reach the standards. The South African standards were a critical input to the development of South Africa's municipal financing system.

** Government of Nepal, Ministry of Urban Development, Department of Urban Development and Building Construction, 2013, Planning Norms and Standards 2013.*
http://www.dudbc.gov.np/uploads/default/files/11fc96caa8c2194ab728796d5e9144cd.pdf.

Table 7 shows the NUDS estimate of investment requirements for the 58 old and 133 new municipalities for both the deficit and additional investment.[5]

To meet the infrastructural deficit, the 58 old municipalities need an estimated NPR 373 billion, and the 133 new municipalities need NPR 881 billion. To meet both the infrastructure deficit and additional 2016 to 2031 investment needs, a total of NPR 626 billion and NPR 1.6 trillion, respectively, is needed, for a "Total Investment Requirement"(TIR) of NPR 2.23 trillion.

This estimate is reduced by a factor that reflects the "demand for infrastructure" by size and age of municipality to arrive at the "Priority Investment Requirement" (PIR).[6] A total of NPR 399 billion and NPR 493 trillion is needed in old and new municipalities, respectively, to meet Priority Investment Requirement for 2016-31, for a PIR of NPR 892 billion, which is 40 percent of TIR.

These figures represent an average annual expenditure of NPR 459 million in the each of the 58 old municipalities and NPR 247 million in each of the 133 new municipalities, presumably in uninflated 2015 currency.

[5] The additional investment presumably reflects the goals of Vision 2030, although the derivation of the amount is not explained in the NUDS.
[6] Standards similar to the Planning Norms and Standards were used to develop these estimates. Whether they approximate investment needs as reflected in the Norms and Standards is not known.

Table 7: Municipal Investment Requirements 2016-2031

In million NPR	58 Existing Municipalities	133 New Municipalities	Total 191 Municipalities
Investment to Address Existing Infrastructure Deficit			
New Roads	151,973	345,560	497,533
Roads Upgradation	96,146	173,460	269,606
Water Supply	9,019	10,169	19,188
Toilets	1,731	4,371	6,102
Electricity	652	1,917	2,569
Landfill Site	743	683	1,426
Storm Drainage	75,129	188,886	264,015
Sewerage	37,502	155,910	193,412
Total Existing Infrastructure Deficit	**372,895**	**880,956**	**1,253,851**
Additional Investment 2015-2031			
Municipal buildings	1,353	1,741	3,094
Bus parks	2,962	4,975	7,937
Other investment demand	248,916	710,148	959,064
Total Additional Investment	**253,231**	**716,864**	**970,095**
Total Investment Requirement (TIR)	**626,126**	**1,597,820**	**2,223,946**
Adjustment for Priority Investment Plan (PIR)			
Reduction from TIR	(227,101)	(1,105,133)	(1,332,234)
Priority Investment Requirement (PIR)	**399,025**	**492,687**	**891,711**
PIR as % of TIR	64%	31%	40%
Annual Average Priority Investment per Municipality	459	247	311

Source: Based on National Urban Development Strategy, 2015

The PIR of NPR 892 billion is then distributed across three five-year periods from 2016 to 2031 as shown in Table 8.

Table 8: Priority Investment Requirement of 191 Municipalities, 2016-2031

In million NPR	58 Old Municipalities	133 New Municipalities	Total
2016-21	81,099	100,552	**181,651**
2021-26	120,571	149,149	**269,720**
2026-31	197,355	242,985	**440,340**
Priority Investment Requirement	**399,025**	**492,687**	**891,711**

Source: Based on National Urban Development Strategy, 2015

The NUDS proposes funding sources for the first five-year period amount of NPR 182 billion (2016-2021) as shown in Table 9. These include the GoN and Development Partners (DPs), municipalities, communities (users) and the private sector. The private sector component of NPR 18.2 billion over five years is assumed to include public-private partnerships and/or SNG borrowing. Given the nearly complete lack of this type of investment today, this number is unrealistic.

Table 9: Funding Sources for Priority Investment Requirement of 191 Municipalities, 2016-2021

In million NPR	GoN/ Development Partners	Municipality	Community	Private Sector	Total
	65%	19%	6%	10%	100%
58 Existing Municipalities	52,714	15,409	4,866	8,110	**81,099**
133 New Municipalities	65,359	19,105	6,033	10,055	**100,552**
Total	**118,073**	**34,514**	**10,899**	**18,165**	**181,651**

Source: Based on National Urban Development Strategy, 2015

As capital investment increases, operating and maintenance costs increase correspondingly, and must also be financed from recurring sources such as taxes or user fees. The NUDS assumes that operations and maintenance costs could be as much as 15 percent of total capital costs, although these costs do not affect the capital investment estimates. A good estimate for operations and maintenance would be between 5 and 25 percent of original capital costs annually, depending on the type of investment.[7]

B. Capital Investment Requirements in the Municipal Finance Framework

The MFF municipal investment requirements are based on the NUDS estimates, but because the MFF was prepared after 26 municipalities were added, the MFF estimates investment requirements for 217 municipalities, rather than the 191 municipalities used for the NUDS estimates.

The MFF analysis goes further than the NUDS in that it attempts to project municipal revenue sources to arrive at an estimated financing gap for the investment plan.

The future investment requirement shown in the MFF is based on a larger number of municipalities and a number of revised assumptions. Even so, it produces a 15-year requirement similar to that in the NUDS: NPR 2.345 trillion, as shown in Table 10 (versus NPR 2.22 trillion in the NUDS).

Like the NUDS, the MFF adjusts the Investment Requirement, in the latter case using three scenarios: meeting 60 percent, 75 percent or 90 percent of the physical targets which make up the Investment Requirement. Table 10 shows an adjustment based on the three scenarios.

Table 10: Investment Requirement Scenarios for 217 Municipalities, 2016-2031

In million NPR	Scenario 1 (60% of target)	Scenario 2 (75% of target)	Scenario 3 (90% of target)
Municipal Infrastructure	2,329,921	2,329,921	2,329,921
Municipal Buildings	5,156	5,156	5,156
Bus Parks	10,348	10,348	10,348
Total Investment Need (TIN)	**2,345,425**	**2,345,425**	**2,345,425**
Adjustment	(947,470)	(597,995)	(248,515)
Adjusted Investment Need (AIN)	1,397,955	1,747,430	2,096,910
AIN as % of TIN	60%	75%	90%
Annual Average AIN per Municipality	429	537	644

Source: Based on Municipal Finance Framework, 2015

The 58 original municipalities had total expenditures of NPR 6.794 billion in FY 2012 (NPR 90 million per municipality), as shown in Table 11**Error! Reference source not found.** Of this amount, 77 percent was capital expenditure. (This percentage has also been applied to total expenditures for 2012/13 and 2013/14 to estimate capital investment and revenue surplus for those years.)

[7] I.e. a NPR150 million investment would require between NPR 7.5 million and NPR37.5 in operations and maintenance costs.

Table 11: Historical Revenues and Expenditures of 58 Municipalities

In million NPR	2011/12	2012/13	2013/14
Municipal Revenue			
Local Tax	905	1,556	1,123
Service Charge Fees & Fines	625	964	1,263
Property Rental	125	178	205
Other Revenue	73	99	67
Total OSR	**1,728**	**2,797**	**2,657**
IGFT and other transfers	5,873	4,853	4,476
Total Revenue	**7,601**	**7,650**	**7,133**
Municipal Expenditures			
Current expenditures **	1,563	*1,557 (est.)*	*1,426 (est.)*
Capital expenditures **	5,231	*5,212 (est.)*	*4,774 (est.)*
Total Expenditure	**6,794**	**6,769**	**6,200**
Revenue surplus	**807**	**881**	**933**
Capital expenditure share	*77%*	*77%*	*77%*
Annual Average Capital Expenditure per Municipality	90	90	82

Source: Based on Municipal Finance Framework, 2015

***Consultants' calculations applying 2011/12 capital expenditure share (77%) to 2012/13 and 2013/14.*

To calculate the financing gap, the MFF projects cumulative municipal income, expenditures and IGFTs for 2016-31 using various assumptions. The financing gap that results ranges from NPR 372 billion under scenario 1 (60 percent of Investment Need funded) to NPR 1.0 trillion under scenario 3 (90 percent of Investment Need funded). Table 12 shows the results of these calculations.

Table 12: Financing Gap Scenarios for 217 Municipalities, 2016-31

In million NPR	Scenario 1 (60% of target)	Scenario 2 (75% of target)	Scenario 3 (90% of target)
Own Source Revenue [8]	**622,600**	**622,600**	**622,600**
Recurrent Expenditures	(389,040)	(389,040)	(389,040)
Previous Debt Service	(4,100)	(4,100)	(4,100)
Revenue Surplus	**229,530**	**229,530**	**229,530**
Unconditional Grant	424,830	424,830	424,830
Revenue Sharing	81,150	81,150	81,150
Conditional Grant	277,560	277,560	277,560
Total IGFT	**783,540**	**783,540**	**783,540**
Summary of Financing Sources			
Revenue Surplus	229,530	229,530	229,530
Total IGFT	783,550	783,550	783,550
Market Borrowing (25% of Revenue Surplus)	57,390	57,390	57,390
Amount Available for Capital Investment	**1,070,470**	**1,070,470**	**1,070,470**
Total Investment Need			
Scenario 1: Meet 60% of physical target	**1,397,940**		
Scenario 2: Meet 75% of physical target		**1,747,430**	
Scenario 3: Meet 90% of physical target			**2,096,910**
Financing Gap	**(327,470)**	**(676,960)**	**(1,026,440)**

Source: Based on Municipal Finance Framework, 2015

The MFF suggests various sources of funding to close the 15-year financing gap *in addition to* those shown in Table 12. These sources are shown in Table 13. They include additional IGFTs, donor grants, additional municipal revenues, municipal borrowing, community contributions and private investment.

Table 13: Sources of Funds to Close Financing Gap, 2016-2031

In million NPR	Additional IGFT	Donor Grants	Municipal Net Revenue	Municipal Borrowing	Community Contribu-tions	Private Sector Equity	Total Financing Gap
	50%	**30%**	**6%**	**4%**	**5%**	**5%**	**100%**
Scenario 1	163,735	98,241	19,648	13,099	16,374	16,374	**327,470**
Scenario 2	338,480	203,088	40,618	27,078	33,848	33,848	**676,960**
Scenario 3	513,220	307,932	61,586	41,058	51,322	51,322	**1,026,440**

Source: Based on Municipal Finance Framework, 2015

[8] This revenue projection is optimistic. It is based on the assumption that for the 58 old municipalities the growth rate of taxes and fees will be 50% higher than the historical rate of increase in these revenues sources, and for the 159 new municipalities, the growth rate for the first three years will be one-half that of the 58 municipalities, and the same for the remaining years.

C. Forecasting Future Investment Requirements

1. Summary of NUDS and MFF investment requirements

The NUDS and MFF financing requirements were calculated using different assumptions and for different groups of municipalities. Nevertheless, it is instructive to compare the conclusions to historical investment figures.

The historical data for 58 municipalities serves as a baseline for the comparison. It shows that, on average, this group's investments in capital projects were in the range of NPR 82-90 million between 20111/12 and 2013/14. These figures should include any TDF loans disbursed during this period.

Table 10: Historical Revenues and Expenditures of 58 Municipalities (MFF)

In million NPR	2011/12	2012/13	2013/14
Annual Average Capital Expenditure per Municipality	90	90	82

The NUDS provides separate estimates for the 58 original and 133 new municipalities. They show that to upgrade existing infrastructure and reach minimum standards of new infrastructure, the original municipalities would need to spend about NPR 459 million annually for the next 15 years and the new municipalities would require NPR 247 million annually. (These figures include a significant reduction of the calculated Total Investment Need in order to arrive at the lower Priority Investment Need, and are uninflated.) This amount for the 58 municipalities is approximately five times what they spent each of the years between 2011/12 and 2013/14.

Table 6: Municipal Investment Requirements of 191 Municipalities, 2016-2031 (NUDS)

In million NPR	58 Existing Municipalities	133 New Municipalities	Total 191 Municipalities
Annual Average Priority Investment per Municipality	459	247	311

The MFF presents scenarios reflecting three levels of investment for 217 municipalities. It concludes that under the most conservative assumptions (accomplishing only 60percent of needed investment), the average municipality would require NPR 429 million per year. Under the most optimistic assumption (90 percent of needed investment is completed), NPR 644 million per municipality is required. The higher figure is nearly eight times the baseline annual capital investment of the 58 municipalities for the years between 2011/12 and 2013/14.

Table 9: Investment Requirement Scenarios of 217 Municipalities, 2016-2031 (MFF)

In million NPR	Scenario 1 (60% of target)	Scenario 2 (75% of target)	Scenario 3 (90% of target)
Annual Average Adjusted Investment per Municipality	429	537	644

The NUDS and MFF come to similar conclusions about the share of needed investment that the private sector could finance. While the categories of sources are not the same, they are comparable. The NUDS assumes that the private sector could finance 10 percent of the total investment (or NPR 89 billion) over 15 years. This private sector figure is assumed to include both borrowing and private equity investment. The MFF suggests for Scenario 3 that about 4 percent of the gap or NPR 41 billion could come from municipal borrowing and about 5 percent or NPR 51billion could come from private equity, for a total of 9 percent or NPR 92 billion over 15 years.

2. Need for expanded estimates of financing requirements

The real financing gap is in fact considerably larger than that shown in Table 7 and Table 12 shows the results of these calculations.

Table 12 for many reasons. Regardless of any limitations in the current estimates, however, the exercise undertaken by the authors of the NUDS and the MFF to develop assumptions, project SNG financing needs by sector and identify and allocate potential funding sources to these needs is extremely useful. The GoN should seriously consider further refining and expanding this modeling exercise as an aid in the fiscal decentralization process.

It is also important to acknowledge that certain types of investments are more suitable for borrowing than others. Projects attractive to lenders are those high economic returns and where revenues are relatively easy to collect, such as bus terminals and markets. Borrowing will be more feasible for these types of projects, especially if transaction costs are reduced by using standard project designs and financing structures.

Future iterations should take into consideration the following points:

- **Expanded scope of projections.** States should be included in the estimates, as well as 46 of the 263 Metropolitan Cities, Sub-Metropolitan Cities and Municipalities. The financing needs of the latter two groups are far more than the averages used here. Future versions should also take into consideration any clearer allocation of functions among levels of government that emerges from ongoing policy discussions.
- **Match investment requirements to funding sources.** More than 60 percent of the funding deficit defined in the NUDS is roads and road upgrading. In a few locations it might be possible to charge road tolls, but generally there is no revenue source associated with road projects. They can only be financed with grants or (if with debt) on a general obligation basis. Each SNG should have a capital budget based on specific funding assumptions by project, but for the overall financial model, project types or infrastructure sectors should be matched against likely funding sources. Identifying the subset of projects that generate revenue will help in the development of an overall SNG financing and borrowing strategy and in dimensioning actual demand for borrowing.
- **Use of revenue surplus.** In the MFF projections, revenue surplus is counted at 1.25 times but should perhaps not be counted at all since it is the source for repayment of the additional debt service that would result from borrowing and of additional operating and maintenance costs resulting from the additional investment. An updated analysis might determine how much debt service and additional operating and maintenance costs could be paid from the surplus, and on that basis calculate how much could be borrowed.
- **Consistent assumptions for inflation.** Inflation appears to have been included in revenues but not capital costs in both estimates, so in fact capital costs will be significantly higher than those estimated. (Inflation has averaged 8.8 percent in the past five years. The MFF analysis assumes an increase in revenues of about 8 percent over inflation.)
- **Operations and maintenance costs.** As cumulative investment increases, debt service and operating and maintenance costs will increase as well, and become cumulative. Therefore, it would be useful to carry out an interactive analysis that adds these costs to municipal expenditures as cumulative borrowing increases.
- **Investment delivery capacity**. The MFF identifies several constraints on SNG investment delivery including poor investment planning, project preparation and project execution. Public sector investment delivery is notoriously inefficient at the national level and increases in subnational funding could just shift this problem to the local level.[9] Projections should be based on realistic estimates for investment delivery by size of SNG or other criteria.

[9] Asian Development Bank, 2016, Macroeconomic Update, Nepal, Volume 4. No. 2.

D. Subnational Capacity to Borrow

Subnational borrowers need certain capacities to successfully prepare and manage investment projects and to borrow to finance them. Without these capacities, projects carry greater risk of failure and therefore will be more difficult to finance.

The critical capacities are considered to be: (i) capital investment planning, (ii) project preparation, (iii) financial management and management and (iv) operation of local services.

There has been extensive analysis of the capacity gaps in SNGs in Nepal and ambitious efforts by the GoN and development partners to address them. The consensus is that Nepal is in the traditional "vicious cycle" of decentralization where local governments are weak organizationally yet lack the resources to address their weaknesses. The analysis in this section is not comprehensive; it is intended to provide insight on specific gaps in the borrowing-related capacities mentioned above.

Three sources of information were analyzed: (i) the MC/PM indicators with respect to general management capacity, (ii) the subnational PEFA with respect to public financial management capacity and (iii) the assessment of 16 municipalities conducted as part of the preparation of this report.

1. Management performance: MC/PM indicators

The GoN has used the minimum conditions (MC) and performance measures (PM) system to monitor the performance of LBs since fiscal year 2007/08 (with budget implications for FY 2008/09). Under the MC/PM system, the Local Bodies Fiscal Commission (LBFC) assesses LBs using predefined criteria that generally are based on statutory requirements. The findings are used to adjust the amount of certain IGFTs.

The annual country-wide MC/PM assessment has been an integral part of local governance reform, as well as a key implementation tool for the multi-donor funded Local Governance and Community Development Program (LGCDP).

The objectives of the MC/PM system are:

- To improve LB performance through an incentive and penalty mechanism
- To identify the capacity gaps of LBs in different functional areas
- To adjust the size of grants to the expenditure and performance capacity in key functional areas
- To strengthen the general monitoring and evaluation systems of the GoN

The MC indicators measure how critical local government functions are discharged (e.g. on-time approval of annual budget and program). The PM indicators measure the accomplishment of specific tasks in key performance areas (e.g. increase the scope of taxes and number of taxpayers). Performance on both sets of indicators has improved over time.

The MC/PM system has provided an objective and apolitical basis for channeling increasing financial resources to LBs. It was also intended to help make LBs more resistant to political pressure and more accountable to users of municipal services, which the GoN believes has occurred. The capacity strengthening that has resulted from the system should help smooth the transition to fiscal federalism.

The MC/PM system could also help support development of the subnational credit market, for example, to screen SNGs for their potential to become market borrowers or to develop a self-assessment tool for potential borrowers. Annex 3 shows the how the 16 municipalities assessed in preparing this report performed on MC/PM indicators related to municipal financing, as discussed below.

2. Financial management capacity: subnational PEFA

No capacity is more critical for financial market development than subnational financial management. Borrowers need to demonstrate their credit capacity to lenders and provide assurance of loan repayment.

The legal framework for subnational PFM and financial management performance were recently assessed in Nepal using the Subnational PEFA framework.

PEFA is an international standard for assessing and measuring the strengths and weaknesses of PFM processes and capacities. It has been applied worldwide for more than 15 years to assess national government PFM and more recently to appraise subnational government PFM. PEFA results are used to promote greater fiscal discipline, strategic resource allocation, and efficient service delivery.

The Nepal subnational PEFA assessed ten District Development Committees (DDC), ten municipalities and 30 VDCs. [10] (Three of the municipalities selected for the PEFA analysis were among the 16 municipalities assessed as part of the current study.)

The PEFA analyzes the following aspects of financial management:[11]

- Credibility of the budget
- Budget comprehensiveness and transparency
- Policy-based budgeting
- Predictability and control in budget execution
- Accounting, recording and reporting
- Adequate external scrutiny and audit

The PEFA analysis identified numerous financial management weaknesses in SNGs, each of which could affect the feasibility of subnational borrowing, as follows.

- Total expenditures and composition of expenditures often do not conform to the budget
- Capital expenditure plans and budgets do not reflect priorities in periodic development plans
- Infrastructure investments and operating and maintenance costs of new infrastructure are often under-budgeted
- Deficient disbursement and liquidation of advances and preparation of bank reconciliations
- Absence of Finance Committees has contributed to weak PFM practices
- Annual financial statements lack required schedules and supplementary information
- Municipalities are not following LSGA requirement to use accrual accounting starting three years after incorporation
- External audits are weak and often conducted off-site; little follow up on audit recommendations

The analysis observes, however, that legal requirements, MC/PM grant requirements and channeling of aid through multi-donor programs have all contributed to more comprehensive budgets.

The PEFA analysis also identified shortcomings in the legal and regulatory instruments that govern municipal PFM, including:

- The existing framework is not always compliant with modern PFM
- The Chart of Accounts is not compliant with standard accounting and reporting standards
- PFM regulations are lacking on important aspects of control
- No single comprehensive set of PFM regulations for SNGs

The PEFA proposes several solutions for strengthening subnational PFM.

---

[10] Asian Development Bank, et al, Strengthening Public Management Program, "Sub-National Public Expenditure and Financial Accountability Assessment: Final Draft Report," ADB TA 8173, January 2016.

[11] The full list of indicators is included as Annex xxx to this report.

- Improving the PFM framework
- Improving compliance with basic financial control procedures
- Better management of resources, including grant allocations from ministries, and change to a medium-term financial framework
- Investment in financial management capacity, including training and better organizational structures
- Investment in design and implementation of IT systems, starting with development of a PFM IT strategy for that goes beyond (and provides standards for) numerous donor PFM-related IT projects

Improving the PFM framework and subnational PFM is an absolute necessity for developing a subnational capital financing system.

3. Results of assessment of 16 municipalities

Data were collected from 16 municipalities during the preparation of this report, in order to provide a real-time glimpse of management practices and financial conditions in the subnational sector. The process involved (i) selection of municipalities, (ii) municipal visits and (iii) gathering and analysis of data, based on an agreed information matrix.[12] The data gathered is included as Annexes 3 and 4.

The municipalities, selected in consultation with the Municipal Management Division of MoFALD and LBFC, are listed below and shown on the map. They include TDF borrowers and municipalities working on local economic development under the technical support of LGCDP financed by UNCDF. The group is politically and geographically distributed, and includes three new municipalities.

State 1: Damak (1) and Itahari Sub-Metropolitan City (SMC) (2)

State 2: Janakpur SMC (3), Birgunj SMC (4) and Chandrapur (5)

State 3: Lalitpur SMC (6), Heatuda SMC (7), Dapcha-Kashikhand (8) and Bharatpur SMC (9)

State 4: Byas (10) and Pokhara SMC (11)

State 5: Butwal SMC (12) and Kohalpur (13)

State 6: Birendranagar (14)

State 7: Dhangadhi SMC (15) and Bhimdutta (16)

[12] Data limitations affect both the scope and reliability of the municipal assessment. These limitations are part of the baseline conditions that a programme to build a credit system would have to address.

a. Capital expenditures

Table 14 and Figure 3 show capital expenditures for FY 2013/14 to 2015/16 for the 16 SNGs analyzed. For FY 2015/16, capital expenditures range from NPR 38 million for Birendranagar to the highest, NPR 440 million for Birgunj, with an average of NPR 185 million. Birgunj also has the highest average investment over the three years at NPR 328 million and (of the SNGs with three years of data) Birendranagar has the lowest average investment at NPR 59 million, with the average for all over the three years of NPR 142 million.

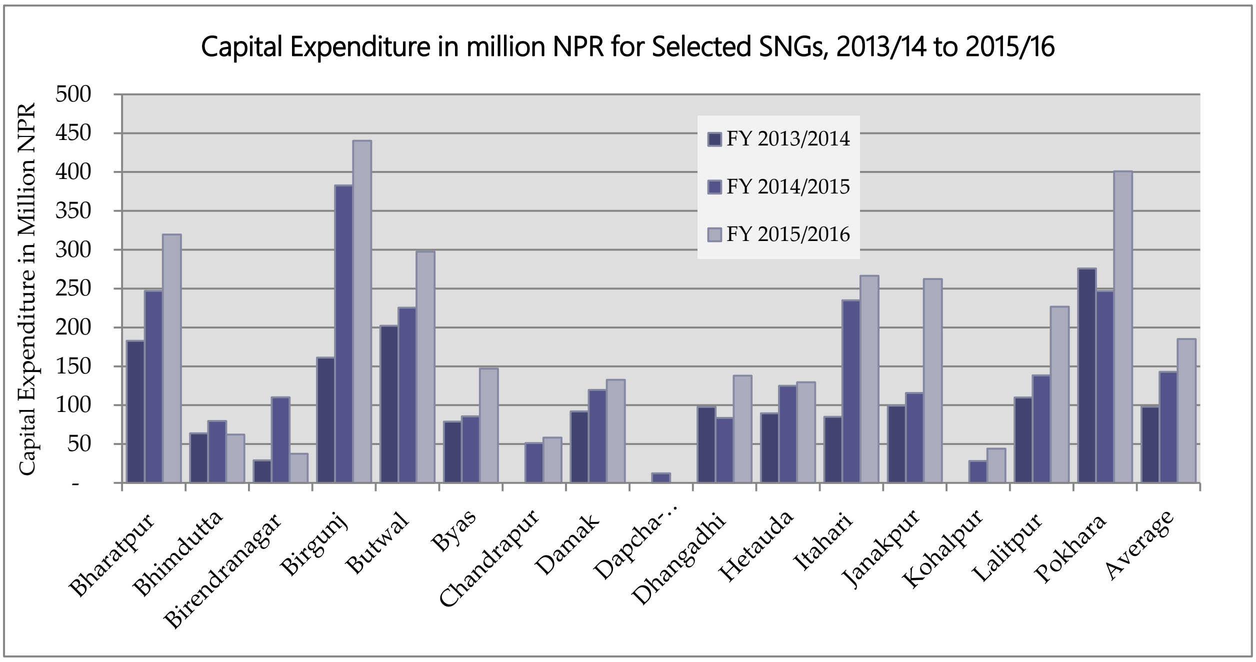
It is useful to note that the average capital expenditure of NPR 142 million is above the range of NPR 82-90 million shown in Table 11 for the 58 municipalities between FY 2011/12 and FY 2013/14. It is well below the average Priority Investment Requirement of NPR 311 million shown in Table 7 for the 191 municipalities in the NUDS and also well below the scenarios for annual Average Adjusted Investment per municipality in the MFF shown in Table 10 of NPR 429 million to NPF 644 million.

Table 14: Annual Capital Expenditure in Million NPR for Selected SNGs, 2013/14 to 2015/16

In million NPR	FY 2013/2014	FY 2014/2015	FY 2015/2016	Average per SNG
Bharatpur	183	247	320	**250**
Bhimdutta	64	80	62	**69**
Birendranagar	29	110	38	**59**
Birgunj	161	383	440	**328**
Butwal	202	226	298	**242**
Byas	79	86	147	**104**
Chandrapur	-	51	58	**55**
Damak	92	120	133	**115**
Dapcha-Kasikhand	-	12	-	**12**
Dhangadhi	98	84	138	**106**
Hetauda	90	125	130	**115**
Itahari	85	235	267	**196**
Janakpur	100	116	262	**159**
Kohalpur	-	28	44	**36**
Lalitpur	110	138	227	**158**
Pokhara	276	247	401	**308**
Average per year	**98**	**143**	**185**	**142**

Source: Consultants' calculations based on SNG data

Figure 3: Annual Capital Expenditure in Million NPR for Selected SNGs, 2013/14 to 2015/16

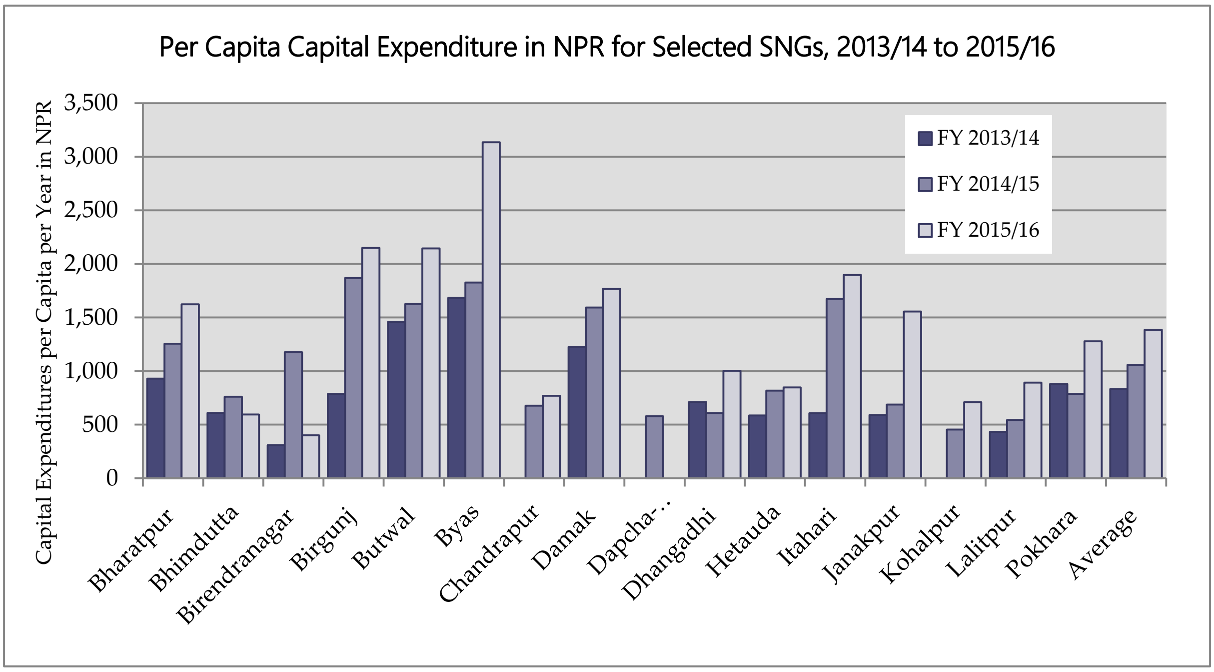


Source: Consultants' calculations based on SNG data

Population levels partially explain the differences in capital expenditures. Per capita capital expenditures (PCCE), an indicator often used to assess the adequacy of capital investment, is more similar among the municipalities analyzed than the total capital investment, as shown in Figure 4.

For FY 2015/16, capital expenditures per capita range from NPR 401 for Birendranagar to NPR 3,135 for Byas, with an average of NPR 1,384. Byas also has the highest average PCCE over the three years at NPR 2,215 and (of the SNGs with three years of data) Lalitpur has the lowest average PCCE at NPR 623, with the average PCCE for all over the three years of NPR 1,091.

Figure 4: Per Capita Capital Expenditure in NPR for Selected SNGs, 2013/14 to 2015/16



It would be instructive to know the share borrowed funds played in financing these expenditures, and whether higher investment numbers correlate with borrowing. Benchmarks such as these should be developed and monitored for all SNGs as part of the market development process.

b. Investment planning

Of the 16 municipalities, about one-half reported having an up-to-date capital investment plan (CIP), generally the CIP prepared for the Periodic Plan. Some municipalities were using the 2012/13 Periodic Plan CIP. Several municipalities were in the process of updating their CIPs.[13] A number of municipalities characterized their current CIP as little more than a "wish list."

Bharatpur identified four priority projects totaling NPR 1.8 billion, all without identified funding. Other municipalities mentioned priority projects that were being implemented or reviewed for financing by TDF, such as bus parks or terminals in Birendranagar, Birgunj and Butwal, and the Integrated Urban Development program of Janakpur.

Logically, there is little motivation to prepare or frequently update local CIPs for major investment projects, given the limited availability of resources and ability to control the timing of project implementation.

As observed, and discussed in the municipal workshop held in connection with the preparation of this report, the tendency of municipalities is to use limited resources to carry out numerous small-scale projects as a way to increase the number of beneficiaries, even though the projects may have low social or economic impact.

It would not be advisable to finance small-scale projects such as these with borrowed funds. However, the experience gained preparing small-scale projects should help municipalities prepare the types of larger-scale projects that will interest lenders, and which many municipalities have in their "wish lists."

c. MC/PM performance

Annex 3 shows the 2014/15 total Performance Measure Grade for the 16 municipalities studied. Six of the municipalities received Grade A, including Bharatpur, Birendranagar, Butwal, Hetauda, Itahari and Pokhara. [14]

Also, a subset of 21 PM indicators that relate specifically borrowing capaciy were analyzed for these same municipalities. These indicators include revenue administration (PM 11), accrual accounting (PM 15), local resource mobilization (PM 19) and service delivery management (PM 29), among others. The highest possible score from these indicators is 50 points, and four municipalities scored between 48 and 50 points (Bharatpur, Butwal, Hetauda and Itahari).

It is interesting to note that while some of the financially well-managed municipalities identified from this analysis also have higher capital expenditures and PCCE, this is not always the case. This implies that it is not necessary to be a "wealthy" SNG in order to be well-run in financial terms. Therefore, even smaller municipalities with less investment experience may be good candidates for borrowing, based on their sound finances and management performance.

d. Need for capacity development

The 16 municipalities chosen reflect a variety of situations, but for nearly all of them borrowing would be difficult in the short run. One factor is financial staffing. The revenues and assets of some

[13] MoUD has recently committed to support the preparation of Integrated Urban Development Plans in 70 municipalities and MoFALD is supporting preparation in 25 municipalities. Whether any of the 16 municipalities analyzed for this report are among the 95 municipalities receiving assistance is not known.

[14] Dapcha-Kasikhand and Kohalpur, being new municipalities, have not yet reported under the MC/PM system.

municipalities are greater than those of some private corporations. For example, the annual revenues of Bharatpur and Birgunj exceed NPR 600 million; Butwal's revenues are nearly NPR 500 million.

However, keeping financial staff with the right qualifications is a problem, according to municipal officials. For example, Birendranagar, Bharatpur, Bhimdutta, Ithaki, Janakpur , and Birgunj have all lost their Finance Chief and had to replace them with an accounting clerk. Turnover is due to low salaries, lack of resources for adequate IT systems and opportunities available elsewhere.

The field work shows that at least two years of intensive, systematic technical assistance and training would be a prerequisite for borrowing. Municipalities need help to prepare comprehensive revenue improvement action plans (RIAP), and to improve their capacity for project preparation, project management and management of PPPs. The majority of SNGs need ungraded accounting systems. More than one municipality has acquired a financial management system and discovered it does not meet requirements and will need to be upgraded further.

Municipalities would benefit from long-term coaching and accompaniment, in addition to training. However, it may be necessary first to recruit and train the trainers, to build up professional skills in municipal finance nationally. In this, the universities could also play a role.

e. Readiness to borrow

Based only their infrastructure needs, all 16 municipalities could be candidates for borrowing if they received sufficient technical assistance.[15] However, only a few municipalities were judged to have a high potential to borrow successfully in the medium term. This judgment is based on the economic potential of the municipalities, the organizational culture, willingness to borrow, existing human resource capacities and commitment to improving services.

- Butwal, Heatuda and Pokhara were the strongest municipalities assessed, although they would require considerable support to become good candidates for market borrowing
- Dhangadhi, Ithaki, Birgunj, Bharatpur and Damak have both strengths and weaknesses, and would need even more support, training and accompaniment
- Lalitpur, Byas, Janakpur, Birendranagar would need extensive technical assistance and capacity development before they could borrow

The remaining municipalities would need intensive and long-term capacity development before they could be considered as candidates to participate in a borrowing program. The commitment to service improvement is also likely to be stronger in many municipalities after local elections are held and new teams are in place.

E. Need for Option of Joint Service Provision

The Local Self-Governance Act 2055 (1999) delegates responsibility for service provision to VDCs, municipalities and DDCs, but is silent on the option of joint provision of services by multiple entities. The new regulation will delegate this responsibility to states, cities and municipalities.

Inter-municipal cooperation arrangements (also referred to as municipal associations, joint powers authorities or using other labels) are common in many countries.[16]

---

[15] The conclusions in this section are based partly on the data included in Annex 3 and Annex 5.

[16] See, for example: Suomi.fi (Finland) https://www.suomi.fi/suomifi/english/state_and_municipalities/municipalities_and_local_government/joint_authorities/index.html; Ohio (USA) law on creation of Joint Economic Development Districts, http://codes.ohio.gov/orc/715.72; Luiz de Mello Santiago Lago-Peñas, 2012, Local Government Cooperation for Joint Provision: The Experiences of Brazil and Spain with Inter-Municipal Consortia, https://pdfs.semanticscholar.org/0446/5d058113c4b1add82e5f2c00265fd1c0a9fd.pdf; and extensive literature (in Spanish) on *mancomunidades* in Latin America.

Such associative arrangements are used in urban areas to allow coordination of metropolitan services that operate across boundaries such as transport and in rural areas to take advantage of economies of scale in service provision where population and population density are low. Municipal associations can also allow cooperation on service provision within specific geographic areas, such as watersheds or development zones, whose limits may not conform to jurisdictional boundaries.

Associating to provide services has benefits and drawbacks that have to be evaluated. However, experience has shown that by improving the cost-efficiency and quality of service provision, these arrangements may make capital investments easier to finance. Also, because associated services provision requires the establishment of a new corporate entity, it provides autonomy and independence from political influences that investors find attractive.

In order to encourage SNGs to consider joint service delivery through intermunicipal cooperation, the new fiscal decentralization framework should allow this option and provide the corresponding legal and regulatory provisions. Issues to be addressed in providing this option include the following.

- Purposes and functions of associations (including borrowing)
- Procedures for the creation and dissolution of associations
- Legal forms for associations
- Rights and responsibilities of member SNGs
- Remedies in the case of default of association member

F. Need for Major Technical Assistance Effort

1. Growing demand for technical assistance

The value of focused technical assistance has been well demonstrated in Nepal over the years. For instance, the transition of municipalities from Housing and Land Tax (HALT) to Integrated Property Tax (IPT) beginning in 1999 was challenging, but the assistance municipalities received helped them gain technical skills and increase their OSR.

All SNGs in Nepal need technical assistance. This need will grow as the new configuration of SNGs is put in place, creating new states and new and larger municipalities. Expanding the subnational borrowing system will create additional demands for technical assistance.

Technical assistance is needed to build management and financial capacity for borrowing (as described inV.D.3.d), and to prepare for and carry out the borrowing process (as listed in Table 18).

The MFF identifies three capacity constraints that particularly affect the lending operations of TDF: capacity for transparent procurement processes, operation and maintenance of infrastructure facilities and working with the private sector.[17]

Technical support is required by all SNGs, whether they plan to borrow or not. However, a concerted effort will be required for potential borrowers.

2. Strategic perspective on financial strengthening

To support the new federal system, a long-term view of subnational capacity building is needed. This includes developing a strategy for human resource development, especially in the financial management area. SNGs require stable, well-trained personnel being paid competitive salaries to carry out the more sophisticated financial management functions discussed in this report.

---

[17] Town Development Fund, 2016, Municipal Finance Framework for the National Urban Development Strategy (NUDS) of Nepal, Section 1.6.5 Key Issues in Urban Infrastructure Financing.

A study could identify the skills required to manage SNG finances and the salary gap between subnational and private sector positions with similar requirements. With that information in hand, a strategy could be developed to close the salary gap.

Ultimately, a new generation of professionals will need to be brought onboard who are prepared academically in fields such as international accounting and auditing standards, capital budgeting, financial management and information technology. Young people need to see subnational financial management as a viable career path and—once hired--to receive on-going, high-quality training. Developing a career path such as this requires the involvement of academic institutions that can develop programs of study, arrange internships and help define professional standards in the subnational finance field.

Professionalizing the subnational finance field also means creating a professional network (and ultimately an association) that would bring subnational finance officers and staff together at least annually to share experiences and good practices and to assist in the design of training programs. Many countries have active associations of subnational finance professionals that can serve as models.[18]

3. Varying technical assistance approaches

Not only financial staff needs technical assistance to make borrowing successful; elected officials and staff such as engineers also require assistance. Ensuring technical staff understands the requirements of borrowing is important because project design, implementation and operation all help to ensure project financial feasibility. Users groups that manage public services such as water distribution may also need technical assistance.[19] TDF is testing a model to better support to these groups with the assistance of the World Bank.

Capacity development should go beyond classroom training. On-sight technical assistance or accompaniment is also needed for both long-term financial strengthening and to ensure the success of investment projects.

Longer-term technical assistance will be especially important in certain situations:

- For "greenfield" projects (i.e. projects start-ups and ones with which the SNG is not experienced)
- Project where cost recovery mechanisms (tariffs) are new, controversial or relatively high
- Project that entails the use of new procedures or systems

If it is not possible to provide full-time technical assistance, periodic on-site assistance could be complemented by help lines (telephone- or web-based) and roving technical teams that cover several SNGs.

Only effective delivery methods should be scaled up. The MC/PM system could be refined and expanded to provide this information. Donor assistance must conform to standards and demonstrate results.[20] Tools such as the comprehensive revenue improvement action plan (RIAP) should be updated and consistently applied as part of this process.

---

[18] See the Institute of Municipal Finance Officers (South Africa), http://www.cigfaro.co.za/default.aspx; Government Finance Officers Association (USA), http://www.gfoa.org/; and City Economic and Financial Governance Group (EU), http://www.cefg.eu/en/home/.

[19] Gyawali, Hemant, *et al*, 2012, Strengthening the Town Development Fund Capacity for Public-Private Partnership, prepared for Town Development Fund and Ministry of Physical Planning and Works. https://www.adb.org/projects/documents/strengthening-town-development-fund-capacity-ppp-tcr.

[20] Installing accrual accounting systems that do not conform to proper accounting standards, as reported in the subnational PEFA, is an example of ineffective technical support. See V.D.2.

Box 3: Methods and Tools to Strengthen SNG Borrowing Capacity

The following is a list of guidelines and other tools that could be developed to support SNG efforts to improve borrowing capacity.

Assessment tools

- SNG creditworthiness self-assessment
- Investment project prefeasibility and feasibility analysis
- Municipal capacity self-assessment
- Data management and information technology assessment

Guidelines

- Revenue enhancement
- Preparation of SNG financial projections
- Preparation of capital budgets
- Project-specific cost recovery calculator
- Development and maintenance of property databases (with specifications for database design)
- Development of public-private partnerships of various types (with standard contracts, legal structures and documentation)

Indicators

- Fiscal soundness indicators (in advance of credit rating)
- Financial management indicators (advanced version of MC/PM combined with PEFA indicators)

Systems/protocols

- For exchange of information with other agencies of government, such as with Ministry of Land Reform and Management for cadastral data and Department of Transport Management for data on vehicle ownership
- Integrated financial management system (IFMS) for various levels of SNG
- Standards and specifications for development of IFMS for various levels of SNG (for private sector systems developer)

G. Conclusions: Subnational Government Demand for Finance and Capacity to Borrow

Key Questions: Is there an effective demand for subnational borrowing in Nepal and can subnational governments and related entities become good borrowers?

Demand for credit is hard to measure. There is an enormous need for local public investment to accomplish desired social and economic development goals in Nepal. While the NUDS and MFF reports use somewhat different approaches to estimate this need, each makes a convincing case for increased investment. The two documents also provide a valuable starting point for developing more detailed estimates of financing needs, financing sources and delivery capacity, and for monitoring progress over time. Yet it is difficult to prove whether SNGs are willing to use credit to carry out needed investment projects. TDF has provided loans for decades, but resources have been limited and eligibility for them quite specific.

Certain investments are more suitable for borrowing: those high economic returns and where revenues are relatively easy to collect, such as bus terminals and markets. Efforts to expand borrowing should focus on these types of projects and on reducing transaction costs by using standardized project designs and financing structures.

Creditworthiness is a function of willingness to pay. The MFF analyses whether municipalities have credit capacity based on their revenue surplus, which is an important question to answer. But the ultimate determinant of credit capacity is citizens' willingness to pay for services. Ability to pay is a fundamental matter to analyze when preparing investment projects as well, but willingness to pay is a more binding constraint. Willingness to pay is not explored in detail in the NUDS or the MFF but will have to be addressed in providing technical assistance. An essential capacity for all SNGs—but especially those wishing to borrow—is the ability to convince citizens of the need to pay higher taxes and fees as a condition of receiving improved services.

Municipal strengthening is a prerequisite to borrowing. Technical assistance is needed by all SNGs in Nepal, and demand will strengthen as the new configuration of SNGs is put in place, creating new states and new and larger municipalities. Certain strengths and capacities—such as revenue mobilization—are particularly important for SNGs that want to borrow. These same skills will benefit all SNGs, whether they plan to borrow or not.

New organizational approaches, such as allowing joint borrowing by two or more subnational entities and encouraging public-private partnerships, will also increase service delivery and require unique forms of technical assistance.

A strategic view of subnational organizational strengthening is needed as well, that includes the support of academia and the development of career paths in local government finance.

Improving revenue management must be a priority. It is worth reinforcing once again the importance of designing a fiscal decentralization strategy that supports borrowing, particularly by providing SNGs with sufficient and predictable sources of revenue. In doing so, policy makers should consider several critical issues related to the management of OSR.

- **Distinguish collection from setting of taxes.** The responsibility for determining a tax or fee should not be confused with responsibility for collecting it. An SNG could determine a fee, such as a water charge, but rely on another entity to collect it. In Latin America, water charges are often collected by power companies along with electricity charges. This lowers administrative costs and provides users more incentive to pay.
- **Consider regulating rate setting not rates.** SNG user fees and tax rates are often set by central government, but there are other approaches that provide more local autonomy and should be considered for stronger SNGs. These include establishing only the procedures and parameters for setting taxes and fees and having a system to review or regulate their application if a complaint is lodged. A system that provides more autonomy forces SNGs to consult with rate payers and to understand ability and willingness to pay. Such a system will also contribute to development of a market-based financing system.
- **Focus on tax efficiency.** Local government tax efficiency is rarely discussed in Nepal. More than one analysis reviewed for this report focused on the share that specific revenue sources represented in overall SNG revenues, but not on the percentage of the tax being collected relative to its potential. A tool to analyze tax (and fee) efficiency could be used to identify weaknesses in tax collection and show the fiscal impact of improvements.

Financial administration has to be standardized and upgraded. Norms and standards–more than software--are the critical starting points for improving subnational accounting and financial management systems. Local governments themselves and DP local government projects have invested in automation of financial administration even before the GoN has defined accounting norms and standards. As a result, software systems and training have been developed based on various accounting standards, some of which do not conform to international standards. The GoN should urgently promulgate subnational accounting and auditing norms and standards based on international norms and other parameters for financial management systems. New subnational systems should then be required to conform to these norms and existing systems should be updated to reflect them.

The effort to build credit capacity will need to be focused. Not all SNGs will or should borrow; for one thing, the economic return on the investment in technical assistance needed to make all SNGs creditworthy would be quite low. Instead, the GoN might consider categorizing SNGs into three groups: (1) those who should borrow (strong SNGs that are required to progress toward capability to borrow), (2) those who should not (disadvantaged SNGs that should be given more generous grants), and (3) a middle group that will be given incentives to become borrowers but may not make it in the medium term, in which case they will need to earn grants through the MC/PM or a similar system.

Group 1 would receive extensive technical assistance and accompaniment to build creditworthiness as long as they keep making good progress. The GoN and DPs would carefully monitor the effectiveness of this assistance and improve the tools and systems being used over time.

A major financial commitment is required. The development of the country now depends on the successful implementation of the federal system and strengthening of subnational entities. There should be no skimping on the budget for technical support to these entities in the next 7 to 10 years. Making subnational government fully functional should be seen as a challenge similar to earthquake reconstruction, and equivalent resources need to be committed to the project.

H. Recommendations: Subnational Government Demand for Finance and Capacity to Borrow

The following recommendations reflect the analysis presented in this chapter and the conclusions reached concerning subnational government demand for finance and capacity to borrow.

	Recommendation	Action Required
7	**Develop tools and systems to build SN capacity**	To prepare SNGs to borrow, provide expanded technical assistance directed at financial strengthening, capital investment planning, project preparation and project management
8	**Select pilot SN borrower group**	Choose a group of SNGs through a competitive process who are committed to becoming creditworthy and provide them sustained technical assistance, training and accompaniment.
9	**Expand financial model prepared for MFF to forecast SN financing needs**	Further develop the approach used in the MFF to model the financing needs of SNGs based on assumptions about source of financing and delivery capacity, and advice provided in the report.
10	**Consolidate PPP experience to date. Introduce new PPP models.**	Facilitate the replication of successful PPP models through documentation, dissemination of information and technical support. Identify and disseminate new uses of PPP model.
11	**Support joint service provision.**	Ensure the new fiscal federalism framework allow for joint service provision and develop the legal and regulatory instruments that will allow it to be operationalized
12	**Engage university sector to develop new curriculum on SN finance, establish technical center**	Academic institutions should be engaged to design courses and curricula in subnational finance. The decentralization process needs a new generation of educated SNG staff and consultants who see subnational financial management as a viable career. Discuss creation of technical center on subnational finance.
13	**Establish network or association to professionalize field of SN financial management**	Establish a mechanism (network or association) that will allow SNG finance staff to share their knowledge and experience and eventually to develop professional credentials and training standards related to SNG financial management.

	Recommendation	Action Required
14	**Support implementation of new accounting norms. Strengthen subnational PFM.**	The GoN should urgently define subnational accounting norms and standards that are consistent with international practice, as shown in the subnational PEF. Require SNG to adjust any existing systems that do not comply and require DPs to conform to norms and standards. Significant financial resources are required to upgrade financial management and financial systems throughout the subnational sector.
15	**Strengthen SN revenue through improved information, systems and capacity building**	Borrowing will only be possible if SNGs have sufficient revenues. In establishing the fiscal decentralization framework, give more flexibility to SNGs to set taxes and user fees, at least for the larger SNGs. Put more focus on tax efficiency rather than the composition of revenues, in order to identify whether revenue sources can cover costs and are being properly collected.
16	**Develop mandatory training program for SNGs preparing to borrow**	Borrowers should be schooled in the preconditions and procedures involved in borrowing before beginning the borrowing process. Once developed, the training program could be a condition of borrowing from TDF or other sources.

VI. SUPPLY SIDE OF SUBNATIONAL BORROWING SYSTEM

Key Question: Can the Nepali financial market or other local sources respond to demands for subnational government financing?

If SNGs can borrow long term, they can match the life of the asset (e.g. water treatment plant) to the term of the financing. If they cannot, they are forced to pay for investments that have long-term benefits with today's funds, which are in short supply. In a competitive market with financing options, borrowers use the most cost-effective option that matches the cash flows of the project. Just like private companies, SNGs should avoid paying any more to finance a project than is absolutely necessary.

Lenders will provide loans to SNGs when they make a reasonable return relative to the risk of the transaction. That is, if SNG borrowers are perceived to be more risky, banks will charge them more.

In competitive markets, there is a range of financing vehicles (bonds, loans, leases, etc.) and various lenders interested in financing a transaction. In an emerging market, there is likely to be few financing vehicles, few if any lenders and a significant difference between what borrowers can afford to pay for funds and what lenders need to charge. Market development involves closing these gaps.

The liberalization of Nepal's economy and encouragement of private sector development that began in the 1980s has occurred in parallel with a tremendous growth of its financial system.[21] The World Bank describes Nepal's financial system as "bank-dominated and characterized by a large number of institutions and significant state ownership."

Box 4: The Money Market and the Capital Market

A financial market includes various submarkets, the most important of which for the purposes of this report are:

Money market: This market consists of intermediaries such as banks, non-bank financial institutions and dealers in short-term securities) selling financial instruments of less than one year's term (savings deposits, collateral loans, acceptances, bills of exchange, and treasury bills).

Capital market: A capital market provides longer-term capital via mechanisms such as the stock and bond market. Organizations such as investment and merchant banks help issuers raise funds through private and public offerings of equity securities (shares), debentures, corporate bonds, and treasury bonds. These instruments are sold in the "primary market" and traded later in the "secondary market."[22]

A. Nepal Commercial Banking Sector

In recent years, the banking system has expanded rapidly (140 percent increase in assets between July 2009 and June 2016). Domestic credit to the private sector increased from 33 percent of GDP in 2005 to 75 percent in 2016, all the result of the growth of private commercial banks.

Starting with fewer than five commercial banks in 1985, the sector has grown to include in 2015 28 "A" class commercial banks, 76 "B" class development banks, 47 "C" class finance companies, 38 "D" class micro-credit development banks, 15 saving and credit co-operatives and 27 NGOs providing

[21] Bank Supervision Report 2015, April 2016, Nepal Rastra Bank, Bank Supervision Department, Kathmandu. https://nrb.org.np/bsd/reports/Annual_Reports--Annual_Bank_Supervision_Report_2015-new.pdf.

[22] It is important to avoid a false distinction between "banks" and "the capital market." In many countries—including Nepal—certain types of banks help corporations raise long-term private capital. Merchant banks, for example, access the capital market to raise funds for their corporate clients or arrange private placements of securities for them.

financial services.[23] Some banks are now being encouraged to merge in the interest of improved sector efficiency and governance, and a few mergers have been completed.

The share of assets held by the three state banks (Agricultural Development Bank Limited, RBB and NBL) declined between 2009 and 2016, but the three banks collectively still represent 18.6 percent of commercial bank assets.

As of July 2015, savings and lending were both dominated by the commercial banks. The distribution among the classes of financial institutions is shown below.

Table 15: Total Deposits and Total Loans and Advances by Class of Financial Institution, 2015 [24]

Total Deposits (in NPR millions)	**1,787,959**	**Share**
Commercial banks	1,462,908	78%
Development banks	237,083	14%
Finance companies	71,876	5%
MF development banks	16,092	4%
Total Loans and Advances (in NPR millions)	**1,416,478**	**Share**
Commercial banks	1,392,463	82%
Development banks	244,235	13%
Finance companies	81,710	4%
MF development banks	69,552	1%

Commercial banking is regulated by the Nepal Rastra Bank under the Nepal Rastra Bank Act, 2002[25] and the Bank and Financial Institution Act, 2006.[26]

Bank involvement in subnational business. Municipalities handle significant financial resources over the course of a year. Of the 16 municipalities studied for this report, four had revenues over NPR 600 million in 2015/16. Lalitpur's revenues exceeded NPR 1 billion. Experience in other countries has shown the benefits for both parties of municipalities doing business with banks. Banks may start by providing checking and deposit services, then offer additional services--including lending--once they better understand subnational financial operations. Competition among banks for subnational business is also beneficial.

SNGs receive IGFTs and other public funding via bank accounts and maintain bank accounts to pay bills and transfer funds. A few municipalities use banks to collect tax payments, but most collect their own taxes at municipal offices.

SNGs in Nepal mostly use state banks. Some municipalities and banks believe municipalities are not allowed to do business with non-government banks. If this restriction does exist, it would be advisable to remove it, in order to increase banking options for SNGs and encourage competition among banks for SNG business.

Only one bank-financed municipal project was identified. Itahari municipality borrowed NPR 2 million from Nabil Bank, Ltd to build a bus park. Nabil Bank's Itahari branch handled the loan, after getting approval from its central office. The land on which the bus park was built was used as collateral. The interest rate on the loan was 4.5 percent with a repayment period of five years,

---

[23] Nepal Rastra Bank, 2015, Bank and Financial Statistics, No. 61. https://nrb.org.np/bfr/statistics/bank_fina_statistics/Banking_and_Financial_Statistics--No_61%20July%202015.pdf,

[24] Nepal Rastra Bank, 2015, Bank and Financial Statistics, No. 61. Table No.1, Financial System at a Glance, Mid- July 2015.

[25] Nepal Rastra Bank Act, 2058 (2002) and First Amendment, 2063 (2006). https://www.nrb.org.np/lgd/acts_ordinances/nepal_rastra_bank_act_2002_%5Benglish%5D.pdf.

[26] http://www.mocs.gov.np/uploads/Act%20list%20English/banks-and-financial-institutions-act.pdf.

although the municipality repaid the loan within three years. The municipality reported that the annual net revenue generated by the bus park was NPR 2.5 million.

B. Nepal's Capital Market

The capital market in Nepal is underdeveloped in terms of the volume and variety of instruments, but most of the key market entities are in place, as described in Table 17.

1. Stock market

The Nepal Stock Exchange Ltd (NEPSE) is the only stock exchange in the country. Since opening in 1993, NEPSE has provided free marketability and liquidity to the securities market, operating under the Securities Act, 1983[27] and the Stock Exchange Operation Regulations, 2064 (2008).[28] The Securities Board of Nepal (SEBON) regulates NEPSE.

Stock brokers, dealers, merchant bankers, fund managers, depository companies, credit rating agencies, and mutual funds are all registered and licensed by SEBON. All of these entities play key roles in the functioning of the market.

There are currently 230 companies listed on NEPSE with a combined capitalization of NPR1.7 trillion. (See further discussion of market capitalization below.)

Market capitalization is the total value of all companies trading in the stock market. The value fluctuates as individual company valuations change from day to day. Market capitalization is relatively low in Nepal, signaling low participation of companies in the stock market compared to the size of the economy and/or undervaluation of shares. Undervaluation may indicate low demand by investors for shares.

Figure 5 shows that while total listed company stock capitalization relative to Gross Domestic Product (GDP) reached a peak of 41 percent of GDP in 2008, it afterward fell to just over 20 percent in 2012.[29] In contrast, India's ratios ranged from 94 to 59 during that same period, and Japan's from 84 to 58. At the same time, it should be recognized that Nepal's GDP rose more than 75 percent in real (uninflated) terms during the period covered by Figure 5, as shown on the right-hand scale.

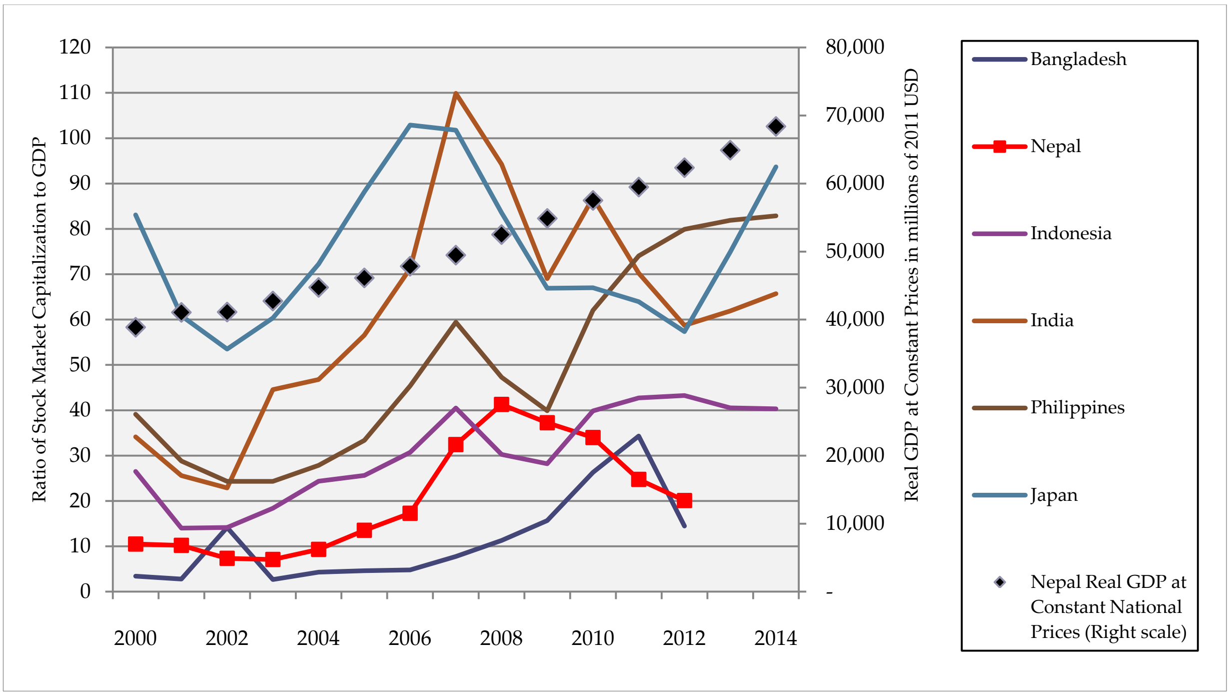
---

[27] http://sebon.gov.np/sites/default/files/securities_laws/SecuritiesAct2063.pdf .

[28] http://sebon.gov.np/sites/default/files/securities_laws/StockExRegulation2064en.pdf.

[29] World Bank, Stock Market Capitalization to GDP (for various countries), retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org, January 2017.

Figure 5: Ratio of Stock Market Capitalization to GDP for Selected Countries and Nepal, 2000-2014



2. Debt market

The debt market includes both government and corporate securities, but it is dominated by government debt, especially short-term securities. The GoN Longer term also sells longer-term development bonds.

Treasury bills and development bonds are sold at auction and bought largely by commercial banks to satisfy statutory liquidity requirements. The bonds can be traded on NEPSE, but they rarely are; most investors hold them to maturity. Savings bonds are sold directly to the public. Table 16 shows the amount of outstanding public securities in various categories as of February 2017 as well as largest buyers, rates and frequency of issues.

Table 16: Selected Nepal Rastra Bank Data on Public Securities Outstanding [30]

Bonds	Amount outstanding (billion NPR)	Largest buyer	Terms	Coupon rate	Frequency [# issues / time period]
Treasury Bills	104.0	Commercial Banks	91, 182, 364 days	Various	13 / 90 days, 8 / 6 months, 20 / 12 months
Development Bonds	108.9	Commercial Banks	5-15 years	2.65-6.5%	18 / 10 years
National Savings Bonds	0.9	Public	5 years	8%	1 / 4 years
Citizen Savings Bonds	7.8	Public	5-15 years	6-9.5%	4 / 9 years
Foreign Employment Bonds	0.5	Public	5 years	9-10%	8 / 4 years
Total	**222.1**				

Source: Nepal Rastra Bank, "Government Securities and Open Market Operations Statistics as on Magha 29, 2073 (11, February 2017)."

[30] Nepal Rastra Bank, Public Debt Management Department, "Government Securities and Open Market Operations Statistics as on Magha 29, 2073 (11, February 2017)." https://nrb.org.np/pdm/Reports_OSGS/Ownership_Structure_of_Government_Securities--2073-10(Magh).pdf

The private bond market is very small and no trading takes place. In 2010, corporate bonds were five percent of the market. Although most debt issues are well-subscribed, investor interest in bonds is said to be still adversely affected by the failure of some debentures to repay in the 1980s and 1990s.[31] No SNG has ever issued debt in the Nepali capital market, even though it is permitted.

3. Key entities and functions in the Nepali capital market

The key entities and functions in the capital market are shown in Table 17.

Table 17: Key Entities and Functions in the Nepali Capital Market

Entity/Function	Purpose
Securities Board of Nepal	SEBON was established by the GoN in 1993 as the apex regulator of the securities markets, in accordance with the Securities Act, 2006 (2007). The Securities Board of Nepal Regulations, 2064 is one of several regulations that guide its work.[32] Its Governing Board comprises its Chairman and private sector representatives. As well as regulating stock exchanges and other capital market entities, SEBON registers securities and provides advice to the GoN on capital market development. SEBON is, therefore, a key stakeholder for the development of a subnational capital market.
Stock exchange	The Nepal Stock Exchange Ltd (NEPSE) is the only stock exchange in the country. Members of NEPSE buy and sell government bonds and listed corporate securities. There are [62] member brokers and 2 market makers. Members also include issue and sales managers (e.g. merchant banks), who manage and underwrite public issue of securities and securities traders (dealers) who act as individual portfolio managers. SEBON regulates NEPSE.
Central depository	Central Depository System and Clearing Limited was established under the Securities Act 2007 and the Securities' Central Depository Services Regulation,[33] 2067 (2010) to provide centralized depository, clearing and settlement services for stock market transactions. Promoted by NEPSE, the company was inaugurated in March 2011. Depository participants can be financial institutions, stock brokers, registrar and transfer agents, or custodian. To date, 50 participants are registered.
Merchant banks	Once they are licensed by SEBON, merchant banks carry out functions related to the issuance and sale of securities, including (a) drafting the prospectus and other legal documents, (b) underwriting the issue (i.e. purchasing the unsubscribed portion); (c) registering ownership of securities and executing transfers, (d) portfolio (asset) management services.[34] There were 14 merchant banks in Nepal in 2011/12. Merchant banks are governed by the Securities Businessperson (Merchant Banker) Regulations, 2008.
Credit rating companies	Two credit rating agencies are registered in Nepal: ICRA, licensed by SEBON in 2012[35] and CARE Ratings, which signed a Memorandum of Understanding in August 2016 to start up CARE Ratings (Nepal) Limited[36] (see further discussion below)

[31] Debentures are private debt instruments. Similar to treasury bills or bonds, they are secured only by the cash flow of the issuer, rather than by any physical collateral.
[32] http://sebon.gov.np/securities-laws.
[33] http://www.cdscnp.com/CDSServiceRegulation_en.pdf.
[34] Securities Businessperson (Merchant Banker) Regulations, 2008. http://sebon.gov.np/sites/default/files/securities_laws/SBMBRegulation2064en.pdf.
[35] http://icranepal.com/

Entity/Function	Purpose
Custodians / trustees	A custodian is a person or entity that holds and protects funds, securities, or investments, and may perform actions in the client's name, such as making payments or collecting dividends. There are [xx] registered custodians in Nepal. In a bond issue, a bond trustee is a financial institution given fiduciary powers to enforce the terms of a bond indenture (contract). The trustee sees that bond interest payments are made to bond holders and protects bondholder interests in default. [Nepali securities law lacks the concept of a trustee, and consequently, none exist.]
Secondary market	Secondary markets allow investors to trade stocks, bonds and other securities after they are purchased at the time of issue in the primary market. Brokers and market makers carrying out trades in NEPSE create the secondary market for shares. However, in Nepal there is no secondary market for bonds.
Market makers	A market maker is a broker-dealer firm that assumes the risk of holding a certain number of shares of a particular security in order to facilitate the trading of that security. Market makers compete for orders by displaying buy and sell quotations for a guaranteed number of shares, which they sell from their own inventory or immediately buy in order to sell. In return for the service of keeping the market liquid, they receive a fee on each transaction.

C. Policy and Institutional Reforms Underway In the Financial Markets

The GoN has made a concerted effort over the past decade to address institutional weaknesses in the financial sector. The Ministry of Finance approved a five-year Financial Sector Development Strategy (FSDS) in January 2017.[37]

The goals of the FSDS are to diversify and deepen the financial sector, with the goal of raising its contribution to the country's gross domestic product (GDP) to 8 percent by 2020. A principal objective of the FSDS is to encourage a more diversified offer of financial products. The FSDS includes legal reforms, improved financial reporting through convergence with international accounting norms, and strengthened risk management capacity and internal control systems.

In carrying out these reforms, the GoN has been supported by various International Financial Institutions (IFIs) and other development partners including the Asian Development, the World Bank, DFID, and the International Monetary Fund (IMF).

In February 2017, the World Bank approved a US$ 100 million loan to support medium-term financial sector reform in order to reduce the banking sector's vulnerability and increase its transparency.[38] Among the commitments the GoN has made in taking the loan are to reduce government involvement in the banking sector and to continue encouraging consolidation of the financial sector.

Currently, less than half of the adult population in Nepal is classified as having access to banking services. Lack of financial services limits the capacity of Nepali people to mitigate risk, smooth

[36] http://www.emergingnep.com/index.html.

[37] International Development Association (World Bank), 2017, Program Document for a Proposed Development Policy Credit in the Amount of SDR 70.6 Million (US$100 Million Equivalent) to Nepal for a Third Financial Sector Stability Development Policy Credit, February 2, 2017.

[38] International Development Association (World Bank), 2017, Program Document for a Proposed Development Policy Credit in the Amount of SDR 70.6 Million (US$100 Million Equivalent) to Nepal for a Third Financial Sector Stability Development Policy Credit, February 2, 2017.

consumption, accumulate assets and invest in productive activities.[39] Expanding financial inclusion also increases savings, which helps to expand and strengthen the financial sector.

NRB has identified financial inclusion as a development priority for the country. Priorities include expanding banking services in rural areas and improving the regulation of both banks and microfinance institutions. Several DPs (including UNCDF, UKAID, and the Danish government) are assisting NRB to reach financial inclusion targets. It is worthwhile to recognize the connection between efforts to expand financial inclusion and those to establish a subnational financing system.

D. Other Ways for Subnational Governments to Raise Funds

1. Donors/ international finance institutions

IFIs and other development partners (DPs) currently supply most of the funds loaned by TDF, as either loans or grants, as described in Section VII.D.2. DPs also provide significant grant funding directly to SNGs.

DPs could be asked to invest directly in TDF or another intermediary, for instance supporting a pooled financing operation or buying municipal bonds through a private placement. DPs could use their "patient capital" to capitalize reserve funds or purchase a "junior" tranche of bonds that would provide a cushion and lower risk to buyers of a "senior" tranche of bonds.

These options change the relationship of the donor with the borrowing entity from one of funding programs to investor. Not all DPs would be able to participate in such an arrangement, but it might be possible to structure the financial arrangement to overcome the restrictions of certain agencies.

2. Institutional investors

Institutional investors such as mutual funds could invest in SNG projects in two ways: by purchasing SNG securities in the bond market or through private placements, or by lending directly to projects.

Mutual funds. Mutual funds are pools of money of individual and institutional investors that are invested in securities such as stocks, bonds, treasuries, derivatives, and other securities. They differ with respect to their investment objectives, investment strategy, risk profile, fees charged, etc. Some are marketed as private pension plans. Mutual funds create diversification and reduce costs for investors. They also give investors access to superior fund management.

SEBON registers and regulates mutual funds. At least a dozen mutual funds are operating in Nepal, and several more have been submitted to SEBON for approval. Mutual funds operate under the Mutual Fund Regulations, 2067 (2010).[40] The total value of mutual funds to date is approximately [ ].

A fund's investment objectives will determine whether it might be interested in investing in municipal bonds. Eventually, special funds could be created composed of municipal bonds. Mutual funds do not invest directly in projects.

Citizen Investment Trust (CIT).[41] The CIT (Nagarik Lagani Kosh) is the largest investment vehicle for individuals in Nepal. CIT was created by the Citizen Investment Trust Act, 2047 and began operating in 1992.[42] The GoN owns it as an autonomous public financial organization. It operates and manages retirement schemes, unit schemes and mutual funds for both domestic and foreign investors,

[39] Sujeev Shakya, et al, 2014, Making Inclusion Possible: Nepal Financial Inclusion Country Report. http://map.uncdf.org/sites/default/files/Documents/nepal_synthesis.pdf.

[40] http://sebon.gov.np/sites/default/files/securities_laws/Mutual_fund_Rules_en_2067.pdf.

[41] https://nlk.org.np/

[42] http://www.lawcommission.gov.np/en/documents/2015/08/citizen-investment-trust-act-2047-1991.pdf.

including the Nepal Army, teachers and civil service members. As of 2015, CIT had 455,200 investors participating in both voluntary and compulsory programs.

CIT is also active in the financial and capital markets, managing its own investments; providing loans to corporations; and offering trustee, custodian, and merchant banking services. As such, CIT could, in theory, be either a buyer of SNG securities or a direct lender to SNGs.

CIT managed more than NPR 67.22 billion as of July 2015.[43] Two-thirds of this amount was from employee retirements funds, with the balance distributed among other savings products. Of this, CIT had NPR 59.1 billion invested, 60 percent in interest bearing deposits, and the balance in stocks, bonds and term and home loans.

By 2020, CIT estimates it could be managing NPR 135 billion and have NPR 122 billion invested. In 2015, CIT issued its Long-term Strategic Plan for 2016-2020, which envisions an expanded role for CIT in the capital market, and a diversification of both its investments and its sources of funds (especially by channeling remittances into productive investments). Given falling interest rates in Nepal, deposits are becoming a less attractive investment vehicle for CIT.

CIT sees itself as a catalyst for capital market development. Its new investment strategy and most of its target sectors are relevant to the development of the subnational financing system. The sectors include: hydropower, infrastructure (roadways, transmission lines, tunnels), productive sector (agriculture, industry), and tourism sector (hotel, airport). CIT has conservative investment policies; therefore, these investments may be a relatively small share of its overall portfolio.

Regarding the local government borrowing, CIT cites its experience lending several years ago to Nepal Airlines under a government guaranty. Now, due to improved accounting and financial management, CIT, Employee Provident Fund and private banks are willing to lend to Nepal Airline without a government guarantee.

Employee's Provident Fund (EPF). The EPF is a compulsory, government-managed retirement savings scheme for Army and Police personnel, civil servants, teachers and employees of state-owned corporations. It is an autonomous public corporation created under the Employee Provident Fund Act, 2019 (1962).[44] The EPF reports to the Ministry of Finance. Private companies with more than ten employees are also eligible to become members. The EPF also manages several social security benefits paid by the GoN such as the funeral grant.

The 466,000 members of EPF (as of 2012) are employees of 28,000 participating entities. The GoN matches the compulsory contributions of its employees. Upon retirement, members can leave their savings in the EPF and receive interest for up to 6 years. Interest rates are fixed each year with a minimum three percent interest rate guaranteed by the GoN.

The EPF has assets of nearly NPR 225 billion.[45] Unlike CIT, more than half of the assets of EPF are in the form of loans to its contributors (53 percent). It also makes project loans (10 percent), and invests in bank deposits (26 percent), and holds a small portfolio of shares and government bonds.

3. Individual investors

Individual investors could invest in municipal bonds through savings instruments such as investment funds or mutual funds or through their savings in pension plans or insurance policies, which in turn invest in these instruments. Only in very active markets with low-cost retail investment channels do individual investors purchase these types of instruments.

[43] This is equivalent to almost 4% of total stock market capitalization.

[44] http://www.lawcommission.gov.np/en/documents/2015/08/employee-provident-fund-act-2019-1962.pdf.

[45] Equivalent to more than 13% of stock market capitalization.

Remittances sent to Nepal from overseas workers amounted to US$6.7 billion in 2015 and are estimated at US$ 6.9 billion for 2016.[46] The 2015 figure represents 32.2 percent of Nepal's gross domestic product (GDP). To capitalize on these inflows, NRB has sold nine issues of Foreign Employment Savings Bonds (diaspora bonds) since 2007 totaling NPR 500 million (see Table 16). Although recently these bonds have not sold very well (sales from the last issue in March 2017 were only NPR 40 million), remittance senders could be a market for subnational bonds.

Some municipalities have sold their bonds (or a special tranche in small denominations) directly to residents and other individuals. Such a sale could give those who own the bond an added stake in the investment project. However, the amount that SNGs can raise in this manner is limited, and securities law may prevent direct selling to unsophisticated investors except through a public issue. This type of sale should probably be viewed more as a form of marketing than a way of raising significant funding.

4. Private placements

A private placement is not a unique financial instrument, but instead an approach to raising funds. In contrast to a public issue, a private placement involves a sale of stock, bonds or other securities directly to a small number of investors. Most bond issues in Nepal are sold as private placements.

The Securities Registration and Issue Regulations, 2008 refer to a private placement as "Issue of Securities through Circular Method," (Section 8) and defines it as issuance and sale of securities by using letter or electronic means targeting a maximum of fifty investors.[47]

The corporation must obtain the resolution of its annual general meeting and sell the securities to associations, institutions, persons or institutional investors SEBOND considers to be qualified.

Disclosure requirements of private placements are usually lower than those associated with public issues, hence the requirement that it be sold to qualified (i.e. sophisticated) investors who would have the expertise to properly analyze the transaction. It is very likely that early municipal bond issues in Nepal would be sold as private placements.

5. Public-private partnerships

Engaging the private sector in the provision of public services through public-private partnerships (PPP) can facilitate local investment in several ways:

- Make an investment project more sound technically, which then justifies an SNG investment
- Provide the public service more cost-effectively
- Raise financing that the SNG cannot raise on its own for the same project

The Investment Board of Nepal is one of the lead entities promoting PPPs in the country. The legal framework for PPPs includes the Private Financing in Build and Operation of Infrastructures, 2063 (2006)[48] and the Private Financing in Build and Operate of Infrastructures Rules, 2064 (2007).[49] In 2015, the GoN approved the Public-Private Partnership Policy, 2015 in an effort to spur national economic growth through investment in public infrastructure and services. Priority sectors for investment include: roads, bridges, airports, communications, power, and water/sanitation.

---

[46] Source: World Bank staff calculation based on data from IMF Balance of Payments Statistics database and country sources.

[47] http://sebon.gov.np/sites/default/files/securities_laws/SecuritiesIssueRegulationEn.pdf.

[48] http://www.lawcommission.gov.np/en/documents/2015/08/private-financing-in-build-and-operate-of-infrastructures-rules-2064-2007.pdf.

[49] http://www.lawcommission.gov.np/en/documents/2015/08/private-financing-in-build-and-operate-of-infrastructures-rules-2064-2007.pdf.

There are many opportunities for public-private collaboration in public service provision. Several local level PPP projects seem to demonstrate the relevance of PPPs to municipalities:[50]

- **Butwal**: Development of the auto village (developed under a PPP model and later converted into a company in which the municipality owns shares)
- **Biratnagar**: Solid waste management, operation of public toilets and management of advertising hoardings
- **Mechinagar** (Jhapa): Management of advertising hoardings and construction and operation of a slaughterhouse
- **Dhulikhel**: Solid waste management, public park and public toilets
- **Siddarthanagar** (Bhairahawa): Fruit and vegetable market and business tax collection
- **Kathmandu**: Waste composting from the main fruit and vegetable market and selling of drinking water in reusable jars
- **Bharatpur**: Management of medical waste, provision of public toilets and bus shelters and generation of biogas from waste at the wholesale vegetable market
- **Hetauda**: Community managed drinking water schemes and bus park toilets

The new PPP policy is more specific and operational that the 2001 version. It aims to facilitate PPPs by making the PPP process more transparent; encouraging public officials to pursue PPPs; simplifying administrative procedures, including for procurement; broadening the definition of PPP to include new modalities and identifying and prioritizing possible PPP projects.

Another positive trend is the presence of financial institutions and consultancies that specialize in preparing financial transactions and PPPs, such as "Emerging Nepal."[51] These entities--sometimes known as financial advisors--work for a fee and provide services such as project preparation and match-making between investors and borrowers. It is in the interest of these entities to find ways to improve access to the market.

E. Other Issues that Affect the Feasibility of SNG Market Borrowing

1. Interest rates

It is difficult to determine the interest rates at which lenders; bond buyers or investors would be interested in financing SNG infrastructure on a market basis in Nepal. Overall, market interest rates are at reasonable levels in Nepal, with the commercial bank lending rate currently below 10 percent (see Figure 6). SNGs must be able to provide reliable financial information to lenders and assurance of loan repayment. Otherwise, SNG loan interest rates will be unaffordable.

a. Bank interest rates

Banks set lending rates by considering on their cost of funds, including savings and other costs including loan preparation, potential loan losses and corporate overhead. The rate-setting process has to consider the rates being charged by competitors and the market demand for loans.

TDF lending is often referred to as taking place at "below market" rates; however, the lack of market financing for SNG infrastructure projects means that there is no "market rate" on which to benchmark loans. In fact, TDF interest rates are based more on policy considerations than concerns about financial market development. Generally, they range from 5 percent to 9 percent.

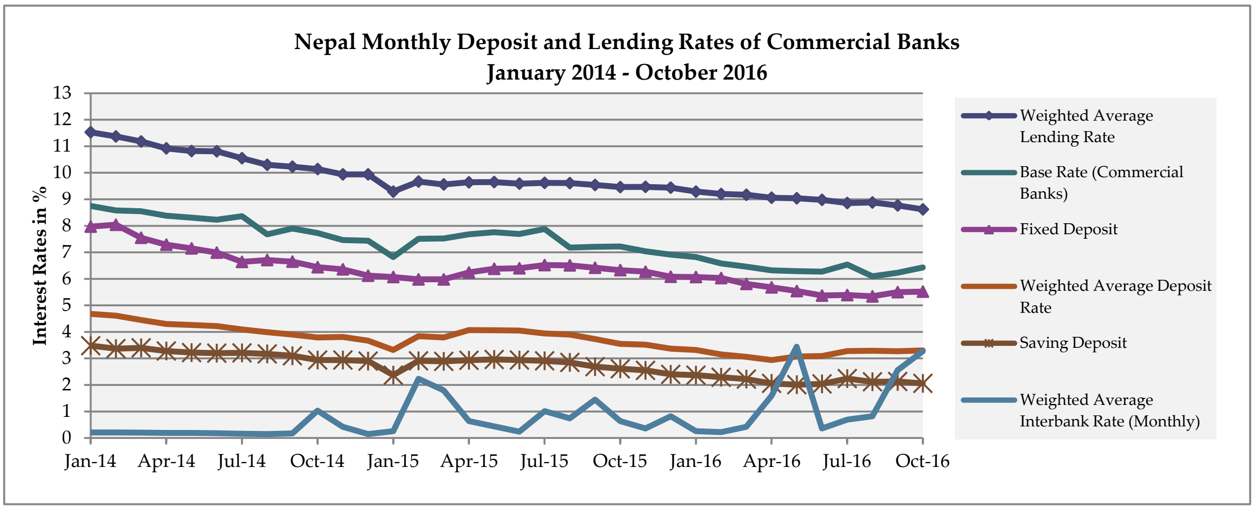
[50] Most of these projects were supported by UNDP under the Public Private Partnership for Urban Environment (PPPUE) project. http://www.np.undp.org/content/nepal/en/home/operations/projects/closed-projects/poverty-reduction/pppue.html.
[51] http://www.emergingnep.com/index.html.

b. Bond interest rates

In active bond markets, bond interest rates are set using a "yield curve," that is, a set of interest rates in the market on income-earning securities of equal quality but different maturities (terms) at a point in time. The starting point for developing a yield curve are yields on secondary market trades of treasury securities of different maturities, since treasury securities are considered to have the lowest risk, and therefore the lowest yields.[52] Municipal bonds carry a risk premium over treasuries, which varies depending on the borrower and the structure of the transaction.

Because yield is one of the main selling points of a bond, it would be difficult to sell securities such as municipal bonds without having a yield curve on which to base the interest rate. Establishing a yield curve is impossible because of the minimal number of secondary market transactions. The secondary market does not develop because of the small number of bonds issued and the sporadic pattern of issuance by the GoN, making trading unprofitable for broker-dealers. (Sometimes in emerging markets, broker-dealers are paid to provide liquidity on a bond issue, but this raises the cost of the issue.)

Figure 6: Market Interest Rates in Nepal, 2014-2016



Source: Nepal Rastra Bank

2. Avoiding subsidized interest rates

Below-market interest rates are a favorite tool used to subsidize local investment. They are justified on the basis of the social purpose of the infrastructure being built, and on the poor financial condition of the borrowers. However, subsidized interest rates are detrimental to the long-term goal of establishing a subnational borrowing system, and a commitment should be made to eliminate them.

Too often, subsidized interest rates are covering up either poor lending practices (lending more than the project can repay) or poor management on the borrower's side (lack of user support, poor cost recovery practices or inefficient operations). Most importantly, subsidized interest rates crowd out financial institutions that could only lend at market rates.

As the subnational credit market grows, and experience is gained, it will become easier to set interest rates that are attractive to both lenders and borrowers.

In the meantime, Nepal's subnational borrowing policies should discourage subsidized interest rates, require larger capital contributions from project sponsors and promote better project management

[52] Yield is not the same as the interest rate on the security, since security values change over time. That is why secondary market trading is needed to develop a yield curve.

and payment systems to increase investment efficiency. These steps will contribute greatly to the development of the subnational market.

3. Tax exemption

Some countries use tax exemption of investment income an incentive to attract more investors to the municipal bond market. In the United States, public-purpose municipal bonds generally carry a tax-exemption, although local governments also issue taxable bonds for projects with a private purpose. Indian SNGs issue both taxable and tax-exempt bonds as well.

There is nothing inherent in SNG borrowing that requires interest to be tax exempt. Tax exempt bonds carry lower interest rates, but may appeal to a smaller group of investors. Managing a tax-exempt market also requires significant expertise in both the capital market and regulatory agencies. The public policy issues need to be carefully analyzed before making this decision. Nepal does not need to be concerned about making this decision for the foreseeable future.

F. Managing Risks of Subnational Financing

Subnational capital market development is largely a process of identifying risks and determining how to mitigate them. Every weakness in the market represents a risk for market participants that makes them unwilling to participate.[53] The most obvious risk for a lender or investor is not to be repaid. Credit enhancement and credit ratings are two tools that can help mitigate this risk.

1. Using guarantees and other forms of credit enhancement

Credit enhancements provide security to lenders and therefore lower risk. Even though there is generally a cost associated with credit enhancement, it may lower the overall cost of borrowing.

Some credit enhancements are external to the project. For instance, bond insurance provides repayment if the borrower defaults on the bond. The issuer (borrower) pays the insurer a fee, but without insurance the interest rate may be much higher. (Bond insurance is only available in large, developed markets such as the U.S.) Guarantees are another form of external credit enhancement. When provided by a higher level of government, the beneficiary is rarely charged, but the expected cost of a guarantee can be calculated, and some guarantors (such as USAID’s Development Credit Authority) require payment of this expected cost (or loss).

Most credit enhancements are internal; that is, they are “built into” the financial structure of a loan or bond. Mechanisms such as reserve funds provide the lender added security against late payments. Municipal bonds often have more than one reserve fund, with each covering a different type of repayment risk. Revenue intercept mechanisms on IGFTs or other SNG revenues provide a secondary source of repayment. Rate covenants ensure that the borrower or bond issuer adjusts user fees as needed to maintain an agreed debt service coverage ratio.

From a market development point of view, credit enhancements should be limited to only what is necessary to satisfy the lender. Excess credit enhancement, such as an unconditional government guarantee, is not only costly, it impedes market development.

Certain lenders such as the IFIs do not lend without a sovereign guarantee. But in local markets experience shows that when lenders are given full guarantees, they may fail to properly understand and mitigate risks. Guarantees also prevents the necessary “learning curve” between lenders and borrowers that is required for market development. It also keeps lenders from innovating and

[53] Of course some risks are so great, the market shouldn’t function. If a municipality does not have the income to repay a loan, no lender should give it to them.

competing for the subnational market. More limited guarantees are superior for market development purposes.

2. Credit ratings

Credit ratings provide reliable, standardized information regarding the financial condition and the risks associated with issuers of debt and specific financial transactions or structures. In bond markets, they make it easier and cheaper for bond buyers to decide whether to buy a bond. They could be useful for lenders as well.

In some developing markets, including India and Mexico, credit rating agencies have supported subnational market development, by helping to establish credit rating norms and standards. In the case of these two countries, ratings agencies began producing "shadow" (non-public) ratings well in advance of the entry of municipalities into the market. These shadow ratings pointed out financial weaknesses that would require strengthening before the SNG should consider market financing.

Bangladesh has been developing municipal ratings standards with the assistance of an international ratings firm. The GoN will disseminate these standards to any local ratings agency interested in offering municipal ratings.

There are currently two credit rating agencies registered in Nepal: ICRA, which was licensed by SEBON in 2012[54] and CARE Ratings, which signed a Memorandum of Understanding in August 2016 with Vishal Group Limited and Emerging Nepal Limited to start a credit rating agency to be called CARE Ratings (Nepal) Limited.[55]

Carrying out SNG ratings would be nearly impossible in Nepal at present, given the poor quality of municipal financial information and the lack of accrual accounting and international standards for municipal accounting. In the short run, the GoN should consider developing a simpler and more qualitative self-assessment tool.

G. Conclusions: Supply Side of Subnational Borrowing System

Key Question: Can the Nepali financial market or other local sources respond to demands for subnational government financing?

Nepal's capital and financial markets–that is, the supply side of the subnational credit system--are not ready to finance SNG borrowers. Yet, a concerted effort could shorten the time until lenders and investors are willing to do so.

There are market weaknesses that are being addressed. The constraints on the supply side of the borrowing equation are significant. They include conditions typical of low-income country financial markets, such as: (i) the shortage of savings and longer-term funds; (ii) the underdeveloped nature of the bond market, including the lack of a yield curve, (iii) inexperience of lenders with SNGs and their financing requirements; (iv) lack of financial information and a credit rating system for SNGs. There may also be some regulatory constraints that would limit subnational lending and would need to be resolved.

Savings are growing in Nepal, as is financial inclusion. More savers should lead to more long-term savings instruments, which should expand the capital market and make it easier for banks to lend long-term.

---

[54] http://icranepal.com/

[55] http://www.emergingnep.com/index.html.

Reforms taking place in the financial sector bode well for future subnational market borrowing. Reforms are being driven by the need for more private sector investment and greater safety in the financial system. Nevertheless, there is no reason that subnational credit market development cannot become a goal within the overall reform agenda.

SNGs may borrow from other sources in the medium term. The fact that the markets are not ready for subnational borrowers does not mean SNGs have no options to gain access to finance in the next few years. SNGs may find financing from less traditional sources, such as private placements (perhaps with mission-driven lenders or investors); transactions with institutional investors such as CIT and EPF; and public-private partnerships. TDF or another intermediary may be able to gain market access in the next few years and thus increase the availability of subnational financing.

Public-private partnerships in effect provide another avenue to private financing. True PPPs that entail investment at risk by the private party give SNGs an indirect route to raise private financing. The experience to date in Nepal needs to be better documented, built upon and scaled up.

Otherwise, strengthening SNG financial condition, financial administration and project development should be the priority over the next few years.

Financial sector stakeholders need to be involved in developing the subnational borrowing system. Development of the subnational borrowing system must be undertaken jointly with the private sector. Financial institutions and institutional investors lack experience designing subnational transactions, but they are very familiar with the market in which they operate and how it is evolving.

A public-private working group could collaborate to: (i) validate the work plan and other information in this report, (ii) analyze options for reform of TDF and/or creation of a municipal development bank or another intermediary; (iii) advise the GoN on specific initiatives such as improvement in accounting standards and financial reporting; (iv) design tools and models such as the self-assessment tool for SNG creditworthiness and eventually an SNG credit-rating system and (v) maintain a dialog among stakeholders on market development.

The temptation to take shortcuts should be resisted. The financial weaknesses of SNGs and their poor standards of financial administration and reporting are the most critical constraints on municipal borrowing, and resolving these issues will take time. In the meantime, those advocating for subnational borrowing should try to avoid SNGs with access to the market through artificial means such as the use of government guarantees. Guarantees reduce lender risk without mitigating underlying weaknesses of borrowers. External credit enhancement strategies are not all bad. For instance, partial credit guarantees may be useful. What should be avoided are shortcuts that undermine long-run market development. The working group might be able to help identify a menu of credit enhancement options that would make private borrowing more feasible.

H. Recommendations: Supply Side of Subnational Borrowing System

The following recommendations reflect the analysis presented in this chapter and the conclusions reached concerning the supply side of the subnational borrowing system.

	Recommendations	Action Required
17	**Support financial market strengthening**	The GoN should continue to address systemic weaknesses in the capital and financial markets while prioritizing the goal of giving market access to SNGs.
18	**Pilot borrowers borrow through non-traditional lenders or from market**	Work with traditional and non-traditional lenders to identify avenues for financing.
19	**Establish public-private working group**	Create a working group between the public sector and interested private-sector stakeholders, especially those in the financial sector, to work on the development of the subnational financing system.
20	**Begin work on credit rating criteria and procedures, starting with self-assessment tool**	Engage the credit rating agencies in a dialog about the development of a self-assessment tool and eventually of municipal credit criteria and credit rating procedures.

VII. FACILITATING MARKET ACCESS FOR SUBNATIONAL BORROWERS

Key Questions: What is the best vehicle for giving SNGs access to market finance? How should the subnational market development effort be organized?

Creating a sustainable market-based subnational financing system in Nepal is a major transformation from the financing system for municipal investment that exists currently, which consists of IGFTs financed by the GoN and very limited credit financed by international donors and channeled through the Town Development Fund (TDF).

Municipal development funds (MDFs) such as TDF and other intermediaries have emerged as important vehicles in the development of market-based borrowing systems in other countries, serving as lead agencies, financing channels and technical assistance providers. This chapter proposed how to organize the overall effort to develop the subnational borrowing system, discusses what form TDF or another financial intermediary might take and analyses the potential role of TDF in this process.

A. Bundling or Unbundling Key Functions

Creating a new subnational financing system as discussed in this report requires that several interrelated tasks are carried out leading to establishment of several critical functions and capacities. These can be categorized as:

(i) Coordination of the market development process

(ii) Regulation of subnational borrowing

(iii) Technical support to subnational borrowing

(iv) Facilitation of access to financial resources[56]

Coordination of the market development process should be led by the GoN, and could be supported by consultants and the public-private working group recommended in Section 0. The suggestion is that Subnational Borrowing Unit be created in MoF, the LBFC or the NNRFC, as mentioned in Section IV.C.3 to provide coordination.

Regulation is clearly a central government function. As discussed in Section IV.C.3, regulation of subnational borrowing is proposed to be shared by Nepal Rastra Bank, the Ministry of Finance, and SEBRON, based on new subnational borrowing regulatory framework.

Technical support requirements will evolve over time and at first will be needed by the GoN (in its roles of market development and regulator), borrowers (both SNGs and private partners in PPPs) and lenders (financial intermediary and financial institutions).

Even in the medium term, few SNGs are likely to access the financial or capital market directly. Because most countries with developing financial markets have contronted this constraint, they have developed a range of financial intermediaries. All of these entities facilitate access to financial resources, but they also perform a variety of other functions.

As with any financing situation, it is critical to avoid conflicts of interest (therefore the intermediary cannot regulate itself, for example). Sustainability is an equally important consideration. As an intermediary takes on more functions, it may encounter greater difficulty operating like a financial institution and in a sustainable manner, unless it is well-structured and carefully managed.

[56] This chapter uses the generic term "intermediary" to describe an entity that would raise funds in the market and channel them to SNGS through lending operations. As discussed in this chapter, the intermediary could be TDF or a newly formed entity.

The role of facilitating market access will evolve. The proposed intermediary (TDF or other) may be the only way for SNGs to gain market access in the medium term, but its clientele will evolve as direct market access by SNGs becomes feasible.

The financial sector may need help to develop its capacity to lend to SNGs. Asking TDF or the intermediary to play this role may put it in a conflict with its own interests as a lender, but the proposed Subnational Borrowing Unit may not have the proper expertise.

Table 18 shows a proposed allocation of tasks in each of the four key functions. It reflects assumptions about roles and the transition from the current set-up to creation of a lending intermediary and eventually (in some cases) to direct market borrowing.

Table 18: Sustainable Subnational Financing System – Allocation of Key Functions

Key Functions and Tasks	Transitional Phase	Later Phases	
		Borrowing from Intermediary	Borrowing from Market
I. Coordinating Subnational Market Development (Stakeholders: All)			
▪ Managing work plan	Subnational Borrowing Unit		
▪ Engage and coordinate stakeholders	Subnational Borrowing Unit / TDF or Intermediary		
▪ Coordinate drafting /approval of legislation, regulations, procedures, etc.	Subnational Borrowing Unit		
II. Regulation of Subnational Borrowing (Stakeholder: Government)			
▪ Regulation of SN borrowing	NRB/MOF/ SEBON		
▪ Monitoring of SN borrowing	NRB/MOF/Subnational Borrowing Unit		
III. Technical and Legal Support (Stakeholders: SNGs)			
A. Training for Borrowing			
▪ Preparation for borrowing	Technical/training entity advised by TDF	Technical/training entity advised by intermediary	Technical/training entity
▪ Project preparation and implementation	Technical/training entity advised by TDF	Technical/training entity advised by intermediary	Technical/training entity
▪ Project management and operations	Technical/training entity advised by TDF	Technical/training entity advised by intermediary	Technical/training entity
B. Transaction-Related			
▪ Loan preparation	TDF / Consultants	Intermediary / consultants	Financial institution / consultants
▪ Loan disbursement	TDF	Intermediary	Financial institution
▪ Legal support	Attorneys	Attorneys	Attorneys
▪ Loan servicing	TDF	Intermediary	Financial institution
IV. Access to Finance (Stakeholders: SNGs, TDF, Financial Intermediary or Institutions)			
A. Lending Related Activities			
▪ Loan packaging	TDF	Intermediary	Financial institution
▪ Loan appraisal / approval	TDF	Intermediary	Financial institution
▪ Loan disbursement	TDF	Intermediary	Financial institution
▪ Loan servicing / workouts	TDF	**Intermediary**	Financial institution
B. Other Activities			
▪ Donor project management	TDF	Division of intermediary	NA
▪ Allocation of grants	TDF	Independent committee	Independent committee
▪ Other credit enhancement	NA	Intermediary / borrower	Financial institution / borrower
▪ Credit rating	Self-assessment	Credit rating agency	Credit rating agency

B. Technical Assistance in the Financing System [57]

Technical and legal support are critical inputs to the subnational financing system. As the table shows, two types of technical assistance are needed to support subnational borrowing: (i) assistance to prepare SNGs to borrow, and (ii) assistance to support specific borrowing transactions. SNGs with capacity to borrow, but without borrowing experience, should first receive training on the borrowing process. Otherwise, it falls to the lender to provide this training, which represents a financial burden.

Currently, TDF assists borrowers with financial transactions, and provides some general technical support on revenue mobilization, PPPs, etc. Comments were received that TDF should be converted into a technical support center for SNGs. However, the recommendation here is that TDF (or its successor intermediary) provide technical assistance needed for financial transactions (and perhaps to prepare for borrowing). All other technical support should be provided by an entity (public or private) whose principal purpose is training and technical assistance.

C. Options for a Financial Intermediary

1. Intermediary as lender

MuAN has been lobbying for the creation of a Municipal Development Bank for many years. In a policy paper published in 2002, MuAN argues that TDF is donor-dependent and not able to function as a financial institution.[58]

An important consideration in deciding on the structure of the intermediary is the sources of funding it could raise. Sources could include savings, borrowing, local capital market transactions (bond issues or private placements of equity or debt), and donor lines of credit or sector projects. Donor sector projects are TDF's principal funding source today.

A government bank could be created, but the costs and benefits of doing so need to be carefully evaluated, particularly in light of the pressure on the GoN to reduce or eliminate its ownership stake in commercial banks.

Alternatively, a private financial institution could be established, but meeting the requirements of the BAFIA might be difficult, and it would probably not have access to public funding. The best option may be a hybrid institution that could act like a bank, but also receive public support.

TDF has proposed mobilizing savings as a way to raise funds. However, existing banking institutions and pension funds already mobilize savings that could potentially be borrowed from the market, so the competitive advantage of a new savings institution would have to be justified.

The various legal forms, and the funding sources available in each case could be evaluated by the working group with the aid of a local attorney.

2. Other roles of the intermediary

Facilitating PPPs. In discussions held while preparing this report, the proposal was made to create an entity that could facilitate public-private partnerships, or serve as the private partner in subnational PPPs. This was sometimes referred to as an "infrastructure development company." The proposed subnational intermediary could eventually form such a company; however, the binding constraints on the development of PPPs at present appear to be: (i) lack of expertise with the modality, and (ii)

---

[57] This section discusses technical assistance directly related to borrowing. Technical assistance needed to support market development and for municipal strengthening is mentioned in other sections of the report.

[58] Amrit Kumar Rai, 2002, "Possibility of the Establishment of a Municipal Development Bank in Nepal," prepared for MUAN.

overall difficulties of doing business in Nepal.[59] It is not clear whether forming a new institution would overcome these constraints, but this option could also be analyzed.

Credit enhancement. The new intermediary could undertake activities to reduce the risks of subnational borrowing, using both technical and financial means. Technical means include providing expertise with project preparation and structuring. Financial means include using internal and external credit enhancements. Some ways the intermediary could lower risk are shown below.

Approach to Risk Reduction	Rationale
▪ **Refinance existing loans in the private market once they have matured and are more attractive to private lenders**	Seasoned loans are less risky to a lender than new loans
▪ **Borrow against the cash flows of a pool of loans backed by projects in the same sector or with other characteristics appealing to lenders**	A pool of loans diversifies risk compared to a single loan
▪ **Create a reserve fund to provide credit enhancement to the intermediary as a whole, structured to reflect the characteristics of the loan portfolio**	A large common reserve fund could provide greater security to a lender than smaller reserves associated with a single transaction

The capital structure of the intermediary will affect the risks it can take on and for that reason is an important consideration in designing the intermediary. The ideal structure will minimize moral hazard while pushing the market to provide financing it otherwise would not.[60] Equity contributions would make it easier for the intermediary to borrow and provide a cushion against losses, but investors should have the assurance of a return. Equity contributions could take different forms and come from the GoN, private investors (individuals or institutions), SNGs and international banks. Municipal officials seem to favor the concept of an intermediary partially owned by local governments.

TDF management is already reviewing its Act to identify options for improving its capital structure. Issuing equity is likely to require modifications to the Town Development Act. It would be advisable to evaluate options for the design of the intermediary before amending TDF's law. The next secttion reviews issues associated with reorganizing TDF to serve as the intermediary.

Administration of donor projects. The intermediary could also continue to administer donor projects since this is an important function and can provide a source of revenue. However, the market operations of the intermediary and loan servicing and technical assistance for donor projects are vastly different functions that should be separated within the intermediary's structure. By separating these functions, the intermediary can better manage and account for market and non-market operations. Such an arrangement will also help ensure proper compensation to the intermediary for providing services to donors. The intermediaries described later in this chapter tend to separate donor projects into individual trust funds.

D. The Option of Restructuring TDF

Rather than creating a new intermediary, an option is to restructure TDF. TDF is already evaluating with its Board of Directors a conversion into a financial intermediary, which demonstrates its openness to such an arrangements. Even if TDF's functions are absorbed by a new entity, it is crucial

---

[59] Nepal ranks 107 overall on the World Bank's Doing Business 2017 report compared to ranking 100 in 2016, out of 190 countries analyzed.

[60] Moral hazard occurs when one party to a transaction has an incentive to assume additional risks that negatively affect the other party. For instance, a SNG whose loan is partially guaranteed by the intermediary's reserves may fail to enforce a politically unpopular tariff agreement, thus putting loan repayment at risk.

to understand the lessons learned during its nearly 30 years of existence. This section describes the history and current situation of the organization.

1. Background on Municipal Development Funds

Municipal development funds (MDF) such as TDF are found in middle-income and low-income countries around the world providing credit to local governments and other organizations for investment in local infrastructure and services. All MDFs were created to expand investment resources by providing credit to local governments, usually by accessing IFI loans. A few have successfully supported a transition to private municipal financing.

The majority of MDFs were created in the 1990s with support from IFI or bi-lateral donor projects. By using donor funds to capitalize quasi-financial entities, governments and donors hoped to support burgeoning demand for municipal infrastructure, while overcoming the fiscal constraints imposed by structural adjustment programs. The goal was to "recycle" donor funds over time in order to carry out repeated rounds of capital project financing. [61]

a. Roles of Municipal Development Funds

MDFs operate with one or more purposes related to municipal financing:

- **Intermediation:** Channeling credit to local governments, financial institutions or both, while simultaneously helping municipalities develop good financial management practices that will eventually allow them to borrow from the private financial market
- **Demonstration:** Demonstrating to the financial sector that local government is an economic sector worth lending to; that is, that local governments can be good clients
- **Graduation:** Graduating their borrowers to the marketplace and (sometimes) evolving into market-based financial institutions.

However, few MDFs ever fully attain these goals. Most are not financially sustainable and don't evolve into market-like entities. The reasons for this "failure to launch" include:

- Becoming instruments of directed lending; that is, becoming an intermediary for donor and government programs that operate under a supply-side rather than a demand-side paradigm
- Lending to municipal clients that are so weak that the cost of supporting them technically and from subsidizing their failure to repay makes credit operations unsustainable
- Failing to conduct their credit operations like a financial institution, in particular, by not separating their non-financial activities from financial operations, which can be benchmarked against the financial sector
- Becoming a monopoly lender, with advantages such as subsidized (or grant) funding and access to sources of repayment, and therefore crowding out private lenders

b. Pitfalls of Municipal Development Funds

While donor organizations that sponsor MDFs are often concerned about the efficiency or transparency of their operations, they rarely promote the reforms that would transform them into market actors. Donors also rarely work as a team, so their programs may compete, or offer such a variety of terms that it becomes confusing and costly to both the intermediary and potential borrowers.

Non-financial activities of MDFs such as training of municipal officials serve a developmental function and should be separately subsidized. Technical assistance and certain loan preparation

[61] George E. Peterson, 1996, Using Municipal Development Funds to Build Municipal Credit Markets (Revised), World Bank. http://siteresources.worldbank.org/INTMF/Resources/339747-1251914038224/77p.pdf.

activities can be provided by private firms, or if provided by the MDF, should also be benchmarked against private providers.

MDFs and MDF-type organizations that have avoided the typical pitfalls and succeeded in gaining market access for their clients and/or for themselves share some crucial characteristics, listed below.

- Very good repayment performance, due to strict procedures and risk management mechanisms such as voluntary intercept mechanisms that are available to all lenders
- Significant equity, debt service reserves, or a moral obligation of the state to replenish reserves of the MDF, each of which insulates lenders and investors from repayment risk
- A variety of ways to finance infrastructure that helps to grow the municipal market and creates a competitive environment that encourages innovation and efficiency by lenders

MDFs and their partners can utilize a number of strategies to become active players in municipal credit market development, such as:

- Redefine the MDF's purpose as promoting the expansion and sustainability of municipal credit supply
- Lay out and keep to a gradual strategy for market development
- Enforce a "hard credit culture" by lending: (a) based on credit capacity, not need and (b) on market terms (even if loans are smaller). Vigorously enforce loan repayment terms
- Stop monopolizing the municipal credit market and accept competition as the cost of market development
- Share the privileges that come with being a monopoly, such as access to voluntary revenue intercepts
- Use a more "hands-off" approach with more capable municipalities (e.g. preparing their own feasibility studies) and force graduation to the market as the market develops
- Establish a spirit of collaboration with the private sector

Two municipal financing institutions that began as MDFs appear to have particular relevance to TDF. These are the Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFS) in the State of Tamil Nadu, India and FINDETER in Columbia (see Section 3, below for detail on these and other organizations).

2. Understanding the Town Development Fund

a. TDF's origins and purposes

The Town Development Fund Board (formation) order, 2045 (1989) established the Town Development Fund (TDF). This was later replaced by the Town Development Fund Act and Rules, 2053 (1997). [62] TDF is an autonomous corporate body, but the GoN may issue orders or directives to the TDF, which TDF must obey.

The purpose of TDF is to strengthen the technical, managerial and financial capabilities of the municipalities and urbanizing VDCs for the formulation, implementation and operations and maintenance of their urban development projects and programs.

According to the TDF Act, the main objectives of TDF are:

- To provide financial and technical support to the institutions related to town development
- To conduct works necessary to keep towns neat and clean
- To conduct revenue generating and basic social infrastructure projects

[62] http://www.tdf.org.np/new/custom/uploads/notice/5526.pdf.

- To conduct objective research on solutions to problems related to the development of towns

TDF can serve clients ranging from municipalities and urbanizing VDCs to other institutions related to urban development such as Town Development Committees (TDCs), Development Authorities, Boards, Corporations, and NGOs and CBOs. To date, it has worked exclusively with urban local governments.[63]

b. TDF's financial operations

The TDF Act empowers the organization to mobilize loans and grants from the GoN and non-governmental organizations and national and international financial institutions.[64] Mobilizing funds can include issuing bonds or debentures or participating in consortia with other financial institutions.

TDF can act as a lender, loan fund manager and a grant fund manager for funds that it receives from the GoN or donors. The TDF Board of Directors has the authority to prepare its financing policy, on the recommendation of its Investment Promotion Committee.

TDF can also make investments in shares, debentures or bonds; receive management fees or interest spread for the mobilization of funds and receive service fees for the provision of technical assistance and consulting services.

TDF has various tools to reduce the risk of its loans and ensure repayment. In its Act and Rules, TDF is given not only the first claim on property if the borrower defaults, but it also has other security mechanisms available to it, including:

- Intercepting central government transfers to municipalities (IGFT)
- Requiring collateral
- Escrowing (ring-fencing) local revenues, either those produced by the project being financed or other sources
- Exercising step-in rights

The TDF Act is broad-ranging and was written in such a way to provide significant scope and flexibility to the organization. It has served the organization well to date, although the organization has not taken advantage of all the options available to it under the Act.

c. Financing received by TDF

Since being established in 1989, TDF has received loans and grants from the GoN, often originating from international donor projects. The German government has been a particularly steadfast partner, providing financial and technical support since its inception via the German Development Bank--KFW and German Technical Institution–GIZ. Other donor support has come from the Asian Development Bank and the World Bank. Table 19 shows funds received to date and projected funding of TDF.

---

[63] TDF may not be able to lend to the newly-created States unless its law is revised.

[64] CSC & Co., Chartered Accountants, 2014, Report on Institutional and Financial Assessment of TDF, Kathmandu.

Table 19: Past, Current and Projected Funding for TDF, 1989-2016

	Date	Cur-rency	Original Amount in Other Currency	Original Amount in NPR	Amount Drawn Down as of 16 July 2015	Cancellations	Balance Remaining (To be Completed)
GTZ/GIZ/KFW							
GTZ Soft loan	1989-96	NPR		NPR13,460,000	NPR13,460,000		NPR 0
KfW (60:40 Loan: grant)	1996-2000	NPR		NPR323,790,000	NPR323,790,000		NPR 0
TDP I	2000-2009	Euro	€ 7,904,812		€ 5,410,273.89		€ 2,494,538.17
TDP II							
TDP III (75:25 Loan Grant Ratio)	2010-2014		€ 7,500,000		€ 2,395,930.81		€ 5,104,069.19
WB/IDA							
WB/IDA	1989			NPR147,000,000	NPR124,000,000	NPR23,000,000	NPR 0
UGDP/ETP Loan	27/2/2012	USD	$ 13,750,000	NPR368,980,000	NPR190,312,000	$ 6,550,000	
UGDP/ETP Grant	2011	USD	$ 1,250,000	NPR371,150,000	NPR13,171,100		
GPOBA Grant		USD	$ 4,288,381	NPR428,000,000	NPR42,500,000		
ADB							
STIUEIP		SDR	8,700,000	NPR907,000,000	NPR575,757,000		NPR331,243,000
UEIP		SDR	2,562,000		NPR157,895,978		
IUDP		SDR	12,000,000		NPR101,300,000		
STWSSSP II		USD	17,000,000	NPR1,700,000,000	NPR1,541,400,000		NPR158,600,000
STWSSSP III		USD	18,000,000	NPR1,800,000,000			
KSUTP Loan		USD	3,040,000	NPR304,000,000			
KSUTP Grant		USD	760,000	NPR76,000,000			

Sources: Town Development Fund, Business Plan: FY 2070/71- 2073/74; Town Development Plan FY 2073/74--2076/77; and Independent Auditor's Report to the Board of Directors of Town Development Fund (TDF), as at Ashadh 31, 2072 (July 16, 2015).

d. Balancing Donor and Borrower Interests

In accepting donor funds, TDF takes on responsibilities associated with the respective program. These include the services typical of MDFs managing donor projects.

- Serving as a financial intermediary for grant and loan funds
- Assisting with project preparation
- Providing technical assistance and training
- Loan servicing
- Managing other aspects of donor programs including coordination with other project implementers, specifically line ministries

The donor lines of credit have specific purposes. They target a sector (e.g. water and sanitation), a predetermined group of municipalities and even particular investment projects. While most include some combination of loan and grant funds (both of which TDF distributes), the policies, terms and conditions on this support vary among programs.

The obligation of TDF to repay donor funds also varies from one source to another. In some cases, TDF is obliged to repay the loan to MoF for subsequent repayment to the donor. In other cases, funds are provided as a grant, or loans are forgiven and therefore converted to grants.

e. TDF's Performance to Date

The performance of TDF in delivering donor projects has been mixed. The disbursement rate of most donor projects is slow. For example, the KfW projects TDP II and TDP III, which originally were to end in 2009 and 2014, respectively, were extended until December 2017.

Repayment of TDF loan was also poor in the past (below 71 percent in July 2011). In July 2014, all repayments from the World Bank IDA project were overdue, as were 27 percent of the ADB Small Town Water Supply I project repayments and 16 percent of KFW II project repayments, for total arrears of NPR 286,582,616.[65] TDF has significantly reduced these balances; 2015/16 collections were 101 percent of what was due.

TDF identifies the following reasons for its underperformance in the delivery of donor projects.

- TDF is not always the implementing agency but relies on other government departments (WB and ADB loans)
- Some loan terms are difficult for municipalities to absorb without extensive technical support (KfW)
- Municipal project preparation and implementation capacity is very weak
- Local authorities have no elected representatives, which reduces accountability and urgency in project implementation
- For some donor projects, municipalities are selected based on criteria of the project sponsor, rather than on criteria such as local interest, demand for services and willingness to pay

User's assessment. During consultations conducted while preparing this report, SNGs offered a range of opinions about TDF's performance. Those consulted expressed the following concerns.

- Slow response times
- Limited assistance with loan/project preparation
- No TDF presence on the ground in municipalities
- Unpredictable timing of disbursements
- Concerns about the criteria by which TDF allocates grant funds and whether they should even be doing this
- Onerous requirements, sometimes seeming arbitrary
- Problems with the attitudes of TDF staff and their way of doing business because they have a monopoly, rather than issues with capacity (although some questioned the loan appraisal capacity)
- Existing level of funding available in TDF is insufficient

Borrowers suggested various solutions to these problems.

- Need for more accountability, including TDF branches at state level or for state loan funds
- Need for stakeholder representation on TDF Board, possibly through representation from local government associations
- Need for revisions to TDF governance structure if states will have access to TDF financing

Financial performance. Table 20 shows key financial performance indicators (KPIs) of TDF. The KPIs show that in the past two years, TDF's total income, and the percentage of its income attributable to lending activities (operating income) have both increased nearly 100 percent. TDF's expenses were increasing disproportionately to its income, but they have declined in the past year, thereby producing a net profit in FY 2015/16 of more than NPR 146 million. At the same time, net disbursement of loans (a predictor of future profitability) exceeded NPR 1 billion for the first time in 2015/16, an increase of more than 50 percent over 2013/14.

---

[65] CSC & Co., Chartered Accountants, 2014, Report on Institutional and Financial Assessment of TDF.

Financial results have improved as a result of several factors. Implementation of the Business Plan (See Section g. below) has cut costs and reduced arrears. Loan disbursement has accelerated, which has increased fee and interest income. The Board of Directors also implemented several budgetary recommendations in the "Institutional and Financial Assessment of TDF" prepared by CSC & Co. Chartered Accountants in 2014. (See Section h, below.)

f. Business Reorganization Action Plan

Since 2010, TDF, the GoN and donors have considered the future of TDF and supported a major reorganization and institutional strengthening process. The agreements reached were documented in the Business Reorganization Action Plan (BRAP). The MoF, Ministry of Physical Planning and Works, Ministry of Local Development (now MoFALD), and the TDF Board all supported the institutional strengthening process.

The organizations considered two options for TDF's future: (i) focusing on retailing donor finance (i.e. managing donor projects) or (ii) becoming a "lender of relevance." The second option would move TDF in the direction of becoming a financial institution, and it was agreed that this the preferable option. The precise form of this financial institution has not been defined.[66]

The BRAP was intended to improve the efficiency and effectiveness of TDF's lending activities and update its management systems so that it could eventually raise its own financing, assist its municipal clients to do so or both.

g. TDF Business Plan

Based on the BRAP, TDF is implementing a Business Plan, which is a long-term roadmap for reaching the objectives set out in the BRAP.[67] Key objectives include:

- Enhancing TDF's financial and management capacity to finance municipal infrastructure and leverage grants with debt
- Establishing a clean delineation between grants and loans
- Approving a universal loan/grant policy and phasing out donor-determined terms
- Allowing TDF to appraise loan proposals based on feasibility, risk, and borrowing capacity
- Implementing an Institutional Development Program

Progress has been made in reaching Business Plan goals, although not on the original schedule.

- The TDF Board approved the Common Loan and Grant Financing Policy, establishing terms and conditions under which TDF will manage donor loan, grant and technical assistance funds.
- TDF has employed the credit enhancement mechanisms granted in the TDA, such as the intercept on IGFTs. As a result, it has improved loan recovery, in some cases collecting arrears that have been past due for years.
- KfW agreed to leave funds recovered from the loans it has financed in TDF as a "Revolving Fund" (RF). As of January 14, 2014, NPR 311 million had accumulated in the RF. From this amount, TDF has so far approved 92 RF loans leveraged by grants from MoF.[68] The TDF Board approved a Revolving Fund Manual to govern its operations under an "open access and criteria-based" approach.

[66] World Bank, 2011, Project Appraisal Document, Urban Governance and Development Program: Emerging Towns Project, Annex 8, Town Development Fund, Current Status, Future Positioning and Short term Actions.

[67] Town Development Fund, [2011], Business Plan: FY 2070/71–2073/74.

[68] CSC & Co., Chartered Accountants, April 2014, Report on Institutional and Financial Assessment of TDF.

h. Other advice provided to TDF

Besides the BRAP, several strategic documents have been prepared by TDF or for TDF to assist in the process of becoming a "lender of relevance."[69] The following table lists and summarizes these documents.

Report	Purpose
Report on Institutional and Financial Assessment of TDF (CSC & Co., Chartered Accountants, April 2014)	Contracted by KfW to review the status of the Business Reorganization Action Plan (BRAP), TDF income and recurrent costs, and operationalization of the Revolving Fund. Its findings include: • TDF was making progress with the reforms included in the BRAP and had approved new business plan, organogram, and Standard Operating Procedures, although at a slower pace than originally planned • Projections in the business plan for disbursement and profits seemed unlikely to be realized • Repayments were being credited to the Revolving Fund but not kept in a separate bank account as intended • TDF was making profits due to interest income from bank deposits rather than income from lending • Overdue loans were significant; ranging from 100 percent to 27% and 16%, depending on the project • KFW loan disbursements were delayed because loan terms (grant/loan mix, interest rates and grace period) were "unfavorable" relative to ADB and World Bank loans
Municipal Finance Framework for the National Urban Development Strategy (NUDS) of Nepal (Khatiwada, *et al*, October 2015)	Specific sections of the MFF report are summarized in Sections IV.A.3 and V.B of this report. MFF sections 5.8 and 7.3 present excellent recommendations regarding the reorientation of TDF into a more market-based organization. These include: • Convert TDF to a financial intermediary institution • Restructure TDF's capital base • Enhance assessment of client's borrowing capacity • Design and enhance tariff system for municipal utilities • Strengthen TDF financial operations • Strengthen TDF borrowing capacity • Develop financing strategies for innovative projects/areas (PPP, etc.)

[69] The Business Plan (including progress report, June 2015), the MFF and the CSC & Co and the Bashyal & Company studies were reviewed in preparing this report.

Report	Purpose
Study Report on Issuing Fixed Income Security (Bond) (Bashyal & Company Pvt. Ltd., September 2016)	The document is a compendium of information on the local debt market and legal framework for debt issuance, and an overview of debt instruments used by local governments in developed countries. Its recommendations include the following: • TDF could issue and or act as a servicer of development bonds raised in the domestic as well as international market and seek income tax exemption on its bond issues • TDF could securitize its bonds basket for various categories of investors and issue different tranches of securities based on investor preferences • The GoN should approve a law that would allow the creation of trustees, since this custodial function is required if the fixed income security market is to develop • The GoN should have clear government guarantee policy and the Loan and Guarantee Act, 2025(1968) should be amended to provide a government guarantee on domestic borrowing too. • After federalization, it will be more feasible to issue revenue-backed development bonds

3. Models for a future intermediary for subnational financing

Two municipal financing organizations that began as MDFs appear to have particular relevance to TDF. These are the Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFS) in the State of Tamil Nadu, India and FINDETER in Columbia.

a. Tamil Nadu Urban Infrastructure Financial Services Limited

TNUIFS is "a Public-Private Partnership in the urban sector."It started out as a simple MDF and is now a Public Limited Company registered under the provisions of the Companies Act, in 1996. It is promoted by the Government of Tamil Nadu with equity participation from banks and financial institutions. The company lists its main functions as:

- Managing trust funds and other funds and acting as managers, consultants, advisors, administrators, attorneys, agents, or representatives of or for any funds; and
- Acting as consultants, financial advisors and investments advisors and rendering consultancy, financial and investment advisory services.

One of its trust funds, the Water and Sanitation Pooled Fund (WSPF), has raised funds in the financial markets including through bond issues. TNUIFS identifies both public and private financial institutions as strategic partners.

The WSFP functions in a similar manner to the Revolving Fund envisioned for TDF. The other trust funds are managed on behalf of particular donors or for projects in specific targeted sectors. This fund structure allows TNUIFS to account separately for and manage the profitability of each line of credit, while support the demand for management of donor programs with lending components.

b. FINDETER

FINDETER in Colombia has an entirely different structure than TNUIFS, although it serves similar functions. Its structure and puposes have evolved over time.

One of FINDETER's roles is to serve as a second-tier lender; that is, raising funds from domestic and international sources and channeling them to financial institutions. FINDETER works very closely with public and private financial institutions and other entities who originate loans for infrastructure and environmental projects. Once these loans are originated, FINDETER "discounts" them (in effect buying the loans from these entities) using longer-term funds than are otherwise available in the market. This discounting may cover all or only a part of the loan.

It sources funds for these discounting operations from mobilizing deposits from public entities, issuing securities and borrowing from international financial institutions such as the World Bank and Interamerican Development Bank.

FINDETER also establishes trusts and enters into agreements to manage resources transferred by other public entities, and provides services of project structuring and technical and financial consulting. Because of its market operations, FINDETER has received an international credit rating as a financial institution.

c. Other intermediary models

During stakeholder consultations, two other organizations emerged as possible models that could be analyzed, although they may be less relevant than the two organizations mentioned above.

Development Bank of South Africa. The Development Bank of Southern Africa (DBSA) is a South African state-owned enterprise and a leading development finance institution working across the African continent.[70] Established in 1983, its primary purpose is to promote economic development and growth, improve the quality of lives of people and promote regional integration through infrastructure finance and development.

DBSA provides infrastructure project preparation, finance (both debt and equity) and implementation support in selected African markets for municipalities and other public and private sponsors. It focuses on the energy, transport, water and communications sectors while providing targeted support to social sectors such as health, education and housing. Its "investment in development activities" (loans, bonds and equity) amounts to R 77 billion (NPR 573 billion).[71]

DBSA lends and invests both its own capital and that of donors. It recently signed an agreement for a $100 million loan facility with AFD, the French development bank. Like TNUDF, it manages its donor projects under "fund management" arrangements. DBSA is governed by the DBSA Act (No 13 of 1997)[72] and regulated by the Public Finance Management Act of 1999.[73]

Viet Nam Provincial Local Development Investment Funds. As of 2013, Viet Nam had 28 provincial Local Development Investment Funds (LDIFs) mobilizing capital and investing in municipal infrastructure.[74] LDIFs are special finance institutions created at the provincial level. The total charter capital of LDIFs in 2011 was estimated at USD 450 million. LDIFs can mobilize up to six times their charter capital from bond issues or from domestic and foreign official development assistance loans. The top seven LDIFs were investing approximately USD 100 million per year in 2013.

LDIFs have the legal status of a subnational state financial institution, and are commercially oriented entities. They make loans with maturities of up to 15 years, take equity stakes in new companies, or enter into contracts with the private sector.

The first fund, the Ho Chi Minh City Investment Fund for Urban Development, was founded in 1997. In 2001, all provincial governments were given permission to establish LDIFs. The Ministry of

---

[70] DBSA web site: http://www.dbsa.org/EN/Pages/default.aspx.

[71] DBSA Integrated Annual Report, 2016. http://www.dbsa.org/EN/About-Us/Publications/Annual%20Reports/DBSA%20Integrated%20Annual%20Report%202015-16.pdf.

[72] DBSA Act (No 13 of 1997). http://saflii.org/za/legis/num_act/dbosaa1997328/.

[73] Public Finance Management Act , 1999. http://www.saflii.org/za/legis/num_act/pfma1999206.pdf.

[74] World Bank, 2013, *Socialist Republic of Vietnam: Assessment of the financing framework for municipal infrastructure in Vietnam: Final Report*. https://openknowledge.worldbank.org/handle/10986/17568.

Finance coordinates and supervises the LDIFs, and carries out an annual qualification process to ensure the financial, operational and institutional soundness. Many LDIFs have good financial positions, including very low non-performing loan ratios, acceptable profitability and strong balance sheets. LDIFs price their loans at market rates, and maintain annual audited financial statements based on accounting standards.

The LDIFs are governed by Decree No. 37/2013/ND-CP of April 22, 2013, on the Organization and Operation of Local Development Investment Funds.[75]

E. Conclusions: Facilitating Market Access for Subnational Borrowers

Key Question: What is the best vehicle for giving SNGs access to market finance? How should the subnational market development effort be organized?

Market development will entail several interdependent activities. Four activities in particular are identified as vital to establish financial market access for subnational governments. These include:

(i) coordination of the market building process

(ii) establishing the regulatory framework

(iii) providing technical support to borrowers

(iv) facilitating market access

The integrated nature of the work requires a motivated lead agency, which is proposed to be a new Subnational Borrowing Unit that would be housed in the LBFC (or the NNRFC) or the Ministry of Finance. Other lead agencies could also be considered.

There is specific technical assistance needed to facilitate borrowing. The technical assistance for general SNG strengthening and revenue enhancement is extremely important; however, it is distinct from the technical assistance needed to support the borrowing process. Support to the borrowing process includes, first, orientation on the borrowing process, as well as specific legal and technical assistance with the financial transaction.

TDF, the financial intermediary or financial institutions cannot be expected to provide the technical support needed by inexperienced borrowers free of charge. These costs need to be identified and funded from other sources until the market develops. As this occurs, transaction costs will drop and fewer external subsidies will be required.

An intermediary is needed to link SNGs to the market in the medium term. SNGs rarely gain direct market access in developing financial markets. For that reason, countries create market intermediaries that reduce risks and facilitate market access, and numerous models have been tested, including several suggested in the chapter as relevant to Nepal. The public/private working group should undertake the task of evaluating intermediary models and proposing the most suitable approach.

In proposing the functions and structure of the financial intermediary, the following should be considered: the legal framework, the perspectives of financial institutions and SNGs and the available resources to finance and capitalize the intermediary. If the financial intermediary takes on functions other than lending, they should be directly related and not undermine its sustainability.

TDF's extensive experience should be carefully considered. The track record of TDF is considered an asset by some and a liability by others. Whether TDF is converted to the financial intermediary, or is replaced by or merged into a new one is not an important distinction. Any of these paths could be

---

[75] Decree No. 37/2013/ND-CP of April 22, 2013, on the organization and operation of local development investment funds, http://hethongphapluatvietnam.com/decree-no-37-2013-nd-cp-of-april-22-2013-on-the-amendments-to-the-government-39-s-decree-no-138-2007-nd-cp-dated-august-28-2007-on-the-organization-and-operation-of-local-development-investment-funds.html

followed, once the purposes of the intermediary are clear and its feasibility is demonstrated. However, TDF's experience must be taken into consideration in evaluating intermediary options. These include:

- *Challenges of MDFs.* TDF has encountered the same challenges as most MDFs, including the donor demands, inexperienced clients, and the fact that while viewed as a lending institution by borrowers, it is not organized as such and in fact, serves several conflicting roles.
- *Borrower discipline required.* Recently, TDF has undertaken laudable reforms that have improved its balance sheet and financial results, including enforcing loan repayment terms. These improvements must continue, so that TDF reaches the benchmarks in the Business Plan. Borrower discipline must be strictly enforced by any intermediary hoping to access the financial market.
- *Profitability matters.* An intermediary needs a financial strategy that produces net income from every activity it carries out. For many years, TDF has had to use grants and interest on undisbursed funds to subsidize lending-related costs.[76] Managing donor credit programs is a service, not a true lending operation. It should have a financial return and be segregated from "normal" (commercially-oriented) lending.
- *Need to track costs.* TDF has lacked an internal cost accounting system to keep track of staff time and other costs by activity, so that their "profitability" can be determined. Such a system is needed and would help TDF properly price its services and benchmark lending costs against the banking sector. TDF does not have to discontinue offering "non-revenue" services such as training and technical assistance related to borrowing, but it must raise non-reimbursable sources to cover these costs.
- *Loan/grant conflict.* Grants make investment projects more feasible, but grants should be awarded through a process separate from lending, or even by a separate entity. Mixing lending with grant making creates a conflict for TDF and no matter how objective the process may be, borrowers perceive it to be political. Further, borrowers should be encouraged raise grants from various sources, including beneficiaries and the private sector, not just the lender. One objective approach would be to use the donor funds in some standard proportion to match grants raised by the borrower from other sources.

The intermediary does not have to be a bank to operate like one. The intermediary should separately manage and account for its core functions, which are likely to include lending, donor project management and technical support. For its lending, the intermediary should adopt financial reporting standards consistent with those of the financial sector, which might be done in parallel with any other financial reporting requirements it may have. Lending-related activities should also be benchmarked against the financial sector.

The intermediary should avoid using government guarantees as its first line of security if it borrows from banks, since lenders may be unwilling to lend in the future without guarantees. Internal credit enhancements such as reserve funds or intercepts or other lending conditions that lower risk are preferable. The intermediary might consider entering the market by refinancing a pool of seasoned well-performing subnational loans and use the cash flows from the pool as security.

Decide whether the intermediary can create its own competition. If TDF (or the new intermediary) can expand access to credit while imposing "hard credit" (private market) conditions, it will prepare borrowers to access the market. However, private lenders must also be preparing to serve these clients. Some entity needs to be assigned the responsibility to assist the financial sector to develop the supply side of the subnational market. The proposed Subnational Borrowing Unit might do this work, but there is more knowledge of the market in TDF (or the new intermediary).

---

[76] CSC & Co., Chartered Accountants, 2014, Report on Institutional and Financial Assessment of TDF.

To this end, TDF might collaborate with commercial banks or institutional investors to carry out its own lending operations, especially given the fact that TDF has no presence throughout the country, while other financial institutions do. Some options might include: (i) setting up payment systems in banks to collect household payments related to TDF loans, (ii) contracting with banks to prepare loan packages, (iii) co-financing loans with banks, or (iv) (eventually) funding municipal loans originated by banks (the FINDETER model).

Financial institutions should also have access to any advantages available to the intermediary, such as lines of credit or ability to intercept fiscal transfers.

If it is not practical for the intermediary to work with banks, the Subnational Borrowing Unit or the public/private task force should take the lead. To the extent TDF (or the new intermediary) helps to develop the SNG borrowing system, it should be rewarded for doing so.

F. Recommendations: Facilitating Market Access for Subnational Borrowers

The following recommendations reflect the analysis presented in this chapter and the conclusions reached concerning how Nepal could best organize the effort to gain financial market access for SNGs.

	Recommendation	Action Required
21	**Create Subnational Borrowing Unit**	A dedicated group, proposed as the Subnational Borrowing Unit, needs to be assigned responsibility for the activities outlined in this chapter. Activities include coordination of: establishing the regulatory framework, developing technical assistance for borrowers, training banks in subnational borrowing and establishing a financial intermediary (or reforming TDF).
22	**Define purposes and structural options for SN financial intermediary**	Several intermediary models are proposed for consideration. This should be done by the public/private working group and consider the restructuring of TDF as one implementation option.
23	**Develop and implement plan for establishment of new intermediary. Seek investors and eventually receive a credit rating.**	Analyze the feasibility of intermediary options, including role of TDF. Seek investors and other financial commitments to support intermediary
24	**Work with TDF/ new intermediary and banks to develop bankable SN financing models without government guarantee**	The advice given on SNG borrowing also applies to the intermediary. If the market is developed based on guarantees, the underlying risks and perceptions to risk will not be addressed. Therefore other risk mitigation strategies should be utilized.
26	**Partner with banks to expand interaction with and services to SNGs**	TDF should explore how it could partner with commercial banks, institutional investors or both to carry out its lending operations and improve its customer service. Options might include banks conducting loan preparation, co-financing loans or serving a collections function.

Table 20: Key Performance Indicators of TDF, FY 2009-10 to 2014-15 (Figures in NPR)

I	**Change in Income by Type**	**FY 2015-16**	**FY 2014-15**	**FY 2013-14**	**FY 2012-13**	**FY 2011-12**	**FY 2010-11**	**FY 2009-10**
	Operating Income	190,605,737	145,938,704	107,246,223	83,225,142	80,876,129	75,595,597	70,279,448
	Non-operating Income	136,685,291	89,998,123	77,038,252	57,728,408	62,233,043	43,587,276	16,120,105
	Total Income	**327,291,029**	**235,936,827**	**184,284,475**	**140,953,550**	**143,109,172**	**119,182,873**	**86,399,553**
	Percentage of operating income to total income	*58.24%*	*61.85%*	*58.20%*	*59.04%*	*56.51%*	*63.43%*	*81.34%*
	Percentage of non-operating income to total income	*41.76%*	*38.15%*	*41.80%*	*40.96%*	*43.49%*	*36.57%*	*18.66%*
II	**Change in Total Expenses**	**FY 2015-16**	**FY 2014-15**	**FY 2013-14**	**FY 2012-13**	**FY 2011-12**	**FY 2010-11**	**FY 2009-10**
	Total Expenses	**139,175,999**	**179,583,661**	**96,260,925**	**79,260,789**	**82,337,908**	**96,950,341**	**69,793,466**
	Change in Total Expenses	*-22.50%*	*86.56%*	*21.45%*	*-3.74%*	*-15.07%*	*38.91%*	*23.99%*
III	**Change in Net Profit**	**FY 2015-16**	**FY 2014-15**	**FY 2013-14**	**FY 2012-13**	**FY 2011-12**	**FY 2010-11**	**FY 2009-10**
	Net Profit	**146,260,049**	**33,438,054**	**65,438,657**	**41,285,547**	**40,541,234**	**14,383,940**	**2,166,577**
	Change in Net profit	*337.41%*	*-48.90%*	*58.50%*	*1.84%*	*181.85%*	*563.90%*	*-79.43%*
IV	**Change in Outstanding Loan portfolio**	**FY 2015-16**	**FY 2014-15**	**FY 2013-14**	**FY 2012-13**	**FY 2011-12**	**FY 2010-11**	**FY 2009-10**
	Loan outstanding as at year end	4,293,820,879	3,201,955,761	2,260,842,659	1,579,222,539	1,279,505,012	1,220,878,381	1,125,061,048
	Change in Loans outstanding (net disbursements)	**1,091,865,118**	**941,113,102**	**681,620,120**	**299,717,527**	**58,626,631**	**95,817,333**	**51,598,592**
	Change in outstanding Loan portfolio	*34.10%*	*41.63%*	*43.16%*	*23.42%*	*4.80%*	*8.52%*	*4.81%*
V	**Recurring Expense Relative to Income**	**FY 2015-16**	**FY 2014-15**	**FY 2013-14**	**FY 2012-13**	**FY 2011-12**	**FY 2010-11**	**FY 2009-10**
	Total Recurring Expenses	**46,869,387**	**70,583,708**	**57,642,780**	**44,903,841**	**43,863,699**	**30,529,201**	**18,352,971**
	% of recurring expense to Total income	*14.32%*	*29.92%*	*31.28%*	*31.86%*	*30.65%*	*25.62%*	*21.24%*
	% of recurring expense to Operating income	*24.59%*	*48.37%*	*53.75%*	*53.95%*	*54.24%*	*40.38%*	*26.11%*
VI	**Recurring Expense Relative to Disbursement**	**FY 2015-16**	**FY 2014-15**	**FY 2013-14**	**FY 2012-13**	**FY 2011-12**	**FY 2010-11**	**FY 2009-10**
	Disbursement to clients	**1,074,933,485**	**1,026,754,724**	**865,695,460**	**415,570,000**	**226,360,000**	**146,700,000**	**140,330,000**
	% of recurring expense to disbursement	*4.36%*	*6.87%*	*6.66%*	*10.81%*	*19.38%*	*20.81%*	*13.08%*

Sources: CSC & Co., Chartered Accountants, 2014, Report on Institutional and Financial Assessment of TDF and TDF Audited Financial Statements, 2014/15 and 2015/16.

VIII. RECOMMENDATIONS AND WORK PLAN FOR SUBNATIONAL BORROWING

A. Final Observations

Nepal needs to make an enormous investment in local infrastructure in the next ten years. The country is urbanizing, expectations of citizens are rising and the country has established the goal of becoming a middle-income country by 2020. Meanwhile, the impact of underinvestment is everywhere – in traffic congestion, inadequate services and substandard environmental conditions.

Public funding is not likely to be sufficient for addressing these investments needs in the long term. In addition, as the responsibility for public investment is shifting to the local level under the federal system, SNGs are seeking more autonomy in making investment decisions. Therefore, a consensus is developing that it is time to begin establishing a market-based credit system for subnational borrowers that can leverage public funds.

Neither the subnational sector nor the financial sector is prepared today for a rules-based subnational financing system. Significant work is needed to strengthen both sectors and to establish the regulatory framework for subnational borrowing. Yet, the timing may be right to engage in this process. The federalization process is underway, local elections are about to be held and key stakeholders are committed to the task. The financial sector is growing and diversifying, savings are increasing as both financial inclusion and formal employment expand, and numerous reforms are underway.

Credit will not be an appropriate form of financing for all SNGs in the medium term. Borrowing needs to be part of a larger fiscal decentralization strategy that encourages bankable SNGs to borrow but provides other means of financing for those that cannot.

One of the foundations of fiscal decentralization must be transparency, and in particular, the improvement of subnational PFM. Improving PFMMM will have many side benefits, even for local governments that are unlikely to borrow.

Accountability between citizens and the local government and between local governments and the market are also necessary for subnational borrowing to succeed. Therefore, with local elections and the launch of the federalization process underway, the conditions are being put in place to begin developing a sustainable, market-based subnational borrowing system.

B. Recommendations

Each major chapter of the report includes analysis and concluding remarks that explain the reasoning behind that chapter's recommendations. These recommendations are also consolidated below.

A work plan follows the list of recommendations that shows how the recommended actions can be staged in three phases over the next several years. The work plan also shows which agency or agencies could take responsibility for these actions and the outcomes that should be expected.

Strengthen the Policy and Legal Framework for Subnational Borrowing

	Recommendation	Action Required
1	**Approve fiscal federalism framework that incorporates option for borrowing**	Approve a fiscal decentralization strategy or policy and a fiscal decentralization law to support the federalization process that addresses revenues, expenditures, fiscal transfers, and borrowing.
2	**Evaluate options for control of subnational borrowing**	Establish borrowing limits and other controls and procedures for workouts, should they be necessary.
3	**Draft and approve subnational borrowing law and regulations**	Appoint a regulatory body for subnational borrowing and adopt regulations that address both the public finance and private market aspects of subnational borrowing. Ensure the laws governing lending and borrowing are mutually consistent.
4	**Update financial sector regulations**	Review financial sector regulations and remove any impediments to banks lending to or conducting other business with SNGs while defining prudential rules for financial institution lending to SNGs.
5	**Draft and approve new SN accounting norms and standards consistent with IPSAS**	Establish subnational accounting norms and standards that require accrual accounting and reflect international accounting standards. Require existing systems be updated to reflect the standards.
6	**Develop prototype accounting software and guidelines and approval process for DP and 3rd-party accounting software designs**	Develop a prototype accounting system for small SNGs. Establish a review process to ensure compliance of accounting systems being financed by DPs. Establish a review process for systems being procured by SNGs from the private sector.

Strengthen Subnational Government Demand for Financing and Capacity to Borrow

	Recommendation	Action Required
7	**Develop tools and systems to build SN capacity**	To prepare SNGs to borrow, provide expanded technical assistance directed at financial strengthening, capital investment planning, project preparation and project management
8	**Select pilot SN borrower group**	Choose a group of SNGs through a competitive process who are committed to becoming creditworthy and provide them sustained technical assistance, training and accompaniment.
9	**Expand financial model prepared for MFF to forecast SN financing needs**	Further develop the approach used in the MFF to model the financing needs of SNGs based on assumptions about source of financing and delivery capacity, and advice provided in the report.
10	**Consolidate PPP experience to date. Introduce new PPP models.**	Facilitate the replication of successful PPP models through documentation, dissemination of information and technical support. Identify and disseminate new uses of PPP model.
11	**Support joint service provision.**	Ensure the new fiscal federalism framework allow for joint service provision and develop the legal and regulatory instruments that will allow it to be operationalized

	Recommendation	Action Required
12	**Engage university sector to develop new curriculum on SN finance, establish technical center**	Academic institutions should be engaged to design courses and curricula in subnational finance. The decentralization process needs a new generation of educated SNG staff and consultants who see subnational financial management as a viable career. Discuss creation of technical center on subnational finance.
13	**Establish network or association to professionalize field of SN financial management**	Establish a mechanism (network or association) that will allow SNG finance staff to share their knowledge and experience and eventually to develop professional credentials and training standards related to SNG financial management.
14	**Support implementation of new accounting norms. Strengthen subnational PFM.**	The GoN should urgently define subnational accounting norms and standards that are consistent with international practice, as shown in the subnational PEF. Require SNG to adjust any existing systems that do not comply and require DPs to conform to norms and standards. Significant financial resources are required to upgrade financial management and financial systems throughout the subnational sector.
15	**Strengthen SN revenue through improved information, systems and capacity building**	Borrowing will only be possible if SNGs have sufficient revenues. In establishing the fiscal decentralization framework, give more flexibility to SNGs to set taxes and user fees, at least for the larger SNGs. Put more focus on tax efficiency rather than the composition of revenues, in order to identify whether revenue sources can cover costs and are being properly collected.
16	**Develop mandatory training program for SNGs preparing to borrow**	Borrowers should be schooled in the preconditions and procedures involved in borrowing before beginning the borrowing process. Once developed, the training program could be a condition of borrowing from TDF or other sources.

Build the Supply Side of Subnational Borrowing System

	Recommendations	Action Required
17	**Support financial market strengthening**	The GoN should continue to address systemic weaknesses in the capital and financial markets while prioritizing the goal of giving market access to SNGs.
18	**Pilot borrowers borrow through non-traditional lenders or from market**	Work with traditional and non-traditional lenders to identify avenues for financing.
19	**Establish public-private working group**	Create a working group between the public sector and interested private-sector stakeholders, especially those in the financial sector, to work on the development of the subnational financing system.
20	**Begin work on credit rating criteria and procedures, starting with self-assessment tool**	Engage the credit rating agencies in a dialog about the development of a self-assessment tool and eventually of municipal credit criteria and credit rating procedures.

Facilitate Market Access for Subnational Borrowers

	Recommendation	Action Required
21	**Create Subnational Borrowing Unit**	A dedicated group, proposed as the Subnational Borrowing Unit, needs to be assigned responsibility for the activities outlined in this chapter. Activities include coordination of: establishing the regulatory framework, developing technical assistance for borrowers, training banks in subnational borrowing and establishing a financial intermediary (or reforming TDF).
22	**Define purposes and structural options for SN financial intermediary**	Several intermediary models are proposed for consideration. This should be done by the public/private working group and consider the restructuring of TDF as one implementation option.
23	**Develop and implement plan for establishment of new intermediary. Seek investors and eventually receive a credit rating.**	Analyze the feasibility of intermediary options, including role of TDF. Seek investors and other financial commitments to support intermediary
24	**Work with TDF/ new intermediary and banks to develop bankable SN financing models without government guarantee**	The advice given on SNG borrowing also applies to the intermediary. If the market is developed based on guarantees, the underlying risks and perceptions to risk will not be addressed. Therefore other risk mitigation strategies should be utilized.
26	**Partner with banks to expand interaction with and services to SNGs**	TDF should explore how it could partner with commercial banks, institutional investors or both to carry out its lending operations and improve its customer service. Options might include banks conducting loan preparation, co-financing loans or serving a collections function.

C. Work Plan for Subnational Borrowing: Short-term, medium and long-term actions

A work plan for the activities recommended in the report is included in Annex 1.

Once a commitment is made to begin the process of developing a market-based financing system for subnational borrowing in Nepal, many activities can begin immediately. The short-term activities, in particular, do not depend on the federalization process being completed.

This work plan is divided into the same topics as the report (policy and legal framework, strengthening demand, expanding supply and supporting market access). The numbered activities correspond to the numbered recommendations.

It is based on the assumption that the long-term goal is to develop a market-based financing system for those SNGs prepared to access it. However, in the short to medium term TDF or another intermediary will play an important role in supporting market access. Finally, a coordination process is needed to facilitate market development.

The activities in the work plan are organized into three phases:

- Phase 1: Improving enabling conditions (years 1-3)
- Phase 2: SNG strengthening and piloting of financial innovations (years 2-4)
- Phase 3: Scaling up the financing system (year 5 and after).

The work plan should be further refined, and updated on an annual basis as the feasibility of various recommendations are validated, and it becomes clearer how stakeholders are responding and how long various activities will take to implement.

Annexes

Annex 1. Work Plan of Short-term, Medium-term and Long-term Activities to Develop Subnational Borrowing System

Annex 2. Stakeholders Interviewed and Participants in Consultation Events

Annex 3. Municipal MC/PM Data and TDF Loan Repayment Performance from Assessment of 16 Municipalities

Annex 4. Bibliography

Annex 5. Profiles of 16 Municipalities Assessed for the Report (separate document)

Annex 1: Work Plan of Short-term, Medium-term and Long-term Activities to Develop Subnational Borrowing System

	Activity	Responsible / Supporting Agencies	Outputs	*Enabling Conditions*				*Scaling Up the Financing System*			
					SNG Strengthening						
				2017	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**Future**
	Strengthen the Policy and Legal Framework for Subnational Borrowing										
**	Hold local elections	GoN	Elected officials in place								
1	Approve fiscal federalism framework that incorporates option for borrowing	MoFALD, MoUD, LBFC/NNRFC, MoF, MuAN	Fiscal federalism framework with four pillars								
2	Evaluate options for control of SN borrowing; monitor results	MoFALD, MoUD, MoF, MuAN	Regulation on control of borrowing								
3	Draft and approve SN borrowing law and regulations	MoFALD, MoUD, MoF, MuAN	Subnational borrowing law and regulations								
4	Update financial sector regulations	MOF, MoUD, MoFALD	Proposed modifications to laws and regulations								
5	Draft and approve new SN accounting norms and standards consistent with IPSAS.	Accounting Standards Board, FCGO, MoF	Subnational norms and standards								
6	Develop prototype software. Establish guidelines and approval process for DP and 3rd-party accounting systems	MoF, FCGO, Private sector, MuAN	Model SN accounting software. Standards and procedures for private sector software development								

	Activity	Responsible / Supporting Agencies	Outputs	*Enabling Conditions*			*SNG Strengthening*	*Scaling Up the Financing System*			
				2017	2018	2019	2020	2021	2022	2023	Future
	Strengthen Demand for Financing and Capacity to Borrow										
7	Develop tools and systems to build SN capacity	MoUD, MoFALD, DPs, TDF, MuAN	Tools and systems								
8	Select SN pilot borrower group	Self-selection led by MoUD and MoFALD, SNGs, MuAN	Pilot group								
9	Expand financial model prepared for MFF to forecast SN financing needs	MoFALD MoUD, TDF	Financial model to help forecast financing needs								
10	Consolidate and expand PPP experience. Introduce new PPP models.	MoFALD, MOUD, TDF, DPs, NPC, SNGs	PPP tools and project standards								
11	Support joint service provision	MoFALD, MOUD, TDF, DPs, NPC, SNGs	Expansion of PPPs								
12	Engage university sector to develop new curriculum on SN finance, establish technical center	MoUD, MoFALD, MOF, MuAN	University curriculum, research and innovation								
13	Establish network or association to professionalize field of SN financial management	MoFALD, MoUD, MoF, MuAN	Network established and active								
14	Support implementation of new accounting norms. Strengthen subnational PFM.	MoFALD, MoUD, MoF, MuAN	Guides, manuals, training, technical assistance on-site								

Activity		Responsible / Supporting Agencies	Outputs	Enabling Conditions				Scaling Up the Financing System			
					SNG Strengthening						
				2017	2018	2019	2020	2021	2022	2023	Future
15	Strengthen SN revenue through improved information and capacity building	MoUD, MoFALD, TDF, SNGs	Increased own-source revenues								
16	Develop mandatory training program for SNGs preparing to borrow	TDF, MoUD, SNGs	Better-prepared SNGS. More feasible and bankable projects								
	Build the Supply Side of Subnational Borrowing System										
18	Pilot borrowers borrow through non-traditional lenders or from market	TDF/ new intermediary, task force, SNGs	Direct borrowing from market								
19	Establish public-private working group	TDF, financial sector, MoUD, MoF, MoFALD, MuAN, selected DPs	Working group formed and active								
20	Begin work on credit rating criteria and procedures, starting with self-assessment tool	Credit rating agencies, Task Force	Municipal ratings criteria and procedures								
	Facilitate Market Access for Subnational Borrowers										
21	Create Subnational Borrowing Unit to coordinate SN market development; support drafting of rules, procedures and tools	MoFALD, MoUD, MoF,	Regulatory framework defined; regulatory entity operational								
22	Define purposes and structural options for SN financial intermediary	Task force	Comparative analysis								

Activity		**Responsible / Supporting Agencies**	Outputs	*Enabling Conditions*				*Scaling Up the Financing System*			
					SNG Strengthening						
				2017	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**Future**
23.1	Develop and implement plan for establishment of new intermediary	Task force	Intermediary business plan								
23.2	Seek investors and other financial commitments to support intermediary	MoUD, MoF	Financial commitments								
23.3	Intermediary receives credit rating	Credit rating agencies	Credit rating								
24	Work with TDF/ new intermediary and banks to develop bankable SN financing models without government guarantee	Task force	Bankable SN projects								
25	Partner with banks to expand interaction with and services to SNGs	Task force	Market funding mobilized for SN lending								

Annex 2: Stakeholders Interviewed and Participants in Consultation Events

Last	First	Middle	Title	Organization	Phone	Phone	Email
Acharay	Meghnath		Revenue Section Chief	Byas Municipality			
Acharya	Bharat	Kumar	Senior Engineer , Planning Section Chief	Bharatpur Sub-Metropolitan City			acharyabharat2013@gmail.com
Acharya	Krishna	Pd.	CEO	Employee Provident Fund			krishna.acharya@epfnepal.com.np
Adhikari	Kedar	Bahadur	Secretary	Ministry of Federal Affairs and Local Development			
Adhikari	Krishna	Bdr.	Manager, Engineers	Hetauda Sub-Metropolitan City	*		krishnabadhikari@gmail.com
Adhikari	Ms.Sita		Account Section Chief	Bharatpur Sub-Metropolitan City	*		adsika33@gmail.com
Air	Himalaya	Singh	Engineer	Bhimdatta Municipality	*		eshimair@gmail.com
Aryal	Dol	Raj	Planning Admin. Officer	Butwal Sub-Metropolitan City			
Aryal	Gopal		Under Secretary	Ministry of Federal Affairs and Local Development			gparyall@hotmail.com
Aryal	Ram	Prasad	Revenue Section Chief	Butwal Sub-Metropolitan City			
Aryal	Ramesh		Under Secretary	Ministry of Federal Affairs and Local Development			rmsaryal79@gmail.com
Atreya	Binod		Executive Director	Emerging Nepal, Ltd.		(977) 98510 56122	binodatreya@hotmail.com
Awasthi	Ganga	Dutta	Former Secretary	Government of Nepal			
B.K.	Ratna		Sub Accountant	Birendranagar Municipality	*		ratnab.k803@gmail.com
Baral	Mahesh		Executive Officer	Bharatpur Sub-Metropolitan City			
Basnet	Mahendra	Bahadur	Administration Section Chief	Damak Municipality			
Basyal	Rukmangat		Planning Section	Butwal Sub-Metropolitan City			
Basyal	Tula	Raj		Ernst and Young,			
Bhaju	Sudip			BEED	-5547424	9851113887	sudip.bhaju@beed.com.np
Bhancan	Bikram		Account Officer	Bhimdatta Municipality	*		bikrambikram111@gmail.com
Bhandari			Internal Auditor	Dhangadhi Sub-Metropolitan City			
Bhatarai			Account Section Chief	Lalitpur Sub-Metropolitan City			
Bhatta	Deej	Raj	Div Engineer, Planning Chief	Dhangadhi Sub-Metropolitan City	*		bhattadeej@yahoo.com

Last	First	Middle	Title	Organization	Phone	Phone	Email
Bhattarai	Tara	Nath	Finance Chief	Citizen Investment Trust	+977-1-4785784, 4785321, 4783799	9841414609	tarabhattarai24@gmail.com
Bhurtel	Shyam		Member	LLRC			shyambhurtel@yahoo.com
Bikram	Mr.		Account Section Chief	Bhimdatta Municipality			
Chandrika	Anil		Program Specialist & Coordinator	Local Governance and Community Development Programme-ll , Development Partners Cell,	+977 016200545 Ext 8007	+977 9801062350	anil.chandrika@undp.org
Chapagain	Mahendra		Finance Section	Hetauda Sub-Metropolitan City			
Chaudhary	Dinesh		Account Section	Janakpur Municipality			
Chaudhary	Lakhan	Lal	Account Officer	Itahari Municipality	*		lakhan61978@gmail.com
Chaurasia	Rajesh	Kumar	Engineer	Birgunj Sub-Metropolitan City	*		dynamicreg@gmail.com
Chaurasiya	Kishor	Prasad	Account Section Chief	Birgunj Sub-Metropolitan City			
Chhetri	Harka	B.	Director	Town Development Fund	(0) +977-1 4493866	-9851086356	tdf@tdf.org.np, pfrm.director@tdf.org.np
Chudal	Samip		ICT	Damak Municipality			
Clancy	Matt		Governance Adviser	UKAID Department for International Development DFID Nepal	+977 1 5542980, Ext. 1201		m-clancy@dfid.gov.uk
Dahal	Bishu		Accountant	Dapcha-Kashikhand Municipality	*		bishnuraj211@gmail.com
Dahal	Dambaru		Executive Officer	Dapcha-Kasikhand Municipality			
Dahal	Kamal	Prasad	Planning Section	Damak Municipality			
Dahal	Manoj		Procurement Section Chief	Itahari Municipality			
Dahal	Tikaram		Revenue Section Chief	Damak Municipality			
Dangi	Dhal	Bd.	Revenue Section Chief	Kohalpur Municipality			
Dangi	Gahendra	Bd.	Executive Officer	Bhimdatta Municipality			
Dawadi	Madhuram		Administrative Officer	Bharatpur Sub-Metropolitan City			madhuramdawadi@hotmail.com
Devkota	Arati		Planning Section chief	Kohalpur Municipality			
Devkota	Kalanidhi		Executive Secretary	Municipal Association of Nepal			kndevkota@gmail.com, muan@ntc.net.np
Dhakal	Dipendra		Revenue Section	Hetauda Sub-Metropolitan City			
Dhakal	Hirdaya	Ram	Revenue Section Chief	Birendranagar Municipality			

Last	First	Middle	Title	Organization	Phone	Phone	Email
Dhungana	Rajkumar			Norwegian Embassy			Raj.Kumar.Dhungana@mfa.no
Dulal	Laxmi		LGCDP Focal Person	Damak Municipality			
Duwadi	Madhu	Ram	Account Officer		*		
Gaire	Kashi	Ram	Executive Officer	Ratnanagar. Muni	*		krgaire@gmail.com
Gautam	Bharat		Finance Section Chief	Damak Municipality			
Gautam	Bishnu	Datta	Under Secretary, MoFALD	Local Body Fiscal Commission			bdgautam@yahoo.com, bdgautam2004@yahoo.com
Gautam	Rudra	Prasad	Senior Engineer Chief of Urban Development Division	Lalitpur Sub-Metropolitan City Office	977-1-5521495 (Office)	9851062110	Rudra_gautam@hotmail.com, grudra5543@gmail.com
Gelal	Nawaraj		Chairpersons	NAVIN			info@navin.org.np
Ghimire	Birat		Planning Section	Bharatpur Sub-Metropolitan City			
Ghimire	Jeevan		Planning Section	Itahari Municipality			
Ghimire	Jiban		Engineers	Itahari Municipality	*		jibanghimire@yahoo.com
Giri	Gita	Maya	Asst Accountant	Damak Municipality	*		gitagiri171@gmail.com
Giri	Rajendra		Chairperson	Kailash Bikas Bank Ltd.	01-4443034, 443213911011 16600111777	9851020091	rajendragiri@kailashbank.com.ra jugiri@gmail.com
Gupta	Shambhu		Procurement Officer	Birgunj Sub-Metropolitan City			
Gurung	Mohan		Account Assistant	Birendranagar Municipality			
Gyawali	Shikshya			BEED			Sujeevshakya@beed.com.np
Hada	Jasmine		Director	KFA	4491414	+977 9802009384	jasmineh@kfaltd.com
Humagai	Mitharam	Ram	Executive Officer	Chandrapur Municipality			
Humblot	Odile		Governance advisor	European Union Delegation			Odile.HUMBLOT@eeas.europa.e u
Jabbar	Abdul		Procurement Section Chief	Janakpur Municipality			
Jaishi	Krishna	P.	Spokesperson	ADDCN			Kjaishi@yahoo.com
Jaiswal	Rakesh	Kumar	Accountant	Birgunj Sub-Metropolitan City	*		bindas.rakesh5@gmail.com
Jha	Kumar	Kant	Planning Officer	Birgunj Sub-Metropolitan City			
Jha	Parmeshwor		Revenue Section Chief	Janakpur Municipality			
Jha	Resta		Executive Chairman & Inst. Development Advisor to TDF	KFA	4491414	+977 9802034075	restaj@kfaltd.com.Website:www. kfaltd.com

Last	First	Middle	Title	Organization	Phone	Phone	Email
Joshi	Pragyan		Programme Officer	UN Capital Development Fund	+ 977 1 5523200, ext. 1041	+977 98511 01805	pragyan.joshi@uncdf.org
Kafle	Sharada	Mohan	Planning Department Chief, Senior Engineer	Pokhara Sub-Metropolitan City	*		smkafle01@yahoo.com
Kandel	Kishor		Sub Engineer	Birendranagar Municipality	*		kishorskt5@gmail.com
Kandel	Resham		Program Manager	Local Governance and Community Development Programme-ll			raysum1980@gmail.com kandelr@lgcdp.gov.np
Kandel	Resham		US/NPM	Local Governance and Community Development Programme-ll	*		
Kandel	Tika		Admin. Section Chief	Bharatpur Sub-Metropolitan City			
Karna	Manoj		Revenue Section Chief	Birgunj Sub-Metropolitan City			
Khanal	Bishnu		Senior Officer	Butwal Sub-Metropolitan City			
Khanal	Gopi		Joint secretary, Municipal Management Division	Ministry of Federal Affairs and Local Development			
Kharel	Lila	Raj	Revenue Section Chief	Bharatpur Sub-Metropolitan City			
Koirala	Ananta	Prasad	Admin Chief	Pokhara Sub-Metropolitan City	*		apkoiralapsmc@gmail.com
Koirala	Nawa	Raj	Finance Manager	Town Development Fund	*		nawaraj.manar@gmail.com
KumarG.C.	Kanchan		Officer & Focal Person	Byas Municipality			
Kunwar	Ramu		Account Assistant	Bhimdatta Municipality			
Kunwar	Toran		Account Chief '	Pokhara Sub-Metropolitan City	*		
Lamichhane	Hem	Raj	Fiscal Decentralization Specialist (FDS).	Local Body Fiscal Commission			hemraj_lamichhane@hotmail.com
Mahargan	Gyanishova		Social Development Section	Lalitpur Sub-Metropolitan City			
Maharjan	Bishnu	Gopal	Planning Officer	Hetauda Sub-Metropolitan City			
Mahat	Maniram	Singh	Executive Director	Town Development Fund	(+977 1)4493866	(+977) 9851089118	ed@tdf.org.np
Mainali	Bidur		General Secretary	Municipal Association of Nepal			
Mainali	Padam	Kumar	JS	Department of Urban Development & Building Construction			pkmainalee@hotmail.com
Mallik	Uma	Shankar	Information Officer	Janakpur Municipality			
Nalbo	Megan		Deputy Director, Democracy and Governance Office	US Agency for International Development			mnalbo@usaid.gov

Last	First	Middle	Title	Organization	Phone	Phone	Email
Nandey	Krishna	Pd.	Executive Officer	Hetauda Sub-Metropolitan City	*		k.p.pandey1965@gmail.com
Nepal	Dharana			DFID			d-nepal@dfid.gov.uk
Nepal	Purushottam		Joint secretary / Member Secretary	Ministry of Federal Affairs & Local Development; Local Body Fiscal Commission	6635827		nepalpuru@yahoo.com
Neupane	Shesraman		ESG	ADDCN			addcn@addcn.org.np
Niraula	Pradip	Kumar	Under Secretary	Ministry of Federal Affairs and Local Development			niraula.pradip@gmail.com
Odigari	Sita		Finance Chief	Bharatpur Sub-Metropolitan City			
Ojha	Dilli	Raj	Senior Admin, Finance Chief	Dhangadhi Sub-Metropolitan City	*		odilli45@yahoo.com
Panday	Bharat	Mani	Executive Officer	LSMC	*		bmpandey@hotmail.com
Pandel	Bhim	Pd.	Engineer	Damak Municipality	*		bhim.saugat@gmail.com
Pandey	Bharat	Mani	Executive Officer	Lalitpur Sub-Metropolitan City Office	-5521587	9851212511	bmpandey@hotmail.com, bharatmp2007@yahoo.com
Pandey	Reshmi	Raj	Joint Secretary and NPD	Local Governance and Community Development Programme-ll			reshmipandey@hotmail.com
Pandit	Menaka		Information Section Chief	Bharatpur Sub-Metropolitan City			
Pangeni	Trilochan		Public Debt Department	Nepal Rastra Bank			tpangeni@nrb.org.np
Paudel	Dor	Mani	President	Municipal Association of Nepal			
Paudel	Prakash		Senior Admin. Officer	Birendranagar Municipality			
Pokharel	Ram	Krishna	Executive Director (CEO)	Citizen Investment Trust	-4784808		ramkrishna@nlk.org.np
Pokhrel	Bimal		Executive Director	NAVIN			info@navin.org.np
Pokhrel	Diwakar		Assistant Director, Public Debt Management Department	Nepal Rastra Bank			pdmissue@nrb.org.np
Pokhrel	Prokshyan		Social Development Section Chief	Itahari Municipality			
Pokhrel	Sanjeev			Deutsche Gesellschaft fur International Zusammenarbeit (GIZ) GmbH			sanjeev.pokharel@giz.de
Pokhrel	Shiva	Raj	Local Governance Specialist	Ministry of Federal Affairs and Local Development			pokhrels@lgcdp.gov.np, shivpokhrel15@gmail.com

Last	First	Middle	Title	Organization	Phone	Phone	Email
Pradhananga	Rajendra		Senior Program Officer, Capacity Development of New Municipalities (CD-Mun)	Deutsche Gesellschaft fur International Zusammenarbeit (GIZ) GmbH	+977 1 4464767	+977 9851082328	rajendra.pradhanangaggiz.de
Puri	Bishnu		Consultant	UN Capital Development Fund	+ 977 1 5523200, ext.		bishnu.puri@uncdf.org
Rai	Bishnu	Dutta	Executive Officer	Itahari Municipality			
Rai	Shukra	Devi	SO	Local Body Fiscal Commission			
Rauniyar	Gautam		Sr. Engineer	Bharatpur Sub-Metropolitan City	*		gautamkomail@yahoo.com
Rawat	Narmada		Account Section	Kohalpur Municipality			
Rayamaijhi	Khim	Badhaur	Under Secretary	Local Body Fiscal Commission			
Regmi	Prakash		Governance Advisor	Swiss Development Cooperation			prakash.regmi@eda.admin.ch
Saha	Nar	Bd.	Revenue Section Chief	Bhimdatta Municipality			
Saha	Riddhiman		Senior Consultant	Ernst and Young			riddhiman.saha@in.ey.com
Sahi	Janak	Bd.	Planning Section chief	Birendranagar Municipality			
Sakya	Dil	Bd.	Revenue Section Chief	Lalitpur Sub-Metropolitan City			
Sapkota	Ram	Kumar	CSO	SB			
Shah	Shiva	Naryan	Senior Officer, Finance Chief	Butwal Sub-Metropolitan City			meromail404@gmail.com
Shakya	Sujeev			BEED	-5547424	9851031977	sujeevshakya beed.com.np
SharanK.C.	Hari			Nepal Rastra Bank -- Banks and Financial Inst. Regulation Dept.			harisharan@nrb.org.np
Sharma	Ajay			Ernst and Young			
Sharma	Dipendra	Nath	Secretary	Ministry of Urban Development			
Sharma	Kedarnath		Joint Secretry	Ministry of Federal Affairs and Local Development			
Sharma	Madhav	Pd.	Executive Officer	Kohalpur Municipality			
Sharma	Shivhari		Revenue Section Chief	Pokhara Sub-Metropolitan City			
Shivakoti	Subhash		Deputy Comptroller	Financial Comptroller General Office			
Shrestha	Kalpana		Under Secretary	Local Body Fiscal Commission			
Shrestha	Prabin		Senior Architect Infrastructure Planner Head, Public Works Division	Lalitpur Sub-Metropolitan City	5526316	9851001447	prabin70@gmail.com

Last	First	Middle	Title	Organization	Phone	Phone	Email
Shrestha	Rachana		Senior Public Management Officer	Asian Development Bank, Nepal Resident Mission	+977 1 4005120		rshrestha@adb.org
Shrestha	Raghu			Local Governance and Community Development Programme-ll DPs' Cell			
Shrestha	Ram	Lal	Executive Officer	Bharatpur Sub-Metropolitan City	*		
Shrestha	Rojesh			BEED			sudip.bhaju@beed.com.np
Shrestha	Suman		Planning Chief	Butwal Sub-Metropolitan City			
Shrestha	Suresh		Engineers ~ Organization	Dapcha-Kashikhand Municipality	*		capspl.suresh45@gmail.com
Shrestha	Surya		Finance Chief	Lalitpur Sub-Metropolitan City			
Singh	Himalaya		Planning Section chief	Bhimdatta Municipality			
Singh	Member		Accountant	Dhangadhi Sub-Metropolitan City			
Subedi	Arjun		Revenue Section Chief	Itahari Municipality			
Subedi	Guru		Under Secretary, Municipal Management Division	Ministry of Federal Affairs and Local Development			
Subedi	Mahesh		Environment Section Chief	Itahari Municipality			
Sunuwar	Nar	Bahadur	Intern	US Agency for International Development			
Tamang	Lilaman		Finance Section	Itahari Municipality			
Tamrakar	Surya		Finance Division Chief	Lalitpur Sub-Metropolitan City			
Thapa	Chandra		SO	Local Body Fiscal Commission			
Thapa	Drona	Bahadur	Procurement Section Chief	Damak Municipality			
Thapa	Prem		Social Development Section Chief	Lalitpur Sub-Metropolitan City			
Thapaliya	Bhanubhakta		IT Officer	Hetauda Sub-Metropolitan City			
Timalsina	Bhim	Prasad	Social Development Division Chief	Hetauda Sub-Metropolitan City			
Tuladhar	Raju		Senior Public Management Specialist (Governance)	Asian Development Bank (ADB), Nepal Resident Mission	97714005120		rajutuladhar@adb.org
Upadhaya	Damodar		Planning Chief	Chandrapur Municipality			
Upadhaya	Parshuram		Specialist	Local Governance and Community Development Programme-ll			

Last	First	Middle	Title	Organization	Phone	Phone	Email
Upadhaya	Shankar	Prasad	Finance Chief	Hetauda Sub-Metropolitan City	*		shankarsirs@gmail.com
Wagle	Gokarna		Accountant/ information Officer	Byas Municipality			
Weir	Gareth		Team Leader-Economic Development Team	UKAID Department for International Development DFID Nepal	+977 1 5542980, Ext. 2020	98010 06196	g-weir@dfid.gov.uk
Yadav	Birendra	Kumar	Planning Section chief	Janakpur Municipality			
Yadav	Ganesh	Prasad	Social Dev. Section Chief	Janakpur Municipality			

* Participant in municipal workshop held in Sauraha, Chitwan, 9-11 February 2017.

Annex 3: Assessment of 16 Municipalities/Minimum Condition and Performance Measures Indicators and TDF Loan Repayment Performance

Municipal Indicator Scores Date Reported: 2015 March (Assessment of FY 2013/2014)	**Bharatpur SMC**	**Bhimdutta**	**Birendranagar**	**Birgunj SMC**	**Butwal SMC**	**Byas**	**Chandrapur**	**Damak**	**Dapcha-Kasikhand**	**Dhangadhi SMC**	**Hetauda SMC**	**Itahari SMC**	**Janakpur SMC**	**Kohalpur**	**Lalitpur SMC**	**Pokhara SMC**
	1	2	3	4	5	6	7	8	9[1]	10	11	12	13	14	15	16
Total Score on All PM Indicators (5 areas / 46 indicators)	**84**	**66**	**81**	**51**	**90**	**73**	**25**	**68**		**76**	**89**	**86**	**45**		**59**	**83**
Performance Measures Grade	**A**	**C**	**A**	**Fail**	**A**	**B**	**Fail**	**C**	**NA**	**B**	**A**	**A**	**Fail**	**NA**	**D**	**A**
Minimum Condition Relevant to Subnational Borrowing																
MC 1: Annual Plan, Budget and its Approval	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass		Pass	Pass	Pass	Pass		Pass	Pass
MC3: Annual and Trimester Progress Report	Pass	Pass	Pass	Pass	Pass	Pass	Fail	Pass		Pass	Pass	Pass	Pass		Pass	Pass
MC 4: Operation of Municipality Accounts Fund	Pass	Pass	Pass	Pass	Pass	Pass	Pass	Pass		Pass	Pass	Pass	Pass		Pass	Pass
MC 5: Recording of Tax and Income sources	Pass	Pass	Pass	Pass	Pass	Pass	Fail	Pass		Pass	Pass	Pass	Pass		Pass	Pass
MC 6: Final Financial Audit and Settlement of Unstated Amount	Pass	Pass	Pass	Pass	Pass	Pass	Fail	Pass		Pass	Pass	Pass	Pass		Pass	Pass
MC 7: Asset Management	Pass	Pass	Pass	Pass	Pass	Pass	Fail	Pass		Pass	Pass	Pass	Pass		Pass	Pass
MC 9: Publication of Details Income and Expenditure and Tax Rates	Pass	Pass	Pass	Pass	Pass	Pass	Fail	Pass		Pass	Pass	Pass	Pass		Pass	Pass
MC 10: Personal Management	Pass	Pass	Pass	Pass	Pass	Pass	Fail	Pass		Pass	Pass	Pass	Pass		Pass	Pass
Performance Measures Relevant to Subnational Borrowing																
PM 1: Participatory Municipal Planning (Max 4)	4	4	4	3	4	4	0	4		4	4	4	4		4	4
PM 3: Expenditure on Targeted Groups (Max 2)	2	2	2	0	2	2	2	2		2	2	2	0		0	2
PM 5: Information Management (Max 4)	4	4	4	4	4	4	2	3		4	4	4	3		2	4
PM 7: Annual/Monthly Physical/Financial Progress Details (Max 2)	2	2	1	2	2	2	1	2		2	2	2	1		1	2
PM 8: Public Hearing (Max 2)	2	2	2	2	2	2	0	2		2	2	2	0		2	2
PM 9: Revenue Feasibility Study and Projections (Max 2)	2	0	2	0	2	0	0	1		2	1	1	0		2	2
PM 10: Actual Income and Expenditure (Max 4)	4	4	4	2	2	4	2	4		4	3	4	2		0	4
PM 11: Management of Revenue Administration (Max 4)	3	3	3	3	4	4	2	4		4	4	4	3		4	4
PM 12: Integrated Property Tax (Max 2)	2	2	2	1	2	2	0	2		2	2	2	0		0	0

[1] New municipalities not participating in MC/PM reporting at this time.

Municipal Indicator Scores Date Reported: 2015 March (Assessment of FY 2013/2014)	**Bharatpur SMC**	**Bhimdutta**	**Birendranagar**	**Birgunj SMC**	**Butwal SMC**	**Byas**	**Chandrapur**	**Damak**	**Dapcha-Kasikhand**	**Dhangadhi SMC**	**Hetauda SMC**	**Itahari SMC**	**Janakpur SMC**	**Kohalpur**	**Lalitpur SMC**	**Pokhara SMC**
	1	2	3	4	5	6	7	8	9[1]	10	11	12	13	14	15	16
PM 13: Public Private Partnership (Max 2)	2	2	2	0	2	0	0	2		2	2	2	2		2	2
PM 14: Following Limitation of Administrative Expenditure (Max 2)	0	0	0	0	0	0	0	0		0	0	0	0		0	0
PM 15: Accrual Accounting System (Max 2)	0	0	0	0	2	0	0	0		0	0	0	0		0	0
PM 19: Local Resources Mobilization (Max 4)	4	0	4	4	3	4	4	0		0	4	4	2		0	0
PM 20: Municipal Periodic Plan (Max 2)	2	0	0	1	1	1	0	1		1	2	2	1		0	0
PM 21: Feasibility Study (Max 2)	2	0	2	0	2	0	0	0		1	1	2	1		0	2
PM 22: Procurement Management (Max 4)	4	4	4	0	4	3	0	4		3	4	4	4		4	4
PM 24: Management of Operation and Maintenance (Max 4)	3	3	0	2	4	2	0	1		2	3	3	2		3	3
PM 25: Transparency in Project Implementation (Max 2)	2	2	0	2	2	1	0	1		2	2	2	1		2	2
PM 26: Monitoring and Evaluation (Max 2)	2	2	0	0	2	2	0	2		2	2	2	0		0	2
PM 28: Job Descriptions of Staff and Monthly Staff Meeting (Max 2)	2	2	2	0	2	2	0	2		2	2	2	0		2	2
PM 29: Service Delivery Management (Max 2)	2	2	2	2	2	2	2	2		2	2	2	2		2	2
Score on PMs Relevant to Subnational Borrowing only	**50**	**40**	**40**	**28**	**50**	**41**	**15**	**39**	**0**	**43**	**48**	**50**	**28**	**0**	**30**	**43**

Source: Local Body Fiscal Commission

TDF Loan Repayment Performance Rating

	Bharatpur SMC	**Bhimdutta**	**Birendranagar**	**Birgunj SMC**	**Butwal SMC**	**Byas**	**Chandrapur**	**Damak**	**Dapcha-Kasikhand**	**Dhangadhi SMC**	**Hetauda SMC**	**Itahari SMC**	**Janakpur SMC**	**Kohalpur**	**Lalitpur SMC**	**Pokhara SMC**
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
TDF Loan Repayment Performance Rating	**3**	**2**	**1**	**2**	**1**	**1**	**NA**	**2**	**NA**	**1**	**2**	**3**	**4**	**NA**	**NA**	**1**

Source: Based on current status of TDF loans and repayment history for last 10 years on scale of 1 (excellent) to 5 (in default) (Information supplied by TDF)

Annex 4: Report Bibliography

Ahmad, Ehtisham, Maria Albino-War and Raju Singh. "Subnational Public Financial Management: Institutions and Macroeconomic Considerations." Chapter 16 in Ehtisham Ahmad and Giorgio Brosio, eds. 2006. Handbook of Fiscal Federalism. http://www.untag-smd.ac.id/files/Perpustakaan_Digital_1/FEDERALISM%20Handbook%20of%20Fiscal%20Federalism.pdf.

Asian Development Bank. 2016. Strengthening Public Management Program, "Subnational Public Expenditure and Financial Accountability Assessment: Final Draft Report," ADB TA 8173, January 2016.

Boex, Jamie. 2016. "Intergovernmental Fiscal Design in the Context of the Federal Constitution of Nepal." Submitted to Ministry of Finance, MoFALD and Ministry of General Administration.

CSC & Co. Chartered Accountants. 2014. "Analysis of the Municipal Accrual Accounting Software (MAAS), Final Report." Commissioned by Subnational Governance Programme, SUNAG (MoFALD – GIZ).

CSC & Co. Chartered Accountants. 2014. "Report on Institutional and Financial Assessment of TDF."

GIZ. 2014. "Forty Years of Nepal German Development Cooperation in Local Governance: Local Bodies Finances and Financing Municipal Infrastructure." (Powerpoint presentation).

Glasser, Matthew D., Thomas H. Cochran, Michael DeAngelis, Marlene Hesketh, Ronald W. Johnson, Christiaan Johannes Kapp, John E. Petersen and K.P.S "Paddy" Roome. 1998. Formulation of a Regulatory Framework for Municipal Borrowing in South Africa: Final Report.
http://siteresources.worldbank.org/INTMF/Resources/339747-1251914038224/4p.pdf.

Government Finance Officers Association (U.S.). "Best Practices: Debt Management Policy."
http://www.gfoa.org/debt-management-policy.

Government of Nepal, Ministry of Urban Development. "Planning Norms and Standards." 2013. Urban Development Division, Physical Planning and Urban Development Section.
http://www.dudbc.gov.np/uploads/default/files/11fc96caa8c2194ab728796d5e9144cd.pdf.

Government of Nepal, National Planning Commission. "Approach Paper of 14th Plan (2016/2017-2018/2019)." pp. 165-168.

Government of Nepal, SEBON. Securities Laws web site. http://sebon.gov.np/securities-laws.

Government of Nepal, Secretariat of Local Bodies Fiscal Commission. 2009. Minimum Condition and Performance Measure Assessment Manual of Municipality, 2009 (2066). (With amendment and Revision).
http://lbfc.gov.np/sites/default/files/unofficial-translation-of-municipality-mcpm-manual-2009.pdf.

Government of Nepal, Secretariat of Local Bodies Fiscal Commission. *An Analysis Report of the Minimum Conditions and Performance Measures of Local Bodies in Nepal, 2015. Assessment Year 2013/14.*

Government of Nepal. Banks and Financial Institutions Act, 2063 (2006).
http://www.mocs.gov.np/uploads/Act%20list%20English/banks-and-financial-institutions-act.pdf.

Government of Nepal. Citizen Investment Trust Act, 2047 (1991).
http://www.lawcommission.gov.np/en/documents/2015/08/citizen-investment-trust-act-2047-1991.pdf.

Government of Nepal. Employee Provident Fund Act, 2019 (1962).
http://www.lawcommission.gov.np/en/documents/2015/08/employee-provident-fund-act-2019-1962.pdf.

Government of Nepal. Local Body Financial Administration Rules, 2064 (2007).
http://www.lawcommission.gov.np/en/documents/2015/08/local-body-financial-administration-rules-2064-2007.pdf.

Government of Nepal. Local Self Governance Regulation, 2056 (1999).
http://www.mofald.gov.np/sites/default/files/Resources/docs_25.pdf.

Government of Nepal. Local Self-Government Act 2056 (1999).
http://www.undp.org/content/dam/nepal/docs/reports/governance/UNDP_NP_Local%20Self-Governance%20Act%201999,%20MoLJ,HMG.pdf.

Government of Nepal. Mutual Fund Rules, 2067.
http://sebon.gov.np/sites/default/files/securities_laws/Mutual_fund_Rules_en_2067.pdf.

Government of Nepal. Nepal Rastra Bank Act, 2058 (2002 and First Amendment, 2063 (2006). https://www.nrb.org.np/lgd/acts_ordinances/nepal_rastra_bank_act_2002_%5Benglish%5D.pdf.

Government of Nepal. Private Financing in Build and Operate of Infrastructures Rules, 2064 (2007). http://www.lawcommission.gov.np/en/documents/2015/08/private-financing-in-build-and-operate-of-infrastructures-rules-2064-2007.pdf.

Government of Nepal. Securities Act, 2007. http://sebon.gov.np/sites/default/files/securities_laws/SecuritiesAct2063.pdf .

Government of Nepal. Securities Businessperson (Merchant Banker) Regulations, 2008. http://sebon.gov.np/sites/default/files/securities_laws/SBMBRegulation2064en.pdf.

Government of Nepal. Securities Central Depository Services Regulation, 2067 (2010). http://www.cdscnp.com/CDSServiceRegulation_en.pdf.

Government of Nepal. Securities Issue Regulation, 2008. http://sebon.gov.np/sites/default/files/securities_laws/SecuritiesIssueRegulationEn.pdf.

Government of Nepal. Stock Exchange Regulation, 2064. http://sebon.gov.np/sites/default/files/securities_laws/StockExRegulation2064en.pdf.

Government of Nepal. Town Development Fund Act, 1997 and Town Development Fund Rules, 1997. http://www.tdf.org.np/new/custom/uploads/notice/5526.pdf.

Gyawali, Hemant, Srijan Aryal and Deependra Pokharel. 2012. Strengthening the Town Development Fund Capacity for Public-Private Partnership. Final Report, Volume 1. Prepared for Town Development Fund, Ministry of Physical Planning and Works. https://www.adb.org/sites/default/files/project-document/73657/44062-012-nep-tacr-01.pdf.

ICRA Nepal web site. http://icranepal.com.

International Monetary Fund. 2009. “Macro Policy Lessons for a Sound Design of Fiscal Decentralization—Background Studies.” IMF Fiscal Affairs Department. https://www.imf.org/external/np/pp/eng/2009/072709.pdf.

International Monetary Fund. November 2015. “IMF Country Report No. 15/317, Nepal. 2015 Article IV Consultation.” Washington, D.C. 20090. https://www.imf.org/external/pubs/ft/scr/2015/cr15317.pdf.

Kelly, Roy. 2011. Stock Taking of Fiscal Decentralization Policies: Consolidated Report. Final Report. http://dukespace.lib.duke.edu/dspace/bitstream/handle/10161/9170/FD%20Stocktaking%20Final%20Report_%20Kelly%202012%20revised.pdf?sequence=1.

Khatiwada, Yuba Raj, Ganga Datta Awasthi, Kapil Dev Ghimire, Khim Lal Devkota, and Pratap P. Pradhan. 2015. Town Development Fund. Municipal Finance Framework for the National Urban Development Strategy: Final Report. http://www.tdf.org.np/new/custom/uploads/notice/5727.pdf.

Ministry of Federal Affairs and Local Development, Ministry of Urban Development and Town Development Fund. 20th December 2016. National Conference on Municipal Finance. http://www.tdf.org.np/new/welcome/content/national-conference-on-municipal-finance-kathmandu.

Ministry of Law, Justice and Parliamentary Affairs. 2015. Constitution Of Nepal 2015, Official Translation. http://www.constitutionnet.org/sites/default/files/nepal_constitution_-_official_translaiton_eng_mljpa.pdf.

Ministry of Physical Planning and Works, Department of Urban Development and Building Construction. 2007. National Urban Policy, 2064 BS.

Ministry of Urban Development. 2015. National Urban Development Strategy. http://moud.gov.np/wp-content/uploads/2017/02/NUDS_cabinet-document_approved-on-2073-10-9.pdf.

Ministry of Urban Development. 2016. Inclusive Cities: Resilient Communities: Nepal National Report. Third United Nations Conference on Housing and Sustainable Urban Development (Habitat III). http://moud.gov.np/?p=536#

Muzzini, Elisa and Gabriela Aparicio. 2013. Urban Growth and Spatial Transition in Nepal: An Initial Assessment. The World Bank: Washington DC. https://openknowledge.worldbank.org/handle/10986/13110.

Nepal Rastra Bank, Public Debt Management Department. “Government Securities and Open Market Operations Statistics as on Magha 29, 2073 (11, February 2017).” https://nrb.org.np/pdm/Reports_OSGS/Ownership_Structure_of_Government_Securities--2073-10(Magh).pdf

Nepal Rastra Bank. 2015. "Bank and Financial Statistics, No. 61." https://nrb.org.np/bfr/statistics/bank_fina_statistics/Banking_and_Financial_Statistics--No_61%20July%202015.pdf.

Nepal Rastra Bank. April 2016. "Bank Supervision Report 2015." Bank Supervision Department. https://nrb.org.np/bsd/reports/Annual_Reports--Annual_Bank_Supervision_Report_2015-new.pdf.

Peterson, George E. 1996. "Using Municipal Development Funds to Build Municipal Credit Markets (Revised)." World Bank. http://siteresources.worldbank.org/INTMF/Resources/339747-1251914038224/77p.pdf.

Rai, Amrit Kumar. 2002. "Possibility of the Establishment of a Municipal Development Bank in Nepal." Prepared for MUAN.

Securities Board of Nepal (SEBON). "Annual Report, 2011-12." http://sebon.gov.np/sites/default/files/publications/AnnualReport1112en.pdf.

Shakya, Sujeev, Sudip Bhaju, Subrina Shrestha, Raju Tuladhar and Shayasta Tuladhar. 2014. Making Inclusion Possible: Nepal Financial Inclusion Country Report. http://map.uncdf.org/sites/default/files/Documents/nepal_synthesis.pdf.

Sharma, Shankar P., T. R. Raghunandan, Khim Lal Devkota. 2015. Government of Nepal, National Fiscal Commission. A Study of Proposed Institutional Arrangement for Intergovernmental Transfer in Nepal (Final Report). Local Bodies Fiscal Commission and Ministry of Federal Affairs and Local Development.

Tamil Nadu Urban Development Fund. Web site. http://www.tnudf.com/.

The Himalayan Times. "MoF finalising draft of financial sector development strategy." March 28, 2016 edition.

The Himalayan Times. 3 December 2016. "Kathmandu to be transformed into 'smart city." https://thehimalayantimes.com/kathmandu/kathmandu-transformed-smart-city.

The Rising Nepal. 11 May 2016. "Seven smart city as per provincial structure." http://therisingnepal.org.np/news/11215.

Town Development Fund. [2011]. "Business Plan: FY 2070/71–2073/74."

Town Development Fund. [2016]. "2016/17-2019/20 Business Plan."

Town Development Fund. 2016. Municipal Finance Framework for the National Urban Development Strategy (NUDS) of Nepal.

Town Development Fund. 2017. "FY 2015/16 Annual Report."

United Nations Development Program. 2005. UNDP Primer: Fiscal Decentralisation and Poverty Reduction. http://www.undp.org/content/undp/en/home/librarypage/poverty-reduction/fiscal-decentralization-and-poverty-reduction/.

United Nations Development Program. Public Private Partnership for Urban Environment (PPPUE) project web site. http://www.np.undp.org/content/nepal/en/home/operations/projects/closed-projects/poverty-reduction/pppue.html.

World Bank. 2011. "Urban Governance and Development Program: Emerging Towns Project, Project Appraisal Document," Annex 8, "Town Development Fund, Current Status, Future Positioning and Short term Actions."

World Bank. 2017. "Program Document for a Proposed Development Policy Credit in the Amount of SDR 70.6 Million (US$100 Million Equivalent) to Nepal for a Third Financial Sector Stability Development Policy Credit, February 2, 2017." http://documents.worldbank.org/curated/en/793331490040216477/pdf/112766-REPLACEMENT-OUO-9.pdf.

World Bank. Doing Business Nepal 2017. Web site. http://www.doingbusiness.org/data/exploreeconomies/nepal.

World Bank. 2013. Socialist Republic of Vietnam: *Assessment of the financing framework for municipal infrastructure in Vietnam: Final Report*. https://openknowledge.worldbank.org/handle/10986/17568.

Annex 5: Profiles of 16 Municipalities Assessed for the Report

[See separate document.]