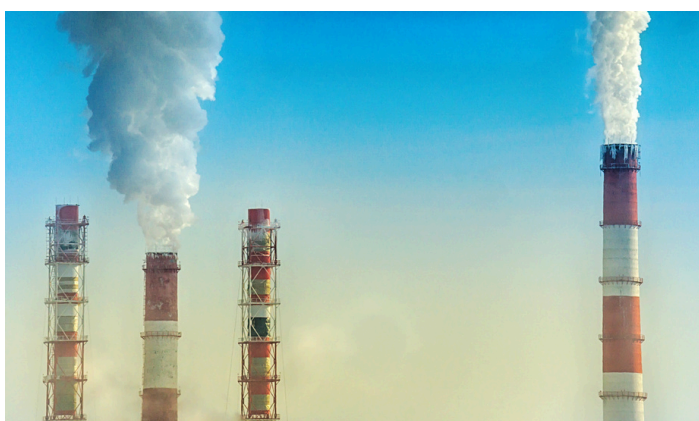


GREEN INSTRUMENTS IN NEPAL

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INTRODUCTION

Sustainable banking involves integrating environmental, social, and governance factors into financial operations and products to promote sustainable development. This approach emphasizes responsible lending and investment practices that focus on environmental conservation and social welfare. Green instruments, such as loans or investment funds for renewable energy projects, are financial products designed to support eco-friendly initiatives. They aim to direct funds toward activities contributing to environmental preservation and climate change mitigation. Together, sustainable banking and green instruments foster a green economy characterized by decreased carbon emissions, improved energy and resource efficiency, and the prevention of biodiversity loss and unsustainable demands on ecosystems.



Green investment opportunities are generally perceived as investments that reduce carbon footprints, greenhouse gas emissions, or depletion of natural capital while enhancing the sustainability of livelihoods. Previous studies in Nepal and other developing countries have developed criteria for identifying green technologies and highlighted promising sectors for green investment (GGGI 2017; Hepburn et al. 2020).

NEPALI CONTEXT

Nepal is in the process of establishing a green finance system, with a focus initially on regulatory measures. In 2018, Nepal introduced the Environmental and Social Risk Management (ESRM) guidelines for Banks and Financial Institutions (BFIs) to ensure these institutions consider environmental and social risks in their operations. In 2020, the Nepal Rastra Bank (NRB) incorporated the ESRM guidelines into its Unified Directives, aligning the financial sector with sustainable practices.

The ESRM guidelines address environmental, social, and climatic risks associated with business activities of BFIs¹. They cover a range of financing types, including SME finance, commercial leasing, and project finance. All BFIs engaging in specified transactions must develop an Environmental and Social Management System (ESMS) compliant with local laws and gradually incorporate international standards. The guidelines also provide tools for risk management and define organizational roles to integrate Environmental and Social (E&S) risk management into credit policy.

Despite these regulatory measures, the focus is primarily on mitigating risks rather than promoting green investment opportunities. The NRB recently released a consultative document called 'Nepal Green Finance Taxonomy'² to provide clearer guidelines for green finance activities. However, the effectiveness of these regulatory measures in promoting green finance remains uncertain, as they do not directly address the demand or profitability of green investments in Nepal.

¹ "Guideline on Environmental & Social Risk Management (ESRM) for Banks and Financial Institutions", NRB, May 2018, https://www.nrb.org.np/contents/uploads/2019/12/2074_75_For_A__B__C_ClassCircular_22Attachment_to_Guideline_on_Environmental__Social_Risk_Management_for_Banks_and_Financial_Institutions_Related.pdf

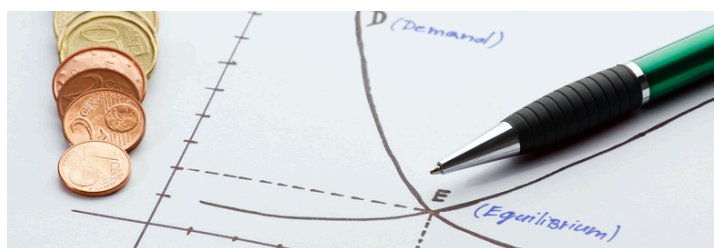
² "Nepal Green Finance Taxonomy", NRB, January, 2024, <https://www.nrb.org.np/contents/uploads/2024/01/Nepal-Green-Finance-Taxonomy-V1.pdf>



DEMAND AND SUPPLY

To support a green transition and growth, financing instruments must be sustainable on both demand and supply sides. On the demand side, businesses and organizations accessing finance must meet their economic viability conditions, meaning green projects should generate adequate returns to repay capital and interest while providing sufficient developmental impact. This developmental impact could include job creation, linkage effects with other sectors, or other criteria that justify government support in addressing market failures.

The financing ecosystem needs to focus on improving firms' productive and technological capabilities to use greener technologies profitably. Simultaneously, there must be efforts to ensure that projects selected for green financing demonstrate sufficient developmental impact to justify policy support. The supply side of financing is better understood, focusing on reducing risks for investors and intermediaries. For instance, DFIs often provide loans to BFIs at rates higher than local deposit rates, making them too expensive for mid-size firms despite providing liquidity to banks. Therefore, it is crucial to balance the supply of finance with measures that address demand-side constraints to create a sustainable green finance ecosystem.



POWER, CAPABILITIES, AND INTERESTS FRAMEWORK

The policy framework for green financing must consider the Power, Capabilities, and Interests of various stakeholders to be effective. Effective policy design requires governance arrangements that enforce high levels of compulsion on supported industries to convert support into productivity growth. This is particularly relevant in developing countries where multiple market failures exist.

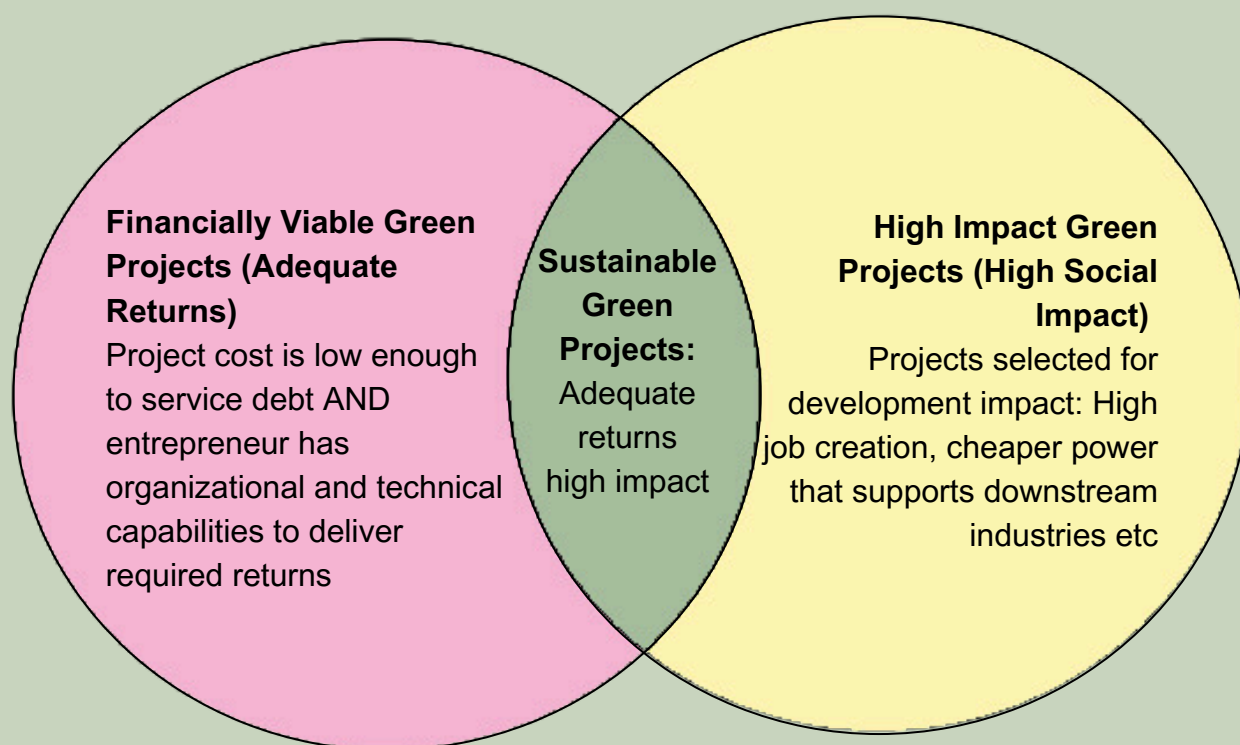
Orthodox supply-side economics is generally opposed to the use of taxes and subsidies to assist firms, arguing that such measures create deadweight welfare losses and rent-seeking behavior. However, effective governance arrangements can mitigate these risks by ensuring that firms that receive support are compelled to deliver improvements in productivity. The Power Capabilities and Interest (PCI) framework suggests designing policies that account for the power, capabilities, and interests of different actors, ensuring no actor can capture resources without delivering results.

Promoting green investments may require public co-financing or other policy or financial support to make investments viable. The implicit cost of this support can be defined as the 'financing gap' needed to make green projects viable. Policies for capability development should aim to 'shift the supply curve out' by trading short-term costs for longer-term gains in productivity and efficiency.

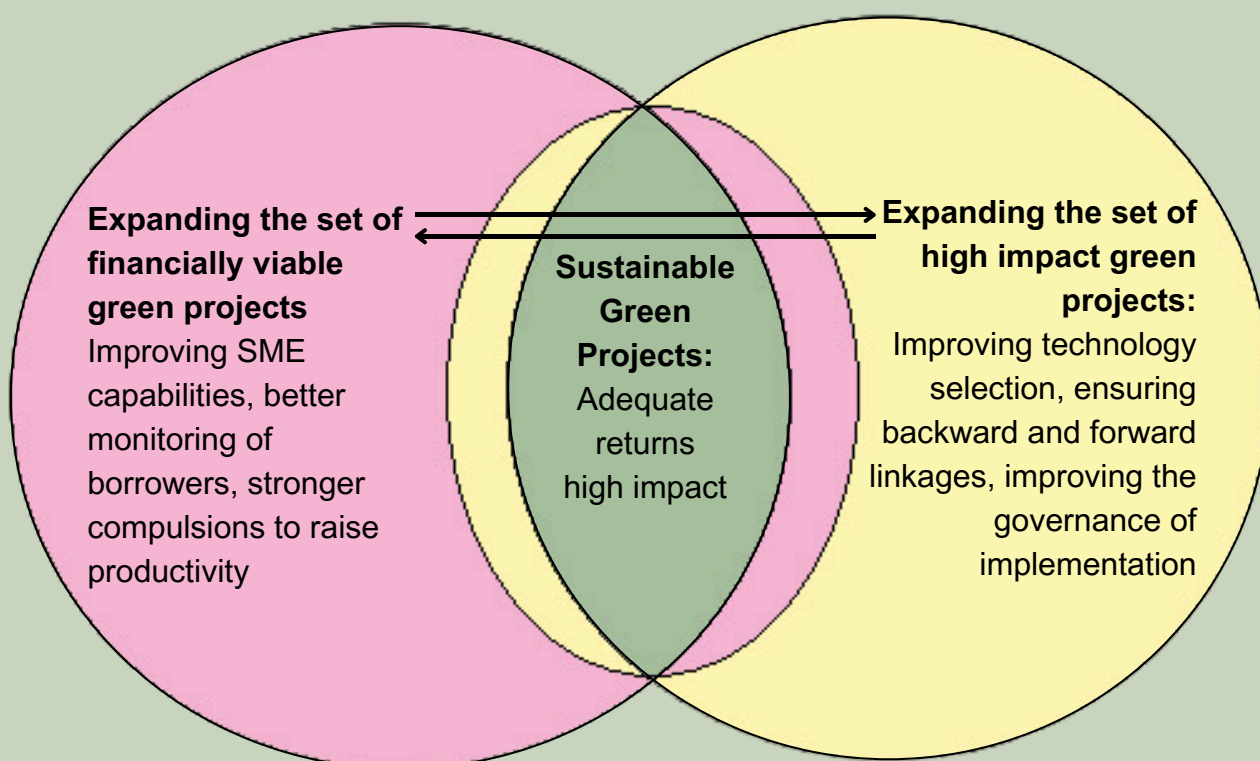
³ Khan, Mushtaq H. and Pallavi Roy 2022. Making Anti-Corruption Real: Using a 'Power Capabilities and Interest Approach' to Stop Wasting Money and Start Making Progress. SOAS-ACE Synthesis Paper No. 1. London: SOAS University of London. <<https://ace.soas.ac.uk/publication/making-anti-corruption-real/>>.

⁴ Khan, Mushtaq H. 2000. Rents, Efficiency and Growth, in Khan, Mushtaq H. and K.S. Jomo (eds) Rents, Rent-Seeking and Economic Development: Theory and Evidence in Asia, pp. 21-69, Cambridge: Cambridge University Press. <<https://eprints.soas.ac.uk/9842/>>. Khan, Mushtaq H. 2013. Technology Policies and Learning with Imperfect Governance, in Stiglitz, Joseph and Justin Yifu Lin (eds) The Industrial Policy Revolution 1. The Role of Government Beyond Ideology, pp. 79-115, London: Palgrave. <<http://eprints.soas.ac.uk/id/eprint/17296>>. Khan, Mushtaq H. 2013. Political Settlements and the Design of Technology Policy, in Stiglitz, Joseph, Justin Yifu Lin and Ebrahim Patel (eds) The Industrial Policy Revolution 2. Africa in the Twenty-First Century, pp. 243-80, London: Palgrave. <<http://eprints.soas.ac.uk/id/eprint/17297>>.

To sustain effective demand for green investments and financing, two conditions must be met, as shown in Figure 1. First, projects and entrepreneurs must be financially viable, providing adequate returns to finance providers and businesses. Second, they must have a developmental impact to ensure continued policy support. In many developing countries, the overlap of these conditions—the "green area"—is small or absent. Thus, building a sustainable green finance ecosystem requires policies that expand the pool of projects and entrepreneurs capable of creating sustainable demand for green financing, as shown in the lower diagram in Figure 1.



Existing set of sustainable green projects may be very small or negligible



Expanding the set of sustainable green projects is essential to maintain a sustainable demand for green financing

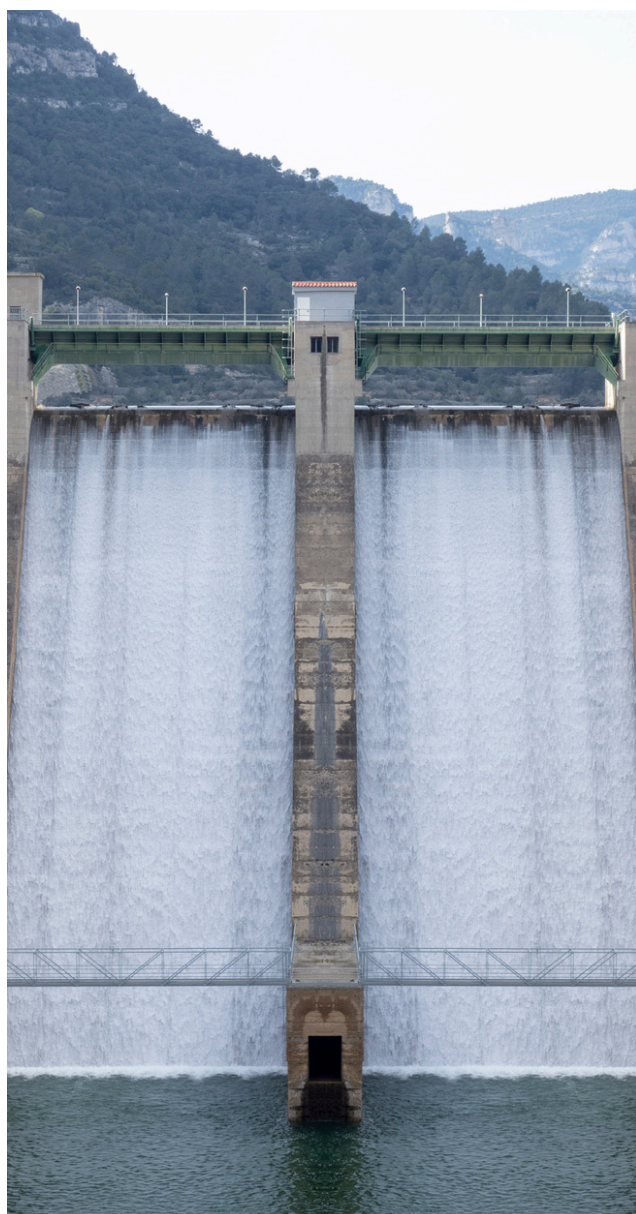
RECOMMENDATIONS

Policy discussions and initiatives to improve the supply side of green finance often focus on technical assistance and strategic partnerships to create a more attractive environment for finance providers and intermediaries. These efforts assume that firms on the demand side are capable of efficiently using funds for green investments, but in many developing countries, such firms may not exist in sufficient numbers. Limited firm capabilities can restrict effective demand for green finance.

A sustainable green financing strategy must address both the supply and demand sides. On the demand side, businesses in developing countries often lack the technical and organizational capabilities to turn green financing into profitable green outcomes. Without upgrading these capabilities, increased green finance supply may only benefit a few high-capability firms, limiting the diffusion of green technologies and potentially leading to misallocation or defaults.

To ensure effective green financing, both the supply of finance and the development of firm capabilities must be improved. A comprehensive strategy that considers both sides is essential for achieving sustainable development. Thus, there is a need for parallel efforts to strengthen demand-side capabilities to avoid limited or adverse outcomes.

1. **Enhancing Firm Capabilities:** Strategies must assist firms in improving their technological and organizational capabilities to profitably use greener technologies. Effective governance arrangements are crucial to ensure that supported firms put in the effort to raise productivity through learning new technologies and skills. Enhancing sustainable demand for green funds is challenging but essential.
2. **Project Selection and Developmental Impact:** Project selection by financial intermediaries and businesses receiving green financing must demonstrate significant developmental impact. Financing green development accessible to only a few firms or with limited societal benefits will not sustain political support in developing countries.
3. **Technical Assistance for the Government:** Development partners should offer the Government of Nepal technical assistance for a sovereign credit rating exercise, potentially catalyzing more Foreign Direct Investment (FDI) in the green sector. The government also needs help operationalizing carbon credits and the compensation mechanism agreed upon at COP 28. These initiatives will only have a developmental impact if there is effective demand from firms that can benefit from greater access to credit or if FDI triggers investments by capable local firms.





4. *Creation of Green Instruments*: The Government of Nepal has created green instruments to support investments in renewable energy through public-private partnerships. There is potential for new Special Purpose Vehicles to broaden green financing in sectors like tourism and agriculture.

5. *Regulatory Changes*: Regulatory changes are required to explore innovative green financing products that reduce the emphasis on collateral based on land and buildings, which constrains access to finance in Nepal.

6. *Green Taxonomies and Guidelines*: The Nepal Rastra Bank (NRB) has released a consultative document on green taxonomies, with a final version expected soon. Improvements should be made to NRB's Environmental and Social Risk Management (ESRM) guidelines, moving towards comprehensive Environmental Social Governance (ESG) guidelines.

7. *Foreign Currency Hedging Mechanism*: Operationalizing a sovereign foreign currency hedging mechanism could mitigate currency risks for investors and reduce risks for FDI investors in Nepal, including in green investments.

8. *Innovative Green Instruments*: As the market develops, NRB can partner with Development Finance Institutions (DFIs) to create new green instruments, including innovative derivatives and credit guarantees. However, the Nepali financial market must deepen sufficiently before initiating this, and the effective demand from businesses for such instruments may need simultaneous development.

9. *Role of SEBON*: The Securities Exchange Board of Nepal (SEBON) could deliver specific green financing instruments. Energy bonds have been floated for power sector investments; a broader range of green bonds may be feasible with technical assistance and effective demand from firms.

10. *Technical Assistance for Banks*: Banks need technical assistance to strengthen their capabilities for assessing green portfolios, including impacts on greenhouse emissions. This would help them identify, justify, and manage green portfolios, sourcing targeted funds from DFIs at more competitive interest rates.