



Report and Recommendation of the President to the Board of Directors

Project Number: 53144-001
October 2019

Proposed Loan and Technical Assistance Grant Nepal: Rural Enterprise Financing Project

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 25 September 2019)

Currency unit	–	Nepalese rupee/s (NRe/NRs)
NRe1.00	=	\$0.0087
\$1.00	=	NRs113.64

ABBREVIATIONS

ADB	–	Asian Development Bank
DRRLRP	–	Disaster Risk Reduction and Livelihood Restoration Project
ESMS	–	environmental and social management system
FSMCCD	–	Financial Sector Management and Corporation Coordination Division
MFI	–	microfinance institution
MSMEs	–	micro, small, and medium-sized enterprises
NRB	–	Nepal Rastra Bank
PAM	–	project administration manual
RFSDCP	–	Rural Finance Sector Development Cluster Program
SFAC	–	small farmers agriculture cooperative
SFDB	–	Small Farmers Development Bank
TA	–	technical assistance

NOTES

- (i) The fiscal year (FY) of the Government of Nepal ends on 15 July. “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY2019 ends on 15 July 2019.
- (ii) In this report, “\$” refers to United States dollars.

Vice-President	Shixin Chen, Operations 1
Director General	Hun Kim, South Asia Department (SARD)
Director	Takeo Konishi, Director, Public Management, Financial Sector and Trade Division, SARD
Team leader	Mayumi Ozaki, Senior Portfolio Management Specialist, SARD
Team members	Monica Mei V. Carino-Young, Project Analyst, SARD Pamela Gutierrez, Project Analyst, SARD Ma. Kristina Hidalgo, Senior Financial Sector Officer, SARD Sajid Raza Zaffar Khan, Financial Management Specialist, SARD Lyailya T. Nazarbekova, Principal Counsel, Office of the General Counsel (OGC) Roshan Ouseph, Counsel, OGC Anjan Panday, Senior Programs Officer, SARD Ma. Virginia Panis, Senior Operations Assistant, SARD Deepak Bahadur Singh, Senior Environment Officer, SARD Suman Subba, Senior Social Development Officer, SARD
Peer reviewer	Arup Kumar Chatterjee, Principal Financial Sector Specialist, Sustainable Development and Climate Change Department

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PROJECT AT A GLANCE

1. Basic Data		Project Number: 53144-001	
Project Name	Rural Enterprise Financing Project	Department/Division	SARD/SAPF
Country	Nepal	Executing Agency	Ministry of Finance
Borrower	Nepal		
Country Economic Indicators	https://www.adb.org/Documents/LinkedDocs/?id=53144-001-CEI		
Portfolio at a Glance	https://www.adb.org/Documents/LinkedDocs/?id=53144-001-PortAtaGlance		
2. Sector		Subsector(s)	
✓ Finance	Inclusive finance		ADB Financing (\$ million)
	Small and medium enterprise finance and leasing		9.75
			40.25
	Total		50.00
3. Operational Priorities		Climate Change Information	
✓ Addressing remaining poverty and reducing inequalities	Climate Change impact on the Project		Low
✓ Accelerating progress in gender equality			
✓ Strengthening governance and institutional capacity			
Sustainable Development Goals		Gender Equity and Mainstreaming	
SDG 1.4	Gender Equity (GEN)		✓
SDG 5.a			
SDG 8.3			
SDG 9.3			
SDG 10.2	Poverty Targeting		
	General Intervention on Poverty		✓
4. Risk Categorization:	Low		
5. Safeguard Categorization	Environment: FI Involuntary Resettlement: FI-C Indigenous Peoples: FI		
6. Financing			
Modality and Sources		Amount (\$ million)	
ADB		50.00	
Sovereign Development financing institution (DFI) (Concessional Loan):		50.00	
Ordinary capital resources			
Cofinancing		0.00	
None		0.00	
Counterpart		0.00	
None		0.00	
Total		50.00	
Note: An attached technical assistance will be financed on a grant basis by the Financial Sector Development Partnership Special Fund in the amount of \$250,000; Technical Assistance Special Fund (TASF-6) in the amount of \$500,000.			
Currency of ADB Financing: US Dollar			

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to Nepal for the Rural Enterprise Financing Project. The report also describes proposed technical assistance (TA) for Capacity Development for Rural Enterprise Financing, and if the Board approves the proposed loan, I, acting under the authority delegated to me by the Board, approve the TA.

2. The project will increase incomes of subsistence small farmers by helping them engage in rural enterprises. The project will finance rural enterprises comprising (i) collective enterprises that are jointly owned and operated by small farmers, and (ii) individual enterprises. The project will also improve the financial intermediary's rural enterprise financing capacity as well as provide value chain development and business facilitation support for small farmers, especially women. The project comprises (i) a loan of \$50 million from the concessional ordinary capital resources of the Asian Development Bank (ADB), and (ii) a TA grant of \$750,000 to be financed from ADB's Technical Assistance Special Fund (TASF 6) for \$500,000 and ADB's Financial Sector Development Partnership Special Fund for \$250,000.¹

II. THE PROJECT

A. Rationale

3. **Rural poverty in Nepal.** Nepal has made notable socioeconomic progress as indicated in the decline of the population living below poverty line from 41.8% in 1995 to 25.2% in 2011.² However, as of 2018, 28.6% of the total population is still multidimensionally poor.³ Nepal's poverty is predominantly a rural phenomenon, with 7% of the urban population and 33% of the rural population being multidimensionally poor. Nepal's rural poverty is closely associated with limited gainful employment opportunities in rural areas where the agriculture sector dominates employment. The agriculture sector contributes 27.0% to the country's gross domestic product but employs 70.1% of the total population.⁴ However, the sector is largely subsistence in nature and confined to primary production of crops and livestock with little value addition and commercialization.⁵ The earnings from subsistence agriculture activities are hardly enough for rural households to move out of poverty.⁶

4. To reduce rural poverty, it is necessary to shift from current subsistence production to value-adding rural enterprises. A value chain in agriculture is a set of activities that adds value to commodities and links primary producers to processors, traders, merchants with storage,

¹ Established by ADB. Financing partner: the Government of Luxembourg.

² Government of Nepal, National Planning Commission, Central Bureau of Statistics. 2011. *National Living Standards Survey 2010–2011*. Kathmandu.

³ Government of Nepal, National Planning Commission. 2018. *Nepal Multidimensional Poverty Index: Analysis Towards Action*. Kathmandu. The multidimensional poverty index is a measure to address multiple dimensions of poverty including health, education, and living standard dimensions of poverty.

⁴ The agriculture sector employment includes nonwage-based self-employment. Government of Nepal, Ministry of Finance. 2018. *Economic Survey 2017–2018*. Kathmandu; International Labour Organization. ILOSTAT. <https://www.ilo.org/global/statistics-and-databases/lang--en/index.htm>.

⁵ Subsistence production is production mainly for own consumption.

⁶ In terms of per capita consumption, the average Nepali spent NRs80,807 in 2017; during the same year the average urban consumption was NRs103,146 and the average rural consumption was NRs64,701. Government of Nepal, National Planning Commission, Central Bureau of Statistics. 2019. *Annual Household Survey 2016–2017*. Kathmandu.

transport, processing, packing, marketing, and financing. Rural enterprises are micro, small and medium-sized enterprises (MSMEs) in rural areas and include on-farm and off-farm enterprises. On-farm enterprises produce crops and livestock for commercial sale. Off-farm enterprises encompass all types of economic activities excluding subsistence production and on-farm enterprises. In general, rural enterprises can generate at least 30% more income than subsistence production.⁷ However, rural enterprise development in Nepal is hampered because of insufficient business facilitation and limited rural enterprise financing. Developing rural enterprises in Nepal requires various support, including business facilitation, capacity building, and financing.

5. **Rural enterprise financing in Nepal.** In Nepal, formal financial institutions are categorized into commercial banks (class A), development banks (class B), finance companies (class C), and microfinance institutions (MFIs) (class D). Class D MFIs include (i) microfinance development banks; (ii) microfinance nongovernment organizations; and (iii) savings and credit cooperatives, which are licensed and supervised by Nepal Rastra Bank (NRB), the central bank. In addition to those financial institutions, there are semiformal microfinance nongovernment organizations and savings and credit cooperatives that provide financial services without NRB licenses.

6. Among the formal financial institutions, commercial banks dominate the sector. As of March 2019, commercial banks' share of the total financial sector loan portfolio was 80.47%, development banks' share was 10.56%, finance companies' share was 2.15%, and MFIs' share was 6.82%.⁸ Finance companies' rural outreach is insignificant. Commercial banks and development banks have rural branches; however, despite the government's various policy measures to increase rural lending, their loan portfolios are mainly concentrated in urban areas and the corporate sector.⁹ Further, banks' loans to MSMEs are estimated at about 25% of their total loan portfolio.¹⁰

7. Banks have limited appetite to finance rural enterprises because of the high cost associated with making small loans in rural areas. In addition, banks' rural financing is limited because of (i) banks' limited rural outreach, (ii) banks' limited knowledge and risk assessment capacity in rural enterprise financing, and (iii) rural enterprises' difficulty in securing valid loan collateral.

8. In Nepal, formal and semiformal MFIs serve over 5 million poor and low-income clients in rural areas. MFIs mainly provide short-term microcredit for subsistence agriculture activities and cottage-sized income-generating activities. MFIs can provide loans up to NRs700,000 without collateral but based on group guarantee, and above NRs700,000 to NRs1 million with collateral. MFIs are unable to scale up their operations to finance rural enterprise because of (i) a regulatory ceiling on MFIs' loans of NRs1 million, (ii) MFIs' limited sources of funding, and (iii) MFIs' limited

⁷ ADB. Impact Study of Microcredit Component of Disaster Risk Reduction and Livelihood Restoration for Earthquake-Affected Communities Project (ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Administration of Grant to Nepal for Disaster Risk Reduction and Livelihood Restoration for Earthquake-Affected Communities Project*. Manila.). Unpublished.

⁸ Nepal Rastra Bank. 2019. *Banking and Financial Statistics Mid-March 2019*. Kathmandu.

⁹ The government currently imposes on banks a productive sector lending scheme and a deprived sector lending scheme. The productive sector lending scheme requires banks to allocate at least 10% of the total portfolio to the agriculture sector. The deprived sector lending scheme requires banks to lend at least 5% of the total portfolio to poor, low-income, and marginalized populations.

¹⁰ Beed Management Pvt. Ltd. 2018. *Demand Study on MSME Financing – Submitted to UKaid Sakchyam Access to Finance for the Poor Programme*. Kathmandu.

knowledge and capacity in rural enterprise financing. Commercial banks' limited lending to rural MSMEs and MFIs' inability to scale up their operations create a vacuum of access to finance for rural enterprises.

9. **Small Farmers Development Bank.** Small Farmers Development Bank (SFDB) was established in July 2001 and licensed by NRB as a class D MFI.¹¹ It is an apex microfinance bank that promotes access to finance to small farmers. SFDB provides wholesale loans to small farmers agriculture cooperatives (SFACs) and technical and training support for SFAC members' income-generating activities.

10. As of March 2019, SFDB had 680 affiliated member SFACs in 68 districts.¹² SFDB offers wholesale loans to SFACs for (i) general microcredit, (ii) livestock credit, (iii) renewable energy credit, and (iv) livelihood restoration microcredit for households that were affected by the earthquake in 2015. Of SFDB's total loan portfolio, 95.79% are general microcredit and livestock loans. However, because of the growing demand for enterprise loans from SFACs, in 2016, SFDB started a pilot loan to a tea processing factory jointly owned by SFAC-member small farmers in Jhapa District in eastern Nepal. In 2019, there are five such collective enterprises in operation.¹³

11. In fiscal year (FY) 2018, SFDB's total loans outstanding with SFACs amounted to NRs17 billion, up from NRs8 billion in FY2015. The on-time recovery rate is 99.95%. SFDB's capital adequacy ratio is 10.38%, which is above the statutory required capital of 8.00% for class D MFIs. SFDB's return on equity of 21.97% and return on assets of 3.21% are adequate. SFDB's net income increased to NRs393 million in FY2018 from NRs154 million in FY2015. SFDB does not collect public deposits but relies mostly on short-term loans from the government, banks, and other financial institutions. Heavy reliance on short-term borrowing puts pressure on SFDB's cost of fund. Its weighted average cost of capital was 5.73% in FY2018 as compared to 2.99% in FY2015, which made its interest rate structure unpredictable and volatile. Access to long-term funding will allow SFDB to strengthen its liquidity and reduce its cost of fund volatility.

12. **Small farmers agriculture cooperatives.** SFACs are member-owned and member-managed community-based organizations that provide savings and credit services to members. SFACs are registered cooperatives with the Department of Cooperatives under the Cooperative Act of 1992. There are 670,866 SFAC members, of which 75% are women in 2018. The SFAC members are small and marginal farmers with landholding of less than 0.75 hectares.¹⁴ In 2018, the total number of SFAC member borrowers was 326,767, of which 75.23% (245,825) were women. The average loan size for all borrowers was NRs140,485, while that for women borrowers was NRs95,300. In FY2018, SFACs' total loans outstanding to members stood at NRs435 billion, up from NRs207 billion in FY2015. SFACs' aggregate recovery rate was 97.63%. SFACs show strong credit demand, as their members are increasingly seeking loans for their MSME ventures.

¹¹ Sana Kisan Bikas Laghubitta Bittiyasanstha Ltd or commonly called SFDB.

¹² SFAC eligibility criteria to be affiliated with SFDB include the following: (i) registered as a cooperative; (ii) at least 2 years of experience in providing savings and credit services after registration; (iii) potentiality to increase outreach and business; (iv) have developed a 3-year business plan; (v) proper record keeping in a double-entry bookkeeping system; (vi) regularity in general assembly and board meetings; and (vii) no delinquent loans with the board of directors, staff and their family members in the cooperative, and other financial institutions.

¹³ The existing SFAC collective enterprises are a milk collection center and two rice mills in Rupandehi District, and a tea processing factory and a seed processing factory in Jhapa District.

¹⁴ SFAC member criteria include the following: (i) a family with land area up to 0.76 hectares in the hills and up to 0.67 hectares in the Terai (a lowland area in southern Nepal); (ii) an individual or household with livelihood difficulties and no regular income; and (iii) an individual or household with no overdue loans with banks, financial institutions, or the government.

Although SFACs are actively seeking other funding sources, their funding source is limited mainly to loans from SFDB and SFACs' member deposits.

13. **Proposed solution.** The project will promote rural enterprises to generate employment and improve incomes of subsistence small farmers. Under the project, rural enterprises are categorized as (i) collective enterprises that engage in the production, processing, and marketing of agriculture produce and are jointly owned by SFACs and their members; and (ii) individual enterprises that are owned and operated by individual SFAC members. SFDB is an anchor facilitator and investor for rural enterprises and uses its SFAC networks across Nepal for enterprise facilitation and financial intermediation. The project has an innovative feature of transforming subsistence small farmers into micro, small, and medium-sized entrepreneurs with the combined support of value chain development, business facilitation, and financing. The financial intermediary modality was chosen because it is the most effective channel to facilitate rural enterprise development. By adopting the financial intermediary modality, the project can exercise prudent client selection and due diligence to ensure the project's rural enterprise investments are sustainable and yield effective social and economic returns for eligible small farmers.

14. **Government policy.** The government's 14th Three-Year Development Plan, FY2017–FY2019 has the goals of (i) improving the living standards of the Nepalese people through various policies of high economic growth, (ii) reducing the poverty rate by 21% through employment generation, (iii) reducing economic inequalities, and (iv) generating dignified and gainful employment opportunities.¹⁵ Further, the government's Agriculture Development Strategy, 2015–2035 promotes the agriculture sector's profitable commercialization to transform the sector from subsistence farming to agribusiness enterprises.¹⁶

15. **ADB's sector experience.** The project is based on ADB's successful rural finance project experiences in Nepal. ADB financed the Rural Finance Sector Development Cluster Program (RFSDCP) (subprograms 1 and 2) and the Disaster Risk Reduction and Livelihood Restoration Project (DRRLRP).¹⁷ The RFSDCP reformed key rural finance institutions, including SFDB. The RFSDCP's project completion reports rated both subprogram 1 and 2 *successful* and recognized the project's impact on expanded rural finance outreach, while recommending close impact monitoring on women's access to finance.¹⁸ The DRRLRP was an emergency assistance grant responding to the earthquake in Nepal in 2015; it has provided livelihood restoration microcredit to over 15,700 affected households. Under the RFSDCP and DRRLRP, SFDB was the implementing agency, and it has successfully implemented the institutional reform and financial intermediary components.

¹⁵ Government of Nepal, National Planning Commission. 2017. *14th Three-Year Development Plan, FY2017–FY2019*. Kathmandu.

¹⁶ Government of Nepal, Ministry of Agricultural Development. 2015. *Agriculture Development Strategy, 2015–2035*. Kathmandu.

¹⁷ ADB. 2006. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to Nepal for the Rural Finance Sector Development Cluster Program*. Manila; ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Loan for Subprogram 2 to Nepal for the Rural Finance Sector Development Cluster Program*. Manila; and ADB 2015. *Report and Recommendation of the President to the Board of Directors for the Proposed Administration of Grant to Nepal for the Disaster Risk Reduction and Livelihood Restoration for Earthquake-Affected Communities Project*. Manila.

¹⁸ ADB. 2012. *Completion Report: Rural Finance Sector Development Cluster Program in Nepal*. Manila; and ADB. 2016. *Completion Report: Rural Finance Sector Development Cluster Program (Subprogram 2) in Nepal*. Manila.

16. **Alignment with ADB's Strategy 2030.** The project is aligned with ADB's Strategy 2030's operational priorities of (i) addressing remaining poverty and reducing inequalities, (ii) accelerating progress in gender equality, and (iii) promoting rural development and food security.¹⁹ The project will contribute to developing rural areas and generating quality jobs by promoting rural enterprises, and support women's economic empowerment by creating entrepreneurship opportunities for women. The project is also consistent with ADB's Review of 2011 Financial Sector Operational Plan, which recommended retaining a focus on inclusive finance to deliver affordable financial services to small businesses.²⁰

B. Project Description

17. The project is aligned with the following impact: employment-oriented economic activities increased (footnote 15). The project will have the following outcome: small farmers' engagement in rural enterprises increased.²¹

18. **Output 1: Collective enterprises developed and financed.** The project will develop and finance at least 50 collective enterprises with value chain development and business facilitation support. Typical collective enterprises include commercial farming, milk collection centers, mustard oil mills, rice mills, seed processing factories, and tea processing factories. For each collective enterprise, a group of SFAC members will be the owner and shareholders, of which at least 40% are women. SFDB will make a wholesale loan to SFACs to finance collective enterprises. The maximum loan size to a collective enterprise will be NRs20 million.²² The repayment obligation of an SFAC's loan for a collective enterprise will be shared among the shareholders proportional to each member's shareholding. SFDB will finance only those collective enterprises with strong financial viability and marketing potential, and which meet the eligibility criteria.

19. **Output 2: Individual enterprises promoted and financed.** The project will also support SFAC members who are willing to start or expand their individual enterprises. Typical individual enterprises include commercial farming and livestock production, and agriculture produce collection, processing and marketing. The project will finance about 500 individual entrepreneurs, including start-ups; at least 30% of the entrepreneurs will be women. The maximum loan size to an individual enterprise will be NRs5 million (footnote 22). SFDB will provide value chain development and business facilitation support for individual enterprises, especially for women.

20. **Output 3: Rural enterprise financing capacity enhanced.** The project will support SFDB's and SFACs' enterprise financing skills, especially in business appraisal, due diligence, risk assessment, financial management, and safeguards. Specifically, the project will support SFDB to develop the collective and individual enterprises by financing operational policies and guidelines as well as assisting in business identification, appraisal and monitoring of the collective, and individual enterprise loan portfolio. The project will also support establishing a detailed management information system to capture the information on rural enterprise business performance, and gender-disaggregated impacts on employment generation and incomes.

¹⁹ ADB. 2018. *Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific*. Manila.

²⁰ ADB. 2017. *Review of 2011 Financial Sector Operational Plan*. Manila.

²¹ The design and monitoring framework is in Appendix 1.

²² A regulatory concession for the loan size above the statutory ceiling of NRs1 million will be obtained from NRB.

C. Value Added by ADB

21. The project aims to build on the RFSDCP's successful outcome, especially SFDB's expanded rural finance outreach (para. 15), and to scale up SFDB's operation from microcredit to rural enterprise financing. Currently, three development partners implement inclusive finance and small and medium-sized enterprise finance projects in Nepal focusing on capacity development for commercial banks.²³ The project's financial intermediation to rural enterprises will complement other development partners' interventions. Further, the project has an innovative approach by promoting collective rural enterprises. Unlike regular small and medium-sized enterprise projects in which the loans are provided to sole proprietorship enterprises, the project will organize subsistence small farmers into enterprise shareholders and transform them into rural entrepreneurs. The project's focus on capacity building of SFDB and its partner SFACs will have a lasting impact on financial inclusion for rural MSMEs by scaling up MFIs' enterprise financing operations. The project will have a strong synergy with the Food Safety and Agriculture Commercialization Program for Nepal by extending the business facilitation and financing support to agribusinesses to be developed under the program.²⁴

D. Summary Cost Estimates and Financing Plan

22. The project is estimated to cost \$50 million (Table 1). The sub-borrowers are expected to contribute at least 18% of the total rural enterprise subproject investments from their own sources.²⁵ The summary financing plan is in Table 2.

Table 1: Summary Cost Estimates
(\$ million)

Item	Amount
Credit line ^a	50
Total	50

^a The sub-borrowers are expected to contribute to at least 18% of the total rural enterprise subproject investments from their own sources.

Source: Asian Development Bank.

Table 2: Summary Financing Plan

Source	Amount (\$ million)	Share of Total (%)
Asian Development Bank		
Ordinary capital resources (concessional loan) ^a	50	100
Total	50	100

^a The sub-borrowers are expected to contribute at least 18% of the total rural enterprise subproject investments from their own sources.

Source: Asian Development Bank.

²³ These are (i) the Department for International Development of the United Kingdom's Sakchyam Access to Finance for the Poor Programme, (ii) German development cooperation through KfW's Sustainable Economic Development Program, and (iii) the International Fund for Agricultural Development's Samridhhi Rural Enterprises and Remittances Project.

²⁴ ADB. Forthcoming. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Loan and Technical Assistance Grant to Nepal for the Food Safety and Agriculture Commercialization Program*. Manila.

²⁵ The sub-borrowers will contribute to the fixed capital investments for the collective and individual enterprise loans, with contributions comprising cash, in-kind, or labor. As such, it is difficult to accurately quantify the sub-borrower contributions in monetary terms. Accordingly, the sub-borrower contributions are not expressed in United States dollars.

23. The government has requested a concessional loan of \$50 million from ADB's ordinary capital resources to help finance the project. The loan will have a 32-year term, including a grace period of 8 years; an interest rate of 1.0% per year during the grace period and 1.5% per year thereafter; and such other terms and conditions set forth in the draft loan and project agreements. The final relending, onlending, and sub-lending terms and conditions are determined during the subsidiary loan agreement negotiation between the government and SFDB.

24. ADB will disburse the loan proceeds following its *Loan Disbursement Handbook* (2017, as amended from time to time) and detailed arrangements agreed between the government and ADB. The advance fund procedure will be used based on the estimate of the eligible expenditures for the forthcoming 6 months. SFDB and the SFACs funded under the project will submit an annual audited statement of utilization of funds.

25. **Relending.** The government will relend the ADB loan proceeds to SFDB in local currency. The provisional relending interest rate and terms are 5% per year with up to a 32-year term, including a grace period of up to 8 years, and other conditions to be defined in the subsidiary agreement between the government and SFDB. The government will bear the foreign exchange risks.

26. **Onlending.** SFDB will onlend to eligible SFACs for financing rural enterprises. The provisional onlending interest rate and terms are 7% per year with up to a 8-year term including a grace period of up to 2 years for the fixed capital loans and no grace period for the working capital loans, and other conditions to be defined in the financing agreement between SFDB and SFACs.

27. **Sub-lending.** SFACs will sub-lend to eligible members for their collective and individual enterprise investments. The provisional sub-lending interest rates and terms are as follows: (i) for collective enterprises, 10% per year with up to a 7-year term, including a grace period of up to 2 years for the fixed capital loans and no grace period for the working capital loans; (ii) for individual enterprises, 10% per year with up to a 5-year term, including a grace period of up to 1 year for the fixed capital loans and no grace period for the working capital loans, and other conditions to be defined in the loan agreement between SFAC and sub-borrowers.

28. **Revolving fund (at Small Farmers Development Bank).** The loans repaid by SFACs will be maintained at the rural enterprise fund account established at SFDB. SFDB will onlend to SFACs with the project's same onlending terms and conditions for rural enterprises financing by SFDB. The same SFAC and sub-borrower eligibility criteria for rural enterprise financing will be applied. SFDB will maintain a separate account for the revolving fund.

29. **Eligibility criteria of small farmers agriculture cooperatives.** An eligible SFAC meets the following criteria: (i) capital adequacy ratio of 10% or above, (ii) internally generated funds-to-outstanding loan ratio of 40% or above, (iii) positive net worth, (iv) operating self-sufficiency ratio of 110% or above, (v) repayment rate ratio of 90% or above, (vi) active members comprise 90% or more of the total membership, (vii) return on equity ratio of 3% or above, (viii) operating expense ratio below 4%, (ix) growth in outstanding loans of 15% or above, (x) outstanding loans of more than NRs30 million, (xi) more than 500 total members, (xii) operating profit in the last 2-year period with no cumulative loss, and (xiii) nonperforming loan ratio below 5%.²⁶ Further, each eligible

²⁶ Capital adequacy ratio is defined as total capital fund to an asset base of total assets less cash, 80% of bank placements and 50% of equity investments. The internally generated funds comprise member equity, member

SFAC should (i) be registered as a cooperative; (ii) have developed a 3-year business plan and implemented activities in line with the plan; (iii) have no delinquent loans with the board of directors, staff and their family members in the cooperatives, or other financial institutions; (iv) have no board of directors or staff and their family members who have taken out loans more than the loan limit of the SFAC; (v) have been maintaining proper record keeping consistent with the Nepal Accounting Standards. The collective enterprise shall also insure assets forming the enterprise with insurers licensed by the appropriate regulatory authority.

30. Eligibility criteria of sub-borrowers (collective enterprises). Eligible collective enterprises should (i) complete all preparatory work prior to applying for the subloan, including collection of member equity contributions, preparation of a business plan and marketing plan, (including a plan for the sourcing of raw materials and scaling up of the proposed enterprise), and preparation of other organizational plans; (ii) establish a project management subcommittee composed of representatives from the SFAC members holding satisfactory and applicable technical knowledge and managerial skills, and excluding any members holding delinquent loans from the SFAC or other financial institutions; and (iii) meet the collateral requirements established by the SFAC.

31. Eligibility criteria of sub-borrowers (individual enterprises). Eligible individual enterprises should (i) complete all necessary preparatory work prior to applying for the subloan, including confirming the individual enterprise's equity contributions, preparation of business plan and marketing plan (including a plan for the sourcing of raw materials and scaling up of the proposed enterprise), and preparation of other organizational plans when applicable; (ii) be an active member of the SFAC; (iii) be in the age range of 18 to 60 years old and obtain a guarantee by a household member; (iv) have not been in default on loans from the SFAC or other financial institutions for at least the last 3 years; (v) have sufficient assets for provision as collateral for the proposed subloan as per the SFAC's requirement; (vi) have engaged in the production of agricultural produce or activities related to the proposed enterprise for at least the last 3 years; (vii) have verifiable experience relevant to the proposed enterprise; and (viii) have received all necessary registrations for the proposed enterprise with the relevant municipality or appropriate authority, or is in the process of obtaining such registrations.

E. Implementation Arrangements

32. The Ministry of Finance, represented by the Financial Sector Management and Corporation Coordination Division (FSMCCD), will be the executing agency. SFDB will be the implementing agency and financial intermediary. A project steering committee will be formed chaired by the secretary of the Ministry of Finance and comprising members from the FSMCCD, NRB, and SFDB. The project implementation unit will be established at SFDB and led by a project coordinator with at least two full-time staff whose qualifications are satisfactory to ADB. The implementation arrangements are summarized in Table 3 and described in detail in the project administration manual (PAM).²⁷

savings, and internal reserves. Net worth is defined as total assets minus total liabilities. Operational self-sufficiency ratio is defined as operating revenues divided by operating expenses including the financial costs and impairment losses on loans. Repayment ratio is defined as the amount received for scheduled payments as a share of total payments due within 12 months. Active members are those who regularly save with or borrow from the SFAC. Return on equity ratio is defined as net income divided by total shareholders' equity. Operating expense ratio is defined as the operating expense to the average outstanding loan. Growth in outstanding loans is defined as the percentage change in the total amount of outstanding loans from the previous fiscal year. Nonperforming loan ratio is defined as the total overdue loans divided by the total loans outstanding.

²⁷ Project Administration Manual (accessible from the list of linked documents in Appendix 2).

Table 3: Implementation Arrangements

Aspects	Arrangements
Implementation period	January 2020–December 2024
Estimated completion date	31 December 2024
Estimated loan closing date	30 June 2025
Management	
(i) Oversight body	Project steering committee Secretary of MOF (chair) Joint secretary, FSMCCD of MOF; executive director, Microfinance Promotion and Supervision Department, NRB; chief executive officer, SFDB (members) SFDB representative (secretariat)
(ii) Executing agency	MOF
(iii) Implementing agency	SFDB
(iv) Implementation unit	Project implementation unit, three staff under the supervision of the chief executive officer, SFDB
Retroactive financing	Withdrawals from the loan account may be made for reimbursement of eligible expenditures incurred under the project before the effective date, but not earlier than 12 months before the date of the loan agreement, subject to a maximum amount equivalent to 20% of the loan amount.
Disbursement	ADB will disburse the loan proceeds following ADB's <i>Loan Disbursement Handbook</i> (2017, as amended from time to time) and detailed arrangements agreed between the government and ADB. An advance account will be used.

ADB = Asian Development Bank, FSMCCD = Financial Sector Management and Corporation Coordination Division, MOF = Ministry of Finance, NRB = Nepal Rastra Bank, SFDB = Small Farmers Development Bank.

Source: ADB.

III. ATTACHED TECHNICAL ASSISTANCE

33. The project will have an attached TA to support SFDB and SFACs to enhance their capacity in rural enterprise financing and extend rural enterprise business facilitation and value chain development support.²⁸ The TA outputs include (i) at least 50 collective enterprise received value chain development and business facilitation support; (ii) at least 500 individual enterprises received value chain development and business facilitation support; (iii) SFDB's rural enterprise financing unit established; (iv) SFDBs' collective and individual enterprise financing operational policies and guidelines developed; (v) at least 100 SFACs developed skills on collective enterprise financing and portfolio management; and (vi) at least 300 SFACs developed skills on individual enterprise financing and portfolio management.

34. The TA is estimated to cost \$750,000, of which (i) \$500,000 will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF 6); and (ii) \$250,000 will be financed on a grant basis by the Financial Sector Development Partnership Special Fund (footnote 1). Disbursement will follow ADB's *Technical Assistance Disbursement Handbook* (2010, as amended from time to time). SFDB will provide counterpart support equivalent to \$30,000 in the form of office space, counterpart staff, logistical support, and other in-kind contributions.

IV. DUE DILIGENCE

A. Technical

35. SFDB is highly skilled in developing saving and credit cooperatives and providing wholesale loans for microcredit. It has established operational procedures and skilled staff for loan appraisal, loan sanction, and portfolio monitoring and reporting. The project will develop SFDB's rural enterprise financing skills through the attached TA. SFACs to be financed under the

²⁸ Attached Technical Assistance Report (accessible from the list of linked documents in Appendix 2).

project will be registered cooperatives and will meet the project eligibility criteria. SFDB will assist capacity development for SFACs' rural enterprise financing.

B. Economic and Financial Viability

36. The unmet rural enterprise financing demand was estimated at NRs106 billion in 2018.²⁹ Regarding financial viability, SFDB is financially sound as indicated by its satisfactory capital adequacy ratio, low nonperforming asset ratio, and high return on equity and assets. SFDB's interest rate risk is appropriately managed but could be strengthened. Based on the financial analysis of 20 sample SFACs, their financial performance is acceptable; however, SFACs are susceptible to credit risk, operational risk, and interest rate risk, which will be mitigated through periodical and structured monitoring. SFACs' credit demand is robust as evidenced by the growth of SFDB's loans outstanding with SFACs, which increased from NRs3.6 billion in FY2013 to NRs16.9 billion in FY2018.³⁰

C. Sustainability

37. Currently, SFDB and SFACs have limited capacity in enterprise financing. The project, through the attached TA, will develop SFDB's and SFACs' enterprise financing capacity especially in business appraisal, due diligence, risk assessment, financial management, and safeguards to ensure the sustainability of the rural enterprise subprojects. SFDB will finance only those SFACs and sub-borrowers that meet the eligibility criteria and have strong financial viability and sustainability. SFDB will ensure that the interest rates to be charged for SFACs and the sub-borrowers cover all costs and risks and have adequate margin to ensure operational sustainability.

D. Governance

38. ADB requirements and policies on financial management and procurement measures, and environmental and social safeguards, were discussed and agreed with the government and SFDB and incorporated in the project design. The specific requirements are described in the PAM. Procurement of goods, works, and non-consultancy services will follow the ADB Procurement Policy (2017, as amended from time to time) and the Procurement Regulations for ADB Borrowers (2017, as amended from time to time). Procurement will be undertaken by the individual beneficiary; fitness for purpose can be achieved by using established private sector and commercial practices.

39. SFDB's governance is found adequate. SFDB's board of directors comprises seven representatives: four from the promotor group, two from the general public, and one independent professional director. SFDB selects and lends only to SFACs whose operational and financial indicators are sound. As a licensed class D institution, SFDB is required to comply with NRB's regulations and directives, and is subject to regular on-site and off-site supervision.

40. The assessed pre-mitigation financial management risk is *moderate*. SFDB's financial management assessment indicated that SFDB has sufficient experience in managing similar projects for ADB and other international development partners and has the necessary financial management arrangements.³¹ However, some weaknesses were identified, including the

²⁹ Economic Analysis (accessible from the list of linked documents in Appendix 2).

³⁰ Financial Analysis (accessible from the list of linked documents in Appendix 2).

³¹ Financial Management Assessment (accessible from the list of linked documents in Appendix 2).

following: (i) outdated management information systems; (ii) heavy reliance on short-term borrowing; (iii) weak financial management capacity; (iv) limited human resources in internal audit; (v) limited capacity for rural enterprise financing; (vi) inadequate internal control mechanism; and (vii) a lack of policies on know-your-customer, risk management, and information technology.

41. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and SFDB. The specific policy requirements and supplementary measures are described in the PAM (footnote 26).

E. Poverty, Social, and Gender

42. The project will generate employment or provide income earning opportunities to at least 30,000 small farmers, including at least 12,000 women. By involving subsistence small farmers in rural enterprises, these farmers can gain better prices from their produce. Currently, 75% of SFAC members are women. However, majority of women members have limited credit history and entrepreneurship skills. The project will develop women's entrepreneurship skills with appropriate client protection. The project is classified *gender equity as a theme*.³²

F. Safeguards

43. In accordance with ADB's Safeguard Policy Statement (2009) and relevant Operations Manual definitions, the project's safeguard categories are as follows.³³

44. **Environment (category FI).** The project's environmental due diligence found the existing SFDB financed collective enterprises as category C. However, so as not to exclude the potential category B subprojects, implementation of an environmental and social management system (ESMS) is made mandatory.

45. **Involuntary resettlement (category FI-C); Indigenous peoples (category FI).** Only subprojects not requiring any involuntary resettlement will be financed. The project can have positive impacts for indigenous peoples by providing them access to finance. If indigenous peoples safeguards are triggered, SFDB will follow the ESMS and ADB's requirements for indigenous peoples.

46. SFDB developed an ESMS, which was agreed by ADB. Subproject screening will be mandatory for all subprojects to be financed under the project, and SFDB will report on the status of the screening checklist to ADB. SFDB will do the following:

- (i) Its regional offices will screen all subprojects to be financed under the project to ensure compliance with government regulations, project legal agreements, the PAM, and environmental and social screening guidelines.
- (ii) It will exclude all subprojects categorized A for environment and indigenous peoples, and A and B for involuntary resettlement. For category B subprojects, SFDB will prepare an initial environmental examination and environmental management plan, or an indigenous peoples plan, and submit the appropriate plan for ADB's approval, before the subproject is financed.

³² Gender Action Plan (accessible from the list of linked documents in Appendix 2).

³³ ADB. [Safeguard Categories](#).

G. Summary of Risk Assessment and Risk Management Plan

47. Significant risks and mitigating measures are summarized in Table 4 and described in detail in the risk assessment and risk management plan.³⁴

Table 4: Summary of Risks and Mitigating Measures

Risk	Mitigation Measures
Weak capacity in financial management of SFDB and SFACs	The attached TA will support SFDB and SFACs in building capacity in all aspects of financial management. Audited statements of utilization of funds and audited financial statements of SFDB and SFACs will be collected.
SFDB's and SFACs' limited experience on enterprise financing	The attached TA will enhance SFDB's and SFACs' enterprise financing capacity. SFACs will be selected based on eligibility criteria, including their past experience, financial and management capacity, and proper fund utilization plan.
Outdated core banking system, IT, and MIS at SFDB and SFACs	The system will be upgraded. A business continuity plan and disaster recovery plan will be established.

IT = information technology, MIS = management information system, SFAC = small farmers agriculture cooperative, SFDB = Small Farmers Development Bank, TA = technical assistance.

Source: Asian Development Bank.

V. ASSURANCES

48. The government and SFDB have assured ADB that implementation of the project shall conform to all applicable ADB requirements, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the PAM and loan documents.

49. The government and SFDB have agreed with ADB on certain covenants for the project, which are set forth in the draft loan agreement and project agreement. The government has also agreed with ADB on the following conditions to the effectiveness of the loan agreement: (i) the subsidiary loan agreement between the government and SFDB, in form and substance satisfactory to ADB, shall have been duly executed and delivered on behalf of the government and SFDB, and shall have become fully effective and binding on the parties thereto in accordance with its terms; and (ii) SFDB shall have provided evidence, in form and substance satisfactory to ADB, that SFDB has obtained from NRB all necessary regulatory approvals to undertake its obligations under the Loan Agreement and the Project Agreement.

VI. RECOMMENDATION

50. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$50,000,000 to Nepal for the Rural Enterprise Financing Project, from ADB's ordinary capital resources, in concessional terms, with an interest charge at the rate of 1.0% per year during the grace period and 1.5% per year thereafter; for a term of 32 years, including a grace period of 8 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan and project agreements presented to the Board.

Takehiko Nakao
President

10 October 2019

³⁴ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

DESIGN AND MONITORING FRAMEWORK

Impact of the Project is Aligned with Employment-oriented economic activities increased (14th Three-Year Development Plan, FY2017–FY2019) ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
<p>Outcome</p> <p>Small farmers' engagement in rural enterprises increased</p>	<p>By December 2025</p> <p>a. At least 30,000 small farmers engaged in rural enterprise activities, of which 40% are women (2019 baseline: not applicable)</p> <p>b. At least 15,000 small farmers engaged in collective enterprises, of which at least 40% are women (2019 baseline: 4,016 shareholders, of which 40% are women)</p> <p>c. At least 2,500 small farmers engaged in individual enterprises, of which 30% are women (2019 baseline: not applicable)^b</p> <p>d. The average income of SFAC members engaging in rural enterprises increased to NRs170,000 (2019 baseline: NRs84,581)^c</p>	<p>a–d. SFDB's annual reports, project completion report, impact assessment study</p>	<p>Political instability and macroeconomic downturn may affect business environment for rural enterprise activities</p>
<p>Outputs</p> <p>1. Collective enterprises developed and financed</p>	<p>By December 2024</p> <p>1a. At least 50 collective enterprises received value chain development and business facilitation support, of which at least 40% of the shareholders are women (2019 baseline: 4,016 shareholders, of which 40% are women) [Under attached TA]</p> <p>1b. At least 50 collective enterprises financed by</p>	<p>1a–1b. SFDB annual reports, collective enterprise structure, rules and regulations, project and TA progress reports, project completion report, impact assessment study</p>	<p>Limited capacity of SFACs to develop investment-ready collective enterprises</p>

<p>2. Individual enterprises promoted and financed</p>	<p>SFDB, of which at least 40% of the shareholders are women (2019 baseline: 4,016 shareholders, of which 40% are women) (RFI A)</p> <p>2a. At least 500 individual enterprises received value chain development support, of which 30% are women (2019 baseline: not applicable) [Under attached TA]</p> <p>2b. At least 500 individual enterprises financed by SFDB, of which 30% are women (2019 baseline: not applicable) (RFI B)</p>	<p>2a-2b. SFDB annual reports, project and TA progress reports, project completion report, impact assessment report</p>	
<p>3. Rural enterprise financing capacity enhanced</p>	<p>3a. SFDB's rural enterprise financing unit established (2019 baseline: not applicable) [Under attached TA]</p> <p>3b. SFDB's collective enterprise financing operational policy and guidelines adopted (2019 baseline: not applicable) [Under attached TA]</p> <p>3c. At least 100 SFACs developed skills on collective enterprise financing and portfolio management, of which 30% are women SFACs (2019 baseline: not applicable) [Under attached TA]^d</p> <p>3d. SFDB's individual enterprise financing operational policy and guidelines adopted (2019 baseline: not applicable) [Under attached TA]</p>	<p>3a-3e. SFDB annual reports, project and TA progress reports, project completion report, impact assessment report</p> <p>3b. SFDB collective enterprise financing operational policies and guidelines</p> <p>3d. SFDB's individual enterprise financing operational policies and guidelines</p>	<p>SFDB may not attract qualified human resources because of competition with other financial institutions</p>

	3e. At least 300 SFACs developed skills on individual enterprise financing and portfolio management, of which 30% are women SFACs (2019 baseline: not applicable) [Under attached TA] ^d		
<p>Key Activities with Milestones</p> <p>1. Collective enterprises developed and financed (under the loan and attached TA)</p> <p>1.1 Consultant recruitment (Q1–Q2 2020)</p> <p>1.2 SFACs consultation and collective enterprise identification (Q1 2020–Q4 2024)</p> <p>1.3 Collective enterprise value chain development and business facilitation (Q1 2020–Q4 2024)</p> <p>1.4 Collective enterprise loan appraisal and due diligence (Q1 2020–Q4 2024)</p> <p>1.5 Collective enterprise loan sanctioning (Q1 2021–Q4 2024)</p> <p>1.6 Collective enterprise loan portfolio performance monitoring (Q1 2021–Q4 2024)</p> <p>2. Individual enterprises promoted and financed (under the loan and attached TA)</p> <p>2.1 Consultant recruitment (Q1–Q2 2020)</p> <p>2.2 SFACs consultation and individual enterprise identification (Q1 2020–Q4 2024)</p> <p>2.3 Individual enterprise value chain development and business facilitation (Q1 2020–Q4 2024)</p> <p>2.4 Individual enterprise loan appraisal and due diligence (Q1 2021–Q4 2024)</p> <p>2.5 Individual enterprise loan sanctioning (Q1 2021–Q4 2024)</p> <p>2.6 Individual enterprise loan portfolio performance monitoring (Q1 2021–Q4 2024)</p> <p>3. Rural enterprise financing capacity enhanced (under the loan and attached TA)</p> <p>3.1 Consultant recruitment (Q1–Q2 2020)</p> <p>3.2 SFDB and SFACs consultation (Q3–Q4 2020)</p> <p>3.3 SFDB rural enterprise financing unit established (Q1 2020)</p> <p>3.4 SFDB collective enterprise financing policies and guidelines development (Q3–Q4 2020)</p> <p>3.5 SFDB collective enterprise financing policies and guidelines dissemination and business proposal development coaching (Q1 2021–Q4 2022)</p> <p>3.6 SFDB individual enterprise financing operational policies and guidelines development (Q3–Q4 2020)</p> <p>3.7 SFDB individual enterprise financing operational policies and guidelines dissemination and business proposal development coaching (Q1 2021–Q4 2024)</p> <p>3.8 SFDB collective and individual enterprise financing policies and guidelines review and updating (Q1 2022–Q4 2024)</p>			
<p>Inputs</p> <p>ADB: \$50 million (loan); \$0.5 million (TA grant)</p> <p>Financial Sector Development Partnership Special Fund: \$0.25 million (TA grant)</p>			
<p>Assumptions for Partner Financing</p> <p>Not applicable</p>			

ADB = Asian Development Bank, FY = fiscal year, Q = quarter, RFI = results framework indicator, SFAC = small farmers agriculture cooperative, SFDB = Small Farmers Development Bank, TA = technical assistance.

^a National Planning Commission, the Government of Nepal. 2017. *14th Three-Year Development Plan, FY2017–FY2019*. Kathmandu.

^b Including household members.

^c SFAC members' average.

^d Women SFACs are SFACs with only women members.

Contribution to the ADB Results Framework:

RFI A: Small and medium-sized enterprise loan accounts opened or end borrowers reached. Target: 15,000 [9,000 male; 6,000 female].

RFI B: Microfinance loan accounts opened or end borrowers reached. Target: 500 [350 male; 150 female].

Source: ADB.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=53144-001-3>

1. Loan Agreement
2. Project Agreement
3. Sector Assessment (Summary): Finance (Rural Enterprise Finance)
4. Project Administration Manual
5. Financial Analysis
6. Economic Analysis
7. Summary Poverty Reduction and Social Strategy
8. Risk Assessment and Risk Management Plan
9. Attached Technical Assistance Report
10. Gender Action Plan
11. Financial Intermediary: Environmental and Social Management System Arrangement

Supplementary Document

12. Financial Management Assessment of Small Farmers Development Bank and Small Farmers Agriculture Cooperatives