Invest for Impact Nepal

Environmental, Social and Governance Landscape Analysis of Financial Institutions in Nepal

Foreword

We are pleased to introduce the Environmental, Social, and Governance (ESG) landscape analysis report of Class A and Class B Banks in Nepal, commissioned by the Nepal Bankers' Association (NBA) and Invest for Impact Nepal (IIN). The findings presented in this report provides a snapshot of Nepalese bank's maturity in managing Environmental and Social risks, benchmarked against the best practices and peer institutions. In an era where sustainable practices play an important role in shaping global finance, evaluating Environmental and Social (E&S) risks is essential for the success of our banks and financial institutions.

In the context of interconnected business world where responsible banking practices are imperative, the introduction of ESRM (Environmental and Social Risk Management) Guidelines by the Nepal Rastra Bank (NRB) in 2018, and the subsequent mandatory enforcement in 2020, stands as a significant milestone for Nepalese banks and financial institutions. This regulatory framework emphasizes the significance of aligning our banking practices with international ESG standards.

NBA acknowledges that ESG factors influence investment decisions and the overall trajectory of financial institutions, and it is critical that our member banks recognise the significance of ESG considerations. By placing ESG as a cornerstone in our business, we not only meet the regulatory requirements but also establish ourselves as responsible financial stewards. The ESG journey is therefore very crucial for promoting sustainable financing in Nepal and attracting international investments.

I extend my gratitude to all those who contributed to the development of this report and special appreciation to the Environmental Management Centre PVT. Ltd (EMC) for conducting the analysis of selected class A and B banks, and consolidating the findings into a comprehensive report along with the strategic recommendations for our banking sector.

I believe the joint efforts of the NBA and IIN would be testimony of constructive collaboration and commitment to a better future of the banking sector in Nepal and to emerge as a symbol of ESG Excellence.

Sincerely,

Anil Sharma

Chief Executive Officer, Nepal Bankers' Association

Preamble

This report is based on the findings of the evaluation of the internal environmental and social (E&S) risks management process and its maturity for selected banks in Nepal. The report identifies best practices among banks, and provides peer comparative analysis, and implementation experiences and challenges. Based on these the recommendations are made.

The findings and recommendations included in this report have been reached through meetings with the selected banks, interactions with relevant stakeholders, and a review of documents available online and provided by the banks.

It should be noted that while efforts have been made to address as many significant aspects and issues as possible, the assessment is limited to the documents and records presented by the banks, discussions with bank representatives, and an understanding of implementation challenges reached through discussions.

This report is prepared by Environmental Management Centre (EMC) and the contents of this report reflect EMC's best professional judgement in the light of the information made available at the time. Any use that a third party makes of this report, or reliance on it, or any decision made based on it is the responsibility of such third party. EMC/IIN accepts no responsibility for damages, if any, suffered by any third party as a result of decisions made or actions taken based on this report.

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Abbreviations

BII	British International Investment
CAPA	Corrective and Prevention Action
CoP	Community of Practice
DFI	Development Finance Institutions
EIA	Environmental Impact Assessment
E&S	Environmental and Social
ESG	Environmental, Social and Governance
ESRM	Environmental and Social Risk Management Framework
EMC	Environmental Management Centre Pvt. Ltd
EPRP	Emergency Preparedness and Response Plan
ESAP	Environmental & Social Action Plan
ESMS	Environmental and Social Management System
ESG	Environmental, Social and Governance
ESDD	Environmental & Social Due Diligence
FMO	Dutch Entrepreneurial Development Bank
GRM	Grievance Redressal Mechanism
GBVH	Gender-Based Violence and Harassment
HR	Human Resources
HSE	Health, Safety and Environment
IIN	Invest for Impact Nepal
IFC	International Finance Corporation
IEE	Initial Environmental Examination
EIA	Environmental impact Assessment
MSMEs	Micro, Small and Medium Enterprises
MOU	Memorandum of Understanding
NBA	Nepal Bankers' Association
NBI	National Banking Institute
NRB	Nepal Rastra Bank
NDA	Non-Disclosure Agreement
NDC	Nationally Determined Contributions
PoSH	Prevention of Sexual Harassment
PCAF	Partnership for Carbon Accounting Financials
RM	Relationship Manager
SDC	Swiss Agency for Development and Cooperation
SDGs	Sustainability Development Goals
ToR	Terms of Reference
TLS	Traffic Light System

1. Introduction

1.1 Background

In Nepal, the banking sector is pivotal for economic growth and transformation. To support this process, the Nepal Bankers' Association (NBA) stands as a cornerstone entity, dedicated to enhancing the efficacy of Nepalese banks while addressing the issues inherent in banking activities.

NBA aims to strengthen the resilience and adaptability of Nepalese banks in the face of an evolving economic climate. Recognising the importance of environmental and social (E&S) risk management, particularly in the eyes of DFIs and international lenders, NBA, in collaboration with the Invest for Impact Nepal (IIN), initiated a comprehensive study to assess the maturity of Nepalese financial institutions in managing E&S risks, thereby strengthening the foundation for sustainable banking practices.

1.2 Objective of the Study

The primary objective of this study is to evaluate the environmental and social (E&S) risk management processes of selected banks in Nepal. By identifying potential challenges and best practices, the study seeks to ascertain the commitment and ambition of Nepalese banks towards a more sustainable financial industry. Through detailed desk research on existing policies, processes, initiatives, and reporting practices, the study intends to provide actionable recommendations to improve sustainable financing practices within Nepal's banking sector.

1.3 Methodology

The study followed a structured approach, featuring in-depth interviews and interactions with selected banks and key stakeholders. Using a traffic light system (TLS), the study evaluated the E&S performance of banks, considering crucial aspects such as sustainability practices, governance, and social responsibility.

This multidimensional methodology, which included both primary and secondary research, aimed to provide comprehensive understanding on the E&S risk management practices thereby, promoting sustainable financing in Nepal's banking industry.

1.3.1 Data Collection Methods

In-Depth Interviews: In-depth interviews were conducted with representatives from selected banks and key stakeholders to gather more information about their E&S risk management practices. These interviews provided qualitative data essential for assessing the maturity of E&S practices within the banking sector.

In addition, consultations were held with the key regulatory body, Nepal Rastra Bank (NRB), to gain a comprehensive understanding of the sector and its regulatory landscape. These discussions facilitated a deeper analysis of the regulatory framework governing E&S risk management in banking operations.

1.3.2 Sample Selection

The sample was drawn from diverse bank categories as outlined below:

- Five Class A banks without DFI funding.
- Three Class A banks with DFI funding.
- Two internationally owned banks.
- Five Class B banks

2 Sectoral Overview

2.1 Overview of the Financial Sector in Nepal

The financial sector in Nepal is dominated by commercial, development and microfinance banking institutions, but also has a range of non-banking institutions including insurance companies, cooperatives and capital markets. The banking institutions represent around 87% of the total assets.

The central bank of Nepal, Nepal Rastra Bank (NRB), regulates the banking sector, which includes the banks and financial institutions (BFIs) as well as co-operatives and NGOs licensed to perform limited banking transactions. The four classes of BFIs in Nepal include commercial banks (Class A), development banks (Class B), finance companies (Class C) and microfinance financial institutions (Class D). As of mid-July 2022, there are 20 commercial banks, 18 development banks, 17 finance companies and 65 microfinance institutions in the country. For the past two years, the banking system in Nepal – and particularly the development banks – have been undergoing restructuring and consolidation through mergers and acquisitions, encouraged by NRB. Between 2018 and 2019 the number of development banks decreased from 33 to 29, and then to 19 by mid-January 2021. The micro credit development banks (Class D banks) are micro finance institutions that work to provide banking and financial services to the poor and marginalised. Small-sized loans, group-based lending, group savings, small-scale entrepreneurs, diversified utilisation, quick repayment, close monitoring and simple terms/conditions on credit (without collateral) are the determining characteristics of micro-finance and, albeit small, they also form a component of Nepal's banking sector.[1]

The Insurance Board is the insurance regulatory authority, while the Securities Board of Nepal (SEBON) is the apex regulator of the securities market in Nepal. Other financial institutions in Nepal include the Employees Provident Fund, the Citizen Investment Trust and the Postal Saving Bank.[2]

Key institutions in the banking sector of Nepal relevant to the study are described in the sub-sections below.

1 A Background Policy Paper on Green Financing in Nepal, UNDP, 2021. https://www.undp.org/nepal/publications/background-policy-paper-green-financing-nepal.

2 A Background Policy Paper on Green Financing in Nepal, UNDP, 2021. https://www.undp.org/nepal/publications/background-policy-paper-green-financing-nepal.

2.1.1 The Nepal Rastra Bank

The Nepal Rastra Bank (NRB) is responsible for regulating and supervising banks and financial institutions in the country. The legal framework, including the Nepal Rastra Bank Act, 2002 and the Bank and Financial Institution Act, 2017, empowers NRB as an autonomous institution to carry out these duties. In addition, the Foreign Exchange Regulation Act, 1962 confers on the central bank the power and jurisdiction to regulate foreign exchange transactions. Cooperatives, which lie outside this legal framework, are governed by the Cooperatives Act, 1992.

NRB issues various directives, guidelines and policies to licensed institutions, taking into account domestic banking conditions and international best practices. The Banks and Financial Institutions Regulation Department has specific responsibility for overseeing these matters.

Through regular supervision, NRB obtains essential insights and information about the banking system, which aids in decision-making processes such as formulating monetary policies, updating regulations and taking timely corrective actions when issues arise with BFIs. The major supervisory functions performed by NRB include continuous monitoring of indicators relating to financial soundness and stability, identifying early warning signals, conducting on-site inspections to ensure proper management of risks, and ensuring compliance with regulatory norms.

Monitoring of BFIs lies with NRB, while the supervision of development banks is carried out by the Financial Institution Supervision Department. Supervision is based on inspection and supervision bylaws, manuals, guidelines, directives and circulars. NRB's supervisory system includes periodic assessments conducted on a quarterly, semi-annual and annual basis. These supervision activities primarily focus on the financial situation, governance practices, compliance with laws and regulations, and risks that may impact business operations. Through regular supervision and monitoring, BFIs are encouraged to maintain a prudent banking system, and early warning signals are identified to proactively address potential risks and ensure overall financial stability.

Nepal Rastra Bank is an active member of international sustainable or green finance networks such as the Sustainable Banking and Finance Network (SBFN) and the Alliance for Financial Inclusion (AFI). However, it is not a member of the Network for Greening the Financial System (NGFS), which is also a global network of central banks and supervisory authorities.[3]

3 A Background Policy Paper on Green Financing in Nepal, UNDP, 2021. https://www.undp.org/nepal/publications/background-policy-paper-green-financing-nepal.

2.1.2 Nepal Bankers' Association

Nepal Bankers' Association (NBA) is dedicated to promoting efficient and modern banking practices within the country Its primary objective is to develop and enhance the banking sector based on contemporary principles and prudent practices.

One of the key roles of the association is to support its members in their banking business and activities. It offers valuable suggestions and guidance to help banks navigate challenges and make informed decisions. Furthermore, the association actively engages with the government of Nepal and NRB, providing recommendations on banking policies and advocating for timely reforms to ensure a dynamic and progressive financial system.

It establishes a platform for cooperation, allowing banks to share experiences and find solutions to common problems relating to business operations, administration, legal matters, procedural aspects and technological advancements.

The NBA also plays a crucial role in facilitating knowledge-sharing and research in the banking sector. It acts as a central hub for collecting and distributing research-oriented materials, analytical articles, information, statistics and reports pertaining to banking activities and business. It functions as a clearing house for banking statistics, enabling banks to access and utilise valuable data for informed decision-making.

NBA organises training sessions, seminars and conferences to enhance the knowledge, skills, efficiency and productivity of banking professionals. In addition, the association has a dedicated Banking Training Centre that collaborates with member banks to provide specialised training programmes.

2.1.3 Development Bankers Association Nepal

Development Bankers Association Nepal (DBAN) was established in 2005 as per the Institutions Registration Act, 2034. The development banks, Class B financial institutions, established as per the Bank and Financial Institutions Act, 2073, are members of the association. The Executive Committee, elected by the Annual General Meeting as per the provisions outlined in the institution's statutes, formulates policies and action plans, and executes them for the benefit of member banks.

DBAN coordinates its member banks, working to ensure financial stability in the banking industry and contributing to the economic development of the country. It identifies common issues among the development banks and raises them with the government, regulators and other stakeholders, offering possible solutions to address them.

DBAN also works to contribute to society by organising various programmes such as enhancing financial literacy, fostering green financing, and minimising the risks in banking transactions, etc. It ensures process standardisation among its member banks, mitigating risks, fostering good governance culture, assisting with compliance with acts, regulations and directives, and educating the boards of directors, senior management and staff of its member banks.[4]

DBAN has now started working on the utilisation and promotion of green finance, and is keen to create uniform standards applicable to its member banks for green financing.

2.2 Key Development Sectors in Nepal

The Central Bureau of Statistics in Nepal had estimated economic growth of 5.84% for 2021/22. Agriculture, industry and service sectors were estimated to grow by 2.3%, 10.19%, and 5.93% respectively. The share of agriculture, industry and service sectors in GDP stood at 23.95%, 14.29% and 61.76% respectively in 2021/22 (Table 2-1).[5]

Table 2-1: Share in GDP (%)

Sectors	2019/20	2020/21[R]	2021/22[P]
Agriculture*	25.16	24.90	23.95
Industry	13.66	13.69	14.29
Service	61.18	61.41	61.76
Real GDP Growth (Percent)			
GDP Growth	-2.37	4.25	5.84
Agriculture*	2.43	2.85	2 .30
Industry	-4.02	4.51	10.19
Service	-4.53	4.19	5.93

*Agriculture, Forestry and Fishing

P: Preliminary Estimation

R: Revised Estimation

Source: Central Bureau of Statistics

4 https://www.dban.com.np/

5 Current Macroeconomic and Financial Situation of Nepal 2021/22, NRB, page 1-2: https://www.nrb.org.np/contents/uploads/2022/08/Current-Macroeconomic-and-Financial-Situation-English-Based-on-Annual-data-of-2021.22-2.pdf.

Nepal's economy is heavily dependent on imports of basic materials, and on foreign markets for its forest and agricultural products. Nepal imports essential commodities such as fuel, construction materials, fertilisers, metals and most consumer goods, and exports products such as rice, jute, timber and textiles. Nepal's great river systems provide immense potential for hydroelectric development. If developed and utilised within the country and exported to India (the principal market for power generated in Nepal), this could become a mainstay of the country's economy. Industrial production represents a small but growing segment of economic activity. Most industries are small, localised operations based on the processing of agricultural products. There are more industrial enterprises (mostly cottage industries) in the private than in the public sector.

Real GDP growth slowed in Q1FY23 as the industrial sector contracted, despite positive growth in the services and agricultural sectors. A decrease in construction activities, the lower registration of new businesses, slower credit growth to the private sector and lower imports of intermediate and capital goods suggest a decline in private investment during Q1FY23.[6] Agricultural sector growth is projected to average 2.6% per year over FY23-FY25, reflecting increased rice paddy production in FY23 and a five-year agreement on the supply of chemical fertilisers between the governments of India and Nepal signed in February 2022. Industrial sector growth is forecast to pick up as newly commissioned hydroelectric power plants drive electricity production higher and boost industrial growth in the medium term.

2.2.1 Environmental and Social Maturity

Environmental Aspects

As a country vulnerable to climate change, environmental sustainability is a critical concern for Nepal. Increasingly, there has been recognition of the need for the financial sector to play a part in addressing this issue. Nepal's financial system is dominated by banks, with much of their assets invested in sectors that can have negative impacts on the environment, such as agriculture, construction and real estate. This continues to expose the financial system to high environmental and climate risks. Furthermore, very little is known on the capacity of the banks to perform environmental risk calculations when making investments.[7]

6 https://www.worldbank.org/en/country/nepal/overview
7 A Background Policy Paper on Green Financing in Nepal, UNDP, 2021.

Green financing and sustainable banking principles have started to be incorporated in the financial sector, with some banks offering green loans for environmentally friendly projects or initiatives. Similarly, there is a growing interest in renewable energy projects, and some financial institutions have started providing loans for such projects. According to a study from the International Finance Corporation (IFC), greening of the financial system would open up an investment potential of $46.1 billion by 2030, which the private sector, including the multilateral development banks and local and regional financial institutions, can tap into. It is important to note that meeting this potential can also fulfil the conditional targets as outlined in Nepal's new, enhanced nationally determined contribution (NDC), which provides an additional argument on the need for private finance.[8]

NRB has also taken steps to promote green financing. It has issued directives for commercial banks to allocate a certain percentage of their total loans to sectors which can be environment-friendly, such as energy, tourism and agriculture. However, the development of green finance is still in its early stages. The country has continued to make progress in the "Developing" sub-stage of the "Implementation" stage of the overall Sustainable Banking and Finance Network (SBFN) Progression Matrix. Nepal has formally launched its sustainable finance framework, including the Guideline on Environmental and Social Risk Management (ESRM) for Banks and Financial Institutions, and the Environmental and Social Due Diligence (ESDD) Checklist and E&S Risk Rating Tool and Annual Reporting Template. The ESRM guideline was made mandatory in 2020 for Nepalese BFIs through a directive. The guideline was updated in February 2022 to include consideration of climate-related risk. At present, NRB is in the process of developing a green finance taxonomy. NRB plans to collect data on sustainable finance, assess the quality of the environmental and social risk assessment reports received, and engage with banks and financial institutions to provide capacity-building. Nepal is also working with UNFCCC to obtain funding from the Green Climate Fund.

8 A Background Policy Paper on Green Financing in Nepal, UNDP, 2021.

Nepal's Sustainable Finance Journey[9]

- **2014-16:** Nepal Rastra Bank (NRB) joins the Sustainable Banking and Finance Network.
- **2018:** NRB issues its Guideline on E&S Risk Management (ESRM) for Banks and Financial Institutions, E&S Due Diligence Checklist and E&S Risk Rating Tool and Annual Reporting Template.
- **2019:** The government of Nepal passes the Environmental Protection Act, 2019 (2076), which creates the Environment Protection Fund. In October NRB conducts a survey on awareness of sustainable banking practices among BFIs.
- **2020:** An NRB Unified Directive mandates all banks and financial institutions to follow the Guideline on E&S Risk Management. The government of Nepal issues Environmental Protection Rules, 2020. NRB issues a Financial Literacy Framework to promote financial education and inclusion.
- **2022:** NRB updates the Guideline on E&S Risk Management (ESRM) for Banks and Financial Institutions, to include consideration of climate-related risks.

Social Aspects

Financial inclusion is a key issue in Nepal, with many people in rural and underprivileged areas lacking access to basic financial services. This has been a significant focus of the government and Nepal Rastra Bank, which have implemented measures such as encouraging the opening of branches in rural areas and promoting microfinance institutions and cooperatives. The 2021 NRB report mentions that 67.3% of the population have access to bank accounts. Similarly, 26% of the population had access to formal insurance in 2019 compared to 11% in 2015. There has also been a rapid expansion of financial services over the past five years, with commercial banks reaching 752 of the country's 753 local government areas.

Despite the decrease in the total number of BFIs, the numbers of financial access points have significantly increased over the years. As per NRB, in 2021 the number of branches of commercial banks, development banks and finance companies per 100,000 population stood at 18.98, which is largely in line with IMF Financial Access Survey statistics.

9 Nepal Country Progress Report, April 2022 accessible at https://sbfnetwork.org/wp-content/uploads/pdfs/2021_Global_Progress_Report_Downloads/2021_Country_Progress_Report_Nepal.pdf

Usage of formal financial services has significantly risen not only for the urban population but also for the rural population as well. In rural areas, usage of formal financial services increased from 58% in 2014 to 88% in 2022, of which 77% use banking services and 11% use other formal financial services.

2.3 Regulatory Landscape

Alongside the broad benefits of the ESRM guideline, regulators in Ne pal have also introduced sector-specific policies. Some of the key laws, policies and initiatives are listed below.

Key Laws, Policies and Initiatives Relating to Sustainable Financing

The following are the laws, policies and initiatives relating to sustainable financing:

- Nationally Determined Contribution (NDC)
- National Climate Policy 2019
- 2017 Nepal Sustainable Development Goals: Status and Roadmap 2016 – 2030 roadmap by the National Planning Commission
- Unified Directive for ESRM (NRB, 2020)
- ESDD Checklist and E&S Risk Rating Tool (NRB, 2018)
- Guideline on ESRM for Banks and Financial Institutions (NRB, 2018)
- National Review of SDGs, Gov of Nepal, National Planning Commission (2017)
- Guidelines for Green Building Technology
- REDD+ Strategy 2017
- Nepal Forest Policy (2017)
- Nepal Climate Financing Framework (2017)
- National Adaptation Plan of Action, 2010
- Environmental Protection Act, 2019
- Environment Protection Rules (EPR) 2020
- National Agricultural Policy, 2004

Recognising the development-induced destruction of natural resources, particularly forest areas, the government of Nepal (GoN) included the need for an environmental impact assessment (EIA) for major infrastructure projects in the periodic policies of the Sixth Plan (1980-1985). A decade later, the government issued National Environmental Impact Assessment Guidelines (1993) to promote the use of an initial environmental examination (IEE) or environmental impact assessment (EIA) for prescribed projects to identify, predict and evaluate the impacts of the project on physical, biological, socio-economic and cultural aspects of the environment, and to propose enhancement and mitigation measures for beneficial and adverse impacts respectively, along with monitoring and auditing requirements. In 1995, the government also issued two separate EIA guidelines for forestry and industry sectors. After nearly four years of EIA guidelines dictating infrastructure project IEEs and EIAs, prescribed projects now fell under the provisions of the Environment Protection Act (EPA, 1996) and the Environment Protection Rules (EPR, 1997).

Following the change in the political system and the new constitution of Nepal (2015), which includes the roles and responsibilities of the three-tiers of government (at national, provincial and local levels), a new Environment Protection Act (EPA) was enacted in 2019 (repealing the 1996 Act), and Environment Protection Rules (EPR) were issued in 2020. The 2019 Environment Protection Act imposed an additional study – a brief environmental study – for small-scale, environmentally sensitive projects. The act makes provision for a separate brief environmental study, an IEE, and a separate EIA under the environmental study, and includes a Strategic Environmental Assessment (SEA) for prescribed projects. Each of the seven provinces of Nepal now has a separate Environment Protection Act and Environment Protection Rules, based on the federal-level Environment Protection Act and Environment Protection Rules.

In Nepal, environmental assessment covers the impacts of a project on physical, biological, social, economic and cultural aspects. There are no separate legal provisions to analyse environmental and social aspects separately (as a stand-alone document) and get approval for project implementation. Depending on the nature and location of the project (either single location or linear) and the sensitivity of the area, existing policies and legal provisions governing issues such as forests, protected areas and species, occupational health and safety, archaeological, cultural and historical sites, labour, and industrial impacts on air, water, noise, etc. are reviewed during the IEE/EIA study. The EPA and EPR are the basic laws to address environmental and social concerns of any prescribed projects in Nepal. The EPA and EPR provide environmental clearance for project implementation.

The EPA (2019) has provisions to carry out a study, on a periodic basis, to analyse the adverse impacts of climate change on local communities, the ecosystem and biodiversity; to prepare and implement an adaptation plan; to identify areas emitting greenhouse gases and launch necessary programmes; to issue necessary orders to mitigate adverse impacts and risks of climate change; to determine and enforce necessary standards to set priorities and mitigate climate change impacts and risks, including development of technologies; and to participate in carbon trading.

The government of Nepal has issued the National Environment Policy (2019), and other sectoral policies such as a National Forest Policy (2019) and Water Resources Policy (2020) etc., which also make provisions to carry out environmental assessments as per the legal framework. IEE and EIA reports of several projects of different sectors are legally prepared and approved. A cumulative impact assessment was carried out for hydropower projects constructed or planned for construction in the Trishuli River basin with support from the International Finance Corporation (IFC). A strategic environmental assessment was carried out for a Water Plan in 2004.

In 2018, Nepal Rastra Bank issued a Guideline on Environmental and Social Risk Management (ESRM) for Banks and Financial Institutions to encourage BFIs (Class A, B and C banks, financial institutions and infrastructure development banks) to consider environmental and social risks before making investments. In February 2022, the bank issued a revised ESRM guideline as per Section 79 of the Nepal Rastra Bank Act, 2002 (with a second amendment in 2016), with the objective of 'requiring BFIs to integrate environmental and social risk management into overall credit risk management process'. This 2022 guideline also focuses on assessing climate risks. The guideline adheres to IFC performance standards for project financing. The guideline provides guidance on environmental and social management systems (ESMS) for BFIs, with elaborate information on its components such as environmental and social (E&S) policy, E&S risk management procedures, conducting E&S due diligence, risk rating, decision-making, and monitoring and reporting to NRB on their sustainability performance, annually. To facilitate reporting to NRB, the guideline also contains a template for BFIs to report annually on ESRM (Annexe 11: Templates for reporting of BFIs to NRB Annual Statement on Environmental and Social Risk Management for [YEAR], page 69 of the 2022 guideline). Nepal Rastra Bank will likely focus on 'green investment' and issue a revised guideline based on 'green taxonomy' within two to three years, and will ask banks to launch ESRM in sectors such as energy and agriculture.

Being party to the UN Framework Convention on Climate Change (UNFCCC) in 1994, the Kyoto Protocol in 2005 and the Paris Agreement in 2016, Nepal has prepared the National Adaptation Programme of Action (NAPA) to implement most urgent immediate adaptation programmes, and is implementing adaptation projects using a National Framework on Local Adaptation Plan for Action (LAPA, 2011). Nepal issued a Climate Change Policy in 2011 and channelled budget for field-level climate change activities (from the Ministry of Finance) through the climate change budget code.

After the new constitution in 2015, the government issued a National Climate Change Policy (2019) and LAPA Framework (2019), submitted the Second Nationally Determined Contribution (NDC) to the UNFCCC Secretariat in December 2020, finalised the National Adaptation Plan (2021-2050) in 2021 to implement medium- and long-term adaptation actions, and released a Long-term Strategy for Net-Zero Emissions (2021) and National Framework on Climate Change-induced Loss and Damage (2021). During preparation of the NAPA, in 2021 Nepal conducted a climate change vulnerability and risk assessment (VRA) for development sectors, including water resources, energy, industry, transport and physical infrastructure. To integrate gender in climate change, the government of Nepal issued a Gender Equality and Social Inclusion (GESI) Strategy and Action Plan on Climate Change (2021-2030) in December 2020.

From 2019 to 2021, necessary policies were formulated to make development initiatives environment- and climate-friendly. The Environment Protection Act (2019) and its Rules (2020) are enforced to address both environmental matters and climate risks. Nepal is also implementing the Good Governance (Management and Operation) Act (2008), to make the public administration of the country pro-people, accountable, transparent, inclusive and participatory, and to make its outcome available to the general public. Several legal provisions are mentioned in the legislation regarding operation of the governance.

3 Current Status on ESRM Implementation, Gaps and Evaluation of Banks Interviewed

3.1 Implementation Experience

There are several E&S policies, guidelines and legal provisions in Nepal aimed at strengthening national efforts towards making development projects environment- and climate-friendly. For BFIs, the ESRM guideline provides ample opportunities to integrate environmental and social safeguards into investment proposals. However, enforcement and implementation are weak. As the study of secondary data and the information gathered through interviews and discussions with key stakeholders in Kathmandu show, Nepal is in the early stage of environmental monitoring and auditing. For example, the results of IEE/EIA reports that have been implemented are yet to be used to improve the quality of the IEE/EIA reports of similar development projects to be implemented in similar physical/ecological conditions. Reporting on the implementation of ESRM has just begun. NRB has not yet undertaken verification of data submitted by banks. Monitoring and evaluation needs to be institutionalised, good practices need to be documented, and learning needs to be customised in similar future development programmes and projects. The overall learnings[10] from interviewing fifteen banks and discussions with key stakeholders have been summarised below:

3.1.1 Understanding of the ESRM guideline

- It is encouraging to note that banks are aware of the ESRM guideline and consider it their responsibility to comply with its provisions.
- Understanding of the elements contained in the ESRM guideline among bankers, borrowers and the regulatory body varies significantly, however.
- Understanding of environmental and social requirements/safeguards varies among bank officers involved in or assigned to handle environmental law and the ESRM guideline.
- Banks are offering loans taking into consideration approved IEE or EIA reports. The ESRM guideline acknowledges Nepal's framework of environmental laws.
- However, inconsistency in the ESRM guideline regarding legal requirements may affect compliance with both the guideline and national environmental law.

10 The findings here are summarised using the information collected through secondary sources available as open resources as well as from interviews with banks. The findings are based on anecdotal evidence. Due to the confidential nature of the internal ESMS manual and checklists, Banks were reluctant to share these with EMC. E&S policy was only available to bank employees internally and the ESMS Manual and checklists were under the control of Credit Risk Departments.

3.1.2 Acceptance of the ESRM guideline

- The ESRM guideline encourages BFIs to integrate environmental and social safeguards and climate vulnerabilities and risks in their credit. NRB is to be appreciated for this effort. This guideline will help BFIs ensure that their investments contribute positively to managing E&S and climate risks.
- NBA informed that banks are now comfortable with the ESRM guideline. This indicates the broader acceptance of ESRM in bank operations, especially in processing loans.
- However, thorough capacity-building is required at all levels to operationalise the ESRM.

3.1.3 E&S Systems

- The banks interviewed indicated that the ESRM policy and procedures are in place and approved by the board.
- However, E&S/ESG policies are not publicly disclosed.
- Policies and procedures are in alignment with the ESRM guideline (February 2022).
- Priority is given to national legal requirements and NRB guidelines.
- The exclusion list adopted is the one provided in NRB's 2022 ESRM policy.
- Banks with DFI investments have an updated list to match DFI requirements.
- The updated exclusion list (in the case of banks receiving DFI funding) is made applicable to the specific project or line of funding.
- Banks are screening all corporate and business loans using the exclusion list and thereafter using ESRM checklists as applicable. According to the ESRM Report of Commercial Banks of Nepal - Fiscal Year 2078/29 published by NRB, no loan requests have been rejected based on the exclusion list in the past year.
- External grievance redressal mechanisms (GRM) are in place as per NRB's guidelines. Information is made available through the website. Suggestion boxes are available at branch level.

3.1.4 Status of ESMS

- Few banks are aware of the details of various elements of environmental and social management system (ESMS), such as policy, procedures (evaluating E&S risk), transaction screening, risk categorisation, E&S due diligence, conditions of financing, monitoring E&S risk and reporting.
- Several banks have also incorporated E&S risks into core risk management, but none of the banks have rejected any transaction based on E&S grounds.
- Development banks consider the approval of an IEE and EIA report by the competent government authority as a basis for providing credit. The environment management plan is an integral part of the approved IEE or EIA report.

3.1.5 E&S Capacity

- At most of the banks interviewed, the credit risk officer is the ESRM officer/manager.
- Most of the BFIs are conducting preliminary training programmes on screening using the exclusion list and the contents of environmental and social due diligence (ESDD) checklists for all relationship managers (RMs) and credit risk department officials.
- In some of the banks, senior level executives have attended training and events conducted by IFC, Dolma Fund, FMO and NBA.
- Most of the training programmes within BFIs are being conducted by the bank staff themselves.
- Many of these banks have a designated E&S officer and allocated funds, and have conducted ESRM training or workshops, and made transactions subject to environmental and social due diligence (ESDD) and with an E&S action plan.

3.1.6 E&S Commitment

- Intent and understanding of ESRM implementation within the credit risk department of banks could be observed.
- There was no evidence to indicate any public commitment by CEOs or boards of the banks interviewed except for two banks.
- For selected Class A banks, commitments to environment and social aspects within the annual report were claimed to have been made. In most cases, this is understood to be synonymous with activities related to corporate social responsibility (CSR).
- Reporting on ESRM implementation is delivered to NRB as per the requirement. NRB has published a summary for commercial banks for the first time. No inspection has yet been carried out to validate the data.
- A green line of credit for Class B development banks is under consideration. The lead is taken by DBAN.
- Most of the banks interviewed are following NRB's requirement of spending 1% of portfolio on green loans to promote electric vehicles, etc.
- Some of the banks have joined the Partnership for Carbon Accounting Financials (PCAF) and/or the Global Alliance for Banking on Values (GABV).

3.1.7 Human Resources, Labour, and Gender-Based Violence and Harassment

- Most of the banks have a whistleblowing policy in place. They state that harassment of any kind is covered under the scope of this policy.
- No evidence of a separate policy on gender-based violence and harassment (GBVH) was found.
- A code of conduct or a code of ethics has been adopted by most of the banks. The officials stated that it included a statement on non-discrimination and equal opportunity.
- Human resource-related policies and documents were briefly discussed as part of the induction training programme, and policies were shared with employees via the intranet upon joining the bank.

- For most banks, internal complaints are reported to be under the remit of the nominated grievance officer for external grievance redressal (as required by NRB).
- Some banks have an internal reporting portal.
- In many cases, the HR department also supports this function.

3.1.8 E&S Reporting

- E&S-related performance reporting is not published or shared.
- The BFIs have started annual reporting on the status of implementation of the ESRM guideline. However, this data has not been verified.
- The ESRM report (fiscal year 2021/2022) notes adoption of ESRM policy (or a similar policy) and ESRM procedures (manuals) in several commercial banks.

3.1.9 Understanding on Climate Risks

- The ESRM guideline emphasises the need to look into climate risks leading to financial risks. However, the guidance is currently not explicit.
- Physical risks include extreme weather events, ecosystem pollution, water scarcity, deforestation, public policy change and technology changes.
- Sea-level rise and marine pollution are also included for Nepal, indicating the need for a review and country-specific climate risks to be addressed.
- It would be necessary to consider the vulnerability and risk assessment (VRA) framework and VRA reports of development sectors published by the government in 2021.
- NRB is in the process of drafting a 'green taxonomy framework' and identifying national priority sectors. The ESRM guideline may be revised to internalise green investment.

3.1.10 Aligning Corporate Social Responsibility towards Sustainability

- Banks are supporting non-governmental organisations and local clubs through corporate social responsibility funds for plantation drives and waste management.
- One of the banks stated that it encourages its staff to use a bicycle for one month to contribute to the reduction of greenhouse gas emission.
- Banks also provide loans for e-vehicles, which supports climate action. These actions indicate increasing awareness of the importance of reducing air pollution and promoting climate friendly actions.
- Alignment of corporate social responsibility with the banks' sustainability goals is needed.

3.1.11 Other Findings

- The banks interviewed do not share their E&S/ESG policies, ESRM procedures and checklists with their borrowers.

- Banks only share action plan/s and mitigation measures with implementation timelines with their borrowers as part of the loan covenants.
- Environmental and social due diligence (ESDD) checklists are completed internally by relationship managers, supported by inspection heads or branch/province heads through review and site visit functions. These completed checklists and loan agreements were not available for review by EMC.
- External consultants are hired mostly for hydro-power projects. This engagement is limited to conducting studies related to IEE or EIA as per national regulations, undertaken by the clients themselves.
- Stringent provision on environmental and social due diligence (ESDD) by banks is currently distracting borrowers and encouraging them to contact other BFIs with low or no ESDD requirements.

3.2 Bank Evaluation and Peer Comparison

A structured approach was used to create a framework for conducting this study. Through planned interviews and interactions, preliminary information was gathered and secondary information was validated on the ground through discussions. A traffic light system (TLS) was used for evaluation of the banks sampled. TLS is a universally recognised assessment tool used for evaluating performance in relation to predefined goals or indicators. TLS allows performance information to be communicated effectively. Eighteen TLS indicators were used for evaluation of the banks sampled. Each of the sampled banks were evaluated on coverage of these 18 TLS indicators within their operations. These indicators are shown in Table 3-1.

Table 3-1: TLS Indicators used for Evaluation of Sampled Banks

Indicator List	
1. E&S policy	10. Climate reporting
2. Exclusion list	11. Differentiated green facilities/ products
3. E&S management system/procedure	12. Policy or statement on gender-based violence and harassment
4. E&S specialist working on E&S management	13. Policy or statement on non-discrimination and equal opportunity
5. External grievance redressal mechanism	14. Employee grievance redressal mechanism and reporting
6. Public commitment by CEO or similar	15. Whistleblowing policy
7. Board champion of E&S/sustainability	16. Willingness to disclose key E&S policies, and documentation
8. Senior manager with knowledge of E&S issues	17. Willingness to retain external E&S consultants for the appraisal and monitoring of certain investments in high-risk sectors
9. E&S reporting	18. Willingness to join international sustainable finance initiatives (e.g., Equator Principles, TCFD)

The sampled banks were scored on coverage of each indicator, based on the availability of information and maturity of E&S aspects, as per the scoring method presented in Table 3-2.

Table 3-2: Scoring Method

Indicator Coverage	Color	Score
Full coverage		4
Partial coverage		3
Planned		2
Does not exist		1
Cannot be determined		0

Table 3-3 shows the evaluation and peer comparison of the 15 banks using the TLS assessment and scoring method described above.

Table 3-3: Bank Evaluation and Peer Comparison using TLS Assessment

#	ESG Assessment Indicator	Nepalese Banks (including Class A without DFI, Class A with DFI, Class B and International Banks)														
		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
1	E&S Policy	3	3	3	3	3	3	3	3	3	3	3	3	2	3	3
2	Exclusion list consistent with international practice	3	3	3	3	4	3	3	3	4	4	4	3	3	3	4
3	E&S management system/ procedure	3	3	3	3	4	3	3	3	3	3	4	3	3	3	3
4	E&S specialist working on E&S management	3	3	3	3	3	3	3	3	3	3	4	3	3	3	3
5	External grievance redressal mechanism	4	4	4	3	4	4	3	4	4	4	4	4	4	4	4
6	Public commitment by CEO or similar	1	1	2	1	1	1	1	1	1	1	3	1	1	1	1
7	Board champion of E&S/ sustainability	4	3	4	3	4	4	3	3	4	4	4	4	3	3	4
8	Senior manager with knowledge of E&S issues	4	4	3	3	4	4	4	4	4	4	4	4	3	3	4
9	E&S reporting	1	3	3	1	3	1	3	3	3	3	3	3	3	3	3
10	Climate reporting	2	1	1	1	1	2	1	1	3	3	3	3	1	1	1
11	Differentiated green facilities/ products	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
12	Policy or statement on GBVH	3	3	3	1	3	3	3	1	3	3	4	1	1	1	1
13	Policy or statement on non-discrimination and equal opportunity	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
14	Employee grievance mechanism and reporting	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
15	Whistleblowing policy in place	4	4	4	1	4	4	1	4	4	4	4	4	2	4	4
16	Willing to share internal policies, procedures, sample investment documentation during ESDD for financing.	4	0	0	0	4	4	0	0	4	4	4	4	0	0	4
17	Willing to retain external E&S consultants for appraisal and monitoring of certain investments in high-risk sectors	4	3	3	3	3	4	3	3	3	3	4	3	3	3	3
18	Willing to join international sustainable finance initiatives (e.g., Equator Principles, TCFD)	4	2	4	2	4	4	2	2	4	4	4	2	2	2	2
Sum Total		**59**	**52**	**55**	**43**	**61**	**59**	**48**	**50**	**62**	**62**	**68**	**57**	**46**	**49**	**56**

Table 3-3 shows the peer comparative analysis of the 15 banks sampled. The individual indicator score has been added for each bank to give the final score. This ranges from 0 to 100. Error! Reference source not found. provides an interpretation of the E&S maturity of these banks with regards to the final scores shown in Table 3-3. The higher the score, the higher the E&S maturity and vice versa.

Table 3-4: Final Scores, E&S Maturity Level and Description

FINAL SCORE	E&S MATURITY LEVEL	DESCRIPTION
0 – 30	No ESRM system	No ESRM-related documentation in place
31 – 40	Initial Phase of ESRM	Commitment on ESRM made, documentation to be initiated
41 – 50	Low E&S Maturity	Documentation in place, implementation just initiated, capacity-building to be initiated
51 – 60	Intermediate E&S Maturity	Selective screening of disbursements against exclusion list, implementation (of checklists in annexe) and capacity-building efforts initiated; dedicated personnel
61 – 70	High E&S Maturity	Screening all loans against exclusion list, due diligence checklists in use, ESRM procedures digitised and well-integrated in credit risk management, capacity-building in place, dedicated personnel ensuring implementation and preliminary internal reporting
71 – 80	Fully Established ESRM System	Advanced implementation as per the ESG policy and ESGMS, ESRM procedures digitised and well-integrated in credit risk management, annual training calendar, regular internal audits and reporting, part of international initiatives
81–100	Fully Established and Functional ESRM System	Advanced implementation as per ESG policy and ESMS, ESRM procedures digitised and well-integrated in credit risk management, annual training calendar, KPIs on ESG for senior management, regular internal audits and reporting; external disclosures include climate-related reporting

The following trends can be observed among the banks:

- No banks score below 40.
- A total of five banks fall into the 41-50 category. It can be inferred that out of the 15 banks, these five have low E&S maturity.
- A total of six banks fall into the 51-60 category, so it can be inferred that these six have intermediate E&S maturity.
- A total of four banks fall into the 61-70 category, so it can be inferred that these four have high E&S maturity in comparison to the other banks.

The recommendations and way forward included in **Section 5** are dependent on the banks' level of E&S maturity.

4 Recommendations and Way Forward

Based on the evaluation of the banks and the information gathered in interviews and the study of secondary resources, this section presents recommendations and the way forward for the Nepalese banks.

General Recommendations

1) A higher level of consistency between the legal provisions and the ESRM guideline would greatly help BFIs and borrowers to comply with the law and the ESRM guideline.

2) A common understanding among regulatory agencies, BFIs and borrowers is needed to achieve the desired outcome of the ESRM guideline and to benefit engaged partners.

3) Increased engagement and dialogue at senior management level plus human resources development at working level (ESRM officer) should be initiated on an immediate basis. A training needs assessment study would help to clearly understand the type of information and needs of relevant stakeholders and to aid the design of target-based training modules. Structured long-term training programmes should be developed.

4) To internalise E&S safeguards and climate risks in BFI credit risk management processes, module-based training and resource materials should be developed to aid common understanding between the regulatory agency, BFIs and borrowers. Relevant organisations should be encouraged to develop practical and easy-to-understand resource materials to effectively implement the ESRM guideline and provisions for climate vulnerabilities and risks.

5) Training in ESRM implementation and sustainable finance could be customised based on the E&S maturity levels noted in this report. Some Class A banks are engaged in ESRM reporting, and development banks are yet to internalise E&S and climate risk management. This customisation will help address the specific needs of each BFI.

6) Resource materials should include guiding principles and processes for assessing borrower proposals, monitoring and reporting. They should also contain case studies on good or bad practices, to inform regulatory agencies and BFIs; and ways to comply with existing requirements on E&S and climate risks. The list of profiles of some of the leading banks in Volume 2 (annexes) may help.

7) To the extent possible, local good practices should be collected and synthesised. Nepal has decades-long experience in implementing climate change adaptation projects

to build the capacity of climate-vulnerable communities to adapt and build resilience to climate change. Good practices may be shared during training and orientation programmes.

8) Field visit and case study preparation should be an integral part of officer-level (hands-on) training. This provides participants with an opportunity to understand the field situation and implementation status of ESDD requirements and/or EIA report and monitoring results. Banks may be interested in organising exposure visits to borrowers to show the outcomes of ESRM/EIA implementation, good and emerging practices.

9) The country today has a limited number of experts and human resources in environmental and social safeguards. Climate vulnerability and risk assessment is a new area. There is some discussion over the scientific basis for assessing climate-related risks. Hence, the Nepal Bankers' Association should organise a Training of Trainers (ToT) programme and develop a 'cadre' of knowledge-based trainers to continue development of human resources in BFIs. Such training should also be provided to relevant officials of NRB and other regulatory agencies. Similarly, training and certification of ESRM auditors will help.

10) A review of the status of implementation of the ESRM guideline every three years would be helpful.

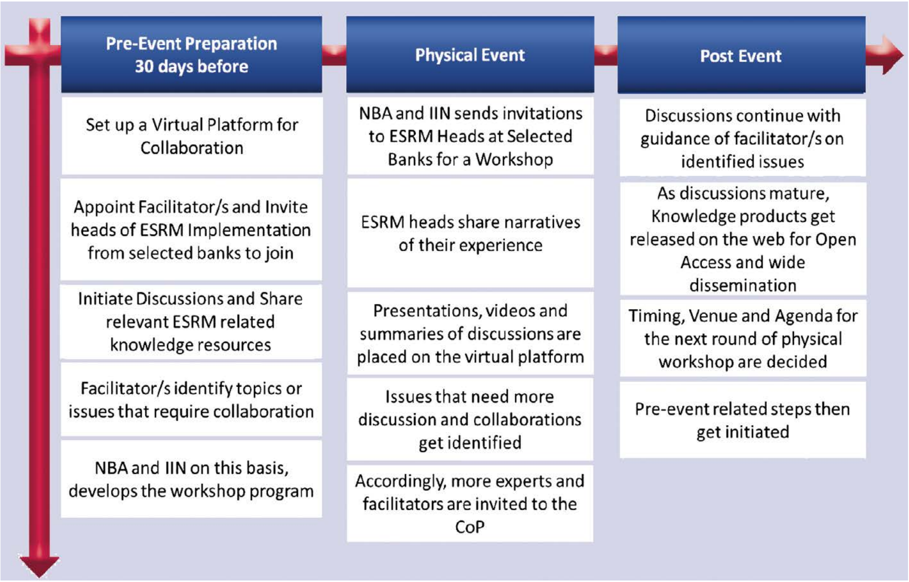
11) BFIs should be trained and encouraged to follow improved and transparent disclosure practices on ESG-related aspects. This can start with effective ESRM implementation, data collection, data verification and validation through structured and regular internal audits and developing ESG KPIs and an ESG framework. These should be aligned with long-term objectives of the BFI, industry standards and emerging national and international ESG issues. As the next stage, the BFI can then choose an appropriate ESG-reporting framework. For reporting, BFIs may explore globally recognised standards such as Global Reporting Initiative, Sustainability Accounting Standards Board, Task Force on Climate-related Financial Disclosures, etc.

Table 4-1: Interventions at Various Levels

Priority	Interventions
Strategic Level	
High	• Develop a **structured road map for sustainable finance** (with climate considerations) for Nepal following a consultative and co-creation process
Capacity-building	
High	• **Create a cadre of expert trainers** through a structured ToT programme • **Train** ESRM heads, managers/officers, risk committee members and relationship managers • Develop an **annual training calendar** and provide refresher trainings • Develop **ESG-related KPIs** for senior management
Medium	• Develop **standardised e-learning modules** that can be used by all banks • Create a **cadre of internal ESRM system auditors** at banks by developing a certificate programme for accreditation
Establish a Community of Practice	
Medium	• Create an **IT-enabled platform** as a Community of Practice (CoP) facilitated by NBA and IIN
Low	• **Publish knowledge products** on ESRM as well as case studies on best practices
Collaborations	
Medium	• Develop a **framework for disclosure** obligations In line with international best practices • Sponsor or facilitate **short "internships"** to international institutions for some of the leading ESRM heads to build their capacities, through a systematic application process. • Hold **annual roundtables** and invite international experts on ESG and sustainable finance

Initiating a Community of Practice (CoP) for long term capacity-building will be particularly beneficial since the BFIs have just started out on their ESG journeys. CoP is a model for collaborative learning through sharing of practice experience. It helps in innovation, providing feedback to policy development and procedures and a continuous update to agencies involved. All ERSM heads who have received a basic training or completed a certificate programme may become eligible to join a CoP established for promoting sustainable finance and ESRM in BFIs in Nepal. The CoP can be built and further developed jointly by NBA and IIN. Quarterly meetings of CoP are recommended. External experts for knowledge-sharing and guidance can be invited during these quarterly meetings, in addition to conducting regular undertakings constituted under the standard CoP meeting agenda. **Figure 4-2** suggests a process for building a quarterly workshop event for consideration while establishing a CoP.

Figure 4-2: Suggested Process for Building Quarterly Workshop Events



Some examples of CoPs in the finance sector include:

- The SME Green Finance Community of Practice at SME Finance Forum
- The Financial Institutions and Natural Capital (FINC) Community of Practice (2014-2016) resulted in a publication, Finance for One Planet. Inspired by the FINC CoP, the European Commission initiated the EU CoP Finance@Biodiversity.
- The Community of Practice at the International Centre for Sustainable Finance

Contact Us

Invest for Impact Nepal

Invest for Impact Nepal

Sanepa, Lalitpur Metropolitan City Ward No. 2, Lalitpur, Nepal

- info@investforimpactnepal.com
- www.investforimpactnepal.com
- www.linkedin.com/company/invest-for-impact-nepal/
- www.twitter.com/Invest4Nepal