Remittance in Development: Harnessing Migrant Money Flow for Economic Growth

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Thank you,

Sujeev Shakya
Team Leader
Chairperson,
NEF

Abbreviation and Acronyms

BFI	Bank and Financial Institutions
CA	Constitutional Assembly
CBS	Central Bureau of Statistics
CDS	Central Depositary System
CIF	Collective Investment Fund
CIT	Citizen Investment Trust
DFID	Department for International Development
DOFE	Department of Foreign Employment
FDI	Foreign Direct Investment
FESB	Foreign Employment Savings Bond
FY	Fiscal Year
GDP	Gross Domestic Product
GNI	Gross National Income
GON	Government of Nepal
IPO	Initial Public Offer
MoF	Ministry of Finance
NAV	Net Assets Value
NEPSE	Nepal Stock Exchange Limited
NLFS	Nepal Labor Force Survey
NPR	Nepali Rupees
NRB	Nepal Rastra Bank
NRN	Non Resident Nepali's
SEBON	Securities Board of Nepal
UAE	United Arab Emirates
ULI	Unity Life Insurance Limited
USD	United States Dollar
WB	World Bank

1. Introduction

Background and Rationale

There are two categories of Nepalis living and working abroad, Non Resident Nepalis (NRNs) and migrant workers. Historically, Nepalis who looked for employment opportunities took advantage of the porous and deregulated borders and migrated to India and later, as more countries opened up for employment, to Gulf countries and South East Asian countries and now also in many parts of the Western World . The diaspora population is increasing rapidly which can be primarily attributed to the increasing trend among Nepali youth to go oversees for employment and education purposes.

Ranked among the top five countries in terms of the contribution of remittance to Gross Domestic Product (GDP), remittance flows currently account for 23% of Nepal's GDP[1]. If channeled appropriately, remittance flows can be the engine for economic growth and development in Nepal. Currently, the bulk of the remittance flows are doing little to support economic growth and job creation in Nepal, primarily because the private sector and government have done little to explore ways to reinvest the cash flows into long-term growth engines. Further, cumbersome documentation process has prompted many Nepalis to send remittances through informal channels such as *Hundi*/*Hawala*, informal business transaction mechanisms and goes unaccounted for by traditional banking systems. Nepal Economic Forum strongly believes that the public and the private sector need to provide mechanisms to both house the capital flows from remittance, as well as to provide investment vehicles in Nepal**.**

Therefore, this study presents an understanding and analysis of the current scenario and practices, opportunities and challenges in the Nepalese financial system, and to identify appropriate investment avenues, to channelize the growing remittance flows into the formal and productive sectors of the economy.

Objective and Scope

The main objective of this study is to identify appropriate investment opportunities to channelize remittance flows into the Nepali financial system. The following were the scope of the study:

1. Determine trends and impacts of remittances in the Nepali economy
2. Analyze the current scenario of the capital market in Nepal and to understand the new developments
3. Review and analyze the existing Acts and Regulations like Mutual Fund Regulation 2067, Securities Act 2063, Portfolio Management Directives 3067 to understand the provisions for investments to migrant workers and, potentially, Non-Resident Nepalis (NRNs).
4. Evaluate the present state of the collective investment fund industry and provide international best practices relevant for Nepal.
5. Evaluate the present state of Foreign Employment Savings Bond (FESB) and provide necessary recommendations
6. Explore the existing impediments and opportunities for investment.

[1] *Migration and Remittance Factbook 2011*, The World Bank

Methodology

The study was carried out by undertaking a detailed review of available secondary literature and a quantitative analysis of the remittance flows in the country.

1. **Literature review** of various documents such as newspaper reports, journals, project documents on migration and remittance, the financial economy of Nepal, existing unregulated collective investment funds in Nepal and international best practices that could be relevant for the Nepali situation. Further, the existing policies that govern the capital market of Nepal were also reviewed to understand the provisions for investment to migrant workers and possibly NRN's.

2. **Quantitative analysis** of various information/database of remittance flows to chart out current financial flows, with particular focus on the high volume countries. Also, the current trends of remittance induced expenditure in the Nepali economy were also determined. Financial highlights and published data of various ministries such as the DOFE, Central Bureau of Statistics (CBS) Nepal, NRB, SEBON and other bilateral and multilateral institutions were reviewed.

The average exchange rate over the period from November 2010-11 of 72.9:1 (USD: NPR) is used throughout the analysis. Figures have been rounded to the second dearest decimal place.

2. Economic Overview

At the turn of the century, Nepal's Gross Domestic Product (GDP) for the FY 2000/01 stood at NPR 413 billion (USD 5.67 billion). Since then, Nepal's economy, as estimated for the FY 2010/11, has painstakingly grown to NPR 1,364 billion (USD 18.71 billion). The decade saw momentous change in Nepal's political spectrum through the removal of the monarchy and the end of the civil war. Political instability remains the major impediment towards attaining economic prosperity in Nepal. The central bank in its mid-term review of the current FY 2011/12 has estimated the GDP to grow by 4.5% at basic prices and annual inflation is expected to remain at 8%.

Changing Trends in National Income, Savings and Investments

Nepal has seen significant structural changes in the composition of GDP over the decade, with the economy gradually emerging as a services-led one, like many developed economies, including neighboring countries like India and Sri Lanka.

Post the peace accord reached in 2006, the share of the services sector in the real GDP has increased to 50.1% in the FY 2010/11 from 47.7% in the FY 2006/07. The Agricultural sector's performance has been volatile; by FY 2010/11 its share towards GDP has dropped to 34.9% from 36.0% in the FY 2006/07. Likewise, the share of Industrial sector has decreased to 15% from 16.3% in the FY 2006/07. Within the Service sector, the Financial Intermediation sub-sector's contribution to GDP at the end of FY 2008/09 was 4.23%, it gradually increased from 3.46% in the FY 2004/05.

Table 1 Nepal's Key Macroeconomic Indicators

Key Indicators	2006/07	2007/08	2008/09	2009/10	2010/11
Gross Domestic Product (GDP)-In NPR crore	72,817.8	81,566.3	98,805.3	117,190.5	134,681.6
GDP growth rate (%)	3.2	5.8	3.77	3.97	3.47
Agriculture, value added (% of GDP)	*36.0*	36.3	35.9	34.7	34.9
Industry, value added (% of GDP)	*16.3*	15.7	15.1	15.3	15
Services, value added (% of GDP)	*47.7*	48.0	49.0	50.0	50.1
Gross Domestic Savings (% of GDP)	*9.7*	11.2	8.0	9.4	6.7
Gross Consumption (% of GDP)	90.3	88.8	92.0	92.6	93.3
Gross Investments (% of GDP)	28.0	31.8	29.7	35.0	30.2
Inflation Rate (%)	5.9	6.7	12.6	9.6	9.6

Source: NRB

One of the important ways in which the financial sector influences economic growth, is through the formation of domestic savings. The average gross domestic savings (as a percentage of GDP) was 9% during the past five fiscal years, which can be considered below average. The sluggish growth of domestic savings can be primarily attributed to higher consumption ratio, and high inflationary pressure coupled with lower access to financial services.

Interest rates have an important impact on savings and on the flow of funds from the household sector to other sectors, as well as to various instruments of investment. As the increment in savings has a direct co-relation with the investments, the Nepali financial market can expect to have higher investment portfolio in the coming years if the inward remittances can be channeled towards savings.

Nepali's access to basic facilities

According to the main findings of Nepal Living Standards Survey-volume 3 (NLSS) 2010/11, unveiled by the Central Bureau of Statistics (CBS) in November 2011, Nepal has made satisfactory progress in social sectors, mainly in education and health. The overall literacy level (15 years and above) rose to 56.5% from 48%. Similarly, as shown in the table below, the access to primary schools has reached 94.7%, while the access to the health centers has reached 73.8%. Furthermore, despite the surge in quantity of Banks and Financial Institutions (BFIs), access to commercial banks is still at a disappointingly low rate of 39.9%.

Table 2 Access to facilities (within 30 minutes)

Facilities	FY 1995/96 (%)	FY 2003/04 (%)	FY 2010/11 (%)
Primary school	88.4	91.4	94.7
Health Center	44.8	61.8	73.8
Cooperative	25.9	33.7	53.9
Agricultural center	24.5	31.9	42.8
Commercial Bank	20.7	27.8	39.9
Haat bazar	41.4	60.7	64
Market center	24.2	34.4	44.7
Paved road	24.2	37.2	51
Dirt road vehicle passable	58	67.6	79.7
Bus stop	33.1	53	66

Source: CBS

In nominal terms, average household income grew by 152% to NPR 202,374 (USD 2,776.05) in the FY 2010/11 as compared to NPR 80,111 (USD 1,098.92) in the FY 2003/04. The disparity of income between the poorest and the richest also seems to be shrinking, with the nominal average per capita income of poorest 20 percent of the population increased to NPR 15,888 (USD 217.95) from NPR 4,003 (USD 54.91) in the FY 2003/04. However, these statistics should be taken only as a rough indicator. It is likely that estimation of earnings of Nepal's poorest population segment is inflated so as to be more politically appeasing to society.

Table 3 Details of Income

	1995/96	2003/04	2010/11
Nominal average household income in NPR	43,732	80,111	202,374
Nominal average per capita income in NPR			
All Nepal	7,690	15,162	41,659
Poorest 20% of population	2,020	4,003	15,888
Richest 20% of population	19,325	40,486	94,149
Share of farm income in household income	61	48	28
Non-farm income	22	28	37
Other income	16	25	35

Source: CBS

The survey shows that household income from the farming sector has decreased significantly, while the income from the non-farming sector has seen a noted increase. The trend shows a shift in people's reliance from agriculture to other sectors. Also the number of people living in their own houses has gone down, while the number of those living in rented houses has gone up, which reflects growing urbanization. The correlation of these statistics with the growing importance of remittance income suggests some of the impacts it has on the domestic economy.

3. Foreign Employment and Remittance

Over the years foreign employment has emerged as one of the primary source of employment for the Nepalese economy. In 2009, more than 3 million Nepalis were estimated to be working abroad (including in India)[2]. According to the Department of Foreign Employment (DOFE), Government of Nepal (GON), in the FY 2010/11, it granted approval to 354,716 workers for foreign employment, an increment of whopping 20.6%, as compared with the previous FY 2009/10, indicating the ever increasing number of Nepali workers leaving for foreign employment.

Foreign employment is dominated by the male workers, and Malaysia & the Gulf countries are the major destinations for Nepali workers. Of the total Nepali workers granted approval for foreign employment in the FY 2010/11, 29.9% are for Malaysia, 29% for Qatar, 20.1% for Saudi Arabia, 12.5% for UAE and 4.3% for Kuwait. The shares of these countries were 38.8%, 19%, 21.6%, 11.3% and 2.8% respectively in the previous FY 2009/10.

The 2008 Nepal Labour Force Survey indicates that 29.1% of households had at least one household member living abroad. The Survey also revealed that 23.0% of the households received remittances from abroad, principally from India, Qatar, Malaysia and Saudi Arabia.

[2] "Helping workers abroad," *Nepali Times,* Issue 52 (Decem 17, 2010- December 23, 2010). Accessed November 1, 2011, http://www.nepalitimes.com/issue/2010/12/23/Nation/17743

Table 4 Number of workers approved for Foreign Employment

	Total Approval for Foreign Employment			% change		Share
Country	**FY 2008/09**	**FY 2009/10**	**FY 2010/11**	**FY 2009/10**	**FY 2010/11**	**%**
	35,070	113,982	105,906	225.01	-7.09	29.86
Qatar	76,175	55,940	102,966	-26.56	84.07	29.03
Saudi Arab	48,749	63,400	71,116	30.05	12.17	20.05
UAE	31,688	33,188	44,464	4.73	33.98	12.54
Kuwait	2,291	8,255	15,187	260.32	83.97	4.28
Others	25,992	19,329	15,077	-25.63	-22	4.25
Total	**219,965**	**294,094**	**354,716**	**33.7**	**20.61**	**100**

Source: DOFE, GON

The rapid growth in the number of overseas migrant workers has resulted in large inflows of remittances, and remittance is gradually becoming the largest contributor to the Nepali economy. In fact, it's often said that Nepal's economy is "surviving on remittances"[3].In the year 2009, remittance accounted for 22.9% of Nepal's national GDP, making Nepal the fifth highest recipient of remittances (as a % of GDP) in the world. Similarly, amongst the Least Developed Countries (LDCs), United Nations classification, in 2010, Nepal was the second highest remittance recipient country after Bangladesh. According to the latest annual data published by NRB for the FY 2010/11, workers remittance grew by 9.4% to NPR 253.55 billion (USD 3.48 billion) compared to its growth of 10.5% in the previous FY 2009/10. The growth rate of inward remittance in the FY 2006/07 declined largely due to the global economic slowdown.

Table 5 Inflow of Remittance (figures in NPR million)

Fiscal Year	Inward Remittance	% Change
FY 2000/01	47,216	
FY 2001/02	47,536	0.7
FY 2002/03	54,203	14.0
FY 2003/04	58,588	8.1
FY 2004/05	65,541	11.9
FY 2005/06	97,689	49.1
FY 2006/07	100,145	2.5
FY 2007/08	142,683	42.5

[3] Birendra P Mishra."To have or not to have PM Bhattrai opted for 'to have'." *The Himalayan Times*, October 31, 2011. Accessed on November 15, 2011. http://www.thehimalayantimes.com/fullNews.php?headline=To+have+or+not+to+have++PM+Bhattarai+opted+for+%27to+have%27&NewsID=307518

FY 2008/09	209,699	47.0
FY 2009/10	231,730	10.5
FY 2010/11	253,550	9.4

Source: NRB

Figure 1 Year on Year Inflow of Remittance

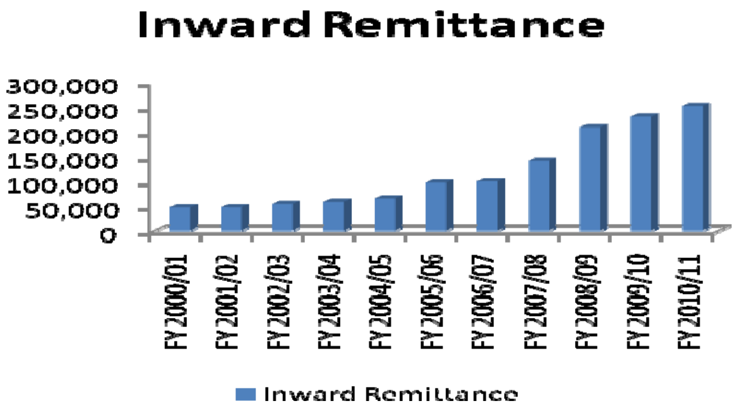
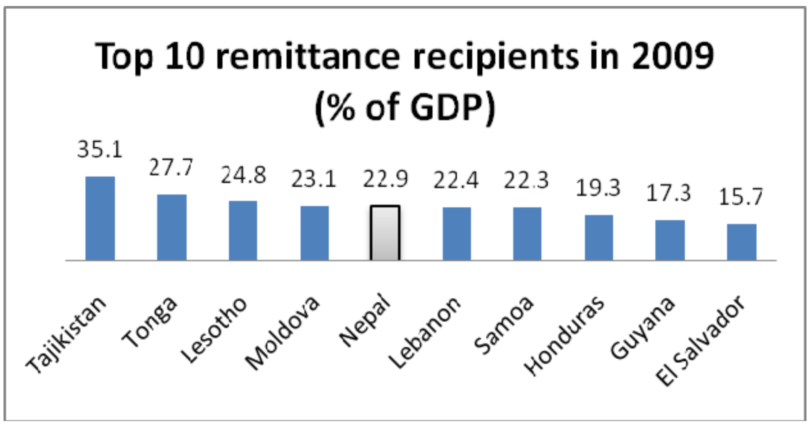


Figure 2Top 10 Remittance Recipient Countries as percentage of GDP



Source: World Bank, Remittances and Migration Fact book 2011, Second Edition, Nov 2011

The proportion of households receiving remittances has increased to 55.8 % in the FY 2010/11, from 31.9 % in the FY 2003/04. Whereas, the per-capita remittance rose to NPR 9,248 (USD 126.86) in the FY 2010/11 from NPR 2,100 (USD 28.81) in the FY 2003/04.

Table 6 Details of Remittance

Description	**1995/96**	**2003/04**	**2010/11**
Percent of all households receiving remittances	23.4	31.9	55.8
Total amount of remittance received (In billion nominal NPR)	13	46	259
Within Nepal	6	11	51
From Abroad	7	35	208
Per-capita remittance for all Nepal (NPR)	625	2,100	9,248

Source: CBS

3.1 Defining migrants: NRNs and migrant workers

There are two categories of Nepalis living and working abroad, Non Resident Nepalis (NRNs) and migrant workers. NRNs are Nepalis living in a foreign country with their immediate family. NRNs identify strongly with their roots in Nepal and are even looking for avenues to invest in Nepal. Migrant workers, on the other hand, are Nepalis who are employed outside Nepal, and are sending money back into the country to support their families. Together, these groups have become major contributors to Nepal's GDP.

3.2 Usage of Remittance

Workers remittance has seen a growth rate of over 20% on average over the last decade, and according to National Living Standard Survey (NLSS) 3, 2011 the primary usage of such is estimated to be 78.9% for daily consumption, 7.1% for repaying loans, 4.5% for Household property, 3.5% for education and 2.4% for capital formation. This highlights that the major portion of remittance is spent in unproductive sector.

Table 7 Primary usage of Remittance

Daily Consumption	78.9 %
Repay loans	7.1 %
Household Property	4.5 %
Education	3.5 %
Capital Formation	2.4 %

Source: CBS

3.3 Opportunities and Challenges

In Nepal's economy remittances provide opportunities to reduce widespread poverty, improve general living standards and stimulate economic growth. Remittance has substantially helped to stabilize Nepal's foreign currency reserves and Balance of Payments (BOP) position as remittance is a more constant source of income to developing countries, than official development assistance, foreign direct investment (FDIs) and other private flows. However, the role of remittance in Nepal so far has been very limited, as large chunks of migrants' inward remittance are absorbed in unproductive sectors like daily consumption, loan repayment and real estate sector, and merely 2.4% of inward remittance is used for capital formation. Moreover, due to the increment in purchasing power fueled by inward remittances, it has exhausted inflationary pressure on the economy as reliance on imported products has substantially increased amidst lower domestic manufacturing capacity.

There is a great amount of risk associated with the Nepali economy "surviving on remittances"[4]. Given the current bleak global economic outlook, and ongoing instability in the Middle-East, testing times could lie ahead for the Nepali economy, if the flow of funds decline substantially or without warning. Therefore, it is crucial to find ways to channel these funds into productive

[4] Birendra P Mishra."To have or not to have PM Bhattrai opted for 'to have'." *The Himalayan Times*, October 31, 2011. Accessed on November 15, 2011. http://www.thehimalayantimes.com/fullNews.php?headline=To+have+or+not+to+have++PM+Bhattarai+opted+for+%27to+have%27&NewsID=307518

investment vehicles through the use of proper financial instruments. It is evident that with the increment in large diaspora population as people have moved outside Nepal to work, we can tap into the wealth and patriotism of these diaspora populations through the use of diaspora bonds and other investment opportunities. The Nepal's financial markets can play a pivotal role to mobilise some portion of remittance into the productive economic activity from which there will be wide reaching benefits. However, lack of awareness and access to the financial services remains a great challenge.

Dominance of Informal channels

Since 2001, money transfer services have been operating in Nepal, however despite the rapid increase of remittances there has failed to be a significant increase in the use of formal financial services due to the bulk of remittances still entering the country informally. According to the World Bank survey (2006) on access to financial services, it is estimated that 69% of foreign remittances arrive through informal channels, even among households that have bank accounts. Further, despite formal remittances being delivered in a day or two at relatively low cost, even to remote areas, the use of informal channels continues to be prevalent. This is primarily due to a lack of familiarity using the formal financial sector, and a perception that family and friends are safer delivery mechanism.

India is the largest source of migrant remittances and, given its close proximity and ease of entry, migrants tend to move quite often between the two countries. And, there are legal and regulatory constraints in the India-Nepal corridor for money transfer operators. To remit funds from India to Nepal, special approvals are required from the Reserve Bank of India (RBI), and the process is cumbersome. Hence,[5]the government should undertake measures to ensure that these funds are routed through formal channels and should also conduct necessary awareness programs.

[5] Ferrari, Aurora, Guillemette Jaffrin and Sabin Shrestha, '*Access to financial services in Nepal*'. World Bank. 2007

4. Nepali Financial System

The financial system plays a pivotal role in the smooth and efficient functioning of the economy. It satisfies the savings need of the economy and facilitates the accumulation of investment capital, which is critical for economic growth and development. Financial system is a complex but well integrated set of sub systems of; financial institutions, markets, Instruments and services.

The Nepali financial system can be classified into formal and informal systems; the formal system is characterized by an organized and regulated set of institutions whereas the informal system is characterized by an unorganized and unregulated system. Currently, there are three regulators in the Nepali financial system; NRB, SEBON and the Insurance Board, and there are two self regulated financial institutions; the Employee Provident Fund and the Citizen Investment Trust. There are various kinds of participants (Table 8) in the financial market namely banks BFI's and insurance companies. Currently, there are 197 BFIs and 24 insurance companies.

Figure 3 Structure of Nepal's Financial System

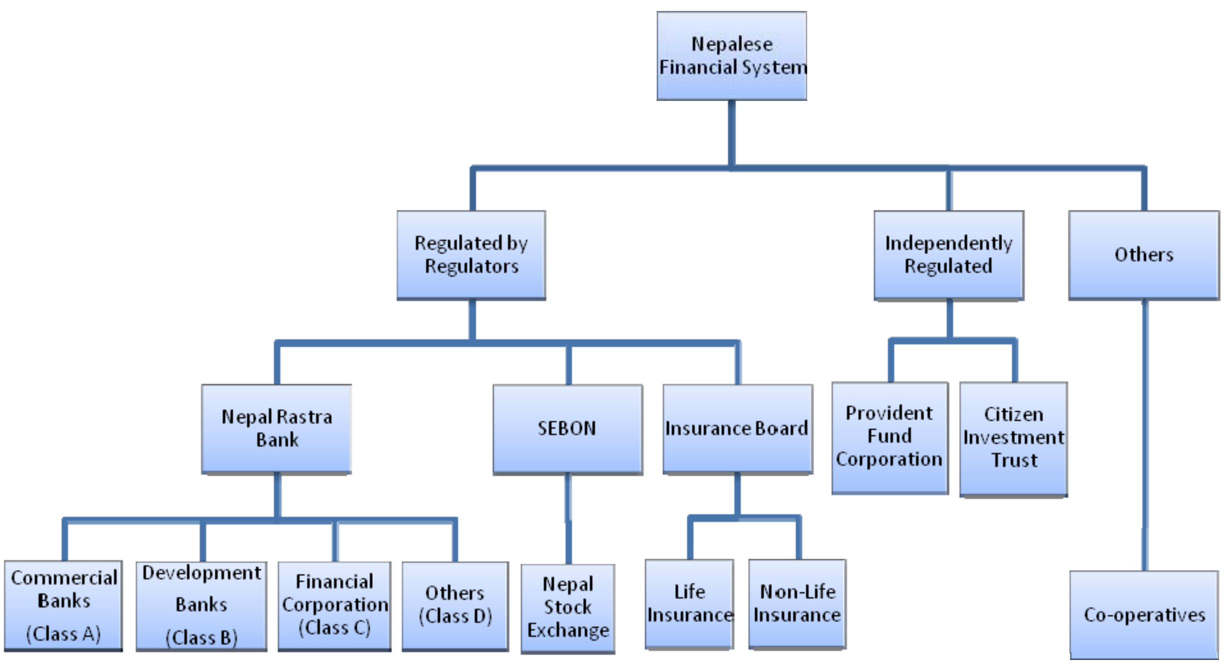


Table 8 Participants in the Nepali Financial system

Category	Numbers
Commercial Banks	31
Development Banks	87
Finance Companies	79
Micro Credit Development Banks	21
Co-operatives (licensed by NRB)	16
Financial NGOs	45
Stock Exchange	1
Life Insurance Companies	8
Non Life Insurance Companies	16

4.1 Nepali's Access to Financial Services

Nepal is amongst the countries with acute problems in access to finance. Despite the best efforts of the government, formal financial institutions have failed to serve the needs of most of the Nepalese population, particularly the low-income people. 'The access to financial services in Nepal survey' conducted by the government of Nepal, DFID and the World Bank in 2006 estimated that only 26% of Nepali households have a bank account and only 52.3% of Nepali households are served by formal or semiformal financial institutions, while about 27.6% were estimated to be served by the informal sources and 19.6% of the household's are financially excluded.

The informal channels dominate the remittance market as larger proportion of the remittance recipient population; especially the rural households have limited familiarity and access to the formal financial services. Transferring remittances via the formal sector offers significant benefits for both the Nepali economy and the migrant workers, as the usage of formal channels reduces the risk of money laundering and other illegal activities moreover, formal channels also provide other benefits to the migrants and their family members, as they can offer other financial services to them for savings and investments.

4.2 Nepali Capital Market

Capital Market at Present

The Security Exchange Board of Nepal (SEBON) oversees the capital market in Nepal. The Nepalese capital market can be broadly divided into primary and secondary market.

Primary Market

Primary market provides opportunity to issuers of securities, government as well as businesses, to raise resources to meet their requirements of investment and, or to discharge some obligation. The issuers create and issue fresh securities in exchange of funds through public issues and, or as private placement. When securities are exclusively offered to existing shareholders it is called 'Rights Issue' and when it is issued to selected mature and sophisticated institutional investors as opposed to general public it is called 'Private Placement Issues'. Issuers may issue securities at face value, or at a discount or premium and these securities may take a variety of forms such as equity, debt or some hybrid instruments.

Nepalese securities market is pelted by offering of equities by listed companies, either by initial public offering (IPOs) or right shares. The increasing number of BFIs with mandatory listing obligation and NRB's capital base requirements could be primary attributed for such situation.

Likewise, the primary market for debt securities is dominated by government securities, and the debt market in Nepal has remained underdeveloped. Moreover, the debt market is largely dominated by short-term debt funds i.e. money market instruments. Government issued debt securities include Development bonds, Citizens Savings Bonds, National Savings Bond, Special bonds, and Treasury Bills (28 days, 91 days, 182 days and 364 days respectively) and Debentures, which are the only form of corporate bond issued in Nepali capital market. Debentures and bonds are similar, except that bonds are relatively more secure; debenture holders are paid after bond-holders have been paid in a case of liquidation.

Secondary Market

Nepal Stock Exchange (NEPSE) is the sole platform for secondary market transactions in Nepal. The NEPSE after reaching an unprecedented high of 1175.38 points on 31 August 2008 has been experiencing a long term downtrend.

Table 9 NEPSE index performance

Fiscal Year	NEPSE Index	% change
FY 2003/04	222.04	
FY 2004/05	286.67	29.11%
FY 2005/06	386.45	34.81%
FY 2006/07	657.47	70.13%
FY 2007/08	963.36	46.53%
FY 2008/09	749.11	-22.24%
FY 2009/10	477.73	-36.23%
FY 2010/11	362.52	-24.12%

Source: NEPSE

The NEPSE currently has over 301 securities listed, of which 210 are listed companies, 16 government bonds, 13 corporate debentures, 1 preferred stock, 1 mutual fund and 60 promoter shares. Listed companies at the NEPSE is dominated by BFI's, 24 commercial banks, 62 development banks,71 finance companies, and 21 insurance companies are listed at the NEPSE. Moreover, the participation of the real sector is very minimal only 18 manufacturing and processing companies, 4 hotels, 4 Hydropower, 4 trading, and 2 'others' companies are listed at the NEPSE.

New Developments in the Nepali Capital Market

The regulatory bodies, SEBON, NRB and NEPSE have been initiating various strategic activities and regulatory transformations to facilitate and strengthen the Nepali capital market which can be expected to revive the securities market in the near future. Various developments came about;

- The Central Depositary System (CDS) is currently underway which will replace the current practice of holding and moving the share scrip physically, by a dematerialized computer based book keeping system.
- Mutual funds regulation came into effect, with the entry of mutual funds it's expected to help pull large institutional investments into the market, and provide small and retail investors a chance to derive benefits from a well-diversified portfolio.
- New stock brokers were appointed,
- Market maker appointed,
- Development of market rescue fund,
- Portfolio management directives and credit rating regulation were issued,
- Favorable fiscal and monetary policy was enacted.
- The borrowing limit against the collateral of securities (Margin Loans) has been removed
- SEBON with the assistance of the World Bank has prepared a five-year capital market development master plan.

Outlook

The continuing downward momentum seen in the secondary market can be primarily attributed to various macro economic factors such as sluggish economic growth, regulatory inadequacy, liquidity crunch coupled with the political deadlock. Similarly, the investor's confidence remained low as influx of new shares in the form of bonus and right shares to meet regulatory capital requirement flooded the market, hence diluting their earnings. However, with the market approaching the bottom end of the market cycle, and with good earnings growth and corrected valuations of listed securities, momentum in reforms, and new developments in the capital market in the offing, a correction is due during the current FY 2011/12 if supported by the macroeconomic circumstances Hence, the Nepali capital market can be one of the rewarding investment avenues to channelize the inward remittance into the productive sector.

4.3 Investment Opportunities

Investors willing to invest in the Nepali financial market can do so through a number of different avenues;

- They can buy and sell securities that are registered with SEBON and listed on the NEPSE.
- They can also acquire securities via Initial Public Offerings (IPOs),
- Fixed income money market instruments guaranteed by GoN and NRB
- Sector specific funds or funds floated for a specific investment objective
- Bank fixed deposit schemes,
- Corporate debentures and bonds

Looking at the current financial instruments available for investments in the Nepali financial market, for Nepali's living and working abroad, Collective Investment Funds (CIFs)/ Mutual Funds and Foreign Employment Savings Bond (FESB) can be a great source for attracting these funds to the Nepali financial market, given that the technical hindrances to pool this capital are addressed properly in a timely manner.

- Foreign Employment Savings Bond
- Collective Investment Fund (Mutual Fund)

5. Foreign Employment Savings Bond

The Foreign Employment Savings Bond (FESB) is a long-term debt security issued by the government of Nepal. The primary objective of the security is to target migrant Nepali workers and to channel their remittance into national development promoting investments moreover; FESB can help the Nepali government to diversify its source of development financing which is highly dependent on foreign grants, loans and internal borrowings. Likewise, it is considered to be an effective passage to divert the remittance coming in from informal channels to the formal channels.

FESB or popularly known as Diaspora bonds are internationally structured like standard, sovereign-backed bonds, but sold to diaspora populations to fund new infrastructure and development programs. This is not a new concept- Israel and India, among other countries- have issued diaspora bonds successfully in the past, and a number of organizations including the World Bank are now pushing the idea in intelligent ways.[6] Moreover, in a time of fiscal retrenchment diapora bonds can be a more effective, affordable and sustainable model.

Despite having an attractive annual interest rate of 10.5%, the "FESB 2073" was undersubscribed. Nepali migrant workers subscribed payments for bond worth NPR 3.38 million (USD 46,365 million) in total, whereas the target was to sell NPR 5 billion (USD 68.59 million) worth. The bond was made available for sale in five foreign countries including South Korea, Malaysia, United Arab Emirates, Saudi Arabia and Qatar. Migrant workers could subscribe bonds themselves or in their family members' names, and the interest earned on the bond would be tax free, and moreover, they could also take loans against the bond.

	FY 2009/10	FY 2010/11
Bond	"FESB "	"FESB 2073"
Coupon Rate	9.75%	10.50%
Issue worth	1 billion	5 billion
Subscription	4.6 million	3.38 million

[6] Glencorse Blair and Matzner Issac"Building bonds with fragile states"

According to Agencies involved in the distribution of the bond, lack of awareness and complicated procedures were the primary reasons for low subscription[7]. It was also due to migrants', being concerned about exchange rate risk, as subscribers would get payment as per the rate at the time of subscription.

The government is gearing up to issue FESB for the current FY 2011/12. As both the previous two issues of FESB were not successful, the government is also planning to permit the purchase of FESB in Nepal using remittance money. According to the spokesperson for Nepal Rastra Bank (NRB) Bhaskar Mani Gyanwali, NRB will make migrant workers open bank accounts at home at zero balance and channel remittances through that channel, he said, adding that the deposits in that account could be used by the worker's family to purchase the FESB.[8]

To ensure the success of upcoming FESB's in the future, the following points should be taken into consideration by the government;

a) Improve awareness
b) Plan ahead
c) Structure the bond appropriately
d) Demonstrate governance
e) Increase incentives for financial agents
f) Increase the target market, and
g) Conduct Investor's education program

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[7] Prithvi Man Shrestha. "Foreign employment bond fails second year in a row," *The Kathmandu Post*, June 25, 2011. Accessed on November 2, 2011. http://www.ekantipur.com/the-kathmandu-post/2011/06/25/money/foreign-employment-bond-fails-second-year-in-a-row/223300.html

[8] "Foreign employment bond in offing this fiscal ,too," *The Himalayan Times*, August 21, 2011. Accessed on November 2, 2011. http://www.thehimalayantimes.com/fullTodays.php?headline=Foreign+employment+bond+in+offing+this+fiscal%26sbquo%3B+too&NewsID=300145

6. Collective Investment Funds

The Nepali financial market could be one of the most lucrative avenues for channeling remittances into productive investment vehicles, however, the market being in it's infant stage lacks stability. People are not confident to invest in the Nepali capital market largely due to the lack of knowledge, time and accessibility. Participating directly into Nepali capital markets could be costly and risky, therefore, Collective Investment Funds (CIFs) or mutual funds might be the best investment tool to reap the benefits in Nepali capital markets.

6.1 Existing Acts and Regulations

The following acts and regulations are issued by SEBON, the regulator of Nepali capital market.

Securities Act, 2063

'Securities Act 2063' of section 2(r) defines Investment fund as a "fund created out of amounts deposited by participants in a collective investment scheme in accordance with a contract as has been taken in its custody by a scheme manager with the object to provide an efficient investment service or assets related with such a fund, and this term also includes a fund which the scheme manager has taken in its responsibility in accordance with this Act or additional assets created from management of investment of assets and amount accumulated by way of consideration. "

As per section 56 of the Nepal 'Securities Act 2063', a company or body desirous of carrying on securities business has to obtain a license to carry on securities business from the board pursuant to this Act and as per the section 63, the securities business has been divided into following types; Securities brokerage, securities trade, issue and sales management, investment management, investment consultancy service, collective investment fund management, market maker and others as specified by the board. Moreover, as per section 71, of the Securitas Act, no one shall operate a collective investment scheme, carry out, or cause to be carried out without obtaining permission from the SEBON.

Portfolio Management Directive, 2067

SEBON has implemented the Portfolio Management Directives, 2067 in a bid to systematize the country's portfolio management business. The directives allow Portfolio Managers to provide three kinds of services—discretionary portfolio management, non-discretionary services and investment advisory.

Meanwhile, SEBON has opened the way for NRNs to invest in the capital market through Portfolio Managers. Portfolio Managers can now buy and sell, and carry out activities related to their portfolios on behalf of the investors, both NRNs and otherwise, if they have received the authority from their clients to do so. The fiscal policy for the FY 2011/12 has directed SEBON to prepare necessary guidelines within mid October 2011 to allow NRNs to invest in the Nepali capital market

Mutual Fund Regulation, 2067

In exercise of the power conferred by Section 116 of Securities Act, 2063 (2007), SEBON has, upon the approval of the Government of Nepal made the "Mutual Funds Regulation – 2067"into effect from 27th September, 2010.

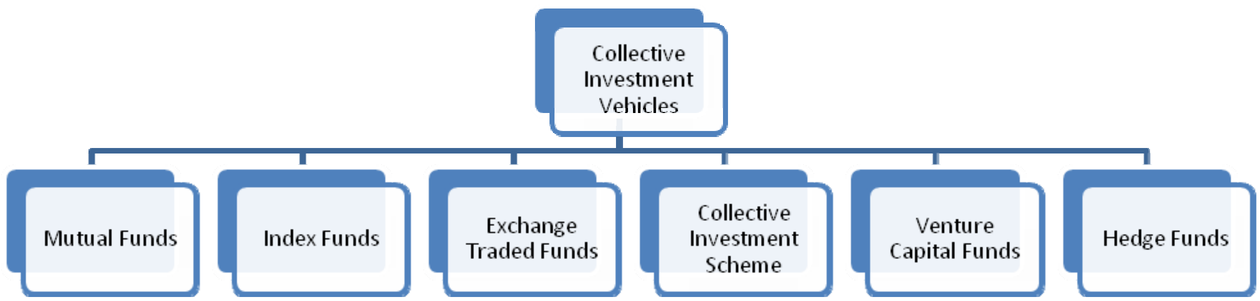
As per section 2(g)-"Open Ended Scheme" means a scheme which is operated without specifying any duration for redemption, and as per section 2(h) "Close Ended Scheme" means a scheme which is operated specifying the period of maturity.

6.2 Types of Collective Investment Funds

Collective Investment Vehicles have emerged as a popular financial instrument to lower cost for investors through economies of scale and maximize stakeholder's value. Simply, a Collective Investment Vehicle is any entity that allows investors to pool their money and invest the pooled funds, rather than buying securities directly as individuals.

Collective investment vehicles are usually managed by a fund management company which is paid for doing so in the form of a management fee. The most common types of collective investment vehicles are mutual funds, index funds, exchange traded funds, collective investment schemes, venture capital funds and hedge funds.

Figure 4 Types of Collective Investment Funds



Mutual Funds

The most popular collective investment vehicle is the mutual funds. Simply, a mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. Mutual funds are an avenue for investors who would like to diversify risks and avail of the services of professional fund managers. Mutual Funds are essentially investment vehicles, where people with similar investment objectives and appetite for risk come together to pool their money and invest accordingly.

Mutual funds are an instrument of investing money and it can be considered as the best investment avenues for NRNs and migrant workers to invest in Nepal. Mutual Funds can play a primary role in channeling migrant's remittance money into investments in equity and debt instruments. In times to come, Mutual Funds could be a significant resource mobilizer in the Nepalese Financial market.

Types of Mutual Funds
Mutual Funds or mutual funds schemes invest in three broad classes of financial assets:

Stocks: Equity and equity-related instruments.

Bonds: Debt instruments that have a maturity of more than one year (treasury bonds, quasi-government bonds, corporate debentures, and asset-based securities).

Cash: Debt instruments that have a maturity of less than one year (Treasury bills, commercial paper, certificates of deposit, reverse repos, and call money) and bank deposits.

On the basis of maturity period, mutual funds can be classified into open-ended or close-ended schemes.

- **Open-ended schemes:** An open-ended scheme is available for subscription and repurchase on a continuous basis. Investors can buy or sell units at Net Asset Value (NAV) related prices that are declared on a daily basis. Liquidity is the key feature of open-ended schemes.

- **Close-ended Schemes:** A close-ended scheme has a stipulated maturity period and is open for subscription only during a specified period at the time of launch of the scheme. Investors can invest in the scheme at the time of initial public issue and after that they can buy or sell units on the stock exchanges where the units are listed. Here, the NAV is published generally on a weekly basis.

6.3 Benefits to the unit holders of Mutual Fund

The unit holders will be the subscribers of the Fund who will own the Mutual Fund Units. Following are the list of benefits to the unit holders of the mutual fund scheme;

Portfolio Diversification
This allows investors to gain a broad exposure to the overall stock market whilst mitigating risk exposure to an extent not possible for an individual investor with limited resources.

Professional Management
Mutual funds are managed by professionals who are experienced in investing money and who have the education, skills and resources to research diverse investment opportunities. This will also relieve individual investors from the stress associated with day to-day management of investments

Transaction cost
Since mutual funds collect money from hundreds of investors, it achieves economies of scale. The cost of running a mutual fund is divided between a larger pool of money and hence mutual funds are able to offer its unit holders lower cost of transactions.

Affordability
The unit price of the mutual fund schemes will be designed in denominations which will allow even small investors to participate in large schemes.

Liquidity
The unit holders have the flexibility of redeeming units or selling shares any time, thus giving liquidity to them.

Accountability and Transparency
Management and operations of mutual funds are subject to strict regulations from SEBON, NRB and fund supervisors. SEBON regularly monitors the performance of mutual funds, and the laws governing mutual funds require exhaustive disclosures to the regulator and the general public.

Opportunity for additional capital appreciation
Mutual funds will enjoy reserved quota (5%) in all IPOs, and as IPOs have historically outperformed the NEPSE index significantly this will ultimately benefit the unit holders.

6.4 Risk Considerations

All mutual funds and securities investments in the schemes are subject to market risks, and there can be no assurance that the fund's objectives will be achieved. Investment in Mutual Fund Units involves investments risks such as trading volumes, settlements risk, liquidity risk, default risk including the possible loss of principal.

As the price/value/interest rates of the securities in which the scheme invest fluctuate, the value of the investment in the schemes may go up or down depending upon the factors affecting the securities market. Therefore, no assurance can be given that that on redemption, or otherwise, investors will receive the amount originally invested. The name and nature of the schemes does not in any manner indicate either the quality of the scheme, or their future prospects and returns. Mutual fund investment is only suitable for investors who understand the risks associated with the fund, and who are able to withstand the loss of their investments.

6.5 Existing CIFs in Nepal

The history of mutual funds in Nepal can be traced from before the enactment of the "Mutual Funds Regulations – 2067 (2010 A.D)" by SEBON. Mutual funds in Nepal began with the establishment of NCM Mutual Fund, 2050 (1993/94 A.D).The fund rode on the NEPSE boom in its early days; however, due to the market's lackluster performance, the fund was suspended and restructured into the NCM Mutual Fund, 2059 (2002). Likewise, the Citizens Investment Trust (CIT) became the second collective investment scheme and started operations in 1994/95.

- NCM Mutual Fund (2059)
- Citizen Investment Trust Mutual Fund (CIT)

6.6 Other Investment funds

The Nepali financial market has also seen a number of private collective investment funds promoted by private entities such as Rajdhani Investment Funds, Dreams Capital Limited and Global Capital Investment. However, private funds are not easily available for the common investor due to their capacity constraints. Moreover, few private equity funds have often created various investment risks to the investors due to their non-compliance with government regulations and poor governance such as the Unity Life International. Recently, Nepali financial market has also seen the entry of investment funds promoted by NRNs to mobilize their remittance incomes as investments.

Global Capital Investment

With the objective to mobilize the earnings of Non-resident Nepalese (NRNs) in Nepal, Global Capital Investment Pvt. Ltd. has been established. The company is chaired by Mr. Devman Hirachan, former Chairman of Nonresident Nepalese Association (NRNA). It aims to provide the required platform for NRN's who are willing to invest in Nepal, but do not have large funds to make individual investments. The company has an authorized capital of NPR 1 billion (USD 13.72 million) and a paid-up capital of NPR 500 million(USD 6.86 million).The company aims to invest in various sectors such as; capital markets, tourism, hydro, Agriculture, self employment, and skill development.

Case Study: Unity Life International

Nepal recently witnessed one of the largest scam in its history. Unity Life International (ULI) Limited, a company which offered social security schemes without legal permission and ran a flawed binary network marketing model based on the pyramid scheme, and also the Co-operatives. According to records of ULI, as of May 1st, 2010, the company was able to make more than 366,342 clients and raked in over NPR 6 billion (USD 82.31 million)[9]. Amongst them, some 58,000 members placed at the top of the pyramid enjoyed handsome commission returns running more than NPR 1.5 billion (USD 20.58 million). Also, it is estimated that over 40,000 migrant workers from Qatar who subscribed the Unity membership lost their money.

The company had offered two long-term social security schemes; an assurance plan and a health plan. And both the plans were neither registered under NRB nor the Insurance Board or any other regulatory bodies, hence its operation was declared illegal by the government. Under the assurance plan, similar to an insurance policy, ULI charged its clients NPR 15,000 (USD 205.77), promising to provide accidental death insurance of NPR 0.5 million (USD 6,858.71) and assurance coverage of NPR 100,000 (USD 1,371.75) in case of death. In case the member survived, ULI promised to refund the money with 10 percent annual interest, in the manner of a bank, in five years. Similarly, under its health plan, the company charged its clients NPR 15,750 (USD 216.05) for life-long free health checkups and a treatment package at hospitals operated by ULI in different districts. ULI has set up Unity Hospitals in 19 districts. While some of its hospitals in Kathmandu, Pokhara and Itahari have modest facilities others are more like clinics with a few rooms.

The ULI case signals that the general behavior of people is that they are willing to invest, given that assurance and security are provided. Sadly however, this was a fraudulent company. Despite having numerous financial products and services which can cater to the investment needs of these people, both public and private sector upto some extent have failed to create awareness of the financial products they offer, and reach these large segments of the market.

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[9] Milan Mani Sharma, "Unity's dubious operation rakes in Rs.6 billion," *Republica*, April 21, 2010. Accessed on November 5, 2011, http://archives.myrepublica.com/portal/index.php?action=news_details&news_id=17718

7. Expected Barriers and Risks

7.1 Impediments

Though the regulation is now in place, the following are the impediments likely to hinder the operations of Collective investment Fund (Mutual Fund) in Nepal:

1. **Cross Holding:** As per clause 8 of the Directive issued by NRB on Investments, banks are prohibited to make investments in the shares of another bank or financial institution. Since the Fund Manager needs to invest 20% of the fund as seed capital of the Mutual Fund for the first scheme, with the Fund Manager being a subsidiary of a Bank there exists an indirect cross holding as the Fund shall invest in the securities listed in the NEPSE which are predominantly Banks and Financial Institutions (BFIs).

2. **Legal existence:** In other countries, Mutual Funds are structured in the form of a Trust. In Nepal, as there is no concept of a trust in domestic law, a contractual pool model is being used however, in most countries, the legal status of the units in such schemes is enshrined in primary legislation and there is not so in Nepal.

   The legal nature and status of the units is not defined in the mutual fund regulation 2067 and there is therefore a considerable doubt about the nature of the legal claim that investors may have on the assets of the mutual fund. In the event of bankruptcy of the manager, the investor may simply be unsecured creditors of the bankrupt manager, rather than owners of the invested assets.

   In India, Mutual Funds and the instrument of trust are in the form of a deed which needs to be duly registered under the provisions of the Indian Registration Act, 1908 and is executed by the sponsor in favor of the trustees, thus ensuring the legal existence of the fund and legal validity of its units. In Nepal, apart from the permission granted by SEBON for the Mutual Fund, its actual legal status and existence can be ambiguous, hence it might undermine the attractiveness of the mutual funds.

3. **Foreign Investment Prohibition Act, 1964:** Clause 37 of Mutual Fund Regulation gives an opportunity and option to invest 25% of the fund in the foreign capital market; however, Foreign Investment Prohibition Act, 1964 restricts any Nepali entities from investing abroad, thus the applicability of the provision is restricted.

4. **Tax Slab:** Income Tax Act has differential capital gain tax slab for individuals and corporations at 10% and 25% respectively. Though Mutual Funds will not technically fall under the corporate tax bracket as they will not be a "company" under Companies Act 2063, they are unlikely to be treated as an "individual". Thus, investor attraction from a tax perspective would be comparatively less due to higher tax burden if Mutual Funds are chosen as their investment vehicle instead of making direct investments as an individual.

5. **Clarification on NRN participation:** Unlike clause 24 of Portfolio Management Directive 2067, wherein the provision for participation of NRNs has been laid down, Mutual Fund Regulation is silent in this regard. Further, Section (3) of Foreign Investment and Technology

Transfer Act 2049 requires approval of Department of Industries (DoI) for any foreign investment in Nepal. Hence, these provisions do not practically allow NRNs to participate in Mutual Funds of Nepal, as they need to get DoI approval each time they buy mutual fund units.

7.2 Ongoing Developments

SEBON and the MoF have been undertaking various measures to ensure smooth functioning and operations of mutual funds in Nepal. Following presents the key developments that have taken place so far.

1. **Operating License Granted:** SEBON has granted license to Siddhartha Bank to operate Mutual Fund in Nepal. As of now, Siddhartha Bank, NMB Bank, Nabil Bank and Laxmi Bank have applied to SEBON for obtaining license to operate mutual fund in Nepal.

2. **Fiscal Policy 2011/12:** The budget for the FY 2011/12 has directed SEBON to prepare necessary guidelines within mid October 2011 to allow NRNs to invest in the Nepali capital market. For this purpose, a committee is being formed consisting of representatives from SEBON, NRB, Company Registrar Office (CRO) and Insurance Board to frame the guidelines. The budget for the fiscal year 2010/11 also had declared to allow NRNs to invest in the Nepali capital market however, due to the practical complications it remained in the papers only.

   The budget has also announced to provide concessions to investments coming from institutional investors such as mutual funds; however, the degree of such concession has not been detailed. To support the fiscal policy, the monetary policy for the fiscal year 2011/12 has declared that NRB will co-ordinate with SEBON to motivate banks to carry out mutual funds

3. **Five Year Capital Market Development Master Plan:** On a positive development, the budget has announced implementation of the five year capital market development master plan in phase wise manner starting in the next fiscal year.

4. **Mutual Fund Legislation:** In order to systemize the Mutual Fund industry, SEBON is preparing a comprehensive Mutual Fund Legislation.

8. Summary and Recommendations

With the growing number of outbound migrant workers, the inward remittance pie will continue to grow, however, if the current trend of higher consumption fueled by remittances continues to dominate, the hard-earned money by fellow Nepali citizens abroad will go in vain. Hence, diverting the remittances into productive sector should be given a higher priority by the government as it will encourage investments, generate employment and expedite national economic growth.

As outlined in the report, the Nepali capital market continues to evolve with great potential, and hence, the foreign employment savings bond and the mutual fund industry offers significant growth potential to the migrant workers and NRNs who are willing to invest in Nepali financial market.

Despite offering industry average return, the failure of government issued-Foreign Employment Savings Bonds (FESB) for the two consecutive fiscal years clearly indicates unfamiliarity and unwillingness of migrant workers towards making investments in Nepali financial market. On the other hand, the success of unregulated Unity Life International to attract thousands of migrant workers to become their member show the basic psychology of migrant workers towards investment provided future security and assurance. Hence, the role of government to analyze and understand their shortcomings is a key towards achieving their target in the coming years, and to establish good co-ordination amongst government units such as MoF, NRB, and SEBON is a key to success.

The government is bringing substantial changes in its upcoming FESB to overcome previous shortcomings; a key issue has been the inability of the government to communicate the value of the process as these bonds can seem overly complex, and thus require concerted publicity strategies to be successful. If promoted and targeted properly FESB can provide a long-term, predictable flow of fund for the Nepali government and can replace the burden of foreign borrowing upto some extent. The government intends to collect almost 26% of fund via foreign grants and loans for its current fiscal budget and 9.72% through internal borrowing.

Moreover, the private sector also needs to come out with innovatively tailored financial products and services so as to tap these opportunities. Mutual funds have emerged as strong financial intermediaries which are substantially contributing towards the process of macroeconomic development of emerging markets. Mutual funds are not only providing stability to the financial system, but have also helped rationalize the process of resource allocation. They have opened new avenues for investors and have been successful in increasing the level of liquidity in the system. Furthermore, they have challenged the predominant role of commercial banks.

As we have negligible mutual funds and investment funds in the market, there exists great scope of growth in Nepal’s financial services industry. Mutual funds would be the ready answer for the alternative source of investment for retail and institutional investors, and for channeling remittances which provide unlimited great scope for development of Mutual funds in Nepal. The growth of mutual funds in Bangladesh and its success to tap remittance further supports this argument. Though the Nepali financial market is very small in comparison to other nations, the

Nepali middle class population is growing rapidly - partially as a result of remittance incomes - and there is a requirement for the financial services industry to accommodate these changes.

8.1 Way forward: Overcoming the barriers

Based on the above assessment of the regulatory impediments, and for the smooth functioning of Mutual Funds in Nepal, the following recommendations are tabularized for addressing the concerned authorities.

Table 10 Summary of the recommendations

S.No	Changes	Relevant Regulation Provisions	Concerned Authority
1.	**"Easy" Participation of Migrant Workers and NRN in the Mutual Fund**	i. Definition of "Participants" in Securities Act 2063 should include NRN.	MoF, act needs to be amended and passed by Constitutional Assembly (CA)
		ii. Mutual Fund Regulation 2067 should include a new clause for NRN wherein any sponsor willing to include NRN as participant, a separate "blanket approval" will be required from the SEBON.	SEBON and approved by MoF
		iii. Section (2)(b) of Foreign Investment and Technology Transfer Act 2049 should clearly spell out that foreign investment does not include investment of and NRN through Mutual Fund.	MoF & MoDC, act needs to be amended and passed by CA.
		iv. Waiver of approval for repatriation of the proceed of the dividends or from disposal of mutual fund units for the NRN should be included in Foreign Exchange Regulation Act, 2019	MoF, act needs to be amended and passed by CA.
2.	**Capital Gain Tax exemption**	i. Income Tax Act should include Mutual Fund under Section (2)(s) as tax exempt entity.	MoF, through the budget and passed by CA
		ii. Capital gain tax exemption for mutual fund unit holder having crossed three years holding period should also be included in the Income Tax Act, 2058	

3.	**Waiver of SEBON and NEPSE charges**	i. Annexure 15 of Securities Business Person (Broker, Dealer, Market Maker) Regulation 2064 should provide mutual fund units exempt for SEBON charges. ii. Waiver of NEPSE charges of 25% in the transaction by the Mutual Fund should be incorporated in the guidelines issued by NEPSE to the broker.	SEBON and approved by MoF NEPSE and approved by SEBON
4.	**Waiver of foreign investment by Mutual Fund**	Mutual Fund should be included in the list of exemption in the Foreign Investment Prohibition Act, 1964	MoF, act needs to be amended and passed by CA.
5.	**Legal existence**	i. New clause should be included in the Mutual Fund Regulation 2067 for the provision of registration of Mutual Funds, and its instrument with a Secured Transaction Registry under Secured Transaction Act 2063. ii. Develop trust legislation	SEBON and approved by MoF SEBON & Ministry of Law
6.	**Waiver of cross holding for Mutual Fund**	i. Clause 8 of the Directive issued by NRB for Banks and Financial Institutions should exclude Mutual Fund sponsored by Banks under this clause.	NRB and approved by MoF.