Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: July 6, 2018 | Report No: 128669

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Nepal	P159547	Fourth Financial Sector Stability Development Policy Credit (DPC4)	
Region	**Estimated Board Date**	**Practice Area (Lead)(s)**	**Financing Instrument**
SOUTH ASIA	August 7, 2018	Finance, Competitiveness and Innovation (FCI)	Development Policy Financing
Borrower(s)	**Implementing Agency**		
Ministry of Finance	Ministry of Finance		

Proposed Development Objective(s)

The objective of the credit is to:
* support the Government of Nepal's financial sector medium-term reform program to reduce the vulnerability of the banking sector and increase its transparency.

Financing (in US$, Millions)

SUMMARY

Total Financing	100

DETAILS

Source:
IDA

Decision

B. Introduction and Context

The proposed DPC supports the financial sector medium-term reform program initiated by the Nepalese authorities to reduce the vulnerability of the banking sector and increase its transparency. Over the past few years, Nepal's financial system has witnessed rapid expansion, fueled primarily by a steady and growing influx of remittances. Since 2011, the growth in remittance transfers has translated into a buildup of liquidity in the financial system, but this has not resulted in efficient financial intermediation nor availability of long-term financing to support Nepal's investment needs in infrastructure and power. The earthquake of 2015 followed by the political crisis of 2016 in the Terai region adversely impacted Nepal's financial sector impairing the ability of many borrowers to generate cash flows to repay their debts on time. Nepal's financial market is currently facing a funding shortage, limiting its ability to support past credit growth levels and the demand for credit for real economic growth. The funding shortage impacts the sustainability of businesses, and increases the risk of potential defaults. In this environment, there are concerns over a continuing trend of slow remittances affecting deposit mobilization. As the country is transitioning to a federal structure, the banking sector is likely to be affected by the devolution of government structure. Banks will face challenges in terms of investing in infrastructure, recruiting competent human resources and meeting increased demand for credit resulting from increased opportunities as well as a higher cost of doing business.

This operation is essential to support continuation of reforms undertaken by the Government of Nepal (GoN). The programmatic series (completed DPC2 and DPC3 and the ongoing DPC4) complements the government's program, builds on reforms completed in DPC1, DPC2 and DPC3, and is grounded in analytical work carried out by the World Bank, IMF, DFID and the 2014 FSAP (Financial Sector Assessment Program). The first IDA Financial Sector Stability Credit (DPC1) was a stand-alone single tranche credit (US$30 million equivalent) approved in June 2013. The second and third credits (each of US$100 million equivalent), designed in a programmatic series of three operations, were approved by the World Bank Board in June 2015 and March 2017 respectively.

The Country Partnership Strategy (CPS) for FY2014–2018 is centered on two pillars: (a) increasing economic growth and competitiveness, and (b) reducing social exclusion and providing opportunities to increase prosperity. One of the three key outcomes of pillar 1 is enhancing financial sector stability. The CPS acknowledges persistent financial sector weaknesses and the risks they pose to macroeconomic stability and economic growth, as illustrated by the liquidity crisis in 2011. It recognizes the efforts undertaken by the authorities to address the root causes of financial sector difficulties and the support provided by the World Bank, IMF, and DFID. The CPS makes the case for the use of DPCs to support the efforts of the authorities to reform the sector. The PLR (2017) of CPS acknowledges the progress made through a series of DPCs particularly in addressing capital adequacy of state-owned banks, strengthening inspection and compliance, ensuring financial sector stability and increasing the number of beneficiaries with access to finance. The Systematic Country Diagnostic highlights financial sector stability and inclusion as important aspects to consider for broader economic growth and poverty reduction.

C. Proposed Development Objective(s)

The objective of the credit is to support the Government of Nepal's financial sector medium-term reform program to reduce the vulnerability of the banking sector and increase its transparency. It would build on the gains already realized through the past policy credits and focuses more on the implementation of the key reforms through a strengthened legal and regulatory framework. The actions supported under the ongoing DPC4 are part of a broader, medium-term, Government-led program aimed at allowing the financial system in Nepal to become deep, resilient, and effective enough to play its role in financing Nepal's extensive development and inclusion.

D. Program Description

The DPC4 continued the approach taken by DPC1, DPC2 and DPC3. DPC1 focused on laying the ground for deeper reforms while DPC2 aimed at supporting the implementation of these reforms to foster the development of a robust, inclusive, and more stable financial sector. DPC3 focused on addressing potential adverse impacts on the solvency of the financial sector and the operational and business continuity of financial institutions along with the enactment of key Laws/Acts.

There are four pillars within the programmatic Financial Sector Stability DPC series: (i) Enhancing financial sector development; (ii) Restructuring and consolidating the financial system; (iii) Strengthening the legal and regulatory framework; and (iv) Enhancing the governance and transparency of the banking system.

Under these pillars, the credit supported the following specific policy prior actions:

1. The Nepal Rastra Bank (NRB) has issued a new directive on Risk Management to the commercial banks.
2. The Nepal Insurance Board (NIB) has (a) completed in-depth diagnostics to identify institutional level risks of the companies which represent sixty percent (60%) of assets within the insurance sector; and (b) implemented corrective action or resolution programs for undercapitalized insurance companies identified under (a) above.
3. The NRB has issued the enabling regulations based on the NRB Act (Second Amendment), 2073 BS (2016).
4. The NRB has approved the functional and technical specification of the Supervisory Information System (SIS).
5. The Cabinet has approved key regulations regarding (a) Deposit and Credit Guarantee Fund's (DCGF) relationship with Banks & Financial Institutions (BFIs); (b) a guaranteed deposit verification process; and (c) BFI reporting, payout and reimbursement of guaranteed deposits.
6. (a) The NRB has executed a tri-partite agreement with the Ministry of Finance (MoF) and DCGF for the provision of funding and liquidity support to the DCGF; and (b) The cabinet has approved a plan to raise the capital of the DCGF to NPR ten billion (NPR 10,000,000,000) under an accelerated schedule.
7. (a) The NRB has adopted an oversight framework for payment systems; and (b) the Ministry of Finance has endorsed the Payment and Settlement Bill.
8. The Cabinet has approved the new Insurance Bill for submission to Parliament.
9. The NRB has: (a) issued a directive on Chart of Accounts; and (b) amended its directives on reporting requirements for BFIs to comply with the Nepal Financial Reporting Standards.
10. The NRB has issued implementing rules and bylaws for the BAFIA.
11. The Parliament has approved the Cooperative Act.
12. The NRB has revised its directive to the BFIs to implement the Asset (Money) Laundering Prevention Regulations.

The programmatic series of DPCs complements the GoN's program and is grounded in analytical work carried out by the World Bank, IMF, DFID, and the 2014 Financial Sector Assessment Program (FSAP). As a result, it is an integral part of the overall banking sector stabilization program to: (a) identify banking sector weaknesses; (b) resolve institution-specific problems; and (c) to address weaknesses in regulation and supervision. The series also includes measures designed to assess and then mitigate risks to the financial sector that have been amplified by the earthquakes and trade disruptions.

E. Implementation

The Ministry of Finance, in coordination with the Nepal Rastra Bank, is the implementing agency to ensure achievement of triggers/prior actions within the stipulated period. Resources and expertise, including analytical underpinnings, for the programmatic series have been provided by the DFID under the Financial Sector Stability Program, the IMF and the Bank (including support from FIRST Initiative).

The Bank team will monitor the impact outcomes of DPC4. The results/outcomes of DPC1, DPC2 and DPC3 have been considered to identify adjustments needed for selection and prioritization of triggers and prior actions under DPC4 which are aligned with the country's political developments, stakeholder support, and feasible options for realizing the intended goals. To monitor and review implementation progress, result/outcome indicators are monitored on a quarterly basis from data published in the central bank website followed by discussion with regulators and supervisors. The quality of NRB data is considered reliable. One of the prior actions involves installation of Supervisory Information System (SIS) at the NRB which is expected to be useful in tracking key indicators concerning health, stability and performance of the financial sector.

F. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

The overall objectives of the DPC are aligned with the World Bank Group's twin goals of ending extreme poverty and boosting shared prosperity. The prior actions under this operation will have either neutral or positive long-term effects on the lives of the poor and the bottom 40 percent. A more stable financial system in the long run is expected to increase financial inclusion, which is an area Nepal lags relative to the regional average. According to the 2017 Global FINDEX database,[1] 45 percent of adult population (age 15 or above) reported having an account at a bank or another type of financial institution in Nepal. While this figure has been increasing over time (from 25 percent in 2011), it is still markedly lower than the regional average of 69 percent in 2017. Compared to 50 percent of the male population having an account, only 42 percent of the total female population have a bank account. Participation in the financial system helps people to start and expand businesses, invest in education, manage household and farming risks, and weather financial shocks, thereby reducing their vulnerability to falling back into poverty and boosting shared prosperity. Ensuring stability in the financial system will also help reduce the risks of a financial crisis, which may significantly swell the ranks of the poor in the country or worsen the living standard of the bottom 40 percent. The operation supports policy reforms, specifically the new Payment and Settlement Act and Cooperatives Act, which contribute towards bridging the gender inequality.

Environmental Aspects

Actions supported by this operation are not expected to have any negative effect on the environment, forests and other natural resources. Enhanced financial sector stability is a clear and necessary bulwark against climate disaster risks such as flood, extreme weather, glacial melt, landslide and drought. As climate impacts continue to grow in-line with projections, these risks will increase as will the importance of a financial sector that understands the specific dangers and can respond accordingly.

G. Risks and Mitigation

The overall risk of the proposed operation is Substantial. The main risks to achieving the intended results of the reform program are political and governance risks, institutional capacity, and fiduciary risks. **Political risk**: Nepal's transition has been characterized by frequent government changes. Nonetheless, new constitutional checks and fewer number of political parties following the 2017 elections bode well for stability in the coming days. However, smoothening the transition from the previous unitary system to the new federal one will remain a daunting task. Implementation risks for DPC4 are mitigated through demonstrated commitment at the highest levels of the bureaucracy and through close alignment with the IMF and DFID, as well as through an extended preparation phase with continued policy dialogue. Moreover, the transition to federal structure is expected to require significant additional funding to finance the budget expenditure. DPC4 support can significantly assist in funding the deficit and is expected to gain traction from the highest

[1] http://datatopics.worldbank.org/financialinclusion/country/nepal

level in the Government, bureaucracy, and the legislature. **Institutional capacity risk:** The pace of implementation of the Government's reform program could be slowed down by institutional capacity risks. The phased approach of a series of DPCs is a risk-mitigating factor. The actions supported under the proposed series of DPCs form the second phase of the medium-term Government financial sector reform program initiated in 2012, supported by DPC1, DPC2 and DPC3. **Fiduciary risk** is due to weaknesses in areas of internal controls and internal audit, delay in follow-up actions on audit recommendations, separation of responsibilities between treasury and audit function, and issues related to timeliness of audits at the entity or project levels. With the approval and implementation of the new financial procedural act, increased accountability and transparency should lower fiduciary risks. Fiduciary risks are also mitigated through on-going institutional capacity strengthening activities funded through a Multi Donor Trust Fund (MDTF) centered around the rules governing budget implementation.

CONTACT POINT

World Bank

Contact: Sabin Raj Shrestha
Title: Sr. Financial Sector Specialist
Tel: 977-1-4236164
Email: sshrestha4@worldbank.org

Borrower

Contact: Dr. Rajan Khanal
Title: Finance Secretary, Ministry of Finance
Tel: 977-1-4211161
Email: rkhanal@mof.gov.np

Implementing Agencies

FOR MORE INFORMATION CONTACT

The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 473-1000
Web: http://www.worldbank.org/projects

APPROVAL

Task Team Leader(s):	Sabin Raj Shrestha (TTL); Gabi G. Afram (co-TTL)

Approved By

Country Director:	Qimiao Fan	