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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A PROPOSED

DEVELOPMENT POLICY CREDIT

IN THE AMOUNT OF SDR71.1 MILLION (US$100 MILLION EQUIVALENT)

TO

NEPAL

FOR THE

FOURTH FINANCIAL SECTOR STABILITY DEVELOPMENT POLICY CREDIT

July 6, 2018

Finance, Competitiveness and Innovation Global Practice
South Asia Region

NEPAL - GOVERNMENT FISCAL YEAR
July 16 – July 15

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of June 30, 2018)

Currency Unit = Statutory Drawing Right (SDR)
SDR1.00 = US$1.406570000

ABBREVIATIONS AND ACRONYMS

AML	Anti-Money Laundering
BAFIA	Banks and Financial Institutions Act
BCP	Basel Core Principle
BFIs	Banks and Financial Institutions
CAR	Capital Adequacy Ratio
CCD	Credit to Core Capital and Deposit
CGAP	Consultative Group to Assist the Poor
CEO	Chief Executive Officer
CFT	Counter Financing of Terrorism
CPS	Country Partnership Strategy
DCGC	Deposit and Credit Guarantee Corporation
DCGF	Deposit and Credit Guarantee Fund
DGF	Deposit Guarantee Fund
DPC	Development Policy Credit
DFID	U.K. Department for International Development
DFS	Digital Financial Services
DoC	Department of Cooperatives
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FI	Financial Institution
FINCO	Financial Cooperative
FINGO	Financial Nongovernmental Organization
FIRST	Financial Sector Reform and Strengthening Initiative
FPO	Follow-on Public Offer
FSAP	Financial Sector Assessment Program
FSSP	Financial Sector Stability Program
FSDS	Financial Sector Development Strategy
GDP	Gross Domestic Product
GoN	Government of Nepal
GRS	Grievance Redress Service
GST	Goods and Services Tax
IDA	International Development Agency
IFC	International Finance Corporation
IMF	International Monetary Fund
IT	Information Technology
M&A	Mergers and Acquisitions
MFI	Microfinance Institution
MoF	Ministry of Finance

MOLJPA	Ministry of Law, Justice and Parliamentary Affairs
MSME	Micro, Small and Medium Enterprise
NBL	Nepal Bank Limited
NFRS	Nepal Financial Reporting Standards
NIB	Nepal Insurance Board
NPL	Non-Performing Loan
NPR	Nepalese Rupees
NRB	Nepal Rastra Bank
PA	Prior Action
PCA	Prompt Corrective Action
PDNA	Post-disaster Needs Assessment
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PPMO	Public Procurement Monitoring Office
RBB	Rastriya Banijya Bank
SIP	Special Inspection Program
SIS	Supervisory Information System
TA	Technical Assistance
WB	World Bank

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NEPAL
FOURTH FINANCIAL SECTOR STABILITY DEVELOPMENT POLICY CREDIT

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SUMMARY OF PROPOSED CREDIT AND PROGRAM

NEPAL

FOURTH FINANCIAL SECTOR STABILITY DEVELOPMENT POLICY CREDIT

Recipient	Nepal
Implementing Agency	Ministry of Finance (MoF)
Financing Data	International Development Association (IDA) Credit Terms: Regular (38 years, with 6 years grace period) Amount: SDR71.1 million (US$100 million equivalent)
Operation Type	The proposed operation is the last in a series of four Development Policy Credits (DPCs) in support of financial sector stability in Nepal. It is expected to be withdrawn in a single tranche. The initial IDA Financial Sector Stability Credit, approved in June 2013, was a stand-alone single-tranche of equivalent to US$30 million credit. The Second and Third IDA Financial Sector Stability credits were each of equivalent to US$100 million, and approved in June 2015 and March 2017, respectively. The Second, Third, and Fourth DPCs are part of a program of three single-tranche Development Policy Operations.
Pillars of the Operation and Program 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. The proposed credit series has four pillars: (a) enhancing financial sector development, (b) restructuring and consolidating the financial system, (c) strengthening the legal and regulatory framework for crisis management, banking and insurance supervision, and (d) enhancing the governance and transparency of the banking system.
Result Indicators (see annex 1 for baselines, targets and results for the whole series)	• All banks are either CAR-compliant or under Prompt Corrective Action (PCA) • All insurance companies are adequately capitalized or are subject to corrective action • A modernized legal framework/implementing regulation for bank resolution is in place • Supervisory capacity strengthened as evidenced by compliance with four additional Basel Core Principles and implementation of a new Supervisory Information System • Legal framework, implementing regulations, and required premium are in place for the Deposit and Credit Guarantee Fund (DCGF) • The framework for contingency back-up funding for bank resolution has been established • Safety and efficiency of payment and settlement systems have been improved • Modernized legal framework for supervision and regulation of the insurance sector and National Insurance Board (NIB) can resolve troubled institutions • Nepal Financial Reporting Standard (NFRS) is adopted by all Class A/B banks • All board of directors' members and Chief Executive Officers of banks and Financial Institutions (FIs), including state-controlled banks, meet the fit and proper criteria • Resolution framework is in place to deal with problematic financial co-operatives and 90 percent of the co-operatives have met the new gender requirement • Nepal remains off the Financial Action Task Force (FATF) grey list
Overall risk rating	Substantial
Climate and disaster risks	Are there short- and long-term climate and disaster risks relevant to the operation? Yes
Operation ID	P159547

IDA PROGRAM DOCUMENT FOR A PROPOSED
FOURTH FINANCIAL SECTOR STABILITY DEVELOPMENT POLICY CREDIT
TO NEPAL

1. INTRODUCTION AND COUNTRY CONTEXT

1. **This is the fourth operation in a series of Development Policy Credit (DPC) operations with the development objective of supporting the Government of Nepal's (GoN) financial sector medium-term reform to reduce the vulnerability of the banking sector and increase its transparency.** This program document describes the Fourth Financial Sector Stability Development Policy Credit (DPC4) to the GoN, in the amount of SDR 71.1 million (US$100 million equivalent). The initial IDA Financial Sector Stability Credit (P129929), approved in June 2013, was a stand-alone single tranche credit in the amount of US$30 million equivalent). The second (P133777) and third (P156960) credits (each in the amount of US$100 million equivalent, and approved in June 2015 and March 2017, respectively), were designed in a programmatic series of three operations. The series has four pillars: (a) enhancing financial sector development; (b) restructuring and consolidating the financial system; (c) strengthening the legal and regulatory framework; and (d) enhancing the governance and transparency of the banking system.

2. **The proposed operation is consistent with the Country Partnership Strategy (CPS) for FY2014–2017** that acknowledges the persistent financial sector weakness and the risk it poses to macroeconomic stability and economic growth. The Performance and Learning Review (PLR, FY2017) of the CPS also acknowledges the progress made through the series of DPCs, particularly in addressing the capital adequacy of state-owned banks, strengthening inspection and compliance, ensuring overall financial sector stability and contributing to access to finance. The Systematic Country Diagnostic (FY2018) highlights financial sector stability and inclusion as important aspects for broader economic growth and poverty reduction. The operation was prepared in close collaboration with the International Finance Corporation (IFC), the International Monetary Fund (IMF), and the United Kingdom Department for International Development (DFID).

3. **The program remains largely materially unchanged compared to the DPC3 Program Document approved by the IDA Board on March 2, 2017.** Four new Prior Actions (PAs) were introduced to further strengthen the proposed results and support implementation and enforcement, and one indicative DPC3 PA did not become a PA in the DPC4 (see section 4.2).

4. **Nepal is at a historic juncture, migrating to a federal state structure under a new constitution that defines Nepal as a federal democratic republic.** The new Constitution, promulgated in 2015, establishes Nepal as federal state with autonomous sub-national governments. Nepal now has seven Provinces and 753 local governments. Funds, functions and functionaries, hitherto managed through the 75 District Development Committees, will move to new local governments. With the completion of elections for all three tiers of government, a new government took office in February 2018.

5. **Nepal faces a range of risks and impacts from climate change that could undermine growth and stability in the financial sector and the economy.** Among these risks is the glacier melt due to a temperature increase, which can increase floods and shift water availability. For example, rising temperatures in the north threaten to increase glacial melt and augment the risks from Glacial Lake Outburst Floods. It is estimated that 26 potentially dangerous glacial lakes exist in Nepal. In addition, drought due to climate change can also seriously harm agricultural yield. Droughts are becoming more frequent occurrences in Nepal, particularly during the winter months and in the western Terai plains, which are characteristically dry because of the late arrival of the monsoons. Drought, as well as shifts in the timing of rainfall and glacier melt, can also affect the country's major hydroelectricity generation.

2. MACROECONOMIC POLICY FRAMEWORK

6. **The macroeconomic policy framework remains adequate for this operation**. Despite several severe shocks in the past (conflict, unstable governments, earthquakes, trade disruptions, India's demonetization and introduction of Goods and Services Tax - GST), Nepal's macroeconomic fundamentals have remained sound. A projected increase in the fiscal and current account deficits are supporting the needed spending for reconstruction (following floods and the earthquake), and the transition to a federal structure (including transfers to subnational government for improved service delivery). Although, increased borrowing of around 5 percentage points (between 2018 and 2021) will be needed, the nominal share of debt to gross domestic prpoduct (GDP) will remain below 40 percent. In addition, a draw down on reserves (to a level of 5 months of imports over the medium term) and reliance on concessional borrowing and grants will support the needed investments and spending for reconstruction and decentralization. Political risks are mitigated by the fact that the new government is now in place and committed to federalism. The risk of a higher fiscal deficit (as federalism is implemented) is mitigated by strong donor support, both in terms of technical assistance (TA)and concessional financing. Over the medium-term, as the transition period is completed, a well-functioning federal structure will help support stability and growth.

2.1 RECENT ECONOMIC DEVELOPMENTS

7. **Recent data released by the Central Bureau of Statistic (consisting of a revision of the FY2017 growth rate and an updated estimate for FY2018), show that growth has been strong, despite the external shock from floods.** In mid-August 2017, the worst flood in decades destroyed 64,000 hectares of standing crop, contributing to an estimated reduction in the agriculture growth rate from 5 to 2.8 percent (in FY2017 and FY2018, respectively). This shock has translated to a reduction in overall GDP growth from 7.9 to 6.3 percent. Growth in services and industry have remained at trend levels. With the continued growth in hydropower capacity and the electricity subsector as well as earthquake reconstruction activities, the construction and industry sector continued to expand to meet the demand gap. In the service sector, the growth rate of the wholesale/retail trade (9.1 percent) and the hotel subsectors (9.8 percent) are estimated to remain strong in FY2018. Tourist arrivals are expected to be at record levels, but their contribution to growth will remain small because of the small GDP share. Wholesale/retail trade is the main driver of service growth (accounting for 33 percent of total growth of the subsector). On the demand side, investment contributed the most to growth. Gross fixed capital formation will reach 30 percent of GDP in FY2018, with over 80 percent of this increase coming from private investment. Consumption, however, will continue to ease with a slowdown in remittances.

8. **Inflation is expected to remain moderate at 4.5 percent in FY2018.** Nonfood items have been the main driver of inflation but have moderated compared to the same period last year. Due to moderating inflation in India and improving supply side constraints, the inflation rate slowed further to 4.2 percent (y-o-y) in December 2017 but increased to 6 percent (y-o-y) in March 2018 owing to a sharp uptick in vegetable prices. The Nepalese rupee is pegged to the Indian rupee at the rate of 1.6 Nepalese Rupees to 1 Indian Rupee (India is the largest trade partner) and, thus, inflation follows the price movements of the nominal anchor. Lower and stable inflation has led to the real effective exchange rate depreciating over the last six months for the first time since 2018.

9. **The trade deficit remained stable at 33 percent in FY2018.** Imports remained high at 43.1 percent of GDP, fueled by industrial supplies, capital goods, and fuel imports. Growth in food imports has been weak and is likely to decline relative to 2017 levels. Average growth of food imports in the first seven months of FY2018 was 3.4 percent per month y-o-y compared to an average growth of 44.3 percent y-o-y per month

for the first seven months of FY2017. The declining trends for food imports are likely a result of the slowdown in remittances. Exports are estimated to be 9.5 percent of GDP (compared to a five-year average of 10.7 percent of GDP) as they continue to slowly recover from the earthquakes and trade disruption with India. In recent months, export demand which is expected to have further dampened due to the demonetization and introduction of the Goods and Services Tax in India[1], grew 28.8 percent (y-o-y) for the first three months of FY2018.

10. **Remittance growth, which financed almost all imports in previous years, has slowed.** The share of remittances in GDP continues to decline and is estimated to reach 23.4 in FY2018 (table 1). The main destinations for Nepali migrants are countries in the Gulf (Qatar, Saudi Arabia, United Arab Emirates) and Malaysia. Following the oil price slump in 2014 and subsequent austerity measures in host countries, the demand for migrant workers from Nepal has weakened.

11. **Continued weak exports, increasing demand for imports and slower growth in remittances has led to further widening of the current account deficit to 4.2 percent of GDP.** A key driver of the widening current account deficit stems from remittances which declined by 3 percentage points of GDP. In addition, the trade deficit is estimated to reach US$ 9.8 billion in FY2018 due to imports for floods and earthquake reconstruction, hydro, other infrastructure projects and oil consumption. Foreign reserves accumulation is expected to decline (by 2 months of imports between FY2017 and FY2018) to reach 7.8 months (or US$8.4 billion). Foreign direct investment (FDI) is estimated to reach US$ 240 million in FY2018, but will remain less than 1 percent of GDP.

12. **Credit growth is moderating while the slower deposit growth continues.** Deposit mobilization eased due to the slowdown in incoming remittances. This led to a squeeze on the availability of loanable funds in banks. Credit growth in February 2018 stood at 16.7 percent (y-o-y), which is a significant decline from the peak of 31.9 percent in February 2017. Credit to Core Capital and Deposit (CCD) ratio of the banks, (capped at 80 percent), reached 78.1 percent in January 2017. The Nepal Rastra Bank (NRB) responded by introducing temporary restrictions on bank lending and temporarily changed the method of calculating the CCD ratio of banks. While these measures did slow lending, and provided breathing space for banks, the fundamental issue of the credit crunch persists because banks have not been able to increase deposit mobilization even as credit growth has dampened.

13. **The banking sector remains adequately capitalized and stable even as slower deposit growth continues.** The capital position of banks has improved significantly owing to the retention of earnings, issuance of rights to shares and mergers to meet the new capital requirement of NPR 8 billion. Recent estimates of the Capital Adequacy Ratio (CAR) is 14.1 percent (compared to 14.72 percent in FY2017). The Non-Performing Loan (NPL) ratio remains low at 1.74 percent of the total loan portfolio (though it increased slightly from a historic low of 1.54 in FY2017). Loan loss provisions are more than adequate to cover the impaired assets.

Table 1. Macroeconomic Indicators

	FY2015	FY2016	FY2017	FY2018(e)	FY2019(f)	FY2020(f)	FY2021(f)
Real economy (Percentage change, unless otherwise stated)							
Nominal GDP, current prices (NPR, billions)	2,130	2,253	2,643	3,007	3,311	3,642	3,988
Real GDP growth (at market prices)	3.3	0.6	7.9	6.3	5.0	5.1	5.0

[1] India reformed their indirect taxation system through the introduction of the Goods and Services Tax (GST) in July 2017. The GST replaces and subsumes 17 central and state taxes. It reduces rates on over 50 percent of items, with many essential items exempt from tax, and charges standard rates of 5 percent, 12 percent, 18 percent and 28 percent.

Real GDP growth (at factor prices)	3.0	0.2	7.4	5.9	5.0	5.2	5.1
Contributions to GDP growth:							
Agriculture (percentage points)	0.4	0.1	1.8	1.0	1.5	2.0	2.0
Industry (percentage points)	0.2	-1.0	1.8	1.4	0.6	0.6	0.5
Services (percentage points)	2.4	1.1	3.8	3.6	2.9	2.6	2.6
Consumer prices (period average)	7.2	9.9	4.5	4.5	5.0	5.0	5.5
Fiscal sector (As percentage of GDP, unless otherwise indicated)							
Total revenue and grants	20.8	23.1	24.4	25.0	24.2	23.8	24.6
Expenditures	21.9	23.6	29.1	31.8	32.3	31.4	32.8
Net incurrence of liabilities	-0.9	2.4	3.2	6.7	8.1	7.6	8.2
Foreign	-0.7	0.7	1.4	2.0	2.4	2.7	2.6
Domestic	-0.2	1.7	1.9	4.7	5.7	4.9	5.6
Total public debt	25.6	27.9	26.6	30.2	35.8	34.4	35.6
Domestic	9.5	10.6	10.9	14.3	18.7	16.0	16.0
External	16.1	17.3	15.7	15.9	17.1	18.4	19.6
Monetary sector (Percentage change, unless otherwise indicated)							
Broad money	19.9	19.5	15.5	….	….	….	….
Domestic credit	15.6	18.1	20.2	….	….	….	….
Private sector credit	19.4	23.2	18.0	….	….	….	….
Balance of payments (As percentage of GDP, unless otherwise indicated)							
Current account balance	5.1	6.2	-0.4	-4.2	-5.6	-4.3	-1.9
Exports of goods and services	11.6	9.5	9.1	9.5	10.6	11.4	12.8
Imports of goods and services	41.5	39.3	42.9	43.1	44.7	45.1	44.7
Remittances (as percentage of GDP)	29.0	29.5	26.3	23.4	22.2	21.1	20.8
Gross official reserves ($, millions, eop)	7,067	8,340	8,730	8,427	7,332	6,623	6,951
Gross official reserves (in months of prospective imports of goods and services)	10.1	11.0	9.8	7.8	6.1	5.1	5.0
Rupees per U. S. dollar (period average)	99.5	106.4	106.2	…	…	…	…
Memorandum items:							
Nominal GDP, current prices (USD, billion)	21.4	21.2	24.9	…	…	…	…
Population, million	28.7	29.0	29.2	…	…	…	…
GDP per capita, USD current	747	731	853	…	…	…	…

14. **In addition to the updates by the Bureau of Statistics, the FY2019 Budget presents updated budget data for FY2017**. As a result, revenue in FY2017 as a share of GDP is slightly lower than estimated in the last data release. Annual revenue growth is robust but government spending has picked up significantly resulting in a higher fiscal deficit. Growth in revenues are a result of the heavy reliance on trade taxes and levies (including value-added tax and imports excise). Overall, these trade taxes amount to roughly 43 percent of the government's domestic revenue or close to 10 percent of GDP. Recurrent spending is estimated to increase to 21.9 percent of GDP in 2018 due to higher civil service wages, fund transfers to local governments, and increased social security spending. Capital spending is estimated to increase from 7.9 percent of GDP in FY2017 to 8.3 percent as post-earthquake reconstruction activities continue. This could result in a further increase in the fiscal deficit from 4.8 percent in FY2017 to 6.7 percent in FY2018 (table 2). As in past years, the level of the fiscal deficit will depend on the degree of underspending of the budget, which continues to

be a challenge to spending efficiency. Hence, it is also possible that the fiscal deficit might be lower than projected should there be significant underspending of the budget.

Table 2. Fiscal Indicators

(As percentage of GDP, unless otherwise indicated)	FY2015	FY2016	FY2017	FY2018 (e)	FY2019(f)	FY2020(f)	FY2021(f)
Total Revenue and Grants	**20.8**	**23.1**	**24.4**	**25.0**	**24.2**	**23.8**	**24.6**
Total revenue	19.3	21.5	23.2	23.8	23.1	22.7	23.5
Tax revenue	16.7	18.7	20.8	21.7	25.0	24.1	23.5
Nontax revenue	2.3	2.7	2.1	2.1	2.3	2.5	2.6
Grants	1.8	1.8	1.2	1.2	1.1	1.1	1.1
Total Expenditure (includes on-lending)	**21.9**	**23.6**	**29.1**	**31.8**	**32.3**	**31.4**	**32.8**
Current expenditure	15.9	16.5	19.6	21.9	22.5	23.2	23.2
Capital expenditure	4.2	5.4	7.9	8.3	8.3	8.4	8.2
Overall balance (excluding grants)	-0.8	-0.4	-4.3	-6.5	-7.7	-7.3	-7.9
Overall balance (including grants)	0.8	1.3	-3.2	-5.2	-6.6	-6.2	-6.8
Fiscal Balance (including on-lending)	**-1.1**	**-0.4**	**-4.8**	**-6.7**	**-8.1**	**-7.6**	**-8.2**
Net financial transactions	-2.7	0.7	1.6	5.2	6.6	6.2	6.8
Net acquisition of financial assets (includes on-lending)	1.8	1.7	1.6	1.5	1.5	1.4	1.4
Net incurrence of liabilities (financing needs)	-0.9	2.4	3.2	6.7	8.1	7.6	8.2
Foreign	-0.7	0.7	1.4	2.0	2.4	2.7	2.6
Domestic	-0.2	1.7	1.9	4.7	5.7	4.9	5.6

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABIITY

15. **Over the medium-term, government interventions to modernize the agriculture sector will strengthen growth which will average 5 percent in the forecast period**. While agriculture growth will initially suffer from the effects of the floods, especially in the food basket in the southern plains, it is expected to slowly recover to historical growth rates and gradually pick up momentum as government programs (recently outlined in the FY2019 Budget Speech) begin to take effect over the medium to longer term. Government targets a doubling of agriculture growth over the next 5 years through reforms to modernize the sector. This will be achieved through establishing Agriculture Knowledge Centers to support extension at the local level and increase access to modern seeds and inputs. The emphasis will be on increased commercialization and expansion of value chains. Construction is likely to remain strong, driven by post-earthquake reconstruction activities. However, the remaining sectors could be affected by uncertainty stemming from the transition to the new federal structure. Remittances could also slowdown further. Inflation, despite the recent uptick is expected to remain stable and below the Central Bank's target of 7.5 percent over the medium-term.

16. **The current account deficit is expected to widen as import growth remains strong, exports remain subdued and the remittance growth rate remains low.** Exports are expected to slowly recover from the adverse effects of the earthquake and trade disruption with India. Growth in exports is expected to remain subdued until infrastructure constraints can be fully removed, despite a possible depreciation of the real effective exchange rate. The decline in outflow of migrant workers and remittance inflows is likely to continue due to lower demand in Gulf countries. Imports growth is projected to remain strong, driven by reconstruction and infrastructure projects such as Pokhara International Airport, Babai Irrigation, Melamchi Drinking Water and efficiency gains in hydro stemming from government interventions supported under the

First Programmatic Power Sector DPC. The persistence of a large trade deficit and a continued slowdown in remittances is expected to keep the current account in deficit over the medium term, and will be financed primarily by long term borrowing, grants and a drawdown of international reserves (table 3). The current account deficit is expected to widen to just under 6 percent of GDP and moderate thereafter as reconstruction activities taper off. International reserves are forecasted to cover close to 5 months imports by FY2020 (table 1). There are negligible portfolio investments in the country and despite some expected increase in FDI (due to foreign investments in large infrastructure projects), it is expected to remain low (t). The central bank has maintained the currency peg with India, its largest trading partner, for the last two decades and is expected to continue to maintain the peg with the Indian Rupee.

Table 3. BOP Financing Requirements and Sources (in US$)

	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
Financing requirements	**1,153**	**-263**	**-1,432**	**-2,004**	**-1,755**	**-1,004**
Current Account deficits	1,320	-95	-1,228	-1,772	-1,502	-727
Debt amortization	-167	-168	-204	-231	-253	-277
Financing Sources	**-1,153**	**263**	**1,432**	**2,004**	**1,755**	**1,004**
FDI and portfolio investment (net)	56	127	243	240	249	333
Long term borrowing	338	589	796	996	1,205	1,262
Others (trade credits, currency deposits, misc items etc)	100	129	-142	-285	-372	-232
Changes in reserves (minus sign indicates increase)	-1,647	-583	535	1,052	674	-360

17. **Government expenditure is expected to increase over the medium-term primarily because of the implementation of fiscal federalism. However, there is considerable uncertainty around the outlook.** Government spending as percent of GDP jumped by 5.5 percentage points between FY2016 and FY2017 primarily driven by a higher wage bill, larger transfers to local bodies to implement federalism and earthquake-related cash assistance and reconstruction activities. The transfers to the local government is estimated to increase to around 5 percent of GDP per year over the medium term (compared to 3 percent in 2017). This is expected to further increase by an additional 1 to 2 percentage points to reach 7 percent of GDP beyond FY2021. In the next three years (2019-2021), on average, total expenditure is likely to grow by 3-4 percent of GDP per year, because of the implementation of the federal structure. While there is considerable uncertainty around the scope and pace of the implementation of fiscal federalism (particularly given underspending), higher spending is expected because of: (a) the establishment cost for state and local governments; (b) increased infrastructure spending by state and local governments; and, (c) additional fund transfers for decentralized service delivery.

18. **The consolidated wage bill is not expected to change significantly.** The wage bill at the central level will decline with decentralization of service delivery[2] as central level civil servants get reassigned to subnational governments. However, with devolution of service provision to the provinces and local governments, the civil service bill will increase at subnational levels. Preliminary estimates of civil servants required for provincial governments is 2,600 and for local governments, 56,000. Reassignment of central level civil servants to the subnational governments have started, and the outcome is being monitored.

19. **Revenue collection is expected to grow, with a continued increase in trade taxes linked to import growth.** Non-tax revenues are also expected to increase because of dividends from institutions (such as Nepal Telecom) and royalties from new hydropower projects (such as *Upper Tamakoshi).* However, expenditure

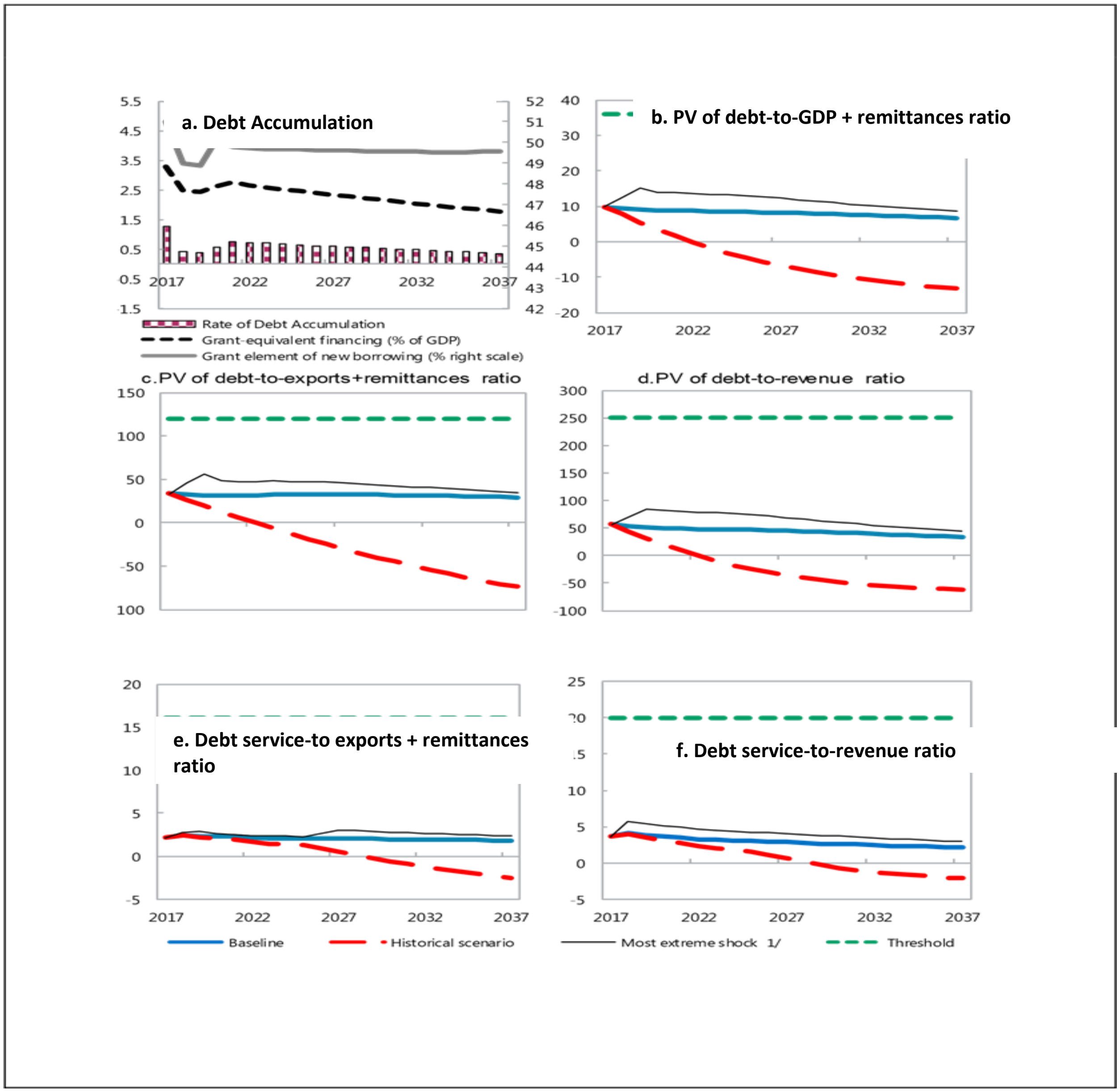
[2] The number of federal level ministries will be reduced from 32 to 15.

growth is likely to outpace the increase in revenue collection, resulting in a fiscal deficit of 6-7 percent of GDP in the forecasted period. The higher deficit will be financed by higher domestic and international borrowing (an increase of about 5 percentage points over the medium term). Also, the availability of concessional financing from international donors is expected to continue and possibly increase, as the government transitions to a federal structure.

20. **Despite the projected increase in the fiscal deficit, the stock of public debt is projected to remain low, increasing from 30 percent in FY2018 to 36 percent by FY2021.** Public debt, as a share of GDP, has fallen dramatically from around 64 percent in 2002 to around 27 percent in FY2017. While prudent fiscal management by the government has played a part in keeping debt levels low, revenue collection has been the key factor - annual growth rate of 0.5 percent of GDP – coupled with under execution of capital expenditure. The Joint World Bank- International Monetary Fund (IMF) Debt Sustainability Analysis (2017) has maintained the "low" risk rating of debt distress. The baseline macroeconomic projections underlying this Debt Sustainability Analysis assume a pickup in government spending and an increase in deficit levels over the medium term. However, Nepal's risk of debt distress is expected to remain low in view of the continued high level of concessionality of official borrowing and limited scaling up of capital spending due to weak implementation capacity. In addition, the government remains committed to fiscal prudence and recently formed a high level Public Expenditure Review Commission to carry out a spending review and suggest measures to cut down on spending, particularly considering federalism. Under the baseline scenario and stress tests, the indicators of the public external debt stock and public debt service ratios remain well below the policy-dependent indicative thresholds (figure 1). The Economic Affairs and Policy Analysis Division at the Ministry of Finance (MoF) is responsible for overall debt management in Nepal. It performs the middle office function of setting the targets and objectives of public debt policy. A Medium-Term Debt Management Strategy awaits cabinet approval, and a dedicated public debt management unit consolidating all debt management functions is being established at the MoF.

21. **Higher expenditure linked to federalism will be financed by a combination of domestic revenue, domestic borrowing and donor funding.** Therefore, indicators of public external debt stock and public debt service ratios remain within the policy-dependent indicative thresholds even under stress tests, due to the continued high level of concessional borrowing.

Figure 1. Indicators of Public/Publicly Guaranteed External Debt under Alternative Scenarios, FY2017–2037



Source: World Bank/IMF Debt Sustainability Analysis.
The most extreme stress test is the test that yields the highest ratio on or before 2026. In figure b. it corresponds to a Combination shock; in c. to a Combination shock; in d. to a Combination shock; in e. to a Combination shock and in figure f. to a One-time depreciation shock.

2.3 IMF RELATIONS

22. **The IMF does not have an ongoing program in Nepal and the 2017 Article IV consultations concluded in March 2017.** The Bank and the IMF coordinate closely on financial sector strengthening, statistical and public financial management (PFM) capacity building and, more recently, on the federalism agenda.

2.4 RECENT FINANCIAL SECTOR DEVELOPMENTS

Structure of the System

23. **Nepal's financial system is bank-dominated and continues to be characterized by a large (albeit declining) number of institutions, multiple banking licenses, and diminishing state ownership.** The banking system's assets grew by 211 percent between 2009 and 2017. Domestic credit to the private sector jumped from 33 to 77 percent of GDP from 2005 to 2017, overtaking the South Asia regional average of 45.8 percent of GDP. Private commercial banks accounted for most of this growth. The share of the three state-owned banks in the sector's total assets declined to around 15 percent in 2018 from 23 percent in 2013. Rastriya Banijya Bank (RBB) is the largest bank, representing 6.5 percent of total commercial bank assets in 2018, while Agriculture Development Bank Limited and Nepal Bank Limited (NBL) are the sixth and eighth largest banks respectively, with 4.7 and 4.5 percent. The ten largest banks account for roughly half of commercial banks' assets. The number of Banks and Financial Institutions (BFIs) has been declined from 199 in 2011 to 89 in 2018 as a result of the moratorium on banking licenses and the four-fold increase in the capital requirement.

Performance of the System

24. **Headline capital adequacy and asset quality ratios appear comfortable.** All banks meet the minimum CAR of 10 percent, with an industry average of 14.1 percent. The forbearance measures introduced by NRB to address the negative impact of the 2015 earthquake and 2015–2016 trade disruptions have been fully rolled back. Despite this, the NPL ratio remained low at 1.74 percent by FY2018 Q2.

25. **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.

Box 1. The 2011 Banking Crisis, Authorities' Response and Reform Efforts

The collapse of the real estate bubble (after a peak in 2008), coupled with a slowdown in remittance growth in early 2011, led to a severe liquidity squeeze in April–May 2011. This followed a period in which Banks in Nepal had proliferated in an environment of weak supervision, accommodative monetary policy, and excessive lending in the real estate market driven by unsterilized remittance flows. Inadequate governance and risk management resulted in connected lending and cross-shareholding among banks (from the pledging of equity shares as loan collateral). This brought the system's vulnerabilities into sharper focus, driving fears of a potential banking crisis. The NRB responded with the following measures:

- **Large-scale liquidity support and regulatory forbearance**, rather than bank intervention and the resolution of insolvent banks. The NRB established a Lender of Last Resort facility and a Special Refinance for Liquidity Management facility (removed once liquidity pressures eased), capped the credit-deposit ratio at 80 percent, and reduced the Cash Reserve Ratio from 5.5 to 5 percent. In addition, the authorities established a deposit insurance scheme, compulsory for all classes of BFIs, and the coverage was set at NPR200,000 per depositor per bank. This strategy was successful in preventing a crisis and the resurgence of remittance flows allowed banks to unwind NRB support.
- **Strengthening of banking regulation and supervision**, benefiting from DFID, IMF TA support and this DPC series. Measures included, among others, issuance of a new risk management directive, new paid-up capital requirement, bylaws to facilitate mergers and acquisitions (M&A), regular stress testing, new instruments to manage excess liquidity, and the establishment of a problem bank resolution department.
- **Strengthening of the resolution framework for problem banks**, contributing to the consolidation in the banking system. The parliament approved the NRB Act Amendment Bill and a new Deposit and Credit

Guarantee Fund (DCGF) Bill that gave the NRB and other safety net partners' stronger powers to intervene in a timely manner in undercapitalized BFIs. The parliament also approved a new Banks and Financial Institutions Act (BAFIA), which has provisions to raise the standard of BFI governance in line with good practices. Because of the moratorium on new banking licenses, new paid-up capital requirements, and the directives allowing Merger and Acquisitions (M&As), the number of BFIs shrunk by 55 percent from early 2012 to early 2018.

3. THE GOVERNMENT'S PROGRAM

26. **The GoN's financial sector reform program aims to reduce the vulnerability of the banking sector and increase its transparency**. The first phase of the Government's program was completed in 2011–2013 and supported by DPC1**.** It included, among others, measures to stabilize the banking system after the 2011 crisis, formalizing the deposit insurance system, adopting a framework for Prompt Corrective Action (PCA), carrying out diagnostics of BFIs and strengthening the legal framework for anti-money laundering (AML). It also began the process of banking sector consolidation, and the first round of recapitalization for NBL and RBB.

27. **The second phase of the Government's program (2014–2018) focuses on reforms designed to achieve two overarching policy objectives.** First, to ensure the stability of the financial system by improving the quality of regulation, supervision, transparency, and governance, and second, to start improving access to formal financial services. To achieve these objectives, the Government's program has four pillars: (a) enhancing financial sector development, (b) restructuring and consolidating the financial system, (c) strengthening the legal and regulatory framework, and (d) enhancing governance and transparency. The programmatic DPC series (DPCs 2, 3 and 4) supported these reforms while gradually shifting the focus from legal and regulatory reforms to implementation and enforcement. The GoN's financial sector program is further explained in the Letter of Development Policy (annex 2).

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

28. **The development objective of the programmatic series of DPCs is to support the GoN's financial sector medium-term reform to reduce the vulnerability of the banking sector and increase its transparency.** The series is anchored on the GoN's program and informed by 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 Government's effort to reinforce financial sector stability and pave the way for the development of a robust and more inclusive financial sector. The series supports the same four pillars of the government program mentioned above.

29. **The design of the series considers the lessons learned from the Financial Sector TA project and the Financial Sector Restructuring project.** Both investment lending projects supported, among others, restructuring the two state-owned banks and strengthening NRB. The results however were limited. Policy-level reforms were needed to achieve broader stability and development in the banking sector. Hence, the shift to policy-based lending complemented by TA for an extended period to help develop broad-based support for medium-term reforms. The identification of PAs considered the need to ensure both early wins for reform champions and the undertaking of key steps toward clear goals to be achieved by the end of the series. A multi-year DFID capacity-building program supported these reforms and was closely aligned with other World Bank and IMF TA activities.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

30. **Compared to the DPC3 Program Document approved by the IDA Board on March 2, 2017, all the indicative policy actions envisaged for DPC4 have become PAs except for one.** In addition, four new PAs were introduced to strengthen the proposed results of the DPC series and to support implementation and enforcement.

31. **Enforcement of legal and regulatory reforms by the regulators has been strengthened over the life of the DPC series, supported through the capacity building program mentioned above**. In particular, the series has ensured that NRB and the Nepal Insurance Board (NIB) take enforcement measures. The series supported NRB in undertaking a Special Inspection Program (SIP) of 54 banks accounting for 60 percent of the banking sector assets, and mandated that these inspections have the same statutory enforcement as regular NRB inspections. As a result, NRB had to take PCA or resolution against under-capitalized banks. The series supported NIB in undertaking an in-depth diagnostic of 60 percent of the insurance sector companies and mandated that these inspections have the same statutory enforcement as regular NIB inspections. As a result, NIB had to take corrective action against undercapitalized insurance companies. Inspectors from both NRB and NIB were trained and participated in these inspections. In addition to enforcement measures, the series is strengthening enforcement capacity. Implementation of the NRB's Supervisory Information System (SIS), and improved accounting and reporting standards together will enhance NRB's capacity to monitor BFI's observance of regulatory norms, reporting standards, and credit policies. Finally, and in tandem with the DPC series, DFID, the Bank and the IMF provided TA to improve supervision and resolution capacity of both NRB and NIB.

32. **The only indicative policy action in DPC3 that did not become a PA in this operation is "publication of an international tender for the sale of the Government's stake in NBL."** This was part of NBL's original restructuring plan, which was conceived in 2011, when NBL was insolvent, placed under NRB stewardship, and unable to engage in new lending. The DPC series backed this plan, by supporting the following actions: a cash injection by the GoN, conversion of the GoN loans to NBL into equity, the sale of NBL's non-banking assets, retaining all earnings, and endorsement by the MoF of NBL's strategic divestiture plan. The conversion of the GoN loans to equity resulted in the GoN owing a majority stake (more than 60 percent ownership), which enables the GoN to offer a majority stake to potential strategic investors. The GoN announced its decision to divest control of NBL in the budget speech in 2014. Owing to changes in priorities and political sensitivities, the GoN has decided not to pursue an international tender at this stage. Instead the GoN is planning to divest part of its stake through an issuance of a Follow-on Public Offer (FPO) in the near future, while keeping 51 percent ownership (which would still allow it to divest to a strategic investor in the future). The NBL restructuring plan, supported by the series, has been successful. The NBL has graduated from NRB stewardship in 2015, it is professionally run, and members of its board of directors meet the professional qualifications of the new BAFIA regulations and NRB directives (also supported by the DPC series). NBL has met all regulatory norms (including on capital adequacy) and has had positive net income for the past three years. Finally, NBL is not a systemic risk anymore. Its market share has declined from 21.7 percent of banking sector assets in 2003 when NBL was technically insolvent, to 4.2 percent in 2017. NPLs declined from above 50 percent to 3.2 percent over the same period. Moving forward, the governance and risk management requirements supported by this DPC series should ensure that this improved performance is sustained. The series' results framework has been modified to reflect this change.

33. **Four new PAs were introduced to strengthen the results of the series and to support enforcement and implementation**. The first new PA, whereby NRB issues a directive on risk management, aims to improve risk management practices in the banking sector and ensure that the whole banking sector (including the state-owned banks) remains adequately capitalized. Similarly, the new PA requiring the Cabinet to raise the

capital of the DCGF would help ensure that the DCGF is well-funded in case of bank resolution. The third new PA on endorsing a new Payment and Settlement Act by the MoF should help strengthen the safety, efficiency and oversight of the payment and settlement system. Finally, the new PA related to enacting a new Cooperatives Act addresses concerns regarding the absence of meaningful regulation and supervision of financial cooperatives (FINCOs), and ensures that the governance of the financial sector is enhanced, given the potential for systemic linkages between cooperatives and BFIs.

34. The next few paragraphs discuss in detail the four pillars of this series, all the PAs of this operation and their role in the overall reform program, as well as expected results under each pillar.

Pillar 1: Enhancing Financial Sector Development

35. **The reforms under this pillar, supported by DPCs 1 and 2, have enabled the GoN to prepare and adopt a Financial Sector Development Strategy (FSDS) that balances the objectives of stability, efficiency, and inclusion**. The strategy was endorsed by the MoF in April 2015, and by the Cabinet in January 2017. Many of its recommendations are already under implementation. There are no additional PAs in this operation.

Pillar 2: Restructuring and Consolidating the Financial System

36. **The PAs under this pillar support restructuring and consolidating the financial system**. PAs under DPCs 2 and 3 aimed to restructure two state-owned banks, complete in-depth diagnostics of 60 percent of the banking system, and enforce PCA on undercapitalized institutions. In addition, the capital requirement for banks was increased and NRB maintained a moratorium on new banking license. The PAs under DPC4 complement them by introducing risk management requirements for banks and completing diagnostics of the insurance sector. Together these actions are expected to result in state-owned banks being adequately capitalized, liquid and profitable, and in a much smaller number of better-capitalized and managed private BFIs and insurance companies.

Prior action 1: The NRB has issued a new directive on Risk Management to the commercial banks.

37. **This PA aims to improve risk management practices in BFIs in Nepal and help ensure that BFIs remain adequately capitalized.** DPCs 2 and 3 supported NRB in undertaking in-depth diagnostics of BFIs to identify risks and ensure their compliance with capital adequacy requirements. DPC 4 built on this by supporting NRB in issuing a Directive making it mandatory for commercial banks to ensure proper risk management structures for the identification, measurement, monitoring, management, control and reporting of risks, in particular, with respect to the impact of risk categories on capital allocation and valuation. The NRB had issued voluntary Risk Management Guideline for BFIs in 2010. Implementation, however, varied amongst banks. The Directive was open to feedback from the public on the NRB website.

38. **The issuance of the Risk Management Directive helps BFIs develop a methodology to better understand climate-related risks[3].** Among others, the Risk Management Directive requires BFIs to prepare a strategy and develop a methodology for better risk management covering climate-related risks. It mandates BFIs to develop a mechanism to monitor operational risks so that the systematic recording of vital information is captured (such as the nature of the risk/event, its severity, and financial losses emanating from

[3] Climate change is considered a potential aggravating factor to credit, market, liquidity and operational risks. Banks can face operational risk due to the location of their branch network, which is addressed through the provision of disaster recovery sites. Banks also face credit risks from the exposure of borrowers to climate related risks. These risks include both direct impacts from climate change (for example, an increase in the frequency and intensity of extreme weather events) and indirect impacts (for example, the diversification away from fossil fuel usage, or added climate regulations). While some risks are protected by insurance, it is difficult to cover them comprehensively given their complexity.

it) and directs BFIs to ensure business continuity in the event of disasters. In addition, the directive requires enterprises seeking financing from BFIs to submit documents evidencing clearances that include an Environmental Impact Assessment/Initial Environmental Evaluation if the proposed activity causes direct and or indirect environmental impact. This is relevant to sectors such as hydropower, mining, cement, large scale manufacturing, agriculture and beverage projects, and so on. While disaggregated data is not available on exposure to these sectors, it is estimated that they represent at least 20 percent of the total loan portfolio, that is, NPR428 billion (US$4.2 billion) as of mid-December 2017. The NRB is also considering issuing a broader Environment and Social Risk Management Guideline.

Prior action 2: The 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.

39. **This PA aims to identify institutional level risks in the insurance sector and ensure that insurance companies remain adequately capitalized**. The 2015 earthquake highlighted the interdependence of the financial sector especially between the insurance sector and BFIs. DPCs 2 and 3 supported NRB in understanding the impact of the earthquake on BFIs. To complement this, DPC4 supported the NIB in completing diagnostics of institutional risks at 14 insurance companies that represent more than 70 percent of the sector's assets. The diagnostic identified weaknesses in corporate governance, internal controls, insurance expertise, valuations, assessment of liabilities, and compliance with the Code of Conduct. The NIB has taken measures to address these risks based on the recommendations of the diagnostic. First, the NIB took corrective action against one of the undercapitalized insurance companies, and approved a capital increment plan to fully capitalize it. Second, the NIB issued a Directive to raise the capital requirements to Nepalese Rupees (NPR) 2 billion for life and NPR 1 billion for non-life insurance companies by mid-July 2018. The World Bank is also providing TA to the NIB to enhance its supervision capacity. Better capitalized insurance companies are more capable of managing climate change risks and offer their rural clients agriculture insurance products to help reduce their vulnerability to weather and climate extremes, especially to floods, droughts and landslides. As a result, some insurance companies have collaborated with microfinance institutions (MFIs) in delivering livestock and crop insurance products to smallholder farmers. A healthy insurance sector will be able to play a more significant role in strengthening climate resilience of the economy.

Pillar 3: Strengthening the Legal and Regulatory Framework for Crisis Management, Banking and Insurance Supervision

40. **The PAs under this pillar support strengthening the legal and regulatory framework for crisis management, banking and insurance supervision.** PAs under DPCs 2 and 3 aimed to approve amendments to the NRB Act to strengthen supervision and resolution, and to establish a new DCGF under its own law. In addition, actions to reduce payment systems risks and improve information sharing between NRB and DCGF were introduced. The PAs under DPC4 complement them by supporting the issuance of enabling regulations for both the NRB and DCGF Acts, and enhancing the capacity of both institutions. In addition, PAs under DPC4 support the adoption of an oversight framework for payment systems and the endorsement of a new Payment and Settlement Act and a new insurance act. Together these actions are expected to result in a modernized legal framework for bank and insurance supervision and strengthened bank resolution capacity. They are also critical for the development of a financial sector safety net and a more efficient payment system.

Prior action 3: The NRB has issued the enabling regulations based on the Nepal Rastra Bank Act (Second Amendment), 20173 BS (2016).

This PA ensures effective implementation of the amended NRB Act especially related to bank resolution. DPCs 2 and 3 supported enactment of amendments to the NRB Act. DPC4 builds on this by supporting the issuance of its enabling regulations focusing on bank resolution and PCA. Before the new implementing regulations were issued, the legal framework for bank resolution was outdated and incomplete, limiting the NRB's ability to resolve BFIs quickly. Conflicts between various laws provided scope for banks to challenge NRB's resolution authority. While amending the regulations, NRB ensured that the provisions of the new BAFIA conforms to the NRB Act and the DCGF Act, thereby removing regulatory arbitrage that hindered the exercise of supervisory authority.

Prior action 4: The NRB has approved the functional and technical specification of the Supervisory Information System (SIS).

41. **This PA strengthens NRB's capacity to monitor BFI's compliance with the newly amended regulations and policies**. The timely availability of relevant and accurate data and information is vital for the NRB to effectively perform its supervisory and monitoring role, especially considering the new regulations and directives. Therefore, DPC4, with assistance from DFID, is supporting the implementation of an automated data management system known as the SIS. The SIS will enable BFIs to access and submit their verified data under a standard framework and in standard formats (eliminating reporting through hard copies, faxes, and soft copies via e-mails/ Excel spreadsheets). The NRB has authorized PWC (the implementing agency of the DFID TA) to sign a contract with the vendor for the development of the SIS, also approving the functional and technical specifications. The development of SIS has already started and is on track.

Prior action 5: The Cabinet has approved key regulations regarding (a) DCGF's relationship with BFIs; (b) a guaranteed deposit verification process; and (c) BFI reporting, payout and reimbursement of guaranteed deposits.

42. **This PA ensures effective implementation of the DCGF Act and improves the financial system safety net.** The FSAP identified that the deposit insurance system was based on a weak legal framework and function under bylaws. DPCs 2 and 3 supported the enhancement DCFG Act. DPC4 builds on this by supporting the approval of key regulations for the implementation of the Act. These regulations cover the functions and operations of the Deposit Guarantee Fund (DGF), the assessment of guaranteed deposit amounts for depositors, information requirements, as well as the methods and procedure for settlement and reimbursement of claims. DPC4 has also supported DCGF in preparing and finalizing the DGF investment policy, which is instrumental in ensuring regular income for DCGF and guaranteeing the sustainability of its operations. The investment policy was approved by the DCGF Board on April 18, 2018.

Prior action 6: (a) The NRB has executed a tri-partite agreement with the Ministry of Finance 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.

43. **This PA establishes the framework for contingency funding for bank resolution**. DPC 3 supported the exchange of information between NRB and DCGF. DPC4 takes this much further and establishes a framework for the provision of liquidity and funding to the DCGF in case of crisis. This represents a major development in the financial crisis management architecture, which until recently was limited to a High-Level Financial Sector Committee that did not hold special anti-crisis intervention powers. In addition, the liquidity and back-up arrangements did not exist. The tripartite agreement supported by DPC4 between the NRB, the

DCGF and the MoF puts in place the necessary arrangements and procedures, with well-defined roles and responsibilities among the three parties to provide the required funding and liquidity support to the DCGF and ensure full coordination among the three parties in the event of a crisis. In addition, DPC4 supports raising the capital of the DCGF up to NPR10 billion under an accelerated schedule, that is, by June 30, 2019, from the current paid-up capital of NPR3.1 billion (as of FY2017).

Prior action 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.

44. **The PA aims to enhance the safety and efficiency of the Payment and Settlement system**. DCP2 supported the approval of a Payment System Development Strategy, while DPC 3 introduced actions to reduce the settlement risk in the payment system. DPC4 complements these by assisting the NRB in adopting an oversight framework for payment and settlement systems, and supporting the MoF in endorsing a new Payment and Settlement Bill. The new draft law is in line with international standards and provides strengthened legal power to the NRB to execute its oversight responsibilities. These actions will help the NRB ensure that the payment system works smoothly and efficiently, thereby minimizing the risk of transmitting shocks resulting from the failure of individual participants to settle their payments obligations. The Bill was prepared by the NRB following extensive consultations with the industry and will undergo further deliberations among the public representatives before being approved by Parliament.

45. **The new act provides an enabling framework for implementing digital financial services (DFS) which enhances the safety, reliability and efficiency of the payments system.** Adoption of DFS makes it possible to transfer funds without the need to open bank accounts or the need to have a brick and mortar branches - especially important for Nepal with geographically challenging terrain thereby contributing to lower carbon emissions. DFS is also useful during unanticipated events (such as natural disasters like floods, drought, and landslides) by making available funds for disaster preparedness and emergency relief. The increasing likelihood of climate-related disasters make DFS an essential tool to transfer funds to affected areas where they are urgently needed and where traditional payment systems can be disabled.

46. **By enabling DFS, the new act also helps improve access to finance for women**. Most of the recipients of remittances in Nepali households are women. Remittances account for 27 percent of GDP. Integrating remittance services (which are low-value retail payment) into the payment systems through DFS[4] helps women gain access to financial services. While the usage of digital payments increased from 9 percent [5] of the adult population in 2014 to 16 percent in 2017, there is a gender gap in favor of men. Whereas 20 percent of adult men use digital payment, only 13 percent of adult women use them. By facilitating DFS especially for remittance services in under-banked areas, the new act is expected to help close the gender gap in the usage of digital payments and access to finance.

[4] Research by Leora Klapper cited on the website of the Consultative Group to Assist the Poor (CGAP) (January 19, 2016) shows how digital payments can empower women through: (a) targeted cash transfers of government social benefits (such as transfers to widowers and pensioners) which help boost their household bargaining power; (b) setting up digital payments systems to receive routine expenses (like school fees and utilities bills) saves women significant time and effort; (c) the promotion of formal savings through digital services makes it easier to meet unanticipated expenses that would otherwise leave women vulnerable to crimes; and (d) the overhauling of regulations encourages the wider use of mobile payments in a geographically challenged terrain like Nepal's. Moreover, when it is cheaper and more convenient for women to make digital payments, the financial sector can develop alternative credit-scoring models to address women's lack of history of formal financial transactions, and can design services to meet women's specific needs and preferences.

[5] *Source:* Findex 2014 and 2017.

Prior action 8: The Cabinet has approved the new Insurance Bill for submission to Parliament.

47. **This PA aims to modernize the legal framework for the supervision and regulation of the insurance sector**. It helps strengthen a key part of the financial sector to complement the reforms undertaken in the the banking sector. Therefore, DPC4 supported the approval by the Cabinet of a new Insurance Bill that will provide NIB with adequate powers to regulate and supervise the sector as well as to take corrective actions to resolve undercapitalized insurance companies. The Bill is also expected to improve reporting requirements and strengthen supervisory practices by shifting emphasis from compliance-based to risk-based supervision. This will help increase availability and penetration of insurance products in Nepal. The World Bank is providing technical support to the NIB towards this effort. The Bill was prepared by the NIB following extensive consultations with the industry and will undergo further deliberations among the public representatives before being approved by Parliament.

48. **A strong legal and regulatory framework for insurance helps in mitigating various vulnerabilities stemming out of life events and business operations.** These vulnerabilities increase due to climate change, especially in those sectors and regions that are particularly exposed. Every year, Nepal faces severe natural disasters due to flood, landslides, drought, and so on. As per the report of the National Planning Commission, in 2017, Nepal faced widespread floods across 35 (of the 77) districts and several districts experienced the heaviest rainfall in over 60 years. This led to the inundation of about 80 percent of the land in substantial parts of the plain region and resulted in damage to 190,000 houses, displacing tens of thousands of people and rendering many homeless. In the severely affected 18 districts, the floods affected a total of around 1.7 million people. DPC4 helps Nepali institutions manage the impact of such catastrophes through supporting a robust insurance sector by strengthening the legal, regulatory and institutional framework for insurance.

Pillar 4: Enhancing the Governance and Transparency of the Banking Sector

49. **The PAs under this pillar support enhancing the governance and transparency of the financial system.** PAs under DPCs 2 and 3 aimed to strengthen the governance of the banking system, including state-owned banks by approving the new BAFIA and issuing regulations related to the Governance of BFIs. In addition, actions to support transitioning toward the new Nepal Financial Reporting Standards (NFRS) and enacting AML/counter financing of terrorism (CFT)-related legislation were introduced. The PAs under DPC4 complement them by supporting the issuance of enabling regulations for the new BAFIA and AML acts, as well as amending the reporting requirements of BFIs to make them NFRS-compliant. In addition, DPC4 supported the enactment of a new Cooperatives Act that introduces for the first time a regulatory and supervision framework for FINCOs, establishes rules to address troubled cooperatives and helps narrow the gender gap in the governance of cooperatives. Together these actions are expected to result in Nepal remaining off the Financial Action Task Force’s (FATF) grey list, all Chief Executive Officers (CEOs) and Board members of BFIs meeting the fit and proper criteria, improved financial reporting according to international standards, a regulator enabled to deal with troubled co-operatives, and ensure equal representation of women in cooperatives’ boards.

Prior action 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 repoting Standards.

50. **This PA improves the transparency and financial reporting of BFIs**. DPC2 supported the issuance of guidelines governing the transition of BFIs to the NFRS by NRB. DPC4 takes this further and supports NRB in issuing a ‘Chart of Accounts’ which will help BFIs to organize their accounts in a standardized and modern way. DPC4 also supports NRB in issuing amended BFI reporting requirements to make them NRFS compliant. This will ensure that the transition to NFRS takes place as planned. The NFRS introduces the improved

accounting standards established in the International Financial Reporting Standards for loan loss classification and provisioning, capital adequacy, ownership, loan concentration, and other key disclosures. The finalization and issuance of the directives pertaining to the Chart of Accounts and NFRS involved extensive consultation with the BFIs, government authorities, regulatory bodies such as the Institute of Chartered Accountants, the Accounting Standard Board, the Office of Company Registry, the Office of Auditor General, and the development partners. Several workshops were held where representatives from the public were also able to provide feedback.

Prior action 10: The NRB has issued implementing rules and bylaws for the BAFIA.

51. **This PA ensures improved governance of all BFIs and requires that all board of director members and CEOs of BFI (including state-owned ones) meet the fit and proper criteria defined by the law.** The SIP and the FSAP identified major weaknesses in governance of BFIs. Laws and directives were weak and gave rise to numerous conflicts of interest on the part of bank directors, who lacked independence from shareholders. Moreover, professional qualification requirements for directors and senior managers were limited, and government-appointed CEOs and directors of state-controlled commercial banks were exempt from qualification requirements. DPC2 supported revision to the NRB directives strengthening the governance of BFIs, while DPC3 supported the enactment of BAFIA strengthened the fit and proper tests and professional qualifications and experience requirements applied to BFI directors and CEOs, including all government-appointed directors and CEOs of state-controlled banks. DPC4 supported the NRB in issuing implementing rules[6] and bylaws for the new BAFIA which provided further details and requirement to strengthen the governance of BFIs.

Prior action 11: The Parliament has approved the Cooperative Act.

52. **This PA establishes a resolution framework for dealing with problematic FINCOs and helps narrow the gender gap in the governance of cooperatives**. This new PA was introduced to address another potential systemic linkage between FINCOs and BFIs, especially given the absence of meaningful regulation and supervision of the former. Cooperatives have grown rapidly since 1992 and currently have an estimated 6 million members (20 percent of the population). Envisaged as self-regulating entities, the cooperative sector was characterized by weak governance, lack of supervision and vulnerability to financial risks. Many co-operatives were categorized as ‘troubled’ placing deposits worth billions at risk. Hence, a stricter legal framework to regulate the co-operative sector was deemed necessary by both the GoN and the stakeholders. DPC4 supported the approval in October 2017 of a new Cooperative Act which is expected to strengthen the legal and regulatory framework for the sector. The new Act provides the regulator and the designated supervisor, the Department of Cooperatives (DoC), with enhanced resolution power for the first time. However, since DoC does not have the required capacity, NRB will provide the necessary expertise to monitor large FINCOs. A special framework will be set up to monitor cooperatives with savings above NPR500 million. Importantly the Act enables NRB to supervise cooperative banks and take over their management and deregister them if necessary. The Act also establishes various funds that cooperatives will have to maintain for liquidity purposes and imposes penalties depending on the nature and severity of the offense (compared to a flat fine NPR1,500 irrespective of offense in the previous Act). Therefore, the Act is likely to result in consolidating the sector. The implementing regulations need to iron out many details including the modus operandi of the different funds. DFID which provided TA to assist the GoN in drafting the law will continue to

[6] The rules cover the areas of (i) revocation of the roster of auditors, (ii) formation of Board of Directors, (iii) oath taking of a Chairperson of the Board of Directors, (iv) qualifications and work experiences for appointment of Directors and Chief Executive of BFIs, (v) policy provisions concerning licensing of Infrastructure Development Bank, and (vi) corporate governance.

provide support in drafting the regulations. Drafting of the Act involved extensive stakeholder and public consultations before it was passed as a law.

53. **The new Act promotes gender inclusion by mandating that the Board of Directors of cooperatives comprises at least thirty-three percent of women**. Total membership in financial co-operatives reached 3,445,554 as of FY2017 of which female accounted for 1,776,089, that is, 52 percent of the total. However, while women account for more than half of the membership of cooperatives, their representation on the Board of Directors is less than a third and varies across cooperatives. The new Act is expected to narrow the gender gap in the representation of women on cooperative boards by mandating that at least 33 percent of the board members of ***each*** cooperative are women. DPC4 supports narrowing this gender gap and further requires that this is complied with by 90 percent of the cooperatives by the project's closing. In addition, the Act has a provision whereby the GoN provides special financial facilities, technical support, cost sharing grants, concessional loans and partial or full exemption of tax to rural women.

Prior action 12: The NRB has revised its directive to the BFIs to implement the Asset (Money) Laundering Prevention Regulations.

54. **This PA ensures that Nepal continues to have normal external financial relations by remaining off the FATF grey-list.** DPC2 supported strengthening the transparency and safety of the financial system by enacting three laws related to AML /CFT. DPC3 supported the approval of regulations related to these laws. While significant progress has been made in the implementation of AML and counter-terrorist financing standards, Nepal needs to meet the commitments in its action plan to address the strategic deficiencies identified by FATF. Therefore, DPC4 focuses on one of the more critical actions and supports NRB in revising the directive for implementing the recently approved Asset (Money) Laundering Prevention Regulations. The Directive helps BFIs to take measures for controlling crimes relating to assets laundering, terrorist financing and associated offences.

55. Table 4 provides an overview of the analytical underpinnings of the proposed DPC4 PAs.

Table 4. Analytical Underpinnings

PAs	Analytical Underpinnings
1. The NRB has issued a new directive on Risk Management to the commercial banks.	FSAP Technical Note (2014) by IMF, IMF TA to conduct diagnostics of 20 financial institutions (FIs), SIP report (2016) by KPMG, IMF Article IV consultations
2. The NIB has completed in-depth diagnostics of 60% of the insurance sector companies by assets, to identify institution-level risks, and has implemented corrective action or resolution programs for undercapitalized insurance companies. The 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 actions or resolution programs for undercapitalized insurance companies identified under (a) above.	Post-Disaster Needs Assessment (PDNA) prepared for National Planning Commission by WB (2015), Fast Diagnostics of BFIs by KPMG (2016) under DFID support, PwC Report under FSSP by DFID, Financial Sector Reform and Strengthening Initiative (FIRST) supported Insurance Sector Strengthening Project by WB
3. The NRB has issued the enabling regulations on the basis of the Nepal Rastra Bank Act (Second Amendment), 2073 BS (2016).	FSAP Technical Note (2014) on Crisis Preparedness by the IMF, Report on Bank Resolution Capacity Building (2014) supported by FIRST Initiative, Findings of the IMF's Article IV missions during 2012–2013, Technical consultation provided to the NRB by Adam Smith

PAs	Analytical Underpinnings
	International under DFID's FSP, Review of the draft NRB Act by Legal Counsel of the Bank under DPC 2 and 3 operations
4. The NRB has approved the functional and technical specification of the Supervisory Information System (SIS).	Technical consultation by PwC under FSSP of DFID
5. The Cabinet has approved key regulations regarding: (a) DCGF's relationship with BFIs; (b) a guaranteed deposit verification process; and (c) BFI reporting, payout and reimbursement of guaranteed deposits.	FSAP Technical Note (2014) on Financial Safety Net by the IMF, Review of the DCGF Regulations and Investment Policy Guideline by WB expert and by PwC under FSSP (2017–2018), Report prepared under Contingency Planning (2010) supported by FIRST Initiative
6. (a) The NRB has executed a tri-partite agreement with the Ministry of Finance 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 DCGF to NPR ten billion (NPR 10,000,000,000) on an accelerated schedule.	FSAP Technical Note (2014) on Financial Safety Net by the IMF, Technical consultation (2015) provided to the NRB and the Deposit and Credit Guarantee Corporation (DCGC) by Adam Smith International under DFID's Financial Sector Program (FSP), Technical Consultation provided to the DCGF by PwC (2017–18) under the FSSP, Draft and Review of Tripartite Agreement by PwC under the FSSP and further review by WB expert (2017–2018)
7. (a) The NRB has adopted an oversight framework for payment systems; and (b) the Minsitry of Finance has endorsed the Payment and Settlement Bill.	FSAP Technical Note (2014) on Payment and Settlement Systems by WB, Nepal Payment System Development Strategy (2014) supported by WBG, Review of Oversight Framework by the IMF TA (2017) and the WB (2017), Review of draft bill by the WB (2017)
8. The Cabinet has approved the new Insurance Bill for submission to the Parliament.	PDNA prepared for National Planning Commission by the WB (2015), Fast Diagnostics of the BFIs by KPMG (2016) under DFID support, Technical review by PwC under the FSSP of DFID, FIRST supported Insurance Sector Strengthening Project by WB, FSAP Follow-up TA by the WB
9. The NRB has: (a) issued a directive on the Chart of Accounts; and (b) amended its directives on reporting requirements for BFIs to comply with the NFRS.	FSAP Summary Report (2014), SIP report (2016) by KPMG under FSP, Technical consultation by PwC under FSSP of DFID
10. The NRB has issued implementing rules and bylaws for the BAFIA.	Review of BAFIA and recommendations provided by IMF Staff and Bank Legal Counsel under DPC 2 and DPC3, Report on Crisis Management (2011) supported by FIRST Initiative, FSAP Summary Report (2014)
11. The Parliament has approved the Cooperative Act.	FSAP Technical Note on Cooperatives (2014); Technical consultation provided by PwC under DFID's FSSP
12. The NRB has revised its directive to the BFIs to implement the Asset (Money) Laundering Prevention Regulations.	Assessment by Asia Pacific Group on Money Laundering, an associate member of FATF

4.3 LINK TO THE CPF, OTHER BANK OPERATIONS AND THE WORLD BANK GROUP (WBG) STRATEGY

56. **The CPS for FY2014–2018[7] 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.

57. **The proposed operation builds on a significant prior engagement.** As mentioned earlier, the proposed DPC4 supports the GoN's medium-term policy program to address the vulnerabilities of the financial sector in Nepal and is a continuation of the three previous budget support operations. It also builds on the lessons learned from the World Bank-financed US$16 million Financial Sector Technical Assistance Project (P071291, approved in 2002 and closed in 2011) and the US$75.5 million Second Financial Sector Restructuring Project (P084219, approved in 2004 and closed in 2009). It also complements and supports the IFC advisory and investment activities in Nepal's financial sector.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

58. **Since 2013, the GoN has stepped up consultations with all stakeholders during the preparation and implementation of the financial sector reform program supported by this DPC series.** Regulatory changes are drafted by the NRB, NIB or MoF and shared with relevant stakeholders—such as the associations, the industry and the public —for their feedback before they are finalized and submitted to the NRB, MoF or the Cabinet. The High-Level Financial Sector Reform Committee, headed by the Finance Minister, takes key decisions on major financial sector reforms and facilitates consultations with key stakeholders. The authorities have also used an extensive consultative process to prepare the FSDS led by the MoF and including the NRB, the NIB, the Securities and Exchange Board, and the DoC. With respect to legislative changes consultations involved deliberations by the peoples' representatives in the Parliament. A feedback mechanism from stakeholders and the public has been established, and a grievance mechanism is in place to consider possible amendments to laws and regulations.

59. **Starting in 2014, the World Bank, IMF, and DFID have formed a coordination group** that meets regularly to discuss progress and capacity building needs for the implementation of the financial sector reform program. The group also ensures that the three institutions' support is coordinated. DFID has provided strong long-term TA and capacity-building support to the GoN during the preparation of the DPC series in support of the four reform pillars and the related policy actions. The cooperation of the World Bank with DFID is an example of how two development partners can work together to contribute to the success of a complex and challenging series of reforms. Starting in early 2012, the two institutions established working arrangements that ensure seamless coordination between their two teams, including: a) DFID contributing experts to work as part of the World Bank team, b) the World Bank providing inputs to the design of DFID support, and c) all missions identified to the authorities as joint missions. DFID's willingness to commit large-scale resources to capacity building has increased the authorities' confidence to move ahead with highly demanding medium-term reforms.

[7] Report #88866, discussed by the Executive Directors on May 29, 2014

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

60. **The overall objectives of the DPC are aligned with the World Bank Group's twin goals of ending extreme poverty and boosting shared prosperity.** Ensuring the stability of the financial system in Nepal is critical to allowing BFIs to continue expanding financial inclusion, which has important implications for reducing poverty by providing access to financial services to the underserved and unbanked population. Participation in the financial system helps people to start and expand businesses, invest in education, manage risk, and weather financial shocks, thereby 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 PAs under this operation will have either neutral or positive long-term effects on the lives of the poor and the bottom 40 percent as detailed in annex 5.

61. **The operation supports policy reforms which contribute to bridging gender gaps**. According to the 2017 Global FINDEX database,[8] 45 percent of adult population (age 15 or above) reported having an account at a bank or another type of FI 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. The new Payment and Settlement Act supported by this operation contributes towards bridging the gender gap in access to finance by facilitating integrating remittance services with the payment systems, which helps women gain access to formal financial services since most remittance receivers are women. In addition, the new Cooperatives Act supported by the operation aims to improve the representation of women on the boards of co-operatives where they constitute more than half of the membership.

5.2 ENVIRONMENTAL ASPECTS

62. **Actions supported by this operation are not expected to have any negative effect on the environment.** The key reforms supported by this operation include enactment of laws and preparation of regulations concerning strengthening the corporate governance of the BFIs, enhanced bank resolution powers of the central bank and insurance regulator, and improving the financial safety net of small low-value and poor depositors. As such, none of the PAs is expected to have any negative environmental effects.

63. **The program supports PAs that enhance climate adaptation.** This is done through (a) better understanding of climate-related risks to commercial banks by improving BFIs Risk Management, (b) strengthening the insurance sector’s ability to recover and reconstruct property destroyed by natural disasters, and (c) promotion of DFS that help improve the country’s adaptive capacity. As climate impacts continue to grow in-line with projections, climate risks will increase as will the importance of a financial sector that understands the dangers and can respond accordingly.

64. The total **climate co-benefits** in this project amount to **US$20.83 million (20.83 percent)** with **potential for increase.**

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

65. **The government’s PFM structures and processes have improved.** The 2015 Public Expenditure and Financial Accountability (PEFA) Assessment concluded that Nepal has made substantial progress in deepening

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

the structures and processes of PFM, particularly related to the use of Information Technology (IT). As compared to the first PEFA Assessment (2007), the 2015 assessment recorded improvements in 16 indicators. There are nonetheless areas that need improvement. The 2016 Auditor General's Report highlights systemic weaknesses in internal control systems. The on-going Fiscal DPC series is designed to strengthen PFM and support reforms to reduce audit irregularities; include expenditures of local governments in the treasury single account; integrate all three tiers of the government's budget spending with the central financial management information system; and adopt prudent fiscal policies, among others.

66. **The government budget classified by functions, functionaries and charts of accounts is publicly available.** Budget information by geographical locations and monthly expenditure reports by functions are available at the Financial Comptroller General Office website. An integrated PFM information platform (budget execution) is operational and information is shared with the line ministries. All financial transactions have been unified under a single treasury.

67. **The Public Procurement Monitoring Office (PPMO) continues to improve transparency in public procurement processes by adopting international standards and IT.** The Public Procurement Act and Public Procurement Regulations comply with United Nations Commission on International Trade Law and provide a procurement legal framework that is up to international standards. Anchored in the Act and Regulations is the single e-GP (Electronic Government Procurement) portal. The e-GP portal facilitates the availability of standard bidding documents online for all procurements and supports on-line procurement progress monitoring by the PPMO. This has drastically reduced paperwork, fostered transparency and competition and enabled faster remedial actions by the authorities. As part of the government's on-going procurement reform program, the Bank is providing support in preparing the public procurement strategic framework, facilitating third party IT security audit of the e-GP system, and strengthening the PPMO.

68. **As per the 2017 IMF Staff Report, Nepal's foreign exchange management regime and safeguards are adequate.** Since October 1997, Nepal's exchange rate has been pegged to a single currency unit, which is the Indian Rupee, at a rate of 1.6 Nepalese Rupee to 1 Indian Rupee. All merchandise imports (except certain goods restricted for security reasons) are freely available through an open general license system, with foreign exchange provided through the banking system at the market exchange rate. The quality of NRB's external audit continued to fall short of international standards, and priority should be given to engaging an auditor with requisite experience. The legal framework should also be enhanced to strengthen NRB's autonomy and governance arrangements.

69. **Disbursements.** The proposed operation is the last in a programmatic series of three DPCs. The credit proceeds will be made available to the government upon the credit's effectiveness. The government will submit a withdrawal application in the requested format to the World Bank once the credit has been approved and the World Bank has notified the credit effectiveness to the government. At the request of the MoF, the disbursement will be made into the treasury account of the government maintained at the NRB that forms part of the country's foreign exchange reserve which will later be transferred in local currency equivalent to the Government's consolidated fund (the General Fund). The government will confirm to the World Bank, within 30 days, receipt of the proceeds and its credit in the General Fund, including the date of receipt, the exchange rate applied to convert the credit proceeds into Nepalese rupees, and the name and number of the government's bank account in which the funds have been deposited.

70. **Confirmation and eligible expenditure.** The MoF will provide to the World Bank a confirmation that the amount of the operation has been accounted for in the budget's management systems. If, after the proceeds are deposited in the government account, the proceeds of the operation are used for ineligible purposes as defined in the Loan Agreement, the World Bank will require the government, upon notice from

the World Bank, to refund an amount equal to the amount of said payment to the World Bank. Amounts refunded to the World Bank upon such request will be cancelled.

71. **Reporting, auditing and closing date.** No audit will be required for the proposed operation. The closing date of the proposed loan will be June 30, 2019.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

72. **The MoF will be responsible for overall oversight and implementation of the present DPC, in close coordination with NRB.** Both the MoF and the NRB, as the lead implementing agencies, have extensive experience and are fully conversant with World Bank policies and procedures.

73. **Since this is the last of the programmatic DPCs, the World Bank team will continue to provide support while undertaking monitoring and evaluation to review progress on achieving the series' results.** The overall status of the government's reforms will be monitored and progress on achieving the results will be captured. DFID will separately carry out periodic management and evaluation reviews of the implementation of its support program linked to the reforms of DPCs 3 and 4.

74. **Grievance redressal.** Communities and individuals who believe that they are adversely affected by specific country policies supported as PAs or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, because of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's GRS, please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

75. **The overall risk of the proposed operation is Substantial.** The main risks to achieving the intended results of the reform program are political, governance, institutional capacity, and fiduciary risks.

76. **Political and governance risks are rated as High.** The past decade has been characterized by frequent government changes in Nepal. Although the new constitution and the 2017 elections have resulted in a fewer number of political parties, the transition from a unitary system to a federal state could be challenging. The new federal system came into being in January 2018 and, in principle, provides opportunities to decentralize development benefits and make service delivery more effective and accountable. However, the risks of jurisdictional overlap between the three tiers of government, lack of clarity and coherence between policies and devolved powers, and duplication of efforts will remain high during the coming few years. Key aspects of the new system require further definition and may continue to be contested by different population groups. The Nepalese authorities have demonstrated during the preparation of DPC1, DPC2 and DPC3 that they are able to take critical decisions in an uncertain political environment. Therefore, 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 a 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 level in the government, bureaucracy, and the legislature.

77. **Institutional capacity risk for implementation and sustainability remains substantial.** The sustainability of the reform program could be put at risk by weak institutional capacity especially for enforcement. The phased approach of the DPC series has helped mitigate this risk by gradually introducing new and improved legislation and regulation while supporting the authorities' enforcement capacity through sustained TA by the key development partners (DFID, IMF, the Bank).

78. **The fiduciary risk is substantial** due to weaknesses in areas of internal control 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 MDTF, centered around the rules governing budget implementation. The frequent procurement and financial management clinics that have been held for World Bank funded project officials have yielded positive results and led to fewer 'audit observations'. These clinics have become a regular activity. Strong leadership and commitment of the MoF to ensure progress on the current programmatic series also mitigates some of the risks.

79. **Macroeconomic risk continues to be moderate.** Economic growth is expected to moderate because the heaviest floods in decades. Inflation is likely to pick up but is expected to remain relatively low compared to the rates seen in previous years. The fiscal deficit is likely to widen with the implementation of federalism but financing is expected to be adequate with the availability of concessional financing and low debt to GDP ratio. The debt sustainability analysis conducted by the World Bank and IMF in 2017 maintains a 'low' risk of debt distress. The current account deficit is expected to further widen as imports continue to grow, while remittances remain sluggish.

80. **Climate and disaster risks** have potentially adverse impacts on the solvency of the financial sector and on business continuity. This operation mitigates these risks by consolidating the banking sector, improving its solvency and climate risk management practices, and enhancing the insurance sector's solvency and regulatory framework

81. Table 5 provides an assessment of the risk categories and an overall risk assessment to the project development objective.

Table 5. Systematic Operations Risk-Rating Tool Table

Risk Categories	Rating
1. Political and governance	High
2. Macroeconomic	Moderate
3. Sector strategies and policies	Moderate
4. Technical design of project or program	Moderate
5. Institutional capacity for implementation and sustainability	Substantial
6. Fiduciary	Substantial
7. Environment and social	Low
8. Stakeholders	Moderate
Overall	**Substantial**

ANNEX 1: POLICY AND RESULTS MATRIX

PAs			Results (Target date: June 2019) (Baseline date = July 2014)
PAs completed under DPC2 (May 2015)	**PAs completed under DPC3 (February 2017)**	**PAs completed by (or prior to) June 2018 for DPC4**	
Pillar 1 - Enhancing Financial Sector Development			
1. The Ministry of Finance (MoF) has endorsed the Nepal Financial Sector Development Strategy (FSDS).	—		**Results indicator**: A strengthened coordination framework for design and implementation of financial sector reforms is established. **Baseline**: No national FSDS is in place to guide policy and regulatory development. **Results so far**: The Cabinet approved the FSDS in January 2017. A High-level Financial Sector Coordination Committee has been set up to monitor progress.
Pillar 2 - Restructuring and Consolidating the Financial System			
2. The Rastriya Banijya Bank (RBB) has implemented the following actions in accordance with the second phase of its recapitalization plan: (a) the conversion of preference shares with a nominal value of NPR 787 million into common shares; (b) the conversion into capital of a dividend of preference shares in the amount of NPR86.57 million; (c) the sale of non-banking assets of the RBB for an amount equal to NPR30.90 million; and (d) retained earnings in FY2012/2013, 2013/2014, and nine months of 2014/2015 in the amount of NPR 7.21 billion.	—	—	**Results indicators:** The RBB meets all regulatory norms (including CAR > 10 percent), the bank has positive net income for the preceding four quarters, and all members of the board of directors meet the professional qualifications of the new BAFIA and the NRB Directive 6/071. **Baseline**: The RBB is 100 percent state-owned and undercapitalized (July 2014 CAR = 5.60 percent). **Results so far:** The RBB's CAR is 12.34 as of Q3FY2018 (mid-January 2018) and the bank booked after tax of NPR3.1 billion in FY17. Composition of RBB Board complies with NRB directive.
3. The Nepal Bank Limited (NBL) has taken measures to	1. The MoF has endorsed the NBL Strategic Divestiture Plan	—	**Results indicators:** The NBL meets all regulatory norms (***including CAR > 10 percent***), has positive

PAs			Results (Target date: June 2019) (Baseline date = July 2014)
PAs completed under DPC2 (May 2015)	**PAs completed under DPC3 (February 2017)**	**PAs completed by (or prior to) June 2018 for DPC4**	
implement the second phase of the NBL's recapitalization plan by (a) converting a loan from the recipient 2.49 billion into capital; (b) retaining earnings in FY2013–2014 and six months of 2014–2015 in the amount of NPR 1.10 billion; and (c) selling non-banking assets of the NBL for an amount equal to NPR 708 million. 4. The decision to reduce the number of state-controlled commercial banks to one by divesting control of the NBL to a bank strategic investor has been announced by the Government in its budget speech of July 2014.	and submitted it to the Secretariat of the Privatization Committee.		net income for the preceding four quarters, and all members of the board of directors meet the professional qualifications of the new BAFIA and the NRB Directive 6/071. **Baseline:** The Government controls two large commercial banks. The NBL is undercapitalized (July 2014 CAR = 5.26 percent) and majority owned (63 percent) by the Government. **Results so far:** The NBL's CAR is 18.02 percent (as per Basel III) as of Q3FY2018 (mid-April 2018), and booked profit of NPR3.2 billion in FY17. Divestment of government stake by way of FPO is under consideration.
5. The NRB has completed the implementation of the first phase of a diagnostic of the banking system and has (a) approved Special Inspection Reports for 27 FIs and (b) approved Prompt and Corrective Action (PCA) Programs (including Resolution Programs) for all FIs found to be undercapitalized.	2. The NRB has completed the implementation of the second phase of a diagnostic of the banking system and has approved (a) Special Inspection Reports for 27 FIs and (b) PCA Programs for all Financial Institutions (FIs) found to be undercapitalized**.**	1. The NRB has issued a new directive on Risk Management to the commercial banks.	**Results indicators:** Banking system stability is evidenced by all banks either being compliant with the CAR or being in NRB-approved PCA or resolution programs. All insurance companies are adequately capitalized (new requirement of NPR2 billion for life and NPR1 billion for non-life to be met by FY 2018) or are subject to corrective action/resolution program. **Baseline**: Compliance-based supervision is inadequate to identify potential risks. Reported CAR is 12.03 percent for commercial banks. Undercapitalized banks not under PCA.
6. The NRB has issued a notice to licensed Bank and Financial Institutions (BFIs) to conduct an assessment of the impact of the earthquake on their assets (collateral and loans) and physical infrastructure.	3. The NRB has completed a diagnostic of the impact of the earthquake on BFIs in the earthquake-affected districts.	2. The NIB has: (a) completed in-depth diagnostics to identify institutional level risks of the companies which represent sixty percent (60%) of assets within the Recipient's insurance sector; and (b) implemented corrective	

PAs			Results (Target date: June 2019) (Baseline date = July 2014)
PAs completed under DPC2 (May 2015)	**PAs completed under DPC3 (February 2017)**	**PAs completed by (or prior to) June 2018 for DPC4**	
		actions or resolution programs for undercapitalized insurance companies identified under (a) above.	One insurance company does not meet the minimum capital requirement (of previous requirement of NPR500 million for life and NPR250 million for non-life) as of July 15, 2017. **Results so far:** CAR for all Class A banks was 13.4% in FY2017. Currently, all banks meet the minimum CAR. PCA applied to four banks following SIP. All insurance companies meet the current minimum capital requirement. Only four meet the new capital requirement level that becomes effective from Mid-July 2018.
7. The NRB continues its policy of consolidating the banking system by maintaining its moratorium on new licenses issuance for Classes A, B, and C FIs as defined in BAFIA and by adopting a new bylaw to facilitate acquisitions of BFIs by other BFIs.	4. The NRB has issued a directive on the increase of minimum paid-up capital for BFIs.		**Results indicators:** The total number of BFIs is reduced to 130 or less and licensing regulations are aligned with the phased impletion of Basel III. **Baseline**: The banking system is characterized by an excessive number of FIs (January 2012 = 199, July 2014 = 167). Banking regulations impede the use of acquisitions as a means of consolidation. **Results so far:** As of FY18Q3 (mid-April 2018) the total number of Class A, B, and C BFIs has decreased to 89.
8. The NRB has issued a notice requiring all NRB-authorized Financial Nongovernmental Organizations (FINGOs) to convert to Class D Micro Finance Institutions (MFIs) as defined in BAFIA by mid-July 2015			**Results indicators:** All NRB-authorized FINGOs' MFIs have been converted to Class D microfinance banks **Baseline**: (a) The NRB supervises only 15 FINGOs out of 17,000 operating; the remainder is licensed by the Registrar of Cooperatives, which has no supervisory capacity and no resolution powers, and (b) there are 47 FINGOs licensed by the NRB.

PAs			Results (Target date: June 2019) (Baseline date = July 2014)
PAs completed under DPC2 (May 2015)	**PAs completed under DPC3 (February 2017)**	**PAs completed by (or prior to) June 2018 for DPC4**	
			Results so far: The new Cooperatives Act provides supervisory and resolution powers to the Registrar of Cooperatives. 25 FINGOs (of the 27 remaining) have applied for conversion to Class D MFI. Only 2 have been given Class D license.
Pillar 3 - Strengthening the Legal and Regulatory Framework for Crisis Management, Banking and Insurance Supervision			
9. The NRB Act Amendment Bill has been approved by Cabinet for submission to Parliament.	5. The NRB Act Amendments Bill has been approved by Parliament.	3. The NRB has issued enabling regulations based on the Nepal Rastra Bank Act (Second Amendment), 2073 BS (2016).	**Results indicators:** ***A modernized legal framework for bank resolution*** is in place and implementing regulations have been issued by the NRB. **Baseline**: The legal framework for bank resolution is outdated and incomplete, limiting the NRB's ability to resolve FIs quickly. **Results so far:** The bill was approved by the Parliament in September 2016. The enabling regulations (including amendments to existing regulations) have been issued through various circular and directives.
		4. The NRB has approved the functional and technical specification of the Supervisory Information System (SIS).	**Results indicators:** The NRB has strengthened its supervisory capacity and is largely compliant with four more Basel Core Principles (BCPs) and a new SIS has been implemented. **Baseline**: The NRB is noncompliant or materially non-compliant with many BCPs and lacks an adequate IT system to support supervision. Financial reporting by FIs involves manual processing and results in errors. **Results so far:** Vendor has commenced installation of SIS. The NRB is considering rolling out Basel III regulatory framework by FY2019.

PAs			Results (Target date: June 2019) (Baseline date = July 2014)
PAs completed under DPC2 (May 2015)	**PAs completed under DPC3 (February 2017)**	**PAs completed by (or prior to) June 2018 for DPC4**	
10. The Bill on the DCGF has been approved by the Cabinet for submission to Parliament.	6. The Bill on DCGF has been approved by Parliament.	5. The Recipient's Cabinet has approved key regulations regarding: (a) DCGF's relationship with BFIs; (b) a guaranteed deposit verification process; and (c) BFI reporting, payout and reimbursement of guaranteed deposits.	**Results indicators:** Legal framework is in place for the DCGF to be the administrator of the DGF. All BFIs have made required deposit guarantee premium payments for the preceding four quarters. **Baseline**: The deposit insurance system has a very weak legal framework based on DCGC (the erstwhile DCGF) bylaws. The DCGC lacks IT system and the regulatory framework for deposit insurance is incomplete. **Results so far**: Key regulations for implementing legal framework have been approved by the Cabinet. All BFIs are up to date in making deposit guarantee premium payments.
FoI	7. The DCGC and NRB have executed a memorandum of understanding governing cooperation and exchange of information.	6. (a) The NRB has executed a tripartite agreement with the Ministry of Finance and DCGF for the provision of funding and liquidity support to DCGF; and (b) The Cabinet has approved a plan to raise the capital of DCGF to NPR ten billion (NPR 10,000,000,000) under an accelerated schedule.	**Results indicators:** The framework for contingency back-up funding for bank resolution is established. **Baseline**: The financial crisis management architecture is limited to a High-Level Financial Sector Committee with the power to coordinate government responses but without special anti-crisis intervention powers. **Results so far:** The framework for contingency back-up funding for bank resolution has been established. The capital of DCGF is being raised to NPR10 billion within June 2019 through a Cabinet decision.
11. The board of the NRB has approved the Nepal Payments System Development Strategy.	8. The NRB has implemented the following three actions to reduce payments system risks: (a) alignment of the operating hours of NRB's banking department with the operating hours of SWIFT (society	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.	**Results indicator**: Safety and efficiency of payment and settlement systems improved as evidenced by the quality of the large value payments being assessed as "medium-high".

PAs			Results (Target date: June 2019) (Baseline date = July 2014)
PAs completed under DPC2 (May 2015)	**PAs completed under DPC3 (February 2017)**	**PAs completed by (or prior to) June 2018 for DPC4**	
	for Worldwide Interbank Financial Telecommunications); (b) implementation of online transfers of funds between NRB branches; and (c) implementation of a pre-settlement file system.		**Baseline**: The payments system regulation lacks a firm legal foundation and is subject to patchwork supervision by different regulators. Quality of large value payment system is assessed as "low". **Results so far:** Efficiency of the payment system has improved due to operationalized transfer of funds between NRB branches on real-time basis. Licenses have been issued to non-banks to operate as Payment Service Providers.
		8. The Cabinet has approved the new Insurance Bill for submission to Parliament.	**Results indicators:** The legal framework for supervision and regulation of the insurance sector has been modernized and the NIB is able to intervene effectively to resolve troubled insurance companies. **Baseline**: The Insurance Act is outdated and does not give the Insurance Board adequate powers to regulate and supervise the sector. The Insurance Board's ability to resolve undercapitalized insurance companies is limited. **Results so far:** The draft of the new insurance Act, endorsed by the MoF, is being reviewed by the MoLJPA.
Pillar 4 - Enhancing the Governance and Transparency of the Banking Sector			
12. The NRB has issued a guideline governing the transition of BFIs to the Nepal Financial Reporting Standard (NFRS).	—	9. The NRB has: (a) issued a directive on the Chart of Accounts; and (b) amended its directives on reporting requirements for BFIs to comply with the Nepal Financial Reporting Standards.	**Results indicators:** The NFRS has been implemented by 100 percent of Class A and Class B BFIs. **Baseline**: The NFRS has been implemented by 0 percent of Class A and Class B BFIs. NFRS-compliant regulations have not been issued by the NRB.

PAs			Results (Target date: June 2019) (Baseline date = July 2014)
PAs completed under DPC2 (May 2015)	**PAs completed under DPC3 (February 2017)**	**PAs completed by (or prior to) June 2018 for DPC4**	
			Results so far: The NRB has issued directives to the BFIs to adopt NFRS and a new Unified Chart of Accounts from FY2019/20.
13. Steps have been taken to strengthen the governance of the banking system, including state-controlled banks, by (a) the endorsement by the MoF of the Bill on banks and FIs for submission to Cabinet and (b) the inclusion by the NRB of adequate governance measures in the revised and reissued Directive 6/071 on Governance of BFIs.	9. The Bill on Banks and FIs has been approved by Parliament.	10. The NRB has issued implementing rules and bylaws for the BAFIA. 11. The Parliament has approved the Cooperative Act.	**Results indicators:** All board of directors' members and CEOs of banks and FIs, including state-controlled banks, meet the *fit and proper criteria* defined in the new BAFIA and NRB directives. Resolution framework is in place to deal with problematic co-operatives and 90 percent of the co-operatives have met the new gender requirement. **Baseline**: Governance provisions are weak; Bank directors lack independence from shareholders. Professional qualifications requirement for directors and senior managers are inadequate while state controlled commercial banks are exempt. There is no resolution framework to address problematic FINCOs. Women are under-represented in the governance structure of the co-operatives. **Results so far:** The enabling regulations, consistent with the BAFIA, have been issued through unified directive on various dates. All banks are subject to new fit and proper criteria. The approval of the Cooperatives Act in October 2017 has ensured 33 percent representation of women; women's membership accounts for 52 percent of the total as of FY2017.
14. The transparency and safety of the banking system has been strengthened by the enactment	10. The Cabinet has approved the Asset (Money) Laundering and Prevention Regulations**.**	12. The NRB has revised its directive to the BFIs to implement	**Results indicators:** Nepal remains ***off the FATF grey list*** which allows normal external financial relations

PAs			Results (Target date: June 2019) (Baseline date = July 2014)
PAs completed under DPC2 (May 2015)	**PAs completed under DPC3 (February 2017)**	**PAs completed by (or prior to) June 2018 for DPC4**	
of the following key Anti-Money Laundering/ Countering Financing of Terrorism (AML/CFT) legislation: The Mutual Legal Assistance Act; the Extradition Act; and (c) the Prevention of Organized Crime Act.		the Asset (Money) Laundering Prevention Regulations.	(trade finance, remittance inflows and FDI). **Baseline**: Nepal is not on the FATF grey list. **Results so far:** National AML/CFT strategy and action plan of Nepal are in place; Asset (Money) Laundering Prevention Regulations have been implemented through revision of NRB's directive # 19 with updated provisions on July 14, 2017.

ANNEX 2: LETTER OF DEVELOPMENT POLICY

Government of Nepal
MINISTRY OF FINANCE

SINGHADURBAR
KATHMANDU, NEPAL

Government of Nepal
Ministry of Finance

22 May 2018

Mr. Jim Jong Kim
President
The World Bank
1818 H Street N.W.
Washington DC 20433
United States of America

Dear Mr. Kim,

RE: LETTER OF DEVELOPMENT POLICY

1. The Government of Nepal is committed to pursuing a medium-term program to reform the financial sector in Nepal. A stable financial sector is critical to enhance economic growth and for sound financial governance. For this, the Government is undertaking major reforms in the financial sector.

2. Following the liquidity crunch that threatened financial sector stability in Nepal in mid-2011, the Government articulated a program of financial sector reforms with the objective of ensuring the stability of the financial system, through overhauling the regulation and supervision of the banking and financial institutions, consolidating the financial sector and limiting Government control and ownership of financial institutions, placing the financial sector safety net on a firm footing, and laying the ground for further program of reforms designed to broaden and deepen access to financial services for both business and individuals.

3. The first phase of reforms (from early-2012 to mid-2013) was carried out in a relatively unstable political climate. The reform program gained momentum with the second phase (from mid-2013 to mid-2015) despite the adverse impact to the financial sector caused by the earthquakes in April/May of 2015. This was followed by the third phase (mid-2015 to mid-2017) which witnessed major reforms through enactment of legislations relating to the financial sector. The on-going reform is the fourth phase (mid-2017 to mid-2019). We have continued to implement major reforms till date with support from the World Bank, the United Kingdom Department for International Development (DFID), the International Monetary Fund (IMF) and other development partners.

4. The initial years of the reform program witnessed some key reforms, namely setting up of a financial sector safety net by establishing the Deposit and Credit Guarantee Fund (DCGF) and embarking on the restructuring and recapitalization of two large state-controlled

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commercial banks, Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL). Both RBB and NBL had been technically insolvent for more than a decade. Both these banks now meet the statutory capital requirement, have significantly reduced their impaired assets and are amongst the highest earning commercial banks contributing to the country's economic growth and development.

5. Extensive amendments to the Nepal Rastra Bank (NRB) Act (NRBA) and the Banks and Financial Institutions Act (BAFIA), and a new Deposit and Credit Guarantee Fund (DCGF) Act, have been enacted by the Parliament. These acts are intended to (i) strengthen the governance of financial institutions, and give supervisors stronger legal tools for bank resolution; (ii) put in place a fully-functioning financial sector safety net; and (iii) improve the governance of state-controlled financial institutions and establish fit and proper requirements and minimum qualifications. These reforms were supported by three Development Policy Credit operations, which were approved by the World Bank's Board of Executive Directors in June 2013, June 2015 and March 2017 respectively. Other key reform activities that were completed during these three phases (2012 – 2017) include the following:

- The diagnostic of the impact of the 2015 earthquake on BFIs in the affected districts with an in-depth special inspections of all at-risk and systemic banks. This was followed by appropriate Prompt and Corrective Action (PCA) and resolution enforcement measures;
- Throughout the reform phases, the NRB has maintained its moratorium on licensing of new Class A, B, and C banks and financial institutions (BFIs), and in 2014 also issued a new bylaw on acquisitions to facilitate further consolidation of the banking system; in particular, the NRB issued a directive on the increase of minimum paid-up capital for BFIs;
- In 2014, the Parliament approved and enacted ordinances covering key Anti-Money Laundering(AML)/Countering Financing of Terrorism (CFT) measures: the Mutual Legal Assistance Act, the Extradition Act, and the Organized Crime Act. These were subsequently ratified by the Parliament. Along with the already enacted Asset (Money) Laundering Prevention Act (2008), these pieces of legislation provide a legal framework in line with international standards, and Nepal is no longer "grey-listed" by FATF. In 2017, the Cabinet approved the Asset (Money) Laundering Prevention Regulations;
- In 2016 and 2017, the Parliament approved and enacted amendments to Nepal Rastra Bank Act, Banks and Financial Institutions Act, and Deposit and Credit Guarantee Fund Act. Subsequently implementing regulations were issued;

- With the aim of creating opportunities for banks and non-bank institutions to offer affordable payment services to a larger proportion of the general-public and businesses the National Payments System Development Strategy was approved and implemented actions to reduce payments system risk. This was followed by initiating strengthened legal, regulatory and oversight framework for the domestic payments system;
- In 2017 the Cabinet approved a long-term Financial Sector Development Strategy (FSDS) based on wide consultations;
- In order to establish a framework on contingency back-up funding for bank resolution, the MOF, DCGF and NRB executed a tripartite MOU governing cooperation and exchange of information;

6. The reforms under our medium-term strategy under the fourth phase which we have completed since the mid-2017, include the following:

- The Insurance Board of Nepal has completed in-depth diagnostics of 60 percent of the insurance companies by assets, to identify institutional level risks, and has implemented corrective actions or resolution programs, for under-capitalized insurance companies;
- In order to implement recently enacted laws, NRB has issued implementing regulations for the NRB Act Amendments, the new Banks and Financial Institutions Act and revised the relevant directives with updated provisions for Asset (Money) Laundering and Prevention Regulations;
- The new Cooperatives Act has been enacted to strengthen the governance and regulatory/supervision framework of the Savings and Credit Cooperatives and making it more inclusive thus contributing to stability and gender equality.
- To further enhance the stability of the banking system, NRB has issued a new directive on Risk Management to the commercial banks; similarly, NRB has gone ahead with the installation of the new Supervisory Information System to strengthen its supervision capacity and comply with four more BASEL Core Principles;
- To reduce settlement risk and improve efficiency of the payments system, NRB has adopted an Oversight Framework; and a new Payments and Settlement Act is being endorsed by the Ministry of Finance and submitted to the Cabinet for further approval;
- With the aim of modernizing the insurance sector and enabling Insurance Board of Nepal to intervene effectively to resolve troubled insurance companies, a new

Insurance Act is being approved by the Cabinet for submission to the Parliament for approval;

- To raise disclosure standard of BFIs in line with Nepal Financial Reporting Standard (NFRS), the NRB has issued a revised 'Chart of Accounts' and amending its directive on BFI reporting requirements; and
- With the objective of strengthening safety net of Nepal's financial system, the DCGF has entered into agreements with NRB and MOF for back-up funding arrangements in the event of a crisis and issued new implementing regulations on its functioning; furthermore, a decision has been undertaken to raise the capital of DCGF to NPR 10 billion by June 30, 2019.

7. Consistent with Nepal's Financial Sector Development Strategy, we intend to implement the next series of reforms to strengthen the financial sector, with an increasing emphasis on deepening and broadening financial access, while continuing to address emerging vulnerabilities that could create a potential risk to the financial sector stability. In light of emerging developments in the financial inclusion landscape, we shall focus on digital innovations, underserved and vulnerable groups and mainstreaming of financial inclusion alongside the other financial sector development goals of stability, integrity and consumer protection.

Finally, we would like to reiterate the commitment of the Government of Nepal to all these reforms, and we trust that our request for World Bank support for their implementation will get your favorable consideration.

Yours sincerely,

(Dr. Yuba Raj Khatiwada)
Minister of Finance

(Dr. Chiranjibi Nepal)
Governor of Nepal Rastra Bank

ANNEX 3: ADDENDUM TO LETTER OF DEVELOPMENT POLICY

Government of Nepal
MINISTRY OF FINANCE

SINGHADURBAR
KATHMANDU, NEPAL

June 28, 2018

Mr. Jim Jong Kim
President
The World Bank
1818 H Street N.W.
Washington DC 20433
United States of America.

Dear Mr. Kim:

Addendum to Letter of Development Policy dated May 22, 2018

In addition to the reform actions specified in the Letter of Development Policy dated May 22, 2018, the Government of Nepal is committed to the following undertaking under the medium-term reform program that supports restructuring and consolidation of the financial sector:

> The Government of Nepal shall divest its share from Nepal Bank Limited (NBL) in FY 2017/2018 through a Follow-On Public Offering (FPO) reducing its stake to 51 percent. Going forward, the Government shall consider divestment of its remaining shares in NBL to a strategic investor if the situation allows.

We reiterate the commitment of the Government of Nepal to above mentioned reform, and we trust that the request for the World Bank support towards the implementation will receive your favorable consideration.

Yours sincerely,

[Minister of Finance]

[Governor of Nepal Rastra Bank]

NEPAL RASTRA BANK
CENTRAL OFFICE
OFFICE OF THE GOVERNOR

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ANNEX 4: FUND RELATIONS ANNEX

Nepal—Assessment Letter
June 29, 2018

This note provides the IMF staff's assessment of Nepal's macroeconomic conditions, prospects, and policies.

Growth has remained strong as Nepal's economy continues to rebound from the earthquakes and trade disruption in 2015. The Central Bureau of Statistics estimates growth at 6.3 percent in FY2017/18 (mid-July 2017 to mid-July 2018). This follows the growth rebound to 7.9 percent in FY2016/17, from 0.6 percent in the previous fiscal year. Activity has been supported by two successive favorable monsoon seasons, accommodative monetary policy, rising government spending, a pickup in reconstruction activity, and a marked improvement in electricity supply. Inflation averaged about 5 percent (y/y) in recent months, after averaging a multi-year low of 3.2 percent in 2017 on low food prices. Growth is projected to moderate to 5 percent in FY2018/19 and inflation to rise to about 6 percent, as activity begins to run up against capacity constraints and food prices firm. In the staff's baseline, growth is projected to average about 4½ percent per annum in the medium term, somewhat above Nepal's historical performance reflecting improved power supply.

Buoyant imports and some one-off factors have led to a marked deterioration in the current account following five years of surpluses. Inflows of remittances have remained resilient, increasing by 10 percent (y/y) in U.S. dollar terms during the first 10 months of FY2017/18, but exports of goods and services and FDI inflows remain low. International reserves have declined by US$200 million since January, but remain adequate at US$9.3 billion in May (more than 8 months of prospective imports of goods and services).

The economy faces both upside and downside risks. Rising government spending associated with the operationalization of fiscal federalism mandated by the 2015 constitution could provide stronger-than-projected support to near-term growth but also widen the current account and fiscal deficits, increasing macro-stability risks. Sustained implementation of appropriate structural reforms by the new government could raise medium-term growth. Key medium-term downside risks pertain to the weak capital budget implementation capacity and financial sector vulnerabilities. These could be exacerbated by a tightening of liquidity conditions reflecting expansionary fiscal policy and/or softening remittances.

Fiscal policy should focus on managing fiscal decentralization prudently and improving the quality of public investment. Nepal's public debt remains moderate (about 29 percent of GDP) but the fiscal balance turned into a deficit in FY2016/17, after four years of surpluses caused by weak capital spending implementation. While central government capital spending has seen a welcome increase, it continues to bunch at the end of the fiscal year, undermining expenditure quality. Increased transfers to local governments are associated with an estimated deterioration of the fiscal position by 2 percentage points of GDP to a deficit of about 5.3 percent of GDP in FY2017/18, although it remains to be seen to what extent local governments have been able to spend the funds that were transferred to them. The budget for FY2018/19 is based on very ambitious revenue targets, and full implementation of budgeted spending, including transfers to the subnational governments, would lead to a further increase in the public debt ratio. Establishing sustainable and well-balanced inter-governmental fiscal arrangements is a priority. To prevent crowding out credit to the private sector and limit demand pressures, net domestic financing of the budget should not exceed 1 percent of GDP per annum. There is also an urgent need to build public financial management capacity at the sub-national level.

The current monetary policy stance is broadly appropriate but the NRB will need to stand ready to tighten to support the exchange rate peg to the Indian rupee if inflation pressures increase.

- After a strong credit expansion that peaked with a 32 percent year-on-year growth rate in February 2017, credit growth moderated to 17 percent, on average, during the first eight months of FY2017/18 thanks to the phasing out of a temporary relaxation of the loan-to-deposit ratio ceiling and the introduction of a loan-to-value ceiling on car loans. Credit growth picked up to 20 percent (y/y) in May 2018, amid resilient inflows of remittances which have been a key funding source for Nepal's predominantly bank-based financial sector.
- The authorities have strengthened monetary management. From November 2017, the implementation of the interest rate corridor has led to higher and more stable interbank rates. With a more expansionary fiscal stance, tighter monetary policy will likely be needed to maintain the stability of the peg and keep inflation in check.
- Rapid credit growth and the buildup of macro-financial risks underscore the need to accelerate banking sector reforms. Building on the recent amendments to the regulatory framework, loan classification, provisioning, and banks' risk management practices should be upgraded.

Structural reforms will be essential to promote sustained high and inclusive growth, and to achieve the Sustainable Development Goals. Boosting potential growth requires improvements in competitiveness and the business climate, as well as in infrastructure. Efforts would need to focus on strengthening the government's policymaking and implementation capacity, creating a conducive environment for domestic and foreign investment, and accelerating implementation of donor-supported projects.

IMF Relations

- In the aftermath of the 2015 earthquakes, the IMF's Executive Board approved the disbursement, as direct budget support, of the equivalent of SDR35.65 million (22.7 percent of quota) under the Fund's Rapid Credit Facility on July 31, 2015.
- The 2017 Article IV Consultation was concluded by the IMF's Executive Board on March 27, 2017. The mission to conduct the 2018 Article IV Consultation is planned for the fourth quarter of 2018.
- In recent years, the Fund has been providing technical assistance in the areas of tax administration, tax policy, public expenditure management, monetary policy operations, and macroeconomic statistics. A long-term resident advisor is supporting the NRB's efforts to strengthen banking supervision. Nepal is a member of the South Asia Regional Training and Technical Assistance Center (SARTTAC) in New Delhi. The joint IMF-World Bank FSAP was completed in mid-2014.

Nepal: Selected Economic Indicators, 2015/16-2018/19[1/]

Population (2016, est. million): 29.0
Quota: 156.9 million SDR
Main exports (2017): Textiles and other manufactured goods, food items
Key export markets (2017): India, U.S., Turkey

	2015/16	2016/17	2017/18	2018/19
			Projections	
Output				
Real GDP growth (percent)	0.6	7.9	6.3	5.0
Employment				
Unemployment (percent)	...	...	...	...
Prices				
Inflation (period average, percent)	9.9	4.5	4.5	5.8
Inflation (end-year, percent)	10.4	2.7	6.3	5.7
General government finances (percent of GDP)				
Total revenue and grants	23.4	24.7	25.9	27.6
of which ; tax revenue	18.7	21.3	22.3	23.4
Expenditure	22.0	28.0	31.2	31.5
of which : current expenditure 2/	16.5	20.0	23.7	24.5
capital expeniture	5.5	8.0	7.5	7.0
Fiscal balance	1.4	-3.3	-5.3	-4.0
Public debt	27.9	26.8	29.9	32.1
Money and credit				
Broad money (percent change)	19.5	15.5	15.8	12.3
Domestic credit (percent change)	17.4	20.2	21.4	19.8
Credit to private sector (percent change)	23.2	18.0	16.5	16.2
Balance of payments				
Current account (percent of GDP)	6.3	-0.4	-6.3	-5.2
Trade balance (percent of GDP)	-30.2	-34.5	-36.9	-36.4
Remittances (percent of GDP)	29.6	26.8	26.4	25.3
Reserves (months of prospective imports)	9.6	8.9	8.3	7.2
Public external debt (percent of GDP)	17.3	15.9	16.3	16.7
Exchange rate				
Exchange rate (Nepali rupees/US$; period average)	106.4	106.2	108.3	109.5
Real effective exchange rate (period average, y/y percent change)	6.0	3.3	...	...

1/ Fiscal year ends mid-July.

2/ Current expenditure includes transfers to subnational governments which can be used for capital expenditure.

ANNEX 5: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

PAs	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
Restructuring and Consolidating the Financial System		
1. The NRB has issued a new directive on Risk Management to the commercial banks.	Positive: Adhering to Risk Management provisions by the BFIs helps meet the country's environmental standards.	No
2. The NIB has: (a) completed in-depth diagnostics to identify institutional level risks of the companies which represent sixty percent (60%) of assets within the Recipient's insurance sector; and (b) implemented corrective actions or resolution programs for undercapitalized insurance companies identified under (a) above.	Positive: Strengthening of the insurance sector enables ability to recover and reconstruct property destroyed by natural disasters.	Positive: Strengthened insurance sector enables the providers and authority to focus on enhancing access to insurance products that can help small holder farmers and MSMEs to create wealth and jobs for the under-served population.
3. The NRB has issued enabling regulations based on the Nepal Rastra Bank Act (Second Amendment), 2073 BS (2016).	No	No
4. The NRB has approved the functional and technical specification of the Supervisory Information System (SIS).	No	Positive: The SIS will enable the NRB to track, among others, investment made by BFIs in meeting deprived sector targets.
5. The Cabinet has approved key regulations regarding: (a) DCGF's relationship with BFIs; (b) a guaranteed deposit verification process; and (c) BFI reporting, payout and reimbursement of guaranteed deposits.	No	No
6. (a)The NRB has executed a tri-partite agreement with the Ministry of Finance 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 DCGF to NPR ten billion (NPR 10,000,000,000) under an accelerated schedule.	No	No
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.	Positive: Enhancement of digital payments services reduces the need for brick and mortar branches.	Positive: Digital payment services reduces the cost of transactions, making it affordable to under or un-banked population and saves time which can be used for productive activity. It also supports remittance

PAs	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
		transfers, which play a crucial role in reducing poverty.
8. The Cabinet has approved the new Insurance Bill for submission to Parliament.	Positive: Strengthening of the insurance sector through an enabling legal framework allows businesses and individuals to recover and reconstruct property destroyed by natural disasters.	Positive: A strengthened insurance sector enables providers and authority to focus on enhancing access to insurance products that can help small holder farmers and MSMEs to create wealth and jobs for the under-served population.
9. The NRB has: (a) issued a directive on the Chart of Accounts; and (b) amended its directives on reporting requirements for BFIs to comply with the Nepal Financial Reporting Standards.	No	No
10. The NRB has issued implementing rules and bylaws for the BAFIA.	No	No
11. The Parliament has approved the Cooperative Act.	No	Positive: New law requires each of the cooperatives to have at least 33 percent representation of women in the board of directors, thereby promoting financial inclusion.
12. The NRB has revised its directive to the BFIs to implement the Asset (Money) Laundering Prevention Regulations.	No	No