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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A PROPOSED

DEVELOPMENT POLICY CREDIT

IN THE AMOUNT OF

SDR 70.6 MILLION (US$100 MILLION EQUIVALENT)

TO NEPAL

FOR A

THIRD FINANCIAL SECTOR STABILITY DEVELOPMENT POLICY CREDIT

February 2, 2017

Finance and Markets Global Practice
South Asia Region

NEPAL—GOVERNMENT FISCAL YEAR
July 16 – July 15

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of January 10, 2017)

Currency Unit: Nepalese Rupee
US$1.00 = NPR 109.03

ABBREVIATIONS AND ACRONYMS

ADBL	Agricultural Development Bank Limited
AML/CFT	Anti-Money Laundering/Counter Financing of Terrorism
BAFIA	Banks and Financial Institutions Act
BCPs	Basel Core Principles
BFIs	Banks and Financial Institutions
CAR	Capital Adequacy Ratio
CDR	Credit-to-Deposit Ratio
CEO	Chief Executive Officer
CPS	Country Partnership Strategy
CRR	Cash Reserve Ratio
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
DPO	Development Policy Operation
ELA	Emergency Liquidity Assistance
ESW	Economic and Sector Work
FATF	Financial Action Task Force
FI	Financial Institution
FINCO	Financial Cooperative
FINGO	Financial Nongovernmental Organization
FIRST	Financial Sector Reform and Strengthening Initiative
FSAP	Financial Sector Assessment Program
FSDS	Financial Sector Development Strategy
GDP	Gross Domestic Product
GoN	Government of Nepal
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IT	Information Technology
KYC	Know Your Customer
M&A	Mergers and Acquisitions
MFI	Microfinance Institution

MIS	Management Information System
MoF	Ministry of Finance
NBL	Nepal Bank Limited
NCP	Net Clearing Position
NEPSE	Nepal Stock Exchange
NFRS	Nepal Financial Reporting Standards
NIB	Nepal Insurance Board
NPL	Non-Performing Loan
NRA	National Reconstruction Authority
NRB	Nepal Rastra Bank
OAG	Office of the Auditor General
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
ROA	Return on Assets
ROE	Return on Equity
SEBON	Securities Board of Nepal
SIP	Special Inspections Program
SIS	Supervisory Information System
STI	Second Tier Institution
TA	Technical Assistance
TSA	Single Treasury System of Accounts

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NEPAL

THIRD FINANCIAL SECTOR STABILITY DEVELOPMENT POLICY CREDIT

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SUMMARY OF PROPOSED CREDIT AND PROGRAM

NEPAL

THIRD FINANCIAL SECTOR STABILITY DEVELOPMENT POLICY CREDIT

Borrower	Nepal
Implementing Agency	Ministry of Finance (MoF)
Financing Data	International Development Association (IDA) Credit Terms: Regular (38 years, with 6 years grace period) Amount: SDR 70.6 million (US$100 million equivalent)
Operation Type	The proposed Third Financial Sector Stability Development Policy Credit (DPC) is the third DPC of SDR 70.6 million (US$ 100 million equivalent) in a series of four DPCs. This IDA credit is expected to be withdrawn in a single tranche. The first IDA Financial Sector Stability Credit (DPC1) was a stand-alone single-tranche US$30 million SDR equivalent credit approved in June 2013. The Second IDA Financial Sector Stability Credit was a US$100 million SDR equivalent credit approved in June 2015. The second, third, and fourth DPCs are a program of three single-tranche development policy operations (DPOs).
Pillars of the Operation And Program Development Objective(s)	The objective of the credit is to support the financial sector medium-term reform program initiated by the Nepalese authorities to reduce the vulnerability of the banking sector and increase its transparency. The proposed credit 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.
Results Indicators (see also annex 1)	• ***Rastriya Banijya Bank (RBB) has a Capital Adequacy Ratio (CAR) of 10%,*** up from 5.6% in July 2014. • ***Nepal Bank Limited (NBL) has a CAR of 10%,*** up from 5.26% in July 2014 and is controlled by private investors. • ***All banks are either CAR-compliant*** or under prompt corrective action (PCA). • The number of financial institutions ***(FIs) has been reduced to less than 130*** from 167 in July 2014. • ***A modernized legal framework for bank resolution*** is in place. • Legal framework in place for the *Deposit and Credit Guarantee Fund* ***(DCGF) to be the administrator of the Deposit Guarantee Fund (DGF).*** • All board of directors members and chief executive officers (CEOs) of banks and financial institutions (BFIs) meet ***the fit and proper criteria***. • Nepal remains off the ***Financial Action Task Force (FATF) grey list***. • ***Settlement risk has been eliminated*** from the payments system.
Overall risk rating	Substantial
Climate and disaster risks *(required for IDA countries)*	(a) Are there short- and long-term climate and disaster risks relevant to the operation? Yes (b) The earthquakes of April and May 2015 and any such disasters have potential adverse impacts on the solvency of the financial sector and business continuity. This operation mitigates these risks by consolidating the sector and improving its solvency.
Closing Date	March 31, 2018
Operation ID	P156960

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

1. **The present program document describes the Third Financial Sector Stability Development Policy Credit (DPC3) to the Government of Nepal (GoN), in the amount of SDR 70.6 million (US$100 million equivalent).** This credit is the third DPC in a series of four. The first DPC was a stand-alone, single-tranche, US$30 million SDR equivalent credit approved by the World Bank's Board in June 2013. The second (SDR 72 million, US$100 million equivalent approved by the World Bank's Board in June 2015), third, and fourth DPCs are programmatic single-tranche operations. DPC3 is expected to be withdrawn in a single tranche of US$100 million SDR equivalent.

2. **The program development objective of DPC3 is to support the medium-term reform program for the financial sector initiated by the Nepalese authorities to reduce the vulnerability of the banking sector and increase its transparency**. It would build on the gains already realized through the past policy credits. A stable financial sector is necessary for broader economic growth and the cost of financial instability can be significant especially for low-income households and small firms whose access to financial services diminishes further. This credit, which comes in the aftermath of the earthquake (April/May 2015) and trade disruptions (September 2015–January 2016), will support efforts to sustain reconstruction and recovery, while mitigating emerging risks to the financial sector for it to be able to play its role in broader economic recovery.

3. **Originally, the series was to end with DPC3; however, in response to the request of GoN, the remaining prior actions (PAs) were split into two operations.** The authorities remain committed to the program, but the scope and details of the program were large enough to require recalibration of the timeline for the following reasons:

(a) The initial set of PAs was too large (18 PAs), and the timelines for achieving them varied substantially. Analysis of the timelines for some PAs (such as divestiture of Nepal Bank Limited (NBL) or implementation of the Supervisory Information System (SIS) needed about 18–24 months to complete, while other PAs needed to be completed earlier (legislative approval of the three laws) to allow for the regulations related to the laws to be prepared and issued

(b) To ensure continuity, DPC4 would pursue implementation, enforcement, and proper sequencing of reforms supported by this series, through the issuance of enabling regulations for three critical laws supported by DPC3. Without enabling regulations, and the support that the World Bank and development partners (International Monetary Fund [IMF] and U.K. Department for International Development [DFID]) will provide in preparing them, the reforms will remain incomplete. Annex 13 summarizes these changes.

1. INTRODUCTION AND COUNTRY CONTEXT

4. **While there have been setbacks on the path toward a stable democracy, Nepal has made progress on consolidating peace and building a new political system.** The prolonged transition period following the end of a 10-year armed conflict in 2006 had seemingly concluded with the promulgation of the new constitution in September 2015. However, new challenges emerged as protests and strikes against the constitution in the southern Terai region disrupted trade, resulting in severe shortages of fuel and essential

supplies across the country in late 2015. The ruling coalition in Parliament initiated amendments to the constitution to reflect the concerns of the agitating Madhesi parties to bring the impasse to an end. However, the impact on the economy has been substantial, especially as it occurred at a time when the country was geared to start the post-earthquake rebuilding process.

5. **Over the past decade, Nepal's relatively good performance on the economic front was adversely set back by the two shocks of 2015.** Real growth[1]—which averaged 4.5 percent over 2006–2014—slowed to 2.7 and 0.6 percent in FY2015 and FY2016, respectively. Inflation remained in single digits for most of the decade, with the peg of the Nepalese rupee to the Indian rupee providing a stable nominal anchor. Inflation jumped sharply following the shocks over the past two years, but has started to moderate. Fiscal balances were in surplus owing to strong revenue growth and modest spending (particularly on capital outlays). Nepal's external position remained equally strong, owing to large remittance inflows that are equivalent to a third of the gross domestic product (GDP) and have helped finance Nepal's large trade deficit.

6. **Concomitantly, there have been significant advances in poverty reduction and human development**. Overall poverty incidence fell from over 50 percent in FY2004 to 25.2 percent in FY2010/2011 according to the national poverty line (allowing Nepal to achieve Millennium Development Goal 1 ahead of time). Most multidimensional indicators of poverty[2] also showed sharp improvements across regions. These outcomes were principally driven by rises in farm incomes, remittance receipts, and nonfarm wage incomes, with the bulk of poverty reduction taking place in the rural areas where about 80 percent of Nepalese continue to live. Access to services increased significantly for most Nepalese, including women. As of 2015, primary education was accessible to virtually all; immunization coverage against major preventable illnesses was close to 90 percent; important strides have been made in reproductive health; and social insurance and assistance programs have been stepped up to 2.5 percent of GDP. As a result, Nepal has achieved most of the Millennium Development Goals, and has also satisfied the social criteria for exiting from 'Least Developed Country' status.

7. **However, challenges to sustaining and amplifying these gains remained, including financial sector vulnerabilities.** In mid-2011, a financial sector crisis nearly unfolded in Nepal. Withdrawals of deposits from smaller financial institutions (FIs) and severe liquidity constraints across the banking sector exposed the vulnerabilities of the financial system and required urgent intervention by Nepal's central bank and bank regulator, the Nepal Rastra Bank (NRB). Some of the liquidity was overinvested in the stock market and in speculative real estate investments, creating asset bubbles in each case. Once both bubbles burst, the sector was on the verge of a financial crisis, from which it emerged with great difficulty. The World Bank, together with the IMF, was asked to support efforts to contain the unfolding crisis and to provide longer-term support for institutional and regulatory changes that would contribute over time to a more robust system. Owing to quick and effective intervention by the NRB and a favorable environment (notably, continuing large flows of remittances, which provided liquidity to the system), a full-blown financial crisis was averted. In this process, substantive dialogue between the authorities and the World Bank developed, leading to the articulation of a medium-term program to address the

[1] Market price.
[2] Including 'child out of school', 'time taken to primary school', 'safe deliveries', 'access to electricity'.

underlying vulnerabilities of the financial sector. These challenges included an excessive number of small FIs with weak governance and supervision, a nascent bank restructuring and resolution framework, insolvency and governance challenges posed by the two largest state-controlled commercial banks, increasing problems in the financial cooperative (FINCO) sector, and issues of transparency in the financial system. As a result of this dialogue, and to support the GoN's medium-term program, the World Bank Board approved a stand-alone, single-tranche Financial Sector Stability Credit of US$30 million in 2013, followed by a second credit of US$100 million in 2015.

8. **This program document describes the Third Financial Sector Stability Credit of SDR 70.6 million (US$100 million equivalent) to support the continuation and expansion of the GoN's efforts to address financial sector vulnerabilities**. The actions supported under the proposed DPC3 are part of a broader, medium-term, government-led program aimed at reinforcing banking-sector stability and paving the way for the development of a robust and more inclusive financial sector. The key components of this program are described in detail in section 3 of this document. A programmatic Fourth Financial Sector Stability Credit (DPC4) is expected to be prepared in FY2017-18 to provide support for the finalization of reforms, for which major preparatory actions will have been completed using support from DPC1, DPC2, and this proposed DPC3.

9. **The objective of the credit is to support the financial sector medium-term reform program initiated by the Nepalese authorities to reduce the vulnerability of the banking sector and increase its transparency**. Even before the earthquake, the economy-wide potential for growth had been depressed by low levels of public and private investment, despite available financing. Over the past few years, Nepal's financial system has witnessed rapid expansion, fueled primarily by a steady and growing influx of remittances. Since 2011, the growth in remittance transfers has translated into a buildup of liquidity in the financial system, but with relatively low intermediation to the private sector due to a lack of demand for credit. This is due to the poor investment climate and the lack of viable investment opportunities. But it is also due partly to the small, fragmented, and shallow financial sector, which is unable to perform financial intermediation efficiently or to channel long-term financing to support Nepal's investment needs in infrastructure and power. More recently, the political crisis in the Terai region adversely impacted Nepal's financial sector by lowering demand for loans and advances (thereby contributing to excess liquidity), and impairing the ability of many borrowers to generate cash flows to repay their debts on time.

2. MACROECONOMIC POLICY FRAMEWORK

10. **Despite the political uncertainty that prevailed following the end of the conflict in 2006, Nepal has enjoyed a broad consensus on economic policy.** While significant political differences across and within political parties prolonged progress on key constitutional issues, there has been broad, albeit informal, consensus around economic policies and priorities. This has allowed progress on a range of technical agenda including public financial management (PFM), monetary policy, and financial sector supervision.

2.1 RECENT ECONOMIC DEVELOPMENTS

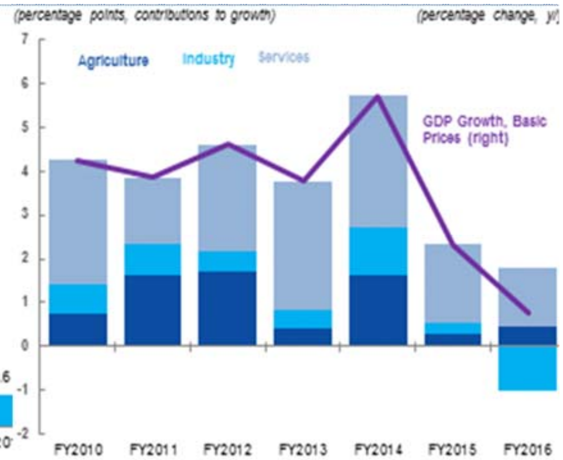
11. **Following the earthquakes and trade disruptions, economic activity is recovering in Nepal.** Real GDP growth, which had already fallen to 2.7 percent in FY2015 after the devastating earthquakes and its frequent and powerful aftershocks, was dragged down further to 0.6 percent in FY2016 as a result of the sluggish post-earthquake reconstruction activities

and disruption in cross-border trade with India (figure 1 and figure 2). Agriculture slowed down primarily due to weak rainfall in 2015, which was exacerbated by fertilizer unavailability as a result of trade disruptions. Industry contracted in FY2016 because manufacturing and construction were severely affected by unavailability of raw materials and transport disruptions. However, economic activity is showing signs of picking up in the first quarter of FY2017. Following two years of subpar rainfall, the 2016 monsoon was good, boosting the prospects of an increase in agriculture output. Also, housing reconstruction, despite a slow start in FY2016, has gathered pace in FY2017.

Figure 1. Growth Slowed in FY2015 and FY2016

Source: Central Bureau of Statistics.

Figure 2. Sectoral Contributions to Growth



Source: World Bank staff calculations from Central Bureau of Statistics.

12. **Imports, which contracted in FY2016 for the first time in decades, are rebounding in recent months.** The trade disruptions ended in January 2016, and by mid-February 2016, imports had recovered and reached the pre-disruption level and continued to grow strongly in the remaining five months of the fiscal year. By April 2016, imports of fuel—the hardest hit commodity—had also fully recovered. Despite the quick recovery, total imports, measured in Nepalese rupees, contracted by 0.7 percent in FY2016, compared to the year before, a first in decades.

13. **However, exports of goods significantly suffered in FY2016 and have not recovered as fast.** Exports were reduced by half during the peak of the trade disruption and were not as quick to recover following the end of the trade disruptions. As a result, exports of goods, measured in Nepalese rupees, contracted by 24 percent in FY2016, compared to the previous year, making this the highest contraction recorded in decades.

14. **Inflation has significantly moderated after a steep rise as a result of shocks.** After the end of the trade disruptions, inflation moderated for three months before accelerating again to double digit rates by the end of FY2016. Despite normalization in imports and a favorable external environment (including low food and oil prices and moderating inflation in India), inflation remained elevated in FY2016 and was 10.5 percent (y/y) in July 2016. However, starting from FY 2017 inflation has significantly moderated and reached 3.8 percent (y/y) in January 2017.

15. **Despite severe trade disruptions, trade balance remained the same at 30 percent of GDP.** While imports rebounded quickly following the end of the trade disruptions, they

were still lower than the year before. However, exports were slow to recover and the trade deficit, measured as a share of GDP, remained the same. At the same time, remittances continued to expand, albeit at a slower pace, in FY2016. The cumulative effect has been a current account surplus of US$1.3 billion in FY2016. This led to a historic high point in Nepal's foreign reserves with over US$8 billion being accumulated by the end of FY2016, covering 10.5 months of prospective imports (merchandise and services). In the first three months of FY2017, growing imports have widened the trade deficit which was largely offset by remittances. This has resulted in the slower growth of foreign reserves, but they remain high at US$8 billion, covering 9.4 months of prospective imports.

16. **The outflow of migrant workers is slowing.** FY2015 was the first year since 2009 in which the outflow of migrant workers declined (down 0.8 percent y/y). In FY2016, the outflow of migrant workers further declined by 18.4 percent (y/y). Three months into FY2017, the outflow of migrant workers has contracted by 16 percent (y/y). If this trend continues, it could adversely affect future growth of remittance inflows.

17. **The GoN exceeded its revenue target in FY2016, despite a difficult year for the economy, and revenue continued to rise in FY2017.** Government revenues, which fell precipitously during trade disruptions, picked up sharply after April 2016, as imports normalized. As a result, the total domestic revenue collection in FY2016 grew 18.9 percent compared to the previous year and exceeded the target set by the Government. Despite the worst economic performance in more than a decade, domestic revenue performed extremely well and reached 21.5 percent of GDP in FY2016. In the first three months of the fiscal year in FY2017, the revenue collection has remained robust.

18. **The ambitious target for post-earthquake government expenditure has not materialized.** The GoN planned to increase spending by 11 percent of GDP in FY2016, largely on account of higher spending on earthquake recovery efforts. However, total spending remained depressed for much of FY2016 due to the impact of the trade disruptions, and there was no robust recovery similar to the pick-up in revenue collection except for a considerable hike of spending in the last month of the fiscal year. As a result, the GoN increased total spending by only 1.3 percentage points of GDP in FY2016 compared to FY2015 spending. In the first three months of FY2017, spending picked up as distribution of housing reconstruction grants is gathering steam, but remains well below target for FY2017.

19. **The trade disruptions are estimated to have adversely affected poverty reduction efforts, which were already hampered by the earthquakes in 2015.** Earlier estimates had suggested that the earthquakes could end up pushing an additional 0.7–1.0 million of Nepalis into poverty in FY2015–2016. Poverty in the near term is expected to worsen as a result of the trade disruptions that hurt the livelihoods of millions of people across Nepal.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

20. **Following two challenging years and disappointing growth, activity is expected to rebound.** The rebound in growth in FY2017 comes on the back of a normal monsoon that will boost agricultural output and is supported by increased investment (both public and private) as earthquake recovery efforts gather speed. However, growth after FY2018 is expected to moderate in line with the country's potential. The high inflation induced by the trade disruptions is expected to ease in FY2017, but is likely to remain elevated owing to persistent supply-side bottlenecks during the forecast period.

21. **All sectors of economy are expected to rebound in FY2017.** Agriculture, which contributes 33 percent of GDP, is expected to rebound following two years of subpar rainfall and output. With monsoon precipitation above the long-term average, rice production is forecasted significantly higher in FY2017 than the previous two years, giving a much-needed income boost to the 60 percent of the population that works in agriculture. The industry subsector is also expected to grow on the back of some improvements in electricity and manufacturing. New hydropower plants are coming on grid in FY2017 and manufacturing is expected to get some boost starting from FY2017 with the apparel and garments industry receiving duty-free access to the U.S. market. Services will be supported by a rebound in wholesale/retail activities with the normalization of trade and a rebound of tourism in FY2017. However, a slowdown of remittances may have some downside impact on the services sector growth.

22. **Fiscal and current account deficits are expected to widen during the forecast period, as the reconstruction efforts take shape.** Expenditure is expected to grow substantially in FY2017 owing to an increase in earthquake-related cash assistance and capital expenditure. Revenue is also projected to pick up, but at a slower pace, resulting in a fiscal deficit that is expected to narrow as reconstruction efforts are completed. Similarly, the current account will likely remain in surplus in the near term but could turn to deficit as remittances growth eases and imports grow, driven by the larger reconstruction efforts.

23. **The joint World Bank-IMF Debt Sustainability Analysis carried out following the earthquake maintained the 'low' risk debt distress rating.** Generally prudent fiscal policy and low execution of capital spending budgets have continued to underpin declining levels of public debt. Higher financing requirements driven by post-earthquake reconstruction and higher public investment expenditures are expected to be manageable under the assumption that they are temporary and that financing terms are favorable. As a result, indicators of the public external debt stock and public debt service ratios remain comfortably within the policy-dependent indicative thresholds, even under stress tests, supported by continued high levels of concessional official borrowing (see also annex 2).

Table 1. Key Macroeconomic Indicators, FY2012–FY2020

	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20
	Actuals				Est.	Projections			
Real economy	*(Percentage change, unless otherwise stated)*								
Nominal GDP, current prices (NPR, billions)	1,527	1,695	1,965	2,120	2,249	2,532	2,830	3,134	3,469
Real GDP growth (at market prices)	4.8	4.1	6.0	2.7	0.6	5.0	4.8	4.3	4.3
Real GDP growth (at factor prices)	4.6	3.8	5.7	2.3	0.8	5.0	4.8	4.3	4.3
Contributions to growth:									
Agriculture (percentage points)	1.7	0.4	1.6	0.3	0.5	1.2	1.0	1.1	1.1
Industry (percentage points)	0.5	0.4	1.1	0.2	-1.0	0.6	0.6	0.5	0.5
Services (percentage points)	2.4	2.9	3.0	1.8	1.3	3.2	3.2	2.7	2.7
Consumer prices (period average)	8.3	9.9	9.1	7.2	9.9	9.0	8.0	8.0	7.5
Fiscal sector	*(As percentage of GDP, unless otherwise indicated)*								
Expenditures	19.3	17.8	18.8	20.2	21.5	22.2	22.9	24.0	24.0
Total revenue and grants	18.7	19.5	20.6	20.9	23.2	24.0	23.9	22.8	22.8
Total public debt	34.3	32.2	28.5	25.6	25.1	25.9	26.3	28.1	29.5
Domestic	20.3	19.7	17.9	9.5	9.1	9.6	9.9	10.9	11.5
External	14.0	12.5	10.6	16.1	16.0	16.3	16.4	17.2	18.0
Monetary sector	*(Percentage change, unless otherwise indicated)*								
Broad money		16.4	19.1	19.9	19.5	….	….	….	….

Domestic credit		17.2	12.7	15.6	18.1	….	….	….	….
Private sector credit		20.2	18.3	19.4	23.2	….	….	….	….
Balance of payments	*(As percentage of GDP, unless otherwise indicated)*								
Current account balance	5.0	3.1	4.8	3.8	4.1	0.3	-1.6	-1.7	-1.8
Exports of goods and services	10.1	10.7	11.5	11.7	9.5	10.6	11.3	12.2	12.4
Imports of goods and services	33.6	37.5	40.8	41.7	39.4	45.1	47.1	47.2	46.5
Gross official reserves ($, millions, eop)	4,635	5,150	5,828	7,067	8,340	8,739	8,632	8,496	8,400
Gross official reserves (in months of prospective imports of goods and services)	7.9	7.9	8.4	10.1	10.5	9.4	8.4	7.6	6.9
Rupees per U. S. dollar (period average)	81.0	88.0	98.2	99.5	106.4	…	…	…	…
Memorandum items:									
Nominal GDP, current prices (USD, billion)	18.9	19.3	20.0	21.3	21.1	…	…	…	…
Population, million	27.5	27.8	28.1	28.4	29.1	…	…	…	…
GDP per capita, USD current	686	693	712	750	727	…	…	…	…

Source: World Bank staff estimates.

24. **The stock of public debt has remained low relative to GDP.** Public debt, as a share of GDP, fell dramatically from about 60 percent of GDP a decade ago to 25.1 percent of GDP percent in FY2016. While prudent fiscal management by the GoN played a part, it is largely a result of persistent capital spending underperformance. Although budget surpluses were used to pay off government debt, the persistent underspending on capital expenditure is hampering Nepal's efforts to achieve higher rates of growth. As overall public debt has decreased, the share of domestic debt is expected to increase in FY2017.

Table 2. Key Fiscal Indicators, FY2012–FY2020

	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20
	Actual				Est.	Projections			
	(percent of GDP, unless otherwise stated)								
Total Revenue and Grants	18.7	19.5	20.6	20.9	23.2	24.0	23.9	22.8	22.8
Total revenue	16.0	17.5	18.5	19.1	21.5	21.8	22.0	21.0	21.0
Tax revenue	13.9	15.3	15.9	16.8	18.7	19.6	19.6	19.0	19.0
Nontax revenue	2.1	2.2	2.6	2.4	2.7	2.2	2.3	2.0	2.0
Grants	2.7	2.1	2.1	1.8	1.8	2.3	1.9	1.8	1.8
Expenditure	19.3	17.8	18.8	20.2	21.5	22.2	22.9	24.0	24.0
Current expenditure	15.9	14.6	15.5	16.0	16.3	16.6	17.5	18.5	18.5
Capital expenditure	3.4	3.2	3.4	4.2	5.2	5.6	5.7	5.5	5.5
Overall balance (excluding grants)	-3.3	-0.4	-0.4	-1.0	-0.1	-2.8	-3.4	-3.0	-3.0
Overall balance (including grants)	-0.6	1.7	1.8	0.8	1.7	-0.5	-1.5	-1.2	-1.2
Net financial transactions	0.6	-1.7	-1.8	-0.8	-1.7	0.5	1.5	1.2	1.2
Net acquisition of financial assets	1.6	1.2	1.1	1.7	1.5	1.3	1.3	1.4	1.4
Net incurrence of liabilities (financing needs)	2.2	-0.5	-0.6	1.0	-0.3	1.8	2.8	2.6	2.6
Foreign	-0.2	-0.1	0.1	0.4	0.4	0.5	0.8	0.6	0.6
Domestic	2.4	-0.4	-0.7	0.6	-0.6	1.3	2.0	2.0	2.0

Source: World Bank staff estimates.

25. **The near-term macroeconomic outlook has been weakened by recent shocks, but it remains adequate for this operation.** At present, the emergence of external and fiscal deficits is predicated on sustained implementation of the reconstruction effort. Should reconstruction be slower than anticipated, however, the expected twin deficits will not materialize. Financed by a combination of increased foreign grant assistance and concessional borrowing, fiscal deficits will not endanger debt sustainability. The inflation rate is expected to remain in high single digits, despite lower oil and food prices and slowing inflation in India, reflecting domestic bottlenecks and the lagged effects of the price spikes induced by the trade disruptions.

26. **Macroeconomic risks to the outlook are moderate, but are weighted on the downside.** The risks associated with this baseline forecasts are on the downside and center mostly on the domestic political situation, such as the political/constitutional issues that led to the trade disruptions. The boundaries of the provinces that were the subject of protests are yet to be resolved, while the demarcation and restructuring of local level governmental bodies has been hampered by controversy. In addition, the new constitution adopted last year stipulates a series of elections by the beginning of 2018, which will further add to policy uncertainty.

27. **The external environment is expected to be less favorable.** With remittances comprising nearly 30 percent of GDP, the economy is extremely dependent on these flows. Gulf Co-operation Council countries and Malaysia, which are the destination for almost 97 percent of all Nepali migrants excluding India, are a key source of remittances. As oil prices in particular, and commodity prices in general, are likely to remain low during the forecast period, the risk of a drop in remittances has increased. Given that remittances enable the consumption-centric structure of the Nepalese economy and the GoN's reliance on taxation of imports as a major source of revenue, a sharp slowdown would have adverse effects on growth, fiscal balances, and external accounts, in addition to hurting the livelihoods of remittance recipients.

2.3 RECENT BANKING SECTOR DEVELOPMENTS

Structure of the System

28. **Nepal's financial system is bank-dominated and is characterized by a large number of institutions, significant state ownership, and the existence of various kinds of banking licenses (see annex 3).** In recent years, the banking system has expanded rapidly (140 percent between July 2009 and June 2016 measured by assets). Domestic credit to the private sector jumped from 33 percent of GDP in 2005 to 75 percent in 2016, overtaking the South Asia regional average of 45.8 percent. Private commercial banks accounted for all of this growth, while the assets of three state banks (Agricultural Development Bank Limited [ADBL], RBB and NBL) declined as a share of the sector's total assets. However, the RBB is still the largest bank, representing 8.2 percent of total commercial bank assets in FY2016 Q2, while ADBL is the fifth largest bank with 5.3 percent of assets, and the NBL is the sixth largest bank, with 5.1 percent of assets. In June 2016, the ten largest banks accounted for 53 percent of commercial banks' assets.

Performance of the System

29. **While headline capital adequacy and asset quality figures appear comfortable, there are concerns whether the data fully reflects the reality.** CAR of commercial banks marginally improved to 12.2 percent in FY2016, compared to 11. 9 percent in the previous year due to retained earnings—and in the case of state-controlled banks, capital injections from debt to equity conversions by the GoN. All banks meet the minimum CAR of 10 percent. There has been a decreasing trend in non-performing loans (NPLs) over the last few years; however, banks' reported asset quality and capital buffers may be overstated. NPLs accounted for 1.8 percent of the total loan portfolio in FY2016. There are indications that ever-greening of bad loans is a recurring issue, leading to an understatement of the NPL ratio, the potential occurrence of under-provisioning, and—as a consequence—an overstatement of the CAR. Banks also have incentives to resort to ever-greening to keep NPL ratios below 5 percent to be able to pay dividends.

Past Crisis, Authorities Response and Reform Efforts

30. **Excessive credit growth during FY2008–2011, weak supervision and enforcement of prudential regulations, and a liberal bank licensing policy have contributed to weaknesses in the sector**. A dramatic proliferation of banks took place 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 heightened systemic fragility. This manifested itself primarily through financial interconnectedness: connected lending and possible cross-shareholding among banks arising from pledging of equity shares as loan collateral. The collapse of the real estate bubble after reaching a peak in 2008, coupled with a slowdown in remittance growth in early 2011, led to a severe liquidity squeeze in April–May 2011, bringing these vulnerabilities into sharper focus and driving fears of a potential banking crisis.

31. **The NRB responded with large-scale liquidity support through multiple lending windows and regulatory forbearance, rather than intervening and closing weak and insolvent banks**. The NRB established a Lender of Last Resort facility and Special Refinance for Liquidity Management facility (which was removed once liquidity pressures eased), capped the credit-deposit ratio at 80 percent, and reduced the cash reserve ratio (CRR) from 5.5 to 5 percent. In addition, the authorities established a deposit insurance scheme which was compulsory for all classes of FIs. The coverage was set at NPR 200,000 per depositor per bank. This strategy was successful in the short run as a resurgence of remittance flows eventually eliminated the liquidity squeeze, allowing banks to unwind NRB support, but balance sheet problems remained unresolved.

32. **The NRB introduced a series of measures to strengthen banking regulation and supervision, some of which was supported by the DFID/IMF TA and the DPC series.** These included:

(a) improved loan classification and provisioning regulations;
(b) issuance of new risk management guidelines;
(c) tightening of the eligibility criteria for licensing upgrades (between A, B, and C);
(d) issuance of new paid-up capital requirements;
(e) issuance of new bylaws to facilitate mergers and acquisitions (M&A) between institutions;
(f) initiation of more intensive on-site supervision by the NRB;
(g) splitting of the department for supervision of Class B and C institutions in two, to allow for closer supervision of these institutions;
(h) regular stress testing of commercial banks;
(i) implementation of a licensing moratorium on new FIs;
(j) increasing the CRR requirement for commercial and development banks;
(k) introduction of new instruments to manage excess liquidity in the system;
(l) enlargement of the prompt corrective action (PCA) framework to include liquidity;
(m) issuance of new guidelines for stress tests and the Internal Capital Adequacy Assessment Process;
(n) transitioning of the on-site supervision from compliance-based to risk-based supervisory processes, more closely aligned with the Basel Core Principles (BCPs) for Effective Banking Supervision;
(o) diagnostic reviews of 20 banks (undertaken with IMF support);

(p) completion of Special Inspections for 54 BFIs, for a total coverage of 64 percent of banking system assets; and
(q) creation of a Problem Bank Resolution Department to handle all BFIs declared problematic, which moves responsibility for managing problem BFIs from the individual supervision departments to one centralized unit.

33. **Efforts have been undertaken to strengthen the resolution framework for problem banks, which has contributed to consolidation in the banking system**. Parliament approved the NRB Act Amendment Bill and a new Deposit and Credit Guarantee Fund Bill that give the NRB and other safety net partners' stronger powers to intervene in a more timely manner in undercapitalized BFIs. 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 M&As, the number of BFIs has shrunk from 199 in mid-January 2012 to 135 as of mid-July 2016, a reduction of 32 percent.

34. **The successive earthquakes and trade disruptions of 2015 have highlighted new potential threats to the stability of the financial system which exacerbate Nepal's already complex financial sector challenges (see annex 6).** Pressures on banks' liquidity and capital buffers may arise from the combined effect of damage to real estate pledged as collateral for loans and an anticipated increase in NPLs due to loss of revenue by borrowers. Borrowers whose businesses have been severely impacted may have difficulty in repaying loans, especially true in the tourism, manufacturing, hydropower, and sector defined as Deprived Sector lending[3]. While regulation requires real estate collateral to be insured, the recent review of 54 BFIs by the NRB through the Special Inspections Program (SIP) showed widespread weakness in collateral administration. There have been concerns about the financial resources of insurance companies and their ability to reimburse BFIs, despite reinsurance agreements with foreign reinsurers covering almost 85 percent of the risk. Many microfinance institutions (MFIs) and financial cooperatives (FINCOs) operate in the rural areas of the country, and some exclusively in the areas that were the worst affected by the disaster. There is concern about the viability of these institutions, given the losses suffered by thousands of their members with no alternative sources of income. Work is under way to quantify these exposures.[4]

Remaining Risks and Vulnerabilities

35. **While risk is spread throughout the system, balance sheets are thought to be weaker in smaller commercial banks, development banks, and finance companies.** These institutions proliferated in the past but have been declining in number since 2012 due to M&As, and resolution. Their proliferation outstripped the NRB's capacity to supervise and regulate the sector. While they are smaller with regard to assets, their vulnerabilities have larger implications due to cross-ownership and exposure to larger banks. Deposits shifted to the perceived safety of Class A banks amid concerns over their balance sheets and

[3] A key source of funding for MFIs is funding from other BFIs which are mandated by the NRB to lend a portion of their portfolio to the Deprived Sector. As of mid-January 2016, BFIs had an exposure of NPR 77 billion under Deprived Sector lending out of which NPR 44 billion was on-lent through the MFIs and the remaining through their own lending. MFIs had a total loan exposure of NPR 62 billion.
[4] The NRB and the Nepal Insurance Board (NIB) with DFID support launched diagnostic reviews of 10 insurance companies and 35 BFIs.

governance. The NRB has a lender of last resort policy that was used in 2011 to help avert a liquidity crisis and liquidity in the large commercial banks has improved, but pressures are now concentrated in Class C institutions.

36. **Risks related to real estate exposure may be underestimated (see annex 3).** Based on reported figures, the direct exposure of commercial banks remained around the same at 13.8 percent as of FY2016 compared with 13.7 percent one year previously, driven almost equally by the personal home loan segment and loans for real estate development. However, if indirect exposure from non-real estate loans collateralized by real estate is included, the ratio is likely to be closer to 70 percent. The home loan (mortgages) portfolio was 54 percent of total real estate exposure compared with 58 percent the previous year. With the market liquidity being in surplus, real estate exposure is likely to increase in line with overall credit expansion as a result of: (a) low yields from the government paper and interbank market, (b) slack in demand for borrowings in new projects, and (c) lack of alternative investment opportunities.

37. **Stress testing suggests real estate exposure posing a risk although price correction has helped reduce vulnerabilities to some extent.** Stress tests conducted by the NRB in mid-January 2014 indicate that the CAR of nine banks would fall below the minimum regulatory level of 10 percent if 25 percent of loans extended to the real estate and housing sector turned bad. Comparatively, only five banks were in that position based on stress tests undertaken in July 2013. One major reason for the deterioration in credit quality is the practice of extending loans solely using real estate as security. This poses a risk to the banking sector as real estate prices, although on an increasing trend, have not fully recovered yet and many banks may fail to recover overdue loans even if they auction properties of defaulters.

38. **The NRB conducted an SIP of 54 BFIs, exposing a myriad of problems in addition to CAR problems at specific BFIs (see annex 4).** The program was to assist the NRB in evaluating BFI compliance in several areas including accuracy and reliability of financial information and reports, assisting the NRB in assessing the impact of transition to International Financial Reporting Standards (IFRS) (Nepal Financial Reporting Standards [NFRS] in Nepal), and specific concerns regarding corporate governance. In total, 54 BFIs (64 percent of the banking sector) were reviewed in two phases. Out of the 54 BFIs reviewed, 26 BFIs were found to be maintaining CAR of less than the minimum required. Most BFIs fixed their problems during the review period but there were several PCAs taken as well as BFIs merging out of existence. The SIP also brought to light weakness relating to corporate governance, loan administration, management information system (MIS), and other issues which the NRB has been working to correct. The changes to BAFIA are aimed at improving corporate governance and are a direct result of the findings of the SIP.

39. **The NPL ratio may be adversely affected by the Nepal earthquakes and the recent blockade but the full extent of the damage is yet to be assessed (see annex 4).** The NRB and the NIB, with support provided by DFID, are undertaking diagnostic reviews of 10 insurance companies to better assess the impact of the earthquake on the solvency of both the insurance and banking sectors. Forbearance measures have been extended to only those borrowers who were not already classified as substandard before the events.

2.4 IMF RELATIONS

40. **Following the earthquake, Nepal received a disbursement of SDR 35.6 million (US$49.7 million equivalent) under the Rapid Credit Facility (RCF), as approved by the Executive Board of the IMF in July 2015.** The RCF was provided to help address the urgent balance of payments and fiscal needs associated with the rehabilitation and reconstruction efforts in the aftermath of the earthquake. The 2015 Article IV consultation mission was completed on October 1, 2015, during which discussions were held for a longer-term engagement with the IMF, possibly through the Extended Credit Facility. This engagement could cover a comprehensive package of macroeconomic and structural reforms geared toward boosting public and private investment, social spending and financial inclusion, and strengthening the financial system. In addition, the IMF is also providing TA on banking supervision. Finally, the IMF and World Bank concluded an FSAP in the first half of 2014. Before the RCF, Nepal had no IMF program. The Fund Relations Annex is provided in annex 12.

3. THE GOVERNMENT'S PROGRAM

41. **The first phase of the Government's program for the financial sector was completed in 2011–2013 and supported by DPC1**. The program included, among others, measures to stabilize the banking system after the 2011 crisis, formalizing the deposit guarantee system, adopting a framework for PCA and bank resolution, carrying out diagnostics of 20 FIs and issuance of ordinances to strengthen the legal framework for anti-money laundering and counter-financing of terrorism. It also started the process of the consolidation of the banking sector, and implementation of the first rounds of the recapitalization process for the NBL and the RBB.

42. **The second phase of the Government's financial sector reform program (2014–2017), 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 to levels closer to international norms, and second, to start improving access to formal financial services. Despite the impact of the earthquake and trade disruptions, the overall reform program continues to be aimed at these key objectives. The 2014–2015 reforms supported by DPC2 and the proposed DPC3 reflect the main recommendations of the 2014 FSAP and aim to reinforce banking-sector stability and pave the way for the development of a robust and more inclusive financial sector. The operation supports that objective by focusing on 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 GoN's financial sector program is further elaborated in the Letter of Development Policy (annex 11).

4. THE PROPOSED OPERATION

4.1 LINK TO THE GOVERNMENT'S PROGRAM AND DESCRIPTION OF THE OPERATION

43. **The programmatic series of DPCs complements the GoN's program and is grounded in analytical work carried out by the World Bank, IMF, DFID, and the 2014 FSAP**. As a result, it is an integral part of the overall banking sector stabilization program to: (a) identify (via the NRB SIP) banking sector weaknesses; (b) resolve institution-specific problems (via PAs to place undercapitalized banks in PCA and resolution programs, and

establishment of the legal foundations and operationalization of the deposit guarantee system); and (c) to address weaknesses in regulation and supervision (via the establishment of effective bank resolution processes, improving transparency and regulation, strengthening of legal, regulatory and governance frameworks through the reform of the NRB Act and BAFIA, enacting and implementing the Anti-Money Laundering/Counter Financing of Terrorism [AML/CFT] legislative framework). The series also includes measures designed to assess and then mitigate risks to the financial sector which have been amplified by the earthquakes and trade disruptions (in particular related to the NRB/NIB Fast Diagnostics Program, strengthening of the financial crisis management architecture, and establishment of a disaster recovery center by NRB). A summary of the proposed DPC3 policy actions and DPC4 triggers is included in the policy matrix in annex 1. PAs for DPC3 are discussed in more detail below. The overall program outcomes envisaged are featured in the last column of the policy matrix.

44. **The proposed operation considers the lessons learned from the Financial Sector TA and Financial Sector Restructuring Projects as well as DPC1 and DPC2.** Both TA projects supported a restructuring of the two state-owned banks, a voluntary retirement scheme to increase the efficiency of those banks, and the introduction of more modern banking practices and professional management to those banks. While the projects did not achieve all their objectives for a number of reasons, many of their impacts were positive. However, policy-level reforms were needed to achieve broader stability and development of the banking system. In light of the improvements in the design principles for Development Policy Operations (DPOs) in fragile states identified in the literature, budget support operations, coupled with TA directly provided by development partners, are considered to be a more effective way to trigger and implement reforms in the financial sector. DPC1 and DPC2 reflected this approach by working with the authorities for an extended period to develop broad-based support for the GoN's medium-term agenda and adjusting PAs to ensure that they provided both early wins for reform champions and constituted steps toward clearly articulated goals which are to be fulfilled with the support of subsequent DPCs. This approach was closely linked to the design of the DFID capacity-building program, as well as TA from the Fostering Innovation through Research (FIRST) program (annex 5), which is fully integrated with the DPC series and designed to ensure that the authorities have all the resources needed to implement DPC-supported reforms.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

First Pillar: Enhancing Financial Sector Development

45. **This pillar is a key pillar of GoN's reform program (supported under DPCs 1 and 2) and aims to facilitate the establishment of a strengthened coordination framework for design and implementation of financial sector reforms by preparing a Financial Sector Development Strategy (FSDS) that balances the aims of stability, efficiency, and inclusion.** Despite the rapid growth of the banking sector, access to financial services in Nepal remains concentrated in the Kathmandu valley and among higher-income groups. An estimated 66.2 percent of Nepal's adult population has no or restricted access to formal financial services. While government-supported interventions and schemes to increase access are needed, in the past such interventions (along with the liberal licensing scheme of FI in order to promote financial access) have not been strategic, resulting in unintended distortions and stability risks.

46. **A high-level government steering committee was formed to provide policy guidance and a technical committee led by the Ministry of Finance (MoF) (supported with TA from DFID and the World Bank) was established to coordinate preparation of the strategy**. Following stakeholder consultation, the strategy was endorsed by MoF in April 2015, as a PA for DPC2. More recently, the Cabinet approved the FSDS in January 2017. MoF is preparing a multi-stakeholder workshop for its dissemination. A few of the sectoral action plans under the FSDS are already undergoing implementation, while the others are being prepared with support from the World Bank and DFID.

Second Pillar: Restructuring and Consolidating the Financial System

47. **Restructuring and consolidation of the financial system is expected to result in: (a) divesting state control in NBL, (b) completing the assessment of the impact of the earthquake on BFIs and insurance companies, and (c) stabilizing and consolidating the banking system with all banks being either CAR-compliant or in PCA or resolution programs.** These measures are expected to strengthen weaker institutions, enabling them to address the emerging vulnerabilities. This will be achieved through support for commencing the divestiture process of the NBL (prior action 1). This pillar also supports actions to enhance the stability of the financial system and respond to the earthquake's impact through: completing the second phase of in-depth diagnostics of the banking system to identify and address institution-level weaknesses which threaten banking system stability (prior action 2); completing the process of assessing the impact of the earthquake on BFIs' balance sheets (prior action 3); and undertaking measures to increase capitalization (prior action 4).

48. **The main recommendations of the FSAP Technical Note on state-controlled banks include the full divestment of the GoN's stake in the NBL to private investors and strengthening the governance of the RBB**. This process began with the first rounds of recapitalization of the NBL and RBB supported by DPC1 and DPC2. The RBB would continue to be profitable and fully recapitalized to meet prudential requirements,[5] while the NBL would also continue to be profitable and achieve a positive CAR of at least 3 percent. The first steps toward reducing the number of large state-controlled banks to one have been taken: it was announced in the budget speech that the Government had decided to divest control of the NBL to a reputable bank strategic investor, and the Cabinet decided to convert a loan to the NBL into equity, giving the Government a more attractive majority stake to sell to a strategic investor. In parallel, the Government is working, with support from DFID, to develop a new strategy to divest its minority stake in the Class A Agricultural Development Bank of Nepal (see annex 7), following the failure of the first attempt to sell the stake.

49. **The RBB was deeply insolvent but highly liquid, with a CAR of −21.79 percent on January 15, 2012**. As one of the DPC1 PAs, the GoN implemented the first phase of the bank's recapitalization, with the CAR rising to 5.6 percent by mid-July 2014. The second phase of the recapitalization program, the chief elements of which were the divestiture of a cross-shareholding in Nepal Investment Bank Limited and retention of earnings was completed, with the RBB reporting a CAR of 11.2 percent as of mid-July 2016, with profits for the year of NPR 2.6 billion (third most profitable bank). The GoN's use of budget funds for the recapitalization of the RBB was limited to NPR 4.3 billion (under phase 1), with the remaining additional contributions taking the form of a debt-to-equity conversion (NPR 3

[5] Key prudential requirements include the NRB ratios for capital adequacy, liquidity, concentrations of credit (including loans to a single borrower), loan loss reserves, and aggregate real estate lending.

billion), conversion of preferred shares into common shares (NPR 787 million), and conversion of a scheduled dividend to equity (NPR 87 million), all actions that were supported by DPC2.

Prior action 1: The Ministry of Finance has endorsed the NBL Strategic Divestiture Plan and submitted it to the Secretariat of the Privatization Committee.

50. The NBL was deeply insolvent, but highly liquid, with a CAR of −8.53 percent on January 15, 2012. As one of the DPC1 PAs,[6] the Government, along with private sector investors, increased the capital of the NBL via a rights offering and the CAR had risen to 0.04 percent by October 15, 2013, and to 5.26 percent by mid-July 2014. DPC2 supported the implementation of a modified recapitalization plan and the CAR improvement is primarily as a result of conversion of a government loan to common equity, sale of nonbanking assets, and retained earnings over the period. The NBL accumulated a net income of NPR 3.01 billion (most profitable bank) during FY2015/2016 and the CAR as of mid-July 2016 is 11.41 percent, thereby meeting minimum prudential capital requirement for the first time after more than a decade.

51. **The NBL's recapitalization program has given the GoN a large majority stake (more than 60 percent ownership) in the bank**. The related PA proposed under DPC3 utilizes this as an opportunity that enables the Government to offer an attractive large majority stake (>62 percent) in the NBL to potential strategic partners.[7] By divesting from the NBL, the GoN would remove the implicit state guarantee from the NBL and eliminate a distortion in the market caused by having a commercial bank that has been noncompliant with the CAR for the past 15 years.

52. **In addition, NBL's governance is expected to improve**. NBL will be subject to the strengthened requirements in NRB Directive 6/071, it will implement NFRS, improving transparency, particularly with reference to asset quality and reporting of earnings, its management and governance control will be transferred to a strategic investor as a result of divestiture by mid-2017, and it will be subject to the strengthened governance provisions of the new BAFIA. DPC4 will continue underpin the NBL divestiture by supporting the preparation and publication of an international tender for the sale of the Government's stake.

Prior action 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 financial institutions, and (b) Prompt Corrective Action Programs for all financial institutions found to be undercapitalized.

53. **A key factor undermining the NRB's regulatory oversight has been the lack of supervisory capacity and the focus on compliance-based supervision.** This has proven to

[6] The full recapitalization of both RBB and NBL was specifically recommended by the FSAP (FSAP Technical Note on State-Controlled Banks) and in multiple IMF Article IV reports. The decision to resolve RBB and NBL on an open basis was made more than a decade ago and attempting to revisit the resolution approach at this point in time—when the banks are profitable and, in RBB's case fully capitalized and NBL's well on the way to full recapitalization—would pose a significant risk of undermining public confidence in the policy reform measures taken so far. There is also now no legal basis for attempting to close NBL.

[7] The FSAP Technical Note on State-Controlled Banks specifically recommended that the GoN structure the bank's recapitalization to create a Government-owned majority stake which would be attractive for a strategic investor.

be inadequate for assessing the risk profile of FIs as well as systemic and institutional risks to the sector. An SIP was therefore deemed necessary to understand the potential risks within the banking system.

54. **In 2012–2013, the NRB (with TA from the IMF) completed a program of diagnostics of 20 FIs.** The results of this program identified significant weaknesses in the quality of governance, risk management, and financial reporting in many of the institutions in the program. The IMF 2013 Article IV Consultations Report highlighted the need for 'deep dive' diagnostics of a much larger sample of FIs to enable the NRB to better identify actual and potential risks within the banking system. With support from DFID, from February 2014 to December 2015, the NRB implemented the SIP in two phases using internationally led auditing firms. Following the completion of the SIP, the NRB has identified the major prudential risks in the banking system, including an in-depth identification of asset quality risks, and taken comprehensive corrective action to remedy weaknesses at the institution level.[8] The NRB also performs annual stress tests of the banking system and these have been supplemented by stress testing performed during the 2014 FSAP and the IMF Article IV consultations.

55. **In order to ensure the stability of the banking system, all banks need to either have a CAR greater than the regulatory minimum, or be in approved PCA or resolution programs.** Under DPC2, NRB completed the implementation of the first phase of special inspections of the banking system covering 27 FIs representing over 24 percent of banking system assets. Of these 27 BFIs, a number of BFIs were identified by the inspections as requiring supervisory enforcement action under the NRB PCA Bylaw. Of those, a few BFIs corrected their problems while some others are still under PCA or have merged with healthier BFIs and ceased to exist.

56. **Under DPC3, the second phase of the SIP covered an additional 27 FIs, with the total banks under SIP representing 64 percent of the banking sector's assets.** In the second phase, 10 banks were found to have CAR below the minimum required, of which 2 banks were maintaining negative CAR. While the majority of the banks and FIs have taken corrective actions on their own before being subject to further action, the NRB enforced PCA on one bank, and another was merged with other banks (this entity will no longer exist).

Prior action 3: The NRB has completed a diagnostic of the impact of the earthquake on BFIs in earthquake-affected Districts

57. **Following the earthquake there was a critical need to assess the impact of the earthquake on BFIs to detect and mitigate possible contagion between the banking and insurance sectors.** The impact of earthquake damage on loans for real estate development and purchase, and on borrowers using real estate as collateral, needed to be adequately quantified. By regulation, all real estate used as collateral is required to be insured, thus transferring risk to the domestic insurance sector (which in turn usually reinsures around 80 percent of coverage below NPR 10 million and 100 percent of coverage above that amount with foreign reinsurance companies). However, poor loan administration practices in some BFIs may have resulted in inadequate or expired insurance coverage of damaged collateral, which would lead to losses and impact capital. Therefore, the NRB and the NIB—with DFID support—launched diagnostics on the impact of the earthquakes on collateral values and bank

[8] For more detailed information on NPLs and the SIP, refer to annex 4.

solvency, as well as on insurance companies, using databases developed in the SIP. The diagnostic of BFIs was completed in December 2015, while the diagnostic of the insurance companies commenced in June 2016 and will be supported by DPC4.

58. **The BFI diagnostic covered 35 banks with a total balance sheet exposure from real estate of NPR 41.9 billion, and included 1,050 properties with a total value of NPR 70.9 billion.** Class A banks accounted for 82 percent of the sampled collateral value, while Class B and Class C institutions accounted for 12 percent and 6 percent, respectively. The total value of damaged collateral amounted to NPR 11.5 billion, of which approximately NPR 2.2 billion was severely damaged. Among the three BFI categories, Class A banks had the highest share of their total real estate collateral damaged (18.2 percent), while for Class B and Class C banks it was 8.4 percent and 4.3 percent, respectively. Only 10 banks had collateral that was severely damaged, with one bank accounting for 69.8 percent of the total severely damaged collateral sampled. Sixty-four hydropower projects (on- and off-balance sheet) were also part of the diagnostic, with Class A banks having the highest exposure (82 percent) to the sampled hydropower projects, and Class B's and Class C's exposure accounting for 17 percent and 1 percent, respectively. Twenty-eight percent of the total sampled hydropower projects were damaged. Class C banks had the highest share of their total hydropower collateral damaged (83 percent of the exposure) followed by less-significant damage on plants financed by Class A (31 percent of the exposure) and Class B (7 percent) banks.

Prior action 4: The NRB has issued a directive on the increase of minimum paid-up capital of BFIs.

59. **Past liberal licensing policies have contributed to the proliferation of banks (particularly in Class B and C), while supervisory resources and resolution frameworks have not kept up with the demand for supervisory capacity to ensure financial sector stability.** As a result, since late 2011, the NRB has pursued a policy which supports consolidation of the banking system by encouraging mergers of BFIs to create larger, stronger institutions. Mergers with stronger institutions have been the main tool used by the NRB to deal with weak or undercapitalized BFIs, and to prepare BFIs for a phased implementation of Basel III. Two policy instruments have been used by the NRB: a moratorium on new licenses for Class A, B, and C BFIs was declared, and in April 2014, an NRB bylaw was adopted to facilitate the acquisition of BFIs by other BFIs. As a result of these policies, which were supported by both DPC1 and DPC2, the number of BFIs has been reduced from a peak of 199 in January 2012 to 135 as of mid-July 2016, a reduction of 32 percent. Additional M&As are under way.

60. **The NRB continues to focus on increasing the consolidation of the banking system and enhancing its stability.** Pursuant to the Monetary Policy Declaration, the NRB issued a Directive to BFIs in July 2015 (Directive No. B.F.I.R.D/Policy/Circular/ABC/02/072/73), requiring a substantial increase in the minimum paid-up capital of Class A, B, and C institutions by mid-July 2017. Class A institutions will need to maintain NPR 8 billion. Class B institutions that are: (a) operating at the national level must maintain NPR 2.5 billion, (b) operating in 4 to 10 districts must maintain NPR 1.2 billion, or (c) operating in 1 to 3 districts must maintain NPR 0.5 billion. Class C institutions that are: (a) operating at national level or in 4 to 10 districts must maintain NPR 0.8 billion, and (b) operating in 1 to 3 districts must maintain NPR 0.4 billion. See annex 8 for analysis of the impact of this capital increase on BFIs.

Third Pillar: Strengthening the Legal and Regulatory Framework for Crisis Management, Banking and Insurance Supervision, and Payment Systems

61. **This pillar aims to strengthen the legal framework and supervisory capacity for bank resolution, the development of the financial sector safety net, and the elimination of settlement risks from the payments system.** This builds on the FSAP recommendations on strengthening the crisis management framework by strengthening the legal framework for bank resolution and deposit insurance. The impact of the earthquake highlighted the need for very urgent action to address major gaps in the financial crisis management architecture: (a) the NRB's own core banking system information technology (IT) has no disaster recovery site and was fortunate to survive the earthquakes; (b) in the event of BFI insolvencies caused by earthquake damage there is no formal mechanism for determining which BFIs are systemic and should be supported using fiscal resources; (c) the NRB does not yet have the resolution powers provided in the NRB Act Bill which would allow it to intervene quickly and effectively in undercapitalized BFIs; (d) the FINCO sector has only the most rudimentary and cumbersome resolution tools and is very weakly regulated and supervised; and, (e) the Deposit and Credit Guarantee Fund (DCGF) lacks the resources and back-up funding lines required to honor the deposit guarantee for less than a handful of small BFIs. With DFID and other donor support, DPC3 is underpinning reforms to address these issues and build on the support provided under DPC1 and DPC2.

62. Proposed trigger actions for DPC4 include: defining the legal framework for financial crisis management (with provisions for emergency liquidity assistance [ELA]), providing back-up funding facilities for the DCGF, and preparing a new Insurance Act (see annex 9). Related technical and financial support for these measures will be provided by DFID and FIRST Initiative.

Prior action 5: The NRB Act Amendments Bill has been approved by Parliament.

63. **Approval of the NRB Act amendments enhances the NRB's effectiveness in exercising its regulatory and supervisory authority.** The legal framework for bank resolution was outdated and incomplete, limiting the NRB's ability to resolve BFIs quickly. Conflicts between laws had provided scope for BFIs to challenge the NRB's resolution authority. The NRB's PCA framework reflects the limited resolution powers given to the NRB under existing laws.

64. **The DPC program supported efforts to strengthen the NRB.** DPC1 supported the MoF's efforts to prepare the NRB Act Amendments Bill aimed at strengthening and clarifying the bank resolution powers of the NRB in line with international practices. In 2014, under DPC2, this text was further improved to enhance the crisis management framework and bank supervisory powers of NRB in accordance with recommendations made by the FSAP. The authorities also completed preparation of a new BAFIA to conform to the NRB Act Amendments and Deposit and Credit Guarantee Fund Act bills, and to remove opportunities for different laws to be used as justification for hindering the exercise of supervisory authority. DPC2 supported preparation of the Bill, clearance by the Cabinet, and its submission to Parliament. DPC3 supported the enactment of the Bill in September 2016. This will result in establishing a modernized legal framework for bank resolution. DPC4 will support finalizing the regulations for implementation of the act and will support the operationalization of SIS at NRB.

Prior action 6: The Bill on Deposit and Credit Guarantee Fund (DCGF) has been approved by Parliament.

65. **The deposit insurance system has a very weak legal framework based on DCGC bylaws.** The DCGC[9] lacks an IT system to administer the system and conduct pay-out operations, and the regulatory framework for deposit insurance is incomplete. DPC1 supported the approval by the MoF of a draft DCGF Bill, prepared with the assistance of the World Bank, IMF, and DFID. It provided the legal framework for the deposit insurance scheme, which had been operating within a weak framework of regulations and bylaws, rather than specific legislation. DPC2 supported enhancement of the text of the Bill to incorporate recent updates to the International Association of Deposit Insurers Core Principles for Effective Deposit Insurance Systems, and to reflect the recommendations made by the FSAP, ensuring the harmonization and convergence with the NRB Act Amendments and the new BAFIA and then submitting the bill to Parliament. The new deposit insurance system follows the 'pay-box' model, and the regulatory oversight of the DCGF will be limited to areas such as reporting of guaranteed data on deposits and depositors, collection of annual deposit guarantee premiums, and management of the investments of the Deposit Guarantee Fund (DGF), reimbursing the guaranteed depositors through the pay-out process in case of any BFI failure. A decision was also made to continue housing the DGF outside the NRB given the additional burden it would place on the NRB's limited resources at a time when they are stretched by capacity building for the transition to consolidated supervision. DPC3 supported the enactment of the DCGF Act in September 2016. This will result in the establishment of the deposit guarantee system and a fully operational DCGF, which is particularly relevant in the aftermath of the disaster and the ensuing losses to FIs that gave rise to depositor protection concerns. DPC4 would support finalizing the regulations for implementation of the Act.

Prior action 7: The DCGC and NRB have executed a memorandum of understanding governing cooperation and exchange of information.

66. **The GoN is committed to increasing the fund's resources through budgetary support and the fund's income through deposit guarantee premiums.** With regard to funding sources, the DCGF Bill proposes, among others: (a) an increase in authorized capital up to NPR 10 billion (GoN contribution), (b) an increase in premiums paid by BFI's in case of need (private sector), and (c) additional special contribution to be paid from members (private sector). For contingency funding, the DCGF Bill proposes: (a) direct loans from the GoN to the fund, and (b) direct credit subsidies or donations from private sector or external sources (through GoN guarantees to the credit amount required by the fund).

67. **The enactment of the DCGF Bill establishes the framework to build a contingency backup funding mechanism coordinated among the MoF, NRB, and DCGF.** As a first step, supported by DPC3, the DCGC and NRB signed a memorandum of understanding governing the exchange of information and cooperation. The three institutions would need to implement the plan for a contingency backup funding mechanism to ensure liquidity and additional funding for the DCGF by signing memorandums of understanding (supported by DPC4) for: (a) a three-way special funding arrangement to grant reversible assistance funds and government subsidies to the DCGF; (b) an agreement between the MoF

[9] The name DCGC, as a deposit and credit insurer, has been replaced by DCGF following the approval of the new DCGF bill by the Parliament.

and DCGF for a standby credit line at the disposal of the fund should there be a need for additional funds/financial means to meet anticipated liabilities for which its existing reserves are insufficient to meet; and (c) a liquidity funding repurchase agreement between NRB and DCGF to ensure immediate liquid financial resources to DCGF to fulfill its liabilities.[10]

68. **The business continuity framework within the NRB as well as BFIs is inadequate, as highlighted in the aftermath of the earthquake.** Business continuity within the financial sector is particularly important in the context of maintaining stability and minimizing operations risk. Currently, the NRB does not have a Disaster Recovery Site (DRS) to ensure business continuity during natural disasters. The Post-Disaster Needs Assessment (PDNA) exercise carried out by the GoN after the earthquakes in May–June 2015 recommends the establishment of a DRS for the NRB as part of the recovery strategy. With support from DFID, the NRB has completed the site selection process and preparation of procurement documents. With further support from DFID, the DRS is expected to be operational by end-2017. DPC4 could also extend the initiative to cover BFIs in the form of compliance with business continuity guidelines.

Prior action 8: The NRB has implemented the following three actions to reduce payments system risks: (a) alignment of the operating hours of the NRB's banking department with the operating hours of SWIFT; (b) implementation of online transfers of funds between NRB branches; and (c) implementation of a pre-settlement file system.

69. **Although the NRB has the objective 'to develop a secure, healthy, and efficient system of payment', progress in payment system modernization has been slow.** Cash and checks remain the dominant modes of payment. The limited use of electronic payments, the lack of robust payment system risk-management frameworks, and the limited NRB oversight increases potential risks to the financial system, which could potentially result in payment systems difficulties contributing to financial instability. While the NRB managed post-disaster payments without too much disruption, it became evident that weaknesses exist in the payments system. DPC2 supported the approval by the NRB board of a Nepal Payments System Development Strategy.

70. **Settlement risk is a serious concern in the electronic check clearing system.** This could be addressed through some simple operational measures, including through an extension of SWIFT operating hours in the Banking Department of the NRB, facilitation of the online transfer of funds from one office of the NRB to another, and preparation of a pre-settlement file ahead of the final settlement file.[11] These operational measures supported by

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[10] For which the NRB needs to establish an operational framework for the provision of ELA. The NRB does have a Lender of Last Resort Policy which was established as a policy directive and used in 2011 when the banking sector faced a liquidity squeeze. As per the Lender of Last Resort Policy 2067, institutions utilizing the facility are charged interest rate equivalent to the bank rate and assets shown on the balance sheet are put up as collateral. In addition, during the liquidity crisis of 2011, the NRB also introduced a 'Special Refinance for Liquidity Management' facility (NRB Circular 27 FY2067/68). Under this facility, banks could apply for refinancing at 7 percent interest rate for 120 days up to 60 percent of their core capital with up to 80 percent of the bank's good loans put up as collateral. The Special Refinancing for Liquidity Management facility was removed in November 2011 when liquidity pressures on the banking sector eased.

[11] At present, there is no automated interbank settlement system in Nepal. All bank-to-bank payments are currently made by SWIFT to the Clearing Division in the Banking Office at the NRB, where they are printed out and manually entered into the NRB's accounting system via postings to settlement accounts in the general ledger. If the SWIFT service is not available, then paper transfer instructions are hand-delivered to the NRB, which imposes an additional workload on the NRB management and staff. With a view to bring down the

DPC3 would go a long way toward minimizing settlement risk that could arise as a consequence of the unwinding of net settlement obligations when balances in the accounts of the banks at the NRB are inadequate. This would enable the banks to be aware of their liquidity obligations and make necessary arrangements for funding their accounts. DPC4 will support further implementation of the Nepal Payments System Development Strategy by assisting the NRB in creating the legal, regulatory, and oversight framework for payment systems.

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

71. **This pillar would support increased transparency of the financial system and improved governance of BFIs, including state-controlled BFIs.** The process of improving the quality of financial reporting by BFIs has been advanced by the issuance of guidelines by the NRB governing the staged transition of the banking sector to the NFRS (which was a PA for DPC2). Transparency has also been improved by the enactment of key AML/CFT laws which resulted in Nepal being removed from the FATF 'grey list' of countries. As recommended by the FSAP, the governance of BFIs has been improved by the new BAFIA, which contains provisions strengthening fit and proper requirements and minimum qualifications for directors and chief executive officers (CEOs). The NRB has also ensured—with support from DPC2—that adequate governance measures are included in a Directive 6/071 on governance of BFIs, which would also now apply to government-appointed directors and CEOs.

72. **Transparency and financial reporting by BFIs remains weak, limiting the strength of supervision, as well as the weakening the detection of emerging financial sector risks.** In particular, there is significant scope to improve accounting standards by adopting IFRS for loan loss classification and provisioning, capital adequacy, ownership, loan concentration, and other disclosures.

73. **Nepal is transitioning to IFRS by adopting NFRS that are IFRS compliant (new legislation is not required for this purpose).** The NFRS transition process is being carried out in a staged manner during 2014–2017 (Class A BFIs in FY2015–2016, and all other BFIs in FY2016–2017) in order to allow for the development of the capacity of regulators and practitioners to implement NFRS. Due to the disruption of the banking sector by the earthquake and trade embargo, this schedule may be put back by a year. The initiative is being supported by extensive capacity building undertaken by DFID, the World Bank, and other donors. DPC2 supported the adoption by the NRB of guidelines, issued by the NRB in November 2014, establishing the NFRS transition timetable and required preparatory actions for each class of FI. Issuance of NFRS-compliant regulation for BFIs is proposed as an

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number of non-SWIFT transfers, NRB banking hours have now been extended until 4 p.m. The NRB has also completed enabling all its branch office to make online transfers. To mitigate settlement risk and to enable banks to make arrangements for funds (to fund their net debit positions), Nepal Clearing House Limited will generate the Net Clearing Position (NCP) file (pre-settlement file) at least 30 minutes before the final settlement. The same NCP could thereafter be sent to the NRB for final settlement. By generating the NCP at an earlier time, it will enable banks to make arrangements for funds to take care of their net debit positions. The NRB will issue a suitable directive to Nepal Clearing House Limited and member banks for implementation of the same. Such a pre-settlement NCP file will be made available in an online mode to all the member banks to enable the banks to monitor their clearing positions and make necessary arrangements for funding their accounts as required.

indicative policy action DPC4. The adoption of NFRS will improve accounting standards and enhance transparency and disclosure.

Prior action 9: The Bill on Banks and Financial Institutions Act has been approved by Parliament.

74. **The outcomes of the IMF-led diagnostics of BFIs, the DFID-supported SIP, and the FSAP have all identified major weaknesses in governance that pose risks to the banking system.** Significant governance problems in state-controlled commercial banks have not emerged in part because both of the largest state banks (the NBL and RBB) were unable to engage in large-scale lending for over a decade owing to negative capital adequacy, and both were also under the management of the NRB. However, governance practices could deteriorate in the future. In addition, governance practices in private banks were found to be lacking, resulting in the closure of BFIs by the NRB over the past three years, with consequences for both stability and confidence in the banking system. Weaknesses in the governance provisions gave rise to numerous conflicts of interest on the part of bank directors who lack independence from shareholders. Professional qualification requirements for directors and senior managers are limited, and government-appointed CEOs and directors of the two state-controlled commercial banks are exempt from qualifications requirements. Supported by DPC2, the authorities completely redrafted governance-related sections in the new BAFIA [12], in order to strengthen the fit and proper tests, as well as the professional qualifications and experience requirements applied to BFI directors and CEOs. This includes all government-appointed directors and CEOs of state-controlled banks, thereby removing the exemption from fit and proper tests and qualification requirements previously given to them. DPC3 supported the enactment of BAFIA, while DPC4 will support issuance of regulations to implement the act.

Prior action 10: The Cabinet has approved the Asset (Money) Laundering and Prevention Regulations.

75. **In 2013 Nepal faced being blacklisted by the FATF because of its weak AML/CFT framework.** Blacklisting would have cut Nepal's financial system off from the international financial system and had the potential to cause massive disruption to trade and the flow of remittances. DPC1 supported the issuance of presidential ordinances on Mutual Legal Assistance, Extradition, and Organized Crime in 2013. There was no Parliament at the time, but all major parties agreed that the ordinances were essential. DPC2 supported the enactment of these ordinances in early 2014, as soon as the new Parliament was constituted. DPC3 underpins the issuance of the Asset (Money) Laundering and Prevention Regulations, which were never issued when the Asset (Money) Laundering and Prevention Act, 2064 was

[12] The BAFIA Bill makes the following changes to governance requirements for BFIs: (a) new Section 17 - 'Professional Director'. The position of professional director was previously to be filled from a list maintained by the NRB. In the new version, a bank can select its own professional director as long as the director meets certain qualifications. Some of these qualifications are listed in Section 17, while the remaining qualifications will be prescribed through NRB directives; (b) Section 18 - 'Disqualification of Directors' has been expanded to include more detail, new provisions, an increase in the age of directors, cooling-off periods for NRB executives, and so on; (c) a new Section 19 - 'Circumstances for Ineligibility to Remain in Office of Director'; (d) Section 21 - 'Details of Directors to be Submitted'. This section has been greatly expanded; (e) Section 16 in the Bill and Section 19 in the current BAFIA - 'Qualification of a Director' has been changed to require a director to meet criteria to be defined by the NRB; (f) Section 25 in the Bill and Section 14 in the current BAFIA - 'Functions, Duties and Powers of the Board of Directors' has been expanded; and (g) Section 29 in the Bill and Section 27 in the current BAFIA - 'Functions, Duties and Powers of the Chief Executive' has been expanded.

promulgated in 2008. The regulation was approved by the Cabinet on October 27, 2016 and is expected to assist in effective implementation of AML/CFT regime. A Mutual Evaluation Review is scheduled for 2018, which will assess the implementation progress made by Nepal and will determine whether or not Nepal will remain off FATF's 'grey list'.

76. Table 3 provides an overview of the proposed PAs and analytical underpinnings of DPC3 discussed in this section.

Table 3. DPC3 PAs and Analytical Underpinnings

PAs	Analytical Underpinnings
The MoF has endorsed the NBL Strategic Divestiture Plan and submitted it to the Secretariat of the Privatization Committee.	Financial Sector Assessment Program (FSAP) Technical Note of State Controlled Banks (2014) by WB, Financial Report of Nepal Bank Limited
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 financial institutions and (b) PCA Programs for all financial institutions found to be undercapitalized.	FSAP Technical Note (2014) on Crisis Preparedness by IMF, Special Inspection Program report (2016) by KPMG, Report prepared under Contingency Planning (2010) supported by FIRST Initiative
The NRB has completed a diagnostic of the impact of the earthquake on BFIs in the earthquake-affected districts.	Post-Disaster Needs Assessment (PDNA) prepared for National Planning Commission by WB (2015), Fast Diagnostics of BFIs by KPMG (2016) under DFID support
The NRB has issued a directive on the increase of minimum paid-up capital of BFIs.	FSAP Technical Note (2014) on Stress Testing by IMF, Report on Bank Resolution Capacity Building (2014) supported by FIRST Initiative, Findings of IMF's Article IV missions between 2012/13
The NRB Act Amendments Bill has been approved by Parliament.	Technical consultation provided to NRB by Adam Smith International under DFID's Financial Sector Program (FSP), Review of draft NRB Act by Legal Counsel of the Bank under DPC 2 and 3 operations, Review of draft NRB Act by IMF Legal staff , FSAP Technical Note (2014) on Crisis Preparedness by IMF
The Bill on DCGF has been approved by Parliament.	FSAP Technical Note (2014) on Financial Safety Net by IMF, Advisory services in drafting of DCGF bill provided by Adam Smith International under DFID's Financial Sector Program (FSP), Review of draft bill by Price Water House (India) under DFID's Financial Sector Stability Project (FSSP), Report prepared under Contingency Planning (2010) supported by FIRST Initiative
The DCGC and NRB have executed a memorandum of understanding governing cooperation and exchange of information.	FSAP Technical Note (2014) on Financial Safety Net by IMF, Technical consultation (2015) provided to NRB and DCGC by Adam Smith International under DFID's Financial Sector Program (FSP), Technical consultation provided to NRB under Bank Resolution Capacity Building (2014) supported by FIRST Initiative
The NRB has implemented the following three actions to reduce payments system risks: (a) alignment of the operating hours of the NRB's banking department with the operating hours of SWIFT; (b) implementation of online transfers of funds between NRB branches; and (c) implementation of a pre-settlement file system.	FSAP Technical Note (2014) on Payment & Settlement Systems by WB, Nepal Payment System Development Strategy (2014) supported by WBG,
The Bill on BAFIA has been approved by Parliament.	Review of draft BAFIA and recommendations provided by Legal Counsel of WB under DPC 2 and 3 operations, Review of draft BAFIA and recommendations provided by IMF staff , Report on Crisis Management (2011) supported by FIRST Initiative, FSAP Summary Report (2014)

PAs	Analytical Underpinnings
The Cabinet has approved the Asset (Money) Laundering and Prevention Regulations.	Assessment by Asia Pacific Group on Money Laundering, an associate member of Financial Action Task Force (FATF)

Note: DCGC = Deposit and Credit Guarantee Corporation.

4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

77. The Country Partnership Strategy (CPS) for FY2014–2018 is centered on two pillars: (a) increasing economic growth and competitiveness, and (b) reducing social exclusion and providing opportunities to increase prosperity. One of the three key outcomes of pillar 1 is enhancing financial sector stability. The CPS acknowledges persistent financial sector weaknesses and the risks they pose to macroeconomic stability and economic growth, as illustrated by the liquidity crisis in 2011. It recognizes the efforts undertaken by the authorities to address the root causes of financial sector difficulties and the support provided by the World Bank, IMF, and DFID. The CPS makes the case for the use of DPCs to support the efforts of the authorities to reform the sector.

78. The operation supports the World Bank Group's twin goals. Ensuring the stability of the financial system in Nepal is critical to allow 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.

79. **The proposed operation builds on significant prior engagement.** As mentioned earlier, the proposed DPC3 supports the GoN's medium-term policy program to address the vulnerabilities of the financial sector in Nepal and is a continuation of the two 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).

4.4 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

80. **Since 2013, the NRB has enhanced the participatory process by stepping up the consultative process with stakeholders to keep pace with the changing environment and to make appropriate amendments to the existing rules and regulations in the financial sector.** Regulatory changes are drafted by the NRB and shared with relevant stakeholders—such as the associations of BFIs—for their feedback before they are finalized and submitted to NRB management and the NRB Board for approval. The High-Level Financial Sector Reform Recommendation Committee, headed by the finance minister, takes key decisions on major financial sector reforms (such as the RBB and NBL restructuring) and facilitates consultations with key GoN stakeholders. The authorities have also used a consultative process to prepare the FSDS led by the MoF and including the NRB, the NIB, the Securities and Exchange Board, and the Ministry of Cooperatives and Poverty Alleviation.

81. **The 2014 IMF-World Bank FSAP provides additional insights**. The FSAP was a first for Nepal and provides an in-depth review of all aspects of the financial sector, helping identify specific reforms that can be integrated into the Government's medium- to long-term

reform agenda for the financial sector. Starting in mid-2015, the World Bank, IMF, and DFID have formed a coordinating group that meets regularly to discuss capacity building needs and ensure that the respective institutions' support to the authorities is harmonized.

82. **DFID is working in close partnership and coordination with the World Bank on financial sector issues.** DFID has given strong TA and capacity-building support to both the World Bank and the GoN for the preparation of the DPC series, and undertook implementation of a larger operation to provide capacity-building support for the GoN's financial sector program and the FSDS, including boosting capacity to complete the proposed triggers for DPC3 and DPC4. The cooperation of the World Bank with DFID should be specifically noted as an example of how two development partners can work together to contribute to the success of a complex and challenging set of operations. Starting in early 2012, the World Bank and DFID established working arrangements that provide smooth coordination between their two teams, with DFID contributing experts to work as part of the World Bank team and all missions identified to the authorities as joint missions, while the World Bank team provided inputs for the design of DFID support. In parallel, DFID TA support is linked explicitly to the GoN's efforts to implement the DPC series' PAs and triggers in key areas. DFID's willingness to commit large-scale resources to capacity building has undoubtedly increased the authorities' confidence to move ahead with highly demanding medium-term reforms, such as the NRB's SIP and the transition to NFRS.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

83. **DFID has calculated that a financial crisis in Nepal would result in an additional 2 million people remaining below the poverty line over 10 years.**[13] The financial sector reform program supported by the DPC series was designed based on the principle of least-cost solutions to addressing banking sector stress, with private shareholders and unsecured creditors bearing the brunt of the costs of bank failures, while giving priority to individual depositors in the process of bank resolution. The DPC series supports a sustained focus on financial sector stability, which is crucial for ensuring broader economic recovery in the aftermath of the earthquake and trade disruptions. In addition, ensuring the stability of the financial system in Nepal is critical to allow BFIs to continue expanding financial inclusion, which is important for poverty alleviation, 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. It facilitates access to essential services, social protection, and markets, as well as enabling women's economic empowerment. In addition, the DPC supports reforms to the payment system which help ensure that the retail payment system is safe and efficient. The retail payment system is the backbone for digital transaction accounts and remittance transfers, which play a critical role in reducing poverty. Finally, through the support to the DCGF law and the DCGF institution, the DPC plays a critical role in protecting small, low-value, and

[13] DFID Nepal, Business Case and Intervention Summary, Macroeconomic Reform Project, January 2013.The analysis is based on a regression analysis which correlates changes in bank credit outstanding with GDP growth (historically the correlation is between 0.9 and 1 – I.e. more or less perfect). The resulting changes in GDP growth from a financial crisis was applied to poverty levels in Nepal using its standard correlation. That is, banking crisis causes shrinkage in credit causing decline in GDP growth rate resulting in people being pulled out of poverty at a lower rate than population growth, with the result that more people are poor.

poor depositors. Implementation of Asset Laundering Prevention Regulation is expected to improve disclosure standards and transparency (see annex 10).

5.2 ENVIRONMENTAL ASPECTS

84. **Actions proposed under this operation are not expected to have any negative effect on the environment.** The prior actions support GoN's medium-term reform program to enhance the stability and transparency of Nepal's banking system. The key reform action plans under this operation include enactment of laws concerning strengthening the corporate governance of BFIs, enhanced bank resolution powers of the central bank and improving financial safety net of small low-value and poor depositors. As such, none of the prior actions are expected to have any negative environmental impact (see annex 10).

5.3 PUBLIC FINANCIAL MANAGEMENT, DISBURSEMENT, AND AUDITING ASPECTS

85. **Public Financial Management (PFM).** The 2015 Public Expenditure and Financial Accountability (PEFA) Assessment concludes that Nepal has made substantial progress in deepening the structures and processes of PFM, particularly in the use of Information Technology (IT) in PFM processes. Investment efficiency gains have been achieved despite the political transition period (2006–2010), a period when reform was not a priority. If these improvements are linked and catalyze reforms in all phases of PFM, it would increase the chances of Nepal's graduation to middle income status and help in reducing poverty. The commitment to change and reform PFM systems and process by the GoN has produced results. As compared to the first PEFA Assessment concluded in 2007, of the 28 performance indicators, 16 indicators improved, 10 indicators remained unchanged, and 2 indicators deteriorated.

86. **A number of PFM-related reforms are currently under implementation through the Multi-donor Trust Fund supported by DFID, Australia, Denmark, Norway, the European Union, U.S. Agency for International Development, and Swiss Development Corporation (SDC), which is administered by the World Bank.** Implementation of the Single Treasury System of Accounts (TSA) has been recognized as a successful intervention with clear outputs achieved before the scheduled date. Similarly, there have been other interventions undertaken through the Multi-donor Trust Fund such as: strengthening of the Office of the Auditor General (OAG) in applying risk-based auditing, improving the techniques for performance auditing, OAG's initiative of engagement of the civil society organizations in conducting performance auditing, engagement of civil society organizations in PFM-related works, various analytical works in PFM including Operational Risk Assessment in PFM, Public Expenditure Tracking Survey in education sector, and Report on the Observance of Standards and Codes (Accounting and Auditing), and repeat PEFA assessment. Budget credibility is internalized; budget outturns compared to original are stable; and monitoring of budget, especially arrears, has improved with the implementation of the TSA. Multiyear budget planning has assisted to maintain sound macro fiscal aggregates. Costed sector strategies can lend to formulation of realistic procurement plans and overall improve budget implementation. Budget information has become more transparent after the implementation of Government Finance Statistics classification and the TSA. The budget is published both physically and online and the public's access to fiscal reports is good. However, the fiscal reports are not comprehensive and many autonomous government agencies and donor projects operate outside the TSA/financial management information system framework. The Public Procurement Act (2007) and Public Procurement Rules (2007)

regulate public procurement. The Act (clause 64) established the Public Procurement Monitoring Office (PPMO) and defines its functions and powers. The PPMO functions directly under the Office of the Prime Minister and Council of Ministers. PPMO is required to ensure, among others, that all public procurement considers the principles of (a) an open, transparent, objective, and competitive procurement and (b) obtain the maximum returns of public expenditures in an economical and rational manner by promoting competition, fairness, honesty, accountability, and reliability in public procurement processes. In view of successful implementation of the TSA system and recognizing the need for further work on integrated financial management system, additional financing to strengthen the PFM system is being proposed.

87. **Despite continuing political instability, the OAG has used its best efforts to submit the Auditor General's Annual Report to the President within nine months of the end of the fiscal year.** The Office of the Auditor General has been able to submit its Annual Report to the President consistently within nine months in since 2011. As in the previous audit reports, the Auditor General 2015 Report also highlighted some systemic weaknesses in the following areas: internal control systems, pre-audit and internal audit, follow-up on audit recommendations, separation of responsibilities between treasury and audit function, and timeliness of entity-level audits. While fiduciary risks exist, they have no direct impact on this operation and the recent improvements and the mitigation measures secure acceptable fiduciary arrangements for the DPC**.**

88. **Disbursements.** The proposed operation is the third in a series of development policy single-tranche credits. The credit proceeds will be made available to the Government upon approval of credit effectiveness. The GoN 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 GoN. At the request of the MoF, the disbursement will be made into the treasury account of the GoN 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 tranche proceeds and its credit in the General Fund, including the date of receipt, the exchange rate applied to convert the credit proceeds into the Nepalese rupees, and the name and number of the Government's bank account in which the funds have been deposited. The GoN would not use the credit proceeds to pay for expenditures included in the World Bank's standard negative list. If the World Bank determines at any time that an amount of the credit was used to make a payment for an excluded expenditure, the borrower shall, promptly upon notice from the World Bank, refund an amount equal to the amount of such payment to the World Bank. Amounts refunded to the World Bank upon such notice shall be cancelled in line with World Bank Policy 8.60.

89. **Audit.** There are notable positive developments, including the successful implementation of a new accounting system and improved financial reporting practices. NRB has been in consultation with ICAN and ASB to finalize model financial statement that is consistent with the NFRS which is required to be adopted by commercial banks by the end of FY 2017. The Safeguard Assessment Update of February 2016 found that the NRB had made limited progress in improving its safeguards framework and addressing recommendations from the previous assessment in 2011. In particular, the quality of the 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

the central bank's autonomy and governance arrangements. The assessment concluded that strong commitment from the NRB Board and management is essential to improve the internal audit function and reinforce controls in key areas, including foreign reserves management and currency operations. No audit will be required under this DPC as permitted under Operational Policy 8.60.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

90. **The MoF would be responsible for overall oversight and implementation of the present DPC, in close coordination with the 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 through investment-lending and TA operations.

91. **Since this is the second of three programmatic DPCs, the World Bank team would continue to provide support while undertaking monitoring and evaluation, to review progress and make adjustments, when required.** The overall status of the Government's reforms will be monitored to determine whether country conditions and the specific policy measures are being fulfilled. DFID will separately carry out periodic management and evaluation reviews of the implementation of its support program linked to DPC3 and DPC4 reforms.

92. **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 DPO 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, as a result 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 corporate Grievance Redress Service (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

93. **The overall risk of the proposed operation is Substantial.** The overall risk rating level of this operation is substantial. The main risks to achieving the intended results of the reform program are political and governance risks, institutional capacity risks, fiduciary risk and stakeholder risk.

94. **Political and governance risk. The likelihood of political instability risk materializing is Substantial, and the severity of impact on achieving the project development objective remains Substantial.** Political uncertainty has been significant in post-conflict Nepal following the signing of the Peace Agreement, characterized by frequent government changes. Since the Board endorsed the current CPS in May 2014, the Prime Minister has changed three times, most recently in August 2016. The government will be changing again in mid-2017 as part of the power-sharing agreement among the coalition partners. However, the Nepalese authorities demonstrated during the preparation of DPC1 and DPC2 that they are able to take critical decisions in an uncertain political environment.

Therefore, implementation risks for DPC3 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 economic crisis has brought about revenue loss to the government and would require funding to finance the budget deficit. DPC3 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.

95. **Institutional capacity for implementation and sustainability.** The pace of implementation of the Government's 2014–2016 reform program could be slowed down by institutional capacity risks and lack of political will for reform. The phased approach of a series of DPCs is a risk-mitigating factor. The actions supported under the proposed series of DPCs forms the second phase of the medium-term Government financial sector reform program initiated in 2012, supported by DPC1 and DPC2. This multistage approach has helped to gradually generate and solidify consensus on the broader reform program. Legislative risks of delays in approval of laws is mitigated by the fact that the Constituent Assembly has finally completed drafting the constitution and has now been transformed into a Parliament with the ability to focus on key legislation, including financial sector laws. Extensive TA helps mitigate institutional capacity risks.

96. **Stakeholder risk.** The risk of resistance from vested interests is substantial. The Government has announced (in the 2014 budget speech) its commitment to divest from the NBL and find a reputable bank strategic partner while keeping the RBB as a state-controlled bank. It is also possible that this decision will face resistance, notably from stakeholders who have vested interests. These risks are mitigated by the financial benefits to the NBL staff from the divestiture (despite the bank's return to profitability, it has been prohibited from paying annual bonuses—a significant component of staff's total compensation—as long as the Government is a significant shareholder) and the now over-60 percent majority stake in the NBL built up by the Government in the course of recapitalization, which limits the ability of other shareholders to interfere in the divestiture process.

97. **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. However, there are mitigation measures, such as implementation of TSA, strengthening of the OAG in applying risk-based auditing, use of IT in auditing, and participation of civil society organizations in performance auditing , being implemented to address some of the fiduciary risks and audit observations, which do not directly affect the operation.

98. **Environmental and Social risk**. The proposed operation aims to address the financial stability risks associated with climate resilience and disaster risks, such as earthquakes, which include heightened financial stability risks and operational and business continuity challenges. The financial sector is centered in Kathmandu where the central bank is located, as well as the headquarters of all the commercial banks. The central bank also has regional offices in seven other cities while branches of commercial banks operate in many cities and towns across the country. As a mitigating measure against earthquake, the disaster recovery site for the central bank is being established in one of the regional offices of Eastern Nepal (Biratnagar). All commercial banks also have a disaster recovery site in one of the branch offices. Several PAs of DPC3 are designed to mitigate the adverse effects of the earthquake on the safety and soundness of the banking system by consolidating the financial

sector and improving its solvency, by bolstering the capacity of the Nepali authorities to identify and respond decisively to instances of financial distress, and by generally strengthening the robustness of prudential regulatory and supervisory frameworks, while ongoing TA is providing support for business continuity. Thus, while risks have increased following the earthquake, sustaining financial sector reform actions proposed in DPC3, becomes even more important due to the need to sustain recovery efforts.

99. Table 4 provides an assessment of the risk categories and an overall risk assessment to the project development objective.

Table 4. 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	Substantial
9. Other	N.a.
Overall	**Substantial**

ANNEX 1: DPC3 POLICY AND RESULTS MATRIX

Completed PAs under DPC2 (May 2015)	PAs (in bold) or Benchmarks to be Completed by January 2017 for DPC3	Indicative Policy Actions to be Completed by January 2018 for DPC4	Results (June 2019) (Baseline = July 2014)
Enhancing Financial Sector Development			
• The MoF has endorsed the Nepal 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 is in place and is meeting as needed. Coordination has improved.
Restructuring and Consolidating the Financial System			
• The 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 NPR 86.57 million; (c) the sale of non-banking assets of the RBB for an amount equal to NPR 30.90 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 requirements of the new BAFIA and 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 11.2 (mid-July 2016) and the bank continues to register positive net income with profit after tax of NPR 2.6 billion in FY16.
• The NBL has taken measures to implement the second phase of the NBL's recapitalization plan by (a) converting a loan from the recipient of NPR 2.49 billion into capital; (b)	**The MoF has endorsed the NBL Strategic Divestiture Plan and submitted it to the Secretariat of the**	• An international tender for the sale of the Government's stake in the NBL has been published.	**Results indicators:** The NBL meets all regulatory norms (***including CAR > 10 percent***), has positive net income for the preceding four quarters, and is controlled by private investors.

Completed PAs under DPC2 (May 2015)	PAs (in bold) or Benchmarks to be Completed by January 2017 for DPC3	Indicative Policy Actions to be Completed by January 2018 for DPC4	Results (June 2019) (Baseline = July 2014)
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. • 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.	**Privatization Committee.**		**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 11.4% (mid-July 2016), is profitable, and a divestiture strategy has been drafted by the NBL and approved by the MoF.
• 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 PCA Programs (including Resolution Programs) for all FIs found to be undercapitalized.	• **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 FIs found to be undercapitalized.**		**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 54 banks given Special Inspections have recorded capital adjustments required by the inspections. **Baseline**: The current compliance-based supervision is inadequate to identify potential troubled BFIs and banking system risks. Reported system CAR is 12.03 percent for Class A, 15.6 percent for Class B, and 15.9 percent for Class C institutions. Action has not been taken to resolve all undercapitalized banks. **Results so far:** CAR for all Class A banks was 12.2% in FY2016. All banks met the minimum CAR During the SIPs, 23 banks were found to be maintaining below-minimum CAR (following NFRS methodology). Most banks have recorded the required adjustments. Corrective measures were undertaken by individual banks while PCA was applied to only four banks. Insurance sector diagnostics are ongoing.
• The NRB has issued a notice to licensed BFIs to conduct an assessment of the impact of the earthquake on their assets (collateral and loans) and physical infrastructure.	• **The NRB has completed a diagnostic of the impact of the earthquake on BFIs in the earthquake-affected districts.**	• 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 NRB continues its policy of consolidating the banking system by	• **The NRB has issued a directive on the increase**	—	**Results indicators:** ***The total number of BFIs is reduced to 130*** or less and licensing regulations are

Completed PAs under DPC2 (May 2015)	PAs (in bold) or Benchmarks to be Completed by January 2017 for DPC3	Indicative Policy Actions to be Completed by January 2018 for DPC4	Results (June 2019) (Baseline = July 2014)
(a) maintaining its moratorium on new licenses issuance for Classes A, B, and C FIs as defined in BAFIA and (b) by adopting a new bylaw to facilitate acquisitions of BFIs by other BFIs.	**of minimum paid-up capital for BFIs.**		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 FY2016 Q4 (mid-July 2016) the total number of Class A, B, and C BFIs has decreased to 135.
• The NRB has issued a notice requiring all NRB-authorized Financial Nongovernmental Organizations (FINGOs) to convert to Class D 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 FINCOs out of 17,000 operating; the remainder are licensed by the Registrar of Cooperatives, which has no supervisory authority and no resolution powers, and (b) there are 47 FINGOs licensed by the NRB. **Results so far:** 23 FINGOs (of the 27 remaining) have applied for conversion to Class D MFI.
Strengthening the Legal and Regulatory Framework for Crisis Management, Banking and Insurance Supervision			
• The NRB Act Amendment Bill has been approved by Cabinet for submission to Parliament.	• **The NRB Act Amendments Bill has been approved by Parliament.**	• The NRB has issued the enabling regulations (or amendments to existing regulations) for the NRB Act Amendments	**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. Conflicts between laws provide scope for FIs to challenge the NRB's resolution authority. The NRB's PCA framework reflects the limited resolution powers given to the NRB under existing laws. **Results so far:** The bill was approved by the Parliament in September 2016. The enabling regulations (including

Completed PAs under DPC2 (May 2015)	PAs (in bold) or Benchmarks to be Completed by January 2017 for DPC3	Indicative Policy Actions to be Completed by January 2018 for DPC4	Results (June 2019) (Baseline = July 2014)
			amendments to existing regulations) need to be finalized.
—	—	• The NRB has implemented and operationalized an SIS.	**Results indicators:** The NRB has strengthened its supervisory capacity and is largely compliant with 4 more BCPs and a new SIS has been implemented. **Baseline**: The NRB is noncompliant or materially noncompliant 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:** An expression of interest was issued to which 15 companies have expressed interest to implement a new SIS. BCPs compliance will be assessed in the next FSAP.
• The Bill on the DCGF has been approved by the Cabinet for submission to Parliament.	• **The Bill on DCGF has been approved by Parliament.**	• The DCGF has approved key regulations covering: DCGF's relationship with BFIs, the guaranteed deposit verification process, BFI reporting, payout and reimbursement of guaranteed deposits, and a DGF investment policy.	**Results indicators:** Legal framework is in place for the Deposit and Credit Guarantee Fund (DCGF) to be the administrator of the Deposit Guarantee Fund (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 bylaws. The DCGC lacks any IT system to administer the system and the regulatory framework for deposit insurance is largely incomplete. **Results so far:** The bill was approved by the Parliament in September 2016. The enabling regulations need to be finalized.
—	• **The DCGC and NRB have executed a memorandum of understanding governing cooperation and exchange of information.**	(i) The NRB and MoF have executed an agreement to provide backup funding to DCGF; (ii) DCGF and NRB have executed a technical repurchase	**Results indicators:** The legal and institutional framework for financial crisis management has been established. **Baseline**: The financial crisis management architecture is limited to a High-Level Financial Sector Committee with the power to coordinate government responses but

Completed PAs under DPC2 (May 2015)	PAs (in bold) or Benchmarks to be Completed by January 2017 for DPC3	Indicative Policy Actions to be Completed by January 2018 for DPC4	Results (June 2019) (Baseline = July 2014)
		agreement to provide liquidity to the DCGF; and (iii) The NRB, MoF, and DCGF have executed a credit line facility for additional funding to the DCGF.	without special anti-crisis intervention powers, and ELA is inadequate. **Results so far:** The first step in setting up this framework has been completed with the signing of memorandum of understanding between the DCGC and NRB governing the cooperation and exchange of information. The liquidity and backup arrangements in a crisis are yet to be finalized.
• The board of the NRB has approved the Nepal Payments System Development Strategy.	• **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; (b) implementation of online transfers of funds between NRB branches; and (c) implementation of a pre-settlement file system.**	• The NRB has adopted an oversight framework for payment systems. The NRB has issued a directive on licensing of bank and non-bank payment system providers and operators.	**Results indicator**: All payments systems institutions are subject to NRB regulation and supervision. ***Settlement risk has been eliminated from the payments system***. **Baseline**: The payments system regulation lacks a firm legal foundation and is subject to patchwork supervision by different regulators. FIs face settlement risk owing to a lack of coordinated operations between the NRB and other payments system institutions. **Results so far:** Settlement risk has been eliminated in the system as the NRB has operationalized transfer of funds between NRB branches on real-time basis. All payment system institutions are subject to NRB licensing but not yet supervision/oversight.
—	—	• A new Insurance Act has been approved by the Cabinet and submitted to Parliament for approval.	**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.

Completed PAs under DPC2 (May 2015)	PAs (in bold) or Benchmarks to be Completed by January 2017 for DPC3	Indicative Policy Actions to be Completed by January 2018 for DPC4	Results (June 2019) (Baseline = July 2014)
			Results so far: A draft of the new insurance Act, which will improve the sector's legal framework, is under discussion with stakeholders.
Enhancing the Governance and Transparency of the Banking Sector			
• The NRB has issued a guideline governing the transition of BFIs to the NFRS.	—	• The NRB has issued a 'Chart of Accounts' and has amended its directives on BFI reporting requirements to them NFRS-compliant.	**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. **Results so far:** None of the BFIs are NFRS compliant as yet. A model financial statement to be used for reporting by the BFIs is under review by the NRB.
• 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.	• **The Bill on Banks and FIs has been approved by Parliament.**	• The NRB has issued implementing rules and bylaws for the new BAFIA.	**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. **Baseline**: Under current law, governance provisions are weak and give rise to numerous conflicts of interest on the part of bank directors who lack independence from shareholders. Professional qualifications requirements for directors and senior managers are limited and government-appointed CEOs and directors of two state-controlled commercial banks are exempt from qualifications requirements. **Results so far:** The Bill was approved by the Parliament in January 2017. The enabling regulations need to be finalized.
• The transparency and safety of the banking system has been strengthened by the enactment of the following key AML/CFT legislation: (a) the Mutual Legal Assistance Act; (b) the	• **The Cabinet has approved the Asset (Money) Laundering and Prevention Regulations.**	—	**Results indicators:** Nepal remains ***off the FATF grey list*** which allows normal external financial relations (trade finance, remittance inflows and foreign direct investment).

Completed PAs under DPC2 (May 2015)	PAs (in bold) or Benchmarks to be Completed by January 2017 for DPC3	Indicative Policy Actions to be Completed by January 2018 for DPC4	Results (June 2019) (Baseline = July 2014)
Extradition Act; and (c) the Prevention of Organized Crime Act.			**Baseline**: Nepal is not on the FATF grey list. **Results so far:** Nepal has successfully remained off of the FTAF grey list.

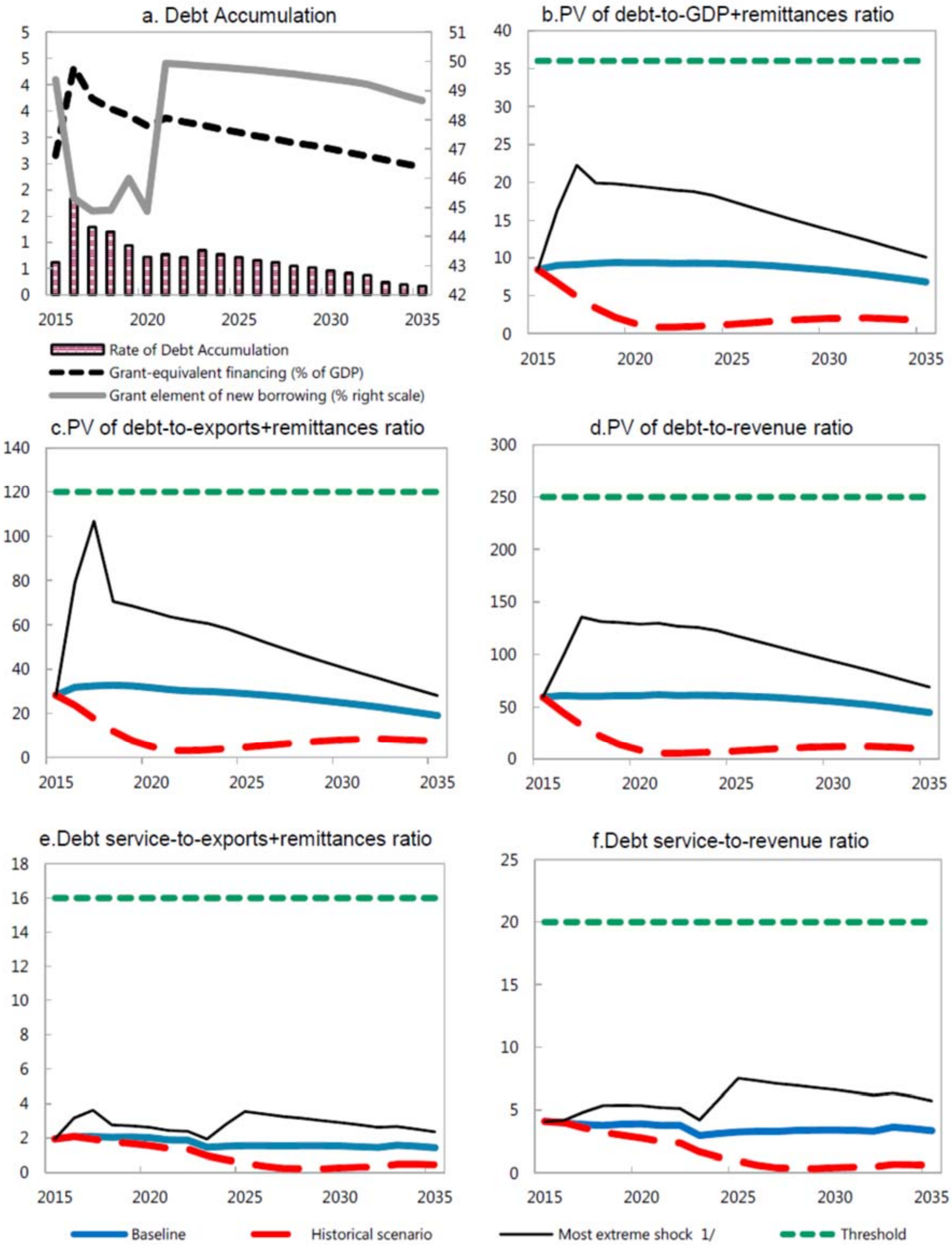
ANNEX 2: INDICATORS OF PUBLIC AND PUBLICLY GUARANTEED EXTERNAL DEBT FY15–35

Overall, the Debt Sustainability Analysis 2015 suggests Nepal's risk of debt distress is low. Generally prudent fiscal policy and low execution of capital spending budgets have continued to underpin declining levels of public debt. Higher financing requirements driven by post-earthquake reconstruction and higher public investment expenditures are expected to be manageable under the assumption that they are temporary and that financing terms are favorable. As a result, indicators of the public external debt stock and public debt service ratios remain comfortably within the policy-dependent indicative thresholds, even under stress tests, due to the assumed continued high level of concessionality of official borrowing.

Under the baseline scenario, Nepal's external debt indicators remain well below indicative sustainability thresholds (Figures below). As in the previous DSA, remittances are formally included in the analysis as inflows remained robust even before the earthquake, reaching 28 percent of GDP in FY 2013/14. However, debt dynamics may be susceptible to volatility in remittance flows, as captured under standard shocks. Over the medium term, the present value (PV) of external debt stabilizes at a level equal to: 9 percent of GDP + remittances (figure b), 29 percent of exports + remittances (figure c), and 60 percent of revenues (figure d). The ratio of debt service-to-exports + remittances stabilizes at 2 percent over the medium term (figure e), while the ratio of debt service to revenues stabilizes at 3 percent (figure f).

Debt dynamics remain resilient to standard shocks. These stress tests include shocks to GDP growth, exports, non-debt creating flows, and a combination of these shocks, as well as a onetime 30 percent nominal depreciation shock. Under the most severe shock (to non-debt creating flows, capturing a remittance shock), the PV of debt to exports + remittances rise rapidly over the next three years but stays below the threshold, and thereafter declines again, while all other indicators remain well below the thresholds.

Alternative Scenarios: Debt dynamics remain resilient to standard shocks



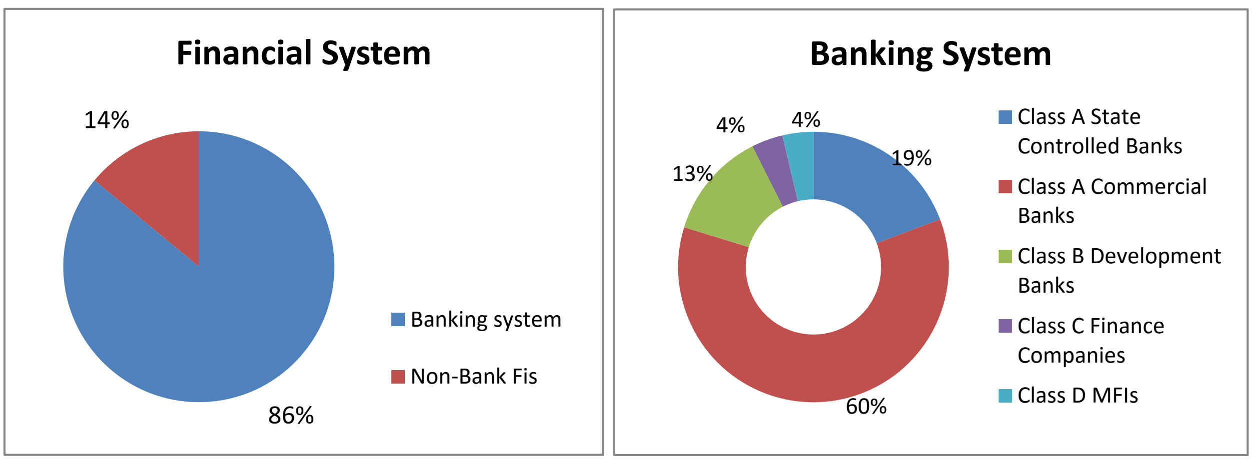
Source: World Bank/IMF Debt Sustainability Analysis, 2015.

ANNEX 3: NEPAL'S FINANCIAL SECTOR - BACKGROUND, ISSUES, AND RECENT DEVELOPMENTS

Structure of the Banking System

1. **Nepal's financial system is bank-dominated and is characterized by a large number of players, significant state-ownership, and the existence of various kinds of banking licenses.** The banking system comprises 28 Class A (commercial banks), 67 Class B (development banks), 41 Class C (finance companies), and 40 Class D MFIs, accounting for 80, 13, 4, and 3 percent of banking system assets, respectively, as of mid-July 2016.[14] In the overall financial system, banking institutions represent about 86 percent of assets, while other FIs such as insurance companies, the Employees Provident Fund, the Citizen Investment Trust, and the Postal Savings Bank constitute approximately 14 percent of financial system assets. Foreign penetration is limited, with only one foreign Class A bank (Standard Chartered). The capital markets are represented by the Nepal Stock Exchange. There are currently 228 companies listed on the Stock Exchange, of which 86 percent are financial sector companies. In addition, there are about 17,000 credit cooperatives registered with the Department of Cooperatives and many FINGOs (see figure 3.1).

Figure 3.1. Structure of the Nepalese Financial System (as of July 2016)



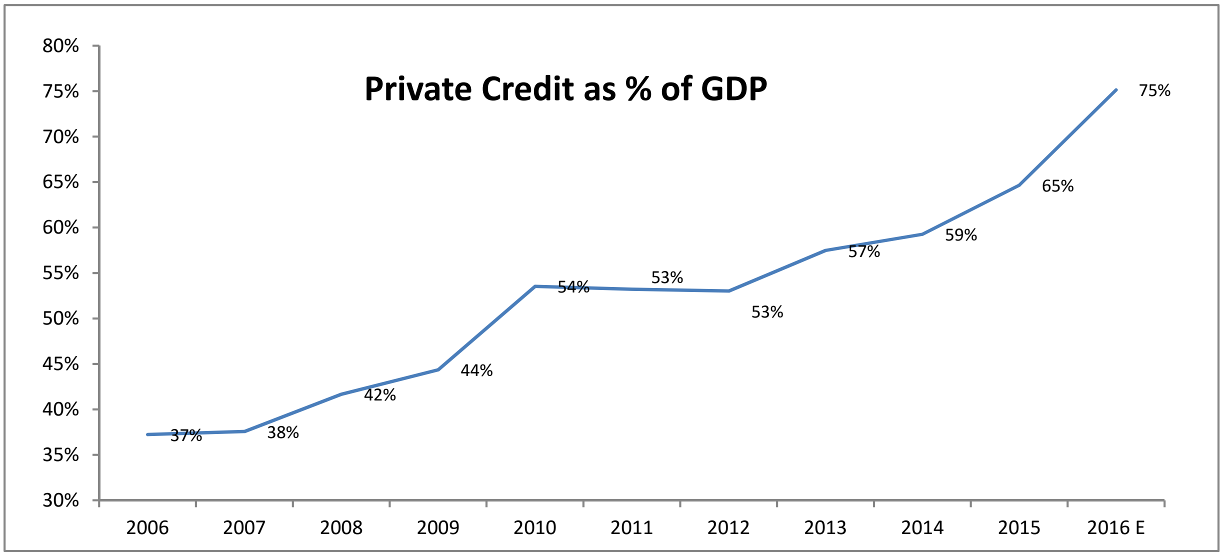
Source: NRB.

2. **In recent years, the banking system has expanded rapidly.** Between 2009 (July) and 2016 (July), the banking system grew by 173 percent. Assets of Class A institutions grew by 169 percent, while assets of Class B and Class C institutions grew by 476 percent and 18 percent

[14] The four classes of bank are differentiated by their capital requirements, as well as the range of permissible activities. Class B and Class C institutions generally conduct operations similar to those of Class A institutions, but on a smaller scale. Class B, Class C, and Class D banks are subject to limits on resource mobilization (deposits, borrowings, debt instruments) of 20, 15, and 30 times core capital, respectively. Tier 1 capital requirements are 6 percent for Class A, 5.5 percent for Classes B and C, and 4 percent for Class D. The corresponding total capital fund requirements are 10 percent, 11 percent, and 8 percent, respectively. A new capital directive was issued by the NRB on August 6, 2015, which increases paid-up capital requirements fourfold across Class A, B, and C. There are 40 microfinance development banks and 28 FINGOs licensed by the NRB which have around 2 million members spread across 73 of the total 75 districts of Nepal and serviced through 1,183 branch locations.

respectively. Domestic credit to the private sector jumped from 33 percent of GDP in 2005 to 75 percent in 2016, overtaking the South Asia regional average of 45.8 percent. Private commercial banks accounted for all of this growth, while assets of three state banks (ADBL, RBB, and NBL) declined as a share of the sector's total assets. However, the RBB is still the largest bank, representing 8.2 percent of total commercial bank assets, while ADBL is the fifth largest, with 5.3 percent of assets, and the NBL is the sixth largest bank, with 5.1 percent of assets as of end of FY2016 (mid-July). As of end FY2016, the ten largest banks accounted for 53 percent of commercial banks' assets (see table 3.1).

Figure 3.2. Domestic Credit as a Percentage of GDP (2006–2016)



Source: NRB.

3. **Although their number is at historic lows, state-controlled FIs still represent a significant part of the banking sector in Nepal.** The three Class A state-controlled banks—the RBB, ADBL, and NBL—account for approximately 18.7 percent of Class A banks' total assets, 18.0 percent of deposits, and 16.3 percent of lending as of end of FY2016. The state also owns Nepal Industrial Development Corporation Class B Development Bank and Nepal Aawas, a Class C Finance Company.

Table 3.1. Total Assets (Market Share) and CAR of Main Commercial Banks, Mid-July 2016

Bank	Assets (%)	CAR (%)
RBB	8.2	11.2
Nepal Investment Bank Limited	6.2	16.2
Nabil Bank Limited	6.1	12.6
Everest Bank Limited	5.4	12.8
ADBL	5.3	12.8
NBL	5.1	11.4
Himalayan Bank Limited	4.7	10.9
Global IME Bank Limited	4.3	12.3
Bank Of Kathmandu	3.9	13.7

NIC Asia	3.8	12.7

Source: NRB.

4. **The overall lending portfolio of the banking system is concentrated in manufacturing and wholesale/retail trade, reflecting 20 percent and 22 percent, respectively.** Class A banks have the highest concentration in these sectors, representing 23 percent and 23 percent, respectively. Class B and Class C banks have more diverse portfolios (see table 3.2).

Table 3.2. Sectorial Breakdown of Banking System Credit, mid-July 2016

	Class A Bank		Class B Bank		Class C Bank		Total	
	NPR, millions	Share (%)	NPR, millions	Share (%)	NPR, millions	Share (%)	NPR, millions	Share (%)
Agriculture, forestry, fisheries, and mining	64,095	4.9	15,972	6.9	2,133	3.8	82,200	4.9
Manufacturing, metal, and machinery	294,632	18.8	17,225	7.4	3,714	6.6	315,571	17.7
Construction	142,303	10.9	32,646	14.0	7,903	14.0	182,852	10.9
Transport, communications, public utilities, electricity, gas, and water	85,348	6.8	21,832	9.4	6,727	11.9	113,907	6.8
Wholesale retail	330,887	22.3	35,847	15.4	7,589	13.5	374,323	22.3
Finance, insurance, and real estate	114,518	8.0	16,265	7.0	4,217	7.5	135,000	8.1
Other services	103,954	7.5	18,657	8.0	3,962	7.0	126,573	7.5
Consumption loans	99,230	7.2	17,035	7.3	4,578	8.1	120,843	7.2
Others	157,534	13.7	57,515	24.7	15,561	27.6	230,610	13.7
Total	**1,392,501**	100.0	**232,994**	**100.0**	**56,384**	**100.0**	**1,681,879**	100.0

Source: NRB.

Performance of the Banking System

5. **Capital adequacy.** While headline capital adequacy and asset quality figures appear comfortable, there are concerns whether the data fully reflects the reality. Capital adequacy of commercial banks have marginally improved to 12.2 percent by FY2016 due to retained earnings—and in the case of state controlled banks, capital injection through rights issue. All banks meet the minimum CAR of 10 percent. There has been a decreasing trend NPLs over the last few years; however, banks' reported asset quality and capital buffers may be overstated. NPLs accounted for 1.8 percent of the total loan portfolio as of end of FY2016.

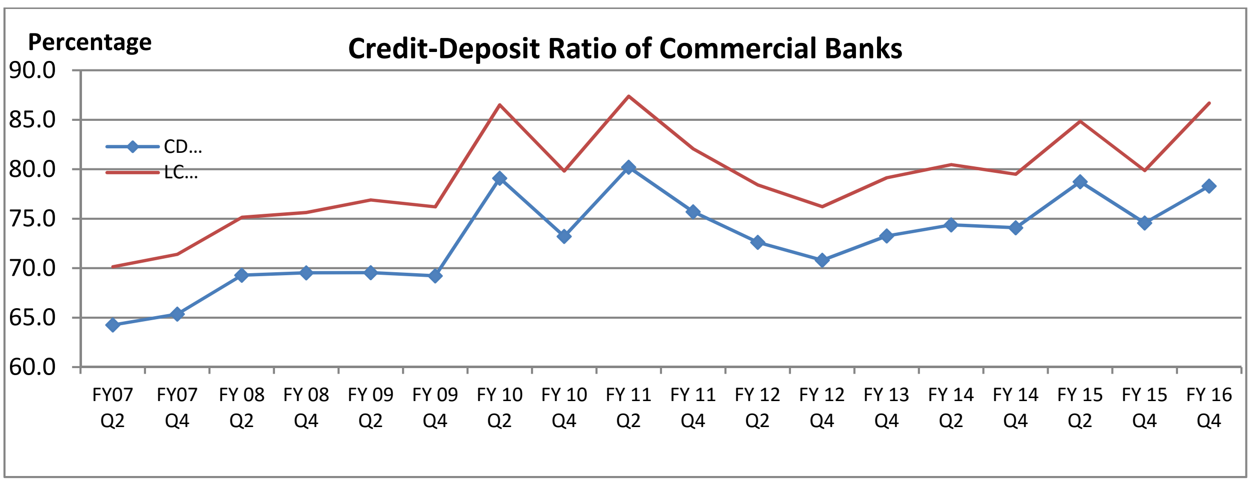
6. **Total loan loss provision coverage in relation to total NPLs is 142 percent for the commercial banking industry.** This is significantly above end of FY2015 (127 percent) and end of FY2014 (124 percent). While the improvement is not even, all banks had loan loss coverage of more than 100 percent in FY2016 compared to four banks (around 11.3 percent market share) which had less than 100 percent coverage as of end of FY2015.

7. **There are indications that ever-greening of bad loans is a recurring issue, leading to an understatement of the NPL ratio, the potential occurrence of under-provisioning, and—as a consequence—an overstatement of the CAR**. Banks have incentives to resort to ever-

greening to keep NPL ratios below 5 percent to be able to pay dividends. Reliable information of the true extent of the problem was however not available until recently. However, stress tests undertaken as part of the FSAP signal a high sensitivity of the banking system to a (modest) reclassification of the loan portfolio. Inadequate governance and risk management in combination with a lack of consolidated supervision has heightened systemic fragility. This manifests itself primarily through financial interconnectedness, including through connected lending, and possible cross-shareholding among banks arising from pledging of equity shares as loan collateral.

8. **End of FY2016 results indicate overall Credit-to-Deposit Ratio (CDR) increased to 78.3 percent compared to 74.6 percent in corresponding period last year.** Demand for loans had slowed down following supply disruptions after the earthquakes of April/May 2015. Total deposits over the last fiscal year increased by 22.3 percent (in line with growth of 21.5 percent a year before), contributed by remittances, versus 28.4 percent year-on-year growth in credit owing to surge in demand for working capital and retail loans in the past few months after the trade disruptions was resolved. More importantly, the reported growth in credit is also partly driven by capitalization of interest following the forbearance measure adopted by the NRB.

Figure 3.3. CDR of Commercial Banks



Source: NRB and provisional financials published by FIs.

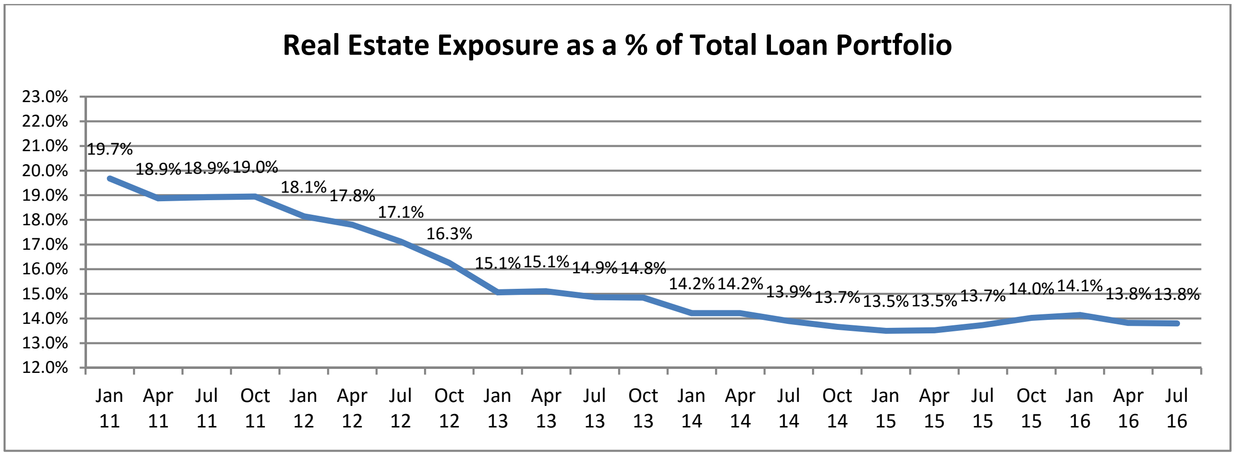
9. **The NRB's forbearance measures include rescheduling and restructuring of debts and allowing BFIs to maintain loan classification of borrowers to pre-trade disruption level without the need for additional loan loss provisions**. The measure expired in the third quarter of FY2016. CDR in local currency, which generally reflects the overall CDR, also increased to 86.7 percent compared to 79.9 percent previous year. Almost all the banks (except one) recorded Local Currency (LCY) CDR above 80 percent while five banks (with 19.7 percent market share) recorded above 90 percent.

Risks and Vulnerabilities

10. **Risks related to real estate exposure may be underestimated (see Figure 3.4).** Based on reported figures, the direct exposure of commercial banks marginally increased to 13.8 percent as of end of FY2016 compared with 13.7 percent one year before, driven almost equally by personal home loan segment and loans to real estate development. However, if indirect

exposure from non-real estate loans collateralized by real estate is included, the ratio is likely to be closer to 70 percent. The home loan (mortgages) portfolio was 54 percent of total real estate exposure compared with 30 percent the FY2011/2012. Although only four banks (comprising 12.5 percent share of market assets) have exposure in excess of 20 percent, it would have been more as some banks may be using a different classification (such as personal overdrafts or business related loans from where funds are diverted to invest in real estate). None had exposure in excess of 25 percent, the cap placed by the NRB.

Figure 3.4. Real Estate Exposure as a Percentage of Total Loan Portfolios, 2011 Q2–2016 Q4



Source: Quarterly provisional financials of commercial banks.

11. With the market liquidity being in surplus, low yields from the government paper and interbank market, slack demand for borrowings in new projects owing to political uncertainty, and lack of alternative investment opportunities, it is likely that real estate exposure, especially in the personal home loan segment, will increase as indicated by highly competitive lending rates being offered by banks and FIs.

12. **The FSAP findings (see box 3.1) suggest real estate exposure posing a risk, although price correction has helped reduce vulnerabilities to some extent since the assessment was made.** Stress tests conducted by the NRB in mid-January 2014 indicate that the CAR of nine banks would fall below the minimum regulatory level of 10 percent if 25 per cent of loans extended to the real estate and housing sector turned bad; only five banks were in that position based on stress tests in July 2013. Risk for banks exposed to real estate is reported to have increased, which is also an indication of the deteriorating credit quality of banks. The major reason for deterioration in credit quality is the practice of extending loans solely on the basis of using real estate as security. Over two-thirds of loans are collateralized by real estate. This poses a threat to the banking sector as real estate prices have not fully recovered yet and many banks may fail to recover overdue loans even if they auction properties of defaulters.

Box 3.1. Main Findings of the FSAP

Nepal has made significant strides, in a post-conflict and politically unsettled setting, in extending access to finance and promoting financial sector dynamism in recent years. The NRB's efforts to upgrade the legal and regulatory framework have been hampered by the absence of a stable government and political leadership. In this context, the NRB has, among others, undertaken diagnostics of 20 major banks, completed a BCPs self-assessment of its supervisory function, and injected capital into two major state-controlled banks that were in difficulty. Nepal ranks favorably compared with the South Asian average in financial inclusion, access to finance, and financial depth, and

the number of BFIs has grown rapidly.
Financial Stability **Nepal continues to face serious financial sector challenges**. These reflect a decade of political instability, lax licensing, a poorly performing and large public bank sector, and a growing and highly interconnected financial sector. The banking system has expanded at a rapid pace following financial liberalization. The sector is characterized by inadequate lending and risk management practices, poor corporate governance, and high credit exposure, with 66 percent of loans collateralized by real estate. Compounding risk is a regulatory framework that is not up to the new challenges and supervision that is under-resourced and compliance-based, with late intervention and a lack of an enforcement culture. Widespread solvency problems, especially in lower license classes, are suspected in the banking sector, which are partially hidden owing to ever-greening. Problems in the banking sector could spill over to the rest of the financial system since term bank deposits comprise an important share of the assets of non-bank FIs. Excessive liquidity from large remittance inflows may be promoting asset bubbles and excessive risk taking, and managing risks is difficult owing to supervisory gaps and inadequate risk management practices in FIs. **Financial Development** **The outreach of the banking sector has increased, but not all population groups have benefited equally and many challenges remain.** Remote areas, small and medium enterprises, and women have less access to financial services. The Government has tried to promote access through various institutions, policies (for example, directed lending and caps), and programs. A more coherent, strategic, and evidence-based approach is warranted. Policies are conflicting at times and can have unintended consequences. Caps on interest rate spreads could diminish banks' appetite for lending to small and medium enterprises and longer maturity lending. Deprived sector lending requirements coupled with liberal licensing of Class D institutions contribute to excessive liquidity in the microfinance sector that does not have adequate absorption capacity. State-controlled banks currently lack clear mandates, leading to overlaps among themselves. Their corporate governance practices require strengthening and their overheads remain high. Cooperatives are important providers of financial services, but several have become problematic in the absence of adequate supervisory and regulatory frameworks. Decisive measures are needed to reinforce the oversight structure and resolution powers and to promote much-needed consolidation. Progress in the modernization of payment systems has been slow. Consequently, the use of electronic means remains limited, reducing the efficiency and safety of the payment infrastructure. The Credit Information Bureau has several weaknesses, including a lower frequency of data reporting, a high minimum reporting threshold, and limited quality of information. The Secured Transactions Act has been enacted but implementation is pending. Loan recoveries through the Debt Recovery Tribunal are lengthy. There is limited use of the insolvency regime because it is poorly understood. Going forward, the root causes of limited access, including poor physical and information infrastructure, could be targeted more directly through improvements in the enabling environment.

Recent Reforms

13. **There has been improvement in regulation and supervision.** On the regulatory side, the NRB is enlarging the PCA framework to include liquidity and nonperforming asset ratio triggers with the previous CAR trigger. Further strengthening of minimum capital adequacy by adopting some elements of Basel III, including 4.5 percent common equity Tier 1, is also under consideration. Stress test guidelines were issued as well as guidelines on the Internal Capital Adequacy Assessment Process. An internal reorganization in the NRB broke up a department in charge of both Class B and Class C banks into two dedicated departments and rotation periods for supervisory staff were extended to five years. On-site inspection practices have also improved in line with IMF recommendations. A financial stability unit has been created within the NRB to prepare semiannual financial stability reports. A problem Bank Resolution Department was created to handle all BFIs that are declared problematic. Following the diagnostic reviews of 20 banks with IMF support, the supervisory departments have used these reviews to complement their on-site inspections. Fifty-four banks and FIs, constituting 64 percent of the system, were subject to an in-depth SIP, supported by DFID.

14. **In line with the new monetary policy of FY2016, the NRB issued a directive in August 2015 requiring fourfold increase in paid-up capital requirements within two financial years, that is, by end of FY2017.** This directive furthers the NRB's efforts to consolidate the banking sector by increasing the minimum paid-up capital Class A, B, and C FIs need to maintain. Class A institutions will need to maintain NPR 8 billion. Class B institutions (a) operating at the national level must maintain NPR 2.5 billion; (b) operating in 4 to 10 districts must maintain NPR 1.2 billion; and (c) operating in 1 to 3 districts must maintain NPR 0.5 billion. Class C institutions: (a) operating at national level or in 4 to 10 districts must maintain NPR 0.8 billion; and (b) operating in 1 to 3 districts must maintain NPR 0.4 billion. The move is intended to encourage banks to merge and create more stable and better-capitalized institutions which have the ability to finance big-ticket infrastructure projects. While the policy has been appreciated as a step in the right direction, the timeline of only two years to achieve the new paid-up capital requirements initially received some criticism as being too optimistic as only a few were, at that time, in a position to meet the new requirement. However, as of date, fifteen commercial banks have over NPR 4 billion paid-up capital.

15. **There has also been progress in improving resolution and related frameworks.** The NRB Act has been amended to provide clear and stronger power to the central bank in managing banks in distress. The deposit guarantee scheme provides cover up to NPR 200,000 per individual. The scheme charges 0.20 percent per insured deposit and has accumulated NPR 1.46 billion in premiums. The DCGF insures total deposits of NPR 319.45 billion as of mid-July 2016. Amendments to BAFIA focus on strengthening corporate governance. All these three bills have been recently approved by the Parliament and are part of the World Bank's policy actions.

16. **Some forbearance measures to deal with a liquidity shortage in FY2012 and a fall in real estate and stock prices remain in place.** While all BFIs have to abide by the 25 percent real estate sector exposure limit, the ceiling for house loan exceptions to this lending limit has been maintained at NPR 10 million and the loan-to-value limit on margin loans against promoter shares have been reduced to 50 percent from 60 percent.

17. **Some relief packages were also introduced for those borrowers whose revenue sources were adversely affected by the earthquakes of April 25 and May 12, 2015.** The measures included debt restructuring facility, deferment in loan repayment period, and extended grace period for term loan repayments. NRB also agreed to provide 0 percent refinancing to BFIs willing to provide loans to earthquake-affected households at 2 percent interest rate. Households within and outside the Kathmandu valley meeting the requirements set by the Government can access the subsidized loans for up to NPR 2.5 million and NPR 1.5 million, respectively.

18. **Additional forbearance measures were introduced to address impaired debt repayment/servicing capacity of borrowers that resulted from trade disruptions (mid-September 2015 to mid-January 2016) along the India border.** The disruption caused widespread fuel shortages and power cuts that compelled business and FIs to reduce working hours. Raw materials and finished goods, including essential supplies, could not move into the Nepal side of the border for four months. The NRB's forbearance measures include rescheduling and restructuring of debts and allowing BFIs to maintain loan classification of borrowers to pre-trade disruption level without the need for additional loan loss provisions. The measure expired at the end of the third quarter of FY2016. Capital position in general has therefore been over-

reported since the end of FY2015 following the NRB measures to address the impact of the earthquake and the trade disruptions.

19. **Mergers among banks are under way.** In 2011, the NRB issued a directive allowing BFIs to merge across the different classes (commercial, development, and finance) as long as the resulting merged entity met all the requirements of the resulting class. This includes minimum capital levels, corporate governance systems, branch network coverage, and so on. The NRB must approve all steps in the merger process, which takes several months to complete. In reviewing the resulting entities from a prudential reporting standpoint and those that were reviewed in the SIP, it was noted that healthy BFIs had resulted from the merger process. In fact, the process has been very successful in helping to reduce the total number of BFIs in Nepal. In mid-January 2012, there were 199 BFIs in the three main classes; as of mid-July 2016, four and half years later, the number of BFIs had shrunk to 135, a reduction of 64 (32 percent). Additional M&A are under way. In 2014, the NRB issued an acquisitions directive that allows a BFI to acquire another BFI through a stock purchase. The NRB must approve the purchase and the NRB's requirements for a solvent and well-run BFI apply to the resulting entity.

Table 3.3. Number of BFIs

Total A, B, and C BFIs mid-January 2012	**199**
Voluntary Merger Completed - Class A	−2
Acquisitions Completed - Class A	0
Voluntary Merger Completed - Class B	−15
Acquisitions Completed - Class B	−1
Voluntary Merger Completed - Class C	−26
Acquisitions Completed - Class C	−2
Voluntary Liquidation Completed - Class C	−2
Forced Liquidation Completed - Class C	−1
Forced Liquidation Completed - Class B	−1
Add For New Charter in Class B	4
Actual A, B, and C BFIs as of mid-July 2015	**153**
Voluntary Merger Completed - Class A	−2
Acquisitions Completed - Class A	0
Voluntary Mergers Completed - Class B	−9
Acquisitions Completed - Class B	0
Voluntary Mergers Completed - Class C	−6
Acquisitions Completed - Class C	0
Court Ordered Liquidation - Class B	0
Court Ordered Liquidation - Class C	−1
Add For New Charter in Class C	1
Actual A, B, and C BFIs as of mid-April 2016	**135**

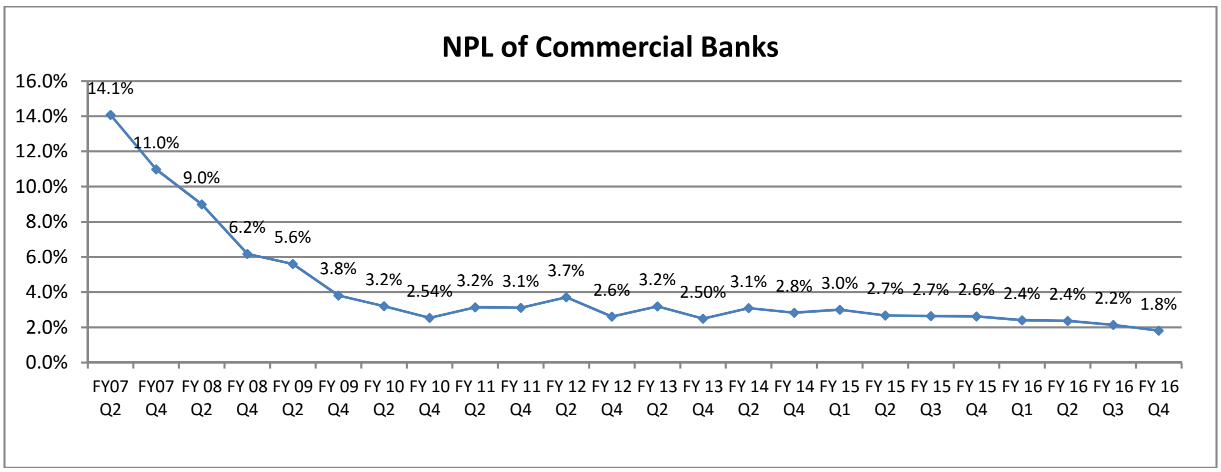
ANNEX 4: NPLs AND SPECIAL INSPECTIONS PROGRAM

Non-Performing Loans - Potential Risks

1. The level of NPL stood at 1.8 percent of the total loan portfolio as of end of FY2016—a notable decline from the last quarter (2.4 percent) and also from the corresponding period of the previous year (2.6 percent). This is the lowest NPL level achieved by the banking industry. While the NPL level has declined as a percentage of total loans portfolio, it has declined in absolute terms as well by NPR 3.3 billion in the last one year.

2. As of end of FY2016, the total loan loss provision coverage in relation to the total NPLs reached 142 percent for the commercial banking industry which is an improvement over the quarter of corresponding last year (127 percent). None of the banks had loan loss coverage of less than 100 percent compared to four banks (11.3 percent market share) last year.

Figure 4.1. NPL of Commercial Banks



Source: NRB and provisional financials published by FIs.

3. Three (16.8 percent market share) of the 28 banks reported NPL ratio in excess of 3 percent and among these, only one bank (3.4 percent of the system) has NPLs in excess of 5 percent. Thirteen banks (38.9 percent of the system) have recorded NPLs below 1 percent. The reported figure is a significant improvement from last year's results wherein eight banks (32.5 percent of system) recorded NPLs in excess of 3 percent and two banks (2.6 percent of the system) had NPLs above 5 percent. Based on published data by individual banks, the three state-controlled banks (18.7 percent market share) had an average NPL of 3.6 percent, six joint venture banks (25.3 percent market share) with 0.79 percent, while the remaining private banks (56.1 percent market share) registered an average NPL ratio of 1.6 percent.

4. **Although asset quality of Class B (Development Bank) and Class C (Finance Company) institutions has improved over the past year, it is considered to be weaker than Class A.** As of FY2016 Q4, development banks' NPLs were 1.48 percent compared to 3.58 percent in the corresponding period last year. Finance companies recorded NPLs of 14.42 percent compared to 15.58 percent last year. Average NPLs for all classes of FIs (A, B, C) are reported to be 2.19 percent in end of FY2016, another lowest in Nepal's financial system, compared to 3.33 percent in FY2015 Q4—a significant improvement but primarily attributed to

the NRB's forbearance measures.

5. **The NRB uses a loan provisioning scheme based on delinquency (number of days past due) of the underlying loan.** As loans become more past the due date, the level of provisions increases to eventually reach 100 percent of loans overdue regardless of the value of the underlying collateral. According to the NRB, indications from special inspections being conducted by the NRB on 54 BFIs reveal that in most cases, the level of loan provisions decreases when IFRS loan loss provisions are taken into consideration. The current system does not consider potential of default (for example, owing to unfavorable market conditions, change in sponsors/management, future cash flows, debtors health, supply constraints, and so on) which may require additional loan loss provisioning although loan repayments could be entirely current. Only one bank (Standard Chartered Bank) in Nepal recognizes/practices potential of default and downgrades the borrower's loan classification before default happens with adequate loan loss provisions, although this is not required under the NRB's prudential guidelines. So clearly, the NPL's guidelines may be understated if one is to follow best practices. As it is, the loan loss provisions' coverage exceeds 100 percent of the 'reported' NPLs and collaterals can be of additional comfort once IFRS-compliant loan provision regulations are issued by the NRB.

6. **The NPL ratio may be adversely affected by the Nepal earthquakes and the recent blockade but the full extent of the damage is yet to be assessed.** The NRB and the NIB, with support from DFID, are undertaking diagnostic reviews of 10 insurance companies and 35 BFIs to assess better the impact of the earthquake on the solvency of both sectors. The consolidated report covering impacts to both BFI and insurance company was completed in early January 2017. Forbearance measures have been extended to only those borrowers who were not already classified as substandard before the events. For example, the loans should be classified as a good/pass loan as of mid-July 2015 if they are to take benefit of forbearance owing to blockade.

7. **The combined effect of damage to real estate pledged as collateral for loans (including non-housing loans) and an anticipated increase in NPLs due to the impairment of borrowers' repayment capacity are likely to weaken balance sheets of many banks.** The reported figure for real estate-related exposure at the end of FY2016 Q4 was 13.8 percent of the bank's total loan portfolios, but it is suspected that the actual exposure through loans to the real estate sector (20–30 percent of total loans) and the use of real estate as primary collateral (a further 50–60 percent of total loans) is much bigger. Around 70 percent of the BFIs' loan portfolio is secured by real estate collateral. Rises in NPLs are especially expected in the tourism and, to a lesser extent, in the manufacturing sectors. In addition, BFIs have exposure to many small- and medium-size hydropower projects in the affected districts which could experience repayment problems.

8. **Many MFIs and FINCOs operate in the rural areas of the country, and some exclusively in the areas worst affected by the 2015 earthquake.** As a consequence, several hundred thousand MFI and FINCO members have suffered loss of shelter, livestock, and livelihood, and in some cases loss of life. As most of the affected borrowers do not have alternative income-generating activity or sources of repayment, the MFIs and FINCOs are likely to face both liquidity and solvency issues, affecting their capacity to assist their communities in a time of need. The sector is especially vulnerable due to the lack of sources of funds diversification, weak or nonexistent IT systems, and low connectivity. Severe difficulties in the

MFI and FINCO sectors could affect Class A, B, and C banks. A key source of funding for MFIs is funding from other BFIs which are mandated by the NRB to lend a portion of their portfolio to the deprived sectors.[15] As of mid-January 2016, BFIs are estimated to have an exposure of NPR 77 billion under deprived sector lending, out of which NPR 44 billion was on-lent through the MFIs and the remaining through their own lending. MFIs had a total loan exposure of NPR 62 billion. Preliminary estimates indicate a third of the deprived sector exposure is considered portfolio at risk.

9. **While there has been a decreasing trend in NPLs over the last few years, banks' reported asset quality and capital buffers may be overstated.** As mentioned earlier, there are indications that ever-greening of bad loans is a recurring issue, leading to an understatement of the NPL ratio, the potential occurrence of under-provisioning, and—as a consequence—an overstatement of the CAR. Banks also have incentives to resort to ever-greening to keep NPL ratios below 5 percent to be able to pay dividends, something that has been observed by the NRB during both the IMF- and DFID-sponsored SIPs. Stress tests undertaken as part of the FSAP signal a high sensitivity of the banking system to a (modest) reclassification of the loan portfolio. Inadequate governance and risk management in combination with a lack of consolidated supervision has heightened systemic fragility. This manifests itself primarily through financial interconnectedness, including through connected lending, and possible cross-shareholding among banks arising from pledging of equity shares as loan collateral.

Stress Tests of the Financial Sector

10. **Under the 2014 FSAP, stress tests were used to assess the resilience of the banking system to shocks.** The FSAP team conducted top-down solvency macro stress tests, which were complemented by bottom-up solvency and liquidity sensitivity tests. The tests covered all Class A banks, which account for 76.5 percent of total assets in the banking system. The top-down stress tests considered three five-year scenarios: (a) a baseline scenario consistent with the IMF country desk GDP projections as of end-December 2013; (b) a short-lived recession scenario in which GDP growth dropped to −1.75 percent in the first year with a rapid recovery thereafter; and (c) a protracted recession scenario in which GDP growth declined to −1.75 percent at the end of the second year before recovering slowly during the last three years of the scenario. The tests also were performed considering the likely underreporting of NPLs, by adjusting NPL ratios upward by 2 percentage points. The stress tests indicate that system wide NPLs in the short-lived recession scenario would rise to 7 percent in the first year, while in the protracted recession scenario they would increase to 6 percent in the first year and 11 percent in the second year. If the initial upward adjustment for underreporting of NPLs was made, NPLs would reach 16 percent (first year) in the short-lived recession scenario and over 15 percent (first year) and 30 percent (second year) in the protracted recession scenario. The stress tests suggest that the banking system could be subject to stress even under the benign baseline scenario. Comparing projections of bank Tier 1 capital ratio against the NRB threshold of 6 percent, 7 out of 31 Class A banks (in 2014) would fail to meet the minimum regulatory CAR during the five-year period.

[15] This sector is defined as "low income and especially socially backward women, tribes, lower caste, blind, hearing impaired and physically handicapped persons, marginal and small farmers, craftsmen, labor, and landless families." There are two types of loans: uncollateralized group lending loans and collateralized microenterprise loans.

11. **The NRB has also conducted stress tests using its stress testing framework, which is based on sensitivity analysis.** The credit-risk stress test considered shocks, including deteriorations in credit quality of the aggregate loan portfolios, the real estate and housing loans, and largest exposures. In the market-risk stress test, adjustments in deposit and loan interest rates, depreciations and appreciations of exchange rates, and a decline in equity price were considered. They also test for the impacts of combined credit and market shocks. For the liquidity stress test, run in retail funding and wholesale funding, as well as haircut occurred to liquid/illiquid assets, are considered. Under the scenario where: (a) 15 percent of performing loans deteriorated to substandard, (b) 15 percent of substandard loans deteriorated to doubtful loans, (c) 25 percent of doubtful loans deteriorated to loss loans, (d) and 5 percent of performing loans deteriorated to loss loans, two banks would have a negative CAR, 20 would fall under the 6 percent threshold, and 11 would remain above 6 percent.

Overview of the SIP

12. The NRB decided to conduct an SIP of selected BFIs. The purpose of this program is as follows: (a) to address concerns regarding the accuracy and reliability of financial reports prepared by Class A, B, and C FIs (BFIs); where justified by the results of the special inspection, the NRB may take legal and/or administrative corrective action to correct identified deficiencies on the part of the BFIs concerned by the appropriate regulator; (b) to assist the NRB in assessing the impact of transition to IFRS (known as NFRS) and International Accounting Standards on the financial system; and (c) the NRB also has specific concerns regarding the quality and accuracy of the statutory financial information produced by BFIs and their corporate governance.

13. The individual BFI SIP reports will cover the following specific areas and concerns at a minimum:

a. Accounting policies and procedures.
b. Internal control policies and procedures.
c. Systems of internal controls and checks, including internal audit.
d. Quality of assets and the implied risk profile of the FI.
    i. Identify and properly classify problem assets.
    ii. Categorize all credit relationships based on ownership and corporate structure (for example, loans to sole proprietorships, loans to state-owned enterprises, and so on).
    iii. Identify actual and potential losses.
    iv. Identify and quantify credit concentrations.
    v. The consulting firm should comment on the adequacy of the FI's policies, practices, and procedures to identify common ownership, control, and reliance on common cash flows.
    vi. Identify and itemize extensions of credit to present or past insiders of the FI.
    vii. Comment on the status of outstanding claims on insiders and on the probability of repayment according to the existing terms of the loans.
    viii. Ability of BFI to identify and track extensions of credit to insiders and whether these credits are based on market terms or more favourable.
    ix. In assessing the quality of assets, the consulting firms aim to assure, at a minimum, 75 percent coverage by value of all credit relationships.

x. Assess quality of assets with primary emphasis placed upon the borrowers' ability to repay his debts and support interest service and principal repayment out of prospective operating cash flow.

xi. Assess the FI's involvement in credit or loan agent or credit or loan brokerage activities with particular reference to the use of 'informal' guarantees made by the FI.

xii. Provide comprehensive evaluation of the capacities of the FI to assess, administer, supervise and control, enforce and recover loans, advances, guarantees and other credit investments, and the FI's current credit procedures.

e. Appraise and report on the adequacy, effectiveness, and application of policies and procedures for managing risk exposures and asset and liabilities, including foreign exchange risk, liquidity, and interest rate risk exposures.

f. Provide a specific memorandum commenting on the reasonableness of the stated values of the FI's securities held.

g. Adequacy of loss reserves.

h. Provide an assessment report as to the adequacy of capital and the efficacy of existing reserves.

i. Verification of title to fixed assets.

j. Ownership of the BFI.

k. Quality of earnings.

l. Evaluate the liquidity position of the BFI.

The volatility of deposits

ii. Concentrations of deposits and borrowings

iii. The frequency and level of borrowing

iv. The reliance placed on interest-sensitive funds

v. Access to many markets or other ready sources of cash

vi. The ability to readily convert assets into cash

vii. The capacity to meet unexpected deposit withdrawals and other demands for payment

viii. The ability to readily satisfy reasonable credit demands

ix. The financial strength of clients related to off-balance sheet liabilities and the prospects and timing for possible draws on guarantees and other off-balance sheet items

x. The overall adequacy, effectiveness, and compliance with liquidity, asset and liability management policies

xi. The nature, volume, and anticipated usage of credit commitments, contingent liabilities, and guarantees

e. Evaluate the sensitivity of the BFI's balance sheet to foreign exchange risk.

f. Provide detailed listing of all adjustments required to assure that the financial statements accurately and fairly represented the financial position and performance of the BFI.

o. Provide a detailed listing of asset and liability items which, after adjustments, are still carried in the financial statements at amounts which may differ significantly from realizable values.

p. Provide a detailed listing of revenue and expense items which, after adjustments, may still be significantly overstated or understated.

q. For corporate governance, perform a high-level gap analysis between regulation issued by the NRB on corporate governance and current practice by BFIs, namely in relation to the following areas (where applicable):
   i. Shareholder/ownership structure,
   ii. Governance organization design,
   iii. Policies in relation to conflicts of interest and segregation of key control and risk management functions,
   iv. Policies and procedures for approval of related party transactions, and
   v. Employee code of conduct and communication process within the BFI.

r. **MIS.** Perform a high-level assessment of the MIS, including the following work:

s. Understand the MIS architecture, the level of integration between different applications, and the level of dependence from manual activities.
   i. Check the existence of reconciliations to monitor interfaces between IT applications and perform walkthrough tests to understand if such reconciliations are effectively implemented.
   ii. Understand if the reports produced by the MIS are adequate for management purposes.
   iii. Check the existence of backup procedures, password procedures, IT business continuity plan, and policy for the development of IT applications.
   iv. Understand skills of the staff in the IT department.
   v. Understand if the internal audit function tests the MIS and review latest reports issued by the internal auditor (if applicable).

t. **AML and Know Your Customer (KYC).** Perform a high-level gap analysis between regulation issued by the NRB on AML and KYC and current practice by BFIs in relation to the following areas (where applicable):
   i. Existence of internal policies and procedures on AML and KYC and performance of walkthrough tests to understand if they are effectively implemented, namely in relation to
   ii. due diligence on acceptance of new customers,
   iii. reporting of cash deposits above the threshold, and
   iv. reporting of suspicious transactions.
   v. Existence of adequate monitoring tools, including IT systems, and performance of walkthrough tests to understand if they cover key AML and KYC areas.

Coverage Size

14. The total number of BFIs subject to the SIP was 22 Class A, 20 Class B, and 12 Class C BFIs for a total of 54. They were divided into two phases of 27 each. Phase 1 was conducted in 2014 with an effective date of January 15, 2014. Phase 2 was completed in December 2015 with an effective date of January 15, 2016.

Table 4.1. SIP Phases 1 and 2

Class of BFI	Number of BFIs	Total Assets	% of Total Banking Sector (A, B, and C)
Phase 1 (NPR, thousands)			
Commercial Banks (A)	11	313,675	18.31
Development Banks (B)	10	61,570	3.59
Finance Companies (C)	6	16,613	0.97
Total for Phase 1	**27**	**391,858**	**22.87**
Phase 2 (NPR, thousands)			
Commercial Banks (A)	11	794,442	40.26
Development Banks (B)	10	21,125	1.07
Finance Companies (C)	6	21,162	1.07
Total for Phase 2	**27**	**836,729**	**42.41**
Final Total	**54**	**1,228,587**	**65.28**

Selection Criteria

15. The SIP was not designed to conduct stress testing of the banking sector but to determine the current condition of a large number of BFIs, including extensive review and evaluation of the credit portfolios. The criteria for determining the list of the BFIs to be included in the SIP (as agreed with the World Bank-DFID team) were: (a) systemic—5 percent or more of banking system assets, (b) the RBB and NBL, (c) BFIs identified as at-risk in the 2012 DFID bank-by-bank stress test for the impact of real estate market declines in mid-2012, and (d) 20 BFIs, given diagnostics under the IMF-supported reviews (the IMF recommended this). Some more BFIs were added by the NRB on the basis of its own concerns regarding specific BFIs.

16. Total value of assets reviewed in the 54 BFIs to total banking sector assets (A, B, and C) must exceed 50 percent per PA in DPC1.

Results

17. **Phase 1.** Out of the 27 FIs that went through the diagnostics, 13 banks were found to be maintaining CAR of less than the minimum required. One of these FIs went through a merger, one was subject to NRB administration, and eight of the FIs resolved the issue without any enforcement. Three of the 27 FIs (one each under A, B, and C class institutions) were subjected to PCA. Most of the FIs are expected to have their CAR pushed up as a result of transitioning to NFRS owing to reduction in risk-weighted assets (RWA) after factoring the value of collateral (supervisory haircuts).

18. **Phase 2.** Ten banks were found to have CAR below the minimum required, of which two banks were found insolvent, which is, maintaining negative CAR. While the majority of the banks and BFIs have taken corrective actions on their own before being subject to further action, the NRB has decided to take PCA on one BFI; another is under consideration and the third is being merged with other BFIs after which this entity will no longer exist.

Other Findings

19. Looking beyond the individual BFI level, the SIP will have a significant impact on the NRB's approach to supervision and regulation over the next few years. Some of the systemic

issues identified include the following:

- **Weakness of supervision.** The contrast between the NRB's inspection results and the SIP results highlighted the inability of the NRB to effectively supervise 160 BFIs and the need to reduce the number of BFIs to manageable levels with large capital 'cushions' in place to cover asset quality problems that the NRB is unable to detect. These factors are the major drivers for the massive increase in capital requirements being imposed by the NRB which should reduce the number of BFIs by up to 75 percent over the next two years.

- **Move to risk-based supervision by the NRB.** A new awareness of its lack of supervisory capacity has also driven the NRB's enthusiasm for implementing a SIS and for risk-based supervision training.

- **Poor corporate governance.** This helped push the NRB to make significant changes in BAFIA and amending Directive 6 on BFI governance.

- **Transitioning to NFRS.** The SIP reports provided the NRB with assurance that starting the transition to NFRS would not have negative effects on system capitalization (it would actually have the opposite effect).

- **Poor audit practices both by the BFIs themselves (internal audit) and their external auditors.** Serious reform is needed in the auditing profession and the lack of discipline and standards imposed by Institute of Chartered Accountants of Nepal (ICAN), NRB, and Securities Board of Nepal (SEBON) on auditors as pointed out by the World Bank accounting Reports on the Observance of Standards & Codes (ROSC) Report.

- **Lack of current financial statements on borrowers and lack of stated purpose for loans.** Loans in this category incur a 100 percent provision requirement. Some of these loans were used to bring other loans current and thus help understating of NPLs.

- **Lack of proper risk management policies and practices inside the BFIs themselves.** The NRB is now working on a Directive on BFI risk management practices as part of the change to risk-based supervision.

- **Lack of proper IT systems and basic core banking applications.** This issue has been exposed by the reports and the IMF diagnostic reports and is affecting the design of the SIS. Many BFIs do not have real-time systems; some were found to be using daily or weekly batch processing instead of real-time systems, and even Class A banks are using branch-based systems with manually constructed consolidated financial information. In other words, many lack a functioning core banking IT system.

ANNEX 5: DFID AND OTHER DONOR CAPACITY-BUILDING SUPPORT FOR DPCs 3 AND 4

PAs	Capacity-building Support
The MoF has endorsed the NBL Strategic Divestiture Plan and submitted it to the Secretariat of the Privatization Committee.	• DFID consulting support for developing a timetable and decision tree for the divestiture
The NRB has completed a diagnostic of the impact of the earthquake on BFIs in the earthquake-affected districts.	• DFID support for an international and local accounting firms to perform the diagnostics
The NRB has issued a directive on the increase of minimum paid-up capital of BFIs.	• IMF was consulted
The NRB Act Amendments Bill has been approved by Parliament.	• DFID resident adviser at the NRB • FIRST, World Bank, and IMF
The Bill on DCGF has been approved by Parliament.	• DFID resident deposit insurance adviser at DCGC • FIRST, World Bank, and IMF support
The DCGC and NRB have executed a memorandum of understanding governing cooperation and exchange of information.	• DFID resident deposit insurance adviser at DCGC support for drafting the Memorandum of Understanding • DFID resident adviser at the NRB
The NRB has implemented the following three actions to reduce payments system risks: (a) alignment of the operating hours of the NRB's banking department with the operating hours of SWIFT; (b) implementation of online transfers of funds between NRB branches; and (c) implementation of a pre-settlement file system.	• Consulting and staff support provided by FIRST, World Bank, and IMF
A new Insurance Act has been approved by the Cabinet and submitted to Parliament for approval.	• FIRST consulting support to review the Insurance Bill
The Bill on BAFIA has been approved by Parliament.	• Consulting and staff support provided by DFID, FIRST, World Bank, and IMF
The Cabinet has approved the Asset (Money) Laundering and Prevention Regulations.	• IMF TA

ANNEX 6: THE EARTHQUAKE AND ITS AFTERMATH

The Earthquake and its Economic and Financial Impact

1. **On April 25, 2015, a massive 7.8 magnitude earthquake hit Nepal, the worst in 80 years.** It, and hundreds of aftershocks that followed, including a 7.3 earthquake on May 12, caused over 8,700 deaths as well as widespread damage. The GoN identified 14 districts[16] as the most affected and has concentrated its relief and reconstruction efforts there. In the early days following the first earthquake, some 24,000 internally displaced people were hosted in 13 camps in Kathmandu alone; 500,000 houses were destroyed (most traditional mud-stone or mud-brick houses in the affected areas collapsed or have become structurally unstable); and as many as 3 million people—many living in very remote rural mountain communities—needed food assistance.

2. **The GoN led a major humanitarian effort, in coordination with the United Nations Office for the Coordination of Humanitarian Affairs and in partnership with national and international agencies.** The Prime Minister Relief Fund was used by the GoN to provide immediate relief of NPR 6 billion, and the Cabinet established a US$2 billion Recovery and Reconstruction Fund. Additionally, the prime minister tabled a proposal in Parliament with various measures, including US$2,000 in compensation to households that suffered complete demolition of their home provided they rebuild to new standards and temporary shelter to the homeless and free education and upkeep of children who have lost their parents. In the financial sector, the authorities' immediate response to the disaster was to restore cash liquidity and payment services to ensure that the population had access to funds so that remittances and trade could flow.

3. **Within a few weeks after the earthquake, the GoN, with the help of development partners, carried out a PDNA.** The PDNA estimated that that total damages and losses resulting from the earthquake amounted to about US$7.1 billion. Of that amount, NPR 5.2 billion (or 76 percent of the total effects) represents the value of destroyed physical assets, and NPR 1.9 billion (24 percent of the total effects) reflects the losses and higher costs of production of goods and services arising from the disaster. Losses are expected to unfold over the next several years.

4. **The sector decomposition of the total effects (damages and losses combined) due to the earthquake illustrates the overwhelming impact on individual households.** With 755,000 houses damaged, the US$3.5 billion worth of damages and losses to housing and human settlements represents almost 50 percent of the US$7.1 billion total disaster effects to the economy. The social sectors—comprising housing and human settlements, health, education, and cultural heritage—sustained 58 percent (US$4.1 billion) of the total effects. Further, the productive sector of agriculture, irrigation, commerce, industry, tourism, and finance as a whole sustained 25 percent (US$1.8 billion) of the total effects while the infrastructure sector and crosscutting issues made up 10 percent (US$0.7 billion) and 7 percent (US$0.5 billion), respectively.

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[16] Sindhupalchowk, Kathmandu, Nuwakot, Dhading, Rasuwa, Gorkha, Kavrepalanchowk, Bhaktapur, Lalitpur, Dolakha, Makawanpur, Ramechhap, Okhaldhunga, and Sindhuli.

5. **Public and private sectors have also been affected disproportionately with 76 percent of the damages and losses inflicted on the private sector while the public sector sustained 24 percent.** This assessment together with the fact that the entire damage and loss in housing was sustained by the private sector and that rural populations were more affected highlights the need to ensure availability of finance through banking and nonbanking institutions for the recovery of the private sector.

6. **Preliminary estimates are that in the most heavily affected 14 districts (which includes Kathmandu), about 9.4 million people are affected.** Rural poverty rates in the affected districts are higher than the national average at 28.6 percent in 2010/2011, and 9 out of the 14 severely affected districts have human development index lower than the national average of 0.491. Further, within the most-affected districts, it is the disadvantaged social groups that have been affected the greatest, with the poorest quintiles of the population suffering the most. As a consequence, the earthquake has disproportionately affected rural and poorer communities more than urban and higher-income households. Even within the urban and peri-urban areas of the Kathmandu Valley, households that were either already at the lower end of the income scale or vulnerable have been more affected. Initial analysis noted in the PDNA suggested that the earthquake could push an additional 2.5–3.5 percent of Nepalese (700,000–982,000 people) into poverty. However, the rise in the level of poverty is yet to be substantiated by the authorities.

7. **Despite substantial challenges, the Government completed the PDNA and presented the findings at the International Conference on Nepal's Reconstruction on June 25, 2015.** The conference was attended by delegates from 43 countries and development agencies, and a total of US$4.1 billion was pledged to assist Nepal in its recovery needs as the GoN articulated its reconstruction plan. Of the total amount pledged, US$2 billion are grants while the remaining are loans.

Table 6.1. Pledges from International Community to Support Nepal's Recovery and Reconstruction Plan (US$, millions)

	Loans	Grants	Total	New Pledges*
Bilateral - Total	**958**	**1,972**	**2,2929**	**2,143**
China	—	767	767	490
European Union	—	117	117	117
India	750	650	1,400	1,000
Japan	208	52	260	260
United Kingdom	—	110	110	63
United States of America	—	130	130	68
Others	—	145	145	145
Multilateral - Total	**1,130**	**20**	**1,150**	**600**
Asian Development Bank	580	20	600	250
IMF	50	—	50	50
World Bank	500	—	500	300
Total	**2,088**	**1,992**	**4,079**	**2,743**

Note: Not reallocated previous commitments.

8. **The Government also announced policy measures which were crucial not only for immediate relief but also for longer-term recovery and reconstruction.** These measures are discussed in the following paragraphs.

9. **Cash assistance to the family of earthquake victims.** Families that lost a member in the earthquake were distributed NPR 40,000 per dead person as cremation cost. Additionally, the Government decided to provide a fixed sum of NPR 100,000 to each family that had lost one or more members.

10. **Temporary shelters and rehabilitation of those rendered homeless.** The Government distributed tents/tarpaulin and other basic items to the affected population in the crisis-hit districts. It also provided tin-sheets or NPR 15,000 to each affected family for managing a temporary accommodation in view of the upcoming monsoon.

11. **Housing subsidy and concessional loan.** The GoN announced a housing subsidy of NPR 200,000 for a fully destroyed house and for those who wished to rebuild their houses on their own. Additionally, a concessional loan up to NPR 2.5 million in the Kathmandu valley and NPR 1.5 million outside the Kathmandu valley at just 2 percent interest rate under 'Earthquake Victim Special Loan' scheme was announced. Those who wished to repair their partially damaged houses were provided with a sum of NPR 25,000 per family as a maintenance cost.

12. **National reconstruction authority (NRA).** Right before the donors' conference, the Government also announced the plan to establish the NRA with the mandate to coordinate and oversee the reconstruction process. It was proposed to be headed by a Cabinet-level CEO.

13. **Budget for FY2016 and FY2017.** During the past two fiscal years, the adopted budgets have called for a substantial increase in expenditures, driven to a large extent by increased needs in post-earthquake reconstruction. The planned outlay for the FY2016 budget was 33.5 percent of GDP while the actual expenditure remained at 23 percent of GDP, that is, the deviation was more than 11 percent of GDP. The FY2017 budget has been even more ambitious, with a target of 36.5 percent of GDP—that is, an increase of 14 percent of GDP compared to FY2016 actual spending—which is also unlikely to materialize.

14. **Monetary Policy FY2016.** The Monetary Policy 2016 is also geared toward supporting economic recovery following the April 2015 earthquake through promoting credit uptake. The NRB reiterating the GoN's earlier announcement of providing 0 percent refinancing to BFIs willing to provide loans to earthquake-affected households at 2 percent interest rate was a direct commitment on post-disaster reconstruction.

15. **Despite these various measures, implementation has been slow in FY2016 and is picking up in FY2017.** The NRA bill in the Parliament was passed with a significant delay. As a result, the actual setup of the NRA and appointment of the CEO was also delayed. Additionally, the political uncertainty surrounding the constitution writing process, which has been marred by severe strikes, curfews, and trade disruptions, has hampered the Government's reconstruction spending plans. Even the reconstruction effort being carried out by individuals and the private sector has been brought to a standstill due to the recent trade and transit impasse. The housing reconstruction subsidy has significantly picked up at the end of FY2016 and beginning of FY2017. More than 500,000 households have received their first tranche of housing subsidy. However, the uptake of loans announced by the GoN is likely to be low as BFIs have voiced concern that the 2 percent interest rate spread was too low to even cover their administrative costs; thus, they lack incentive to promote the product.

16. The Government's recurrent expenditure is expected to grow in FY2017, owing to an increase in earthquake-related cash assistance, the hike in civil servants' salaries, increase in pensions, and other social security expenditures. The slow pickup in capital expenditures, particularly those related to earthquake reconstruction, resulted in a fiscal surplus in FY2016 (estimated 1.7 percent of GDP). The healthy growth in revenues is expected to continue, particularly in light of increased imports for reconstruction activity. However, with the pace of expenditures picking up as reconstruction efforts take full shape, the fiscal balance is likely to turn negative in FY2017 (projection of negative 0.5 percent of GDP). Foreseeing this, out of the pledges received, the GoN has been requesting development partners to commit the resources. Additional domestic and external borrowing, however, would be unlikely to put Nepal at risk of debt distress given the current low levels of external debt, which bodes well for recovery efforts.

17. In the financial sector, the authorities' immediate response to the disaster was to restore cash liquidity and payments services to ensure that the population has access to funds and that remittances could be received and to allow private domestic and international trade to flow to maintain critical supplies. Despite severe physical damage to the NRB's main cash distribution facilities and to its headquarters, it was successful in getting cash to banks and in restarting the electronic check clearing system. SWIFT, automated teller machines, and debit/credit card services were also quickly restored, and some damaged bank branches quickly reopened.

18. **The earthquake created new challenges for Nepal's financial sector whose resilience is critical to recovery efforts.** Preliminary analysis indicates that concerns to the financial system fall into the following main areas: (a) physical damage to the NRB's and BFIs' infrastructure (including the collapse of NRB's headquarters and its main cash vault building); (b) capital erosion and the threat of insolvency of some institutions due to disaster-related asset quality problems; (c) potential stresses in the balance sheets of some insurance companies as a result of massive claims arising from the disaster; and (d) a major reduction in access to finance to small firms and also in rural areas as a result of large-scale insolvency of MFIs and FINGOs. The impact of the disaster on banks and insurance companies has the potential to cause stresses, with contagion between the two sectors. Work to quantify the potential impact of the disaster on BFIs and insurance companies is under way.[17]

19. **Potential for contagion from the insurance to the banking sector is also an issue.** By regulation, all of the BFIs' direct real estate exposure should be covered by casualty insurance. However, the analysis of collateral performed as part of the 54 BFIs in the NRB SIP showed widespread weaknesses in collateral administration. In addition, zoning violations are common and in many cases borrowers have not obtained proper building certification. There are also concerns about the insurance sector's financial capacity to reimburse banks, which are the beneficiaries of the insurance arrangement. Given the possibility of some weaker BFIs and insurance companies being affected and the potential contagion between the sectors, the authorities will have to consider action to strengthen the financial sector safety net (including

[17] The NIB has announced formation of a task force to examine post-disaster insurance company solvency and in October 2015, DFID launched a cross-assessment of BFIs, drawing on the collateral database and loan portfolio structure data developed for the SIP.

providing adequate funding lines for the DCGF) and to establish last-resort recapitalization facilities for BFIs and insurance companies that are considered systemically important.

20. **The earthquake and its aftermath may also exacerbate access to finance-related problems.** Many MFIs and FINCOs operate in the rural areas of the country, and some exclusively in the areas worst-affected by the disaster. As a consequence, several hundred thousand MFI and FINCO members have suffered loss of shelter, livestock, and livelihood, and in some cases loss of life. A prolonged disruption in the functioning of these institutions may be a severe obstacle to rebuilding livelihoods in the worst-affected communities. As most of the affected borrowers do not have alternative income-generating activities or sources of repayment, the MFIs and FINCOs are likely to face both liquidity and solvency issues, affecting their capacity to assist their communities in a time of need. The sector is especially vulnerable due to the lack of sources of funds diversification, weak or nonexistent IT systems, and low connectivity. Severe difficulties in the MFI and FINCO sectors could affect Class A, B, and C banks. A key source of funding for MFIs is funding from other BFIs which are mandated by the NRB to lend a portion of their portfolio to the Deprived Sector. As of mid-July 2016, BFIs had an exposure of NPR 94.2 billion under Deprived Sector lending, out of which NPR 52.4 billion was on-lent through the MFIs and the remaining through their own lending. MFIs had a total loan exposure of NPR 77.2 billion. Preliminary estimates indicate that a third of the Deprived Sector exposure is considered portfolio at risk. Assistance to the MFI sector may be required in the short term in the form of a temporary reprieve of regulatory requirements, liquidity support, and even capital injection if necessary.

ANNEX 7: THE RECAPITALIZATION AND STRENGTHENING OF NBL AND RBB

1. **The recapitalization plans of the two state-controlled banks are phased and have been proceeding mostly according to plan, indicating the seriousness of the GoN and the NRB in addressing the vulnerabilities of the financial sector and, in particular, those of the two state-controlled banks.** Both the RBB and NBL have been essentially 'sterile' for more than 10 years as a result of lending limit restrictions (due to CAR non-compliance). The RBB has begun to increase lending, but the bank is focused on retail lending with small loans (for example, for vehicle and home purchases) and neither bank participated in financing the real estate bubble that is the proximate cause of asset quality problems in other BFIs. Major NPLs—which mostly date from the 1990s before the banks began the restructuring process—have been written down to zero in both banks, providing scope for significant capital gains as a result of collateral sales. Both the RBB and NBL are systemic, with more than 5 percent of system deposits. Both banks were profitable in FY2013–2014 and FY2014–2015 (the RBB was the most profitable bank in Nepal in FY2014–2015). As part of the FSDS, the future role of the RBB in the banking system will be addressed.

2. **The status of the two banks' recapitalization plans and achievements as of mid-July 2015 is shown in**

3.

4. Table 7.1 **and Table 7.2.** The first phase, supported by DPC1 and DPC2, achieved its targets of increasing the solvency for these two banks: both banks were insolvent (that is, a negative CAR) and moved to positive CAR under phase 1 of the recapitalization supported by DPC1. DPC2 supported phase 2 of the recapitalization, which ensured that the RBB was profitable and fully recapitalized to meet prudential requirements and that the NBL was profitable and achieved a positive CAR of above 5 percent.

5. **DPC3 further deepens the institutional reform process and supports the completion of critical steps required for the final cleanup of the banks' balance sheets which will lead to the full divesture of the NBL.** In the second half of 2015, both the RBB and NBL began the NRB Special Inspections as part of the DFID-supported SIP, the results of which will not appear in the two banks' audited financial statements for FY 2016, as the audit is likely to be completed by third quarter of FY 2017. SIP inspections are expected to result in significant adjustments to the banks' CAR as a result of the in-depth diagnostic of accounting, reconciliation, and bookkeeping errors which have built up over time and the identification of any unrecognized asset quality problems.

6. **As result of the SIP inspections, major adjustments to the CAR of both RBB and NBL (with possible further small adjustments to reflect impact of the earthquake on the two banks) occurred in early 2016, although both banks are expected to remain operationally profitable.** In case the CAR of both RBB and NBL falls below prudential norms, it will be addressed using retained earnings of subsequent fiscal years which are likely to be sufficient. In the case of the NBL, the CAR shortfall can be further addressed by GoN divestiture of its shares in the bank. No further fiscal contribution to the recapitalization of either banks is expected, and the GoN will be able to secure the return of its investment in the NBL.

Table 7.1. Status of Implementation of the Capital Plan of the NBL

	Source of Approved Capital Plan	Estimated Amount to be Received as Capital	Status as of mid-July 2015
1	From sale of rights shares to the then shareholders at the ratio of 1:1.515728	Paid up capital to be NPR 4 billon	NPR 3.96 billion
2	From sale of nonbanking assets (houses and land)	Provision of NPR 2 billion to be made	NPR 910 million
3	From profits accrued during FY2013/2014, and FY2014/2015	NPR 3.27 billion	NPR 1.24 billion
4	To convert the SDR loans received in FY2014 as additional resources in share capital	NPR 2.49 billion	NPR 2.49 billion
5	Estimated capital adequacy percentage	Targeted CAR as of mid-December 2014: 5%	7.08% as of mid-July 2015 (5.28% as of mid-December 2014)

Source: NBL.
Note: CAR as of mid-July 2016 is 11.4 percent.

Table 7.2. Status of Implementation of the Capital Plan of the RBB

	Details	Share Capital as per Plan	Status as of Mid-July 2015
	Existing equity shares	NPR 385.3 million	NPR 385.3 million
1	Conversion of 1% preference shares	NPR 787 million	NPR 787 million
2	Capitalization of dividend payable	NPR 86.57 million	NPR 86.57 million
3	Book value merger with Nepal Industrial Development Corporation	NPR 415.82 million	n.a.
4	Transfer of long-term SDR borrowing	NPR 2,500 million	NPR 3,004.79 million
5	Further capital injection	NPR 4,325.31 million	NPR 4,325.31 million
6	From profits accrued during FY2012/2013, FY2013/2014, and FY2014/2015	NPR 3,000 million	NPR 7, 648 million
	CAR as of end of fiscal year mid-July 2015	10.34 percent	—

Source: RBB.
Note: CAR as of mid-July 2106 was 11.2 percent.

7. As can be seen in these two tables, no fiscal contribution is expected in the final phase of the banks' recapitalization programs which are being fully financed by asset sales and retained earnings. In the case of the NBL, which has private shareholding, the recapitalization plan has adequately minimized unintended benefits for private shareholders.

ANNEX 8: EFFECT OF NRB CAPITAL INCREASE REQUIREMENTS ON NEPAL FINANCIAL SECTOR

1. **In the NRB Monetary Policy for 2015/2016 published in July 2015, the NRB announced a fourfold increase in paid-up capital of all Commercial Banks (Class A), Development Banks (Class B), and Finance Companies (Class C).** This announcement was followed up by the issuance of a new Directive in August 2015. BFIs will be required to increase the minimum paid-up capital to promote the financial stability and mobilize the resources needed for the long-term development. Commercial banks will be required to increase paid-up capital to NPR 8 billion, national-level development banks NPR 2.5 billion, development banks operating in 4 to 10 districts NPR 1.20 billion, and the development banks operating in 1 to 3 districts NPR 0.50 billion. Similarly, national-level finance companies and finance companies operating in 4 to 10 districts will require NPR 0.80 billion paid-up capital and those operating in 1 to 3 districts NPR 0.40 billion paid-up capital. BFIs are required to meet this provision by mid-July 2017. In addition, BFIs will be further encouraged for mergers and acquisitions (M&A).[18]

2. **Table 8.1 provides a comparison of the previous and new paid-up capital requirement.** According to the NRB, the new levels were determined after a review of similar programs in other developing countries.

Table 8.1. Old and New Paid-up Capital Requirements

Class	National Level		4–10 District (2)		1–3 District (2)	
	Old (NPR)	New (NPR)	Old (NPR)	New (NPR)	Old (NPR)	New (NPR)
A	2 billion	8 billion	n.a.	n.a.	n.a.	n.a.
B	640 million	2.5 billion	300/200 million (1)	1.2 billion	300/100 million (1)	500 million
C	300/200 million (1)	800 million	n.a.	800 million	300/100 million (1)	400 million

Note: (1) Second number represents the required amount if no leasing business or other limitations.
(2) The required levels for Class B and C differ depending upon their operating area.

3. **BFIs were required to submit a plan on how they will attain these new levels by mid-September 2015.** According to the NRB, some BFIs have indicated they will issue shares to cover the increase and others have said they will seek merger partners. Those BFIs who fail to meet the new requirements by mid-July 2017 will be subject to the following actions:

(a) Restrictions on declaring and distributing dividend or bonus shares

(b) Prohibition in deposit collection

(c) Prohibition in providing loans

(d) Prohibition in opening new branches

4. **This effectively renders a BFI no longer an active operating bank and would lead to voluntary liquidation of some other form of resolution.** M&A have been active already

[18] From NRB Monetary Policy 2015/2016 published on the NRB website.

among the three affected classes, reducing the number from 199 at mid-January 2012 to 135 by mid-July 2016 (a reduction of 64 percent or 32 percent). To meet the new capital requirements, many additional BFIs are expected to merge or go out of business.

Table 8.2. Current and New Required Paid-up Capital if All Banks Survive

Class	Paid-up Capital mid-July 2015 (NPR, thousands)	New Required Levels by mid-July 2017 (NPR, thousands)
A	97,923	240,000
B	27,450	91,200
C	15,390	33,600
Total	**140,763***	**368,700**

Note: * As of mid-March 2016, total paid-up capital for all Class A, B, and C BFIs was 155,048, an increase of 14,285 or 10.15 percent.

5. **A paper published by the NRB provided the rationale behind the increase and their preference for BFIs to merge or acquire each other.** In table 8.2, current paid-up capital (not total capital fund but only what many refer to as common stock internationally) amounts to NPR 140.8 billion. As of July 2015, if all 153 BFIs survived by raising new capital, the total required capital would have been NPR 368.7 billion. That is an increase of NPR 227.9 billion or 161.93 percent. As of mid-March 2016, total paid-up capital was 155,048 for an increase of 14,285 or 10.15 percent. It seems highly unlikely that kind of additional capital exists in Nepal or foreign sources would be willing to come and invest in Nepal. Fewer number of BFIs leads to better corporate governance, stronger capitalized institutions, and a greatly reduced supervision burden on the NRB, which requires to conduct annual examinations of all 145 current BFIs.

6. **The more likely scenario is a reduction by merging and for those who cannot find a merger partner, voluntary or involuntary liquidation depending upon the individual circumstances of each BFI.** In addition to the scenario described above of all new capital, another scenario (although the real answer is probably somewhere between the two extremes) no new capital enters the financial sector. Based on the new requirements, using mid-July 2015 data, the number of BFIs would reduce by 100 to 53, as shown in table 8.3, based on BFI operating levels and level of paid-up capital. Given the high number of BFIs, considerable consolidation in the banking sector remains to meet the mid-July 2017 deadline.

Table 8.3. Current and New Number of BFIs if No New Capital Enters the Banking Sector

Class		National Level		4–10 Districts		1–3 Districts		
	Total BFI By Class	Current Number of BFIs	New Number of BFIs	Current Number of BFIs	New Number of BFIs	Current Number of BFIs, Old	New Number of BFIs	New BFIs By Class
A	30	28	12	n.a.	n.a.	n.a.	n.a.	**12**
B	76	23	7	8	3	36	11	**21**
C	47	36	18	0	0	6	2	**20**
Total	**153**	**87**	**37**	**8**	**3**	**42**	**13**	**53**

International Experience with Banking Sector M&A and Recapitalization

7. **Analyzing the effects of M&A and capitalization in Malaysia and Nigeria illustrate differing consequences.** In response to the Asian Financial Crisis of the 1990s, the Central Bank of Malaysia implemented guided mergers of the banking industry to reduce the total number of

banks from 54 to 10 anchor banks. The central bank increased the minimum capital requirement to RM 2 billion and minimum total assets to RM 25 billion by the end of 2000 to build strong local banks that were capable of competing with international banks. As a consequence, there was significant improvement on return on assets (ROA) and return on equity (ROE) of the Malaysian banking industry.[19] On the other hand, Nigeria's banking sector history is littered with central bank-directed recapitalizations for commercial banks (averaging nearly once every four years since 1952)—in many cases, to keep up with high inflation rates. Over a long period (1970 to 2010), it was observed that there was a positive correlation between increases in the capital base of banks and profitability.[20] However, the opposite was found to be true during the Central Bank of Nigeria-directed minimum capital increase in 2005. The mean ROA and ROE for banks were considerably lower in the five years after the central bank-directed capitalization of 2005 than the five years previous to capitalization[21] even as banks benefitted from decreasing costs.[22]

8. **The improvements in ROA and ROE in Malaysia after banking sector consolidation are likely attributable to banks exploiting economies of scale and economies of scope.** The improved ROA is most likely attributable to the fact that M&A helped banks reduce the fixed cost by removing duplicate operation departments, thereby increasing income through reduction in operating cost. M&A can also increase the ability of banks in diversifying their businesses through consolidation of a variety of assets which allows banks to provide a greater variety of services and investments. In addition, it increases the talent pool and the knowledge base of the bank after mergers can improve management's performance.

9. **However, the greatest positive impact of the Malaysian banks were on small- and medium-size banks as they made cost savings from mergers via economics of scale,[23] while larger banks, which already enjoyed economies of scale before M&A, did not benefit as much.** This finding is also supported by Amel et al. (2004), where they indicate that scale economies in retail commercial banking have a relatively flat U-shaped average cost curve, indicating that efficiency gains from exploiting economies of scale disappear once a certain size is reached.[24] Further, Ugwuanyi and Eqwah (2015) point to the fact that capital increases alone are not sufficient to improve profits and banking sector stability, as in the case with Nigeria in the 2000s, but rather a conducive economic environment is important where banks can generate an optimal investment portfolio mix from their capital bases. Further, conventional theory states more capital enhances stability and reduces risk, but since capital is costly to raise, over-capitalization can put banks under pressure to generate higher returns from the additional capital,

[19] Ong, T. S., and P.P. Ng. 2013. "Capital Structure Before & After Merger and Acquisition: Banking Industry in Malaysia*." International Journal of Management Sciences a Business Research* II (1).
[20] Clementina, K., and H. O. Isu. 2013. "The Impact of Capitalization on Bank Performance in Nigeria 1970–2010: An Assessment." *International Review of Management and Business Research* II (3).
[21] Ugwuanyi, G. O., and E. B. Ewah. 2015. "Bank Capital Requirement as Regulatory Tool in Nigeria – A Critique." *International Journal of Economic, Commerce and Management* III (2).
[22] Barros, C. P., and G. M. Caporale. 2012. "Banking Consolidation in Nigeria 2000-2010." Economics and Finance Working Paper Series. Working Paper 12-06. Brunel University.
[23] Sufian, F. 2004. "The Efficiency Effects of Banks Mergers and Acquisitions in a Developing Economy: Evidence From Malaysia." *International Journal of Applied Econometrics and Quantitative Studies.*
[24] Amel, D., C. Barnes, F. Panetta, and C. Salleo. 2004. "Consolidation and Efficiency in the Financial Sector: A Review of the International Evidence." *Journal of Banking & Finance* 28 (10).

thereby forcing them to take greater risks which, if it occurs, will have a negative impact on the performance of banks.

Regulators' Role: Supervision, Guidance, and Oversight

10. **Drawing on experience in other countries which have used a large increase in minimum capital requirements to drive consolidation of banks, the likely merger of a large number of BFIs over a short period will present the NRB and other regulators such as SEBON and Nepal Stock Exchange (NEPSE) with major supervisory challenges.**

- For banks which apply to merge, it is essential that the NRB ensure that neither of the following happens:

  - Mergers between poorly capitalized and problematic banks occur (given the number of BFIs which will be seeking merger partners, the probability of weak institutions only being able to find weak merger partners will increase sharply). Such mergers often simply create larger problem banks—an effect compounded by the operational and managerial stresses of the merger process—increasing potential resolution costs for the taxpayer.

  - Mergers where the weaker institution has the potential to make a merger with a healthier partner only result in the failure of the merged banks. In all cases, the NRB should ensure through rigorous analysis and in-depth full scope pre-merger inspections that the resulting institution from a merger is viable in the long term and can meet or exceed all prudential norms.

- Given the amount of capital which will have to be raised from investors for capital increases, the NRB, SEBON, and NEPSE will need to ensure that investors are not defrauded, given the impact that could have in suppressing the market for BFI investment. This highlights the importance of ensuring that the financial information and other information provided by BFIs in offering documents is accurate and complete, which in turn implies that the NRB ensures that banks are fully provisioning problematic assets and accurately reporting their capital and earnings.

- As highlighted by the Nigeria case, it is essential that the NRB, SEBON, and NEPSE be on guard against BFIs using their deposits to finance 'purchases' of their own capital issuances. Recent inspections have highlighted that false recording/not recording the purpose of loans is endemic in BFIs, and over the past year, there has been an increase in margin lending for share speculation. The regulators, and particularly the NRB, should be on guard and incorporate into inspections targeting of not-used-for purpose, no stated purpose, loans to brokerages, and margin lending and sudden increases in lending in the period before a share increase to detect self-financing of capital increases.

ANNEX 9: THE FINANCIAL COOPERATIVES SECTOR AND THE INSURANCE SECTOR

1. **Concerns regarding the condition of the fast-growing FINCOs sector have been increasing.** Three recent government task forces[25] and analyses performed by the FSAP and for the FSDS have concluded that regulation and supervision of FINCOs is essentially nonexistent owing to weaknesses in the Cooperatives Act and a lack of supervisory capacity. The NRB supervises only 15 FINCOs out of 17,000 operating ones which account for more than 15 percent of the assets of the financial system. The remainder are licensed by the Registrar of Cooperatives, which has virtually no supervisory authority and no resolution powers of its own. Growth has been driven by the limited reach of the formal banking sector, the ease of registration, tax incentives, and access to deprived sector funds. Furthermore, KYC oversight is less stringent in the cooperative sector, which—with the exception of NRB-regulated Class D MFIs—does not report to the Credit Information Bureau, potentially creating adverse selection problems. Regulatory arbitrage and weak oversight have created the conditions for the emergence of fraudulent and poorly performing FINCOs. In 2013–2014, a number of large FINCOs collapsed and exposed the lack of a resolution mechanism as a major problem. This affects the reputation of the whole sector and its continued growth could undermine the stability of the formal financial sector, as many of these cooperatives have financial dealings with regulated FIs.

2. **The FSDS prioritizes preparing a feasibility and design study for an apex institution for FINCOs.** The strategy emphasizes the importance of assigning and institutionalizing the roles of the NRB and Department of Cooperatives in the regulatory and supervisory framework for cooperatives. It also advocates developing a crisis management system and legal protection measures for cooperatives and their members, which will become even more relevant in the aftermath of the earthquake. An ordinance approved by the president was issued in late April 2015—which is now being considered by Parliament —to create some rudimentary resolution tools (such as creation of a Management Committee led by a retired judge to oversee the restructuring of troubled financial cooperatives and pursue prosecution of management and insider malfeasance) and the Registrar of Cooperatives has made efforts to intensify its monitoring of troubled FINCOs. The act has been forwarded to the Parliamentary for approval. In addition, the government is also considering introducing a new act—Second Tier Institution (STI) Act to oversee and regulate the FINCOs. Preliminary draft of the STI Act is being reviewed by the NRB and the Ministry of Finance. Provisions of a minimum threshold with regard to balance sheet size of the FINCOs are being deliberated to ensure that larger institutions are governed (licensed, supervised, and regulated) by the Central Bank while smaller institutions are governed by the STI. The threshold being deliberated is NPR 250–500 million (US$2.5–5 million). A major issue surrounding the execution of the STI Act relates to resources to operate the STI. The NRB is considering deputing some of its human resources to the institution in the initial phase of operations. The linkages between the Cooperatives Act and the STI Act will be similar to the BAFIA and NRB Act that run in parallel.

[25] The Aryal Committee of 2012, the Adhikari Probe Committee of 2013, and the Karki Commission of 2013.

3. **In addition, there are many small FINGOs, of which 27 are licensed by the NRB, with low capital requirements and small-scale operations.** As part of the NRB's efforts to consolidate the microfinance and cooperative sector and strengthen the regulation and supervision of MFIs (supported by DPC2), it issued a notice in October 2013 to FINGOs, authorized by the NRB, to convert to Class D MFIs by mid-July 2015. Because of the massive earthquake in April 2015, the NRB extended the timeline for conversion of FINGOs to Class D institutions to mid-July 2016. As most of the FINGOs were not yet in a position to meet Class D requirements, the deadline is being considered for extension and a new date is expected to be announced after consultation with registrar of the NGOs, Company's registrar and relevant stakeholders. Many of these institutions will need to increase their capital to comply with this requirement, as a result of which many are likely to merge or be acquired by other BFIs. The impact of the earthquakes on FINGOs may also have been very severe and there is potential for contagion between FINGOs and BFIs as a result of BFI-deprived sector lending to FINGOs, which then on-lend the funds to FINCOs and MFIs that may now be insolvent. DFID has already committed to support diagnostics of the FINCO sector and may accelerate and expand its support to incorporate FINGOs in these diagnostics.

4. **The Insurance Act is outdated and does not give the NIB adequate powers to regulate and supervise the sector.** The NIB's ability to resolve undercapitalized insurance companies is limited. The DFID-supported NRB/NIB diagnostic of the impact of the earthquake on FIs and insurance companies is expected to be completed by December 2016 and is expected to highlight the need for improvements in the regulatory framework in the insurance sector. In particular, it is expected to lead to a better understanding of the impact of the earthquake by identifying contagion risks between insurance companies and BFIs. To ensure that there is adequate focus on maintaining insurance sector stability, DPC4 will support the enactment of the new Insurance Act which empowers the NIB to ensure that all insurance companies are compliant with minimum capital and technical reserve requirements or are in NIB-approved corrective actions or resolution programs. DFID-supported in-depth diagnostics of insurance companies in 2016 (along the lines of the SIP for BFIs) will also be a trigger for DPC4.

ANNEX 10: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
Restructuring and Consolidating the Financial System		
1. The MoF has endorsed the NBL Strategic Divestiture Plan and submitted it to the Secretariat of the Privatization Committee.	No	No
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 FIs found to be undercapitalized.	No	No
3. The NRB has completed a diagnostic of the impact of the earthquake on BFIs in the earthquake-affected districts.	No	Positive: Diagnostic will assist the NRB in evaluating the impact of the earthquake on the financial sector and expected to have positive impact through NRB measures adopted to benefit the borrowers from the affected areas.
4. The NRB has issued a directive on the increase of minimum paid-up capital for BFIs.	No	No
Strengthening the Legal and Regulatory Framework for Crisis Management, Banking and Insurance Supervision		
5. The NRB Act Amendments Bill has been approved by Parliament.	No	No
6. The Bill on DCGF has been approved by Parliament.	No	No
7. The DCGC and NRB have executed a memorandum of understanding governing cooperation and exchange of information.	No	No
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; (b) implementation of online transfers of funds between NRB branches; and (c) implementation of a pre-settlement file system.	No	Positive: Supports retail payments system which is the backbone of digital transaction accounts and remittance transfer, which plays a crucial role in reducing poverty.
Enhancing the Governance and Transparency of the Banking Sector		
9. The Bill on Banks and FIs has been approved by Parliament.	No	No
10. The Cabinet has approved the Asset (Money) Laundering and Prevention Regulations (ALPR)	No	Positive: Implementation of ALPR is expected to improve disclosure standards in opening and operation of bank accounts.

ANNEX 11: LETTER OF DEVELOPMENT POLICY

Government of Nepal
MINISTRY OF FINANCE

RECEIVED
03 JUN 2016
Ref/1298
WORLD BANK RECEPTION

SINGHADURBAR
KATHMANDU, NEPAL
2 June 2016

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 crisis 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, overhauling the regulation and supervision of the banking and financial institutions, limiting Government control and ownership of financial institutions, placing the financial sector safety net on a firm footing, and laying the ground for further reform programs 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.The on-going reform is the third phase (mid-2015 to mid-2016). 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. In the initial years of the reform program, we were able to set up a financial sector safety net by establishing the Deposit Guarantee Fund (DGF) and embarked on the restructuring and recapitalization of two large state-controlled commercial banks, Rastriya

Tel : Minister 4211809, Secretary 4211332, IECCD 4211371, 4211867
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Banijya Bank (RBB) and Nepal Bank Limited (NBL). Both RBB and NBL insolvent for more than a decade, now meet the statutory capital requirement and are amongst the highest earning commercial banks in the country. Following the drafting of extensive amendments to the Nepal Rastra Bank (NRB) Act (NRBA Bill) and the Bank and Financial Institutions Act (BAFIA), and a new Deposit and Credit Guarantee Fund Bill (DCGF Bill), these bills have been submitted to the Parliament for approval. These three bills propose to strengthen the NRB's resolution powers, to improve governance of financial institutions and to place the DGF on a firm legal foundation.These reforms were supported by two Development Policy Credit operations, which were approved by the World Bank's Board of Executive Directors in June 2013 and June 2015 respectively. Other reform activities that were completed during these two phases (2012 – 2014) include the following:

- The diagnostic of the banking system covering 27 of the 54 financial institutions, of a program of 54 in-depth Special Inspections of all at-risk and systemic banks has been completed. The NRB also initiated appropriate prompt corrective action and resolution enforcement measures;

- Throughout the reform phases, the NRB has maintained its moratorium on licensing of new banks and financial institutions (BFIs), and in 2014 also issued a new bylaw on acquisitions to facilitate further consolidation of the banking system;

- In 2014, the Parliament approved and enacted ordinances covering key AML/CFT measures: the Mutual Legal Assistance Act, the Extradition Act, and the Organized Crime Act. Along with the already enacted Asset (Money) Laundering Prevention Act (2008). These legislations provide a legal framework in line with international standards, and Nepal is no longer "grey-listed" by FATF;

- In 2014, NRB Board approved the National Payments System Development Strategy;

- In 2015, Ministry of Finance completed and approved a long term Financial Sector Development Strategy (FSDS) based on wide consultations;

5. The Government of Nepal is making rapid progress towards implementing the medium-term strategy for reforming the financial sector and has been able to refine policies and strategies using the information and recommendations provided by Nepal's participation in the Financial Sector Assessment Program (FSAP) in 2014. The Government's on-going program

for the financial sector focuses on reforms designed to achieve two over-arching policy objectives; (i) to ensure the stability of the financial system by improving the quality of regulation, supervision, and transparency to levels closer to international norms; and, (ii) to start improving access to formal financial services. These objectives will be maintained and also supplemented by measures designed to support the recovery of the financial sector from the impact of the earthquake and the trade disruptions, and put in place needed measures to ensure the operational resilience of the sector in the face of natural disasters.

6. The reforms under our medium term strategy under the third phase which we have completed since the mid-2015, include the following:

- Taking further steps to complete the restructuring and divestiture of state-controlled commercial banks by: in the case of RBB, recapitalization to above the minimum capital adequacy ratio of 10 percent; and, in the case of NBL, recapitalization to 9.55 percent capital adequacy and initiation of divesting Government owned shares in NBL to a bank strategic investor;

- Completion in December 2015 of the second and final phase of a diagnostic of the banking system, thereby representing about 70 percent of banking system assets of a program of 54 in-depth Special Inspections of all at-risk and systemic banks. The NRB has initiated appropriate prompt corrective action or resolution enforcement measures (including recapitalization, merger, and closure) for all undercapitalized financial institutions;

- In December 2015, a quick diagnostics of the BFIs to assess the impact of the earthquake disaster on their assets was carried out;

- In 2015 and in 2016, the Government responded to the queries/comments raised on NRBA Bill, DCGF Bill and BAFIA Bill by the parliamentary sub-committee as part of deliberation process and the remaining NRBA Bill is not be tabled in the ongoing parliamentary session and Finance Committee has already tabled two out of three Bills in the full House for approval. The bills, once enacted, are expected 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; and (iii) improve the governance of state-controlled financial institutions and establish fit and proper requirements and minimum qualifications.

Government of Nepal
MINISTRY OF FINANCE

SINGHADURBAR
KATHMANDU, NEPAL

7. In 2016-18 we intend to implement the remaining major reform agendas to strengthen the financial sector and support its recovery from the double impacts of the 2015 earthquake and trade disruptions (September 2015 to January 2016), with an increasing emphasis on deepening and broadening financial access. The reform steps will include: (i) initiation for publishing international tender for the divestiture of Government's stake in NBL; (ii) Completion of in-depth diagnostic of the insurance sector to identify institution level risks and implementation of corrective action or resolution program for undercapitalized insurance companies. (iii) undertake steps to improve the supervisory capacity of the financial cooperatives regulator; (iv) issue enabling regulations consistent with the NRB Act Amendments; (v) implement and operationalize a supervisory information system by the NRB; (vi) approve DCGF's regulation that covers its relationship with BFIs, guaranteed deposit verification process, BFI reporting, payout and reimbursement of guaranteed deposits and a deposit guarantee fund investment policy; (vii) execute arrangements to provide back-up funding,liquidity and credit line facility to DCGF; (viii) approve Payment System Act by the cabinet for submission to the parliament; (ix) approve a new Insurance Act by the cabinet ready for submission to the Parliament; and (x) issuance of NFRS complaint regulations and reporting requirements for BFIs and issuance of rules and by-laws for the newly enacted BAFIA by the NRB.

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

Yours sincerely,

B.paudel

Bishnu Prasad Paudel
Minister of Finance

Shiba Raj Shrestha
Officiating Governor
Nepal Rastra Bank

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ANNEX 12: FUND RELATIONS

Nepal—Assessment Letter for the World Bank
January 31, 2017

Since the staff report for the 2015 Article IV Consultation was discussed by the IMF's Executive Board in November 2015 growth slowed to 0.6 percent in 2015/16 (mid-July 2015-mid-July 2016) but the economy is now showing signs of a broad-based recovery.

1. **Economic activity suffered in 2015/16 due to earthquakes and border blockades, while policy support was stymied by the continued under-execution of the budget**:

- *Growth and inflation*. Growth slowed to 0.6 percent in 2015/16. Shortages of fuel and other essential goods due to the trade disruption and earlier earthquakes drove up inflation to 12 percent (y/y) in January 2016. Inflation eased subsequently to 3.8 percent (y/y) in December 2016, mainly on account of lower food prices.
- *Fiscal*. Budget under-spending, in particular capital expenditure, worsened in 2015/16. At the same time, revenues exceeded the budget due to one-off telecom sector collections (1 percent of GDP). As a result, the budget was in surplus for the fourth year in a row and net public debt (gross public debt net of government deposits held at the central bank) fell to 21.7 percent of GDP, down from 33.7 percent of GDP in 2012.
- *External*. The current account surplus reached 6.3 percent of GDP on account of lower imports from the trade disruption. Exports also suffered. The growth rate of remittances slowed sharply, to 1 percent in 2015/16, from an annual average of 15 percent during the previous 5 years, due to weak growth in oil-producing host countries. Gross reserves of the central bank reached a record US$8.7 billion (10 months of imports) in December 2016.

2. **The economy is now showing signs of a broad-based recovery**:

- *Cyclical rebound*. The normalization of economic activity, a favorable monsoon season, loose monetary policy and rising government spending in part due to the disbursement of housing grants to earthquake-affected households are spurring a cyclical rebound, with growth expect to reach 5.5 percent in 2016/17.
- *Inflation deceleration*. Base effects related to last year's trade disruption have pushed down inflation in Nepal. Nevertheless, inflation is projected to remain above India's this year and next.
- *India shock*. India's sudden withdrawal of legal tender of high-denomination banknotes is expected to have a limited economic impact overall on Nepal. Banks' holdings of Indian rupee notes are small but some corporates and households, especially migrant workers in the border area, are likely to hold such notes.

3. **Macro-financial risks are on the rise**:

- Nepal maintains a peg to the Indian rupee and a de jure closed capital account. Insufficient sterilization of large BOP inflows loosened monetary conditions in recent years. This, along with the fourfold increase in paid-up capital required by the NRB, pushed private credit growth to a 6-year high of 30 percent (y/y) by December 2016. The increase in credit was concentrated in overdrafts which may have been used to purchase land, real estate, and stocks. Stock prices rose by as much as 80 percent (y/y) by mid-2016 notwithstanding a subdued economic outlook.

- High credit growth has now pushed banks' loan to deposit ratio to the regulatory maximum of 80 percent. Softening remittances—which have been a key funding source for Nepal's predominantly bank-based financial sector—and rising imports contributed to a tightening of liquidity, pushing up interbank interest rates and leading to a partial correction in stock prices.

4. **In the baseline scenario, medium-term growth settles below the 4 percent average of the past decade, delivering only modest improvements in living standards and social indicators**. Experience in other low-income countries shows that events such as the recent earthquakes and trade blockade can have permanent effects on potential growth. In addition, persistent political uncertainty and slow progress in strengthening key institutions and the bureaucracy would make it hard to overcome the chronic under-implementation of the budget and improve the business climate to boost private investment and growth. Risks to this baseline scenario are broadly balanced. The rebound in economic activity could be more pronounced and persistent, particularly if (i) accelerated payments of housing grants add to the recent surge in government spending; and/or (ii) the momentum in policy and structural reforms created in recent months is sustained and deepened. Key downside risks pertain to domestic political instability, the financial sector, slowing remittances impacting financial sector liquidity, and lower growth in India due to the demonetization shock. Hasty implementation of a framework for federal fiscal relations as mandated under the constitution could strain government capacity and finances given PFM and institutional capacity weaknesses.

5. **Sustaining and deepening the nascent reform momentum would deliver significant growth dividends and allow more progress in achieving the sustainable development goals (SDGs).** Efforts would need to focus on (i) strengthening the government's policymaking and implementation capacity, including with regard to capital budget implementation and the central bank's monetary policy framework; (ii) a tightening of monetary policy to maintain competitiveness and external balance through closing the inflation wedge with India on a sustained basis; (iii) bolster regulation and supervision of the financial sector in line with FSAP recommendations to mitigate financial sector risks; and (iv) create a conducive environment for domestic and foreign investment, as well as accelerated implementation of donor-supported projects. Macro-prudential measures introduced in the aftermath of the 2010-11 episode of financial sector pressures (e.g., loan to deposit ratio, loan-to-value ratios for real estate and margin lending) have served Nepal well and should be maintained.

IMF Relations

- In the aftermath of the 2015 earthquakes, the Nepalese authorities requested the equivalent of SDR35.65 million (50 percent of quota) under the Fund's Rapid Credit Facility. The IMF's Executive Board approved the request on July 31, 2015. The funds were disbursed as direct budget support.
- The 2015 Article IV Consultation was concluded by the IMF's Executive Board on November 16, 2015. At that time the authorities expressed interest in a longer-term Fund engagement. Since then the authorities' priorities have evolved and the

relationship with the IMF has focused on surveillance and technical assistance. The mission to conduct the 2017 Article IV consultation took place during January 11–23. The IMF's Executive Board is expected to complete the consultation in March.

- In recent years, the Fund has been providing technical assistance in the areas of tax administration, tax policy, public expenditure management, monetary policy operations, banking supervision, and macroeconomic statistics. The joint IMF-World Bank FSAP was completed in mid-2014.

ANNEX 13: CHANGES TO DPC 3 INDICATIVE TRIGGERS

Indicative Policy Actions for DPC3 in the Program Document of DPC2	Status Update
• Sub-sectoral Financial Sector Development Strategy (FSDS) action plans have been approved by the FSDS Steering Committee.	• These sub-sectoral strategies are being prepared by GoN with TA support from the development partners. Many of these strategies have been developed. Removed as a PA as it was not a policy action
• The government has divested a controlling stake in NBL.	• Indicative trigger for DPC4
• The NRB has completed the implementation of the second phase of a diagnostic of the banking system and the NRB has approved Special Inspection Reports and prompt corrective action programs/resolution programs for all financial institutions found to be undercapitalized.	• PA for DPC3
• The Nepal Insurance Board (NIB) has completed a diagnostic of the insurance sector to identify institution-level risks and has implemented corrective action or resolution programs for undercapitalized insurance companies.	• Indicative trigger for DPC4
• The NRB continues its policy of consolidating the banking system by issuing a new licensing policy for BFIs in line with Basel III.	• PA for DPC3 (changed into the PA on increase the capital of BFIs in line with Basel III)
• The Government has (a) submitted a new Savings and Credit Cooperatives Bill or equivalent amendments to the Cooperatives Act to Parliament and (b) taken steps to improve the supervisory capacity of the financial cooperatives regulator/s.	• Replaced with the following new indicative trigger for DPC 4: A new Insurance Act has been approved by the Cabinet and submitted to Parliament for approval. This will allow continuity of support to the insurance sector affected by the earthquake. Support to the cooperatives sector is provided by other development partners.
• The NRB Act Amendments Act has been enacted. • The NRB Board has approved a new prompt corrective action framework in line with the NRB Act Amendments Act.	• PA for DPC3 • Indicative trigger for DPC4
• The NRB has (a) implemented a framework and regulations for consolidated supervision and (b) operationalized a supervisory information system.	• Indicative trigger for DPC4
• The Deposit and Credit Guarantee Fund Act has been enacted. • The DCGF has put in place a deposit insurance payout system and key regulations	• PA for DPC3 • Indicative trigger for DPC4

Indicative Policy Actions for DPC3 in the Program Document of DPC2	**Status Update**
have been approved covering: DCGF's relationship with BFIs, the guaranteed deposit verification process, BFI reporting, payout and reimbursement of guaranteed deposits, and a deposit guarantee fund investment policy.	
• The Government has taken steps to strengthen the crisis management architecture by submitting to Parliament a Financial Crisis Management Bill granting special powers, including emergency liquidity assistance, to the MoF and the NRB to intervene in the event of a systemic crisis and creating a Financial Stability Committee.	• Replaced with the following indicative trigger for DPC4 to ensure continuity of building the framework for deposit insurance: (i) The NRB and MoF have executed an agreement to provide backup funding to DCGF; (ii) DCGF and NRB have executed a technical repurchase agreement to provide liquidity to the DCGF; and (iii) The NRB, MoF, and DCGF have executed a credit line facility for additional funding to the DCGF.
• The NRB has put in place a business continuity framework for NRB and BFIs and has initiated the establishment of a Disaster Risk Site (DRS)	• DRS is being implemented with TA support from DFID and will be operational by October 2017. A business continuity framework has been put in place. Removed the indicative trigger as implementing the DRS is not a policy action.
• The NRB has established the National Payments Council. • The NRB has implemented four actions to reduce payments system risks by (a) aligning the operating hours of the NRB Banking Department with SWIFT, (b) implementing online transfers of funds between NRB branches, (c) implementing a pre-settlement file system, and (d) establishing a crisis recovery facility.	• Replaced with a more comprehensive indicative trigger for DPC4: The NRB has adopted an oversight framework for payment systems. The NRB has issued a directive on licensing of bank and non-bank payment system providers and operators. • (a), (b) and (c) are PAs for DPC3
• The NRB has issued NFRS-compliant regulations and reporting requirements for BFIs.	• PA for DPC3
• The governance of the banking system, including state-controlled banks, has been strengthened by (a) enactment of the Banks and Financial Institutions Act and (b) issuance by the NRB of implementing regulations.	• (a) PA for DPC 3 • (b) Indicative trigger for DPC4
• The GoN has issued the enabling regulation to implement the key AML/CFT Acts	• PA for DPCs