PROGRAM INFORMATION DOCUMENT (PID)

CONCEPT STAGE

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Operation Name	Nepal Third Financial Sector Stability Credit DPC3
Region	SOUTH ASIA
Country	Nepal
Sector	Banking (50%); General finance sector (43%); Microfinance (7%)
Operation ID	P156960
Lending Instrument	Development Policy Lending
Borrower(s)	Ministry of Finance
Implementing Agency	Ministry of Finance
Date PID Prepared	28-Oct-15
Estimated Date of Appraisal	8-Mar-16
Estimated Date of Board	31-Mar-16
Approval	
Corporate Review Decision	
Other Decision *{Optional}*	N/A

I. Key development issues and rationale for Bank involvement

In mid-2011, a financial sector crisis nearly unfolded in Nepal. Withdrawals of deposits from smaller financial institutions 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). The World Bank, together with the International Monetary Fund (IMF), was called on by the NRB and the Government of Nepal (GoN) to provide assistance, both technical and financial, 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. Due to quick and effective intervention by the NRB, with technical assistance from the Bank, DFID and the IMF, and thanks to a favorable environment (notably continuing large flows of remittances which contributed liquidity to the system), a fullblown 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 underlying vulnerabilities of the financial sector. This included the insolvency and governance challenges posed by the two largest state-controlled commercial banks, the excessive number of small financial institutions with weak governance and supervision, the nascent bank restructuring and resolution frameworks, and issues of transparency in the financial system.

As a result of this dialogue, and to support the Government of Nepal's medium-term program, the World Bank provided a single tranche Financial Sector Stability Development Policy Credit (DPC1) of US$ 30 million on June 25, 2013 which facilitated identification of clearly articulated reform actions in the medium-term. Following DPC1, the World Bank team designed a programmatic Financial Sector Stability DPC series to deepen 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. This approach has been closely linked to DFID's capacity building program which is designed to ensure that the authorities have the requisite resources to implement reform actions.

In the aftermath of the devastating earthquake in Nepal in April 2015, the scope of the programmatic Financial Sector Stability DPC series was expanded to include identification and implementation of reforms to address post-disaster financial sector vulnerability. Additionally, the post disaster second Financial Sector Stability Credit of US$100 million was supplemented with US$50 million in IDC crisis response window resources, approved by the World Bank Board on June 16, 2015. The proposed Third Financial Sector Stability Credit of US$100 million is expected to support the continuation and expansion of the Government's efforts to address financial sector vulnerabilities.

The draft Nepal Country Partnership Strategy (CPS) 2014-2017, highlights the importance of enhancing financial sector stability. It underlines persistent financial sector weakness and the risk this poses to macroeconomic stability and economic growth. The CPS makes the case for the use of DPCs to support the reform efforts of the authorities.

II. Proposed 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. It would build on the gains already realized through the past policy credits. In addition the credit, which comes in the aftermath of the earthquake and recent trade disruptions, will support efforts to sustain reconstruction and recovery, while mitigating emerging risks to the financial sector in order for it to be able to play its role in broader economic recovery.

The actions supported under the proposed DPC3 are part of a broader, medium-term, Government-led program aimed at allowing the financial system in Nepal to become deep, resilient, and effective enough to play its role in financing Nepal's extensive development, inclusion and post-disaster reconstruction challenges.

III. Preliminary Description

The proposed DPC3 is likely to continue with the approach taken by DPC1 and DPC2. DPC1 focused on laying the ground for deeper reforms while DPC2 aimed at supporting the implementation of these reforms to foster the development of a robust, inclusive, and more stable financial sector. The scope of reforms in DPC2 and those envisaged in DPC3 also focuses on addressing potential adverse impacts on the solvency of the financial sector and the operational and business continuity of financial institutions.

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

Under these pillars, the credit will support the following specific policy areas:

a) Privatization Committee approval and initiation of divestment of two state-controlled banks.
b) Completion of the second phase of a diagnostic of the banking system, including a diagnostic of the impact of the earthquake on financial sector institutions, followed by appropriate measures to ensure that all banks are in regulatory compliance.
c) Increase in the solvency of the banking system through a directive to increase minimum Paid-Up Capital.
d) Putting in place a functioning financial sector safety net through enactment of the Deposit and Credit Guarantee Fund Act, Cabinet approval of the Financial Crisis Management Act, and operationalizing the deposit insurance system.
e) Adopting amendments to the NRB Act and BAFIA to give supervisors stronger legal tools for bank resolution and issuance of new regulations reflecting the enhanced bank resolution framework;
f) Improving the transparency of the financial system through a staged adoption of NFRS and issuance of NFRS-compliant regulations by the NRB;
g) Rules and bylaws to implement the key AML/CFT Acts.

The Bank team continues to monitor the impact outcomes of DPC1 and DPC2 in order to identify adjustments needed for selection and prioritization of triggers and prior actions under DPC3 which are aligned with the country's political developments, stakeholder support, and feasible options for realizing the intended goals.

IV. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

Nepal is making progress on consolidating peace and building a new political system. Still emerging from a-ten year armed conflict that ended in 2006, the country is currently passing through a prolonged political transition. It has made significant progress towards alleviating poverty and improving its economic growth. However, country's financial sector remains vulnerable to stress. A financial crisis could cause a loss of 30 percent of Nepal's GDP and result in severe fiscal distress. According to the recent estimates, a financial crisis in Nepal would result in an additional two million people remaining below the poverty line over 10 years[1]. DPC3 proposes to support continued measures to safeguard the banking system and to provide stability while giving priority to individual depositors in the process of bank resolution. By leveraging on the actions undertaken through DPC1 and DPC2, it makes a case for strengthening the legislative and regulatory framework of the financial sector, which in turn would develop the financial sector, and enhance its transparency through a NFRS compliant reporting structure and a mature AML/CFT regime. Any non-compliance with the international standards on AML/CFT can have an adverse bearing on financial sector credibility, thereby reducing the remittances inflows and direct foreign investment. This could aggravate poverty statistics for the country, and curtail Nepal's international financial transactions. Finally, DPC2 and DPC3 have a strong emphasis on post-disaster financial sector vulnerabilities which impact the revival of economic activity after a disaster.

Environment Aspects

Actions proposed under this operation are not expected to have any negative effect on the environment.

V. Tentative financing

Source:	($m.)
Borrower/Recipient	0
International Development Association (IDA)	50
Others (specify)	
Total	50

VI. Contact point

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[1] DFID Nepal *Business Case & Intervention Summary, Macroeconomic Reform Project,* January 2013

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