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PROJECT INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

May 14, 2016
Report No.: 105899

Operation Name	Nepal Third Financial Sector Stability Credit DPC3
Region	SOUTH ASIA
Country	Nepal
Sector	Banking (50%); General financial 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	May 14, 2016
Date of Appraisal Completion	April 27, 2016
Estimated Date of Board Approval	June 30, 2016
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.
Other Decision *{Optional}*	N/A

I. Country and Sector Background

Nepal’s prolonged transition towards a stable democracy following the end of a 10-year armed conflict in 2006 had seemingly come to an end with the promulgation of the new constitution in September 2015. However, new challenges emerged as Nepal was hit by twin shocks in the span of six months. The first was the April/May 2015 earthquakes that have caused a huge loss of life and assets. The second shock has come in the form of a near complete disruption of external trade following the adoption of the new Constitution. Protests and strikes against the constitution in the southern Terai region disrupted trade that lasted from mid-September 2015 through January 2016. This had resulted in acute shortages of fuel and essential supplies across the country, which in turn curtailed economic activity while also hampering government’s budget execution and revenue collection.

On the other hand, over the past decade Nepal has been performing reasonably well on the economic front as well as making significant advances in poverty reduction and human development. From 2006 to 2014 growth averaged 4.4 percent while inflation remained in single digits for most of the decade and fiscal balances remained sustainable owing to strong revenue growth and modest spending. Nepal’s external position remained equally healthy, owing to large remittance inflows (29 percent of GDP in 2014/15) that has allowed Nepal to finance its large trade deficit. Concomitantly, poverty incidence fell from over 50 percent in 2003 to just under 25 percent in 2010/11 with most multidimensional indicators of poverty showing sharp improvements across regions. These outcomes were principally driven by rises in farm incomes, remittance receipts and non-farm 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 early 2015, primary education was accessible to virtually all; immunization coverage against major preventable illnesses was close to 90 percent; Nepal had also made important strides in reproductive health; and the country had also stepped up social insurance and assistance programs which have risen to 2.5 percent of GDP from a very low base. 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. Moving forward, especially in light of the twin shocks, sustaining and amplifying these gains remain a challenge.

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 of 30 Class A (commercial), 73 Class B (development banks), 47 Class C (finance companies), and 40 Class D (microfinance institutions) institutions, accounting for 79, 13, 5, and 3 percent of banking system assets, respectively, as of FY2016 Q2. In the overall financial system, banking institutions represent about 88 percent of assets, while other financial institutions such as insurance companies, the Employees Provident Fund, the Citizen Investment Trust, and the Postal Savings Bank constitute approximately 12 percent of financial system assets. Foreign penetration is limited, with only one foreign Class A bank. The capital markets are represented by the Nepal Stock Exchange. There are currently 258 companies listed in 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 other Financial Non-Government Organization (FINGOs).

The Bank’s Financial Sector Stability Development Policy Credit (DPC) series in Nepal began in 2011 when 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 NRB. The Bank, together with the International Monetary Fund (IMF), was asked to provide technical and financial assistance to 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 contributed 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 underlying vulnerabilities of the financial sector. These challenges included the excessive number of small financial institutions with weak governance and supervision, the nascent bank restructuring and resolution frameworks, the insolvency and governance challenges posed by the two largest state-controlled commercial banks, increasing problems in the financial cooperative 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 on June 25, 2013, which was followed by the post-disaster second Financial Sector Stability Credit of US$100 million on June 29, 2015.

II. Operation Objectives

The 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. 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 supervision and deposit insurance; and (iv) Enhancing the governance and transparency of the banking system.

Under these pillars, the credit supported the following specific policy areas:

a) Ministry of Finance endorsement of the Nepal Bank Limited's Strategic Divestiture Plan and submission to the Privatization Committee to proceed with implementation.
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 and the execution of a memorandum of understanding between DCGC and NRB governing cooperation and exchange of information
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) Reducing payments system risks by (a) aligning the operating hours of NRB's banking department with the operating hours of SWIFT; (b) implementing online transfers of funds between NRB branches; and (c) implementing a pre-settlement file system.
g) Enhancing the transparency and safety of the banking system by issuing the regulations to implement the key AML/CFT Acts.

III. Rational for Bank Involvement

DPC3 complements the Government's program, builds on reforms completed in DPC1 and DPC2, and is grounded in analytical work carried out by the World Bank, IMF and DFID and the 2014 FSAP. In addition, the Nepal Country Partnership Strategy (CPS) 2014-2017 highlights the importance of enhancing financial sector stability. It underlines the persistent financial sector weaknesses 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.

IV. Tentative Financing

{Same as in AUS}

	($m.)
Source:	
Borrower/Recipient	0

IBRD	
IDA	100
Others (specify)	
Total	100

V. Tranches

($m.)

Not Applicable

VI. Institutional and Implementation Arrangements

The Ministry of Finance (MoF) would be responsible for overall oversight and implementation of this DPC in close coordination with NRB. Both MoF and NRB, as the lead implementing agencies, have extensive experience and are fully conversant with Bank policies and procedures for investment and policy lending operations. Since this is the second DPC in a programmatic series of three DPCs, the Bank team would continue to provide implementation support. In parallel, DFID's TA support to the authorities is linked explicitly to support the Government's efforts to implement the DPC's prior actions and triggers in key areas.

VII. Risks and Risk Mitigation

The overall risk of the proposed operation is substantial. The main risks to achieving the intended results of the reform program are political instability, post-earthquake increased financial sector vulnerabilities, reform implementation risk, and the risk of resistance from vested interests.

The likelihood of political instability risk materializing is substantial, and the severity of impact on achieving the project development objective remains substantial. After the passing of the Constitution in September 2015, there were widespread protests along the border with India which has resulted in blockade of fuel and essential goods entering Nepal and thereby causing an economic crisis. While the trade disruptions ended in January 2016, the adverse impact on the financial sector is yet to be fully assessed. Additionally, the recent (October 11, 2015) change in the Government may also potentially create increased risks to the country's reform program. 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, which has allowed the authorities to complete the prior actions. 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 government, bureaucracy and the legislature. The newly formed government also undertook measures to diffuse the crisis and proposed amendments to the Constitution to address grievances.

The proposed operation aims to address the financial stability risks associated with the earthquake and pre-existing risk factors, which include heightened financial stability risks, deterioration of divesture prospects for the two state-owned banks, and operational and business continuity challenges. Several prior actions 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 technical assistance 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. Hence, the DPC series constitutes an important part of overall recovery strategy of the authorities.

The pace of implementation of the government's 2014-16 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 multi-stage 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.

The risk of resistance from vested interests: The likelihood of this risk materializing is substantial. The Government has announced (in the 2014 Budget Speech) its commitment to divest from NBL and find a reputable bank strategic partner while keeping RBB as a state-controlled bank. It is also possible that this decision will face resistance, notably from politically-linked NBL unions or some NBL shareholders. These risks are mitigated by the financial benefits to 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.

VIII. Poverty and Social Impacts and Environment Aspects

Nepal has made significant progress towards alleviating poverty. However, the country's financial sector remains vulnerable to stress. DFID has calculated that a financial crisis in Nepal as projected by the IMF would result in about an additional 2 million people remaining below the poverty line over 10 years. 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 banking system in Nepal is critical to allow BFIs to continue their playing a big role in financial inclusion, which is important for poverty alleviation, by providing access to financial services to the under-served 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, to social protection, to markets, and enables women's economic empowerment. In addition, the DPC supports reforms to the payment system which help ensuring that the retail payment system is safe and efficient. The retail payment system is the backbone for digital transaction accounts and remittance transfer, which in the case of Nepal, 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 poor depositors.

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

IX. Contact point at World Bank and Borrower

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