



Government of Nepal

MINISTRY OF FINANCE

SINGHADURBAR
KATHMANDU, NEPAL

May 31, 2015

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



**OFFICIAL
DOCUMENTS**

CS 5401-NP

RE: LETTER OF DEVELOPMENT POLICY

Dear Mr. Kim,

1. The Government of Nepal is 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 tightening of liquidity that threatened financial sector stability in Nepal in mid-2011, the Government prepared – and has since significantly expanded and deepened – a program of financial sector reforms designed to be implemented over about five years which will ensure the stability of the financial system, completely overhaul the regulation and supervision of the banking and financial co-operative systems, limit Government ownership of financial institutions, place the financial sector safety net on a firm footing, and lay the ground for a further program of reforms designed to broaden and deepen access to financial services for both business and individuals.

3. Our program was launched in 2012 with support from the World Bank, the United Kingdom Department for International Development (DFID), the International Monetary Fund (IMF) and other development Partners. We have continued to implement major reforms since that date. The first phase of reforms (from early 2012 to mid-2013) was carried out in an unstable political climate but since the election of the new Government following elections in late 2013 the pace of reform has been accelerating.

4. We were able to take the first step towards establishing a financial sector safety net by establishing – albeit on a weak legal foundation – the Deposit Guarantee Fund (DGF) and embarked on the restructuring and recapitalization of two large state-controlled commercial banks, Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL). The Government made large capital injections in RBB and NBL while installing new management. Lastly, we completed the process of preparing drafts of extensive amendments to the Nepal Rastra Bank (NRB) Act (NRBA Bill) and a new Deposit and Credit Guarantee Fund Bill (DCGF Bill) to strengthen the NRB's resolution powers and to place the DGF on a firm legal foundation.



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These reforms were supported by the First Development Policy Credit, which was approved by the World Bank's Board of Executive Directors in June 2013.

5. The devastating earthquake of April 25, 2015, creates potentially new challenges to Nepal's financial sector in terms of physical damages to NRB and BFIs, impact on banks' capital and liquidity buffers; pressures on insurance companies' resources; and potential repayment issues for the microfinance and credit cooperatives in the affected districts.

6. Therefore, the imperative to pursue financial sector reforms to mitigate the potential downside effects has become stronger after the disaster, especially in order to allow the sector to play its role in the broader post-disaster recovery effort. The reform program's focus on consolidation of the banking sector, better supervision and regulation, capitalization of banks, strengthening the crisis management framework, enhancing the deposit insurance function, and further diagnostics of the financial sector is particularly relevant following the earthquake.

7. The Government of Nepal is making rapid progress towards implementing the second phase of our medium-term strategy for reform 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 the first half of 2014. The Government's 2014-16 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 – not all of which we can define so soon after the disaster – designed to support the recovery of the financial sector from the impact of the earthquake and put in place needed measures to ensure the operational resilience of the sector in the face of natural disasters.

8. The reforms under our medium term strategy which we have completed since the mid-2013 include the following:

- Since mid-2013, 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 4.78 percent capital adequacy and the announcement by the Government in the Budget Speech of the decision to divest all state owned shares in NBL to a bank strategic investor;
- Throughout 2014, the NRB has maintained its moratorium on licensing of new Class A, B, and C banks and financial institutions (BFIs), and in 2014 also issued a new bylaw on acquisitions to facilitate further consolidation of the banking system;



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- In 2014, the Parliament approved and enacted ordinances issued in 2012 and 2013, 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 pieces of legislation provide a legal framework in line with international standards, and Nepal is no longer “grey-listed” by FATF;
 - Completion in 2014 of the first phase of a diagnostic of the banking system covering 27 financial institutions, representing about 24 percent of banking system assets of a program of 54 in-depth Special Inspections of all at-risk and systemic banks. The NRB has also initiated appropriate prompt corrective action or resolution enforcement measures (including recapitalization, merger, and closure) for all undercapitalized financial institutions;
 - In 2015, the NRB issued a circular requiring all BFIs to assess the potential impact of the earthquake disaster on their assets;
 - Issuance of a notice to financial non-government organizations (FINGOs), authorized by NRB to convert into "D" class microfinance institution by mid-July 2015;
 - Approval in 2014 by the NRB Board of the National Payments System Development Strategy;
 - In 2014, the NRB moved to start the implementation of improvements to the transparency of the financial system through issuance of an NRB Guideline governing the staged adoption of Nepal Financial Reporting Standards by financial institutions;
 - In 2015, completion and approval by the Ministry of Finance of a long term financial sector development strategy (FSDS) based on wide consultation with stakeholders;
 - In 2015, the Government moved forward the process of strengthening the governance of financial institutions, and giving supervisors stronger legal tools for bank resolution by submitting to Parliament the NRBA Bill;
 - An important step towards putting in place a fully-functioning financial sector safety net was taken in 2015 as a result of submission of the DCGF Bill to Parliament; and
 - In 2015 improvements to the governance of state-controlled financial institutions were made by the issuance of a revised Directive 6 on governance by the NRB and by submission of the new Bill on Banks and Financial Institutions (BAFIA Bill) containing provisions establishing fit and proper requirements and minimum qualifications for Government-appointed directors and Chief Executive Officers.
9. In 2015-16 we intend to implement an ambitious agenda of further major reforms to strengthen the financial sector and to support its recovery from the impact of the 2015 earthquake, with an increasing emphasis on deepening and broadening financial access.



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While some modifications to the timing, scope, and content of reforms may be necessary to cope with the impact of the earthquake the reform steps will include: (i) starting to implement the strategies described in the FSDS; (ii) Restructure public banks by limiting government ownership through divestment (iii) completion of the NRB Special Inspections Program for a further 27 BFIs; (iv) completion of a diagnostic of the insurance sector to identify institution-level risks and the implementation of corrective action or resolution programs for undercapitalized insurance companies; (v) adoption of a new NRB licensing policy for BFIs in line with the Third Basel Accord; (vi) preparation of legislation to transform the regulation and supervision of financial co-operatives and measures to build regulatory capacity; (vii) enactment of the NRBA Bill and approval of a new prompt corrective action framework reflecting the strengthened provisions in the new law; (viii) strengthening of bank supervision by the implementation of consolidated supervision and a new supervisory information system; (ix) further steps to strengthen the deposit guarantee system; (x) progress towards establishing the legal and financial frameworks for financial crisis management and ensuring business continuity of the NRB and BFIs; (xi) improvements to the governance and reduction of risks in the payments system; (xi) issuance of NFRS-compliant regulations for BFIs; and, (xii) further strengthening BFI governance by enactment of the BAFIA bill and its implementing regulations.

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,

Dr. Ram Sharan Mahat
Minister of Finance

Dr. Chiranjibi Nepal
Governor Nepal Rastra Bank