

**PROGRAM INFORMATION DOCUMENT (PID)
CONCEPT STAGE**

March 31, 2014

Report No.: AB7501

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Operation Name	Financial sector stability DPC2
Region	SOUTH ASIA
Country	Nepal
Sector	Banking (50%); General finance sector (25%); Central government administration (25%)
Operation ID	P133777
Lending Instrument	Development Policy Lending
Borrower(s)	Ministry of Finance
Implementing Agency	Ministry of Finance
Date PID Prepared	January 27, 2014
Estimated Date of Appraisal	August 11, 2014
Estimated Date of Board Approval	December 15, 2014
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.
Other Decision <i>{Optional}</i>	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 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. 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's Board approved a stand-alone, single tranche Financial Sector Stability Development Policy

Credit (DPC1) of US\$ 30 million on June 25, 2013. The Bank's involvement with the Government of Nepal through DPC1 has facilitated identification of clearly articulated action steps which are to be fulfilled through a second DPC. This approach is closely linked to DFID's capacity building program which is designed to ensure that the authorities have the requisite resources to implement DPC2's prior actions.

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)

This objective of the Second Financial Sector Stability Development Policy Credit is to support the continuation of the Government's efforts to address financial sector vulnerabilities and increase the transparency of the banking sector.

The actions supported under the proposed DPC thus form part of a broader, medium-term Government program aimed at reinforcing banking sector stability and paving the way for the development of a robust and more inclusive financial sector.

III. Preliminary Description

The proposed DPC2 is likely to continue with the approach taken by DPC1. The latter focused on laying the ground for deeper reforms while the former would aim at supporting the implementation of these reforms to foster the development of a robust, inclusive, and more stable financial sector.

The Bank team would focus on the impact outcomes of DPC1 and identify the adjustments needed, particularly for the subsequent selection of triggers and prior actions, to take into account the country's political developments, stakeholder support, and feasible options for realizing the intended goals.

The credit will support the following specific policy areas:

- (a) Formulating a long term financial sector development strategy based on extensive consultation with a broad range of stakeholders;
- (b) Restructuring of two state-controlled banks through recapitalization to above minimum prudential ratios;
- (c) Completing a program of in-depth diagnostics of all at-risk and systemic banks covering at least 50 percent of banking system assets, followed by appropriate measures to ensure that all banks are in regulatory compliance;
- (d) Putting in place a functioning financial sector safety net through enacting the DCGT Bill 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) Parliamentary approval/ratification of ordinances already issued by the President to fight against money laundering and counter financing of terrorism.

IV. Poverty and Social Impacts and Environment Aspects

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 years¹. DPC2 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, 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 mature regime for Anti Money Laundering and Combatting Financing of Terrorism (AML/CFT). 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.

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)	70
Borrower/Recipient	
IBRD	
Others (specify)	
Total	70

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

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