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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A PROPOSED CREDIT

IN THE AMOUNT OF SDR 72 MILLION (US$100 MILLION EQUIVALENT)

WITH US$50 MILLION

IN IDA CRISIS RESPONSE WINDOW RESOURCES

TO

NEPAL

FOR THE

POST DISASTER SECOND FINANCIAL SECTOR STABILITY CREDIT

June 16, 2015

Finance and Markets Global Practice (GFMDR)
Nepal Country Unit (SACNP)
South Asia Region (SAR)

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NEPAL—GOVERNMENT FISCAL YEAR
July 16 - July 15

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of June 12, 2015)

Currency Unit: Nepalese Rupee
US$1.00: NPR 102.60

WEIGHTS AND MEASURES
Metric System

ABBREVIATIONS AND ACRONYMS

ADBL	Agricultural Development Bank Limited
AML / CFT	Anti-Money Laundry / Counter Financing of Terrorism
BAFIA	Banks and Financial Institutions Act
BCP	Basel Core Principle
BFI	Banks and Financial Institution (Classes A, B and C 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
DCGFA	Deposit and Credit Guarantee Fund Act
DGF	Deposit Guarantee Fund
DPC	Development Policy Credit
DFID	Department for International Development (United Kingdom)
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
ESW	Economic and Sector Work
BFI	Banking and Financial Institution
FINCO	Financial Cooperative
FINGO	Financial Non-Governmental Organization
FIRST	Fostering Innovation through Research, Science and Technology
FSAP	Financial Sector Assessment Program
FSDS	Financial Sector Development Strategy
FY	Financial Year
GDP	Gross Domestic Product
GoN	Government of Nepal
IDA	International Development Association
IFRS	International Financial Reporting Standards

IMF	International Monetary Fund
MoF	Ministry of Finance
NBL	Nepal Bank Limited
NFRS	Nepal Financial Reporting Standards
NIDC	Nepal Industrial Development Corporation
NPL	Non-Performing Loan
NPSDS	Nepal Payment System Development Strategy
NRB	Nepal Rastra Bank
NRBAA	Nepal Rastra Bank Act Amendments
OMO	Open Market Operation
PCA	Prompt Corrective Action
PFM	Public Financial Management
PRSC	Poverty Reduction Support Credit
RBB	Rastriya Banijya Bank
SDR	Special Drawing Rights
SMEs	Small and Medium Enterprises
SIP	Special Inspections Program
T-bill	Treasury-Bill

All dollar amounts are U.S. dollars unless otherwise indicated.

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NEPAL

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The second Financial Sector Stability Credit was prepared by an IDA team comprising Gabi G. Afram (Task Team Leader, SACPK), Sabin Raj Shrestha, Miquel Dijkman, Nagavalli Annamalai, Sarmad Shaikh, and Santosh Pandey (GFMDR), Aurélien Kruse, Roshan Darshan Bajracharya and Damir Cosic (GMFDR), Bigyan B. Pradhan (SACNP), Yogesh Bom Malla and Rajat Narula (GGODR), Kiran Afzal (GTCDR), Giovanni Bo (LEGES), Sailesh Tiwari (GPVDR), and a DFID team comprising Andrew Lovegrove (Senior Financial Sector Adviser, Team Leader), David Bufton (Bank Resolution Adviser), and Silvana Sejko (Deposit Insurance Adviser).

PROPOSED CREDIT AND PROGRAM SUMMARY

NEPAL

POST DISASTER SECOND FINANCIAL SECTOR STABILITY 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: US$100 million equivalent (US$50 million in IDA Crisis Response Window Resources)
Operation Type	The proposed Post Disaster Second Financial Sector Stability Credit is the second Development Policy Credit (DPC) in a series of three DPCs and its preparation was completed against the backdrop of a devastating disaster resulting from a massive earthquake that hit Nepal on April 25, 2015. The first IDA Financial Sector Stability Credit (DPC1) was a stand-alone single-tranche US$30 million special drawing rights (SDR) equivalent credit approved by the World Bank's Board in June 2013. The second and third DPCs are two programmatic single-tranche development policy operations that support the reform program of the Government of Nepal (GoN) to address financial sector vulnerability. This IDA credit is expected to be withdrawn in a single tranche of US$100 million SDR equivalent.
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. Although this operation was designed prior to the April 2015 earthquake, the magnitude of the devastation that ensued, the associated financial needs of GoN, as well as the heightened vulnerabilities of the financial sector as a result of the disaster - only make the rationale for the proposed reforms and further financial support even stronger. Therefore an additional objective is to provide the GoN with much needed short term financial support to expedite and scale up relief and recovery efforts while mitigating new emerging financial sector weaknesses and allowing it to play its role in the broader post-disaster recovery effort. The proposed credit is composed of four policy areas: • First pillar: Enhancing financial sector development • Second pillar: Restructuring and consolidating the financial system • Third pillar: Strengthening the legal and regulatory framework for crisis management, banking supervision and payment systems • Fourth pillar: Enhancing the governance and transparency of the banking system The second and third pillar in particular assume special significance in the aftermath of the earthquake.
Results indicators	(a) Pillar 1: • A strengthened coordination framework for design and implementation of financial sector reforms is established. (b) Pillar 2: • The restructured and recapitalized RBB and NBL meet all regulatory norms (including CAR >10 percent) and state control of NBL has been divested.

	• The banking system has been stabilized and consolidated with all banks being either CAR-compliant or in prompt corrective action programs, and the number of financial institutions has been reduced to less than 130 (c) Pillar 3: • The legal framework for bank supervision and regulation and for financial crisis management has been strengthened by the enactment of amendments to the NRB Act and the Deposit and Credit Guarantee Fund Act. • The institutional capacity of the NRB and DCGC have been strengthened by operationalization of a Supervisory Information System for NRB and a Deposit Guarantee Information System for DCGC. (d) Pillar 4: • The governance and transparency of the banking system has been strengthened by the enactment of a new Banks and Financial Institutions Act and the implementation of NFRS by Class A and B financial institutions.
Overall Risk Rating	Substantial
Climate and disaster risks *(required for IDA countries)*	(i) Are there short and long term climate and disaster risks relevant to the operation? Yes (ii) The earthquake of April 25 has potential adverse impacts on the solvency of the financial sector and the operational and business continuity of financial institutions. This operation mitigates these risks by consolidating the financial sector and improving its solvency, by bolstering the capacity of the Nepali authorities to respond decisively to instances of financial distress and by generally strengthening the robustness of prudential regulatory and supervisory frameworks, while on-going technical assistance is providing support for business continuity.
Closing Date	December 31, 2015
Operation ID	P133777

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A PROPOSED

POST DISASTER SECOND FINANCIAL SECTOR STABILITY CREDIT

TO NEPAL

1. **The present program document describes the Post Disaster Second Financial Sector Stability Credit to the Government of Nepal (GoN), DPC2 (US$100 million equivalent).** This Credit is the second DPC in a series of three. 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 and third DPCs are programmatic single-tranche development policy operations. DPC2 is expected to be withdrawn in a single tranche of US$100 million SDR equivalent. The program development objective of DPC2 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.

2. **The proposed operation is also intended to provide emergency support to the Government of Nepal following the April 25 earthquake.** Although the full consequences of the earthquake remain unknown at present, it is already clear that it will entail: (i) significant adverse economic and social outcomes, with great destruction of private and public assets as well as a slowdown in economic activity; (ii) heightened government financing needs due to both lower revenue realizations and increased spending commitments; and (iii) enhanced stresses on the financial sector whose resilience is fundamental to underpin recovery. As a result, the amount of DPC2 is being increased from US$50 million to US$100 million to ensure ongoing financial sector reforms are not derailed due to vulnerabilities arising from the earthquake and to provide additional post-earthquake financing support to the GoN. The Government had achieved almost all of the operation's prior actions before the earthquake struck and was anticipating approval of the support this Fiscal Year (FY). DPC2 is the most ready operation within the current portfolio for quickly providing such support.

3. **The magnitude of the earthquake and associated devastation have led to an urgent need for government action and an enhanced development spending program.** The proposed operation would allow the Bank to provide support in a timely manner so that the Government can deal rapidly with the aftermath of the earthquake, while also ensuring that the much-needed DPC-supported financial sector reforms are continued.

4. **The imperative to pursue financial sector strengthening efforts and reforms to mitigate potential downside effects has become stronger after the disaster** in light of the serious adverse effects of the disaster on both the banking and insurance sectors and the emerging financing requirements emanating from the disaster. The Government and the Nepal Rastra Bank (NRB) are committed to implementing the reform program. DPC2's focus on consolidation of the banking sector, better supervision and regulation, and capitalization of banks is particularly relevant following the earthquake. It is anticipated that triggers for DPC3 will be adjusted in consultation with the authorities once the results

of initial diagnostic work to assess the impact on the financial sector becomes available. This DPC is proposed as a key initial response from the Bank to the crisis, and will be complemented by other projects to support recovery and rebuilding efforts.

I. INTRODUCTION AND COUNTRY CONTEXT

PRIOR TO THE APRIL 25 EARTHQUAKE

5. **While there were setbacks in the path towards a stable democracy, Nepal has made progress on consolidating peace and building a new political system**. Following a 10-year armed conflict that ended in 2006, the country has remained in a prolonged political transition involving two interrelated processes. Nepal has made good progress on the peace process—notably by formally concluding the integration of ex-combatants into the armed forces in August 2012—but the country's political transition has been proceeding slowly. A first Constituent Assembly, in session from 2008 to 2012, did not agree a new constitution. Differences between and among the existing political parties and the rise of "ethnic identity politics" complicated consensus building, with the future federal architecture of the state being the main stumbling block. A second Constituent Assembly, formed in late 2013, had a clear public mandate to draft the constitution, yet failed to conclude it by the January 2015 deadline it had set itself.

6. **Over the past decade, Nepal has been performing reasonably well on the economic front.** Growth[1] averaged 4.3 percent over 2005-14. 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. Fiscal balances remained sustainable owing to strong revenue growth and modest spending (particularly on capital outlays). Nepal's external position remained equally healthy, owing to large and fast-growing remittance inflows that have come to amount to over a fourth of gross domestic product (GDP) and have allowed Nepal to finance its large trade deficit.

7. **Concomitantly, there have been significant advances in poverty reduction and human development**. Overall poverty incidence fell from over 50 percent in 2003/04 to just under 25 percent in 2010/11 (allowing Nepal to achieve MDG 1 ahead of time) and possibly 20 percent by 2013. 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 non-farm wage incomes, with the bulk of poverty reduction taking place in rural areas where four out of five 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 account for 2.5 percent of GDP (from a very low base). As a result, Nepal

[1] Market price.

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

was in a position to achieve most of the *Millennium Development Goals* and had also satisfied the social criteria for exiting from "Least Developed Country" status.

8. **However, even before the earthquake struck, 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 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. The World 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 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 Government of Nepal's medium-term program, the World Bank's Board had approved a stand-alone, single-tranche Financial Sector Stability Credit of US$30 million on June 25, 2013.

THE EARTHQUAKE AND ITS ECONOMIC AND FINANCIAL IMPACT

9. **On the 25th of April, 2015, a massive 7.8 magnitude earthquake hit Nepal, the worst in 80 years (see Annex 5).** 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 has identified 14 districts[3] 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 three million people—many living in very remote rural mountain communities—needed food assistance.

10. **The Government of Nepal is leading a major humanitarian effort, in coordination with the United Nations Office for the Coordination of Humanitarian Affairs (UNOCHA) and in partnership with national and international agencies.** The *Prime Minister Relief Fund* was used by GoN to provide immediate relief of NPR 6 billion, and the cabinet established a US$2 billion *Recovery and Reconstruction Fund* to which the

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

Ministry of Finance has pledged US$200 million. Additionally, the Prime Minister tabled a proposal in parliament with various measures including: US$ 2,000 in compensation to households that suffered complete demolition of their home provided they rebuild to new standards; 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 payments services to ensure that the population has access to funds, that remittances and trade could flow.

11. **The impact of the disaster will be significant, both in the short and medium run.** The negative repercussions include (i) an expected immediate rise in poverty levels in affected areas in the absence of social safety nets and given the disruption in existing community driven development programs; (ii) a deterioration in human capital outcomes, specifically in health and education, especially if services are not able to resume in a timely manner; and (iii) a rise in unemployment and under-employment as natural-resource based local economies collapse. While humanitarian assistance may alleviate human distress in the short term, rapid and substantial funding is needed for recovery and reconstruction to start and to mitigate the negative impacts which will be felt over months and years to come.

12. **The immediate impact on poverty, livelihood and output is likely to be severe.** Preliminary estimates are that in the most heavily affected districts (which includes Kathmandu), about 2.8 million people are affected. Initial analysis suggests that the earthquake will push an additional 2.5-3.5 percent of Nepalis (700,000-982,000 people) into poverty in 2015/16. Further, within the most affected districts, the impacts are disproportionately felt by the poorest segments of the population. Even within the relatively prosperous areas that have been affected, households that were already either poor or vulnerable have been particularly exposed.

13. **Preliminary estimates suggest that the total damage and loss of combined public and private assets in the affected districts could amount up to US$10 billion or 50 percent of GDP.** This is based on very early range estimates of the areas affected and of the proportion of assets to be replaced or rebuilt. The impact of the damage on productivity depends also on the extent to which critical network infrastructure (e.g. power, roads) is damaged and the time needed for repairs. Moreover, the fact that Kathmandu was hit and that a majority of the country's assets were located in the valley suggests that the impact will be significant. Assessing the full extent of the damage will take time and on-the-ground verification.

14. **Of the total loss, initial estimates of the overall public cost of the relief and reconstruction program, could be as high as US$5 billion**. This includes the cost of a comprehensive recovery program of humanitarian relief, the reconstruction and rehabilitation of public infrastructure[4], social safety net programs, and the public grant element of targeted interventions to replace some of the private assets for the poor and most vulnerable (e.g. housing construction grants, agricultural asset replacement).

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[4] These estimates are based on the initial assumptions about the share of assets damaged, the reconstruction to damage cost ratio, and the additional markup to "build back better" infrastructure

15. The magnitude and pace of implementation of the recovery program, will determine the earthquake's ultimate impact on poverty, jobs, and output. For instance, according to preliminary estimates, output growth is expected to be lower by 0.5 percentage point of GDP in FY15 (4.1 percent relative to the pre-quake projection of 4.6 percent), though the pace of recovery in outer years will be determined by the speed at which reconstruction and rehabilitation efforts proceed as well as external financing, it is expected that economic growth will recover to 4.5 percent in FY16.

16. The combination of a decline in tax revenues and an increase in spending is expected to narrow the anticipated budget surplus of 1.1 percent of GDP to 0.1 percent in FY15 with a deficit of 2.1 percent projected for FY16. This is due to unanticipated post-disaster spending in FY15 estimated at around US$303 million, or 1.4 percent of GDP, to be partially financed by the contributions of development partners. In addition to pledges already received, the Government is requesting development partners to mobilize increased support. 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. The earthquake creates 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: first, physical damage to the NRB's and Banking and Financial Institutions (BFIs)' infrastructure (including the collapse of NRB's headquarters and its main cash vault building); second, capital erosion and the threat of insolvency of some institutions due to disaster-related asset quality problems; third, potential stresses in the balance sheets of some insurance companies as a result of massive claims arising from the disaster; and, fourth, a major reduction in access to finance to small firms and also in rural areas as a result of large scale insolvency of Microfinance Institutions (MFIs) and Financial Non-Government Organizations (FINGOs).

18. 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 beginning. The microfinance sector, which plays an important role in enhancing financial access, is particularly exposed to the physical destruction caused by the disaster. The sector is extremely vulnerable due to the lack of source of funds diversification and extreme vulnerability of the clients/beneficiaries they serve. The livelihoods of large numbers of poor people who rely on microfinance services as the only source of finance for income generating activities will be particularly exposed as a result of the current shock.

19. Following the earthquake, the Government asked the World Bank Group to assist its reconstruction efforts in the affected areas. Specifically, it requested a rapid reprogramming of resources from ongoing projects towards reconstruction efforts; fast disbursement of upcoming projects, including through allowing retroactive financing of eligible expenditures; preparation of an emergency recovery loan that will (*inter alia*)

provide income support and housing recovery support to poor households that have suffered losses to their homes and assets; and fast-tracking and augmentation of DPC2.

20. In response, the Bank Group is preparing a comprehensive package of recovery and reconstruction support. The package consists of: (i) just-in-time technical assistance, knowledge sharing on damage assessment and recovery and reconstruction planning, including Post-Disaster Needs Assessment (PDNA); (ii) restructuring and re-allocation of existing IDA and trust-funded projects (US$850 million undisbursed); (iii) new IDA operations, including DPC2 and an emergency recovery loan; (iv) mobilizing the IDA Crisis Response Window (CRW); and (v) IFC support to the private sector (including a US$70 million early response liquidity facility for partner banks) (See Annex 5).

21. The present program document describes the Post Disaster Second Financial Sector Stability Credit of US$100 million to support the continuation and expansion of the Government's efforts to address financial sector vulnerabilities, an important objective in the aftermath of the disaster, as well as to provide emergency financial support to the GoN. The actions supported under the proposed DPC2 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 III of this document as well. These reforms have gained urgency and relevance to mitigate the impact of the earthquake on the ability of the financial sector to support economic and social recovery. A programmatic Third Financial Sector Stability Credit (DPC3) is expected to be prepared in FY16 in order to provide support for the finalization of reforms for which major preparatory actions will have been completed using support from DPC2.

22. The ultimate aim of this program is to allow 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. Even before the earthquake the economy-wide potential for growth has been depressed by low levels of public and private investment, despite available financing. As mentioned earlier, over the past few years Nepal's financial system has witnessed great expansion, fuelled primarily by a steady and growing influx of remittances. However, as evidenced by the near-crisis of 2011, most of this liquidity was invested in the stock exchange and in the real estate market, creating bubbles in each case. Once both bubbles burst, the sector was on the cusp of a financial crisis, from which it emerged with great difficulty. Since 2011, the spectacular growth in remittance transfers has translated into a buildup of liquidity in the financial system but with relatively low uptake by the private sector in terms of 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 effectively and to channel funding to the country's investment needs in infrastructure, power and long-term financing.

II. MACROECONOMIC POLICY FRAMEWORK

23. **Despite the political uncertainty that prevailed following the end of the civil war in 2006, there has broadly been consensus on economic policy.** While significant political differences across and within political parties have prevented 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 issues including public financial management, monetary policy, and financial sector supervision.

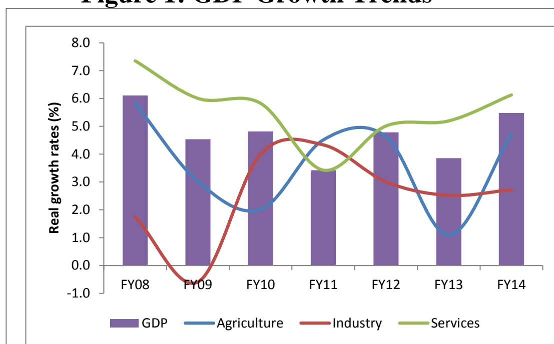
24. **Such consensus has allowed macroeconomic policy to remain sound and supportive of stable –albeit modest- growth.** Over the period FY06-14 economic growth has averaged 4.4 percent. Nepal has managed to move from a position of current account deficit to a surplus, from FY12 onwards, reaching 4.6 percent of GDP in FY14 and owing largely to robust remittance inflows. Likewise the budget has moved from a position of modest deficits to surpluses, from FY13 onwards, reaching 2.2 percent of GDP in FY14. Finally inflation was kept broadly in check (below double digits), despite accommodative monetary policy designed to boost credit.

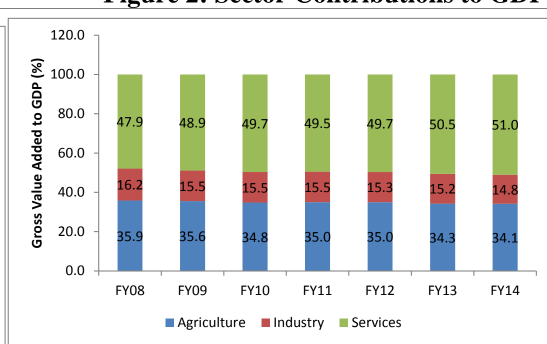
A. Recent Economic Developments Prior to the Earthquake

25. **Nepal's macroeconomic framework, as well as the fiscal and monetary policies pursued by the government, have been broadly sound in recent years.** Though modest, economic growth has been stable in the past decade and the country's economy remained largely insulated from external shocks, given the small export base and limited financial integration. Since FY13 Nepal managed to sustain a budget surplus (which prior to the earthquake it was expected to sustain in FY15) reflecting, to some extent, spending bottlenecks, particularly for capital, but also the government's efforts to strengthen tax administration and to control the growth of recurrent spending, despite ample fiscal space. While monetary policy has remained accommodative in recent years, corresponding to a consistent effort to support credit growth and financial sector strengthening, this has not fueled inflationary pressures, as prices are overwhelmingly driven by inflation in India.

26. **Economic performance has been hitherto largely dependent on exogenous factors.** Growth was driven mainly by the services sector and, to a lesser extent, agriculture, with performance in the former supported by remittance inflows and in the latter determined by weather patterns. By contrast, industrial sector growth has been lackluster and the share of manufacturing in GDP has shrunk to a modest 6.6 percent in FY14 from 8 percent a decade ago. In FY14, overall growth at market prices reached 5.5 percent, reflecting both (a) a base effect after a disappointing performance in FY13 (3.9 per cent) and (b) positive developments in agriculture and services (figure 1 and figure 2). Prior to the earthquake, the economy was projected to grow at 4.66 percent (market prices) in FY15, with the slight deceleration relative to FY14 on account of the delayed monsoon and lower agricultural output growth as a result.

Figure 1: GDP Growth Trends **Figure 2: Sector Contributions to GDP**





Source: Central Bureau of Statistics.

27. The modest growth, particularly in industry, was reflected in sluggish investment and decelerating credit growth. In FY14, gross fixed capital formation stood at only 23.1 percent of GDP. While there was significant growth in public investment (18 percent over FY13), private investment growth declined in FY14 despite a very favorable interest rate environment[5]. In FY15, prior to the earthquake, domestic private investment was expected to pick up on the back of rising demand for credit during the first half of the year (private credit growth of 21 percent y-o-y in mid-FY15 compared to 16 percent y-o-y in mid-FY14) although FDI had remained sluggish. However, public capital spending was expected to be only marginally better in FY15 than in the previous year[6].

28. Accommodative monetary policy did not translate into inflationary pressures, although price growth remained high in FY14. Overall inflation (year-on-year average) declined to 9.0 percent in FY14 from 9.9 percent the year before, driven mostly by food prices, which rose by 11.6 percent, and the evolution of prices in India (see figure 3 and a footnote below[7]). In the first half of FY15, average inflation slowed to 7.3 percent (y-o-y)**,** the lowest figure at mid-year since FY08. The deceleration was attributable essentially to slowing inflation of non-food items as well as to -more modest- price increases of food.

29. Despite a large and growing trade imbalance, the current account remained in surplus and significant foreign exchange reserves were accumulated in FY14, owing predominantly to robust growth of remittances (figure 3 and figure 4). The balance of payments surplus reached US$1.3 billion (6.6 percent of GDP), growing at 65.1 percent from FY13, while the current account was positive by US$915 million. This healthy position was overwhelmingly due to remittance growth. Total private transfers reached a

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[5] Private gross fixed capital formation growth slowed to 6.1 percent (from 16.7 percent the previous year) and private sector credit growth to 18.3 percent (from 20.2 percent). Finally FDI inflows also declined sharply to NPR 3.1 billion (a meager 0.5 percent of GDP)

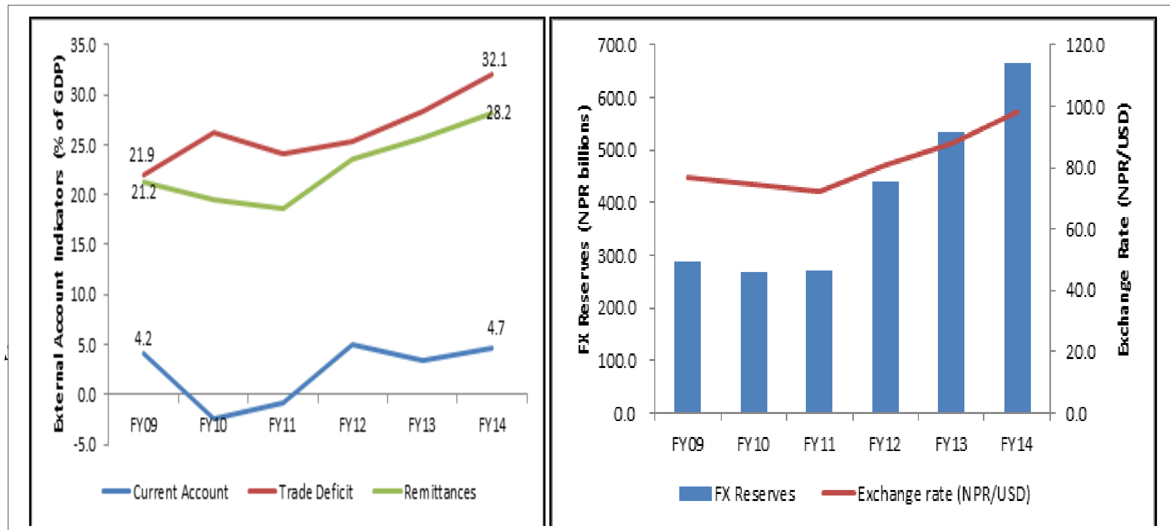
[6] Overall capital spending in nominal terms increased by 28.3 percent during the first six months of the fiscal year compared to 49.6 percent during the same period in FY14

[7] According to the IMF's 2014 Article IV review the elasticity of Nepali inflation to India's is high at 0.45 (i.e. a 1 percent increase in India's inflation leads to a 0.45 percent increase in Nepali inflation) making Indian inflation the main driver by a wide margin. By contrast the elasticity of inflation to broad money growth is estimated at 0.1 percent.

record of US$5.5 billion, equivalent to 28.2 percent of GDP and almost on a par with the trade deficit of US$6.1 billion, equivalent to 30.9 percent of GDP. As a result, gross official reserves grew by 24.2 percent in FY14 to reach US$6.2 billion, enough to cover some 8.6 months of imports of goods and services. For FY15, before the earthquake, Nepal was expected to maintain a sizeable current account surplus (5.8 percent of GDP) thanks to robust remittance growth as well as to lower world prices for oil (the largest import item).

Figure 3: External Account Position

Figure 4: Foreign Exchange Reserves and Exchange Rate



Source: Nepal Rastra Bank.

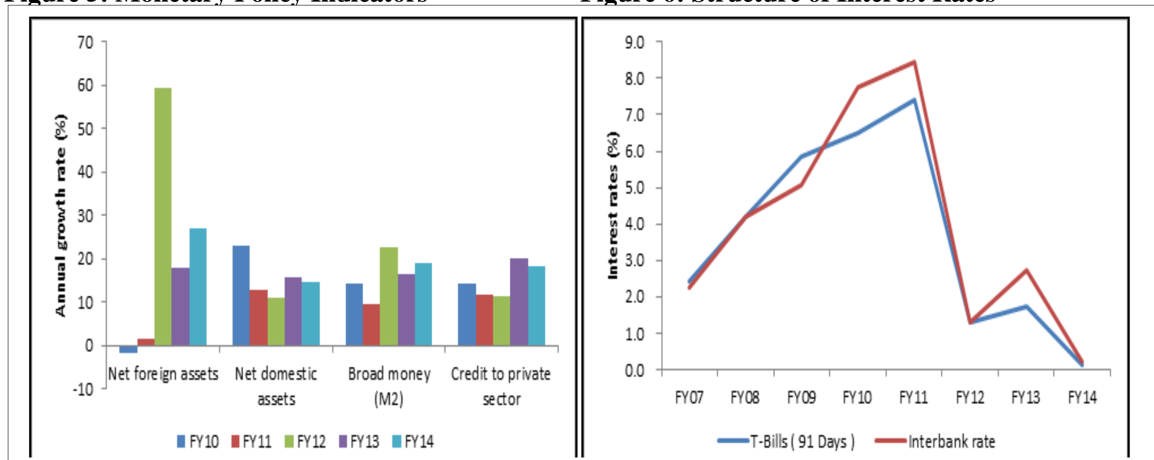
30. Given the peg of the domestic currency to the Indian rupee, the exchange rate with other currencies has fluctuated alongside that of the Indian currency. After a significant depreciation in FY13, the exchange rate appreciated slightly in FY14, reflecting renewed confidence of international investors in the Indian economy and efforts of the Reserve Bank of India to contain inflation. Nepal, for its part, has very limited exposure to short-term capital.

31. Monetary policy has continued to be expansionary to support economic activity and financial sector stability (figures 6 and 7). Broad money (M2) supply increased by 19.1 percent in FY14 (up from 16.4 percent in FY13), resulting in very low interest rates. The NRB deliberately maintained relatively loose monetary policy—and minimal sterilization of remittance inflows—to stimulate private sector lending while also allowing banks to rebuild balance sheet strength by keeping interest rates low[8]. In the first half of FY15 Money supply (M2) growth slowed significantly: at the end of the first half of FY15 it stood at 15.6 percent (y-o-y), reflecting a decline in net foreign assets (NFA) growth on the back of weaker remittances and lower foreign grants receipts.

[8] While the policy has been successful in the immediate aftermath of the 2011 crisis, the steady buildup of excess liquidity in the system and modest credit uptake by the private sector have led the NRB to revisit its monetary stance (see Section II.B below). In addition, loose monetary policy given the pegged exchange rate led to excess inflation relative to India, thus damaging competitiveness

32. High deposit growth coupled with slower credit offtake kept the cost of borrowing low. The weighted average Treasury-bill (T-bill) (91 days) and interbank rates for FY14 were 0.13 percent and 0.22 percent respectively. Likewise, the average base rate of commercial banks stood at 8.36 percent. This trend was partly reversed in the first half of FY15 (before the earthquake), with credit growth outpacing deposit growth resulting in a significant decrease of excess liquidity in the system[9].

Figure 5: Monetary Policy Indicators **Figure 6: Structure of Interest Rates**



Source: Nepal Rastra Bank.

33. Though it picked up significantly in FY14, public spending—specifically investment—remained low compared with both needs and the space afforded by healthy fiscal balances (figure 7). For the second year in a row, Nepal was the only country in South Asia to register a budget surplus (1.1 percent of GDP), reflecting, among other things, continued impressive revenue growth, prudent fiscal management and significant spending bottlenecks for capital projects. A similar trend was observed in the first half of FY15, prior to the earthquake. The budget, at mid-year, was significantly under-executed both for capital and recurrent, with the 'burn rate' for capital and recurrent expenditures at 12.6 percent and 31.0 percent of plans respectively, which was lower than in FY14[10]. At the same time domestic revenue mobilization grew by 16.6 percent in the first six months of FY15 (although revenue performance seems to have weakened during the third quarter of FY15). Consequently, the fiscal deficit after grants decreased from 1 percent of GDP in FY11 to 0.6 percent in FY12; thereafter it moved into surplus: 2.1 percent and 2.2 percent of GDP in FY13 and FY14 respectively. Before the earthquake it was anticipated that the fiscal surplus for FY15 would reach 1.1 percent of GDP.

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[9] At mid-year, excess liquidity in the banking system had come down to NPR 2 billion (compared to a surplus of NPR 60 billion as of Q4 FY14). In turn, the gradual moderation in market liquidity and increasing credit growth has impacted weighted T-bill (91 days) and average inter-bank rates considerably. T-bill (91 days) rates ranged between 0.927 percent to 0.004 percent and inter-bank from 1.03 percent to 0.15 percent in the first half of FY15.

[10] In absolute (nominal) terms, total government spending grew by only 3.8 percent in the first six months of the FY15, relative to the first half of FY14. Although capital expenditures were up by 28.3 percent, this was well below the 49.6 percent increase in the previous fiscal year (albeit from a very low base). Recurrent expenditures fell by 5.1 percent relative to the first six months of FY14 (when they increased by almost 50 percent).

34. The overall stock of debt has fallen steadily (figure 8). The stock of public debt is estimated to have reached a historic low in FY14 at 30.5 percent of GDP with declines in both total domestic and external debt (respectively equivalent to 11 percent and 19.5 percent of GDP), with the latter contracted on highly concessional terms. Moreover, there have been further reductions in the stock level of both internal and external loans in the first half of FY15.

35. The most recent DSA undertaken by the Bank and the IMF, before the earthquake, assessed Nepal's risk of debt distress to be "low", from "moderate" in the previous assessment. Under the baseline scenario, Nepal's indicators for external and public debt remained well below indicative sustainability thresholds and debt dynamics remain resilient even under the most severe shock scenarios.

Figure 7: Fiscal Balance

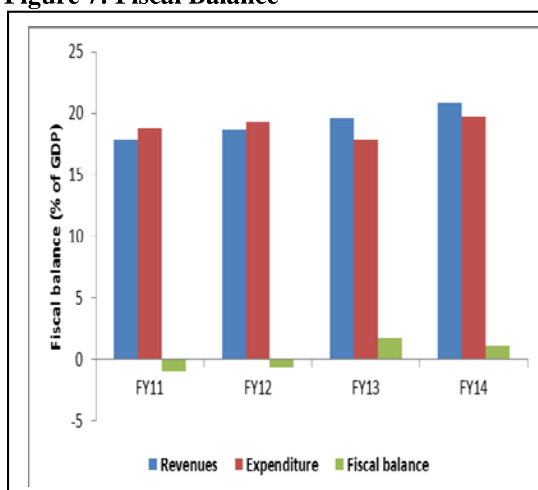
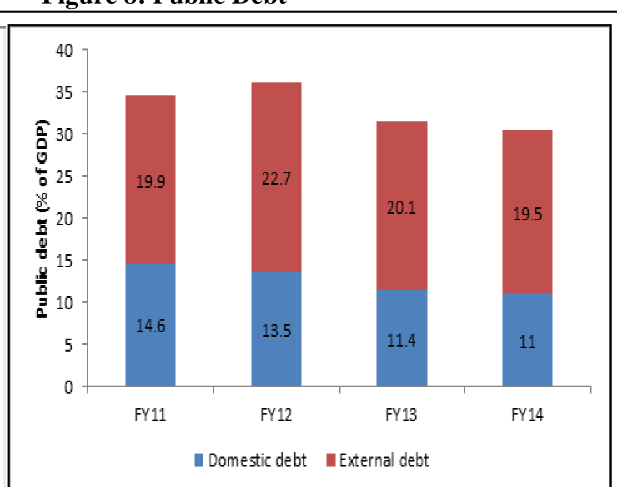


Figure 8: Public Debt



Sources: Ministry of Finance (MoF); IMF.

B. Macroeconomic outlook and debt sustainability

36. The macroeconomic framework has been considerably affected by the recent earthquake, but remains overall adequate for DPC2. Growth is expected to decelerate significantly in FY15 before rebounding in following years as reconstruction efforts begin in earnest. In turn, while the budget may remain (marginally) in surplus in FY15, a significant fiscal gap is expected to emerge in FY16 and beyond. Inflation is expected to be higher than initially projected (pre-earthquake) though remaining in single digits. Finally Nepal is expected to move from a position of significant current account surplus to deficits given the vastly expanded import needs for reconstruction and rehabilitation.

37. Economic growth is expected to decelerate, but remain at reasonable levels considering the disaster, although the estimates remain tentative (table 1). Given the widespread devastation following the earthquake, damage to crops and seeds as well as other economic assets in affected areas, and significant interruption in economic activity there (with most people unable to return to full time employment and a significant movement of population out of Kathmandu city) economic growth is projected to

decelerate to 4.1 percent in FY15. Though the pace of recovery in outer years will be determined by the speed at which reconstruction and rehabilitation efforts proceed as well as external financing, it is expected that economic growth will recover to 4.5 percent in FY16 under a baseline scenario that accounts for: (i) persisting spending bottlenecks (given the disturbance to regular government systems) and (ii) possible financial sector stress. In FY17 economic activity is expected to grow at 5.5 percent before adjusting back to historical trend levels (4.0 percent).

Table 1: Key Macroeconomic Indicators, FY11-FY19

	FY11	FY12	FY13	FY14	FY15 (pre)	FY15 (post)	FY16	FY17	FY18	FY19
	Actual				Projections					
Real economy	(Percentage change, unless otherwise stated)									
Nominal GDP at market prices (NPR, billions)	1367	1527	1693	1929	2170	2143	2433	2778	3115	3417
Real GDP growth (at market prices)	3.4	4.8	3.9	5.5	5	4.1	4.5	5.5	4.1	4.0
Real GDP growth (at factor prices)	3.7	4.4	3.3	4.8	4.6	…	…			
Contributions:										
Agriculture	1.5	1.6	0.4	1.5	1.1	…	….	….	….	….
Industry	0.6	0.4	0.4	0.4	0.4	…	….	….	….	….
Services	1.6	2.4	2.5	2.9	3	…	….	….	….	….
Per capita GDP (current $)	714	702	707	703	….	…	….	….	….	….
Consumer prices (period average)	9.6	8.3	9.9	9	7.1	7.6	8.6	8.2	7.8	7.0
Consumer prices (eop)	9.7	11.5	7.7	8.1	6.5	8.8	8.5	8.0	7.5	6.5
Fiscal sector	(As percentage of GDP, unless otherwise indicated)									
Expenditures	18.7	19.3	17.2	18.8	20.2	20.8	23.8	24.2	23.8	22.6
Total revenue and grants	17.7	18.7	19.3	21	21.3	20.9	21.8	21.9.	22.1	22.3
Net incurrence of liabilities	2	2.2	-1	-1.3	0.4	1.4	3.5	3.8	3.4	2.0
Foreign	-0.3	-0.2	-0.3	-0.1	…	…	…	…	…	…
Domestic	2.3	2.4	-0.6	-1.2	…	…	…	…	…	…
Total public debt	34.5	36.3	28.9	25.1	24.4	24.2	25.3	26.6	27.7	27.8
Domestic	14.6	13.5	11.4	8.8	6.9	8.0	9.7	11.2	12.4	12.1
External	19.9	22.7	17.5	16.3	17.5	16.2	15.6	15.4	15.3	15.7
Monetary sector	(As percentage of GDP, unless otherwise indicated)									
Broad money	12.3	22.7	16.3	19.1	19.5	14	19.1	….	….	….
Domestic credit	13.7	8	16.9	13.9	17	15.1	33	….	….	….
Private sector credit	13.1	11.3	20.2	18.3	21.1	16.9	31.8	….	….	….
Balance of payments	(As percentage of GDP, unless otherwise indicated)									
Current account balance	-1	4.8	3.3	4.6	5.8	2.2	-4.2	-3.1	-4.0	-3.7
Exports of goods and services	5.1	5.3	5.1	5.2	4.8	4.5	4.1	3.9	3.8	3.8
Imports of goods and services	28.6	29.8	32.3	36.2	34.4	35.5	38.8	38.0	38.4	38.7
Gross official reserves ($, millions, eop)	3085	4307	4972	6172	7137	6543	5728	5274	4727	4195

Gross official reserves (in months of imports of goods and services)	5.8	7.2	7.3	8.6	8.8	7.2	6	5	4.2	3.4
Rupees per U. S. dollar (period average)	72.27	81.02	87.96	98.21	....		....	....	....	....
Memo:										
Nominal GDP at market prices (in $, billion)	19	18.9	19.2	19.6	....	....	....	....	....	....
GDP, PPP (current international in $, billion)[a]	55.03	59.2	62.4	....	....	....	....	....	....	....

Sources: Central Bureau of Statistics; Nepal Rastra Bank; IMF.
Note: eop=end of period; ppp=purchasing power parity.

38. As a result of the earthquake, the GoN is projected to face significant fiscal financing needs in FY15 and beyond. It is expected that projected fiscal financing needs will be covered by additional borrowing without major adverse consequence to the debt sustainability outlook. In FY15, a combination of lower than anticipated revenues (owing to disruption in tax collection and lower taxable imports) and heightened expenditures, are expected to result in greater needs (net incurrence of liabilities) equivalent to 1.4 percent of GDP (approximately US$303 million), to be filled by external loans (approximately US$108 million), and the remainder by domestic borrowing. Heightened expenditures, as a result of the reconstruction effort, mean that in FY16 and FY17 fiscal financing needs are expected to reach 3.5 and 3.8 percent of GDP respectively (table 2). Assuming that no additional external funding is mobilized with respect to the pre-earthquake baseline, domestic borrowing would increase by 2.6 percent of GDP in each year to cover the financing needs for FY16 and FY17 and would remain consistent with debt sustainability.

Table 2: Key Fiscal Indicators, FY12-19
(Percentage of GDP)

	FY12	FY13	FY14	FY15 (pre-quake)	FY15 (post-quake)	FY16	FY17	FY18	FY19
	Actual			Projections					
Revenue and grants	18.7	19.3	21.0	21.3	20.9	21.8	21.9	22.1	22.3
Total revenue	16.0	17.5	18.3	18.8	18.4	19.4	19.6	19.9	20.1
Tax revenue	13.9	15.3	16.3	16.6	16.2	17.2	17.3	17.6	17.8
Nontax revenue	2.1	2.2	2.0	2.2	2.2	2.2	2.2	2.2	2.2
Grants	2.7	1.8	2.7	2.5	2.5	2.5	2.5	2.4	2.4
Expenditure	19.3	17.2	18.8	20.2	20.8	23.8	24.2	23.8	22.6
Current expenditure	15.9	14.2	15.4	16.3	16.6	17.5	17.9	18.2	18.2
Capital expenditure	3.4	3.0	3.3	3.9	4.4	6.5	6.5	5.8	4.5
Overall balance (excluding grants)	-3.3	0.3	-0.5	-1.4	-2.4	-4.5	-4.8	-4.1	-2.7
Overall balance (including grants)	**-0.6**	**2.1**	**2.2**	**1.1**	**0.1**	**-2.0**	**-2.3**	**-1.7**	**-0.3**
Net acquisition of financial assets	1.6	1.1	0.9	1.5	1.5	1.5	1.5	1.7	1.7
Net incurrence of liabilities (financing needs)	**2.2**	**-1.0**	**-1.3**	**0.4**	**1.4**	**3.5**	**3.8**	**3.4**	**2.0**

Sources: MoF; IMF.

39. Given the large reconstruction-related need for imports, the current account balance is projected to become negative from FY16. In FY15, the current account surplus is projected to decline from 5.8 percent of GDP (initially anticipated) to 2.2 percent despite robust remittance inflows. Thereafter, as reconstruction efforts begin in earnest the

surplus is projected to give way to a potential large deficit equivalent to 4.2 percent and 3.2 percent of GDP in FY16 and FY17 respectively (or US$1billion and US$830million). This scenario assumes that external funding flows remain as projected pre-earthquake. However, given expected increases in remittance flows and development partners' significant pledges of support, the actual deficit level is expected to be lower.

40. Monetary policy is expected to be relaxed going forward to stimulate the economy and support financial recovery. Though broad money growth is expected to moderate in FY15 in the immediate aftermath of the earthquake (14 percent projected), it is expected to increase significantly thereafter reaching 19.1 percent in FY16. The policy challenge for the NRB will be to set up liquidity management systems that effectively sterilize large expected external inflows, while for the GoN it will include ensuring that the business environment is strengthened to promote investment and that absorptive capacity (for public investment) is increased.

41. Given the projected increase in public spending and labor shortages, inflation is expected to increase though remain below double digits. Prior to the earthquake, a significant deceleration in inflation was anticipated reflecting both the NRB's cautious stance as well as the impact of significantly lower oil prices and price growth in India. Given reconstruction needs, the projections have been adjusted upwards to 8.8 percent and 8.5 percent for FY15 and FY16 respectively.

42. As mentioned earlier, in the most recent joint World Bank-IMF Debt Sustainability Analysis (2014), Nepal was assessed to be at low risk of debt distress. This represented an improvement over the previous "moderate" assessment, reflecting reduced estimates of the cost of a potential financial sector shock and an increase in the discount rate used. Baseline external public debt indicators showed that external debt dynamics were broadly sound and remained resilient to standard stress tests. An increase in public capital spending, raising the net incurrence of liabilities to around 2.5 percent of GDP, was considered to remain consistent with a stable debt profile (Annex 2). Although this assessment will be reviewed in light of the earthquake and net incurrence of liabilities is projected to rise above the 2.5 percent baseline it appears unlikely that the "low risk" rating would need to be revised (given the expected increased mobilization of grants and highly concessional financing following the donors' meeting planned for June 2015).

43. Debt management. A 2014 Debt Management Performance Assessment has revealed modest improvements over the previous (2010) Assessment, linked to the setting up of the Treasury Single Account and the operation of the General Ledger Custody module, which provides delivery versus payment settlement and secure records of all holders of government securities. However, important shortcomings remain, including weak coordination with fiscal policy and low in-house analytical capacity to carry out debt sustainability analysis.

44. Macroeconomic risks to the outlook are believed to remain moderate. Given Nepal's relatively limited exposure to external shocks, with low levels of financial market integration and a very modest export base, the main sources of vulnerability would come

from either slower than expected growth in remittances or weaknesses in the domestic financial sector (especially weaker smaller banks and cooperatives), or any new natural disaster/earthquake or both. Remittance flows are unlikely to slow-down (and indeed there was a post-earthquake hike in remittance receipts), given the relatively well-diversified portfolio of destination countries for Nepalese migrants. Financial sector weaknesses are being mitigated through the reforms supported by this proposed operation.

C. Recent Banking Sector Developments

45. **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.** In recent years, the banking system has expanded rapidly (91 percent between 2009 and 2014). Domestic credit to the private sector jumped from 33 percent of GDP in 2005 to 60 percent in 2014, overtaking the South Asia regional average of 45.8 percent. Private commercial banks accounted for all of this growth, while assets of two state banks (RBB and NBL) declined as a share of the sector's total assets. However, the RBB is still the largest bank, representing 8.0 percent of total commercial bank assets, and the NBL is the sixth largest bank, with 5.2 percent of assets as of FY15 Q2. In January 2015, the nine largest banks accounted for 51.6 percent of commercial banks' assets.

46. **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 has improved marginally to an estimated 12.3 percent in FY15 Q2 compared with 11.8 percent in the previous year. All banks meet the minimum CAR of 10 percent except two banks – one state controlled bank (NBL representing 5.2 percent of the banking system) with CAR of 4.78 percent and one private bank representing 1.2 percent of the system and with CAR of 2.2 percent. There has been a decreasing trend in nonperforming loans (NPLs) over the last few years; however, banks' reported asset quality and capital buffers may be overstated. NPLs accounted for 2.7 percent of the total loan portfolio as of FY15 Q2. 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 capital adequacy ratio. Banks have incentives to resort to ever-greening to keep NPL ratios below 5 percent to be able to pay dividends. 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.

47. **Excessive credit growth during FY08-11, weak supervision and enforcement of prudential regulations, and a liberal bank licensing policy have contributed to the fragility of 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. The collapse of the real estate bubble after reaching a peak in 2008, coupled with a subsequent 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.

48. The NRB responded with large-scale liquidity support through multiple lending windows and regulatory forbearance, rather than intervening and closing weak and insolvent banks. 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 remain.

49. While risk is spread throughout the system, balance sheets are thought to be weaker in smaller commercial and development banks and in nonbank financial institutions. These institutions have proliferated in the past 10 years and have generally outstripped the NRB's capacity to supervise and regulate the sector. While they are smaller in terms of assets, their vulnerabilities could have larger implications depending on the extent of cross-ownership and exposure to larger banks. Liquidity pressures continue to be felt by Class C institutions. Deposits shifted to the perceived safety of Class A banks amid concerns over their balance sheets and governance. The NRB has a lender of last resort policy that was used in 2011 to help avert the liquidity crisis but since then, liquidity in the commercial banks has improved; with pressure now concentrated on Class C institutions.

50. The NRB introduced a series of measures to strengthen banking regulation and supervision. These include (a) increasing the cash reserve ratio (CRR) requirement for the commercial banks and development banks and the introduction of new instruments to manage excess liquidity in the system; (b) enlarging the prompt corrective action framework to include liquidity and nonperforming asset ratio triggers; (c) issuing new stress test guidelines and guidelines on the Internal Capital Adequacy Assessment Process; (d) improving on-site inspection practices in line with IMF recommendations; (e) creation of a financial stability unit at the NRB; (f) diagnostic reviews of 20 banks were undertaken with IMF support; and (g) completion of 27 Special Inspections and launching of Special Inspections for a further 27 BFIs (for a total coverage of about 64 percent of banking system assets) supported by DFID, which was agreed as a prior action under the first DPC.

51. Efforts are also being undertaken to strengthen the resolution framework for problem banks, which has contributed to consolidation in the banking system. The Cabinet has approved for submission to Parliament amendments to the NRB Act that gives stronger powers to the NRB to intervene in undercapitalized BFIs. In 2011, the NRB issued a directive allowing BFIs to merge across the different classes of BFI as long as the resulting merged entity met all the requirements for the class of the merged institution. Two additional policy instruments have been used by NRB: a moratorium on new licenses for Classes 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 162 as of mid-January 2015, a reduction of 19 percent.

POTENTIAL IMPACT OF THE EARTHQUAKE ON THE FINANCIAL SYSTEM

52. **The 25 April 2015 earthquake creates potentially major new threats to the stability of the financial system which exacerbate Nepal's already complex financial sector challenges**. Preliminary analysis indicates – as discussed in Section 1 - that threats to the financial system fall into the following main areas: operational and business continuity challenges; impact on banks' capital and liquidity buffers; pressures on insurance companies and a major reduction in access to finance in rural areas as a result of physical damage to branches and large scale insolvency of MFIs and FINCOs.

53. **The authorities' immediate response was successful in minimizing disruptions in the availability of payment services**. The NRB's quick response contributed to the restoration of cash liquidity in the banks. Outside the most heavily affected areas, payment systems were quickly resumed, remittances could again be received, and domestic and international trade flows were recovered. This is a remarkable achievement, given the serious physical damage to the NRB's main cash distribution facilities and to its headquarters and the absence of a Disaster Recovery Site. The NRB has been successful in getting cash to banks and in restarting the electronic check clearing system. SWIFT, ATM and debit/credit card services have also been mostly restored, and some damaged bank branches have reopened. Thanks to these measures, depositors have maintained continued access to their account with only minimum downtime, which has been key in maintaining public confidence in the banking system, and the prevention of disorderly bank runs.

54. **The earthquake is expected to put additional pressures on banks' liquidity and capital buffers.** The impact arises from 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. BFI loan portfolios are heavily exposed through loans to the real estate sector (20-30 percent of total loans) and by the use of real estate as primary collateral (a further 50-60 percent of total loans). As of mid-March 2015, 83 percent of the BFI's loan portfolio was secured by real estate collateral. Rises in NPLs are especially expected in the tourism, and, to a lesser extent, in the manufacturing sector. In addition, BFIs have exposure to many small and medium sized hydro-power projects in the affected districts which could result in repayment problems.

55. **Potential for contagion from the insurance to the banking sector is also an issue**. By regulation, all of BFIs' direct real estate exposure should be covered by casualty insurance. There are however concerns about the robustness of this arrangement. The analysis of collateral performed as part of the first 27 BFIs in the NRB SIP showed widespread weaknesses in collateral administration which implies that this regulation may not have been fully complied with by all BFIs. In addition, zoning violations are common and in many cases borrowers have not obtained proper certification. There are also concerns about the insurance sector's financial capacity to reimburse banks, which are the beneficiaries of the insurance arrangement. According to preliminary estimates, Nepalese insurance companies have retained 20 – 30 percent of the risk, while reinsuring the remainder with global reinsurance companies. In the event that insurance companies are

unable to reimburse, or reimbursement is significantly delayed, BFIs would be faced with losses on damaged/destroyed real estate collateral.

56. Difficulties of banks and insurance companies could also adversely impact capital market activity, BFIs and insurance companies make up for more than 80 percent of the capitalization of the stock exchange (NEPSE), which was closed after the disaster. BFI also engage in margin lending for stock market transactions. There is uncertainty about the effects of market developments on both BFI's stock market capitalization and their asset quality (margin lending).

57. Work to quantify the potential impact of the disaster on BFIs and insurance companies is just beginning[11]. 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 providing adequate funding lines for the Deposit and Credit Guarantee Fund DCGF) and to establish last-resort recapitalization facilities for BFIs and insurance companies that are considered systemically important[12]. In addition, the ability of the insurance sector to reinsure against natural disasters will be impaired as the premiums for reinsurance are expected to hike substantially.

58. The earthquake and its aftermath may also exacerbate access to finance related problems. Microfinance Institutions (MFIs) and financial coops, which are very important providers of financial services in the remote areas of the country and for those underserved by the banking system are expected to be affected by the disaster. Most MFIs operate in the rural areas of the country, some exclusively in the worst impacted by the disaster. As a consequence, several hundred thousand MFI members have suffered loss of shelter, livestock, and livelihood and in some cases loss of life. Out of the 35 districts that have been hit, 14 are considered to be severely affected. A prolonged disruption in the functioning of these entities may be a severe obstacle in rebuilding livelihoods in the worst-affected communities. As most of the affected borrowers do not have alternative income generating activity and source of repayment, the MFIs are likely to face both liquidity and solvency issues, impacting their capacity to assist their communities in a time of need. The sector is especially vulnerable due to the lack of source of funds diversification, weak or nonexistent IT systems, and low connectivity. Some MFIs will be susceptible to rapid loss of liquidity as members withdraw their funds to pay for immediate expenses and there are no central liquidity facilities available to supply additional funds. In addition, there are around 17,000 cooperatives registered with Department of Cooperatives that offer savings and credit services to around 3.3 million members some of which also operate exclusively in the disaster-hit areas and are likely to be similarly affected. Cooperatives in Nepal are

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[11] The NIB has announced formation of a task force to examine post-disaster insurance company solvency and DFID is considering providing support for a cross-assessment of insurance companies and BFIs, drawing on the collateral database and loan portfolio structure data developed for the Special Inspections Program.

[12] The WBG will provide advice on financial crisis management tools (building on work already done by FIRST) while DFID will deploy additional resources to support bank resolution/restructuring and for the design and management of BFI/insurance company recapitalization funds. Support from other donors will be sought to increase the capital of the DCGF and possibly contribute to the recapitalization funds.

very important providers of financial services to the poor and rural areas especially since a number of financial cooperatives are in trouble due to inadequate regulation and supervision (which is planned to be addressed under DPC3.

59. Severe difficulties in the MFI sector could affect class A, B and C banks. A key source of funding for MFIs is funding from other BFIs which are mandated by NRB to lend a portion of their portfolio to the "Deprived Sector[13]". As of mid-March 2015, BFIs had an exposure of NPR 55 billion under Deprived Sector lending out of which NPR 34 billion was on-lent through the MFIs and the remaining through their own lending. MFIs had a total loan exposure of NPR 38 billion. Preliminary estimates indicate a third of the Deprived Sector exposure is considered portfolio at risk (PAR) which translates to NPR 18 billion, affecting around 700,000 households. 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[14].

D. Relations with the International Monetary Fund

60. Nepal currently does not have an ongoing IMF program but discussions are now underway regarding a possible arrangement to provide post-disaster support. The IMF is also providing technical assistance on banking supervision. In addition, the IMF and World Bank concluded a Financial Sector Assessment Program in the first half of 2014. The key findings of the FSAP are summarized in Annex 3.

III. THE GOVERNMENT'S PROGRAM

61. The first phase of the Government's program for the financial sector was completed in 2011-13 and supported by DPC1. The program included, among others, measures to stabilize the banking system after the 2011 crisis, including formalizing the deposit insurance system, adopting a framework for prompt corrective action and bank resolution, implementation (with IMF support) of a pilot program of diagnostics for 20 financial institutions, issuance of ordinances to strengthen the legal framework for anti-money laundering and counter-financing of terrorism, starting 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.

62. The second phase of the Government's financial sector reform program (2014-2016), 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

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[13] 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, craft-men, labor and landless families". There are two types of loans uncollateralized group lending loans and collateralized micro-enterprise loans.

[14] DFID is expected to restructure support for the Financial Cooperatives sector previously planned to commence in the second half of 2015 to focus on diagnostics and the design of assistance/support for FINCOs and the DOC to restore financing to rural communities, which will also draw on advice from the WBG.

earthquake the overall reform program is expected to maintain these key objectives, with the addition of measures to respond to the impact of the disaster on the financial sector which would be supported by the proposed DPC3. The 2014-15 reforms supported by the proposed DPC2 reflect the main recommendations of the FSAP (see Annex 3) 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 by focusing on four broad policy areas: (a) enhancing financial sector development, (b) restructuring and consolidating the financial system, (c) strengthening the legal and regulatory framework for crisis management, banking supervision and payment systems and (d) enhancing the governance and transparency of the banking system. In the light of the recent earthquake additional focus of the operation is on supporting GoN to provide immediate relief and support reconstruction as well as ensuring that the financial sector is resilient enough to support the reconstruction, and subsequent economic recovery effort.

IV. THE PROPOSED OPERATION

A. Link to the Government's Program and Description of the Operation

63. **The proposed programmatic series (DPC 2 and 3) complements the Government's program, builds on reforms completed in DPC 1, responds to the impact of the earthquake on the financial sector, and is grounded in analytical work carried out by the WB, IMF, DFID and the 2014 FSAP**. As a result, the programmatic series is an integral part of the overall banking sector stabilization program to: (a) identify (via the NRB Special Inspections Program) banking sector weaknesses; (b) resolve institution-specific problems (via prior actions to place undercapitalized banks in prompt corrective action and resolution programs); and, (c) to address weaknesses in regulation and supervision (via the establishment of effective bank resolution processes, improving transparency and regulation by implementing NFRS, strengthening of regulatory and governance frameworks through the reform of the NRB Act and BAFIA, enacting and implementing the AML/CFT legislative framework, and commencing work to strengthen the regulation and supervision of financial cooperatives). The programmatic series (DPC2 and 3) has been modified to include measures designed to assess and then mitigate risks to the financial sector which have been amplified by the impact of the earthquakes. These include the strengthening of the financial crisis management architecture, establishment of disaster recovery centers by the NRB and BFIs, and expanded diagnostic work to assess the impact of the earthquake on bank and insurance company solvency.

64. **DPC2 and 3 would build on and amplify reforms initiated under DPC1 and respond to the need to assess and mitigate the impact of the earthquake on the financial sector.** DPC1 focused on laying the ground for deeper reforms while DPC2 and DPC3 aim at supporting the implementation of these reforms, along with additional reforms, to foster the development of a robust, inclusive, and more stable financial sector. The DPCs will also help mitigate the risk of financial sector stresses following the earthquake, and enable the financial sector to better support reconstruction and the recovery efforts. A summary of the proposed DPC2 policy actions and DPC3 triggers is included in the policy matrix in Annex 1 and the proposed prior actions for DPC2 are discussed in more detail below. It should be noted that the DPC3 triggers may have to be modified to

better respond to the impacts of the earthquake on the financial system as these impacts become clearer. The overall program outcomes envisaged from the program are featured in the last column of the policy matrix.

65. The proposed operation takes into account the lessons learned from the Financial Sector Technical Assistance and Financial Sector Restructuring Projects, from DPC1, and World Bank operations responding to the impact of natural disasters in Haiti and the Philippines on the two countries' respective financial sectors. Both technical assistance 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 reform and stability 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,[15] budget support operations, coupled with technical assistance directly provided by development partners, were considered to be a more effective way to trigger and implement reforms in the financial sector. The designers of DPC1 reflected this understanding by working with the authorities for an extended period to develop broad-based support for the Government's medium-term agenda and adjusting DPC1's prior actions to ensure that they provided both early wins for reform champions and constituted first steps towards clearly articulated goals which are to be fulfilled with the support of DPC2 and DPC3. This approach was closely linked to the design of DFID's capacity-building program (Annex 4), which is fully integrated with the proposed DPC2 and DPC3 support and designed to ensure that the authorities have all the resources needed to implement the reforms.[16]

B. Prior Actions, Results and Analytical Underpinnings

First pillar: Enhancing financial sector development

66. This pillar aims to assist GoN in establishing a strengthened coordination framework for design and implementation of financial sector reforms by preparing a Financial Sector Development Strategy that balances the aims of stability, efficiency

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[15] "Stakeholders also generally agreed that intertwining DPOs and technical assistance usually strengthens the enabling environment for policy reform. In Armenia, for example, all stakeholders agreed that the [Poverty Reduction Strategy Credit] PRSC series was useful in helping the government better identify technical assistance needs. In Vietnam, the government suggested the creation of a task force to link the PRSC-supported reforms with technical assistance needs, while the donors suggested that technical assistance needs be discussed in early stages of preparation of a PRSC operation. In some cases, excess of bureaucracy on the part of the donors who provide technical assistance, including the World Bank, was raised as a reason for delays in reform implementation." *2009 Development Policy Lending Retrospective: Flexibility, Customization, and Results*, World Bank OPCS, 2009, para. 72.

[16] "...rather than viewing budget aid as simply a transfer of financial resources to the country's budget, and with a narrow focus on public financial management, it should be considered as a key element of an aid package that consists of evidence-based policy dialogue, analytical work, technical assistance, capacity building activities, as well as financial transfers. This package should be more explicitly geared at addressing the underlying causes of fragility and supporting the transition toward resilience." *Providing Budget Aid in Situations of Fragility: A World Bank-African Development Bank Common Approach Paper,* Fragile and Conflict Affected Countries Group of the Operations Policy and Country Services Vice-Presidency at the World Bank, and the Governance, Economic and Financial Management Department at the African Development Bank, 2011, p. 1.

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 78 percent of Nepal's adult population has no or restricted access to formal financial services. Similarly, access to credit for small and medium-sized enterprises remains constrained, and lending practices involve excessive collateral requirements. While government-supported interventions and schemes to increase access are needed, in the past such interventions have not been strategic, resulting in unintended distortions and stability-related risks. As mentioned earlier, the liberal licensing policy of financial institutions aimed at enhancing access resulted in too many small and weak institutions that undermined stability.

Prior action 1: The Ministry of Finance has endorsed the Nepal Financial Sector Development Strategy.

67. In order to better align financial sector stability and development objectives, the government decided to prepare a comprehensive long-term FSDS in 2013. As recommended by the FSAP, the strategy aims to focus—in addition to the stability and health of the financial sector—on broadening and deepening access to financial services. A high-level government steering committee was formed to provide policy guidance and a technical committee led by the MoF (supported by DFID and FIRST) was established to coordinate preparation of the strategy. Following stakeholder consultation, the strategy was endorsed by the Minister of Finance in April 2015. Implementing the FSDS will ensure that the government and regulators' policies and regulations are aligned.

Second pillar: Restructuring and consolidating the financial system

68. Support under this pillar is expected to result in: (a) restructuring and recapitalizing RBB and NBL to meet all regulatory norms (including CAR >10 percent), (b) divesting state control of NBL, and (c) stabilizing and consolidating the banking system with all banks being either CAR-compliant or in prompt corrective action programs, and a reduction in the number of financial institutions. This will be achieved through support for the completion of the restructuring process begun under DPC1 for the two large state-controlled Class A commercial banks (prior actions 2, 3, and 4) and support for actions to enhance the stability of the financial system and respond to the earthquake's impact through: completing the first phase of in-depth diagnostics of the banking system to identify and address institution-level weaknesses which threaten banking system stability (prior action 5); and commencing the process of assessing the impact of the earthquake on BFIs' balance sheets (prior action 6); promoting the continued consolidation of the system (prior action 7); and, taking the first steps towards enhancing the regulation and supervision of financial cooperatives (prior action 8). [17]

69. The main recommendations of the FSAP Technical Note on State-Controlled Banks include the full divestment of the government's stake in the NBL to private

[17] Although started pre-disaster, these action are particularly important in its aftermath as they significantly mitigate financial sector vulnerabilities while promoting stability and efficiency.

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. The RBB would be profitable and fully recapitalized to meet prudential requirements[18] while the NBL would be profitable and achieve a positive CAR of at least 6 percent. The first steps towards 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 foreign bank strategic investor during FY14-15, and the Cabinet has decided to convert a loan to 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 the Asian Development Bank, to divest its minority stake in the Class A Agricultural Development Bank of Nepal (see Annex 6).

70. State-controlled banks in Nepal lacked clear mandates, leading to overlaps, weak corporate governance, poor capital adequacy, and suboptimal delivery on the government's financial sector development goals such as promoting access to finance to underserved market segments and providing sources of long-term infrastructure financing. A clear mandate, directed restructuring, and adequate regulatory oversight can support the government's financial sector development goals through RBB, while divesting other state-controlled banks, which enjoy an implicit state guarantee.

Prior action 2*: *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 RBB for an amount equal to NPR 30.90 million; and (d) retained earnings in Fiscal Years 2012/13, 2013/14, and nine months of 2014/15 in the amount of NPR 7.21 billion.

71. The RBB was deeply insolvent but highly liquid, with a CAR of -21.79 percent at 15 January 2012. As one of the DPC1 prior actions, the government implemented the first phase of the bank's recapitalization, with the CAR rising to 3.78 percent by mid-October 2013 and 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, has now been completed, with the RBB reporting a CAR of 10.1 percent as of mid-January 2015 and profits for the financial year to the same date of NPR 847 million. The government's use of budget funds for the recapitalization of the RBB has been limited to an NPR 4.3 billion new share purchase in 2012, with the remaining additional contributions taking the form of a debt-to-equity conversion (NPR 3 billion), conversion of NPR 787 million of preferred shares into common shares, and conversion of a scheduled dividend to equity (NPR 86.57 million).

72. The recapitalization of RBB is in line with the government's policy objective of divesting all state-controlled commercial banks except the RBB, which will remain

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

as the sole state-controlled commercial bank and comply with all prudential requirements while retaining a development focus, particularly given the bank's importance for access to finance in rural areas. The recapitalization program for RBB will be supported by measures to strengthen governance of the institution. The measures include RBB being subject to the provisions of NRB Directive 6/071, appointment of non-Government directors following the legally-required divestiture, implementation of NFRS, and application of governance provisions of the new BAFIA to be submitted to the Cabinet and the reissued NRB Directive 6/071. In addition, both RBB and NBL are scheduled for Special Inspections in the first half of 2015 (these inspections have commenced but may be delayed to the second half of 2015 – along with the other scheduled Special Inspections – in order to allow the banks to focus on disaster recovery), which will incorporate diagnostics of governance, risk management systems and controls along with regulatory compliance diagnostics and the conclusions and recommendations are legally enforceable by the NRB. In addition, the condition of the banks will be assessed for the impact of the earthquake on asset quality and capital in mid-2015.

***Prior action 3*: NBL has taken measures to implement the second phase of NBL's recapitalization plan by: (a) converting a loan from the Recipient of NPR 2.49 billion into capital; (b) retaining earnings in Fiscal Years 2013/14 and six months of 2014/15 in the amount of NPR 1.10 billion; and (c) selling non-banking assets of NBL for an amount equal to NPR 708 million.**

73. The NBL was also deeply insolvent, but highly liquid, with a CAR of -8.53 percent at 15 January 2012. As one of the DPC1 prior actions[19], 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 15 October 2013 and to 5.26 percent by mid-July 2014. DPC2 has 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 net income of NPR 1.10 billion (excluding gains from the sale of non-banking assets) for FY 13/14 and the first six months of FY 14/15. As mentioned above, the impact of the earthquake on NBL's asset quality, capital and its non-banking assets will be assessed in July 2015 and could have a material impact on the bank's profitability for FY 2014/15 and its ability to raise additional capital from asset sales. This recapitalization program has given the government a large majority stake (more than 60 percent ownership) in the bank, which will support the divestiture process by enabling the government to offer an attractive large majority stake in the NBL to potential foreign bank strategic partners. [20]

[19] 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.

[20] For NBL, the FSAP Technical Note on State-Controlled Banks also *specifically recommended* that the Government structure the bank's recapitalization to create a Government-owned majority stake which would be attractive for a strategic investor to purchase.

***Prior action 4**: 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.*

74. In the FY14-15 Budget Speech, delivered in early July 2014, the government announced its intention to proceed with divesting NBL to a bank strategic investor. Given the impact of the earthquake, it seems likely that the divestiture process will be delayed (this is a trigger action for DPC3) until late 2015 or 2016. By recapitalizing and divesting from NBL, the government would remove the implicit state guarantee from NBL and remove distortion in the market caused by having a commercial bank that has been noncompliant with the statutory CAR for the past 15 years. The government's use of budget funds for the recapitalization of the NBL has been limited to a NPR 1.37 billion subscription for a 35 percent share of the 2013 rights offering, with an additional contribution taking the form of a debt-to-equity conversion (NPR 2.49 billion).

75. In addition, NBL's governance is expected to improve given that it will be subject to the strengthened requirements in NRB Directive 6/071 (governance related), 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-2016, and it will be subject to strengthened governance provisions of the new BAFIA, once enacted.

76. This pillar also supports actions to enhance the stability of the financial system through: completing the first phase of in-depth diagnostics of the banking system to identify and address institution-level weaknesses which threaten banking system stability; promoting the continued consolidation of the system; and, first steps towards enhancing the regulation and supervision of financial cooperatives.

***Prior action 5**: The NRB has completed the implementation of the first phase of a diagnostic of the banking system and the NRB has: (a) approved Special Inspection Reports for 27 financial institutions; and (b) approved Prompt Corrective Action Programs (including Resolution Programs) for all financial institutions found to be undercapitalized.*

77. A key factor undermining the NRB's regulatory oversight has been the lack of capacity and the focus on a compliance-based supervisory framework. This has proven to be inadequate for assessing the risk profile of financial institutions as well as systemic and institutional risks to the sector. A Special Inspections Program (SIP) was therefore deemed necessary to understand the potential risks within the banking system.

78. In 2012-13 the NRB (with technical assistance from the IMF) completed a program of diagnostics of 20 financial institutions. 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 and highlighted the need for "deep dive" diagnostics, according to the IMF 2013 Article IV Consultations Report, of a much larger sample of financial institutions to enable the NRB to better identify actual and

potential risks within the banking system. With support from DFID, from February to end-October 2014 the NRB implemented the first phase of an SIP using internationally led auditing firms[21]. The Special Inspections incorporate in-depth diagnostics, which provide a significantly more accurate identification of institution-level asset quality and other risks than stress testing exercises. The NRB is using the SIP to replace its yearly examination, hence the outcomes of the SIP and recommendations are presented to the NRB Board, which has to act on them in the same way it handles its annual supervision reports. A benchmarking report has also been prepared by the consultants for the first phase of the SIP and a final report will be prepared when the SIP is completed, based on the results, to help the NRB identify specific risks. 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. By the end of the second phase of the SIP, NRB will have 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.

79. The stability of the banking system stability would be evidenced by all banks either having CAR greater than the regulatory minimum or being in approved PCA or resolution programs. By end-October 2014, 27 financial institutions representing over 24 percent of banking system assets had been inspected. Of these 27 BFIs, a number of BFIs were identified by the inspections as requiring supervisory action either in the form of PCA programs for those institutions with capital levels higher than 2 percent, or by declaring as problematic those BFIs with capital levels below 2 percent. The NRB had commenced implementing either Prompt Corrective Action programs, including resolution programs, for all undercapitalized BFIs by end-March 2015.

***Prior action 6*: 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.**

80. The impact of earthquake damage on loans for real estate development and purchase, and to borrowers using real estate as collateral is not known. By regulation, all real estate used as collateral is required to be insured, thus transferring risk to the domestic insurance sector (which in turn is required to reinsure not less than 75 percent of coverage below NPR 10 million and 100 percent of coverage above that amount with foreign reinsurance companies), but 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. The self-assessment will assist the NRB to identify potentially weakened BFIs and provide a basis for further diagnostics required to determine

[21] The Special Inspection Program 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 Bank-DFID team) are (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 further BFIs were added by the NRB on the basis of its own concerns regarding specific BFIs.

what restructuring and/or resolution/risk mitigation strategies will be needed to stabilize the banking system (a diagnostic of the insurance sector is a proposed trigger action for DPC3). The NRB and NIB are also engaged in discussions with DFID regarding conducting a fast diagnostic of the impact of the earthquakes on collateral values and bank solvency, and the corresponding impact on insurance companies, using databases developed in the SIP.

<u>Prior action 7</u>: The NRB continues its policy of consolidating the banking system by: (a) maintaining its moratorium on new license applications for Classes A, B and C financial institutions, as defined in BAFIA; and (b) adopting a new bylaw to facilitate acquisitions of BFIs by other BFIs.

81. Past liberal licensing policies have contributed to the proliferation of banks (particularly in the Class B and Class C sectors), while supervisory resources and resolution frameworks have not kept up with growing needs 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. Two policy instruments have been used by NRB: a moratorium on new licenses for Classes 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 162 as of mid-January 2015, a reduction of 19 percent. Additional mergers and two acquisitions are underway (but may need to be reassessed in light of the impact of the earthquake on the BFIs involved) to further reduce the number of BFIs to 146, with a target at the end of the program of 130.

<u>Prior action 8</u>: The NRB has issued a notice requiring all NRB-authorized financial non-governmental organizations to convert to Class D microfinance institutions as defined in BAFIA by mid-July 2015.

82. Concerns regarding the condition of the fast-growing financial cooperatives sector have been increasing. Three recent government task forces[22] and analyses performed by the FSAP and for the FSDS have concluded that regulation and supervision of financial cooperatives is essentially nonexistent owing to weaknesses in the Cooperatives Act and a lack of supervisory capacity. The NRB supervises only 15 financial cooperatives 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, know-your-customer oversight is less stringent in the cooperative sector, which – with the exception of NRB-regulated Class D microfinance institutions - does not report to the Credit Information

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

Bureau, potentially creating adverse selection problems. Regulatory arbitrage and weak oversight have created the conditions for the emergence of fraudulent and poorly performing financial cooperatives. In 2013-14, a number of large financial cooperatives 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 financial institutions.

83. The FSDS prioritizes preparing a feasibility and design study for an apex institution for financial cooperatives. The strategy emphasizes the importance of assigning and institutionalizing the roles of NRB and Department of Cooperatives (DoC) 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 coops and pursue prosecution of management and insider malfeasance) and the Registrar of Cooperatives has made efforts to intensify its monitoring of troubled FINCOs.

84. 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 microfinance institutions, it issued a notice in October 2013 to FINGOs, authorized by NRB to convert to Class D microfinance institutions by mid-July 2015. The notice was also included in the monetary policy declaration of July 2014. 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 which 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.

Third pillar: Strengthening the legal and regulatory framework for crisis management, banking supervision and payment systems

85. This pillar would also build on preparatory steps taken under DPC1 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, and 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 earthquakes has 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 IT has no disaster recovery center 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 NRBA 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 DCGF lacks the resources and back-up funding lines required to honor the deposit guarantee for less than a handful of small BFIs. DPC3 with DFID and other donor support will support reforms to address these issues.

86. Legislation to strengthen the bank resolution powers of the NRB by amending the NRBAA and providing a proper legal framework for deposit insurance (the DCGFA) have both been approved by Cabinet for submission to Parliament. Preparation of legislation to define the legal framework for financial crisis management (including provisions to provide emergency liquidity assistance), provision of back-up funding facilities for the DCGF, establishment of an NRB disaster recovery site and business continuity plan, establishment of a business continuity framework for all BFIs, and the establishment of an appropriately-empowered Financial Stability Committee are proposed trigger actions for DPC3. Technical and financial support for these measures will be provided by DFID.

***Prior action 9*: The NRB Act Amendments Bill has been approved by Cabinet for submission to Parliament.**

87. Current legislation continues to be refined to allow the NRB to effectively exercise 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 provide scope for BFIs to challenge NRB's resolution authority. The NRB's prompt corrective action framework reflects the limited resolution powers given to the NRB under existing laws.

88. DPC1 supported the approval by the MoF of the text, prepared with the assistance of DFID, the IMF and the World Bank, of a bill (the NRB Act Amendments Bill) to amend the NRB Act to strengthen and clarify the bank resolution powers of the NRB in line with international practices. In 2014 this text was further improved to strengthen 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 NRBAA and DCGFA 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 NRBAA and its submission to Parliament. This will result in establishing a modernized legal framework for bank resolution. The prior actions envisaged under DPC 3 include development of the framework for crisis management, which is financed through IMF support to NRB and is aligned with the country's sustainable transition from fragility to stability.

***Prior action 10*: The Bill on the Deposit and Credit Guarantee Fund has been approved by Cabinet for submission to Parliament.**

89. 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 incomplete. DPC1 supported the approval by the MoF of a draft bill (the DCGF Bill), prepared with the assistance of the World Bank, IMF, and DFID, which would provide the legal framework for the deposit insurance scheme, which presently operates within a weak framework of regulations and bylaws rather than specific legislation. The new deposit insurance system will follow the "pay-box" model and the regulatory oversight of the DCGF will be limited to areas such as reporting of insured deposits, deposit guarantee premiums, and management of the Deposit Guarantee Fund's investments. A decision was also made to continue housing the Deposit Guarantee Fund outside the NRB given the additional burden it would place on the NRB's limited resources at a time when they are already being stretched by the capacity-building and training requirements for implementation of the NFRS and the transition to consolidated supervision. 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 NRBAA and the new BAFIA and then submitting the bill to Parliament. The result will be that the deposit insurance system has been established and the DCGF is fully operational, which is particularly relevant in the aftermath of the disaster and the ensuing losses to financial institutions and rise in depositor protection concerns.

90. The government is committed to increasing the fund's resources through budgetary support and the fund's income through deposit guarantee premiums. On funding sources, the DCGF draft bill proposes, among others, (i) an increase in capital up to NRP 10 billion (Government contribution), (ii) an increase in premium paid by BFI's in case of need (private sector), and (iii) additional special contribution to be paid from members (private sector). In addition, for contingency funding, the DCGF draft bill proposes (i) direct loans from the Government to the fund, and (ii) direct credit subsidies or donation from private sector or external sources (through Government guarantee to the credit amount required by the fund).

91. The DCGF bill creates the framework to build a coordinated contingency funding plan which builds on the provisions contained in the bill. Ongoing dialogue has resulted in a strategy to develop a contingency funding plan in cooperation with the Ministry of Finance and /or NRB, under (i) a three parties special funding arrangement agreement, and/ or (ii) providing for a stand- by credit line at the disposal of the fund in case of the emergency need for the pay-out.

***Prior action 11*: The board of NRB has approved the Nepal Payments System Development Strategy (NPSDS)**

92. Although the NRB has as a formal 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 use of electronic payment means remains limited, there are no robust payment system risk-management

frameworks, and lack of NRB oversight reduces the efficiency of the financial system and could potentially result in the payment systems contributing to financial instability. While NRB managed post disaster payments without too much disruption, it became evident that weaknesses exist in the payments system – which can be addressed by the NPSDS.

93. Settlement risk is a serious concern in the Electronic Check Clearing System, which could be addressed through some simple operational measures, including through an extension of SWIFT operating hours in the Banking Department, facilitating the online transfer of funds from one office of NRB to another, and the preparation of a pre-settlement file ahead of the final settlement file. These operational measures would go a long way in minimizing settlement risk that could arise as a consequence of the unwinding of net settlement obligations that are due to inadequate balances in the accounts of the banks at the NRB. This would enable the banks to be aware of their liquidity obligations and make necessary arrangements for funding their accounts.

94. In July 2014 the NRB Board approved the NPSDS and established a new desk—the Payment and Settlement Unit—under the Regulations Department. However, the new Unit's oversight capacities need to be fully developed and its independence and authority strengthened by upgrading it to a stand-alone department.

95. Implementing the NPSDS and related reforms will result in the establishment of a safe, efficient, and modern payment and settlement system infrastructure that is compliant with best practices by 2016. The NPSDS covers all the pillars of a comprehensive payments system strategy, including (a) a robust legal framework, (b) safe and efficient large value payments systems, (c) securities settlement systems, (d) interbank money markets, (e) retail payments, (f) government payments, (g) international remittances, (h) regulatory and oversight frameworks, and (i) a collaborative framework with the participation of all stakeholders in the form of a National Payments Council.

Fourth pillar: Enhancing the governance and transparency of the banking sector

96. 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 a guideline by the NRB governing the staged transition of the banking sector to the NFRS. Transparency has also been improved by the enactment of key anti-money laundering/counter-financing of terrorism laws which resulted in Nepal being removed from the FATF "grey list" of countries. As recommended by the FSAP Stability module, the governance of BFIs has been improved by submitting the new BAFIA to Cabinet containing provisions strengthening fit and proper requirements and minimum qualifications for directors and CEOs, and NRB ensuring that adequate governance measures are included in a Directive 6/071 on governance of BFIs issued by NRB which would also now apply to government-appointed directors and CEOs.

Prior action 12: The NRB has issued a guideline governing the transition of BFIs to NFRS.

97. Transparency and financial reporting within the financial sector, particularly in Class B and Class C institutions, remains weak, limiting the potential for adequate supervision and assessment of financial sector risks. In particular, there is significant scope to improve accounting standards that are guided by international best practices for loan loss classification and provisioning, capital adequacy, ownership, loan concentration, and corporate governance.

98. Nepal is transitioning to International Financial Reporting Standards by adopting Nepal Financial Reporting Standards 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 2014-17 (Class A FIs in FY15-16, and all other FIs in FY16-17) to allow the development of the capacity of regulators and practitioners to implement the NFRS. Due to the disruption of the banking sector by the earthquake, this schedule may be put back by a year. This activity is being supported by extensive capacity building activities undertaken by DFID, the World Bank and other donors. DFID has undertaken a major capacity-building project to support the transition to the NFRS, providing a 15-week NFRS training program for 277 regulators and also supporting the preparation of NFRS-compliant regulations and taxation rules. DPC2 supported the adoption by the NRB of a guideline, issued by the NRB in November 2014, establishing the NFRS transition timetable and required preparatory actions for each class of financial institution. The adoption of the NFRS will improve accounting standards, enhance transparency, and possibly require more provisioning on the part of BFIs, all of which will help improve the transparency and stability of the system. There is a need to strengthen the quality assurance process of audit firms that carry out audit of BFIs.

Prior action 13**: *Steps have been taken to strengthen the governance of the banking system, including state-controlled banks, by (a) the endorsement by MoF of the Bill on Banks and Financial Institutions for submission to Cabinet and (b) the inclusion by NRB of adequate governance measures in the revised and reissued Directive 6/071 on Governance of BFIs.***

99. The outcomes of the IMF-led diagnostics of BFIs, the DFID-supported SIP, and the FSAP have all identified weaknesses in governance as posing 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 (NBL and RBB) were unable to engage in large-scale lending for over a decade owing to negative capital adequacy and were also under the direct control of the NRB. However, there remains a concern that governance practices could deteriorate in the future. In addition, governance practices in private banks have been 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. 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 the two state-controlled commercial banks are exempt from qualifications requirements. Supported by DPC2, the

authorities have completely redrafted governance-related sections in the new BAFIA submitted to Cabinet to strengthen the fit and proper tests and professional qualifications and experience requirements applied to BFI directors and CEOs, (*including 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 the latter*)[23]. In the interim, the NRB has ensured that adequate governance measures are included in the reissued Directive 6/071 on governance of BFIs.

Prior action 14: The transparency and safety of the banking system has been strengthened by the enactment of the following key AML/CFT legislation: (i) the Mutual Legal Assistance Act; (ii) the Extradition Act; and (iii) the Prevention of Organized Crime Act.

100. 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.

101. Table 3 below provides an overview of the proposed prior actions and analytical underpinnings of DPC2 discussed in this section.

Table 3: DPC2 Prior Actions and Analytical Underpinnings

Prior actions	Analytical underpinnings
The Ministry of Finance has endorsed the Nepal Financial Sector Development Strategy	• FSAP, Bank economic and sector work (ESW), Bank and donor analyses, government analyses
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 RBB for an amount equal to NPR 30.90	• FSAP, Bank, DFID and NRB analytical work, RBB financial reports

[23] 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, etc., (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 Rastra Bank, (e) 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 (f) Section 29 in the Bill and Section 27 in the current BAFIA – "Functions, Duties and Powers of the Chief Executive" has been expanded

Prior actions	Analytical underpinnings
million; and (d) retained earnings in Fiscal Years 2012/13, 2013/14, and nine months of 2014/15 in the amount of NPR 7.21 billion.	
NBL has taken measures to implement the second phase of NBL's recapitalization plan by: (a) converting a loan from the Recipient of NPR 2.49 billion into capital; (b) retaining earnings in Fiscal Years 2013/14 and six months of 2014/15 in the amount of NPR 1.10 billion; and (c) selling non-banking assets of NBL for an amount equal to NPR 708 million.	• FSAP, Bank, DFID, and NRB analytical work, NBL financial reports
The decision to reduce the number of state-controlled commercial banks to one by divesting control of the NBL has been announced by the Minister of Finance in its Budget Speech of July 2014.	• FSAP, Bank, DFID, and NRB analytical work, NBL financial reports
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 financial institutions and (b) approved Prompt Corrective Action Programs (including Resolution Programs) for all financial institutions found to be undercapitalized.	• IMF, Bank and DFID analytical work, Bank core ESW, FSAP analysis
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 continues its policy of consolidating the banking system by (a) maintaining its moratorium on new licenses issuance for Classes A, B and C financial institutions as defined in BAFIA and (b) by adopting a new bylaw to facilitate acquisitions of BFIs by other BFIs.	• IMF, Bank and DFID analytical work, Bank core ESW, FSAP analysis
The NRB has issued a notice requiring all NRB-authorized financial non-governmental organizations to covert to Class D microfinance institutions as defined in BAFIA by mid-July 2015.	• Bank core ESW, FSAP analysis
The NRB Act Amendments Bill has been approved by Cabinet for submission to Parliament.	• Bank and IMF core ESW, DFID and Bank analytical work, FSAP analysis
The Bill on the Deposit and Credit Guarantee Fund has been approved by Cabinet for submission to Parliament.	• Bank and IMF core ESW, DFID and Bank analytical work, FSAP analysis
The board of NRB has approved the Nepal Payments System Development Strategy	• Bank and IMF core ESW, Bank analytical work, FSAP analysis
The NRB has issued a guideline governing the transition of BFIs to the NFRS.	• FSAP analysis and DFID ESW
Steps have been taken to strengthen the governance of the banking system, including state-controlled banks, by (a) the endorsement by MoF of the Bill on Banks and Financial Institutions for submission to Cabinet and (b) the inclusion by NRB of adequate governance measures in the revised and reissued Directive 6/071 on Governance of BFIs.	• Bank and IMF core ESW, DFID and Bank analytical work, FSAP analysis
The transparency and safety of the banking system has been strengthened by the enactment of the following key AML/CFT legislation: (i) the Mutual Legal Assistance Act; (ii) the Extradition Act; and (iii) the Prevention of Organized Crime Act.	• FATF analytical work, Bank ESW

C. Link to the Country Assistance Strategy and Other Bank Operations

102. A new Country Partnership Strategy (CPS) for FY14-17 was approved by the Bank's Board in May 2014. The CPS is centered on two pillars aimed at increasing economic growth and competitiveness, and 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 the persistent financial sector weakness and the risk it poses 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 the financial sector difficulties and the support provided by the World Bank, IMF and DFID. The CPS makes the case for the use of Development Policy Credits to support the efforts of the authorities to reform the financial sector.

103. The proposed operation builds on significant prior engagement. As mentioned earlier, the proposed Second Financial Sector Stability Development Policy Credit follows the approval of the first Financial Sector Stability Development Policy Credit of $30 million in June 2013, and supports the government's medium-term policy program to address the vulnerabilities of the financial sector in Nepal. It also builds on the lessons learned from the World Bank-financed $16 million Financial Sector Technical Assistance Project (P071291, approved in 2002 and closed in 2011) and the $75.5 million Financial Sector Restructuring Project (P084219, approved in 2004 and closed in 2009).

D. Consultations and Collaboration with Development Partners

104. During the period 2013-15, the NRB 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 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 RBB and NBL restructuring) and facilitates consultations with key government stakeholders. The authorities have also used a consultative process to prepare the Financial Sector Development Strategy that was led by a high-level Steering Committee and guided by several Technical Committees incorporating regulators and other stakeholders and coordinated by the MoF, including the NRB, the Insurance Board, the Securities and Exchange Board of Nepal, and the Ministry of Cooperatives and Poverty Alleviation)

105. The recently completed IMF-World Bank Financial Sector Assessment Program provides additional insights. This in-depth review, the first for Nepal, of all aspects of the financial sector has helped identify specific reforms that can be integrated into the Strategy and the government's medium- to long-term reform agenda for the financial sector.

106. DFID is working in close partnership and coordination with the World Bank on financial sector issues. DFID has given strong technical assistance and capacity-

building support to both the World Bank and the government for the preparation of DPC1 and DPC2, and has commenced implementation of a larger operation to provide capacity-building support for the government's 2014-16 financial sector program and the FSDS for up to five years, including providing capacity to complete the proposed triggers for DPC3. DFID will also continue to provide support to the World Bank for the preparation of DPC3 and in response to the earthquakes is also considering expansion of its current program to respond quickly to urgent needs for assistance. The cooperation of the 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 operation. Starting in early 2012, the Bank and DFID established working arrangements which provide "seamless" coordination between their two teams, with DFID contributing experts to work as part of the Bank team and all missions identified to the authorities as joint missions, while the Bank team provided inputs for the design of DFID support. In parallel, DFID technical assistance support to the authorities is linked explicitly to support the Government's efforts to help implement the DPC's prior actions 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 Special Inspections Program and the transition of the regulatory community to NFRS.

V. OTHER DESIGN AND APPRAISAL ISSUES

A. Poverty and Social Impact

107. 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.[24] The financial sector reform program supported by DPC1 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. Similarly, DPC2 proposes to support continued measures to safeguard the banking system and provide stability while giving priority to individual depositors in the process of bank resolution. DPC2 also supports a sustained focus on financial sector stability, which is crucial for ensuring broader economic recovery in the aftermath of the earthquake. By leveraging on the actions undertaken through DPC1, DPC2 and DPC3 make a case for strengthening the legislative and regulatory framework of the financial sector, in order to develop the financial sector and enhance its transparency and governance.

B. Environment Aspects

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

[24] DFID Nepal, *Business Case and Intervention Summary, Macroeconomic Reform Project,* January 2013

C. Public Financial Management, Disbursement and Auditing Aspects

109. **Public Financial Management (PFM):** The 2014/15 Public Expenditure and Financial Accountability (PEFA) Assessment concludes that Nepal has made substantial progress in deepening the structures and processes of public financial management (PFM), particularly in the use of information technology 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 to PFM systems and process by the Government of Nepal 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 two indicators deteriorated. However, compared to 2007, with improved systems, data availability has assisted to fine tune the assessment and downgrade the score of an indicator to reflect the current system.

110. **A number of PFM related reforms are currently under implementation through the Multi-Donor Trust Fund (MDTF) supported by DFID, Australia, Denmark, Norway, the European Union (EU), US AID and 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 target date. Similarly, 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 (CSOs) in conducting performance auditing, engagement of CSOs in PFM related works, various analytical works in PFM including Operational Risk Assessment in PFM, Public Expenditure Tracking Survey (PETS) in education sector etc. are some of the interventions that were undertaken through MDTF contributing to development outcomes. Budget credibility is internalized, budget outturns compared to original is stable and monitoring of budget, especially arrears, has improved with the implementation of the TSA. Multi-year 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 (GFS) classification and the TSA. The Budget is published both physically and on-line 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/FMIS framework. The Public Procurement Act (2007) and Public Procurement Rules (2007) regulate public procurement. The Act (clause 64) establishes 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 (OPMCM). PPMO is required to ensure, inter alia, that all public procurement takes into account 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 TSA system and recognizing the need for further work on

integrated financial management system, additional financing to strengthen the PFM System is being proposed. The earthquake has affected TSA infrastructure in a few earthquake affected districts and necessary support is planned for rehabilitation.

111. Despite continuing political instability, 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. Despite the delayed appointment of the Auditor General, the report was submitted within nine months in 2011, 2012 and 2013. Following the appointment of the Auditor General in May 2013, the AG's Report continued to be submitted within nine months in 2014 and 2015. The Auditor General 2015 Report highlighted some weaknesses in the following areas: internal control systems, pre-audit and internal audit, follow-up actions on audit recommendations, separation of responsibilities between treasury and audit function, and timeliness of audits at the entity or project levels.

112. Disbursements. The present operation is the first of a series of two programmatic single-tranche credits of US$100 million SDR equivalent. The credit proceeds will be made available to the government upon approval of credit effectiveness. GoN will submit a withdrawal application in the requested format to the Bank once the credit has been approved and the Bank has notified the credit effectiveness to GoN. At the request of the MoF, the disbursement will be made into a foreign currency account maintained at 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 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 NPR, and the name and number of the government's bank account in which the funds have been deposited. GoN would not use the credit proceeds to pay for expenditures included in the Bank's standard negative list. If the 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 Bank, refund an amount equal to the amount of such payment to the Bank. Amounts refunded to the Bank upon such notice shall be cancelled in line with Bank Policy 8.60.

113. Audit. No audit will be required under this DPC. The IMF Safeguard Assessment of the NRB of July 2014 indicates that there are no strong reasons for the Bank to request an audit of the deposit account or to require additional safeguard measures, as permitted under Operational Policy 8.60. As such, no audit will be required under the DPC. NRB audits take place periodically, but experience delays. GoN is working closely with Development Partners to develop a second phase PFM Action Plan to address weak areas mainly the downstream aspect of PFM. Weak areas as identified during the PEFA assessment will receive focus during the preparation of the Action Plan. Once the Action Plan is approved and adopted, these actions will be supported through the MDTF financing. Therefore, while fiduciary risks exist, the recent improvements and the mitigation measures secure acceptable fiduciary arrangements for the DPC.

D. Monitoring and Evaluation and Accountability

114. The Ministry of Finance 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 technical assistance operations.

115. Since this is the first of two programmatic DPCs, the Bank team would continue to provide support while undertaking monitoring and evaluation, to review progress and make adjustments, when required. The Bank team will focus on the reforms and prior actions for the program. At the same time, 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 DPC2 and DPC3 reforms carried out on a monthly, quarterly and annual basis.

116. Grievance Redress. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation 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 in order 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

VI. SUMMARY OF RISKS AND RISK MITIGATION

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

118. The earthquake and its aftermath pose substantial risks to achieving the intended development outcomes of this reform program. This is reflected in a substantial rating for environmental and social risk in the Systematic Operations Risk-Rating Tool (SORT) table (table 4). These risks are:

- *Heightened financial stability risks*: As mentioned earlier, the disaster has potential adverse impacts on the solvency of the financial sector and hence can impact the Capital

Adequacy of the two state-controlled banks, as well as the other BFIs through rising NPLs, additional provisioning charges and pressure on BFIs' capital buffers. In the short term, DFID is planning an initial diagnostic of the insurance sector's financial capacity to provide reimbursement.

- *Deterioration of NBL's divesture prospects*: The potential deterioration in the financial outlook of BFIs, along with the potential effect of the earthquake on NBL's capital adequacy and NPL levels, may also affect the availability and cost of capital. Consequently, the appetite of reputable investors for acquiring a majority stake in NBL may be reduced, which weighs on the feasibility of the planned divesture.
- *Operational and business continuity challenges*: Many banks are faced with serious damage to their physical infrastructure, particularly their branch networks in the more remote areas of the country. Considering that many banks are still grappling with serious operational challenges, the NRB is at this stage understandably hesitant to make additional demands on banks. Therefore, some delays in the execution of the remaining 27 Special Inspections of banks are unavoidable.

119. The proposed operation aims to address the financial stability risks associated with the earthquake. Several prior actions of DPC 2 and indicative triggers for 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 respond decisively to instances of financial distress and by generally strengthening the robustness of prudential regulatory and supervisory frameworks, while the on-going technical assistance is providing support for business continuity. Thus, while risks have increased following the earthquake, given that the proposed DPC2 and DPC3 mitigate these risks and are crucial for reconstruction and recovery efforts, they assume even greater importance in light of these risks. Indeed, lack of attention to, and, not sustaining financial sector reform actions such as those in the DPC2, would inevitably have enhanced risks further and would likely have severely hampered recovery efforts and caused further distress. The DPC series therefore, constitutes an important part of overall recovery actions on the part of the authorities.

120. The likelihood of political instability risk materializing is substantial, and the severity of impact on achieving the project development objective remains substantial. 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 (such as the closure of distressed financial institutions, the decision to proceed with in-depth diagnostics, and the approval of the recapitalization plans for the NBL and RBB and subsequently making large capital injections into the two banks). Implementation risks for DPC2 are mitigated through demonstrated commitment at the highest levels of the government and 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. To continue to mitigate political uncertainty to the extent possible, the Bank actively engages with leaders across the political spectrum to confirm multiparty support for continuing financial sector reforms.

121. The pace of implementation of the government's 2014-16 reform program could be slowed down by institutional capacity risks in the event of changes of key personnel and lack of reform will. The phased approach through a series of DPCs is a risk-mitigating factor. The actions supported under the proposed series of DPCs form the second phase of the medium-term government financial sector reform program initiated in 2012. This multi-stage approach has helped to gradually generate and solidify consensus on the broader reform program, and most prior actions for DPC2 reflect the extensive work done to fulfill the prior actions for DPC1. Legislative risks posed by the need for Parliament to focus on completing the new constitution in its first year of operation are mitigated by limiting DPC2 legislative prior actions to submission to Parliament of two key pieces of financial sector legislation (NRBAA and DCGFA) for which there is firm government support in place, with the expectation that these laws will be passed by the end of 2015 (that is, after the new constitution is approved), and having the remaining financial sector legislation deal with financial crisis management.

122. The risk of resistance from vested interests. The likelihood of this risk materializing is substantial. The Special Inspections of 54 BFIs currently underway is providing more accurate information on the financial situation of the institutions under review. If undercapitalized institutions are identified, it will be critical for the NRB to be able to continue to enforce resolution actions. While the government has announced (in the 2014 Budget Speech) its commitment to divest from the NBL and find a reputable bank strategic partner (while maintaining the 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.

123. Table 4 below, provides an assessment of the risk categories and an overall risk assessment to the project development objective following the Systematic Operations Risk-Rating Tool (SORT) framework.

Table 4: Systematic Operations Risk-Rating Tool (SORT) Table

Risk categories	Rating
1. Political and governance	Substantial
2. Macroeconomic	Low
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	Substantial
8. Stakeholders	Substantial
9. Other	Not applicable
Overall	**Substantial**

ANNEX 1: DPC2 POLICY AND RESULTS MATRIX

Prior Actions under DPC2 (May 2015)	Indicative Policy Actions under DPC3 (April 2016)	Results (June 2017) (Baseline = July 2014)
Enhancing Financial Sector Development		
• The Ministry of Finance has endorsed the Nepal Financial Sector Development Strategy.	• Sub-sectoral Financial Sector Development Strategy (FSDS) action plans have been approved by the FSDS Steering Committee.	**Results indicator**: A strengthened coordination framework for design and implementation of financial sector reforms is established as evidenced by progress in implementation of FSDS sub-sectoral action plans. **Baseline**: No national FSDS is in place to guide policy and regulatory development.
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 RBB for an amount equal to NPR 30.90 million; and (d) retained earnings in Fiscal Years 2012/13, 2013/14, and nine months of 2014/15 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).
• NBL has taken measures to implement the second phase of NBL's recapitalization plan by: (a) converting a loan from the Recipient of NPR 2.49 billion into capital; (b) retaining earnings in Fiscal Years 2013/14 and six months of 2014/15 in the amount of NPR 1.10 billion; and	• The government has divested a controlling stake in NBL.	**Results indicators:** The NBL meets all regulatory norms (including CAR >10 percent), has positive net income for the preceding four quarters, and has decreased government ownership.

Prior Actions under DPC2 (May 2015)	Indicative Policy Actions under DPC3 (April 2016)	Results (June 2017) (Baseline = July 2014)
(c) selling non-banking assets of 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.		**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.
• 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 financial institutions; and (b) approved Prompt Corrective Action Programs (including Resolution Programs) for all financial institutions found to be undercapitalized.	• 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.	**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.
• 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 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.[25]	**Results indicators:** Insurance system stability is evidenced by all insurance companies either being compliant with minimum capital and technical reserve requirements or being in NIB-approved corrective action or resolution programs.

[25] Prior to that, a rapid diagnostic of the impact of the earthquake on BFIs and insurance companies will be completed.

Prior Actions under DPC2 (May 2015)	Indicative Policy Actions under DPC3 (April 2016)	Results (June 2017) (Baseline = July 2014)
		Banking system stability is enhanced by better understanding of the impact of the earthquake on BFIs and by identifying contagion risks between insurance companies and financial institutions. **Baseline**: The NIB lacks adequate and accurate financial and risk information to identify troubled insurance companies and assess the impact of earthquake losses on their technical reserves and capital.
• The NRB continues its policy of consolidating the banking system by (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.	• The NRB continues its policy of consolidating the banking system by issuing a new licensing policy for BFIs in line with Basel III.	**Results indicators:** The total number of BFIs is reduced to around 130 and licensing regulations are 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.
• The NRB has issued a notice requiring all NRB-authorized financial non-governmental organizations to convert to Class D microfinance institutions as defined in BAFIA by mid-July 2015.	• 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.	**Results indicators:** All financial cooperatives are regulated and supervised by NRB or the Registrar of Cooperatives or a Second Tier Institution depending on their size and activities. Each of these regulators has adequate supervisory authority and resolution powers over the financial cooperatives they regulate. All NRB-authorized FINGO microfinance institutions have been converted to Class D microfinance banks. **Baseline**: (a) The NRB supervises only 15 financial cooperatives out of 17,000 operating. The remainder

Prior Actions under DPC2 (May 2015)	Indicative Policy Actions under DPC3 (April 2016)	Results (June 2017) (Baseline = July 2014)
		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.
Strengthening the Legal and Regulatory Framework for Crisis Management, Banking Supervision and Payment Systems		
• The NRB Act Amendment Bill has been approved by Cabinet for submission to Parliament.	• 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.	**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.
	• The NRB has (a) implemented a framework and regulations for consolidated supervision and (b) operationalized a supervisory information system.	**Results indicators:** The NRB has strengthened its supervisory capacity and is largely compliant with 4 more BCPs and a new supervisory information system 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.

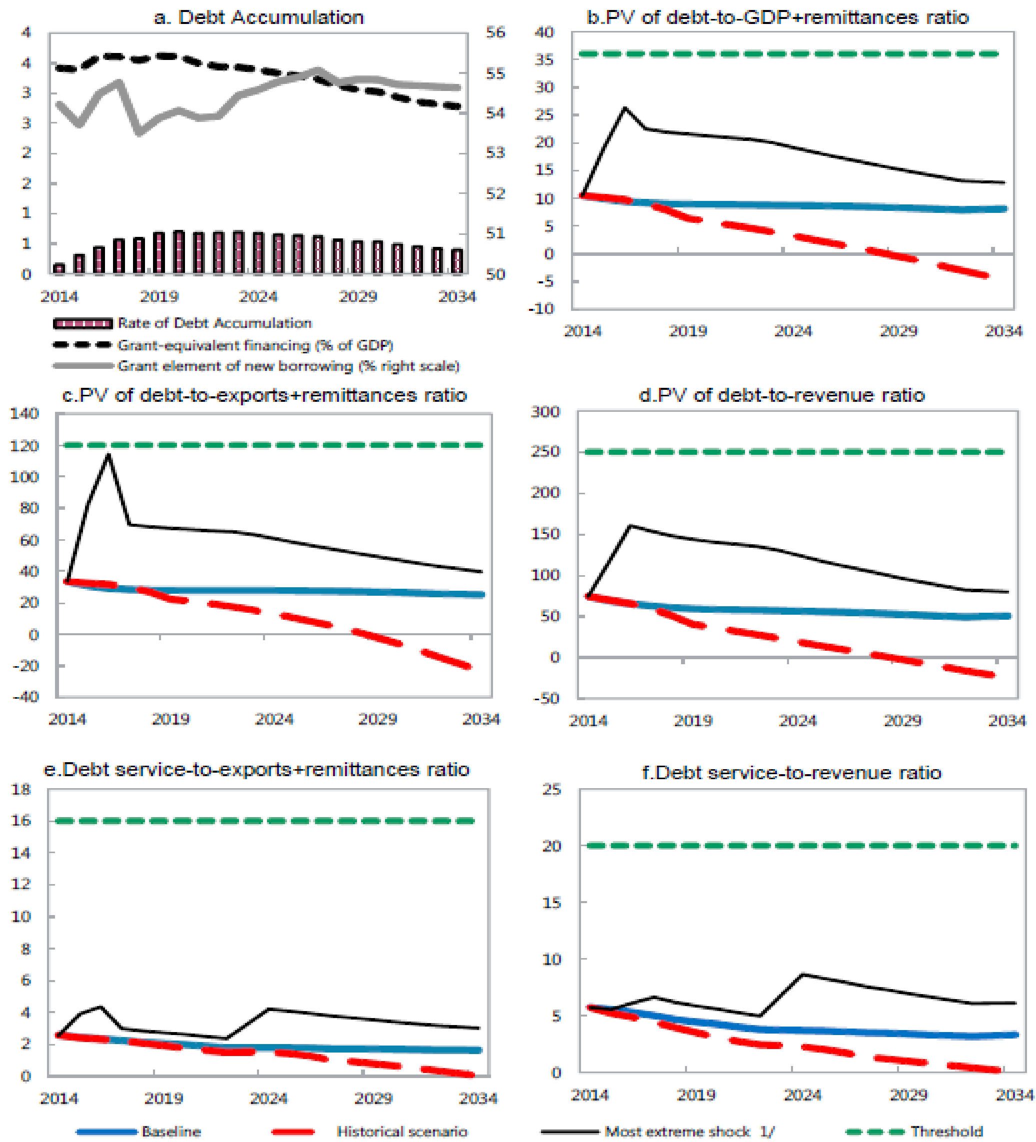
Prior Actions under DPC2 (May 2015)	Indicative Policy Actions under DPC3 (April 2016)	Results (June 2017) (Baseline = July 2014)
• The Bill on the Deposit and Credit Guarantee Fund has been approved by Cabinet for submission to Parliament.	• The Deposit and Credit Guarantee Fund Act has been enacted.[26] • The DCGF has put in place a deposit insurance payout system and key regulations 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.	**Results indicators:** The DCGF has replaced the DCGC as administrator of the DGF. All BFIs have made required deposit guarantee premium payments for the preceding four quarters. DCGF is adequately capitalized **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. DCGF lacks adequate funding.
	• 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 (ELA)[27], to the MoF and the NRB to intervene in the event of a systemic crisis and creating a Financial Stability Committee.	**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 without special anti-crisis intervention powers, and emergency liquidity assistance is inadequate.
	• 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)	**Results indicators**: operational risk and business continuity in cases of natural disaster is minimized.

[26] The Act includes provisions for the establishment of a back-up funding mechanism for the DCGF in the form of direct borrowing from GoN or borrowing under a GoN guarantee. This assumes special significance given the adverse impacts of the earthquake on the financial sector.
[27] For which NRB needs to establish an operational framework for the provision of ELA.

Prior Actions under DPC2 (May 2015)	Indicative Policy Actions under DPC3 (April 2016)	Results (June 2017) (Baseline = July 2014)
		Baseline: Operational risk is high as the NRB does not have a Disaster Risk Site and the Business Continuity framework is inadequate
• The board of NRB has approved the Nepal Payments System Development Strategy.	• 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.	**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. Financial institutions face settlement risk owing to a lack of coordinated operations between NRB and other payments system institutions.
Enhancing the Governance and Transparency of the Banking Sector		
• The NRB has issued a guideline governing the transition of BFIs to NFRS.	• The NRB has issued NFRS-compliant regulations and reporting requirements for BFIs.	**Results indicators:** 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.
• Steps have been taken to strengthen the governance of the banking system, including state-controlled banks, by (a) the endorsement by MoF of the Bill on Banks and Financial Institutions for submission to Cabinet and (b) the inclusion by NRB of adequate governance measures in the revised and reissued Directive 6/071 on Governance of BFIs.	• 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.	**Results indicators:** All board of directors members and CEOs of banks and financial institutions, 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

Prior Actions under DPC2 (May 2015)	Indicative Policy Actions under DPC3 (April 2016)	Results (June 2017) (Baseline = July 2014)
		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.
• The transparency and safety of the banking system has been strengthened by the enactment of the following key AML/CFT legislation: (i) the Mutual Legal Assistance Act; (ii) the Extradition Act; and (iii) the Prevention of Organized Crime Act.	• The GoN has issued the enabling regulation to implement the key AML/CFT Acts	**Results indicators:** Nepal remains off the FATF grey list which allows normal external financial relations (trade finance, remittance inflows and foreign direct investment). **Baseline**: Nepal is not on the FATF grey list

ANNEX 2: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, FY14-34



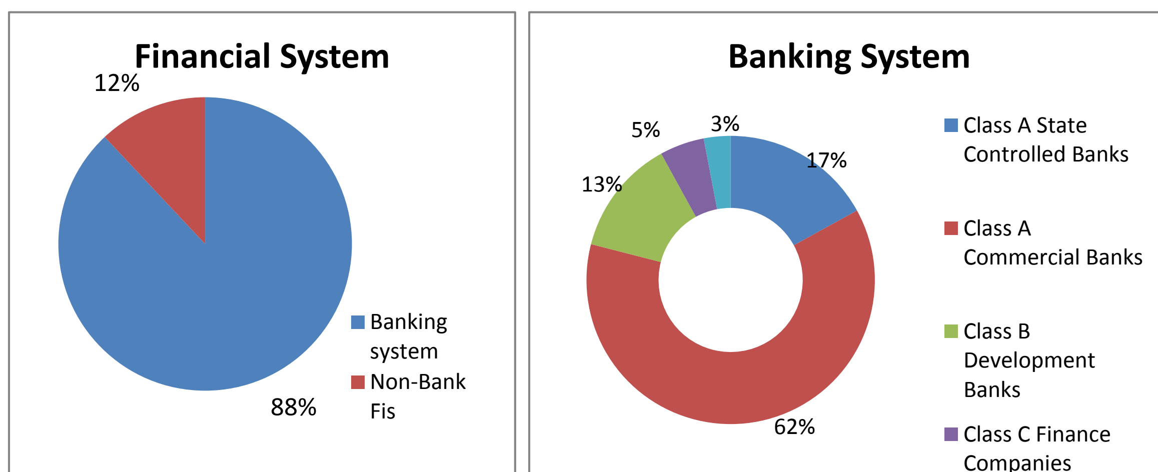
Source: World Bank/IMF DSA, 2014.

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 30 Class A (commercial banks), 81 Class B (development banks), 50 Class C (finance companies), and 35 Class D (microfinance institutions) institutions, accounting for 79, 13, 5, and 3 percent of banking system assets, respectively, as of mid-January 2015.[28] 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 (Standard Chartered). The capital markets are represented by the Nepal Stock Exchange. There are currently 24 insurance companies and 209 companies listed on the Stock Exchange, of which 85 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 A3.1).

Figure A3.1: Structure of the Nepalese Financial System



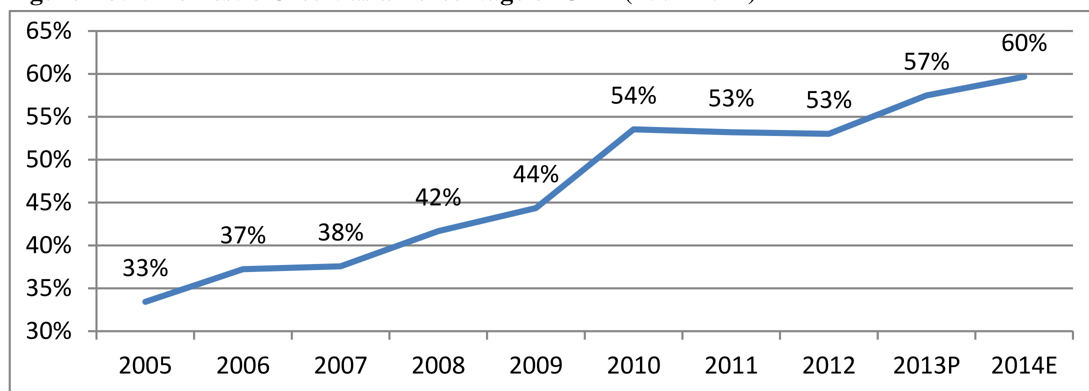
Source: NRB

2. **In recent years, the banking system has expanded rapidly**. Between 2009 and 2014, the banking system grew by 91 percent. Assets of Class A institutions grew by 82 percent, while assets of Class B and Class C institutions grew by 281 percent and

[28]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. There are 35 microfinance development banks (MFDBs) and 28 Financial Intermediary Non-government Organizations (FINGOs) licensed by the NRB which have around 2 million members spread across 73 of the total 75 districts of Nepal and serviced through 1,029 branch locations.

26 percent respectively. Domestic credit to the private sector jumped from 33 percent of GDP in 2005 to 60 percent in 2014, overtaking the South Asia regional average of 45.8 percent (figure A3.2). Private commercial banks accounted for all of this growth, while assets of two insolvent state banks (RBB and NBL) declined as a share of the sector's total assets. However, the RBB is still the largest bank, representing 8.0 percent of total commercial bank assets, and the NBL is the sixth largest bank, with 5.2 percent of assets as of FY15 Q2. In January 2015, the nine largest banks accounted for 51.6 percent of commercial banks' assets (see tableA3.1).

Figure A3.2: Domestic Credit as a Percentage of GDP (2005-2014)



Source: NRB.
Note: P=projected; E=estimated.

3. **Although their number is at historic lows, state-controlled financial institutions represent a significant part of the banking sector in Nepal.** The three Class A state-controlled banks—Rastriya Banijya Bank, Agriculture Development Bank Limited, and Nepal Bank Limited—account for approximately 21 percent of Class A banks' total assets, 19 percent of deposits, and 17 percent of lending as of mid-March 2015. The state also owns Nepal Industrial Development Corporation (NIDC) Development Bank, a Class B bank.

Table A3.1: Total Assets and Capital Adequacy Ratio of Main Commercial Banks, January 2015

Bank	Assets (%)	CAR (%)
Rastriya Banijiya Bank	8.0	10.90
Agriculture Development Bank	6.2	15.18
Nabil Bank Limited	6.7	11.38
Nepal Investment Bank Limited	62	11.92
Nepal Bank Limited	5.2	4.78
Nepal SBI Bank Limited	4.2	13.29
Himalayan Bank Limited	5.1	11.06
Everest Bank Limited	5.6	11.54
Global IME Bank Limited	4.3	10.09

Source: NRB.

4. **The overall lending portfolio of the banking system is concentrated in manufacturing and wholesale/retail trade, each reflecting 22 percent of total credit. However, Class A banks have the highest concentration in these sectors, representing 25 percent and 23 percent respectively.** Class B and Class C banks have more diverse portfolios (see **Error! Reference source not found.**).

Table A3.2: Sectorial Breakdown of Banking System Credit, mid-January 2015

	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	48,252	5	10,528	6	2,118	3	60,898	5
Manufacturing	254,103	25	13,376	8	4,602	7	272,081	22
Construction	102,748	10	21,782	13	11,120	17	135,650	11
Transport, communications and public utilities	50,466	5	17,397	10	6,264	10	74,127	6
Wholesale retail	238,940	23	29,438	17	8,291	13	276,669	22
Finance, insurance and real estate	78,331	7	11,437	7	4,565	7	94,333	7
Other services	79,138	8	13,031	8	3,933	6	96,102	7
Consumption loans	75,039	7	13,584	8	5,415	8	94,038	7
Others	102,330	10	38,114.	23	19,391	29	159,835	13
Total	**1,029,347**		**168,687**		**65,699**		**1,263,733**	

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 has improved marginally to an estimated 12.3 percent in FY15 Q2 compared with 11.8 percent in the previous year. All Banks meet the minimum CAR of 10 percent except two banks – one state controlled bank (NBL representing 5.2 percent of the banking system) with CAR of 4.78 percent and one private bank representing 1.2 percent of the system and with CAR of 2.2 percent. Development banks and finance companies recorded CARs of 15.6 percent and 15.1 percent respectively as of the mid-March 2015. There has been a decreasing trend in nonperforming loans (NPLs) over the last few years; however, banks' reported asset quality and capital buffers may be significantly overstated. NPLs accounted for 2.7 percent of the total loan portfolio as of FY15 Q2. This is a modest improvement from the 3.1 percent recorded in FY14 Q2. The lowest NPL level in the last decade (2.5 percent) was recorded in FY13Q4. The NPL ratios of development banks and finance companies stood at 3.9 percent and 14.4 percent respectively by mid-March 2015. Loan classification and loan loss provisioning are based on past-due days rather than on an expected loss approach and NRB does not conduct a thorough asset quality review. Banks have incentives to resort to ever-greening to keep NPL ratios below 5 percent to be able to pay dividends. **Total loan loss provision coverage vis-à-vis total NPLs is 113 percent for the commercial banking industry.** However, there are variations between institutions and three banks (6 percent market share) had coverage of less than 100 percent compared with nine banks (30 percent market share) a year ago.

6. **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 capital adequacy ratio**. 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 is however not available, neither is it clear which banks are most exposed. 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.[29] 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.

Box A3.1: Recent Analytical Work Indicates the Risk of a Financial Crisis Has Receded

The 2014 IMF-WB Financial Security Assessment Program (FSAP) confirmed the existence of significant financial stability challenges, originating from a past lax licensing policies, a poorly performing and large public bank sector, weaknesses in regulatory and supervisory frameworks, and poor bank risk management practices and inadequate internal controls.

Problem loans in the banking system may also be understated. Reportedly, system wide problem loans are a modest 3¾ percent of total loans, but a sizable number of BFIs report high nonperforming loans with loan evergreening hiding the true extent of the problem. However, stress tests suggest that only in a protracted recession would recapitalization needs be as high as 2¾ percent of GDP, with a majority of the larger banks failing to meet the regulatory CAR. This unlikely scenario is further highlighted in the DSA conducted by the World Bank and the IMF, where two shock scenarios were analyzed. The most extreme shock is a 30 percent one-time depreciation in 2015, which does not lead to a breach of the debt sustainability threshold. The second is an increase in debt to 10 percent of GDP that mimics a financial sector shock leading to domestic debt-financed bank recapitalization needs. Under this shock, the present value of the public debt-to-GDP ratio rises to a peak of 29 percent in 2015, again staying well below the 56 percent threshold. However, such a scenario is very unlikely. **A stress test conducted during the recent FSAP suggests that the recapitalization needs for the entire banking sector (public and private) from a financial sector shock in which nonperforming assets increase by 2 percentage points (implying a 50 percent increase) could amount to 4¾ percent of GDP**. This test, based on updated calibration, supersedes the one conducted in the previous DSA. According to the most recent DSA, t**he financial sector shock assumed in the previous DSA, which led to sustained breaches on multiple debt indicators, is considered unlikely in view of the stress test findings in the recent assessment under the FSAP, and of some progress on financial sector reforms.**

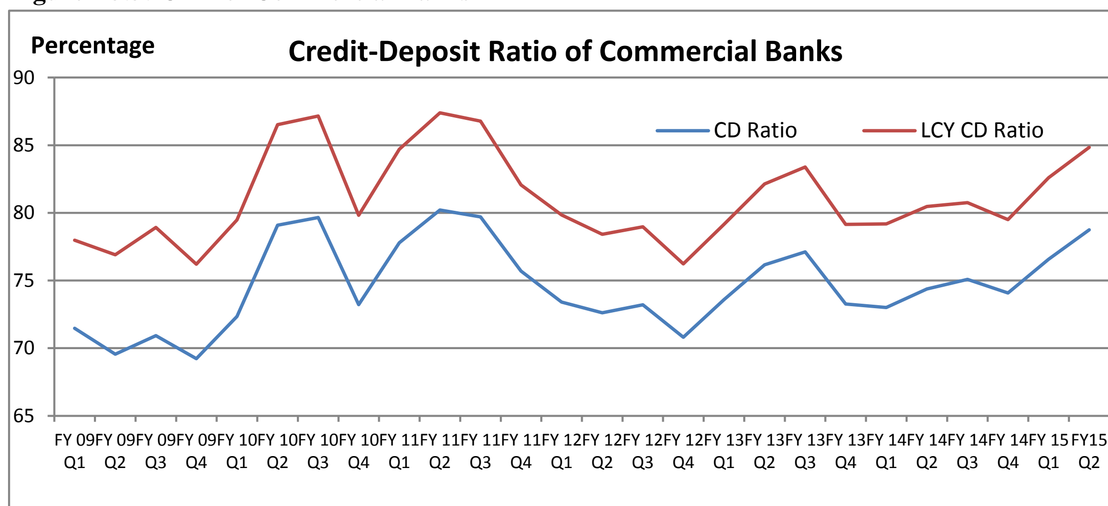
7. **The banking sector has surplus liquidity**. The government has recently made efforts to tighten the monetary policy stance. However, as those efforts have just started and have yet to yield substantial effects, there is excess liquidity in the financial systems. While the market has been enjoying liquidity surplus for more than 2 years, there has been a slight reversal in excessive liquidity with surplus coming down to only NPR 2

[29] Total loan loss provision coverage to total NPLs is 113 percent for the commercial banking industry. However, there are variations between institutions and three banks (6 percent market share) had coverage of less than 100 percent compared with nine banks (30 percent market share) a year ago.

billion by the end of FY15 Q2 owing to surge in bank loans and slowdown in deposit growth. Towards the end of FY15 Q2 (mid-January 2015), the overall credit to deposit ratio (CDR) in local currency for commercial banks stood at 84.8 percent (see figure A3.3). **Five commercial banks (18 percent market share) recorded CDR (in LCY) in excess of 90 percent** and three banks (18 percent market share) recorded CDR less than 70 per cent. The average CDR for development banks (Class B) and finance companies (Class C) were reported as 83.23 percent and 87.72 percent respectively as of Mid-January 2015.

8. **Excess liquidity has had an impact on the earnings of the banks as investment instruments yield less than 1 percen**t. The maximum yield during FY14 for T-bills (91 days) and Interbank (weighted average) was 0.515 percent and 0.411 percent respectively against 4.874 percent and 6.858 percent in the previous year. The average yield for T-bill and Interbank has further declined to 0.1511 percent and 0.51 percent respectively.

Figure A3.3: CDR of Commercial Banks



Source: NRB.

9. **Liquidity pressures continue to be relatively high among Class C institutions.** Deposits shifted to the perceived safety of Class A banks amid concerns over their balance sheets and governance. On-site inspections of institutions applying for liquidity assistance reveal serious governance failures, impaired assets, and financial interconnectedness. The NRB has a lender of last resort policy that was used in 2011 to help avert the liquidity crisis but since then, liquidity in the commercial banks has significantly improved; with pressure now concentrated on the Class C institutions, banks that are considered non-systemic would be allowed to fail.

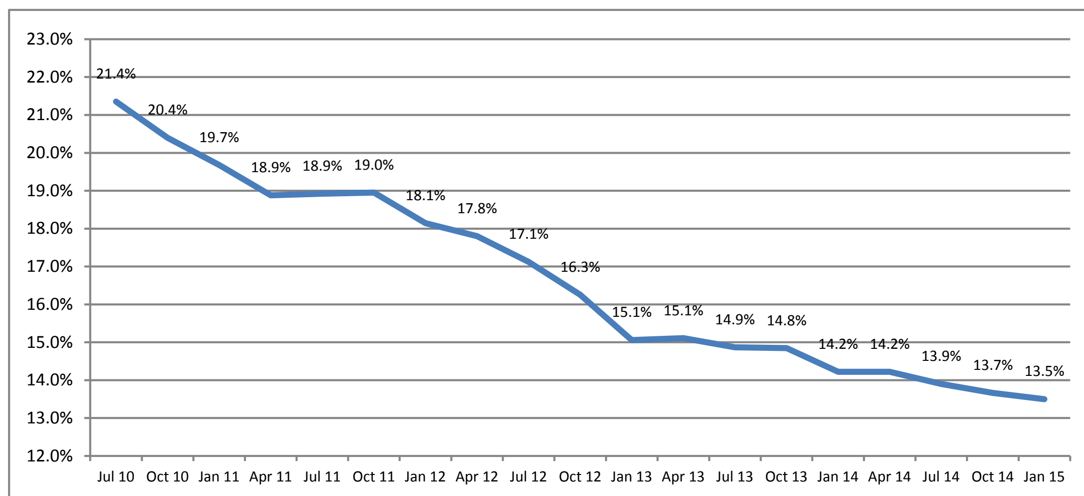
10. **NRB introduced a series of measures in response to excess liquidity in the banking system.** These include (a) an increase in the cash reserve ratio (CRR) requirement for the commercial banks and development banks from 5 percent and 4.5 percent to 6 percent and 5 percent respectively (however, the central bank kept the CRR for the finance companies unchanged at 4 percent), (b) the introduction of a "fine

tuning operation" as an emergency measure to manage the liquidity of BFIs if it poses a risk to financial stability or creates short-term interest rate volatility, (c) allowing commercial banks to invest up to 40 percent of their foreign exchange reserves on secured instruments, (d) reducing the refinancing rate for agro, hydro, fishery and other productive sector loans to 4 percent, and (e) launching of a new liquidity mopping instrument called "term deposit" in August; the first issue of NPR 20 billion was oversubscribed by 90 per cent.

Risks and Vulnerabilities

11. Error! Reference source not found.**Risks related to real estate exposure may be underestimated (figure A3.4).** Based on reported figures, the direct exposure of commercial banks declined to 13.4 percent as of FY15 Q2 compared with 14.2 percent one year before, although in absolute terms there was an increase of NPR 21.1 billion in the real estate portfolio during the same period, primarily driven by home loan segment. However, if indirect exposure from non-real estate loans collateralized by real estate are included, the ratio is likely to be closer to 80 50 percent. The home loan (mortgages) portfolio was 55 percent of total real estate exposure compared with 47 percent the previous year. **Only two commercial banks, accounting for 7.4 percent of the system, had exposure in real estate that was in excess of 20 percent and n**one had exposure in excess 25 percent, the cap placed by the NRB.

Figure A3.4: Real Estate Exposure as a Percentage of Total Loan Portfolios, 2010-2015



Source: NRB

12. **While price correction has helped reduce vulnerabilities to some extent, the real estate sector still poses risk (see Box A3.2 on FSAP Findings).** Despite government revenue from property transactions having increased by 50 percent during FY14 following price corrections, 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 A3.2: 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, inter alia, undertaken diagnostics of 20 major banks, completed a BCP 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 very poorly performing and large public bank sector, and a growing and highly interconnected financial sector. The banking system of Nepal 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 the 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 financial institutions. 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 financial institutions.
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 (SMEs), 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 SMEs 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 prompt corrective action 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 recently 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 (per the IMF Technical Assessment) 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. Diagnostic reviews of 20 banks were undertaken with IMF support. The supervisory departments plan to take stock of these diagnostic reviews to complement their on-site inspections. Fifty-four banks and BFIs, constituting 64 percent of the system, will be subject to an in-depth Special Inspection Program (SIP), supported by DBFID, of which 27 SIs have been completed.

14. **There has also been progress in improving resolution and related frameworks**. A redraft of the NRB Act has been prepared that gives 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 1.3 billion in premiums. The DGF is now at about NPR 3 billion and insured deposits total NPR 268 billion.

15. **Some forbearance measures to deal with a liquidity shortage in FY12 and a fall in real estate and stock prices remain in place**. While all BFIs have to abide by a new 25 percent real estate sector exposure limit, the ceiling for house loan exceptions to this lending limit was raised from NPR 8 million to 10 million. Also, the loan-to-value limit on margin loans against promoter shares was raised from 50 percent to 60 percent.

16. **Mergers among banks are underway.** 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, etc. 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-January 2015, three years later, the number of BFIs had shrunk to 162, a reduction of 37 (18.59 percent). In addition, as of mid-January 2015, an additional 16 BFIs were in the process of either merging, being acquired or liquidating to further reduce the number of BFIs to 146, a reduction of 53 (26.63 percent) since mid-January 2012. 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. No acquisitions have yet been completed but two are in process.

Table A3.3: Merger Activity, Mid January 2012-Mid January 2015

Total number of BFIs, mid-January 2012	**199**
Voluntary mergers completed - Class A	-2
Voluntary mergers completed - Class B	-11
Voluntary mergers completed - Class C	-24
Voluntary liquidations completed - Class C	-2
Forced liquidations completed - Class B & C	-2
Add for new charter in Class B	4
Total - Actual number of BFIs as of Mid-January 2015	**162**

Table A3.4: Anticipated Future Merger Activity

Total - Actual number of BFIs as of mid-January 2015	**162**
Reduction for pending mergers in Class A	0
Reduction for pending mergers in Class B	-6
Reduction for pending mergers in Class C	-8
For court-ordered liquidation - Class C	-2
Voluntary liquidation possible - Class C	0
Subtotal - Potential additional reduction	**-16**
Estimated number of BFIs	**146**

ANNEX 4: DFID and Other Donor Capacity-Building Support for DPC2

Prior actions	Capacity-building support
The Ministry of Finance has endorsed the Nepal Financial Sector Development Strategy	• DFID coordinating consultant to assist with the drafting of individual FSDS sections and work with a consultant from Financial Sector Reform and Strengthening Initiative (FIRST) on drafting the complete document • DFID sponsorship of stakeholder consultation meetings and dissemination of the FSDS
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 RBB for an amount equal to NPR 30.90 million; and (d) retained earnings in Fiscal Years 2012/13, 2013/14, and nine months of 2014/15 in the amount of NPR 7.21 billion.	• DFID consulting support to the MoF and World Bank on design of recapitalization
NBL has taken measures to implement the second phase of NBL's recapitalization plan by: (a) converting a loan from the Recipient of NPR 2.49 billion into capital; (b) retaining earnings in Fiscal Years 2013/14 and six months of 2014/15 in the amount of NPR 1.10 billion; and (c) selling non-banking assets of NBL for an amount equal to NPR 708 million	• DFID consulting support to the MoF and World Bank on design of recapitalization to optimize the potential for divestiture.
The decision to reduce the number of state-controlled commercial banks to one by divesting control of the NBL has been announced by the Government in its Budget Speech of July 2014.	• DFID consulting support to the MoF and World Bank to optimize the potential for divestiture and define the divestiture process
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 financial institutions and (b) approved Prompt Corrective Action Programs (including Resolution Programs) for all financial institutions found to be undercapitalized.	• DFID support of audit firms to perform Special Inspections. • DFID resident bank resolutions adviser support for design and implementation of PCA/resolution programs.
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 continues its policy of consolidating the banking system by (a) maintaining its moratorium on new licenses issuance for Classes A, B and C financial institutions as defined in BAFIA and (b) by adopting a new bylaw to facilitate acquisitions of BFIs by other BFIs.	• DFID resident bank resolutions adviser support for drafting the acquisitions bylaw
The NRB has issued a notice requiring all NRB-authorized financial non-governmental organizations to covert to Class D microfinance institutions as defined in BAFIA by mid-July 2015.	

Prior actions	Capacity-building support
The NRB Act Amendment Bill has been approved by Cabinet for submission to Parliament.	• DFID resident bank resolutions adviser at NRB support for drafting the Bill • FIRST, World Bank and IMF support for drafting of the DCGF Bill
The Bill on the Deposit and Credit Guarantee Fund has been approved by Cabinet for submission to Parliament.	• DFID resident deposit insurance adviser at DCGC support for finalize the DCGF bill • FIRST, World Bank and IMF support for drafting of the DCGF Bill
The board of NRB has approved the Nepal Payments System Development Strategy.	• Consulting and staff support provided by World Bank and IMF
The NRB has issued a guideline governing the transition of BFIs to the NFRS.	• DFID-supported international accounting firm to provide training for 277 regulators and transition regulations to NFRS for financial sector regulators and taxation authority
Steps have been taken to strengthen the governance of the banking system, including state-controlled banks, by (a) the endorsement by MoF of the Bill on Banks and Financial Institutions for submission to Cabinet and (b) the inclusion by NRB of adequate governance measures in the revised and reissued Directive 6/071 on Governance of BFIs.	• DFID consulting support to the MoF, NRB and World Bank to assist with drafting BAFIA provisions • World Bank and IMF staff legal advice • FIRST support for World Bank staff legal advice
The transparency and safety of the banking system has been strengthened by the enactment of the following key AML/CFT legislation: (i) the Mutual Legal Assistance Act; (ii) the Extradition Act; and (iii) the Prevention of Organized Crime Act.	• FATF support for drafting of legislation

ANNEX 5: The earthquake and its Aftermath

1. **On the 25th of April, 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 has identified 14 districts[30] 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 rural families lost their homes (most traditional mud-stone or mud-brick houses in the affected areas collapsed or become structurally unstable); and as many as three million people—many living in very remote rural mountain communities—needed food assistance.

2. **The damage to physical infrastructure is yet to be assessed but will be very large**. Although strategic infrastructure (including the airport and access roads to the Kathmandu valley) fortunately remained operational throughout most of the post-earthquake period, other economic and social infrastructure has sustained significant damage, including not just private houses but also government buildings, hospitals and schools. Government estimates are that about 500,000 houses have been destroyed and 250,000 damaged, and that about 11,000 Government offices were fully destroyed and about 15,000 damaged. In addition Nepal has lost many historically- and religiously-significant cultural assets and monuments, including some of its most famous temples.

3. **The impact of the crisis will be significant, both in the short and medium run.** The negative repercussions include (i) an expected immediate rise in poverty levels in affected areas in the absence of social safety nets and given the disruption in existing community driven development programs; (ii) a deterioration in human capital outcomes, specifically in health and education, especially if services are not able to resume in a timely manner; and (iii) a rise in unemployment and under-employment as natural-resource based local economies collapse. While humanitarian assistance may alleviate human distress in the short term, rapid and substantial funding is needed for recover and reconstruction to start and to mitigate the negative impacts which will be felt over months and years to come.

4. **While the earthquake has not principally affected Nepal's poorest areas, the dependence of affected communities on rural activity and their isolation could lead to a rapid deterioration in livelihoods.** Six affected districts (Sindhuli, Rasuwa, Makawanpur, Dolakha, Ramechhap and Sindhupalchowk) have poverty rate higher than the national average. Many rural households have lost key assets as well as means of production (land, buildings, permanent crops and cattle, agricultural equipment). Opportunities to work (on self-operated farms or as daily laborers) have dwindled. Additionally there are strong multiplier effects to the informal sector (basic services) which constitutes a large share of the economy.

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

5. The health status of the population in the affected areas could worsen, as health service infrastructure has sustained significant damage while health risks and health care needs have surged. Initial reports indicate that more than 700 government hospitals and rural health units have sustained damage, of which 266 are fully destroyed; supply chains for medicines and equipment have been disrupted; the cold supply-chain was destroyed; and many health care workers have been injured or displaced. Thousands of people need short- and long-term care from psycho-social stress and physical injuries, while the risk of potentially life-threatening diarrheal and water-borne disease stemming from the absence of clean water and sanitation has increased. Furthermore, food shortages experienced by victims will compromise the health of vulnerable groups such as young children, pregnant women and the elderly. Overcrowding in temporary shelters increases the risk of communicable disease; poor drainage and stagnant water can increase the malaria and dengue risk; and there will be increased environmental exposure due to damaged buildings.

6. The earthquake has also disrupted the education of about one million children. Preliminary reports estimate that 4,000 schools were totally or partially damaged. Classes were suspended in the most affected districts until end-May. In addition, the traumatic experience of students and teachers may have a long lasting impact on their mental health and learning and teaching performance, if not addressed immediately.

GOVERNMENT'S RESPONSE TO THE CRISIS

7. After the disaster struck, the Government responded decisively despite the temporary loss of power and communications. On April 30, the government set up a National Reconstruction Fund to rebuild physical infrastructure and immediately allocated $200 million (NPR 20 billion) to the fund with the aim of collecting USD 2 billion (NPR 200 billion). The Prime Minister Relief Fund was also used by GoN to provide immediate relief of NPR 6 billion. It will be used to resettle people rendered homeless by the disaster with the construction of low cost houses, reconstruct demolished government buildings and other construction works. The GoN also announced that it would provide cash relief of USD 1,400 (NPR 140,000) to each of the families of those killed in the earthquake as well as financial support USD 250 (NPR 25,000) to each of the families capable enough to reconstruct their houses with minor repair.

8. Additionally, the Prime Minister tabled a proposal in the parliament with various measures: US$ 2,000 in compensation to households that suffered complete demolition of their home provided they rebuild to new standards; temporary shelter to the homeless and free education and upkeep of children who have lost their parents; farmers to receive free seeds and outstanding loans up to US$ 500 to be written off. The Cabinet has formed a Monitoring and Assistance Coordination Committee, headed by the Prime Minister and comprising leaders of the major political parties. The Government is also preparing a Recovery and Reconstruction Plan. Disaster response and recovery will constitute a considerable financial burden on the budget of the national government and affected local governments.

9. **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 in order 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, ATM and debit/credit card services were also quickly restored, and some damaged bank branches quickly reopened.

WORLD BANK GROUP RESPONSE AND STRATEGY

10. **Following the earthquake, the Government asked the World Bank Group to assist its reconstruction efforts in the affected areas**. Specifically, it requested a rapid reprogramming of resources from ongoing projects towards reconstruction efforts; fast disbursement of upcoming projects, including through allowing the retroactive financing of eligible expenditures; preparation of an emergency recovery loan that will (*inter alia*) provide income support and housing recovery support to poor households that have suffered losses of their homes and assets; and fast-tracking and augmentation of DPC2.

11. **In response, the Bank Group is preparing a comprehensive package of recovery and reconstruction support**. The package consists of: (i) just-in-time technical assistance, knowledge sharing on damage assessment and recovery and reconstruction planning; (ii) restructuring of existing investment IDA projects; (iii) new IDA operations, including DPC2 and an emergency recovery loan; and (iv) IFC support to the private sector (banks, small and medium-sized businesses, power companies, etc.). In addition technical assistance on damage assessment including the PDNA is being provided.

12. **Immediate technical assistance.**

a. **The Bank Group is helping the Government to complete a comprehensive structural damage assessment focused on housing, schools, health facilities, residential structures and small businesses.** Experiences in post-disaster response and recovery (e.g. Haiti 2010, Kashmir 2005, Gujarat 2001) underline the critical importance of building-level damage surveys. A single comprehensive structural and household status assessment would be an powerful tool to ensure public safety (against the risk of compromised buildings), assist with the social and economic recovery (by encouraging the reoccupation of safe buildings), relieve trauma (by demonstrating the recovery is starting), recovery planning (by providing the essential data to formulate and budget recovery plans), implementation and monitoring of recovery (by linking assessments to follow-up recovery actions by households), and promoting long-term risk reduction (by informing the development of resilient reconstruction practices). The Government of Nepal agreed that the Bank would lead this effort and the DRM team is fully engaged in cooperation with Government, National Society for Earthquake Technology-Nepal (NSET), Nepal Engineering Association (NEA) and United Nations Office for Project Services (UNOPS),

with other agencies and donors likely to be involved as well. This effort will continue over a sustained period of time.

b. **The Bank Group, with the EU and the UN, has also completed a post-disaster needs assessment (PDNA) on June 15, 2015.** A wide range of experts and other development partners were also involved.

13. **Financing of reconstruction.** The Bank is mobilizing and redirecting financing for reconstruction through:

c. **Reallocation of IDA or trust-funded resources of existing projects** ($850 million undisbursed): This includes potentially activating the contingency components in IDA operations or providing additional financing for ongoing projects. The reallocation will prioritize earthquake recovery needs against other sector needs[31];

d. **Preparation of an emergency recovery operation**

e. **Mobilizing the IDA Crisis Response Window (CRW)** to complement existing operations or new emergency operations.

14. **The IFC envisages setting up an early response liquidity facility in response to the natural disaster for a program of emergency loans ("Nepal Emergency Liquidity Facility") for seven partner banks in Nepal ("Program").** The credit lines under this Program would be utilized for lending to existing clients in need of affordable funding as result of economic decline and/or physical damage suffered due to the earthquake. Although not restrictive, it is envisioned that the majority of the funds under this facility will be on-lent to medium and small sized enterprises ("MSME"). The aggregate size of the facility across all partner banks will be US$70mn. The purpose of these loans will be (i) ensure business continuity and restoring banking facilities in areas where they may have been effected, (ii) help these clients support provision of credit to MSMEs, (iii) contribute to the rehabilitation of the Nepalese economy and (iv) signal IFC support in the Nepalese private sector and its key role in the recovery process.

[31] Only a portion of the uncommitted funds will be reallocated, so that existing commitments (which continue to be important) do not go unfunded

ANNEX 6: 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 government of Nepal and the NRB in addressing the vulnerabilities of the financial sector and, in particular, those of the two state-controlled banks.[32]** The first phase, supported by DPC1, did achieve its target of solvency for these two banks. Both banks were insolvent (that is, a negative CAR) and moved to solvency under phase 1 of the recapitalization. DPC2 is supporting phase 2 of the recapitalization, which would ensure that the RBB was profitable and fully recapitalized to meet prudential requirements and that the NBL was profitable and achieved a positive CAR of at least 6 percent. Both the RBB and NBL are systemic, with more than 5 percent of system deposits. Both banks are profitable; the RBB is the largest and most profitable bank in Nepal.[33] Further significant adjustments to the banks' CAR as a result of major new asset quality problems prior to the earthquake were considered to be unlikely, and no fiscal contribution to the final phase of the banks' recapitalization programs—which are being fully financed by asset sales and retained earnings—was expected. However, once an assessment of the impact of the earthquake on the two banks is completed, further capital injections could be required. Both banks 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 1990's before the banks began the restructuring process - have all been written down to zero in both banks, providing scope for significant capital gains as a result of collateral sales. As part of the FSDS, the future role of the RBB in the banking system will be addressed. Moving forward, to address the issues of financial interconnectedness, including through connected lending, and possible cross-shareholding among banks arising from pledging of equity shares as loan collateral, DPC3 will support the NRB in implementing a framework and regulations for consolidated supervision and in operationalizing a supervisory information system. The status of the recapitalization plans as of mid-July 2014 is shown in tables A6.1 and A6.2.

Table A6.1: Status of Implementation of the Capital Plan of Nepal Bank Limited

	Source of approved capital plan	Estimated amount to be received as capital	Status as of mid-January 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 non-banking assets (houses and land)	Provision of NPR 2 billion to be made	NPR 708 million

[32] 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.
[33] Forty-six percent of the total capital increase for RBB (NPR 13.3 billion) has come from retained earnings, while 23 percent of the total capital increase for NBL (NPR 9.24 billion) has come from retained earnings.

3	From profits accrued during FY 13/14, and half of FY 14/15	NPR 3.27 billion	NPR 1.10 billion
4	To convert the SDR loans received in FY14 as additional resources in share capital	NPR 2.49 billion	NPR 2.49 billion
5	Estimated capital adequacy percentage	Targeted CAR as of mid-Dec. 2014: 5.0 %	5.28 % as of mid-December 2014

Source: NBL

Table A6.2: Status of Implementation of the Capital Plan of Rastriya Banijya Bank

	Details	Share capital as per plan	Share capital upon implementation
	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 NIDC	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 FY12/13, FY 13/14, and nine months of FY 14/15	NPR 3,000 million	NPR 7, 210 million
	CAR as of mid-Jan 2015	10.1 percent	

Source: RBB

2. As can be seen in the two tables above, 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 NBL which has private shareholding, the recapitalization plan has adequately minimized unintended benefits for private shareholders. As noted above the requirement for additional capital as a result of the impact of the earthquake remains to be assessed and may result in the need for additional injections by the government.

ANNEX 7: Letter of Development Policy

Government of Nepal
MINISTRY OF FINANCE

SINGHADURBAR
KATHMANDU, NEPAL

Ref: 2264

May 31, 2015

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

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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Government of Nepal
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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

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ANNEX 8: Fund Relations Annex

Nepal—Assessment Letter for the World Bank
May 29, 2015

1. **Before the earthquakes of April 25 and May 12, Nepal's macroeconomic performance was relatively strong:**

- Growth accelerated to 5.5 percent in 2013/14, thanks largely to a favorable monsoon.
- Inflation had been moderating, broadly in line with developments in India, but remained high at 7 percent (y/y) in March 2015.
- The fiscal position in 2013/14 (mid-July 2013 to mid-July 2014) was again in surplus, on account of under-execution of spending amid solid revenue growth. As a result, public debt eased further, to 25 percent of GDP. The trend of budget under-execution continued through April 2015, indicating that a small fiscal surplus looked again likely in 2014/15. Public debt remained on a declining path.
- The external position remained strong. The current account surplus reached 4.6 percent of GDP in 2013/14, as remittances continued to grow rapidly, reaching a record-high 28 percent of GDP. Net of remittances, however, Nepal ran a current account deficit of 23.6 percent of GDP in 2013/14. International reserves rose to US$6.2 billion by March 2015, equal to 29 percent of GDP and covering almost eight months of prospective imports.

2. **The earthquakes are expected to cause an initial slowdown in economic activity and to strain Nepal's external position**. Pending the completion of the Post-Disaster Needs Assessment it is too early to provide estimates of the damage. However, Nepal's Cabinet has established a US$2 billion (about 10 percent of GDP) *Earthquake Relief Fund for Reconstruction and Rehabilitation*. The damage to property has adversely affected productive capacity. The tourism sector which generated about 2½ percent of GDP in foreign currency earnings in 2013/14 has also been hit. The growth recovery will largely be determined by the vigor of the reconstruction effort. There are two components to the expected increase in reconstruction activity:

- The large-scale import needs related to public sector reconstruction will strain Nepal's external position and the pace of public sector reconstruction will importantly depend on the amount of external finance Nepal receives to rebuild. Alternatively, without the mobilization of substantial additional aid, foreign reserves would be expected to fall significantly over the medium term
- Private sector reconstruction will largely be driven and financed by remittances.

It should be noted that the speed of Nepal's recovery will not only depend on the amount of external financing received. Other key factors include the extent to which Nepal's absorptive capacity is increased by addressing implementation bottlenecks, as well as effective coordination among donors.

3. **Risks to the outlook other than those related to the earthquake pertain to external demand, financial sector, and political risks.** With limited links to global financial markets, the main external risks to the outlook stem from a slowdown in host countries for Nepali workers (especially in oil-exporting countries, e.g., the GCC countries and Malaysia), and a potential slower-than-anticipated recovery in India, which is Nepal's largest trading partner. Domestic risks are related to long-standing vulnerabilities in the financial sector, as identified in the 2014 FSAP, and political instability which could undermine confidence and delay economic reforms.

4. **There is ample scope to strengthen monetary, fiscal and financial sector policies, but the earthquakes have made reinforcing fiscal policy and financial sector policy top priorities:**

- Before the earthquakes staff argued that there was fiscal space to significantly boost investment in public infrastructure (power and transport) without endangering debt sustainability. The joint World Bank-IMF DSA conducted in the 2014 Article IV cycle rated Nepal at "low" risk of debt distress, and staff believes this rating continues to be warranted, as little new debt has been incurred. At the same time, the large post-earthquake reconstruction needs have added urgency to addressing institutional constraints—including in the budget planning and execution processes—which impede an efficient execution of the capital budget. Recent technical assistance by the IMF's Fiscal Affairs Department provided detailed recommendations to address implementation bottlenecks.

- The widespread earthquake-related damage to property could expose financial sector vulnerabilities. The 2014 FSAP—Nepal's first—identified a number of financial sector weaknesses, including asset quality issues, interconnections in the financial system, as well as financial sector infrastructure—including the legal framework—and supervision and crisis preparedness. At the same time, a largely unsupervised credit cooperatives sector has been growing rapidly. The Nepal Rastra Bank has in recent years taken a number of macro-prudential measures to curb risks, and improved its supervision. However, it will be important for the NRB to strengthen its capacity further, use its corrective and sanctioning powers more fully, and respond decisively to possible instances of financial distress caused by the earthquakes.

- The exchange rate peg with the Indian rupee serves as a transparent anchor for monetary policy, and continues to benefit Nepal in view of its close economic relationship with India. Against this background, monetary policy should aim at controlling the level and volatility of excess liquidity to keep Nepalese inflation in the neighborhood of that in India. Liquidity management may now be complicated by increased aid and remittances flows.

IMF Relations

The joint IMF-World Bank FSAP was completed in mid-2014 and the 2014 Article IV consultation was concluded by the IMF's Executive Board on July 3, 2014. An IMF mission visited Nepal during May 10-15, 2015 to help assess the macroeconomic impact

of the earthquakes. Staff is planning a follow-up mission to discuss the provision of financial support through the Rapid Credit Facility. In recent years, the Fund has been providing ample technical assistance in the areas of tax administration, tax policy, public expenditure management, monetary policy operations, banking supervision, and macroeconomic statistics.