



## 1. Program Information

**Country**  
Nepal

**Practice Area (Lead)**  
Finance, Competitiveness and Innovation

**Programmatic DPF**

**Planned Operations**  
0

**Approved Operations**  
0

**Operation ID**  
P133777

**Operation Name**  
NP: Financial sector stability DPC2

L/C/TF Number(s)	Closing Date (Original)	Total Financing (USD)
IDA-57010	31-Dec-2015	99,422,640.00

Bank Approval Date	Closing Date (Actual)
29-Jun-2015	31-Dec-2015

	IBRD/IDA (USD)	Co-financing (USD)
Original Commitment	100,000,000.00	0.00
Revised Commitment	100,000,000.00	0.00
Actual	99,422,640.00	0.00

**Country**  
Nepal

**Practice Area (Lead)**  
Finance, Competitiveness and Innovation

**Operation ID**  
P156960

**Operation Name**  
Financial sector stability DPC3 ( P156960 )



<b>L/C/TF Number(s)</b> IDA-57010,IDA-58750	<b>Closing Date (Original)</b> 31-Mar-2018	<b>Total Financing (USD)</b> 97661685.98
<b>Bank Approval Date</b> 02-Mar-2017	<b>Closing Date (Actual)</b> 31-Mar-2018	
	<b>IBRD/IDA (USD)</b>	<b>Co-financing (USD)</b>
Original Commitment	100,000,000.00	0.00
Revised Commitment	100,000,000.00	0.00
Actual	97,661,685.98	0.00

**Country**  
Nepal

**Practice Area (Lead)**  
Finance, Competitiveness and Innovation

**Operation ID**  
P159547

**Operation Name**  
Fourth Financial Sector Stability DPC4 ( P159547 )

<b>L/C/TF Number(s)</b> IDA-58750,IDA-63040	<b>Closing Date (Original)</b> 30-Jun-2019	<b>Total Financing (USD)</b> 99330255.62
<b>Bank Approval Date</b> 07-Aug-2018	<b>Closing Date (Actual)</b> 30-Jun-2019	
	<b>IBRD/IDA (USD)</b>	<b>Co-financing (USD)</b>
Original Commitment	100,000,000.00	0.00
Revised Commitment	100,000,000.00	0.00
Actual	99,330,255.62	0.00

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## 2. Program Objectives and Pillars/Policy Areas



## a. Objectives

The objective of the Nepal Second (DPC2), Third (DPC3), and Fourth (DPC4) Financial Sector Stability Development Policy Credit, a programmatic series of three operations, was "to support the medium-term reform program in the financial sector to reduce the vulnerability of the banking sector and increase its transparency." This statement of the program objective remained the same across all three Program Documents (DPC2, page v; DPC3, page i; and DPC4, page iv).

The First (DPC1) Financial Sector Development Policy Credit, which preceded this three-operation programmatic series, was a stand-alone operation and is not covered by this ICR Review.

## b. Pillars/Policy Areas

The program had four policy areas:

**Enhancing Financial Sector Development** aimed to assist the government in establishing a strengthened coordination framework for the design and implementation of financial sector reforms by preparing a Financial Sector Development Strategy that balanced the goals of financial stability, efficiency, and inclusion.

**Restructuring and Consolidating the Financial System** was expected to result in: the recapitalization and restructuring of the Rastriya Banijya Bank (RBB), the largest commercial bank and fully government-owned, and the Nepal Bank Limited (NBL), the first commercial bank and majority government-owned; the divestment of state control in NBL; and the recapitalization and consolidation of the banking system through a reduction in the number of financial institutions and with all banks being either compliant with capital adequacy requirements or under prompt corrective action (PCA) or resolution programs.

**Strengthening the Legal and Regulatory Framework for Crisis Management, Banking Supervision, and Payment Systems** would build on preparatory steps taken under DPC1 and following the recommendations of the *Nepal Financial Sector Assessment Program (FSAP) of 2014* to strengthen the legal framework and institutional capacity for bank supervision, bank resolution, financial crisis management and the development of the financial sector safety net, bank deposit insurance, and the elimination of settlement risk in the payments system.

**Enhancing the Governance and Transparency of the Banking System** supported increased transparency of the financial system and improved governance of banks and financial institutions.

## c. Comments on Program Cost, Financing and Dates

**Program Cost:** DPC2 was estimated at appraisal to cost Special Drawing Rights (SDR) 72 million (US\$100 million equivalent), DPC3, SDR 70.6 million (US\$100 million equivalent), and DPC4, SDR 71.1 million (US\$100 million equivalent). The total estimated program cost was SDR 213.7 million (US\$300 million equivalent).

**Financing:** DPC2 was financed with an SDR 72 million credit (US\$99.4 million equivalent disbursed) from the International Development Association (IDA), DPC3, an SDR 70.6 million credit (US\$97.7 million equivalent disbursed), and DPC4, an SDR 71.1 million credit (US\$99.3 million equivalent disbursed). The total program financing was SDR 213.7 million (US\$296.4 million equivalent disbursed). The differences in the U.S. dollar



amounts estimated at appraisal and disbursed during implementation were due to changes in the SDR/US\$ rate.

Dates: DPC2 was approved on June 29, 2015, became effective on September 20, 2015, and closed as scheduled on December 31, 2015. DPC3 was approved on March 2, 2017, became effective on May 8, 2017, and closed as scheduled on March 31, 2018. DPC4 was approved on August 7, 2018, became effective on December 30, 2018, and closed as scheduled on June 30, 2019.

### 3. Relevance of Design

#### a. Relevance of Objectives

The program objective "support the medium-term reform program in the financial sector to reduce the vulnerability of the banking sector and increase its transparency" aimed to address vulnerabilities that the *Nepal FSAP of 2014*, a joint assessment by the International Monetary Fund (IMF) and the Bank, had determined were significant risks to financial stability and serious impediments to economic growth.

**Context.** The FSAP diagnostics and recommendations were triggered by the liquidity crisis of 2011 when the real estate and stock market bubbles burst and remained the relevant challenge through to the disaster in 2015 when an earthquake damaged the central bank's physical facilities, threatened banks with capital erosion, stressed the balance sheets of insurance companies, and resulted in the insolvency of many microfinance institutions and financial cooperatives.

- Liberal licensing policies of the past had allowed the banking sector to grow rapidly to 30 commercial banks (Class A), 86 development banks (Class B), 56 finance companies (Class D), 35 microfinance institutions (Class D), as well as 17,000 financial cooperatives and many small financial non-government organizations (NGOs), yet access to finance remained limited. The banking sector, which dominated the financial system (88 percent of the system's assets) reported decent capital adequacy and asset quality figures, but the headline numbers were doubtful in view of evidence of widespread ever-greening of bad loans, a practice that under-stated non-performing loans and over-stated capital and reserves. State-controlled banks were a significant part of the banking sector (21 percent of assets) but lacked clear mandates, suffered high overheads, and performed very poorly. The balance sheets of smaller commercial banks and development banks were thought to be weaker. Overall, the banking sector required recapitalization and consolidation.
- In the non-bank sector, financial cooperatives were important providers of financial services especially in rural areas (the 17,000 cooperatives offered savings and credit to some 3.3 million members) but several had become problematic in the absence of regulatory frameworks and lack of adequate supervision. Meanwhile, many small financial NGOs with low capital requirements maintained small-scale operations but were too connected to the formal financial sector (through bank on-lending) to trigger contagion in crisis periods. In addition, potential contagion from the insurance to the banking sector remained an issue, centered on questions about the capacity of insurance companies to reimburse banks which were the beneficiaries of insurance contracts. Like the banks, the non-bank sector needed recapitalization and restructuring.
- The legal, regulatory and institution framework for banking and finance remained generally weak, contributing to the fragility of the financial sector. Bank supervision was compliance-based, under-resourced, and fragmented, with a record of late intervention and a lack of an enforcement



culture. Implementation of laws on insolvency and debt enforcement were ineffective, with inconsistencies in the laws leading to disputes. Risk management was difficult because risk management practices were inadequate at many financial institutions. Deposit insurance lacked a formal legal framework, operating on the basis of bylaws rather than specific legislation. The payments system lacked redundancy and was handicapped by the limited use of electronic methods, reducing the efficiency and safety of the payments infrastructure.

- Overall, the financial system remained fragmented and shallow, unable to perform financial intermediation effectively and unable to channel resources to meet the country's investment needs in infrastructure and for long-term finance.

**Program.** The program objective was consistent with the strategy of the Bank Group in Nepal.

- At appraisal, the *Country Partnership Strategy for Nepal FY 2014-2018 (CPS)* advocated two "pillars": "increasing economic growth and competitiveness" and "increasing inclusive growth and opportunities for shared prosperity." The program objective was related to the third outcome of the CPS first pillar -- "improved environment for private sector investment, including increased financial sector stability." The CPS stated that "support to the financial sector will aim to address economic risks stemming from the sector's rapid expansion and associated distress in the banking sector. To address financial-sector vulnerabilities, the Bank has been providing technical assistance in the areas of crisis management, bank resolution and deposit insurance. A DPO, developed closely with DFID and the IMF, helped to address some of the root causes of the sector's difficulties. A follow-up DPO -- building on a joint WBG-IMF Financial Sector Assessment Program as well as a DFID-supported banking sector diagnostic -- will aim to consolidate banking sector stability and pave the way for developing a more robust and inclusive financial sector."
- At program closing, the *Country Partnership Framework for Nepal for the Period FY2019-2023 (CPF)* identified three "transformative engagement areas": "public institutions", "private-sector led jobs and growth", and "inclusion and resilience". The program objective was related to the third objective of the CPF second engagement area --- "improved financial sector stability and financial inclusion." The CPF stated that the Bank "will continue to support efforts to consolidate progress in financial sector stability and enhance financial inclusion and long-term finance. Nepal's financial system is commercial bank-dominated and fragmented. While capital adequacy and asset quality figures appear robust, the data may not fully reflect reality. There are concerns of underfunded safety nets, ever-greening of bad loans, and vulnerability to exogenous shocks. Moreover, the financial system is not efficient in financial intermediation or in channeling long-term financing for investment."

## b. Relevance of Prior Actions

### Rationale

The prior actions were consistent with the program objectives. Fourteen prior actions were listed for DPC2, 10 for DPC3, and 12 for DPC4, with many designed as two- or three- or four-part actions. Many of the prior actions that aimed to strengthen the legal, regulatory, and institutional frameworks for banking and finance consisted of sequences of related actions --- Cabinet approval and submission of draft laws to Parliament, Parliamentary enactment of the bills into law, and executive agency issuance of the rules and regulations to implement the new laws.



Prior Actions to Reduce the Vulnerability of the Banking Sector - By Restructuring Banks, Financial Cooperatives, Microfinance Institutions, and Insurance Companies - Satisfactory

- **Endorsement of the Nepal Financial Sector Development Strategy.** The endorsement by the Ministry of Finance of the Nepal Financial Sector Development Strategy (FSDS) (DPC2, Prior Action 1) was consistent with the objective to reduce the vulnerability of the banking sector as the FSDS would lay out a comprehensive long-term plan to foster the health and stability of the financial sector and to broaden and deepen access to financial services. Informed by the FSAP, the FSDS would provide strategic guidance for the development of the financial sector.
- **Implementing the Second Phase of the RBB Recapitalization Plan.** Following the first round of recapitalization supported by DPC1, implementation of the second phase would help the RBB to meet key prudential requirements for capital adequacy, liquidity, credit concentration, aggregate real estate lending, and loan loss reserves. Designed to recapitalize the RBB (the bank had been insolvent with a capital adequacy ratio of -21.8 percent in January 2012) and return it to profitability, the prior actions included: (a) the conversion of preference shares with a nominal value of Nepalese rupee (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 for NPR 30.9 million; and (d) the retention of earnings in FY2012/13, FY2013/14, and nine months of FY2014/15 of NPR 7.21 billion (DPC2, Prior Action 2).
- **Implementing the Second Phase of the NBL Recapitalization Plan.** Following the first round of recapitalization supported by DPC1, implementation of the second phase would help the NBL to meet key prudential requirements for capital adequacy, liquidity, credit concentration, aggregate real estate lending, and loan loss reserves. Designed to recapitalize the NBL (the bank had been insolvent with a capital adequacy ratio of -8.5 percent in January 2012) and return it to profitability, the prior actions included: (a) the conversion a loan from the government of NPR 2.49 billion into capital; (b) the sale of non-banking assets for NPR 708 million; and the retention of earnings in FY2013/14 and six months of FY2014/15 of NPR 1.1 billion (DPC2, Prior Action 3). More importantly, two additional prior actions would pave the way for the divestment by the government from the NBL, following the strategic decision to keep government control only of the RBB. The government would announce, in the Budget Speech of July 2014, the decision to divest control of the NBL to a bank strategic investor (DPC2, Prior Action 4). The Ministry of Finance would endorse the NBL Strategic Divestiture Plan and submit it to the Secretariat of the Privatization Committee (DPC3, Prior Action 1).
- **Preparing for the Recapitalization of All Banks.** Three prior actions were consistent with the objective to reduce the vulnerability of the banking sector by raising the capital at all banks. The Nepal Rastra Bank (NRB), the central bank and bank regulator, would complete the first phase (DPC2, Prior Action 5) and the second phase (DPC3, Prior Action 2) of a diagnostic of the banking system by ordering special inspection reports for 27 financial institutions and approving PCA or resolution programs for those found to be under-capitalized. The special inspections program had been tested by the NRB on 20 financial institutions in 2012-13 to identify significant weaknesses in the asset quality, corporate governance, risk management, and financial reporting of the institutions using in-depth diagnostics and stress tests. Using the services of international auditing firms, the extension of the special inspection program to another 27 institutions would allow the NRB to also identify major prudential risks to the banking system. The NRB would issue a directive to increase of the minimum paid-up capital of all banks and financial institutions (DPC 3, Prior Action 4). Commercial banks (Class A) would be required to have minimum capital of NPR 8 billion, development banks (Class B), NPR 0.5 billion (operating in 1-3 districts) to NPR 2.5 billion (operating nationally), and finance companies (Class C), NPR 0.4 billion (operating in 1-3 districts) to NPR 0.8 billion (operating in 4-10 districts).



- **Accelerating the Consolidation of the Banking System.** The NRB would impose a moratorium on new license applications for Class A, B and C financial institutions and adopt a new bylaw to facilitate the acquisition of banks and financial institutions by other banks and financial institutions (DPC2, Prior Action 7). The licensing moratorium would reinforce the policy adopted by the NRB in 2011 to rationalize and consolidate the banking system. Mergers of weaker or under-capitalized banks with stronger institutions had reduced the number of banks from a peak of 199 in January 2012 to 162 by January 2015, but further consolidation was necessary.
- **Ordering the Conversion of Financial Non-Government Organizations to Micro-Finance Institutions.** The issuance by the NRB of an order requiring all NRB-authorized financial non-government organizations to convert to microfinance institutions (Class D) by mid-July 2015 (DPC2, Prior Action 8) would set the stage for the consolidation of the microfinance and the cooperatives sectors. The program objective had not been stated to include the non-banks, but the non-bank and banking sectors were linked and a financial crisis in the former (with the 12 percent of the assets of the financial system) could readily spill over into the latter. Prior to the issuance of the notice, the NRB supervised all microfinance institutions, but only 15 of the 17,000 cooperatives and some 27 financial NGOs. The Registrar of Cooperatives licensed most cooperatives but had no supervisory authority or resolution power of its own. The failure of a large number of financial cooperatives in 2013-14 exposed the gravity of a rudimentary problem --- the lack of a resolution mechanism for, and the absence of effective regulation and supervision of, financial cooperatives.
- **Preparing for the Recapitalization of Insurance Companies.** A two-part prior action was consistent with the objective to reduce the vulnerability of the insurance sector. The Nepal Insurance Board (NIB), the industry regulatory authority, would complete in-depth diagnostic assessments to identify institutional-level risks of companies that represented 60 percent of assets in the insurance sector and would implement PCA or resolution programs for the under-capitalized insurance companies (DPC4, Prior Action 2). The diagnostic would identify weaknesses in areas including valuation, liabilities, internal controls, and corporate governance. The NIB would then issue a directive raising the capital requirement to NPR 2 billion for life insurance companies and NPR 1 billion for non-life insurance companies by mid-July 2018.

Prior Actions to Reduce the Vulnerability of the Banking Sector - By Strengthening the Legal, Regulatory, and Institutional Framework for Bank Supervision, Bank Resolution, Bank Risk Management, Deposit and Credit Insurance, and the Payments and Settlement System - Satisfactory

- **Enactment of the Amendment to the NRB Act.** Three prior actions would begin to strengthen the bank supervision system, and hence foster the stability, and reduce the vulnerability, of the financial sector. The Cabinet would approve and submit the NRB Act Amendment Bill to Parliament (DPC2, Prior Action 9) and Parliament would pass the Amendment to the NRB Act (DPC3, Prior Action). The amendment would strengthen the bank supervisory powers of the NRB, in line with international best practice, and clarify its bank resolution powers, following the recommendations of the FSAP of 2014. The NRB would approve the specification of the new Supervisory Information System (SIS) (DPC4, Prior Action 4). The SIS would provide bank and financial institutions with an automated data management system that would require them to submit data to the NRB in standard format and thus give the NRB timely information to better perform its supervisory function.
- **Issuance of Regulations to Implement the Provisions on Bank Resolution.** The NRB would issue the regulations to implement the provisions pertaining to bank resolution contained in the Amendment to the NRB Act (DPC4, Prior Action 3). The provisions on bank resolution aimed to discourage regulatory arbitrage, which banks had frequently resorted to in the past, amid ambiguity in the law over the resolution power of the NRB.



- **Enactment of the Cooperatives Act.** Parliamentary approval of the Cooperatives Act (DPC4, Prior Action 11) would strengthen the legal and regulatory framework for cooperatives. The Act would designate the Department of Cooperatives as the regulator and supervisor of cooperatives, but allow the NRB to monitor cooperatives with savings greater than NPR 500 million, supervise cooperative banks, and close any if necessary. Moreover, the Act would mandate each cooperative to reserve at least a third of its board membership for women, injecting a gender dimension to the financial sector stability operation.
- **Executive Approval of the Insurance Bill.** Cabinet approval of a new Insurance Bill for submission to Parliament (DPC4, Prior Action 8) would begin to modernize the legal framework for the regulation and supervision of the insurance industry. The proposed law would authorize the NIB to take corrective action to resolve under-capitalized insurance companies, encourage a shift from to compliance-based to risk-based supervision, and help tighten financial reporting requirements. A stronger legal and regulatory framework would help the industry mitigate risks to the industry arising from the recent spate of natural disasters triggered by climate change.
- **Conduct of Assessments of the Impact of the 2015 Earthquake.** In the context of the 2015 earthquake, two prior actions would assist the NRB to identify potentially weakened banks and financial institutions and provide a basis to determine strategies that would be needed to stabilize the banking system. The NRB would require banks and financial institutions to conduct an assessment of the impact of the earthquake on their loan and collateral assets as well as on their physical infrastructure (DPC2, Prior Action 6). The NRB would complete its own assessment of the impact of the earthquake on banks and financial institutions in affected districts (DPC3, Prior Action 3).
- **Issuance of a Directive on Risk Management.** The NRB would issue a new directive on risk management to the commercial banks (DPC4, Prior Action 1). The directive would mandate commercial banks to establish processes for the identification, measurement, monitoring, management, control, and reporting of risks and their impact on capital allocation and firm valuation. The NRB had issued risk management guidelines for voluntary compliance in 2010 but found implementation to be lacking.
- **Enactment of the Deposit and Credit Guarantee Fund Act.** Four prior actions would strengthen the bank deposit insurance system. The Deposit and Credit Guarantee Corporation (DCGC) was established in 1974 not by a specific law but under the Companies Act and had since been operating under its own bylaws. The Cabinet would approve and submit the Deposit and Credit Guarantee Fund (DCGF) Bill to Parliament (DPC2, Prior Action 10) and Parliament would enact the Deposit and Credit Guarantee Fund Act (DPC3, Prior Action 6). The new law would increase the authorized capital of the DCGF, increase premiums paid by banks and financial institutions if needed, and authorize additional special contributions from private sector members. Subsequently, the DCGF and NRB would execute a memorandum of understanding governing cooperation and the exchange of information (DPC3, Prior Action 7). The Cabinet would approve regulations pertaining to: the DCGF's relationship with banks and financial institutions; the guaranteed deposit verification process; and the reporting, payout, and reimbursement of guaranteed deposits (DPC4, Prior Action 5). Finally, the Cabinet would approve a plan to raise the capital of the DCGF to NPR 10 billion and the DCGF, the NRB, and the Ministry of Finance would enter into an agreement for contingency back-up funding and liquidity support for the deposit insurance system (DPC4, Prior Action 5).
- **Approval of the Payments and Settlement Bill.** Three prior actions would culminate in the endorsement of the Payments and Settlement Bill. The NRB would approve the Nepal Payments System Development Strategy (NPSDS) (DPC2, Prior Action 11) which aimed to develop a safe, efficient and modern payments and settlement infrastructure and address concerns with settlement risk arising from the Electronic Check Clearing System. To begin to implement the strategy, the NRB





would take three measures to reduce payments system risk: align the operating hours of the NRB banking department with the operating hours of the Society for Worldwide Interbank Financial Telecommunication (SWIFT), the network that enables financial institutions worldwide to send and receive information about financial transactions; implement transfers of funds between NRB branches online; and implement a pre-settlement file system (DPC3, Prior Action 8). Finally, the NRB would adopt an oversight framework for the payments systems, while the Ministry of Finance would endorse the Payments and Settlement Bill to Parliament (DPC4, Prior Action 7).

#### Prior Actions to Increase the Transparency of the Banking Sector - Satisfactory

- **Issuance of Guidelines for the Eventual Adoption of the Nepal Financial Reporting Standards.** Two prior actions were consistent with the transparency objective. The NRB would issue a guideline governing the transition of financial reporting by banks and financial institutions to the Nepal Financial Reporting Standards (NFRS) (DPC2, Prior Action 12). The NRB would issue a directive on a Chart of Accounts and amend existing directives to comply with the NFRS (DPC4, Prior Action 9). The eventual adoption of the NFRS, following a four-year staged transition process which these prior actions supported, would improve accounting standards, enhance financial reporting, and improve the transparency of the banking and financial system as the NFRS was compliant with the International Financial Reporting Standards.
- **Enactment of the Banks and Financial Institutions Act to Ensure Compliance with the Fit and Proper Criteria and Other Governance Standards.** Three prior actions were consistent with the transparency objective. The Ministry of Finance would endorse the proposed Banks and Financial Institutions Act (BAFIA) to the Cabinet and, in the interim, the NRB would revise and reissue Directive 6/071 on the governance of banks and financial institutions (DPC2, Prior Action 13). Parliament would approve the BAFIA (DPC3, Prior Action 9). And, the NRB would issue the bylaws and implementing rules for BAFIA (DPC4, Prior Action 10). The BAFIA aimed to strengthen adherence to the fit and proper tests and other professional qualification and experience requirements for directors and chief executive officers (CEOs) of banks and financial institutions, including by removing the exemptions previously granted to directors and CEOs of state-controlled banks.
- **Enactment of Anti-Money Laundering and Combating the Financing of Terrorism Laws to Prevent Blacklisting by Financial Action Task Force.** Two prior actions were consistent with the transparency objective. Parliament would enact three anti-money laundering and combating the financing of terrorism (AML/CFT) laws to strengthen the transparency and safety of the banking system: the Mutual Legal Assistance Act; the Extradition Act; and the Prevention of Organized Crime Act (DPC2, Prior Action 14). To implement these laws, the Cabinet would approve the Asset (Money) Laundering and Prevention Regulations (DPC3, Prior Action 10) and the NRB would revise relevant directives to banks and financial institutions to implement these regulations (DPC4, Prior Action 12). The new laws and regulations would help Nepal from being blacklisted by the Financial Action Task Force (FATF) because of a weak AML/CFT framework.

## Rating

Satisfactory

## 4. Relevance of Results Indicators



## Rationale

The program defined 18 results indicators to measure attainment of the program outcomes. In general, the results indicators reflected the program objectives (see Section 3.A), could be attributed to the program actions (see Section 3.B), and were clearly defined and measurable. At least two results indicators could have been more specifically defined, however.

### Outcome Indicators for the Objective to Reduce the Vulnerability of the Banking Sector by Restructuring Banks, Financial Cooperatives, Microfinance Institutions, and Insurance Companies

- The results indicator "strengthened coordination framework for design and implementation of financial sector reforms is established" was imprecise. The Program Document left it to the ICR to define this indicator to mean that the FSDS was adopted and the coordination bodies were established by the government.
- A restructured RBB would be evidenced by the bank: having a capital adequacy ratio greater than 10 percent; posting positive net income for the preceding four quarters; and having all members of its board of directors meet the professional qualifications required by the new BAFIA and NRB Directive 6/071.
- A restructured NBL would be evidenced by the same results indicators. In addition, the bank would have "decreased" government ownership. The target "decreased" was imprecise; any number marginally lower than the 63 percent at baseline would have sufficed. With the Bank dropping the DPC3 indicative trigger "divestment by the government of its controlling stake in NBL" in favor of the DPC4 prior action "endorsement by the Ministry of Finance of the NBL Strategic Divestiture Plan," a precise target consistent with the divestment plan would have been preferable.
- A restructured and more stable banking system would be evidenced by all banks being compliant with the new capital requirements, or, if any were under-capitalized, being in NRB-approved PCA or resolution programs.
- A consolidated banking system would mean a reduction in the total number of banks and financial institutions from their bloated numbers before the program, the target being set at 130 or less.
- The conversion of all financial NGOs to microfinance institutions (Class D), licensed by the NRB, would evidence a successful restructuring of the microfinance sector.
- And the compliance by all insurance companies with the new capital requirements or, if any were under-capitalized, being in PCA or resolution programs would evidence a successful restructuring of the insurance sector.

### Outcome Indicators for the Objective to Reduce the Vulnerability of the Banking Sector by Strengthening the Legal, Regulatory, and Institutional Framework for Bank Supervision, Bank Resolution, Bank Risk Management, Deposit and Credit Insurance, and the Payments and Settlement System

- A stronger supervisory capacity at the NRB would be reflected in the subscription by the central bank to four additional BCPs and in the implementation of the new SIS.
- Following the passage of the Amendment to the NRB Act, a modernized legal framework for bank resolution would mean the NRB had issued the implementing rules to the new law.
- Passage of the new Cooperatives Act enabling the Department of Cooperatives, acting as Registrar of Cooperatives, to resolve troubled cooperatives would provide evidence of having a resolution framework for cooperatives. The program added a gender outcome and target to the governance of cooperatives ---



the representation of women (minimum one third) in the boards of directors of cooperatives (target 90 percent of all cooperatives).

- Passage of the new Insurance Act enabling the NIB to resolve troubled insurance companies would provide evidence of having a resolution framework for insurance companies.
- An improvement in financial risk management would be measured by having a framework for contingency back-up funding for bank resolution.
- An improvement in operational risk management would be measured by having both a framework for business continuity planning at commercial banks and a disaster site at the NRB.
- Following the passage of the DCGF Act creating the DCGF to replace the DCGC, a stronger framework for deposit insurance would be evidenced by an increase in the capital of the DCGF and the full payment by all banks and financial institutions of the required insurance premium for the preceding four quarters.
- An improvement in the safety and efficiency of the payments and settlement system would be measured by assessments of the quality of large-value payments reaching "medium-high", from "medium-low" previously.

#### Outcome Indicators for the Objective to Increase the Transparency of the Banking Sector

- The implementation by all commercial banks (Class A) and development banks (Class B) of the NFRS would indicate achievement of the transparency objective in financial reporting.
- The observance by all members of the board and CEOs of all banks and financial institutions, including state-controlled banks, of the fit and proper criteria, as defined in the new BAFIA and NRB directives, would measure achievement of the transparency and governance objective.
- Exclusion from the FATF grey list, as a result of passage and observance of the new AML/CFT laws and regulations, would indicate the achievement by Nepal of the transparency and integrity objective.

### Rating

Satisfactory

## 5. Achievement of Objectives (Efficacy)

### **OBJECTIVE 1**

#### **Objective**

To support the medium-term reform program in the financial sector to reduce the vulnerability of the banking sector.

#### **Rationale**

The program met all seven outcome targets for the objective to support the medium-term reform program in the financial sector to reduce the vulnerability of the banking sector by restructuring banks, financial cooperatives, and insurance companies.



- **Strengthened Coordination Framework for Financial Sector Development.** The target for a strengthened coordination framework for the design and implementation of financial sector reforms was met with: the approval by the Cabinet of the FSDS in January 2017; the appointment of a high-level Financial Sector Coordination Committee; and the formation of two committees to monitor progress with the FSDS recommendations, one headed by the Governor of the NRB and the other by the Minister of Finance.
- **Restructuring of the RBB.** The capital adequacy ratio of the RBB was raised to 13.15 percent by the second quarter of FY2020, exceeding the target of 11 percent. In the baseline, the bank had been under-capitalized, with a capital adequacy ratio of 5.6 percent, lower than the regulatory norm of 11 percent. The bank posted positive net income in the four quarters ending in the second quarter of FY 2020, totaling NPR 5.1 billion, meeting the target that it register positive net income in the four quarters preceding the program closing date. The board of directors of the RBB met the required professional qualifications, achieving the target that the bank comply with the new BAFIA rules and NRB Directive 6/071 on professional qualification standards for bank directors.
- **Restructuring of the NBL.** The capital adequacy ratio of the NBL was raised to 17.4 percent by the second quarter of FY2020, meeting the target of 10 percent. The bank had been under-capitalized, with a capital adequacy ratio of 5.26 percent in the baseline, lower than the regulatory norm of 11 percent. The bank posted positive net income in the four quarters ending in the second quarter of FY2020, totaling NPR 2.3 billion, meeting the target that it register positive net income in the four quarters preceding the program closing date. The board of directors of the NBL met the required professional qualifications, achieving the target that the bank comply with the new BAFIA rules and NRB Directive 6/071 on professional qualification standards. The government cut its ownership of the NBL to 51 percent, meeting the target for a "decreased" government ownership of the bank. In the baseline, government ownership of the bank was 63 percent.
- **Capital Adequacy at Banks.** All banks in Nepal met the minimum capital adequacy ratio of 10 percent in FY2020 --- an average 13.7 percent at commercial banks (Class A), 15.3 percent at development banks (Class B), 19.4 percent at finance companies (Class C), and 13.9 percent at all finance institutions. The target was for all banks to be compliant with the capital adequacy requirement or be in an NRB-approved PCA or resolution program. In the baseline, capital adequacy ratios averaged 12 percent for commercial banks, 15.6 percent for development banks, and 15.9 percent for finance companies. Under-capitalized banks were not in a PCA or resolution program, and supervision was inadequate to identify potential risks.
- **Consolidation of Banks.** Following 47 mergers, 53 acquisitions and 16 corrective actions involving 108 banks and 120 financial institutions, the total number of banking and financial institutions was reduced to 72 in FY2020, meeting the target that the number of banking and financial institutions be reduced to 130 or less by the program closing date. In the baseline, the number of banks and financial institutions reached 199 in January 2012 and 167 in July 2014. Banking regulations at that time impeded the use of acquisitions to consolidate the banking system.
- **Conversion of Financial Non-Government Organizations to Micro-Finance Institutions.** All NRB-authorized financial NGOs were converted to microfinance institutions (Class D) by March 2020, meeting the target. The new Cooperatives Act, passed in 2018 (part of the prior actions), assigns supervisory and resolution powers over cooperatives to the Department of Cooperatives, acting as Registrar of Cooperatives. In the baseline, the NRB supervised only 15 financial cooperatives out of 17,000 that were operating in the country. The Registrar of Cooperatives licensed the remainder, but did not have any supervisory authority or resolution power over the cooperatives. The NRB had also licensed 47 financial NGOs.



- **Recapitalization of Insurance Companies.** The target that all insurance companies are adequately capitalized --- the new capital requirements are NPR 2 billion for life insurance companies and NPR 1 billion for non-life insurance companies --- or are subject to a PCA or resolution program was met. The NIB determined that three of the country's 39 insurance companies did not meet minimum capital requirements. The two state-controlled insurers that did not were directed to raise their capital, while the sole private insurer that did not, Gurans Life, started a rights offering. The insurance companies had implemented the NFRS as of October 2019. In the baseline, the NIB lacked the financial and risk data to identify troubled insurance companies (as well as to assess the impact of the earthquake of 2015 on the insurers' capital and technical reserves).

The program met six of the eight outcome targets for the objective to support the medium-term reform program in the financial sector to reduce the vulnerability of the financing sector by strengthening the legal, regulatory, and institutional framework for bank supervision, bank resolution, financial crisis management, operational risk management, deposit and credit insurance, and the payments and settlement system. The first part of the outcome target for the cooperatives sector (on the resolution framework for cooperatives) was met, but the achievement of the second part (on the membership of women in boards of directors of cooperatives) could not be assessed. The outcome target for the insurance sector (on the passage of the new Insurance Act) was not met .

- **Strengthened Supervisory Capacity for the NRB.** The NRB launched the Supervisory Information System (SIS) in October 2019, with all commercial banks connected to the system on real-time basis beginning in December 2019, meeting the target to implement a new SIS. In the baseline, the NRB lacked an adequate information technology system to support its supervision function. Reports from banks and financial institutions were processed manually, resulting in errors. The NRB announced the observance of four additional Basel Core Principles for Effective Banking Supervision (BCPs) beginning in FY2020, meeting the target that the NRB be "largely compliant" with four more BCPs by the program closing date. The IMF determined that the NRB was "largely compliant" with the new BCPs. Formulated by the Basel Committee on Banking Supervisors, the BCPs are the *de facto* minimum standard for the sound prudential regulation and supervision of banks and banking systems. The four additional BCPs adopted by the NRB included: standards on banks' internal control systems (BCP14); the prevention of fraud and money-laundering (BCP15); the overall framework for on-site and off-site bank supervision (BCP16); and maintaining increased contacts with bank management and staff (BCP17). In the baseline, the NRB was judged to be "non-compliant" or "materially non-compliant" with many BCPs.
- **Modernized Legal Framework for Bank Resolution.** The legal framework for bank resolution was modernized and the target met with the approval by Parliament of the Amendment to the NRB Act in September 2016. Resolution is the restructuring of a bank by an authority through the use of resolution tools that safeguard public interest, including the continuity of the bank's critical functions, the stability of the financial system, and the minimization of the costs of resolution to taxpayers. The NRB issued the regulations to implement the Amendment to the NRB Act. In the baseline, the legal framework was outdated, incomplete, and had conflicting provisions, limiting the ability of the NRB to resolve problem banks and providing the banks with the scope to challenge the authority of the NRB.
- **Legal and Regulatory Framework for the Resolution of Cooperatives.** The new Cooperatives Act established a new resolution framework for problem cooperatives, meeting the target that a resolution framework for cooperatives be available by the program closing date. In the baseline, there was no resolution framework for problem cooperatives. Women were represented in the boards of directors in 40.1 percent of 13,578 registered savings and credit cooperatives by March 2020, according to



*Cooperatives Statistics 2018*. However, it could not be determined if each of the cooperatives had women for one-third of their board membership. Thus, the achievement of the target that 90 percent of cooperatives meet the gender requirement could not be verified. In the baseline, women were under-represented in the governance structure of cooperatives.

- **Legal and Regulatory Framework for the Resolution of Insurance Companies.** Parliament had not passed the new Insurance Act, which aimed to modernize the legal and regulatory framework for the supervision and regulation of the insurance sector. According to the ICR (pages 18-19), the bill is expected to be on the agenda of Parliament after completion of the deliberations over the Budget for FY2020-21. Under the current regulatory framework, the NIB has authority to resolve insurance companies with the approval of the Ministry of Finance, which is vested with the ultimate power to appoint the liquidator. These powers are derived from the current Insurance Act, 2049 and from the Companies Act, 1964. The draft bill gives the NIB the power to intervene and take control of a failing insurance company.
- **Legal and Institutional Framework for Financial Crisis Management.** A framework for back-up funding of bank resolution was established, meeting the target. Under the framework, a back-up funding arrangement would come from the central bank, while the Ministry of Finance would support the deposit insurer under a financial sector safety net. In the baseline, the financial crisis management architecture was limited to having a high-level financial sector committee coordinating the government response to a financial crisis, but without having intervention powers. Moreover, any emergency liquidity assistance was limited.
- **Institutional Framework for Operational Risk Management.** A business continuity framework for all commercial banks and for the NRB was established, meeting the target. A disaster risk site was also established, meeting the target. Business continuity refers to an organization's ability to ensure that operations and core business functions are not severely impacted by a disaster or unplanned incident that takes critical systems offline. Both the business continuity framework and the disaster site would serve to minimize operational risk arising from a natural disaster or other national emergency. In the baseline, operational risk in the banking sector was considered high, as the business continuity framework was inadequate and the NRB lacked a disaster risk site.
- **Establishment of the Deposit and Credit Guarantee Fund.** The legal and regulatory framework for deposit insurance was established with the creation of the DCGF as administrator of the deposit guarantee fund, replacing the DCGC. The paid-up capital of the DCGF was also increased to NPR 10 billion by the fourth quarter of FY2019. In the baseline, the legal and regulatory framework for the deposit insurance system was weak and incomplete, based mainly on the bylaws of the DCGC. By March 2020, all banks and financial institutions had made the required deposit guarantee premium payments for the preceding four quarters, meeting the target.
- **Legal and Regulatory Framework for the Payments and Settlement System.** The legal and regulatory framework for the payment system was established with the passage of the Payment and Settlement Act in March 2019. According to the new law, all bank and non-bank institutions involved in payment transactions, including retail payment systems, payment service providers, and payment system operators, are to be governed by regulations issued by the NRB. According to the ICR (page 43), the quality of large-value payments improved from "medium-low" to "medium-high" as a result of the operationalization of Real Time Gross Settlement (RTGS) in November 2019, meeting the target that the safety and efficiency of large-value payments be assessed as "medium-high" by the program closing date. An RTGS is specialist funds transfer system that allows for the instantaneous transfer of money and securities in a continuous process of settling payments on an individual order basis without netting debits with credits across the books of the central bank. In the baseline, regulation of the payment system lacked a firm legal foundation. Many different regulators exercised



patchwork supervision over the system, with little coordination. As a result, financial institutions faced settlement risk. The quality of large-value payments was also assessed as "low".

## Rating

Satisfactory

## OBJECTIVE 2

### Objective

To support the medium-term reform program in the financial sector to increase the transparency of the banking sector.

### Rationale

The program met all three outcome targets for the objective to support the medium-term reform program in the financial sector to increase the transparency of the banking sector.

- **Adoption of the Nepal Financial Reporting Standards.** The NFRS was implemented by all commercial banks (Class A) and development banks (Class B) as of October 2019, meeting the target that all commercial and development banks implement the NFRS by the program closing date. Issued by the Nepal Accounting Standards Board in 2013, the NFRS provides the common rules to be used by accountants in Nepal to make company accounts understandable to internal and external users and comparable across companies. Prepared in line with the International Financial Reporting Standards (IFRS) of the International Accounting Standards Board (IASB), the NFRS consists of 13 standards for accounting and reporting on the financial performance and financial position of firms. The NRB had not issued NFRS-compliant regulations in the baseline and, therefore, no financial institution could be recognized to have had implemented the NFRS at that time.
- **Compliance with the Fit and Proper Criteria.** All members of the board of directors and the CEOs of all banks and financial institutions, including state-controlled ones, met the fit and proper criteria defined in the new BAFIA and in NRB directives as of March 2020, meeting the target. A standard concept in the corporate governance of financial institutions, the fit and proper criteria pertains to the capacity and competence of managers, directors, and shareholders to fulfill their duties ("fitness") and have integrity and suitability ("propriety"). According to the Bank for International Settlements (BIS), supervisors should assess whether financial institutions observe the fit and proper principles to help ensure that the institutions are soundly and prudently managed and that key shareholders are not a source of weakness to these institutions. In the baseline, governance provisions in banks were weak, giving rise to conflicts of interest among bank directors who lacked independence from shareholders. Moreover, professional qualification requirements were limited, with government-appointed directors and CEOs at state-controlled banks being exempt from even these scant requirements.
- **Steering Clear of the Financial Action Task Force Grey List.** Nepal remains off the FATF grey list in March 2020, meeting the target. The FATF is the intergovernmental institution, founded in 1989, to combat money laundering, terrorist financing, and financial crimes. Officially known as the "Jurisdictions Under Monitoring", the FATF grey list includes countries that represent a high risk of



money laundering and terrorism financing but have formally committed to working with the FATF to develop action plans that address their anti-money laundering and combating the financing of terrorism (AML/CFT) deficiencies. Countries in the grey list are subject to increased monitoring by the FATF, which either assesses them directly or uses FATF-style regional bodies to report on the progress made towards AML/CFT goals. While not as negative as the black list classification (those which the FATF considers non-cooperative in the global effort to combat money laundering and the financing of terrorism), countries on the grey list may still face economic sanctions from international institutions and may experience adverse effects on trade. Nepal was not in the FATF grey list in the baseline and has remained off the list since.

### Rating

Satisfactory

## Overall Achievement of Objectives (Efficacy)

### Rationale

The program achieved the objective to support the medium-term reform program in the financial sector to reduce the vulnerability of the banking sector with the recapitalization of the RBB, the recapitalization of, and partial divestment from, the NBL, and the recapitalization and consolidation of the rest of the banking system. Financial NGOs were converted to microfinance institutions and the capital requirements at insurance companies were raised. The program resulted in a stronger legal, regulatory and institutional framework for: (a) bank supervision, with the introduction by the NRB of the SIS and adoption of additional BCPs; (b) bank resolution, following the passage of the Amendment to the NRB Act, designation of the Registrar of Cooperatives as regulator following the passage of the new Cooperatives Act, and the assignment of resolution powers to the NIB in the proposed new Insurance Act; (c) financial crisis management, with approval of a back-up funding arrangement for bank resolution; (d) operational risk management, with the adoption of a business continuity framework for banks and creation of a disaster risk site; (e) bank deposit insurance, with the creation and recapitalization of the DCGF following the passage of the DCGF Act; and (f) the payments and settlement system, with the operationalization of the RTGS following the passage of the Payments and Settlement Act. The program achieved the objective to support the medium-term reform program in the financial sector to increase the transparency of the banking sector. All commercial and development banks implemented the NFRS, the financial reporting system designed to be compliant with the IFRS, and met the fit and proper criteria, as defined by the new BAFIA, in the appointment of their boards of directors and CEOs. Following the passage of three key AML/CFT laws -- the Mutual Legal Assistance Act, the Extradition Act, and the Prevention of Organized Crime Act -- Nepal steered clear of the FATF grey and black lists.

### Overall Efficacy Rating





Satisfactory

## 6. Outcome

### Rationale

The objective "to reduce the vulnerability of the banking sector and increase its transparency" was relevant to the priorities advanced in the *Nepal FSAP of 2014* and aligned with the Bank Group *CPS for FY2014-18* and *CPF for FY2019-23*. The prior actions were consistent with the program objectives and the results indicators were valid and reliable measures of the expected outcomes of the program. The degree of achievement of the objective to reduce the vulnerability of the banking sector is assessed as satisfactory. The degree of achievement of the objective to increase the transparency of the banking sector is assessed as satisfactory.

### a. Rating

Satisfactory

## 7. Risk to Development Outcome

With the program delivering marked improvements in the legal, regulatory, and institutional framework for banking and finance, the challenge moving forward is to have regulators, supervisors, bankers and insurers enforce and observe the new laws and regulations. There are several risks to the sustainability of the program outcomes.

**Political Risk.** The inauguration of a new government with a five-year term in 2018 (the Prime Minister changed four times from 2014 to 2017) and the commitment by the government to federalism has moderated the political risk arising from the opposition, staged three years earlier in the southern Terai region, against the Nepal Constitution of 2015. While differences among and within political parties on constitutional issues are expected to persist, there has been broad consensus, at least, on economic policies and priorities for the nation. In particular, structural reforms aimed at reducing financial sector vulnerability and fostering financial sector development have received broad political support beginning with DPC1 in 2013. An international tender for NBL was the only DPC3 indicative trigger that did not become a prior action for DPC4, owing reportedly to political sensitivities, but, even then, the government managed to reduce its ownership of NBL from 63 to 51 percent (see Section 5). Over the medium-term, as the political transition toward a federal state with autonomous sub-national government progresses, it is expected that a well-functioning federal structure will help support political stability and economic growth and reinforce the commitment to financial sector stability.

**Macroeconomic Risk.** The macroeconomic framework had been adequate for the reform program, well before the COVID-19 pandemic. Economic growth had been strong in recent years, supported by greater political stability, improved electricity supply, and reconstruction activity following the earthquake in 2015. The IMF Staff Report on the 2020 Article IV Consultation, prepared in January 2020, reported that there has been a welcome narrowing of the current account deficit, stabilization of gross official reserves, and slower credit growth. However, GDP growth was expected to moderate amid slower growth in India, sluggish remittances, and weaker agricultural production. Downside risks remained, including renewed balance of payments pressures and increased financial sector risks if credit growth were to increase sharply or if remittances were to slow down abruptly (remittances were 29 percent of GDP in 2018). To address these challenges, the IMF



recommended additional measures to support inclusive growth, while safeguarding macroeconomic and financial stability. Fiscal policy would need to remain prudent, and the transition to fiscal federalism carefully managed. Macroprudential measures would have to remain in place to limit any buildup of financial sector risk.

COVID-19 Risk. The COVID-19 pandemic has had a severe impact on Nepal's economy. In recent months, remittances have fallen considerably, tourist arrivals have collapsed, and domestic activity has contracted. To address the pandemic, the Government has taken measures to increase health spending, strengthen social assistance, ensure adequate liquidity in the financial system, and support access to credit. In April 2020, the Bank approved a \$29 million COVID-19 Emergency Response and Health Systems Preparedness Project to help Nepal respond to the pandemic and strengthen its public health system. In May 2020, the IMF approved a disbursement equivalent to SDR156.9 million (US\$214 million) under the Rapid Credit Facility to help cover urgent balance of payments and fiscal needs stemming from the pandemic. Moreover, the IMF had earlier determined that Nepal was eligible for debt service relief under the Catastrophe Containment Window of the Catastrophe Containment and Relief Trust.

## 8. Assessment of Bank Performance

### a. Bank Performance – Design

#### Rationale

The programmatic series was informed by the *FSAP of 2014*, prepared jointly by the IMF (which conducted the stability assessment) and the Bank (which conducted the development assessment) in 2014. The FSAP identified significant vulnerabilities in the country's financial sector, asserting that the under-capitalized banking system, largely unsupervised cooperative sector, fragmented bank supervision, weak bank resolution framework, and limited financial infrastructure posed significant risks to financial stability and were impediments to economic growth (see Section 3). The FSAP laid out a number of key recommendations on financial stability, financial sector oversight and crisis management, and financial development and infrastructure that formed the basis for many prior actions supported by this Bank series and were integrated into IMF surveillance.

Apart from the *FSAP Main Report*, other analytic products associated with the assessment underpinned the prior actions, according to the Program Documents for DPC2 (pages 33-34), DPC3 (pages 23-24), and DPC4 (pages 18-19), including the: *Technical Note on State-Controlled Banks*; *Technical Note on Stress Testing*, *Technical Note on Crisis Preparedness*, *Technical Note on Financial Safety Net*, and *Technical Note on Payments & Settlement System*.

In preparing the programmatic series, the Bank also drew support from technical assistance provided by DFID, under the latter's Financial Sector Stability Project and Financial Sector Program, and by FIRST. DFID assistance consisted of the: *Special Inspection Program Report (2016)* and *Fast Diagnostics of Banks and Financial Institutions (2016)*, both provided by the consulting firm KPMG; *Technical Consultation to the NRB, Advisory Services in Drafting the DCGF Bill*, and *Technical Consultation to the NRB and DCGC (2015)*, all provided by the consulting firm Adam Smith International; and *Review of Draft DCGF Bill*, provided by the consulting firm PriceWaterhouseCoopers. The FIRST assistance were conveyed through technical assistance projects for Nepal: *Contingency Planning (2010)*, *Crisis Preparedness (2011)*, *Bank Resolution Capacity*



*Building* (2014), *Strengthening Banking Supervision* (2015), and *Insurance Sector Strengthening* (2016).

The Bank vetted questions about the capacity of the authorities to implement the reform program. According to the Program Document for DPC2 (page 41), the Bank realized that the preoccupation by the Constituent Assembly with the Nepal Constitution of 2015 posed risks to the legislative initiatives supported under this program and hence decided to limit the legislative actions under DPC2 to two items --- the submission to Parliament (the Constituent Assembly transformed to become the Parliament after completing drafting the Constitution) of the NRB Act Amendment bill and the Deposit and Credit Guarantee Fund bill. In general, staging the reform program over three operations in five years afforded the authorities the time to strengthen the institutional and technical capacities of the agencies responsible for implementation the reform program --- the NRB, the Department of Cooperatives, NIB, DCGF, and the Ministry of Finance.

The Bank examined the potential poverty, social, gender and environmental impacts of the series.

- According to the Program Document for DPC2 (page 36), DPC3 (pages 25-26), and DPC4 (page 21), this program would help mitigate poverty impacts of financial sector instability by: (a) safeguarding bank deposits through a stronger deposit insurance system; (b) supporting the least-cost solution to bank failures (shareholders and unsecured creditors, rather than depositors, would bear the costs of a bank failure); (c) ensuring that the retail payment system was efficient and reliable; and (d) encouraging banks to promote financial inclusion. For Nepal, having a stable financial sector was vital because a financial crisis could send two million people below the poverty line for a period of 10 years, according to DFID.
- Passage of the new Cooperatives Act, a prior action in this program, would yield a positive gender impact. The law required savings and credit cooperatives to raise the representation of women in their boards of directors. Passage of the new Settlement and Payment Act, another action under the program, would also yield a positive gender impact. Most remittance recipients in the country were women, and integrating remittance services with the payments system would yield benefits to women.
- According to the Program Document for DPC2 (page 36), DPC3 (page 26), and DPC4 (page 21) actions proposed under this operation were not expected to have any negative effects on the environment. Rather, certain prior actions would help enhance climate adaptation through: (a) the inclusion of climate-related risks in risk management guidelines issued by the NRB to banks, (b) support for insurance industry's ability to rehabilitate property damaged by natural disasters, and (c) the promotion of digital financial services that would strengthen the economy's resilience in the face of natural disasters. The Program Document for DPC4 (page 21) estimated that the climate co-benefits from the operation could reach some US\$20.8 million.

The Bank considered the risks to this programmatic series and proposed mitigation measures.

- The Bank rated political and governance risk to be high because of the repeated changes in government over 2014-17, the contentious drafting of the Nepal Constitution of 2015, and the transition to a federal structure beginning in 2018. However, the Bank noted that even in an uncertain political environment, the authorities had made crucial decisions supportive of the program objective during the preparation for DPC1 and DPC2 --- the closure of distressed financial institutions, the decision to proceed with in-depth diagnostics of the banking system, and the approval of the recapitalization plans for the RBB and the NBL, including large capital injections into the two banks. To mitigate any escalation of the political and governance risk, the Bank recommended intensive policy dialogue between the IMF, the Bank and DFID and the highest levels of the government and the bureaucracy, including with leaders across the political spectrum, to confirm multiparty support for continuing financial sector reforms.



- The Bank considered institutional capacity risk to be substantial across all three operations. In response, the phased preparation and execution of the reform program would match the implementation capacity of the authorities, including the legislature. The Bank also recommended the provision of extensive technical assistance to various government agencies and financial institutions. The Bank, IMF, DFID and FIRST, as well as the International Finance Corporation (IFC), provided sustained technical assistance to various parties, including the private sector (private partner banks of the IFC), to help upgrade their institutional and technical capacity to implement the program.
- The Bank also considered stakeholder risk as substantial across all three operations. Under-capitalized banks and financial institutions might resist resolution and corrective actions. In response, the Bank called for regulators to stay firm with their PCA and resolution decisions. According to the Program Document for DPC2 (page 41), the divestment by the government from the NBL could be resisted by the NBL unions or by some NBL shareholders. The Bank thought that majority ownership by the government of the NBL vested it with ultimate control of the privatization decision. The government could extend financial benefits to NBL staff. It could also limit the ability of other shareholders to interfere with the divestment decision and find a reputable strategic partner for the bank.

## Rating

Satisfactory

### b. Bank Performance – Implementation

#### Rationale

In addition to the technical assistance delivered during program preparation, the Bank also provided technical assistance to Nepal during program implementation. The Bank's Legal Counsel and the IMF's General Counsel delivered the *Review of the Draft Bank and Financial Institutions Act* and the *Review of the Draft NRB Amendment Act* to aid in the deliberations of the proposed laws.

Capacity building activities during program implementation benefitted three organizations: (a) the high-level Financial Sector Coordination Committee, created earlier in 2011 to address the liquidity crisis at that time, would hence guide and monitor progress with the FSDS; (b) a new Financial Sector Management Division at the Ministry of Finance to review policies and programs related to the financial sector, assuming the previous functions of the Economic Policy and Analysis Division; and (c) the DCGF, with a stronger legal framework (than the older DCGC) consistent with the principles of the International Association of Deposit Insurers.

The Bank worked closely with the Ministry of Finance, which served as coordinator of the program activities for the government, and maintained very close cooperation with the NRB. On the donor's side, the Bank collaborated closely with the IMF, DFID, FIRST and the IFC.

The Bank maintained flexibility during program implementation, dropping three indicative triggers (that would have become prior actions for the succeeding operation) and revising two others

- "Approval by the FSDS Steering Committee of Subsector Financial Sector Development Strategy action plans" was dropped as a prior action to DPC3.



- The "issuance by the NRB of a new licensing policy for banks and financial institutions in line with Basel III" was revised to become a stronger prior action for DPC4 --- the "issuance by the NRB of a directive on the increase of the minimum paid-up capital for all banks and financial institutions."
- "Divestment by the government of its controlling stake in NBL" was revised to become a different prior action for DPC3 --- the "endorsement by the Ministry of Finance of the NBL Strategic Divestiture Plan and submission of the plan to the Secretariat of the Privatization Committee" (see Section 7).
- "Publication of an international tender for the sale of the government's stake in the NBL" was dropped as prior action to DPC4, a logical extension of the foregoing decision.
- "Establishment by the NRB of a National Payments Council" was dropped as prior action to DPC3.

In supervising the program, the Bank maintained continuous policy dialogue with the government. The Bank monitored progress towards outcome targets regularly, with Bank team members located in the field.

## Rating

Satisfactory

### c. Overall Bank Performance

#### Rationale

The program design was well-informed by extensive policy analysis and research produced by the Bank, IMF, DFID and FIRST. The Bank collaborated closely with other development partners and with the principal government agencies engaged in this policy and structural reform program. The Bank and other development partners provided valuable technical assistance and expert advisory services, which also helped with institutional and technical capacity building at government agencies, both during preparation and implementation. Implementation was well supervised, with the program fully achieving 16 of 18 results targets.

#### Overall Bank Performance Rating

Satisfactory

## 9. Other Impacts

### a. Social and Poverty

The ICR (page 27) argues that: (a) the financial stability program helped mitigate the adverse effects of the earthquake in 2015 by supporting the resumption of credit and economic activity, with positive benefits for the working population including the poor; (b) the deposit insurance system, which insures NPR 300,000 in deposits per account holder and covers 82 percent of all deposit accounts in the banking system, has also benefitted the poor, since it protects what could be their sole and life-time savings; and (c) overall, a more stable financial



sector reduces the risk of a financial crisis, which in Nepal, would worsen the living standards of the bottom 40 percent of the population and significantly swell the ranks of the poor. The ICR did not quantify these effects.

## **b. Environmental**

The ICR (page 29) stated that the climate co-benefits from the operation were assessed to be US\$20.8 million. With the amount equal to that cited in the Program Document for DPC4, it is not clear that the ICR had made an independent determination of the benefits or simply re-stated the figure at appraisal (see Section 8).

## **c. Gender**

The ICR (page 27) reiterated the assertion made in the Program Documents that the passage of the new Cooperatives Act and the new Payments and Settlement Act have positive gender impacts. The former improves the representation of women on the boards of financial cooperatives, where they constitute more than half of the membership. The latter provides better access to banking services to women, who are the main recipients of remittances (see Section 8).

## **d. Other**

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# **10. Quality of ICR**

## **Rationale**

The ICR offers a succinct record of this 36-prior action, 18-results indicator, four-policy area, three-operation programmatic series. The document summarizes the achievement of the program objectives plainly in roughly two-pages of discussion (pages 23-25), supported by a table of details running 12 pages in a lengthy annex (pages 34-45). The details of DPC1 in Annex 5 (pages 55-59) is also instructive.

The discussion of the efficacy of the program is candid. All records of achievement are presented in the context of, and in contrast with, the prevailing problems in the banking and financial system before the program. The document calls attention to two of the 18 outcome targets that were either not met (the new Insurance Act had not been approved by Parliament by program closing) or could not be conclusively determined were met (data on the total number of women -- 39,205 -- in the boards of directors of 13,578 savings and credit cooperatives is available, but not on the individual cooperative basis required by the results indicator). The ICR (page 23) rates the efficacy of the program as moderately satisfactory, a rather harsh conclusion, unless the ICR counts the inability of the government to completely divest from the NBL as a minus against the program, which it does not.

The discussion on the relevance of the prior actions is also candid. The prior actions are related to the objectives of the program, broken down into the policy areas. The ICR rating of satisfactory for the relevance of



the prior actions is well substantiated.

**a. Rating**

Substantial

**11. Ratings**

Ratings	ICR	IEG	Reason for Disagreement/Comments
Outcome	Moderately Satisfactory	Satisfactory	The program fully met 16 and partially met one of 18 outcome targets.
Bank Performance	Satisfactory	Satisfactory	
Relevance of Results Indicators	---	Satisfactory	
Quality of ICR	---	Substantial	

**12. Lessons**

Three lessons are offered, including two adapted from the ICR (page 32).

**Close collaboration among major donors is vital to the success of broad national reform programs, particularly where the institutional and technical capacity for program design and implementation needs augmenting.** In this program, the Bank and the IMF jointly prepared the *Nepal FSAP of 2014* which informed the prior actions supported by this program. The legal departments of both organizations also helped review the draft BAFIA and the draft NRB Amendment Act. DFID and FIRST provided significant technical assistance and advisory services through their staff and international consultants. According to the ICR, the close collaboration between the Bank and DFID was exemplary, starting in 2012, and consisting of joint missions, employment of experts, capacity-building activities, and large resource contributions for program design and implementation.

**Reform champions in a country's bureaucracy are needed for the implementation of complex reform programs where the political environment is uncertain and potentially volatile.** In this program, the Bank worked closely with reform champions in key positions at the Ministry of Finance and the NRB who were knowledgeable about the financial sector, held strong convening power over stakeholders, and made compelling arguments for policy and structural reform. These key executives kept their organizations well informed of the program rationale, design, and implementation plan. The reform-minded bureaucracy at the Ministry of Finance and the NRB pressed on with the medium-term program notwithstanding the political uncertainty from frequent changes in the national leadership and the civil disturbance related to the drafting of the country's new federalist Constitution.

**Governments can successfully take advantage of the opportunities offered by crisis situations to motivate reform programs.** In this program, the liquidity crisis of 2011, the failure of many financial cooperatives in 2013-14, and the devastating earthquake in 2015 exposed the vulnerability of Nepal's banking,



cooperatives, and insurance sectors to macro-financial shocks and to natural disasters. In response, the authorities committed to a comprehensive reform program to recapitalize and restructure the country's financial institutions and to strengthen the legal and institutional framework for bank supervision, bank resolution, financial crisis management, operational risk management, deposit insurance, payments and settlement, and transparency. The demand for post-crisis recovery helped firm up broad political support for the reforms.

### **13. Project Performance Assessment Report (PPAR) Recommended?**

No