



Government of Nepal  
**MINISTRY OF FINANCE**  
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 WORLD BANK RECEPTION

SINGHADURBAR  
 KATHMANDU, NEPAL

2 June 2016

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

Dear Mr. Kim:

**RE: LETTER OF DEVELOPMENT POLICY**

1. The Government of Nepal is committed to 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 liquidity crisis that threatened financial sector stability in Nepal in mid-2011, the Government articulated a program of financial sector reforms with the objective of ensuring the stability of the financial system, overhauling the regulation and supervision of the banking and financial institutions, limiting Government control and ownership of financial institutions, placing the financial sector safety net on a firm footing, and laying the ground for further reform programs designed to broaden and deepen access to financial services for both business and individuals.
3. The first phase of reforms (from early 2012 to mid-2013) was carried out in a relatively unstable political climate. The reform program gained momentum with the second phase (from mid-2013 to mid-2015) despite the adverse impact to the financial sector caused by the earthquakes in April/May of 2015. The on-going reform is the third phase (mid-2015 to mid-2016). We have continued to implement major reforms till date with support from the World Bank, the United Kingdom Department for International Development (DFID), the International Monetary Fund (IMF) and other Development Partners.
4. In the initial years of the reform program, we were able to set up a financial sector safety net by establishing the Deposit Guarantee Fund (DGF) and embarked on the restructuring and recapitalization of two large state-controlled commercial banks, Rastriya



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Banijya Bank (RBB) and Nepal Bank Limited (NBL). Both RBB and NBL insolvent for more than a decade, now meet the statutory capital requirement and are amongst the highest earning commercial banks in the country. Following the drafting of extensive amendments to the Nepal Rastra Bank (NRB) Act (NRBA Bill) and the Bank and Financial Institutions Act (BAFIA), and a new Deposit and Credit Guarantee Fund Bill (DCGF Bill), these bills have been submitted to the Parliament for approval. These three bills propose to strengthen the NRB's resolution powers, to improve governance of financial institutions and to place the DGF on a firm legal foundation. These reforms were supported by two Development Policy Credit operations, which were approved by the World Bank's Board of Executive Directors in June 2013 and June 2015 respectively. Other reform activities that were completed during these two phases (2012 – 2014) include the following:

- The diagnostic of the banking system covering 27 of the 54 financial institutions, of a program of 54 in-depth Special Inspections of all at-risk and systemic banks has been completed. The NRB also initiated appropriate prompt corrective action and resolution enforcement measures;
- Throughout the reform phases, the NRB has maintained its moratorium on licensing of new banks and financial institutions (BFIs), and in 2014 also issued a new bylaw on acquisitions to facilitate further consolidation of the banking system;
- In 2014, the Parliament approved and enacted ordinances 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 legislations provide a legal framework in line with international standards, and Nepal is no longer "grey-listed" by FATF;
- In 2014, NRB Board approved the National Payments System Development Strategy;
- In 2015, Ministry of Finance completed and approved a long term Financial Sector Development Strategy (FSDS) based on wide consultations;

5. The Government of Nepal is making rapid progress towards implementing the medium-term strategy for reforming 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 2014. The Government's on-going program



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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 designed to support the recovery of the financial sector from the impact of the earthquake and the trade disruptions, and put in place needed measures to ensure the operational resilience of the sector in the face of natural disasters.

6. The reforms under our medium term strategy under the third phase which we have completed since the mid-2015, include the following:

- 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 9.55 percent capital adequacy and initiation of divesting Government owned shares in NBL to a bank strategic investor;
- Completion in December 2015 of the second and final phase of a diagnostic of the banking system, thereby representing about 70 percent of banking system assets of a program of 54 in-depth Special Inspections of all at-risk and systemic banks. The NRB has initiated appropriate prompt corrective action or resolution enforcement measures (including recapitalization, merger, and closure) for all undercapitalized financial institutions;
- In December 2015, a quick diagnostics of the BFIs to assess the impact of the earthquake disaster on their assets was carried out;
- In 2015 and in 2016, the Government responded to the queries/comments raised on NRBA Bill, DCGF Bill and BAFIA Bill by the parliamentary sub-committee as part of deliberation process and the remaining NRBA Bill is not be tabled in the ongoing parliamentary session and Finance Committee has already tabled two out of three Bills in the full House for approval. The bills, once enacted, are expected to (i) strengthen the governance of financial institutions, and give supervisors stronger legal tools for bank resolution; (ii) put in place a fully-functioning financial sector safety; and (iii) improve the governance of state-controlled financial institutions and establish fit and proper requirements and minimum qualifications.



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7. In 2016-18 we intend to implement the remaining major reform agendas to strengthen the financial sector and support its recovery from the double impacts of the 2015 earthquake and trade disruptions (September 2015 to January 2016), with an increasing emphasis on deepening and broadening financial access. The reform steps will include: (i) initiation for publishing international tender for the divestiture of Government's stake in NBL; (ii) Completion of in-depth diagnostic of the insurance sector to identify institution level risks and implementation of corrective action or resolution program for undercapitalized insurance companies. (iii) undertake steps to improve the supervisory capacity of the financial cooperatives regulator; (iv) issue enabling regulations consistent with the NRB Act Amendments; (v) implement and operationalize a supervisory information system by the NRB; (vi) approve DCGF's regulation that covers its relationship with BFIs, guaranteed deposit verification process, BFI reporting, payout and reimbursement of guaranteed deposits and a deposit guarantee fund investment policy; (vii) execute arrangements to provide back-up funding, liquidity and credit line facility to DCGF; (viii) approve Payment System Act by the cabinet for submission to the parliament; (ix) approve a new Insurance Act by the cabinet ready for submission to the Parliament; and (x) issuance of NFRS complaint regulations and reporting requirements for BFIs and issuance of rules and by-laws for the newly enacted BAFIA by the NRB.

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,

Bishnu Prasad Paudel  
Minister of Finance

Shiba Raj Shrestha  
Officiating Governor  
Nepal Rastra Bank

