Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 26-May-2020 | Report No: PIDA28901
BASIC INFORMATION

A. Basic Project Data

<table>
<thead>
<tr>
<th>Country</th>
<th>Project ID</th>
<th>Project Name</th>
<th>Parent Project ID (if any)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nepal</td>
<td>P173044</td>
<td>Finance for Growth Development Policy Financing (P173044)</td>
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</tbody>
</table>

Region: SOUTH ASIA

<table>
<thead>
<tr>
<th>Estimated Board Date</th>
<th>Practice Area (Lead)</th>
<th>Financing Instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>14-Jul-2020</td>
<td>Finance, Competitiveness and Innovation</td>
<td>Development Policy Financing</td>
</tr>
</tbody>
</table>

Borrower(s): Nepal

Implementing Agency: Ministry of Finance

Proposed Development Objective(s)

Support the government of Nepal in its efforts to strengthen financial sector stability, diversify financial solutions, and increase access to financial services.

Financing (in US$, Millions)

<table>
<thead>
<tr>
<th>SUMMARY</th>
<th>DETAILS</th>
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<tbody>
<tr>
<td>Total Financing</td>
<td>Total World Bank Group Financing</td>
</tr>
<tr>
<td>200.00</td>
<td>200.00</td>
</tr>
<tr>
<td></td>
<td>World Bank Lending</td>
</tr>
<tr>
<td></td>
<td>200.00</td>
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Decision

The review did authorize the team to appraise and negotiate

B. Introduction and Context

Country Context

1. The COVID-19 pandemic is expected to significantly disrupt economic activity, increase the risk of falling into poverty, and raise macro-financial risks. The pandemic is expected to significantly reduce growth in FY20 due to the shock to tourism, the disruption on trade, distribution channels and supply chains, as well as the reduction in outmigration and related remittance flows. A significant financing gap may arise as revenues decline and government spending increases from programs to support households, businesses and possibly financial intermediaries (FIs). In line with real sector developments, financial stability risks are likely to build up. Reduced profitability, weaker asset quality, and lower credit
growth are expected to amplify the effect on the real economy and reduce economic growth. Maintaining and leveraging a resilient financial sector will underpin macro-financial stability and stimulate economic recovery as Nepal and the global economy respond to, and emerge from, the crisis.

2. Nepal’s financial sector faces constraints that will challenge the COVID-19 response in the short-term, as well as its role to support private investment and equitable growth in the medium-term. Notably in respect of: (i) Financial stability - the supervision of the dominant banking sector has progressed, but gaps persist on supervisory practices and in respect of the anti-money laundering and combating the financing of terrorism (AML/CFT) framework; (ii) Financial solutions - Nepal is exposed to natural disaster and health risks such as the COVID-19 pandemic but lacks financial solutions that can provide liquidity when it is needed most, whether for relief to the population or for recovery and reconstruction; (iii) Access to finance - Financial intermediaries’ capacity to borrow abroad and extend credit is constrained by regulation and impacts negatively the sector’s capacity to provide an immediate response to the current COVID-19 crisis. Nepal also compares unfavorably on indicators of financial inclusion. Gaps in its financial infrastructure and the low adoption of digital finance solutions impede access to financial services at a time when the need to more efficiently and effectively deliver social program payments, facilitate financial transactions and increase access to credit becomes more critical to households and firms, due to the impact of the pandemic. The proposed US$200 million Finance for Growth (F4G) Development Policy Credit (DPC) will help relieve some of these constraints. The focus on financial sector stability, diversification of financial solutions, and improved access to financial services will strengthen the country’s resilience in the face of the COVID crisis and the government’s recovery efforts.

Relationship to CPF

3. The operation contributes to the FY19-23 CPF, Report No. 83148-NP, July 10, 2018 discussed at the Board on August 7, 2018. The CPF’s second Pillar “private sector-led jobs and growth” identifies the importance of financial sector stability, inclusion and the provision of long-term finance. The CPS’s third Pillar “inclusion and resilience” targets resilience to shocks and climate impacts (including exposure to external demand shocks from natural disasters and limited macroeconomic and fiscal space to deal with an external shock) and the enabling of more inclusive and sustainable growth. The F4G DPC will directly contribute to these CPF targeted outcomes. The operation is also part of the World Bank Group’s policy response to COVID-19 in Nepal, designed to support reforms that provide financial stability, stimulate the economic recovery, and mitigate the impact of future disasters.

C. Proposed Development Objective(s)

4. Support the government of Nepal in its efforts to strengthen financial sector stability, diversify financial solutions, and increase access to financial services.

Key Results

5. **Pillar 1**: (i) the Nepal Rastra Bank’s (NRB) improved compliance with selected Basle Core Principles; (ii) a National Risk Assessment that meets at least a minimum level of technical compliance for selected Financial Action Task Force recommendations, observed through the upcoming Asia-Pacific Group evaluation. **Pillar 2**: (i) the placement of disaster risk finance instrument(s) on the market, (ii) the percent increase in the securities holdings (excluding government securities) of institutional investors (including the provident funds), and (iii) the percent increase in the financing through capital contribution and credit received by private equity and venture capital companies. **Pillar 3**: increased (i) international borrowing by BFIs, (ii) individuals using transaction accounts to make electronic payments with higher targets for women, (iii) individuals and firms enrolled with the CIB with higher targets for women, and (iv) new registrations of security interests in the secured transactions registry.

D. Project Description

6. The Finance for Growth (F4G) Development Policy Credit (DPC) is a proposed two-operation programmatic
series comprising three reform pillars. Pillar 1, comprising two Prior Actions (PA) and two triggers, seeks to strengthen financial sector stability with reforms focused on improving the NRB supervision of the banking sector and Nepal’s compliance with the international standards for Anti-Money Laundering/Combatting the Financing of Terrorism (AML/CFT). Pillar 2, comprising four PAs and four triggers, seeks to promote reforms that diversify financial solutions focused on disaster risk finance (DRF), the development of capital market instruments and the emergence of institutional investors. Pillar 3, comprising four PAs and four triggers, seeks to promote reforms that remove constraints to international borrowing in order to support domestic liquidity and reforms that aim to increase access to financial services by focusing on the retail payments system and digital payment services, as well as the credit infrastructure comprising of credit information reporting and secured transactions. This policy matrix also looks to reduce the gender gap in access to finance, including one PA and one trigger that supports the development of a Financial Literacy Framework which has women as one of its principal target groups as well as being a cross-cutting focus for all other target groups.

7. There is extensive other Development Partners (DP), together with the World Bank supporting these key financial sector reforms. In the case of Pillar I, consultations with DPs have been extensive, particularly with the UK Department of International Development (DFID) and the International Monetary Fund (IMF). In the case of the AML/FCT supported prior actions, the consultation is formalized through the establishment of the Working Group that includes also private sector stakeholders. Under Pillar II, the development of the DRF strategy is supported by a significant and active DP engagement including the Asian Development Bank (ADB), the United States Agency for International Development (USAID) and the DFID. The initiatives being undertaken in government and non-government securities sectors have also involved sustained collaboration with other key DPs, including the ADB and the DFID.

E. Implementation

Institutional and Implementation Arrangements

8. The reform agenda to be supported through the F4G operation will be led by the Ministry of Finance (MOF), in close partnership with the NRB. The MOF has experience and is conversant with World Bank policies and procedures through lending and technical assistance. A long history of budget support operations has built up some institutional capacity on data requirements and overall monitoring arrangements. Nepal has implemented the IMF’s Enhanced General Data Dissemination System and data is generally available through the MOF and the NRB websites, and the Statistical Agency. Other key implementing partners include the Securities Board of Nepal (SEBON) and the Nepal Insurance Board (NIB). Core data needed to monitor results will also be drawn from the principal regulatory agencies including NRB, SEBON, NIB and the Nepal Stock Exchange. This will be completed by ongoing technical assistance supported by the World Bank Group and other key DPs to further strengthen monitoring and evaluation of the reform outcomes supported by the F4G, with particular additional attention to those areas where the data is more limited including in respect of gender gaps to access to financial services and more broadly the poverty and social impact of the operation.

F. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impact

9. Overall, the reforms supported by this operation can have long-term positive effects on the poor and those at the bottom 40 percent of the welfare distribution. A stronger, deeper and more efficient financial sector is critical for sustained economic growth. The legal and regulatory reform initiatives supported through this operation have the potential to unlock sources of private sector investment and foster more inclusive access to finance, both of which are necessary conditions for accelerating the growth and the job creation needed to end poverty and promote shared prosperity. The potential positive effects on the poor and women, particularly for the post-COVID-19 recovery phase that will have a disproportionately negative impact on the poor and marginal segments of the population, could accrue through improved access to finance, financial literacy, as well as firm entry, growth and the related employment opportunities created.
10. The NRB’s initiative to improve financial literacy complements the financial infrastructure policies by promoting effective use of financial services. The planned scale up of these services under the Financial Literacy Framework, with its focus on women as a key target group, will serve a critical role during the COVID-19 recovery phase. Over the course of this DPC series, further in-depth analysis is planned to deep dive on issues of access to finance and financial services delivery drawing on surveys, administrative data and mixed-method assessments.

Environmental, Forests, and Other Natural Resource Aspects

11. Actions supported by this operation are not expected to have a significant direct negative effect on the environment. Improved access to credit will benefit enterprises that are engaged in sustainable management and harvesting of natural resources - notably forests -, providing jobs and eventually reducing activities that lead to forest degradation. Furthermore, new market-based financial instruments aimed to promptly address significant disaster risks will allow for prompt and effective responses and limit the negative impacts on the environment. The program also supports reforms that enhance climate adaptation. The supported reforms that diversify financial solutions for DRF will improve the country’s financial capacity to address: (i) weather-induced disasters; and, (ii) severe infrequent disasters. In addition, supported reforms related to the insurance sector have the potential to mitigate vulnerabilities stemming from life events and business risks associated with climate change and improve the ability to recover and reconstruct property affected by natural disasters. This will be reinforced by the activities undertaken in the context of the DRF strategy that will promote greater use of insurance products to address disaster-related events.

G. Risks and Mitigation

12. The overall risk of the proposed operation is Substantial. The main risks to achieving the results of the proposed policy measures are related to macro-economic, political and governance, institutional capacity, and fiduciary which are now further exacerbated by the inherent (current impact) and residual impact (principally relating to currently unforeseen future path/pace/spread) of the COVID-19 crisis. A further residual risk includes the parliamentary process that can result in unexpected changes to draft legislation submitted for approval by the COM.

13. Mitigation measures to address the different risks include: (i) a relatively narrow focus on implementing agents (MOF, NRB) that have a track record on delivering on reforms; (ii) the commitment of the MOF to delivering on this critical reform agenda and readiness to work closely with Parliament to facilitate the passage of legislation that will be key to the realization of the reform actions being supported by the F4G operation.; (iii) extensive technical assistance in support of this reform program provided by the World Bank and other DPs. Notwithstanding these strong mitigating measures, the ongoing COVID crisis and the uncertainty this entails, the larger challenges of implementing the federalism system set out in the 2015 constitution and the separation of the executive and legislative arms all entail residual risks to the F4G reform agenda that cannot be fully mitigated. However, the significance of these reforms in terms of the positive impact they can have to business development and to the wider welfare of the population justify proceeding with the operation.

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APPROVAL

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Approved By

Country Director: Faris H. Hadad-Zervos 12-May-2020