



# Report and Recommendation of the President to the Board of Directors

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Project Number: 36169  
October 2006

Proposed Sector Development Program Cluster of  
Loans, Asian Development Fund Grant, and Technical  
Assistance Grant  
Nepal: Rural Finance Sector Development Cluster  
Program

Asian Development Bank



## CURRENCY EQUIVALENTS

(as of 24 September 2006)

Currency Unit	–	Nepal rupee/s (NRe/NRs)
NRe1.00	=	\$0.01
\$1.00	=	NRs73.72

For the purpose of calculations in this report, the rate of \$1.00 = NRs74 was used.

## ABBREVIATIONS

ADB	–	Asian Development Bank
ADBL	–	Agricultural Development Bank Limited
ADBN	–	Agricultural Development Bank of Nepal
ADF	–	Asian Development Fund
ARP	–	Agricultural Development Bank Limited Restructuring Plan
BAAC	–	Bank for Agriculture and Agricultural Cooperative
BFIO	–	Banks and Financial Institutions Ordinance
CBO	–	community based organization
CPN/M	–	Communist Party of Nepal/Maoist
GBB	–	Grameen Bikash Bank
GDP	–	gross domestic product
GTZ	–	<i>Gesellschaft fur Technische Zusammenarbeit</i>
IDP	–	institutional development program
IPO	–	initial public offering
MFDB	–	microfinance development bank
MFI	–	microfinance institution
MIS	–	management information system
MOF	–	Ministry of Finance
NGO	–	nongovernment organization
NRB	–	Nepal Rastra Bank
PIU	–	program implementation unit
PMU	–	program management unit
PRGF	–	Poverty Reduction and Growth Facility
PSC	–	program steering committee
RF	–	rural finance
RFI	–	rural finance institution
RFSDCP	–	Rural Finance Sector Development Cluster Program
RMDC	–	Rural Microfinance Development Centre
SFCL	–	small farmers cooperative limited
SFDB	–	Small Farmers Development Bank
SFDP	–	Small Farmers Development Program
SPO	–	subprogram office
SPR	–	subprogram review
TA	–	technical assistance

## NOTES

- (i) The fiscal year (FY) of the Government ends on 15 July. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2006 ends on 15 July 2006.
- (ii) In this report, "\$" refers to US dollars.

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## LOAN AND PROGRAM SUMMARY

<b>Borrower</b>	Nepal
<b>Classification</b>	Targeting Classification: General intervention Sector: Finance Subsector: Finance sector development Themes: Sustainable economic growth, governance Subtheme: Financial and economic governance, developing rural areas
<b>Environment Assessment</b>	Category C. Environmental implications were reviewed, and no significant adverse environmental impacts are anticipated in this program.
<b>Rationale</b>	<p>With 31% of the population living in poverty, Nepal is one of the poorest countries. Nepal has a population of 25 million, including 22 million people in the rural sector. While rural poverty has been declining, mainly due to the large inflow of remittances, it remains pervasive. About 95% of the poor in the country are rural. Rural poverty is rooted in limited landholding, scarce non-land assets, low agricultural productivity, and lack of access to social services and economic infrastructure. For the rural population, the political insurgency and conflict during the past decade also caused personal insecurity, dislocation, and disruption of business activities. As the political conflict and insurgency was largely rural, it affected the rural population most.</p> <p>Access to reliable and affordable financial services is crucial for the rural poor to capture the opportunities of the reviving economy and break the vicious cycle of poverty. Increased financial intermediation will enable resources to flow to the rural sector, giving the rural poor opportunities to invest in productive activities, reconstruct their livelihoods, and improve their incomes. This will contribute to political and economic stability in rural areas. Yet, access to institutional financial services in Nepal is severely limited, reaching only 28% of the total population.</p> <p>Rural finance (RF) can be deepened significantly and rapidly to reduce poverty in Nepal's context by revitalizing and enhancing the network RF institutions (RFI). A high-risk RF profile, repressive policy environment, and security concerns in rural areas make private sector participation in RF extremely difficult. Difficult terrain and topography inhibits rapid deployment of private institutional RF services on a larger scale. Wider sector reform is required to address the policy and institutional bottlenecks to growth and development of efficient and sustainable RF services for the poor.</p>

**The Program Loan Objectives**

The goals of the Rural Finance Sector Development Cluster Program (RFSDCP) are to (i) ensure sustainable access of rural households to institutional financial services, and (ii) encourage private sector participation in the RF sector. The objective is to develop a sustainable RF system to generate income and reduce poverty of rural households.

Considering the comprehensiveness of the sector reform, and the medium-term approach to institutional reforms, RFSDCP will be structured in two sequential subprograms under the program cluster modality. The objective of subprogram I is to develop an enabling RF sector framework through policy, legal, regulatory, and institutional reforms. As a continuation of subprogram I, subprogram II will aim to promote a conducive sector environment, expand sound RF outreach, and enhance private sector participation in RF. The processing of subprogram II is subject to the review of the implementation of subprogram I. The review of subprogram I does not obligate the Asian Development Bank (ADB) to provide loans for additional subprograms under RFSDCP. Subprogram II will be subject to the approval of ADB's Board of Directors.

**Components and Outputs**

The program components of RFSDCP are (i) policy reforms to create an enabling RF sector environment, (ii) restructuring and reforms of RFIs, (iii) supportive legal and regulatory framework, (iv) sector capacity building, and (v) product and process innovations. The policy reforms are to deregulate and liberalize RFIs to limit Government interventions, and to increase private sector participation. RFSDCP supports fundamental reform and restructuring of the major RFIs, including the Agricultural Development Bank Limited (ADBL) for commercialization and, eventually, privatization.

Each subprogram of RFSDCP has policy and institutional reform targets. The emphasis of subprogram I will be consolidating the fragmented RF regulatory framework, initiating commercialization of RFI operations, and upgrading the sector capacity. Subprogram II will continue to promote the policy and institutional reforms, and will expand commercial-based RF service outreach, and privatization of important RFIs.

**Financing Plan**

As proposed, ADB will provide a loan of \$56 million from the Asian Development Fund for subprogram I of RFSDCP. The loan will have a term of 24 years, including a grace period of 8 years, with interest rate of 1.0% during the grace period and 1.5% thereafter; and such other terms and conditions set forth in the Loan Agreement.

Subprogram II of RFSDCP will be presented for Board consideration after completion of subprogram I and a review of the implementation.

<b>Procurement and Disbursement</b>	In accordance with provisions of ADB's <i>Simplification of Disbursement Procedures and Related Requirements for Program Loans</i> , the proceeds of the program loan will be disbursed to the Government as the Borrower. The proceeds of the program loan will be used to finance the foreign exchange costs of imports produced in, and procured from, ADB's member countries, other than those specified in the list of ineligible items and imports financed by other bilateral and multilateral sources.
<b>Program Period and Tranche Release</b>	RFSDCP will be implemented over 5 years from 2007 to 2011, including the subprogram review in 2009. Subprogram I is estimated to start in January 2007 and be completed in December 2008. The program loan of subprogram I will be released in two tranches over 2 years. The first tranche of \$40 million will be released upon loan effectiveness, while the second tranche of \$16 million will be released 12 months after the first tranche. All the first tranche release conditions have been complied with, which could enable the release of the first tranche upon loan effectiveness. Subprogram I allocates more resources in the first tranche to meet the Government's immediate requirements for rural investments, as emphasized in the FY2007 budget.
<b>Executing Agency and Implementation Arrangements</b>	The Ministry of Finance (MOF) is the Executing Agency. As the Implementing Agencies, ADBL, Nepal Rastra Bank (the central bank), and Small Farmers Development Bank will set up program implementation units. MOF will constitute a program steering committee for interagency coordination, comprising the program implementation unit directors and representatives from MOF and other Government agencies.
<b>Counterpart Funds</b>	The entire counterpart fund (local currency equivalent) of the program loan of subprogram I will be dedicated for the financial restructuring (recapitalization) of ADBL. ADBL will be recapitalized through cash subscription of additional preference shares. The counterpart fund to ADBL will be to enhance its liquidity to increase its net loans to the rural sector, as well as improve its net worth for divestment and privatization. The Government has incurred cost more than the policy loan amount as adjustment costs for the ADBL restructuring.
<b>The Project Grant Objective</b>	The objective is to support the Government's RF sector reform efforts by facilitating institutional reform and restructuring of key RFIs, and improving sector capacity and governance.
<b>Financing Plan</b>	As proposed, ADB will provide a grant of \$8.7 million from its Asian Development Fund resources.

<b>Executing Agency and Implementation Arrangements</b>	The Executing and Implementing Agencies, as well as the implementation arrangements, for the project grant are the same as the program loan. The expected closing date of the grant is 30 June 2009.
<b>Procurement and Disbursement</b>	Goods and services will be procured subject to the provisions of ADB's <i>Procurement Guidelines</i> . Grant disbursement will be in accordance with ADB's <i>Loan Disbursement Handbook</i> . All the consultants to be financed from the proceeds of the ADB grant will be recruited in accordance with ADB's <i>Guidelines on the Use of Consultants</i> . The program management unit will recruit the consultants. Where firms are to be engaged, the quality- and cost-based selection method with a full technical proposal will be used for selecting consultants.
<b>Technical Assistance</b>	A technical assistance grant of \$500,000 from the Japan Special Fund resources will be provided for advising ADBL's Board of Directors and senior management on all aspects of the restructuring and reform process. MOF will be the Executing Agency, while ADBL will be the Implementing Agency. Consulting services will be procured in accordance with ADB's <i>Guidelines on the Use of Consultants</i> . The technical assistance grant modality will ensure quality inputs by international and domestic experts for the restructuring in line with international best practices.
<b>Benefits and Beneficiaries</b>	RFSDCP responds to a national priority for enhancing the flow of resources to the rural sector. It is designed to address development constraints to broad-based inclusive growth critical for achieving a lasting solution to the conflict. The shift in the RF policy to emphasize good governance will permit sustainable RF markets to develop, enhancing the flow of resources to the rural sector and creating significant economic opportunities for the rural poor. Financial and operational restructuring of ADBL will provide the right incentives for the private sector to participate in RF, and induce the ADBL privatization. Gains of the restructuring will come from improved governance, substantial cost savings through reducing staff and lower transaction costs for small and marginal farmers over the long term. Deepening RF markets and outreach are correlated with rural growth and poverty reduction. As a result of RFSDCP, RF sector outreach is expected to increase by about 200,000 clients by 2011.
<b>Social and Environmental Issues</b>	Recognizing that the underlying causes of the conflict are persistent poverty, social exclusion, and lack of economic opportunities in rural areas, the poverty reduction impact of RFSDCP contributes to peace process in rural areas. RFSDCP will generate jobs and enhance incomes significantly through financial deepening and efficient intermediation to increase the profitability and productivity of rural economic activities. Further, RFSDCP will not have any adverse impact on indigenous peoples or any significant adverse environmental impacts.

## Risks and Mitigating Measures

The success of RFSDCP depends on a number of assumptions with varying risks. Despite the risks, the political and sector context provides sufficient basis to expect the results and outputs of RFSDCP. These are:

- (i) The conflict in Nepal has subsided almost completely, permitting development activities throughout all rural areas after more than a decade.
- (ii) The outputs and outcomes of RFSDCP will address the root causes of rural poverty, helping to mitigate the revival of conflicts.
- (iii) RFSDCP's conflict-sensitive approach assesses risks and incorporates mitigating measures in the program design and implementation.

Key risks and mitigating measures are:

As the country is going through a major political transition, the reform policy of financial institutions—especially the privatization of RFIs—may change. The Government assured the implementation of RFSDCP reforms with strict adherence to laws and regulations. As the regulatory requirements are enforced, Government interventions are reduced. Setting specific policy reform conditions for the release of the second tranche will ensure the prudent use of the program loan proceeds.

The security situation in some areas remains tenuous. As a result, the planned outreach expansion might be delayed in these areas. Though the restructuring process of ADBL does not include area-specific priorities, the regional business center structure—in which a regional center will manage and control the outreach expansion and service delivery through local outlets—allows the regional center to engage in rural outreach selectively, starting from low security risk areas and expanding to other areas as the security situation improves.

Government officials might have difficulty changing their mindset and formulating RF sector policies based on market and commercially oriented perspectives. At the start of the Program, an intensive initial orientation program will be conducted for Government officials and ADBL management. The new business processes of the restructured ADBL require new skill and competencies, which long-serving ADBL employees might not have. The voluntary retirement scheme of ADBL has released approximately 350 staff with adequate compensation, and another scheme is expected to be implemented in 2007. Meanwhile, ADBL is recruiting new staff to fill the skills gap better.

If the reform policies are redirected or RFI restructuring is delayed, the private sector might lose confidence in the process, delaying the privatization of RFIs. The measures under RFSDCP to improve investor confidence include (i) up-front recapitalization of ADBL to meet the minimum capital requirement, (ii) rigorous monitoring of the implementation of the restructuring to meet the restructuring performance benchmarks, and (iii) support to Nepal Rastra Bank to supervise RFIs for good governance and sustainability. The minimum 30% public shareholding requirement of the Banks and Financial Institutions Ordinance ensures the divestment of Government shares in the majority of formal RFIs.





## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on the Rural Finance Sector Development Cluster Program (RFSDCP) in Nepal, comprising (i) a proposed sector development program cluster for rural finance sector development, (ii) a proposed loan for subprogram I of RFSDCP, and (iii) a proposed grant for the Rural Finance Sector Development Project.<sup>1</sup> The report also describes a proposed technical assistance (TA) grant for capacity building in rural finance institutions (RFI). If the Board of Directors of the Asian Development Bank (ADB) approves the proposed sector development program cluster, loan and grant, I, acting under the authority delegated to me by the Board, will approve the TA.<sup>2</sup>

## II. THE SECTOR: PERFORMANCE, PROBLEMS, AND OPPORTUNITIES

### A. Sector Description and Performance

#### 1. Macroeconomic Context

2. Nepal's economic growth in the late 1990s, which was induced by structural reforms, has reversed due to the deterioration of the security situation.<sup>3</sup> Gross domestic product (GDP) growth has stagnated in the past several years, ranging from -0.4% in 2002 to 2.3% in 2005. The GDP growth in 2006 is forecast to be about the same as in 2005.

3. Nepal is entering a new phase of the peace process. In April 2006, Nepal's political scenario changed dramatically following a mass movement against the erstwhile Government. The dissolved Lower House of the Parliament was reinstated, followed by the formation of the new interim coalition government. The Communist Party of Nepal/Maoist (CPN/M) declared a ceasefire, and the Government of Nepal (the Government) reciprocated by declaring an indefinite ceasefire. Recently, the Government and CPN/M have held several rounds of peace talks, leading to an agreement on a road map to restoring peace and democracy. This includes the formation of an interim government with CPN/M's participation and elections.

4. These political developments present a challenging but unique opportunity to restore peace, stimulate economic recovery, and re-engage in development projects. Cognizant that the underlying cause of the conflict is poverty, social exclusion, and scarce economic opportunities in the rural sector, the Government has made a strong commitment in its FY2007 budget to supporting inclusive social and economic development, and poverty reduction, in the rural sector.<sup>4</sup> The FY2007 budget commits the Government to large resource transfers to support major social and economic transformation to address rural poverty. The moderately

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<sup>1</sup> In this document, RFSDCP denotes the cluster program comprising subprograms I and II. Subprogram I refers to the first cluster program to be implemented for 2007–2008, while subprogram II is the second cluster program for 2010–2011. The program loan denotes the loan under subprogram I. The design, implementation modality, and other aspects covered in this report refer to the cluster program—RFSDCP—unless specifically referred otherwise.

<sup>2</sup> RFSDCP was prepared based on one advisory TA and two subcluster TAs: ADB. 2001. *Technical Assistance to Nepal for Strengthening Corporate and Governance, Subcluster 3: Institutional Strengthening of Nepal Rastra Bank for Regulation and Supervision of Rural Finance; and Subcluster 5: Financial and Operational Review of Agricultural Development Bank of Nepal and Nepal Industrial Development Corporation*. Manila; ADB. 2003. *Technical Assistance to Nepal for Strengthening Selected Rural Financial Institutions*. Manila. The chronology of events is in Supplementary Appendix A.

<sup>3</sup> The conflict, which started in 1996 as a small rebellion in the four western hills districts of Nepal, has affected all 75 districts, with 36 classified as severely affected. Districts in midwest and far-west regions, the most severely affected, are the poorest and most isolated.

<sup>4</sup> The budget for FY2007, which the finance minister presented on 12 July 2006, reflects the Government's commitment to initiate post-conflict reconstruction and rehabilitation to address rural poverty.

expansionary budget for rural development is imperative to support of the peace process, which is still at an early stage.

5. While the Government will face a difficult reform environment, it recognizes the need to return to sound macroeconomic management and accelerate development activities. The Government has indicated it will adopt a two-track approach—the political process for establishing peace and democracy as the primary agenda, while remaining focused on reforms and development.<sup>5</sup> Sector reforms, including those in the financial sector, must continue, though with some modifications to accommodate the fragile political and security environment.<sup>6</sup>

## 2. Rural Poverty Profile

6. **Rural Poverty Profile.** With 31% of the population living in poverty, Nepal is among the poorest countries in the world.<sup>7</sup> Nepal has a population of 25 million in 4.8 million households, including about 22 million people in 4 million households in the rural sector. The rural poor, estimated at 7.5 million in 4 million households, constitute about 95% of the poor in the country. Historically, rural poverty has been associated with unemployment; underemployment; limited landholdings; scarce non-land assets; low agricultural productivity; and lack of access to basic social services, social capital, and economic infrastructure. Most of the poor are (i) farmers cultivating low-value crops on small plots, (ii) workers in the livestock sector, (iii) workers and self-employed in remote areas, and (iv) landless workers in low-wage and seasonal activities. Insufficient access to productive resources, such as agricultural inputs, technology, and credit, is another important constraint to the rural poor breaking the vicious cycle of poverty.

7. Although the portion of people living in poverty dropped from 42% in 1996 to 31% in 2004, poverty has declined less in rural areas<sup>8</sup> than in urban areas. While urban poverty declined from 22% to 10%, rural poverty fell from 43% to 35% in the same period. The decline in poverty in rural areas—though less dramatic than in urban areas—was mainly the result of growth before 1999, when the rural insurgency was less pervasive. A marked increase in overseas employment from rural areas also contributed to the drop in poverty.

8. **Conflict Impact on Rural Poverty.** For rural households, the conflict affected personal security and movement more than economic and productive activities. The death toll between February 1996 and March 2006 reached 13,000. By October 2003, the number of internally displaced persons was estimated at 200,000. Rural households also suffered from illegal activities, such as extortion and land confiscation. Security concerns also hampered the Government's ability to deliver basic services and development projects. A conflict impact assessment is in Supplementary Appendix B.

<sup>5</sup> The finance minister presented a white paper to the Parliament on 15 May 2006, describing the macroeconomic risks and proposing short-term measures to address them. These included more effective expenditure management, strong revenue administration, and an interim economic program.

<sup>6</sup> In the statement to the House of Representative on 9 July 2006, the Prime Minister addressed the need to (i) remove distortions and anomalies in the financial sector, and (ii) carry out legal and institutional reforms of the sector to increase the efficiency of the rural credit market. The report on monetary policy for FY2007 of Nepal Rastra Bank (NRB)—the central bank—emphasizes the need of legal and institutional reforms to expand the credit to rural areas. NRB. *Monetary Policy for FY2006/2007*. Kathmandu.

<sup>7</sup> Government of Nepal. 2005. *Nepal Living Standards Survey Report 2003–2004*. Kathmandu.

<sup>8</sup> The official poverty line is NRs15,224 (\$211) per capita per year (consumption expenditure at 2004), or 2,144 calories per rural adult per day.

### 3. Rural Finance Sector

9. **Outreach.** Due to historically weak governance and institutional capacity, the development of the rural finance (RF) sector in Nepal has been constrained severely, and its outreach has been minuscule relative to the potential demand. An estimated 18 million people in Nepal lack access to institutional financial services. While the supply of RF has been growing, even during the conflict (para. 15), formal institutional RF services in Nepal meet only an estimated 10% of the potential demand in terms of lending volume. The combined outreach of formal and semiformal sources was NRs2.6 billion in rural credit during FY2005, including NRs4.5 billion of agricultural credit to 927,000 households. The accessibility to RF services is particularly unfavorable for people living in the hills and mountains. The sector analysis is in Appendix 1.

10. **Market.** The RF market in Nepal can be classified into three broad categories: (i) lower segment—about 35% of the rural households, comprising the landless and subsistence farmers; (ii) middle segment—about 50% of the rural households, comprising mainly petty traders, and small and tenanted farmers; and (iii) upper segment—commercial farms, medium-to-large farms and rural enterprises, and wholesalers of agriculture produce.

11. **Institutions.** Though underdeveloped, the RF sector in Nepal has a range of financial services, including microfinance.<sup>9</sup> RF services in Nepal are provided by formal, semiformal, and informal sources:<sup>10</sup>

- (i) **Formal institutions.**<sup>11</sup> These include 17 commercial banks, Agricultural Development Bank Limited (ADBL),<sup>12</sup> five Grameen Bikash Banks (GBB) (Supplementary Appendix C), 47 microfinance nongovernment organizations (NGO),<sup>13</sup> 11 private sector microfinance development banks (MFDB), 19 savings and credit cooperative societies, and Small Farmers Development Bank (SFDB) (Supplementary Appendix D).
- (ii) **Semiformal institutions.** These include Government-sponsored rural credit programs, nearly 60 multisector NGOs, and an estimated 2,300 savings and credit cooperative societies.<sup>14</sup>
- (iii) **Informal sources.** These include an estimated 12,000 informal community-based organizations (CBO), such as self-help groups and informal savings and credit organizations, traders, friends, relatives, and moneylenders.

<sup>9</sup> Considering the demographics of Nepal, microfinance is primarily rural, even though microfinance institutions (MFI) also target the urban poor. RF, including microfinance, as described in this document, is part of the broader financial sector.

<sup>10</sup> The wide range of RF providers has been given a broad classification for clarity. In this document, unless otherwise specified, RFIs collectively denote all formal sources other than commercial banks, and the semiformal RFIs, including microfinance nongovernment organizations. The term RF or RFI, thus, includes microfinance or MFIs, respectively. The term microfinance or MFI is used only for specific microfinance-related references. Likewise, wherever relevant, commercial banks are specifically mentioned.

<sup>11</sup> Those include ones supervised by NRB. Nepal has 63 supervised finance companies, though their operations barely reach the rural sector.

<sup>12</sup> This is the erstwhile Agricultural Development Bank of Nepal (ADBN), which was incorporated on 15 July 2005 as part of the RFSDCP reforms. Reference to ADBL in this document is made for discussing the issues with regard to ADBN and the restructuring efforts of ADBL.

<sup>13</sup> NRB permits savings and credit cooperative societies to undertake financial intermediation. The Financial Intermediation Act of 1998 requires NGOs dealing with financial services to meet requirements specified by NRB from time to time.

<sup>14</sup> Those are registered under the Cooperatives Societies Act of 1996.

- (iv) **Other institutions.** The Rural Microfinance Development Centre (RMDC) (Supplementary Appendix E)—a microfinance apex organization—provides refinance and capacity-building support, mainly for microfinance NGOs.

12. In Nepal, formal institutions are the main providers of institutional RF services (formal and semiformal). In FY2005, ADBL accounted for 63% of rural credit, followed by commercial banks at 26%. GBBs and MFDBs provided about 7% of the aggregated credit. The balance is from cooperatives and other semi-formal institutions. The key RFIs include:

- (i) **ADBL.** The Government established Agricultural Development Bank of Nepal (ADBN) in 1968 to specialize in agriculture and rural credit. As part of the restructuring, it was incorporated as ADBL in 2005. ADBL is the third largest bank in Nepal<sup>15</sup> with paid-up capital of NRs1.6 billion, a loan portfolio of about NRs24 billion, deposits of NRs30 billion. It operates in all the 75 districts through 300 branches and offices. Under the pre-2005 structure, the Government owns 93% of the equity of ADBL, with the balance primarily owned by individuals. With an asset base of NRs42 billion, ADBL provides short-, medium-, and long-term loans to individual farmers, farmer groups, cooperatives, and village committees. In addition, ADBL trains its beneficiaries. Besides the commercial and agriculture operations, it operates the Small Farmers Development Program (SFDP) through refinancing its subsidiary, SFDB. Despite its institutional weakness, including high nonperforming loan ratio and unsatisfactory accounting practices, ADBL is essential to RF service delivery in Nepal. With more than 500,000 borrowers and depositors, ADBL is the single most important institution for the rural sector. Details of ADBL's operational and financial status are in Appendix 2.
- (ii) **SFDB.** Established in 2002, SFDB is jointly owned by ADBL, the Government, two private commercial banks, and cooperatives. SFDB is the Implementing Agency of SFDP, which receives funding from ADBL<sup>16</sup> and provides funds for microcredit for cooperatives of small farmers. SFDB acts as an apex wholesale agency to small farmer cooperatives. Due to its weak institutional capacity, SFDB's outreach and impact are limited, with NRs480 million outstanding to 200 small farmer cooperatives. As a focus of the ADBL restructuring, SFDP financing will gradually shift from ADBL to SFDB, and SFDB is to be strengthened to maintain focused financial services to small farmer cooperatives. SFDB is a key institution for promoting agriculture and microcredit in remote rural areas through community-based cooperatives and complements ADBL for rural small farmer outreach. The institutional profile of SFDB is in Supplementary Appendix D.
- (iii) **GBBs.** Five GBBs were established in 1990s to provide microfinance services to the poor, especially poor women, through a group-based methodology. Nepal Rastra Bank (NRB), commercial banks, and the Government jointly own GBBs.<sup>17</sup> With a network of 146 branches, mostly in remote rural areas, GBBs provide microfinance services to approximately 200,000 clients. However, GBBs also suffer from poor governance, politicization, operational inefficiency, and overstaffing, which have resulted in recurring losses, negative net worth, and low

<sup>15</sup> The two other largest banks in Nepal are: Nepal Bank Limited and Rastriya Banijya Bank.

<sup>16</sup> ADB.1990.*Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Technical Assistance Grants to the Kingdom of Nepal for the Third Small Farmers Development Project*. Manila (Loan 1037-NEP and TA 1382/1383-NEP, approved on 4 October); and ADB. 1998. *Project Completion Report on the Third Small Farmers Development Project in Nepal*. Manila.

<sup>17</sup> NRB holds up to 10–75% equity of GBBs, commercial banks 20–25%, and Government 8–16%.

productivity. In line with the financial sector reform, the Government initiated a restructuring of GBBs. Four GBBs were recapitalized, and two profit-making GBBs were privatized. Given the shallow markets and depressed investor sentiment, further progress in divestment is expected to take time. The institutional profile of GBBs is in Supplementary Appendix C.

- (iv) **Commercial banks.** Commercial banks' lending to the rural sector constitutes about 3% of their loan portfolio. Most of their rural lending is under the mandatory priority sector lending requirements. Within the commercial banks, the private commercial banks' exposure to retail rural credit is miniscule, except via indirect lending through GBBs and MFDBs. Due to the rationalization of their operations, commercial banks closed many rural branches, and are reluctant to expand rural outreach due to the higher return of operations in urban areas.

13. **Demand.** The average size of rural loans to non-poor households is approximately NRs47,000, compared with NRs8,400 to the poor (or microcredit average). The aggregate demand for rural credit from all sources is estimated at NRs24 billion, of which microcredit is about NRs4 billion.<sup>18</sup> The major credit demands are from small rural enterprises, and agriculture and allied sectors. The upper market segment seeks services such as long-term investment capital. The middle segment requires working capital; cash credit; loans against pledge of produce; and medium- to long-term loans for crop cultivation, rural transport, and land development. The lower market segment requires credit for consumption, microenterprises, crops, livestock, and minor irrigation.

14. As with credit, the demand for savings is diverse. It comprises self-finance for investments, livestock, cash, and bank deposits. With the domestic savings to GDP ratio at 12%, the savings potential is immense. In addition, risk mitigation is widely needed. As Nepal received nearly \$1 billion in remittances in 2005, a significant opportunity exists for the RF sector to tap into this market.

15. **RF Market and the Conflict.** Despite the conflict, the demand for RF services remained strong over the past decade. The number of households borrowing from all sources grew during 1996–2005. Institutional credit also expanded, mainly because commercial banks have become even more reluctant to lend money in rural areas, while farmers' and microenterprises' demand for financial services has not waned. Throughout the conflict, ADBL kept open its 45 commercial banking branches, as well as 108 out of 181 development banking branches at original locations. Security concerns, especially in the western region, have required 80 development banking branches to be relocated or merged with branches at secure areas. Still, ADBL's overall transaction grew steadily from NRs8.9 billion loans outstanding in FY1996 to NRs24 billion in FY2006.<sup>19</sup> Total deposits also grew from NRs8.6 billion in FY1996 to NRs30 billion in FY2006. Clients have been willing to commute to relocated branches, given the acute lack of affordable credit sources. MFDBs and microfinance NGOs also have received increased client interest. In contrast, most of the rural savings with commercial banks were deployed in urban and semi-urban areas.

<sup>18</sup> ADB.1999. *Rural Finance Development in Nepal: A Medium-Term Strategy*. Manila. The estimates have been inflation adjusted.

<sup>19</sup> By mid-July 2006.

## B. Issues and Opportunities

### 1. Sector Challenges

16. Efficient and reliable financial intermediaries are essential to equitable and pro-poor-oriented rural economic growth and development. Access to affordable institutional financial services is crucial for the rural poor to take advantage of the opportunities engendered by the peace process. Systematic intervention to induce rapid outreach expansion of institutional RF services, combined with policy and institutional reforms, is required urgently. Yet, the policy and institutional framework of the RF sector in Nepal is still too weak to quickly respond to changing market conditions to meet the demands of the recovering rural economy. The key sector constraints are as follows:

17. **Historical Politicization in RF.** The fundamental weakness in RF in Nepal is political interference in lending, loan collection, and loan write-offs. The Government has intervened in the RF market to increase lending by reducing the costs and risks for RFIs in making loans to preferred clients. Prolonged interventions by the Government weakened institutional sustainability of RFIs.

18. **Limited Financial Prospect for Private Sector Participation.** Extensive politicization, repressive policies, and market distortions failed to create conditions that are conducive to private sector-led RF market development. The high-risk profile in RF, cost considerations, and difficult topographical conditions deter private financial institutions from entering the market. Although cooperatives and microfinance NGOs remained active during the conflict, their outreach is minuscule. The condition of the RF market provides little alternative than to strengthen existing formal RFI channels.

19. **Weak Institutional Capacity.** The evolution of the RF market over the past three decades was supply-driven to accelerate agriculture production. Thus, the development of efficient institutions was ignored. The Government intervened through directed credit, state-owned RFIs, concessional refinance, and loans at below-cost interest rates. Repressive financial policies, with the lack of autonomy and weak governance, eroded institutional sustainability and constrained outreach potential. The capacity of formal RFIs in Nepal for portfolio management, accounting and reporting, business planning, and risk mitigation is below international best practices of RF.

20. **Erosion in RFI Confidence.** Most formal financial institutions were reluctant to operate in rural areas due to the fragile security situation and high costs. In recent years, the most affected commercial banks have reduced the size of their rural networks, which already had been scaled down by cost-saving measures. This has added to the current financial difficulties. Cooperatives and savings associations were less affected by the conflict, though interest waivers or reductions in interest eroded their financial viability.

21. **Weak Supervisory and Regulatory Framework.** While RFIs proliferated, supervision remained weak and ineffective. Although most semiformal RFIs, especially cooperatives, mobilize non-member savings, they remain inadequately supervised. The enactment of Banks and Financial Institutions Ordinance (BFIO) 2004<sup>20</sup> and NRB Act 2002 defragmented the

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<sup>20</sup> Enacted in December 2003, BFIO supersedes the Agricultural Development Bank Act 1967, Commercial Bank Act of 1974, Nepal Industrial Development Bank Act 1967, Finance Company Act 1985, and Development Bank Act 1995. As an ordinance, BFIO is promulgated every 6 months, and it is expected that Parliament—in its next session—probably will approve the transformation of the ordinance into an act.

banking sector and gave greater autonomy to NRB.<sup>21</sup> However, supervising many small RFIs is not cost-effective, and should be the focus of NRB. An effective supervision and regulatory system must be developed.

**22. Limited Product Diversification.** Leasing and insurance services have not made an impact in rural areas because of (i) limited opportunities for viable operations, (ii) scant client information to assess risks, (iii) high administrative costs due to widely dispersed clients, and (iv) weak contract enforcement. A sustainable mechanism for crop and calamity insurance has not emerged due to the difficulties of asymmetric information and coverage of risks, while the demand for effective risk mitigation products is strong. Remittance, term deposits, and other savings facilities also have little presence in rural areas, forcing rural people to depend on informal means to save and remit money.

**23. Insufficient Sector Support Infrastructure.** Affordable, high-quality training for mainstreaming RF best practices is lacking. Curricula and training courses in banking and financial products offered at universities are inconsistent with best practices in banking and finance, and specialization for RF is rare or nonexistent. Further, semiformal RFIs are unaware of their need for such training. The training needs of the RF sector, including those of policy makers and regulators, will have to be supported for effective institutional reform.

## 2. Lessons Learned

**24. Lessons from ADB RF and Microfinance Projects.** ADB has financed numerous loan and TA projects in RF. In most of the projects, ADB has extended credit line assistance as a stand-alone credit project, or as components of projects generally in the agriculture and natural resources sector. RF projects in the early 1990s generally were poorly targeted, with little attention paid to financial viability. Typical projects<sup>22</sup> were assistance to ADBN,<sup>23</sup> Bangladesh Krishi Bank, and Bank for Agriculture and Agricultural Cooperative (BAAC) in Thailand. However, those agricultural lending institutions were loaded with Government-directed subsidized credit programs, and ADB financing often supported the Government programs. Such directed programs have not induced a good credit culture, and the institutions suffered from low repayment. Further, ADB funding to those projects was disbursed slowly. Prevailing Government policies largely influenced subsequent sustainability of those RF and microfinance projects. Institutions that operated in a policy environment that did not encourage self-supporting operations have continued to suffer low recovery rates, and have required recapitalization by the Government, as in the cases of ADBN and Bangladesh Krishi Bank.

**25.** However, the institutions that have been reformed (even without an explicit privatization exit) and allowed to operate with market-oriented interest rates have improved their ability to mobilize resources and become self-sustaining institutions. BAAC is fully Government owned, and its operation had been staggered over more than 30 years. Before the reform, BAAC

<sup>21</sup> As part of NRB reengineering through the ongoing World Bank-funded Financial Sector Technical Assistance Project, and TA 3580-NEP: Subcluster 3: *Institutional Strengthening of Nepal Rastra Bank for Regulation and Supervision of Rural Finance*, for \$800,000, approved on 27 August 2002. This is associated with ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Kingdom of Nepal for the Corporate and Financial Governance Project*. Manila.

<sup>22</sup> Those projects include ADB. 1990. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Kingdom of Nepal for the Third Small Farmers Development Project*. Manila (Loan 1037-NEP, approved on 4 October); and ADB. 1990. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Kingdom of Nepal for the Sixth Agricultural Credit Project*. Manila (Loan 1112-NEP, approved on 31 October).

<sup>23</sup> As part of the restructuring, the erstwhile ADBN was incorporated as ADBL in July 2005.

depended almost exclusively on capital from the Government, and its repayment rate was as low as 51%. In 1975, the Government of Thailand initiated agriculture sector reforms, and removed interest rate ceiling and other restrictive regulations of agricultural finance. BAAC was placed under the supervision of the Bank of Thailand. The organization and operation of BAAC also were reformed, including clearing nonperforming loans, mobilizing commercial deposits, and expanding retail outreach. By 1998, BAAC had 4.8 million clients, representing 86% of the farm households of the country. BAAC's example suggests that the reform of agricultural banks is feasible, and that their financial performance and outreach can be improved greatly. However, such reforms must be implemented in connection with the development of an enabling financial sector environment, including (i) appropriate legal and regulatory framework, (ii) prudential norms and effective internal control, and (iii) genuine commitment to profitability and sustainability of operations.<sup>24</sup>

26. **Lessons from ADB's Nepal Operations.** An assessment in July 2006 found that the security situation had not seriously affected 13 (57%) of the 23 ongoing ADB-assisted projects in Nepal, while 10 (43%) had been moderately affected and zero (0%) had been highly affected. The limited impact on the projects was mainly because the disruptions were time- and location-specific. Project designs were based on participatory and community-based activities, which enabled them to continue effectively and safely, even in the unstable environment. More improvements are expected as the peace process progresses and the ceasefire endures. This indicates that projects with effective links with CBOs, and flexibility in intervention areas, can be implemented safely and achieve the expected results. RMDC, which is supported under the ADB-funded Rural Microfinance Project,<sup>25</sup> provides loans to microfinance institutions (MFI) to onlend to women rural borrowers. Despite the security situation, RMDC's loan disbursement to MFIs substantially grew during the conflict, and had served more than 280,000 poor women in rural areas as of July 2006.

### 3. Government Strategy

27. Given recent political developments, the Government has adopted a two-pronged approach to development—conducting serious peace talks, while maintaining focus on reform and economic recovery and development. Rural investment and improvement of the livelihoods of the rural poor are the top priorities in the Government's FY2007 budget. This is a keen recognition that social economic benefits need to be delivered quickly to the rural poor. The Government's strategy is to address the root causes of the conflict, specifically social exclusion and large urban-rural and regional disparities. At the same time, the Government has been reinvigorating the reform process in areas such as civil service, corporate governance, and labor ordinances.<sup>26</sup> The Government concedes that undertaking fundamental reforms requiring major legislative changes and institutional restructuring would be difficult in the prevailing

<sup>24</sup> BAAC underwent comprehensive reform in the late 1980s and 1990s, including interest rate liberalization, rationalization of loss-incurring operations, and savings mobilization. BAAC's transformation is considered a successful example of the restructuring of agricultural banks, along with Bank Rakyat Indonesia (BRI). BAAC and BRI are state-owned. Analysis of BAAC and BRI reforms can be found in Seibel, Hans Dieter. 2000. Agricultural Development Banks Close Them or Reform Them? *Finance and Development* Vol. 37 (June) No. 2. Washington, DC: International Monetary Fund.

<sup>25</sup> ADB. 1998. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Kingdom of Nepal for Rural Microfinance*. Manila.

<sup>26</sup> As part of the reform, a new labor ordinance has been promulgated, a new governance ordinance and a procurement ordinance have been endorsed by the cabinet, and oil prices and distribution have been deregulated, substantially fulfilling the outstanding reform conditions under the World Bank's Poverty Reduction Support Credit II and the Poverty Reduction and Growth Facility of the International Monetary Fund.

political environment. However, it has made a strong commitment to maintaining continuity of reform policies, despite potentially difficult reform environments (para. 5 and footnote 6).

28. The Government adopted the Financial Sector Strategy Statement in 2000 to (i) reduce the role of the Government in the financial sector, (ii) improve governance and transparency, (iii) strengthen the authority of NRB, (iv) enhance the legal framework for credit enforcement, and (v) expand the availability of financial services in remote areas. The Government has demonstrated its commitment to banking reforms by enacting BFIO 2004 (footnote 21); and promulgating the Company Law, and laws for secured transactions, securities, and insolvency.<sup>27</sup> The mandatory priority sector credit lending quota for banks also will be phased out by the end of 2007.<sup>28</sup> The Tenth Plan (FY2002–FY2007)<sup>29</sup>—the Government’s Poverty Reduction Strategy Paper—highlights the need to address chronic poverty and social exclusion. To meet RF demands for post-conflict rehabilitation, the Government is keen to enlarge the network for sustainable RFIs to significantly enhance outreach to small and marginal farmers and the poor.

#### 4. ADB Strategy

29. **ADB’s Microfinance and RF Strategy.** ADB’s Microfinance Development Strategy<sup>30</sup> is to ensure permanent access to institutional financial services for a majority of poor and low-income households, and their microenterprises. The strategy specifically focuses on (i) creating a policy environment enabling to microfinance, (ii) developing the financial infrastructure, (iii) building viable institutions, (iv) supporting pro-poor innovations, and (v) supporting social intermediation. Under the strategy, ADB will catalyze the expansion of microfinance supply, as well as strengthen the capacity of the potential clients to access services. On the supply side, the strategy focuses on building financial systems that can grow and provide financial services permanently to an increasing proportion of the poor, and on promotion of pro-poor innovations. Further, the strategy emphasizes support for the reform of agricultural and rural development banks in countries, where those institutions continue to undermine development of sustainable microfinance/RF operations.

30. **ADB’s Operational Strategy in Nepal.** ADB’s *Country Strategy and Program for Nepal (2005–2009)*<sup>31</sup> focuses on (i) pro-poor and broad-based economic growth, and inclusive social and human development; (ii) empowerment of the poor; and (iii) good governance to ease social tensions and create the foundation for sustainable poverty reduction. The primary aim is to improve access for the poor and those excluded from markets and economic opportunities. ADB’s new operational approach<sup>32</sup> in Nepal endorses continued engagement in the country with a cautious, conflict-sensitive approach, and close monitoring of the evolving situation in collaboration with other development partners. With this approach, projects and programs will be developed based on the political and security assessments of the implementation

<sup>27</sup> These laws are covered under ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Kingdom of Nepal for the Corporate and Financial Governance Project*. Manila.

<sup>28</sup> However, the mandatory deprived sector quota is in place. Given the social exclusion in Nepal, the RFSDCP has only sought a review of deprived sector quota and appropriate action during subprogram II.

<sup>29</sup> Government of Nepal. 2003. *The Tenth Plan—Poverty Reduction Strategy Paper 2002–2007*. Kathmandu.

<sup>30</sup> ADB. 2000. *Finance for the Poor: Microfinance Development Strategy*. Manila. The strategy defines microfinance as “the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households, and their microenterprises”. The definition largely is consistent with the one for RF in the RFSDCP context.

<sup>31</sup> ADB. 2004. *Country Strategy and Program Nepal*. Manila.

<sup>32</sup> The President of ADB approved the new operational approach in Nepal on 26 May 2006. The new approach proposes continued engagement in Nepal through cautious and conflict-sensitive approach, priority in rural finance and road connectivity, and review in governance and public policy reform interventions.

environment, with risk mitigation measures incorporated as appropriate. RFSDCP is identified as a priority intervention due to its rural and community focus, as well as its high potential to deliver expected development results in the current political and security environment.

## **5. External Assistance to the Sector**

31. The funding agency community welcomed the recent political development as a step toward a peaceful solution to the conflict. Funding agencies, which had suspended or reduced their assistance since early 2005, have resumed their operations, or are scaling up to 2003–2004 levels (when the country was less politically unstable). While taking a cautious approach, funding agencies believe harmonized and coordinated assistance for rural development, power, water supply and sanitation, education and health, and infrastructure will benefit the country's peace-building, reform, and development.

32. The International Monetary Fund's Poverty Reduction and Growth Facility expires in November 2006. Given the generally pro-poor orientation of the FY2007 budget, the continuation of this facility generally is perceived to be preferable, because it will support the peace process and stabilize the fragile political situation. The World Bank supports the Financial Sector Restructuring Project<sup>33</sup> to develop a healthier financial sector with emphasis on private sector participation. The key component of the project is the reform and divestment of the two largest commercial banks, Rastriya Banijya Bank and Nepal Bank Limited.<sup>34</sup> Since the Government has endorsed a new labor ordinance, governance ordinance, and procurement ordinance, World Bank is expected to release its Poverty Reduction Support Credit II. German development cooperation, through Gesellschaft für Technische Zusammenarbeit (GTZ), implements the Rural Finance in Nepal Project to develop community-based financial services through capacity development of small farmer cooperatives. As cooperatives are essential to maintaining access to financial services for small and marginal farmers in rural areas, GTZ will continue to support the small farmer cooperatives and finance capacity development for SFDB in parallel with RFSDCP. The development coordination matrix is in Appendix 3.

## **III. THE PROPOSED SECTOR DEVELOPMENT CLUSTER PROGRAM**

### **A. The Program Loan**

#### **1. Rationale**

33. As the peace process is now largely on track, reducing rural poverty by addressing rural-urban income disparity, limited access to economic resources, and social exclusion is widely regarded as the key to lasting peace and development. Increased financial intermediation will enable the heavier flow of resources to the rural sector, as well as give RF clients opportunities to improve their incomes and reconstruct their livelihoods. This will contribute to political and economic stability in rural areas. The scarcity of institutional financial services in rural areas, caused by the historic politicization and institutional weaknesses, constrains the achievement of

<sup>33</sup> World Bank. 2004. *Financial Sector Restructuring Project*. Washington, DC (International Development Agency, for \$75 million, approved on 9 March).

<sup>34</sup> Rastriya Banijya Bank is a fully state-owned bank, while Nepal Bank Limited is a private institute with the Government as the largest shareholder (41%).

inclusive social and economic development in rural areas. Rural credit facilities throughout the country need to be expanded by restructuring RFIs.<sup>35</sup>

34. Developing the RF sector for outreach impact requires an integrated package of policy and institutional strengthening measures. A sector development cluster program approach will facilitate comprehensive reforms, with specific policy and institutional reform targets, while enabling flexible reforms according to changing political and economic conditions.

## 2. Impact and Outcome

35. **Impact and Outcome.** The goals of the cluster program—RFSDCP—are to (i) ensure sustainable access of rural households to institutional financial services, and (ii) encourage private sector participation in the RF sector. The objective is to develop a sustainable RF system for providing affordable services to the rural poor to generate income and reduce poverty. The scope is comprehensive RF sector development, mainly through enabling sector policy environment and institutional reform, and restructuring of major RFIs.

36. **Application of Program Cluster Modality.** As the reforms are comprehensive and interlinked, and the institutional reform process will unfold over the medium term, RFSDCP will be structured in sequential subprograms under the program cluster modality. Under this modality, each subprogram will be implemented over 2 years. Subprogram II will be formulated and finalized during the subprogram review (SPR) immediately following the completion of subprogram I. This will allow the flexibility to adjust the program based on progress made and changes in the external environment, and will build momentum in the reform process as the Government gains experience through implementation. However, the SPR does not obligate ADB to additional lending for subprogram II under RFSDCP. Subprogram II will be subject to ADB's Board approval.

37. **Subprogram Objectives.** The objective of subprogram I of RFSDCP is to develop an enabling RF sector framework through policy, legal, regulatory, and institutional reforms. The objective of subprogram II will be to promote further reform for an enabling sector environment, enhance sound RF outreach, and private sector participation in RF. Subprogram II will focus strongly on the privatization of RFIs, including ADBL. For each subprogram, achievement targets will be formulated to keep the reform process on track and coordinated. The targets for tranche release under the subprogram, as well as indicative targets under subprogram II, are in the policy matrix attached to the Government's development policy letter (Appendix 4).

38. **The RFSDCP Subprogram I Structure.** Subprogram I consists of a program loan and an ADF grant. The counterpart funds to be generated out of the proceeds of the program loan will be used to recapitalize ADBL through subscription of ADBL's preference shares, which will be divided between redeemable and irredeemable shares. The ADF grant will support the implementation of the institutional reforms, legal and regulatory framework, sector capacity building, product and process innovation, and project management. The agreements on RFSDCP are reflected in the Government's development policy letter and the attached policy matrix and RF sector road map (Appendix 4). The design and monitoring framework is in Appendix 5.

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<sup>35</sup> The rural development impact of RFSDCP will complement strongly the Commercial Agriculture Development Project (being processed), which promotes local infrastructure investment, production, and marketing support for agriculture-related enterprises. The Project will support local infrastructure development, such as storage centers, cool stores, access to market information, and agribusiness product improvement technology. It also will assist subsistence and semi-commercial producers for commercialization of their businesses.

### 3. Components and Outputs

39. RFSDCP has five components: (i) favorable policy environment, (ii) institutional restructuring and reforms, (iii) supportive legal and regulatory framework, (iv) sector capacity building, and (v) product and process innovations.

#### a. Favorable Policy Environment

40. The financial sector reforms in Nepal aim to develop a market-oriented and predominantly privately owned financial sector for efficient financial intermediation.<sup>36</sup> Consistent with the financial sector reform, a high-level policy review committee will be established to support RF policy reform actions (paras. 41–42).<sup>37</sup>

41. The following reforms will be completed under subprogram I:

- (i) establishing rules, regulations, and processes for the supervision and regulation of RFIs;
- (ii) divesting NRB shares in RFIs to the legally defined level;
- (iii) phasing out Government ownership of technically insolvent RFIs; and
- (iv) discontinuing the application of interest rate ceilings to ADBL and SFDB.

42. The following reforms will be pursued throughout RFSDCP:

- (i) ensuring the full enforcement of the debt recovery law for willful defaulters;
- (ii) promoting lending from formal and semiformal RFIs to CBOs;
- (iii) divesting the Government shares and increasing participation of the private sector in ADBL and SFDB; and
- (iv) discontinuing Government interventions in ADBL and SFDB to implement financially or economically unsound concessions, write-offs, or waivers.

#### b. Institutional Restructuring and Reforms

43. **ADBL.** RFSDCP supports reform and restructuring of ADBL to transform it into a viable and efficient RFI relevant to rural poverty reduction. The restructuring under RFSDCP will focus on the progressive divestment of the Government shares of ADBL, which is linked to performance improvement and commercialization to enable the privatization of ADBL under subprogram II (Appendix 4). The Government has initiated a series of reforms, which have included (i) the Government's adoption of the ADBL Restructuring Plan (ARP) (Supplementary Appendix F) in 2004, and the conversion of \$65 million of the Government's debt to ADBL into preference shares of ADBL for recapitalization; and (ii) ADBL's incorporation and licensing as a class A financial institution under BFIO. These reforms are part of the first tranche release conditions (Appendix 4). The restructuring of ADBL is detailed in the ARP.

44. Important reform output targets under subprogram I are (i) divestment of Government shares, (ii) initiation of the initial public offering (IPO), (iii) completion of a voluntary retirement scheme, and (iv) attainment of viable operations by meeting performance indicators set under ARP. Subprogram II aims to (i) achieve privatization, (ii) complete the implementation of ARP, and (iii) divest equity in SFDB. Reform targets under each subprogram are in the policy matrix (Appendix 4). The following reform areas are covered throughout subprograms I and II:

<sup>36</sup> Government of Nepal. 2000. *Financial Sector Strategy Statement*. Kathmandu.

<sup>37</sup> A policy review committee will be made up of representatives from NRB, Ministry of Finance, and private RFIs.

- (i) **Governance.** Restructuring will promote sound and autonomous management at ADBL. To enhance the governance of ADBL, substantial restructuring steps have been taken: (a) incorporation of ADBL under the Company Law 1997 on 15 July 2005, (b) formation of the governance committee and audit committee in accordance with regulatory requirements, and (c) licensing of ADBL as a class A financial institution under BFIO to enable it to operate as a universal bank under the supervision and regulation by NRB. In addition, a professional board of directors, with three of the seven members from private sector, will be constituted as the divestment progresses.
- (ii) **Financial restructuring.** RFSDCP supports the financial restructuring of ADBL to facilitate divestment and privatization. First, ADBL will be recapitalized to cover bad and doubtful debts, estimated at NRs8.42 billion, to ensure that capital adequacy of ADBL remains above 12%, in accordance with the NRB requirement. Second, the issued capital of NRs11.2 billion will be subscribed in phases, with an initial NRs6.5 billion filled by the current equity of NRs1.6 billion and conversion of NRs4.9 billion of the Government's debt to ADBL equity (preference shares).<sup>38</sup> The Government also has bought NRs30 million of NRB equity. The Government will subscribe to the balance as redeemable and irredeemable preference shares for the duration of RFSDCP, provided ADBL meets agreed performance benchmarks.<sup>39</sup> Detailed financial analysis and projections of ADBL are in Supplementary Appendix G.
- (iii) **Organization.** Restructuring will promote a lean and efficient organization structure of ADBL. ADBL operations will be decentralized under a regional business center structure. Seven regional business centers will be established as profit centers, offering products and services that are best suited to the needs of the local market. The structure will enable subordinate outlets to attend to clients' needs proactively, thereby delivering quality and raising productivity. The reform also will strengthen significantly human resource management. Staff members, whose skills sets do not meet the new requirements, will be phased out gradually through voluntary separation schemes with adequate compensation. About 350 staff members, approximately 15% of the total, have opted for voluntary separation. Clear benchmarks will be established to link staff compensation to their performances. In addition, a transparent recruitment and appointment process will be in place.
- (iv) **Institutional strengthening.** The monitoring and reporting system of ADBL will be upgraded through an improved management information system (MIS) in line with international best practice.
- (v) **Business strategy.** The new business plan of ADBL will be developed to set specific operational targets through improved business processes. The aim is to reach 565,000 clients<sup>40</sup> by 2011 (compared with the current 430,000 clients) by adopting efficient practices. Risk will be kept within acceptable levels by undertaking due diligence in loan appraisal, and meeting prudential norms. Management and control of risks, especially delinquency, will be strengthened.

<sup>38</sup> This mainly includes non-recoverable loans approved according to Government directives.

<sup>39</sup> On 16 March 2005, the Government issued a cabinet resolution to invest NRs2.3 billion as the redeemable and irredeemable preference shares in ADBL as the initial recapitalization.

<sup>40</sup> In terms of active accounts.

Lending will come from repayments and deposit mobilization until ADBL significantly improves its repayment rate.

- (vi) **Performance benchmarking.** The progress of the restructuring will be evaluated based on agreed performance indicators (Appendix 2, Table A2.4) to ensure that ADBL's operations are turned around successfully and sustainable.
- (vii) **Privatization.** The restructuring incorporates the privatization of ADBL through phased divestment of the Government shares. BFIO requires the public to hold 30% of all financial institutions. Accordingly, ADBL will be required to undertake an IPO in consultation with ADB, Ministry of Finance (MOF), and NRB.<sup>41</sup> In addition, the existing 500,000 general shareholders (mostly clients) also will be given the option to buy additional shares. These will be the basis for further divestment of Government shares, and privatization during subprogram II.<sup>42</sup>
- (viii) **Anticorruption.** Restructuring also will address corruption issues within ADBL. ADBL has set up an anticorruption and complaints cell to support the audit committee of ADBL in tracking and minimizing corruption. In addition, measures to minimize corruption risks have been identified and incorporated in the restructuring process, including adoption of the code of conduct, strengthening auditing system, and ensuring accountability at each level of ADBL operations.

45. **SFDB.** SFDB and small farmer cooperatives will be strengthened substantially to supplement ADBL's efforts to ensure that agriculture credit needs of small farmers are met adequately in areas that commercial banks do not consider viable. In addition, the transformation of SFDP into small farmer cooperatives—and their links with SFDB—will be redesigned for expediting outreach to small farmers and local communities.<sup>43</sup> Based on the diagnostic review of SFDB,<sup>44</sup> an SFDB restructuring plan will be developed to enhance SFDB's viability and outreach to small farmer cooperatives with specific performance indicators. The restructuring assistance will prioritize strengthening SFDB's microfinance and banking operations, staff capacity building, and accounting and auditing. The reform output targets under subprogram I will be (i) adoption of the SFDB restructuring plan, (ii) initiation of the restructuring process, and (iii) partial divestment of Government shares to the legally required level as set out in BFIO. The subprogram II reforms are expected to achieve viable operations by meeting performance indicators of the SFDB restructuring plan, and privatization.

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<sup>41</sup> The sale of NRB stake in GBBs has not progressed substantially due to inadequate investor response and depressed market sentiment.

<sup>42</sup> The Government owns 65% of the ordinary shares of the issued capital of ADBL, amounting to NRs1.63 billion (with voting rights). ADBL will undertake an IPO of ordinary shares worth NRs870 million to enable the public to own 35% of ADBL (30% as required by BFIO, and 5% to the existing public shareholders of ADBN). The balance of the issued capital will be divided into redeemable and irredeemable preference shares (non-voting). Subscription of non-voting preference shares by the Government is a credible demonstration to potential investors of Government's intention to fill financial gaps of ADBL, for which it is directly and indirectly responsible. This is intended to facilitate private sector interest in ADBL. BFIO's provision on reduction of issued capital could be applied to reducing the preference shares held by the Government with improvements in ADBL performance. The privatization of ADBL is conditional upon the successful turnaround of ADBL into a viable commercial institution during subprogram I. The privatization plan will be developed under subprogram II.

<sup>43</sup> Lessons learned in RF sector reforms in Sri Lanka will be applied to outreach in districts severely affected by conflict. ADB. 2003. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Democratic Socialist Republic of Sri Lanka for the Rural Finance Sector Development Program*. Manila

<sup>44</sup> ADB. 2003. *Technical Assistance to the Kingdom of Nepal for Strengthening Selected Rural Financial Institutions (Cofinanced by the Government of Germany)*. Manila (TA 4259-NEP, for \$515,000, approved on 16 December).

46. **GBBs.** Governance, institutional, and financial issues left unaddressed for a long period have reduced significantly the potential service delivery capacity of GBBs. The RFSDCP reforms will support the completion of GBB divestment. The recapitalization support for viable GBBs will be considered under subprogram II, subject to the SPR.

### **c. Supportive Legal and Regulatory Framework**

47. The Government will consolidate the fragmented and ineffective supervisory and regulatory mechanisms for all financial intermediation entities that are not supervised by NRB. This process is required to address the concerns regarding proliferating cooperatives and RFIs that are supervised and regulated ineffectively. RFSDCP supports the development and adoption of an appropriate supervision and regulation system for RFIs that would remain outside BFIO.<sup>45</sup> The output targets under subprogram I are (i) enacting a legal and regulatory framework, (ii) establishing a supervisory authority, and (iii) initiating licensing and supervision of RFIs. Supervision and regulation functions will be strengthened under subprogram II.

### **d. Sector Capacity Building**

48. Irrespective of the type of institution, the need for capacity building for the financial sector to enhance the sustainable outreach of RF services is pervasive. An autonomous training institution on comprehensive banking and finance subjects will be established, incorporating the existing training facility of ADBL, with NRB, ADBL, and other financial institutions as shareholders.<sup>46</sup> The training establishment will address capacity building needs of formal and semiformal RFIs. In addition, the training establishment will help rural communities to improve financial literacy and access RF services. Subprogram I will field consultant experts for the initial 2 years to help make the training institute operational. Subprogram II will enhance its training delivery.

### **e. Product and Process Innovations**

49. The RF sector in Nepal is concentrated on a single product, i.e., credit. With limited access to diversified financial products, the rural poor have scarce opportunities to save, invest, and mitigate risks. Reducing the vulnerability of rural households, as well as the risk perception of the RFIs, is important to induce economic activities in the context of post-conflict rehabilitation. A pilot crop insurance scheme for up to four districts will be initiated with the assistance of international and national consultants. In addition, capacity development support will be provided to important RFIs to help them develop, market, and implement diversified RF products, including savings, micro-insurance, and remittance services. Outputs under subprogram I will be a review of the results of the pilot, as well as initiation of diversified products and services by important RFIs.

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<sup>45</sup> ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Kingdom of Nepal for the Corporate and Financial Governance Project*. Manila.; and ADB. 2000. *Technical Assistance to the Kingdom of Nepal for Institutional Strengthening of Nepal Rastra Bank for Regulation and Supervision of Rural Finance*. Manila.

<sup>46</sup> The existing training institute of ADBL will be incorporated as a limited company with ADBL, NRB, and private financial institutions as shareholders. For the first 2 years, support for operational and training expenditures, as well as transferring management skills to the local stakeholders, will be provided. For this, 56 person-months of consultant inputs will be provided (Supplementary Appendix K).

#### 4. Important Features

50. RFSDCP focuses on post-conflict rehabilitation and poverty reduction within the framework of financial sector reform. RFSDCP adopts a conflict-sensitive approach by (i) prioritizing the RF outreach to the lower segment of the RF market in institutional reform and restructuring, (ii) emphasizing links between the institutional and financial services and community-based groups, and (iii) instituting good governance and a code of conduct as a prerequisite in institutional restructuring.

51. **Private Sector Participation in RFIs.** RFSDCP includes a road map for increasing private ownership of ADBL.<sup>47</sup> A phased increase of the private sector's stake will be pursued to ensure efficient resource allocation and good governance.<sup>48</sup> The divestment of the Government shares in ADBL and the IPO will be initiated to meet the BFIO requirement of 30% public shareholding. Privatization options also will be developed as part of the policy conditions under subprogram II.

52. **Emphasizing RF Outreach.** As part of ongoing financial sector reforms, rural branch networks of commercial banks have been rationalized rapidly to streamline operational costs by eliminating unviable branches. Given the scarce presence of RF in rural areas, conventional institutional restructuring through rationalization of branch networks is not a preferred option under RFSDCP. ADBL will be restructured under the regional business center structure, which regionalizes management of rural outlets, while continually expanding outreach to areas without significant security concerns.

53. **Link With CBOs.** With institutional financial services in rural areas severely limited, RF service delivery through CBOs is the most effective way to reach the lowest segment of the RF market. By supporting SFDB, RFSDCP will facilitate an effective link between the formal RFI and small farmer cooperatives. The SFDB restructuring plan for SFDB will reflect the close links with GTZ's ongoing Rural Finance in Nepal Project, which supports developing the capacity of small farmer cooperatives to deliver effective microfinance services.

54. **Good Governance and Code of Conduct.** Cognizant that good governance is crucial to achieving the sector reform and institutional restructuring objectives, RFSDCP places good governance and adherence to the code of conduct at the center of the ADBL restructuring. To assess the existing governance issues, as well as the implementation capabilities of the Government and ADBL, a good governance and anticorruption assessment was carried out (Appendix 6 and Supplementary Appendix H). RFSDCP incorporates measures to ensure good governance, including (i) establishing a governance committee at the ADBL Board of Directors, (ii) strengthening the audit system through the establishment of an audit committee of the ADBL, and (iii) providing capacity development assistance for the implementation of the governance aspect of the ADBL restructuring.

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<sup>47</sup> Stieglitz, Joseph E. 1993. *The Role of the State in Financial Market*. Washington, DC: World Bank. If the net social returns to efficient financial operations are greater than the returns perceived by private capital, a public sector role can be rationalized on grounds of market failure due to the information and enforcement problems, and high transaction costs, in rural areas. However, rationalization for inefficiency or imprudent practices, which essentially represent policy and institutional failures, is not found.

<sup>48</sup> Robinson, M. 1994. *Financial Intermediation at the Local Level from Indonesia. Part II; A Theoretical Perspective*. Cambridge, M.A.: Harvard Institute of Development Studies, Harvard University. The large private sector banks got interested and are now operating in rural areas only after the public sector banks proved that RF operations can be profitable. BRI successfully undertook a large initial public offering in 2005.

## **5. Financing Plan**

55. As proposed, ADB will provide a loan of \$56 million from its ADF resources for subprogram I of RFSDCP, with a term of 24 years, including a grace period of 8 years. The loans will have an annual interest rate of 1.0% during the grace period and 1.5% thereafter, as well as other terms and conditions set forth in the Loan Agreement.

56. The ADB fund is to support the institutional reforms and restructuring of ADBL to meet the required adjustment costs. The estimated adjustment cost of \$145 million for ADBL restructuring includes (i) conversion of the Government's loan to ADBL (\$65 million) into non-voting preference shares of ADBL, (ii) performance-linked equity in the form of non-voting preference shares from the Government to ADBL (\$65 million), and (iii) reducing staff size of ADBL through a voluntary retirement scheme (\$15 million). The Government will use the proceeds of the policy loan to recapitalize ADBL through cash subscription of additional preference shares, which will be divided into redeemable and irredeemable shares. The Government has converted its loan of \$65 million to ADBL into non-voting preference shares of ADBL. By specifying the entire counterpart fund in cash to ADBL as preferential shares, the financing modality of RFSDCP provides the Government with no flexibility in the use of the program loan funds, and enables a precise flow of funds that can be monitored.

## **6. Implementation Arrangements**

### **a. Program Management**

57. The MOF, the Executing Agency, will establish a program management unit (PMU), headed by a program director with the rank of joint secretary, to coordinate, monitor, and supervise program implementation. The program director will be assisted by a full-time staff recruited with the project grant support (para. 75), and with qualifications and experience satisfactory to ADB.

58. NRB, ADBL, and SFDB will be the implementing agencies. NRB will handle sector capacity building, supportive legal and regulatory framework, and product and process innovation. ADBL and SFDB will be responsible for institutional reform and restructuring of their respective organizations. NRB, ADBL, and SFDB will set up program implementation units (PIU). To facilitate the implementation of policy reforms under its responsibilities, each PIU shall have a PIU director supported by one specialist staff member, with qualifications and experience acceptable to ADB. PIUs will (i) ensure smooth implementation of the Project, (ii) produce and submit progress reports on time, and (iii) liaise with the PMU for the implementation of the Project. The PIU director will report to the program director.

59. MOF will set up a program steering committee (PSC), chaired by the MOF secretary, with membership comprising the general manager of ADBL; general manager of SFDB; program director; senior representatives of National Planning Commission, Ministry of Agriculture and Cooperatives, and Ministry of Land Reform and Management; and deputy governor of NRB. The PSC will (i) provide policy and technical guidance to the PMU and PIUs, (ii) review the progress of program implementation, (iii) monitor the performance of the PMU and PIUs, and (iv) ensure program coordination. The PSC will meet at least quarterly. The program organization chart is in Supplementary Appendix I.

**b. Implementation Period**

60. The two cluster subprograms of RFSDCP will be implemented over 5 years, from 2007 to 2011. The implementation period of subprogram I is 2 years, from January 2007 to December 2008. Based on the implementation progress under subprogram I and the SPR, the proposal for funding subprogram II is expected to be submitted for ADB Board consideration in 2009. The program implementation schedule is in Appendix 7.

**c. Procurement and Disbursement**

61. In accordance with provisions of ADB's *Simplification of Disbursement Procedures and Related Requirements for Program Loans*, the proceeds of the program loan will be disbursed to the Government as the Borrower. The proceeds of the program loan will be utilized to finance the full foreign exchange costs (excluding local duties and taxes) of imports produced in, and procured from, ADB's member countries, other than those specified in the list of ineligible items (Appendix 8) and imports financed by other bilateral and multilateral sources. The Government will certify that (i) the value of the country's eligible imports is equal to, or exceeds, the amounts of ADB's projected disbursements under the policy loan in a given period; and (ii) the policy loan proceeds will be utilized in a manner satisfactory to ADB. The policy loan proceeds will be disbursed based on the certification provided by the Government, which confirms that the requirements for the policy loan have been met. ADB will have the right to audit the use of the loan proceeds, and to verify the accuracy of the Government's certification.

**d. Counterpart Funds**

62. The Government will transfer the counterpart funds in cash to ADBL for the recapitalization by subscribing to the non-voting preference shares, equally divided into redeemable and irredeemable shares. The precise definition of counterpart funds, with an explicit expenditure commitment, will ensure that the ADB loan proceeds will be utilized for intended purposes. The Government and ADB will monitor the use of counterpart funds linked to the progress of ADBL restructuring and attainment of performance benchmarks (Appendix 2, Table A2.4; Appendix 4).

**e. Tranche Release and Monitoring**

63. The program loan of subprogram I will be released in two tranches. More resources will be allocated in the first tranche to meet the immediate resource requirements of the Government for rural investments, as emphasized in the FY2007 budget. In addition, the Government has converted \$65 million in debt to ADBL into equity of ADBL for the restructuring (para. 56). The first tranche for the equivalent of \$40 million will be released upon loan effectiveness. The second tranche of \$16 million will be released 12 months after the first tranche, subject to compliance with the conditions for their release.

**f. Accounting, Auditing, and Reporting for the Program Loan**

64. At ADB's request, the use of the loan proceeds will be audited. ADB will retain the right to audit any account relating to subprogram I, and to verify the validity of the certification issued by the Government for each withdrawal application. Before withdrawal, the Government will open a deposit account at NRB to receive the loan proceeds. The Government will establish, manage, operate, and liquidate the account in accordance with terms satisfactory to ADB.

65. The PIUs will submit quarterly progress reports to the PMU, as well as additional information and analysis to the PMU as appropriate or required. The PMU, in turn, will submit to ADB reports on policy and institutional reform implementation. The reports will include a quarterly report, annual report, and midterm review report. The reports will be submitted in such form and in such detail as ADB may request, and should include (i) progress made and problems encountered during the period under review; (ii) steps taken, or proposed to be taken, to remedy problems encountered; (iii) proposed detailed activity for RFSDCP implementation; and (iv) expected progress during the next review period. MOF will submit a program completion report within 3 months of subprogram I completion.

66. The Government also will ensure that, within 18 months of the loan effectiveness date, ADBL will undertake a performance audit. An independent and external auditor will conduct the audit, which shall focus on operational and financial activities, and will recommend time-bound measures to further improve its accountability and transparency. Based on the recommendations of the performance audit, the Government will ensure that, within 6 months of the submission of the audit report, ADBL will implement these recommendations to the satisfaction of ADB.

#### **g. Program Performance Management System**

67. The PMU will establish and maintain a program performance management system that will include a database on the status of policy measures and program indicators based on the policy matrix. This will be linked with the project performance management system (para. 86).

#### **h. Program Review**

68. ADB and the Government will conduct semiannual reviews throughout the implementation of subprogram I to identify further actions required for the continued development of the RF sector. PSC will undertake an SPR for the Program (as the first subprogram cluster), based on the implementation of the studies undertaken, as well as the experience gained under subprogram I and the Project. This will reflect the changes that might occur in the external policy environment during the program period. The first SPR will be undertaken before the release of the second tranche under subprogram I to (i) review compliance with the second tranche conditions, (ii) identify initial lesson learned, and (iii) formulate the initial outline for the subsequent subprogram under RFSDCP. The final SPR will be undertaken before subprogram II starts to examine and finalize the design of subprogram II.

### **B. The Project Grant**

#### **1. Objective**

69. The objective of the project grant is to support the Government's RF sector reform and restructuring efforts by facilitating institutional reform and restructuring of essential RFIs, and improving sector capacity and governance. The Project will be implemented over 2 years, from January 2007 to December 2008.

#### **2. Components and Outputs**

##### **a. RFI Restructuring**

70. **RFI Restructuring: ADBL.** The grant will support the implementation of ADBL restructuring processes identified in the ARP with domestic and international consultant experts.

These processes cover (i) governance, (ii) systems, (iii) business processes, (iv) products and services, (v) human resource development, and (vi) information technology.

71. **RFI Restructuring: SFDB.** The grant will finance capacity development support for SFDB to (i) develop and finalize the SFDB restructuring plan; and (ii) implement the priority restructuring areas of microfinance and banking operations, staff capacity building, and accounting and auditing.

**b. Supportive Legal and Regulatory Framework**

72. NRB will be assisted in (i) reviewing the legal and regulatory arrangements for supervision and regulation of RFIs, (ii) developing an appropriate legal framework for RFI supervision and regulation, and (iii) implementing licensing and supervision of MFIs.

**c. Sector Capacity Building**

73. The Project will support the establishment of a training institute in banking and finance, which will incorporate the existing training unit. ADBL, NRB, and other private financial institutions will be shareholders of the new center (para. 48 and footnote 46). The support will be used to (i) develop training curricula, (ii) assess training needs for banks and nonbank financial institutions, (iii) conduct in-class and off-site training for RF operations, (iv) design in-house training programs for RFIs, and (v) arrange training programs for financial literacy improvement of rural communities in coordination with NGOs. Such assistance will cover staffing, library, equipment, and costs of recurring training.

**d. Product and Process Innovations**

74. The grant will cover the development of a pilot crop insurance plan and implementation of a pilot crop insurance scheme, which will be implemented in at least four areas. Replication of the plan will be considered under subprogram II, subject to the successful outcome of the pilot. The grant also will provide technical support for product development and marketing for savings, insurance, and remittances to RFIs. Technical support on product development will be arranged through the training institute.

**e. Project Management Support**

75. The Project will support the establishment and operations of the PMU and PIUs through the fielding of an RF specialist and an accounting specialist.

**3. Financing Plan**

76. The project cost is estimated at the equivalent of \$11.47 million, as detailed in Table 1. The financing plan is in Table 2. The Government and RFI contributions include counterpart staff salaries, office expenses, training, local travel, and other costs. The detailed cost estimates and financing plan are in Appendix 9 and Supplementary Appendix J.

**Table 1: Project Cost Estimates**  
(\$ million)

Item	Total Cost	Total Costs (%)
<b>A. Base Cost</b>		
A. Institutional Restructuring and Reforms		
1. Agricultural Development Bank of Nepal	6.4	55.6
2. Small Farmers Development Bank	0.5	4.3
<b>Subtotal</b>	<b>6.9</b>	<b>59.9</b>
B. Supportive Legal and Regulatory Framework	0.7	6.1
C. Sector Capacity Building	1.6	14.1
D. Product and Process Innovations	0.6	4.9
E. Project Management Support	1.0	8.7
<b>Total Base Cost</b>	<b>10.8</b>	<b>93.7</b>
1. Physical Contingencies	0.5	4.7
2. Price Contingencies	0.2	1.6
<b>Total Cost To Be Financed</b>	<b>11.5</b>	<b>100.0</b>

Source: Asian Development Bank estimates.

**Table 2: Financing Plan**  
(\$ million)

Source	Amount	Percent
Asian Development Bank	8.70	75.9
Government	1.71	14.9
Rural Finance Institutions	1.06	9.2
<b>Total</b>	<b>11.47</b>	<b>100.0</b>

Source: Asian Development Bank estimates.

#### 4. Implementation Arrangements

##### a. Project Management

77. MOF, as the Executing Agency, is responsible for the implementation of the Project. NRB, ADBL, and SFDB will be the implementing agencies. NRB will handle sector capacity building, supportive legal and regulatory framework, and product and process innovation. ADBL and SFDB will be responsible for institutional reform and restructuring of their respective organizations. The PMU and PIUs established under subprogram I also will assume certain roles and responsibilities under the Project. The program organization chart is in Supplementary Appendix I. The roles and responsibilities of the PMUs are to (i) supervise and advise PIUs on project implementation, (ii) recruit consultants and award procurement contracts, and (iii) arrange PSC meetings. The roles and responsibilities of the PIUs are to (i) ensure smooth implementation of the Project, (ii) produce and submit progress reports on time, and (iii) liaise with the PMU on project implementation. The PSC established under the Program will have the same functions for the Project.

##### b. Procurement

78. The procurement of goods, related services, and works financed by the grant will follow procedures outlined in the ADB's *Procurement Guidelines (2006)*. Goods and equipment for an MIS package for ADBL, estimated to cost \$1 million equivalent or more per contract, will be procured using international competitive bidding. Goods and equipment contracts estimated to cost between \$100,000 and \$1 million will be procured through national competitive bidding. Goods and equipment to be procured through national competitive bidding include all types of

office furniture, computer (stand-alone), computer peripherals, and office equipment. Contracts that cost \$100,000 or less may be procured through shopping. Before commencement of national competitive bidding, ADB and the Government will review the Government's procurement procedures to ensure consistency with ADB requirements. Any necessary modifications or clarifications to the Government's procedures will be documented in the procurement plan. The procurement plan is in Appendix 10.

### **c. Consulting Services**

79. Consulting services will be procured in accordance with ADB's *Guidelines on the Use of Consultants* (2006). The Project will finance approximately 26 person-months of international consulting services and 318 person-months of national consulting services. Where firms are to be engaged, the quality- and cost-based selection method will be used for selecting consultants. The terms of reference for consulting services are in Supplementary Appendix K.

### **d. Anticorruption Policy**

80. ADB's *Anticorruption Policy* was explained to, and discussed with, the Government, NRB, ADBL, and SFDB. Consistent with its commitment to good governance, accountability, and transparency, ADB reserves the right to investigate, directly or through its agents, any alleged corrupt, fraudulent, collusive, or coercive practices relating to RFSDCP. To support these efforts, relevant provisions of ADB's *Anticorruption Policy* are included in the grant regulations and the bidding documents for the Project. In particular, all contracts financed by ADB in connection with RFSDCP shall include provisions specifying the right of ADB to audit and examine the records and accounts of NRB, ADBL, and SFDB, as well as all contractors, suppliers, consultants, and other service providers as they relate to RFSDCP.

81. Specifically, RFSDCP has been designed to reduce vulnerability to corruption by seeking to ensure that

- (i) the board of financial institutions are aware of the possibility of corruption and mismanagement in their own institutions, and can demonstrate how they are dealing with these problems;
- (ii) adequate steps to enhance corporate governance are taken in all relevant institutions;
- (iii) all relevant institutions and the Government give assurances that they will abide by transparency and disclosure stipulations, as specified by NRB; and
- (iv) rigorous monitoring mechanisms are put in place to ensure that proper accounting is made continually of, among others, mandated actions and full fund flow management.

82. Further, during program implementation, ADB will review regularly the reports of audit authorities to assess (i) the nature of financial and administrative irregularities, (ii) pilferage of funds, and (iii) how the financial institutions have responded to the findings. During regular review missions, governance and anticorruption risks assessments will be updated as necessary. Details of anticorruption measures are in Supplementary Appendix H.

### **e. Disbursement Arrangements**

83. Immediately after the effectiveness date of the grant, an imprest account denominated in US dollars will be established at NRB. The imprest account will be operated and maintained in accordance with ADB's *Handbook on Loan Disbursements* (January 2001). ADB will advance

into the imprest account 6 months of estimated expenditures, or 10% of the grant amount, whichever is lower. The Government uses the imprest account to pay contractors, suppliers, and others for ADB's share of eligible project expenditures incurred in local and foreign currency. ADB's statement of expenditure procedure will be used to reimburse eligible expenditures, and to liquidate and replenish the imprest account for individual payments not exceeding \$50,000.

#### **f. Accounts, Auditing, and Reporting**

84. The PMU will maintain separate records and accounts for the imprest fund and project expenditure in accordance with sound accounting principles, and will have such accounts and records audited annually by auditors acceptable to ADB. Auditors satisfactory to ADB will audit the use of the imprest account and statement of expenditures procedures. The Government is requested to submit the audited financial statements for project accounts and imprest funds to ADB not more than 6 months following the end of the fiscal year. Independent auditors acceptable to ADB will audit ADBL and SFDB accounts annually. The Government will ensure that audited accounts of ADBL and SFDB will be submitted to ADB within 6 months of the end of financial year. Audited financial and operational information will be made available on the ADBL and SFDB Websites. MOF will submit a program completion report within 3 months of RFSDCP completion.

85. The PMU will submit reports to ADB on the use of the loan proceeds, project administration, and financial management. The reports will be submitted quarterly and annually. The reports will cover (i) information on project expenditures; (ii) highlights of audit reports of ADBL; other RFIs; and RF operations of commercial banks; (iii) training activities under the Project; and their impact; and (iv) performance of the pilot crop insurance scheme. The project completion report will be submitted to ADB within 3 months of project completion.

#### **g. Project Performance Management System**

86. ADBL and SFDB each will establish and maintain a project performance management system that will generate semiannual reports. The performance management reports will comprise (i) financial reports covering loan portfolio growth and performance; liability growth and management, especially of savings deposits; and financial performance indicators, including capital adequacy ratio, collection rate, operating profit ratio, and nonperforming loan ratio; (ii) details of the number of borrowers by gender, poverty classification, type of services, and size of transactions; (iii) information on the performance of staff, measured by financial volume, number of customers, and earnings ratios; (iv) information on planned and actual levels of activities, as specified in the design and monitoring framework (Appendix 5); and (v) annual financial statements. A format for assessing the impact of the services rendered under the Project on poverty reduction also will be developed.

#### **h. Project Reviews**

87. ADB and the Government will undertake semiannual reviews of project implementation. The reviews will evaluate the (i) project scope, (ii) implementation arrangements, (iii) implementation of ADBL's restructuring plan, (iv) progress on the policy reform agenda, and (v) capacity building measures. ADB and the Government also will undertake the midterm review to evaluate physical and financial progress, implementation procedures, procurement, and performance of consultants, including that of the attached TA.

#### IV. TECHNICAL ASSISTANCE

88. A TA grant of \$500,000 from the Japan Special Fund resources is attached to subprogram I of RFSDCP to assist with the implementation of ADBL's restructuring plan. The TA will recruit an international chief technical advisor and a domestic internal audit specialist for 12 months each, and an international MIS specialist for 6 months to advise ADBL's Board of Directors and management on all facets of the restructuring. The consultants will be recruited through a firm using the quality- and cost-based selection method with biodata technical proposal. The TA cost is estimated at \$600,000. MOF is the Executing Agency. ADBL, as the Implementing Agency, will finance the equivalent of \$100,000 to cover office accommodation, transport, and administrative expenses. The cost estimates and terms of reference of the TA consultants are in Supplementary Appendix L.

#### V. PROGRAM BENEFITS, IMPACTS, AND RISKS

##### A. Benefits and Impacts

##### 1. Policy

89. By addressing the systemic policy issues of the RF sector, the Program will improve the RF market environment and reduce the Government's direct involvement in RF. The right market conditions will induce healthy competition among formal and semiformal RFIs, as well as facilitate cost-efficient and client-centered RF services. ADBL restructuring will provide incentives for RFIs' self-resource mobilization through savings and demand-led rural lending.

##### 2. Institutional

90. As the largest RFI in the country, ADBL will establish the benchmark for RF operations. Divestment of the Government shares in ADBL, and movement towards its privatization, will encourage commercial banks to enter the RF market. Privatization of SFDB also will be pursued through the divestment of ADBL shares in SFDB, and by increasing the shareholder participation of small farmer cooperatives. The privatization of GBBs will continue to be supported.

##### 3. Economic and Financial

91. RFSDCP will generate a significant number of jobs and enhance incomes. Direct employment will be generated by developing small and microenterprises. Enhanced financial and institutional sustainability of RFIs will enable them to mobilize deposits safely, and deploy them more efficiently in credit, facilitating the flow of resources to rural areas. Improved financial viability of RFIs will reduce significantly the Government's budgetary burden.

##### 4. Environmental

92. Environmental implications of farm and non-farm activities have been assessed. As clients engage mainly in subsistence farming on a limited scale, no negative environmental impacts are expected. Environmental classification of RFSDCP is category C.<sup>49</sup> The environmental assessment is in Supplementary Appendix M.

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<sup>49</sup> A project is classified as one of the environmental categories (A, B, C, or FI). If a project is categorized C, it unlikely has adverse environmental impacts.

## 5. Social and Poverty

93. RFSDCP is expected to reduce poverty, contributing to stability and the peace process in rural areas. Increased financial intermediation will help farmers to increase their productivity and support private farm and non-farm enterprises, which will generate jobs for the rural poor. RFSDCP will not have any adverse impact on indigenous peoples. The summary poverty reduction and social strategy is in Appendix 11. The poverty impact assessment is in Supplementary Appendix N.

### B. Risks

94. The success of RFSDCP depends on a number of assumptions that are subject to risks (Appendix 6). The main risks would include (i) inadequate staff capacity in RFIs and regulatory bodies to implement the reforms; (ii) lack of Government commitment to reforms; (iii) weak boards in RFIs, and generally weak capacity in them; and (iv) deterioration in the security situation. To manage these risks and minimize residual risks, the Project has several ongoing and proposed mitigating measures.

95. **Continued Commitment for Reform.** As the Government is in transition, reform policy of financial institutions, especially on privatization and the role of RFIs, might change. The Government has provided assurances regarding the implementation of the reforms, with strict adherence to the law. The Government is fully committed to the restructuring of ADBL, as demonstrated by the conversion of the Government debt to equity in ADBL (para. 43). Further, the Government recognizes the importance of strengthening ADBL operations for effective services and poverty reduction.

96. **Fiduciary Management.** The most recent update of Nepal's Country Financial Accountability Assessment, carried out in May 2005 by World Bank and the Department for International Development,<sup>50</sup> concluded that, despite some progress, substantial issues remain and Nepal's fiduciary risk is still considered high. However, by specifying that the program loan proceeds be used for the recapitalization of ADBL, RFSDCP provides a clear framework for fiscal control. As a class A institution under BFIO, ADBL is subject to NRB supervision. Further, regular progress monitoring of the restructuring process, and internal and external audits of ADBL, will ensure that the funds are used for the intended purpose. The financial management assessment is in Supplementary Appendix O.

97. **Local Level Security.** Though the overall security situation has improved, the situation in some parts remains tenuous. As a result, expected outreach expansion and new product service delivery might be delayed in those areas. While the restructuring of ADBL does not include area-specific priorities, the regional business center structure allows a regional center to manage and control the outreach expansion and service delivery through local outlets. This will enable the regional center to engage in rural outreach selectively, starting from low-risk areas and expanding to other areas as the security situation improves.

98. **Implementation Capacity and Conceptual Changes.** The reform of RF policies and the restructuring of RFIs require understanding of the new RF sector policies and the skill sets to implement the activities. Government officials might have difficulty changing their mindsets and formulating sector policies from private sector-oriented perspectives. At the onset of the Program, therefore, an intensive initial orientation program will be conducted for them. The new

<sup>50</sup> Department for International Development, World Bank. 2005. *Nepal's Country Financial Accountability Assessment*. Kathmandu.

business processes of ADBL require different skill sets that long-serving ADBL employees might not have. In 2006, the first voluntary retirement scheme released approximately 350 staff members whose skills were not in line with the requirements under the new business process. ADBL is planning a second voluntary retirement scheme in 2007, while simultaneously recruiting new staff members to better fill the skills gap.

99. **Private Sector Perception.** The private sector's confidence to invest in RF in Nepal depends on whether the Government and RFIs can produce successful outcomes as a result of the reform. Any redirection of the reform policies, or delay in RFI restructuring processes, might cause the private sector to lose confidence. The measures under RFSDCP to improve investor confidence includes (i) up-front recapitalization of ADBL to meet the minimum capital requirement, (ii) rigorous monitoring of the implementation of the restructuring process to meet the performance benchmark, and (iii) support to NRB for supervision of good governance and sustainability of RFIs.

100. Notwithstanding these risks (paras. 94–99), program implementation is not likely to be affected given the following:

- (i) The conflict in Nepal has subsided almost completely, permitting development activities throughout all rural areas after more than a decade.
- (ii) The outputs and outcomes of RFSDCP will address the root causes of rural poverty, helping to mitigate the revival of conflicts.
- (iii) RFSDCP takes a conflict-sensitive approach, which assesses risks and incorporates mitigating measures in the program design and implementation.

## **VI. ASSURANCES**

101. In addition to the standard assurances, the Government has given the following assurances, which have been incorporated in the legal documents:

### **A. The Program Loan**

- (i) The Government will (a) maintain the policies adopted and actions taken prior to the date of the Loan Agreement for the program loan, as described in the development policy letter and the policy matrix, for the duration of RFSDCP and subsequently; (b) promptly adopt the other policies and the other actions included in RFSDCP as specified in the development policy letter and the policy matrix; and (c) ensure that such policies and actions continue in effect for the duration of RFSDCP and subsequently.
- (ii) The Government will ensure that the pilot crop insurance scheme will be implemented to the satisfaction of ADB.
- (iii) The Government will ensure that any actions taken by the Government in respect of the operations of ADBL will be done in accordance with the prevailing laws and regulations and promote financial soundness and operational viability of ADBL.
- (iv) The Government will ensure that ADBL will promptly inform ADB of any change in its board of directors or its General Manager, and ensure that any such change

will be made in accordance with the prevailing laws and regulations and its Memorandum and Articles of Associations.

- (v) The Government will ensure that ADBL will carry out its banking operations in accordance with the provisions under BFIO and prudential norms prescribed by NRB under its directives throughout the implementation of the Program and subsequently thereafter.
- (vi) The Government will ensure that ADBL will adopt and implement good corporate governance norms and practices prescribed by the relevant regulatory institutions throughout the implementation of the Program and subsequently thereafter.
- (vii) If requested by ADB, the Government will undertake an audit of the use of loan proceeds. Further, ADB retains the right to (a) audit any account relating to the Program, and (b) verify the validity of the certification issued by the Government for each withdrawal application.
- (viii) Within 12 months from the loan effectiveness, the Government will ensure that ADBL will have acquired and installed forensic accounting ability to support the Audit Committee to track and minimize corruption cases.
- (ix) Within 6 months of the loan effectiveness, the Government will ensure that ADBL will have established the necessary mechanisms required for the full implementation of its Code of Conduct to the satisfaction of ADB.
- (x) Within 18 months of the loan effectiveness, the Government will ensure that ADBL undertakes a performance audit to be conducted by an independent and external auditor, which will focus on its operational and financial activities, and will recommend time-bound measures to further improve its accountability and transparency. Based on the recommendations of the audit, the Government will ensure that within 6 months of the submission of the audit report, ADBL will have implemented these recommendations to the satisfaction of ADB.

## **B. The Project Grant**

- (i) The Government will ensure that throughout the implementation of the Project, adequate budgetary allocations of the required counterpart funds are made, approved, and released in a timely manner to ensure proper project implementation.
- (ii) In case of natural calamities and unforeseen circumstances that affect the equity and liquidity of ADBL, SFDB, and other key RFIs under RFSDCP, ADB will be consulted immediately and a remedial action plan acceptable to ADB will be prepared within 1 month thereafter.
- (iii) The Government and ADB acknowledge and agree that if there is a significant shortfall in the achievement of agreed performance indicators by ADBL as specified in ARP, ADB will carry out a special financial and operational review of ADBL and reach agreement with ADBL and the Government regarding implementation of the recommendations of the review. It is further agreed that until such agreement has been reached, no disbursement under the Project shall be made.

- (iv) The Government will ensure that the lending operations of ADBL, SFDB, and other key RFIs will be carried out in accordance with all applicable environmental laws and regulations of the Government and with ADB's environmental policies and procedures.
- (v) The Government will comply with—and will cause ADBL, SFDB, and NRB to comply with—ADB's *Anticorruption Policy*. The Government (a) acknowledges that ADB's right to investigate, directly or through its agents, any alleged corrupt, fraudulent, collusive, or coercive practices relating to the Project; and (b) agrees to cooperate fully with, and to cause ADBL to cooperate fully with, any such investigation and to extend all necessary assistance, including providing access to all relevant books and records, as may be necessary for the satisfactory completion of any such investigation.
- (vi) The Government will (a) ensure that ADBL, SFDB, and NRB conduct periodic inspections on the activities of the contractors, suppliers and consultants related to fund withdrawals and settlements under the Project; and (b) ensure that—and will cause ADBL, SFDB, and NRB to ensure that—all contracts financed by ADB in connection with the Project include provisions specifying the right of ADB to audit and examine the records and accounts of ADBL, SFDB, NRB, and all contractors, suppliers, consultants, and other service providers as they relate to the Project.

## VII. RECOMMENDATION

102. I am satisfied that the proposed loans and grant would comply with the Articles of Agreement of ADB and recommend that the Board approve

- (i) the sector development program cluster of \$91,000,000 for the Rural Finance Sector Development Cluster Program in Nepal;
- (ii) the loan in various currencies equivalent to Special Drawing Rights 37,906,000 to Nepal for subprogram I of the Rural Finance Sector Development Cluster Program from ADB's Special Funds resources, with an annual interest rate of 1% during the grace period and 1.5% thereafter; a term of 24 years, including a grace period of 8 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan and Program Agreements presented to the Board; and
- (iii) the grant not exceeding the equivalent of \$8,700,000 to Nepal for the Rural Finance Sector Development Project from ADB's Special Funds resources, in accordance with terms and conditions as are substantially in accordance with those set forth in the draft Grant and Project Agreements presented to the Board.

Haruhiko Kuroda  
President

3 October 2006

## SECTOR ANALYSIS

1. In the overwhelmingly rural and agrarian economy of Nepal, rural households demand a full range of financial services, including savings, credit, insurance, and remittance services, to engage in gainful productive activities. Although financial institutions have proliferated, financial service outreach remains shallow, reaching only 28% of the total population. Nepal's rural poor have not reaped the potential gains of the Government's efforts to liberalize the financial sector. The weak performance of the rural finance (RF)<sup>1</sup> sector and limited outreach are mainly due to (i) excessive public involvement in the sector, (ii) a weak regulation and supervision system, and (iii) inadequate institutional capacity. Fundamental sector reforms are required to address the policy and institutional bottlenecks for the development of the RF sector through (i) institutional reform and restructuring, (ii) development of a supportive regulatory framework, (iii) sector capacity building, and (iv) widening of products and services.

2. **Rural Finance Market Structure.** The demand profile stratifies the RF sector into three broad segments—upper, middle, and lower—that reflect the landholding pattern, nature of employment, and socioeconomic structure of the rural society. These segments are interdependent and inherently overlap. The upper segment includes agriculture commodity processors, wholesalers, and farmers with large holdings. The middle segment comprises petty traders, and small and tenanted farmers. The lower segment includes landless poor, as well as small, marginal, tenanted, and subsistence farmers. The middle and upper segments demand credit products, including (i) working capital; (ii) cash credit; (iii) loans against pledge of produce; (iv) and medium- to long-term loans for crop cultivation, rural transport, and land development. The lower segment primarily requires small and short- to medium-term loans for consumption, microenterprises, and crop cultivation.

3. **Rural Finance Supply Side.** Nepal's RF market comprises a range of heterogeneous institutions (Table A1.1). The formal RF sector that is supervised or registered with Nepal Rastra Bank (NRB)—the central bank—comprises (i) the Agricultural Development Bank Limited (ADBL); (ii) Small Farmers Development Bank (SFDB); (iii) five Grameen Bikash Banks (GBB), i.e., rural development banks; (iv) 17 commercial banks; (v) 11 private sector microfinance development banks; (vi) 19 savings and credit cooperative societies; (vii) 47 microfinance nongovernment organizations (NGO); and (viii) 63 finance companies. The semiformal sector, which is not supervised by NRB, comprises Government-sponsored rural credit programs, about 2,300 savings and credit cooperative societies registered under the Cooperative Act, and nearly 60 multisector NGOs. The Rural Microfinance Development Centre, an apex body, provides refinance and capacity building support to RF institutions (RFI) and their clients. The informal sector comprises money lenders, traders, friends, relatives, and about 12,000 community organizations.

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<sup>1</sup> RF can be classified as financial services provided to rural farm and non-farm households, a large proportion of which are poor and low-income households. Microfinance, as an RF subset, targets the poor. While RF institutions also service the poor, low-income households, and the non-poor, microfinance institutions (MFI) focus exclusively on the poor. Considering the demographics of Nepal, microfinance is primarily rural, though some MFIs also target the urban poor. In this article, the terms "RF" and "RFIs" include "microfinance" and "MFIs", respectively. The terms microfinance and MFIs are used only for specific microfinance-related references.

**Table A1.1: Formal Financial Intermediaries' Share of Total Assets**

<b>Institutions</b>	<b>Number of Institutions</b>	<b>Share in Total Assets (%)</b>
Commercial Banks	17	88.28
Finance Companies	63	6.94
Development Banks <sup>a</sup>	29	4.69
Microfinance Development Banks	11	0.01
Savings and Credit Cooperatives	19	0.06
Non Government Organizations <sup>b</sup>	47	0.02

Note. As of January 2006.

<sup>a</sup> Including Agricultural Development Bank Limited, and Nepal Industrial Development Cooperation.

<sup>b</sup> Those performing limited banking activities.

Source: Nepal Rastra Bank Banking and Financial Statistics.

4. Most of the formal financial institutions are concentrated in the urban and semi-urban areas, because the majority of modern economic activities take place in urban areas. Rural or urban populations at lower segments of income distribution have had difficulty accessing banks and other formal financial institutions. The majority of rural households, especially in the hill areas, have no access to institutional financial services. In most of the rural areas, ADBL, SFDB, and cooperatives provide RF services.

5. **Demand and Supply Gap.** The total rural credit requirement is estimated at NRs24.3 billion, while the total supply from the formal and semiformal sectors is estimated at NRs2.6 billion—meeting only 10% of the potential demand. The supply is primarily for credit and, to some extent, savings. On the supply continuum, the upper and middle segments have more access to formal financial sources, while the lower segment relies mostly on informal sources. Of the aggregate supply, nearly three fourths is from informal sources. ADBL and the rural branches of commercial banks concentrate primarily on the upper and middle segments of the RF sector. GBBs, SFDB, private sector microfinance banks, and NGOs focus on the lower end of the RF sector. ADBL accounts for nearly two thirds of rural credit.

6. **Public Intervention.** In response to rural poverty in a predominantly agricultural economy, the Government of Nepal (the Government) participated in, and controlled until recently, RF on the assumption that (i) access to cheap institutional credit could induce investment; (ii) intervention was required to ensure a sufficient flow of rural credit; and (iii) banks, both commercial and specialized, had a social responsibility to serve the rural clientele, even if it meant incurring losses. The Government pursued this approach through directed credit, state-owned RFIs, and loans at below-cost interest rates. In this environment, RFIs and commercial banks had little, if any, incentives to adopt sound practices and enhance portfolio quality through strict credit appraisal and delinquency management.

7. **Institutional Inadequacies.** Weak management that is not driven by the market, as well as deviation from best practice standards, has affected the sustainability of RFIs. RFIs suffer from weak governance, high transaction costs, and high nonperforming loans. Inadequate supervision has allowed these weaknesses to remain unattended. Financial and institutional constraints limit ADBL's capacity to expand its outreach. The ongoing restructuring of GBBs<sup>2</sup> has shown mixed results, and a turnaround of two of the five GBBs is unlikely. While NGOs are effective in reaching the rural poor, only a few large NGOs are moving towards self-

<sup>2</sup> The GBB restructuring process, which was initiated by the Government, includes the divestment of NRB's shares in GBBs, and the privatization of solvent GBBs. Of the five GBBs (Eastern, Central, Western, Mid-western, and Far western), the Eastern and Western ones have already been privatized.

sustainability. Only the private sector microfinance banks have an overall positive performance record, primarily due to better governance. The high-risk perception and politicization of the RF sector has deterred commercial banks from expanding their RF portfolios. As part of the ongoing restructuring of the two largest commercial banks, their branch networks in rural areas are likely to be reduced further.

8. **Limited Outreach and Range of Services.** Despite their extensive network, RFIs have inadequate outreach and are concentrated in the flat lands. The outreach in sparsely populated mountainous areas is negligible. The aggregate credit outreach from formal and semiformal institutions is estimated at 23% of the rural households. Given the limited access to credit, rural households have been restricted to borrowing levels that are substantially below their needs. Many borrowers in the middle and lower segments do not borrow because they are averse to risk, particularly when risk mitigation products and services are not widely available. Qualitatively, the supply side remains shallow, with a lack of variety, breadth, and range of services provided. The RF system is not in a position to provide credit products tailored to purpose, crop insurance, and remittance services to the majority of rural households. Despite some credit expansion, the availability of medium- to long-term credit in rural areas has remained limited. Further, the disturbed security situation in rural areas has accentuated RF sector weaknesses.

9. **Impact of Conflict on Rural Finance.** Despite the conflict during 1996–2006, the demand for RF services remained strong. The number of borrowing households from all sources grew during the conflict. Institutional credit also grew, mainly because commercial banks have become more reluctant to lend money in rural areas, while the demand for financial services from farmers and microenterprises has not waned. Some microfinance institutions and cooperatives remained stable or expanded during the conflict, while commercial banks became more focused on urban consumer lending and housing finance. Due to the conflict, weak cooperatives have been driven out or weakened further. Some of them have closed, while others have relocated to safer places. Microfinance NGOs, small farmer cooperatives with active members, and capable leaders have not been affected or recovered quickly.

10. **Strengthening the Rural Finance Sector.** Structural reforms in Nepal have brought a visible shift in financial sector policies. Financial markets are deepening, with institutional restructuring, product innovation, and expansion. This has established the foundation for fundamental RF reforms. The Government strategy for strengthening RF is broadly two-pronged. The first set of the strategy focuses on improving the (i) policy environment, (ii) financial governance, and (iii) supervisory and regulatory mechanisms. The second relates to (i) implementing institutional restructuring, (ii) strengthening the demand side, and (iii) enhancing sustainable outreach.

11. The most critical element in RF reforms is a policy change to shape the norms and incentives in which RFIs operate, and to enable the development of a sustainable RF subsector. Repressive interest rate controls have been removed, and mandatory priority sector credit requirements are being phased out. NRB is divesting ownership in GBBs; wherever possible, GBBs are being privatized, and their executive directors are being recruited from the market. Simultaneously, the Government and NRB have encouraged the establishment of private sector microfinance banks to enhance institutional diversity.

12. The enactment of the Banks and Financial Institutions Ordinance (BFIO) in 2004 created a legal framework that allows classes and types of institutions, including RFIs, to be established based on capitalization and scope of functions. In terms of BFIO, all RFIs will be subject to NRB

supervision and will be required to meet prescribed prudential norms. BFIO requires enhanced measures for good governance, disclosures, and reporting requirements in financial institutions. In addition, the Financial Intermediary Act 1998 provides a facilitating framework and a legal status for NGOs to participate actively in RF service delivery. Simultaneously, the supervisory and regulatory functions for NRB are being strengthened, and the possibility of a second tier regulatory arrangement for small RFIs is being explored. ADBL, as well as SFDB, can be turned around with institutional strengthening and capacity enhancement support. Sustained application of international best practices will be required to (i) enhance good governance and autonomy; (ii) improve financial, accounting, and management systems; and (iii) reduce transaction costs.

13. Given the infrastructure and skills deficit context in which most RFIs operate, RF reforms must be accompanied by investments in demand-side development that enable the rural poor, for instance, to utilize RF services effectively through better skills and access to markets. To address core poverty issues in conflict-affected areas, a flexible approach for reactivating, strengthening, or establishing new institutions is required. Further, innovations in products and services—such as for savings, remittances, and risk mitigation—must be supported. The emphasis on poverty reduction also will require sustained and specific support for RFIs that target the lowest segment of the RF sector, as well as arrangements aimed at enhancing the outreach of RF in remote and mountainous areas. In this context, expanding the role and coverage of the Rural Microfinance Development Centre will be important (Supplementary Appendix E).

14. The Government is pursuing an RF policy that places RF sector development in the broader perspective of financial sector development. The strategic elements suggest a shift to a demand-driven approach, where sustainable RFIs are expected to reach more clients and diversify products, thereby meeting rural people's diverse needs more effectively. However, for the ongoing reforms to succeed, sustained emphasis on good governance, transparency, and systemic depoliticization is imperative. The resulting sustainable system will reduce fiscal pressure, enabling increased investment in development.

## **AGRICULTURAL DEVELOPMENT BANK LIMITED**

### **A. Legal Framework, Objectives, and Ownership**

1. The Agricultural Development Bank Limited (ADBL)<sup>3</sup> was founded as the Agricultural Development Bank of Nepal (ADBN) under the ADBN Act in 1967. In 1968, ADBL assumed the assets and liabilities of the Cooperative Bank to provide credit for agricultural development, and absorbed the Land Reform Savings Corporation in 1973. The purpose of ADBL is to contribute to the development of agriculture and improvement of living standards of the rural population, and to make capital and loans available to the agriculture sector, according to the ADBN Act. ADBL has been the largest rural finance institution, supplying more than 67% of institutional credit in the country. Under the pre-2005 structure, the Government owned the majority (92.94%) of ADBN's shares, followed by individuals (4.87%), Nepal Rastra Bank (NRB) (1.98%), other companies (0.17%), and cooperatives (0.04%).

### **B. Management**

2. The ADBL Board comprises seven members, including the general manager of ADBL and representatives from NRB (the central bank); cooperative institutions; Ministry of Agriculture and Cooperatives; Ministry of Land Reform and Management; and Ministry of Finance. The ADBN Act gives the board powers to guide and control the general administration of ADBL. However, the board's role as the supreme decision-making and governing body of ADBL are limited, because timely and accurate information on ADBL's financial and operational position usually is not available due to insufficient management and information system capacity. In addition, the interests of clients and the Government often do not converge, and the current governance structure could force the board to act on behalf of the Government.

### **C. Organization, Staffing, and Personnel Administration**

3. With its head office in Kathmandu, ADBL operates 300 units, including one head office, 11 regional offices, 181 development banking branches, 45 commercial banking branches, 57 Small Farmers Development Program (SFDP) offices, and 5 regional training center branches. At the head office, ADBL has four deputy general managers who oversee 11 divisions. The organizational structure of ADBL is fragmented and duplicated with specialized support units within various departments across the organization. The roles and mandates of the divisions are not defined sufficiently, resulting in multiple lines of reporting and chains of command. ADBL has 3,985 staff. ADBL's ratio of clients per loan officer is high at approximately 450 clients per officer. Recruitment of staff is centralized, career planning and development, and an effective promotion policy are lacking. Due to the inefficient performance evaluation system, incentives and rewards do not necessarily stimulate increased productivity or foster initiatives. Staff also have limited training opportunities, a prerequisite for offering quality services to clients.

### **D. Operations**

4. ADBL's operations are broadly divided into three areas: development finance, commercial banking, and SFDP. The development finance operations provide loans for agricultural production and related activities, and include short-, medium-, and long-term loans.

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<sup>3</sup> The erstwhile Agricultural Development Bank of Nepal (ADBN) was incorporated and renamed the Agricultural Development Bank Limited (ADBL) in July 2005. In this appendix, ADBL is used throughout, even when referring to the pre-incorporated status. ADBN is used for the Act (ADBN Act), and to distinguish the status of ADBN from ADBL, as necessary.

ADBL's development finance loans account for more than 63% of the agriculture credit from the banking system. In addition to providing loans, ADBL also promotes agricultural technology to farmers, and operates the agricultural credit training institute and regional training centers to create awareness and develop the skills of borrowers.

5. Commercial banking activities include loans, deposits, guarantees, and money transfer services. Deposits are available for demand deposits, savings, and term deposits. Commercial loans of ADBL are provided for commercial, industry, overdraft, contract, and hire-purchase for construction, transportation, and services. ADBL has access to a savings and fixed-term deposit base of NRs30 billion, of which savings deposits accounted for more than 50%.

6. In addition to an agriculture development division and a commercial banking division, ADBL operates a small farmer development division, which manages and controls SFDP. Under SFDP, members from households with a per capita family income equal to or less than NRs2,500 form groups of 5–10 members. The groups are eligible to receive services of credit, savings, training, social and community development, and empowerment. ADBL provides loans to the groups for production, marketing, and other income and employment-generating activities. Savings facilities are provided as a mandatory activity to instill in the members a savings habit. ADBL also provides training and skills development for the members, including group management, savings mobilization, and skills for income-generating activities.

## E. Financial Performance

7. **Profitability.** ADBL's income was NRs2.8 billion in FY2005 (Table A2.1). Profit grew by 1% during fiscal year (FY) 2002, declined by 83% during FY2004, and has been negative since 2004 due to the provisioning required for writing off the bad debt. Stagnated profitability and significant portfolio growth until 2004 resulted in the deterioration of key ratios over the past 3 years (Table A2.2). Interest income, which accounted for 89% of the total income in FY2004, grew to 95% in FY2005—still lower than the 97.5% recorded in FY1999. Assets declined from NRs40 billion in FY2003 to NRs29 billion in FY2005 due to the change in income recognition and loan loss provisioning policies in accordance with NRB directives. ADBL went from a net profit of NRs16 million in 2003 to a loss of NRs79 million in 2005 due to the heavy provisioning required for the nonperforming loans.

**Table A2.1: Agricultural Development Bank Limited's Profit and Loss**  
(NRs million)

Item	FY2001	FY2002	FY2003	FY2004	FY2005
Average Assets	27,775	30,766	34,039	34,090	28,604
Average Equity	1,722	1,840	1,935	(2,234)	(6,002)
Average Earning Assets	22,469	25,383	28,726	32,062	–
Interest Income	2,987	3,320	3,555	2,892	3,915
Interest Expense	1,641	1,714	1,979	2,093	1,487
Net Interest Income	1,346	1,606	1,576	799	2,428
Other Income	137	152	201	354	422
Total Income	1,483	1,758	1,777	1,153	2,849
Average Loans	19,784	22,932	26,239	29,371	21,780
Average Deposits	16,446	19,293	22,375	25,097	26,734
Net Profit	93	94	16	(8,000)	(79)
Operating Expenses	880	1,114	1,175	1,147	1,190

– = not available, ( ) = negative, FY = fiscal year.  
Source: Agricultural Development Bank Limited.

8. **Operational Efficiency and Ratios.** Despite improvements in controlling certain costs, operational sustainability of ADBL remains low. Return on assets fell from 0.3% in FY2001 to -0.28% in FY2005. Return on equity also dropped from 5.4% in FY2001 to 0.8% in FY2003. Since 2004, ADBL has had negative net worth. However, important performance ratios have shown overall improvement, such as growth in yield on assets and decline in operation cost to total income. Yield on loans also has increased from 9.85% in FY2004 to 17.29% in FY2005.

**Table A2.2: Agricultural Development Bank Limited's Financial Ratios**  
(%)

Item	FY2001	FY2002	FY2003	FY2004	FY2005
Return on Average Assets	0.33	0.31	0.05	(23.02)	(0.28)
Return on Average Equity	5.40	5.11	0.83	—	—
Gross Yield on Assets	13.29	13.08	12.38	9.02	13.7
Cost of Funding	7.30	6.75	6.89	6.53	4.17
Net Interest Margin	5.99	6.33	5.49	2.49	7.75
Operating Cost to Total Income	59.34	63.37	66.12	89.59	41.77
Other Income to Total Income	9.24	8.65	11.31	30.70	14.81
Yield on Loans	15.10	14.48	13.55	9.85	17.29
Cost of Deposits	9.98	8.88	8.84	8.34	3.76
Credit to Deposit Ratio	120.29	118.86	117.27	117.03	120.25
Earning Assets to Total Assets	80.90	82.50	84.39	94.05	88.63

( ) = negative, — = not available, FY = fiscal year.

Source: Agricultural Development Bank Limited.

9. **Assets and Liabilities.** ADBL's total assets at the end of FY2005 stood at NRs29.3 billion (Table A2.3), a decline of 27% from FY2003, largely due to change in accounting policies. The share of development banking loans in the portfolio fell from 74% in FY1999 to 71% at the end of FY2005. Average annual rate of growth of the development banking portfolio during FY2003 was 8.6%, compared with 14.3% for the commercial banking portfolio. ADBL's liquidity position has declined since FY2003, and ADBL currently has negative net worth of NRs6 billion.

**Table A2.3: Agricultural Development Bank Limited's Assets and Liabilities**  
(NRs million)

Item	FY2001	FY2002	FY2003	FY2004	FY2005
<b>Asset</b>					
Cash and Bank Balance	2,702	2,520	2,766	2,911	3,035
Loans	21,030	23,774	24,253	20,922	22,638
Investment	2,576	2,326	2,647	702	338
Fixed Assets	1,405	1,746	603	865	816
Other Assets	4,185	4,798	10,050	3,448	2,836
Branch Account	244	0	0	(987)	(317)
<b>Total Assets</b>	<b>32,141</b>	<b>35,163</b>	<b>40,319</b>	<b>27,861</b>	<b>29,347</b>
<b>Liabilities</b>					
Due to Banks and Credit Institutions	5,091	4,440	4,053	5,959	6,028
Deposits and Savings	17,786	20,800	23,949	26,244	27,223
Other Liabilities	7,393	7,916	10,343	1,673	2,085
Other Reserves	89	110	424	—	—
<b>Total Liabilities</b>	<b>30,360</b>	<b>33,266</b>	<b>38,769</b>	<b>33,875</b>	<b>35,336</b>
<b>Capital</b>					
Core (Tier 1)	1,735	1,855	1,547 <sup>a</sup>	(6,014)	(5,989)
Supplementary (Tier 2)	47	42	—	—	—
<b>Total Liabilities and Capital</b>	<b>32,141</b>	<b>35,163</b>	<b>40,318</b>	<b>27,861</b>	<b>29,347</b>

( ) = negative, — = not available, FY = fiscal year.

<sup>a</sup> Breakdown of tier 1 and tier 2 capital is not available.

Source: Agricultural Development Bank Limited.

10. Borrowing fluctuated over the period, reaching nearly NRs4.0 billion at the end of FY2003, of which Government borrowing accounted for 77%. Domestic sources comprise funds from NRB, commercial banks, and the Government. Borrowing from commercial banks represents the requirement for 12% of their portfolio in priority sector lending and 3% in deprived sector lending. Priority sector lending is expected to be phased out by 2007. Deposits and savings were NRs27 billion at the end of FY2005, representing 93% of total liabilities and capital. The loan–deposit ratio increased between FY2004 and FY2005 from 1.25:1 to 1.17:1 due to the 8.2% growth of the loan portfolio during that period.

11. **Nonperforming Loans.** Based on the international practices of loan classification, 52.6% of the gross loan portfolio of NRs24.2 billion was estimated as performing in FY2003, while the remaining 47.4% was classified as nonperforming. In FY2005, 36.5% of the NRs31.3 billion in outstanding loans were nonperforming, according to the NRB classification. The NRB classification is less stringent than the international practices and the ratio of nonperforming loans is higher if adjusted to international practices. ADBL portfolio quality has deteriorated due to (i) weak loan appraisal, (ii) absence of credit risk management, (iii) inadequate internal audit controls, and (iv) political interference in loan collections.

## F. ADBL Restructuring Plan

12. In 2003, the Government conducted the operational and financial review of ADBL through technical assistance<sup>4</sup> funded by Asian Development Bank. The review found serious deficiencies in ADBL operations in terms of (i) loan appraisal, sanctioning, and disbursements; (ii) loan classification and provisioning; (iii) supervision and monitoring; (iv) management information system; (v) policies and procedures; (vi) loan rescheduling process; and (vii) staff skills and orientation. In addition, problems in realization of securities, natural calamities, rural security issues, deficiencies in the segregation of responsibilities for loan approval and management, and lack of preventive controls contributed to low repayments and huge accumulation of nonperforming loans.

13. The operational and financial review resulted in the ADBL restructuring plan (ARP), which is available in Supplementary Appendix F. In February 2004, the Government adopted the ARP as part of its commitment under the Poverty Reduction and Growth Facility of the International Monetary Fund.<sup>5</sup> ARP aims to bring about (i) fundamental reforms in governance, management, and business processes and services; (ii) divestment of the Government shares in ADBL; and (iii) the eventual privatization of ADBL. The Government has initiated reforms identified in the ARP: (i) incorporating the erstwhile ADBN as ADBL in July 2005, with authorized capital of NRs12 billion; (ii) initiating the recapitalization of ADBL by converting its loan of NRs4.9 billion to ADBL into the preferential shares in ADBL in May 2006; and (iii) planning to inject additional capital by subscribing to more preference shares. In accordance with the enactment of the Banks and Financial Institutions Ordinance<sup>6</sup> in 2004, the ADBN Act was repealed and ADBL was licensed as a category A financial institution.

<sup>4</sup> ADB. 2000. *Technical Assistance to the Kingdom of Nepal for the Financial and Operational Review of Agricultural Development Bank of Nepal and Nepal Industrial Development Corporation (Subcluster 5)*. Manila. This was associated with ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Kingdom of Nepal for the Corporate and Financial Governance Project*. Manila.

<sup>5</sup> Government of Nepal. 2003. *Poverty Reduction Strategy Paper*. Kathmandu. The Tenth Year Plan – Poverty Reduction Strategy Paper set the target of the broad-based poverty reduction and commits the Government to the restructuring of key specialized banks, including ADBL and Nepal Industrial Development Corporation.

<sup>6</sup> Enacted in February 2004, the ordinance unifies five banking laws and strengthens Nepal Rastra Bank's supervisory powers over the financial sector.

14. Within the context of ongoing financial sector reforms, the reform of ADBL was considered crucial to facilitate fundamental rural finance sector policy changes for greater efficiency and outreach expansion. Under the ARP framework, ADBL will be reformed to become a viable and reliable rural finance institution with greater relevance to agricultural and rural sector development. In connection with the implementation of ARP, the Government has agreed to the performance benchmarks for operational improvement (Table A2.4), as well as the implementation of the following reform framework over 3 years:

- (i) **Legal, ownership, and governance.** The equity stake gradually will be privatized as the implementation of ARP progresses.
- (ii) **Financial restructuring.** Capitalization and adequate provisioning for bad and doubtful assets will be undertaken based on NRB reforms for commercial banks. ADBL is expected to attain a net profit of NRs74 million in 2006 and positive net worth from 2007 (Supplementary Appendix G).
- (iii) **Organizational restructuring.** The organization will be rationalized around a profit-center concept, and staff reduction through a voluntary separation scheme.
- (iv) **Institutional strengthening.** Business processes, including products, services, systems, and procedures, will be reoriented; information technology and management information system upgraded; and training capacity and staff skills enhanced.

**Table A2.4: Performance Indicators for Agricultural Development Bank Limited**

Performance Indicator	Projection				
	15 July 2007	15 July 2008	15 July 2009	15 July 2010	16 July 2011
Capital Adequacy Ratio (%) <sup>a</sup>	9.1	13.1	13.5	14.0	14.6
Collection Rate (%) <sup>b</sup>	82	86	90	90	90
Operating Profit Ratio (%) <sup>c</sup>	24.4	30.6	29.3	30.5	31.6
Outreach (active loan accounts) <sup>d</sup>	433,742	463,604	495,232	528,729	564,206
Deposit Mobilization (NRs million) <sup>e</sup>	1,717	1,972	2,262	2,420	2,589
Loan Disbursement (NRs million) <sup>f</sup>	2,686	2,736	2,941	3,162	3,399
Nonperforming loan ratio (%) <sup>g</sup>	28	23	21	19	17
Number of Staff (person) <sup>h</sup>	3,927	3,856	3,856	3,689	3,760
Number of Branches <sup>i</sup>	234	236	236	236	236

<sup>a</sup> Capital Adequacy Ratio: As percentage of risk-weighted assets.

<sup>b</sup> Collection Rate: Collections as a percentage of amounts due in a period.

<sup>c</sup> Operating Profit Ratio: Before tax profit to interest and other income.

<sup>d</sup> Outreach: The number of active loan accounts.

<sup>e</sup> Deposit Mobilization: Amounts mobilized during the year.

<sup>f</sup> Loan Disbursement: Forecasted figures for disbursements in each financial year.

<sup>g</sup> Nonperforming Loan Ratio: Percentage of loans on arrears to the total loans outstanding.

<sup>h</sup> Number of Staff: At the end of each financial year.

<sup>i</sup> Number of Branches: Branch numbers to be maintained to ensure adequate coverage in rural areas.

Restructuring Plan Milestones: As shown in the restructuring plan.

Source: Asian Development Bank estimates.

## DEVELOPMENT COORDINATION MATRIX

Rural Development	Agriculture and Social	Financial	Rural Finance/Microfinance
<p><b>Asian Development Bank (ADB)</b> Rural infrastructure and connectivity</p> <ul style="list-style-type: none"> <li>Road Connectivity Sector I Project (\$55.2 million, approved on 10 August 2006)</li> <li>Decentralized infrastructure and Livelihood (\$40 million, approved on 24 September 2004)</li> </ul> <p><b>Others</b></p> <ul style="list-style-type: none"> <li><b>World Food Program:</b> Rural Community Infrastructure Works and Quick Impact Project (2003)</li> <li><b>World Bank:</b> Nepal Poverty Alleviation Fund and Rural Infrastructure Learning and Innovation Loan (2006); Rural Access Improvement and Decentralized Project (2006)</li> <li><b>Department for International Development (DFID):</b> Rural Access Program (2004), Improving Rural Livelihood, and Security (2004)</li> <li><b>Canadian International Development Agency:</b> Capacity Building of Rural Communities to Manage Sustainable Natural Resources (2002)</li> </ul>	<p><b>ADB</b> Agribusiness, irrigation projects, small farmers extension and training, and research</p> <ul style="list-style-type: none"> <li>Second Agriculture Program (\$50 million, approved on 22 January 1998)</li> <li>Crop Diversification Project (\$12.4 million, approved on 9 November 2000)</li> <li>Community Livestock Development Project (\$20.8 million, approved on 19 December 2003)</li> <li>Skills for Employment Project (\$20 million, approved on 25 November 2004)</li> <li>Community-Managed Irrigated Agriculture Sector Project (\$20 million, approved on 17 November 2004)</li> <li>Gender Equality and Empowerment of Women (\$10 million, approved on 16 December 2004)</li> </ul> <p><b>Others</b></p> <ul style="list-style-type: none"> <li><b>International Fund for Agricultural Development:</b> Leasehold Forestry and Livestock Programme (2004)</li> <li><b>Food and Agriculture Organization for the United Nations:</b> Support for Operationalization of Agriculture Perspective Plan (2003); Women in Agriculture and Integrated Pest Management (2003)</li> <li><b>World Bank:</b> Commercial Agriculture and Growth; Irrigation Sector Support Program (2004)</li> </ul>	<p><b>ADB</b> Corporate and financial governance, financial infrastructure, and institutional capacity building.</p> <ul style="list-style-type: none"> <li>Corporate and Financial Governance (\$8.4 million, approved on 14 December 2000)</li> </ul> <p><b>Others</b></p> <ul style="list-style-type: none"> <li><b>World Bank:</b> Financial Sector Technical Assistance Credit (2002); Financial Sector Study (2001); Financial Sector Restructuring Project (2004); Economic Reform Technical Assistance (2005)</li> <li><b>DFID:</b> Financial Sector Study (2000); cofinancing for World Bank's Financial Sector Restructuring Project (2004); and United Nations Development Programme's Microfinance Project (2002)</li> </ul>	<p><b>ADB</b> Microcredit for productive activities</p> <ul style="list-style-type: none"> <li>Microcredit Project for Women (\$5 million, approved on 24 June 1993)</li> <li>Rural Microfinance Project (\$20.6 million, approved on 8 December 1998)</li> </ul> <p><b>Others</b></p> <ul style="list-style-type: none"> <li><b>United Nations Development Programme:</b> Local Governance Program/participatory district development program (in connection with the Norwegian Development Corporation and DFID) (2005)</li> <li><b>Deutsche Gesellschaft für Technische Zusammenarbeit:</b> Support for Agricultural Development Bank of Nepal and its Small Farmer Cooperatives (2001)</li> </ul>
<p><b>International Monetary Fund:</b> Improve regulatory and supervisory capacity of Nepal Rastra Bank through (i) policy advice on restructuring the two largest commercial banks; (ii) support to re-engineer its supervisory, accounting, and statistical capacities; and (iii) technical assistance in monetary exchange systems and reserves management, tax administration governance, and state-owned enterprises reform. The 3-year Poverty Reduction and Growth Facility (2003) will probably be extended.</p>			
<p><b>Rural Finance Sector Development Cluster Program</b></p>			
<p>Maintain and expand network of financial services available for rural development activities.</p>	<p>Sustain institutional credit for agriculture-related activities through strengthened Agricultural Development Bank Limited (ADBL) networks.</p>	<p>Sector legal and regulatory policy harmonized and standard norms applied to rural financial institutions.</p>	<p>Institutional restructuring of ADBL; diagnostic institutional assessment of Small Farmers Development Bank; new products and promotion for rural finance institutions.</p>

Source: Asian Development Bank estimates.

## DEVELOPMENT POLICY LETTER, POLICY MATRIX, AND RURAL FINANCE SECTOR ROAD MAP



**Dr. Ram Sharan Mahat**  
Finance Minister

14 September 2006

Mr. Haruhiko Kuroda  
President  
Asian Development Bank  
Metro Manila, Philippines

### Re: Nepal: Rural Finance Sector Development Cluster Program (RFSDCP)

Dear Mr. President:

On behalf of the Government of Nepal (the Government), we would like to thank the Asian Development Bank (ADB) for the very substantial assistance which it has continued to provide to Nepal over the years. This has helped the country tremendously in all major sectors.

The majority of the population in Nepal, including most of the poor, lives in rural areas. However, the rural financial sector cannot adequately meet their needs for financial services. Many rural finance institutions (RFIs) suffer from weak governance and limited viability. Loan collection problems have reached alarming levels, outreach remains limited, and transaction costs for both borrowers and lenders are high. As a result, most rural households do not have access to affordable rural finance services. The availability of adequate and affordable rural finance services is critical for the revitalization and economic development of the rural sector. Therefore, the measures outlined in the IMF's Poverty Reduction and Growth Facility included restructuring of the Agricultural Development Bank Limited (ADBL), the key RFI. I summarize the key RFSDCP reform priorities below. The details are in the attached policy matrix.

**Conducive Policies.** The Government will complement, facilitate, and improve the functioning of rural finance markets. This will be done by improving rural financial sector supervision and regulation. The RFIs will have the autonomy to price their services. Accordingly, ADBL and other institutions will make their own price and product decisions. The Government will emphasize repayment of outstanding loans and debt recovery by RFIs. Key RFIs with reasonable prospects of becoming viable will be fundamentally reformed, but for those with little prospects of being turned around other options will be adopted. Divestment of the stakes of Nepal Rastra Bank (NRB) in other financial institutions will be continued,

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along with a phasing out of the mandatory priority sector lending requirements. The Government will review the viability and impact of mandatory lending for the destitute class. The Government will also review the performance of the Nepal Industrial Development Corporation. A policy review committee will be constituted to periodically review rural finance sector reform progress, particularly in the context of RFSDCP. In this regard, you will be pleased to note that, in consultation with ADB, we have also developed a long-term road map to integrate the efforts of various stakeholders for rural finance sector development.

**Institutional Reforms for Sustainability.** The Government has begun the transformation of ADBL into a sustainable RFI for providing efficient services through fundamental changes in its mission, statute, governance, organization, human resources, business processes, and products and services. We thank ADB for facilitating this process by providing alternatives and identifying the prerequisites based on experience of reforming RFIs in 2 Appendix 5 other countries. The newly incorporated ADBL is the first financial institution to be registered under the Banks and Financial Institutions Ordinance. The privatization of ADBL under RFSDCP will improve the efficiency of the rural finance sector. To ensure ADBL's sustainability, ADBL will adopt the provision of sustainable rural finance services and products as its institutional mandate and will not engage in economically or financially unsound concessions, write-offs, or waivers. ADBL will ensure good corporate governance through a transparent selection and appointment process for members of its Board of Directors and management in accordance with regulatory requirements. In addition, the Government, in consultation with ADB, will also undertake institutional reforms of the Small Farmers Development Bank (SFDB) based on the recently completed portfolio audit and diagnostic report. This will strengthen the linkages of SFDB with grassroots cooperative organizations.

**Supportive Legal and Regulatory Framework.** Effective supervision and regulation of RFIs are crucial elements of the reform agenda. As part of the reform agenda, NRB will select the most appropriate option in consultation with ADB to enable an orderly sector development process and provide protection to small rural depositors and borrowers. At the same time, the prudential norms applied to ADBL will be brought into line with those at commercial banks to ensure financial discipline.

**Sector Capacity Building.** Irrespective of the type of institution, there is a pervasive need for capacity building to enhance the sustainable outreach of rural

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finance services. Priority capacity building needs relate to credit appraisal and loan management for improving the repayment rate and minimizing non-performing loans; risk management for reducing credit, price, operational, and liquidity risks; and accounting, audit, and internal controls for enhancing good governance and transparency. In this context, NRB is actively leading the establishment of an autonomous training center specializing in banking with an emphasis on rural finance by pooling the resources of banks and other financial institutions as part of RFSDCP.

**Product and Process Innovations.** To find a viable way of reducing the risks in rural finance for both lenders and borrowers, and to improve the availability of diversified financial services for the complex livelihoods of the rural poor, a pilot crop insurance scheme will be introduced in selected areas. If successful, this will be replicated more widely. Technical support will also be provided to key RFIs so they can introduce life and general insurance, savings facilities, and remittance services. Nepal remains committed to enhancing economic opportunities in the rural sector. RFSDCP's emphasis on good governance and sustainability will strengthen rural finance, thus opening up the possibility of arresting the flow of resources from the rural sector, expanding incomes, stabilizing rural communities, and reducing poverty. We assure you of the Government's commitment to relevant and needed policy and institutional reforms. The Ministry will continuously monitor progress to ensure that RFSDCP reforms are implemented on time. By supporting RFSDCP, ADB has once again demonstrated the alignment of its interventions with key national priorities.

Yours sincerely,

Ram Sharan Mahat, Ph. D.

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Table A4.1: Policy Matrix

Subprogram I (October 2006–October 2008)				Subprogram II
Objective	Rationale	First Tranche Actions Completed February 2004–September 2006	Second Tranche Actions October 2006–December 2008	Tentative Policy Actions January 2010–December 2011 (timing of tranche release to be based on subprogram I review in 2009)
<p>The objective of the proposed Rural Finance Sector Development Cluster Program is to develop a sustainable rural finance (RF) system for providing affordable services to reduce poverty significantly and generate income. The goals include (i) sustainability, (ii) reduction in subsidy dependence, and (iii) greater outreach to small and marginal farmers. Investments in RF sector will enhance financial intermediation and provide clients with opportunities to generate income and employment. To achieve this, the Government of Nepal (the Government) will initiate actions for (i) creation of a favorable policy environment, (ii) institutional restructuring and reforms, (iii) supportive legal and regulatory framework, (iv) sector capacity building, and (v) product and process innovations.</p>				
<b>A. Creating a Favorable Policy Environment</b>				
Develop a enabling RF policy	The negative impact of Government interventions through directed credit, poorly governed rural finance institutions (RFI), refinance at soft terms, and loans at below-cost interest rates necessitated the adoption of a new RF policy. Under the new policy, the Government's role will be to complement, facilitate, and improve the functioning of RF markets. Focus will be on creating enabling policies, promoting strategic initiatives for private sector participation, restructuring potentially viable RFIs, and phasing out mandatory credit controls.	<p>The Government's adoption of RF sector development policies, which include:</p> <ul style="list-style-type: none"> <li>(i) reviewing periodically RF sector reform progress within the context of the Rural Finance Sector Development Cluster Program, through the policy review committee;</li> <li>(ii) establishing RF sector supervision and regulation;</li> <li>(iii) phasing out the stake of Nepal Rastra Bank (NRB) in RFIs;</li> <li>(iv) implementing RFI reforms;</li> <li>(v) enhancing debt recovery system enforcement;</li> <li>(vi) reviewing the performance of the Nepal Industrial Development Corporation (NIDC);</li> <li>(vii) granting RFIs autonomy to price their services; and</li> <li>(viii) reviewing the mandatory credit allocation for the destitute class <b>(Development Policy Letter)</b>.</li> </ul> <p>The Government will ensure that Agricultural Development Bank Limited (ADBL) will adopt sustainable RF services and products as its institutional mandate <b>(Policy Letter, and ADBL Memorandum of Association and Articles of Association)</b>.</p>		<p>Annual review of the Government's RF sector development policy to address emerging sector issues.</p> <p>Review of the impact of deprived sector lending requirements for commercial banks.</p> <p>Completion of divestment of NRB's stake in Grameen Bikash Banks (GBB).</p>

Subprogram I (October 2006–October 2008)				Subprogram II
Objective	Rationale	First Tranche Actions Completed February 2004–September 2006	Second Tranche Actions October 2006–December 2008	Tentative Policy Actions January 2010–December 2011 (timing of tranche release to be based on subprogram I review in 2009)
		Maintenance of the policy on autonomous interest-rate setting by RFIs. <b>(NRB Directive)</b>		
<b>B. Institutional Restructuring and Reforms</b>				
<b>1. ADBL</b>				
Transform ADBL into a sustainable and efficient RFI	Despite significant investments over the past four decades, RF outreach from institutional sources is less than 25% of the rural households. The Government has recognized that outreach cannot be extended through inefficient institutions. ADBL, therefore, will be restructured to become a viable RFI to provide sustainable RF products and services. ADBL will undertake fundamental changes in its mission, statutes, governance, organization, human resources, business processes, and products and services.	<p>Repeal of Agricultural Development Bank Act 1967 <b>(Banks and Financial Institutions Ordinance [BFIO])</b>.</p> <p>Development and adoption of ADBL restructuring plan covering:</p> <ul style="list-style-type: none"> <li>(i) strategy and polices,</li> <li>(ii) legal and governance structures,</li> <li>(iii) financial restructuring,</li> <li>(iv) organization and human resources development,</li> <li>(v) operating policies and guidelines,</li> <li>(vi) institutional strengthening,</li> <li>(vii) implementation schedule, and</li> <li>(viii) performance indicators and outputs <b>(ADBL Restructuring Plan, ADBL Board Approval, and Ministry of Finance [MOF Letter])</b>.</li> </ul> <p>Development and adoption of ADBL's business plan, including performance benchmarks for implementing the ADBL restructuring plan <b>(Business Plan, ADBL Board Approval, and MOF Letter)</b>.</p> <p>Incorporation of ADBL as limited liability company <b>(Certificate of Incorporation)</b>.</p> <p>Capitalization by conversion of all dues (principal and interests) of the Government into tier 1 capital preference shares of ADBL <b>(MOF Letter)</b>.</p>	<p>Issuance of a notice to offer ADBL shares to the small shareholders of ADBL <b>(ADBL Notification)</b>.</p> <p>Decision to initiate initial public offering of ADBL <b>(ADBL Board of Directors Resolution)</b>.</p> <p>Settlement of the Government's dues payable to ADBL <b>(MOF Notification and ADBL Audit Report)</b>.</p> <p>Finalize divestment plan of Government shares in ADBL <b>(Divestment Plan)</b>.</p> <p>ADBL will (i) write-off bad debts and (ii) provide adequate provisions for its other categories of debts, in each case in accordance with NRB directives <b>(MOF Notification and ADBL Audit Report)</b>.</p> <p>Revision and update by ADBL of its policies related to (i) human resources management, (ii) portfolio management, (iii) financial management, and (iv) credit</p>	<p>Divestment of agreed level of the Government's stake in ADBL.</p> <p>Assessment for privatization.</p> <p>Review of ADBL performance by MOF and NRB before further equity support.</p> <p>Achievement of performance indicators outlined in the business plan.</p> <p>Completion of the initial public offering by ADBL.</p> <p>Cash equity and reinvestment of surplus to meet the capitalization requirements linked to increased operations.</p> <p>Provision for bad and doubtful debts in accordance with NRB requirements.</p> <p>Completion of implementation of ADBL restructuring plan.</p> <p>Divestment of equity in Small Farmers Development Bank (SFDB) in accordance with BFIO requirements.</p> <p>Increased outreach to rural women and disadvantaged groups.</p> <p>Continued emphasis on good governance.</p>

Subprogram I (October 2006–October 2008)			Subprogram II	
Objective	Rationale	First Tranche Actions Completed February 2004–September 2006	Second Tranche Actions October 2006–December 2008	Tentative Policy Actions January 2010–December 2011 (timing of tranche release to be based on subprogram I review in 2009)
		<p>Issuance of banking license (class A) to ADBL under BFIO (<b>License Issued by NRB</b>).</p> <p>Constitution of Board of Directors of ADBL, including appointment of at least one woman director and appointment of general manager in accordance with BFIO, Companies Ordinance, and articles of association (<b>ADBL Board Minutes</b>).</p> <p>Completion of the first phase of the voluntary retirement scheme in ADBL (<b>ADBL Report</b>).</p> <p>Constitution of committees of the Board in accordance with Companies Ordinance, BFIO, and ADBL Article of Association (<b>ADBL Board Minutes</b>).</p> <p>Provision of NRs6.9 billion for doubtful and bad debts of ADBL in the annual accounts for FY2005 (<b>ADBL Audited Account</b>).</p> <p>Adoption of a code of conduct at ADBL, satisfactory to Asian Development Bank (ADB) (<b>ADBL Board Minutes</b>).</p>	<p>management to the satisfaction of ADB (<b>ADBL Approved Policies</b>).</p> <p>Completion by ADBL of second voluntary retirement scheme (<b>ADBL Progress Report</b>).</p> <p>Achievement of the performance indicators and critical implementation targets set out in ADBL Restructuring Plan to the satisfaction of ADB (<b>ADBL Progress Report</b>).</p> <p>Establishment of a separate unit within ADBL to deal with client complaints, including those relating to corruption. The unit will report to the Audit Committee (<b>ADBL Progress Report</b>).</p> <p>Establishment of management information system by ADBL that allows measurement of its banking service outreach to women and disadvantaged groups (<b>ADBL Report</b>).</p> <p>Completion of the phasing out of ADBL's small farmers development program (<b>ADBL Progress Report and Audited Statements</b>).</p> <p>Completion of ADBL's assessment of the</p>	<p>Partial divestment of equity through initial public offering.</p>

Subprogram I (October 2006–October 2008)				Subprogram II
Objective	Rationale	First Tranche Actions Completed February 2004–September 2006	Second Tranche Actions October 2006–December 2008	Tentative Policy Actions January 2010–December 2011 (timing of tranche release to be based on subprogram I review in 2009)
			performance of small farmers' cooperatives, which will be the basis for determining further onlending support by ADBL to SFDB ( <b>ADBL Assessment Report</b> ).	
<b>2. SFDB</b>				
Transform SFDB into a model apex agency for small farmers cooperative societies	SFDB, including the small farmers development program and small farmers cooperatives, have significant outreach in many parts of the country; they are the only channel for delivery of RF services. However, weak governance and politicization have affected performance and sustainability. Fundamental changes are required to upgrade governance, organization, human resources, business processes, products, and services for viability and outreach.	Decision on SFDB institutional reform and strengthening based on portfolio audit and diagnostic report by the Government ( <b>Development Policy Letter</b> ).	Development and adoption of SFDB restructuring plan in consultation with ADB, covering: <ul style="list-style-type: none"> <li>(i) strategy,</li> <li>(ii) legal and governance structure,</li> <li>(iii) organization and human resources development,</li> <li>(iv) operating policies and guidelines for financial activities,</li> <li>(v) partnership arrangements,</li> <li>(vi) performance benchmarks, and</li> <li>(vii) implementation schedule (<b>SFDB Restructuring Plan, SFDB Board Approval</b>).</li> </ul>	Review of SFDB performance by MOF and NRB before determining the recapitalization support. <p>Achievement of performance indicators specified in the SFDB restructuring plan.</p> <p>Provision for bad and doubtful debts in accordance with NRB requirements.</p> <p>Lending to small farmer cooperatives that meet with the performance criteria specified in the SFDB restructuring plan.</p> <p>Partial divestment of equity.</p>
<b>3. GBBs</b>				
Continue strengthening GBBs	Governance, institutional, and financial issues left unaddressed for a long period have reduced significantly the potential service	Review of the implementation of GBB divestment plan by NRB ( <b>NRB Report</b> ). <p>Commencement of the divestment of NRB's stake in the two solvent GBBs (<b>NRB Report</b>).</p>	Decision to be undertaken on the future direction of the technically insolvent GBBs ( <b>NRB Report</b> ).	Implementation review of the GBB reform plan to determine the need for recapitalization support for GBBs with satisfactory performance.

Subprogram I (October 2006–October 2008)				Subprogram II
Objective	Rationale	First Tranche Actions Completed February 2004–September 2006	Second Tranche Actions October 2006–December 2008	Tentative Policy Actions January 2010–December 2011 (timing of tranche release to be based on subprogram I review in 2009)
	delivery capacity of GBBs. Implementation of the GBB reform plan will need to continue.			
<b>C. Supportive Legal and Regulatory Framework</b>				
Enhance the of supervision and regulation of RFIs	Effective supervision is a prerequisite for the orderly development of the RF sector. Accordingly, the supervisory and regulatory mechanisms need to be significantly enhanced.	Development of options for the supervisory and regulatory framework of the RFIs, including the option for the establishment of a second tier supervisory and regulatory authority <b>(Draft Ordinance)</b> .	(i) Decision on the appropriate supervisory and regulatory framework of the RFIs and (ii) initiation of its implementation by NRB <b>(NRB Report)</b> .	Review of performance of the institutional arrangement for supervision and regulation <b>(NRB Report)</b> .  Upgrading and enhancement of the supervisory and regulatory arrangement as required <b>(NRB Report)</b> .
<b>D. Sector Capacity Building</b>				
Develop a systemic sector capacity building mechanism	Irrespective of the type of institution, the need for capacity building to enhance sustainable outreach of RF services is pervasive. Priority capacity building needs to relate to credit appraisal; management of delinquency; risk management for reducing credit, price, operational, and liquidity risks; and accounting, audit, and internal controls for enhancing good governance and transparency.	Decision on the establishment of a training institution specializing in banking and finance with emphasis on rural finance <b>(Policy Letter)</b> .	Incorporation of the training institution pursuant to Companies Ordinance, with necessary financial contributions from NRB, ADBL, and other financial institutions <b>(Certificate of Incorporation)</b> .  Develop business plans for training, course curriculum and materials, library, training of trainers, and equipment <b>(Training Institute Report)</b> .  Start of training by the proposed training institution <b>(Training Institute Report)</b> .	Review of the performance of the training institute <b>(NRB Report)</b> .  Upgrading and enhancement of the training institute, as required <b>(NRB Report)</b> .

Subprogram I (October 2006–October 2008)				Subprogram II
Objective	Rationale	First Tranche Actions Completed February 2004–September 2006	Second Tranche Actions October 2006–December 2008	Tentative Policy Actions January 2010–December 2011 (timing of tranche release to be based on subprogram I review in 2009)
<b>E. Product and Process Innovations</b>				
Reduce vulnerability risks of lenders and borrowers	Reducing the vulnerability of the rural households is important. Absence of risk mitigation services forces households to forego economic opportunities, borrow at usurious rates, and save in nonfinancial assets. The risk perception of RF is reduced significantly with products and services that could effectively mitigate risks.		Development of the pilot crop insurance plan by NRB in consultation with local stakeholders ( <b>MOF Letter</b> ).	<p>Develop and finalize a pilot risk mitigation plan. Accessible to ADBL borrowers, the pilot will include actuarial premium rate and restrict indemnity to verifiable instruments.</p> <p>Disseminate diversified financial products and services to RFIs.</p> <p>Implement the pilot in identified locations.</p> <p>Assess impact for larger replication.</p>

Source: Asian Development Bank estimates.





<b>VISION: Establish a viable and effective rural and microfinance system for providing affordable financial services to enhance rural incomes and reduce rural poverty.</b>	<b>Phase I (2006–2007)  Implement Policy and Institutional Framework</b>	<b>Phase II (2007–2008)  Increase Small Farmer and Pro-poor Orientation</b>	<b>Phase III (2009–2011)  Enhance Outreach</b>
		<ul style="list-style-type: none"> <li>• Introduce specialized skills for off-site and on-site supervision</li> </ul>	
<b>Ensure Pro-Poor and Small Farmer Orientation</b>	<b>Capacity for optimal utilization of financial services</b> <ul style="list-style-type: none"> <li>• Improve product range of rural finance institution services for better resource utilization by small farmers</li> <li>• Enhance capacity of small farmer groups</li> </ul>	<b>Promote innovative pilot projects</b> <ul style="list-style-type: none"> <li>• Introduce product and process innovations to reduce risks to small farm households</li> </ul>	<b>Enhance outreach to special groups</b> <ul style="list-style-type: none"> <li>• Replicate successful pilots</li> <li>• Enlarge coverage of risk mitigation efforts</li> </ul>

Source: Asian Development Bank mission estimates.

## DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks <sup>a</sup>
<p><b>Impact</b></p> <p>Economic growth and poverty reduction in rural areas through improved rural financial intermediation and enhanced access to affordable rural finance (RF) services</p>	<p>Reduce overall poverty incidence to 28% by 2009 (benchmark 38% in 2000).</p> <p>Reduce the rural poverty incidence from 35% in 2006 to 30% in 2009.</p>	<ul style="list-style-type: none"> <li>• Economic reform program assessment</li> <li>• Baseline study and impact monitoring report</li> <li>• Project completion report</li> <li>• Asian Development Bank (ADB) evaluation missions</li> </ul>	<p><b>Assumptions</b></p> <p>Political stability and absence of civil strife</p> <p>Favorable macroeconomic conditions</p> <p>Proper targeting of program to rural clientele</p> <p><b>Risk</b></p> <p>Changes in policy environment that discourage further reform and liberalization</p>
<p><b>Outcome</b></p> <p><b>Improved soundness, efficiency, and outreach of RF system through policy, legal, regulatory, and institutional reforms</b></p> <p>Favorable policy environment</p> <p>Institutional restructuring and reforms at Agricultural Development Bank Limited (ADBL), Small Farmers Development Bank (SFDB), and Grameen Bikash Banks (GBB);</p> <p>Supportive legal and regulatory framework</p> <p>Sector capacity building</p>	<p>No Government refinancing and direct provision of credit to RF institutions (RFI) by 2009</p> <p>No Government enforcement of below-cost lending and priority sector lending to RFIs by 2008</p> <p>Expand RF client outreach by 200,000 from existing level by 2011</p> <p>RFIs achieve financial self-sustainability ratio of 90% or above by 2009</p> <p>No instances of Nepal Rastra Bank (NRB) failure to regulate RFIs, per Banks and Financial Institutions Ordinance (BFIO), by 2009</p> <p>At least 20 RFIs follow international best</p>	<ul style="list-style-type: none"> <li>• Program reports</li> <li>• Program reviews (semiannual, annual, and midterm)</li> <li>• Audit reports</li> <li>• ADBL reports</li> <li>• ADB review missions</li> <li>• Project completion report</li> <li>• Project performance audit report</li> <li>• NRB reports</li> <li>• Reports of RFIs</li> <li>• Parliamentary briefings</li> <li>• Reports of the auditor general</li> </ul>	<p><b>Assumptions</b></p> <p>Government's commitment to pursue economic policy reforms that enable RFIs to operate autonomously within a liberalized financial policy regime</p> <p>Weak RFIs are appropriately restructured and operate in a framework that supports good governance</p> <p><b>Risks</b></p> <p>Politicization of the RF sector during the reform process</p> <p>Deteriorating law and order situation</p> <p>NRB is not able to enhance its capability to regulate the subsector.</p>

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks <sup>a</sup>
Product and process innovations	<p>practices on accounting, reporting, and credit operations by 2011.</p> <p>At least three RFIs provide insurance, savings, and remittance services by 2009.</p> <p>At least 20,000 rural poor people are covered by crop insurance by 2011.</p>		
<p><b>Outputs</b></p> <p><b>1. Favorable policy environment for RF operations</b></p>	<p>Establishing rules, regulations, and processes for supervision and regulation of RFIs by the fourth quarter of 2007</p> <p>Divestment of NRB's shares in RFIs to the legally defined level by 2009</p> <p>Divestment of Government shares in ADBL and SFDB by at least 60% from the 2006 level by 2011</p> <p>Phasing out of the Government's stake in technically insolvent RFIs by 2009</p> <p>Full enforcement of debt recovery law for willful defaulters by 2009</p> <p>Phasing out of priority sector credit requirements by 2007</p> <p>Discontinuation of interest rate ceilings by 2007</p> <p>Increase of private ownership in ADBL and SFDB to the legally defined level as per BFIO by 2009</p>	<ul style="list-style-type: none"> <li>• Program reports</li> <li>• Program reviews</li> <li>• ADB review missions</li> <li>• The memorandum of association, articles of association, and banking license for ADBL</li> <li>• NRB reports</li> <li>• RFI reports</li> </ul>	<p><b>Assumptions</b></p> <p>Government maintains its commitment to facilitate and improve the working of RF markets</p> <p>RF pursued as a market-based activity to generate private sector interest in RF sector</p> <p><b>Risks</b></p> <p>Labor union movement that could disrupt RFI reform and restructuring</p> <p>Weak enforcement capacity of the Government</p>
<p><b>2. Institutional restructuring and reforms at ADBL</b></p> <p>This output will lead to the restructuring and</p>	<p>ADBL incorporated as a limited company by 2006</p> <p>ADBL recapitalized by conversion of all dues (principal and interest) of</p>	<ul style="list-style-type: none"> <li>• Program reports</li> <li>• Program reviews</li> <li>• ADB review missions</li> <li>• The memorandum of association, articles of association, and banking</li> </ul>	<p><b>Assumptions</b></p> <p>The Government's strong commitment to pursue the restructuring plan</p> <p>No politically motivated</p>

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks <sup>a</sup>
<p>reforming of ADBL, with its operations streamlined in accordance with the ADBL restructuring plan, which covers</p> <ul style="list-style-type: none"> <li>(i) strategy and policies,</li> <li>(ii) legal and governance structures,</li> <li>(iii) financial restructuring,</li> <li>(iv) organization and human resources,</li> <li>(v) operating policies and guidelines,</li> <li>(vi) institutional strengthening, and</li> <li>(vii) implementation schedule</li> </ul>	<p>the Government into tier 1 capital preferred shares by 2007</p> <p>ADBL licensed as a class A institution under BFIO by 2006</p> <p>New board of directors, including one woman director, constituted in accordance with the articles of association and BFIO by 2007</p> <p>At least 600 redundant staff reduced through the voluntary retirement scheme by 2009</p> <p>Board committee constituted in accordance with NRB, BFIO, and Company Law by 2006</p> <p>Management information system—at par with international industry standards—installed by the fourth quarter of 2007</p> <p>New business processes installed, and operational manual produced and disseminated by 2008</p> <p>ADBL meets performance indicators, including outreach expansion and reduced nonperforming assets in accordance with the ADBL restructuring plan by 2011</p> <p>ADBL privatized by 2011</p>	<p>license for ADBL and small farmers</p> <ul style="list-style-type: none"> <li>• ADBL audit report</li> <li>• Program midterm report</li> <li>• NRB Report</li> </ul>	<p>change in the appointment of ADBL's Board of Directors</p> <p><b>Risks</b> Limited implementation capacity for the restructuring process of ADBL staff and management</p> <p>Increased competition in the labor market that inhibits retaining qualified staff at ADBL</p>
<p><b>3. Institutional restructuring and reform at SFDB</b></p> <p>This output will lead to the restructuring and reforming of SFDB, with its operations streamlined with a strong pro-poor orientation in accordance with the SFDB restructuring plan, covering</p> <ul style="list-style-type: none"> <li>(i) strategy and</li> </ul>	<p>SFDB restructuring plan adopted by the SFDB Board of Directors by the third quarter of 2007</p> <p>Improvement in financial and operational self-sustainability by 20% from the 2006 level by 2009</p> <p>SFDB meets performance indicators in accordance with the SFDB's restructuring plan by 2011</p>	<ul style="list-style-type: none"> <li>• Program reports</li> <li>• Program reviews</li> <li>• ADB review missions</li> <li>• SFDB audit report</li> <li>• NRB report</li> <li>• RFI reports</li> </ul>	<p><b>Assumptions</b> The Government's commitment to pursue the restructuring of SFDB</p> <p>No politicization of small farmer cooperatives</p> <p>SFDB's withdrawal of lending to non-viable small farmers' cooperatives</p>

<b>Design Summary</b>	<b>Performance Targets/Indicators</b>	<b>Data Sources/Reporting Mechanisms</b>	<b>Assumptions and Risks<sup>a</sup></b>
<p>policies,</p> <p>(ii) legal and governance structures,</p> <p>(iii) financial restructuring,</p> <p>(iv) organization and human resources,</p> <p>(v) operating policies and guidelines,</p> <p>(vi) institutional strengthening, and</p> <p>(vii) implementation schedule</p>	<p>SFDB management and operational review fully conducted, and recapitalization requirements determined by 2009</p> <p>SFDB privatized by 2011</p>		<p><b>Risks</b></p> <p>Worsening rural economic conditions that harm small farmers</p> <p>Continued default practices induced by politically motivated directions</p> <p>Union opposition to SFDB restructuring and reforms</p>
<p><b>4. Institutional restructuring and reform at GBBs</b></p> <p>This output will lead to the divestment and transformation of GBBs into effective microfinance providers through the implementation of the GBB plan</p>	<p>NRB's shares in solvent GBBs divested to the legally required level by 2008</p> <p>NRB adopts options for insolvent GBBs, including liquidation by 2009</p>	<ul style="list-style-type: none"> <li>• Program reports</li> <li>• Program reviews</li> <li>• ADB review missions</li> <li>• GBB audit report</li> <li>• Program midterm report</li> <li>• NRB report</li> <li>• RFI reports</li> </ul>	<p><b>Assumption</b></p> <p>Continued Government policy in favor of NRB divestment of RFI</p> <p><b>Risks</b></p> <p>Limited management and staff capacity to operate GBBs profitably after the divestment</p> <p>Union opposition to liquidation of GBBs</p>
<p><b>5. Supportive legal and regulatory framework</b></p> <p>This output will lead to effective supervision and regulation mechanisms installed for RFIs that are not currently under the supervisory authority of NRB</p>	<p>Government and NRB adopt an option for supervisory and regulatory arrangement by the fourth quarter 2007</p> <p>A new act is approved, or BFIO is amended, to provide a sustainable legal basis for the regulation and supervision of RFIs by 2009</p> <p>By 2009, the Government and NRB develop and adopt a business plan of the supervisory and regulatory authority, including</p> <p>(i) management,</p> <p>(ii) staffing,</p> <p>(iii) budget,</p> <p>(iv) business process, and</p> <p>(v) implementation plan</p> <p>At least 20 RFIs are regulated and supervised by the second quarter of 2010</p>	<ul style="list-style-type: none"> <li>• Program reports</li> <li>• Program reviews</li> <li>• ADB review missions</li> <li>• GBB audit report</li> <li>• Program midterm report</li> <li>• NRB report</li> <li>• RFI reports</li> <li>• Relevant parliamentary reports</li> </ul>	<p><b>Assumptions</b></p> <p>The Government's commitment to enforcing effective supervision of, and regulatory system for, RFIs</p> <p>RFIs have sufficient capacity to meet the reporting requirements under the new regulations.</p> <p><b>Risks</b></p> <p>Limited revenue-earning capacity of the regulatory authority</p> <p>Insufficient number of qualified auditors to conduct supervision function for RFIs</p>

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks <sup>a</sup>
<p><b>6. Sector Capacity Building</b></p> <p>This output will lead to the delivery of capacity-building training on a wide range of banking and RF subjects</p>	<p>Training center at ADBL incorporated as an independent training institute, with the participation of NRB, ADBL, commercial banks, and other financial institutions as shareholders by the second quarter of 2007</p> <p>Training curricula and pedagogic methods are on par with benchmark standards (either regionally or internationally) by the fourth quarter of 2008.</p> <p>In-class and on-site banking and financial training delivered, with participation of at least 20 financial institutions from 2008</p>	<ul style="list-style-type: none"> <li>• Program reports</li> <li>• Program reviews</li> <li>• ADB review missions</li> <li>• Project audit report</li> <li>• Program midterm report</li> <li>• NRB report</li> <li>• ADBL reports</li> <li>• RFI reports</li> <li>• Reports of the training institute</li> </ul>	<p><b>Assumption</b> Continued interest by the banking sector in establishing the training institute</p> <p><b>Risk</b> Limited revenue-earning capacity of the training institute, thus impacting sustainability</p>
<p><b>7. Product and Process Innovations</b></p> <p>This output will lead to reduced risks by introducing a crop insurance scheme for wider replication and diversified RF products including savings, microinsurance, and remittances</p>	<p>Government adopts pilot insurance plan by the third quarter of 2007</p> <p>Pilot insurance scheme implemented in at least four districts by 2009</p> <p>At least three RFIs start offering new savings, microinsurance, and/or remittance products targeting the rural poor from 2010</p>	<ul style="list-style-type: none"> <li>• Program reports</li> <li>• Program reviews</li> <li>• ADB review missions</li> <li>• Project audit report</li> <li>• Program midterm report</li> <li>• NRB reports</li> <li>• RFI reports</li> </ul>	<p><b>Assumptions</b> RFIs' interest in risk mitigation services and diversified products</p> <p>Adequate funding set aside for product and process innovations</p> <p><b>Risk</b> Limited technical capacity of RFIs to provide new services</p>
<p><b>Activities with Milestones – for subprogram I</b></p> <p><b>1. Create favorable policies environment</b></p> <ul style="list-style-type: none"> <li>- Constitute a policy review committee (QIV 2006)</li> <li>- Establish rules, regulations, and processes for supervision and regulation of RFIs (QIII 2007)</li> <li>- Put in place other needed policies (such as on debt recovery, etc.) (QIV 2008)</li> </ul> <p><b>2. Institutional Reforms and Restructuring: ADBL</b></p> <ul style="list-style-type: none"> <li>- Implement restructuring plan (to QIV 2008 for subprogram I)</li> <li>- Develop appropriate business processes, including realigning accounting and auditing (QI 2007)</li> <li>- Incorporate management information system (MIS)—both systems and protocols (QII 2007)</li> <li>- Develop human resources strategy and conduct relevant training (from QII 2007)</li> <li>- Review institutional reforms and restructuring (QIV 2008)</li> </ul>			<p><b>Inputs – for subprogram I</b></p> <p>Program Loan: \$56 million</p> <p>Asian Development Fund grant: \$8.7 million</p> <p>Asian Development Fund grant resources will cover the following: Equipment (\$5.1 million) Vehicles (\$25,000) Training (\$500,000) National consultants (\$1.9 million) International consultants (\$600,000)</p>

Design Summary	Performance Targets/Indicators	Data Sources/Reporting Mechanisms	Assumptions and Risks <sup>a</sup>
<p><b>3. Institutional Reforms and Restructuring: SFDB</b></p> <ul style="list-style-type: none"> <li>- Develop SFDB restructuring plan with performance benchmarks (QII 2007)</li> <li>- Develop appropriate business processes, including realigning accounting and auditing (QI 2007)</li> <li>- Develop human resources strategy and conduct relevant training (from QII 2007)</li> <li>- Implement restructuring plan (to QIV 2008 for subprogram I)</li> <li>- Review institutional reforms and restructuring (QIV 2008)</li> </ul> <p><b>4. Institutional Reforms and Restructuring: GBBs</b></p> <ul style="list-style-type: none"> <li>- Divest NRB's stake in GBBs (by QIV 2007)</li> <li>- Adopt options for insolvent GBBs (QIV 2007)</li> </ul> <p><b>5. Supportive Legal and Regulatory Framework</b></p> <ul style="list-style-type: none"> <li>- Review and redraft Microfinance Act (QII 2007)</li> <li>- Develop appropriate regulations (QIII 2007)</li> <li>- Establish supervisory authority (by QIV 2007)</li> <li>- Procure MIS system (QI 2008)</li> <li>- Develop supervision and regulation manuals (QI 2008)</li> <li>- Initiate adequate licensing and supervision of RFIs (from QI 2008)</li> </ul> <p><b>6. Sector Capacity Building</b></p> <ul style="list-style-type: none"> <li>- Incorporate training institute (QI 2007)</li> <li>- Procure office equipment, etc. (QIII 2007)</li> <li>- Develop training curriculum (by QIII 2007)</li> <li>- Conduct training of trainers (QIV 2007 and QI 2008)</li> <li>- Conduct training on banking and finance (from QI 2008)</li> </ul> <p><b>7. Product and Process Innovation</b></p> <ul style="list-style-type: none"> <li>- Develop pilot insurance plan (QII 2007)</li> <li>- Implement pilot insurance plan in four districts (QVI 2007)</li> <li>- Provide technical support to RFIs for product development (from QI 2007)</li> </ul> <p><b>8. Program Implementation Support</b></p> <ul style="list-style-type: none"> <li>- Program management unit established (QIV 2006)</li> <li>- Program implementation units established (QIV 2006)</li> <li>- Consultants recruited (QIV 2006)</li> </ul>			<p>Technical assistant grant: \$500,000</p> <p>Technical assistance grant resources will cover the following:  International chief technical advisor (\$240,000)  Domestic internal audit specialist (\$110,000)  International MIS specialist (\$150,000)</p>

<sup>a</sup> See also Supplementary Appendix F for further risk assessment for the program.

## **SUMMARY GOVERNANCE, ANTICORRUPTION, AND FINANCIAL MANAGEMENT ASSESSMENT**

1. Good governance and anticorruption are being assessed in conformity with the recommendations of the Asian Development Bank's *Second Governance and Anticorruption Action Plan*.<sup>1</sup> As per this plan, this governance assessment takes a risk-based approach to—and an institutional focus on—the work on rural finance (RF) in Nepal.<sup>2</sup> This approach enables the viewing of potential risks in the sector and their perceived severity, as well as a review of ongoing and recommended mitigation measures to address the risks, and specification of residual risks.

### **A. Governance Issues in RF**

2. Governance issues, particularly regarding RF, have to be seen in the context of the legal bases of RF reforms (including on regulation and supervision), and the institutional and political dimensions of RF reforms.

#### **1. Legal Bases of RF Reforms**

3. Until the enactment of the Banks and Financial Institutions Ordinance (BFIO), Nepal had a weak and fragmented legal financial environment. Laws and regulations that were institutionally rather than functionally focused proliferated, creating a fragmented legal environment. In February 2004, the Government came up with BFIO to serve as a legal basis for the work of, among others, RF institutions (RFI) in the country. The ordinance includes provisions concerning (i) establishment of banks/financial institutions and their boards, (ii) licensing, (iii) operation of financial transactions, (iv) regulation, (v) inspection and supervision, and (vi) accounts and records. The finance sector has hailed the ordinance as a timely measure to direct the work of financial institutions in Nepal, which had been haphazard since the liberalization of the finance sector in the early 2000s.

#### **2. Institutional and Political Dimensions of RF Reforms**

4. The evolution of the RF market in Nepal over the past three decades was driven by the goal to accelerate agriculture production. As a result, the development of efficient institutions was ignored. The Government intervened in the market through directed credit, concessional refinance, and loans at below-cost interest rates. As Nepal Rastra Bank (NRB), the central bank, had little capability to enforce relevant regulations, heavy-handed state involvement worsened the inefficiency of the financial sector. This resulted in growing nonperforming loans, and wider systemic risk within the sector. The financial system generally has been seen as favoring the urban rich and the rural elite. This point touches on one of the reasons for the insurgency, and has engendered resentment of central control in rural areas.

### **B. Identification of Risks, Their Severity, and Mitigation Measures**

5. The underlying assumptions in analyzing the risks to the Rural Finance Sector Development Cluster Program are that (i) the Government will remain committed to reforming the financial sector, particularly in RF; (ii) the legal reforms implemented thus far in the finance sector will be sustained; and (iii) effective institution building in essential agencies will proceed as planned.

<sup>1</sup> ADB. 2006. *Second Governance and Anticorruption Action Plan (GACAP II)*. Manila.

<sup>2</sup> Supplementary Appendix F provides further details on the governance and anticorruption risk assessment.

## 1. Risk Specification

6. A review of the political macro- and micro-economy shows six categories of risks that could undermine the success of the Project:

- (i) **Policy.** This includes lack of commitment to instituting needed RF reforms.
- (ii) **Regulatory framework and capability.** The Government might not have considered thoroughly the regulatory framework; and staff capability is weak in regulatory bodies that supervise and regulate RFIs.
- (iii) **Legislation.** This area includes the BFIO, which still has weaknesses.
- (iv) **Process.** This includes the existence of asymmetric information, and the possibility of fraud and corruption.
- (v) **Organization.** The voluntary retirement scheme at the Agricultural Development Bank Limited (ADBL) could run into problems due to union pressure; and the boards of RFIs could remain weak.
- (vi) **Programmatic.** ADBL and Small Farmers Development Bank could implement financially or economically unsound concessions, write-offs, or waivers.

7. Risks that are either wholly or partially uncontrollable by Government include (i) the security situation at the local level, which remains tenuous, and might not allow RFIs to operate effectively in the field; (ii) Parliament might not push through financial reforms.

## 2. Risk Severity and Mitigating Measures

8. A risk severity analysis conducted on the risks of (i) – (vi) of para. 6 shows the following type 1 risks<sup>3</sup> that warrant specific attention at program design:

- (i) **Weak staff capacity in regulatory bodies to monitor and engage RFIs.** While the BFIO does give NRB considerable powers in this area, the central bank must have the capacity to implement the rules and regulations effectively. Measures to address this risk include (a) better use of the skills and expertise base in NRB to engage the RFIs (including reviewing the skill sets within the organization); and (b) more targeted technical assistance to NRB for supervision and inspection of RFIs.
- (ii) **Lack of Government commitment to reforms.** While the current Government appears committed to reforms, much will be asked in this regard of this Government and the interim one to be formed soon. Strong engagement by development partners to encourage the Government to stay the course, and incentives (or disincentives) in the Program for committing to (or opposing) RF reforms, are two ways this risk can be mitigated.
- (iii) **Regulatory framework not considered thoroughly.** Current regulatory provisions are stringent, though rules and regulations have to be prepared rigorously and implemented effectively. To strengthen the regulatory framework, NRB should inspect ADBL at least once each fiscal year, and relevant BFIO provisions should be reviewed regularly and updated based on inspection lessons.

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<sup>3</sup> A risk severity analysis identifies four types of risks. Type 1 risks require urgent attention and need to be mitigated/addressed before any assistance is rendered in the sector concerned.

- (iv) **Weak boards in RFIs.** The selection of boards has not always been very effective. If this problem recurs, RFIs would not be accountable or effective. The risk of weak RFI boards can be mitigated by, for example, using BFIO to remove the legislated majority shareholding position of Government (thus reducing its scope of influence), and by ensuring strict adherence to nomination guidelines for board membership in accordance with company articles of association.
- (v) **Weak capacity in RFIs.** RFIs do not appear capable of delivering the outcomes that have been specified for them in the Program. Particular gaps include management information systems, loan recovery systems, and effective human resource practices. These weaknesses can be mitigated by improving management information systems and accounting systems in the institutions, introducing career planning and development opportunities, and urgently reviewing pay in line with performance systems.
- (vi) **RF training institution lacks sustainability.** Based on experience, the training institution to be established by the Program could run into difficulties sustaining its operations if a dedicated source of funding for its recurrent operational expenditure is not established. Incorporating the RF training institution as a limited liability company might allow it to generate enough resources to meet recurrent expenditure.

### C. Controls for Corruption in the Program

9. Corruption, particularly in RF, includes pilferage of funds and irregularities in financial administration, rent-seeking behavior by RFI staff, inadequate reporting and accounting systems, weak procurement and tendering processes, and inadequacies in full fund flow management. However, information is patchy from the RFIs in Nepal regarding the status of corruption and inefficiencies in the RF sector.

10. In general, however, while the Government has made some recent advances in fighting corruption across all sectors, measures to mitigate the corruption risks in this Program include:

- (i) Strengthened audit systems, internally through the audit committee in the Board, and externally through the auditor general.
- (ii) Rigorous monitoring systems of operations on the ground through monitoring cells, as well as internal administrative and management processes through continuous review and evaluation of protocols.
- (iii) Capability of full fund flow management, which allows the Program to track expenditures from appropriation to final output and, if conducted rigorously, to outcomes as well.<sup>4</sup>
- (iv) Adherence to codes of conduct by management and employees, and for the Board to initiate mechanisms to monitor the adherence.
- (v) Accountability for action and outcomes as demonstrated at three levels by (a) employees to management; (b) management to the Board; and (c) the Board to Parliament, and ultimately to the general public.
- (vi) Integrated mechanisms for grassroots civil society organizations to monitor program results during implementation.

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<sup>4</sup> This allows the Project to minimize opportunities for corruption through a strong measurable results framework, where fund disbursements are tied to concrete and measurable results.

## RURAL FINANCE SECTOR DEVELOPMENT PROGRAM IMPLEMENTATION SCHEDULE

Component/Activity	Years																																					
	2006			2007				2008				2009			2010			2011																				
	N	D	J	F	M	A	M	J	J	A	S	O	N	D	J	F	M	A	M	J	J	A	S	O	N	D	J	F	M	A	M	J	J	A	S	O	N	D
<b>Preparatory Actions</b>																																						
Establishment of program management unit																																						
Establishment of program implementation units																																						
Recruitment of consultants																																						
<b>1. Subprogram I</b>																																						
<b>1.1. Creating a Favorable Policy Environment</b>																																						
1.1.a. Policy review committee constituted																																						
1.1.b. Policy review on emerging rural finance (RF) issues																																						
<b>1.2. Institutional Restructuring and Reforms</b>																																						
1.2.a. Agriculture Development Bank Limited (ADBL) restructuring and reforms																																						
1.2.a. (i). ADBL restructuring plan implementation (for detailed implementation plan: refer to Supplementary Appendix F)																																						
1.2.a. (ii). Procurement and Incorporation of MIS																																						
1.2.b. Small Farmers Development Bank (SFDB) restructuring and reforms																																						
1.2.b. (i). Finalization of the SFDB restructuring plan																																						
1.2.b. (ii). Staff capacity development training																																						
1.2.b. (iii). Realignment accounting and auditing																																						
1.2.b. (iv). Microfinance (MF) business process improvement																																						
1.2.b. (v). Implementation of the SFDB restructuring plan																																						
1.2.b. (vi). Review of restructuring and reforms																																						
<b>1.3. Grameen Bikash Bank (GBB) Plan Implementation</b>																																						
1.3.a. GBB plan implementation																																						
1.3.b. GBB plan implementation review																																						
<b>1.4. Supportive Legal and Regulatory Framework</b>																																						
1.4.a. Review of Microfinance Act																																						
1.4.b. Redrafting the Act																																						
1.4.c. Adoption of the regulation and supervision system																																						
1.4.d. Development of regulations																																						
1.4.e. Establishment of the supervisory authority																																						
1.4.f. Procurement of management information system																																						
1.4.g. Development of supervision and regulation manuals																																						
1.4.h. Licensing and supervision of MF institutions																																						
<b>1.5. Sector Capacity Building</b>																																						
1.5.a. Incorporation of the training institute																																						
1.5.b. Training curriculum development																																						
1.5.c. Procurement of equipment, etc.																																						
1.5.d. Training of trainers																																						
1.5.e. Banking and finance training																																						
<b>1.6. Product and Process Innovation</b>																																						
1.6.a. Pilot insurance plan development																																						
1.6.b. Pilot insurance plan implementation																																						
1.6.c. Product development support for RFIs																																						
<b>1.7. Project Implementation Support</b>																																						



### LIST OF INELIGIBLE ITEMS

1. Loan proceeds will finance the foreign currency expenditures for the reasonable cost of imported goods required during the Rural Finance Sector Development Cluster Program.

2. No withdrawals will be made for the following:

- (i) expenditures for goods (included in the following Standard International Trading Commodity chapters or headings):

Chapter	Heading	Description of Items
112		Alcoholic beverages
121		Tobacco, unmanufactured; tobacco refuse
122		Tobacco, manufactured (whether or not containing tobacco substitutes)
525		Radioactive and associated materials
667		Pearls, precious, and semiprecious stones, unworked or worked
718	718.7	Nuclear reactors, and parts thereof, fuel elements (cartridges), non-irradiated for nuclear reactors
897	897.3	Jewelry of gold, silver, or platinum-group metals (except watches and watch cases) and goldsmiths' or silversmiths' wares (including set gems)
971		Gold, non-monetary (excluding gold ore and concentrates)

- (ii) expenditures in the currency of the Borrower, or of goods supplied from the territory of the Borrower;
- (iii) payments made for expenditures incurred more than 180 days before the effectiveness date of the loan;
- (iv) expenditures for goods supplied under a contract that any national or international financing institution or agency will have financed, or has agreed to finance, including any contract financed under any loans from the Asian Development Bank;
- (v) expenditures for goods intended for a military or paramilitary purpose, or for luxury consumption;
- (vi) expenditures for narcotics; and
- (vii) expenditures for pesticides categorized as extremely hazardous or highly hazardous in cases I-a and I-b, Classification of Pesticides by Hazard and Guidelines to Classification.

## COST ESTIMATES AND FINANCING PLAN

**Table A9.1: Detailed Cost Estimate by Expenditure Category**

Item	(NRs '000)			(\$ '000)			% Total Base Costs
	Foreign	Local	Total	Foreign	Local	Total	
<b>A. Investments<sup>a</sup></b>							
1. Equipment	337,856.3	112,618.8	450,475.0	4,565.6	1,521.9	6,087.5	57
2. Vehicles	1,480.0	2,220.0	3,700	20.0	30.0	50.0	-
3. Training	22,200.0	22,200.0	44,400.0	300.0	300.0	600.0	6
4. Consulting Services	47,389.6	226,847.0	274,236.6	640.4	3,065.5	3,705.9	34
<b>Total Investment Costs</b>	<b>408,925.9</b>	<b>363,885.8</b>	<b>772,811.6</b>	<b>5,526.0</b>	<b>4,917.4</b>	<b>10,443.4</b>	<b>97</b>
<b>B. Recurrent Costs</b>							
1. Implementation	0	22,915.7	22,915.7	0	309.7	309.7	3
<b>Total Recurrent Costs</b>	0	22,915.7	22,915.7	0	309.7	309.7	3
<b>Total Baseline Costs</b>	408,925.9	386,801.5	795,727.3	5,526.0	5,227.0	10,753.1	100
Physical Contingencies <sup>b</sup>	20,446.3	19,340.1	39,786.4	276.3	261.4	537.7	5
Price Contingencies <sup>b</sup>	16,357.0	24,379.2	40,736.2	71.6	106.3	177.9	2
<b>Total Project Costs<sup>c</sup></b>	<b>445,729.2</b>	<b>430,520.7</b>	<b>876,249.9</b>	<b>5,873.9</b>	<b>5,594.7</b>	<b>11,468.6</b>	<b>107</b>

– = not available.

<sup>a</sup> In mid-2006 prices. Potential exchange rate fluctuations under the assumption of constant purchasing power parity exchange rates.

<sup>b</sup> Physical contingencies on all expenditure accounts are assessed at 5%. Price contingencies are estimated at 7.25% and 5.75% per year, respectively, on local currency; and 2.35% and 1.90% per year, respectively, on foreign exchange.

<sup>c</sup> Includes taxes and duties of \$0.16 million.

Source: Asian Development Bank estimates.

**Table A9.2: Disbursement Accounts by Financiers**  
(\$ '000)

Item	Total	Asian Development Bank (Grant)	Rural Finance Institutions	Government
<b>A. Investment Costs<sup>a</sup></b>				
1. Equipment	6,467.0	5,410.6	1,056.4	0
2. Vehicles	53.1	26.6	0	0
3. Training	644.2	515.3	0	0
4. Consultant Services				
a. International Consultants	680.4	680.4	0	0
b. National Consultants	3,291.5	2,003.2	0	1,288.3
Subtotal (A4)	3,971.9	2,683.5	0	1,288.3
5. Taxes and duties	<b>0</b>	<b>0</b>	<b>0</b>	155.4
<b>Subtotal (A)</b>	<b>11,136.1</b>	<b>8,636.0</b>	<b>1,056.4</b>	<b>1,443.7</b>
<b>B. Recurrent Costs</b>				
1. Implementation	332.5	64.1	0	268.4
<b>Subtotal (B)</b>	<b>332.5</b>	<b>64.1</b>	<b>0</b>	<b>268.4</b>
<b>Total</b>	<b>11,468.6</b>	<b>8,700.0</b>	<b>1,056.4</b>	<b>1,712.1</b>

<sup>a</sup> In mid-2006 prices. Potential exchange rate fluctuations under the assumption of constant purchasing power parity exchange rates.  
Source: Asian Development Bank estimates.

## PROCUREMENT PLAN

### A. Procurement

1. All procurement of goods, related services and works financed by the Asian Development Bank (ADB) will follow procedures outlined in ADB's *Procurement Guidelines* (2006). Consulting service will be procured in accordance under ADB's *Guidelines on the Use of Consultants* (2006). Procurement of goods and services will follow ADB's standard bidding documents.

### B. Goods (\$5.5 million)

2. **International Competitive Bidding (ICB)** (\$4.8 million). Goods and equipment contract for the management information system (MIS) package (software, hardware, training, peripheries, and installation) for the Agricultural Development Bank Limited (ADBL) restructuring estimated to cost \$1 million equivalent or more per contract will be procured using ICB.

3. **National Competitive Bidding (NCB)** (\$0.7 million). Goods and equipment contracts estimated to cost between \$100,000 and \$1 million will be procured through NCB procedure. These include: (i) office equipment for the ADBL restructuring, (ii) supportive legal and regulatory framework, and sector capacity building (training institute); and (iii) MIS package (software, hardware, peripheries, and installation) for sector capacity building.

4. **Shopping** (\$26,600): Goods and equipment contracts estimated to cost \$100,000 or less per contract may be procured using shopping procedures. These include procurement of a vehicle for sector capacity building.

### C. Consulting Services (\$2.7 million)

5. ADB will finance consulting service package valued at \$2.7 million comprising: (i) the implementation support for ADBL restructuring estimated at \$0.8 million; (ii) the implementation support for the Small Farmers Development Bank restructuring estimated at \$0.3 million; (iii) legal review, design, and implementation of the supportive legal and regulatory framework for the supervision of microfinance institutions estimated at \$0.4 million; (iv) curriculum development, organization, and delivery of training programs for the sector capacity building estimated at \$0.5 million; (v) rural finance product design, development, and institutional capacity building for product and process innovations estimated at \$0.4 million; and (vi) project management support for \$0.3 million.

6. **Quality- and cost-based selection (QCBS)**. Consulting services will be procured following the QCBS method under the ADB's guidelines.

### D. Procurement and Selection Planning

7. Prior to issuance of invitation for bids for procurement of goods and selection of consultants, the draft bidding documents shall be furnished to ADB for its review and approval, following ADB's *Procurement Guidelines* (2006) and *Guidelines on the Use of Consultants* (2006).

8. Before the commencement of NCB procurement, ADB and the Borrower will review the Borrower's procurement procedures to ensure consistency with ADB requirements. Any

necessary modifications or clarifications to the Borrower's procedures will be documented in the procurement plan.

15. For the selection of consulting firms, ADB's standard Request for Proposal (RFP), including standard contract forms, will be used. ADB's Standard Bid Evaluation Form for Goods and Sample Form of Evaluation for Consultants Services will be followed in submission of evaluation report to ADB.

9. ADB will carry out prior review of all contracts under ICB, the first contract package under NCB, and contracts under consulting services. ADB will monitor compliance with different procurement methods and performance standards on a continuous basis. As part of the regular program review, and in consultation with the Government, ADB may revise the prior review threshold, including the procurement and selection methods.

### **E. Procurement Management Capacity**

10. The procurement activities will be administrated by the project management unit (PMU) in consultation with the implementing agencies to whom goods and services are supplied. MOF has project experience in implementing several ADB-financed projects and has good knowledge and expertise to carry out project procurement activities. The MOF's procurement management capacity has been reviewed on the basis of (i) institutional strengthening and staff skills, (ii) quality and adequacy of supporting and control systems, and (iii) suitability of rules and regulations.

11. To mitigate the procurement associated risks and to strengthen management capacity of MOF and implementing agencies, the following provisions have been made: (i) a full time consultant will be placed at PMU to assist all the aspects of procurement actions for MOF and implementing agencies, (ii) MOF will nominate a counterpart staff for the training of trainers' courses for the procurement management, and (iii) MOF will nominate an adequate number of staff to undertake formal procurement training.

**Table A10.1: Procurement Plan for the Initial 18 Months**

Project Information	
Country	Nepal
Name of Borrower	Nepal
Project Name	Rural Finance Sector Development Cluster Program I
Loan or TA Reference	Project Number: NEP 36169
Date of Effectiveness	Targeted at 30 November 2006
Project Cost (\$)	\$11.47 million
Of which ADB loan amount (\$)	\$8.7 million
Executing Agency	Ministry of Finance (MOF)
Approval Date of Original Procurement Plan	23 September 2006
Period Cover by This Plan	18 months from loan effectiveness of the Project

**Table A10.2: Procurement Thresholds Goods and Related Services,  
Works and Supply and Install and Consulting Service**

<b>Procurement Method</b>	<b>To be used above</b>
ICB Work: Goods with prior approval of bidding documents and bid evaluation reports from ADB	\$1 million above
NCB: Goods with prior approval from ADB	\$100,000 to \$1 million
<b>Procurement Method</b>	<b>To be used above</b>
Shopping: Goods without prior approval from ADB	Less than \$100,000
QCBS: Consulting service with prior review and approval by ADB	Full Technical Proposal: \$1 million or above
Exceptional Methods	none

**Table A10.3: List of Contract Packages of Goods and Consulting Services**

<b>Reference</b>	<b>Contract Description</b>	<b>Estimated Cost (\$'000)</b>	<b>Procurement Method</b>	<b>Expected Date of Advertisement</b>	<b>Prior Review Y/N</b>
Institutional Restructuring and Reform – ADBL Restructuring	MIS Package	4,755	ICB	30 June 2007	Y
Institutional Restructuring and Reform – ADBL Restructuring	Office Equipment	89	NCB	30 January 2007	Y
Supportive Legal and Regulatory Framework	Office Equipment	133	NCB	30 January 2007	Y
Sector Capacity Building	MIS Package	122	NCB	30 January 2007	Y
Sector Capacity Building	Office Equipment	133	NCB	30 January 2007	Y
Sector Capacity Building	Vehicle	27	Shopping	30 January 2007	Y
Project Management Support	Office Equipment	178	NCB	30 January 2007	Y
All	Consultants Contract	2,684	QCBS	30 January 2007	Y

## SUMMARY POVERTY REDUCTION AND SOCIAL STRATEGY

### A. Linkages to the Country Poverty Analysis

<b>Is the sector identified as a national priority in country poverty analysis?</b>	<input checked="" type="checkbox"/> Yes  <input type="checkbox"/> No	<b>Is the sector identified as a national priority in country poverty partnership agreement?</b>	<input checked="" type="checkbox"/> Yes  <input type="checkbox"/> No
<p><b>Contribution of the sector or subsector to reduce poverty in Nepal:</b>          Policy constraints, institutional inadequacies, and limited outreach have impeded the potential contribution of rural finance (RF) to rural and agricultural growth. The development of a sound, sustainable RF sector is essential to extend broad-based, pro-poor economic growth in the rural sector, and employment and income-generating opportunities to poor in rural areas. By transforming the Agricultural Development Bank Limited—the key RF institution in the country—into a reliable and sustainable RF service provider, and by strengthening its rural network, the delivery of essential financial services to the rural sector will be improved. The financial services will support rural economic activities, and reverse negative capital flows and the exodus of rural migrants to urban centers. This process will induce increased rural household asset accumulation, private sector development (especially micro and small enterprises), better income- and employment-generation opportunities, and improved rural livelihoods.</p>			

### B. Poverty Analysis

**Targeting Classification:** General intervention

#### What type of poverty analysis is needed?

Nepal is an overwhelmingly rural and agrarian economy. More than 85% of the population lives in rural areas, and nearly 80% of the labor force is engaged in agriculture and related activities. Smallholders and marginal farmers operate 90% of the 2.7 million agricultural holdings. Agriculture sector growth has been low and employment—farm or non-farm—is mainly in subsistence activities. This has resulted in a poverty incidence of 31% and a per capita gross domestic product of only \$292, the lowest among South Asian countries. Further, with annual population growth of 2.2%, Nepal needs to absorb about 300,000 new laborers a year, mostly in rural areas. An estimated 17.6 million people, or a majority of the population of Nepal, lack access to financial services. A fraction of the rural households have access to institutional sources of financial services. The Government of Nepal plans to support enhancement of rural employment, add value to rural produce, and strengthen rural-urban economic links under its Tenth Plan (Poverty Reduction Strategy Paper) 2002–2007.

The initial poverty analysis focused on small and marginal farmers in terms of their socioeconomic status, access to RF services, savings habits, and level of savings and indebtedness. The poverty analysis identified issues and constraints faced by the small and marginal farmers, including women. It showed that, due to the severely underdeveloped formal financial sector and rural security concerns, a majority of the rural population has no access to formal financial services (even to savings products), and/or depend on informal sources of finance that charge extremely high interest rates. Because formal institutional credit from the Government and nongovernment organizations lacks financial discipline and sustainability, it achieves marginal outreach to the rural poor. The prolonged conflict in Nepal severely disrupted access to financial services, especially in rural areas. Most of the financial institutions are reticent to operate in rural areas, and commercial banks have reduced the size of their rural networks due to a rationalization of their operations. As a result, unmet or under-met demands for formal credit for investment are considerable, constraining the poor's opportunities to initiate gainful income-generating activities and improve their social and economic welfare. During program appraisal, the poverty analysis was elaborated to develop targets, strategies, and products to enhance the accessibility of RF by the poor, especially women.

### C. Participation Process

#### Is there a stakeholder analysis?

Yes       No

The Program aims to enhance the access to RF services by the rural poor people, especially through the institutional reform and strengthening of important RF institutions (RFI)—Agricultural Development Bank Limited, and Small Farmers Development Bank (SFDB). Institutional and operational reviews of those organizations were conducted in 2003, including a participatory client survey. Focused group interviews were undertaken to identify special needs and demands for RF services by the rural poor.

#### Is there a participation strategy?

Yes       No

The restructuring plan for SFDB, a main microfinance provider, incorporates a participation strategy to incorporate beneficiary clients' views and demands into SFDB's operations. In addition, the policy review to be undertaken will address the issue of inclusion of the poor's needs and demands in the operations of RFIs.

**D. Gender Development****Strategy to maximize impacts on women:**

The social analysis will include gender analysis to identify issues and constraints for women to access and utilize RF services. A strategy of social intermediation was prepared during program appraisal to assess special support to increase women's accessibility to RF services, as well as training and skill development needs for women.

**Has an output been prepared?** (to be prepared as part of the institutional strengthening and reform to be undertaken during the Program)  Yes  No

**E. Social Safeguards and Other Social Risks**

<b>Item</b>	<b>Significant/ Not Significant/ None</b>	<b>Strategy to Address Issues</b>	<b>Plan Required</b>
<b>Resettlement</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	Implementation of the Rural Finance Sector Development Cluster Program (RFSDCP) is not expected to create any resettlement issues due to marginal scale of subprojects to be undertaken by the beneficiaries. The Program will have positive impacts on resettlement due to improved productivity in agriculture sector, as well as greater employment and more diversified employment opportunities in the rural economy.	<input type="checkbox"/> Full <input type="checkbox"/> Short <input checked="" type="checkbox"/> None
<b>Affordability</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	RFSDCP will not create any affordability-related issues. In contrast, reduced dependence on expensive informal sources of credit will lower the prices of inputs and cost of production, as well as ensure that rural households are able to get better prices for their produce. The reduced cost of production, along with productivity improvements, will result in a competitive rural sector that will not be as dependent on Government subsidies and welfare programs.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>Labor</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	Enhanced outreach as a result of RFI restructuring will increase rural economic activities, leading to more jobs. Further risk mitigation measures to be provided under RFSDCP I will create favorable labor conditions in rural agricultural and non-agriculture sectors.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>Indigenous Peoples</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	No adverse issues related to indigenous people are anticipated. Rather, indigenous people will benefit from an expanded outreach of RF services.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>Other Risks and/or Vulnerabilities</b>	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None		<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No