



Project Preparatory Note

Project Number: 36169
August 2004
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NEP: Rural Finance Sector Development Cluster
Program

PROJECT PREPARATORY NOTE

NEPAL: RURAL FINANCE SECTOR DEVELOPMENT CLUSTER PROGRAM (RFSDCP)

I. BACKGROUND

1. A healthy and vibrant rural finance (RF)¹ sector including the microfinance (MF) sub-sector is required in Nepal for reducing poverty, generating employment, and enhancing agricultural production and productivity. His Majesty's Government of Nepal (HMGN), therefore, aims to develop the RF sector for poverty reduction and income expansion. Asian Development Bank (ADB) prioritized its support for enhancing the access of the poor households to MF. The ongoing ADB-funded Rural Microfinance Project² supports the development of the MF subsector through conducive policies and regulation, institutional strengthening, and onlending funds.

2. HMGN sequenced the reform of the state-owned Agricultural Development Bank of Nepal (ADBN), the major RF provider for rural enterprises and agriculture,³ along with Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL), the two largest state-owned commercial banks (CBs). The reform of these three banks for improving their financial and operational status is a HMGN commitment under the ongoing Poverty Reduction and Growth Facility (PRGF) of the International Monetary Fund (IMF). The World Bank is supporting the restructuring of RBB and NBL. Consistent with ADB's lead role in the RF sector and emphasis on strengthening good governance, ADB assistance for a diagnostic study and portfolio audit of ADBN was provided to HMGN.⁴ The outcome reiterated governance, financial, and institutional inadequacies that affect the sustainability and potential outreach of ADBN. After a consensus on the findings, an ADBN Restructuring Plan (ARP) was developed with ADB assistance in consultation with stakeholders. On HMGN approval of the ARP in February 2004, the proposed RFSDCP was included in the Country Strategy and Program (2005-2009) to support broad based inclusive economic growth and strengthen corporate governance. While subprogram I of the proposed RFSDCP with \$40 million ADB loan is firm for 2005, subprogram II with \$35 million ADB loan is firm for 2007 and standby for 2006.

II. ISSUES

A. Major Issues in the Context of the Sector

3. Nepal is an overwhelmingly rural and agrarian economy. Over 85% of the population live 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, either farm or nonfarm, is mainly in

¹ Financial services provided to rural farm and nonfarm households. Microfinance (MF), as an RF subset, exclusively targets the poor. In this paper, if not specified, the terms 'RF' and 'RF institution (RFI)' include 'MF' and 'MF institutions' respectively.

² ADB. 1998. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to the Kingdom of Nepal for the Rural Microfinance Project*. Manila.

³ The quantum and tenure of RF services for farmers with seasonal cash flows and rural enterprises with large medium- to long-term requirements are different compared to MF, which is more suited to clients with regular cash flows that require small short-term non-collateralized loans.

⁴ ADB. 2000. *Technical Assistance to the Kingdom of Nepal for Corporate and Financial Governance Institutional Support - Subcluster 5: Financial and Operational Review of Agricultural Development Bank of Nepal and Nepal Industrial Development Corporation*. Manila for \$850,000 approved on 6 December 2001 and 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.

subsistence activities. This has resulted in poverty incidence of 38% and a per capita gross domestic product of \$241, the lowest in South Asia. Further, with a population growth rate of 2.2%, Nepal needs to absorb about 300,000 new laborers, mostly rural, every year.

4. As a part of its rural and agriculture development agenda, HMGN supported the emergence of a diverse RF sector for enhancing investments in agriculture and nonfarm activities to generate rural employment, provide value addition to rural produce, and strengthen rural-urban economic linkages. However, policy constraints, institutional inadequacies, and limited outreach impeded the potential contribution of RF to rural and agricultural growth.

- (i) **Policy Paradigm.** As a state-owned bank, ADBN for the most part operated under a paradigm that repressed viable financial intermediation through controls on pricing and client selection. In response to rural poverty, HMGN control of RF was perpetuated on the assumption that access to cheap credit could induce investment. Despite some success in credit expansion, availability of medium- to long-term rural credit has remained limited.
- (ii) **Institutional Inadequacies.** The diagnostic study highlighted weak non-market driven management, deviation from best practice standards, inefficiencies, and heavy overheads. In addition, deficiencies in loan appraisal and delinquency management contributed to low repayments and accumulation of non-performing loans up to one-third of the portfolio. On institutional aspects, the diagnostic study found that governance, transparency, corporate planning, management information system, human resource management, accounting, and auditing require significant improvements. Inadequate supervision allowed these weaknesses to remain unattended. As a result, sustainability of ADBN successively declined.
- (iii) **Limited Outreach and Range of Services.** With the largest branch network in the country, ADBN including the Small Farmers Development Bank (SFDB), a subsidiary, accounts for three fourths of agriculture credit disbursements. Nevertheless, all formal sources including ADBN and SFDB reach only 23% of the total rural households. Given the limited access to credit, the rural households have been restricted to borrowing substantially below their need from informal sources at usurious interest rates. Qualitatively, the services provided by ADBN show lack of variety and depth. Further, at the sector level, the RF system is not in a position to provide credit products tailored to purpose, crop insurance, and remittance services.

5. HMGN opted for ADBN restructuring⁵ in view of the demand and supply gap for RF services from formal sources. Realistic alternatives that could substitute for ADBN outreach are not immediately available and the cost of liquidating ADBN, both financial and political, is significantly higher than the estimated restructuring cost. Further, private sector capacity or interest to acquire ADBN and continue its rural operations does not exist, at least for the present. Merger with a CB is also not feasible considering ADBN's size and depth of issues.

6. Restructuring of ADBN is important, as its weaknesses on the one hand raises the risk perception of RF and deters the CBs from extending their RF portfolio. On other hand, there is a growing apprehension that the ongoing restructuring of RBB and NBL will further reduce their rural branch network. Without a viable nation-wide RF delivery system, ADB's rural and agriculture sector projects that require subproject financing will continue to be affected.

⁵ Restructuring of RFIs is being supported by ADB, among others, in Lao PDR, Pakistan, Mongolia, and Sri Lanka.

Restructuring of ADBN along with the ongoing ADB-assisted efforts to strengthen the MF subsector (para.1) will enhance the diversity of RF products for the rural sector.

7. Inadequate access to RF services is also a cause of concern in the context of the ongoing insurgency, especially in the rural areas. Considering that RF institutions (RFIs) have been adversely affected due to the insurgency, it is important to strengthen the RFIs that can significantly enhance the supply of RF with improvements in security situation. The challenge is to support the development of RF sector that will be able to provide quality RF services on a permanent basis as well as meeting the immediate financing needs of rural households.

B. Methodology to Resolve the Issues

8. This ongoing financial sector reform under IMF's PRGF has set the basis for fundamental RF reforms that require simultaneity in dealing with the policy environment, financial infrastructure, and institutional reforms. Financial markets are deepening with improved legislation and institutional restructuring. The enactment of the Banks and Financial Institutions Ordinance 2003 (BFIO) has created a legal framework that allows financial intermediaries, including RFIs, to be established based on equity size and scope of functions. In addition, the BFIO requires that all financial intermediaries, including RFIs, henceforth be subject to Nepal Rastra Bank (NRB), the central bank, supervision and meet prescribed prudential norms and enhanced measures for good governance and transparency. Simultaneously, NRB is being reorganized and RBB and NBL are being restructured. The supervisory capacity of NRB for RF is being strengthened with ADB assistance.⁶

9. In consultation with ADB, HMGN is already pursuing a two-pronged approach for strengthening the RF sector, which corresponds to a sector development program (SDP) modality of ADB. The first set of elements of HMGN's approach focuses on improving the (i) policy environment, (ii) financial governance, and (iii) supervisory and regulatory mechanisms. The second set of components relates to (i) implementing institutional restructuring, (ii) strengthening the demand side, and (iii) enhancing sustainable outreach. Consistent with this approach, the proposed scope and design of the RFSDCP will adopt a SDP modality to facilitate introduction of appropriate policies for optimizing investments in institutional reforms (para. 12). This approach has already enabled the HMGN to establish policies conducive for the MF sector, encourage the establishment of private sector MF banks, and introduce successful MF practices. Subsequently, HMGN also initiated the reform of state-owned MF banks, including their downsizing and privatization. On the demand side, investment in client capacity has facilitated outreach of MF services to rural poor women.

⁶ ADB. 2000. *Technical Assistance to the Kingdom of Nepal for Corporate and Financial Governance Institutional Support - Subcluster 3: Institutional Strengthening of Nepal Rastra Bank for Regulation and Supervision of Rural Finance*. Manila for \$800,000 approved on 27 August 2002.

III. PROJECT PREPARATION ACTIVITIES

A. Status of Project Preparatory Work

10. Reform of ADBN is the key recommendation of RF sector assessments of ADB as well as other funding agencies.⁷ Accordingly, ADB in consultation with HMGN, NRB, ADBN, IMF, the World Bank, and bilateral agencies ensured that the ARP reinforces good governance and sustainability. The ARP is a comprehensive road map with sequenced and phased activities for the transformation of ADBN into a sustainable RFI over a 3-4 year period, as follows.⁸

- (i) **Legal, ownership, and governance.** ADBN will be incorporated as a company with a professional board of directors. Majority ownership will initially remain with HMGN, as private sector participation is unlikely unless the ARP is substantially implemented.
- (ii) **Financial restructuring.** Capitalization and adequate provisioning for bad and doubtful assets will be undertaken based on NRB norms.
- (iii) **Organizational restructuring.** The organization will be rationalized around a profit-center concept, and right-sized through a voluntary separation scheme.
- (iv) **Institutional strengthening.** Business processes including products, services, and systems will be reoriented; information technology upgraded; and staff skills enhanced. Capacity to introduce demand adapted products and services will be specifically enhanced.
- (v) **Business plan and performance benchmarking.** ADBN will pursue a sustainable business plan emphasizing sustainability and small and marginal farmer outreach.

11. A high level committee headed by General Manager with Deputy General Managers as members, has been set up by ADBN for facilitating the implementation of the ARP. The enactment of the BFIO and the planned repeal of the ADBN Act will pave the way for incorporating ADBN as a professionally managed banking company with NRB regulatory oversight. As part of the organizational restructuring, ADBN has already rationalized its network of offices and branches and abolished 531 sanctioned staff positions. In addition, 325 staff opted for the first phase of voluntary retirement scheme. To maintain the momentum of reforms, an ongoing ADB technical assistance⁹ is improving the knowledge and skills of managers at all levels to manage the transformation of ADBN into a sustainable RFI and to lead the on-the-job training that will be essential for successfully implementing the ARP.

B. Outline of the Proposed RFSDCP

⁷ (i) ADB. 2000. *Rural Finance Development in Nepal: A Medium-term Strategy*. Manila; (ii) DFID (United Kingdom). 2000. *A Review of the Financial Sector in Nepal*. Kathmandu; (iii) World Bank. 2002. *Financial Sector Study*. Washington; (iv) ADB. 2002. *Technical Assistance to Nepal for Agriculture Sector Performance Review*. Manila; (v) ADB. 2003. *Technical Assistance to Nepal for Strengthening Corporate and Financial Governance – Subcluster 3: Institutional Strengthening of Nepal Rastra Bank for Regulation and Supervision of Rural Finance*. Manila; and *Subcluster 5: Financial and Operational Review of Agricultural Development Bank of Nepal and Nepal Industrial Development Corporation*. Manila; and (vi) GTZ (Germany). 2003. *Reforming an Agricultural Development Bank: Insights from an ex Bank CEO in Nepal*. Kathmandu.

⁸ The ARP (originally titled as Restructuring Plan for the Commercialization of ADBN) is available on request.

⁹ ADB. 2003. *Technical Assistance to the Kingdom of Nepal for Strengthening Selected Rural Financial Institutions*. Manila for \$515,000 (co-financed by the Government of Germany).

12. The objective of the RFSDCP is to develop a sustainable RF system for providing affordable services for significant poverty reduction and income expansion impact. The goals include (i) sustainability, (ii) reduction in subsidy dependence, and (iii) greater outreach to small and marginal farmers. The RFSDCP will be designed as a SDP with two subprograms spread over four years. Each subprogram will have policy and project components. Subprogram II will be contingent on successful implementation of subprogram I. HMGN confirmed the tentative scope of the RFSDCP proposed by ADB Reconnaissance Mission in April 2004 (summarized below) and initiated prior actions to trigger the processing of the RFSDCP (Appendix 1). Selected prior actions are HMGN's commitment under the IMF's PRGF.

Policy Loan

Subprogram I

- **Comprehensive policy framework** for RF development and a medium-term RF sector road map that identifies key activities, corresponding institutions, and expected outcomes.
- **ADBN Restructuring in accordance with the ARP** (para. 10).

Subprogram II

- **ARP implementation** to continue.
- **SFDB Restructuring Plan** along with corresponding legal and policy changes.¹⁰
- **Mainstream insurance** in rural areas.

Project Loan (Subprograms I and II)

- **Institutional strengthening of ADBN** (and possibly of SFDB) will cover governance, organization, human resources, business process, and products and services. Support will be contingent on meeting agreed performance benchmarks.
- **Capacity building** will include support for developing a center for excellence in RF training. Assistance will be provided to (i) CBs for upgrading their RF operations and enhancing RF products, services, and technology; and (ii) introducing risk mitigation products and services.
- **Project management** support will include capacity building for project management unit and project implementation units.

Technical Assistance

- **Technical Assistance** (\$400,000) will be provided for ARP implementation.

C. Gaps in Project Design

13. During processing, (i) the phasing of the policy and project interventions will be firmed up keeping in view the expected costs,¹¹ fiscal implications, and financing arrangements; (ii) performance benchmarks for ADBN will be updated based on the latest financial statements, agreed business projections, and the assessment of the duration of the reform process; (iii) risk associated with the reform process will be reassessed; (iv) policy matrix will be developed; (v) program framework (Appendix 2) will be firmed-up; (vi) initial summary poverty and social analysis (Appendix 3) will be finalized; and (vii) updated status of RBB and NBL reforms including fiscal implications will be reviewed to draw lessons learned. In addition, the scope of

¹⁰ While ADBN will be the key focus of the RFSDCP, the sub program II could include SFDB if the loan size permits.

¹¹ The estimated \$100-125 million cost of restructuring ADBN comprises recapitalization, resolution of non-performing loans, rightsizing, and institutional strengthening. This estimate will be firmed up based on the financial statements for the year-ending July 2004. Part of the costs, especially for recapitalization, could be met by asset and liability adjustments and, depending on the phasing of the costs, by the expected improvements in ADBN profitability.

the proposed technical assistance will be determined and either crop or weather-based insurance will be considered as pilot component.

D. Resources Required

14. A Financial Advisor (4-person months) and a Legal Advisor (2-person months), both domestic consultants, have been fielded in June 2004 to assist the transformation of ADBN into a company and finalize the phasing of the financial restructuring. Individual domestic consultant could be recruited for one person-month, on a need basis, for social and poverty assessment. The TOR for the consultant is in Appendix 4.

E. Time Frame

15. The fact-finding and appraisal missions have been tentatively scheduled for September 2004 and November 2004 respectively in response to HMGN's request for implementation of subprogram I in the first quarter of 2005. Subject to completion of prior actions (Appendix 1), the processing of the RFSDCP is proposed as per the following schedule.

Fact Finding	I – II May 2005
1 st Management Review Meeting	III September 2005
Appraisal	I-II October 2005
2 nd Management Review Meeting	IV October 2005
Loan Negotiation	I November 2005
Board Circulation	III November 2005
Board Approval	II December 2005

**AGRICULTURAL DEVELOPMENT BANK, NEPAL (ADBN)
Major Actions for 2004**

**This information was deemed confidential according to exception #s 2 and 3
of ADB's Public Communications Policy (2005)**

PROGRAM FRAMEWORK

Design Summary	Measurable Indicators	Monitoring Mechanisms	Assumptions and Risks
<p>1. Sector/Area Goals</p> <p>Economic growth and poverty reduction through access to affordable rural finance (RF) services</p>	<p>Reduce poverty incidence from 38% in 2000 to 28% by 2008</p> <p>Attain economic growth rate of 6% by 2008</p> <p>Enhance outreach and sustainability of the RF sector</p>	<ul style="list-style-type: none"> • Economic reform program assessment • Program reports • Program reviews (semiannual, annual and midterm) • Impact monitoring report • Project completion report (PCR) • Asian Development Bank (ADB) review missions 	<p>Macroeconomic growth and market opportunities will continue to improve the profitability of rural economic activities</p> <p>Sustained progress in the security situation in rural areas</p>
<p>2. Purpose</p> <p>Establish a sustainable RF system through policy, legal, regulatory, and institutional reforms</p>	<p>Develop policy framework for RF sector to decrease His Majesty's Government of Nepal's (HMGN's) direct involvement in provision of RF services</p> <p>Strengthen the enabling legal and regulatory framework for RF sector</p> <p>Enhance sustainability of RFIs through governance reforms, mainstreaming of RF industry best practice, and diversification of products and services</p> <p>Expand the RF sector through active participation of commercial banks (CBs) and their increased outreach</p>	<ul style="list-style-type: none"> • Program reports • Program reviews • Audit reports • ADB review missions • PCR • Project performance audit report 	<p>HMGN'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>3. Outputs</p> <p>3.1 Favorable policies for RF development</p>	<p>Policy letter and policy matrix implemented</p> <p>Independent and autonomous RFIs operating in a competitive environment</p>	<ul style="list-style-type: none"> • Program reports • Program reviews • ADB review missions 	<p>HMGN 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>

Note:

- Indicators will be firm-ed-up during processing.
- Details on Small Farmers Development Bank (SFDB) will be incorporated after it is decided to include SFDB restructuring under the proposed Rural Finance Sector Development Cluster Program.

Design Summary	Measurable Indicators	Monitoring Mechanisms	Assumptions and Risks
3.2. Institutional reforms and restructuring	Strengthened corporate governance at the Agricultural Development Bank of Nepal (ADB) and Small Farmers Development Bank (SFDB) by implementing policy attributes that emphasize sustainability and autonomy	The Memorandum of Association, Article of Association, and Banking License for ADB and SFDB Nepal Rastra Bank (NRB) monitoring and supervision reports	ADB and SFDB will be restructured to ensure good corporate governance NRB will effectively supervise ADB and SFDB
3.2.1. Restructured ADB	ADB Restructuring Plan (ARP) implemented	ADB reports and documents Program reports Program reviews ADB review missions	Continued emphasis by NRB on good governance and capable board of directors and management team at ADB Proper phasing and institutionalization of systems and procedures
(i) ADB board of directors effectively managing and controlling operations	Directors, Chairperson, President, and Management team appointed and ARP approved by the new board	Operating manuals Program reports	Staff commitment for reorientation
(ii) Systems developed	Systems documented in operating manual	Program reports Program reviews	Management commitment to right-size ADB continues
(iii) Organization rationalized and rightsizing undertaken	Organization de-layered, severance pay paid to 700 staff by 2006	Program reports Program reviews	Management commitment for enhancing institutional efficiency
(iv) Efficient systems and procedures and management information system implemented	Improved credit appraisal and monitoring system installed	Repayment record Portfolio quality	Operating procedures reflect the local context
(v) Outreach backed by improved loan appraisal	Staff incentives linked to repayment performance and enhanced credit risk management system installed	Repayment record Portfolio quality	Delinquency is within manageable limits
(vi) Repayment rates and profitability enhanced	Staff trained to meet new job specifications	Productivity and performance indicators	NRB is proactive in downscaling CB operation
(vii) Staff trained	RF training center opened; director appointed; course design finalized; training materials developed; trainers trained; and training conducted	Program reports Program reviews ADB review missions	NRB earmarks adequate human resources
3.2.2 Strengthening the RF operations of CBs	RF Training Centre provide training and advisory services to CBs	HMGN to furnish the guidelines	CBs maintain interest in expanding rural portfolio
3.3 Crop or Weather-based Insurance Plan to mitigate borrower and lender risks in RF	Crop or Weather-based Insurance Plan prepared and presented to insurance service providers	Program reports Program reviews ADB review missions	Cost of premium is affordable and reinsurance is available
	Crop or Weather-based Insurance Plan operationalized		Economic growth and political stability

Design Summary	Measurable Indicators	Monitoring Mechanisms	Assumptions and Risks
<p>3.4 NRB effectively supervises RFIs</p> <p>3.5 Outreach expansion through ADBN and SFDB</p> <p>3.6 Effective project management</p>	<p>Supervisory and regulatory system revised and equipment installed</p> <p>NRB staff further trained on supervision and regulation of RFIs</p> <p>About 150,000 over the current level by ADBN and SFDB by 2008</p> <p>Increase in the amount of rural savings mobilized by RFIs by 40% by 2008</p> <p>A project management unit (PMU) is established in the Ministry of Finance and project implementation units (PIUs) at NRB and ADBN.</p>	<p>Program reports Program reviews ADB review missions</p> <p>Trainer's report</p> <p>Program reports Program reviews ADB review missions</p> <p>Program reports Program reviews ADB review missions</p>	<p>NRB takes a proactive role in RF sector development</p> <p>The environment for RF remains conducive</p> <p>RFIs focus on the lower segments of the market, especially the small and marginal farmers and maintain performance standards to attract resources for outreach expansion.</p> <p>Capable and adequate PMU/PIU staff appointed.</p> <p>Cooperation between PMU and PIU is effective.</p>
<p>4. Activities</p> <p>4.1 Creating favorable policies that include redefining the role of HMGN, effective supervision and regulation for deposit protection, and promoting private sector participation in RF</p> <p>4.2 Implementing institutional reforms and restructuring of ADBN and SFDB by strengthening governance, organization, human resources, business process, and products and services</p> <p>4.2.1 Restructure ADBN</p> <p>(i) Appoint Board of Directors and Chairperson</p> <p>(ii) Develop updated systems and procedures in line with best practices and train staff on the updated systems and procedures</p>	<p>Favorable policies adopted</p> <p>High-level coordinating body for the RF sector policies established</p> <p>RF sector supervision and regulation improved</p> <p>Legal changes made to facilitate the incorporation of ADBN and SFDB into companies with professional board and the flexibility to undertake institutional reforms</p> <p>ARP implemented</p> <p>ADBN Board of Directors appointed</p> <p>Chairperson selected</p> <p>Operating manuals developed</p> <p>Staff training conducted</p>	<p>HMGN provided policy framework Program reports Program reviews ADB review missions</p> <p>The Memorandum of Association, Article of Association, and Banking License for ADBN</p> <p>NRB monitoring and supervision reports</p> <p>ADBN reports and Documents Program reports Program reviews ADB review missions</p> <p>ADBN reports Program reports Program reviews</p> <p>ADBN reports Program reports Program reviews</p>	<p>The RF policy is pursued and implemented without political interference</p> <p>ADBN and SFDB committed to implement institutional reforms</p> <p>No political interference in ARP implementation</p> <p>Qualified professionals are available as Board members</p> <p>Trained staff will remain at ADBN</p>

Design Summary	Measurable Indicators	Monitoring Mechanisms	Assumptions and Risks
(iii) Carry out organizational rationalization and rightsizing	Organization restructured Staff size reduced by 700 by 2006	ADB reports Program reports Program reviews	ADB will retain skilled staff
(iv) Establish effective MIS system	Physical infrastructure for MIS installed Operating manual developed Staff trained	ADB reports Program reports Program reviews	Availability of qualified expert to provide MIS development support
(v) Expand outreach through improved loan appraisal	150,000 rural households, small and microenterprises receive loans by end 2008 Improved quality of loan portfolios Increased number of loan appraised per each loan officer	ADB reports Program reports Program reviews	Favorable economic environment in the rural sector
(vi) Improve repayment performance and portfolio quality	Staff incentive system to increase repayments developed New credit risk management system developed	ADB reports Program reports Program reviews	Conducive conditions are created for the repayment of dues in time
(vii) Train staff according to reformed functions	Staff training curriculum developed Training conducted for ADBN staff engaged in operations	ADB reports Program reports Program reviews	Trained staff retained at ADBN
4.2.2 Establish RF training center including appointing Director, developing training materials, training the trainers, and conducting training	RF training center established and operated CBs receive advisory services by the RF training center	RF training center reports and documents Program reports Program reviews ADB review missions	NRB's continuing engagement in downscaling CB operations Availability of qualified human resources within NRB CBs' commitment for expanding businesses in the rural sector
4.3 Initiate a Crop or Weather-based Insurance Plan	Crop or weather-based Insurance Plan adopted and participated by insurance service providers Risk for farmers mitigated in selected districts	HMGN guidelines on Crop Insurance Plan Program reports Program reviews ADB review missions	Availability of reinsurance Farmers' willingness to pay the insurance premium Conducive rural economic environment
4.4 Enhance NRB's supervisory capability for RFIs	New supervisory and regulatory system installed Infrastructure for supervisory system installed NRB staff trained	Program reports Program reviews ADB review missions	

Design Summary	Measurable Indicators	Monitoring Mechanisms	Assumptions and Risks
4.5 Establish Program Management Unit (PMU) and Program implementation units (PIUs)	PMU established at the Ministry of Finance PIUs established at NRB and ADBN	Program reports Program reviews ADB review missions	Availability of capable staff for PMU and PIUs Effective coordination among PMU and PIUs
5.Inputs Program Loan ADBN Restructuring -Re-capitalization -Resolving non-performing assets Total Project Loan Institutional Strengthening Training and capacity building Project Implementation Support Counterpart Contribution Total	Amounts to be decided during the processing based on the latest financial statements.	Program reports Program reviews ADB review missions	HMGN willingness to borrow for institutional strengthening. Competent consultants are timely fielded. Quality equipment is procured.

INITIAL POVERTY AND SOCIAL ANALYSIS (IPSA)

A. Linkages to the Country Poverty Analysis

Is the sector identified as a national priority in country poverty analysis?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	Is the sector identified as a national priority in country poverty partnership agreement?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
<p>Contribution of the sector or subsector to reduce poverty in Kingdom of Nepal:</p> <p>Policy constraints, institutional inadequacies, and limited outreach impede the potential contribution of rural finance (RF) to rural and agricultural growth. The development of a robust, vibrant, and sustainable RF sector is essential for broad based and inclusive pro-poor growth with rural emphasis. Reforming Agricultural Development Bank of Nepal (ADBN), the key RF institution, through conducive policies and institutional support, into a sustainable RF service provider and strengthening its rural network will facilitate the outreach of affordable RF services to the rural households particularly to the small and marginal farmers. The enhanced outreach of affordable RF services will improve agricultural production and productivity, generate rural employment, provide value addition to rural produce, and strengthen rural-urban economic linkages through investments in agriculture and nonfarm activities. These will have significant poverty reduction and income expansion impact, as three-fourths of the rural population depends on the agriculture sector for subsistence.</p>			

B. Poverty Analysis

Proposed Targeted Intervention

What type of poverty analysis is needed?	
<p>Nepal is an overwhelmingly rural and agrarian economy. Over 85% of the population live 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, either farm or non-farm, is mainly in subsistence activities. This has resulted in poverty incidence of 38% and a per capita GDP of \$241, the lowest among South Asian countries. Further, with annual population growth rate of 2.2%, Nepal needs to absorb about 300,000 new laborers every year, mostly rural. To address these concerns His Majesty's Government of Nepal (HMGN) supported the emergence of a diverse RF sector. However, less than one-fourth of the rural households have access to institutional RF services. The weak financial and institutional capacity of ADBN increases the dependence of the small and marginal farmers on usurious informal sources that leaves very little for household asset build.</p> <p>The poverty analysis will focus on small and marginal farmers in terms of their socioeconomic status including poverty level, education and literacy, employment opportunities, and access to RF services, savings habits, and level of savings and indebtedness. Further, the poverty analysis will identify issues and constraints faced by the small and marginal farmers, including women, in accessing institutional RF services and assess their ability to effectively utilize RF services. In addition to the field work, the poverty analysis will use Nepal Living Standard Survey data, work undertaken by the Mission, and poverty analysis done for ADB-financed projects during 2003 and 2004 to provide inputs for enhancing the focus of ADBN on small and marginal farmers through improvements in institutional capability, credit delivery mechanism, and products.</p>	Rural households

C. Participation Process

Is there a stakeholder analysis?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	Is there a participation strategy?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
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D. Gender Development

<p>Strategy to maximize impacts on women: The social analysis will include gender analysis to identify issues and constraints for women in accessing and utilizing RF services. A strategy of social intermediation will be prepared to assess special support required to increase women's accessibility to RF services.</p>	
Has an output been prepared?	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No (to be prepared)

E. Social Safeguards and other Social Risks

Item	Significant/ Not Significant/ None	Strategy to Address Issues	Plan Required
Resettlement	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	No resettlement issues are expected from implementation of the RFSDCP due to marginal scale of subprojects to be undertaken by the prospective beneficiaries. There will be positive impacts on resettlement due to improved productivity in agricultural 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
Affordability	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	There will be no affordability-related issues. In contrast, reduced dependence on very expensive informal sources of credit will not only reduce the price of inputs, cost of production, but will also ensure that rural households are able to get better price for their produce. The reduced cost of production along with productivity improvements will result in a competitive rural sector that will not be dependent on HMGN subsidies and welfare programs.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
Labor	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	Enhanced outreach as a result of ADBN restructuring will increase rural economic activities, leading to greater employment opportunities.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
Indigenous Peoples	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None	No adverse issues relating to indigenous people are anticipated. Rather, indigenous people, depending on their need or demand, could benefit by the expanded outreach of RF services.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
Other Risks and/or Vulnerabilities	<input type="checkbox"/> Significant <input type="checkbox"/> Not significant <input checked="" type="checkbox"/> None		<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No

TERMS OF REFERENCE FOR CONSULTING SERVICES

Poverty/Social Development Specialist (Domestic, one person-month)

1. The specialist will have demonstrated strengths in sociology and poverty assessment. The specialist will assess, through participatory approach, the design of the Rural Finance Sector Development Cluster Program (RFSDCP) to ensure that the rural finance institutions (RFIs) being restructured with RFSDCP support adequately enhance the access of small and marginal farmers to institutional rural finance (RF).

2. Based on the summary social and poverty analysis prepared by the Mission, similar assessments made for Asian Development Bank (ADB)-financed projects during 2003 and 2004, and Nepal Living Standard Survey data the specialist will undertake further gender-specific social analysis and poverty impact assessment to provide inputs for reinforcing the goal of enhanced access to small and marginal farmers, especially women. The specialist will specifically undertake the following.

- (i) Gather further gender disaggregated details on small and marginal farmer households in terms of their socioeconomic status including poverty level, education and literacy, employment opportunities, and access to RF services, savings habits, and level of savings and indebtedness.
- (ii) Identify, through participatory methodology, issues and constraints faced by the small and marginal farmers including women in accessing institutional RF services and review their ability to effectively utilize RF services.
- (iii) Based on the above, provide inputs that could be useful during the processing of the RFSDCP to enhance the focus of RFIs on small and marginal farmers with special emphasis on women beneficiaries with regard to institutional capability of RFIs, credit delivery mechanism, and new products.

(Consultant has been hired.)