

ASIAN DEVELOPMENT BANK

RRP:NEP 28332

**REPORT AND RECOMMENDATION
OF THE
PRESIDENT
TO THE
BOARD OF DIRECTORS
ON A
PROPOSED LOAN
AND
TECHNICAL ASSISTANCE GRANT
TO THE
KINGDOM OF NEPAL
FOR THE
CORPORATE AND FINANCIAL GOVERNANCE PROJECT**

November 2000

CURRENCY EQUIVALENTS

(as of 17 November 2000)

Currency Unit	-	Nepalese Rupee/s (NRe/NRs)
NRe1.00	=	\$0.0133
\$1.00	=	NRs 74.94

The Nepalese rupee is pegged to the Indian rupee (Re) at NRs1.60 to Re1.00. It is fully convertible on all current account transactions.

ABBREVIATIONS

ADB	-	Asian Development Bank
ADB N	-	Agricultural Development Bank of Nepal
ASB	-	Accounting Standards Board
AuSB	-	Auditing Standards Board
CDS	-	Central Depository System
CLB	-	Company Law Board
CRO	-	Companies Registrar Office
Danida	-	Danish International Development Assistance
DFI	-	development finance institution
DFID	-	Department for International Development
EPF	-	Employee's Provident Fund
GDP	-	gross domestic product
GTZ	-	Gesellschaft Für Technische Zusammenarbeit (German Agency for Technical Cooperation)
HMG N	-	His Majesty's Government of Nepal
eFIT	-	electronic finance and information technology
ESAF	-	Enhanced Structural Adjustment Facility
IA	-	Implementing Agency
ICT	-	information and communication technology
ICAN	-	Institute of Chartered Accountants of Nepal
IMF	-	International Monetary Fund
IT	-	information technology
MIS	-	management information system
MOF	-	Ministry of Finance
NBFI	-	nonbank financial institutions
NBL	-	Nepal Bank Limited
NEPSE	-	Nepal Stock Exchange
NGO	-	Nongovernment organization
NIDC	-	Nepal Industrial Development Corporation
Ninth Plan	-	Ninth Five-year Plan, FY1998-FY2002
NJA	-	National Judicial Academy
NRB	-	Nepal Rastra Bank
NJA	-	National Judicial Academy
RBB	-	Rastriya Banijya Bank
RRDB	-	regional rural development bank

SDR	-	Special Drawing Rights
SEBO	-	Securities Board
SOCB	-	state-owned commercial bank
STC	-	Secured Transaction Center
TA	-	technical assistance
RFI	-	rural financial institutions
UNDP	-	United Nations Development Programme

NOTES

- (i) The fiscal year (FY) of the Government ends on 15 July. FY before a calendar year denotes the year in which the FY ends, e.g., FY2000 began on 16 July 1999 and ended on 15 July 2000.
- (ii) In this report, "\$" refers to US dollars.

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LOAN AND PROJECT SUMMARY

Borrower	The Kingdom of Nepal
Project Description	<p>The Project will support a long-term process for sustainable private and financial sector development by strengthening the basic foundations of Nepal's corporate and financial sector. It will improve governance, transparency, and accountability in the corporate and financial sector by (i) upgrading the legal and regulatory framework, standards, and policies; (ii) strengthening key sector institutions involved in corporate and financial governance; (iii) strengthening institutions for improved drafting and enforcement of laws and regulations; (iv) creating an enabling environment for upgrading payment systems and information and communication technology (ICT) infrastructure for financial service delivery; and (v) preparing for the restructuring and development of selected financial intermediaries.</p>
Classification	Economic growth
Environmental Assessment	<p>Category C</p> <p>The environmental implications of the Project are minimal.</p>
Rationale	<p>To escape the poverty trap, Nepal must increase its average per capita annual growth rate in a sustainable manner to at least 5 percent, with equitable distribution. This requires, among others, an efficient financial system to support real sector growth and employment generation. Unfortunately, Nepal's financial system has not been in a position to fulfill its supportive role because of deficiencies in the basic foundations in the system.</p> <p>The fundamental requirements of an efficient financial system are a sound policy, legal, and regulatory environment with adequate institutions and effective enforcement. An efficient financial system also calls for access to reliable information that is disclosed in a timely and transparent manner, responsible market participants with proper accountability structures, and a technological infrastructure to reduce transaction costs. In short, an efficient financial system requires good corporate and financial governance with adequate ICT support. It must be in place before more sophisticated markets and services can be developed, and if financial institutions are to be successfully restructured.</p>
Objectives and Scope	<p>The long-term goal of the Project is to contribute to a higher and more equitably distributed economic growth through a robust and efficient financial sector characterized by transparency, accountability, and basic infrastructure. The results will be increased competition and better services, coupled with reduced transaction costs in financial intermediation. The Project is part of a multidimensional and longer term reform process to achieve that goal.</p>

More specifically, the Project's objective is to improve transparency, accountability and basic financial sector infrastructure comprising (i) a legal and regulatory framework, accounting standards and sector policies; (ii) key sector regulatory and supervisory institutions; (iii) a legal and judicial system with capacity for proper enforcement and dispute resolution; and (iv) environment for ICT infrastructure for payments, disclosing information, and delivering financial services. In addition, the Project will initiate work to restructure and develop selected market participants to enable them to play a better role in the financial system. In covering these assistance areas, the Project takes a holistic approach by seamlessly blending a number of loan and technical assistance (TA) grant-funded components. From a subsector perspective, the Project will focus on governance in the corporate sector and in nonbank financial institutions, including rural finance and capital markets.

At the end of the Project, key policy impediments should be removed and Nepal should possess a basic but sound regulatory and institutional framework with improved enforcement capacity, and be prepared for introduction of ICT and further reforms to support continuous growth of the financial and real sectors.

Cost Estimates

The total cost of the Project is estimated at \$13.3 million equivalent, including contingencies and taxes. The foreign exchange cost is \$7.9 million (59 percent) and the local currency cost is \$5.4 million equivalent (41 percent).

Financing Plan

Source	(\$ million)			
	Foreign Exchange	Local Currency	Total Cost	Percent
ADB Loan	5.1	2.2	7.3	54.9
ADB TA Grant	2.8	0.5	3.3	24.8
Government	0.0	2.7	2.7	20.3
Total	7.9	5.4	13.3	100.0

A loan of SDR 5.706 million in various currencies equivalent to \$7.3 million will be provided from ADB's Special Funds resources, with a term of 32 years, including a grace period of 8 years, and with an interest charge of 1 percent per annum during the grace period and 1.5 percent per annum thereafter.

Period of Utilization

Until 30 June 2005

Executing Agency

Ministry of Finance (MOF)

Implementation Arrangements

MOF will administer the loan proceeds and coordinate and monitor the implementation of the Project. To implement the loan-funded components, MOF will coordinate with the (i) Securities Board, Nepal Stock Exchange, and Ministry of Industry in improving corporate governance and capital markets; and (ii) Ministry of Law and Justice and Supreme Court in improving legal and judicial enforcement

mechanisms and capacities. In addition, MOF will coordinate with various line ministries and agencies in implementing of the TA grant-funded components. To oversee effective coordination, MOF has established a project coordination and monitoring unit which will report to a steering committee comprising private sector representatives, and which was established during the project formulation phase.

Procurement

Goods and services will be procured according to the *ADB's Guidelines for Procurement*. Supply contracts for equipment and materials will be awarded on an international competitive bidding basis for packages with over \$500,000 aggregate value, international shopping for packages costing over \$100,000, and local competitive bidding or local shopping, in accordance with procedures acceptable to ADB, for other items, except minor items for which off-the-shelf purchases will be permitted. Any civil works financed under the loan will be on a local competitive basis, as costs are less than \$5 million.

Consulting Services

The loan will finance the provision of consulting services for policy advice, institutional development and training, preparation of ICT solutions, and project management. About 87 person-months of international and 152 person-months of domestic consulting services will be required. Consultants will be recruited in accordance with *ADB's Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for engaging domestic consultants.

Technical Assistance

The Government has requested an umbrella TA with six sub-TAs under ADB's cluster modality for a total amount of \$3.3 million on a grant basis from the ADB-funded TA Program. This will complement the loan-funded components, help in preparing further sector interventions, assist in addressing key sector issues on an urgent basis, and support the establishment of a conducive framework in a more strategic and comprehensive way than would a single-TA approach. Specifically, the proposed TA cluster will comprise (i) TA 1: Streamlining Financial, Corporate, and Commercial Legislation (\$250,000); (ii) TA 2: Improved Accounting and Auditing Standards in the Public Sector (\$250,000); (iii) TA 3: Institutional Strengthening of the Nepal Rastra Bank for Regulation and Supervision of Rural Finance (\$800,000); (iv) TA 4: Developing Nepal's Payment System (\$400,000); (v) TA 5: Financial and Operational Review of Agricultural Development Bank of Nepal and Nepal Industrial Development Corporation (\$850,000); and (vi) TA 6: Developing of Insurance, Pensions, and Contractual Savings (\$750,000).

Estimated Project Completion Date

31 December 2004

Project Benefits

The Project will reinforce the basic fundamentals for a robust and efficient financial sector. It will increase transparency, accountability, and better governance standards as well as law enforcement. More reliable financial information to the public will reduce the scope for rent-seeking opportunities of individuals through a monopoly of

information at the expense of the larger society. Access to information and justice is often excessively priced for the poorest segment of the population. Initial work for upgrading the payments systems and creating the enabling environment for development of ICT infrastructure will promote competition and further growth in service delivery. It will also include measures to prevent money laundering through Nepal's payment system.

A better regulatory and institutional framework will also increase stability of the financial system and make it more robust against any financial crisis. This will reduce the risk of a negative socioeconomic impact associated with a financial crisis, which is most severe for the poorest segment of the population.

The Project is part of a longer term development process for private and financial sector development. A computable general equilibrium model as well as international comparison with other reform countries indicates that comprehensive financial sector reform will boost Nepal's annual gross domestic product growth by about 2 percent – or \$100 million – per annum. Importantly, growth will be even stronger in rural areas as any ensuing investment will raise the demand for rural labor, especially in the most labor-intensive activities.

I. THE PROPOSAL

1. I submit for your approval the following Report and Recommendation on (i) a proposed loan to the Kingdom of Nepal for the Corporate and Financial Governance Project; and (ii) proposed technical assistance (TA) cluster for Corporate and Financial Governance Institutional Support.

II. INTRODUCTION

2. Development of the financial and private sector is high on the policy agenda of His Majesty's Government of Nepal (HMGN). In response to this, the Asian Development Bank (ADB) country assistance plan for Nepal in 2000 includes the Project to improve governance in the corporate and financial sector. This represents an initial phase of a long-term reform process for sustainable financial and private sector development in Nepal.

3. Formulation of the Project and policy dialogue were based on extensive economic sector work by ADB and extensive stakeholder consultation from an early stage. A Reconnaissance Mission visited Nepal in November 1998 and identified weak financial infrastructure - including legal and regulatory framework, enforcement capacity, institutions, and technological support - as a major impediment to sustained private sector development. Subsequently, ADB conducted a number of studies and workshops to further analyze key policy and institutional issues related to nonbank financial intermediation.¹ The findings suggest that addressing corporate and financial governance issues is key to sustainable financial and private sector development, and that improving accounting standards and corporate legislation were of immediate priority.

4. In response, ADB approved a capacity building TA for the accounting and auditing profession and a TA for reform of company, insolvency and secured transactions legislation.² To augment the analytical capacity of HMGN and assist in coordinating the complex reforms in the financial sector, ADB also approved a TA³ for a focal point for financial sector reform. Under this TA, a web site (www.neat.net.np) was established for information on the reform process and discussion among stakeholders and aid agencies. In January 2000, HMGN formed a steering committee, with private sector representation, to closely interface with ADB in formulating further assistance and the proposed Project. Project implementation arrangements were finalized during a Fact-Finding Mission in April 2000 and an Appraisal Mission in September 2000. Throughout the project design phase, ADB's project team⁴ coordinated closely with the World Bank and the International Monetary Fund (IMF), as well as with the bilateral sources actively involved in the sector, such as Gesellschaft für Technische Zusammenarbeit (GTZ) and Department for International Development (DFID).

¹ ADB's findings are summarized in five reports: (i) Capital Market Development II, 1998; (ii) Private Sector Development Issues, 1999; (iii) Financial Sector Regulation and Governance in Nepal, 1999; (iv) Transparency and Enforcement in the Corporate Sector in Nepal, 1999; and (v) Information Technology Applications in the Financial Service Sector in Nepal, 2000. Some of the findings were presented and discussed with a wide range of stakeholders from the public and private sector at two workshops: Corporate Governance and Financial Sector Development, in September 1999; and Corporate and Financial Governance, in November 1999. The latter was organized at the initiative of the Nepalese legal profession through the Supreme Court Bar Association.

² TA 3356-NEP: *Capacity Building for the Accounting and Auditing Profession*, for \$665,000, approved on 22 December 1999; TA 3461-NEP: *Company and Insolvency Law Reform*, for \$250,000, approved on 27 July 2000.

³ TA 3371-NEP: *Establishing a Focal Point for Financial Sector Reform*, for \$150,000, approved on 27 December 1999.

⁴ The core project team comprised W. Liepach, Senior Financial Economist, IWFI (Mission Leader); H.P. Brunner, Senior Project Economist, IWFI; H. Sharif, Senior Counsel, OGC; L. Ding, Trade Economist, IWFI; B. Frielink, Programs Officer/Economist, NRM; K. Julian, Programs Officer, NRM; A. Sharma, Rural Finance Specialist, AWAR; X. Zhang, Economist, IWFI; J. Zveglic, Economist, PW1.

III. BACKGROUND

A. Sector Context

1. Macroeconomic and Poverty

5. Nepal's growth experience has been uneven throughout the 1990s, with overall performance dominated by the agriculture sector. Growth performance has been disappointing, averaging less than 5 percent per annum over the last decade. In FY2000, agriculture, which accounts for 41 percent of output and 76 percent of employment, grew at 5.0 percent. Industry grew by 8.3 percent, while services expanded by 5.9 percent. Inflation has been brought under control, falling from 12.7 percent in FY1999 to about 4 percent. Monetary policy has been passive, supporting the exchange rate peg with the Indian rupee, and is largely influenced by India. While treasury bill and deposit rates of 6 to 7 percent mean little real returns to these instruments, prime lending rates remain at more than 12 percent. The current account is showing a slight deficit compared with the slight surplus of the previous year. Foreign exchange reserves are at a comfortable level covering 6.7 months of imports. Even though the macroeconomic situation is currently stable, the decline in new business activities does not bode well for future performance. Company registrations, capital investment, and employment generation by new firms have been declining over the past few years in all main industrial sectors. The decline in new business activities in manufacturing in particular is worrisome, given the fact that manufacturing has traditionally been the most important industry subsector in generating new employment, ahead of tourism and services. Foreign direct investment, which is not particularly encouraged by public policies, was only 0.6 percent of gross domestic product (GDP) in FY1999.⁵

6. Policies promoting nonagricultural activities in rural areas have so far shown little impact on the ground. Industrial activity remains heavily concentrated around Kathmandu and the Central Region where 52 percent of industrial establishments are located, as well the Eastern Region which accounts for another 30 percent. Industrial activity falls away dramatically once one moves west of Kathmandu, with the Far Western Region accounting for less than 2 percent. Industrial activity is concentrated in a small number of powerful Nepali families who own and control about 27 percent of total private sector assets in the country. In addition, a number of enterprises remain in public sector hands and operate at very low efficiency. Nepal's incremental capital output ratio (ICOR) stands around 5,⁶ showing lower investment efficiency than in its South Asian neighbors which have an average ICOR of around 4. For widespread reduction of poverty, a key challenge facing Nepal is to address the long-standing constraints to higher growth, particularly the efficiency and outreach of the financial sector.

7. In 1996, about 42 percent of Nepal's population lived below the national poverty line of NRs4,404 (\$64) per capita per annum, which is based on a minimum calorie intake, housing, and other nonfood expenses. This figure varies widely across the country. While only 23 percent of the urban population did not have sufficient incomes to meet basic consumption needs, 44 percent of the rural population fell below the standard. Geographically, the incidence of poverty in the Mid-Western and Far Western development regions greatly exceeded the national average, as did the rate in the mountain districts. Taking a broader view of human deprivation than the simple income measure, Nepal ranked 144th out of 174 countries in the United Nation Development Programme's (UNDP's) 1999 Human Development Report. The

⁵ For a more comprehensive assessment of economic performance, see CER:NEP98023, January 1999.

⁶ This means investment of 5 percent of GDP is required to generate 1 percent of additional GDP growth.

people in the poorest regions of the country have the lowest access to education and basic health services, highest rates of infant mortality, and highest rates of child malnutrition. Poverty is also associated with lower access to productive inputs, which inhibits the poor's ability to break the cycle of poverty. Rural households in the lowest income quartile own a smaller percentage of the land they farm, are less likely to benefit from year-round irrigation for their land, and use less fertilizer than their better-off neighbors. Poor households tend to be located further from roads. Borrowing from formal financial institutions, including microcredit, makes up a lower share of the poor's outstanding loans.

2. Key Financial Sector Issues in Nepal

8. Ongoing financial sector reforms since the 1980s have not yielded significant improvements in resource mobilization and allocating efficiency. Traditionally, financial sector policies and institutions in Nepal were premised on these assumptions: (i) access to cheap institutional credit could break the low equilibrium trap and induce investment, (ii) informal credit agencies were exploitative and credits obtained from these sources were seldom used for productive purposes, (iii) the government was required to intervene in the sector to ensure sufficient flow of rural credit, and (iv) commercial banks had a social responsibility to serve the rural clientele even if in some cases it meant incurring losses. As a result, the policy and institutional framework was deliberately designed to allow considerable government participation and control with limited competition. Reform initiatives undertaken in the past include easing of licensing policies, statutory requirements, foreign exchange exposure, and cash reserve ratios; liberalization of the interest rates; and introduction of various prudential and regulatory reforms. However, the past piecemeal approach has not succeeded in substantially extending access to the formal financial sector to rural people, much less to the rural poor. The reform measures were not embedded in a wider policy reform framework and financial sector development strategy, and as such were improperly sequenced. Importantly, they took place within a fragmented and nontransparent legal, regulatory, and institutional environment. It is widely recognized that the financial sector, and the state-owned commercial banks (SOCBs) in particular, face many problems.

9. **Ambiguous Vision, Policies, and Strategies for Financial Sector Development.** The Government has issued a number of statements emphasizing the need for financial sector reforms and development on market-based principles, most notably in the Ninth Five-Year Plan (para. 25); however, a subset of policies with contradictory objectives exist, which aim to achieve socially desirable activities in the financial sector. The sector continues to operate in a policy environment where (i) Government targeted and subsidized interventions override competitive and efficient financial intermediation, (ii) interest rate spread does not reflect the higher transaction cost associated with rural credit, (iii) institutions have no effective control over their corporate strategy, and (iv) the opening of new urban branches of commercial banks is linked to the opening of additional rural branches. The absence of competition and of a profit motive in Government-mandated credit programs does not encourage lenders to fund projects that will produce high growth for the economy. Instead, they spawn adverse selection and moral hazard problems with negative economic and social consequences.

10. **Dominant Government Role and Poor Governance.** One striking feature in Nepal's financial sector is the extent to which the Government plays an active role. The Government owns key financial institutions - Rastriya Banijya Bank (RBB), Agricultural Development Bank of Nepal (ADBN), Nepal Industrial Development Corporation (NIDC), five regional rural development banks (RRDBs), a large share of the insurance industry, and, until recently, the Nepal Bank Limited (NBL). The central bank (Nepal Rastra Bank, NRB) itself is involved directly

in several directed lending (development fund) schemes to the microenterprise sector and to support rural finance activities. NRB is also a shareholder in a number of financial institutions that it is supposed to regulate and supervise, thus creating considerable conflict of interest and regulatory arbitrage. The Government's extensive involvement in the ownership and management of the financial sector has resulted in strong political influence and interference in all aspects of banking operations, and led to lax enforcement of auditing, provisioning, and reporting requirements. Moreover, there is concern over the lack of banking knowledge of many Government nominees to the boards of the financial institutions. Government-owned institutions, especially those established under their own separate acts, further benefit unduly - compared with their private sector competitors - from direct or indirect subsidies in the form of explicit or assumed Government guarantees, and less stringent enforcement of tax collection.

11. Poor Quality of Financial Information and Disincentives to Information Disclosure.

One of the most serious impediments to sustained growth of the private sector in Nepal is the weak accounting and financial reporting systems. Nepal lacks sound accounting and reporting standards, which are among the most fundamental prerequisites for commercial activities. There are no generally accepted accounting principles in the country, and disclosure requirements for both listed and unlisted companies are inadequate. The fact that foreign accountants are not allowed to operate in Nepal has undermined opportunities for technology and skills transfer in the sector. It is believed that many companies submit the required financial information with a few years delay, but insufficient supervision has allowed them to continue operating without much penalty. As information available to lenders is often incomplete or expensive to establish, lending is based primarily on collateral and personal guarantees instead of a credit analysis relying on financial statements and business plans. The information deficiency has resulted in misallocation of capital. Increased nonperforming assets in the banking sector and lack of investor confidence in the stock market have, in turn, increased the cost of capital for industries. The information gap also causes prudent lenders to restrict the provision of financial services to low-risk clients, or to demand excessive collateral. Enhancing the role of the Credit Information Bureau (CIB) to share information on borrowers' creditworthiness is being considered, but that requires broad-based participation of market players. In addition, poor reporting by financial institutions complicates adequate supervision and assessment of the financial sector health. Lending records within the institutions are usually maintained in manual files and often are missing or incomplete. To help address the information problem, ADB approved in December 1999 a TA to assist the Institute of Chartered Accountants of Nepal (ICAN) to raise accounting and audit standards (footnote 2).

12. Issues in Tax Administration. It is generally felt that Nepal's tax policies, particularly income tax and customs and property-related taxes, have many deficiencies. They allow tax officers to exercise discretionary powers, resulting in arbitrary tax assessment. It is widely believed that many companies maintain different books and accounts for different purposes, such as tax assessment and credit applications. Such practice has exacerbated the mistrust between tax collector and payers. The GTZ has initiated a comprehensive program to strengthen income tax administration and registration of taxpayers in the main cities. The Danish International Development Assistance (Danida) has provided assistance for introducing the value-added tax. A uniform tax identification number will be used for tax purposes. Improvement in tax administration is particularly important in corporate governance as it is indispensable for accurate financial disclosure of business entities, and information needs to be reconciled in a systematic and transparent way.

13. Fragmented and Inconsistent Legal and Regulatory Framework. Nepal's legal and regulatory environment is highly fragmented, inconsistent, and institution based rather than

function based. This is particularly true of lending activities, which are regulated by at least eight acts.⁷ The result is a segmented financial system with special privileges for government-owned institutions and regulatory arbitrage for unevenly supervised financial intermediaries, particularly in rural finance.⁸ The various acts governing the financial sector are not necessarily consistent and often conflict with commercial and corporate legislation, in particular the Companies Act. This causes a high degree of nontransparency. Laws, rules, and regulations allow for discretionary interpretation and lead to excessively high business transaction costs and lower private sector competitiveness. While there is a need to streamline legislation, some important areas – such as bankruptcy, debt recovery, and secured transactions – are not yet adequately covered and require legislation that meet the needs of the market economy. To assist in addressing some of the most urgent needs, ADB approved a TA for law reform (footnote 2) and the World Bank initiated assistance to streamline banking sector legislation.

14. Ineffective Legal Enforcement Mechanism. Notwithstanding the proliferation of laws and its associated problems, the country's judicial system has not been fully equipped to implement legislation in a consistent manner. In the absence of a commercial court or specialized bench to deal with commercial matters, dispute resolution through the existing court system is usually a lengthy process. Judgments often are not made public or are inconsistent. With assistance from the United States of America, the Government recently developed and passed a new Arbitration Act 1998, which is expected to address this issue. Good progress in implementing the Act, however, remains to be seen. Improving the quality of legal professionals is another crucial issue in private sector development. Law application and enforcement are constrained by lack of competent lawyers and judges, especially in commercial law. Legal education and training are poor. Courts lack modern court administration techniques, and case management by the judiciary or the courts is largely unknown. A recent United States Agency for International Development (USAID) project with the Supreme Court is examining the problem of delay in courts and will recommend adoption of modern case management techniques. The judiciary also suffers from severe funding constraints. The budget allocation of less than 0.5 percent of total expenditures is low and insufficient for the judiciary to effectively fulfill its role.

15. Weak Institutional Capacity for Regulation and Supervision. While the Government plays a key role as an owner and operator within the financial system, effective supervisory and regulatory oversight functions that one would expect from a government vis à vis the financial sector are largely missing. The key agencies entrusted with regulation and supervision are the NRB for banking and selected nonbank lending institutions, and the Securities Board (SEBO) for capital market activities and institutions. Both lack a clear mandate and adequate enforcement powers and tools, and are constrained by a weak human resource base and inadequate information technology (IT) support. Specifically, the capacity of the NRB for regulation and supervision is weakened because of (i) dependence on policy directives from the Ministry of Finance (MOF), (ii) inherent conflicts of interest through direct shareholding in state-owned financial institutions, and (iii) inconsistent legal and regulatory framework. Moreover, responsibilities for regulating of rural finance activities are diffused as a result of the fragmented legal framework. To improve governance and give a clearer mandate to SEBO, ADB has

⁷ Nepal Rastra Bank Act, 1955; ADBN Act, 1967; NIDC Act, 1990; Commercial Bank Act, 1974; Developing Banks Act, 1996; Financial Companies Act, 1985; Cooperatives Act, 1992; Financial Intermediation Act, 1998.

⁸ For example, some rural cooperative societies, which are allowed to collect savings from the general public, fall under the purview of the central bank (NRB) under the Cooperatives Act, while others which cater only to members are supervised by the Ministry of Agriculture. Rural financial intermediaries such as credit unions will fall under the newly legislated Financial Intermediation Act, and therefore are regulated and supervised indirectly by NRB through the Rural Finance Development Board.

assisted in reviewing and modernizing of a new Securities Act. IMF is providing assistance for a review of the NRB Act.

16. **Financial Difficulties of State-Owned Financial Institutions.** All state-owned financial intermediaries face financial difficulties, although the extent of the problems is difficult to assess in the absence of reliable financial information. The poor performance can be attributed to deficiencies in governance, lack of commercial orientation and managerial skills, as well as inadequate policies. Financial record keeping and auditing are not of international standards. Internal monitoring, evaluation, and supervision are weak, as is the system of appraisal and follow-up on loans. The problems are most acute for the two government-controlled commercial banks, RBB and NBL, which dominate the banking system with about 70 percent of total assets. A recent international audit indicates that both banks suffer serious, critical shortfalls in all key areas, and that both are technically insolvent, with negative worth estimated at up to 7 percent of GDP. Although deposits are presumed to be implicitly guaranteed by the Government, a systemic banking or fiscal crisis could emerge if problems remain unaddressed. World Bank assistance in this area has been requested.

17. The specialized development finance institutions (DFIs) - ADBN and NIDC - account for about 8 percent of financial sector assets, but are widely believed to be in bad shape as well. Prudential regulations such as for loss provisioning are more relaxed than those for commercial banks, and their financial statements may give an incorrect picture of their true financial performance and condition. Loan recovery rates for some programs are estimated at below 60 percent. While the DFIs had traditionally emphasized lending based on credit lines by international aid agencies, recently they started mobilizing deposits, as their traditional funding sources have dried up. A major problem of the DFIs has been their diffused focus. ADBN includes promotion of biogas, rural electrification, small irrigation development, and solar energy. While these activities appear interesting from a development perspective, there exists little credit appraisal expertise to properly assess the corresponding risks and returns are believed to be poor. NIDC has diversified its services and established leasing and banking departments, and operates a closed-end mutual fund.

18. **Overemphasis on Credit, Neglect of Savings.** Nepal has overstressed the lending functions of the banking system while neglecting the development of saving options. This is one reason why the nation's rate of savings mobilization is among the lowest in Asia. From the individual household perspective, savings are an asset and borrowings are a liability, but the two can be used to finance investment and smooth consumption. As earned interest on savings adds to family income while interest paid on debt reduces it, adding to the household debt is more likely to reduce people's welfare than raise it, in particular in a stagnant economy where families have few good investment options. If the cost of capital, which is often high because of high transaction cost, cannot be matched by investment returns, credit may be contributing to poverty rather than reducing it. In such an environment, family savings are better suited to finance small businesses or help offset a poor crop year, and make it unnecessary to visit the local moneylender who often charges rates as high as 5 percent per month. The main objective of reform in the rural finance sector should be to expand the range of both saving and borrowing opportunities for farmers on a competitive basis and to minimize transaction cost.

19. **Limited Outreach and Poor Quality of Rural Financial Services.** Both formal and semiformal rural financial services in Nepal have inadequate outreach. Spatially, they are concentrated in the Terai; operationally, they are biased in favor of agriculture; and in depth of outreach, the poor have limited access. By 1997, the entire system of formal sector credit programs and institutions had reached a cumulative coverage of about 23 percent of the rural

population.⁹ The diffused institutional and policy framework for micro and rural finance institutions is partly to blame for this low figure. The combined coverage of ADBN and commercial banks, whose loans were essentially collateral-based, was about 20 percent. The actual coverage of the rural poor, judging from the coverage of the group-based loans, was much lower at 3 percent. By implication, the remainder is borrowing from noninstitutional sources. That is not bad in itself, except that the credit review reported that only 13 percent of these borrowings were for productive purposes. The causes of low institutional and productive borrowings may be many, but in the wake of an intensive agriculture and rural development plan in the country under the Agricultural Perspective Plan, it is important to ensure that all strata of the rural population have easy access to a broad range of financial services.

20. Underdeveloped Capital Markets. As in most countries in its income group, Nepal's financial system relies heavily on banking transactions. The origins of the Nepalese capital market can be traced back more than 20 years, but the capital market was given a proper structure only in 1993. Though the creation of the capital market immediately attracted the interests of the retail investors, in size and maturity it has not kept pace with the growth of the private sector. Up to now, about 110 companies are listed on the stock exchange with a market capitalization of about NRs46 billion (\$650 million equivalent). While registering some initial successes, the Nepal Stock Exchange (NEPSE) has little daily trading activity taking place, primarily retail, in only a few select share issues (mainly financial institutions shares). The vast majority of shares remain illiquid. Also, capital markets have so far not been playing a significant role for long-term financing, e.g., of infrastructure or capital expansion. Individuals and institutions prefer to deposit savings in banks and fixed-interest government securities, even at very low or even negative interest rates, than they would if the market was working properly. Long-term savings that should be invested in the capital market are going into short-term instruments. In part, this stems from an overall weak governance structure with poor accountancy standards and weak disclosure of financial information - which offers limited investor protection - as well as an undeveloped institutional investor base. Institutional strengthening of the regulator, SEBO, and the NEPSE will be required not only to avoid further confidence crisis through market irregularities, but also to lay the foundation for a more diversified, resilient, and market-led financial sector. Although the current role of capital markets is small, their development is mutually reinforcing with improvements in corporate governance and information disclosure standards.

21. Weak Information Technology Base. Nepal's financial system operates largely on a manual basis. Therefore procedures are costly and cumbersome and poor service delivery. Payment and settlement systems are not fully computerized and no electronic funds transfers are possible. It may take up to 30 days to have a cheque cleared if it was issued outside Kathmandu, and as a result, the economy is largely cash based. Moreover, the absence of IT in all areas of the financial sector makes information collection costly and unreliable, and hinders effective monitoring and supervision. It also increases the cost of branch operations and hinders competition.

⁹ Sharma, S. R. et. al. 1997. Strengthening of Credit Institutions/Programs for Rural Poverty Alleviation in Nepal. A report prepared for the United Nations/Economic and Social Commission for Asia and the Pacific (UN/ESCAP).

3. Prospects and Priorities for Future Reforms and Development

22. Financial reforms have been ongoing, on a piecemeal basis, for more than a decade, but have not yielded significant impacts in terms of improved resource mobilization and intermediation efficiency. A more positive scenario in the future requires a clear vision and credible commitment by the Government to address some of the policy inadequacies. This must be anchored in demonstrated actions to shift the role of the Government away from being a direct owner to being a prudential regulator and supervisor of financial sector activity. In doing so, the Government will need to ensure that it does not evolve into an overly bureaucratic regulatory structure but that it maintains constant dialogue with major market participants.

23. The reform agenda is huge, and is more likely to be implemented over a 10-year horizon than a short-term program period. However, urgent measures need to be adopted, particularly with respect to the SOCBs to avert a larger crisis and to lay the foundation for sustainable development of the sector. Policy reforms must be sequenced and coordinated properly and be in line with institutional development to effectively implement them. Thus, capacity building in a wider range of areas must be emphasized during the early program period, requiring considerable resources for TA. To gain and maintain momentum, some real and visible benefits will need to be front-loaded to the extent possible. The planned use of IT is a very powerful tool in this respect. Significant benefits of policy and institutional reforms as well as better use of IT are expected in certain rural areas where transaction costs are highest and accessibility is lowest. The development of rural markets must be an integral part of a comprehensive reform program. Effective coordination with and feedback from stakeholders throughout the reform process are imperative for successful reforms and broad-based ownership.

24. In pursuing further financial sector reforms, it is important to recognize the continuing role of traditional financial conventions and informal credit sources in Nepal's economy. Cooperatives have not supplanted moneylenders, and branch offices of ADBN have not reached a significant portion of the population. In rural credit, at least one half of farm - family loans come from moneylenders, suppliers, or sales agents. The formal and informal sectors are in some ways competitive and in other ways complementary. Smoothing rural financial intermediation by providing improved access to information and greater choices for savings and investment will be crucial for growth, employment generation, and ultimately, poverty alleviation.

B. Government Policies and Plans

25. A key objective of the Ninth Five-Year Plan, FY1998-FY2002 (Ninth Plan) is to combat poverty by increasing investment and reduce dependence on foreign borrowing through improved domestic resource mobilization. Policy measures for the financial sector that were specified in the Ninth Plan include (i) lowering barriers to entry, (ii) allowing mergers and takeovers to promote competition, (iii) privatization of Government-owned banks and nonbank financial institutions (NBFIs), (iv) recapitalization of major banks, (v) making the debt recovery system effective, (vi) expanding microfinance services for poverty reduction, and (vii) strengthening NRB's supervisory and regulatory capacity. The finance minister reiterated the importance of financial sector development during the FY2000 budget speech, stating "Development of the financial sector and capital market is necessary to provide sustainable support to the economic growth of the country".¹⁰ Prioritization of corporate and financial sector reforms has continued in the Government's FY2001 programs and budget. Moreover, the Agriculture Perspective Plan, the Government's 20-year plan for rural development, which was

¹⁰ Ministry of Finance. 1999. Budget Speech for Fiscal Year 1999-2000

initiated in 1995, identifies credit as one of the key inputs for boosting agricultural production. A recent review of the plan concludes that weaknesses in the financial sector constrain its implementation. While the Ninth Plan highlights the critical link the financial sector plays in channeling savings into productive investments, it also notes deficiencies in the current system that impede this process. To address these deficiencies, the Ninth Plan stresses the need to create an environment that increases the efficiency of financial institutions so as to generate internal resources for the country's development.

26. Among the main complaints of investors is the high interest rates on loans. The Ninth Plan points to high operating costs of banks as the cause of large spreads between deposit and lending rates. These high operating costs in turn are caused by weak financial management systems, high compulsory cash reserve ratio, growing proportion of bad debts, and unnecessary expansion of organizations. However, while the FY2000 budget speech does call for the formulation of laws on the repayment of loans and bankruptcy to address those costs, the speech also calls for better enforcement of the mandated 5 percent interest spread to force lower rates. In other areas, policy-related operating costs may actually be increased. For example, while the Ninth Plan admits that directed credit programs would need to be phased out in the future, the Government will in fact expand such programs during the current planning period. The expansion of directed credit programs is also reflected in the FY2000 budget speech, in which the rural credit programs are nearly all aimed at a list of specific activities ranging from milk processing to solar energy.

27. One important aspect of enhancing the efficiency of financial institutions is raising the level of corporate governance standards in the country. The Ninth Plan proposes to increase public confidence in and liquidity of the securities market by protecting investor rights and promoting corporate transparency. Toward this end, adopting international accounting standards, establishing a secured transaction center and a central security depository system, and upgrading the credit rating system play important roles. Improving transparency and disclosure standards will support the Government's privatization plans by helping to assess a fair price and facilitating performance monitoring following privatization.

C. External Assistance to the Sector

28. ADB lending to develop Nepal's financial institutions has traditionally focused on rural finance - mainly through ADBN - and microfinance. Although ADBN was established under some of ADB's first assistance to Nepal, experience in more recent projects suggests that establishing the appropriate regulatory environment must take precedence over continued financial support to that institution. Recent TA work in financial sector development and corporate governance provides the groundwork for the reform agenda outlined in this Project (Appendix 1). Ongoing TA in the sector supports the reform process by building up the accounting and auditing profession through the strengthening of ICAN, reform of the company law and development of legislation for insolvency and secured transactions, and creating a focal point within MOF to sustain the momentum and augment capacity for financial sector reform (footnotes 2 and 3).

29. The IMF has been a strong advocate of financial sector development in Nepal. To support the reform efforts of HMGN after the establishment of multiparty democracy in 1990, the IMF approved a three-year Enhanced Structural Adjustment Facility (ESAF) of SDR33.57 million in October 1992, the policy framework of which included financial sector reforms. Specific reforms covered the restructuring of RBB and NBL, with the goal of eventually privatizing the two state-owned banks, strengthening the supervision capacity of the NRB as

well as its monetary control and management functions, and capital market development. Due to the rise in political instability after the fall of the majority government, reform measures stalled and the ESAF arrangement expired in October 1995 after only SDR16.79 million was disbursed. However, IMF TA helped strengthen the monetary operations of NRB, including compilation and reporting of monetary statistics, and establishing a secondary window for the government securities at the central bank. During the IMF's preliminary discussions with the Government on a possible Poverty Reduction and Growth Facility (PRGF) program, financial sector reforms remain a high priority, with emphasis on improved banking supervision and commercial bank reforms. ADB staff also joined the IMF Article IV Consultation Mission to Nepal in 1999 and 2000, providing feedback on the proposed policy matrix for a PRGF program and discussing the division of labor between ADB and IMF in reforming Nepal's financial sector.

30. The World Bank supported the financial sector reforms under its Second Structural Adjustment Credit, a quick-disbursing credit amounting to \$60 million, approved in 1989, with three tranche releases contingent on a number of policy conditions. The financial sector adjustment program under this credit focused on the SOCBs and the central bank. While the establishment of CIB was a condition for submitting the project to the Board, most of the first and second tranche conditions for strengthening financial sector reforms consisted of preparing studies and action plans. For release of the third tranche, the conditions included Government funding for provisioning and recapitalization of the SOCBs, and payments for the unpaid debt of nonfinancial public enterprises. While the conditions were not fully met, the tranche was nevertheless released in 1992. However, while NBL has been partially privatized, RBB is again in need of recapitalization due to continued poor management at the operation level. The World Bank's proposed Financial Sector Technical Assistance Project will continue to focus on the commercial banking subsector and the NRB's supervisory capacity. Preparatory TA is ongoing, beginning with an audit of RBB by international auditors and a resident consultant in NRB to strengthen the central bank's supervision functions.

31. UNDP financed the Government's Commercial Bank Problem Analysis and Strategy Study, which provided background information for much of the financial sector reforms under the World Bank's Second Structural Adjustment Credit. DFID has ongoing TA to MOF in the area of corporate governance for state-owned enterprises under its Privatization Project as well as legal reforms under its Enabling State Project. Some initial work to assist ICAN in formulating its strategic plan has also been supported by DFID. In addition, Danida and GTZ are providing assistance in reforming and strengthening tax administration, as well as support to the cooperative and microfinance subsector, particularly small farmers development. The proposed Project aims at complementing and reinforcing some of these activities.

32. In preparation for this Project, ADB and the World Bank held a joint financial sector reform stakeholder consultation workshop in Kathmandu in September 1999. Representatives from the Government, private sector, academe, and aid agencies participated in the discussions. Nepal Resident Mission (NRM) staff participated in the regular aid agency coordination meetings on governance chaired by UNDP as well as on financial sector reforms chaired by the World Bank. Progress has been made in establishing an appropriate division of labor in the financial sector between ADB and World Bank during regular review missions in Nepal, as well as World Bank consultation missions to ADB in November 1999 and again in October 2000. Discussions with the World Bank and other aid agencies will continue during the Project to avoid duplication of efforts or conflicting advice to the Government.

D. Lessons Learned

33. General lessons learned from ADB operations in Nepal, as outlined in the Country Operational Strategy,¹¹ point to the need for broad-based support for policy and institutional reforms to achieve and sustain any meaningful change. To this end, stakeholder participation is critical at the project design stage, particularly in formulating policy reforms. Institutional strengthening and capacity building initiatives should be consistent with a plan for short-, medium-, and long-term sector development. Project preparation should include an analysis of issues and strategies for improving governance and combating corruption. A recent study of postevaluation findings for ADB projects in Nepal¹² emphasizes the need for rigorous assessment of the capabilities of the executing agencies. Moreover, for projects with multiple implementing agencies, it is necessary to clarify their roles and functions from the start.

34. Evaluation of ADB's assistance to Nepal's rural financial sector through ADBN¹³ indicates that lending by ADBN has not achieved its intended impact, mainly as a result of distorted incentive structures for staff and management and poor operational policies and systems, leading to decapitalization of the institution. While ADBN experienced a rapid expansion of operational scope and a modest degree of institutional strengthening, it did not address endemic problems associated with information flow, contract monitoring, and enforcing repayment from farmer borrowers. The persistence of high transaction costs also precluded effective competition with established informal lenders. Overall the project performance audit report (PPAR) concludes that ADBN's operations were not sustainable, financially and economically. The PPAR proposes a reframing of ADBN's structure and mission for the rural sectors. In the future, considerable practical attention needs to be devoted to anticipating and to reducing transaction costs, information deficiencies, and moral hazard in rural finance. These three terms are central to the rationale and design of this Project and should be more fully discussed with reference to actual problems faced.

35. PPARs for two recently completed financial sector reform projects in Sri Lanka and India¹⁴ also emphasize the importance of Government ownership of the reform agenda, including the pace and sequence of reforms. The World Bank's experience in financial sector reform in Nepal under its Second Structural Adjustment Credit demonstrated the need for involving the Government at the design stage. Furthermore, a project must (i) show a clear relationship between its objectives and the policy measures; (ii) include consistent, monitorable performance benchmarks; (iii) assess the sustainability and practicality of policy measures; and (iv) address the financial implications of the policy measures. Project design must address institutional weaknesses and consider the extent of political support for policy measures, particularly those that affect vested interests. Finally, loan conditions should include well-defined actions and targets, rather than studies to determine future measures or vaguely worded performance indicators.

E. ADB's Sector Strategy

36. Toward the goal of sustainable reductions in poverty in Nepal, the strategic approach of ADB's Country Operational Strategy (footnote 11) is to build effective institutions needed to

¹¹ STS: NEP 99006: *Country Operational Strategy Study, Nepal*, July 1999.

¹² Asian Development Bank Postevaluation Findings: *Country Synthesis of Evaluation Findings in Nepal*, October 1999.

¹³ PEO 502, Loan 831 NEP: *Fifth Agricultural Credit Project*, December 1997.

¹⁴ Loan SRI 1051: *Financial Sector Program*, for \$80 million, approved on 20 November 1990; and Loan IND 1208: *Financial Sector Program*, for \$300 million, approved on 15 December 1992.

implement socioeconomic development in a market economy. In this context, financial sector development aims at (i) increasing the stability and resilience of the sector by improving supervisory standards and supporting the development of alternative second-tier financial institutions to foster competition; (ii) improving the efficiency of financial intermediation by increasing transparency and access to information while depoliticizing the process of allocating resources; (iii) improving access to and quality of financial services, particularly in rural areas; and (iv) supporting regional integration within the South Asian Association for Regional Cooperation. To achieve these strategic objectives, the operational priorities have to respond to Nepal's generic financial sector needs for policy support, institution building, and transparent regulatory framework before direct assistance for specific market segments and intermediaries can be contemplated.

37. Starting from a very low base, a mixture of quite different activities is required, such as training of judges and linking financial service providers through IT. During the early phases, these may appear somehow scattered, but they will flow together toward a coherent system over the medium to long term. Without addressing a range of areas simultaneously at an early stage, long-term sustainability cannot be achieved.

38. Given the complexities and interlinkages of the sector a wholistic approach with various phases over about 10 years will be pursued to ensure a significant and sustainable impact. Phase I, to be implemented with the support of the Project over 3-4 years, will focus on the creation of basic financial sector infrastructure and a sound enabling environment. Specifically, phase I aims at (i) creating a policy and legal environment for effective competition, based on sound economic and sector work; (ii) capacity building for key institutions for financial sector regulation, supervision, and legal enforcement; (iii) improving information disclosure standards and corporate governance, including accounting and auditing standards as well as capital markets development; and (iv) introducing basic IT for improved transparency and financial service delivery. ADB's focus will be NBFIs, including DFIs, rural finance, and capital markets, and the World Bank will look after the commercial banking sector.

39. Phase II will continue capacity building measures initiated under phase I, but expand the institutional level to include restructuring of selected lending institutions such as ADBN and NIDC. The use of information and communications technology (ICT), for electronic (e)-banking and supporting e-commerce, will be pursued more vigorously. Some preparatory work toward this effect will be undertaken in phase I. Some work on deposit insurance coverage will also be required to better deal with the political economy of bank restructuring. In addition, deepened capital markets will be through development of contractual savings and further outreach in rural financial markets will be pursued. Privatization of state-owned enterprises and reforms in trade and industry will be undertaken to complement financial sector reforms. Phase III will follow up on the restructuring of selected lending institutions, broaden and deepen the financial market further, and pursue regional integration more rigorously. The full benefits of the overall reform process will only become available upon completion of the cycle, but phase I in particular is needed to allow the growth of financial markets in a sustained manner.

40. Special emphasis will be given to nonbank financial intermediation and the development of rural financial markets. Toward this end, ADB has developed a rural finance strategy, which was discussed with a large number of stakeholders in Kathmandu in February 2000. The various strategic components that were proposed are supported by the Project and aim at improving the environment for rural financial services, allowing new entrants, and strengthening the existing ones. In addition, ADB will explore complementary activities to promote private sector development, particularly for small and medium-scale enterprises.

F. Policy Dialogue

41. Policy dialogue has focused essentially on (i) sector governance and role of the government; (ii) prevailing sector policies for rural finance and NBFIs; (iii) improving the legislative and regulatory environment, including measures to enhance transparency and institutional strengthening; (iv) legal enforcement mechanisms and measures to improve the judicial system; and (v) introducing selected legislation. At this stage, ADB's dialogue largely avoided detailed discussion of restructuring the state-owned financial institutions, particularly the DFIs, which will follow once progress is made on the policy, governance, and regulatory front.

42. To improve overall sector governance direct participation, ADB together with IMF and the World Bank has stressed the need for HMGN to shift its role from one of regulation and prudential supervision. Further clarification is required as regards the institutional setup and mandate of the key regulators, which will be subject to ongoing dialogue. The governing legislation of NRB will be revised to provide a high degree of independence within a well-defined policy framework and clear accountability. Legislation governing the financial institutions is also being reviewed to ensure equal opportunities for state-owned and private sector market participants. To facilitate this process, HMGN has agreed to establish a Corporate and Financial Law Review Committee to ensure that a consistent and consultative process is applied. This committee will also review other laws related to the sector to streamline the legislative framework. Also, official translation of key economic laws will be provided and a legal resource center for online access to all corporate and financial sector legislation will be established.

43. To remove policy impediments to extension of rural financial services, the Government has agreed to further rationalize interest rates, and to review the priority and directed credit sector lending requirements as well as branch licensing policies. In this regard, the urban branch network of ADBN - and rural branch regulation for commercial banks - will be reviewed further. Subsidized credit schemes may be justifiable, but should be funded in a transparent manner through the budget, not through the banking system. The Government agreed to spinoff ADBN small farmers subproject offices into cooperatives, with possible assistance by GTZ.

44. In the areas of corporate governance and capital market development, HMGN with assistance from ADB, has formulated a new Securities Act that provides for an autonomous and accountable SEBO including significant private sector representation on its Board. In addition, the NEPSE will be privatized. To promote improved accounting standards and information disclosure, HMGN has agreed to repeal the Auditors Act and give full effectivity to the ICAN Act, and to consider the controlled opening of the services sector to qualified foreign legal and accounting professionals to allow transfer of skills. Options to enhance the role of the SEBO or Office of the Companies Registrar in information disclosure also for tax purposes will be discussed further under the Project. An official English translation of key corporate legislation will improve transparency for foreign investors. HMGN further agreed to the establishment of a judicial academy for training of judges and government and private sector lawyers under the Judicial Council chaired by the Chief Justice, with sufficient commercial orientation, and improvement in funding allocations to the judiciary. For developing the legal profession, the Bar Association of Nepal recently set up an examination to certify qualified lawyers. To improve judiciary transparency and accountability, there will be disclosure of assets by all judges and publication of an annual report to the public. HMGN also agreed to support the introduction of e-banking and e-commerce, installed and operated by the private sector or on a public-private partnership basis, and allow electronic funds transfer within a well-regulated and supervised framework. It further agreed to protect the required frequencies for this network.

45. The Government incorporated many elements from the ongoing policy dialogue in its background paper on financial sector development, which was presented to the aid community at the Nepal Development Forum in Paris in April 2000, as well as its financial sector strategy statement released in August 2000. However, given the complex and dynamic nature of the sector, policy dialogue will be continued throughout project implementation.

IV. THE PROPOSED PROJECT

A. Rationale

46. To escape poverty, Nepal must achieve a per capita annual growth rate of 5 percent or more on a sustained basis. This rate is much higher than the current 2 to 3 percent per year. Thus, to reduce widespread poverty encountered in Nepal, growth and employment opportunities must be generated. This requires higher levels of investment - and saving to fund investment - as well as more efficient use of resources. Sustained private-sector-led growth and increased productive activities by a greater portion of the population, in turn, must be supported by an effective financial system. Such a system comprises a complex set of laws, regulations, policies, practices, institutions, and technology that link savers and investors in the economy to allow effective allocation of financial resources. An ADB study¹⁵ concludes that, with an effective financial system in place, Nepal's annual growth could be boosted by as much as 2 percent per annum, effectively bridging the gap to escape the trap of poverty.

47. An effective financial system offers a positive incentive structure for financial intermediation. It provides positive returns to a wide range of savers, provides timely and competitively priced credit to a wide range of borrowers; and, through a wide range of instruments and institutions, allocates society's scarce capital to its most efficient, growth-promoting uses. As more effective financial intermediation reduces the cost of capital, the return of investment that is required to break even is lowered, which in turn will result in more successful investment and employment generation. In addition, a sound financial system mitigates vulnerability to financial crisis and the economic and social costs that follow financial disruption. Broader and deeper financial markets are important because of the stability, efficiency, and access they confer, all of which are key determinants of prosperity and poverty reduction.

48. Unfortunately, Nepal's financial system has been ineffective in fulfilling its role and is inherently vulnerable. The system is marred by many shortcomings (paras. 8-21), which lead to distorted incentive structures, high transaction costs, and misallocation of capital. It is therefore important to adjust Nepal's financial system to reduce the high costs and increase access to information, capital, and savings opportunities, particularly in rural areas where 90 percent of Nepal's population live. A very basic element of this adjustment is improvement in corporate and financial governance structures.

49. The importance of corporate governance is one of the important lessons of the Asian crisis. Absence of basic governance provisions such as on the role of directors and managers, generally accepted accounting standards, and transparent information disclosure leads to moral hazard and adverse selection¹⁶ and puts at risk the sustainability of the corporate sector, which

¹⁵ TA 3135-NEP: *Financial Sector Regulation and Governance*, for \$150,000, approved on 22 December 1998.

¹⁶ Moral hazard and adverse selection describe situations in which incentive structures or asymmetric information leads to perverse economic outcomes.

is closely interlinked with the health of the financial sector. Good corporate and financial governance standards are essential for a conducive investment framework.

50. In pursuing any reforms in the private and financial sector, it is important to keep in mind that Nepal's economy is closely linked to India's economy, which underwent significant structural changes over the past years. If Nepal's investment environment cannot compete with its dominant immediate neighbor, resources and investment will dry up or even flow out of the country. As a small landlocked country, Nepal has to lead rather than follow the reform process to offer comparative advantages to investors. Thus, the challenge for Nepal is to create a financial system that is supportive of growth.

51. The Project initiates a much-needed structured approach for long-term financial and private sector development. This requires the establishment of an effective regulatory, institutional and technological framework. The project framework is in Appendix 2.

B. Objectives and Scope

52. The long-term goal of the Project is to contribute to higher and more equitably distributed of economic growth through a robust and efficient financial sector. This will be achieved through improved transparency, accountability, and basic financial sector infrastructure, leading to increased competition and better services, coupled with reduced transaction costs in financial intermediation. In pursuing this goal, the Project is part of a multidimensional and long-term reform process.

53. The immediate objective of the Project is to improve governance and efficiency in Nepal's corporate and financial sector. Specifically, this involves

- (i) improving selected parts of the legal and regulatory framework, standards, and policies, particularly those relating to accounting, auditing, companies, securities, and rural finance;
- (ii) capacity building for essential regulatory, supervisory, or service institutions for the Project, including sections of NRB, Auditor General, ICAN, SEBO, NEPSE, Central Depository System (CDS), Company Registrar's Office (CRO), and establishment of a secured transactions registry;
- (iii) capacity building for improved legal drafting and enforcement of laws by establishing of the National Judicial Academy (NJA) to enhance the skills of judges, court officials, officials exercising quasi-judicial powers, Government lawyers and private practitioners, particularly in keeping abreast with new and changing legislation;
- (iv) improving financial service delivery by strengthening the payment system and supporting the institutional infrastructure for future investment in ICT through a public-private partnership, the electronic Financial Information & Technology (e-FIT) company; and
- (v) preparing to restructure and develop selected financial intermediaries, including ADBN, NIDC, Employees Provident Fund, and the insurance industry.

54. The Project will contribute to a consistent and transparent legal and regulatory framework for corporate and financial governance, with effective implementation institutions. The objective is to give the public more reliable financial information and reduce the scope for rent-seeking activities by few individuals at the expense of the larger society. The Project also

intends to foster competition and support expansion of financial services. As a result, economic transaction costs should go down (through reduction in both information acquisition cost and bad lending/investment decisions). The improved environment will support the development of new savings alternatives, and new avenues for funding of companies (including capital markets) have a better chance of realization.

55. The Project contains a mix of loan and TA grant-funded components for advisory services, with TA proposed under an associated TA cluster. The loan and TA-funded components blend and complement each other. Using a process approach, at a conceptual level ADB's overall assistance package for the Project also comprises the TAs approved in 1999 and 2000 for strengthening accounting and auditing; review of company, insolvency, and secured transaction law; and reform coordination (footnotes 2 and 3, and Table 1).

Table 1: ADB Assistance (ongoing and proposed)^a

Assistance Area	Loan Financed	TA Grant Financed
1. Improving corporate and financial governance policies, regulatory and legal framework, and standards		<ul style="list-style-type: none"> ● TA 3371: Focal Point for Financial Sector Reform in MOF (ongoing) ● TA 3461: Review of Company, Insolvency and Secured Transaction Legislation (ongoing) ● <i>TA1: Support for Streamlining of Selected Corporate and Financial Legislation and Strengthening of Law Reform Process.</i> ● <i>TA2: Improving Public Sector Accounting and Auditing standards.</i>
2. Capacity building for key financial institutions	<ul style="list-style-type: none"> ● <i>Loan Component A: Corporate governance and capital markets Securities Board of Nepal, Nepal Stock Exchange, Central Depository System, Companies</i> 	<ul style="list-style-type: none"> ● TA 3356: Capacity Building for Accounting and Audit Profession. ● <i>TA3: Strengthen NRB for Regulation and Supervision of NBFIs and rural finance.</i>
3. Improving legal enforcement capacity and infrastructure	<ul style="list-style-type: none"> ● <i>Loan Component B: National Judicial Academy, legal information and secured transactions registry.</i> 	
4. Improving infrastructure for payments and financial service delivery	<ul style="list-style-type: none"> ● <i>Loan Component C: Start-up funding of public-private partnership for improved financial service delivery through ICT.</i> 	<ul style="list-style-type: none"> ● <i>TA4: Improvement in Payment System.</i> ● Preparation of Investment in ICT for Financial Service Delivery.
5. Development of selected market participants		<ul style="list-style-type: none"> ● <i>TA5: Diagnostics and Options for ADBN and NIDC.</i> ● <i>TA6: Development of Insurance, Pensions and Contractual Savings.</i>

^a Components in italics are initiatives for funding under the proposed Corporate and Financial Governance Project.

56. From a subsector perspective, the proposed Project will focus on nonbank financial intermediation, including rural finance, DFIs, capital markets, and the corporate sector. Key

issues related to commercial banks will be addressed under proposed assistance by the World Bank. Some components, such as adoption of international accounting standards, streamlining of legislation, or strengthening the capacity of NRB, will have wider sector implications and will be appropriately coordinated with other aid agencies, particularly the IMF and World Bank.

57. Specifically, the proposed Project includes the following:

1. Improving Legal and Regulatory Framework, Standards, and Policies

58. Improving the basic legislative, and regulatory framework as well as policies and standards is the fundamental step in a longer term reform process. In terms of sequencing, this area must be addressed first before assistance is provided on the institutional level. ADB has already initiated steps in this regard under the ongoing TAs. Further assistance will be provided under the proposed TA cluster.

a. Upgrading of Selected Legislation

59. Past and ongoing assistance to strengthen the legal and regulatory framework for corporate governance has included support in drafting the Securities Act (TA 2834: Capital Market Development), and support for reform of the company law, insolvency law, and secured transactions law (footnote 2).

60. The new Securities Act, currently in draft form, will establish the Nepal SEBO as an independent statutory body and provide for a legal and regulatory framework for registration and issuance of securities, licensing, and regulation of stock exchanges and those engaged in securities business, and curbing of malpractices including insider trading.

61. Reform of the company law, under TA 3461, will strengthen disclosure requirements for companies. It will introduce provisions to regulate self-dealing by directors and controlling shareholders, and strengthen minority shareholders' rights, allowing representative actions by minority shareholders to enforce good corporate governance. Presently charges over a company's assets are not registered with the company registrar. Such registration will need to be compulsory to create transparency for those dealing with companies. Reform of the company law will also include examining of the role of the various agencies and offices involved in implementing the company law, including the CRO, the Company Law Board (CLB), SEBO, and the courts, so as to rationalize the institutional arrangements for administering and enforcing of the company law.

62. The support for drafting of insolvency and secured transaction legislation, also under TA 3461, will ensure an orderly process for exit or restructuring of companies in financial difficulties, and strengthen the collateralization process for movable assets. This will contribute to good corporate governance as the potential use of efficient insolvency and debt enforcement procedures will discipline firms to contract only debts that they can service.

63. HMGN, with support from other aid agencies, has initiated a number of other legislative reform initiatives. Most important is the review of the NRB Act and development of an unified Financial Institutions Act covering all institutions involved in lending and deposit taking activities. ADB has been requested to provide inputs into the drafting process to ensure consistency particularly with regard to the securities, companies, and insolvency laws.

64. Even with the ongoing activities, numerous inconsistencies and contradictions in commercial, corporate, and financial legislation remain. Under TA1 of the TA cluster, assistance will be provided to further streamline commercial and financial laws as required, such as laws relating to rural and microfinance, IT and e-commerce-related activities, and legislation to mandate the boards and the standards they set. HMGN is considering reconstituting the Law Reform Commission to institutionalize the reform process. Depending on the pace at which HMGN moves, assistance may be provided to the Law Reform Commission.

b. Development of Information Disclosure, and Accounting and Auditing Standards

65. Assistance is included for improvements in the accounting and auditing standards. The company law reform provides for an information disclosure system that can serve the needs of a modern financial system. It will include (i) recognition of an Accounting Standards Board and an Auditing Standards Board (ASB/AuSB) - collectively the boards; (ii) recognition of mandatory compliance with the standards issued by these boards; (iii) appropriately severe penalties for noncompliance with these standards; and (iv) recognizing of an office of the chief accountant within SEBO and empowering that Office to enforce proper information disclosure and reporting by investigating and penalizing any non-compliance.

66. In developing the accounting and auditing profession, the role of ICAN will be crucial. For ICAN to develop in a professional manner, repeal of the Auditors Act is imperative as the act currently provides official recognition to auditors of lower standards. ICAN has submitted to MOF an amendment to the ICAN Act that will be submitted to Parliament during the winter session in February 2001. Importantly, ICAN agrees to accept all existing registered auditors (RAs) as ICAN members on a one-time exemption basis within six months of repealing the Auditors Act. This is to ensure a professional future for the existing RAs. Through TA 3356 (footnote 2), ICAN is in the process of preparing training programs that will assist these RAs in upgrading their skills.

67. The independent accounting and auditing standards boards are being established under TA 3356. The boards will at first develop standards based on international accounting standards (IAS) and international auditing standards (IAuS) for the private sector through a participatory method.

68. For Nepal's Government departments, the current cash-based accounting standards applied are completely unsuited to the management of assets and liabilities, while auditing practices also need to be improved. Moreover, many unrealistic "auditing" duties are set down in disparate processes and legislation, placing inappropriate and unrealistic demands on auditors.

69. Internationally, convergence of public and private sector accounting and auditing standards is occurring. For example, the International Public Sector Committee (IPSC) has just issued eight public sector accounting standards heavily based on IAS. The efforts made under TA 3356 will establish much of the infrastructure also needed for the public sector. Once the boards are established, in addition to their roles in relation to private sector corporate accounting and auditing standards, they will be able to develop accounting and auditing standards for the public sector. In carrying out this responsibility, it is presumed that the financial reporting and auditing requirements of the public and private sectors will be entirely consistent with one another and identical in most instances.

70. Integration of the public and private sector efforts in accounting and auditing standards in the medium to long run will greatly facilitate introduction of a consistent accounting and auditing system in Nepal. This will ultimately require public sector entities to exhibit greater transparency and accountability, and greatly facilitate state-owned enterprise reform and privatization, including flotation on the stock exchange. The public sector claim that their reporting should be fundamentally different from that of the private sector is difficult to justify, but transitional strategies can move the public sector to a system based on full accrual accounting.

71. Under TA2 of the cluster TA, the Auditor General and the Comptroller General of Finance will be assisted in moving towards uniform standards. TA2 will assist the key public sector entities in adopting internationally accepted accounting standards issued by the Public Sector Committee of the International Federation of Accountants (IFAC) and the auditing standards issued by the International Auditing Practices Committee (IAPC), by providing intensive training activities. Similarly, the accounting and auditing standards boards will be acquainted with strategies for broadening the applicability of standards, and, where necessary, their content, to allow application of the standards to all forms of public sector bodies. TA2 will give an initial opportunity to public sector entities and auditors to commence development of expertise and systems, with the objective of upgrading their knowledge and skills for carrying out audits based on a system of full accrual accounting, in accordance with accounting standards similar to those applicable in the private sector. TA2 will identify how this can occur.

2. Capacity Building for Key Institutions

72. To increase the capacity of key regulatory, supervisory, and service institutions for corporate and financial governance, the Project will support the development of SEBO, strengthening and privatization of NEPSE, establishment of CDS for securities, and improvements in the operations of CRO. Assistance in this regard will be financed under a loan component (component A). In addition, technical support will be provided under the TA cluster to the boards and the Auditor General for moving toward improved accounting and auditing standards in the public sector, as well as for upgrading the capacity of NRB to regulate and supervise NBFIs and rural finance.¹⁷

a. Strengthening SEBO and CRO

73. Capacity building for SEBO under the Project is required not only for the orderly development of Nepal's still nascent capital market, but also to enforce corporate governance and information disclosure provisions. Disclosure will be crucial for increased transparency in the financial and corporate sector, and will boost business confidence and predictability in business dealings.

74. In defining the scope of the assistance to SEBO, it is important to recognize that SEBO's activities at present are confined to companies that have listed securities and companies that are eligible to list them. SEBO does not deal with statutory corporations. The existing institutional arrangements are inefficient and fraught with potential for regulatory arbitrage as a number of organizations are involved in regulation of companies' affairs, including the CRO and CLB. For SEBO to be effective, it must have adequate financial resources and statutory autonomy that insulate it from political interference. The ongoing TA 3461 will formulate recommendations for rationalization of the institutional environment and examine the possibility

¹⁷ The World Bank will assist in strengthening NRB's capacity to regulate and supervise commercial banks.

of SEBO regulating all companies. Any form of rationalization may need to be phased and will require recognition of SEBO's role in developing the corporate sector as a whole.

75. To enable SEBO to effectively supervise capital market activities and enforce corporate governance and information disclosure provisions, proposed assistance under loan component A will review and strengthen SEBO's organizational structure. The establishment of a chief accountant's office for SEBO will be crucial to ensure that accounting and auditing standards are observed. Detailed outputs of the assistance will include a corporate and financial plan consistent with the operational and financial independence of SEBO, including review of responsibilities, duties, and job descriptions; refinement of performance parameters; setting up of a management information system; and further definition of SEBO's regulatory duties. Assistance will also develop various securities market regulations, allow skills transfer to key SEBO staff, and provide training programs and public awareness strategy. Operations of CRO will be streamlined and automated, to link with the newly automated income tax office to ensure consistency of records and data and to facilitate enforcement.

b. Strengthening NEPSE and CDS

76. NEPSE, which is majority owned by HMGN, lacks the rules, regulations, discipline by market participants, and systems to instill confidence in the capital market. Support is required for establishing a proper system for registering shares to ensure transparency and efficiency in settlement.

77. Under loan component A, ADB will support the privatization of NEPSE and assist it to become a self-regulatory organization with transparent governance and professional management, complemented by upgrading of its operational systems and procedures. The relationship between SEBO and NEPSE will be rationalized. To support improved transparency in shareholdings and ensure safe custody and settlement of company ownership titles, CDS will be established to operate on a commercial basis.

c. Strengthening NRB for Regulation of Nonbank Financial Institutions

78. Over the past decade, financial intermediation activities in Nepal's rural areas have evolved but with distorted policies in a poorly regulated and supervised environment. A great number of nongovernment organizations (NGOs) and cooperatives mobilize and lend resources outside the regulatory environment, or the applicable financial rules and regulations are not enforced. Poor enforcement by NRB is due to (i) insufficient institutional capacity; (ii) lack of autonomy; (iii) conflicting roles of ownership and supervision of rural financial institutions (RFIs) by NRB; (iv) lack of focus, including NRB's involvement in developmental programs; and (v) multiplicity of financial laws and regulations. The ongoing comprehensive review of the NRB Act and Financial Institutions Act is expected to sharpen the focus of NRB and help clarify its role and responsibilities.

79. Following the streamlining of the regulatory and policy environment for rural finance, there is a need to upgrade NRB's capacity for prudential supervision and enforcement to ensure the sustainable and orderly expansion of the rural finance system.

80. Cluster TA3 will review the prevailing policy framework pertaining to RFIs and rural finance operations of commercial banks, especially as it relates to institutional autonomy, governance, ownership, competition, directed credit, subsidies, and human resources. The TA will assist in further rationalizing the legal framework governing the operations of the array of

institutions involved in rural finance so as to eliminate gaps, ambiguities, and overlaps. It will further assess the regulation and supervision needs of RFIs; assess NRB's capacity for regulation, supervision, and enforcement and recommend improvements; develop prudential norms, information and disclosure systems, accounting, auditing, and licensing procedures for RFIs; draft rules and regulations to regulate and supervise RFIs; and formulate guidelines, operational procedures, and standards for off-site and on-site inspection, supervision, and reporting for the rural finance sector.

3. Improving Legal Enforcement Capacity and Infrastructure

81. Enforcing Nepal's legal system is a key challenge. In a dynamic environment with changing laws and rules, judges, attorneys, and other members of the legal profession need to keep abreast of latest developments. There is also need for an institutional environment that supports transparency as well as rapid and fair enforcement. Under loan component B, the proposed Project will support the (i) establishment of NJA, (ii) improvement of the legal information system, (iii) establishment of a secured transactions registry, and (iv) establishment of a special commercial bench.

a. National Judicial Academy

82. A strong consensus has emerged from three major stakeholders (the judiciary, government lawyers, and the bar) in Nepal for establishing a single training academy that will cater to the needs of the whole legal community. Given the small size of each group of stakeholders, and the lack of financial and human resources, this was considered the optimal solution for Nepal. The stakeholders agree that the NJA should be an independent and autonomous body established by statute and the governing council chaired by the Chief Justice, and that the existing Judicial Training Center be merged with the NJA.

83. The mandate of the NJA will be to conduct programs for continuing professional education, training, and development for judges, court officers, officers exercising quasi-judicial powers, public sector legal officers, and members of the private legal profession. To consolidate the independence and integrity of the judiciary, judges will be trained by judges. Lawyers will be trained by lawyers, academics, or judges as required and practicable. The education program will be designed to provide practical, rather than theoretical, training relevant to judicial and legal officers in their day-to-day duties. The NJA may also offer theoretical courses in new areas of law, particularly in the commercial area. This training will focus on substantive law and procedure, forensic skills, judicial management and administration, professional responsibility, and relevant interdisciplinary subjects. Training will be provided at the pre-service (orientation) and in-service (continuing) levels, mainly through programs of conferences, seminars, and workshops; and programs of publishing bench books, practice manuals, digests, and bulletins.

84. The NJA will strengthen the capacity of the judiciary to develop and improve judicial policies and administration by giving it the role to review and propose developments to improve case management and judicial administration practices and procedures, particularly in commercial law; and to provide training to support these improvements. Particular attention will be given to strengthening judicial capacity to resolve commercial disputes expeditiously by establishing a commercial bench in an existing court. The NJA may also incorporate and develop the collection of the Central Law Library, and will provide research and development services to the legal community. A draft Policy and Mandate of the Academy, together with an organization chart, is presented in Appendix 3.

85. A draft National Judicial Academy Bill has been formulated. The NJA will regularly report to and coordinate with the Judicial Council, a constitutional body charged with appointment and discipline of judges, to monitor and evaluate the effectiveness of its training activities in raising the competence and professional performance of judges. It will similarly coordinate with the Judicial Services Commission, a body that appoints and disciplines government lawyers; and the Bar Council, a statutory body for regulation of the legal profession, to link training to raising competence and performance of Government lawyers and private practitioners, respectively.

86. Under loan component B, the Project will support the establishment and operationalization of the NJA by financing its building, equipment, development of its curriculum, teaching materials, and faculty development. The Project will also support development of bench books, practice manuals, and other relevant publications. The initial project phase will include finalization of a detailed needs assessment for the NJA, strategy plan and curriculum, establishment plan, and operational budgets, as well as construction of the building. The Project will also assist in selecting a cadre of trainers, and will design/conduct the faculty development induction program including an overseas study tour and train-the-trainer workshops, and collaborate with the Judicial Council in setting bench work performance standards.

87. On completion of construction of the NJA building, the Project will support the commencement of the operational phase, including an 18-month placement at the NJA of a consultant acting as counselor to senior staff, specifically developing and launching pilot courses, and commissioning and producing new publications. On completion of this placement, the consultant will support the NJA with two quarterly visits of two weeks each in the second year of operations, and two half-yearly visits of two weeks each in the third year

b. Legal Information

88. Under loan component B, the capacity of the Nepal Law Books Management Board (NLBMB) within the Ministry of Law & Justice will be expanded to improve access to legal information and reduce information cost. In the initial Project phase, NLBMB's capacity to serve as a central repository of all laws will be enhanced. NLBMB will develop web-based publishing of the laws of Nepal, giving priority to the statutes, and in the later phases to important new cases of the Supreme Court and pre-existing cases. ADB will also finance web-based publishing of the statute laws and case laws of Nepal, equipment, and training to enable NLBMB to publish all the laws of Nepal in a timely fashion on the web, as well as in hard copy.

c. Secured Transactions Registry

89. Under loan component B, the Project will support the establishment of a secured transactions registry (STR) to allow collateralization of movable assets and provide relevant information to the financial community, including recommendation on legal status and ownership; development of information systems infrastructure as well as business and operational plans: organization, financing, administration, and staffing. The drafting of the secured transactions law under TA 3461 will be a condition for establishment of the STR. The proposed loan will finance establishment of the registry procurement of hardware for a modern automated registry and staff training.

d. Special Commercial Bench

90. Most stakeholders have expressed the need for a special court to deal with commercial cases. The Supreme Court has also recognized this need for special treatment of such cases in

a recent report. Under loan component B, the Supreme Court will be given assistance in establishing a special bench for commercial cases, delineating its jurisdiction, and drafting of its procedural rules.

4. Improving Infrastructure for Payments and Financial Service Delivery

91. The development of Nepal's financial sector is hampered by its poor and unreliable communication infrastructure. The regulatory and technological infrastructure must be improved to support an efficient payment system as the backbone of financial service delivery. This is essential to increase competition in financial services, as the cost of information and transaction costs, including those for operating bank branches, can be cut down significantly through adequate ICT. This is particularly important for a country such as Nepal, which has a generally poor transport system and mountain communities that have traditionally been cut off from each other. ICT will also support documentation of the economy.

a. Upgrading of Payments System

92. To improve financial service delivery and competition under TA4 of the TA cluster, the Project will assist NRB to upgrade Nepal's payment system. The assistance will assess the current financial service delivery system and identify gaps between the current capacity of the payment system and the requirements of the growing financial and real sectors. It will examine the current legal and policy framework, operating systems, institutional capacity, information technology, and existing and required staff skills. It will formulate recommendations for an appropriate institutional environment, including the necessity of establishing a Nepal Payment Association, and draft regulations as required. It will further develop an implementation plan with a practical timetable for a medium term upgrade of Nepal's payment system that will meet the needs of businesses, consumers, and financial institutions to transfer funds. The project will also assist in putting in place effective safeguards in line with international best practices in preventing money laundering.

b. Support of Institutional Infrastructure for ICT Investments in Financial Service Delivery

93. A low technological base and poor communication facilities make financial transactions costly and nontransparent. In particular, the absence of a reliable and secure ICT backbone for transmission of financial information makes branch operations more costly, and thus hampers competition. The eventual investment in ICT technology and infrastructure will require extensive preparation and will be carried out under a separate stand-alone project preparatory technical assistance (PPTA).¹⁸ This will help define and improve the institutional and policy environment to support the investment, as well as in costing the investment requirements.

94. To ensure the reliability and data security of the financial services network and to attract private sector investment to this area, it is important that the ICT backbone be operated and managed by a competent institution. Under the Project, it is expected that future investment in ICT for financial sector delivery will be channeled through a public-private joint-venture company, which will provide a high-quality wireless data transmission backbone network for financial information and transactions on a commercial basis. A joint-venture company will help bundling resources to exploit economies of scale in providing a large bandwidth, and the cost-efficiencies of a common transmission channel for diverse banking services.

¹⁸ TA for *ICT for Improved Financial Service Delivery*, for \$500,000, proposed for approval.

95. Private sector participation for this will be required as HMGN, with its limited resource, is unlikely to respond to the market needs in this respect. HGMN participation is required to ensure policy consistency, as a number of government institutions are currently involved in ICT affairs. In this regard, HMGN agreed to support an appropriate institutional coordination mechanism and to protect the frequency spectrum band for the electronic transmission of information. HMGN will also support the establishment of the public-private joint-venture company to manage this. The domestic banking industry has been consulted on this matter and expressed very strong support for such initiative. To operationalize such a joint-venture company, which is expected as an outcome of the PPTA, funding will be required for the initial start-up activities.

96. Under loan component C, the Project will provide a portion of the loan proceeds (\$1 million) to assist in the start-up funding of a public-private ICT company (e-FIT), to be established as the outcome of the PPTA. The funds will cover immediate financing needs for setting up the institution: key personnel, operational and organizational development, as well as training, marketing, and human resource development. The loan will only be provided if the viability of the project is confirmed, and sufficient private sector interest is forthcoming and a shareholder agreement concluded. Future investment in hardware and software for the establishment of the ICT backbone will only be considered once the appropriate institutional infrastructure, including setting up of e-FIT, has been established. The preparedness to provide a start-up loan to e-FIT also signals a strong commitment by HMGN to this initiative and will be essential if the private sector is to come forward.

5. Restructuring and Development of Selected Financial Intermediaries

a. Diagnostic Study of ADBN and NIDC

97. Nepal's financial institutions such as ADBN and NIDC face a severe crisis that needs to be resolved. Institutional strengthening measures at this stage will have little impact and will require further improvement in the operating environment. But given the importance of these institutions in the financial sector, some basic analytical work for reforming them will need to be initiated. This will complement the work initiated by the World Bank on the reform of the public sector commercial banks.

98. Under TA5 of the TA cluster, ADB will support a review of the role of these institutions within the economy and an assessment of their financial health, governance structures, and management strengths and weaknesses. Specifically, assistance will be provided to conduct a detailed audit of both institutions and present an option study for their future direction.

b. Development of Insurance and Contractual Savings

99. Deepening and broadening the financial sector require orderly growth and expansion of insurance, pension, and other forms of contractual savings. This growth necessitates a sound regulatory environment under a legal framework, and strengthening the capacity of regulatory organizations for prudential supervision and protection's of investors and policyholders in relation to sophisticated financial products.

100. Under TA6 of the TA cluster, the Project will support the development of an appropriate institutional and policy framework for regulating insurance, pension, and other types of contractual savings including investment trust, so as to broaden the financial sector and

increase the growth of insurance, pension, and provident funds. It will also assess the existing institutions operating in the subsector, e.g., the National Insurance Corporation and Employees Provident Fund, and formulate recommendations for their institutional development.

C. Cost Estimates

101. The total cost of the Project is estimated at about \$13.3 million equivalent, including physical and price contingencies and taxes and duties. The total foreign exchange cost is about \$7.9 million (59 percent of the project cost), primarily for services of international consultants and ICT equipment. The local currency cost is about \$5.4 million equivalent (41 percent of the project cost), primarily for domestic consultant inputs, minor civil works as well as taxes and duties. The Project cost estimates are summarized in Table 2, and details are in Appendix 4.

Table 2: Cost Estimates
(\$ million)

Item	Foreign Exchange	Local Currency	Total Cost
A. Base Cost (September 2000 prices)			
1. Improving Policies, Standards, and Legislation	0.4	0.2	0.6
2. Capacity Building for Regulation and Supervision			
a. Corporate Governance and Capital Markets	1.9	0.6	2.5
b. Regulation and Supervision for Rural Finance	0.7	0.2	0.9
3. Improving Legal Enforcement Capacity and Infrastructure ^a	1.7	3.3	5.0
4. Improving Infrastructure for Payments and Financial Service Delivery			
a. Development of Payment System	0.3	0.1	0.4
b. Establishment of ICT Private-Public Partnership ^b	1.0	–	1.0
5. Developing Selected Market Participants	1.2	0.4	1.6
Subtotal (A)	7.2	4.8	12.0
B. Contingencies			
1. Physical ^c	0.1	0.2	0.3
2. Price ^d	0.5	0.4	0.9
Subtotal (B)	0.6	0.6	1.2
C. Interest Charge	0.1	–	0.1
Total Cost	7.9	5.4^e	13.3
Percent	59.2	40.8	100.0

– = zero magnitude

^a Cost may vary depending on the cost of the (STC). In case the cost is beyond \$1 million, the STC will be excluded.

^b Will only be provided if financial viability is confirmed through separate PPTA

^c At 5 percent on selected items.

^d At 10 percent for consulting services, and 6 percent for local currency cost for civil works.

^e Including taxes and duties of about \$0.2 million equivalent.

D. Financing Plan

102. A loan in various currencies of about \$7.3 million equivalent is proposed from ADB's Special Funds resources to finance the consultant and procurement packages under sub-components 2(a) and 3, as well as onlending under subcomponent 4(b). The loan will carry a term of 32 years, including a grace period of 8 years, and an interest charge of 1 percent per annum during the grace period and 1.5 percent per annum thereafter. The Borrower will be the Kingdom of Nepal. In addition, a grant of \$3.3 million equivalent from the ADB-funded TA Program is proposed to finance a cluster of various TA activities under assistance areas 1, 2(b), 4(a), and 5 (Table 1). ADB will finance the entire foreign exchange cost of the Project, as well as a portion of the local currency cost. Total financing by ADB is about 79.2 percent of the total Project cost. It is 78.1 percent for the loan-financed component and 84.5 percent for the grant-financed component. A summary of the financing plan is in Table 3, with details in Appendix 5.

Table 3: Financing Plan
(\$ million)

Source	Foreign Exchange	Local Currency	Total Cost	Percent
Asian Development Bank Loan	5.1	2.2	7.3	54.9
Asian Development Bank Grant (TA cluster)	2.8	0.5	3.3	24.8
Government	0.0	2.7	2.7	20.3
Total	7.9	5.4	13.3	100.0

103. The Government has requested partial financing of local currency expenditures as well as grant financing which is considered necessary in view of the Government's limited capacity to generate internal resources to meet all expenditure requirements, and the high consultant inputs required for capacity building. Nepal has one of the lowest ratios of tax collection to GDP (about 8 percent of GDP) among ADB's member countries, but it recently introduced a number of reforms and initiatives to improve this situation, which will further be reinforced by the Project. Moreover, grant financing through the ADB-funded TA Program does allow for greater flexibility in project implementation. The Government will finance about \$2.7 million equivalent of the local currency cost, including provision of land for the National Judicial Academy.

E. Implementation Arrangements

104. Effective implementation arrangements are crucial for the ultimate success and development impact of the Project. For maximum project impact, the implementation arrangements will be structured along three guiding principles:

- (i) minimize administrative burden for the Executing Agency (EA) and Implementing Agencies (IAs);
- (ii) maximize sense of project ownership by skills transfer to IAs; and
- (iii) maximize accountability and minimize scope for misuse of funds.

1. Project Organization

105. MOF as EA will be responsible for overall coordination of the project activities. MOF will administer the loan proceeds monitor their utilization, and interface with ADB and the IAs on project administration matters. MOF will also follow up on reporting requirements to monitor implementation progress. MOF will regularly (and at least on a quarterly basis) convene meetings of the project steering committee which includes private sector representatives, to review overall progress in implementation and to seek shareholder feedback.¹⁹ To ensure dissemination of information on the reform process and discussion among stakeholders and aid sources, a project web site was established (www.neat.net.np) and will be updated regularly to ensure proper integration in HMGN's overall reform program for the financial sector.

106. To perform its functions as EA, MOF will nominate a senior official as project director, who will be supported by administrative staff to function as the project coordination and monitoring unit (PCMU). Given the modular structure of the Project, which has only limited procurement and other administrative requirements, while operational interaction with the consultants will be performed by the IAs, it is expected that involvement of PCMU will be minimal, and more of a periodic nature. The role of EA is above all one of coordination, oversight, and accountability. It is expected that staff resources for this can be allocated among existing MOF staff, with operational support from the TA on financial sector reform (footnote 3).

107. To ensure a strong sense of project ownership and skills transfer to the IAs who are the direct beneficiaries of the assistance, close interaction between the consultants and key staff in the IAs is important. This requires close involvement of the IAs in consultant selection, effective operational interaction, and provision of an adequate working environment.

108. To formalize the working and reporting relationships between the IAs and PCMU, a project implementation team will be formed for each project component related to corporate governance and capital markets (component A) and NJA and legal strengthening (component B). Each team will be headed by a senior official as the team leader who should be a member of the steering committee, as well as senior officials from the other IAs involved in project implementation. For component A, these will be SEBO, NEPSE, and CRO. For component B, these will be the Supreme Court and Ministry of Law and Justice.

109. Specifically, the project implementation teams will:

- (i) lead the consultant selection process for the respective components, including preparation of a long list, shortlist, and selection criteria;
- (ii) interact with the consulting teams to produce outputs as agreed;
- (iii) monitor resource inputs, including verifying consultant timesheets and withdrawals from the imprest account for eligible project activities; and
- (iv) prepare progress implementation reports to be submitted to PCMU for wider distribution.

110. As is the case for the PCMU, required staff resources will come from the existing staff of the IAs. For handling administrative matters related to the activities outlined above and to

¹⁹ The steering committee was established in January 2000 with private sector participation. Regular consultation between the Government and the private sector initiated during the design and processing phase of this Project will be extended to the implementation phase of the Project. Subcommittees have been formed to provide guidance and stakeholder consultation on policy matters.

perform as secretary to the respective project implementation teams, SEBO and the Supreme Court will each assign one of its staff. ADB will familiarize this staff with ADB's procurement, disbursement, and reporting requirements.

111. For the TA components, the respective line ministries will be the IAs and will report implementation progress to the steering committee. An organization chart outlining project implementation and coordination arrangements is in Appendix 6.

2. Implementation Schedule

112. The Project will be implemented over 48 months from loan effectiveness, starting in early 2001 with completion by December 2004. Initial activities will focus on selection and recruitment of loan consultants for the two components covered. The overall project implementation schedule is summarized in Appendix 7. The implementation schedule and arrangements will be reviewed and details provided after the consultants are fielded.

3. Procurement of Goods and Services

113. Procurement of goods and services out of the loan proceeds will follow ADB's *Guidelines for Procurement*. Supply contracts for equipment and materials will generally be awarded on international competitive bidding for packages with over \$500,000 aggregate value, international shopping for packages costing over \$100,000, and local competitive bidding or local shopping, in accordance with procedures acceptable to ADB, for other items, except minor items for which off-the-shelf purchases will be permitted. Computer hardware and software, including software development, will be procured under the contract with the consultants selected under loan components A and B, in accordance with ADB procedures. Any civil works financed under the loan for establishing NJA in loan component B will be for a turnkey contract on a local competitive basis as the cost is less than \$5 million. A procurement selection committee will choose the contractor.

114. MOF and the IAs will ensure that goods and services procured are reasonably priced and suitable for the project activities, and that fair canvassing is done and normal commercial practices are followed in selecting suppliers in the case of international or local shopping. Before procuring any goods and services, the EA will submit to ADB for its concurrence a list of equipment, quotations obtained from at least three suppliers (for international shopping from at least two ADB member countries), and justification for selection.

115. The loan will finance of consulting services for policy advice, institutional development and training, preparation of ICT solutions, and project management. It is estimated that about 87 person-months of international and 152 person-months of domestic consulting services will be required. Consultants will be recruited in two bidding packages for loan components A and B, in accordance with the ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for engagement of domestic consultants. The required expertise and outline terms of reference are attached as Appendix 8.

4. Disbursement Procedures

116. Immediately after loan effectiveness, the EA will establish an imprest fund account for disbursement of the loan proceeds. The IAs will use the account to pay suppliers of minor items as well as organizers of workshops and for attendance at training events under the Project. The imprest account will be operated in accordance with ADB's *Loan Disbursement Handbook*.

Advances to the imprest account will be based on MOF's projected expenditures. ADB's statement of expenditure procedures will be used to liquidate advances and replenish the imprest account. Payment for consulting services and computer equipment, including software development contracts, as well as civil works will follow ADB's direct payment procedures. This will minimize the administrative burden on the EA and IAs. The Government contribution to the Project will be provided through the annual budget process and in a project account.

5. Relending Arrangements

117. Under a subsidiary loan agreement, the Borrower will relend up to \$1 million of the loan relating to the public-private sector joint-venture company to be established under the Project for operating the ICT infrastructure (component C). The proceeds will finance start-up costs including key personnel, operational and organizational development, as well as training and social mobilization needs. The subsidiary loan agreement with the joint-venture company will be denominated in Nepalese rupees with a maturity of up to seven years including a grace period of up to three years. The foreign exchange risk will be borne by HMGN as the Project is expected to generate revenues in local currency only. The rate of interest for the re-lent portion will not be less than that applicable to loans from ADB's ordinary capital resources.

6. Reports and Reviews

118. To ensure proper monitoring of fund utilization and effective progress in implementation, implementation teams will submit regular reports to PCMU for wider distribution among stakeholders. MOF will submit to ADB quarterly progress reports on overall progress in project implementation in line with the project framework and in a form and level of detail satisfactory to ADB. The quarterly progress report will be submitted to ADB within four weeks after the end of the relevant quarter. Within three months of substantial project completion, MOF will prepare and submit to ADB a project completion report. ADB and HMGN will jointly conduct review missions at least twice a year. A project inception mission will take place after loan effectiveness to ensure that delays during the start-up phase are avoided. A comprehensive midterm review 18 months after project inception will examine all aspects of project implementation. The review will focus on (i) the performance of the EA and IAs, and coordination issues; (ii) the performance of the consultants; (iii) progress in disbursement and adequacy of implementation arrangements; (iv) policy constraints in project implementation; and (v) initial project impact. In addition, feedback from beneficiaries will be sought through occasional workshops and regular meetings of the project steering committee.

7. Accounts and Audit

119. MOF and the IAs will establish and maintain separate accounts for expenditures under the Project in accordance with accounting procedures acceptable to ADB. All financial transactions will be recorded in the project account in a manner that allows identification of expenditures on the project facilities provided under the loan.

120. The financial statements by MOF and the IAs on the use of loan proceeds will be audited annually by an accounting firm acceptable to ADB. Certified copies of the audited accounts and financial statements will be submitted to ADB in the English language within six months after the end of each fiscal year. Any delay in submission of such audited accounts and financial statements may result in suspension or cancellation of the loan.

8. Benefit Monitoring and Evaluation

121. To ensure effective utilization of the funds and adequate development impact, including skills transfer, performance parameters will be established for the key agencies benefiting from the capacity building components. They will be monitored annually. A set of detailed performance criteria is in Appendix 9.

122. Throughout the life of the Project, civil society, as representatives of the consumers and potential consumers of judicial and legal services, will be consulted to assess public confidence in the quality of service provision, need for professional development, and effectiveness of training provided.

123. Progress in implementing this program will be independently monitored and evaluated at the completion of the first, second, and third years of operation, in addition to regular reporting to and liaising with the Judicial Council, the Judicial Services Commission, and the Nepal Bar Council, to evaluate the effectiveness of education services in improving the professional competence and performance of judges, government lawyers, and private practitioners.

124. With specific reference to judges, a performance management system will be introduced in liaison with the Judicial Council to implement and monitor bench work performance standards, as part of a related merit-based approach to judicial appointment being introduced by the Judicial Council under powers invested by the Constitution. Similar performance management systems will be introduced in the Judicial Services Commission and the Nepal Bar Council to monitor improvements in the performance of government lawyers and private practitioners, respectively.

125. Key performance parameters for other agencies benefiting from assistance under the TA cluster will be established at the beginning of each TA, depending on the scope of NRB's mandate in this area after revision of the NRB Act. For example, for ICAN, performance may be monitored annually against key criteria such as (i) progress in implementing its business plan, (ii) increases in application for membership, (iii) number of accountants trained and training courses offered, (iv) output of the proposed accounting and auditing standards boards, and (v) the activity level of its disciplinary committee.

126. Continued feedback and participation by the private sector and other beneficiaries will be sought throughout implementation. For this purpose workshops and stakeholder forums will be organized.

F. The Executing Agency

127. The EA will be MOF, through its Economic Affairs Division. MOF and NRB are the key agencies involved in the financial sector reform program in Nepal. MOF has considerable experience with administering ADB and other externally funded projects. Currently, it is EA for TA 3356 for strengthening the accounting and auditing profession (footnote 2). MOF will be supported by NRB, SEBO, Ministry of Industry (MOI), Ministry of Law and Justice, Supreme Court, and Ministry of Information and Communication (MOIC) as IAs. While NRB, MOI, and MOIC have reasonable experience in implementing externally funded projects, the experience of SEBO and the Supreme Court is limited. However, SEBO has performed well as the EA for TA 2834 for capital markets development. Due to MOF's many ongoing commitments and the complex nature of the Project, institutional support has been provided under TA 3371 (footnote 3) to assist MOF with the wider scope and responsibilities under the Project.

G. Environmental and Social Measures

128. The Project will have no direct environmental impact; therefore no mitigating measures are required. Longer term environmental and social impacts will result from a general increase in living standards, and more open communication and access to information. Expected social impacts are discussed in paras. 131-134.

H. Technical Assistance

129. For assistance in implementing, on an urgent basis, the key measures related to policy reforms and transparency of the legal framework; improving accounting and auditing standards in the public sector; strengthening NRB to regulate and supervise rural finance; upgrading the payment system; and developing selected market participants, including ADBN and NIDC, the Government requested an umbrella TA for Corporate and Financial Governance Institutional Support, with sub-TAs, under ADB's cluster modality for a total amount of \$3.3 million on a grant basis from the ADB-funded TA Program. Specifically, the proposed TA will comprise the following:

- (i) TA1: Streamlining of Financial, Corporate and Commercial Legislation (\$250,000);
- (ii) TA2: Improved Accounting and Auditing Standards in the Public Sector (\$250,000)
- (iii) TA3: Institutional Strengthening of NRB for Regulation and Supervision of Rural Finance (\$800,000)
- (iv) TA4: Development of Nepal's Payment System (\$400,000)
- (v) TA5: Financial and Operational Review of ADBN and NIDC (\$850,000); and
- (vi) TA6: Development of Insurance, Pensions, and Contractual Savings (\$750,000).

130. Detailed scope and implementation arrangements will be finalized before the start of each subproject, based on the outlined scope and indicative budget, and will be subject to close scrutiny prior to approval by ADB's Management. Upon the start of implementation of each subproject, ADB's Board will be informed of overall progress of the cluster through a brief information paper. The objectives, scope, and terms of reference for the six sub-TAs are outlined in Appendix 10.

V. PROJECT JUSTIFICATION

A. Poverty Reduction and Socioeconomic Impact

131. The Project will reinforce the basic fundamentals for a robust and efficient financial sector. It will increase transparency, accountability, and better governance standards as well as law enforcement. More reliable financial information to the public will reduce the scope for rent-seeking opportunities of individuals through a monopoly of information at the expense of the larger society. Access to information and justice is often excessively priced for the poorest segment of the population. Initial work for upgrading the payments systems and creating the enabling environment for development of ICT infrastructure will promote competition and further growth in service delivery. It will also include measures to prevent money laundering.

132. A better regulatory and institutional framework will also increase stability of the financial system and make it more robust against any financial crisis. This will reduce the risk of a negative socioeconomic impact associated with a financial crisis, which is most severe for the poorest segment of the population.

133. The Project is part of a longer term development process for private and financial sector development. A computable general equilibrium model as well as international comparison with other reform countries indicates that comprehensive financial sector reform will boost Nepal's annual gross domestic product growth by about 2 percent – or \$100 million per annum. Importantly, growth will be even stronger in rural areas as any ensuing investment will raise the demand for rural labor, especially in the most labor-intensive activities.

134. The Project supports primarily regulatory and institutional development and has limited direct impact on individual beneficiaries. In a wider sense, changes in Nepal's social fabric are expected over the longer term as economic growth and more transparency in information result from the Project. The shift toward more formal economic patterns and industrialization following improved financial intermediation are often accompanied by increasing urbanization and associated social implications, including social protection patterns. The Project includes preparatory work for future investments in ICT, which will, in the longer term, support introduction of e-banking and e-commerce. The longer term social impacts of internet technology in particular for remote societies are not yet well known. Additional work is needed to better understand how the benefits of new IT applications can best be put to use in SMEs and other low-income customers, and its social implications. Initial research findings suggest that, in some cases, this can lead to disruption of long-standing power structures and traditional patterns, particularly for hierarchical societies.²⁰

B. Risks

135. **Policy reversal and loss of momentum.** The principal risk associated with the Project is that of policy reversal. To bring about sustained improvement, a long-term vision and strong commitment to reform and development in a number of areas are required. Although the Government has expressed a clear commitment to comprehensive reform, the political situation is fragile and any measures that cut the existing privileges of selected groups are subject to political exploitation. Moreover, many benefits of the project initiatives may only occur in the medium to longer term and enthusiasm for the reform process may fade. An active communications strategy will be pursued, including a series of consultative workshops to muster wider stakeholder support. In addition, the inclusion of private sector representatives in the project steering committee makes the Project less vulnerable to changes in Government.

136. **Limited implementation capacity.** The Project covers a wide range of activities involving a number of IAs. However, given the multidimensional aspect of financial and corporate governance, developing of a sustainable financial system needs a holistic approach with proper sequencing and a realistic time frame over a longer term than in the project horizon. To ensure proper coordination and implementation, TA 3371 (footnote 3) is assisting MOF in effectively coordinating and monitoring financial sector reforms, as well as organizing consultative workshops for continued feedback. An internet web site has been created to keep all parties updated on progress and developments under the Project. Beneficiaries have been involved from an early stage in project design and a steering committee with adequately staffed

²⁰ See New York Times, When Villages Go Global – How a Byte of Knowledge Can Be Dangerous, too; 23 April 2000.

specialized subcommittees has been created. In addition, ADB will conduct at least two annual review missions.

137. **Effective skills transfer by consultants.** The institutional capacity in Nepal's financial sector is extremely weak and expertise available domestically is limited. Capacity building, one of the key project outputs, requires significant consultant inputs. The consulting expertise will be primarily for hands-on work in establishing systems, rules and procedures, as well as transferring knowledge to local counterparts, and only to a lesser extent for additional studies and review. Clear performance measurement standards have been established to ensure measurable progress.

138. **Delays in establishing the public/private partnership company (eFIT).** The Project envisages onlending to a public-private joint-venture company with majority private sector participation that is still to be established. The Government has assured its full support to this venture and a PPTA has detailed the investment parameters (footnote 18). The loan component for this will be disbursed only if sufficient investor interest is mustered and due diligence carried out on the financial sustainability of the proposed company.

VI. ASSURANCES

A. Specific Assurances

139. HMGN has given the following assurances, in addition to the standard assurances, which have been incorporated in the legal documents:

- (i) By 30 June 2001, submission to Parliament of the following proposed legislation, acceptable to ADB: (a) Securities Bill, (b) Companies Bill, (c) Insolvency Bill, (d) Secured Transactions Bill, (e) a bill to amend the Nepal Chartered Accountants Act, and (f) NJA Bill. Old legislation covering these areas will be repealed, as necessary.
- (ii) By 31 December 2001, submission to Parliament of the following proposed legislation, acceptable to ADB: (a) NRB Bill, (b) Financial Institutions Bill (or a bill serving similar purpose), and (c) e-commerce Bill, each in a form acceptable to the Bank. Old legislation covering these areas will be repealed, as necessary.
- (iii) HMGN will issue a gazette notification to bring into force the Judicial Fund Act 1986 so that the Fund can, among other things, be used for developing the judiciary, including training requirements, to ensure sustainability of the NJA.
- (iv) Institutional and organizational arrangements for regulation of companies will be rationalized, including possible merger or reorganization of SEBO, CRO, and Company Law Board, on the basis of the findings under TA 3461 (footnote 2).
- (v) Interest rates and branch licensing policies will be rationalized, and priority and directed credit sector lending requirements reviewed by 30 June 2001.
- (vi) By 31 December 2002, finalize fair tax treatment based on certified accounts that gives minimal discretionary powers to income tax officials for companies that submit themselves to higher disclosure requirements, including an audit of

accounts through chartered accountants who are members of ICAN, and supervision by SEBO.

- (vii) Ownership of and control over NEPSE will be transferred to the private sector by 31 December 2002.
- (viii) The NJA will be established under the auspices of the Supreme Court and budgetary allocation for the judiciary will gradually be increased.
- (ix) The Nepal Payments Association will be created, or alternative institutional arrangements as recommended under the TA cluster will be adopted, to coordinate development of the payments system, electronic funds transfer, and clearing and settlement under supervision of NRB, in coordination with the Nepal Bankers' Association.
- (x) The radio frequency spectrum band for electronic transmission of information through the financial very small aperture terminal communication network will be protected.
- (xi) The Government will support the establishment of a public-private joint-venture company - if found viable - to establish, operate, and maintain the ICT network and services.

B. Conditions for Loan Effectiveness

140. The Project will be declared effective when Cabinet:

- (i) approves tabling of the Nepal Chartered Accountants Bill, acceptable to ADB, that would, among others, lead to the repeal of the Auditors Act - thus allowing ICAN to be the sole licensing body for accountants - and establishment of the accounting and auditing standards boards, and
- (ii) approves tabling in Parliament a Securities Bill, acceptable to ADB, that establishes an independent SEBO, thus granting security of tenure to members of SEBO and allows their removal only for just cause after due process. The draft will also ensure the financial autonomy of SEBO by allowing registration and other fees levied by SEBO to accrue to the SEBO fund. The bill will provide for investigation and enforcement of the Securities Law including the establishment of the office of the chief accountant in SEBO, headed by a chartered accountant.

C. Conditions for Disbursement

141. The following will be conditions for disbursement of the loan for the Project:

- (i) Funds under component B (National Judicial Academy) will be disbursed only when the Cabinet approves tabling in Parliament of a bill, acceptable to ADB, for establishing the NJA, and after an adequate plot of land within Kathmandu valley has been allocated for the NJA.

- (ii) Funds under component C (onlending to a private-public sector joint-venture [e-FIT] to provide ICT for financial services) will be disbursed only when a shareholding agreement with private sector participation for establishment of e-FIT has been concluded, based on a viable business plan developed under the PPTA for ICT for improved financial service delivery.

VII. RECOMMENDATION

142. I am satisfied that the proposed loan and technical assistance would comply with the Articles of Agreement of ADB and recommend that the Board approve:

- (i) the loan in various currencies equivalent to Special Drawing Rights 5,706,000 to the Kingdom of Nepal for the Corporate and Financial Governance Project, with a term of 32 years, including a grace period of 8 years, and with an interest charge of 1 percent per annum during the grace period and 1.5 percent per annum thereafter, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board; and
- (ii) the provision of technical assistance in an amount not exceeding the equivalent of \$3.3 million to His Majesty's Government of the Kingdom of Nepal for Strengthening Corporate and Financial Governance.

TADAO CHINO
President

21 November 2000

APPENDIXES

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SUPPLEMENTARY APPENDIXES

(available on request)

A	Background Note on Nepal's Financial Sector and Institutions
B	CGE Model on Welfare and Distribution Impacts of Financial Liberalization in Nepal

**EXTERNAL ASSISTANCE SUPPORTING
FINANCIAL SECTOR DEVELOPMENT AND CORPORATE GOVERNANCE**

Institution, Project	Type	Year Approved	Commitment Amount (\$ '000)
ADB			
Capital Market Development	TA Grant	1992	187
Capital Market Development II	TA Grant	1997	596
Financial Sector Regulation and Governance	TA Grant	1998	150
Improvement of Disclosures and Corporate Governance	TA Grant	1998	150
Capacity Building for Accounting and Auditing Profession	TA Grant	1999	665
Establishing a Focal Point for Financial Sector Reform	TA Grant	1999	150
Company and Insolvency Law Reform	TA Grant	2000	250
World Bank			
Second Structural Adjustment Credit	Loan	1989	60,000
Banking Reform Project (RBB)	Grant	1999	425
Reform of Banking Regulation and Strengthening Supervisory Function of NRB	Grant	1999	92
Project Preparation Facility for Financial Sector Development Program	Grant	1999	550
UNDP			
Strengthening Accounting and Auditing Capabilities	Grant	1987	1,010
Commercial Bank Problem Analysis and Strategy Study	Grant	1989	950
Commercial Bank Problem Analysis and Strategy Study, Phase II	Grant	1992	695
DFID			
Privatization Project	Grant	1997	3,550

ADB = Asian Development Bank, DFID = Department for International Development, NRB = Nepal Rastra Bank, TA = technical assistance, UNDP = United Nations Development Programme.

PROJECT FRAMEWORK

Design Summary	Performance Indicators and Targets	Monitoring Mechanisms	Assumptions and Risks
<p>Goal</p> <p>Deepen and broaden financial sector and increase efficiency of financial intermediation for growth and equity</p>	<ul style="list-style-type: none"> ● Increase the domestic investment (credit volume) and monetized savings (deposits) rate ● Increase in liquidity of financial instruments, including capital markets ● Improve domestic credit/deposits ratio and incremental capital output ratio (ICOR) 	<ul style="list-style-type: none"> ● Nepal Rastra Bank (NRB) statistics for monitoring domestic investment, savings, credit creation and stock, deposits, liquidity, spreads and interest rates in the formal finance system ● Securities Board (SEBO) statistics on capital market activities ● nongovernment organization (NGO)/private sector feedback 	<ul style="list-style-type: none"> ● Continued political commitment to reform ● Adequate human resources and institutional capacity ● Timely and accurate statistics
<p>Purpose/Objectives</p> <p>1. Increased competition for improved financial resource mobilization and intermediation</p>	<ul style="list-style-type: none"> ● Adequate regulatory and supervisory framework to ensure and safeguard orderly market entry/exit mechanisms for finance institutions; includes Bankruptcy Act, Companies Act, Secured Transaction Act, Securities Exchange Commission (SEC) Act, e-Commerce Act and other financial and corporate laws as agreed upon with His Majesty's Government of Nepal during project implementation ● Equal opportunities in the nonbank financial institutions and rural subsector to stimulate more competitive market; includes rationalization of interest rates and branch licensing policies and elimination of directed credit sector lending requirements ● Improved rural savings mobilization ● Improved allocation of financial resources in capital markets 	<ul style="list-style-type: none"> ● Asian Development Bank (ADB) review missions and regular project progress reports ● Coordination with the World Bank ● Annual report by SEBO and NRB 	<ul style="list-style-type: none"> ● Strong political will and policy consistency during transition period ● Effective restructuring of commercial banks (with World Bank assistance) ● Domestic players see foreign participation as opportunity for know-how and business

<p>2. Reduced information and transaction costs to increase the effectiveness of financial intermediation</p>	<ul style="list-style-type: none"> ● Rationalized incentive structure for key market players to comply with information disclosure requirements ● Simplified laws/regulations/directives and procedures ● Clear bankruptcy law, arbitration, and enforcement 	<ul style="list-style-type: none"> ● ADB review missions and regular project progress reports ● Cost and time required for funds transfer ● Spreads applied by financial intermediaries ● Increase in transactions with secure property rights ● Increase in number of successful cases of creditor rehabilitation, or bankruptcy /collateral enforcement 	<ul style="list-style-type: none"> ● Adequate analysis of incentive structure of key financial sector players ● Improved legal and institutional capacities and human resources
<p>3. Improved transparency and disclosure as basis for sound financial sector risk analysis</p>	<ul style="list-style-type: none"> ● Development of market infrastructure: <ul style="list-style-type: none"> (i) institutions; (ii) human resources; (iii) application and enforcement of international financial, auditing, and accounting standards 	<ul style="list-style-type: none"> ● ADB review missions and regular project progress reports ● Issue of new standards by the independent accounting and auditing standards boards 	<ul style="list-style-type: none"> ● Continued Government support and commitment in pursuing reforms without reversal ● Buildup of trust between government and market participants to encourage reliable and timely revelation of information ● Professional support and institutional capabilities needed for moving to improved standards, their application and enforcement
<p>4. Improved corporate and sector governance with effective enforcement and dispute resolution mechanism</p>	<ul style="list-style-type: none"> ● Clear institutional framework and roles of NRB, SEBO, Companies Registrars Office for financial sector regulation and supervision explicitly defined ● Finance and commerce dispute resolutions mechanism outside of court system ● Clearly defined rules and procedures for arbitration for corporate matters ● Effective legal enforcement by strengthening regulatory and judicial structure, and processes and procedures in the finance and commerce sectors 	<ul style="list-style-type: none"> ● ADB review missions and regular project progress reports ● Institutional structure of regulators setup, defined roles of regulators 	<ul style="list-style-type: none"> ● Emerging consensus of key players: International Monetary Fund (IMF), World Bank, and ADB.

Outputs			
<p><i>Area 1 - Improved corporate and financial governance (CFG) policy, regulatory and legal framework, and standards</i></p> <p>1.1. Consistent legal framework for financial and corporate sector (Sub-TA 1)</p> <p>1.2. Convergence of public and private accounting and auditing standards towards international level (Sub-TA 2)</p>	<ul style="list-style-type: none"> ● Consolidation of laws with qualitative improvement ● Number of people trained in international accounting and auditing standards 	<ul style="list-style-type: none"> ● ADB review missions and regular project progress reports <ul style="list-style-type: none"> ● Number of laws reviewed and drafting activities under Legal Reform Coordination Committee ● Asian Development Bank review missions and regular project progress reports 	<ul style="list-style-type: none"> ● Adequate drafting capacity and understanding of key issues ● Broad stakeholder support ● Political commitment to elimination of special privileges and reduction of direct intervention in the running of affairs of financial institutions
<p><i>Area 2 – Institution building for key CFG for regulation and supervision</i></p> <p>2.1. – Improving corporate and capital markets (loan component A)^a</p> <p>2.1.(1) SEBO strengthened. Details on performance parameters for benefit monitoring are in Appendix 9.</p> <p>2.1.(2) Nepal Stock Exchange (NEPSE) privatized</p>	<ul style="list-style-type: none"> ● Corporate and governance plan prepared and implemented; staff trained; management information system (MIS) installed; rules and regulations for securities market operation issued ● NEPSE to develop rules and regulation and move toward effective self-regulation 	<ul style="list-style-type: none"> ● Asian Development Bank review missions ● Track development on SEC legislation, corporate and governance plans ● SEBO/consulting team to furnish regular progress reports ● SEBO to furnish ADB with its annual reports ● Review of NEPSE to provide a report to SEBO on the strategy of privatization, and improvements in corporate governance and trading ● SEBO/consulting team to furnish regular progress reports 	<ul style="list-style-type: none"> ● Delay in promulgation of the SEC legislation ● Delay in adoption of recommendations of the consultants on institutional strengthening of SEBO. ● Support from Government and members for stock exchange reforms

^a Further details on performance parameters for benefit monitoring are summarized in Appendix 9.

2.1.(3) Central depository system (CDS) established	<ul style="list-style-type: none"> ● A fully automated CDS established as a separate legal entity and licensed to performing clearing and settlement operations. Business and governance plan prepared and implemented; rules and guidelines to ensure CDS developed; staff trained 	<ul style="list-style-type: none"> ● CDS/consulting team to furnish regular progress reports 	<ul style="list-style-type: none"> ● Private sector interest in bidding for the license to operate CDS
2.1.(4) Companies Registrars Office (CRO) upgraded	<ul style="list-style-type: none"> ● Legal status of CRO clarified; corporate and financial plan prepared and implemented; new database designed to allow link with tax administration and credit information bureau; registration of existing companies data updated 	<ul style="list-style-type: none"> ● CRO/consulting team to furnish regular progress reports 	<ul style="list-style-type: none"> ● Sufficient financial and human resources to maintain the database, if possible through outsourcing ● Compliance of registered companies in submitting required information
2.2. Strengthened capacity of NRB for supervision of rural finance activities (Sub-TA 3)	<ul style="list-style-type: none"> ● Development of rules and procedures for reporting by financial institutions; implementation of MIS; specialist staff trained for effective assessment of reports 	<ul style="list-style-type: none"> ● Asian Development Bank review missions ● NRB/consulting team to furnish regular progress reports on development of rules, regulations, MIS implementation, training conducted 	<ul style="list-style-type: none"> ● NRB Act reviewed to redefine role and mandate of NRB ● Responsibilities within NRB clarified and streamlined; specialist wing established in NRB to deal with nonbank rural finance
<p><i>Area 3: Improving legal enforcement capacity and infrastructure</i></p> <p>3.1 Loan component B: Improving legal Enforcement capacity and infrastructure</p> <p>3.1.(1) A commercial bench and dispute resolution established</p>	<ul style="list-style-type: none"> ● Compilation of judicial statistics ● Strategic and operational plan for development of judiciary and administration ● Review of Arbitration Act ● Development of scheme for establishment of commercial courts or specialized benches within existing system 	<ul style="list-style-type: none"> ● Regular progress reports, review missions ● Stakeholder workshops 	<ul style="list-style-type: none"> ● Support for collection and availability of required statistical data

3.1.(2) National Judicial Academy (NJA) established ^b	<ul style="list-style-type: none"> ● Governance structure of NJA agreed upon and key personnel selected; development of organizational, business and financial plan; development of curriculum; pilot training courses conducted; training facilities and MIS installed; key staff trained; design of annual report 	<ul style="list-style-type: none"> ● Regular progress reports; review missions ● Stakeholder workshops 	<ul style="list-style-type: none"> ● Agreement on operational independence of NJA ● Adequate budgetary provisions
3.1.(3) Legal Information System improved	<ul style="list-style-type: none"> ● Development of financial and operational and plan; MIS/internet infrastructure in place; legislation translated; development of case filing and indexing system; public relation campaign; training of key staff for translation and updating of system 	<ul style="list-style-type: none"> ● Regular progress reports, review missions 	<ul style="list-style-type: none"> ● Full support from the Government, judiciary, and legal profession ● Adequate budgetary provisions or fee structure for financial sustainability ● Acceptance of LIC output as reliable and recognized in court system
3.1.(4) Secured Transaction Center (STC) established	<ul style="list-style-type: none"> ● Legal status of STC clarified; license to operate STC awarded; business plan prepared; MIS system installed; operations manual and guidelines prepared; staff trained. 	<ul style="list-style-type: none"> ● Regular progress reports, review missions 	<ul style="list-style-type: none"> ● Private sector interest in bidding for the license to operate STC ● Sufficient financial and human resources to sustain information system
<i>Area 4 – Improving infrastructure for payment and financial services delivery</i>			
4.1. Nepal Payments Association established and functioning electronic interbank settlement service (Sub-TA 4)	<ul style="list-style-type: none"> ● Organizational, governance, and business plan prepared and implemented; key staff trained; information and communication technology infrastructure installed; rules, procedures and reporting to NRB developed 	<ul style="list-style-type: none"> ● Regular progress reports, review missions ● Stakeholder workshops ● Number and volume of financial transactions passed through the system 	<ul style="list-style-type: none"> ● Participating banks/financial institutions will be able to integrate electronic operations with their overall management and operations.
4.1.1 Electronic finance and information technology (eFIT) established (Loan Component C)	<ul style="list-style-type: none"> ● Support of eFIT start-up operations, key staff recruited; eFit incorporated; organizational, governance and business plan prepared and implemented 	<ul style="list-style-type: none"> ● Regular progress reports, review missions 	<ul style="list-style-type: none"> ● Interest of international technology partner and financial viability of eFIT. ● Financial community, Government and international and domestic IT providers work together in establishing eFIT.

^b Further details on performance parameters for benefit monitoring of NJA are summarized in Appendix 9.

<p><i>Area 5 – Development of selected market participants</i></p> <p>5.1. Detailed operational and financial diagnosis and recommendations for restructuring of ADBN and NIDC (Sub-TA 5)</p> <p>5.2. Recommendations for development of insurance industry and contractual savings (Sub-TA 6)</p>	<ul style="list-style-type: none"> ● Detailed operational and financial audit report ● Report on regulatory framework for insurance industry, pension, and contractual savings ● Report on operations of National Insurance Company (NIC) and plans for restructuring and investment developed ● Report on operations of Employees Provident Fund (EPF) and private pension funds ● Provision of training programs 	<ul style="list-style-type: none"> ● Regular progress reports; review missions ● Stakeholder workshops ● Regular progress reports, review missions ● Stakeholder workshops 	<ul style="list-style-type: none"> ● Operational autonomy and improved governance of ADBN/NIDC. ● Cooperation of ADBN/NIDC management and availability of required information, and acceptance of possibly negative findings ● Government support for streamlining of legal, regulatory, and policy environment ● Cooperation of NIC/EPF management and availability of required information
<p>Inputs and Activities</p> <p>Loan Components</p>	<p>.</p>	<ul style="list-style-type: none"> ● Regular progress reports, review missions 	<ul style="list-style-type: none"> ● Adequate and timely provision of counterpart funds, skilled staff, and facilities ● Project ownership by Government and stakeholders ● Successful consensus building and consistent political support. ● Timely recruitment of consultant

<p>Loan Component A</p> <p>\$2,500,000 (loan): Consulting services: 40 person-months international and 85 domestic IT equipment</p>	<ul style="list-style-type: none"> ● Develop operational plans (governance, legal, organization, business and financial) and support in drafting of rules, regulations and procedures for activities of SEBO, NEPSE, CDS, and CRO ● Procurement and installation of IT systems ● Training of key staff ● Organization of stakeholder workshops 		
<p>Loan Component B</p> <p>\$ 3,800,000 (loan): Consulting services: 46 person-months international and 72 domestic. IT equipment</p>	<ul style="list-style-type: none"> ● Support to Ministry of Law and Justice and Supreme Court in review of commercial arbitration and dispute resolution mechanisms and formulate recommendations ● Develop and implement operational plan (governance, organization, administration, business, and financial) for establishment of NJA ● Training of key staff ● Development of curriculum for training judges and pilot testing ● Establish LIC ● Establish STC ● Procurement and installation of IT systems ● Consultation with key stakeholders 		
<p>Loan Component C</p> <p>\$1,000,000 (loan) for onlending to eFit</p>	<ul style="list-style-type: none"> ● Provision of start-up financing needs of eFIT including key personnel, operational and organizational development, training and marketing, and human resource development 	<ul style="list-style-type: none"> ● Regular progress reports submitted under the PPTA on ICT for improved financial service delivery 	<ul style="list-style-type: none"> ● Strong commitment by HMGN to the initiative to encourage the private sector to come forward ● Private sector's willingness to contribute equity share to eFit

Inputs and Activities			
TA Cluster		<ul style="list-style-type: none"> ● Regular progress reports, review missions 	<ul style="list-style-type: none"> ● Adequate and timely provision of counterpart funds, skilled staff, and facilities
<p>I. Sub-TA1 \$ 250,000 Consulting services: 6 person-months international and 15 domestic</p>	<ul style="list-style-type: none"> ● Support to Legal Reform Coordination Committee in reviewing and drafting legislation ● Support in review and formulation of regulatory and policy framework for NBFIs ● Organization of stakeholder workshops 		<ul style="list-style-type: none"> ● Project ownership by Government and stakeholders ● Successful consensus building and consistent political support ● Timely recruitment of consultants
<p>II. Sub-TA2 \$250,000 Consulting services: 6 person-months international and 10 domestic</p>	<ul style="list-style-type: none"> ● Support the public sector to move toward improved accounting and auditing standards ● Design/conduct training programs for key staff from the auditor general's office and other key public entities 		
<p>III. Sub-TA3 \$800,000 Consulting services: 20 person-months international and 20 domestic IT equipment</p>	<ul style="list-style-type: none"> ● Support to NRB in review of organizational setup and drafting of policies, rules, regulations and procedures for regulation and supervision of rural and micro finance activities ● Procurement and installation of IT systems ● Training of key staff ● Organization of stakeholder workshops 		

<p>IV. Sub-TA4 \$400,000 Consulting services: 9 person-months international and 11 domestic</p> <p>V. Sub-TA5 \$850,000 Consulting services: 20 person-months international and 30 domestic</p> <p>VI. Sub-TA6 \$750,000 Consulting services: 18 person-months international and 27 domestic</p>	<ul style="list-style-type: none"> ● Review of legal policy/institutional framework of current financial service delivery system and recommend an appropriate institutional environment for improvement ● Design an implementation plan for upgrading the system ● Training of key staff ● Operational and financial audit of ADBN and NIDC ● Review of regulatory framework for insurance industry, pension, and contractual savings ● Review of operation of NIC, EPF, etc. 		
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Draft Policy, Mandate, and Organization Chart of the Proposed National Judicial Academy

A. Mission

1. The mission of the National Judicial Academy is to conduct programs of continuing professional education training and development for judges, court officers, officers exercising quasi-judicial powers, public sector legal officers, and members of the private legal profession (judicial and legal officers).

B. Objectives

2. The purpose of the programs of continuing professional development is to improve the rule of law by improving the competence and performance of judicial and legal officers in providing judicial and legal services. Specifically, the objectives of the Academy are to

- (i) assist judicial and legal officers acquire the knowledge, skills, and attitudes required to perform their professional responsibilities competently;
- (ii) conduct legal research and publishing;
- (iii) provide access to legal information;
- (iv) develop judicial policies and administration;
- (v) promote the highest standards of personal and professional conduct and practice;
- (vi) consolidate the integrity, efficiency, and effectiveness of the judicial and legal process; and
- (vii) enhance public confidence in the justice system.

C. Guiding Principles

3. The Academy will be established as an independent and autonomous statutory body. To preserve the independence, integrity, and authenticity of the judiciary, the training of judges will be done by judges. Lawyers will be trained by lawyers, academics, or judges as required and practicable.

4. The education program will be designed and conducted to provide practical, rather than theoretical, training relevant for judicial and legal officers in their day-to-day duties. The Academy may also offer theoretical courses in new areas of law, particularly in the commercial area, and enable stakeholders that need such training to further strengthen their grounding in law.

D. Education Services

5. The Academy will provide a program of educational services designed to meet the needs for professional development of judicial and legal officers throughout their careers. This program will comprise the following elements:

6. **Content.** Substantive law and procedure—law, particularly commercial law, evidence, court procedure, and practice forensic skills including legal research, analysis, communication skills. Using computers for electronic legal research; and specifically for judges: conducting

hearings, fact-finding, applying law to facts, judicial reasoning, decision making and sentencing, management and administration—judicial caseload management and administration, legal practice management, personnel management including team-building, delegation and supervision, time management and priority-setting; professional responsibility—codes of conduct and ethics, doctrine of judicial and professional independence, attitudes and values, the role of the judge/role of the lawyer; interdisciplinary—business transactions, financial accounting, and forensic pathology and psychology.

7. **Level.** Preservice (orientation)—giving new appointees with comprehensive training, both before and after appointment, in the jurisdiction of courts/role of the ministry or prosecution services, practices and procedures, and the professional duties of judges and lawyers; a mentor scheme and an observation program in-service (continuing) including updating judicial and legal officers on important changes in law and practice; facilitating exchange of experience and problem-solving on current issues; developing a collegiate judicial/professional outlook; specialist and advanced development for more experienced judicial and legal officers members; and refresher training where appropriate.

8. **Media.** Conferences including annual and ad hoc conferences, seminars, and small group workshops conducted at the Academy; and around the Kingdom publications including bench books, practice manuals and guidelines, and bulletins and digests on new legislation, cases and procedure, and articles on matters of judicial and legal importance; distance learning including the investigation and development of audiotapes and videos; and the viability of information technology (IT) applications such as computer-based learning, electronic publishing of bench books and digests; and satellite teleconferencing resources center including library facilities for statutes, cases, texts and journals; and specifically including electronic legal research facilities, mentoring, and networking; mentor programs for inexperienced judicial and legal officers, and discussion groups.

E. Research and Development

9. Research and development—promoting and conducting research on matters of judicial and legal importance, as appropriate, and in addition to needs analysis—assessing the need for training and professional development; standard-setting—defining standards of professional competence and performance; faculty development—conducting training and support for trainers in designing and delivering training services evaluation: monitoring, evaluating, and reviewing educational effectiveness.

F. Judicial Policy and Administration

10. The Academy will strengthen the capacity of the judiciary to develop and improve judicial policies and administration by establishing a role to review and propose developments to commercial laws; improve case management and judicial administration practices and procedures, particularly in the commercial area; and to provide training to support these improvements. The focus will be on strengthening judicial capacity to resolve commercial disputes expeditiously, possibly involving the establishment of a commercial bench in an existing court.

G. Governance

11. **Governing Body.** The governing body will be responsible for defining the policy and strategies of the Academy, and determining direction and the priority of its services (Figure A3.1). The chief justice will be president of the Academy, and chairman of the governing body whose members will be the Minister for law and justice, the attorney-general, the president of the Nepal Bar Association, and two representatives of civil society nominated by the Federation of Nepalese Chambers of Commerce and Industry and the Association of nongovernment organizations, respectively. The executive director will be a nonvoting member of the governing body, and will serve as secretary. The governing body will meet at least biannually. It will submit annual report to the Judicial Council, and supply copies of its reports to the Parliament, attorney general and president of the Nepal Bar Association.

12. **Executive Subcommittee.** The governing body will constitute an executive subcommittee comprising the executive director as chairman, the secretary of law, the registrar of the Supreme Court, and a representative of the bar association. The executive subcommittee will meet monthly to oversee the management of the Academy.

13. **Management Committee.** The management committee will be responsible for the operational management and administration of the Academy. The committee will advise the governing body by making recommendations on policy matters, and will implement the decisions of the governing body between meetings. The executive director will chair the management committee. Other members will include the director of education and the director of research, policy and publishing.

14. **Education Committee.** The education committee will oversee the quality of the education program, specifically needs assessment, program development, and educational evaluation. There may be one such education committee or, alternatively, three committees for judges, government lawyers, and private practitioners, respectively. Members of the committee will be nominated representatives of judges, court officers, government lawyers, prosecutors, and private practitioners. The director of education and the director of research, policy and publishing will be nonvoting members of the committees.

15. **Professional and Support Staff.** The Academy will employ professional and support staff to administer the education program and training services under the direction of the executive director who will be responsible to the governing body (Figure A3.2). The executive director will be responsible for overall management of the Academy, and for formulating policy proposals on judicial administrative matters for consideration of the governing body. The deputy director of education and the deputy director of research, policy and publishing will support the executive director. These officers will be supported by six assistant directors (for judges, public/private lawyers, research/policy, publications and resource center; and management and financial services), together with three senior instructors for judges and court officers, prosecutors, and legal research skills, respectively. Junior professional, clerical, and support staff will assist these officers.

Figure A3.1: National Judicial Academy Organization Chart

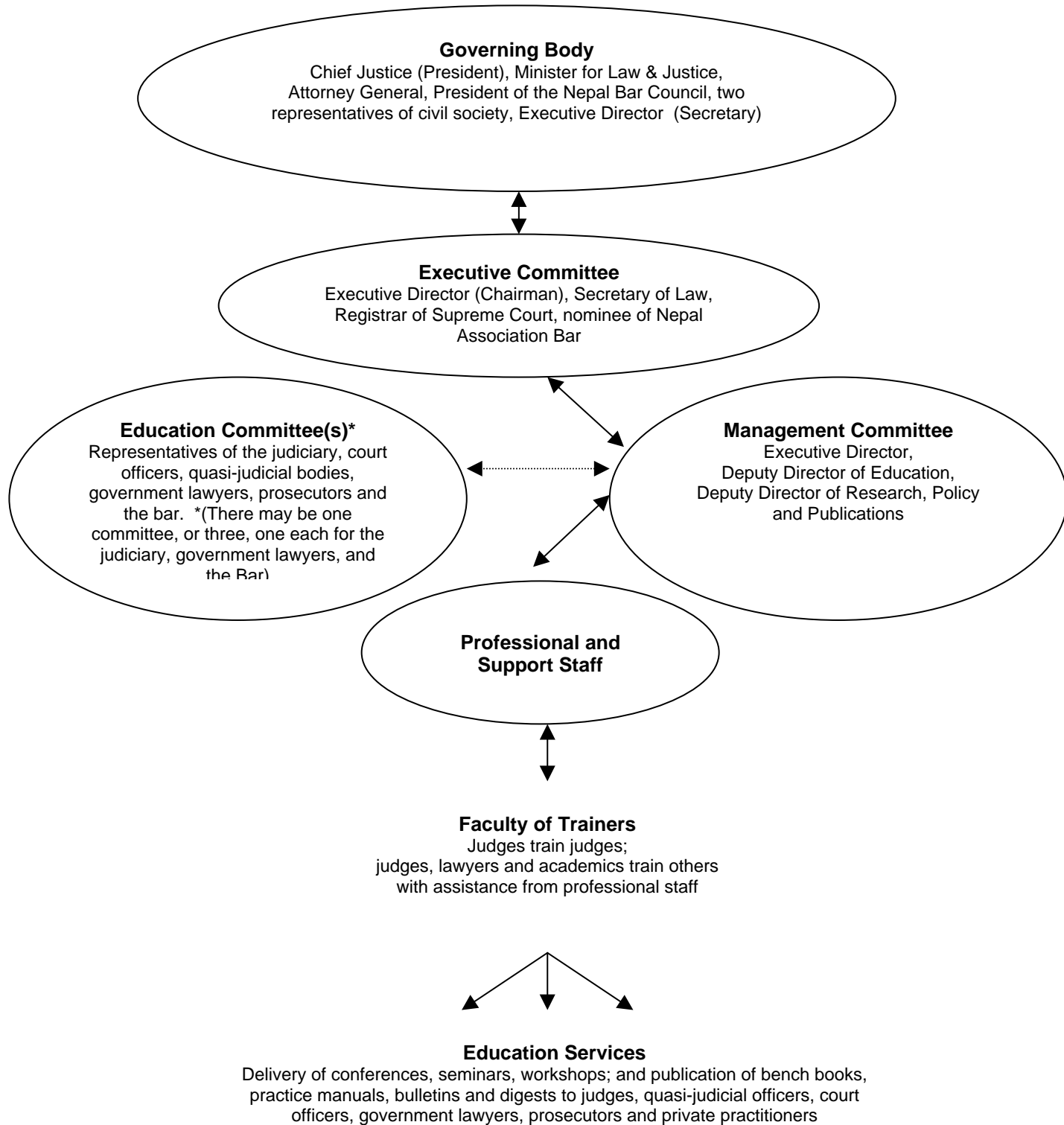
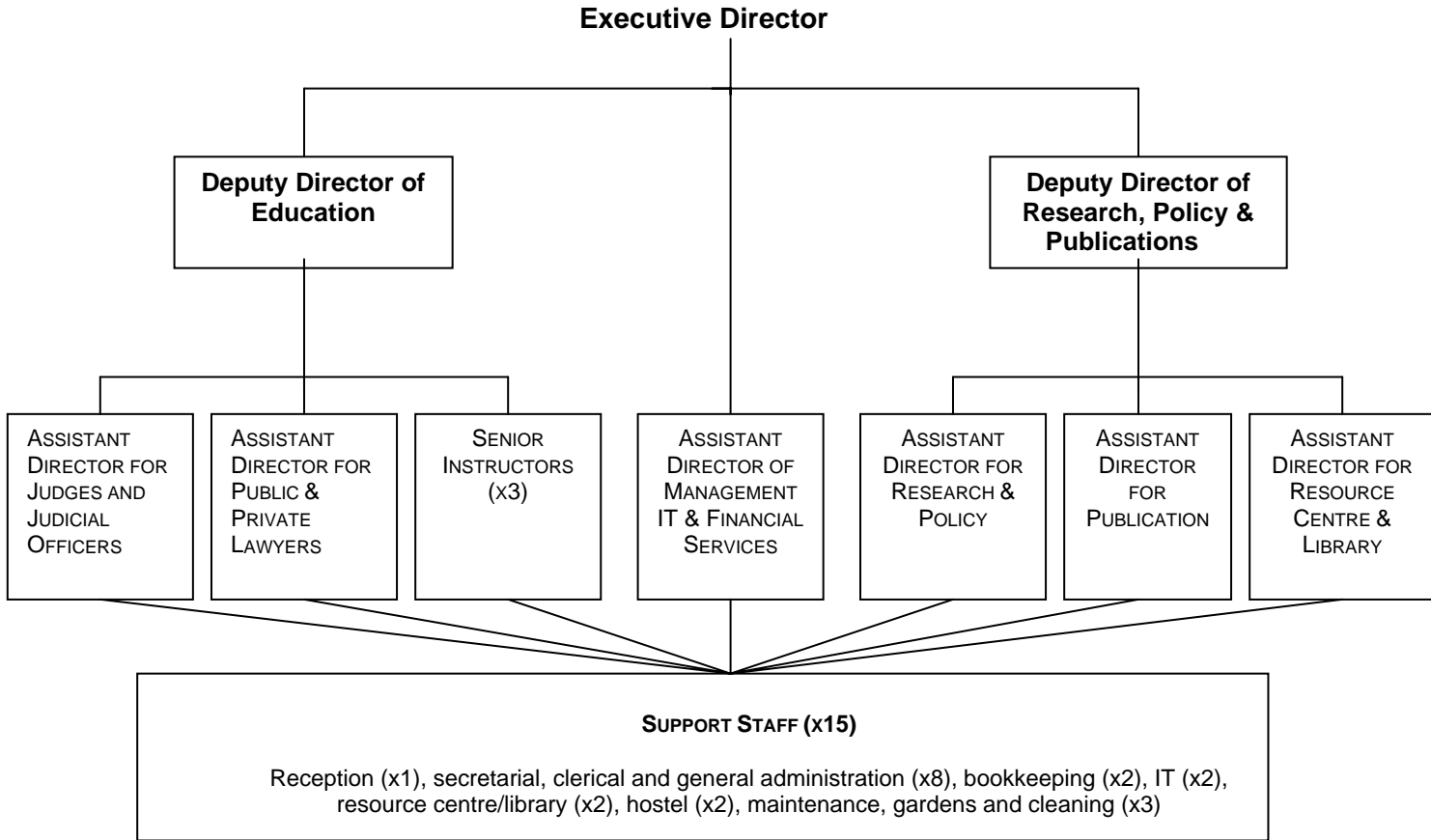


Figure A3.2: National Judicial Academy Management and Staff Establishment



COST ESTIMATES

	FC	LC	Total Cost	% of FC	% of Baseline
Area 1: Improving CFG Policy, Regulatory and Legal Framework, and Standards					
A. Streamlining of financial, corporate and commercial legislation (TA1)	181,500	88,000	269,500	67.3	2.2
B. Improving accounting and auditing standards in the public sector (TA2)	186,500	88,000	274,500	67.9	2.3
Subtotal	368,000	176,000	544,000	67.6	4.5
Area 2: Institution Building for key CFG for Regulation and Supervision					
A. Loan component A: Strengthen corporate governance and capital markets					
1. Strengthening of SEBO	693,000	229,000	922,000	75.2	7.7
2. Strengthening of NEPSE	575,500	152,000	727,500	79.1	6.0
3. Establishment of CDS	427,250	122,000	549,250	77.8	4.6
4. Strengthening of CRO	229,000	128,000	357,000	64.1	3.0
B. Capacity Building in Rural Finance for NRB (TA3)	656,500	207,000	863,500	76.0	7.2
Subtotal	2,581,250	838,000	3,419,250	75.5	28.4
Area 3: Improving Legal Enforcement Capacity and Infrastructure					
A. Loan component B					
1. Improvement of judicial policies and administration	123,000	94,000	217,000	56.7	1.8
2. Establishment of NJA	1,071,000	2,992,000	4,063,000	26.4	33.7
3. Establishment of legal information center	165,500	139,000	304,500	54.4	2.5
4. Establishment of STC	335,500	97,000	432,500	77.6	3.6
Subtotal	1,695,000	3,322,000	5,017,000	33.8	41.7
Area 4: Improving Infrastructure for Payments and Financial Services Delivery					
A. Development of Nepal's payment system (TA4)	317,000	95,000	412,000	76.9	3.4
B. Loan component C: Start-up funding for ICT	1,000,000	0	1,000,000	100.0	8.3
Subtotal	1,317,000	95,000	1,412,000	93.3	11.7
Area 5: Development of Selected Market Participants					
A. Financial and operational review of ADBN and NIDC (TA5)	621,000	239,000	860,000	72.2	7.1
B. Development of insurance, pension and contractual savings (TA6)	567,500	221,000	788,500	72.0	6.5
Subtotal	1,188,500	460,000	1,648,500	72.1	13.7
Subtotal Baseline Cost	7,149,750	4,891,000	12,040,750	59.4	100.0
Price Contingencies	539,000	361,000	900,000	59.9	
Physical Contingencies	100,000	175,000	275,000	36.4	
TOTAL PROJECT COST	7,788,750	5,427,000	13,215,750	58.9	
Interest Charges	100,000	0	100,000	1.0	
TOTAL COST TO BE FINANCED	7,888,750	5,427,000	13,315,750	59.2	
% of TOTAL	59.2	40.8	100		

ADB N = Agricultural Development Bank of Nepal, CDS = Central Depository System, CFG = Corporate and Financial Governance, CRO = Company Registrars Office, ICT = information and communication technology, NEPSE = Nepal Stock Exchange, NIDC = Nepal Industrial Development Corporation, NJA = National Judicial Academy, NRB = Nepal Rastra Bank, STC = Secured Transaction Center.

FINANCING PLAN

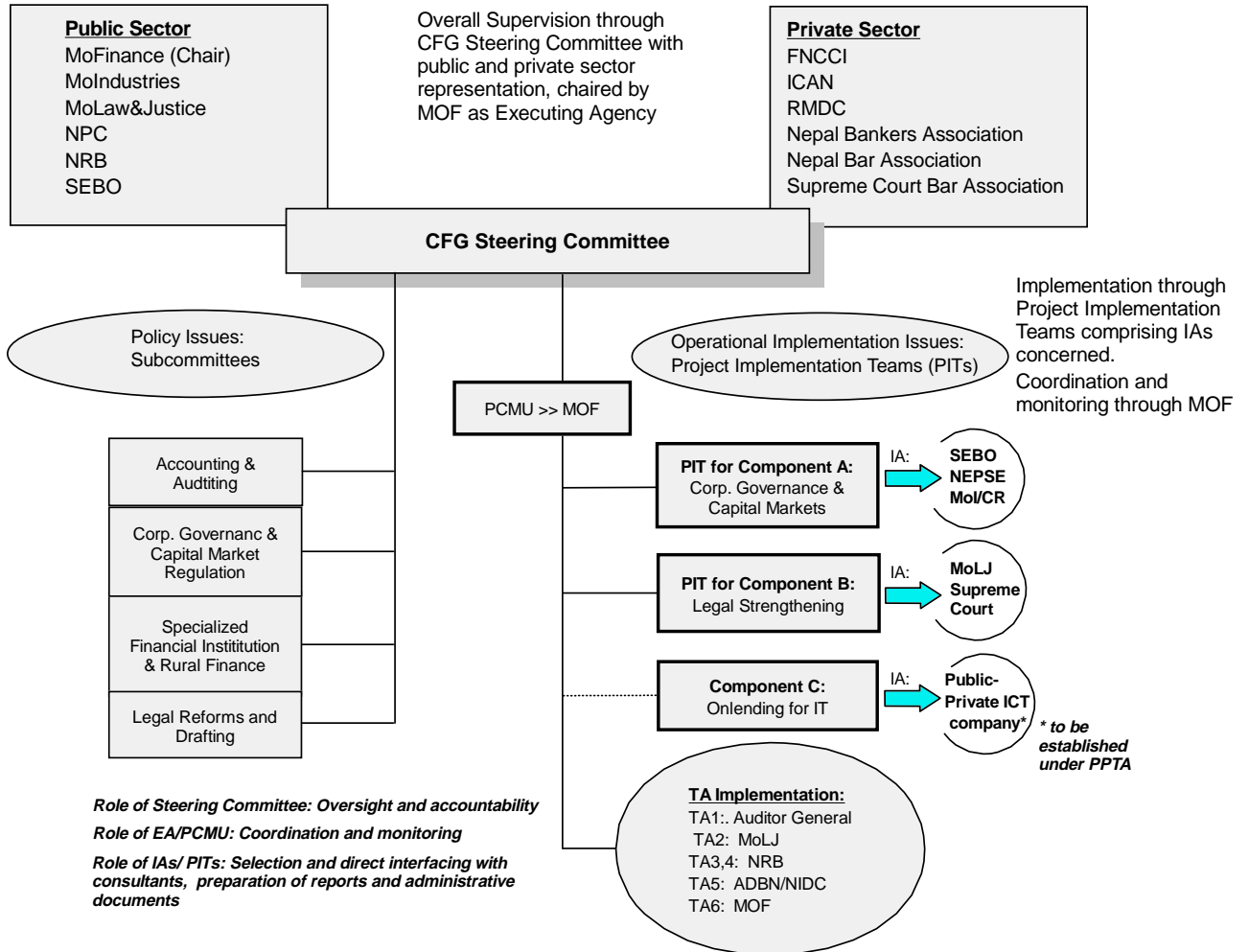
Cost	Loan-Financed Components						TA-Grant Financed Components						Total Amount	Foreign Exchange	Local Currency	Duties & Taxes	
	ADB Loan			Government			ADB Grant (TA)			Government							
	FX Amount	%	Local Cost	%	Local Cost	%	FX Amount	%	Local Cost	%	Local Cost	%					
A Investment Cost																	
Land	0	0	0	0	1,200,000	92	0	0	0	0	0	1,200,000	10	0	1,200,000		
Equipment & Civil Works	800,000	16	1,500,000	66	0	0	68,000	2	0	0	0	2,368,000	20	868,000	1,500,000		
Onlending for ICT	1,000,000	20	0	0	0	0	0	0	0	0	0	1,000,000	8	1,000,000	0		
Consulting Services	2,649,750	52	456,000	20	0	0	2,388,000	85	350,000	74	0	5,843,750	49	5,037,750	806,000		
Training and Public Education	170,000	3	95,000	4	0	0	50,000	2	55,000	12	0	370,000	3	220,000	150,000		
Others and Contingency	345,000	7	233,000	10	110,000	8	318,000	11	71,000	15	0	1,077,000	9	663,000	414,000		
Subtotal	4,964,750	100	2,284,000	100	1,310,000	100	2,824,000	100	476,000	100	0	11,858,750	100	7,788,750	4,070,000	0	
B Recurrent Cost																	
Administrative Expenses	0		0		160,000	21	0		0		145,000	24	305,000		0	305,000	
Office Space and Facilities	0		0		192,000	26	0		0		92,000	15	284,000		0	284,000	
Operation and Maintenance	0		0		350,000	47	0		0		296,000	49	646,000		0	646,000	
Others and Contingency	0		0		49,000	7	0		0		73,000	12	122,000		0	122,000	
Subtotal	0		0		751,000	100	0		0		606,000	100	1,357,000		0	1,357,000	0
C Interest	100,000		0		0		-		-		-		100,000		100,000	-	-
TOTAL	5,064,750		2,284,000		2,061,000		2,824,000		476,000		606,000		13,315,750		7,888,750	5,427,000	
			9,409,750						3,906,000								
Financing Percentage of Total	53.8		24.3		21.9		72.3		12.2		15.5		100		59.2	40.8	

ADB = \$7,348,750, FX = \$5,064,750, ICT = \$1,000,000, \$3,300,000.

By Financing Source

ADB Loan	7,348,750	5,064,750	2,284,000
ADB Grant	3,300,000	2,824,000	476,000
Government	2,667,000	0	2,667,000
	13,315,750	7,888,750	5,427,000

PROJECT ORGANIZATION CHART



ADBN = Agricultural Development Bank of Nepal, ICAN = Institute of Chartered Accountants of Nepal, NEPSE = Nepal Stock Exchange, NIDC = Nepal Industrial Development Corporation, NPC = National Planning Commission, NRB = Nepal Rastra Bank, PCMU = Project Coordination and Monitoring Unit, RMDC = Rural Microfinance Development Center, SEBO = Securities Board.

OUTLINE TERMS OF REFERENCE FOR CONSULTING SERVICES

1. A total of two consulting packages will be procured under the loan:
 - (i) corporate governance and capital markets, addressing institution building measures under project assistance area 2; and
 - (ii) improving legal enforcement mechanisms and judicial capacity, addressing institution building measures under project assistance area 3.

A. Corporate Governance and Capital Markets (Package 1)

2. The consultants will support (i) institutional strengthening of the Securities Board (SEBO); (ii) privatization of the Nepal Stock Exchange (NEPSE); (iii) establishment of a central depository system (CDS); and (iv) capacity building for the Company Registrars Office (CRO).

1. Subcomponent 1: Institutional Strengthening of the Securities Board

3. The consulting team will strengthen SEBO's institutional capacity to effectively perform its duties as an autonomous regulator to instill confidence in the capital markets. The activities to be undertaken and outputs to be provided are the following:

- (i) Develop a strategic plan for SEBO, taking into account its role in relation to the Nepal Rastra Bank, the Insurance Board, and NEPSE; develop SEBO's corporate and financial plan, including organization structure, administrative setup, staffing requirements, job descriptions, and regulatory duties.
- (ii) Develop management information systems (MIS) and help SEBO staff to develop capacities to perform efficiently making use of information technology, and operate and maintain MIS.
- (iii) Develop regulations for (a) disclosure for listed companies, (b) insider trading, (c) corporate register service, (d) protection of minority shareholders' rights, (e) portfolio managers, (f) public issues and offering, (g) underwriters, and (h) corporate takeovers.
- (iv) Prepare inspection manuals for NEPSE and other market participants.
- (v) Provide training for SEBO staff to perform their regulatory duties effectively and for key market participants on regulatory compliance.

4. The consulting team must have understanding of (i) securities market operations and regulations; (ii) prudential norms and regulations, supervision and inspection of stock exchanges, and other intermediaries; and (iii) operational procedures of stock exchanges, listing procedures, and market dealings; and (iv) designing and conducting training programs on

securities/stock market operations and experience in both developed and developing countries. The experts and the required inputs (person-months in parentheses) are as follows:

- (i) International project director (2)
- (ii) International regulatory expert on securities market and capital market/team leader (12)
- (iii) International training expert (3)
- (iv) International accounting expert (1)
- (v) International management information system expert (2)
- (vi) Domestic public relations expert/coordinator (12)
- (vii) Domestic capital markets/stock exchange expert (6)
- (viii) Domestic financial market education/training expert (9)
- (ix) Domestic accounting expert (9)
- (x) Domestic management information system expert (4)

2. Subcomponent 2: Privatization of the Nepal Stock Exchange (NEPSE)

5. The consulting team will formulate a strategy and detailed implementation plan to privatize the Nepal Stock Exchange (NEPSE), then upgrading the systems and rules, to enable NEPSE to operate as a self-regulatory organization (SRO). The work will comprise the following:

- (i) Review the constitution and rules governing NEPSE and draft relevant regulations to keep the Government regulatory oversight function separate from the operation and governance of the stock exchange.
- (ii) Develop policy options for privatizing NEPSE and prepare detailed plans on its proposed ownership, operation, funding, and management under private ownership.
- (iii) Develop rules and procedures to assist the stock exchange to become an SRO and carry out its self-regulatory responsibilities; prepare manuals for the stock exchange staff on the self-regulatory function.
- (iv) Establish bylaws that are adequate to protect investors and facilitate the efficient execution of securities transactions; draft and finalize implementation procedures to conduct investigations and hold hearings.
- (v) Train stock exchange staff in both regulation and operational matters, and assist NEPSE in acquiring the ability to design and implement investor education programs.

6. The consulting team must have understanding of stock market operations, governance and self-regulatory concepts and experience in both developed and developing countries. The experts and the required inputs (person-months in parentheses) are as follows:

- (i) International capital market development expert/team leader (6)
- (ii) International stock exchange system expert (3)
- (iii) International legal expert (1)

- (iv) Domestic stock exchange expert (6)
- (v) Domestic legal expert (3)
- (vi) Domestic MIS expert (6)
- (vii) Domestic trainer (financial markets/management) (6)

3. Subcomponent 3: Establishment of a Central Depository System

7. The consulting team will ensure that a CDS will be established and become operational to ensure safe custody and settlement of shares. Their tasks include the following:

- (i) Recommend the most appropriate solution to establish CDS as a separate legal entity and operate it as a private sector venture under the supervision of SEBO.
- (ii) Develop business, governance, and staffing plans, including determination of ownership structure, operational and funding needs, funding sources, and skills required.
- (iii) Define and detail the operating procedures of CDS and implement systems to ensure effective functioning in conformity with G30 standards.
- (iv) Draft rules and guidelines to ensure that CDS performs all clearing and settlement operations in a centralized manner for all NEPSE trades, and for Government securities, as appropriate.
- (v) Provide on-the-job training to key CDS staff to operate and maintain the system.

8. The consulting team must have understanding of depository, clearing, and settlement operations for securities and experience in both developed and developing countries. The required inputs (person-months in parentheses) are as follows:

- (i) International CDS systems/business expert/team leader (4)
- (ii) International legal expert (1)
- (iii) Domestic systems expert (10)
- (iv) Domestic legal expert (1)

4. Subcomponent 4: Capacity Building for the Company Registrars Office (CRO)

9. The consulting team will review the role and function of CRO with a view to upgrade its operations in support of improved transparency and governance. Its tasks are as follows:

- (i) Review the powers and responsibilities of CRO to increase transparency of companies and business activities.
- (ii) Develop specifications to define the range of activities and data that the new CRO system should cover.

- (iii) Draft and implement a corporate and financial plan, which will cover staffing, job descriptions, computerization, with the objective of transferring CRO into an effective information depository agency.
- (iv) Update registration of the existing companies.
- (v) Explore possibilities of linking the CRO system with the income tax system currently assisted by Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ), and credit information bureau.
- (vi) Provide on-the-job training to CRO staff to utilize and maintain the database.

10. The consulting team must have understanding of company legislation and registration, corporate governance, and information systems and experience in both developed and developing countries. The required inputs (person-months in parentheses) are as follows:

- (i) International expert on company registration/team leader (3.5)
- (ii) International systems development expert (1)
- (iii) International legal expert (0.5)
- (iv) Domestic business administration/MIS expert (8)
- (v) Domestic legal expert (1)
- (vi) Domestic interpreter (4)

B. Improving Legal Enforcement Mechanisms and Judicial Capacity (Package 2)

11. The consultants will provide support for the establishment of a (i) national judicial academy, (ii) legal information center, (iii) secured transaction center, and (iv) commercial bench and dispute resolution.

1. Subcomponent 1: Establishment of National Judicial Academy (NJA)

12. The consulting team will support the establishment of the NJA in all aspects to ensure effective development of the skills of judges in commercial and financial matters on a sustainable basis. The activities to be undertaken are as follows:

- (i) Develop a strategic plan for NJA and make recommendations on governance aspects.
- (ii) Assist in upgrading facilities, including conditioning of building and installation of IT infrastructure and computers.
- (iii) Develop organizational, administrative, and financial plan; train key administrative staff.
- (iv) Develop a teaching curriculum, train trainers/teaching staff, and develop and implement a pilot training module.

13. The consulting team must have understanding and experience in both developed and developing countries in judicial education and training, institutional development and capacity-building, public administration, architecture and IT systems development. The required inputs (person-months in parentheses) are as follows:

- (i) International legal experts/team leader (24)
- (ii) International public administration expert (6)
- (iii) International IT expert (2)
- (iv) Domestic legal experts (20)
- (v) Domestic architect (6)
- (vi) Domestic IT expert (4)
- (vii) Domestic translator (6)

2. Subcomponent 2: Establishment of Legal Information Center (LIC)

14. The consulting team will support the establishment of a LIC as a central repository for all laws and judgments by the judiciary to enhance transparency, reduce information cost, and enable the judiciary to schedule workloads and manage the court system. Specific tasks are as follows:

- (i) Develop organizational, administrative and financial plan for the LIC.
- (ii) Develop secure internet-based IT infrastructure for centralized information dissemination, including keyword search, and decentralized update on commercial cases.
- (iii) Develop a case filing and indexing system, and place existing laws and cases into the system.
- (iv) Train staff to administer and update the system.

15. The consulting team will have expertise in business administration, internet-based database and document management, and electronic filing and indexing systems. The required inputs (person-months in parentheses) include the following:

- (i) International business administration expert/team leader (3)
- (ii) International IT expert (1)
- (iii) Domestic IT expert (10)
- (iv) Domestic translator/document indexing expert (10)

3. Subcomponent 3: Establishment of a Secured Transaction Registry (STR)

16. The consulting team will establish a STR to allow collateralization of movable assets and provide relevant information to the financial community. The tasks will include the following:

- (i) Recommend institutional structure for STR, legal status, and ownership.
- (ii) Develop information systems infrastructure.

- (iii) Develop business and operational plans including organization, financing, administration, and staffing; develop detailed operational procedures and train key staff.

17. The consulting team of experts must have understanding and experience in both developed and developing countries of secured transaction registries and collateralization mechanisms, legal implications, and information systems. The required inputs (person-months in parentheses) are as follows:

- (i) International expert on secured transactions (4)
- (ii) International systems development expert (3)
- (iii) Domestic systems expert (9)
- (iv) Domestic lawyer (2)

4. Subcomponent 4: Establishment of a Commercial Bench and Dispute Resolution

18. The consulting team will review existing policies and arbitration mechanisms for the resolution of commercial disputes and recommend changes including court-annexed and court-diversionary ADR strategies to ensure more effective disposal, including improvement in case management and judicial administration.

- (i) Review and compile judicial statistics.
- (ii) Review and improve the Arbitration Act.
- (iii) Recommend a scheme for effective arbitration, advise on establishment of commercial courts or specialized benches within the existing system.
- (iv) Develop strategic operational plans for judicial administration, including financial implications and skills development.
- (v) Organize stakeholder workshops.

19. The consulting team must have understanding of and experience in judicial reform, arbitration and ADR mechanisms, and judicial administration systems in various jurisdictions. The required inputs (person-months in parentheses) are as follows:

- (i) International judicial expert/team leader (3)
- (ii) Domestic legal expert/lawyer (5)

PERFORMANCE PARAMETERS FOR BENEFIT MONITORING

1. The performance of Securities Board (SEBO) will be monitored against these key criteria:

- (i) number of companies newly listing securities;
- (ii) number of prospectuses vetted and average time to vet such prospectuses;
- (iii) number of companies lodging audited accounts within the required time;
- (iv) number of companies whose financial statements are reviewed for compliance with accounting and auditing standards;
- (v) efficacy of any prosecutions for noncompliance with accounting and auditing standards;
- (vi) frequency and adequacy of liaison with parties impacted by the securities market;
- (vii) inspection of market participants, critical report of findings and follow-up actions;
- (viii) relevant training courses attended by SEBO staff;
- (ix) rules and regulations issued by SEBO for the corporate and securities market and user feedback on those; and
- (x) Interaction with general public, including organization of stakeholder workshops.

2. The performance of Central Depository System and Nepal Stock Exchange will be monitored against the following key criteria:

- (i) trading volume and market capitalization,
- (ii) average clearing and settlement period,
- (iii) number of complaints,
- (iv) number of shares deposited with the CDS, and
- (v) percentage of trading volume settled through CDS.

3. The performance of Company Registrars Office (CRO) will be monitored against these key criteria:

- (i) number of updates in the registry,
- (ii) number of companies maintained in the (newly) computerized system,
- (iii) number of companies that fail to comply with submission of accounts,
- (iv) actions undertaken by CRO to enforce compliance with account submission, and
- (v) number of inspections.

4. The performance of the National Judicial Academy will be monitored quantitatively and qualitatively annually against these key criteria:

- (i) number of judges, lawyers, and government officials trained;
- (ii) number of new courses;
- (iii) number of courses conducted;
- (iv) number of new publications;
- (v) satisfaction of participants;
- (vi) intentions of participants to improve their work practices;

- (vii) perceived satisfaction of education committees and other stakeholders with the utility of training and improvements in work performance; and
- (viii) quantitative improvements in judicial and legal performance disclosed in the following indicators:
 - (a) court management data on case openings, closing, and elapsed throughput times;
 - (b) number and rates of successful appeals;
 - (c) number and nature of complaints relating to professional incompetence to the Judicial Council, the Judicial Services Commission, the Nepal Bar Council, and other relevant public/professional authorities. This will require the collection, collation, and analysis of baseline, interim, and exit data.

OBJECTIVES, SCOPE, AND TERMS OF REFERENCE FOR TA CLUSTER

Sub-TA 1: Streamlining Financial, Corporate, and Commercial Legislation (\$250,000)

A. Rationale and Objectives

1. Nepal has a proliferation of laws that are inconsistent and allow for arbitrary interpretation. They inhibit effective regulation of the financial sector, and corporate affairs, and efficient conduct of business, resulting in increased business transaction costs. Financial and corporate sector legislation must be streamlined to provide the much-needed clarity to regulators and businesses. The TA aims to support His Majesty's Government of Nepal in reviewing and streamlining corporate, commercial, and financial sector legislation, with a view to incorporate international practices.

B. Scope

2. The TA will support updating of legislation in areas identified by the Review Committee for Financial and Corporate Legislation. The activities will include the following:

- (i) make a diagnostic study of existing law and issues, taking into account the institutional framework for implementation and enforcement;
- (ii) develop guiding principles and policy objectives to be addressed through legislation, and conduct workshops to foster a participatory process in updating legislation;
- (iii) provide drafting support for new legislation based on the reform needs identified; and
- (iv) make recommendations to improve the institutional framework for enforcement.

C. Implementation Arrangements and Consulting Services

3. The Executing Agency will be the Ministry of Law and Justice, in coordination with the line ministry of the agency in charge of administering the law being reviewed. The consulting services under the TA will be carried out over 12 months by individual experts engaged to undertake TA implementation. The consultants will be selected and engaged in accordance with the Asian Development Bank's (ADB's) *Guidelines on the Use of Consultants*. The TA will require about 10 person-months of international consulting services with expertise in areas identified by the Review Committee for Financial and Corporate Legislation, as well as experience in developing new legislation. An additional 20 person-months of domestic consulting services in the same disciplines will be required.

Sub-TA 2: Improved Accounting and Auditing Standards in the Public Sector (\$250,000)**A. Rationale and Objectives**

4. The Auditor General (AG) was established as a constitutional body under the 1990 Constitution of Nepal to audit the accounts of public sector institutions and corporate bodies fully owned by the Government. The AG also issues directives to audit entities to make proper arrangements on matters of accounting. Currently, AG has approximately 350 professional staff and a training division with a core group of only three or four trainers. The core trainers train trainers working in the various divisions of the AG's office.

5. AG received assistance from the World Bank on performance audit and this assistance was completed in November last year. AG at the moment is receiving no further assistance from other aid agencies.

6. In Nepal, the current cash-based accounting standards for the public sector are completely unsuited to the management, while the auditing practices are not clearly articulated. Moreover, many unrealistic "auditing" duties are set down in separate pieces of legislation, placing inappropriate demands on auditors. For audit of Government accounts, AG applies standards approved by the International Organization of Supreme Audit Institutions (INTOSAI).

7. Under ADB's ongoing TA 3356: Capacity Building for the Accounting and Auditing Profession in Nepal, independent accounting and auditing standards boards will be established respectively. These boards will in the first instance develop standards based on international accounting (IAS) and auditing standards (IAuS) for the private sector through a participatory method.

8. In relation to international experience, convergence of public and private sector accounting and auditing standards is accepted as the way to go. The efforts made under TA 3356 will also establish most of the infrastructure needed for the public sector, i.e., once the accounting and auditing standards boards are established. In addition to their roles in private sector corporate accounting and auditing standards, the boards will also develop and establish accounting and auditing standards for the public sector. In carrying out this responsibility, presumption is that the financial reporting and auditing requirements of the public and private sectors will be consistent with one another.

9. For Nepal, integrated public and private sector efforts in accounting and auditing standards in the medium to long run will greatly facilitate introduction of a consistent accounting and auditing system. The public sector call that its reporting should be fundamentally different from that of the private sector is difficult to justify, but transitional strategies will be required to move the public sector to a system based on full accrual accounting. The Public Sector Committee (PSC) of IFAC (International Federation of Accountants) is issuing accounting standards for the public sector based on International Accounting Standards Committee (IASC) standards.¹

¹ Under TA 3356, assistance to Institute of Chartered Accountants of Nepal for accreditation with IFAC has been given high priority.

10. The objective of the TA is to assist Nepal to move toward improved accounting and auditing standards in the public sector based on the internationally accepted convergence of public and private sector accounting and auditing standards. The TA aims to familiarize the proposed accounting and auditing standards boards, AG, and key public sector entities with internationally accepted standards issued by PSC of IFAC, the International Auditing Practices Committee (IAPC), and IASC through provision of intensive training activities. The TA will be used as an opportunity to allow public sector entities and auditors to commence development of expertise and systems so as to upgrade their knowledge and skills for carrying out audits based on a system of full accrual accounting, in accordance with accounting standards similar to those applicable in the private sector. The TA also aims to convince the public sector of the need to be involved in the standard-setting processes from the beginning.

B. Scope

11. The TA will concentrate on designing specific training programs and giving intensive training to staff from AG and other key public entities in acquiring knowledge of international standards on accounting and auditing. To be cost-effective and to ensure consistency, it is recommended that the training materials designed under TA 3356 be used as reference whenever appropriate. The TA will assist in

- (i) developing a transitional plan for adopting accounting and auditing standards based on international best practice;
- (ii) developing capacity for adopting new standards at various stages of the transitional plan;
- (iii) designing a training program and materials for training of trainers and delivery of certain courses by trainers who have been trained and the Comptroller General of Finance;
- (iv) developing and delivering training programs for key staff from AG and other key public entities on core principles of the IASs and IASbS;
- (v) training key AG staff to understand the standard-setting process;
- (vi) assisting the independent accounting and auditing standards boards to be established, to develop accounting and auditing standards for any significant aspects of the public sector not covered by specific private sector standards; and
- (vii) developing a manual on public sector accounting and auditing practices/standards, etc.

C. Implementation Arrangements and Consulting Services

12. The Executing Agency will be the AG, in coordination with other agencies involved in public sector accounting issues. The consulting services will be carried out over 10 months. A team of one international and one domestic professional accountants will be engaged to undertake TA implementation. The consultants will be selected and engaged in accordance with

ADB's *Guidelines on the Use of Consultants*. The TA will require about 6 person-months of international consulting services and experience in international accounting/auditing standards and delivery of training programs; and 10 person-months of domestic consulting services in the same disciplines.

Sub-TA 3: Institutional Strengthening of NRB for Regulation and Supervision of Rural Finance (\$800,000)

A. Rationale and Objectives

13. Over the past few years, financial intermediation activities in Nepal's rural areas have evolved in a poorly regulated and supervised environment. A great number of nongovernment offices and cooperatives mobilize and lend resources outside the regulatory environment, or financial rules and regulations are not being enforced. Limited enforcement by Nepal Rastra Bank (NRB), which is entrusted with overall responsibility, is due to (i) insufficient institutional capacity; (ii) lack of autonomy; (iii) conflicting role between ownership of and supervision of rural financial institutions (RFIs) by NRB; (iv) lack of focus, including involvement in developmental programs; and (v) multiplicity of financial laws and regulations. To ensure the sustainability of the sector, there is an urgent need to streamline the regulatory environment and upgrade NRB's enforcement capacity. The objective is to improve the regulatory framework for micro and rural finance, and strengthen NRB's capacities for regulation and prudential supervision, to allow the orderly expansion of the rural finance system.

B. Scope

14. The TA will assist NRB in

- (i) reviewing the prevailing policy framework as it pertains to RFIs, and rural finance operations of other central banks, especially those that relate to institutional autonomy, governance, ownership, competition, directed credit, subsidies and human resources; and then rationalize the legal framework governing the operations of the array of institutions with rural finance operations so as to eliminate gaps, ambiguities, and overlaps;
- (ii) assessing the regulation and supervision needs of RFIs, and commonality and differences in the needs of the commercial banks;
- (iii) assessing NRB's capacity for regulation, supervision, and enforcement; and then recommend improvements in organization, as well as regulation and supervision systems;
- (iv) developing prudential norms, information and disclosure systems, accounting, auditing, and licensing procedures for RFIs; drafting of rules and regulations to regulate and supervise RFIs;
- (v) conducting seminars for wider consultations on the policy, regulatory, and supervisory framework;

- (vi) formulating guidelines, operational procedures, and standards for off-site and on-site inspection, supervision, and reporting for the rural finance sector;
- (vii) assessing necessary staff, skills and information technology requirements in NRB to implement the recommended regulatory and supervisory system; and
- (viii) installing basic information technology infrastructure and providing training and skills development to NRB staff to institutionalize the new regulatory framework. This will comprise the holding of seminars for wider consultations on the policy, regulatory, and supervisory framework.

C. Implementation Arrangements and Consulting Services

15. NRB will be the Executing Agency for the TA and will form a project management unit to coordinate the TA and provide logistic support. NRB will constitute a corporate and financial governance (CFG) team headed by a deputy governor, and including heads of departments involved with components of the TA. The CFG team will include senior officers (joint secretary or above) from the Ministry of Finance, Ministry of Agriculture, Ministry of Law and Justice, Ministry of Rural Development, and a member of the National Planning Commission. NRB will also constitute small counterpart working groups to assist the consultants and will assign two full-time graduate-level computer programmers for data analysis.

16. An international consulting firm will implement the TA. The consultants will be selected and engaged in accordance with ADB's *Guidelines on the Use of Consultants*. The TA will require about 20 person-months of international consulting services in rural finance policy; financial, legal, central banking operations; rural credit; management information systems; IT systems; and institutional development; and 20 person-months of domestic consulting services in the same disciplines. The consulting services will be carried out over 18 months.

Sub-TA 4: Developing Nepal's Payment System (\$400,000)

A. Rationale and Objectives

17. Nepal's weak payment system fails to provide timely financial resource and information transfer, thus contributing to high transaction costs. To cut the transaction costs, a major factor in promoting real and financial sectors' growth, it is imperative to upgrade the payment system. ADB's TA aims at examining the current payment system, and forming a future development timetable.

18. To improve financial service delivery, ADB intends to assist in NRB's efforts to upgrade Nepal's payment system. The TA will (i) assess the current financial service delivery system, and (ii) design an implementation plan in upgrading the system to meet the needs of businesses, consumers, and financial institutions to transfer funds, and help NRB with macroeconomic management.

B. Scope

19. The TA will examine the current legal and policy framework, operating systems, institutional capacity, IT, and staff skills in key institutions (NRB Clearing House, the National Payments Association [NPAN], etc.) in Nepal's financial delivery system. In addition, the TA will identify gaps between the current capacity of the payment system and the requirements of the growing financial and real sectors, and assess the necessity and feasibility of establishing the Nepal Payment Association (NPA). The TA will then propose a detailed and practical timetable for Nepal's payment system upgrading. The timetable should cover at least five years, and should consider the social and economic cost implications for all concerned parties including NRB, all financial institutions involved, and consumers (individuals and corporate entities). Specifically, the TA will

- (i) identify the gaps between the current capacity of the payment system and the requirements of the growing financial and real sectors and propose a long-term vision and operational plans for improvement;
- (ii) propose policy, operational guidelines, institutional arrangements, human resource, and technical infrastructure for the NRB Clearing House and other possible new institutions, such as the National Payments Council or related financial institutions (especially those which handle credit payments);
- (iii) assess the necessity for NPA, and develop an institutional and operational structure if needed;
- (iv) make recommendations for upgrading the payment system, and design an implementation timetable for the upgrading. The timetable should cover at least five years, and should consider the cost implications. It should also be practical in Nepal, given all constraints;
- (v) detail potential cost implications for all concerned parties including NRB, all financial institutions involved, and consumers (individuals and corporate entities) at different payment system upgrading stages; and
- (vi) train NRB Clearing House other concerned staff to prepare for system upgrading.

20. In addition, a study tour to one developing and one developed country will be considered for selected NRB Clearing House and other concerned staff to expose them to best practice in the world's payment systems.

C. Implementation Arrangements and Consulting Services

21. NRB will be the Executing Agency, and will provide counterpart staff and office space to assist consultants in their duties. An international consulting firm will be engaged to implement the TA. The consultants will be selected in accordance with ADB's *Guidelines on the Use of Consultants*. The TA will be implemented over four months. It will require nine person-months of international experience with practical knowledge of legal, policy, and operational aspects of payment systems in a developed country, as well as design of payment systems in developing

countries; and 11 person-months of domestic consulting services with similar expertise and knowledge of financial systems.

Sub-TA 5: Financial and Operational Review of ADBN and NIDC (\$850,000)

A. Rationale and Objectives

22. ADBN was established in 1968 under a special act to finance agriculture and agroprocessing sectors. As the country's specialized rural and agricultural lending institution, it operates through an extensive rural branch and office network of 657 (230 regular branches, 3 commercial banking branches, and 424 subproject offices).² In addition, it has 23 urban commercial branches, which are primarily for deposit collection. The total savings mobilized by the commercial branches as of mid-July 1997 was NRs8.64 billion (around 10 percent of the total deposits mobilized by the formal system). The rural branches do not mobilize savings; they only deliver credit.

23. ADBN is owned and controlled by the Government. Its board has representatives from Government line ministries, NRB, cooperatives, and individuals nominated by the Government. The Government also appoints the chief executive (general manager), who is often changed with the change in Government. ADBN has little autonomy and NRB has little control over its financial operation.

24. A major problem of ADBN is its diffused focus. As a Government-controlled bank, it has implemented many community development and subsidy-laden programs, including promotion of biogas, rural electrification, small irrigation development, and solar energy.³ It recruits and maintains technical staff for this purpose, but operating costs for these programs have not been computed.

25. There have been serious concerns about the financial structure and performance of ADBN. Return on total assets has averaged less than 0.27 percent against an acceptable level of 4 percent, and return on net worth has averaged 5.71 percent against the acceptable level of 14 percent.³ Financial record keeping and auditing are not of international standards. Internal monitoring, evaluation, and the supervision system are weak, as is the system of appraisal and follow-up on loans. It has suffered from high overdues and low recovery rates. The Rural Credit Review Study identified inadequate follow-up on loans as one of the main reasons for poor loan recovery and stated that ADBN had not paid any visit to 43 percent of its borrowers. Poor recovery, inefficient management, and proliferation of unsound loans have rendered the institution nonviable.

26. During 1996/97, the total rural credit disbursed by all central banks was NRs917 million, while that disbursed by ADBN was NRs4,023 million. About 78 percent of ADBN's credit went to crop production (cereal and cash crops), livestock, agro-industry, and agrimarketing. In contrast, the commercial banks' loans to agriculture constitute a small proportion of their total loan portfolio; this proportion declined from 2.5 percent in 1992 to 1.8 percent in 1997/98. In mid-July

² Including the subproject offices of its Small Farmer Development Program.

³ About 37,000 biogas plants, 75,000 small irrigation schemes (both ground and surface), 975 solar systems, and 517 rural electrification projects have been installed and financed to date by ADBN.

1997 ADBN accounted for nearly 56 percent of the total rural outstanding loans (NRs13.82 billion). Despite its dismal position, ADBN remains by far the single largest rural lending agency in the formal banking system. There is a need for a detailed assessment of ADBN's financial situation, outlook, and options to transform it into an effective institution that can compete on market terms.

B. Scope

27. The TA will provide a detailed audit of ADBN's financial position and operations, and an options study for its future direction. It will

- (i) make a detailed assessment of ADBN's accounting practices and assessment of its financial position and performance, including loan portfolio and reserves, in line with international standards;
- (ii) develop a loan classification system to comply with NRB's emerging regulations;
- (iii) review ADBN's existing and potential clientele and market environment;
- (iv) conduct an organizational review and management audit, including incentive structures, governance, human resources and skills, treasury functions, budgeting, information systems; establish requirements and recommendations to meet those;
- (v) review credit policies and procedures, and develop a basic credit scoring system for credit appraisal; establish credit review committees; and
- (vi) develop a strategic plan including vision, objectives, target markets, products, and services in a competitive environment, and list steps required to implement this plan.

C. Implementation Arrangements and Consulting Services

28. ADBN will be the Executing Agency for the TA and will form a project management unit to coordinate the TA with the activities for financial sector reform, and the steering committee for the Corporate and Financial Governance Project. ADBN will also provide logistic support and counterpart staff to assist the consultants in their duties. An international consulting firm will be engaged to implement the TA. The consulting services will be carried out over 12 months. The consultants will be selected and engaged in accordance with ADB's *Guidelines on the Use of Consultants*. The TA will require about 26 person-months of international consulting services in rural finance policy, accounting and finance, banking, rural credit, auditing, law and institutional development; and 30 person-months of domestic consulting services in the same disciplines, with focus on accounting.

Sub-TA 6: Developing Insurance, Pensions, and Contractual Savings (\$750,000)**A. TA Rationale and Objectives**

29. Deepening and broadening the financial sector require expansion and orderly growth of insurance, pension, and other forms of contractual savings. A sound regulatory environment and strong regulatory institutions are also needed. Development of insurance and contractual savings can play an important role in enforcing corporate governance provisions and enforcing alternative savings instruments. The TA will lay the foundation for proper regulation and policy directives as well as institutional development.

B. Scope

30. The TA has three components: (i) development of the regulatory framework, (ii) development of the insurance industry, and (iii) development of pension and provident funds and other forms of contractual savings including investment trusts. The consultants will undertake specific tasks under each component.

1. Regulation of Insurance and Contractual Savings

- (i) Conduct, in close collaboration with the consultants undertaking component 2 and 3, an overview of the current status of various forms of contracting savings in Nepal, identifying issues related to the effective and consistent regulation of these financial products.
- (ii) Based on the results of the review, recommend an appropriate institutional and macro policy framework for regulating insurance, pension, and other forms of contractual savings.
- (iii) Review the existing legal framework for trusts, and recommend amendments to facilitate the development of contractual savings on a trust basis. This includes reviewing the legal and institutional bases, as well as operational and financial conditions of the existing collective investment funds established under the Securities Investment Trust Act.
- (iv) Explore the need for legislation to govern the provision of financial advice, and provide appropriate draft legislation if necessary.

2. Development of the Insurance Industry

- (i) Examine the performance and business practices of the insurance companies; identify issues prevailing in the industry and, where appropriate, propose amendments to the regulatory framework to address these issues.
- (ii) Review the 1992 Nepal Insurance Act, identifying constraints or weaknesses in the act, which hinder the functioning and sustainability of an effective regulatory system or the effective operation of the insurance market, propose appropriate amendments.

- (iii) On the basis of (i) and (ii), and considering the findings of component 1, propose a suitable governance structure and prepare the corporate plan for the insurance regulator.
- (iv) Building the capacity of the insurance regulator by defining the role and responsibility of its functional wings, preparing rules and regulations, operational manual, and a management information system; and developing its capacity to enforce regulations, etc.
- (v) Design training programs and provide on-the-job training to staff of the insurance regulator.
- (vi) Review the operational and financial performance of the National Insurance Company (NIC/Rastriya Beema Sansthan), assessing the value of assets and liabilities including its policyholder liabilities, and assessing the quality of risk management in terms of pricing risk, asset liability management, risk, and exposure to major losses. In addition, identify impediments to equal opportunities between the private and public sector insurance companies. On the basis of the results, develop restructuring and divestment plans for NIC and actions, as appropriate, to remove any market distortions between the public and private sectors.

3. Development of Pension and Provident Funds

- (i) Obtain and review the financial and operational information on private pension funds and the Employees Provident Fund (EPF). Examine the legal and regulatory framework currently applicable to pension and provident funds, including the Employees' Provident Fund Act of 1992, and identify weaknesses relating to solvency, fund administration, investment management, fiduciary requirements, and member protection.
- (ii) Based on the results of item i) and considering the findings of component 1, recommend an appropriate regulatory structure and policies for pension schemes and provident funds in Nepal that cater to various segments of the population and industry.
- (iii) Recommend and draft appropriate amendments to existing law, including amendments to the EPF Act and new legislation to govern private pension funds, as well as supportive rules and regulations to implement the recommendations made.
- (iv) Analyze the existing and potential role of pension and provident funds in the Nepalese capital markets in reducing old-age poverty.
- (v) Explore the feasibility of establishing a national (pillar 1) pension scheme.

- (vi) Recommend approaches and modalities for encouraging professional management of pension and provident funds and gratuity schemes in the public and private sectors.
- (vii) Review the operations of the EPF; propose revision of the investment policy of EPF and prepare a plan for decentralized fund management activities.
- (viii) Conduct workshops with public and private sector representatives and professional firms to discuss the proposed options, with the objective of developing a feasible reform proposal.
- (ix) Prepare training programs and conduct training to upgrade the knowledge of staff in charge of pension and provident funds.
- (x) Recommend incentive schemes to promote pension and provident funds.

C. Implementation Arrangements and Consulting Services

31. An international consulting firm will be engaged to implement the TA over 12 months. The consultants will be selected and engaged in accordance with ADB's *Guidelines on the Use of Consultants*. The TA will require about 25 person-months of international consulting services with expertise in insurance and pension policy, contractual savings development, regulation, accounting and auditing, law, and actuarial assessment and institutional development in both developed and developing markets; and 41 person-months of domestic consulting services in the same disciplines. The consulting team will be under the overall responsibility of the team leader in component 1. The Executing Agency will be the Insurance Board.