CHAPTER III

FINANCIAL SYSTEM OF NEPAL

3.1 Introduction

3.2 Evolution of Financial System in Nepal

3.3 Structure of Financial System

Financial Institutions

Central Bank

Depository Institutions

Non-Banking Financial Institutions

Financial Markets

Money Market and Instruments

Capital Market and Instruments

3.4 Nepal Rastra Bank: Policy, Role and Functions

3.5 Performance of Commercial Banks

3.6 Problems and Challenges of the Financial System

3.7 Conclusion

CHAPTER III

FINANCIAL SYSTEM OF NEPAL

3.1 INTRODUCTION

Financial markets and intermediaries are two important ingredients of a financial system (Demirguc-Kunt and Levine, 2001). Savers can directly acquire primary securities from the borrowers by lending them in the financial markets. In a market-based financial system, borrowers can find loanable fund by directly issuing securities to the primary savers. Because of absence of intermediation, the cost of funds becomes low whereas the lender may find a maximum yield on saving.

Financial intermediaries, on the other hand, accumulate savings from myriads of small savers and lend to several borrowers; reduce risks by diversifying lending to several borrowers more efficiently than individual saver; assure savers to liquid their savings and borrowers to find long-term maturity and loans at a minimized transaction costs.

The savers acquire secondary securities from the financial intermediaries as they deposit their savings with them. Financial intermediaries ultimately lend the borrowers and get hold of primary securities. Financial intermediaries act as go-betweens by linking the savers and investors. Thus, households can finance their savings to the borrowers directly or simply deposit it with the financial intermediaries. In other words, investors can acquire funds directly from the financial market or obtain debt from the financial intermediaries and the lender. Thus, both the intermediaries (banks) and markets have their own merits.

Regulations over the financial institutions, aimed to direct and maintain control over their activities were important until the beginning of 1980s. Different countries experienced several distress and crises in their financial system at different times during the era of deregulation, particularly in 1980s and 1990s. Prudential regulation and effective supervision has received more importance. However, the context of regulation has changed. The role of thc state, instead of becoming the owner and controller of the financial system has been diverted as facilitator. More transparent and standard norms of regulation helped to promote economic activities in private sector and hence to achieve the objective of sustainable economic growth. Regulations oriented to control the activities of financial institutions and markets (in the form of interest rate and credit ceiling) were deregulated while prudential norms, standard accounting and auditing standards were introduced. Thus, risks minimizing, pro-competitive and efficiency fostering regulations replaced the regulations limiting competition.

3.2 EVOLUTION OF FINANCIAL SYSTEM

Financial innovations have been impetus to determine the structure of financial system and underpinning for development. Introduction of money (currency) was one of such innovations, which sorted out the inconveniences of barter economy as a means of payment in the rudimentary economy (Gurley and Shaw: 1955). During the Malla-regime, Nepalese trade was flourishing beyond the territory with Tibet and India. Nepal had a nodal role in trading of gold from Tibet to India. Nepalese coins, which were acceptable in Tibet, reduced the inconveniences occurring in the barter exchange to promote trade extensively. Thereafter, eighteenth century onwards, gold, silver, copper and other metallic coins were widely used as money for the exchange as well as for the store of money (Nepal Rastra Bank, 1996). It is noteworthy that in spite of the introduction of currency, Nepalese economy remained under primitive or rudimentary stage for a long period (until the middle of twentieth century) due to the lack of development of financial institutions (Mahat:1978). Shankhadhar Sakhwa's declaration debt free Kathmandu Valley and Tankadharis' specialization in money lending as their occupation certainly indicated the prevalence of credit practices in Nepal (NRB: 1996). It is imperative to comment that if organized financial institutions had supported such system, then the economy would have certainly followed some other course.

An organized financial system was lacking in Nepal until the establishment of the Nepal Bank Limited in 1937. Some of the following evidences also explain the prevalence of unorganized financial system. Underdeveloped indigenous individuals, like large farmers, local merchants and shopkeepers, pawnbrokers, sarafis as well as family, relatives and friends were only the sources to meet financial needs. "Tejarath Adda" was set up in 1877 in order to avail cheap loans to the civil servants. Kaushi

Toshakhana was initiated to collect revenue during the regime of Prithvi Narayan Shah, the founder of the nation (NRB: 1996). Both of them were not financial institutions because the later was set up only to collect revenue, while the former to disburse cheap loans for civil servants (which faced financial problems while catering credit). No efforts were made to institutionalize saving and investment until the establishment of Nepal Bank Limited (NBL) in 1937, which took over all the liabilities of the Tejarath Adda.

Table: 3.1

Financial Institutions before 1980s

S N	Financial Institution	Establishment	Remarks
1.	Tejarath Adda	1880	Not existing
2.	Nepal Bank Limited (NBL)	1937	First Commercial Bank
3.	Nepal Rastra Bank (NRB)	1956	Central Bank
4.	Industrial Development Bank	1957	Changed into NIDC in 1959
5.	Nepal Industrial Development Corporation	1959	Industrial Financing DFI
6.	Cooperative Bank	1963	Merged with ADB in 1968
7.	Employs Provident Fund (EPF)	1962	Contractual saving entity
8.	Rastriya Banijya Bank (RBB)	1966	
9.	Land Reform Savings Corporation	1966	Merged with ADB in 1973
10.	Agriculture Development Bank (ADB)	1968	
11.	National Insurance Corporation (Rastriya Beema Sansthan)	1967	
12.	Credit Guarantee Corporation	1974	
13.	Securities Marketing Centre	1977	
14.	Postal Savings Bank	1977	

Source: Forty Years of the Nepal Rastra Bank (1996): pp 40

Development of formal financial system begins in Nepal with the establishment of Nepal Bank Limited in 1937 as the first commercial bank. Nepal Rastra Bank was established in 1956 as the central bank with immediate objectives to maintain exchange rate stability, management and circulation of Nepalese currency, development of banking system and mobilize resources for economic activities. Indian currency was dominant, in circulation. Elimination of dual currency regime, maintaining price stability and development of a sound banking and financial system were critical challenges of the time. The establishment of other financial institutions under the domain of Nepal Rastra Bank has made remarkable contribution to support planned development effort by means of financial and monetary policy instruments, maintaining price and exchange rate stability and rapid financial development.

Unlike the central banks of other industrialized countries, Nepal Rastra Bank had to perform some developing functions and lead for the economic development. Development of the financial system was its primary responsibility in order to expand economic activities in different sectors of the economy (trade, industry, agriculture etc.). Various financial institutions such as Nepal Industrial Development Corporation, Agriculture Development Bank, Employees Provident Fund, National Insurance Corporation, Credit Guarantee Corporation etc and supporting institutions contributed a lot in the development of agriculture, industry and trade. The services extended by Nepal Bank Limited though soothing, were not sufficient. Therefore, Rastriya Banijya Bank was established in fully public sector ownership in 1966, as the second commercial bank in order to foster competitive and efficient banking system.

Further, developmental works in the public sector required more banking services throughout different parts of the country. Both the commercial banks were motivated to extend their branch networks throughout the kingdom by adopting branch-banking policy. Financial institutions established before 1980s are depicted in table: 3.1.

Thus, efforts before the 1980s were concentrated to cultivate banking habit among people at large, by expanding the financial sector rapidly. A forceful bank branch policy adopted during 1970s continued until late 1980s. Until 1989, Nepal Rastra Bank used to provide resources in the form of subsidized loans and interest free working capital to commercial banks for their branch expansion in the specified areas. (Acharya et al 2003: p 32) This policy was successful to extend the banking facilities, at least one bank branch in each of 75 districts of the country. Nepalese banking sector has extended widely after the initiation of liberalization in the financial sector. The number of commercial banks increased from two in 1980, to five in 1990 and reached to seventeen in 2003. One bank branch is able to serve 51.8 thousand of people on average.

Expansion of the network of financial institutions certainly made positive impact in the promotion of economic activity and entrepreneurship growth in the country. People even not knowing about banks; began to depend increasingly on banking services. Domestic resource mobilization increased with the elaboration of financial institutions and expansion of bank branches in particular. The financial sector reforms and market oriented economic policy led to the mushrooming of financial institutions in a small and underdeveloped economy. The diversification of the financial system is certainly reflected by the consecutive policy changes, followed by active participation of private sector and growing complexities with the development of new financial instruments and services. (Khatiwada, 2000; World Bank 2002a).

Informal Finance: The prevalence of traditional role of informal sector in the contemporary period replicates its significance in fulfilling financial needs of individual household as well as business firms in an economy. In Nepal, about 80 percent of rural credit demand used to be fulfilled by informal arrangement (NRB: 1995). However, being scattered, there was no unanimity in the interest charges, rather it varied sometimes and exacerbated (sometimes even above 100 percent or even more). Debtor's land, house, or precious metals are accepted as collateral. In case of any failure to pay back within the mentioned time, they had to give up their property. Although the role of informal finance was crucial for economic activities, it is beyond the scope of present study.

3.3 STRUCTURE OF THE FINANCIAL SYSTEM

Nepalese financial system has grown as a complex of financial institutions and markets, availing different types of financial instruments and services to mobilize resources and allocate them for investment. In addition, institutional developments have occurred in order to ensure a smooth operation of the financial institutions. Financial institutions, financial markets and instruments are major components of financial system. Despite of a small economy, Nepalese financial sector has been proliferated. The financial system keeps concern about money, credit and finance, which are different from each other, however intrinsically linked with each other. In other words, they all are part of our financial system. Money is used as the current means of payments or exchange, loans are debt for the economic units, which are the future value of money paid back to the lender with some interest, and finance comprises of debt and ownership of funds as monetary resources (Bhole, 2004). Thus, Nepalese financial system has been divided into and discussed as a complex of financial institutions and financial markets. (Appendix: F)

Predominantly agro-based Nepalese economy was in need of extensive finance. Directed credit to small and agricultural sector as well as refinance facilities had contributed a lot in this context. However, high operation and lending cost as well as more risk of default in such lending deteriorated the profitability of the banking system. Therefore, a resolution has been adopted in 2003 to phase out the priority sector lending completely by 2008, considering the existing problems, in conjunction with liberal financial policy and development and expansion of financial sector. However, deprived sector lending is in existence as mandatory provision.

It is notable that Nepalese financial system has expanded with varied financial institutions and markets with a wide range of financial instruments after the introduction financial liberalization.

Regulation and Supervision of Financial System

Regulation and supervision is crucial for the development of healthy, sound and stable financial system. Economic liberalization and technological development of the 20th century has integrated the financial market around the globe. Regulation lays specific rules over the behavior of the participants in the financial system. Regulation helps to keep the financial system in the desired track. Strengthening of the regulatory, supervisory and legal infrastructure is an important component of the financial sector reform. All these infrastructures are directed to streamline the operations of financial institutions and markets so that mobilization and allocation of domestic saving could be efficient.

There are three distinct regulatory authorities in the financial system of Nepal. Banks and other depository institutions are at the heart of the financial system and Nepal Rastra Bank is the regulatory authority for these institutions. Similarly, Insurance Board and Security Exchange Board of Nepal are responsible for the regulation of the insurance companies and stock market respectively. The Ministry of Finance directly regulates some other financial institutions like, Employees Provident Fund and Citizen Investment Trust.

The regulation and supervision of different types of financial institutions became insufficient and cumbersome due to the fragmented legal system, particularly for the financial institutions. The enactment of Bank and Financial Institutions Ordinance in 2003 is expected to govern the operation of all depository institutions to provide for sufficient regulation and supervision as an umbrella act.

Financial Institutions

The financial institutions or intermediaries are firms producing financial services just like non-financial firms producing goods and services. The financial institutions are special types of entities, incorporated to mobilize savings and allocate the resources in the form of credit and finance for investment projects. The financial institutions provide an array of financial services to different economic agents. Thus, financial institutions are different to business or industrial set up, for most part of their asset and liabilities comprise of financial assets. This is the reason why they are distinguished as financial sector with real sector economy. They link the surplus saving units and deficit spending units in an economy while providing a wide range of financial services and instruments. The borrowers sell financial claims, i.e., loan to the financial intermediaries. They issue claims against themselves to the savers while collecting savings (deposits). Thus, funds flow between the savers and borrowers, while financial intermediaries act as go betweens.

The financial institutions can be categorized into depository (banking) institutions and non-banking financial institutions. The banking institutions intermediate the primary savers and ultimate borrowers by mobilizing deposits and allocating funds as loans and investment. Non-bank financial intermediaries include all the insurance companies (including Deposit Insurance and Credit Guarantee Corporation), and other institutions like Employees Provident Fund, Citizen Investment Trust.

Table: 3.2

Banks and Financial Institutions

Year	Commercial Banks	Development Banks	Finance Companies	Cooperatives*	NGOs*	Total
1983	2	2				4
1990	5	2	0	0	0	7
1993	8	4	4	0	0	16
1994	8	4	7	1		20
1995	10	6	22	7	8	53
1996	10	7	34	11	21	83
1997	11	7	42	16	29	105
1998	11	7	44	22	34	118
1999	13	12	44	35	30	134
2000	13	13	46	35	7	114
2001	15	17	48	34	15	129
2002	16	21	54	34	25	150
2003	17	22	57	34	40	170

Source: Banking and Financial Statistics (various Issues), Nepal Rastra Bank, Bank and Financial Institutions Regulation Department

* With limited banking business

In July 2003, there were 17 commercial banks, 21 development banks (including 5 regional rural development banks), 54 finance companies, 34 financial cooperatives, and 38 financial Non Government Organizations. Altogether 116 postal saving offices were mobilizing savings especially in the rural areas. In addition, there were insurance companies (17), Employees Provident Fund, Citizen Investment Trust and Deposit Insurance and Credit Guarantee Corporation as non-bank financial institutions.

Different types of financial institutions such as Nepal Industrial Development

Corporation, Agricultural Development Bank, Employees Provident Fund, National Insurance Corporation, Deposit Insurance Credit Guarantee Corporation, Rastriya Banijya Bank etc. established prior to 1980 were set up under special laws. Commercial banks operate under the Commercial Bank Act 1974, finance companies under the Finance Company Act 1985, development banks under the Development Bank Act 1996, financial cooperatives under the Cooperative Act 1992, and financial NGOs under the Financial Intermediary Act 1998. The commercial banks, finance companies and development banks are registered with the company registrar as public limited companies, whereas the financial cooperatives with the Department of Cooperative and FINGOs with the respective District Administration office.

Nepal Rastra Bank

Nepal Rastra Bank, the apex financial institution was established under the Nepal Rastra Bank Act, 1955. The act had envisaged the objectives as managing the issue of Nepalese currency; encouraging economic activities by developing banking and financial system; maintaining exchange rate and price stability and acting as the banker to the government. At the time of establishment, eliminating the dual currency system and development of the financial system were great challenges. The Bank has played crucial role on maintaining interest rate and exchange rate stability for the overall growth and stability of the economy. On behalf of the government, the bank has established its relationship with regional and international financial institutions, like SEACEN, SEANZA, APRACA, Asian Development Bank, International Monetary Fund, and the World Bank etc. The bank has been playing developmental and promotional functions for the institutionalization of savings through the cultivation of banking habit among people at large, extension of banking services, establishment of specialized financial institutions, particularly in the rural areas of the country.

The establishment of Nepal Rastra Bank was, thus, a landmark in the history of financial development of Nepal. Banking and financial system could attain certain shape and evolved with structural changes. It developed necessary financial mechanism within the financial system. The role of different types of financial institutions was important to link the savers and investors and promote entrepreneurship in the economy. Realizing the importance of saving mobilization for economic development, Nepal Rastra Bank has followed the *supply leading approach* (Patrick, 1966) of finance for the 'start-up' as well as expansion of economic activities. Thus, the creation of financial institutions was motivated to the supply of more financial assets, which were crucial on the efforts of planned development.

The role of the Nepal Rastra Bank necessitated revisiting, so that it could prudentially regulate and supervise the financial institutions and retain control over the activities in the financial system. The role and functions of the Nepal Rastra Bank were inadequate and ineffective, particularly, in the area of implementation of prudential regulation and effective supervision. The Bank was lacking autonomy and so was its accountability. Therefore, a new Nepal Rastra Bank Act, 2002 was enacted to ensure its autonomy, provide more authority and increase responsibility, so that it could be able to perform its responsibility as a modern central bank. The new act has clearly spelled out the objectives and functions of the central bank emphasizing for maintaining price, exchange rate and financial stability. The Bank at present is only the authority to formulate and implement monetary and exchange rate policy as well as financial policy. The bank has been thus provided free from government interference in its day-to-day administration. The post of the governor has been empowered. Further, the Banks and Financial Institutions Ordinance (2003) has provided more authority to the bank, in order to regulate and supervise the banks and financial institutions and ensure a sound, healthy, competitive and efficient financial system, ultimately to contribute for the expansion of economic activities.

Depository Institutions

Depository institutions are comprised of commercial banks and other banking institutions that are involved in deposit mobilization and credit allocation. Other banking institutions include finance companies and development banks. Saving and credit co-operatives (FINCOOP) and Non-Governmental Organizations authorized for limited banking transactions are also grouped into depository institutions. Large portions of the liabilities issued by these financial intermediaries are deposits. Market shares of deposit taking banks and financial institutions is given in following table.

Table: 3.3

Market Shares of Deposit-Taking Banks and Financial Institutions

As of mid-July 2003 (in Percent)

Deposit Taking Institutions	Total Assets	Total Deposit	Total Credit	Total Investment	Liquid Fund
Commercial Banks	80.0%	80.0%	72.0%	88.0%	81.0%
Development Banks	6.0%	7.0%	8.0%	5.0%	7.0%
Finance Companies	13.0%	12.0%	19.0%	7.0%	11.0%
Cooperatives (Limited Banking)	1.0%	1.0%	1.0%	0.0%	1.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Economic Report 2003, Nepal Rastra Bank

Commercial Banks

Commercial banks are the oldest and largest financial institutions dominating the financial sector. Therefore, they are important for mobilizing resources, allocating credit and are crucial for payment system. The market size of both the joint venture and domestic private banks has been increasing at the expense of the public sector banks, which are shrinking over time.

Nepalese financial sector underwent a rapid deregulation during the 1990s and early 2000. Supervision and regulation of banks were also strengthened during the same period with the amendment of the Nepal Rastra Bank Act, Finance Company Act and Commercial Banks Act, introduction of Development Bank Act and Financial Intermediation Act and reorganization of Nepal Stock Exchange. Relaxation of entry restrictions attracted a number of new banks (both joint venture and domestic) and other financial institutions into the financial system. This was not only meant to increase the level competition and hence efficiency of the financial system, but along with other reforms to contribute in financial deepening. The commercial banks are divided into three distinct groups on the basis of ownership namely, (i) public sector banks, (ii) public sector banks, and, (iii) domestic private banks.

(i) Public Sector Banks

Public sector banks include the two largest banks, namely Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL) established as public sector entity before 1980s. RBB is fully government owned and NBL is with 41 percent public-sector ownership. During the 1970s and 1980s, these banks followed an active branch expansion policy and extended their branch network throughout the country. As a result, there was at least a bank office in each of the 75 districts.

Table: 3.4

Public Sector Banks in Nepal

SN	Name of Bank	Date of Estd.	Ownership	Paid Up Capital (Rs Million)	Remarks
1.	Nepal Bank Limited	1937	Majority Government	3804	Government is gradually offloading shares
2.	Rastriya Banijya Bank	1966	Fully Government	11723	

Source: Bank and Financial Institutions Statistics July 2003, Nepal Rastra Bank Bank and Financial Institutions Regulation Department

Both the banks have significant contribution on improving banking habit among the people at large and encourage entrepreneurship in both the urban as well as rural areas. However, branch-banking policy adopted so far, was uneven, leading the banks to bear a high operation cost. They are effectively controlling the financial system through the nationwide branch networking. Both the banks experienced liquidity and solvency problems in the early 1990s resulted mainly from management deficiencies (NRB, 1996). They were restructured and recapitalized during early 1990s as part of the process of financial sector reform. However, severe managerial and structural problems and external interference affected both the banks, leading to poor financial performance. As a result these banks are undergoing rigorous restructuring since 2002.

(ii) Joint Venture Banks:

With the amendment of the Commercial Banking Act in 1984, entry barrier was relaxed to allow banking institutions operate in the private sector. The joint venture banks started to be established since mid-1980s. They have foreign equity participation (along with domestic) and management with good name with international reputation, conducting banking business professionally. They are well mechanized and supervised by their respective home country supervisory authorities.

The share of total assets of the joint venture banks has been increased to about 50 percent of total commercial bank assets. The joint venture banks are dominated by three large banks, Standard Chartered Bank, Himalayan Bank and Nabil Bank with 9 percent each of the total banking system assets, while remaining goes to the other banks in the private sector. The introduction of joint venture banks infused modern banking and financial technology and new financial instrument in the financial system. However, the spillover effect of their efficient management and modern banking skills was less in the domestic banks, as per expectation.

Table: 3.5

Joint Venture Banks in Nepal

SN	Name of Banks	Year of Operation	Paid Up Capital	Partnership with	Remarks*
1.	Nepal Arab Bank	1984	4917	National Bank Ltd, Bangladesh	Nabil Bank
2.	Nepal Indo-Suez Bank	1986	2953	Credit Agricole Indo-Suez, France	Nepal Investment Bank
3.	Nepal Grindlays Bank	1987	3746	Standard Chartered, UK	Nepal Standard Chartered Bank
4.	Himalayan Bank	1993	5363	Habib Bank, Pakistan	
5.	Nepal SBI Bank	1993	4269	State Bank of India, India	
6.	Nepal Bangladesh Bank	1993	3599	IFIC Bank, Bangladesh	
7.	Everest Bank	1994	4550	Punjab National Bank, India	
8.	Bank of Kathmandu	1995	4636	Siam Commercial Bank Thailand	
9.	Nepal Bank of Ceylon	1996	5950	Bank of Ceylon	Nepal Bank for Credit and Commerce

* The name of banks are changed

Source: Nepal Rastra Bank, Bank Supervision Dept

Nabil Bank (formerly Nepal Arab Bank) Limited was the first among joint venture banks, established in 1984, which was followed by Nepal Standard Chartered Bank (formerly Nepal Grindlays Bank) and Nepal Investment Bank (formerly Indosuez Bank) Limited in the subsequent years. Thus, until 1992, there were only three joint venture banks in the financial system.

Table: 3.5 shows foreign equity participation of different joint venture banks. Those banks have brought in modern banking technology, financial instruments and financial services along with foreign capital investment. Introduction of joint venture bank has brought into revolution in Nepalese banking system. The foreign participation in joint venture banks was mainly from India, United Kingdom, Bangladesh, France, Sri Lanka and Pakistan. Joint venture banks characterize the banks with foreign participation in management with at least 50 percent equity participation.[1] They have better experiences in banking as they have been operating internationally. They have been performing well as showing more efficiency over the years.

(iii) Domestic Private Banks

Private sector banks other than joint venture banks are in this group. Most of them are relatively small in asset size as well as their network.

Table: 3.6

Domestic Private Banks

S.N.	Name of Bank	Year of Operation	Paid Up Capital	Remarks
1	NIC Bank	1998	5000	Initially established outside the capital
2	Lumbini Bank	1998	3500	Initially established outside the capital
3	Machhapuchhre Bank	2000	5500	Established outside the Capital
4	Kumari Bank	2001	5000	
5	Laxmi Bank	2002	5498	Initially established outside the capital
6	Siddhartha Bank	2002	3500	Established outside the Capital

[1] By the year 2004 foreign equity-participation has been raised up to two-third of total share capital (Monetary Policy for Year 2004, Nepal Rastra Bank).

Source: Banking and Financial Institution Statistics

Domestic private banks came in operation by late 1990s and early 2000s. There were six domestic private banks in July 2003. They are managed and owned by private sector with or without foreign equity participation. Since they are relatively new banks, they have the opportunity to start as 'fresh banks' without bad loans in their portfolios and with the possibility of adopting recent banking technologies during their inception.

Other Banking Institutions

Deposit taking institutions other than commercial banks are grouped as other banking institutions (OBIs). They are different to banks that they do not operate checking accounts and they are specialized institutions in credit allocation. Other banking institutions consist of 21 Development banks, 54 finance companies (FCs), 34 financial cooperatives (FINCOOPs), 40 financial NGOs (FINGOs) and 116 postal saving offices (or postal saving banks), all functioning as financial intermediaries.

In 2003, paid up capital (Rs. 5088.6 million), deposits (Rs. 47854.9 million) and borrowed funds (Rs. 8111.8 million) were the major sources of funds for the OBIs. Finance companies were mobilizing deposit more than the other OBIs. Out of total assets Rs. 81694.2 million, loans and advances is Rs. 50520 million, investment in share, government securities and fixed deposits Rs. 6214.9 million, and, cash and bank balance Rs. 7657.2 million. The total outstanding loans of OBIs as at mid-July 2003 remained at Rs. 37.8 billion. Of the total loan outstanding, the ADB/N accounted for 49.3 percent, finance companies 38.3 percent, NIDC 5.1 percent, co-operative societies (with limited banking transactions) 3.8 percent and rural development banks 3.5 percent.

Development Banks

Development banks are specialized institutions for financing long term and medium term loans for agricultural and industrial enterprises. There are 21 development banks, which include Nepal Industrial Development Corporation (NIDC) and Agriculture development Bank (ADB/N), micro-finance development banks, small farmers' development bank and other development banks. Out of 21 development banks the NIDC and ADB/N, were established under corresponding special acts, all the other development banks are established under Development Bank Act 1995. Five Rural Development Banks (RRDBs) as well as microfinance development banks are all included in the category of development banks.

Finance companies

The finance companies are operating under the Finance Companies Act 1985, as public limited companies. The finance companies are different to banks that they can accept only time deposits of maturity period minimum 3 months to a maximum of 6 years. Further, they are limited to collect deposit up to ten times of their primary capital. They can extend loans to individuals, firms as well as companies and other institutions to purchase consumer durables, automobiles, household appliances, and furniture. They also extend loans to business to finance inventories and purchase or leasing of equipments. These needs are relatively small and risky as well and commercial banks are reluctant to lend.

Finance companies have the largest share of total deposit among the OBIs. There were 54 finance companies in July 2003 and the number has been increasing each year gradually. Major sources of funds of the finance companies are deposits, capital funds, and borrowing. In July 2003, they had deposits Rs. 451.6 million, capital funds Rs. 201.5 million and borrowing Rs. 1324.9 million. Out of total assets Rs. 2205.4 loans and advances constituted Rs. 1309.1 million, investments Rs. 573.4 million and liquid funds Rs. 211.3 million.

Financial Cooperatives

The Cooperative Societies are basically, non-profit social organizations, established for the collective benefit of the members in the society. Nepal Rastra Bank has authorized 34 co-operative societies for limited banking transactions. The Cooperative Act 1992 has allowed the co-operative societies to mobilize and allocate savings from and to its members. Financial cooperatives can become important tool in mobilizing savings and financing the needs of local people and prevent poor people from high interest charges of the informal sector.

Major sources of funds of the FINCOOPs are deposit (Rs 1.9 billion), capital funds (Rs 273 million), and borrowing (Rs 66.4 million). Out of total assets of Rs 2.7 billion, liquid assets was Rs 389.1 million, investment Rs 251.9 million and loans and advances Rs 1463.2 million in July, 2003.

Financial NGOs

Non-governmental organizations, mobilizing public deposit with a prior approval of the Nepal Rastra Bank are the Financial NGOs (FINGOs) are non-profit social organizations. Such social organizations are important vehicle to formalize the informal sector particularly in the rural areas. Their services are critical in the unbanked areas of the country. There were 38 FINGOs in July 2003 and their number is encouragingly increasing each year. Borrowed funds and grants either from domestic or foreign agencies are their major sources of funds. Membership fees and accumulated profits are other sources.

In the year 2003, their aggregate sources of funds increased by 60.4 times than the previous year and reached to Rs 129.3 million (most of which is borrowed funds from both the domestic as well as foreign institutions). Out of the total assets, 37.7 percent was lent in micro-finance and 38.8 percent in investment in government securities.

Postal Savings Offices

There were 116 Postal Savings Offices (Postal Saving Banks) throughout the country. Total deposit mobilized in 2003 is Rs 500 million. Total number of accounts has down from 900 in 2001 to 600, due to an increase in the minimum amount requirement from Rs 10 to 100. General Post Office regulates and supervises them. Postal savings could become an effective instrument to mobilize small savings, particularly, in the rural areas. Since it does not offer credit facilities and the volume of savings is rather small, it is no more popular in Nepal.

Non-Bank Financial Institutions

The Non-Bank Financial Institutions (NBFIs) include all the other financial institutions, which do not directly involve in accepting public deposit but they are important in the financial system in mobilizing financial resources. They receive regular payments under specified conditions of contingent claims. The insurance companies acquire premium while in exchange of contingent and casualty insurance. Employees Provident Fund (EPF) collects contributions from both the employees and employer in exchange for retirement benefits. Citizen Investment Trust (CIT) accepts voluntary savings from corporate employees, which are tax-exempted. Thus, there were 20 Non-bank Financial Institutions, which include 18 insurance companies (including the Deposit Insurance and Credit Guarantee Corporation DICGC), Employees Provident Fund and Citizen Investment Trust.

Insurance Companies

There are insurance companies established in both public and private sector, offering life and non-life insurance services in Nepal. The life insurance companies provide protection (or compensation against the financial costs, losses, and reduction in income associated with death, disability and old age and various other health problems. The beneficiaries make payment as premium under installment in exchange of protection and compensation. They can lend the funds to business and government for a longer period. It is because premium payment is relatively steady and predictable well the policyholders likely become ill or die in a given year. However, it is less predictable in case of non-life insurance firms, due to uncertainty of natural disasters. The life insurance companies can invest a large portion of their funds to acquire long-term assets from the business or the government. Long-term instruments generally provide better yield to them further. The insurance companies invest most of their funds in the government securities yet.

In July 2003, total assets of the insurance companies were Rs. 13.8 billion of which 71.1 percent goes to the part of the life insurance companies. Out of total assets, 87.3 percent is investment. National Insurance Corporation and Deposit Insurance and Credit Guarantee Corporation are on the public sector, while other insurance companies are in the private sector. Most of the insurance companies in the private sector are set up within the decade of 1990s and onwards.

Nepal Rastra Bank, being the major owner, has promoted Deposit Insurance and Credit Guarantee Corporation (DICGC) was established in 1974. It's main objective is to guarantee the compensation on any loss of loans, lent under the priority sector (such as agriculture, industry, and services). The corporation is authorized for deposit insurance as well. Its main sources of income are the guarantee fee, return on investment on the government securities. The decline in the priority sector lending by the banks to Rs. 302 billion (insured with the DICGC) has reduced the fee income of the corporation.

Employees Provident Fund

Employees Provident Fund (EPF) was established in 1962 by merging two independent entities, Army Provident Fund and Civil Servants Provident Funds. It mobilizes the compulsory savings from the employees in the corporate sector (among others). Like life insurance companies, EPF mobilizes the steady flow of contributions by the employees and that from their employer. The number of members retiring from their job is predictable and it does not need to maintain liquidity and can invest in long-term less liquid assets.

As of July 2003, 91 percent of its sources of funds were the provident fund contribution. Total assets of the EPF were Rs. 35.6 billion, out of which loans to the members and other institutions was 39.25 percent and investment 54.5 percent. Investment at the Fixed Deposit accounts with the commercial banks accounts for 42.9 percent of the total assets.

Citizen Investment Trust

The Citizen Investment Trust (CIT) was established in 1991 in order to mobilize the voluntary savings of the employees in the corporate sectors out of their salary income. It can invest on government securities, fixed deposit in commercial banks or shares of the corporate firms. Like insurance companies and EPF, it can make long-term investment. The trust has been authorized to manage the pension funds since 2001. In July 2003, total assets of the CIT was Rs. 2.6 billion, out of which 47.5 percent was investment, 23.9 percent on loans and advances 25.6 percent as deposit with the banks, 38.5 percent of its sources of funds comes from employees' contribution and the remaining from paid up capital 61.5 percent.

Financial Markets

The innovation of interest-bearing financial assets like private bonds, mortgage and loans are considered as an important course of logical order for financial development. The deficit spending units could issue interest-bearing financial claims direct to the surplus spending units. For both of the surplus as well as deficit units, there is a possibility of borrowing future contingencies, which reduces the need to hold money balances for precautionary purposes. It has provided an alternative low-risk wealth as well as store of purchasing power. The issue of the primary security is, thus, the beginning for the development of financial market due course in the evolution of an organized new market. However, we can see the development of organized financial market took place only in the very recent decade in Nepal.

During the 1970s, the banking system was in the process its functional as well as structural expansion. Underwriting practice was absent and investment in public sector enterprises was negligible. The development of the banking system can successfully contribute economic growth process only if the capital market is enabled together to transform saving in the society to resources for investment (Cho: 1986). The Securities Marketing Centre was established in 1977 aiming to develop capital market. However, the development of capital market is associated with the growth of financial institutions and private sector entrepreneurship. Despite the vigorous effort to activate the commercial banks and development financial institution (DFIs) to foster capital market, it could not become successful due to the lack of public confidence to the business community. Financial markets can be classified in various ways according to the nature, type and maturity of the financial instruments traded.

Primary and Secondary markets: New financial claims or securities are issued in the primary markets (and is known as IPOs) mobilize savings of the community by fresh issue to generate initial or additional capital. In the secondary market, securities or financial assets already issued are traded. Secondary markets do not have their direct role in supplying additional capital but, more importantly, they contribute to make the securities more liquid and encourage new issues thereby.

Money and Capital Markets: Classification of the financial markets in terms of the maturity of the securities is very common. The distinction of the financial assets is based on their maturity period. Money market instruments are those with maturity period of one year or less and are traded in the money market. Treasury bills, commercial papers, savings and demand deposits, negotiable certificates of deposits, banker's acceptance, repurchase agreements (Repos) etc are money market instruments.

In Nepal, Treasury Bills and Repos are the most commonly used money market instruments. Treasury Bills are widely used short-term debt instrument with maturity 90 days to 364 days. They do not bear interest rate explicitly rather pay discount at a price lower than the amount paid at maturity. T-Bills are the most liquid among financial instruments, they have an active secondary market since 1996 (managed by the Nepal Rastra Bank) and relatively shorter is the term of maturity. Repurchase Agreements (Repos) are short-term agreements between buyers and seller of government securities, where the seller agrees to buy back the instruments at a higher price on a later date. Government securities serve as collateral. In case the seller fails to pay, the buyer holds them.

Securities with maturity more than a year are traded in the capital market. Stocks, bonds, debentures and CIT certificates are examples of the capital market instruments. Shares, equities, bonds, debentures etc of the corporate sector and development bonds of the government etc are traded in the capital market. Development bonds and shares are traded in Nepal Stock Exchange.

Nepal Stock Exchange

Nepal Stock Exchange Limited (NEPSE) was reorganized in 1994 as the successor of Securities Exchange Center(which was established in 1977). It has been helping investors in buying and selling securities of corporate sector (company shares, debentures, and private bonds) which are already issued in primary market. Private bonds are virtually non-existent and capital market is dominated mainly by share-transactions of major financial institutions listed in the NEPSE. Although, the secondary market does not mobilize savings, it is important for the saving mobilization as it assures the liquidity of the securities. Therefore, stock exchange is the complementary to the market for initial public offer (IPO). The stock exchange is primitive yet in its operation. It follows 'open-out-cry system' and 'paper-versus-payment system'.

The number of the listed companies in the NEPSE was 115 in 2001, which decreased to 96 in 2002 and further increased to 108 in 2003. In July 2003, total paid up value of listed shares was Rs. 11898 million. Similarly, market capitalization was Rs. 35240.4 million and annual turnover Rs. 576 million. The NEPSE index has fallen from 348.4 in 2001 to 204.9 in 2003. Capital market development is at its infancy in Nepal yet. Nepal Stock Exchange is the only stock market and Securities Exchange Board of Nepal is the regulatory authority for the stock market.

In 2003, NEPSE had 29 brokers, 1 market maker, and 4 dealers in the primary market, 4 dealers in both primary and secondary markets, and 3 both market maker and dealer in the primary market, as its members. The broker acts as agent for the buyers and sellers of securities together through the trading mechanism of stock market. Brokerage firms do not manage portfolio on behalf of their clients. Their role has been limited to advising the clients based on their analysis of the company's financial reports or other information whether particular stocks will be good investment or not. The functions of the dealer are different to that of agents as they act as underwriter, issue manager, and market maker in addition to broker. They can hold the securities on their own account. Because underwriting and dealing in securities require sufficient capital for holding securities, only the commercial banks and finance companies are performing as the dealers in the securities market.

Table: 3.7

Capital Market in Nepal

Year	Listed Comp	Paid Up Capital	Market Capitalization	Turnover	NEPSE	Market Capitalization Ratio	Turnover Ratio	Value Traded Ratio
1994	66	2182.2	13872.0	441.6	226.0	0.0724	0.0318	0.0022
1995	79	2961.8	12963.0	1054.3	195.5	0.0617	0.0813	0.0048
1996	89	3358.5	12295.0	209.9	185.6	0.0514	0.0171	0.0008
1997	95	4476.5	12698.0	416.2	176.3	0.0471	0.0328	0.0015
1998	101	4959.8	14289.0	202.6	163.4	0.0493	0.0142	0.0007
1999	107	6487.4	23508.0	73.8	216.9	0.0712	0.0031	0.0002
2000	110	7347.4	43123.3	283.7	360.4	0.1177	0.0066	0.0007
2001	115	7339.0	46349.4	128.0	348.4	0.1178	0.0028	0.0003
2002	96	8680.2	34704.0	80.9	227.5	0.0856	0.0023	0.0002
2003	108	11898.0	35240.0	64.7	204.9	0.0809	0.0018	0.0001

Source: QEB July 2003, Nepal Rastra Bank

The table depicts some indicators of stock market development in Nepal. Total market capitalization as at July 2003 is 8.1 percent of GDP, which had reached at its highest point at 11.8 percent in 2001. Turnover ratio was at the highest point of 8.13 percent in 1995 that decelerated to 0.02 percent in 2003. Similarly, the ratio of value traded to market capitalization is found to be dismal. This indicates that stock market is still underdeveloped in Nepal. Thus, Despite a notable effort to develop the capital market, the role of stock market is dismal in terms of the ratio market capitalization to GDP which was only 8.1 percent of GDP in 2003. According to Czekaj and Owsiak (1999)[2] a stock exchange plays an important role in an economy only once the market capitalization reaches around 20 to 25 percent of GDP.(cited in Andriesz et al, 2005: 398)

The Security Exchange Board of Nepal

The Securities Exchange Act, 1983 (with its amendment in 1992) has instituted the Security and Exchange Board of Nepal (SEBON) as the authority responsible to regulate, monitor, and supervise the capital market in Nepal. The Board of Directors consists of seven members and the Government appoints them. Registration of public issues is mandatory. The Board registers the public issues, issues license for stock exchanges and others (like market makers, dealers, brokers and agents). The SEBON is responsible to regulate, monitor and supervise the management and operation of organized secondary market for securities in the country, with the co-operation of market intermediaries like market makers, dealers, and brokers. It issues guidelines and prudential regulations, and it executes the policies through its market intermediaries and stock exchange.

Government Securities Market

Weekly auctions of 91-day TBs by the NRB are decided by the Open Market Operation Committee, which takes into account the government deficit of the previous month. The bid versus offered amount in the most recent auction, amount maturing and monetary considerations are considered further. The TBs are mainly bid by the commercial banks and are used to comply with the Reserve Requirements (liquidity requirements). The NRB attempts to control liquidity and conduct monetary policy by their sales.

Foreign Exchange Market

Nepalese rupee was fully convertible on its current account since 1993, (while there is a fixed exchange rate with the Indian rupee). It has been expected to

[2] Andriesz, Ewa; D. Asteriou and K. Pilbeam (2005). The Linkage between Financial Liberalization and Economic Development: Emperical Evidence from Poland. Journal of Economic Integration, 20 (2)

encourage the inflow of FDI in terms of both capital and technology. The foreign investors were encouraged through a 'One Window Policy.'

3.4 NEPAL RASTRA BANK: OBJECTIVES AND FUNCTIONS

A strong central bank can effectively formulate and implement sound monetary and exchange rate policy and maintain financial stability. Authority and responsibility of central bank has been gradually expanded in order to provide cushion against possible instability caused mainly through changes in technological development and financial innovation. In this connection, it would be highly imperative to discuss the objectives and functions of Nepal Rastra Bank.

Objectives of Bank:

Nepal Rastra Bank Act, 2002 has specified following objectives of the Bank to maintain price, exchange rate and financial stability and efficient payment system.

(a) To formulate necessary monetary and foreign exchange policies in order to maintain the stability of price and balance of payment for sustainable development of economy, and manage it;

(b) To promote stability and liquidity required in banking and financial sector;

(c) To develop a secure, healthy and efficient system of payment;

(d) To regulate, inspect, supervise and monitor the banking and financial system; and

(e) To promote entire banking and financial system of the Kingdom of Nepal and to enhance its public credibility

The new Nepal Rastra Bank Act, 2002 has extended more autonomy to the Bank so that monetary policy matters may be affected less from the partisan politics. This has eliminated uncertainty in the leadership in the financial system. The term of governor is crucial while talking about the central bank autonomy. The act has clearly mentioned the academic qualification, appointment and removal of the governor, deputy governor and directors. The council of ministers can remove the governor on the recommendation of Inquiry Committee when he/she is incapable to implement or cause to implement the functions of the Bank, or causing loss and damage to the banking and financial system of the country or found dishonest or infamy intension.

Functions of Nepal Rastra Bank

In order to accomplish above-mentioned objectives the Nepal Rastra Bank Act 2002 has mentioned four functional areas of central bank with adequate autonomy and independence to the Nepal Rastra Bank. They are monetary, foreign exchange, regulation-supervision and payment system areas.

1. Formulation and implementation of monetary and exchange rate policy is the major function of Nepal Rastra Bank so as to ensure price and exchange rate stability. It is the bank's responsibility to ensure money and credit are available to expand long term potential growth trend under conditions of relatively low level of inflation.

2. Supervision and regulation of the financial system is directed at promoting the safety and soundness of the depository institutions. It ensures the banks are operated prudently in accordance with statues and regulations. The offsite surveillance and on site supervision ensures the financial condition of individual banks and financial institutions and compliance with existing regulations. Banks are required to submit reports of their activities and financial conditions on a regular basis and to publish their financial statements and interest rates on lending and deposits. Regulation complements the supervisory role of the NRB, which involves issues of specific rules to govern the structure and conduct of banking system in order to establish a framework of sound banking system along with fair and efficient service delivery to the public at large and customers in particular. Regulations define permissible activities, and ensure fair treatment (to the customers) in financial transaction. However, the rules, regulation and their impact are subject to change over time. It is the responsibilities of the banks and financial institutions to comply NRB rules and regulations. Regulations protect the customers, depositors, investors as well as owners of the banks. NRB ensures the compliance of such regulations through effective supervision.

   In order to undertake these responsibilities the NRB monitors over the financial institutions, investigates customers' complaints, reviews accounting standards and requires banks and financial institutions to report their financial activities on a regular basis. Thus, it is the responsibility of Nepal Rastra Bank to find orderly solutions to encounter serious difficulties and in danger of failure of many of the financial institutions – may be due to fraudulent activities or misguided lending practices and preserve public confidence over the financial system.

3. Payment system is the major part of a financial system. Financial system necessarily eases the inconveniencies in payment of goods and services to settle financial deeds and in turn, acquire financial securities. Any disruption in the payment mechanism may seriously affect the economy as a whole. Development and upholding of a safe and efficient payments system is the responsibility of a central bank. The NRB facilitates the financial system with adequate supply of currency and coins as well as clearing cheques.

4. As the fiscal agent of the government, and bank to the government Nepal Rastra Bank furnishes banking services to the government. It issues the treasury bills, redeems government securities, and provides financial services. Nepal Rastra Bank maintains financial relationship with foreign government, International Financial Institutions (IFIs) and foreign central banks.

Major Policy Tools

In order to accomplish its functions, Nepal Rastra Bank Act, 2002 has prescribed following instruments of monetary and financial policies. A combination of various tools can relieve pain of the economy and restore financial health. The Board of Director is the supreme authority to decide monetary, exchange rate and regulatory and supervisory policies. In order to achieve its policy, bank has adopted monetary policy instruments like open market operation, bank rate policy and required reserve ratio.

1. Open Market Operation

Open market operation is one of the important policy equipments with the disposal of the NRB. It involves the purchase and sell of government securities by the NRB affecting the level of money supply in the economy. Open market operation have direct effect on reserves available to depository institutions because they are required to hold reserves equal to certain percentage of their deposit liabilities. Any changes in reserves affect the ability and capacity of the depository institutions to credit extension. Banks and financial institutions create demand deposit while extending credits and affects money supply in the economy.

2. Bank Rate Policy

Depository institutions can borrow through the discount window of the NRB when they fall short of reserves. Interest rate charged on borrowing from the NRB is Bank Rate, which is highly visible, but relatively less effective. It has lag effect in short-term interest rates and thus, it is the signal of the NRB to the depository institutions to bring changes in their interest rates. Bank rate can bring into changes in the behavior of the depository institutions. An increase in the discount rate raises the cost of funds borrowed. However, in real sense, other factors are rarely ever constant and depository institutions' decision to borrow from the NRB is based on several factors other than the discount rate.

Borrowing is a privilege accorded to the depository institutions. NRB urges them to borrow only when they are in a most need and other alternatives are not available. Under normal circumstances, borrowing from the NRB is to meet temporary liquidity needs caused by unexpected deposit outflows or surge in loan demands.

Exceptional circumstances (may be due to natural disaster, closing down of industries, other developments in which their management cannot control or poor management decisions) may badly affect an individual institution and cause it to severe difficulties. It can lead into existing borrowers not repaying loans or depositors withdrawing large amount of funds due to fear over safety and solvency of the concerned financial institution. In such a situation, as the lender-of-last-resort, the NRB stands ready for lending funds for an extended period to help them to adjust to its new circumstances, to provide certain time for managerial reform or to work out merger or orderly closing. As the central bank, NRB mainly concentrates minimizing risks to the public and the financial system as a whole. The lender-of-last-resort preserves public confidence in the safety and soundness of the financial system and depository institutions in particular.

3. **Reserve Requirements**

The NRB requires the depository institutions to hold certain proportion of reserve assets against their outstanding deposit liabilities as required reserve ratio or cash reserve ratio (CRR). The CRR has been gradually brought down to 5.5 percent in July 2003 after the initiation of reforms in the financial sector A lower level of CRR encourages the financial institutions to expand more credit because they require holding less reserve assets so that they have additional funds to invest. It can have significant effect in money supply and reduction in the cost of credit.

Prudential Regulations of Nepal Rastra Bank

A stable and efficient financial system is important for achieving the objectives of high economic growth and reducing mass poverty. Nepal Rastra Bank is the authority to regulate the depository institutions (including specialized financial institutions). Under the Nepal Rastra Bank Act, 2002 maintaining price and financial stability are the objectives of Nepal Rastra Bank. It is empowered to charter different depository institutions, and regulate and supervise them.

Regulation and supervision of commercial banks is the responsibility of Nepal Rastra Bank (NRB) and motivated to maintain financial stability. Regulation includes the licensing the Commercial banks and other depository institution as well. Prudential regulatory norms are based on the Basel guidelines on capital adequacy. Nepal Rastra Bank has been tightening prudential norms to bring it in line with best international practices in the recent years.

Capital Adequacy

The Commercial banks are required to maintain 12 percent of capital adequacy ratio (CAR) based on risk-weighted assets, whereas the international best practice is 8 percent (World Bank, 2003). The CAR was 8 percent in Pakistan, 9 percent in India and Bangladesh, and 10 percent in Sri Lanka. While computing the CAR, capital funds are divided into Core Capital (Tier I) and Supplementary Capital (Tier II). The Tier I capital should be 6.0 percent of total risk-weighted assets. It comprises of paid up capital, share premium, non-redeemable preference shares, retained earnings and general reserves so as it is freely and readily available to meet bank-claims.

Supplementary capital includes general loan loss provisions (at a maximum of 1.25 percent of risk-weighted assets), exchange equalization reserve, undisclosed reserves, assets revaluation reserves, hybrid capital instruments, unsecured subordinated debts and other free reserves. Supplementary capital does not exceed core capital.

Reserve Requirements

Statutory reserve requirements were completely abolished by 1993. All the commercial banks are subject to maintain prescribed Cash Reserve Requirement (CRR). Accordingly, banks require holding 6 percent of deposit liability as a balance with the Nepal Rastra Bank and 2 percent in their own vault.

Asset Quality

Among bank assets term loans are most popular, which is followed by cash credit and other loans. Accrued interest, collectability, and adequate provisioning quantitatively recognize problem assets. Identification of non-performing assets is crucial to stimulate efforts on collection, reduce the volume of such assets, and hence maintain the financial health of banks and financial institutions.

Income Recognition

Income on non-performing assets is recognized on accrual basis, whereas income on non-performing assets is realized only on cash basis. The interest accruals on all loans and advances are recognized on cash basis. Interest accrued but not received is treated as the liability in the balance sheet.

Risk Diversification

Prudential regulations have imposed exposure limits to banks while extending credit to single borrower or group of borrowers. Banks may extend loans and advances up to 25 percent of their core capital on fund based and 50 percent on non-fund based lending to a single borrower or related borrowers. A smaller limit is desirable to enjoy the benefits of diversification of risks so as adverse effects of exposure from credit concentration could be minimal.

Directed Lending

Commercial banks are clearly directed to lend certain portion of credit portfolio to national priority sectors in Nepal. Accordingly, commercial banks require to extend their loans in the productive, priority and deprived sectors of the economy. Out of total loans and advances, banks have to lend (i) 40 percent in productive sector which includes (ii) 12 percent in priority sector and (iii) 3 percent to deprived sector. However, priority sector lending has been phased out gradually by 2003 and it will be eliminated by 2007.

Restructuring of Loans

Banks are authorized to restructure or reschedule their non-performing loans if the borrower requests with action plan along with payment of at least 25 percent of total interest in arrear. Further, restructuring of pass loan is not restricted; however, rescheduled loans are subject to an additional provisioning of at least 12.5 percent.

Classification of Loans and Advances

Loans and advances are classified into four categories, based on information from the banks and financial institutions on the number of days principal and interests are due, and primary as well as secondary sources of repayment.[3] Pass loans are generally current assets. Loans if in arrears, principal, or interest are past due for not exceeding 90 days. Such loans require making provision for loan loss by 2 percent of outstanding balances.

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[3] Primary sources of repayment are cash or its substitute and secondary sources is the collateral or potential for fresh capital.

Substandard loans are either principal and/or interest due are more than 90 days (but less than 180 days) or primary sources of repayment are inadequate to serve loan and the financial institutions must rely on secondary sources or repayment. The credits may not be overdue, but if it indicates poor financial information or inadequate the collateral, are to be classified as substandard. Loan loss provision for substandard loans is 25 percent.

Table: 3.8

Loan Classification of and Provisioning for Loss

S.N.	Classification	Days Past Due	Provisioning
1.	Pass	Up to 90 days	1 percent
2.	Substandard	90 days to 180 days	25 percent
3.	Doubtful	180 days to a Year	50 percent
4.	Loss	More than a year	100 percent

Source: Regulatory Guidelines for Commercial Banks. Nepal Rastra Bank.

Doubtful loans demonstrate all the weaknesses with the substandard one, overdue more than 180 days but less than a year and secondary sources of repayment are poor and indicate low probability of recovery. Banks and financial institutions require keeping 50 percent of outstanding loans as provision for loss. Loss loans are overdue of principal and/or interest for more than a year. have no possibility of recovery (and hence, can no more exist as assets), without charge-off. However, the classification does not mean the asset has no recovery or salvage value absolutely. Cent percent of provision is required to meet for loss loans.

Adequate collateral should back the assets in order to protect the banks and financial institutions from loss of principal (and interest) through its timely disposition in the case of forced liquidation. The net realizable market value of the collateral must be adequate to cover the amount of outstanding loans. Fully secured loans (such as gold, silver, Fixed Deposit Receipts and government securities, as well as loans to the bank staff can be classified into the pass loans, despite the loan is due. On the other extreme, loans without any or inadequate security, borrower declared bankrupt or not found, bills purchased or discounted but not remitted within 90 days or credits utilized other than the proposed projects should be classified into loss category. In the same way, additional provisioning of 20 percent is imposed above the general provision on loans secured by a personal guarantee without any other sources of collateral.

Uninsured priority and deprived sector loans are to be fully provisioned while that for insured would be 25 percent. Unless and until the loans are completely paid by the debtor or it is completely written off, banks are prohibited on adjusting their loan loss provisioning. When banks and financial institutions are out of compliance with provisioning, the NRB can be ask for clarification about the classification of assets and faulty provisioning. If their response is unsatisfactory, they may be ordered to reclassify the loans and advances and make needful adjustment in provisioning within three months. Otherwise, they may be suspended to distribute dividends or loan extension or deposit acceptance as well.

3.5 PERFORMANCE OF COMMERCIAL BANKS

The commercial banks are the largest financial intermediaries dominating the financial system. The role of capital market is dismal in terms of ratio calculated as market capitalization to GDP. Since other financial institutions in the private sector (non-bank as well as OBIs) have come up during the late 1990s or onwards, and they are tinny in size and activity, present study confines with the size, activity and efficiency of the commercial banks.

Total deposit of the banking sector in terms of GDP was 17.4 percent in 1985. It increased to 21.5 percent in 1990 and further increased to 44.8 percent in 2003. Similarly, total loans and advances were13.9 percent and 11.7 percent of GDP in 1985 and 1990 respectively and increased to 27.4 percent of GDP in 2003. The share of credit to the private sector was 54 percent in 1985, 100 percent in 1990 and 97.7 percent of total loans and advances in 2003. Both the ratios of M1 and M2 to GDP have increased by 11.8 and 26.4 percent; 13.8 and 30.5 percent; and 18.41 and 54.05 percent respectively in the corresponding years. Different banks and financial institutions in 2003 undertook more than 90 percent of the transactions in the Nepal Stock Exchange (NEPSE). It also indicates rapid development of the banking sector relative to other sectors of the economy.

Total asset of the commercial banks (aggregate) including commercial banking branches of the ADB was 26.0 percent of GDP in 1990, which increased to 55.2 percent in 2000 and further to 67.2 percent (Rs.305561.4 million) in 2003. Out of total financial assets in the economy, commercial banks were holding 47.1 percent in 1990. It increased to 66.55 percent in 2000 and 68.32 percent in 2003 respectively. Deposit liabilities of all the banks were 82.96 percent of total assets and 21.54 percent of GDP in 1990. This ratio increased to 40.83 and 44.82 percent in 2000 and 2003 respectively. Similarly, Loans to the private sector was 11.65 percent of GDP in 1990, which increased to 25.38 percent in 2000 and 27.37 percent in 2003. In terms of total assets, these ratios were 54.10, 60.80 and 59.67 percent in 1990, 2000 and 2003 respectively.

As of July 2003, total deposit of commercial banking system was 69.42 percent of total liabilities and 83.38 percent of total credit and investment. Their liquid assets were 39.9 percent of total deposit. Out of 17 commercial banks in Nepal (in July 2003), two banks are state controlled, nine of them are joint-venture banks and the rest six are domestic private banks. Table: 3.9 shows commercial banks have 80 percent each of assets and total deposit liabilities, 72 percent of total loans and advances, 88 percent of total investment (mainly consisting of government securities) and 81 percent of liquid fund among all the deposit taking institution. It is followed by Finance companies with assets 13 percent and total loans and advances 19 percent. The development banks and other deposit taking institution have 7 percent of total assets and 9 percent of total loans and advances out of all deposit taking institution.

The number of commercial banks increased from five in 1990 to 17 in 2003, following the ease of entry barriers. The entrance of new banks into the financial system increased competition, and degree of concentration in the banking sector reduced from a three-bank asset ratio of 85.7 percent in 1990 to about 55.9 percent in 2003. However, the market was segmented due to differences in the age, ownership and performance of banks. Total assets of the banking system was Rs. 305561.4 million in 2003 which was 167 times more than that of 1975, 11.38 times of 1990 and 1.46 times of 2000. Major earning assets of all the banks are loans and advances, and investments in government securities. Banks have tendency of portfolio shifts to mitigate risk through the investment in risk-free government securities. It may however reduce the private sector credit.

Table: 3.9

Selected Indicators of Performance of Commercial Banks

(Annual Growth Rate)

Year	Total Assets	Liquid Assets	Capital Funds	Deposit	Loans and adv	Private Sector
1976	8.40	29.75	79.40	30.76	-0.83	-8.95
1980	15.41	-7.94	5.21	15.21	22.24	45.64
1985	24.73	8.52	34.21	19.42	29.73	26.42
1990	18.93	50.96	17.04	17.40	13.91	12.19
1995	14.10	25.59	22.17	17.23	40.95	45.02
2000	21.46	23.40	10.73	21.81	17.82	19.02
2003	11.15	-23.58	15.80	10.12	10.03	10.36
Average						
1975-03	20.27	19.49	33.06	20.42	18.27	20.74
1975-89	19.93	19.79	24.17	22.15	16.68	21.53
1990-03	20.61	19.19	41.94	18.69	19.86	19.95

Source: Banking and Financial Statistics (various issues). Nepal Rastra Bank.

Average annual growth rate of loans and advances between 1990 and 2003 was 18.2 percent. The growth rate was 42.9 percent in 1994 at the highest point and 3.7 percent at the lowest in 2002. The deceleration of the growth rate of loans and advances was mainly due to poor investment environment. Decelerations in both imports and exports and sluggish performance of tourism sector (adversely affected by both internal and external factors) are major reasons for lower growth rate of private sector credit. Out of total credit of the commercial banks, industrial sector accounts highest of 45.2 percent following commercial sector by 32.1 percent, agriculture sector 8.9 percent, and social purpose 7.2 percent as on July 2003. Average annual growth rate of loans and advances between 1990 and 2003 was 13.1 percent and it was reduced to 4.6 percent between the period 1998 and 2003. The growth rate of credit to the private sector has been declining from 44.2 percent in 1994 to 7.1 percent in 2000 and the growth rate further declined to 4.16 percent in 2003.

Liquid assets of the commercial banks had decreased in 1980 and started to increase since 1985 continued until 2000. It decreased by 23.6 percent in 2003. This decline was due to the reduction in CRR. Thus, the growth rate of liquid assets has been fluctuating widely, highest at 50.96 percent in 1990 and lowest at 23.58 (negative) in 2003. Over the period, liquid fund has been growing at an average rate of 19.49 percent during 1975 - 2003 and 19.19 during 1990 - 2003.

Out of total deposit liability of commercial banks, public sector banks and joint venture banks owned 88.1 percent and 11.9 percent respectively in 1990 whereas the share of public sector banks declined to 47.6 percent, joint venture banks increased to 46.8 percent and domestic private banks owned remaining 5.6 percent in 2003. Similarly, loans and advances of public sector banks decreased to 45.2 percent in 2003 from 86.4 percent in 1990, whereas the share of public sector banks increased to 46.5 percent in 2003 from 13.6 percent in 1990. In 2003, domestic private banks owned 8.2 percent of total loans and advances in their asset portfolio.

Sectoral Disbursement of Loans

While studying the commercial banks loan disbursement in different sectors of the economy, the share of industrial credit in total loans has gradually increased from 5.1 percent in 1975 to 18.8 percent in 1985. It further increased to 32.4 percent in 1990 and 45.1 percent in 2000 and remained at 45.4 in 2003. Credit for commercial purpose and general uses were much popular during early years.

Table: 3.10

Share of Sectoral Loan Disbursement

In Percentage

Year	Agriculture	Industrial	Commercial	General/ other	Service
1975	0.06	5.08	45.47	48.04	1.35
1980	0.92	11.96	62.16	20.98	3.98
1985	3.21	18.78	44.08	30.03	3.89
1990	12.98	32.36	28.58	23.61	2.48
2000	8.91	45.13	32.93	7.28	5.74
2003	8.60	45.41	31.29	6.98	7.72

Source: Banking and Financial Statistics (various issues). Nepal Rastra Bank.

The share of commercial loans is declining gradually while that of general uses decreased faster. Commercial credit was 45.5 percent in 1975, which declined to 44.1 percent in 1985. It further decreased to 32.9 percent in 2000 and 31.3 percent in 2003. However, loans for general purposes, which were 48.0 percent in 1975, declined to 30 percent in 1985, which further came down to 23.6 percent in 1990, 7.3 percent in 2000 and 7.0 percent in 2003. Instead, credit to services sector was 1.4 percent of total loan in 1975. It increased, though marginally, to 3.9 percent in 1985, 5.7 percent in 2000 and 7.7 percent in 2003. Loans to agricultural sector were negligible in 1975. It increased to 13.0 percent in 1990. However, the ratio declined to 8.9 percent and 8.6 percent in 2000 and 2003 respectively.

Analysis of Grouped Banks

As a result of easing entry barriers for new banks (and financial institutions), there was a notable increase in competition and a reduction in the degree of concentration in the banking sector, from a three-bank asset ratio of 85.4 percent in 1990 to about 55.9 percent in 2003. Although it is still high, reduced level of concentration is consistent with the declining interest rate spread over the period. The segmentation and competition in banking market contributes on the narrowing of interest spreads. However, it has been difficult to narrow down the spread because of the profit pressures emanated from some marginal banks.

Table: 3.11

Composition of Balance sheet Items of Commercial Banks

Rs. In Millions

Description	Public Sector Banks		Public sector banks		Private Banks
	1990	2003	1990	2003	2003
Capital Fund	64.3	25.5	35.7	54.1	20.5
Deposit	88.1	47.6	11.9	46.8	5.6
Liquid Fund	82.5	39.2	17.5	56.1	4.7
Investment	89.6	35.3	10.4	59.3	5.4
Loans and Advances	86.4	45.2	13.6	46.5	8.2

Source: Banking and Financial Statistics (various issues). Nepal Rastra Bank.

It is worthwhile noting that the market share of assets of this group dropped from 54 percent in 1990 to about 34 and percent in 2000 and 2003. The decline is mainly attributed to the stiff competition among other banks.

Public Sector Banks

Public sector commercial banks are largely controlling Nepalese commercial banking sector. Their share in terms of assets, capital, and deposit is declining with the presence of banks in private sector and other financial institutions.

Total assets of public sector banks was (excluding that of Agricultural Development Bank) 97.4 percent in 1985, and decreased to 87.7 percent to that of commercial banking sector. It declined to 60.2 percent in 2000 and further to 56.6 percent in 2003. The liquid assets was 96.8 percent in 1985 and 82.5 percent of aggregate of commercial banks in 1990, which declined to 48.4 percent in 2000 and 39.2 percent in 2003. Similarly, loans and advances were 97.9 percent in 1985 and 86.4 percent in 1990, which further decreased to 58.8 percent in 2000, and 45.2 percent in 2003. Out of total loans and advances, the share of loans to private sector was 48.4 percent in 1985. It increased to 95.3 percent in 1990 and further increased to 96.8 percent in 2000 and 2003. The structure of investment of public sector banks also showed a declining trend. Total investment of public sector banks was 89.6 percent of total commercial banking sector in 1990, which came down to 54.5 percent and 35.3 percent in 2000 and 2003 respectively. Out of total investment, the share of bonds and debenture is negligible, less than two percent. In the same way, total deposits of public sector banks declined from 84.7 percent in 1990 to 57.0 percent in 2000 and 47.6 percent in 2003 respectively. Out of total deposits share of demand deposits was 19.1 percent in 1990, which decreased to 11.4 and 11.1 percent in 2001 and 2003 respectively. Capital funds of public sector banks are also declining with their share from 64.3 percent in 1990 to 37.6 percent and 25.4 percent in 2000 and 2003 respectively. Despite the restructuring of the 1990s, their financial performance could not improve. They continued making losses throughout the review period. A rigorous restructuring program has been under progress in order to improve the financial health of the public sector banks since 2002.

Joint Venture Banks

The joint venture banks have very few branch network and are concentrated in urban centers. Market share of joint venture banks was 36.3 percent in 2003. Out of total assets of commercial banks, the share of joint venture banks was 2.55 percent in 1985. It increased to 12.3 percent in 1990, 37.9 percent in 2000 and further reached to 38.4 percent in 2003. Similarly, liquid assets increased from 3.2 percent in 1985 to 17.54 percent in 1990. It further increased to 50.7 percent in 2000 and 56.09 percent in 2003 respectively. Loans and advances increased from 2.1 percent in 1985 to 13.6 percent in 1990, which further rose up to 38.6 percent in 2000 and 46.5 percent in 2003. Out of this, loans to private sector were 95.6 percent in 1985. It declined to 86.7 percent in 1990 and again increased to 94.0 percent in 2000 and 96.2 percent in 2003. In their asset portfolio, joint venture banks investment in share and debenture was 13.1 percent in 13.1 percent in 1990, which declined to 2.8 percent in 2000 that increased to 20.5 percent in 2003.

The share of total deposits of joint venture banks was 1.8 percent in 1985. It increased to 11.9 percent in 1990, 40.9 percent in 2000 and 46.8 percent in 2003. Out of total deposit, demand deposits were 54.1 percent and 34.2 percent in 1985 and 1990 respectively. This share changed to 15.9 percent in 2000 and 18.3 percent in 2003. Capital funds of joint venture banks were 17.1 percent in 1985, which increased to 35.7 percent in 1990, 54.6 percent in 2000. It slightly decreased to 54.1 percent in 2003.

Domestic Private Banks

An increase in the number of banks in this group and aggressive competition for deposits with the larger banks, their market share of assets increased from 2 percent in 2000 to 5 percent at the end of June 2003. Liquid assets were one percent in 1998 and increased to 4.7 percent in 2003. Investment portfolio of domestic private banks comprised of government securities 98.2 percent and share bond and debenture 1.8 percent in 2000. The former decreased to 72.3 percent while later increased to 27.7 percent in 2003. Similarly, in 2000, loans and advances were 2.7 percent of total commercial banking sector and increased to 8.2 percent in 2003. Loans to private sector were 97.4 percent in 2000, which increased to 98.1 percent in 2001. On liabilities side, capital fund was 7.8 percent of total capital funds of commercial banking sector and increased to 20.5 percent in 2003. Deposit liabilities were 2.1 percent of total in 2000 and 5.6 percent in 2003. the share of demand deposit was 5.8 percent in 2000 which marginally increased to 6.0 percent in 2003.

Table: 3.12

Performance of Domestic Private Sector Banks

(Rs. in million)

SN	Name of Bank	Bran- ches	Total Assets	Capital Fund	Total Deposits	Loans and Advances
1	NICB	6	4247.7	526.1	3143.9	2564.3
2	Lumbini	4	3651.5	380.5	2959.8	2632
3	Machhapuchhre	5	2431.5	486.4	1778.7	1496
4	Kumari	2	3067.3	348.6	2513.1	2146.4
5	Laxmi	3	1112.1	330	691.8	776.2
6	Siddhartha	1	875.4	350	391.6	629

Source: BFS (41), July 2003, Nepal Rastra Bank, Kathmandu

The increase in loans to private sector indicates a declination of bank lending to public enterprises after the introduction of financial sector reforms. Investment of public sector banks is mostly made in government securities. A declining share of assets, capital fund and deposit of public sector banks to aggregate of commercial banks clearly depicts an increasing competition in the commercial banking sector with existence of private sector commercial banks. A low share of demand deposits with the public sector banks indicates a higher volume of interest bearing deposits with them that may have caused to higher cost of funds. A decline in demand deposits with the public sector banks indicates increasing competition to mobilize resources.

Financial Ratio Analysis

The basic objective of the study is to assess the financial system and its performance in relation to the financial sector reform programme. In this context, it is imperative to assess the overall strength of the banking system as a whole as well as the safety and soundness of each category of the banks. In order to find out the overall strength, quality, efficiency and operating soundness, we are performing an assessment of banks for the compliance of prudential regulations and ratio analysis based on their accounts.

Nepalese banking sector constitutes 90 percent of total assets of the financial system, which is followed by Employee's Provident Fund with 5.1 percent and Finance Companies 3.8 percent (as at July 2003). Commercial banks account for 73.2 percent of total assets of the financial system whereas development banks (including Regional Rural Development Banks) have 19.1 percent and Finance companies 7.6 percent. Total asset of the financial system was Rs. 289.8 million that is approximately equivalent to 65 percent of GDP. The banking sector comprises of 17 commercial banks, out of which 2 are public sector, 9 are joint venture with foreign investment participation and the rest 6 are domestic private banks having 38.8 percent of assets (Appendix: C and World Bank, 2002).

A stable and efficient financial system is important for achieving the economic objectives of economic growth as well reducing mass poverty in Nepal. The performance of financial system can be measured by using various financial statistics and includes population, GDP, per capita GDP, M2/GDP, number of commercial banks, population per bank branch and employees. Bank deposit as percentage of, financial system assets as percentage of GDP can be used as the indicators of claims on government and public enterprises as a percentage of GDP as well as statutory reserve requirement of central bank. (The analysis is based on Appendix tables A through E.)

Asset Position

The analysis of asset quality reflects the quantity and magnitude of credit risk associated with the loan and investment. The large part of assets in Nepalese banks is the loans and advances. It accounted for 32.6, 49.5 and 66.5 percent in the public sector, joint venture and domestic private banks respectively in 2003. Similarly, the ratios were 44.9, 46.8 and 65 percent in 2000. However, the ratios for public sector banks and joint venture banks in 1990 were 44.2 and 49.7 percent respectively.

In 2003, the share of liquid assets to total assets for public sector banks, joint venture banks and domestic private banks were 18, 37 and 20 percent and the ratio of liquid assets to liquid liabilities stands for 32, 44 and 24 percent respectively for each group of the banks.

Investment in government securities is another important asset of commercial banks. In 2003, the ratios of government securities to total assets were 9.2. 18.3 and 11 percent to for public sector, joint venture and domestic private banks in the respective years. In aggregate, loans and advances comprised major portion (40.8 percent) of total assets followed by investment in government securities (13 percent) in 2003.

Leverage Ratio

The Leverage Ratio is the ratio of total assets in the balance sheet to own funds. It is an effective tool in financial analysis. It basically shows the strength of the company in relation to its shareholders funds. The public sector banks have inadequate own funds in comparison to their assets. The ratio was found to be high and fluctuating for public sector banks over the period as 75.13, 28.80, 49.93 and 57.53 times in 1990, 1995, 2000 and 2003 respectively. For joint venture banks, it stood in lower range as 18.99, 18.36, 21.58 and 18.35 times in 1990, 1995, 2000 and 2003 respectively followed by domestic private banks as 37.45 and 9.60 in 2000 and 2003 respectively.

Profitability Ratio

The earning and profitability assessment reflects not only the quantity and trend of earning but also the factors that affect the sustainability or quality of earnings. The Profitability Ratios particularly Return on Assets (ROA) and Return on Equity (ROE) are common in ratio analysis. These ratios are self-explanatory and show the strength of profit in relation to assets and equity capital of the banks and the banking system.

In recent years, the performance of the banking system is not satisfactory in terms of net profit. The public sector banks had major impact on the deterioration of overall profitability because they dominate the banking system. **Return on Assets (ROA)** for the public sector banks, on an average, over the period of 1990 to 2003, was negative by 0.2 percent. They are severely suffering from accumulated loss and have eroded share capital. The ratio for joint venture banks, on an average, was 2.7 percent. In 2003 such ratio for domestic private banks was 1.5 percent.

Return on Equity (ROE) ratios for the public sector bank in 1990 and 2003 were 71.58 percent and 32.42 percent repectively. The ratio over the period was negative except for a couple of years like 1994, 1995, 1997 and 1998 in which it stood positive in between 0.01 to 0.25 indicating some improvements (See Appendix). In contrast, the ROE ratios for the joint venture banks and domestic private banks stood positive over the period (1998 to 2003). The ratio for joint venture banks was 148.9 percent and 43.49 percent in 1990 and 2003 respectively. Similarly the ratio for domestic private banks was 9.51 percent in 2003. The ratio for joint venture bank was really encouraging over the period 1985 to 2003. The ratio also indicates that joint venture banks and domestic private banks are earning profit and are in satisfactory position.

Table No. 3.13

Profitability Ratios

Particulars	Public Sector		Joint Venture		Private
	1990	2003	1990	2003	2003
Return on Assets	-0.0012	-0.003	0.0405	0.0139	0.015
Return on Equity	-0.7158	-0.3242	1.489	0.4349	0.951
Net Interest Income to profit	-8.049	-2.408	1.111	2.191	2.455
Net Interest Margin	0.0098	0.00701	0.0451	0.0305	0.0368

The **Ratio of Net Interest Income to Net Profit** shows the intensity and stood vulnerable over the period. The ratio for the public sector bank generally stood negative ranging in between -8.05 and -0.29 over the period 1990 to 2003 except for couple of years like 1994, 1995, 1997 and 1998 in which it stood positive in between 1.48 to 9.27 whereas the ratio for joint venture banks stood positive and for domestic private banks fluctuating. Nevertheless, the ratio of joint venture banks was decreasing over the period from 10.8 in 1985 to 1.01 in 1995 and 2.19 in 2003.

The **Ratio of Net Interest Margin** finds the difference between interest income and interest expenses and finally establishes the relationship between net interest and total assets. The ratios for public sector banks in 1990 and 2003 were 1.0 percent and 0.7 percent respectively whereas that for JV banks was 4.5 percent in 1990 and 3.0 percent in 2003. Such ratio for domestic private banks was 3.7 percent in 2003.

Liquidity Ratio

Recently commercial banks have shown very good result particularly for liquidity management. The **Ratio of Liquid Assets to Total Assets** for public sector bank was really high in the beginning of 1990's in an average about 0.38 and moderate during the following years, in an average about 0.23. The ratio of joint venture banks stood strong over the period ranging in between 0.35 to 0.53 and that of domestic private banks stood moderate over the period (1998-2003) in between 0.19 and 0.38. Similarly, the **Ratio of Liquid Assets to Liquid Liabilities** has shown mixed result. For public sector banks, it was 0.42 in both 1990 and 1995, 0. 37 in 2000 and 0.32 in 2003. Further for joint venture banks and domestic private banks had held strong position recording in an average 0.53 and 0.25 respectively. These two ratios are common to show the competitiveness of the banks.

The **Ratio of Total Deposit to Total Loan and Advances** stood roughly similar ranging in between 1.30 and 2.43 for public sector banks, 1.08 and 2.15 for joint venture banks and 1.12 and 1.41 for domestic private banks.

Non-Performing Loans

Non Performing Loan (NPL) has been increasing over the years and transforming into a chronic problem. In addition, private sector banks and other financial institutions have also been suffering from this problem. NPL was around 22 percent in 1989, 14.3 percent in 2000 and 28.7 percent in 2003. NPL for public sector banks was in higher range accounting 49.5 percent, 55.6 percent and 60.3 percent in 2001, 2002 and 2003 respectively. It was in lower range for joint venture banks accounting 11.2 percent, 9.8 percent and 8.0 percent in respective years followed by that of domestic private banks 8.0 percent, 10.9 percent and 5.3 percent respectively. The share of public sector banks in NPL is extremely high accounting in an average

82 percent that simply indicates the degradation of quality of loans and concentration as well.

Table: 3.14

Analysis of Non-Performing Loans

(Rs. In million)

Bank Group	Year	GDP	Total Assets	Total Loans	Non-Performing Loans	Provision for Loan Loss	NPL to Total Loans	Net NPL to Total Loans	NPL to Total Assets	NPL to GDP
Public Sector Banks	2001	393566	141685.4	4779.4	2364.6	1607.7	49.5	15.8	1.67	0.60
	2002	405632	160808.3	4629.0	2572.3	2396.2	55.6	3.8	1.60	0.63
	2003	435531	172975.3	4474.1	2697.0	2509.1	60.3	4.2	1.56	0.62
Joint Venture Banks	2001	393566	10438.4	4717.2	528.6	240.6	11.2	6.1	5.06	0.13
	2002	405632	103647.3	5025.0	491.9	315.6	9.8	3.5	0.47	0.12
	2003	435531	117200.5	5693.9	458.1	354.9	8.0	1.8	0.39	0.11
Domestic Pvt. Banks	2001	393566	8402.0	516.8	41.4	9.0	8.0	6.3	0.49	0.01
	2002	405632	10462.4	658.5	72.0	33.2	10.9	5.9	0.69	0.02
	2003	435531	15385.6	1022.4	54.5	40.2	5.3	1.4	0.35	0.01
Aggregate Com. Banks	2001	393566	251525.8	10013.4	2934.6	1857.3	29.3	10.8	1.17	0.75
	2002	405632	274918	10312.5	3136.2	2745.0	30.4	3.8	1.14	0.77
	2003	435531	305561.4	11190.4	3209.6	2904.2	28.7	2.7	1.05	0.74

Source: Banking Supervision Annual Report 2002 - 2003, Nepal Rastra Bank, Bank Supervision Department

Notes 1. Non-performing loans are other than pass loans

2. Net non-performing loans is derived by deducting provision from total non-performing loans.

In order to measure the real quality of loan, the total loans and advances net of provision is compared to total loans and advances. The reason behind the logic is that provision is already charged from profit, which would have become capital, had the charge not made, and risk if credit exposure to the extent of provision made is hedged (Bank Supervision Department NRB: 2003). The ratio of net NPL to total loans for commercial banks (aggregate) in 2001, 2002 and 2003 was 10.8 percent, 3.8 percent and 2.7 percent respectively. The ratio differs significantly for grouped banks. Hence, for public sector banks it accounted 15.8 percent, 3.8 percent and 4.2 percent respectively in 2001, 2002 and 2003. Similarly, the ratio for joint venture banks was 6.1 percent, 3.5 percent and 1.8 percent in review years followed by that of domestic private banks 8.0 percent, 10.9 percent and 5.3 percent respectively.

The amount of non-performing loans to total assets of the banking sector is large due to huge non-performing loans of the public sector banks. The Ratio of Non Performing Assets (NPA) for the commercial banks (aggregate) was 1.2 percent in 2001, 1.1 percent in both 2002 and 2003. The ratio somehow differs for grouped banks. Hence, for public sector banks it accounted 1.7 percent in 2001 and 1.6 percent in both 2002 and 2003. Similarly, the ratio for joint venture banks was 5.1 percent, 0.5 percent and 0.4 percent in review years followed by that of domestic private banks 0.5 percent, 0.7 percent and 0.4 percent respectively.

The ratio of NPL to GDP stood less than one percent during years under review. The Ratio of NPL to GDP on an average stood 0.76 for the commercial banks (aggregate) during the review years. Similarly, the ratio for public sector banks, joint venture banks and domestic private banks stood 0.62 percent, 0.12 percent and 0.01 percent respectively.

Concentration Ratio

Rastriya Banijya Bank, Nepal Bank Limited and Standard Chartered Bank form the major part of the commercial banking sector. The bank concentration in the financial system was assessed on the basis of some vital components that form a major part of sources and uses of funds in financial system as well as on accounts of financial institutions. The ratios of deposit, total loans and advances, and total assets were calculated to find their portion in aggregate amount and thus found to be decreasing over the period from 1989 to 2003. The deposit of three banks had formed 88 percent in 1989 in aggregate. It decreased gradually forming 70 percent in 1995, 56 percent in 2000 and 46 percent in 2003.

Similarly, total loan and advance that formed 93 percent in 1989 also decreased gradually and formed 72 percent in 1995, 59 percent in 2000 and 43 percent in 2003. Further, the concentration of total asset of these three banks in the aggregate followed the same pattern thus forming 89 percent in 1989, 74 percent in 1995, 62 percent in 2000 and 56 percent in 2003. Hence it shows a positive indication for the sound and efficient financial system.

Table: 3.15

Market Share of the largest three banks

In percentage

Year	Capital Fund	Deposits	Investments	Loan & Adv	Pvt. Sector	Total Assets
1989	77.28	88.34	92.11	93.03	93.37	89.13
1990	73.23	84.08	95.16	89.15	89.62	85.37
1991	93.87	82.63	95.70	84.30	84.82	85.36
1992	91.09	78.67	90.86	85.70	86.24	81.68
1993	80.07	77.76	90.91	80.92	80.32	81.08
1994	78.89	74.99	86.48	78.29	78.17	79.44
1995	72.53	70.34	89.13	72.41	72.37	74.44
1996	69.09	65.32	67.81	70.69	70.76	71.53
1997	60.02	62.64	51.70	69.50	69.27	69.63
1998	55.45	62.04	72.71	67.11	67.37	68.35
1999	52.86	60.99	74.33	65.35	66.21	65.24
2000	49.96	55.86	73.18	59.14	59.21	61.83
2001	43.17	50.32	67.81	51.70	51.87	58.02
2002	38.23	48.00	60.22	48.86	48.71	58.06
2003	34.92	45.52	58.11	43.05	42.97	55.88

Source: Various issues of Nepal Rastra Bank BFIS, QEB and Annual Reports

Ratio of Financial Assets to GDP

In 1975, total assets of the financial system were amounted to Rs. 2.52 billion. This figure was Rs. 5.91 billion, Rs. 42.07 billion, Rs. 242.45 billion and Rs. 375.31 billion in 1980, 1990, 2000 and 2003 respectively. It depicts a remarkable increase of over than 800 percentage over the review period. Out of total financial assets, commercial banks' share was 58 percent, whereas that of a central bank, OBI's and NBFI's were 24 percent, 16 percent and 2 percent respectively in 1975. These ratios have not shown any significant shifts over the period recording just normal change. The financial asset of commercial banks accounted 61 percent, 67 percent and 68 percent portion in 1980, 2000 and 2003 respectively. Similarly, the domestic asset of Nepal Rastra bank formed 23 percent, 13 percent, and 10 percent in the consecutive years.

The ratios of financial asset to GDP as well as other ratios like domestic asset of NRB to GDP and financial asset of commercial banks to GDP are calculated. The ratio of total financial asset to GDP was found to be 15 percent, 25 percent, 42 percent, 66 percent, and 88 percent in 1975, 1990, 2000 and 2003 respectively. The ratios of domestic asset of NRB to GDP and financial asset of commercial banks to GDP in 1975, 1980, 1990, 2000 and 2003 were found as 4 percent and 9 percent, 6 percent and 15 percent, 13 percent and 20 percent, 9 percent and 40 percent, 8 percent and 60 percent respectively.

Table: 3.16

Financial Assets to GDP Ratio

In percentage

	1975	1980	1990	2000	2003
NRB Assets to total Financial Assets	0.24	0.23	0.33	0.13	0.10
CB Fin Assets to Total Financial Assets	0.58	0.61	0.47	0.67	0.68
OBIs Assets to total Financial Assets	0.39	0.36	0.27	0.33	0.37
NBFIs Assets to total Financial Assets	0.02	0.02	0.05	0.02	0.04
NRB Domestic Assets /GDP	0.04	0.06	0.14	0.09	0.08
CB Financial Assets to GDP	0.09	0.15	0.20	0.44	0.59
CB Private Credit to GDP	0.05	0.08	0.12	0.29	0.34

Source: Appendix: C

Similarly, the ratio of private credit of commercial banks to GDP was found to be remarkable over the period recording sharp increase in its share. The ratio of private credit to GDP in 1975, 1980, 1990, 2000 and 2003 was found as 5 percent, 8 percent, 12 percent, 29 percent, and 35 percent respectively. The increment of private sector credit and its direction is always important to assess the financial deepening.

Findings and Interpretation:

The above analysis about the structure, evolution, performance and problems and challenges of financial system has clearly depicted the real picture of Nepalese financial system.

Though there were couples of banks and financial institutions, the financial system was not proliferated until 1984. The system was suffering from several problems. The initiation of openness and reforms in financial sector and introduction of market oriented economic policies led for the mushrooming of financial institutions. The investment of private sector as well as foreign institutions has flooded in financial system resulting for diversification of financial system during a short span of time. In addition to this the development of new financial instruments and services, introduction of regulatory framework and institutionalization of savings has certainly created new venues for economic growth and development.

- Nepalese financial system has been proliferated with a varied number of financial institutions.
- New financial instruments and services have been introduced thus providing a space for development and growth.
- The banks in the public sector were suffering with severe problems making the system absolute and unproductive.
- PS banks are found responsible for the deterioration of financial system as they hold a dominant position in terms of deposit taking, credit lending and asset holding.
- High Leverage Ratio reflects the financial weaknesses and poor equity position of the public sector banks. The ratio also confirms that such high ratio is a major source of vulnerability in the institution as well as in Nepalese banking system.
- The performance of the banking system is not satisfactory in terms of net profit and profitability. The ratio simply indicates that JV banks and DP banks are strong whereas PS banks are very unsatisfactory.
- The Ratio of Net Interest Margin does not indicate the strong position for any banks rather show fair for JV banks, unsatisfactory for DP and very unsatisfactory position for PS banks.

- Liquidity ratio shows that banks in Nepalese financial system are competent enough in terms of liquidity. The liquidity ratios for PS banks, JV Banks and DP banks clearly indicate strong position.
- Non Performing Loans has been chronic in Nepalese banking sector and particularly in public sector banks.
- The concentration of three banks in financial system shows a mild picture in recent years. It, in fact is a positive indication for the sound and efficient financial system.
- The commercial banks have maintained the sectoral portfolio concentration ratio below the level of one percent. Thus, the risk posed related lending and other deposit taking institutions has been limited.
- However, the NPL to GDP ratio seems good it does neither indicate nor confirm about asset quality and soundness of the banking sector.

The profitability ratios and some other ratios have clearly indicated for an alarming situation. There was no any other option except to strengthen the financial health and soundness with the introduction of financial sector reforms. Hence, in the beginning restructuring was initiated in these banks following financial sector reforms. It has certainly drawn many positive results in terms of safety and soundness of the system.

3.6 PROBLEMS AND CHALLENGES OF THE FINANCIAL SYSTEM

The financial distress troubled the banking system; in terms of the scale of losses and widespread torment in both the public sector commercial banks including the development banks. Both the banks were technically insolvent and required recapitalization through the budget. Non-performing loans were at the core of both the types of distress, caused by poor loan quality (Booz, Allen and Hamilton - CBPASS, 1990). Political pressure to lend for less creditworthy borrowers was the main reason why these banks incurred substantial level of non-performing loans accounting 60 percent of the total loans. Out of total non-performing loans, the largest share was with the less profitable public enterprises and loans extended to private sector under political or bureaucratic influence. Further, banks were pressured not to disclose the defaulted borrowers. Periodic announcement of loan rescheduling and writing off (in the name of droughts or disasters) encouraged wilful defaulters on the one hand, and weak foreclosure and very lengthy judicial procedure, on the other.

Loan portfolio of the public sector banks was undermined due to poor loan procedures, credit appraisal capacities, lack of monitoring and weak internal control. Overstaffing and overly extended branch networking increased their operating expenses as well. Poor management, insider or connected lending and fraud were also factors to raise the level of non-performing loans. Inadequately diversified assets portfolios, adverse selection of bank borrowers, under capitalization, and poor enforcement of prudential regulation contributed to weak management. However, public sector banks were able to avoid political and bureaucratic pressures and hence financial distress. They have prudent lending policies, experienced management and good internal control system relative to the public sector banks.

Both NBL and RBB have been facing a number of problems including a large amount of non-performing loans in their portfolio and inadequate capitalization. Weak banking supervision, increasing default rates, poor accounting policies and excessive branches in commercially non-viable locations throughout the country weakened the financial health of the public sector banks.

Structural problems like inadequate capitalization, insufficient provisioning for bad debts etc are the major problems of the banking sector. Capital base was far less than the Basle capital accord of 4 percent on core capital (NBL just over 1 percent and RBB below 1 percent). Special budgetary allocation in 1991 allotted Rs. 560 million for capitalization and recover bad loans of those banks guaranteed by the government.

Three public sector banks confined their activities in urban areas and particularly in Kathmandu valley. They were consistently failing to meet obligation regarding the priority sector lending. Main purpose for allowing the foreign banks to operate in Nepal was to promote efficiency in the banking sector through competition as well as transfer of modern technological innovations in the domestic banking sector. Both the objectives were not met due to the concentration of these banks only in the capital city. Their cost of operations was significantly low in comparison to the domestic banks. Their loans portfolios were relatively small but significantly high for the agency (off-balance-sheet) transactions. Inability of authorities to enforce regulations and healthy competition encouraged them not to reduce the lending rates.

The problems and challenges of financial system were summarized in the study reports carried out by Asian Development Bank (2000) and the World Bank (2002). Most of the problems recited in the reports are incorporated with some addition.

Excessive Government Ownership

The major problem in the financial sector in Nepal is the overwhelming dominance of the government. It owns the largest commercial bank RBB and possesses the biggest shareholder in the second largest bank NBL as well as in all the joint-venture banks virtually (all public sector banks are 50 percent Nepali owned with shares generally being held by NRB, NBL, RBB or the Employees Provident Fund). In addition, the government owns two largest development banks ADB and NIDC), insurance companies, Employees Provident Fund, regional rural development banks, and so on. This has ultimately led poor internal governance, weak management, fragile financial health, and an unhealthy politicization of these state-owned institutions.

Role of Central Bank

Nepal Rastra Bank has been questioned for inadequate regulation and supervision of the financial system whereas the government for the domination of the financial system as an owner and operator. One cannot deny the truism for severe problems of the two largest commercial banks and for the general deterioration in the system. However, the central bank was not in a position to discharge its responsibilities adequately. Lack of autonomy, inadequate and outdated legal framework, an excessive number of poorly trained staff and outdated and unproductive structuring handicapped the Nepal Rastra Bank.

The weak and outdated legal framework was among the main sources of the central bank's ineffectiveness. Nepal Rastra Bank Act, 1955 was especially designed for a central bank operating in a government-controlled economy and supervising government-owned banks. Therefore, it was outdated in a complex, modern central bank and banking system. The act did not empower the central bank for effectively managing monetary policy, improving needed financial infrastructure, strengthening and improving financial markets and their supervision, and facilitating the growth of the financial sector. Moreover, its direct participation in the financial sector through representation on bank boards and ownership of development banks has added to its diffuse responsibilities, created conflicts of interest, and undermined its credibility.

Poor Banking Environment

Nepalese financial system has been performing inadequately with outdated and inappropriate laws leading for weaknesses. Other problems also plagued the banking environment, including weak corporate governance, lack of competition, the absence of a sound banking culture, and asymmetries in information.

Weak and Fragmented Legal Framework

The Commercial Bank Act, 1974 has critical gaps in its coverage and growing needs. The legal framework for the financial sector had immediate need for strengthening or amendment in corresponding laws including Company Act, Financial Intermediary Act as well as the enactment of some new laws related to insolvency and liquidation, asset management company, securitization, credit rating, debt recovery etc. Enforcement was inadequate. Virtually there was no action against defaulters. The asset liquidation has rarely been successful.

Another problem was the proliferation of laws and regulations applying to specific institutions rather than generalized banking functions. For example, the Development Banks Act governs neither of the two largest development banks. Such institution-specific laws and regulations have created a fragmented legal environment and hence a fragmented financial system.

Weak Corporate Governance

Corporate governance has been extremely weak in Nepal. There are no clear rules of engagement between a company's management, its board, its shareholders, and other stakeholders. In addition, weak systems, poor procedures, and information asymmetry. Accounting and auditing practices were weak. Many banks did not provide financial statements on time and did not maintain up-to-date, externally audited financial data.

The government's involvement in financial system had led for the conflicts of interest. Many banks and other financial institutions have interlocking ownership, with Nepal Rastra Bank playing a prominent role. Despite its supervisory role, Nepal Rastra Bank funds some development banking activities and holds share in several banks. Some central bank officials represent on the bank boards. Similarly, cross holding of bank shares was a serious problem.

Lack of Competition

Although Nepal's financial system has been proliferated over the past decade, it still lacked the competitive environment required for proper financial intermediation required for the benefit of borrowers, depositors and other users of financial services, and shareholders. The lack of competition reflects the fragmentation of the system and dominance of the two large banks. It also reflects the inability of government to ensure efficient and cost-effective banking services.

Poor Banking Culture

The elements of a good banking culture are almost nonexistent in Nepal, whether among banks or among their customers. Banks find it difficult to make informed lending decisions because many of their private sector clients fail to maintain good financial information on their activities or are unwilling to reveal their true financial position. As a result, firm level data are largely unreliable, and banks are forced to reconstruct firm accounts from client estimates. Even when banks can undertake a proper financial analysis, they often extend credit on the basis of collateral rather than credit worthiness. Lenders always request primary collateral, and request secondary collateral or guarantees if needed. They assess the value of the collateral initially and do not re-evaluate it regularly. The Credit Information Bureau maintains a blacklist of customers however, is hindered in its operations by the inability or reluctance of the banks and financial institutions providing required data.

Another part of the problem lies in the implementation/enforcement of the prudential regulations. The large banks maintain high real interest rates and margin spreads to cover high operating costs and large losses, while private small banks are able to earn substantial profits by hiding behind these high prices. As a result, private banks have not been forced to compete for more customers or to expand their activities outside a few main cities. They merely offer much better service at the prices set by the large banks.

Non-Performing Loans

Increasing non-performing loans is one of the severe problems in the public sector banks. It was around 22 percent in 1989. Main reason behind this was the extension of loans without prudent appraisal, external pressure, inadequate monitoring and supervision both by individual banks and central bank. Similarly, other causes for this are enforcement problems of penalties against any violations of banking regulation and ever-increasing amount of loans guaranteed by the government for the public enterprises. Private sector as well as publicly owned banks and financial institutions have been suffering from the problem of NPAs. However, the level differs from one institution to another. No doubt, the NPAs are weakening the allocation, delivery, and recovery of credit, which ultimately affects future investment and economic growth.

Information Asymmetry and Lack of Financial Sophistication

The public, in general has limited knowledge of the financial position of banks and little access to financial information. Further, they are financially unsophisticated and do not understand the accounts and annual statements of financial institutions. Financial institutions do not provide neither timely nor reliable accounts even if audited. Moreover, accounting and auditing practices Nepal do not conform to international standards.

Corruption

In Nepal, corruption has been a big contributor to the poor financial health of most of the financial institutions. The problem has been chronic because of insufficient regulation and supervision, a weak legal environment, poor corporate governance, poor accounting and auditing standards, and poor banking culture. In addition, fraud, self-dealing, insider dealing, and improper evaluation of collateral have been among the reported abuses. Such actions have shifted resources from the poor and to the rich.

Inadequate Banking Services for the Poor

Nepal government has always emphasized the social dimensions of banking. Notwithstanding this, most of the policies aimed at benefiting the poor (directed credit, branch opening policies) are too broad creating considerable operating disincentives in financial sector. These policies usually have a minimal or even negative impact on their intended target audience and insufficient delivery mechanisms as well. Further development banks and state-dominated micro-finance institutions have failed to produce the intended results and created large contingent liabilities for the government.

3.7 CONCLUSION

The banks in the public sector were suffering with severe problems; they were responsible for the deterioration of financial system as they had a dominant position. In order to strengthen the financial health and soundness, restructuring was necessary in these banks. The above analysis about the structure and performance has clearly depicted the picture of financial system and its problems. In addition, it has provided with the problems and challenges of overall financial system.

The importance of the financial sector was recognized as the groundwork for economic growth and poverty alleviation. A healthy financial sector can contribute more for economic development through efficient domestic resources mobilization. Various reforms were initiated in the Nepalese financial system since mid-1980s and are continuing. Reforms were generally aimed at correcting the problems of the public sector banks (Rastriya Banijya Bank and Nepal Bank Limited) particularly about portfolio problem, operational performance, and management capability.

Although, restructuring plans for the two public sector banks were formulated in 1992 following the diagnostic CBPASS study, the implementation was slow and cumbersome. The government recapitalized both banks in 1993. New credit policy guidelines with standard credit appraisal procedure were introduced. In the mean time organization has been modified introducing banking operation and recovery departments. However, only the Nepal Bank (NBL) made little progress in implementing the restructuring plans. It reduced staff and improved credit policies. True financial condition could not be assessed because of unavailability of up-to-date accounts. The Rastriya Banijya Bank (RBB) made few efforts to implement reforms, but continued to lend heavily to loss-making enterprises and was unable even to produce financial information and audited balance sheets.

The performance analysis clearly shows enough diversification and growth in banking services. The varied banks and financial institutions along with their nationwide branch networking have overwhelmingly provided the access of financial services to the mass, financialization of saving. It has provided the backup and pace for financial development, growth and financial deepening.

Next two chapters are especially designed to assess the effectiveness of Financial Sector Reforms empirically.