

# NEPAL RASTRA BANK

*Then, Now and Ahead*



April 2014





**Published by**

**Nepal Rastra Bank**

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# Foreword

Transparency, accountability and effective communication with the general public are indispensable characteristics for the legitimacy of a well-functioning central bank. This publication provides a compact and easily readable introduction to the Nepal Rastra Bank (NRB) from the historical and futuristic perspectives: then, now and ahead. Using the present as a reference point, the publication presents the history of NRB from its establishment to the present – this is the “then” component. The “now” component has two parts: the first part deals with the present structure of NRB and the second part discusses NRB's major functions. The final component, which looks “ahead”, peeps into the expected challenges and the measures to be undertaken to face those challenges. This publication will serve as an accessible handbook about Nepal Rastra Bank.

This publication has come out from the hard work of our staff and senior officials. In this context, I would like to acknowledge the effort of the whole team at the Office of the Governor in bringing out this publication. I would like to thank them all for their enthusiastic involvement and valuable contribution in this work. I would also recognize the assistance of Mr. Rishikesh Bhatta, Manager; Ms. Sita Ghimire, Acting Director; Mr. Ashok Kumar Paudel, Deputy Director; Mr. Ganesh Man Maharjan, Assistant Director; and Ms. Sajana Silpakar, Assistant Director of this bank.

I hope this publication will be able to provide a greater understanding of the responsibilities of NRB and can be taken as a step to promote greater financial literacy. This should also be useful for all those who hold a keen interest in the evolution and historical development of Nepal Rastra Bank.

Dr. Yuba Raj Khatiwada  
Governor

April 2014



# List of Acronyms

ACU	:	Asian Clearing Union
ADB	:	Asian Development Bank
AML	:	Anti-Money Laundering
APRACA	:	Asia Pacific Rural and Agricultural Credit Association
BFI	:	Banks and Financial Institutions
BIS	:	Bank for International Settlements
BTC	:	Bankers' Training Center
CFT	:	Combating Financing of Terrorism
CICTAB	:	Centre for International Co-operation and Training in Agricultural Banking
DRT	:	Debt Recovery Tribunal
FIU	:	Financial Information Unit
FSAP	:	Financial Sector Assessment Program
FSDS	:	Financial Sector Development Strategy
FSOC	:	Financial Sector Oversight Committee
FSAP	:	Financial Sector Assessment Program
FSRP	:	Financial Sector Reform Program
FSU	:	Financial Stability Unit
GoN	:	Government of Nepal
ICAAP	:	Internal Capital Adequacy Assessment Process
ICT	:	Information Communication Technology
IMF	:	International Monetary Fund
KYC	:	Know Your Customer
NBL	:	Nepal Bank Limited
NGOs	:	Non-Governmental Organizations

NRB	:	Nepal Rastra Bank
OMO	:	Open Market Operation
PCA	:	Prompt Corrective Action
PRGF	:	Poverty Reduction and Growth Facility
RBB	:	Rastriya Banijya Bank
RSRF	:	Rural Self Reliance Fund
SAP	:	Structural Adjustment Program
SEACEN	:	South East Asian Central Banks Research and Training Centre
SEANZA	:	South East Asia, New Zealand and Australia Central Banker's Forum
SLR	:	Statutory Liquidity Ratio
SMK	:	Sadar Muluki Khana
TSA	:	Treasury Single Account
WB	:	World Bank
WTO	:	World Trade Organization

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List of Acronyms

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## **Part I**

### **Historical Background**

The basis for establishment of Nepal Rastra Bank, the Central Bank of the Federal Democratic Republic of Nepal, was rooted in the 1950s in an environment of dual currency in circulation - both Nepalese and Indian currencies circulating side by side as the legal tender. The exchange rate between these two currencies was highly unstable and volatile. At that time there was only one commercial bank in operation. The economy was least monetized and there was a very low level of development of the domestic financial sector. Likewise, Nepal had insignificant interaction with the outside world other than India and China.

In this rudimentary domestic financial and monetary system, Sadar Muluki Khana (SMK), which managed the Government Accounts and had also issued first Nepalese currency notes in 1945, had virtually no role in development and oversight of the Nepalese financial sector. This factor largely propelled the need for a modern central bank in the country.

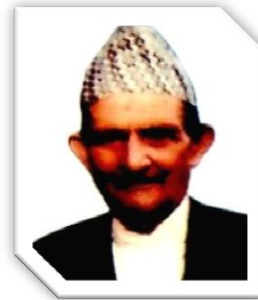
## ***Khajanchees (Cashiers) of Sadar Muluki Khana & their Tenure***



Mr. Janak Raj  
(Tenure : NA)



Mr. Bharat Raj  
(..... - 1952)



Mr. Narendra Raj  
(1952 - 1956)

Keeping this situation in view, the Nepal Rastra Bank (NRB) was established on 26 April 1956 with the objectives:

- to widen the circulation of domestic currency;
- to stabilize the exchange rate of the Nepalese currency vis-à-vis the Indian currency;
- to expand the banking network in the country; and
- to evolve policy instruments for monetary management.

## **Governors & their Tenure**

Mr. Himalaya Shumsher JBR provided the leadership to the Nepal Rastra Bank as the founding Governor.



Mr. Himalaya Shumsher JBR  
(26 April 1956 – 7 February 1961)

The following section deals with the major developments of Nepalese financial sector and achievements of Nepal Rastra Bank decade-wise proceeded by the list of Governors depending on when their tenure commenced.

During the remaining period of the first decade of establishment (1956–66), Mr. Laxmi Nath Gautam and Mr. Pradyumna Lal Rajbhandari led the Bank as second and third Governors respectively.



Mr. Laxmi Nath Gautam  
(8 February 1961–17 June 1965)



Mr. Pradyumna Lal Rajbhandari  
(18 June 1965–13 August 1966)

During the first decade, the NRB primarily focused on enhancing the circulation of the Nepalese

currency throughout the country by expanding its branches. Similarly, Nepalese currency was also made available through the establishment of currency chests in the commercial banks. Further, the Bank had also initiated efforts to stabilize the exchange rate between the Nepalese currency vis-à-vis Indian currency. Later, the Foreign Exchange Regulation Act, 1963 was enacted, which empowered the NRB as the custodian of foreign exchange reserves of the country. By the end of the first decade, the Bank had succeeded in replacing the wide circulation of Indian currency by the Nepalese currency. Likewise, during this decade, the foundation for relationship with international organizations was set through commencing membership with the International Monetary Fund (IMF) and the World Bank (WB) from 1961.

During the second decade (1966-76) of NRB, Dr. Bhekh Bahadur Thapa, Dr. Yadav Prasad Pant and Mr. Kul Shekhar Sharma had respectively provided the leadership to the Bank as the fourth, fifth and sixth Governors.



Dr. Bhekh Bahadur Thapa  
(14 August 1966 – 26 July  
1967)



Dr. Yadav Prasad Pant  
(24 April 1968 – 18 April  
1973)



Mr. Kul Shekhar Sharma  
(29 April 1973 – 12 December  
1978)

The second decade is characterized as a period of expansion of the domestic financial sector. This decade resulted in the evolution of monetary instruments and guidelines of the NRB, which is related, among others, to:

- credit control;
- fixation of interest rates;
- margin rates;
- refinance rates;
- cash reserve requirement;
- liquidity requirements;
- credit limit; and
- directed credit programmes.

During this period, economic policy of the Government of Nepal (GoN) had focused on strengthening internal economic activities and promoting the import substituting industries. In order to diversify and promote exports, both commodity-wise as well as country-wise, an incentive based trade regime called *bonus voucher* was introduced. This mechanism entitled exporters to third countries with additional incentives. International relations had also been established with Asian Development Bank, ADB (1966); South East Asia, New Zealand and Australia Central Banker's Forum, SEANZA (1968) and Asian Clearing Union, ACU, (1975).

During the third decade (1976-86) of NRB, Mr. Kalyan Bikram Adhikari and Mr. Ganesh Bahadur



Thapa respectively provided leadership to Nepal Rastra Bank as the seventh and eighth Governors.



Mr. Kalyan Bikram Adhikari  
(13 June 1979 – 8 December 1984)



Mr. Ganesh Bahadur Thapa  
(25 March 1985 – 22 June 1990)

The third decade was a period of massive banking expansion in which the Bank played an active role in promoting development financing along with growing emphasis on attracting assertive domestic and foreign private sector investments in the financial sector. Policy measures taken during this decade ranged from downward revision in the interest rate structure to credit ceilings and directed credit programmes. During this period, the focus was on widening institutional set-up for monetary deepening and formulating directed credit programmes to provide institutional facilities to targeted sectors, regions and groups of the society. Meanwhile, the GoN continued the incentive based trade policy. To support the policy of GoN, the NRB introduced a dual exchange rate system: an auction system with regard to convertible foreign currencies and a fixed rate with the Indian currency. International relations had also been established with Asia Pacific Rural and Agricultural Credit Association, APRACA (1977), South East Asian Central Banks (SEACEN)

Research and Training Center (1982), and the South Asian Association for Regional Cooperation (1985).

During the fourth decade (1986-1996) of NRB, Mr. Hari Shankar Tripathi and Mr. Satyendra Pyara Shrestha, provided the leadership as the ninth and tenth Governors.



Mr. Hari Shankar Tripathi  
(10 August 1990–17 January 1995)



Mr. Satyendra Pyara Shrestha  
(18 January 1995–17 January 2000)

The fourth decade can be characterized as a decade of accelerated financial liberalization. It was complemented by restructuring and economic stabilization along with the overall economic liberalization policy of the GoN. Liberal economic policies were initiated in the wake of persistent balance of payments crisis that surfaced in the early 1980s. These reforms were introduced in 1987 under the aegis of the Structural Adjustment Program (SAP) with the financial support of the IMF. This decade also saw major changes in the policy measures such as deregulation of interest rate in 1989; moving from direct to indirect methods of monetary control, emphasizing Open Market Operations (OMO) as the major policy tool; abolishing the provision of Statutory Liquidity Ratio (SLR) in 1993; and permitting market-

determined exchange rate of the Nepalese currency against convertible currencies and full convertibility of the Nepalese currency in the current account. The latter is reflected by the acceptance of the Article VIII of the Articles of Association of the IMF on 30 May 1994. Thus, during the second, third and fourth decades of its establishment, the NRB was able to steer the deepening of the domestic financial sector. This period marks the transformation of the role of NRB from merely providing financial services to prudential regulation and supervision of financial institutions in a dynamic manner.

During the fifth decade (1996-2006) of NRB, Dr. Tilak Bahadur Rawal, Mr. Dipendra Purush Dhakal and Mr. Bijaya Nath Bhattarai respectively had provided the leadership as the eleventh, twelfth and thirteenth Governors.



Dr. Tilak Bahadur Rawal  
(31 Jan. 2000–28 Aug 2000)  
(9 April 2001–28 Jan. 2005)



Mr. Dipendra Purush Dhakal  
(29 Aug. 2000–8 Apr. 2001)



Mr. Bijaya Nath Bhattarai  
(18 Jan. 2005–15 Jan.  
2009)

Mr. Bijaya Nath Bhattarai  
(18 Jan. 2005–15 Jan. 2009)

The fifth decade can be broadly categorized into two parts. The first part was characterized by greater financial sector deregulation and liberalization along

with emerging challenges, namely, growing financial sector fragility; increased non-performing assets in the two large commercial banks of Nepal viz. Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB); and increasing depth and sophistication of the financial system through integration in the global economy. The later part of this decade was characterized by financial sector reform aimed at improving the efficiency and effectiveness of the domestic financial sector to face challenges encountered by the ongoing global transformation.

During this period, the two state-owned commercial banks simultaneously encountered problems of huge non-performing loans (above 60%) and negative net worth. This called for an aggressive reform package. Hence, the domestic Financial Sector Reform Program (FSRP) was started in 2002 with the cooperation from the WB. The three major components of FSRP were:

- (1) Re-engineering of NRB;
- (2) Restructuring of NBL and RBB; and
- (3) Capacity building in the financial sector.

These components were aimed at accomplishing all the programs as mentioned in the Financial Sector Strategy Paper of GoN, which was publicly announced on November 22, 2000.

The financial sector reforms in the latter part of the fifth decade were initiated under the aegis of the IMF

supported program of Poverty Reduction and Growth Facility (PRGF). In addition, there have been a number of initiatives to meet the increasing challenge of regulation and supervision of the domestic financial institutions. The promulgation of Bank and Financial Institutions Ordinance, 2004, an umbrella act governing different financial institutions acts, was a bold initiative undertaken to address this challenge. Also, the Debt Recovery Act was introduced which paved the way for the establishment of a Debt Recovery Tribunal (DRT) in 2002. The amendment of the Public Debt Act and the Foreign Exchange Regulation Act also took place during this decade. During 2004, international relations were established with the World Trade Organization (WTO) and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) as well as agreed to a framework for a South Asian Free Trade Agreement (SAFTA).

The most salient achievement of financial sector reform is the enactment of the Nepal Rastra Bank Act, 2002, which addresses the challenges brought by the emerging financial sector and also focuses on the role of the Bank on effective monetary management and financial sector stability. The Act explicitly lays down the Bank's primary functions, which are:

- To formulate necessary monetary and foreign exchange policies in order to maintain the stability in price and consolidate the balance of payments



for sustainable development of the economy of the country;

- To develop a secure, healthy and efficient system of payments;
- To make appropriate supervision of the banking and financial system in order to maintain its stability and to foster sound and healthy financial sector;
- To further enhance the public confidence in entire banking and financial system.

As per the mandates of the Nepal Rastra Bank Act, 2002, the Bank has started to publicly announce its annual monetary policy since.

During the ongoing sixth decade (2006 - present) of NRB, Mr. Deependra Bahadur Kshetry had provided the leadership as the fourteenth Governor. At present, starting from 19 March 2010, Dr. Yuba Raj Khatiwada, a prominent economist, is providing leadership to the Bank as its fifteenth Governor.



Mr. Deependra Bahadur Kshetry  
(16 Jan. 2009–26 July 2009)



Dr. Yuba Raj Khatiwada  
(19 March 2010-till present)

The sixth decade is characterized by financial sector consolidation and governance reform in a period of political fluidity. While the regulation and supervision of the financial sector under the purview of the NRB has become more systematic and rule-based, dynamic and step-by-step issuance of by laws, rules and regulations and directives; have resulted in a gradual correction of the risks and governance deficits in the financial system. As a sudden and strict implementation would have a negative impact on the health of the domestic financial system and thus financial stability, a prudent sequencing of the reforms is made to enable the financial system to cope with the new rules and regulations. The period, which is still continuing, was characterized initially by domestic insurgency and ongoing political fluidity – both having an effect on the path of financial sector development and also contributing to the asset price bubbles, stock market volatility, BOP problems in 2010, liquidity crunch and distortions in governance. Nonetheless, these non-economic challenges are being efficiently handled in a mature and cautious manner by the current leadership of the Bank and so far have averted any serious financial crisis and its contagion effect.

## Part II

### The Present Structure of NRB

The Nepal Rastra Bank Act, 2002, provides guidance to the present organizational structure of the Bank. To discharge its statutory functions, duties and powers, the structure of the NRB is formulated in two levels: the macro and policy level. The Bank is governed by a Board of Directors consisting of following seven members –

- Governor (as Chairperson);
- Secretary to the Ministry of Finance of the GoN;
- Both the Deputy Governors;
- Three other appointees as member appointed by the GoN for a five-year term.

#### Board of Directors

The Board of Directors is responsible for necessary formulation of Bank related by-laws, rules, regulation, guidelines as well as its overall management. Presently officiating members of Board of Directors are as follows:



#### **Chairman & Governor**

Dr. Yuba Raj Khatiwada

2010/03/19 - upto five years



**Member**

Mr. Yuba Raj Bhusal  
Secretary, Ministry of Finance  
2014/03/10 - Till Finance Secretary



**Member & Deputy Governor**

Mr. Gopal Prasad Kaphle  
2010/12/27 - upto five years



**Member & Deputy Governor**

Mr. Maha Prasad Adhikari  
2010/12/27 - upto five years



**Member**

Prof. Dr. Sri Ram Poudyal  
2012/03/29 - upto five years



**Member**

Dr. Ramhari Aryal  
2012/03/29 - upto five years



**Member**

Mr. Bal Krishna Man Singh  
2013/02/15 - upto five years

There is an Audit Committee under the Board of Directors, which is headed by one of its member in a non-executive capacity. The Internal Audit Department reports to the Board of Directors through the Audit Committee. The Nepal Rastra Bank Act, 2002 has also a provision for a Management Committee, which is chaired by the Governor and both Deputy Governors being its members. The execution and implementation of necessary decisions taken by the Board of Directors and the top management of the NRB, is done through the Office of the Governor, which disseminates the information. The two Deputy Governors also act as deputy executive chiefs of the Bank.

### **Functional Classification and Responsibilities**

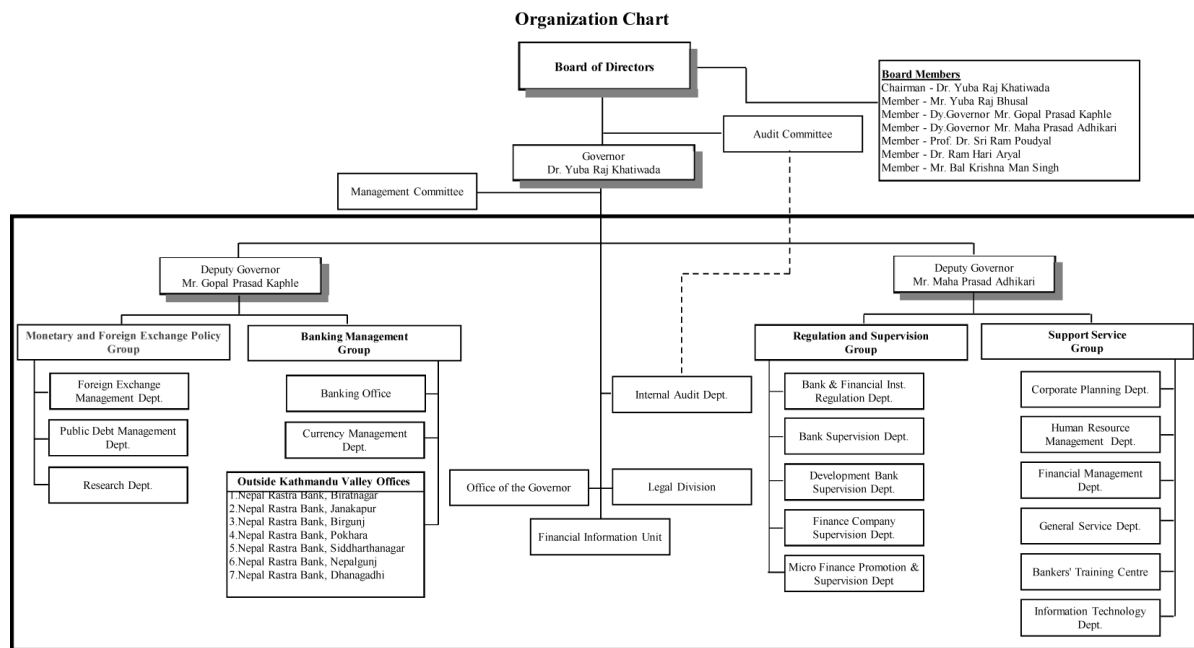
To facilitate the execution of the decisions issued by the Board of Directors and the Management Committee, the operational level of the Bank has been accordingly streamlined and its organizational structure has been broken down into four functional groups namely:

- (A) Monetary and Foreign Exchange Policy Group;
- (B) Bank Management Group;
- (C) Regulation and Inspection Group and;
- (D) General Services Group

The two Deputy Governors undertake the responsibility of overseeing two groups each. Currently, the Governor directly supervises Office of the Governor, Legal Division and Financial Information Unit.



## Organogram



Based on the organogram, the following are the functional classification of the Bank activities and responsibilities provided by respective Departments, divisions and district offices:

### (A) Monetary and Foreign Exchange Policy Group

The following three Departments discharge the group of functions:

1. **Research Department**– the Department monitors domestic and international macroeconomic and financial situation and undertaken review, as well as projection of the real, fiscal, monetary and external sectors of the economy. The Department is responsible for collection, compilation, analysis and dissemination of various statistics, such as balance of payments statistics, monetary statistics, and price related statistics. It also conducts different special studies, which are helpful for

formulating economic policies and macroeconomic forecasting for the Government and the NRB itself. Research Department coordinates the compilation of various information that are necessary for formulation and announcement of monetary policy as well as preparing reports including NRB annual report. The Department supervises the Central Library and hosts the IMF Resident Representative Office. The Department also prepares the Current Macroeconomic Situation (monthly report), Quarterly Economic Bulletin and the *NRB Economic Review*, a bi-annual peer reviewed journal.

2. Foreign Exchange Management Department– the Department is responsible for management of foreign exchange transactions and foreign exchange reserves as well as decides on foreign exchange interventions to balance the demand and supply of foreign currency in the market. The Department also provides license to remittance and currency exchange companies and supervises them. It has a primary responsibility of facilitating ACU related transactions.
3. Public Debt Management Department– the Department handles all aspects of domestic public debt management of the GoN from preparing the issue calendar, distributing the debt, and accounting as registrar to the debt. In

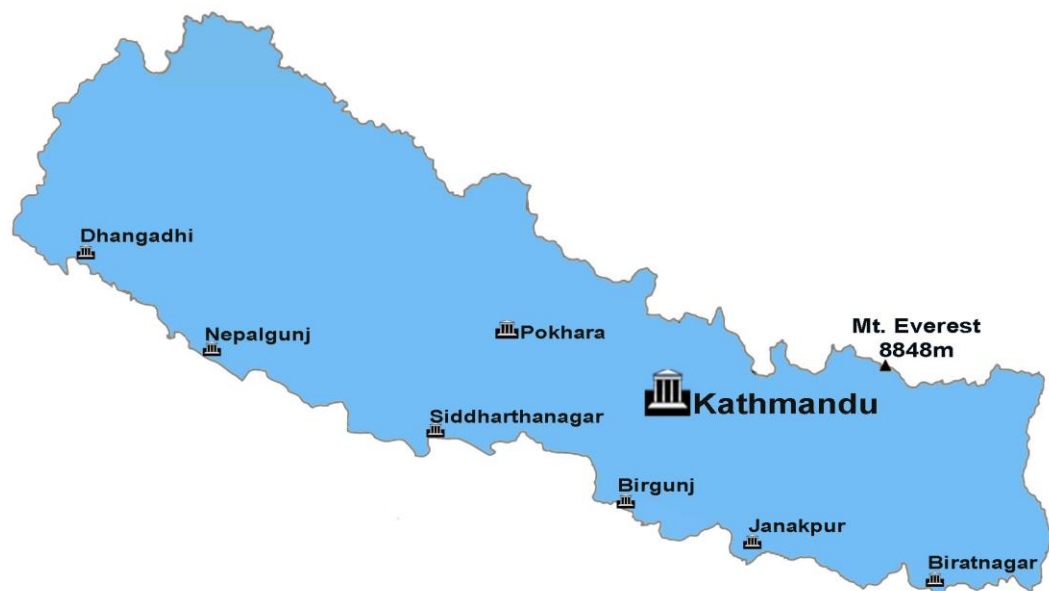
addition to being the secretariat of the OMO committee, the Department implements the decisions regarding OMO in order to manage liquidity in the money market.

## **(B) Banking Operation Group**

The functions of this group are discharged by the following office, Department and network:

4. Banking Office – the Banking Office manages government transactions, government revenue and expenditures through Treasury Single Account (TSA). This Office also acts as a clearing house for payments and settlement. It also deals with the foreign exchange payments and settlement transactions. The Banking Office also oversees the management of Money Museum and also manages IC Currency chests selected in NRB Offices and commercial bank branches.
5. Currency Management Department– the Department is responsible for management of paper money/notes and coins, which includes designing of notes, issuance of notes, transferring of notes all over the country and destruction of soiled notes. The Department also manages currency chests in NRB and commercial bank branches.
6. Offices Outside Kathmandu Valley– there are seven offices outside of the Kathmandu Valley. In general, these Offices have three main functions:

(1) circulation of currency (in coordination with Currency Management Department); (2) managing government transactions (in coordination with Banking Office); and (3) monitoring and reporting of local economic activities (in coordination with the Research Department). In addition, these Offices also prepare yearly and half yearly economic activities study report pertaining to the local economic activities at the district level. These seven NRB offices are located in Biratnagar, Janakpur, Birgunj, Pokhara, Siddharthanagar, Nepalgunj, and Dhangadhi. The location of each these offices reflect the geographical spread as are shown in figure below:



NRB offices operating outside the valley are the mirror image of various central level units operating in the Kathmandu Valley.

### **(C) Regulation and Supervision Group**

The following five Departments discharge the group of functions:

7. Banks and Financial Institutions Regulation Department – the Department is responsible for policy-related and regulatory matters regarding banks and financial institutions (BFIs), which are categorized as A, B, C and D class license for commercial banks, development banks, finance companies and micro finance development banks respectively. The Department also monitors domestic financial stability and prepares *Financial Stability Report* bi-annually.
8. Bank Supervision Department– the Department is in charge of on-site and off-site inspection and supervision of "A" class banks. In addition, this Department is also responsible for studying and implementing international best practices such as stress testing and risk management guidelines; developing the guidelines for risk-based supervision and implementing it; facilitating the implementation of Basel III from Basel II. The Department is also responsible for continuous improvement and implementation of "Prompt Corrective Action".



9. Development Bank Supervision Department - the Department is in charge of on-site and off-site inspection and supervision of development banks.
10. Finance Company Supervision Department - the Department is in charge of on-site and off-site inspection and supervision of finance companies
11. Micro Finance Promotion and Supervision Department – the Department, in addition to on-site and off-site inspection of Micro Finance Institutions (licensed by the NRB), is also responsible for micro finance promotion activities such as promoting financial literacy and microcredit in areas where people are deprived from access to formal financial services. This Department is also responsible for studying international best practices to promote microfinance activities in the country. The Department handles various projects including Rural Self-Reliance Fund (RSRF).

#### **(D) Support Services Group**

The following six Departments and one centre discharge the group of functions:

12. Corporate Planning Department – the Department is in charge of formulating NRB Strategic Plan and also for monitoring and evaluating progress related to current NRB Strategic Plan. This Department is involved in internal budget formulation, evaluating fund release and monitoring it. The Corporate Planning

Department is also responsible for undertaking risk analysis as well as assessing and evaluating the Bank's technical cooperation. Additionally, this Department is continuously monitoring probable risks to the Bank and it periodically reviews and analyzes the risk mitigating techniques.

13. Human Resources Management Department – the Department is responsible for staff recruitment, training, placement, transfers, appointment, monitoring, deputation, promotion and development. It also keeps the inventory record of existing and retired personnel. Recommendation for salary and perks fall within the domain of this Department.
14. Financial Management Department – the Department handles payments and expenditures of the Bank and also manages the staff pension/retirement fund.
15. General Services Department – the Department handles procurement, construction of physical facility, maintaining existing property and overall management of transportation among others. This Department is also responsible for activities relating to overall NRB staff welfare, such as clinic, cafeteria and parks among others.
16. Bankers' Training Centre – the Centre is responsible for providing training to both NRB employees and its stakeholders. It is also the secretariat for international trainings, seminars and workshops.

17. Information Technology Department – the Department is responsible for managing Information Communication Technology (ICT) related hardware and software to ensure smooth, prompt and quality services in the Bank. This Department also prepares necessary software and provides advice to the Bank in IT related matters.
18. Internal Audit Department – the Department monitors and verifies the compliance of rules and regulations in different Departments, divisions and offices within the NRB, as per prescribed guidelines. This Department acts as secretariat to the Audit Committee, which is headed by a non-executive member of the Bank's Board of Directors.

The following office, division and units are under the direct supervision of the Governor:

19. Office of the Governor - the office includes the personal secretariat of the Governor, the secretariat of both Deputy Governors and the secretariat of the Board of Directors. The office also has two divisions – Public Relations and International Relations. The Office of the Governor regularly publishes *Mirmire* - a bi-monthly staff journal and Nepal Rastra Bank News.
20. Legal Division – the division is responsible for giving legal advice to the NRB as well as representing the Bank in the courts, whenever necessary. It is also

responsible for all the legal matters, such as providing assistance to formulate new acts, by-laws, rules and regulations among others, as well as the amendment of them.

21. Financial Information Unit – the unit coordinates and records financial transactions and provides the information to the GoN as and when necessary. It also acts as the secretariat to AML/CFT.

## Part III

### NRB Functions

#### **(A) Monetary Management**

As envisaged by the NRB Act, 2002, the Research Department of the Bank drafts annual monetary policy and its mid-term (half yearly) review, which is discussed in Management Committee and Board of Directors prior to public release. The report contains both a comprehensive review and evaluation of the previous monetary policy as well as justification and analysis of the proposed monetary policy that the Bank is going to announce. The monetary policy has been dynamic as per the country's need and has been addressing the prevailing domestic as well as international macroeconomic and financial situation. In this regard, monetary policy for FY 2012/13 has been formulated with the objectives of maintaining price stability, external and financial sector stability, promoting financial access to the general public for facilitating high and sustainable economic growth.

*Instruments:* The major instruments of monetary policy have been the bank rate, refinance rates, cash reserve ratio, statutory liquidity requirement, standing liquidity facility and OMOs through secondary markets. Besides, direct instruments such as credit ceiling, targeted credit, and moral suasion have also been used for achieving the desired monetary policy goals.

*Targets:* Monetary aggregates such as broad money and credit aggregates have been the intermediate target of monetary policy. At present, the excess liquidity of BFIs has been chosen as the operating target of monetary policy. Besides, other money market indicators such as short-term interest rates and private sector credit growth are also taken into account while assessing the monetary development. The pegged exchange rate with the Indian currency continues to be a nominal anchor of monetary policy.

In recent times, containing inflation has been a prime concern of the monetary policy. The NRB is watchful in controlling inflation particularly originating from the demand side. However, some external and supply side factors have been contributing to upward pressure in inflation. Likewise, large and volatile movement of remittance inflows and exchange rate movements affect the external sector. In such situation, the monetary policy has played a vital role in controlling inflationary pressure by appropriately managing money supply and maintaining external sector stability through foreign exchange reserve management.

## **(B) Surveillance of the Financial System: Financial Stability in Nepal**

The Nepal Rastra Bank Act, 2002 has expressed financial stability as one of its objectives. To address challenges arising out of complexity and diversity in the financial business environment, the NRB has



established a Financial Stability Oversight Committee (FSOC) chaired by the senior Deputy Governor. Other members are heads of relevant Departments and include invitee members from stakeholders in the domestic financial sector, such as Insurance Board and Securities Board of Nepal.

To support FSOC, a dedicated Financial Stability Unit (FSU) was established in 2012 within the NRB. The unit has been given the responsibility of conducting macro prudential surveillance of the financial system, preparation of the financial stability report, developing and preparing core and encouraged set of financial soundness indicators, and conducting stress test to assess resilience to various shocks. The unit regularly publishes a bi-annual **Financial Stability Report**, which provides an assessment and analysis of the domestic financial sector.

### **(C) Foreign Exchange Management**

The NRB maintains prudent mechanism to manage its foreign exchange reserves in an effective and efficient manner. The Bank maintains adequate reserves taking into account the inherent potential risks in foreign exchange market. Investment guidelines have been prepared with a view of benchmarking reserve management practices of other central banks and exploring possible alternative investment opportunities.

*Exchange Rate Policy:* Nepal has adopted a pegged exchange rate system with the Indian currency since 1960. The NRB assures unlimited convertibility of the Nepalese currency against the Indian currency. Since

1960, there have been seven changes in the level of peg with the Indian currency. The last change was made in 1993 where presently one unit of Indian currency is equivalent to 1.6 units of Nepalese currency.

#### **(D) Public Debt Management**

The NRB carries out internal debt management on behalf of the GoN. It issues government securities, which are subscribed by the general public, BFIs as well as non-BFIs depending on the characteristics of securities. The government securities issued by the NRB are Treasury Bills and various types of bonds, such as: Development Bond, Citizen Savings Bond, National Saving Certificate and Foreign Employment Bond.

Once the Government announces its annual budget with attendant domestic borrowing requirements, the NRB develops an issue calendar in coordination with the Ministry of Finance for raising necessary resources through internal borrowing. The NRB carries out public debt management functions such as issuance of government securities, operation and management of secondary market of government securities, payment of interest on outstanding securities, payment of principle of matured securities and settlement with government agencies. In addition, it also conducts OMO through the instruments like repo, reverse-repo, outright sale and outright purchase.

## **(E) Currency Management**

Currency management is an important activity of the NRB. The Bank is responsible for printing and minting the paper notes and coins. At present, the notes are in following denominations: Rs. 1, 2, 5, 10, 20, 50, 100, 500 and 1000 with special notes issued in denominations of Rs. 25 and 250. Coins issued by the NRB are Rs. 0.05, 0.10, 0.25, 0.50, 1, 2, 5 & 10. The Bank also mints various commemorative coins of different denomination in both gold and silver - as per the demand of various agencies mostly the GoN.

*Clean Note Policy:* The objective of the Clean Note Policy is to ensure maintenance of existing notes, to upgrade their lifespan and to facilitate the destruction of soiled notes. In regard to the prior, the NRB has implemented only one stitch on the notes, sorting of notes and labeling separately for fit and unfit notes. To prevent from the possession of counterfeit notes, the Bank has also initiated a regular campaign for interaction program, seminar and workshops with various stakeholders.

*Management of Currency:* The Bank's seven offices, located outside the valley, work on circulating domestic currency, both paper money and coins. In the areas where the NRB does not have its own offices, commercial banks are used to cover up total geographic location of the country. Such centers are called "note chests" since they keep the physical cash (money) and make necessary supply. Note chests are

managed by Currency Management Department itself and handled by designated commercial banks.

## **(F) Payments and Settlement system in Nepal**

As per the NRB Act, 2002, the Bank has authority and responsibility to develop secure, healthy and efficient payment system in the country and has the sole authority for printing paper notes and minting coins. The major portion of Retail Payment System transactions is done in physical cash (i.e. payment of consumer goods and services); thus the availability of money to be circulated in the country plays a crucial role in smoothening the domestic payments and settlement system.

Similarly, the payments settlement system made by financial instruments (such as cheque, draft, debit/credit cards) is another major factor to make the payments system healthy and efficient. While the system of cheque clearing was done manually until 2012, since then the Nepalese payment system has entered into electronic cheque clearing system. The use of electronic cheque clearing system has made settlement secure, faster and more convenient.

The payment of big amounts, i.e. Large Value Payment System such as transfer of funds in inter-bank lending and borrowing as well as the purchase and sale of government bonds and treasury bills, is handled by the NRB and is done at the end of the day on a net settlement basis.

*Pension payments:* The retired employees of the GoN receive pension from a number of designated

commercial banks and from the NRB as per their convenience. These retired government employees receive the pension amount upon presentation of their "patta" (Pension Book) to the Bank. If branches of NBL and RBB are used for disbursing pension to the employee, they will get reimbursement from the NRB, Banking Office, Thapathali and ultimately from "Kausi Toshakhana", a government entity.

### **(G) Banker to the Government**

The NRB handles accounts of the GoN. The Bank facilitates accounting of revenue collection and public expenditure management. The process of government transaction is becoming more systematic because of the implementation of these activities through TSA.

### **(H) Regulation of Bank and Financial Institutions**

The NRB is responsible for regulating BFIs licensed by it. Many fragmented acts were unified in an umbrella act, the Banks and Financial Institutions Act, which was promulgated in 2006. It provides four types of licenses as per type of BFIs: Class A, Class B, Class C and Class D which are commercial banks, development banks, finance companies and microfinance development banks respectively. The focus of the Bank is on issuing prudential regulations for BFIs, analysis of financial health of overall financial system as well as monitoring the overall growth of banking business. At present, there are 22 major directives issued by the NRB to

regulate BFIs based on international banking norms and standard. The following table provides a glimpse of some major directives issued by the NRB (For more details on the directives, please refer to the NRB home page at [www.nrb.org.np](http://www.nrb.org.np)).

S.N.	Directives on	Description
1.	Capital adequacy	Describes the minimum capital adequacy requirements for BFIs based on Basel capital guidelines  Further, the directive provides guidelines for prompt corrective action, which are implemented for non-compliance/shortfall in required minimum capital adequacy ratios.
2.	Loan classification and provisioning	The NRB has categorized loan and advances and classified them on the basis of period of past dues (good, substandard, doubtful and bad) along with other subjective criteria, which are defined to assess the quality of loan.



S.N.	Directives on	Description
3.	Credit concentration and single obligor limits	In order to protect the BFIs from the perils of concentration risk, the NRB has issued guidelines on Single Obligor Limits. The directive provides guidelines on both the limits to a group of borrower as well as on the concentration in a specific sector of the economy.
4.	Risk Management	Directives have been issued to minimize the risks associated with liquidity, interest rate and foreign exchange transactions of BFIs.
5.	Corporate Governance	The directive incorporates the role and responsibilities of board of directors; chief executive officer; and senior management of BFIs. It provides roles and responsibility of audit committee and also includes prohibition for going against the interest of institution and depositors and other minimum codes of conduct.

S.N.	Directives on	Description
6.	Provisions relating to investments	The licensed institutions shall formulate and implement the policies and procedures regarding the investment in Government securities, NRB bonds, and other corporate shares and debentures as well as provision for their classification.
7.	Cash Reserve Ratio	This directive provides the provisions for Cash Reserve Ratio and Statutory Liquidity Ratio. The compulsory reserve, statutory reserve and liquid assets to be maintained by a licensed institutions shall be based on its deposit and borrowing liabilities.
8.	Deprived Sector Lending	The directed lending has been tied up with the total loans since 1984. The deprived sector is targeted to the low-income people, especially socially deprived women, indigenous, lower caste and landless people.

S.N.	Directives on	Description
9.	Know Your Customer	Know Your Customer (KYC) directives include the compliance of laws and regulation related with AML/CFT.
10.	Electronic Banking	Directives on Electronic Banking require banks to follow best practices for minimizing risks in the electronic banking transactions.

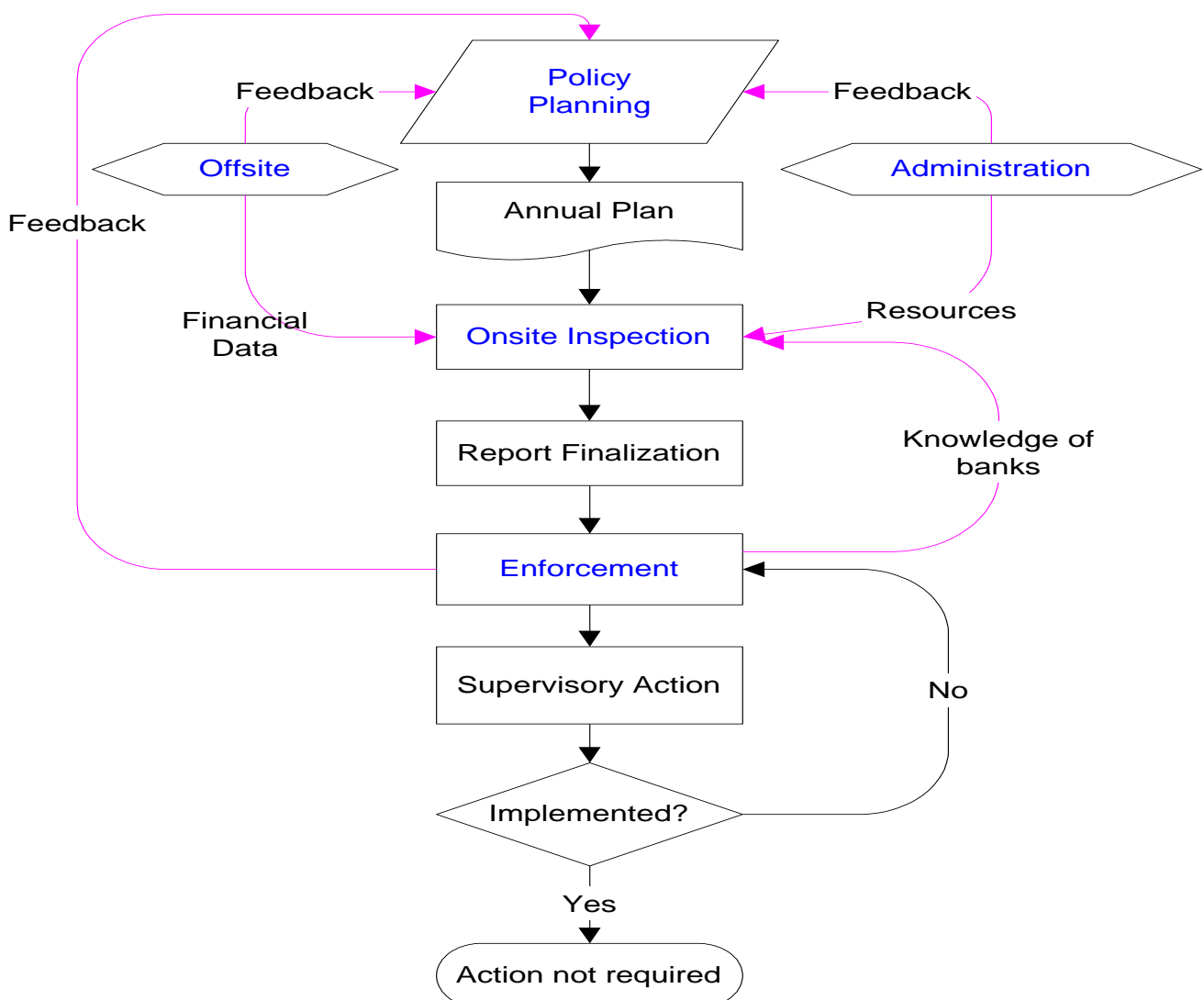
### (I) Supervision of Bank and Financial Institutions

For proper and smooth operation of BFIs in line with the NRB Act, 2002, all the fragmented provisions relating to supervisory authority of the NRB have been brought into one place in the **Unified Directives**, which is available on the NRB home page at [www.nrb.org.np](http://www.nrb.org.np). This has considerably eased the concerted and converged supervision. The 2003 Supervision By-law and Onsite Inspection Manual lays the clear-cut procedures and methodology of on-site examination and reviews the Bank's overall business on the basis of CAMELS rating. Similarly, Off-site Supervision Manual was issued in 2004, which strengthened the analysis, surveillance and provides early warning signals for future possible actions.

New Capital Adequacy Framework (based on Basel II guidelines from international practices with appropriate level of customization) was developed

and enforced in 2007. The NRB has promulgated Stress Testing Guidelines for the commercial banks in April 2011 to gauge the resilience of the banking sector against plausible shocks. In 2012, Internal Capital Adequacy Assessment Process (ICAAP) Guidelines have been issued with a view that each bank identifies its unique risks and sets the capital according to this risk. "Prompt Corrective Action" (PCA) was introduced with different triggers for capital deficiency. Similarly, PCA based on liquidity shortfall and non-performing loan is being implemented. The general flow chart of supervision of BFIs is provided below:

### Flow chart of Work of Supervision Department



## **(J) Access to Finance**

The NRB is effortful to increase access to finance and is pursuing this in four ways.

*Directed Credit:* The NRB has introduced the Directed Credit Policy in 1974 for the first time. The requirement of this policy was to invest a specified percent of total deposits in the underprivileged sector to increase the flow of credit to small farmers and businesses. The scheme was collectively renamed as "Priority Sector Credit" in 1976, when its mandate was extended to all banks and the amount was increased to 70 percent of total deposits. In 1984, the lending requirement under this program was tied up with total outstanding loans. This lending target was fixed at 12 percent of outstanding loans and advances since 1990. Moreover, the NRB has directed that 12 percent of priority sector loan including three percent of the total portfolio, be given to the hard-core poor under the "Deprived Sector Credit" program since 1991/92. The priority sector lending program was phased out since mid-July 2006. Nonetheless, deprived sector lending requirement still continues.

*Services for Enhancing Access to Finance:* In this regard, five Grameen Bikas (Rural Development) Banks were established focusing on the philosophy of banking to the poor, with the support of NRB in each of the five-development regions. This model was the replication of the Grameen Banking model in Bangladesh. The distinctive features of these banks are

collateral free credit to the poor women on group guarantee basis. This program also provides loan to the woman clients who are required to have mandatory saving and other social and educational programs. In addition, the refinance rates and the lending procedures have been further eased to facilitate special category loans targeting to women entrepreneurs and low-income groups. Currently, the financial literacy campaign is also underway targeting the students.

*Enhancing Confidence on Microfinance Institutions:* The NRB has initiated special and follow-up inspections of microfinance institutions. However, thousands of cooperatives operate saving and credit related activities, virtually beyond the supervisory jurisdiction of a competent authority. To address this issue, the NRB has submitted a proposal to GoN for introducing a separate Microfinance Authority Act. The enactment of this Act will initiate the establishment of a separate institution for regulating and supervising all the microfinance service providers including Class D financial Institutions in order to enhance public confidence on them.

*Rural Self-Reliance Fund:* In 1991, just after the restoration of multi-party democracy, the GoN established the Rural Self Reliance Fund (RSRF), with the objective of providing wholesale loans to NGOs, Co-operatives and other financial intermediaries for lending to the poor in order to improve their standard



of living through income generating activities. The RSRF provides loan through NGOs or co-operatives that are actively engaged in local saving mobilization and community development activities. It provides wholesale loan to the cooperatives and NGOs at an interest rate of eight percent. However 75 percent of the total interest paid to the RSRF by such institutions will be reimbursed to the same institution as grant for compensative administrative expenses for their institutional capacity building. The RSRF credit is now widely spread throughout the country. The NRB has been entrusted with the responsibility of managing RSRF since its inception.

### **(K) Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)**

The NRB plays a rigorous and highly pro-active role in all AML/CFT campaign of the country. The roles range from legal and regulatory drafting to policy and strategy development, skill development to lobbying for international cooperation, strategic planning to risk assessment and international representation to mass awareness. It has been more fruitful as the Financial Information Unit (FIU), which is a functionally independent unit of the NRB under the direct supervision of the Governor. Moreover, the NRB has been serving the GoN as a professional agency and advisor on AML/CFT matters.

The NRB hosts the FIU. The unit compiles the suspicious transaction report provided by BFIs (including KYC

requirements) as well as transactions that breach the pre-determined threshold provided for reporting. The report is analyzed and, if necessary, disseminated to law enforcement authorities (such as Department of Money Laundering Investigation, Department of Revenue Investigation, Central Bureau of Investigation, Commission for Investigation of Abuse of Authority, etc.) for necessary actions.

### **(L) Relations with International Financial Institutions**

The NRB, has been enjoying friendly and cordial relations with different international financial institutions such as, representing Nepal in different financial forums and with the major international financial institutions like IMF, WB, ADB, SEACEN, SEANZA, ACU, SAARCFINANCE, BIS, APRACA, CICTAB, etc. The NRB, as an active member of these financial institutions/forums, is broadly benefiting with their financing facilities, technical assistances and trainings on different economic and financial matters.

### **(M) Annual Report**

As stated in the Nepal Rastra Bank Act, 2002, the Bank prepares annual report for each fiscal year. The report contains the macroeconomic and financial situation of the country and overall activities of the NRB, including its financial statements. The report is submitted to the Government of Nepal within four months of completion of each fiscal year.

**(N) Major Publication**

Apart from the Annual Report, the NRB publishes the following documents regularly, which are also available on the NRB home page at [www.nrb.org.np](http://www.nrb.org.np)

-  Economic Review
-  Economic Bulletin and Indicators
-  NRB Working Papers
-  Special Publications
-  Study Reports
-  Financial Stability Report
-  Current Macroeconomic Situation

## Part IV

### Future Activities

#### Strategic Plan of Nepal Rastra Bank

Domestic financial sector liberalization, which was initiated since mid-1980s, has ushered in a rapid growth in the number of BFIs. This has raised the complexity and volatility of the financial sector, which has also increased due to use of modern technology and innovation in products and services. This has raised numerous challenges for the NRB in its task of maintaining macroeconomic and financial stability. To address such issues, the NRB embarked on the strategic planning process in 2006 to proactively address those challenges.

As a first step, the NRB Board of Directors has set the long-term vision and mission for the Bank, which acts as a guidepost for all its operations. The vision of NRB is to evolve as a *“modern, dynamic, credible and effective Central Bank”*. The mission of the NRB is to *“maintain macroeconomic stability through sound and effective monetary, foreign exchange, and financial sector policies”*. The NRB has since then been formulating and implementing medium-term Strategic Plans in order to attain its vision and mission.

An important output of the strategic planning process is the five-year NRB strategic plans. The NRB has completed the first strategic plan (2006 – 2010) and is currently in the second strategic plan (2012 – 2016).

The present plan has been formulated through a wide consultative process of all stakeholders and is being implemented as a continuation to the first strategic plan. The core values, which are the guiding principles identified in the first five-year plan, have been modified in the second five-year plan to reflect the needs of the changing scenario. These are provided in the table below:

Table 1: Core Values of Nepal Rastra Bank

First Strategic Plan (2006-2010)	Second Strategic Plan (2012-2016)
C : Credibility	C : Commitment to institutional goals
R : Responsibility	R : Responsibility
E : Efficiency	E : Efficiency and Effectiveness
A : Accountability	A : Accountability and Transparency
T : Transparency	T : Teamwork
E : Effectiveness	E : Equity and Fairness

The strategic framework of the present plan is built upon seven key pillars, each of which includes a group of strategic priorities.

**Table 2: Strategic Pillars and Strategic Priorities in second NRB Strategic Plan**

Strategic Pillars	Strategic Priorities
Macroeconomic Stability	Improve the effectiveness of monetary policy; Strengthen macroeconomic surveillance and enhance the quality of research studies and policy analysis; Establish resource center of an international standard.
Financial Sector Stability	Strengthen the legal framework for financial sector stability and operations; Enhance regulatory and supervisory framework against money laundering; Strengthen regulatory framework; Increase the financial deepening; Strengthen supervisory framework to ensure the safety and soundness of the BFIs; Introduce forward-looking approaches in supervision; Establish and strengthen supporting institutions for the financial stability.
Foreign Exchange Management	Make foreign exchange reserve management more efficient and effective; Reform foreign exchange regime to maintain external sector stability.



Strategic Pillars	Strategic Priorities
Payment Systems and Mechanisms	Promote efficient and effective payment system; Ensure timely supply of bank notes and coins.
Human Resources Management and Capacity Development	Strengthen the structural mechanisms of NRB; Strengthen the human resource management system of NRB.
Infrastructure, Corporate Governance and Customer Services	Create conducive work environment for the delivery of quality services; Create sound corporate governance through strengthening the policies and programs; Introduce risk based internal audit; Create environment of zero tolerance in compliance matter; Develop efficient internal control system; Ensure transparency and accountability.
Information and Communications Technology	Promote business process automation to enhance bank's efficient operations; Improve data management capacity and IT security framework; Implement and upgrade IT related policies; Enhance ICT capacity building.

Each strategic priority has a set of objectives. Each objective has a list of actions with time bound performance indicators and attainment of those

actions which would lead to the fulfillment of objectives. Every action has been assigned to a lead Department to ensure the proper accountability. Each action/activity will be measured against their performance indicators. The NRB is committed to implement this strategic plan through employees of high spirit, motivation, experience, and demonstrated ability in managing the future challenges.

For more details about the NRB Strategic Plans, please refer to the NRB home page at [www.nrb.org.np](http://www.nrb.org.np).

### **Financial Sector Development Strategy**

A Financial Sector Development Strategy (FSDS) is felt essential to guide the development of the financial sector since if left to the free markets alone, its development lead to greater inequality. Hence, the GoN has initiated exercise for drafting a FSDS, involving all stakeholders in the financial system including capital markets and insurance markets. The Bank is involved and is responsible for the institutions that it has licensed. It is also the Technical Secretariat for FSDS activities. In general, FSDS will focus on balancing regulation for having greater financial efficiency and productivity on one hand and financial inclusion and financial safety nets on the other. This is also being facilitated by a systematic assessment of the domestic financial system by the IMF and WB, who have jointly initiated a program named the Financial Sector Assessment Program (FSAP).





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