NEPALESE FINANCIAL SYSTEM: GROWTH & CHALLENGES

July 2009

Financial Sector Development and Economic growth in Nepal: FY 1975 - FY 2007
A Joint Study of EAD and FID of Nepal Rastra Bank

Nepalese Financial System: Policy Development and Challenges
Dr. Bhubanesh Pant

Central Banking Practices and Evolving Challenges to Nepal Rastra Bank
Dr. Dandapani Paudel

Experience of the Nepalese Commercial Banks and Challenges Ahead
Bhuvan Dahal

Development Banking in Nepal
Shiv Ram Koirala

Development and Challenges of the Nepalese Finance Companies
Siddhant Raj Pandey

Micro-Finance Business in Nepal
Dr. Harihar Dev Pant

Performance and Challenges of Financial Cooperatives in Nepal
T.M. Sharma & B.P. Ghimire

The Evolution of Post-Office Savings Banks in Nepal
Shree Dhar Gautam

Stock Market and Mutual Fund in Nepal
Dr. Bijay K.C. & Mr. Ashok R. Pandey

Credit Information Bureau in Nepal: Analysis of Critical Success Factors
Anil Chandra Adhikari

NEPAL RASTRA BANK

July 2009

NEPALESE FINANCIAL SYSTEM: GROWTH & CHALLENGES

EDITORIAL BOARD

Trilochan Pangeni

Rameswori Pant *Shiba Devi Kafle*

Ramesh Kumar Pokharel *Nephil Matangi Maskay*

The Editorial Board has the pleasure of releasing this issue of ***Nepalese Financial System: Growth & Challenges***. This issue incorporates analytical articles from the staff of the NRB and academicians outside the NRB on contemporary issues of the economy.

Though the articles are reviewed by the Editorial Board, the Board does not guarantee the accuracy of the data and analytical results along with their implications. Moreover, the views and interpretations included in the articles are those of the authors and do not necessarily reflect and represent the views and policies of the NRB. The Editorial Board would also like to thank Mr. Tulashi Prasad Ghimire, Deputy Director, Mr. Amar Ratna Bajracharya, Computer Supervisor (retired) and Mr. Sanu Bhai Maharjan, Supervisor (Computer) of the Research Department for their valuable assistance in the publication of this issue.

Any comments, queries, suggestions, and correspondence should be directed to the Editorial Board.

Foreword

A strong and sound financial system can promote economic growth, mobilize and allocate resources efficiently, make capital more productive and create jobs. It lessens vulnerability to financial crisis and defrays the economic and social costs that accompany financial disruption. Since the financial system performs the crucial task of raising funds for, and channeling funds to, productive investment, successful financial liberalization is normally a significant constituent of a country's strategy for economic growth. In Nepal, the pace of financial liberalization started in the mid 1980s when the government allowed the entry of commercial banks in joint venture with foreign bank. Since then, the Nepalese financial system has undergone rapid structural changes, with a large number of financial institutions rendering an array of financial products and services. While the increased competition has been instrumental in enhancing efficiency in the financial sector, new challenges have also emerged. A case in point is the outreach by the financial service providers to poor and low income households which remains limited.

Against this background, the significance of undertaking a study on the different issues and challenges faced by the diverse financial institutions in this globalization era was recognized by the Research Department. Accordingly, this department's Financial Institution Division has come out with this publication that encompasses the different aspects of financial institutions written by the related resource persons. This publication, among others covers central bank, commercial banks, and development banks, Finance companies, micro-finance and cooperatives.

I am positive that this publication will be a valuable asset and serve as a crucial reference material both for the Nepal Rastra Bank and also for those interested in keeping abreast of the developments in Nepal's financial system.

This publication would not have come out in its present shape without the cooperation and support provided by a number of people. In this respect, first of all my sincere appreciation goes to all those valued contributors for providing scholarly papers. I would also like to extend my greater thanks to Director Mr. Ramesh Kumar Pokharel and Director Dr.Nephil Matangi Maskay, Research Department, Deputy Director Dr. Bhubanesh Pant and Deputy Director Mr. Balram Parajuli, Research Department and Assistant Director Mr. Manohar Basnet, Assistant Director Mrs. Sumitra Joshi and Assistant Director Mr. Karna Gopal Shrestha of the Research Deparment for their devoted and untiring efforts in carrying out all the crucial tasks related to this publication. Last but not the least, my appreciation also goes to Mr. Amar Ratna Bajracharya, Computer Supervisor (retired) and Mr. Sanu Bhai Maharjan, Computer Supervisor, Research Department for their admirable support in the formatting and designing of this publication.

Finally, the views and opinions expressed in this publication are those of the contributors themselves and do not necessarily reflect and represent the views and policies of the banks.

Trilochan Pangeni
Act. Executive Director

15th July, 2009

Acknowledgement

A sound financial system accelerates the economic development by facilitating intermediation, maturity transformation, credit allocation and payment system with financial discipline. A well-developed financial system promotes investment by identifying and financing lucrative business opportunities, mobilizing savings, efficiently allocating resources, helping diversify risks and facilitating the exchange of goods and services.

In Nepal, we lack in depth any academic work, which is enough to establish a robust relationship between financial development and economic growth, an endeavor is made through this publication to explore some ideas that will be instrumental to depict importance of financial sector development to economic growth.

We come out with this publication of Financial Institutions Division (FID) of Research Department incorporating articles covering the areas of financial sector development in Nepal. Due to various technical reasons, we apologize for the delay in publication. Despite of our honest efforts, we became unable to collect the articles from all components of financial sector. However, we will try to incorporate the views of all in the next issue.

This publication is an outcome of the cooperation and support provided by a number of individuals. In this regard, I would like to extend my sincere appreciation to all those valued contributors for providing such valuable and scholarly papers. I would like to extend my sincere thanks to Mr.Trilochan Pageni, Executive Director, Research Department for encouraging us in order to bring this publication at this form. My thanks also go to Dr.Nephil Matangi Maskey, Director, Research Department, Dr. Bhubanesh Pant, Deputy Director, Mr. Balram Parajuli, Deputy Director and Mr. Gunakar Bhatta, Deputy Director of Research Department (now pursuing doctoral studies in the US) for their valuable works, guidance and editorial suggestions. My thanks is also due to Deputy Director Mr. Gyanu Krishna Adhikari, Financial Institutions Supervision Department (previously with the Research Department), Deputy Director Mr. Hem Prasad Neupane, Bank Supervision Department (previously with the Research Department) and Deputy Director Mr. Tulashi Prasad Ghimire and Assistant Director Mr. Manohar Basnet, Assistant Director Mrs. Sumitra Joshi and Assistant Director Mr. Karna Gopal Shrestha of the Research Department for their continuous efforts in carrying out all the crucial tasks related to this publication. Last but not the least, my appreciation also goes to Mr. Amar Ratna Bajracharya, Computer Supervisor (retired) and Mr Sanu Bhai Maharjan, Computer Supervisor for their untiring works in the formatting and designing of this publication.

To end with, the views and opinions expressed in this publication are those of the contributors themselves and do not necessarily reflect and represent the views and policies of their respective organizations.

Ramesh Kumar Pokharel
Director

15th July, 2009

NEPALESE FINANCIAL SYSTEM: GROWTH & CHALLENGES

July 2009

Financial Sector Development and Economic growth in Nepal: FY 1975 - FY 2007 1
– *A Joint Study of EAD and FID of Nepal Rastra Bank*

Nepalese Financial System: Policy Development and Challenges 24
– *Dr. Bhubanesh Pant*

Central Banking Practices and Evolving Challenges to Nepal Rastra Bank 36
– *Dr. Dandapani Paudel*

Experience of the Nepalese Commercial Banks and Challenges Ahead 50
– *Bhuvan Dahal*

Development Banking in Nepal 64
– *Shiv Ram Koirala*

Development and Challenges of the Nepalese Finance Companies 78
– *Siddhant Raj Pandey*

Micro-Finance Business in Nepal 85
– *Dr. Harihar Dev Pant*

Performance and Challenges of Financial Cooperatives in Nepal 92
– *T.M. Sharma & B.P. Ghimire*

The Evolution of Post-Office Savings Banks in Nepal 103
– *Shree Dhar Gautam*

Stock Market and Mutual Fund in Nepal 112
– *Dr. Bijay K.c. & Mr. Ashok R. Pandey*

Credit Information Bureau in Nepal: Analysis of Critical Success Factors 124
– *Anil Chandra Adhikari*

Chapter I

Financial Sector Development and Economic Growth in Nepal: FY 1975 – FY 2007

A Joint Study of Economic Analysis Division (EAD) and Financial Institution Division (FID)* of Nepal Rastra Bank

Background

The growth of financial services sector is theoretically important for a nation's economic growth and development. Its importance to economic growth emanates from its critical role in facilitating financial intermediation and enhancing trade related payments. The efficacy of financial system to reduce information and transaction costs plays an important role in determining the rate of savings, investment decisions, technological innovations and hence the rate of economic growth. This hypothesis has been supported by the number of studies such as McKinnon (1973); Shaw (1973); Greenwood and Jovanovic (1990) and Levine (1997). These studies share a common view that financial development is pre-requisite for the economic growth of a nation. Further, Levine (1997) states that the level of financial development is a good predictor of future rates of economic growth, capital accumulation, and technological change. He also concludes that countries with larger banks and more active stock markets grow faster over subsequent decades even after controlling for many other factors underlying economic growth.

However, there are also literatures such as Robinson (1952), which do not find positive impact of financial development on economic growth. Instead, they opine that financial development follows the economic growth. Robinson (1952) states that "… although growth may be constrained by credit creation in less developed financial systems, in more sophisticated systems finance is viewed as endogenous responding to demand requirements". Similarly, a number of researchers have also moved beyond the basic finance-growth question to ask more detailed questions about this relationship. An emerging research area considers how the relationship between financial development and economic growth may change with levels of economic or financial development.

Amid these controversial opinions regarding the finance-growth relationship, it is felt that the Nepal Rastra Bank (NRB) – as a regulatory and supervisory body of most of the

---

* Lead researcher: Assistant Director Satyendra Raj Subedi, EAD.
Note: The research team is very much thankful to Mr. Trilochan Pangeni, Executative Director; Mrs. Shiva Devi Kafle, Director; Mr. Ramesh Kumar Pokharel, Director, Dr. Bhubanesh Pant, Deputy Director; Mr. Rajendra Pandit, Deputy Director; and Mr. Ashok Paudel, Deputy Director, all from Research Department of Nepal Rastra Bank, for their respective comments on initial draft of this paper.

financial system of Nepal, and also having an important role in the economic growth of the nation – needs to be aware of the relation between financial development and economic growth.

In Nepal, growth of the formal financial services sector had commenced only in 1937 with the establishment of Nepal Bank Limited. The establishment of NRB, the central bank of the Federal Democratic Republic of Nepal, in 1956 paved the way for the growth of financial services institutions; the process was soon initiated with the opening of another state-owned commercial bank, Rastriya Banijya Bank in 1966. Since that time there has been a consistent growth of financial service institutions, initially through public initiative but after the period of rapid economic liberalization in 1991, through the private sector initiative. There are presently 235 banks and financial institutions under the license and direct supervision of NRB - e.g. those covered by the "umbrella" Banks and Financial Institution Act, 2006 (see Box 1 below). Besides these institutions the domestic financial service sectors also comprises of one Employee Provident Fund; one Citizen Investment Trust; 21 Insurance Companies (both life and non-life); and 117 Postal Saving Banks.

Box 1: Number of Banks and Financial Institutions Operating Under the License of NRB

As of Mid-July, 2008, there are 235 banks and financial institutions operating in the domestic financial market under the license of NRB consisting of 25 commercial banks (Class A), 58 development banks (Class B), 78 finance companies (Class C), 12 micro-credit development banks (Class D), 16 Cooperatives and 46 NGOs. The cooperatives and NGOs are, however, licensed for limited banking transaction.

Source: Nepal Rastra Bank

The figures on the financial services reflect the numerical growth of the domestic financial services industry. The above description of the financial services sector is consistent with classification of the General Agreement on Trade in Services (GATS) under the World Trade Organization (WTO)[1]. Looking at its association with the growth of the economy, however, it is essential to have an empirical exercise on its relationship vis-à-vis the growth of the overall economy. Also it is equally important to analyze the growth path of the economy before and after the liberalization process in the financial service sector. Since NRB has the important responsibility of maintaining "the stability and healthy development of the banking and financial system" (Nepal Rastra Bank Act, 2002, Preamble), it is essential for the Bank to have those necessary information on the domestic financial services sector, to effectively formulate policy actions.

The objectives of the study therefore, are to:

a. Critically review literature so as to determine the interrelationship of financial services sector development and economic growth,

b. Estimate the impact of the growth of the domestic financial services system on Nepal's economic growth and

Incorporating all the service sub-sectors for their impact on economic growth becomes a vast activity. Therefore, this study limits the scope of the financial services sector to those institutions directly under the NRB's supervision. More specifically, this study confines the

---

[1] The list of financial services in GATS consists of three main categories: i) All insurance and Insurance-related services, ii) Banking and other financial services, and iii) Other (WTO home page)

proxy of financial development to that of statistics of commercial banks only, because of the dominance of commercial banks in the economy in terms of assets, deposits and credit.

The outline of this research study is as follows: Section II provides literature review on empirical assessment of financial development and its relationship on economic growth -- both within and outside the nation; Section III describes methodology along with the definition of variables used; this being followed by results or findings of the empirical estimation in Section IV, Section V is about the analysis of the results and recommendation followed by summary and conclusion.

Literature Review

Theoretically, financial development is growth supportive due to its efficient role in moving funds from savers to investors. Several theoretical studies have lent support to this view - for example Greenwood and Jovanovic (1989), Levine and Zervos (1998) etc. - via the channel of resource allocation decisions. In the literature there are four major channels for this relation (Levine (1997) and Pagano (1993)): (a) the financial intermediaries improve the screening of funds-seeking investors and then monitor the funds-receiving investors, which improves the allocation of resources and hence they play the roles of “gate-keepers” and ‘‘delegated monitors’’; (b) the financial sector encourages the mobilization of savings by providing diverse instruments that match the differing preferences of savers; (c) the financial sector lowers transaction costs as well as screening and monitoring costs through economies of scale; and lastly (d) financial intermediaries provide for risk and liquidity management.

Empirically however, there is no consistent results regarding the effects of financial development on resource allocation and hence on economic growth. Economists differ in their conclusion regarding which causes what – that is whether financial development is pre-condition for economic growth or the economic growth spurs the financial development – the former is known as "supply-leading" hypothesis and the later as "demand-following" hypothesis. In the same way, some economists also argue that there is potentially a negative relationship of financial development on the growth performance. Some of the studies relating to all such conclusions are examined below.

A seminal work in finance-growth nexus dates back to 135 years. Walter Bagehot (1873) in an essay verbally ascribed the growth process to the development of money-market. Following that period, economists started to examine this relationship. Some of the more cited works in favor of positive impacts of financial intermediaries are those by Schumpeter (1912), McKinnon (1973), Shaw (1973), (King and Levine (1993), Levine (1997), Levine and Zervos (1998). These empirical researches, using different econometric techniques and data set, produce consistent results – countries with developed financial system tend to grow faster; simultaneity bias does not seem to be the cause of this; better-functioning financial systems ease the external financing constraints that impede firm and industrial expansion (Levine, 2003).

Box 2: What does the Financial System do and How Could it Promote Economic Growth?

To understand how the financial system might influence economic growth, we need to review the roles of the financial system in greater detail. First, the financial system mobilizes savings. Since an individual saver may be unable or unwilling to completely fund a borrower, financial markets and institutions pool the savings of diverse households and make these funds available for lending. This activity reduces the transaction costs associated with external finance for both firms and households. By going directly to a financial institution, firms seeking to borrow avoid the costs of

having to contact a diverse group of savers. Similarly, savers avoid the costs of evaluating every potential borrower by placing their funds with a financial institution. Second, the financial system allocates savings by determining which borrowers obtain loans. Since financial institutions are specialists, they can determine worthwhile investment opportunities and judge the creditworthiness of borrowers at lower cost than the average small investor. The third role of the financial system is to reduce risk by spreading investors' savings across many different investment opportunities. Spreading savings diversifies risk for households and reduces their exposure to the uncertainty associated with individual projects. This reduction in risk encourages savings. The fourth role of the financial system derives from its ability to generate liquidity. Some investments with potentially high returns involve projects that require long-term commitments of capital. However, some investors may unexpectedly need access to their savings. Fortunately, when the financial system pools the investments of many households, it allocates funds to both short- and long-term projects. Thus, investors obtain higher returns on their savings than they would if their investments were limited to short-term projects, but they still have access to their savings in unforeseen circumstances. Further, mixing investments in this way ensures that worthwhile long-term projects are funded. Sixth, the financial system facilitates trade by extending credit and guaranteeing payments. For example, currency, demand deposits, and credit card accounts all allow individuals to exchange goods and services without having to resort to barter. Additionally, letters of credit help firms order the inputs for current production when they experience delays in payment for past sales. The financial system also exerts corporate control and monitors managers. Entrepreneurs' or managers' information about the operation and outcome of their projects tends to be superior to information that outside creditors and shareholders have. Insiders' attempts to exploit this informational advantage by engaging in opportunistic behavior would tend to discourage savings. For example, managers might underreport their firms' profits to lenders and shareholders in order to raise their own earnings. To offset this information advantage, banks monitor borrowers, and equity markets allow shareholders to discipline managers by voting out poor management.

Source; copied from Aubhik Khan(?), "The Finance and Growth Nexus" available at
www.philadelphiafed.org/files/br/brjf00ak.pdf, page 6-7

King and Levine (1993) noted that Schumpeter in his 1912 article had also acknowledged the role of finance in innovation and production process probably for the first time, arguing that the services of financial intermediaries – mobilizing savings, evaluating projects, managing risks, monitoring managers, and facilitating transactions – stimulate technological innovation and economic development. Similarly McKinnon (1973) and Shaw (1973) concluded that alleviating financial restrictions in developing countries, by allowing market forces to determine real interest rates, can exert a positive effect on growth rates; they thus favored for financial liberalization which they felt would stimulate savings and would finally finance higher level of investment, leading to higher growth.

On the contrary to above findings, some studies have also shown no-effect or insignificant effect of financial development on economic growth. For example, Mohapi and Motelle (2007) have examined three of such studies namely - Neusser and Kugler (1996); Dawson (2003); and Allen and Ndikumana (2000). According to Mohapi and Motelle (2007), i) Neusser and Kugler (1996) had found that the causal link from financial development to economic growth was weak, especially for the smaller countries; ii) Dawson (2003) had found the link between finance and growth to be insignificant for 13 Central and Eastern Europe countries; and iii) Allen and Ndikumana (2000) had found positive but insignificant effect of finance on growth from a sample of 11 SADC countries.

There are also some studies which show the reverse relationship: that is the economic growth leads financial development – the demand-following hypothesis. Such studies include Lewis (1995), Patrik (1966), Robinson (1952), Stiglitz (1994) and a more recent country case study by Bhattacharya and Sivasubramanian (2003). All these studies

questioned the importance of the financial system in promoting economic growth. They proposed that it was the economic growth that created additional demands for financial services, which in turn might bring about more developed financial sectors.

However, following the East Asian crisis of 1990s which was led by the uncontrolled financial liberalization, economists have growing skepticism in the belief that financial intermediaries always matter. Some studies, in this regard, have shown the negative impact of financial development on growth as well. Accordingly, Shrestha (2005), van Wijnbergen (1982) and Buffie (1984) have highlighted the role of informal "curb" markets in developing countries and suggested that financial development in some cases might have a negative impact on growth. According to this view, Shrestha (2005) quotes, "…as the formal financial system develops, the funds move from curb market to formal financial market. But due to the reserve required ratio in formal market the entire fund switched into the curb market cannot be loaned. This reduces the aggregate domestic credit supply. The reduction in the supply of credit leads to credit crunch, which can retard economic growth by lowering the investment and slowing the production".

Cross-country/Panel Studies

2.8 King and Levine (1993) studied the finance-growth relationship for 77 countries over the period 1960 – 1989 and found a strong positive relationship between each of the financial development indicators and the three growth indicators. The authors also concluded that the level of country's financial development helps predict the nation's rate of long-term economic growth (e.g. 10 to 30 years). King and Levine (1993) used four proxies for the financial development indicator: i) LLY: ratio of liquid liabilities of financial system to GDP; ii) BANK: ratio of bank credit to bank credit plus central bank domestic assets; iii) PRIVATE: the ratio of claims on the non-financial private sector to total domestic credit; and iv) PRIVY: ratio of private enterprises to GDP. Similarly, they took three proxies for economic growth: real per capita GDP growth; real per capita capital growth; and total productivity growth ("a residual obtained from Solow growth model"). The equation relating the growth rate and financial depth that they used was

$$Gj = a + b^{*}\,\text{DEPTH} + c\,{}^{*}X + u.$$

Where *Gj* stands for the measure of economic growth and X is a matrix of conditioning information that controls for other factors associated with economic growth (e.g education; political stability; trade, fiscal and monetary policy)

Levine and Zervos (1998) added the measures of stock market besides the banking indicators and thus examined the independent impact of stock market as well as banks on economic growth. They constructed mainly six measures of stock market development -- four measures being directly related to domestic stock market performance and remaining two measures being related to degree of integration to world financial markets to provide evidence on theories linking market integration to economic growth. The first four direct measures of capital market were: (i)) market capitalization ratio (MCAP), which equals the value of listed domestic shares divided by GDP and measures the size of the stock market; (ii) the turnover ratio(TOR), which measures total value of shares traded on a country's stock exchanges divided by stock market capitalization; (iii) value-traded ratio(TVT), which equals the total value of domestic stocks traded on domestic exchanges as a share of GDP; and (iv) volatility of market returns (VOL), which equals twelve-month rolling standard deviation estimate that is based on market returns. Similarly they used two models and hence two indicators of degree of financial integration

to world: (i) international capital asset pricing model (CAPM); and (ii) international arbitrage pricing model (APM). Using the data of 42 countries over the period 1976-93, they found that the initial level of stock market development liquidity and the initial level of banking development are positively and significantly associated with current and future economic growth, productivity growth and capital accumulation. The regression equation they used was:

$$Gj = a^*X + b^*\text{BANK} + c * S(k) + u$$

where Gj stands for the measure of rate of economic growth (they used four such measures: per capita GDP growth, per person capital stock growth, productivity growth, and private savings rate); X stands for set of control variables; BANK stands for initial level of banking development; and S(k) stands for the measures of stock market indicator as mentioned above.

More recently, Tang (2006) examined the finance-growth relationship among the Asia-Pacific Economic Cooperation (APEC) countries during the period 1981-2000, both using the data as a whole and separating the data into developed and developing countries. The author looked at three aspects of financial development namely stock market, banking sector and capital flow and found that the stock market development showed strong growth-enhancing effect. Methodologically Tang (2006) started with simple OLS techniques and then examines robustness of the results by utilizing control variables. The author also eliminates the simultaneity bias problem by utilizing two-stage least square estimation method.

Country-specific Studies

Kamat and Kamat (2007) empirically analyzed the relationship between financial infrastructure and economic growth in India. The authors examined the short and long run impact of the specified variables and found that financial infrastructure was leading economic growth. Kamat and Kamat (2007) used 34 annual observations for the study over the span 1971-2004. This study used Granger Causality tests with stationary variables and concluded that "finance" was a leading sector in the short-term. The dependent variable used was economic growth (EG), which was the growth rate of GDP at i) factor cost and ii) current prices. Similarly, they used following financial development indicators: i) financial activity (FA), which was defined as the ratio of gross capital formation by the private sector to GDP; ii) the ratio of financial savings (FS) to GDP, where FS was taken just as a difference between M3 and M1 so as to get the quasi-liquid asset that they considered to be a main source of investment financing and hence having expected positive impact on growth; and iii) financial deepening (FD), which was total asset of financial system as measured by M3 divided by GDP. In order to avoid the simultaneity bias, they also used liquidity Adjustment (LA) measure as the control variable.[2] This study provides robust empirical evidence in favor of supply leading hypothesis for the Indian economy.

Shrestha (2005) empirically examined the impact of financial liberalization on different macroeconomic variables for Nepal. In order to ascertain the effectiveness of financial liberalization, the author evaluated the impact of the various liberalization measures on

[2] Unit root tests (ADF and PP) tests conducted to verify the stationarity property. Johanson cointegration and the ECM tests revealed that there was evidence in favor of a short run effect of financial infrastructure leading to economic growth. Finance was found to be a leading sector, only, in the short term link in Granger Causality tests with stationary variables.

the Nepalese financial system and hence on domestic economic growth. The author also constructed a financial liberalization index through principal component method which was used throughout his study as the main indicator of the degree of financial liberalization. The paper is analyzed via cointegration and causality tests between various sets of variables. The composite index of financial liberalization is positively associated with per capita income as well as with industrial development. This suggests that increased availability of financial resources has encouraged the opening of new investment projects in the agricultural as well the non-agricultural sector. As a consequence, it has promoted the nation's economic growth. The study does not find any causal relationship between financial development and economic growth.

Paudel (2005) also did simple bi-variate analysis taking four proxies of growth and four proxies of financial development indicators, with the sample from 1975 to 2004. Among the growth proxies were real GDP, nominal GDP, per-capita real GDP and per-capita nominal GDP. Similarly the financial indicators were M1, M2, total credit and credit to private sector. His basic equation was

$$\text{Ln } Y = \alpha + \beta \text{ Ln } FD + u$$

Where Y and FD were represented by any one of growth variables and financial development variables respectively among the one as explained above. All of the estimation results showed positive and almost significant impact of FD indicators to economic growth indicators. However, these results were based on simple bi-variate analysis with FD indicators rarely found in literature.

Bhetuwal (2007) examined the causal relationship between economic liberalization and financial development. The author constructed indices of financial liberalization and financial development using principle-component method. Bhetuwal (2007) assumed that financial development had a positive impact on economic growth. Utilizing 30 sample observations over the period from Fiscal Year 1975 to 2006[3], he found the bi-directional causality between the indices of economic liberalization and financial development using Granger Causality test; the paper concluded that these variables had a significant contribution in accelerating economic growth.

Methodology and Variables Defined

To estimate the impact of financial development on economic growth, this study uses the secondary annual data of the variables from FY 1975 to FY 2007, since Nepal does not have systematic and reliable record of such data before FY 1975. This study emulated the empirical methodology of Tang (2007). More specifically, this study uses OLS technique of estimation with dependent variable as economic growth and Financial Development (FD) as an independent variable. Therefore, the **conceptual equation** of the study is:

Economic Growth = f (FD) I

However, notwithstanding the fact that growth is also affected by number of other non-financial factors such as labor and capital productivity, trade, political stability etc, the

---

3 In Nepal, Fiscal year 1974/1975, for example, means that the year from Mid July 1974 to Mid July 1975 and simply this is written as FY 1975. Similar principle has been used in this study from onward.

study also introduces a number of control variables (CV) into above equation. Inclusion of these variables helps control for variability. Thus the modified growth equation is:

Economic Growth = *f (FD, CV) .... II*

These two equations are the conceptual equations of this study which are converted into operational equation, as explained below.

Variables and Data Sources

Dependent Variable: Economic growth is measured by per-capita growth of real GDP at factor cost and is denoted by *Growth*.[4] For the purpose of *Growth*, data on population has been taken from International Financial Statistics Yearbook 2002 of IMF for the period from 1975 to 2000 and from Central Bureau of Statistics (CBS) from 2001 onward. Similarly, data on real GDP have been taken from CBS but converted into the constant base year price of FY 1985 using the growth rate formula. Also it is worthy to note that real GDP from FY 2002 onward are based on SNA 1993 while all such data before this period are based on SNA 1968.

Independent Variables: Since this study examines the relationship of financial development on economic growth, independent variables only related to financial sector development are used. This study thus uses three proxies of financial development indicators as explained below:

(i) The first is associated with the size of financial intermediary sector which is denoted by *Liqliab*. It is defined as the sum total of currency plus demand and interest-bearing liabilities (domestic only) of commercial bank divided by nominal GDP. More specifically the study uses the ratio of M2 to GDP to measure *Liqliab*. This proxy has been used traditionally by different scholars beside D. Tang (2007), such as by King and Levine (1993), Levine and Zervos(1998) etc. The weakness of this measure is that although it measures the size of financial system (here represented by commercial banks only) it may not provide an accurate proxy for the functioning of the financial system which is related to quality aspect. Therefore it cannot be a proxy for how well commercial banks provide risk management services to clients. The data source for M2 is NRB's Quarterly Economic Bulletin (QEB) while for nominal GDP is GON's CBS. Here also, the nominal GDP from 2001 onward are based on SNA 1993.

(ii) The next measure of FD is *Commbank*. This is the total asset of commercial banks divided by sum of commercial bank's total asset plus NRB's total assets. Both are taken from NRB's QEB. This measure is expected to capture the relative importance of commercial banks vis-à-vis NRB in enhancing the financial services with the assumption that commercial banks are more likely to tolerate the risk in financing than central bank and also their services affect the public decision on financial matters.

(iii) The last proxy is *Bankcred*. This relates to the qualitative measure of financial development and is the ratio of total credit of commercial banks to nominal GDP. Since commercial banks are established for commercial purpose and hence have a

[4] Although some studies such as King and Levine (1993), Levine and Zervos (1998) use different alternative measures of growth besides per-capita real GDP such as per-capita physical capital accumulation, private savings etc., these measures, though attractive are not available for Nepal from the perspective of data reliability and authenticity.

goal of profit maximization, their credit allocation depends on high level of financial assessment and appropriate levels of credit supervisors. Therefore, this measures to some extent the quality of financial sector development. Although the total credits of banks include: claims on government, claims on non-financial institutions, claims on government enterprises, and claims on private sectors, the first two have been excluded while constructing *Bankcred* series. The reason is that the claims on government sector are not expected to support the per-capita income growth. The necessary data for *Bankcred* are being taken from QEB, NRB.

Control Variables: The study follows Tang (2007) for the set of such variable as well. Following are the control variables we use in this study:

i) *Trade*: This is the total merchandise trade to GDP ratio. This variable proxy for economic openness as measured by increasing volume of total trade and trading partners affect positively on economic growth. Nepal is open economy and its trade in terms of volume is also expanding over time. The data have been taken from QEB, NRB.

ii) *Govtcons*: This is the government's capital expenditure divided by GDP. It also shows how much the government's expenditure on development activities have been justified from the perspective of its role in outcome, i.e. economic growth and hence on per-capita income growth. The source of this data is economic survey

iii) *Invest*: This is the private sector investment to GDP ratio. The private sector investment means the private gross fixed capital formation, taken from CBS. This variable is most important control variable among others since the share of private sector investment in total investment has been increasing drastically, leaving government's share at marginal level.

iv) *Popgrow:* This is the population growth rate. In the economy with excess capacity and less capital-intensive technology like ours, this variable can be expected to have negative impact on growth and hence we include it as a control variable.

All the above-mentioned variables (except *Growth* and *Popgrow*) are taken into *natural logarithm* form while estimating the equations. The summary picture of all the related variables of this study is provided in the table below.

Table 1: Summary list of Variables used in the study

Variables Name		Definitions
Dependent	*Growth*	The rate of per-capita Real GDP at factor cost
Independent	*Liqliab*	The ratio of total liquid liabilities (demand and interest bearing liabilities) of financial system to nominal GDP.
	Commbank	The ratio of financial systems' asset to the total assets (assets of financial system plus that of NRB)
	BankCred	The ratio of the total credits by financial system to GDP
Control	*Trade*	Total merchandise trade to GDP ratio
	Govtcons	Government's capital expenditure divided by GDP
	Invest	Private sector investment to GDP ratio
	Popgrow	Population growth rate

Note: As mentioned earlier, only the commercial banks are taken as a proxy of financial system in this study

Graph and Summary Statistics: The time series of all these variables are provided in annex 1: annex 1(A) shows the raw variables and that of 1(B) shows the estimated variables by taking their logarithms. Also the graphs of raw variables are provided in annex 1(C). As is seen from the graphs, all of three measures of FD possess an increasing trend with the slope being much steeper from 1992 onward. This may be due the introduction of more and effective economic liberalization policies of the democratic government that was formed after the restoration of the multiparty system in 1992. Due to this, a dummy variable is introduced for 1991 and is denoted by D1991.

The summary statistics consisting of arithmetic mean and standard deviations of all the variables are shown in the table provided in annex 2. The statistics are provided by breaking the whole period into two sub-periods: FY 1975 - FY1991; FY 1992 - FY2007. The first sub-period provides the picture before Nepal entered into the economic liberalization period[5]; the second sub-period stands for the period after the democratic government was formed and the nation introduced liberalized economic policies.

The average annual rate of per capita growth (Growth) over the total study period is 1.7 percent. However, the rate of growth is not found to be time invariant. This growth rate more or less remained the same before and after the economic liberalization process. However the standard deviations of these mean growth shows that before the FY 1991 such rate had more deviation (st. deviation is 0.034) from the mean growth rate compared to that after the liberalization period (st. deviation 0.017). On the other hand all of the financial development indicators show that there was less than average value of such measures before the liberalization period and more than average values after the liberalization period. More interestingly, unlike that for per-capita growth, these indicators in general were less volatile before FY 1991 compared to those after FY 1992.

Estimating Equations: Based on the above-mentioned conceptual equations and the variables defined, the equations are estimated in two sets. In Set I, Growth will be estimated using only FD indicators with different combinations of contemporaneous and lagged values[6]. From the coefficient analysis from the above set I equation(s), significant equations will be identified. In Set II, the growth equations are estimated taking those FD indicators, which may be found significant in Set 1, along with control variables and dummy. The analysis of Set II equations will then be concluded based on the robustness of the results. Although FD variables of equations under Set I will be tested in the lag effects, the control variables under Set II will be used in contemporaneous level only because the latter are not the proxy variables of financial development.

Equations under Set I: As mentioned, this set of equations contains *Growth* as dependent variable and only FD indicators as independent variables. There are altogether 15 equations in this set with different combinations of regressors; these are divided into i) contemporaneous FD indicators, ii) contemporaneous with lagged FD indicators, and iii) lagged FD indicators. These are:

---

[5] Although economic liberalization process in Nepal started during mid-1980s, the effective liberalization that the country saw was only after the political movement of early 1990s that established democratic government in 1992.

[6] The inclusion of the lag variables in our estimation is consistent with earlier domestic studies

Estimations with Contemporaneous FD indicators

Growth = $\alpha_1 + \beta_1$ Liqliab + β_2 Commbank + β_3 Bankcred 1
Growth = $\alpha_1 + \beta_1$ Liqliab + β_2 Commbank 2
Growth = $\alpha_1 + \beta_1$ Liqliab + β_2 Bankcred 3
Growth = $\alpha_1 + \beta_1$ Commbank + β_2 Bankcred 4

Estimation with Contemporaneous and Lagged FD indicators

Growth = $\alpha_1 + \beta_1$ Liqliab + β_2 Commbank + β_3 Bankcred + β_4 Liqliab (-1)
+ β_5 Commbank (-1) + β_6 Bankcred (-1) 5
Growth = $\alpha_1 + \beta_1$ Liqliab + β_2 Commbank + β_3 Liquliab (-1) + β_4 Commbank (-1) 6
Growth = $\alpha_1 + \beta_1$ Liqliab + β_2 Bankcred + β_3 Liquliab (-1) + β_4 Bankcred (-1) 7
Growth = $\alpha_1 + \beta_1$ Commbank + β_2 Bankcred + β_3 Bommbank (-1) + β_4 Bankcred (-1) 8

Estimation with Lagged FD indicators

Growth = $\alpha_1 + \beta_1$ Liqliab (-1) + β_2 Commbank (-1) + β_3 Bankcred (-1) 9
Growth = $\alpha_1 + \beta_1$ Liqliab (-1) + β_2 Commbank (-1) 10
Growth = $\alpha_1 + \beta_1$ Liqliab (-1) + β_2 Bankcred (-1) 11
Growth = $\alpha_1 + \beta_1$ Commbank (-1) + β_2 Bankcred (-1) 12
Growth = $\alpha_1 + \beta_1$ Liqliab + β_2 Liqliab (-1) 13
Growth = $\alpha_1 + \beta_1$ Commbank (-1) + β_2 Commbank (-1) 14
Growth = $\alpha_1 + \beta_1$ Bankcred + β_2 Bankcred (-1) 15

3.3.2 Equations under Set II: Besides the set of FD indicators along with their lagged form as explanatory variables of economic growth, this study utilizes a set of control variables (CV) along with FD variables, as explained above, with the view to examine the robustness of the growth equation. The estimating general equation, therefore, is represented as:

Growth = $\alpha_1 + \beta_1$ FD + β_2 CV + β_3 D 1991 16

Where FD and CV are defined as the vector of FD indicators and control variables respectively with β_i s as their respective coefficient vectors.

However, the FD vector in this set is chosen on the basis of iterative regression under set I -- meaning that the set of FD indicators in equation 16 will come from significant FD variables from the equations under set I. Similarly for CV, all are simultaneously estimated, followed by different combinations on pair-wise basis. The criteria for the robustness of the model are then judged by the improvement of model in terms of adjusted R2, DW statistic and F statistics. Finally, this study also attempts to include interaction variables to examine the interplay of different variables; this is done by taking different combinations of the product of FD and CV as explanatory variables of economic growth.

Results

Results Under Set I: The results of equations under *Set I* are provided in the table in annex 4. In that table, the equations with variables that are statistically insignificant up to 10 percent level are noted by asterisks (*). The table shows that all the equations using only the contemporaneous (equations 1-4) variables of FD are not significant even at 10

percent level of significance. However, *Liqliab* at first lag level was found to be significant in most of the equations having FD variables at both contemporaneous and lagged level. But remaining indicators, namely *Bankcred* and *Commbank* but more specifically *Bankcred,* are found to be statistically insignificant in almost all of the equations. The only equations which are found to be significant are equations 9, 10 and 13. The empirical equations of these are:

Growth = -0.024 + 0.097* *Liqliab* (-1) – 0.282 * *Commbank* (-1)
(0.39) (0.051) (0.089)
+ 0.002* *Bankcred* (-1) 9
(0.968) Adjusted R^2 = 0.077

Figures in parenthesis are P-values

Growth = -0.024+ 0.098* *Liqliab* (-1) – 0.278* *Commbank* (-1) 10
(0.372) (0.023) (0.03) Adjusted R^2 = 0.109

Growth = 0.02 - 0.140* *Liqliab* + 0.137* *Liqliab* (-1) 13
(0.18) (0.033) (0.026) Adjusted R^2 = 0.104

Based on above three estimation results, it is concluded that although the explanatory power is not very strong, *Liqliab* at its level and lagged level and *Commbank* at its lagged level are found to be significant and therefore are carried out for further analysis in the equations under Set II.

Results Under Set II: The results from equations under Set I provided three Financial Development variables – *Commbank(-1)*, *Liqliab* and *Liqliab(-1).* With these variables and the vector of CVs along with D1991, seven separate equations are estimated in this set and are sequentially carried out as: (i) putting together all CVs along with identified FD vector (equation 16); and (ii) using all possible pair-wise combinations of CVs with significant FD indicator(s) found in (i) (equation17 to 22). The results are provided in the table in annex 5.

As seen from annex 5, *Liqliab* is significant both in contemporaneous and lagged form in equation 16. However, *Commbank(-1)* was found to be insignificant. Therefore, equation 17 to 22 (Annex 5) are estimated using all six pair-wise combinations of CV indicators with FD indicators being L*iqliab* and *Liqliab(-1)* and hence dropping out *Commbank(-1)*.In all of these equations, *Liqliab* and *Liqliab(-1)* were found to be statistically significant. Also, among the control variables, *Trade* and *Popgrow* were found to be significant in each equation where they appear both individually as well as together. Therefore, from the process of iteration and method of elimination, the most representative equation under this set of equations is equation 22. The empirical equation is

Growth = 0.187 – 0.212 * *Liqliab* + 0.158* *Liqliab* (-1) + 0.142 * *Trade*
(0.008) (0.003) (0.005) (0.013)

– 0.863 * *Popgrow* + 0.049 * D 1991 22
(0.029) (0.045)

Adjusted R^2 = 0.302, Prob (F-statistic) = 0.012, DW = 2.306

The above estimated equation 22 was also enhanced by two interaction variables – i) product of *Liqliab* and *Popgrow*; and ii) *Liqliab(-1)* and *Popgrow* – but the results did not

show any improvements. Therefore, the final representation of the empirical exercise of this study is given by the equation 22.

Test of Causality : he equation 22 is further analyzed for the Granger Causality Test (GCT), since any statistically significant empirical equation may be significant just because of the presence of bidirectional relationship. It means that if a variable X causes Y and vice versa, it is always possible that the regression of Y on X is statistically significant. GCT ensures such doubt on bidirectional causality. The standard Granger Causality Equation is given by:

$$X_t = \alpha + \sum_{i=1}^{m} \beta_i X_{t-1} + \sum_{j=1}^{n} Y_j Y_{t-j} + u_t \qquad \text{................ (A)}$$

$$Y_t = \alpha + \sum_{i=1}^{q} \beta_i Y_{t-1} + \sum_{j=1}^{r} c_j X_{t-j} + v_t \qquad \text{................. (B)}$$

where u_t and v_t are zero-mean, serially uncorrelated, random disturbances and the lag lengths m, n, q and r are assigned on the basis of minimizing Akaike's information criterion.

The variable Y is said to Granger Cause X, if the null hypothesis that H_0: $\gamma_1 = \gamma_2 = \gamma_3 = \gamma_n = 0$ is rejected against the alternative H_1 : at least one γ_i is not equal to zero for i = 1,2,3...n. in equation A. Conceptually, Y granger causes X means that the past values of Y series can statistically enhance the forecasting capability of X series. Similar interpretation can be made for equation B.

Refering to our equation 22, the GCT is to perform between *Growth* and *Liqliab*, since the only FD indicator that we found statistically significant during our analysis above is *Liqliab*. However, GCT may give spurious result if the variables are not stationary. Therefore, two variables *Growth* and *Liqliab* are first tested for stationarity. The ADF test suggested that *Growth* is I(0) but *Liqliab* is I(1). The t-statistics and P-value for both these variables at level and first difference are shown in table 2 below:

Table 2: ADF Test of *Growth* and *Liqliab*

Variable	t-statistics	P-value
Growth	-5.928	0.000
Liqliab	-1.661	0.440
*D(Liqliab)**	-6.185	0.000

* D here stands for the notation that *Liqliab* is tested for stationarity in first difference

As depicted from table above, the GCT has to be conducted between *Growth* and D*(Liqliab)* because these two variables follow I(0) process. However, running bivariate regression equation from Growth to *D(Liqliab)* with different lag period assigned on D*(Liqliab),* the Akaike's information criterion became smallest in lag length of 3[7]. Therefore, appropriate lag length to conduct GCT came to be equal to 3. The GCT test revealed that there is one directional causality from D*(Liqliab)* to Growth as can be

[7] Akakie's information criterion for different lag lengths are found to be: -4.479, -4.414, -4.545, -4.45 and -4.380 for lag lengths of 1, 2, 3, 4 and 5 respectively.

interpreted from the result provided in table 3. This test supported the result from equation 22 that it is lag form of *Liqliab* that causes *Growth* but not vice-versa.

Table 3: Result Granger Causality Test between *Growth* and D*(Liqliqb)*

Pairwise Granger Causality Tests Sample: 1975 2007 Lags: 3			
Null Hypothesis:	*Obs*	*F-Statistic*	*Probability*
D(LIQLIAB) does not Granger Cause GROWTH	29	2.5826	0.07918
GROWTH does not Granger Cause DLIQLIAB		0.67093	0.57894

Analysis and Recommendations

The results before introducing control variables showed that neither of the proxies of FD indicators showed significant impact on growth in the contemporaneous level. However, in the lag form of the variables, it showed mixed results depending on which proxy of FD has been used. For example, the result showed a significant but negative impact of lag level of *Commbank* (private financial asset to total financial asset ratio) but significant positive impact of one period lagged value of *Liqliab* (liquid liability of financial system to GDP ratio). But other proxy of financial development indicator, namely bank credit to GDP ratio, did not show remarkable impact on per-capita growth both in present and lag level.

The above findings were not significantly altered even when using control variables and hence revealed that the results were robust. As shown by the final representative equation 17, one percent increment in liquid liability to GDP ratio of the nation would increase per-capita GDP by 0.15 percent in next period. However, present level of liquidity to GDP ratio showed negative impact on GDP. The significant and positive impact of liquid liability to GDP ratio in one period lag cannot be discarded because of two reasons: (i) it measures the liquidity position of the nation which is essential for the investments; and (ii) the outcome of investment cannot be realized in the contemporaneous time. Also, it is hypothesized that the lagged effect of liquid liability on growth took place due to the weakness in the domestic financial system, especially in the post liberalization period, reflected in increasing level of Non-performing Assets (NPAs) of two big banks, namely Nepal Bank Limited and Rastriya Banijya Bank. The increasing share of NPAs, in general, indicates that the borrowers were not able to pay back the loan because of their losses in the respective business, among others. The loss in the business having investment in productive sector would mean a marginal or even negative contribution to national output and hence to per-capita output. This may be the reason that the positive impact of increasing level of liquidity position would be seen only after one period with contemporaneous impact being negative. This analysis is more justified in light of the people's war which lasted for almost 12 years ending at 2006.

Among the control variables, the economic liberalization in terms of increasing volume of trade showed both a positive and significant impact on growth – a one percent increase in total trade to GDP ratio has a nearly 0.14 percent increase in per-capita growth. This is also consistent with the theory from international trade that in a liberal environment, trade will facilitate domestic economic growth. Nepal's stage of economic liberalization spurted

from 1992 with the introduction of different liberalized macro policy instrument. This is also evidenced by the significant result of D1991. Similarly the study suggests that the nation's population growth has hindered the economic performance.

Implications and recommendations: The results suggest that financial development - measured from liquid liability to GDP ratio - does matter for economic growth and hence for per-capita growth after one year lag. However, the effects, while significant, is time varying with differential impacts: contemporaneously it is negative but at one year lag it is positive. This may be because of the embryonic state of the domestic financial system. To enhance the efficiency and effectiveness of the financial markets, it is recommended to seriously think on our financial environment in terms of determining the measures which have direct linkages on economic activities. One way to do this may be by developing a financial sector master plan (FSMP) in view of medium and long term perspective pointing to where the nation's financial system would move. The master plan would find out objective targets of financial health, both in terms of quantity and quality in consideration with the possible entry of foreign bank branches after 2010. The proposed FSMP should also incorporate all entities of financial system including insurance services, stock market, provident fund etc. into single framework and should specify a high level committee to regularly monitor and supervise the financial system. Besides the importance of financial development strategies and policies, the empirical results suggest that GON should also pay more attention to foster and get maximum benefit from trade. The last implication of the result is on population growth. The negative impact of population growth suggests that there is a negative and significant relation with economic growth. The short term measure for this would be to effectively control the population growth measures. But in long term, the government should find the way to enhance the quality of human resource and make the environment feasible to absorb them within the nation.

Summary and Conclusion

Nepalese financial system has witnessed a rapid growth both in terms of quantitative and qualitative aspects. Growing share of total credit, total assets and other measures of financial development indicators can prove this fact. Notwithstanding this fact, there are mixed empirical findings about the role of financial development indicators on economic growth; this study tried to determine the relationship with economic growth of Nepalese economy over the period FY 1975 - FY 2007. For this purpose the study selected per-capita real GDP as a measure of growth and four proxies of financial development indicators.

Using simple OLS technique and then utilizing the CVs for robustness of the results, the study showed that not all the measures of financial development indicators affect the economic growth. The one variable that affects economic growth is the ratio of liquid liability to nominal GDP. The positive effect of such indicator in one period lag form suggests that the government should proactively guide the domestic financial environment and thereby develop a master plan in this regard.

However, the conclusions *from* this study are subject to the methodology used, the quality of data especially on real sector side. Hence there are many potential areas for future study. For example, this study was aimed to focus on the impact of financial development on economic growth with the narrow definition of financial development – limiting to commercial banks based statistics only due to data availability. Therefore, future exercises can be extended covering to all banks and financial institutions,

insurance companies, stock exchange, provident fund and citizen investment trust. Likewise, the issue of separating total private sector credit into productive credit and non-productive credit is not covered in this study. Finally, the methodology that this study can be extended into more sophisticated form to get more refined and fine-tuned aspect of analysis.

Selected References

Bagehot, W. (1873), Lombart Street. A Description of Money Market, viewed on http://www.fullbooks.com/Lombard-Street--A-Description-of-the-Money.html on 21 September, 2007 at 1 PM.).

Bhattacharya, P. and Sivasubramanian, M. (2003). "Financial Development and Economic Growth in India: 1970-1971 to 1998-1999." *Applied Financial Economics*, 13 (12), 905-909.

Bhetuwal K.R. (2007). "Financial liberalization and Financial Development in Nepal." *Economic Review*, Occasional paper-19, April, Nepal Rastra Bank.

Buffie, Edward F. (1984). "Financial Repression, the New Structuralists, and Stabilization Policy in Semi-industrialized Economies." *Journal of Development Economics* 14: 305-322.

Greenwood, J. and Jovanovic, B. (1989). "Financial Development, Growth and the Distribution of Income." *NBER working paper* series No. 3189 www.nber.org

Kamat M. and Manasvi Kamat. (2007). "Does Financial Growth Lead Economic Performance in India? Causality-Cointegration using Unrestricted Vector Error Correction Models." *Indian Institute of Technology Bombay*, Goa University, November.

Khan Aubhik (2000). "The finance and Growth Nexus." available at www.philadelphiafed.org/files/br/brjf00ak.pdf

King, R. G. and Levine R. (1993). "Finance and Growth: Schumpeter Might Be Right." *Quarterly Journal of Economics,* CVIII pp. 717-737

Levine (2004). "Finance and Growth: Theory and Evidence." *NBER working paper 10766*, available at http://www.nber.org/papers/w10766

Levine R. (1997). "Financial Development and Economic Growth: Views and Agenda." available at web.nps.navy.mil/~relooney/levine.pdf –

Levine R. (2003). "More on Finance and Growth: more Finance, more Growth?" available at research.stlouisfed.org/publications/review/03/07/Levine.pdf

Levine, R and Zervos, S (1998). "Stock Markets, Banks, and Economic Growth." *American Economic Review*, 88, 537–558.

Lewis, W. Arthur (1995). " The theory of Economic Growth." London, George Allen and Unwin Ltd.

McKinnon, R.I. (1973). "Money and Capital in Economic Development." Washington, DC: The Brookings Institution.

Mohapi, P. L. and Motelle S. I. (2007). "The Finance – Growth Nexus in Lesotho: Causiltity Revelations From Alternative Proxies." viewed onhttp://search.sabinet.co.za/images/ejour/bersee/bersee_v31_n3_a2.pdf

Neusser, K. and Kugler M. (1996). "Manufacturing Growth and Financial Development: Evidence from OECD Countries." *Review of Economics and Statistics*, 80(4), 645.

Pagano (1993). "Financial Markets and Growth: An Overview." available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=392606

Patrick, Hugh T. (1966). " Financial Development and Economic Growth in Underdeveloped Countries." *Economic Development and Cultural Change* 14: 174-189

Paudel, N. P. (2005). "Financial System and Economic Development." Nepal Rastra Bank in 50 Years, *Sajha Prakashan,* Pulchok,Kathmandu, Nepal, pp. 176-201

Robinson, J. (1952), "The Generalization of the General Theory." in *The Rate of Interest and Other Essays*, London: Macmillan, pp. 69-142.

Schumpeter, J. A. (1911) "The Theory of Economic Development." Cambridge, Mass.: Harvard University Press.

Shaw, Edward S., (1973), "Financial Deepening in Economic Development." Oxford University Press, New York.

Shrestha M.B. (2005), "Financial Liberalization in Nepal." Ph.D. Dissertation submitted to University of Wollongon, Australia.

Tang D. (2006), "The Effect of Financial Development on Economic Growth: Evidence from the APEC Countreis, 1981-2000." *Applied Economics*, 38, pp 1889-1904.

van Wijinberge, Sweder. (1982), "Stagflationary Effects of Monetary Stabilization Policies." *Journal of Development Economics,* 10: 133-169

Wachtel (2002), "Growth and Finance: What Do We Know and How Do We Know It." available at www.stern.nyu.edu/~pwachtel/IFAut01.pdf

Annex 1(A) : Time Series of Raw Variables Before Taking Natural Logarithm

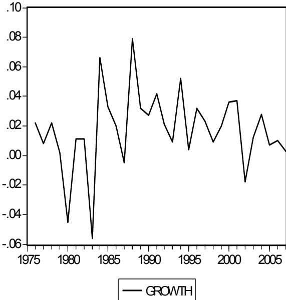
Variable Year	GROWTH	LIQLIAB	COMMBANK	BANKCRED	TRADE	GOVTCONS	INVEST	POPGROW
1975	-	0.129	0.448	0.075	0.169	0.061	0.153	-
1976	0.022	0.152	0.460	0.069	0.191	0.075	0.156	0.021
1977	0.008	0.198	0.501	0.071	0.195	0.092	0.166	0.022
1978	0.022	0.205	0.506	0.089	0.191	0.098	0.169	0.021
1979	0.002	0.183	0.506	0.082	0.169	0.080	0.123	0.021
1980	-0.045	0.241	0.523	0.120	0.212	0.105	0.144	0.022
1981	0.011	0.248	0.565	0.135	0.237	0.107	0.139	0.070
1982	0.011	0.257	0.545	0.119	0.221	0.128	0.146	0.026
1983	-0.056	0.291	0.554	0.122	0.235	0.157	0.164	0.026
1984	0.066	0.283	0.553	0.111	0.222	0.140	0.145	0.026
1985	0.033	0.277	0.548	0.117	0.236	0.124	0.185	0.027
1986	0.020	0.285	0.531	0.130	0.233	0.117	0.148	0.026
1987	-0.005	0.286	0.543	0.132	0.227	0.121	0.166	0.025
1988	0.079	0.293	0.543	0.136	0.246	0.129	0.155	-0.011
1989	0.032	0.310	0.539	0.153	0.238	0.144	0.141	0.021
1990	0.027	0.316	0.534	0.148	0.236	0.130	0.129	0.021
1991	0.042	0.325	0.545	0.141	0.264	0.138	0.173	0.021
1992	0.021	0.315	0.567	0.147	0.315	0.114	0.186	0.024
1993	0.009	0.353	0.554	0.150	0.342	0.117	0.220	0.023
1994	0.052	0.364	0.573	0.174	0.370	0.111	0.213	0.024
1995	0.004	0.386	0.588	0.217	0.387	0.094	0.226	0.024
1996	0.032	0.387	0.620	0.249	0.394	0.104	0.229	0.024
1997	0.023	0.385	0.635	0.255	0.431	0.098	0.219	0.024
1998	0.009	0.436	0.646	0.280	0.402	0.100	0.211	0.024
1999	0.020	0.463	0.663	0.294	0.373	0.070	0.179	0.024
2000	0.036	0.508	0.680	0.317	0.432	0.070	0.183	0.023
2001	0.037	0.504	0.690	0.314	0.403	0.067	0.157	0.011
2002	-0.018	0.504	0.681	0.322	0.348	0.056	0.163	0.022
2003	0.012	0.519	0.708	0.340	0.368	0.047	0.176	0.022
2004	0.028	0.535	0.682	0.354	0.367	0.045	0.182	0.022
2005	0.007	0.530	0.705	0.373	0.367	0.048	0.177	0.022
2006	0.010	0.557	0.703	0.363	0.376	0.048	0.189	0.022
2007	0.003	0.572	0.717	0.393	0.365	0.047	0.184	0.022

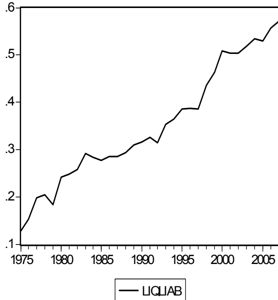
Source: CBS and NRB. The detail description are provided in "Variables and Data sources" under Methodology section of the study

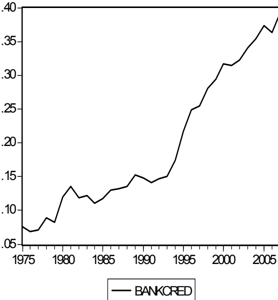
Annex 1(B) : Time Series of Estimating Variables

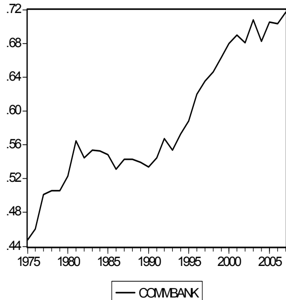
Obs.	GROWTH	LIQLIAB	COMMBANK	BANKCRED	TRADE	GOVTCONS	INVEST	POPGROW
1975		-2.046	-0.803	-2.593	-1.776	-2.804	-1.874	
1976	0.022	-1.883	-0.777	-2.673	-1.656	-2.595	-1.86	0.021
1977	0.008	-1.618	-0.691	-2.642	-1.634	-2.384	-1.796	0.022
1978	0.022	-1.586	-0.682	-2.414	-1.656	-2.321	-1.779	0.021
1979	0.002	-1.7	-0.681	-2.501	-1.776	-2.524	-2.098	0.021
1980	-0.045	-1.421	-0.649	-2.12	-1.553	-2.249	-1.936	0.022
1981	0.011	-1.396	-0.571	-2.002	-1.439	-2.233	-1.976	0.07
1982	0.011	-1.359	-0.607	-2.125	-1.509	-2.053	-1.922	0.026
1983	-0.056	-1.233	-0.59	-2.107	-1.447	-1.849	-1.809	0.026
1984	0.066	-1.264	-0.593	-2.194	-1.505	-1.969	-1.93	0.026
1985	0.033	-1.285	-0.601	-2.147	-1.444	-2.091	-1.689	0.027
1986	0.02	-1.256	-0.633	-2.041	-1.455	-2.148	-1.911	0.026
1987	-0.005	-1.251	-0.61	-2.023	-1.482	-2.115	-1.798	0.025
1988	0.079	-1.228	-0.611	-1.994	-1.403	-2.049	-1.867	-0.011
1989	0.032	-1.171	-0.619	-1.876	-1.434	-1.94	-1.959	0.021
1990	0.027	-1.151	-0.628	-1.909	-1.446	-2.037	-2.046	0.021
1991	0.042	-1.125	-0.607	-1.958	-1.333	-1.983	-1.754	0.021
1992	0.021	-1.155	-0.568	-1.915	-1.155	-2.172	-1.68	0.024
1993	0.009	-1.042	-0.591	-1.894	-1.074	-2.142	-1.514	0.023
1994	0.052	-1.01	-0.557	-1.749	-0.995	-2.202	-1.545	0.024
1995	0.004	-0.953	-0.532	-1.526	-0.949	-2.362	-1.487	0.024
1996	0.032	-0.949	-0.479	-1.39	-0.931	-2.26	-1.474	0.024
1997	0.023	-0.955	-0.454	-1.367	-0.842	-2.318	-1.519	0.024
1998	0.009	-0.829	-0.437	-1.272	-0.911	-2.304	-1.558	0.024
1999	0.02	-0.77	-0.411	-1.226	-0.985	-2.664	-1.721	0.024
2000	0.036	-0.677	-0.385	-1.149	-0.839	-2.665	-1.701	0.023
2001	0.037	-0.685	-0.371	-1.158	-0.909	-2.71	-1.853	0.011
2002	-0.018	-0.684	-0.384	-1.134	-1.057	-2.886	-1.813	0.022
2003	0.012	-0.655	-0.346	-1.078	-1	-3.053	-1.737	0.022
2004	0.028	-0.625	-0.383	-1.038	-1.002	-3.11	-1.704	0.022
2005	0.007	-0.634	-0.35	-0.987	-1.001	-3.031	-1.731	0.022
2006	0.01	-0.586	-0.352	-1.015	-0.979	-3.047	-1.668	0.022
2007	0.003	-0.559	-0.333	-0.935	-1.008	-3.06	-1.694	0.022

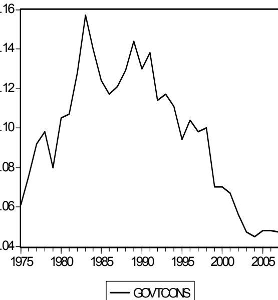
Annex 1(C) : The Graphs of Raw Variables

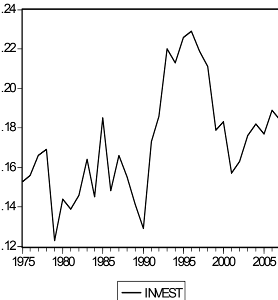


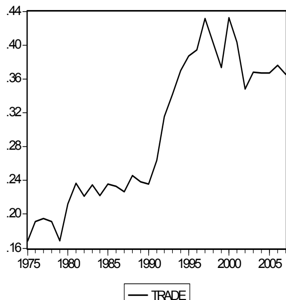


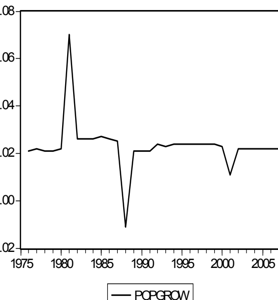












Annex 2 : Summary Statistics: Divided Two Time-Segments

		GROWTH	LIQLIAB	COMMBANK	BANKCRED	TRADE	GOVTCONS	INVEST	POPGROW
1975-2007	Mean	0.0173	0.3584	0.5909	0.2005	0.2998	0.0975	0.1732	0.0232
	Std. Dev.	0.0265	0.1209	0.0742	0.1025	0.0836	0.0324	0.0284	0.0108
	Obs.	32	32	32	32	32	32	32	32
1976-1991	Mean	0.0168	0.2517	0.5261	0.1147	0.2189	0.1145	0.1531	0.0241
	Std. Dev.	0.0342	0.0586	0.0325	0.0275	0.0271	0.0264	0.0162	0.0151
	Obs.	16	17	17	17	17	17	17	16
1992-2007	Mean	0.0178	0.4574	0.6508	0.2839	0.3775	0.0773	0.1934	0.0223
	Std. Dev.	0.0169	0.0819	0.0550	0.0787	0.0306	0.0274	0.0228	0.0032
	Obs.	16	16	16	16	16	16	16	16

Annex 3 : Correlation Matrix of Estimating Variables (1975-2007)

	GROWTH	LIQLIAB	COMMBANK	BANKCRED	TRADE	GOVTCONS	INVEST	POPGROW	D1991
GROWTH	1.000	0.046	-0.018	0.005	0.112	0.126	0.066	-0.294	0.019
LIQLIAB		1.000	0.960	0.966	0.904	-0.443	0.492	0.049	0.806
COMMBANK			1.000	0.973	0.878	-0.591	0.444	0.101	0.819
BANKCRED				1.000	0.912	-0.582	0.487	0.033	0.845
TRADE					1.000	-0.403	0.730	0.046	0.934
GOVTCONS						1.000	-0.156	0.127	-0.571
INVEST							1.000	-0.019	0.731
POPGROW								1.000	-0.015
D1991									1.000

Annex 4 : Regression Results of Estimating Equation (Set I)

Name of Eq.	*Constant*	FD Contemporaneous			FD Lagged			*Adjusted R2*	*DW*
		Liqliab	*Commbank*	*Bankcred*	*Liqliab*	*Commbank*	*Bankcred*		
1	*	*	*	*					
2		*	*						
3	*	*		*					
4			*	*					
5	-0.024	-0.062	-0.089	-0.046	0.141	-0.195	0.057	0.102	2.416
	0.44	0.471	0.668	0.465	0.043	0.317	0.312		
6	-0.02	-0.088	-0.097		0.163	-0.137		0.131	2.328
	0.467	0.222	0.579		0.014	0.454			
7	0.015	-0.07		-0.062	0.127		0.021	0.086	2.086
	0.396	0.421		0.286	0.061		0.677		
8	-0.005		-0.175	-0.042		-0.051	0.096	-0.014	2.325
	0.875		0.422	0.449		0.789	0.096		
9	-0.024				0.097	-0.282	0.002		
	0.39				0.051	0.089	0.968	0.077	2.542
10	-0.024				0.098	-0.278			
	0.372				0.023	0.03		0.109	2.54
11					*		*		
12						*	*		
13	0.02	-0.14			0.137			0.104	2.035
	0.18	0.033			0.026				
14			*			*			
15				*			*		

Annex 5 : Regression Results of Estimating Equation (Set II)

No	*Constant*	*Liqliab*	*Liqliab (-1)*	*Commbank (-1)*	*Trade*	*Invest*	*GovCons*	*Popgrow*	*D1991*	Adj R2	F-stat	DW
16	0.030	-0.202	0.194	-0.200	0.180	-0.017	-0.025	-0.880	0.065	0.283	2.527	2.482
	0.758	0.012	0.004	0.194	0.022	0.722	0.244	0.031	0.057		0.039	
17	0.153	-0.197	0.151		0.132	-0.005			0.045	0.159	2.170	2.111
	0.114	0.009	0.015		0.064	0.927			0.089		0.089	
18	0.159	-0.210	0.156		0.149		-0.009		0.056	0.165	2.226	2.1201
	0.030	0.010	0.012		0.053		0.653		0.110		0.082	
19	0.121	-0.155	0.153			0.042		-0.746	0.013	0.145	2.055	2.2781
	0.201	0.026	0.015			0.319		0.082	0.539		0.104	
20	0.110	-0.140	0.144			0.031	0.010		0.007	0.048	1.309	2.1708
	0.270	0.057	0.030			0.544	0.613		0.778		0.291	
21	0.071	-0.141	0.138				0.015	-0.758	0.006	0.145	2.047	2.2627
	0.163	0.042	0.024				0.326	0.078	0.736		0.105	
22	0.187	-0.212	0.158		0.142			-0.867	0.049	0.302	3.683	2.3066
	0.008	0.003	0.005		0.013			0.029	0.045		0.012	

Chapter II

Nepalese Financial System : Policy Developments and Challenges

Dr. Bhubanesh Pant*

Background

The financial sector refers to all the wholesale, retail, formal and informal institutions in an economy offering financial services to consumers, businesses and other financial institutions. In its broadest definition, it includes everything from banks, stock exchanges, and insurers, to credit unions, microfinance institutions and money lenders (DFID, 2004).

The notion that financial and economic activities are closely interrelated is not new. Indeed, it has a long tradition in economic theory. For instance, Clément Juglar – the French economist who was among the first to investigate the nature of business cycles – argued back in 1860 that economic fluctuations originate in the credit system.

A modern financial system is important in the economy in order to pool and utilize financial resources, reduce costs and risks, expand and diversify opportunities, increase the allocative efficiency of resources and promote the productivity and facilitate the economic growth. As a country's financial sector develops and becomes more efficient, it enables individuals and institutions to channel savings to more productive enterprises. This offers the prospect of significant growth in GDP. Hence, while a sound and healthy financial system contributes to the growth of the real sector on a sustainable basis, uncertainty and fragility in the financial system adversely affect the objectives of economic development in general and poverty reduction in particular, as witnessed by the experiences of the financial crises of the 1990s.

From the point of view of central banks, developments in the financial sector have a special role that distinguishes them from other services. In so far as financial developments influence the long term output and employment growth, they can affect the wide range of indicators and tools that central banks use to monitor and model the behaviour of the economy. More specifically, changes in the banking sector may affect the monetary transmission mechanism. A more developed and efficient financial system is likely to contribute to a more effective, harmonised and smooth transmission of the single monetary policy. In addition, the stability of the financial system is also a crucial concern for central banks and for the economy as a whole. In principle, deeper and more complete financial system should provide a number of social benefits, including better risk

* Acting Director, Research Department, Nepal Rastra Bank

hedging and risk diversification that render economies less vulnerable to disturbances. However, there have long been concerns that some financial developments may lead to increased speculative behaviour, market volatility and, ultimately cause or exacerbate financial crises (González-Páramo, 2008).

The efficiency of a financial system typically depends on several key factors, including its degree of integration, market competition, level of development and innovation capacity. Indeed, there is a significant amount of empirical evidence derived from cross-country data showing that countries in which more credit to the private sector is extended typically experience stronger economic growth.

One way for countries to develop their financial systems is to open up the sector to foreign competition and liberalize international capital flows. However, many countries are reluctant to do so because it also may expose them to more foreign shocks. Moreover, many economists also argue that if the institutional framework in which the banks operate is not well enough developed, the costs of liberalization may be high. A poorly regulated financial system may increase a country's susceptibility to bank runs and balance of payments crises (due to more external shocks), crony capitalism (due to poor enforcement of regulations), and excessive risk-taking by banks (due to implicit government guarantees). Thus, the costs of having a larger financial system could overwhelm the benefits from higher growth. However, the strength of the evidence indicates that financial development, if accompanied by well-designed regulations and enforcement, plays an important role in channeling savers' resources to more productive firms, thus resulting in sustainable long-run growth.

Experience with financial sector policies in developed and emerging markets offer valuable lessons on the role of government in the financial systems (Beck, 2006). There needs to be a critical and active role for government in enabling and creating markets, by ensuring competitive and contestable banking and capital markets and providing an incentive-compatible financial safety net. Defining a proper role for government is even more important as more and more countries embrace open capital accounts, which increases pressures to remove domestic policy distortions and liberalize markets.

Against the foregoing backdrop, the objectives of this paper are two-fold: a) to examine the policy developments pertaining to Nepal's financial system and b) to delineate some challenges of the country's financial system

Nepal's Financial System: Policy Developments

Since the financial system performs the crucial task of raising funds for, and channeling funds to, productive investment, successful financial liberalization is normally a significant constituent of a country's strategy for economic growth. Financial liberalization generally possesses multiple objectives: boosting deposit mobilization, enhancing the allocative efficiency of financial intermediation by abolishing the distortion created by administrative controls, stimulating greater competition in financial markets and improving monetary control.

In Nepal, the process of financial liberalization was actually initiated in the mid-1980s when the government gave a green signal for the entry of commercial banks in joint venture with foreign banks. With the need to modernize banking services through the transfer of technology and managerial skills, Nabil Bank Limited was established in 1984 as the first joint-venture bank in Nepal, which was subsequently followed by the

establishments of Nepal Investment Bank Limited and Standard Chartered Bank Nepal Limited.

The process of financial liberalization gained momentum in 1987/88 when Nepal entered into a three-year Structural Adjustment Programme (SAP) with the IMF. The broad aim of this programme was to increase the role of market forces in the financial system. The NRB initiated regular auctions of treasury bill since 1988/89 in order to introduce greater flexibility in the interest rate structure. It also redesigned its rediscounting rates in the form of three windows: basic rate, selective rate and lender of the last resort rate in 1989.

For reducing the dependence of commercial banks on the NRB for short-term borrowing requirements, a call money market was set up during 1988/89. During the same period, a comprehensive study entitled "Commercial Bank Problem Analysis and Strategy Study (CBPASS)" was undertaken in order to improve the financial and organizational structure of the two state-owned commercial banks (Nepal Bank Limited [NBL] and Rastriya Banijya Bank [RBB]). Some of the suggestions incorporated in the CBPASS were implemented in 1990/91.[1]

Because of the satisfactory results of the SAP, Nepal entered into another three-year Enhanced Structural Adjustment Facility (ESAF) with the IMF in 1992/93. During that period, the core focus of financial liberalization was directed towards a) allowing market forces to play a greater role in the financial system, b) enhancing private sector participation in the development of the financial system, c) increasing competition and thereby efficiency of the financial system, d) improving and increasing increase financial instruments and e) developing the capital market.

Under the loan assistance of the World Bank and grant assistance of the Department for International Development (DFID) of the United Kingdom, the Financial Sector Technical Assistance (FSTA) Project has been implemented since 1998. The re-engineering of the NRB, restructuring of NBL and RBB and capacity building in the financial sector are the main components of the Project. Under FSTA, Project, some progress has been made in strengthening the regulatory and supervisory capabilities of the NRB. A new licensing policy in 2002 (last revised in 2007) was framed for opening a new commercial bank or financial institution.[2]

An array of reform measures pertaining to financial sector legislation included the enactment of a new Nepal Rastra Bank Act, 2002 and Debt Recovery Act, 2002. With the enactment of the Nepal Rastra Bank Act, 2002, the central bank of the country has become an independent body in executing its policies for ensuring sound, efficient and healthy financial system through prudent regulatory and supervisory mechanism.[3] A Debt

---

[1] These included the recapitalization of the banks, repayment of government guaranteed loans and issue of government securities for provision for loan loss.

[2] This policy clearly spells out the following aspects: (a) minimum paid-up capital required, (b) share ownership structure, (c) depositing amount of share capital committed by the promoters, (d) special provisions on minimum paid-up capital for establishing bank/financial institution in economically backward regions of the country, (e) promoters' educational qualification, working experience and financial disciplinary aspects, (f) provisions on sale or transfer of the promoter shares, and (g) application processing time.

[3] According to the NRB Act, 2002, the major objectives of NRB are as follows: a) formulation of monetary and foreign exchange policies in order to maintain the stability of price and BoP for sustainable economic development; b) promoting stability and liquidity required in banking and financial sector; c) developing secure, healthy and efficient payment system; d) regulating,

Recovery Tribunal (DRT) was set up under the Debt Recovery Act, 2002 with the aim of improving the legal and judicial processes of recovering problem loans of banks and financial institutions.

Although the Credit Information Bureau (CIB) was established in 1989 under the initiation of Nepal Rastra Bank, it was registered as a company in September 2004 and started its operation as a company from March 2005. The CIB is the prime organization in the country acting as the repository of credit information of the customers and commercial borrowers of all the banks and financial institutions. It collects the credit information from the banks and financial institutions and disseminates them on demand. Regulatory provisions on blacklisting the borrower and credit information were revised.

To make the legal structure pertaining to banks and financial institutions up-dated, strong and convenient for the purpose of making bank and financial sector transactions healthy, secured and sound, the Secured Transactions Act and Insolvency Act were made effective from November 16, 2006 and November 20, 2006, respectively.

With a view to develop the NRB into a modern central bank, capable in maintaining financial sector stability, the second phase of financial sector reform is being focused on updating the information technology, supervisory capability and human resource management. Moreover, the accounting system of the NRB is being updated to comply with the requirements of international accounting standard and Nepal accounting standard.

In 2004, Bank and Financial Institution Ordinance was enacted and the new legal framework replaced different fragmented legal framework governing the operations of banks and financial institutions.[4] In the context of promulgation of the Banks and Financial Institutions Act (BFIA), the existing prudential regulations and directions, which were separately issued for banks and financial institutions, have already been revised and integrated into a unified directive and came into implementation from July 16, 2005.

To minimize the risk involved in the financial sector, the regulation regarding risk management has already been issued. To monitor such system by the NRB, the policy of implementing risk-based supervision is also being pursued. To develop risk management system, the private sector has been encouraged to establish a credit rating agency.

In reference to the building up of appropriate infrastructure for the implementation of BASEL II Accord since 2007, necessary directives, policies and provisions for the banks and financial institutions have been formulated in compliance with the accord. Further, as per BASEL II Accord, the regulatory provision has been prepared complying with the Simplified Standardized Approach (SSA) for capital base and Basic Indicator Approach (BIA) for operational risk.

---

inspecting, supervising and monitoring the banking and financial system; and e) promoting entire banking and financial system of Nepal and enhancing its public credibility. The Act also makes the NRB mandatory to make public the monetary policy report. For details, see NRB (2002).

[4]The Bank and Financial Institution Ordinance, 2004 has made a provision of categorizing deposit-taking financial institutions into four categories: A, B, C and D. With the enactment of a single or umbrella act governing the functions of deposit-taking financial institutions in Nepal, the issues related to the establishment, operation and exit of banks and financial institutions have been clearly spelt-out in the new legal framework. It should be noted that the Bank and Financial Institution Ordinance 2004 was converted into Bank and Financial Institution Act (BFIA) 2006 and made effective from November 3, 2006.

The large amount of non-performing assets (NPA) has been a major challenge for financial sector development and its stability.[5] As a measure to reduce the NPA level, the NRB is coordinating with the government in strengthening the capacity of Debt Recovery Tribunal and establishing an 'Asset Management Company' (AMC).

To discourage the possible fraud and crimes in the financial system, the "Anti-Money Laundering Act 2008" and "Banking Crime and Punishment Act, 2008" have been enacted on January 28, 2008 and February 5, 2008 respectively. In this connection, the Financial Intelligence Unit has been established in the NRB and the related by laws and directives are being prepared.

The profile of all commercial banks and financial institutions along with their major financial indicators has been prepared and posted on the web site of NRB to provide adequate information on financial conditions of commercial banks and financial institutions to the public. In addition, the directives issued to the licensed financial institutions by the NRB on the basis of on-site and off-site supervision has been placed on the website from 2006/07 for the use of the general public.

The NRB as a regulator and supervisor of the banking and financial sector has been trying to ensure a healthy, and efficient financial sector by improving regulation on par with international standard. As such, the capital adequacy, single borrower limit, loan loss provisioning, professionalism of the promoter, standardized capital base, total deregulation in interest rate, open licensing policy, phasing out the directed credit, etc., have been the major prudential regulatory reforms undertaken by the NRB.

The NRB as a central bank has been contributing through the sequential financial sector liberalization, extending financial services to the people, who were previously beyond the reach of banking and financial services, and the process of deregulation to micro finance activities. Similarly, the micro-finance activities are encouraged through the establishment of microfinance development banks, micro-finance institutions and non-government organizations together with the contribution made by the NRB in the self-reliance fund (SRF).

Against this perspective, the Government unveiled the National Micro-Finance Policy on May 4, 2008 with the objective of enhancing the capacity for microfinance. As per the Policy, a separate body would be set up to regulate and supervise the microfinance. The aim of the Policy is to increase access of microfinance to backward and financially weak families and women for improving employment opportunities. National Microfinance Development Fund would be established to mobilize resources from local and international communities. The NRB would monitor and supervise the implementation of this Policy.

The NRB has revised some of the regulatory norms that are not consistent with the market oriented economic policies. The provision relating to the interest rate spread has been abolished and the mandatory requirement of investing in priority sector for commercial banks has been phased-out. From 2007/08 onwards, priority sector lending requirement will not be mandatory for commercial banks.

In the process of accession to the World Trade Organization, Nepal had made commitments in financial services under the General Agreement on Trade in Services (GATS) and the Annex on Financial services. But, all the commitments are conditional upon entry requirement, domestic laws, rules and regulations as well as the terms and

---

[5] The overall size of NPLs in the Nepalese banking system has been estimated at about 8.98 percent as of mid-January 2008.

conditions of the NRB and Insurance Board. Financial services can carried out in Nepal through a domestically incorporated company. Branches of foreign banks are to be given a green signal for wholesale banking as of January 1, 2010. However, only those financial institutions that obtain a rating of at least 'B' from prominent global credit rating agencies such as Moody's and Standard and Poor's will be permitted to seek commercial business in the country. Against this perspective, considering the beginning of banking transactions by foreign banks in Nepal and opening of branches by the Nepalese banks abroad, the bank has prepared a new draft of 'Banks and Financial Institutions Act' as per international standard and submitted to the Ministry of Finance. The draft contains special and separate provisions for the licensing and the operation of foreign bank branches.

Due to the various measures initiated by the NRB in the financial sector of the country and thus generating a hospitable environment for the entry of new financial institutions, many financial institutions have been established and competition has been boosted to some extent. Overall, as of mid-July 2008, there were 25 commercial banks ('A' class financial institutions), 58 development banks ('B' class financial institutions), 78 finance companies ('C' class financial institutions), 12 micro-credit development banks ('D' class financial institutions), 16 credit cooperatives and 46 non-governmental organizations (NGOs) licensed by the NRB to undertake limited financial transactions. Besides these, there are other financial institutions consisting of Employees Provident Fund, Citizens Investment Trust, Postal Savings Bank, and 25 insurance companies (Table 1).[6] Commercial banks, development banks, finance companies and cooperatives and NGOs licensed to undertake limited banking businesses fall under the regulatory and supervisory jurisdiction of the NRB. Given the relatively small and under-developed economic base of the country, Nepal has a reasonably diversified financial sector as evidenced by the number and variety of institutions that play an active role in the sector.

Table 1: A Glimpse of Nepal's Financial Institutions

	2006 (Mid-July)	2007 (Mid-July)	2008 (Mid-July)
Commercial Banks (A class)	18*	20*	25*
Development Banks (B class)	29	38	58
Finance Companies (C class)	70	73	78
Micro-credit Financial Institutions (D class)**	11	12	12
Credit Cooperatives***	19	17	16
NRB licensed NGOs***	47	47	46
Insurance Companies	21	21	25
Employees Provident Fund	1	1	1
Citizens Investment Trust	1	1	1
Postal Savings Bank	117	117	117

*Including Agricultural Development Bank
**Including 5 Rural Development Banks
***Licensed by NRB to conduct limited banking transactions.
Source: NRB

[6] There is also the Deposit Insurance and Credit Guarantee Corporation (DICGC) set up in September 20, 1974 to encourage commercial banks to extend loan in priority sector. The DICGC guarantees a number of loans such as priority sector loans, livestock loan, vegetable farming loan, foreign employment loan, micro and deprived sector credit, and credit for small and medium industries.

A brief survey of the different players of the financial system, excluding the banks, is undertaken below. Development banks and finance companies are not permitted to take demand deposits or undertake foreign currency business, but are otherwise treated similarly to commercial banks. A number of development banks were established with active participation of private sector after the Development Bank Act 1996 became effective with the aim of enhancing agriculture, industry and commerce through the provision of credit. Prior to this Act, there were only two development banks namely Agricultural Development Bank (which has been converted into commercial bank) and Nepal Industrial Development Corporation, both owned by the government. At present, development banks are operating under Bank and Financial Institutions Act 2006 possessing the status of "B" class financial institutions. NRB issues necessary directives on regular basis for the effective regulation of these banks.

The establishment of finance companies speeded up after the first amendment of the Finance Companies Act 1986 in 1992. At present, these companies operate under Bank and Financial Institutions Act, 2006 as "C" class financial institutions. Cooperatives, on the other hand, have been set up under Cooperatives Act 1992. The NRB has licensed a small number of these cooperatives to undertake limited financial transactions. These cooperatives operate under the directives issued by the NRB. There are also NRB-licensed NGOs to undertake limited banking transactions in accordance with the provision of the Financial Intermediation Related Institutions Act 1999.

The Employees Provident Fund (EPF), established on September 16, 1962 under the Employees Provident Fund Act 1962, manages the provident fund of the government employees, army, police, teachers, government corporations, and of some private companies. On the other hand, the Citizen Investment Trust (CIT) mobilizes the private and institutional savings, extends loans and advances, and works as an issue manager. The Ministry of Finance regulates the CIT which was set up in March 18, 1991. The Postal Savings Bank, on the other hand, established under the Postal Service Department, Government of Nepal came into operation in 1976. This service has played a role in inculcating the habit of saving on the part of people in lower level income groups.

The financial sector also encompasses areas such as capital market and insurance. The stock exchange, being the important player of the capital market, has a significant role in the Nepalese financial market. Nepal Government, under a program initiated to reform capital markets converted Securities Exchange Center into Nepal Stock Exchange Limited (NEPSE) in 1993.[7] The NEPSE's primary objective is to impart free marketability and liquidity to the government and corporate securities by facilitating transactions in its trading floor through member, market intermediaries, such as broker, market makers etc. NEPSE opened its trading floor on January 13, 1994. Secondary market transaction of Government bonds commenced at NEPSE on December 15, 2006. The NEPSE introduced fully automated screen based trading since August 24, 2007, replacing the previous open-out-cry system. It facilitates trading in the following instruments: a) shares (equity shares and preference shares), b) debentures, c) government bonds, and d) mutual funds. Further, process has begun to enter more securities brokers into the securities market and make it more competitive as per the provision in the Securities

[7] Securities Exchange Center was established in 1976 with an objective of facilitating and promoting the growth of capital markets. Before conversion into stock exchange it was the only capital markets institution undertaking the job of brokering, underwriting, managing public issue, market making for government bonds and other financial services.

Broker Regulations, 2007. Moreover, the NEPSE has reconstructed its website and has started to include real time information since October 2007.[8]

The Securities Act 2007 came into effect on January 14, 2007. The Act has further broadened the mandate of the Securities Board of Nepal (SEBON) as the regulator of the securities market. The SEBON has introduced Security Board Regulations 2007, Securities Market Operation Regulation 2007, and Securities Dealers Regulation 2007 on November 5, 2007 and Merchant Banker Regulation on March 15, 2008. It has developed Securities Registration and Issue Regulation 2008, and has been submitted to the GON for final approval.[9]

The insurance sector was opened to the private sector in 1990. There are altogether 25 insurance companies established under Insurance Act, 1992. Seven of these are life insurance, 17 non-life insurance, and 1 is composite (both life and non-life). From the ownership perspective, 1 is government owned, 18 are owned by the private sector, 3 are foreign joint ventures, and 3 are foreign branches. The largely government-controlled National Insurance Corporation is the oldest corporate entity in this sector. The Insurance Board regulates the insurance sector.[10]

Challenges

- It is clear that establishment of banks, financial institutions and insurance companies help develop innovation and entrepreneurship that support long-term economic development. With the development of the financial sector, the challenge is to promote financial stability and discipline. Presently, the issue of ensuring effectiveness, transparency and discipline has also been of concern at the global level. Hence, it is also crucial to maintain financial stability in Nepal. The major challenge lies in enhancing competitiveness, expanding the financial access, and ensuring merger and acquisition besides strengthening systemic efficiency, discipline, and financial consolidation.

- Although recent measures undertaken by the NRB has improved the performance of the financial sector, the sector is still fragile and there is little access to financial services for the small businesses and low-income households. In this context, a recent study has identified two initiatives that the Government could take to help banks increase small business lending: a) develop a technical assistance fund to help

[8] Further, as stated in the budget statement of FY 2007/08 to privatize NEPSE, a concept paper regarding the transfer of government assets to listed companies, employees and locals has been prepared and submitted to the Ministry of Finance.

[9] With the grants assistance from the International Development Association (IDA), the SEBON has launched a project on March 19, 2008 to establish securities data management system. This is intended to establish a central data bank related to securities by setting up internal and external direct information relation, management of data system and information related to securities. Once the project is completed, companies listed as well as making fresh issues can submit required statements electronically to the SEBON as per the Securities Act and Regulations.

[10] The Insurance Board was constituted to systematize, regularize, develop and regulate the insurance business within the country under Insurance Act, 1992. This Board looks after all the insurance related activities in the country. As a regulatory body, the Board's main concern is to create a professional, healthy and developed insurance market in Nepal. To fulfill the needs of the changing scenario, Insurance Act, 1968 was repelled by new Insurance Act, 1992. The preamble of the Act explicitly notes the purpose of the Act, thus "to establish an Insurance Board to systematize, regularize develop and regulate the insurance business".

potential banks build up suitable products and procedures for profitable lending to small businesses; b) create an enabling environment so that small business lending is safer, cheaper and faster.[11] Similarly, for facilitating microfinance institutions serve a large number of low-income households, two steps could be undertaken by the government. The first one relates to promoting the microfinance industry by upgrading technical skills, reenergizing the sector, and reforming state-owned providers. The second measure concerns the creating of a legal and regulatory environment that protects microfinance consumers and promotes stability.[12]

- With Nepal's membership to the World Trade Organization (WTO), the changes and reforms that the banks and financial institutions have to make are more intricate and challenging. The accession of Nepal to this global organization exemplifies both opportunities and risks in the process of maintaining overall financial stability so as to help accelerate the speed of economic growth. In the long run, it is indispensable for the banking sector to have the financial resources, skills and large-scale commitment to compete with larger competitors that have sophisticated system, capital to handle credit and operational risks.

- The financial services sector (FSS) of Nepal will be completely open for foreign participation after 2010 as per the commitments of FSS liberalization. However, experiences have demonstrated that liberalization coupled with inadequate strengthening of regulatory and supervisory framework, is an open invitation for financial crisis. Hence, the opportunities and threats of liberalization of the financial sector need to be properly accessed. In order to compete at par with foreign financial institutions the Nepalese financial institutions not only needs to upgrade its skills but also its size and reach. The ability to tap right technology becomes increasingly important to meet the more sophisticated demands. As such financial services entities will require large amounts of capital investments to remain competitive and be able to assume higher risks.

- The country's financial sector has witnessed many changes in the past fostered, in part, by the emergence of new products and new market participants. While new financial products have undoubtedly led to better risk-sharing in the economy, they have also complicated the NRB's task of ensuring systemic stability through financial regulation and supervision. Moreover, due to a rapid increase in the number of banking and non-banking financial institutions with different modes of operations, the task of ensuring adequate monitoring and control by the NRB has been made more challenging.

- The development of credit rating agencies stands out as one of the possible options that would help reduce risk and check the high lending rates charged by financial intermediaries in the country. Equally important, credit rating agencies could help to de-emphasize the high importance attached by financial intermediaries to track records, a requirement that results from mistrust and lack of information about potential borrowers. The setting up of a credit rating agency is also necessary to provide information related to the securities and other market instruments besides

[11] To meet this objective, efforts need to be focused on a) building a registry for secured transactions; b) raising loan loss provisioning requirements overall while lowering them for small loans without registered movable collateral; and c) bolstering Nepal's credit bureau.
[12] These are issues are clearly examined in Ferrari et. al (2007).

contributing to the institutional good governance and practice of professional ratings of the institutions.

- An array of hindrances has restrained capital market development. A central depository system and a scriptless trading platform are prerequisites for an efficient capital market system but have been held up by the lack of an adequate legal framework. Current disclosure levels for listed companies are also weak and need to be supported by the development of a comprehensive set of accounting standards by the Institute of Chartered Accountants of Nepal. The nascent state of the insurance and pension sectors, and more generally, a limited investor and issuer base are also impediments to the development of the private securities markets.[13]

- Given the present context of lacking the appropriate investment infrastructure for institutional investors, such as the CIT, EPF, and insurance companies, there is a need to promote and manage the issuance of debentures, mutual funds, and unit plans through the stock exchange. Furthermore, to make the capital mobilization activities more professional and transparent, there is a need of clear regulatory measures for these institutions.

- Since the NEPSE is being run under the government ownership and management, it would be difficult for an autonomous regulatory institution to regulate and supervise it. In this context, there is a need to review the ownership and management and develop it as a modern institution operating as per the international practice.

- Given the growing concept of international listing and trading in the South Asian region, it is necessary to strengthen the professional and institutional capability of securities market and brokers. Establishment of a Central Depository System (CDS) is necessary in this regard. This will spread up the securities transfer process. Further, there is a challenge to develop the securities market, to make it a better avenue for NRNs and FIIs.

- Closer links between formal and informal financial markets should be developed by encouraging formal financial institutions to mobilize deposits and allocate credit through informal and community-based banks and microfinance agents in areas where the reach of formal banks is limited. Fiscal policies, as well as regulatory and supervisory structures, should be designed to encourage these developments.

- Capital account liberalization can play a useful role in financial reforms. Opening up to foreign banks and other financial firms and to foreign direct investment in the financial sector has many potential benefits. These benefits include the introduction of financial innovations and sophisticated financial instruments by foreign financial firms, added depth in domestic financial markets due to foreign inflows, and more efficiency in the domestic banking sector through increased competition. The academic literature indicates, however, that precipitous opening of the capital account before the domestic financial sector has reached a certain level of maturity and the appropriate regulatory expertise is in place could spell trouble.

- Action should be taken to build local capabilities in risk management. This encompasses development of trust and policy credibility, as well as governance procedures. Macroeconomic risks can be reduced by pursuing sound

---

[13] Peiris (2008) has extensively discussed the problems of developing the capital market in Nepal.

macroeconomic policies, improving coordination between fiscal and monetary policies, and careful management of government borrowing. Market risks can be mitigated by improving capital market efficiency, reducing interest rate volatility, developing secondary markets for treasury bills and improving liquidity management. Microeconomic risks can be lowered by improving the accuracy, reliability and timeliness of financial information, enforcing financial contracts, providing efficient and reliable payment systems, risk-sharing and credit risk insurance schemes, and enhancing diversification in small markets.

- An essential prerequisite of fiscal and monetary control is reliable and timely information on the financial and nonfinancial sectors. Decision-makers in central banks, supervisory agencies, and finance ministries need adequate financial information to monitor and diagnose financial sector problems and to distinguish between illiquidity and insolvency of individual institutions. Similarly, banks and investors need good financial information to assess and monitor the creditworthiness of borrowers and issuers of shares.

- Strong and reliable legal and regulatory frameworks are the foundations upon which policy credibility and financial stability rest. In their absence, economic and financial policies can not be implemented. Legal and regulatory enforcement is needed to ensure action is taken against those that violate their prudential and financial obligations, and to act as a credible deterrent for all market participants.

Conclusions

Financial markets build in many ways the backbone of an economy. A well-regulated financial sector leads to an efficient transformation of savings to investment, ensuring that resources are deployed where they earn the highest returns. A strong and resilient financial system and the orderly evolution of financial markets are the major prerequisites for financial stability and economic progress.

A healthy financial system is the one that effectively fosters resource mobilization for capital accumulation and determines efficient allocation of resources. It is important to remember that success of any financial system, in its resource mobilization and allocation functions, depends on its ability to offer the public a variety of assets (money as a medium of exchange, earning assets, pension funds, etc.) corresponding to the various needs and preferences of economic agents. A clear understanding and recognition of this fact is very important to formulate appropriate policies to enable the financial system to function properly and efficiently.

The test of the strength of a country's financial sector is its capability to make available the appropriate types of institutions and financial instruments that can support economic growth. The NRB’s challenge is to build up a financial system that is supportive of growth, and dynamic enough to change and fulfill the evolving demands of a real economy.

Selected References

Beck, Thorsten. 2006. "Creating an Efficient Financial System: Challenges in a Global Economy." *World Bank Policy Research Working Paper 3856*, February.

Department for International Department (DFID). 2004. "The Importance of Financial Sector Development for Growth and Poverty Reduction." Available in: http://www.dfid.gov.uk/Pubs/finseworkingpaper.pdf

Ferrari, Aurora, Guillemette Jaffrin and Sabin Raj Shrestha. 2007. *Access to Financial Services in Nepal*. Washington, D.C.: World Bank.

González-Páramo, José Manuel. 2008. "Financial Systems, New Technologies and Productivity Growth." Available in: http://www.ecb.int/press/key/date/2008/html/sp080711.en.html

Levine, R. 1997. "Financial Development and Economic Growth: Views and Agenda." *Journal of Economic Literature*, XXXV, 688-726

Ministry of Finance. 2008. *Economic Survey Fiscal Year 2007/08*. Kathmandu: Ministry of Finance. .

Nepal Rastra Bank. 2002. *The Nepal Rastra Bank Act, 2002*. Kathmandu.

Nepal Rastra Bank. 2005. *Nepal Rastra Bank in 50 Years*. Kathmandu.

Nepal Rastra Bank. 2008. *Economic Report FY 2006/07*. Kathmandu.

Pant, Bhubanesh. 2005. "Financial Sector and Development Planning" in NRB (ed.), *Nepal Rastra Bank in 50 Years*, Kathmandu.

Peiris, Shanaka. 2008. "Nepal: Selected Issues." IMF. May 2.

Chapter III

Central Banking Practices and Evolving Challenges to Nepal Rastra Bank

Dr. Dandapani Paudel*

Prior to the establishment of Nepal Bank Ltd.(NBL), the formal modern banking institution in Nepal, in 1937, the banking like practices were introduced in the 7th and 8th centuries respectively by Gunakama Dev and Shankhadhar while restructuring the Kathmandu valley and initiating Nepal Sambat through collecting loan from the public. As such, the loan transaction that prevailed in the early days of Nepal was in the form of Tankadhari, Tejarath, money lenders and indigenous bankers. On the whole, these traditional systems focused on deposit taking and providing loan for the purpose of commercial, family/social activities under personal guarantee and / or against the collateral of land basically. However, the Tejarath was a government owned financial type institution providing soft loan at 5 percent interest rate under personal guarantee for government staff and against gold and silver collateral for the general public normally for consumption purpose aiming at protecting from the exorbitant interest rate from other sources. However, this traditional system was demeritzed on the ground of exploitation, unscientific accounting system, unorganized money market, cheating through preparing fake documentation, etc.

The organized modern banking system came into practice after the establishment of NBL. With the exception of currency printing, and the management of foreign exchange reserve which was dealt through Reserve Bank of India (RBI), the NBL was virtually performing not only the commercial banking function but also the central banking function. Also prior to the establishment of Nepal Rastra Bank (NRB) as a central bank, the economic situation was not only traditional but also very backward. The national economy was not integrated due mainly to lack of transport and communication facility. Agriculture, virtually the synonym of the economy, was in a backward traditional form totally depending on monsoon. Foreign trade was virtually limited with India whereas industrialization was limited to a few jute mills, match factories, oil and rice mills, etc. The circulation of Indian currency (IC) overwhelmingly exceeded the circulation of the Nepalese currency (NC). The convertible foreign exchange was deposited to the Indian foreign exchange fund managed by the RBI lessening the opportunity of control of Nepal over its foreign exchange and export. The NBL, with 13 branches, was only the formal financial system, leaving the overall financial services on the hands of informal sector like money lenders.

---

* Member of the Board of Directors, Rastriya Banijya Bank

The central banking with the exception of the United Kingdom as an apex financial authority is a twentieth century innovation that came about as an evolutionary process of financial institution. The central bank though normally known as government owned is also on a joint venture/private ownership. Traditionally, central bank as a monetary authority acts as the leader of the money market and it also directly influences the capital market on the whole. Traditional theory suggests that the central bank, being a monetary authority, should have the objectives of employment generation and economic growth, among others. Nonetheless, the central bank regulates, supervises and controls the overall activities of various types of banks and financial institutions, which are supposed to obtain operating licenses from the central bank to help stabilize monetary and financial system, and hence, contain inflation and help achieve sustainable and higher economic growth.

Basically, the central banking philosophy was concentrated at the time of its establishment in most of the developing countries context on:

- institutional aspect such as establishing specialized financial institutions in view to promote financial services for particular prioritized sectors including the advisory role to its owner(s) and to develop guarantee mechanism in providing the financial services;
- mobilizing financial resources for increasing development fund to provide concessionary facility to needy sectors, formulating policy measures for domestic resource mobilization particularly in the case of deposit and credit rates; and,
- allocation of funds through prescribed credit guidelines and refinance facilities, directed credit program, development finance, etc.

Realizing the importance and the need, the NRB as a central bank was established in 1956 under the NRB Act 1955. After the 13th amendment in the NRB Act 1955, the NRB Act 2002 was promulgated replacing the earlier Act. A quick and brief comparative analysis between the two Acts is presented below.

A Comparative Overview

NRB Act 1955	NRB Act 2002
• The objectives of establishing the NRB are to (i) ensure proper management for the issue of Nepalese currency notes, (ii) make proper arrangements for the circulation of Nepalese currency throughout the country, (iii) stabilize the exchange rates of the NC, (iv) mobilize capital for development and encourage trade and industry, and, (v) develop the banking system in Nepal. • The major functions of the NRB are to (i) publish the report on the economic, banking and	• The objectives of the establishment of NRB are to (i) formulate necessary monetary and foreign exchange policies, (ii) maintain stability in domestic prices, (iii) consolidate balance of payments (BOP) for sustainable development of the economy, (iv) develop a secure, healthy and efficient system of payments, (v) regulate, inspect and supervise in order to maintain the stability and healthy development of banking and financial system and (vi) enhance public credibility towards the entire banking and financial system. • The major functions of the NRB are to (i) issue bank notes and coins, (ii) formulate monetary policy in order to maintain price stability, (iii) formulate foreign exchange policies, determine exchange rates and manage and operate foreign exchange reserves, (iv) issue license to banks and financial institutions and regulate, supervise and monitor the financial system, (v) act as banker,

monetary situation, (ii) collect statistics, (iii) issue of currency notes, (iv) perform government transaction, (v) management of public debt, (vi) determine interest rates for both deposits and loans, (vii) prescribe directed credit program, (viii) develop and regulate the banking system, (ix) inspect and supervise the banking and financial institutions, and (x) publish refinance / bank rates from time to time, etc. • The governor of the bank shall be appointed by the government for five years term, and also the government may retire governor anytime, if circumstances so require. • The board of directors of the NRB consist of (i) governor (as chairman), (ii) two deputy governors (without voting power) and (iii) four other directors.	advisor and financial agent of the government, (vi) act as the banker of financial system and function as the lender of the last resort, (vii) establish and promote the system of payment, clearing and settlement and regulate these activities and (viii) implement any other functions to achieve the objectives of the bank. • Nepal government, the council of ministers shall appoint governor on the basis of the recommendation of the recommendation committee formed by the government as (i) Minister of Finance (chairperson), (ii) one person from among the former governors, and (iii) one person from amongst the persons renowned in the fields of economic, monetary, banking, finance and commercial laws. Such committee shall recommend the names of three persons renowned in the same fields as mentioned earlier. • Nepal government shall prior to removing the governor constitute an enquiry committee consisting of retired justice of the supreme court as chairperson and two persons amongst renowned persons belonging to economic, monetary, banking, financial commercial or management sectors. • The Nepal government shall on the recommendation of the governor, who recommends double in number among the special class officers of the bank, appoint the deputy governor (s).

Obviously, the NRB as a central bank is an apex authority to guide the overall financial system of the country whereas it has a multiple role to play in the economy. Looking at the above mentioned objective themes of the NRB Act, the NRB in its earlier days focused particularly in the areas of issuance and circulation of the Nepalese currency, maintaining exchange rate stability, capital mobilization and development of the banking and financial institutions. As such, the NRB is the regulator and supervisor of the institutions like commercial banks, development banks, finance companies, microfinance development banks, financial cooperatives, NGOs, which are licensed by the NRB to operate. Over time, the NRB, as in other developing countries, has specially focused in formulation and implementation of the monetary policy and prudent regulation and supervision of the financial sector under its periphery instead of direct involvement in the development finance and equity participation.

Nevertheless, a quick review of the major policy issues and the overall activities in a brief manner may help to understand how the NRB as a central bank has been performing its function during a half century life. Obviously, the review shows that from the very beginning NRB has had to address issues pertinent to the situation of the review period. As such, the NRB's functions have been concentrated from the typical traditional central banking to institutional development, development finance, resource mobilization and their productive allocation, regulation and supervision and formulation and implementation of monetary and foreign exchange policies.

Monetary Policy Stance, Instruments and Other Activities

1956 – 65:

- Circulation of NC with a view to control dual currency system in the context of rampant circulation of IC;
- Banking branch expansion for expanding NC currency chest for its greater circulation;
- Introduction of Foreign Exchange (Regulation) Act 1963 to help stabilize exchange rate of NC against IC;
- Opening up of various level of branches and depots for exchange facility, among others, including 27 branches, 72 exchange counters, and 23 mobile counters and also the use of NBL network;
- Conversion of IC accounts of the government into NC accounts and collection of government revenue in NC term;
- Establishment of banks and financial institutions as deemed necessary for the development of financial infrastructure as well as conducting monetary policy; and,
- Equity participation and financial support for the establishment of the Agriculture Development Bank (ADB/N), National Industrial Development Corporation (NIDC) and Rastriya Beema Company with a view to develop agriculture, industrial and commercial sectors.

1966 – 75:

- Introduction of effective monetary policy through the regulations of credit creation and controls;
- Monetary policy instruments under such regulations included (i) minimum cash balances by commercial banks with NRB; (ii) margin rates; (iii) interest rates; (iv) refinance rates; and (v) liquidity management;
- As a result of the use of these instruments, control over credit creation capacity regularized;
- Mobilization of larger savings with corresponding bank credit for productive sectors through the fixation of deposit, credit and margin rates;
- Preventive measures to check aggregate demand through excess deposit mobilization, productive use of bank credit and foreign exchange reserves through historically high upward revision on deposit and credit rate;
- Promulgation of Commercial Bank Act 1974;
- Expansion of financial services through the establishment of Rastriya Banijya Bank (RBB) , Land Reform Saving Corporation (later on merged with ADB/N);
- Encouragement to small and priority sector credit and identifying feasible agricultural projects, the single largest sector of the economy, respectively through equity participation in the establishment of the Credit Guarantee Corporation and Agriculture Project Services Center; and,
- Introduction of cash reserve regulation, imposition of statutory liquidity ratio (SLR) to minimize the impact of import prices on domestic prices, and sectoral credit limit with a view to encourage private sector considered as the most productive credit among all.

1976 – 85:

- Downward revision in the interest rate with a view to help expand credit to agriculture, industry and export-oriented activities;
- Flexibility in setting interest rates within a given band to commercial banks on time deposits (saving and fixed deposit);
- Revision on directed credit program and selected credit policies;
- Introduction of defined productive sector credit, educated unemployed loan scheme and limit of credit/ deposit (C / D) ratio to commercial banks;
- Prescribing priority sector credit as compulsory lending for the commercial banks in terms of deposit liabilities with penalty in case of obligatory failure;
- Permission to commercial banks for long -term lending at a fixed cap (15%) of total liabilities;
- Introduction of letter of credit (L / C) for third country import trade; and,
- Opening up of license permission for commercial banks in private / joint venture ownerships.

1986-95

- Instability of the macroeconomic situation of early 1980s led to the initiation of financial sector liberalization, among others;
- Implementation of the structural adjustment program (SAP) and later on enhanced structural adjustment facility (ESAF) for tightening monetary policy with the use of credit ceiling, CRR, and SLR;
- Phasing out of the provision of SLR to offer independency to commercial banks;
- Historically high (12%) CRR to control expansionary monetary aggregates;
- Partial convertibility in the current account surged up credit leaving no option in backtracking SLR at historically high (36%) level including CRR; however completely abolished SLR provision shortly later on;
- Introduction of NRB bonds in fulfilling the insufficiency of monetary instruments in mopping up excess liquidity for the first time;
- As a process of deregulation, the maximum lending rates and minimum deposit rates prescribed for the welfare of depositors;
- As part of economic and financial liberalization, full fledged deregulation of interest rates with an adjustment tools of spread rate initiated;
- Introduction of auction of Treasury Bills (TBs) on weekly basis as an effective open market operations (OMOs) instrument for better monetary management;
- Full convertibility on the current accounts accepting the obligation of Article VIII, Section 2, 3 and 4 of the International Monetary Fund (IMF) Articles of Agreement;
- Allowing foreign currency deposit based on the foreign currency – earning sources; and,
- ll together 42 banks and financial institutions and 10 financial cooperatives and 17 NGOs licensed to enrich institutional development during the period.

1996 – 05:

- Effortful to ensure a healthy and efficient financial sector by improving regulation at par with international standard;
- Prudential regulatory reforms as implemented include capital adequacy, single borrower limit, loan loss provisioning, professional promoters, standardized capital base, deregulation of interest rate, open licensing policy, phasing out of directed credit with the exception of deprived sector credit;
- Completely phasing out of the issuance of NRB bonds;
- Promulgation of NRB Act, 2002 replacing the earlier Act, 1955;
- Categorization of banks and financial institutions into four groups (A, B, C and D) according to Banks and Financial Institutions Act (BAFIA) as an umbrella Act;
- Implementation of Basle – I with a view to focus on credit risk;
- Completely phasing out of the spread rate to be obliged by commercial banks;
- Establishment, operation, management and regulation of banks and financial institutions with appropriate legal provisions as covered in the Act;
- Reforms on the problem facing public sector banks namely NBL and RBB under management contracts and re-engineering of NRB under the ongoing financial sector reform ongoing;
- Implementation of corporate and financial governance (CFG) in making the financial sector more dynamic, capable and effective;
- Implementation of the legislations regarding insolvency, secured transaction, anti-money laundering, etc.,
- Opening financial sector services by 2010 as per the commitment in Nepal's accession to the World Trade Organization (WTO);
- Implementation of monetary policy framework and stance as deemed necessary by the situation;
- Establishment of about 65 new banks and financial institutions; and,
- Reform in the balance of payments (BOP) account as per international standard.

2006 Onwards:

- Gradual liberalization of exchange rate facility;
- Continuation of the establishment of additional new banks and financial institutions with standard reformed criteria and reestablishment of the closed / merged commercial bank branches including the new branches;
- Basel – II being implemented in view to improve the operational and market risk;
- Non performing asset (NPA) problem of the banking sector is still chronic due to non-establishment of the Asset Management Company;
- Introduction of national microfinance policy; and,
- Implementation of standing liquidity facility for commercial banks with a view to smoothing the internal payment system.

Obviously, the NRB Act, 2002 provides a greater operational independency in comparison to the earlier Act, among others, in the conduct of monetary policy. As such, the greater independency is also followed by the greater transparency and accountability in the formulation, announcement and implementation of monetary and credit policy. As a

standard practice, monetary policy is designed to ensure a more effective operator of the economic system through the influence upon supply, cost, availability and direction of money and credit. As such, the major objectives of monetary policy as spelt out in the Act are to achieve (i) domestic price stability, (ii) balance of payments stability, (iii) financial stability, (iv) payments stability, and ultimately in facilitating a sustainable economic growth, among others. The NRB in achieving these objectives is free to formulate and manage monetary and exchange rate policy. Also the NRB can contribute in promoting economic growth through:

- establishing financial institutions for mobilizing deposits and providing credit;
- coordinating the direction and volume of investible resources of the existing financial system; and,
- better credit management to promote economic growth and price stability.

The main objectives of monetary policy are met through monetary and credit policy. For the last many years, the NRB has been setting the objectives of maintaining domestic price stability, reasonable surplus in the balance of payments and financial sector stability with a view to help achieve a sustainable economic growth. Since Nepalese currency is officially pegged with Indian currency, external stability means the BOP stability in Nepal. It is obvious that the relative focus between the objectives depends on the underlying economic conditions from time to time as elsewhere. Historically, the focus has been given in containing the inflation on a single digit and a favorable balance of payments. Nevertheless, inflation in Nepal has been influenced by the supply shock, imported inflation, oil price shock and the hike in the administered prices. Nonetheless, the share of price which comes directly under the monetary phenomenon is still not empirically found out and also the agriculture, which is the largest single sector contributing a dominating role in the gross domestic product (GDP), is weather based and also not sufficiently monetized reflecting the limitation of monetary policy in Nepal. It is but natural that the monetary impulses are to be transmitted through the demand-supply determined market prices. The non-agriculture sector is comparatively better monetized.

Historically, monetary policy as part of macroeconomic goals may have focused on the highest possible economic growth or lowest unemployment. In the developed context, monetary policy strategy can be extremely simple due to postulating a policy objective function like stabilization of inflation and growth. Optimal monetary policy can be reduced to the mathematical derivation of an optimal policy rule setting the value of the policy instrument as a function of available information. The pursuit of final targets of monetary policy rests on a series of choices regarding the information set used as a basis for short-term and long-term policy adjustment like the weights and specific rules attached to various economic variables. As such, in the process of conducting monetary policy, most of the central banks have to decide the final goals together with intermediate and operational targets. Since the double oil shocks of 1970s, and the frequent unpredictability shocks of the oil prices, most of the central banks raised concern on price stability. As a result, some central banks in the late 1980s and more central banks after 1990s have been shifting their monetary policy intent in favor of a single or multiple targets in achieving the overall objectives. Nonetheless, there is not a common anchor and in-built mechanism regarding the choice of a proper single/multiple target of monetary policy for a central bank. It is obvious that the choice of targeting depends on the market based activity and economic features of the country.

For example, New Zealand and Canada were the first countries in adopting inflation targeting regime in numerical term as the single goal of monetary policy. The central bank of New Zealand can be taken as an example in the case of inflation targeting where such target has clearly been mentioned in the contract paper of the governor. As such, in case the actual inflation exceeds the target rate of inflation the Parliamentary Committee evaluates and assesses the causes for inflation and if it is due to monetary policy effect the governor of the central bank is to be removed from the post and if it is due to government tax policy effect the governor should not be liable to take the responsibility. Similarly, with the capital control and fixed exchange rate regime, Malaysia has been opting interest rate targeting whereas Singapore with highly open economy has been using exchange rate targeting in its monetary policy. Most of the developing countries have been practicing multiple objectives like inflation and monetary aggregates targeting.

The trend and tendency all over the world has been increasing in favor of the independency of the central bank particularly in monetary policy. However, most of the central banks in the developing context even legally empowered for the autonomy, have been enjoying the independency within the government and / or owners, since the policy making body of the bank including the governor is appointed by the government. It can be said that to some extent the given independency can be properly and boldly implemented by the personality per se. The increasing focus of the central banking over the time has been shifted towards functional specialization. As such, most of the central banks wish to stick on monetary policy matters and the regulatory and supervisory authority functions have been transferred to other independent and specialized bodies. It clearly indicates that the core theme of the specialization is to increase the degree of influence in the financial stability function. Obviously, it is a challenge for the central bank everywhere to build confidence with a proven track record in achieving the set targets in order to repute the given autonomy.

In attaining the final targets the central bank elsewhere, though targets may differ, has to impact on the set variables called operating targets, e.g., reserve money, liquidity of commercial banks, overnight and short term inter-bank interest rates. In between the operating targets and final goals, there is a set of variables called intermediate targets which includes inflation, monetary aggregates, interest rates, exchange rates, etc., as per the targeting of the respective central bank.

Nepalese Monetary Policy Framework

As mentioned above, the final goals or targets of the Nepalese monetary policy for the last many years have remained a set of multiple objectives of domestic price stability, reasonable surplus in the balance of payments, financial stability and sustainable economic growth. In achieving theses objectives, the NRB in the recent years have been putting in place the monetary aggregate (M_2) as intermediate target due mainly to the stable demand for money function in relation to income and prices. Such targets are selected on the basis of central bank's confidence on relative controllability and predictability. Moreover, the intermediate target should have a significant and economically valid relationship with the final targets.

To influence the intermediate target(s) the central bank normally sets the operational target. As such, the NRB as in the past used reserve money and short term interest rate and very recently, it has been using the excess liquidity of commercial banks as the operating target. By monitoring the operating target, the NRB can influence the intermediate target (M_2) which ultimately helps to achieve the final targets. This whole

process can be termed as implementing framework of monetary policy. The success of targeting depends on the stability of the relationship between operating and intermediate targets and the intensity of influence of exogenous variables both on operating and intermediate targets.

In Nepal the economic and financial sector liberalization started slowly in the mid-1980s and in a full swing since early 1990s. Prior to liberalization, monetary policy was in a controlled regime where most of the direct policy instruments were in use. The NRB in the past had prescribed the deposit and lending rates, sectoral quantitative credit limit, SLR and other liquidity provisions, etc. To start with the liberalization process, NRB adopted free entry policy for banks and financial institutions, and deregulated interest rates with a safety cushion of fixing the weighted average spread rate between the lending and deposit rates as mandatory. All commercial banks and financial institutions were free to decide lending and deposit rates by maintaining the prescribed spread rate. The liberal policy regime made a departure from the direct policy instruments to the indirect instruments. Later on, since commercial banks and financial institutions did maintain the spread rate limit, NRB did away with the mandatory spread rate.

Monetary Policy Instruments

In the liberalized policy regime, NRB has been relying on the indirect monetary policy instruments, which are CRR, bank/refinance rate and open market operations.

Cash Reserve Ratio

Commercial banks and financial institutions are required to maintain cash reserve ratio as prescribed by the central bank. The CRR is the percentage of deposit liability to be retained by commercial banks and other deposit money banks as prescribed by the central bank. Total reserves of the commercial banks include the required reserve as mandatory and excess reserve, which the commercial banks keep for additional protection against reserve deficiency and sudden withdrawal. Commercial banks and other depository institutions in general as elsewhere hold required reserve ratio either in the form of cash in vault and / or balances with the central bank. In the United States of America and in other few countries since the early 1990s, reserve requirement has been applied only to demand deposits (checking accounts) and zero reserve required for time deposits. Also in some of the countries including India, the central bank pays interest on the balances with the central bank for more than the level as they termed legal limit more or less equivalent to refinance rate.

The CRR as a policy instrument however is changed less frequently. Nevertheless, if banks fail to meet their reserve requirement, they are subject to financial penalties. The tendency of borrowing by the resource deficit banks from the resource surplus banks in meeting the balances for the reporting time is a common practice. Similarly, for the same purpose, banks make use of government securities and other eligible collaterals in the central bank's discount window. The reserve requirement in the form of balances with the central bank with zero return is considered a factor responsible for increasing financial intermediation cost. Therefore, there is a global trend and tendency of reducing the reserve requirement ratio just to minimize the intermediation cost. Nevertheless, if there is a full deposit insurance system, there is no need of reserve requirement. Similarly, paying the interest on reserve requirement by the central bank as have been done by few countries seems both reasonable and feasible only in the case where the central bank can make use of such balances to refinance facility. In Nepal, the refinance facility for the

last many years has not been used even at the lower interest rate by the concerned banks and financial institutions.

The reserve requirement affects the potentiality of the banking system in creating deposit liability, which ultimately helps money supply. For example, if the reserve requirement is 10 percent of the deposit liability, a bank which receives Rs. 100 as deposits may loan out Rs. 90 only from that deposit. As the process continues up to the end limit, the banking system can expand the credit by deducting every time the 10 percent of the received deposit. As such, if the CRR is higher, banking system can create lower level of credit and vice-versa. In the past, NRB did practice for some years the CRR in terms of deposit mix like separate level of balances for the demand and saving deposit, and fixed deposit based on the logic of the withdrawal facility as well as cash in vault. The present single component of CRR as balances with NRB is 5 percent of the total deposit liability. In case of failure in maintaining the reserve ratio, banks are subject to financial penalties for the part of commercial banks. Since Nepal has not yet developed the deposit insurance scheme of the banking system fully, and the NRB has inadequate scope of expanding refinance facility, there is no immediate scope of abolishing CRR system and paying interest on the balances with NRB.

Bank / Refinance Rate

The bank/refinance rate is the rate charged by the central bank when it extends credit to depository institutions either through advances or through the discount of certain types of eligible government or other papers. The bank/refinance rate plays a significant role in the conduct of monetary policy which deserves mainly announcement effects by signaling the upward/downward revision on interest rate structure. In other words, a higher discount rate can be used to indicate more restrictive policy intent, whereas a lower rate may signal more expansionary policy.

Due to external and internal factors, the economic slowdown and liquidity crunch of the banking sector called for central bank to ease its monetary policy in the recent past. As a good intent, NRB reduces its bank/refinance rate signaling to commercial banks to reduce credit rates for the defined productive sectors. However, due to lack of genuine credit demand, the banking sector has not been able to make use of this facility as expected. But in a normal situation the bank / refinance rate is very much supportive in providing credit for the needful sectors. At present, NRB has prescribed concessionary refinance rate to sick industry, export credit, small and cottage industry, defined backward classes for foreign employment, and 5 percent rate for general purpose.

Open Market Operation

Open market operation is one of the major effective instruments of monetary policy. This instrument elsewhere has been used for the purpose of short-term liquidity management. For the conduct of monetary policy through OMOs, primary market is related with the fresh issuance and renewal of the TBs while secondary market includes the repurchase agreement (Repo) and outright purchase and sale of government securities. During the early 1990s, the Nepalese economy had faced the situation of excess liquidity for which the government securities were not sufficient enough for mopping up of the excess liquidity. Therefore, NRB introduced its own bond by the name of “NRB Bond” for the first time in its history in December 31, 1991. When the liquidity situation did not warrant for its continuation, the issuance of “NRB Bond” was completely phased out from the system from April 1, 1998. Since the instruments are limited, TBs of various maturity days are

used for the conduct of OMOs. Weekly auction is held for the fresh issue and / or renewal of TBs as necessary and the discount rate of such bonds are determined by the auction. The discount rate is quite different from the interest rate. As such, the discount rate refers to how an individual or corporate sector wants to pay to get Rs. 100 after 91-days by now. All the transactions of the auction are settled on the basis of secret offer price through sealed tender.

For the development of money market, secondary window has been put in place for the transaction of short-term government securities with effect from June 1994, wherein deals are done in terms of outright purchase and sale of TBs. Similarly, the Repo was introduced on March 25, 1997. Among the indirect policy instruments, the OMO is becoming the short-term popular means of liquidity management through the purchase and sale of government TBs. The main indicator is the volume of transaction amount and its diversification. For example, about 81 percent of the total TBs was purchased by the NRB and 17 percent by commercial banks in early 1990s while the situation has been reversed in the recent years indicating the diversified patterns of TBs holdings as well as safety cushion to money multiplier. The non-marketable special bonds holding by the NRB has been made marketable, and the excess overdraft loan by the government has to be converted into ad-hoc TBs and others with a view to help increase marketable securities and to comply with new NRB Act.

In assessing the level of development of the banking sector, the financial layering / deepening and the asset structure ratios can be used as more dependable indicators. As such, the financial deepening as proxied by M_2 / GDP ratio which was 30.5 percent in 1990 increased to 62.2 percent in 2007 showing an increased intensity of financial layering / deepening ratio over the time. However, this ratio could not always hold true, if the financial system stability cannot be maintained.

There is a common belief that the profit of the central bank is just like the profit of a liquor shop. As such, the higher the ratio of central bank assets over the total banking sector assets, it shows the least developed banking sector whereas the vice-versa situation indicates a healthy development of the banking sector. The ratio of central bank assets to overall banking (central bank and commercial banks) assets was 46.6 percent in 1990 which came down significantly to 27.8 percent in 2007 respectively corresponding ratio of commercial banks assets to total banking sector assets for the period which was increased from 53.4 percent to 72.2 percent indicating a healthy sign of banking development. However, these ratios in isolation without the support of financial stability remain vulnerable.

Challenges and Immediate Reforms

Obviously, the NRB as a central bank has to be very careful in maintaining the price level clearly segregating the core inflation from the headline inflation which virtually comes under the responsibility of monetary policy. The NRB can increase its policy credibility through a transparent view publicly on the compositional aspect of inflation that how much is the core inflation which virtually comes under the monetary phenomena. It is not a matter of inflation targeting but the general public should be educated on the effect of monetary and credit policies on the price level. Similarly, looking at the mushrooming growth of the financial sector due mainly to an easy task of making business, maintaining financial stability is a challenging job for the central bank including the external sector stability.

The definition of broad money changes over the time depending upon the introduction of new financial instruments that corresponds closely to the concept of money as temporary store of value. As such, the broad money (M_2) is to incorporate the repurchase agreement (Repos) transactions effected by the commercial banks, which is treated as non-transferable deposits. Also negotiable certificates of deposits (NCD) are to be included in such definition of money, if applicable.

The net non-monetary liabilities (NNML) denote a residual category for other liabilities (not included in broad money) less other assets. Looking at its increasing size over the time, it is normally vague to understand the major components effect to this heading. It is therefore for the simplicity and clarity that the NNML in the monetary survey is to be disaggregated at least into (i) capital, (ii) reserves and (iii) net other items, in conformity with the international practices.

The definition of monetary aggregates as elsewhere is in line with the progressive liquidity. The narrow money (M_1), which comprises currency in circulation and demand deposits, is the highly liquid form of money supply. By virtue of the progressive liquidity as has been practiced more liberally in terms of withdrawal facility, the saving deposit is more or less like the demand deposit raising a serious concern in the existing calculation of M_1. It is but natural that a reasonable portion of saving deposit based on its withdrawal facility survey as practiced in other countries should be included in M_1 making this monetary aggregate more accurate. It is therefore necessary in establishing the authentic money demand function in relation to the variables related to final target of monetary policy.

Since the financial sector has been expanding with various types of banks and financial institutions, the monetary aggregates should at least cover the overall transaction of banks and financial institutions. The NRB in the context of reengineering under financial sector reform program should have to be capable to ensure various types of monetary aggregates by including the overall banks and financial institutions in reflecting the actual situation of financial development of the country. Obviously, the overall liquidity as well as monetary aggregates which are undoubtedly very important factors in analyzing the economy from different aspects are still unknown. The NRB as a central bank even in the twenty-first century with having so much international exposure surprisingly is still being unable to incorporate the overall transactions of the financial system into monetary aggregates.

The NRB so far has developed its organizational structure on the basis of core functional areas under the reengineering program. However, it lacks the accountability on its monetary policy stance and targets as well as on the regulatory and supervisory functions. Looking at the good examples from other well run central banks, the NRB should at least develop a share in responsibility and accountability on the performance of the financial system. Obviously, one can easily raise the question that if the NRB as a central bank regularly regulates, supervises and instructs accordingly to the concerned banks and other financial institutions how the bad debts, and other serious problems are on increasing trend. With a view to resolve such problems, the NRB should devise a mechanism which makes the central bankers more responsible and accountable in line with the sole regulator and supervisor. Similarly, the regulation and supervision should be improved at par with international standard since the financial services will be open to international banks by 2010 as part of commitments in the WTO.

The Nepalese currency has been officially pegged to Indian currency for many years, which might be technically feasible given the open border, socio economic openness and free capital and human mobility. It might be favorable for containing the price given the larger share of trade with India over the total international trade. However, the ever increasing long list of the commodities in the import trade from India in US$ term, which was conceptually originated for the promotion of exportable items may reflect the self-defeating policy stance in the medium term, if the IC income source will continuously deteriorate and the objective of sustainable export base is not met.

Free circulation of Indian currency in Nepal, though officially illegal, has been a serious problem in estimating the demand for money. The NRB as a central bank has not justified with good reasoning how the existing estimation of the demand for money reflects the actual situation of the demand for money in Nepal. There is no official estimation of the size and volume of the Indian currency which is illegal but commonly in circulation all over the country. The question is not simply regarding the cost benefit of printing money, but it should be rationalized from the point of view of illegal circulation and moreover, with the loosing identity of currency sovereignty.

The recent study on inflation by the NRB using the empirical test of purchasing power parity (PPP) model strongly recommends reorienting monetary policy framework in line with its finding that inflation in Nepal is mainly determined by the Indian inflation. However, this method ignores the important differences between price determination processes of the tradable and non-tradable goods. As such, the Scandinavian approach, which includes those factors ignored by PPP approach, in reality, fits well in Nepalese context as sufficient research and empirical evidences are found in Nepalese case as well as in similarly placed economies. Thus the recent study of NRB can be taken as a rigorous exercise, but it would be biased for official recommendation based on a partial and piece meal approach. It rather creates confusion and raises the question of immediate action of adjustment in the monetary policy framework according to the recommendation.

It is a standard practice that central banks elsewhere needs to make projection, though not estimation, of the GDP for various purposes on official use-basis, if the authorized government agency does not have any estimation. The Central Bureau of Statistics (CBS) is an authorized agency which regularly estimates the GDP after eleven months of every year sometime in June. The GDP, as is common, is a scale variable for measuring and assessing the overall economic activities and making necessary policy adjustment on sectoral basis. However, with the lack of such important variable, it is virtually impossible in assessing the likely growth assumptions and the overall movement of economic activities. Moreover, quarterly recording of macroeconomic data and estimation is a common practice elsewhere but the Nepal government has been historically maintaining trimester data/information collection which is virtually a typical practice which is not consistent with the rest of the world. Thus, being an economic advisor of the government of Nepal, NRB should play a leading and bold role for the regular projection of the GDP and convincing the government in shifting the trimester system of data/information collection to quarterly basis to compare with the rest of the world.

Nonetheless, India is ready for a phase-wise start of capital account convertibility, whatever the modality, reflecting a forward approach with better backup of more orderly, gradual and in a well-sequenced manner. With the given special factors with India, Nepal has pegged its currency to Indian currency at a fixed exchange rate. In such a situation, there is no official workout and view as to what step will be more feasible for Nepal if

India opted for full convertibility. For this, the NRB has to seriously think on the issue with a rigorous analysis as well as to interact with the related stakeholders in devising a suitable policy framework, since there is no cookbook recipe for dynamic policy.

Selected References

Economic Survey, Nepal Government, Ministry of Finance, various issues.

Milestone. An International Souvenir published on the Occasion of Golden Jublee Celebration of Nepal Rastra Bank, 2005.

Nepal Rastra Bank, Twenty-five Years (1956-76), Nepal Rastra Bank, 1976.

40 Years of the Nepal Rastra Bank, (1956-96), Nepal Rastra Bank, 1996.

Nepal Rastra Bank in 50 Years, (1956-2005), Nepal Rastra Bank, 2005.

Nepal Rastra Bank, Monetary Policy, various issues.

Chapter IV

Experience of the Nepalese Commercial Banks and Challenges Ahead

Bhuvan Dahal*

Evolution of Banking in Nepal

Like many other countries, goldsmiths, merchants and money lenders were the ancient bankers of Nepal. Tejarath Adda established in 1880 during the tenure of the then Prime Minister Ranoddip Singh was the first step towards the institutional development of banking in Nepal. Some historians say Kausi Tosha Khana established during the time of King Prithvi Narayan Shah (1723-1755) is the first banking institution but there is very little known about it. Tejarath Adda did not collect deposits from the public but gave loans to public against the security of gold and silver and to the government employees against the security of their salary. Since interest rate of Tejarath Adda was just 5%, beneficiaries were very much relieved of exorbitant interest rate being charged by the traditional bankers. Tejarath Adda however had a narrow reach because of just few branches and resources crunch it used to face due to not collecting deposits from the public. Thus, the larger section of deficit units of the society had no choice but to knock the doors of the traditional bankers to cover their deficit and the surplus units who were not traditional bankers had the Hobson's choice of keeping their surplus money in ghyampos (a large clay jar) exposing themselves to the risk of theft and erosion in the value of money.

Savers and users of the society were always looking for an institution which offers relatively safe, convenient, liquid and accessible securities and at the same time accepts relatively risky, illiquid, inconvenient, long term and large denomination securities offered by the borrower. Such an intermediation (denomination, risk, maturity and information) encourages savings and entrepreneurship in the society by bringing together and resolving fundamentally variant financing requirement of households, businesses and governments. Moreover, Nepal had gradually opened to the international trade and the then rulers-Ranas (favourites of British India)- wanted to keep their money in Nepalese banks instead of Indian banks because the independence movement against British Rule was keeping momentum in India. All these were the backgrounds for establishment of a modern bank.

---

* Head-Finance & Planning, Nabil Bank Limited

Banking in modern sense started with the inception of Nepal Bank Limited (NBL) on 15 November 1937 under Nepal Bank Act 1937 though in Europe modern banks were set up in the 12th century itself. NBL was set up with cooperation of Imperial Bank of India. The Bank was inaugurated by the then King Tribhuvan. The then Premier Juddha Shamsher JBR highlighted the importance of the bank in his inaugural speech as follows:

"This work which is being done in the larger interest of the nation is a great moment for me. Until today a bank could not be opened in Nepal. Therefore, this Bank which is being established under the name of Nepal Bank Limited to fill that need and to be inaugurated by His Majesty the King is a moment of great joy and happiness. The Bank's objectives to render service to the people whether rich or poor and to contribute to the nation's development will also need the support and best wishes of all, which I am confident will be forthcoming."

The preamble of NBL Act 1937 states the objective behind establishment of NBL as follows:

"In the absence of any bank in Nepal, the economic progress of the country was being hampered and causing inconvenience to the people and therefore with the objective of fulfilling that need by providing services for the people and for the betterment of the country, this law is hereby promulgated for the establishment of the Bank and its operation."

NBL took over all the assets and liabilities of Tejarath Adda. It accepted deposits, gave loans, rendered other banking services to the public, acted as government's bank etc. NBL had to do some central banking functions until the establishment of central bank (Nepal Rastra Bank) on 26th April 1956. Initially, NBL had authorized and paid up capital of Rs.10 million and Rs.0.842 million respectively**-** 51% owned by the government and 49% owned by the private sector**.** Due to low level of awareness about banks, raising of equity and mobilization of deposits was a very tough task then. Out of Rs.2.5 million equity shares floated, the Bank was able to raise only Rs.0.842 million. Likewise, the total deposits collected in the 1st year was Rs.1.7 million only.

Nepal Bank Limited, the first commercial bank of the country, had a herculean responsibility of attracting the people toward banking sector from pre-dominant money lenders' net and expanding banking services to various parts of the country. It could not open branches across the country due to various factors. It had only 12 branches till 1956.

The government's realization of need for expanding banking services to the nook and corner of the country, ending dual currency system and stabilizing highly volatile exchange rate gave birth to Nepal Rastra Bank (NRB) on 26 April 1956 as a central bank. As per preamble of Nepal Rastra Bank Act 1955, the objective behind opening NRB was as follows:

"Whereas it is expedient to ensure proper management of the issuance of Nepalese currency notes, to make arrangement for the circulation of Nepalese currency throughout the kingdom and to stabilize the exchange rates of the Nepalese currency in order to maintain comfort and economic interests of the general public."

While inaugurating NRB on 26 April 1956, the then King Mahendra had said: "*It is our belief that the establishment of this bank will, by the proper management of our currency,*

promote the growth of banking industry and commerce and rejuvenate the economic life of the country."

Since then, NRB has been working as a central bank and has contributed to the growth of various types of financial institutions across the country in addition to stabilizing exchange rates and ensuring circulation of Nepalese currency throughout the country.

As the need of a development bank committed for industrial development of the country was felt, the government converted Industrial Development Centre (IDC) set up in 1957 to Nepal Industrial Development Corporation (NIDC) in 1959 at the initiative of NRB.

Similarly, another commercial bank named Rastriya Banijya Bank (RBB) was set up on 23 January 1966 as a fully government owned commercial bank. In the early 1970s, NRB encouraged both NBL and RBB to expand branches to various parts of the country. For this purpose, NRB itself had conducted feasibility studies. NRB had a policy of absorbing losses of any of these branches for the first 3 years of operation. In 1975, NRB achieved its target of having at least one branch of commercial bank in each district head quarter. After this, NRB announced one bank branch for 30,000 population by mid 1980s but could not achieve this target due to high costs involved in branch operation.

Though Nepal has been an agricultural country, our agricultural productivity is very low due to traditional farming system. Hence, Agricultural Development Bank (ADB) was established in 1968 to provide finance for introducing modern agricultural techniques (modern agricultural inputs, advanced seeds, chemical fertilizer etc.) so that agricultural productivity could be enhanced. Cooperative Bank, set up in 1963, was merged with it.

With the establishment of NBL, RBB and ADB coupled with incentives offered by NRB, banking service spread to both the urban and rural areas. This helped the common people reduce their burden of paying higher rate of interest to money lenders and absolved them from kowtowing before money lenders. Similarly, savers got rid of the compulsion of keeping their money in ghyampo and running risks/demerits associated with it.

It is natural for the customers to expect better and banking service as the days pass by. Once they got banking services, they were expecting improvement in the banking services. However, excess political and bureaucratic interference coupled with absence of modern managerial concept in these institutions was a major hurdle in this regard. Banking service to the satisfaction of customers was a far cry. The inception of Nepal Arab Bank Limited (renamed as Nabil Bank Limited on 1st January 2002) on 12 July 1984 as a first foreign joint venture bank proved to be a milestone in the history of banking.

Nabil launched its operation with a marketing concept, i.e. customers are living gods/goddesses- please them and get immediate blessings/results. Nabil started knocking the doors of customers breaking the then trend of knocking the door of a bank by customers. In banking sector, Nabil set the trend of following the definition of customer given by Mahatma Gandhi, "*A customer is the most important visitor on our premises. He does not depend on us. We are dependent on him. He is not an interruption on our business. He is purpose of it. He is not an outsider on our business. He is part of it. We are not doing him a favour by serving him. He is doing us a favour by giving us an opportunity to do so."*

The very marketing concept of Nabil has made it one of the most successful banks in Nepal. Having observed the success of Nabil and also because of liberal economic policy

adopted by the successive governments/Nepal Rastra Bank, 23 commercial banks came into being by mid October 2007 (Table 1). A couple of financial institutions have already got an approval for conversion to commercial banks and some applications for license have also been filed at NRB.

Table 1 M Growth of Commercial Banks

S.No.	Names	Operation Date	Head Office
1	Nepal Bank Limited (NBL)	15-Nov-37	Kathmandu
2	Rastriya Banijya Bank (RBB)	23-Jan-66	Kathmandu
3	NABIL Bank Limited (NABIL)	12-Jul-84	Kathmandu
4	Nepal Investment Bank Limited (NIBL)	27-Feb-86	Kathmandu
5	Standard Chartered Bank Nepal Limited (SCBIN)	30-Jan-87	Kathmandu
6	Himalayan Bank Limited (HBL)	18-Jan-93	Kathmandu
7	Nepal SBI Bank Limited (NSBI)	7-Jul-93	Kathmandu
8	Nepal Bangladesh Bank Limited (NBBL)	5-Jun-93	Kathmandu
9	Everest Bank Limited (EBL)	18-Oct-94	Kathmandu
10	Bank of Kathmandu Limited (BOK)	12-Mar-95	Kathmandu
11	Nepal Credit and Commerce Bank Limited (NCC)	14-Oct-96	Siddharthanagar
12	Lumbini Bank Limited (LBL)	17-Jul-98	Narayangadh
13	Nepal Industrial and Commercial Bank Limited (NIC)	21-Jul-98	Biratnagar
14	Machhapuchhre Bank Limited (MBL)	3-Oct-00	Pokhara
15	Kumari Bank Limited (KBL)	3-Apr-01	Kathmandu
16	Laxmi Bank Limited (LAXMI)	3-Apr-02	Birgunj
17	Siddhartha Bank Limited (SBL)	24-Dec-02	Kathmandu
18	Agriculture Development Bank Ltd. (ADBL)	16-Mar-06	Kathmandu
19	Global Bank Ltd. (GBL)	1-Jan-07	Birgunj
20	Citizens Bank International Ltd. (CBIL)	21-Jun-07	Kathmandu
21	Prime Bank Limited (PBL)	24-Sep-07	Kathmandu
22	Sunrise Bank Limited (SRISE)	12-Oct-07	Kathmandu
23	Bank of Asia Nepal Limited (BOA)	12-Oct-07	Kathmandu

Source: NRB

Note: After change in major ownership, Nepal Arab Bank Limited renamed as Nabil Bank Limited on 1st January 2002, Nepal Indosuez Bank Limited renamed as Nepal Investment Bank Limited on 30 May 2002, Nepal Grindlays Bank Limited renamed as Standard Chartered Bank Nepal Limited on 13 July 2001 and Nepal Bank of Ceylon Limited renamed as Nepal Credit and Commerce Bank Limited on 10 September 2002. Agricultural Development Bank Nepal set up in 1968 as a development bank converted to Commercial Bank in 2006.

After restoration of democracy in 1990, a wave of setting up other financial institutions has also increased. As at mid-October 2007, there were 79 finance companies, 70 development banks (including 12 micro credit development banks), 17 NRB licensed cooperatives (undertaking limited banking transactions) and 47 NRB licensed NGOs (undertaking micro finance transactions). Thousands of other cooperatives are also operating today in the country but they are not under the supervision of NRB. 3

commercial banks, 20 development banks and 5 finance companies came into operations in the 1st 3 months of FY 2007/08, probably a record in the history of Nepalese banking. Further, some financial institutions are in a process of upgradation and NRB has been regularly receiving applications for license to incorporate banks and financial institutions.

Table 2: Position of Commercials Banks amongst the Depository Intermediaries

	As at Mid-July 2007	
	Number	**Share**
Commercial Banks	20	14%
Development Banks	38	26%
Finance Companies	74	51%
Micro Credit Development Banks	12	8%
Total	144	100%

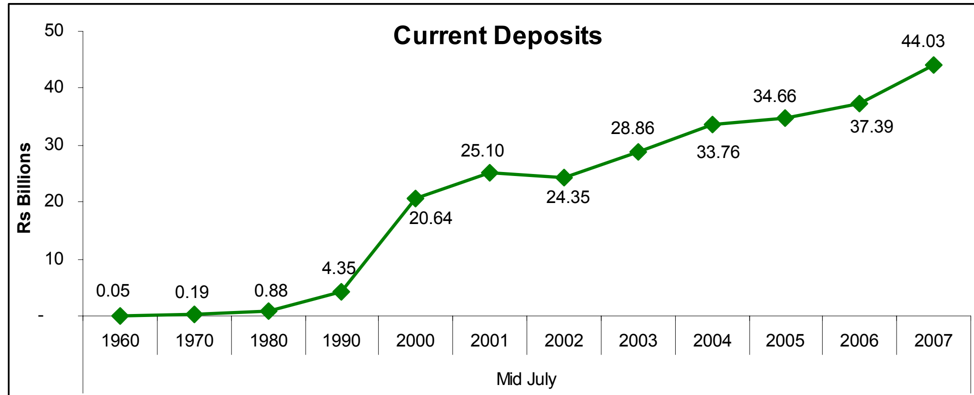
Table 3 : Deposits & Loans
As at mid-July 2007

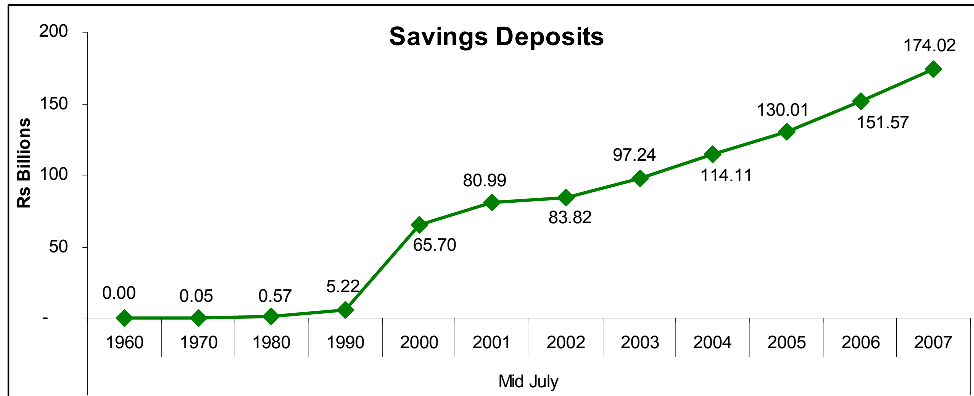
Rs. Million

	Deposits		Loans	
	Amount	Share	Amount	Share
Commercial Banks	338,054	86.8%	221,073	79%
Development Banks	15,619	4.0%	16,109	6%
Finance Companies	34,515	8.9%	35,622	13%
Micro Credit Development Banks	1,103	0.3%	5,781	2%
Total	389,291	100%	278,585	100%

Though the share of commercial banks is just 14% in numbers, it has a lion's share in total deposits (87%) and total loans (79%). This is mainly due to their long history, higher capital base, large and wide branch network, more products and ability to command trust of customers' being more than other financial institutions.

Fig. 1 : Growth of Deposits and Loans of Commercial Banks





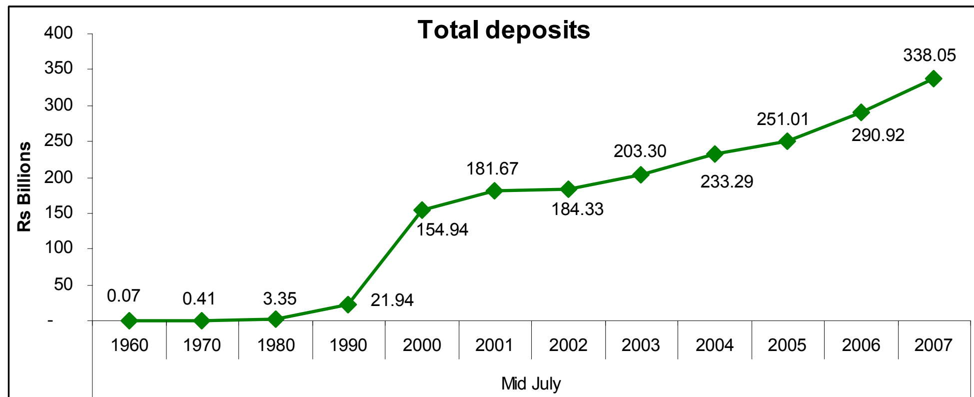
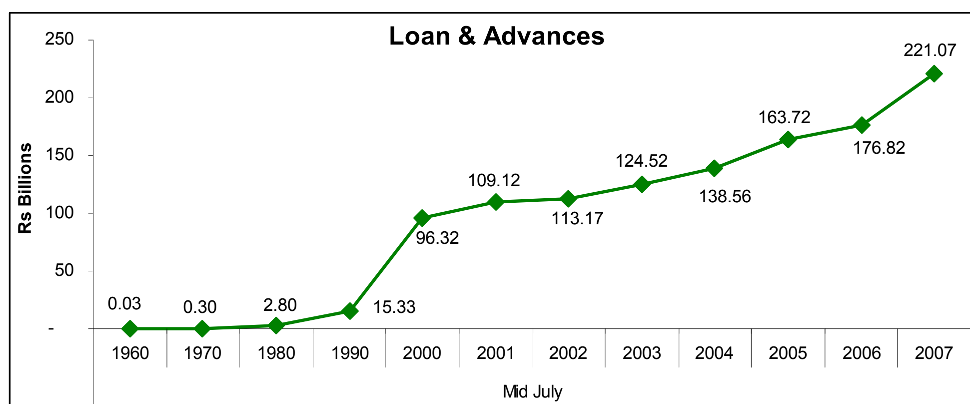


Table 4 : Trend of Deposits Mix

	Mid-July											
	1960	1970	1980	1990	2000	2001	2002	2003	2004	2005	2006	2007
Current	63%	48%	26%	20%	13%	14%	13%	14%	14%	14%	13%	13%
Savings	6%	13%	17%	24%	42%	45%	45%	48%	49%	52%	52%	51%
Others	31%	39%	57%	56%	44%	42%	41%	38%	37%	34%	35%	35%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

Decline in the share of government's current deposits to total deposits, growing trend of business houses toward opening interest bearing accounts and a higher growth of savings of households are the major reason behind decline in the share of current deposits in the total deposits though there is no decline in the volume of current deposits. Impressive growth in share and volume of savings deposits after 1990 is caused by the modification in the feature of savings deposits and narrow gap in interest rate with fixed deposits. Banks started offering various prizes to the savings account holders. Withdrawal feature of savings deposits was made similar to current deposits. Moreover, the banks offered savings deposits products tying up interest rate with the deposits volume. Decline in shares of other deposits, especially fixed deposits, in total deposits after 1990 is mainly due to attractiveness of savings deposits for the reasons mentioned above. Banks were in a position to offer that types of interest rates following the complete deregulation of interest rates in 1989.

Fig. 2 : Growth of Loans and Advances



Services Offered by Commercial Banks

Today the people of Nepal can avail of almost all types of commercial banking services available in the developed countries. Similarly, they have options of both brick (branch banking) and click (Internet banking, telebanking, ATM, POS, Cards, mobile etc) banking channels.

The major products offered by the Nepalese commercial banks include various types of deposits, loans, letter of credit, letter of guarantee, remittance, trust services, merchant banking, retirement fund management, investment banking and foreign exchange. In other words, we can call Nepalese commercial banks 'financial department stores' selling

almost all types of financial services. It is however true that all the commercial banks are not selling all the products mentioned here and level of product sophistication is low due to the nature of demand in the financial market. Once the market demands products with higher sophistication, the banks in Nepal are capable of introducing the same.

Table 5 : Comparative Financial Position of Commercial Banks
(As at Mid July 2007)

Rs. in billion

Banks	Balance Sheet Size	Deposits	Loans	Net Worth	Capital Adequacy Ratio (%)	Non Performance Loan/Total Loan (%)	Loan Loss Provision/NPL (%)
NBL	42.6	39.0	13.8	(6.1)	(38.9)	15.2	114.0
RBB	54.7	50.3	25.4	(17.2)	(42.6)	29.2	106.6
NABIL	27.6	23.3	15.9	2.6	14.6	1.1	199.8
NIB	28.2	24.5	17.8	1.9	12.3	1.8	138.2
SCBN	29.1	24.6	10.8	2.4	18.5	1.8	145.9
HBL	35.0	30.0	18.0	2.6	12.9	3.5	120.7
NSBI	15.1	11.4	10.1	1.0	14.8	4.6	128.4
NBB	10.1	9.5	5.9	(1.2)	(9.8)	38.2	94.5
EBL	22.2	19.1	14.1	1.3	11.4	0.8	100.0
BOK	15.1	12.4	9.7	1.1	1`3.5	2.2	133.0
NCC	8.7	6.5	5.1	(0.4)	(5.9)	30.6	89.7
LBL	7.2	6.0	4.9	(0.4)	(7.2)	19.9	108.3
NIC	11.7	10.1	8.9	0.9	12.4	1.1	185.1
MBL	10.9	9.5	7.1	1.0	12.4	1.4	115.0
KBL	12.0	10.6	8.9	1.0	12.4	0.7	201.3
LAXMI	8.7	7.6	6.5	0.9	12.5	0.4	399.0
SBL	8.1	6.6	6.3	0.8	12.2	0.3	461.0
ADBL	38.2	32.4	27.3	1.3	5.9	17.3	120.6
GBL	3.6	3.0	2.6	0.5	16.0	-	NA
CBIL	3.7	1.6	2.0	0.5	20.1	-	NA
Total	392.6	338.1	221.1	(5.4)			

Source: Unaudited Financial Results Published by Concerned Banks.

Table 6 : Ranking of Banks I

Banks	Balance Sheet Size	Deposits	Loans	Net Worth	Capita Adequacy Ratio (%)	Non Performing Loan/Total Loan (%)	Loan Loss Provision/NPL (%)	Average Rank Points
NBL	2	2	7	19	19	15	13	11.0
RBB	1	1	2	20	20	18	15	11.0
NABIL	7	7	5	2	5	8	4	5.4
NIB	6	6	4	4	11	10	7	6.9
SCBN	5	5	8	3	2	11	6	5.7
HBL	4	4	3	1	7	13	10	6.0
NSBI	9	10	9	9	4	14	9	9.1
NBB	14	14	16	18	18	20	17	16.7
EBL	8	8	6	6	14	4	16	9.1
BOK	10	9	10	7	6	12	8	8.9
NCC	16	17	17	17	16	19	18	17.1
LBL	18	18	18	16	17	17	14	16.9
NIC	12	12	11	11	10	7	5	9.7
MBL	13	13	13	10	9	9	12	11.3
KBL	11	11	12	8	13	5	3	9.0
LAXMI	15	15	14	12	8	4	2	10.0
SBL	17	16	15	13	12	3	1	11.0
ADBL	3	3	1	5	15	16	11	7.7
GBL	20	19	19	15	3	1	1	11.1
CBIL	19	20	20	14	1	1	1	10.9

Except NPL to total loan, the higher ration/volume has been ranked better.
Overall average is the summation of individual rating under each parameter divided by number of parameters
GBL & CBIL are no. 1 in both NPL to total loan and LLP to NPL. Ranked 1 & 2 above only for ease.

Table 7 : Ranking in Banks II

Rank	Balance Sheet Size	Deposits	Loans	Net Worth	Capital Adequacy Ratio	NPL to Total Loan	LLP to NPL	Overall Average
1	RBB	RBB	ADBL	HBL	CBIL	GBL	CBIL	NABIL
2	NBL	NBL	RBB	NABIL	SCBN	CBIL	GBL	SCBN
3	ADBL	ADBL	HL	SCBN	GBL	SBL	SBL	HBL
4	HBL	HBL	NIB	NIB	NSBI	LAXMI	LAXMI	NIB
5	SCBN	SCBN	NABIL	ADBL	NABIL	KBL	KBL	ADBL
6	NIB	NIB	ELB	EBL	BOK	EBL	NABIL	BOK
7	NABIL	NABIL	NBL	BOK	HBL	NIC	NIC	KBL
8	EBL	EBL	SCBN	KBL	LAXMI	NABIL	SCBN	NSBI
9	NSBI	BOK	NSBI	NSBI	MBL	MBL	NIB	EBL
10	BOK	NSBI	BOK	MBL	NIC	NIB	BOK	NIC
11	KBL	KBL	NIC	NIC	NIB	SCBN	NSBI	LAXMI
12	NIC	NIC	KBL	LAXMI	SBL	BOK	HBL	CBIL
13	MBL	MBL	MBL	SBL	KBL	HBL	ADBL	NBL
14	NBB	NBB	LAXMI	CBIL	EBL	NSBI	MBL	RBB
15	LAXMI	LAXMI	SBL	GBL	ADBL	NBL	NBL	SBL
16	NCC	SBL	NBB	LBL	NCC	ADBL	LBL	GBL
17	SBL	NCC	NCC	NCC	LBL	LBL	RBB	MBL
18	LBL	LBL	LBL	NBB	NBB	RBB	EBL	NBB
19	CBIL	GBL	GBL	NBL	NBL	NCC	NBB	LBL
20	GBL	CBIL	CBIL	RBB	RBB	NBB	NCC	NCC

Due to data constraints, CAMELS rating could not be applied to all banks. SCBN and NABIL are no. 1 & 2 respectively under CAMELS rating while RBB, NBBL, NCC and LBL are at the bottom 5.

Table 8 : ROE of Banks with Positive Net Worth in 2005/06

Rs. Million

S.No.	Banks	FY 2005/06			FY 2006/07		
		PAT*	Net Worth**	ROE (%)	PAT*	Net Worth**	ROE (%)
1	SCBN	665	1,582	42	692	1,754	39
2	Nabil	635	1,658	38	674	1,875	36
3	NIBL	351	1,180	30	501	1,415	35
4	HBL	457	1,542	30	492	2,126	23
5	BOK	208	721	29	208	840	25
6	EBL	239	833	29	296	963	31
7	MBL	134	638	21	134	931	14
8	NSBI	117	689	**17**	117	689	17
9	SBL	65	388	17	95	603	16
10	KBL	104	642	16	170	864	20
11	NIC	97	684	14	158	766	21
12	Laxmi	35	644	5	35	679	5
Total		**3,107**	**11,199**	**28**	**3,573**	**13,505**	**26**

* Profit after tax of the finacial year excluding tax paid for prior years.
** Sum of paid up capital and reserves & surplus as at the beginning of the financial year

Six commercial banks namely NBL, RBB, ADBL, NBBL, NCC and LBL had negative networth in FY 2005/06. Though overall return on shareholders' fund appears to be impressive in Nepal, it is in a declining trend and at the same time not high if we exclude some established old banks.

Negative Net Worth of Some Banks and Reform Measures

Some analysts say banking is nothing but management of the risks. Banks are exposed to mainly credit, operational, market and liquidity risk. Taking risk by choice, not by chance is the main mantra of banking. Unfortunately, risk management system in all those banks was poor due to poor corporate governance. Like most other public sector enterprises, government owned banks were not professionally run resulting in a huge non-performing loans (NPL). Similarly, NBBL, NCC and LBL have negative networth due to undue interference of the promoters/directors in credit operations causing huge NPL.

NRB has today adopted many measures to erase negative networth of these banks and to safeguard the interest of the depositors. Negative networth in those banks is due to the high level of NPL. This critical situation however would not have arisen in private banks had NRB screened the promoters correctly at the time of awarding license and taken proactive measures as soon as the symptoms of the problems were sensed. The fate of semi/government banks was inevitable looking at the way the government offices in

Nepal operate. Strong commitment of the government and support of judiciary is also a must for restoring good health of these banks.

After the initiation of financial sector reform, various new acts relating to banking sector have been promulgated. Similarly, prudential regulations of international standard have been introduced. NRB's supervisory system has also been strengthened. These reforms will definitely contribute to keep the financial sector robust. However, pre-requisite for sustainability of RBB and NBL is introduction of effective risk management system which requires strong commitment of the Board, top level management and other staff of the banks. Just bringing few professionals with high pay will not give the desired result. Unless structural changes including raising employees' remunerations at par with other private banks is done, the current style of reform will not bring about the desired result in the semi/government owned banks. Failure of the reform initiated based on CBPASS reports must also be a good lesson to learn. We can take cue from improved regulatory and supervisory system of NRB following the various structural changes and pay revision. Though there might be many areas to improve, our experience tells NRB of today is far superior to government owned entities. So, NRB needs to diagnose the crux of the problem and prescribe the appropriate solution.

The World Bank should be convinced that the foreign management is not the solution of the problem. With the involvement of Nepalese professionals, reform in problem banks can be successfully carried out with low cost. Above statistics on ROE shows all the banks professionally managed are in a good condition. Return of some of the above banks is very lucrative. The fact that most of these banks are run by Nepalese professionals prove a point that the Nepalese are capable of running the banks effectively and efficiently. Only thing required is creation of the environment for running the banks professionally. In this context, it would be appropriate to present the success story of Nabil Bank Limited, the 1st foreign joint venture bank, which has been run by Nepalese brain for over a decade:

Date of operation: 12 July 1984
Capital injected by shareholders till date: Rs.30 million
Cash dividend distributed by the bank till date: Rs.2.86 billion
Market capitalization as at 16th July 2007: Rs.24.8 billion
Return on Equity: around 36%

Regulatory Framework

Nepal Rastra Bank has introduced many prudential guidelines governing the operations of commercial Bank. They mainly pertain to capital adequacy, risk management in credit and investment portfolio (single borrower/unit limit, single sector limit etc.), loan/investment classification and provisioning, income recognition, market risk management, liquidity management and corporate governance including disclosure norms and provision of Audit Committee.

With regard to Basel II implementation, NRB has prescribed the approaches most suitable for Nepalese financial market. New capital adequacy framework prescribed by NRB based on new Capital Accord (Basel II) of Basel Committee on Banking Supervision is meant for parallel run in FY 2007/08 and shall come to force effective FY 2008/09.

The directed lending imposed on commercial banks has been gradually phased out in line with open market policy. However, the deprived sector lending meant for very poor section of the society has been continued.

So far, the following acts about commercial banks have come into force:

Nepal Bank Limited Act 1937	Commercial Bank Act 1964
Rastriya Banijya Bank Act 1965	Commercial Bank Act 1974
Bank and Financial Institution	Ordinance 2004, (Ordinances introduced many times until introduction of the Act in 2006) [Bank and Financial Institution Act 2006]

Challenges and Recommendations

- High Level of NPL and Risk Management System: Unaudited figures of mid July 2007 show negative networth of above Rs. 25 billion in 5 commercial banks. This is undoubtedly due to high level of NPL in those banks. As a fiduciary of public money, current situation is unfortunate and collapse of a large bank may invite systemic risk. So, the challenge today is to erase negative networth of the banks and to create an environment to avoid recurrence of such a situation in future. Current measures adopted by NRB have to be continued in case of problematic private banks. However, the structural changes are necessary in case of RBB and NBL. HR management and risk management practices of best managed private banks are to be applied in these banks.

  Strong commitment of government and strengthening judiciary in terms of commercial transactions are necessary to bring down NPL level of banking sector. There should not be political interference and cases of ex-parte injunction should be rare. There is a need of making Debt Recovery Tribunal strong and efficient including its expansion at least in major cities and setting up an efficient assets management company.

  In addition to credit risk, banks can face adverse situation from other risks like market, operational and liquidity. It is sad to note that collateral based lending instead of cash flow based lending is still prevalent. This speaks the need of a comprehensive risk management system in a bank. All the banks need to work in this direction to assure the public that they have adopted all the possible measures to keep their money safe. Moreover, regulating authorities should create an environment whereby the banks can make lending decisions based on the financial statements of the borrowers.

- International Level Competition: Competition in the financial market is already tough with the presence of large number of financial institutions including joint venture banks of international banks. Interest spread, exchange spread etc of the banks is constantly narrowing. The competition is expected to stiffen further with the government's commitment of allowing foreign banks to open their branches from 1st January 2010. When international banks come, they come with large capital, modern technology and an array of products. Experience of our neighbouring countries suggests us not to panic with the arrival of international banks. We however need to focus on the following areas to remain competitive:

  - Augmenting capital base: Mergers and acquisitions can be effective in this regard. Sadly, there is not a single case of M&A amongst the commercial banks. Current level of return on equity and Nepalese culture are the major obstacles but the competition exerted by the international banks will force us to behave like

international players. Similarly, the local banks should maintain their position so high that they can raise capital from international market.

- Develop expertise in various fields: International banks have better exposure mainly in treasury and credit area than local banks. The local banks thus need to focus on enhancing skills of their human resources in these areas.
- Adopt best human resource practices.
- Strengthen risk management system and corporate governance.
- Improve customer service quality.
- Maximize use of information technology.
- Focus on product innovation and cost management.

- Reach of banking services: Even after 7 decades of formal banking history, it is sad to note that $3/4^{th}$ of population is far from the formal banking net. Poverty is one of the main reasons for fuelling the social tension. Financial inclusion is a must for social and communal harmony. Banks need to work in coordination with micro credit institutions, local governments, NGOs and cooperatives to make financial service accessible to the common people across the country. Moreover, the banks can play a role in infrastructure development of the country. Proper management of remittance, attraction of remittance from high networth NRNs, FDI and control of the capital flight can be a stable source of fund for infrastructure financing.
- Supervisory capacity of NRB: Currently, it appears NRB wants to give license to all those who meet its criteria for opening banks and financial institutions. NRB is not working in the direction of putting a cap in the number of banks and financial institutions citing it will be against the spirit of open market regime. As an autonomous body, it is free to adopt the policy it deems the most appropriate. As the situation of bank failures may invite systemic risk resulting in financial disintermediation, NRB needs to screen the integrity of promoters thoroughly before issuing a license. Utmost care should be exercised to avoid potential conflicts of interest while issuing license to promoters having other large business. Supervisory capacity of NRB should be strengthened to the required level so that we do not see the repeat of current scenario.

To conclude, commercial banks of Nepal have made significant contribution to the economy. They however need to multiply their contribution for overall economic development of the country. As the country offers multitude of opportunities amidst various adversities, the banks have to plan their operation meticulously to tap the opportunities. To achieve the broader goal of new Nepal, NRB and commercial banks should work hand in hand.

Selected References

40 years of the Nepal Rastra Bank, Nepal Rastra Bank

Nepal Rastra Bank in 50 years, Nepal Rastra Bank

NRB Acts

Commercial Bank Acts and Bank and Financial Institution Ordinances/Act

Kanoon Patrika

Commercial Bank Management, Peter Rose

NRB Publications

NRB Website

NBL Website

Annual Reports of Banks

Chapter V
Development Banking in Nepal

Shiv Ram Koirala*

Background

Economic growth of the country has not improved substantially over time to overtake population growth. As the current population growth is 2.25 percent per annum, growing population has overshadowed the gain achieved by development activities. Population census 2001 reports that 53.1 percent population of age 10 years and over are employed and 5.1 percent are unemployed (CBS, 2006).

As our economy still depends on agriculture sector, the need is to increase the production and productivity of this sector by pursuing it in more integrated and systematic manner. Similarly, the development of non-agriculture sector needs to be encouraged so as to create conducive environment for investment. The increasing savings and investment gap, coupled with foreign aid and loan dependability, has warranted domestic resource mobilization towards the productive sector to facilitate economic output and employment generation.

Constantly widening trade deficit together with very slow industrial growth indicates the need of specialized bank to cater to the needs of the industrial sector of the country. Given the under and unemployment problem in the country, there is no choice but to make industrialization process successful. In order to achieve sustainable economic development, greater portion of GDP should be directed to investment. Also, in order to maximize benefits from investments, it is necessary that the share of private sector investment should be increased.

With a view to ensure foreign investment, review and revision of related policies including infrastructure development and expansion of existing infrastructure have already been started. Infrastructure development holds the key to rapid economic growth and it is being realized that infrastructure development cannot be brought about only through public sector. With this realization, the Government has already opened up power and communication for private sector participation, which will require huge investment in the coming years.

There is huge need to create more and more productive and gainful on and off-farm job opportunities to reduce the percentage of unemployed and semi-unemployed population. The importance of employment opportunities in industry, trade and services

---

* Act. Chief Manager, Small Farmer Development Bank Ltd.

under the private sector in relation to the ever increasing number of educated unemployed labor force is the important task to be addressed. In this connection, efforts are needed to reduce poverty and semi-unemployment situation in the rural areas. Against this backdrop, bank could be the important tool to some extent to accomplish planned expectations.

Sustainable economic growth will be attained only if the productive activities are enhanced and exportable surplus is generated. The scarcity of fund for the development of cottage and small-scale industry is a major problem. Thus for sustainable economic growth, more specialized bank for the development of industrial sector is the need of the economy.

The development of industrial sector in Nepal is still in its infancy. This fact has been disclosed by the share of contribution of non-agricultural sectors to the GDP of the country. The potential of economic development can be fully realized only when the private sector participates actively in industrialization processes. If the majority of population depending on agriculture could be induced to shift to the non-agriculture sector, it would not only solve the problem of unemployment and underemployment prevailing in the country, but also significantly help in economic development.

Development Banking Theory

In development banking the concept of development is combined with the concept of "banking" to achieve the construction of a mechanism for the financing and implementation of development projects, which has been named "development bank". Development banks are sometimes considered as of relatively recent origin but it is true that a development bank viz Societe Generale de Belgique existed as early as in 1822 in Belgium for the specific task of financing Belgian Industries. Another similar institution was established in 1852 in France with the name 'Credit Mobiler" (ADFIAP, 2006). The later institution continued to inspire the industrial finance specialists throughout the nineteenth century. As a result, the Industrial Bank of Japan came into being in 1902.This was followed by the Industrial Bank of Germany and a number of specialized industrial financing agencies in other European countries leading to the setting up of numerous development banks towards the termination of the Second World War. Historically, development banks in most developing countries were established as the government owned creations to provide institutional mechanisms for promoting, supporting and financing medium to long-term projects generally not catered by commercial banks. While governments and donors have sustained this type of financial support over the years, increasing competing demands on scarce central financial resources have forced governments and donor agencies to shift their financing focus from just access and availability of funds considerations to the goal of financing. This in turn has placed a greater accountability and responsibility on the part of development bank to demonstrate strong performance in terms of profitability and growth and more importantly in terms of financial sustainability in the long term. Financial sustainability has thus become strategically important not only for commercial bank but also for development finance institutions including development bank and micro finance institutions (Banuri, 2002)

Development bank is largely a public institution expected to engage in the delivery of social goods and at the same time attain financial sustainability. However, the need to improve efficiency by the bank is of immense importance not only as a public interest concern, but also as one of the prerequisites for financial sustainability (Yaron, 1992).

Scope and Role of Development Banking

Scope

The subject 'development banking' is wider in scope than the concept of a development bank. A development bank is a financial institution with the scope that can be more precisely delimited with regard to its functions and operations. The field of development banking goes beyond the scope of the development bank proper. It deals with the number of areas that extend beyond the functions and operations of a development bank as an institution. Development banking, in addition to the functions and operations of a development bank, also covers the relations of these institutions with national and local governments, with national planning agencies, the link-up with national development programs and with industrial, agricultural, infrastructure, social and other development processes. Development banking deals also importantly with the appraisal and evaluation of projects. In addition, development banking requires certain knowledge about financial markets and international finance. The above illustrates how development banking is wider in scope than the more direct concerns of the development bank as a financial institution. So far as the objects and scope of the development banks are concerned, they differ widely from one country to the other and from the objects at some stage of economic development to the other. This is manifested by the fact that development banks have been established in countries which differ widely from each other in their socio economic backgrounds e.g. USA, UK, France, Germany Bolivia, China India, Thailand, Indonesia and Bangladesh. Each development bank is modeled on a pattern which is best suited to the economic, social, cultural and industrial setup of the country in which it operates. Some of the development banks like the Japan Development Bank, Industrial Development Bank of Canada and the Industrial Development Corporation of Nepal confine their activities to the industrial sector only whereas some other development banks like Bank for Agriculture and Agricultural Cooperatives (BAAC), National Bank for Agricultural and Rural Development (NABARD), the Development Finance Corporation of Sri Lanka, the Development Bank of the Philippines and the Agricultural Development Bank of Nepal also provide financial assistance for agricultural development. Further, National Bank for Economic Development of Brazil and the Hellenic Industrial Development Bank of Greece provide financial resources for housing, fisheries, commerce, tourism crafts and meat packing plants etc (ADFIAP, 1990).

Role

The role of development banking differs between an advanced economy and an underdeveloped economy. In the case of the former, development bank generally evolve “through normal process of market pressure” and their main concern is to increase the rate of growth of the economy (ADFIAP, 2006). This the development bank do by collecting small savings from a large number of people spread over a wide area, allocating the fund so collected among different sectors for maximum return with the help of their technical and financial expertise and in this process reducing the risk of the investors. In an advanced economy in some exceptional cases, the development bank is not required “to fill up the gaps in the industrial structure of the economy”.

On the other hand, the position of a development bank in an underdeveloped economy is much different. Because of the peculiar structural drawbacks from which an

underdeveloped economy suffers, the responsibilities of development bank increases manifold. It has to increase capital formation, induce the investors and the entrepreneurs, seal the leakages of material and human resources by careful allocation thereof, and undertake developmental activities and try to ensure that no good project suffers for want of financial and /or technical resources. In brief in an underdeveloped economy the development banks are conceived as instruments for increasing the rate of growth of the economy so fast that it surpasses the rate of growth of the population, increases the per capita real national income and helps the economy leap forward into the phase of self generated and self sustained growth.

Some countries have floated “Regional Development Bank” for the development of certain specific regions. The development bank, intended not only to provide capital for the private industrial sector, but also to mobilize savings, enterprise and skills for productive investment in that sector, is largely a post World War II creation. The last sixty years have seen the least developed countries swept by a determination to accelerate the pace of their economic development. This determination has been manifested by an increasing emphasis on industrialization, and by the hope that industrial expansion can be speedily achieved.

However, progress has been impeded in most countries by the lack of inadequacy of various ingredients of industrial development. The first impediment is a shortage of capital for industrial investment. Their resources don’t permit the accumulation of earnings sufficient to finance a rate of growth satisfactory to them. Some capital usually exist in the form of private savings but not enough, and only a small part of those savings is in any event readily available for investment in industry; wealth is traditionally invested in land or commercial enterprises. The second ingredient of industrial development which is generally lacking is the absence of a capital market. Finally, many countries suffer from a limited initiative on the part of the industrial community – a disinclination to seek out and to venture into new areas of activity-and from limited or no opportunity to become acquainted with and to profit by technological advances achieved abroad.

To help in overcoming these obstacles and in supplying the missing ingredients, the institution known as a development bank has been devised. Because each bank is a response to the particular needs of the country which it serves, and to the political economic and social environment in which it functions, there is considerable variety among them, particularly in scope of activity.

As financial intermediaries, development banks increases the level of mobilization of financial resources in a country and contribute to capital deepening. This is an important role of development banks. Considering this role, development bank can substantially contribute to the development of the country like Nepal by extending credit support to the rural people, majority of whom are still deprived of institutional credit. Approximately 28 percent of the population has been able to get institutional financial services so far.The existing development banks both in public and private sector have been able to satisfy the credit need of only about 20 percent Nepalese households. These banks also play an important role in socio-economic transformation through women empowerment, local resource utilization and most importantly social mobilization. They focus on medium and long term financing of larger rural and agricultural projects. Some of them focus on particular economic sectors. Due to their development objects, they can and do support microfinance networks and apex institutions and provide refinancing to member based bank, such as rural village bank.

Over the years, history has shown and reinforced the view that development banks do have an important role to play in a country's socio economic development. For instance, in Europe the advent of development banking can be traced back to the mid nineteenth century and was established to meet the increased demand for medium to long term capital by new and emerging enterprises during the industrial revolution. The years following World War II saw the establishment of development banks in many developing countries to provide, in particular, medium and long term financing that was identified to be so critical in supporting the economic development agenda of these countries.

In a laissez-faire economy, an efficient financial intermediation system mobilizes and allocates scarce resources that would optimize the rates of return. On this basis, the commercially driven and profit maximizing banking institutions would often tend to take a short term view and consider solely the private benefit of a project, at the expense of the potential long term social benefit that could be derived from financing a particular project. This has therefore, created a gap in the market place whereby certain segments of the economy have been underserved by the banking system. These include development projects which involve high potential risk and long gestation period, but yet have significant long term benefits to the overall economic development of a country. Similarly, there are some sectors or groups of business which, due to their business characteristics and lack of track record, limited credit history and inadequate collateral, do not have adequate access to financing from the banking system. These are clearly instances of market failure and the establishment of the development banks is an attempt to rectify this shortcoming.

In this regard, in achieving national policies for economic and social development, the development banks are established as a strategic conduit to bridge the gaps in the supply of financial services, by channeling the resources and funds in the financial system to areas and sectors that are deemed as strategic for long term economic development purposes. In essence, the establishment of development banks are part of the national development plan itself.

As policy based banks, the development banks have roles and mandates which are linked closely to their country's national development objectives. This is evidenced from the establishment of development banks with specific purposes to promote development of identified sectors ranging from industrial and agriculture sectors to areas such as export promotion, infrastructure development as well as the small and medium enterprises (SMEs)

It is notable that the roles of development banks have evolved in the course of a country's economic development and transformation. This is important in ensuring that the development banks remain relevant to support the changing financing needs of the economy. In some instances, the development banks have widened and diversified their scope of activities, to cater to the financial needs of new growth areas, such as information and communication technology (ICT) and bio-technology. Many of them have expanded their financial products to include providing short term working capital loans, equity participation and investment banking. While operating with the widened scope of activities, it is observed that the majority of development banks continue to maintain the provision of medium to long term finance and project finance as the core of their activities . At the same time, the development banks still fundamentally remain complementary, especially in supporting strategic sectors such as the SMEs and agriculture.

As reflected by the term “development bank” development banks are not only expected to provide development finance for nation building, but also to undertake a higher degree of developmental role to nurture and develop the targeted sectors. With regard to this, the development banks have been demonstrating outstanding performance in their developmental role. For instance, the Kew Mittelstand Bank, a prominent development bank in fostering SME development to Germany, is providing credit facilities to not only the established SMEs but also the new start-ups. Another example is the organization for SMEs and regional innovation of Japan which focuses on providing advisory and consultancy services and training to nurture and develop the SMEs. In view of the fact that industrialization is usually considered an important path to economic growth, development banks may have an important role to play in the industrial development of a planned economy. In many countries there are development bank that are exclusively meant for providing finance for the private sector. Sometimes a distinction is made between “a development bank providing long term loan capital and a development corporation seeking to participate in equity capital and promoting and managing companies." A development bank may be defined as an institution either wholly or partially owned by government or by private interests (both domestic and foreign) primarily devoted to the supply of entrepreneurship, including technical know how and management of the private corporate sector (Zamani, 2005).

Growth and Position of the Banking and Non-Banking Sector in Nepal

Growth

There has been a tremendous growth of financial institutions in Nepal over the last two and half decades. At the beginning of the 1980s when financial sector was not liberalized, there were only two commercial banks namely Nepal Bank limited (NBL) and Rastriya Banijya Bank (RBB) and two development banks namely Agricultural Development Bank, Nepal (ADBN) and Nepal Industrial Development Corporation (NIDC) performing banking activities. There were no micro-credit development banks, finance companies, cooperatives and NGOs with limited banking transactions. After the liberalization of the financial sector, financial sector has made a tremendous progress both in terms of the number of bank and clients of financial services. By mid January 2007, NRB licensed bank and non-bank bank totaled 203.Out of them, 19 are commercial banks, 35 development banks, 11 micro credit development banks, 72 finance companies, 19 saving and credit cooperatives and 47 NGOs. (Banking and Financial Statistics mid January, 2007, No.48)

Following the financial sector reforms, a number of development banks have come up recently. Currently, there are altogether 35 development banks operating in Nepal (NRB, 2007). The ADBN and NIDC are the state owned enterprises. They are the specialized bank for the development of agriculture and industry, respectively. Thus, there has been a tremendous growth in private sector development bank after the Nepalese government adopted liberal economic policy in 1990 and mainly after the enforcement of Development Bank Act, 1996.

Present Position

The total number of development banks reached 35 in mid-January 2007.Out of them, 7 are national level and rest are district level development banks. Since ADBN was upgraded to 'A' grade banks in April,2006, all the financial transactions has been excluded from the development bank section and consolidated into commercial banks from mid-January 2007. This results in the substantial changes in the figures of development banks compared to previous years.

The total assets/ liabilities of development banks remained at Rs.18645.2 million in mid-Jan. 2007. In mid-July 2006 it was Rs 60,200.2 million. Of the component of liabilities in mid-Jan 2007, the share of deposits occupied 66.28 percent followed by capital fund 19.90 percent and borrowing 11.20 percent. Similarly, on the assets side, loans and advances accounted 66.37 percent, liquid funds 16.17 percent and investments 1.0 percent of total assets in mid-Jan 2007 (NRB, 2007).

In mid-January 2007, the share of assets of development banks to the total assets of financial system was 3.38 percent .Of the total deposits of the financial system in mid-January 2007, development banks held 3.38 percent. Similarly out of total loans and advances the share of development banks stood at 4.55 percent in mid-January 2007. .However it was 11.75 percent in mid-July 2006.As far as sectorwise outstanding credit of development bank is concerned, it is Rs 123,922 lakh under 13 different sectors. Non performing loan assets (NPL) is 6.31 percent of total loan outstanding. This percentage however, was 15.56 percent in the previous year at mid-Jan.2006 (NRB, 2007).

In Nepal, most of the institutional systems providing rural financial services are not self-sustainable and capable to provide widespread and attractive financial services. Development banks exhibit the characteristics of dependency on borrowing for expansion, very little deposit mobilization, low level of profitability, insignificant profit retention, average to poor recovery of loans and interest income and weak financial structure[1]. Development bank's cost of funds still remains high and has also incapacitated them to compete with other bank.

Five rural development banks, mainly owned by the government and the Central Bank have been suffering from poor governance and management which in turn results in low performance and depleting financial position. These banks may take longer period to have commercial culture and professional management if required efforts are not taken immediately from the concerned. It would be a disaster if the rural development banks were not rehabilitated soon as they have already reached a large number of poor families; however the concerned parties have not shown adequate seriousness in bringing them to track.

ADBN[1] and NIDC, according to Price Water House Coopers study, are mired in the bad financial situation caused by bad debts and piled up non-banking assets. These wo government banks have a negative net worth of around 7 percent of GDP. Further with the present liabilities of the ADBN, total financial sector liabilities can increase the fiscal burden by as much as 10 percent of GDP. The ADBL's auditor's report for FY 2002-03 has pointed out that the Bank has claimed to be operating in profit by showing accrued but unrealized interest as income, loan loss provisioning less than that prescribed by the

---

[1] ADBN has changed its legal status as Agricultural Development Bank Ltd (ADBL) after its incorporation under company Act.

Central Bank and non banking assets not written off. These evidences clearly show that the Bank in fact is operating at a loss. Reaching the rural and remote areas to cater to the needs of rural populace and attaining financial sustainability is still a dilemma for the Nepalese development bank whatever operating models they have followed. According to the detail onsite inspection report prepared by a team of expertise that the NRB had instituted to find out the real financial condition of the NIDC, negative net worth and its accumulated loss in 2000/01 was Rs.650 million, paid up capital being Rs. 415 million. Plagued by its huge NPAs which is around 50 percent, the NIDC has been compelled to allocate around Rs.710 million for the loan and investment-loss provisions,. Presently, there is very limited number of development banks attaining financial viability and reaching sizeable number of rural and especially poor households at the same time. So far only few have realized financial self-sufficiency although they have been able to attain operational self-sufficiency.

Despite these facts, most of the development banks in Nepal, except a few private development banks, are found operating continuously at loss and hence their sustainability over the years has been questionable. Private sector development banks like Nepal CSI Development Bank Ltd. (CSI), Nepal Development Bank (NDB), Malika Development Bank (Malika) United Development Bank Ltd (United) and Narayani Audyogik Development Bank ltd. (Narayani) have a large volume of non performing loan portfolio, which obviously indicates that private sector development banks as well are not being professionally managed and run. CSI's non -performing loan portfolio is 48 percent (NRB, 2007) of the total loan assets, which is alarmingly high. Rural development bank, for example, for efficient operation needs structural reform in order to reduce their piling up losses. ADBL, the largest financial sector state owned enterprise of Nepal, is in a stage of immediate financial reform for its long-term sustainability. Thus, there is a need of a large number of development banks to cater to the unmet demands of institutional credit on the one hand, and prevent the existing development bank from further financial deterioration on the other.

Policy Provisions

According to the Bank and Financial Institutions Act, 2006, minimum paid up capital required for "B" class national level development bank is Rs.640 million, development bank covering 4-10 districts, Rs.300 million (excluding Kathmandu valley and carrying out leasing business only) and Rs.200 million. Similarly, development bank covering 1-3 districts Rs.300 million (excluding Kathmandu valley and carrying out leasing business only) and Rs.100 million. (NRB, 2063)

Regulatory Framework

i. Capital fund: The minimum capital fund required is 12 percent for "B" grade banks/financial institutions.

ii. Financial resources: B grade development bank can collect financial resources maximum up to 20 times of core capital.

iii. Mandatory cash reserve: Development banks and financial institutions should maintain 20 percent of total deposit liability and borrowed fund as mandatory cash reserve.

iv. Loans and advances: Development Bank and Financial Institution should classify loans and advances as good, substandard, doubtful and bad and maintain loan loss provision of 1.0, 25.0, 50.0 and 100 percent, respectively.

v. Per customer loan: Development bank can advance, per customer credit and loan facility up to 25 percent for fund based and 50 percent for non fund based advances.

vi. Institutional good governance: The promoters, directors and employees should be professional, honest and disciplined and of high morale for the efficiency enhancement of the development banks and FIs.

vii. Investment: Development bank and FIs may execute the policy and process for the investment on government bonds, securities, shares and debentures organized institutions, only after the approval of their Board of Directors.

viii. Interest rate: Development bank can decide their own interest rate on deposits and loans.

ix. Branch office: Development bank needs to take prior approval of NRB to open any type of branch.

x. Sale of promoters' share: Prior approval of NRB is required for the sale and transfer of ownership of promoters' share.

xi. Auditing: Auditing should be performed by the auditor authorized by NRB. Such auditing report should be submitted to NRB within 5 months from the expiry of the financial year.

xii. Arrangement has been made for the submission of financial statements in the NRB prescribed format, for making the financial statements of development bank and FIs clear and transparent.

Prospects and Challenges

With the growing and changing global economy, development banks will remain important and relevant to meet the increasing developmental needs of their respective countries. This development, indeed, presents both opportunities and challenges to the development banks in the way forward. While the expanding economies both in the developed and developing countries would create greater business activities for the development banks, this also means that they have to remain innovative in their products and services by exploring new ways of doing business, to be able to respond effectively to the different financing and developmental requirements. Development banks must continuously evolve and review their areas of comparative advantage in order to remain relevant, effective and strategic.

To drive performance, one important aspect is to clearly identify key performance indicators for the development banks, in order to measure efficiency and effectiveness in performing their mandated roles. Recognizing the development bank’s developmental role, the performance measurement of a development bank should go beyond the standard financial measurement to encompass quantitative and qualitative non-financial indicators that evaluate economic and social contribution of development banks,

consistent with their objectives of establishment. For development banks that are involved in SME development, the key performance indicators should include the number of new start-ups, the extent of borrowers receiving advisory services and the number of SMEs that have "graduated" from the development banks.

An important aspect to highlight is the need for development banks to be financially sound and sustainable in their operations. This is critical so that the development banks could fulfill their roles without continuously drawing resources from the government and the public sector. It is indeed heartening to note that many development banks have been successful in balancing the change to fulfill developmental roles, while ensuring that their operations are financially sustainable. For instance, the Development Bank of Japan, which is focusing on the provision of supplementing long term funding to qualified infrastructure projects, has shown favorable financial performance with a return on equity of 6.5% in 2004. Similarly, the Business Development Bank of Canada, a leading SME development bank in the country, has also recorded encouraging performance with an average return on equity of 7.1 % in the past five years (ADFIAP, 2006).

The experiences of these development banks have proven that despite the specific mandates to finance development activities, business operation of development banks can be financially sustainable. These success stories essentially share several key factors, including a high focus on their mandates, dynamic leadership and proper accountability within the development banks; continuous development of human resource capability, intensive use of information technology to improve efficiency; and last but not least the adoption of sound and prudent financial principles as well as best practices in their operations.

At the same time, given their relatively limited access to funds, it is recognized that financial support from the government is important to enable the development banks to play their role on a sustainable basis. This however does not mean that development banks should solely rely on government funding. In order to remain relevant and effective in meeting the growing financial needs of an expanding economy, development banks need to increasingly draw funds from alternative sources, such as the capital market. Sourcing funds directly from the market would also help instill certain form of discipline on the operations of the development banks.

The need for development banks to remain financially sustainable while performing their mandated roles cannot be over emphasized. This would require continuous capacity and capability enhancement of the development banks, especially the strengthening of human capital skills and institutional efficiency, together with the adoption of good corporate governance and best practice by the development banks. In addition, to ensure that available resources are channeled adequately and appropriately to support the targeted sectors, development banks would need to strategically reduce the channeling of funds to the sectors and businesses that have matured and, on their own, would be able to obtain financial resources from the banking institutions or the capital market

Prominent Issues

One of the main issues in the financial sector in general and development banking sector in particular at the present time is the overwhelming role that the government plays as an owner and operator of financial institutions. It owns both the development

banks, ADBL and NIDC. Government ownership has resulted in poor internal governance, weak management, fragile financial health and an unhealthy politicization of these institutions. There is an important need for the Government to divest its ownership of these banks and to replace the role by "fit and proper" private sector owners and operators.

Continued political intervention is another crucial factor behind the weakening financial condition of the state owned banks. The leadership, for example of NIDC, has changed for about ten times in the last 12 years. (The Kathmandu Post,Jan,16,2003)

The Government has failed to play an adequate role as a supervisor and regulator of the financial system. Consequently, weak institutions have been permitted to carry on business without government or central bank sanction-and indeed have continued to deteriorate over time. Many institutions are characterized by weak capital base, high levels of non-performing loans, and even allegations of corruption and inappropriate management action. In an industry based upon confidence, such conditions cannot be allowed to persist. Hence, there is a critical need for the Government to realign its role within the financial system away from being a direct owner to being a supervisor and regulator of financial sector activity. In doing so however, it will need to take care of the fact that it does not replace its role as an inefficient owner, operator of the state banks with that of an overly bureaucratic supervisor, thereby replacing one form of excessive public sector influence with another. Achieving the correct balance in ensuring adequate prudential supervision without injecting undue interference will therefore be an important challenge.

Reform Measures

In view of the deteriorating financial health of both the state owned development banks, NIDC and ADBL, the Government of Nepal (GON) in line with the Tenth Plan adopted a resolution to restructure ADBL into a viable and autonomous rural finance institution to facilitate economical and efficient resource flow for reducing rural poverty. GON subsequently approved the restructuring plan for the commercialization of ADBN. This restructuring plan was developed under the Asian Development Bank (ADB) funded TA for strengthening corporate and financial governance. This plan aims to transform ADBL into a sustainable Bank after reviewing its ownership and governance, financial status, organizational set-up and operations (Financial and operational review of ADBN and NIDC in 2003). The ADBL was established to provide lending services for developmental activities in the agricultural sector, while the NIDC was designed to support development activities in the industrial sector. The ADBL however is a significantly larger institution than NIDC, with roughly ten times more assets. These two institutions account for about 8 percent of total financial system assets. (MOF, 2004)

State owned agricultural or rural bank need to be transformed based on business principles; otherwise these banks become a continuing burden to the tax payer and to rural financial systems building. They constitute the classical case of government failure in rural finance. The lessons learnt from the old paradigm still apply today in many countries such as China, India, Egypt and Pakistan. However, some of these banks have shown that true political commitment and ownership of reforms can be successfully transformed (as BRI of Indonesia and BAAC of Thailand demonstrated) with business oriented management reforms. A study of rural state-owned bank in Nepal, Sri Lanka and India analyzes recent reform efforts that seek to apply and adapt some of the lessons learnt in Thailand and Indonesia. Profit and success in business is

not necessarily incompatible with public ownership if management is given the right incentives. Often, state owned development banks possess large branch networks for rural financial intermediation and have staff that is specially familiar with agricultural enterprises.

Better monitoring capacity of the central bank needs to be initiated. It should properly perform the role especially with respect to large, inefficiently operated and politicized institutions. To this end, NRB heads to develop itself as a professional institution with greater autonomy and accountability.

The legal environment within which the financial sector operates also requires modernization and upgrading to internationally accepted norms. Development banks which accept deposits should be subjected to similar supervisory norms and capital adequacy requirements as other deposit taking institutions.

There is also need to address the problems of the two development banks -the ADBL and NIDC – and the five regional rural development banks, which support SME and micro enterprises. All of these publicly owned development banks have major financial and managerial weaknesses-which requires a rationalization of their activities, a divestiture out of the public sector, or perhaps even liquidation. The restructuring of financial institutions which provide finance to the rural economy is particularly important as a vibrant rural economy is a key prerequisite for broad based growth in Nepal. Broadening and deepening rural financial markets will be an important challenge for the future. Here again ,transitional and sequencing issues will need to be carefully managed in addressing the problems .of the development banks, and attention will need to be given to the legal and regulatory issues which pertain to these institutions.

ADBL and NIDC suffer from systematic inadequacies of the financial infrastructure reflected in (i) a lack of institutional autonomy (ii) an inadequate regulatory framework, standards and regulatory capacity of NRB (iii) weak auditing and accounting standards (iv) insufficient information database and (v) a feeble legal recourse system and contractual enforcement. Today these institutions constitute core elements of the rural and private sector financial infrastructure and these problems thus need to be addressed by the Government. In addition to the financial sector issues, ADBL is also affected by non financial policies such as agricultural pricing, investments in agriculture and rural development.

Given the difficult circumstance of ADBL and NIDC, a complete review of the role of these two institutions within the economy needs to be undertaken soon. This institutional analysis of both the banks would assess their financial health, their management strengths and weaknesses, and would make recommendations for their future operation. Fundamental changes in the activities of these two institutions will be unavoidable for streamlining development banking sector and thereby creating overall sound financial sector in Nepal.

Conclusion and Recommendation

Development banking is supposed to serve the cause of development. A development bank therefore must safeguard its economic and financial viability. Without this, it cannot play a developmental role. It cannot long operate as a bank since its resources would soon be depleted and its responsibility completely lost. To preserve its integrity as a development bank, it must assign the highest priority to depending and promoting its own viability. Consequently, it must be exigent in observing all the rules of financial

prudence and professional behavior. Its credit system must be kept inviolate and free from undue interference. All the dictates of business discipline and institutional decision making must be scrupulously followed.

Nepal's financial sector faces serious problems. The sector is predominantly owned and controlled by the state. Large parts of the system operate with very serious governance problems. Several of the key institutions are technically insolvent, and in some cases, have been maintained liquid by capital injections from the budget. The financial system acts as yet one more drag upon overall economic growth in Nepal.

The Government is committed to private sector led growth in Nepal. It is also committed to greater private sector ownership and operation within the financial sector. Turning this into reality involves an ambitious agenda which focuses first and foremost upon strengthening the central bank and reforming the two largest commercial banks. Strong government commitment and willingness to take politically difficult action will be required to deal with these two key areas. However, if steps are taken now, and existing commitments are acted upon, the financial sector could look healthier. Failure to do so will result in more lost years of development to the detriment of most Nepalis and most likely to additional financial losses, which would make the problems even more intractable than what they are at present.

Willingness to reform the financial sector will not merely demonstrate strong political courage and commitment for the sake of economic growth leading to poverty reduction but it would also evidence the government's willingness to strike the core of some of the worst excesses of bad governance within the nation.

The globalization and internationalization of financial market, the complex financial systems within the country and the emerging needs for better and quality service require NRB to be innovative, dynamic and effective. The ongoing Financial Sector Reform Program and the NRB's efforts towards developing long-term strategic plan for the financial sector development are vital steps for the development of a sound financial sector. It is also important that the reform should be a continuous process built in into its system and processes, in its structure and people.

Significant progress has been made in the task of developing a sound financial sector in Nepal through establishing procedures for opening banks and financial institutions, establishing minimum qualification requirements for promoters interested in opening banks and financial institutions, introducing regulations at par with international norms and standards, ensuring transparency and disclosure through establishing reporting mechanism, and ensuring corporate governance in the financial sector through establishing Code of Conduct and defining roles and responsibilities of Board, CEO and employees. However, the way ahead is quite challenging. The globalization of financial markets demands congruence with rest of the world on regulatory, supervisory and corporate governance issues. This calls the need for support and cooperation from all players in the financial sector. All Institutions in the financial sector should move towards achieving a common goal of making the financial sector sound, prudent, efficient and effective. The NRB needs to be committed in its work of leading the financial sector development with the object of creating a sound, healthy and competitive environment in which the bank will be able to compete in this globalized market.

Selected References

ADFIAP. "Principles and practices of Development Banking." Volume 1, 2, 3, IDF, 2002

ADFIAP. "Journal of Development Finance." July, 2006

Banuri. "Financing for Sustainable Development, International Institute for Environment and Development." UK, 2003

CBS. Nepal in figures, 2006

Ghani Abdul Zamani. "Role of Development Financial Institutions in the Financial system." Kuala Lumpur, 2005

Ministry of Finance (MoF), Nepal Development Forum, 2004

NRB, Banking and Financial Statistics, No 48, Mid January, 2007

NRB Directives, Issued by Bank and Financial Institutions Regulation Department of NRB

NRB Licensing Policy, 2063 Issued by NRB

Yaron J. "Assessing Development Financial Institutions, A Public policy analysis, Discussion Paper." 174, The World Bank, 1992

Chapter VI

Development and Challenges of the Nepalese Finance Companies

Siddhant Raj Pandey*

Introduction

Finance is the linchpin of any development strategy. Prior to the mid eighties finance markets in Nepal were characterized by barriers to entry. The development in this sector actually took place in the mid 1980s with joint venture banks entering the Nepali financial market reversing the monopoly of state owned banks. The licensing of non-banking financial institutions (NBFIs) in 1984 marked, with lower capital requirements, the need for more players in the market to avail access of services to the public. However, the actual proliferation of finance companies did not commence until the mid-90s. During the same period, the financial sector reform in India also took place. This paper attempts to track the growth in this sector, the regulatory constraints and whether the need for such players was warranted at all in the financial market. India's development in this sector has been phenomenal; however, Nepal has seen more growth than development in the banking and financial sector.

According to the findings of the 2006 Access to Financial Services Survey conducted by the World Bank and other, only 26 per cent of Nepalese house holds have bank accounts and 15 per cent have a loan account taken from the banks and financial sector (Ferrari et.al. 2007). In terms of numbers there has been an exponential increase of finance companies: in 1984 there was 1 and in 2007 there are 79. Despite the high number of finance companies, they manage to serve only 2 per cent of the population. Therefore, the expectation of mid-90s that the hordes of licenses issued for setting up finance companies would expand has not been fulfilled. It has only increased the number of players who are competing with each other for a share from the same segment of the market.

Historical Background

It was the Finance Companies Act (2042) that governed the operation and limitations of finance companies in 1984. It allowed finance companies to take deposits from the people and institutions and make investment on hire purchase, housing industry, commerce etc. In effect they were allowed to operate as mini banks. Some eight years later the Merchant Banking Act 2050 allowed certain finance companies that met the regulatory requirements to acquire merchant banking license. As of 2007 data there are 8 non banking financial institutions (NBFI) with merchant banking license. This has been

* Managing Director and CEO of Ace Development Bank Ltd., which was the first financial institution to upgrade into a development bank.

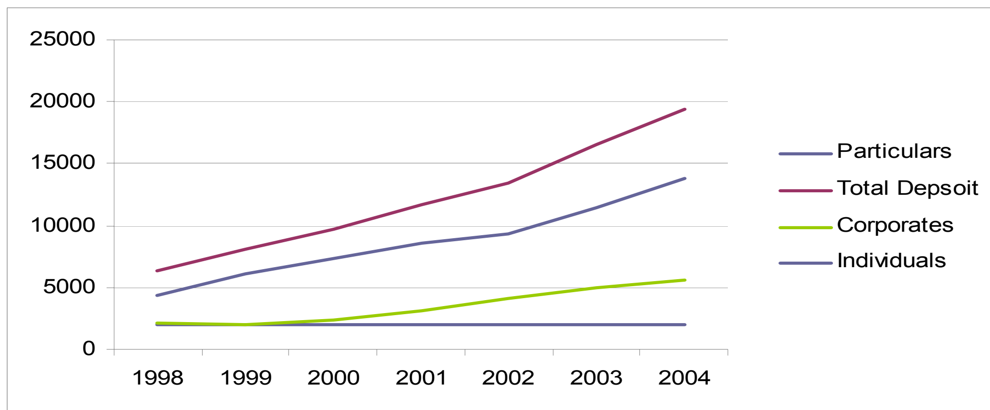
from the beginning till date the only major difference between a commercial bank and finance company in terms of the activities allowed to them. The only areas reserved for the commercial banks are: over drafts, personal loans, foreign exchange except Indian currency, and opening letters of credit. Recently, the finance companies are allowed to transact also in Indian currencies though they are still restricted to transact in other foreign currencies. In order to govern this sector more prudently the Banks and Financial Institutions Act 2061 (also known as the Umbrella Act) replaced all other earlier acts thus making this the single Act that governs all financial sector players from commercial banks and finance companies. The banks and finance companies are divided into various categories fixing the extent of services based on capital. The players with the highest capital base are commercial banks and they were given a class "A" category; development banks a class "B" category, finance companies a class "C" category and micro-financing institutions and cooperatives were given a class "D" category. Products and services were allowed according to the class the institution belonged to. Although this has been in line with the principle of prudential regulation factor and it has enabled the Nepal Rastra Bank to incorporate all the formal players in the financial sector under its regulatory jurisdiction, the purpose of making financial services endemic has not materialized. All it has done is that it has divided up the number of players into capital structured groups. The Umbrella Act along with the prudential regulations of the Nepal Rastra Bank has made this sector the most transparent and highly regulated industrial group despite the frequent changes in directives.

Efficiency Parameters

Growth in numbers, across the financial sector, has failed to address the main issue of accessibility. Ironically the reach to the masses is in decline. Between 1992 and 1995, Nepal Rastra Bank licensed almost three dozen finance companies. The need at that time was to make financial services more accessible to the general public. The handful of joint venture commercial banks in operation during that period were more inclined to serve institutions and high net worth customers. The newly licensed finance companies filled the void initially by catering to the general urban populace. The premise that wholesale banking would continue in the commercial banking sector and finance companies would enter consumer, retail financing and be a replacement for the informal sector was short-lived. In the beginning the simple process and quick sanction of loans as opposed to the long and cumbersome process appealed to the average urban population, as a result, finance companies can be given credit initially, for providing higher yielding depository products and access for loans in a market where people were subject to government banks and joint venture commercial banks with their stringent loan procedures. As competition in the entire banking and finance sector grew, the demarcation began to be vague; furthermore, all the players whether a bank, development bank or a finance company were vying for the same market share. Time series data of finance companies (aggregate), from 1994 to 2006, shows that there has been an average annual growth of deposits of 1156 percent, but corporate deposits are increasing and slowly displacing individual deposits and finance companies are heavily dependent on commercial banks for borrowing. What has transpired is that finance companies have serviced an area which used to be exploited by the informal sector, but due to increasing competition and proliferation of banks they are losing market share to the banks. On the loan side there has not been significant difference in the percentage of outstanding loans between 1998 and 2004. Term loans increased by 5 percent in 2004 as compared to 1998, the year when this type of loan commanded the highest weighted exposure. (i.e. 40 percent). Housing sector took second place at 30 percent in 2004 (29

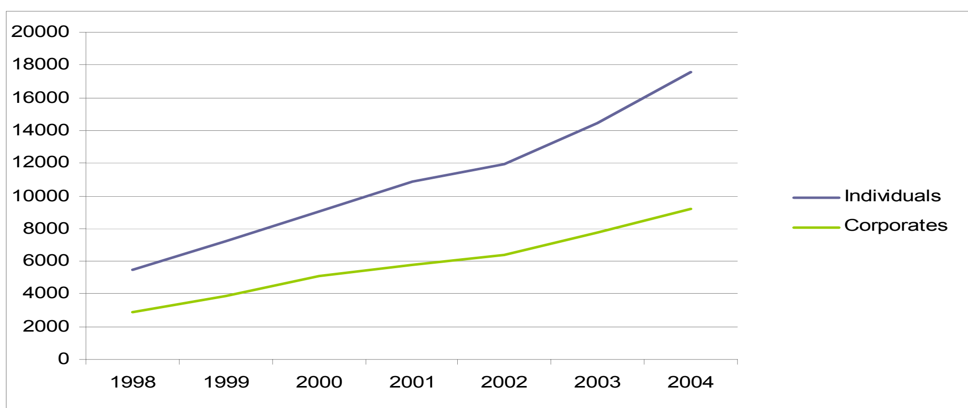
percent in 1998), which was a negligible increment. The loan exposure was strictly restricted to urban areas. Data to support the increasing trend of listed stock purchase loans and IPO (initial public offering) financing was not available at the time of writing this article, but finance companies have been heavily exposed recently in advancing funds for margin trading and IPO investment. To stop this trend Nepal Rastra Bank directed (NRB 2063/12/8) all finance companies and banks not to advance loans to IPO investment in the first week of scrip's floatation and allowed loans only if the scrip was under subscribed after the first week of floatation. Subsequently, more stringent regulations were directed towards equity financing, misconstrued and popularly known in Nepal as margin trading. However, this has not deterred many of the finance companies from withdrawing from this area of investment as it has been extremely profitable. The present trend, as it is heading, continues to show a drifting away from areas of investment in the real sector and towards more lucrative and highly profitable but yet extremely risky and volatile stock market.

Figure 1 :Trend Analysis of Deposits



Source: Nepal Rastra Bank

Figure 2 : Trend Analysis of Credit Flows



Source: Nepal Rastra Bank

Table 1 : Sources and Uses of Fund of Finance Companies (Aggregate)

(In millions)

Sources of Fund	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007 Jan
1. Capital Fund	**97.4**	**245.6**	**515.3**	**726.2**	**917.7**	**1174**	**1489.5**	**1928.9**	**2662.1**	**3205.2**	**3653.8**	**4250**	**5520.7**	**4653.1**
a. Paid-up Capital	93.7	232.2	485.2	635.6	732.8	837.7	945.1	1220.6	1522.6	1947.4	2155.8	2411.5	3356.7	3663.8
b. General Reserve	1.4	4.9	7.9	21.8	50.5	96.8	186	242.6	303.2	339.1	405.5	481.1	586.5	669
c. Others Reserve	0	0.6	1.3	15.7	17.6	26.3	72.5	70.6	182.7	43.3	99.9	129.6	371.5	191.7
d. Loan loss provisions	2.3	7.9	20.9	53.1	116.8	213.2	285.9	395.1	653.6	875.4	992.6	1227.8	1206	128.6
2. Deposits	**195.8**	**647.7**	**1730.6**	**3700.4**	**6387**	**8036.6**	**9748.6**	**11654**	**13453.9**	**16510.3**	**19391.7**	**22341.6**	**27351.6**	**31867.3**
3. Borrowings	**0.7**	**4.4**	**48.3**	**245.1**	**122.1**	**82.8**	**175.9**	**215**	**244.8**	**134.3**	**1306.5**	**990.8**	**1154.8**	**2272.8**
a. NRB	0	0	0	0	0	0	0	0	0	13.9	0	0	0	0
b. Commercial Banks	0.7	4.4	48.3	239.9	122.1	82.8	175.9	215	244.8	120.4	1306.5	990.8	995	1140
c. Other Fin Institutions													140.9	688.9
d. Bonds and Securities	0		0	5.2	0	0	0	0	0	0	0	0	18.9	443.9
4. Others	**117.1**	**197.8**	**205.7**	**445.6**	**799.1**	**1339.6**	**1392.5**	**1665.1**	**1825.5**	**1788.5**	**2231.2**	**1945.6**	**4257**	**5990**
5. P/L Accounts							**243.2**	334.2	266.4	478.2	615.5	908.7	572.1	447.1
Total Sources and Uses of Fund	**411**	**1095.5**	**2499.9**	**5117.3**	**8225.9**	**10633**	**13049.7**	**15797.2**	**18452.7**	**22116.5**	**27198.7**	**30436.7**	**38856.2**	**45230.3**
Uses of Fund	**411**	**1095.5**	**2499.9**	**5117.4**	**8225.9**	**10633**	**13049.7**	**15797.2**	**18452.7**	**22116.4**	**27198.7**	**30436.7**	**38856.2**	**45230.3**
1. Liquid Fund	**83.8**	**95.8**	**124.5**	**342.2**	**452.5**	**1133.6**	**1728.6**	**2048.5**	**2862.4**	**2674**	**4469.8**	**3904.9**	**5386.6**	**5607.5**
a. Cash in hand	15.5	5.6	26.5	41.5	44.6	110.3	95.6	139.9	170.4	109	132.1	125.9	198.7	193
b. Bal.with NRB	0	0	1	3.4	6.2	12.6	20.1	17.2	31.2	178.9	430.1	440.9	749.9	716.4
c. Bal.with Dom.Bank	68.3	90.2	97	297.3	401.7	1010.7	1612.9	1891.4	2660.8	2386.1	3907.6	3338.1	4438	4698.1
2. Investments	**79.5**	**233.9**	**284.4**	**754.7**	**1758.5**	**1262.1**	**1129.2**	**1268**	**1623.4**	**2392.4**	**2510.5**	**2411.2**	**2784.4**	**3539.3**
a. Govt.Securities	3	35.2	97.5	413.2	1440.9	932.1	842.8	837.2	1120	702.4	1270	567.5	963.2	1066.7
b. NRB Bond	0	0	0	0	0	0	0	326.1	393.9	210.6	1240.5	0	0	0
c. Others	76.5	198.7	186.9	341.5	317.6	330	286.4	104.7	109.5	1479.4		1843.7	1821.2	2472.6
3. Loans and Advances	**217.3**	**670.6**	**1852.7**	**3667.1**	**5477.7**	**7218.8**	**9062.8**	**10865.3**	**11949.6**	**14473.7**	**17540.8**	**21223.3**	**27078.9**	**31284.8**
a. Hire Purchase	134.1	301.9	532.3	680.3	964.3	1304.2	1640	2151.6	2435.9	2477.4	3049.9	0	0	0
b. Housing	30.4	176.9	504.7	1001.7	1586	2004.2	2340.4	2965.4	3144.4	4211.1	5286.5	0	0	0
c. Term loan	52.8	131	729.4	1673.6	2207.1	3104.6	4239.4	4704.3	5292.6	6806.5	7954.8	0	0	0
d. Leasing		26.3	54.5	185	310.3	260.1	235.3	277.8	363.6	148.8	138.2	0	0	0
e. Fixed Deposit Receipts		0					474.7	464.2	479.1	586.3	713.2	0	0	0
f. Other		34.5	31.8	126.5	410	545.7	133	302	234	243.6	398.2	21223.3	27078.9	31284.8
4. Others	**30.4**	**95.2**	**238.3**	**353.4**	**537.2**	**1018.5**	**1129.1**	**1615.4**	**2017.3**	**2576.3**	**2677.6**	**2897.3**	**3527.8**	**4388.9**
5. P/L Accounts													**78.5**	**409.8**
Number of FCs	7	20	34	41	43	45	46	48	54	57	58	59	70	72

Regulatory Development

Finance Companies Act in 1984 allowed the inception of finance companies, after allowing merchant banking activities in 1992; the only significant change in operations commencing in 2004 with the Banks and Financial Institutions Act (BAFIA). Finally,

finance companies, in addition to the limited activities were allowed to be a member of the check clearing house, transact in Indian Currency and were authorized to transact in real estate business. Subsequent directives in 2005 allowed finance companies to be able to provide debit and credit cards by being a subsidiary member of a bank. Finance companies henceforth were expected to follow all prudential regulations that commercial banks were following. One of the biggest changes, after the Umbrella Act came into operation, was on the balance sheet of finance companies which were now to follow cash based accounting system as opposed to accrual based in the past along with strict provisioning and interest suspense allocations. In turn, the effect on the balance sheet, the first year for a majority of companies was considerable. The stringent reporting requirements also compelled them to upgrade their technology to be in compliance with NRB reporting standards. This was a wake up call to many of the finance companies which operated as a family run business. Overnight prudential regulations were in effect compelling them to transform and be transparent. The Umbrella Act was a beginning towards harnessing all the various players towards operating in a transparent and highly regulated system. The Umbrella Act of 2004 narrowed the gap between a commercial bank, a development bank and a finance company. However, none of the new directives were enablers to make the financial sector neither more endemic nor far reaching. In contrast, the new directives only increased the competition in an already over-crowded market, and has attempted to enforce prudential regulations on all. Out of the three categories, category “C” group, finance companies may boast that not a single member company has been penalized for misconduct of operations or on any other issues by NRB. A few banks in category “A” and “B” have been taken under NRB management due to misappropriation and non-compliance to directives.

Constraints to Reaching Out

If the mandate of the finance companies was to be an arbiter between borrowers and lenders for the masses then the whole exercise has not quite been successful; but if the intention was to create a parallel institution with lesser capital to cater to a segment the commercial banking sector avoided, then finance companies have served that purpose.

The constraints to reaching out to rural areas have been many some of which include the following:

1. The trend of loans and advances based on fixed collateral of immovable assets as a primary source of recourse to possible default has been the biggest impediment in reaching out to the rural poor or to an entrepreneurial group that can produce no fixed security. The other reason behind this is the NRB guidelines that require heavy provisioning for loans secured by any other means other than collateral of immovable assets and equipments. This has been a deterrent to the lending institutions who do not wish to take overt risks.

2. Although the Secured Transaction Act was passed in 2006, safety of collateralized equipment is still not there due to lack of a transaction registry. The risk is that it is very difficult to track the equipment collateralized and the same equipment can be used as collateral in a number of lending agencies. Once the registry comes into operation, the problem is expected to be solved.

3. There has been a dearth of skilled man power in this sector willing to go to remote areas to work. The cost of monitoring projects outside the urban areas is high. This, coupled with the security risks, has acted as a major deterrent in recent times.

4. The financial sector has been the fastest growing industry quantitatively and as a result of new innovations and technology it is the most progressive. Unfortunately, the legal system has not been able to keep pace with this development. Reform in the legal apparatus is much needed to facilitate quick decisions in this sector. The debt recovery tribunal set up in 2001 has tried to address the legal problems on behalf of the financial sector, but the process is usually slow. Constant stay orders from the courts have been major impediments due to the process.

5. Regulatory directives are not consistent and change at any pressure from vested interest parties. Directives have been known not to be applicable to a few players and have been changed to facilitate them. This will undermine the regulator's capacity and cast doubt on the slogan of good governance being propagated.

India's Experience

India has had enormous gains from its financial sector development. They have been successful in elimination of segmentation across various markets, easing the liquidity management process and making resource allocation more efficient across the economy. To facilitate this, restrictions on pricing of assets have been removed, new financial instruments have been introduced and technological infrastructure has been strengthened. Furthermore, there has been relaxation in investment norms for financial intermediaries, especially banks. The emergence of new institutions such as primary dealers and mutual funds has helped the market to develop and diversify. The gap between non bank financial institutions and the banking sector in its sector of allowed operations is very wide in India. In Nepal, we see the gap narrowing.

The Future

As competition grows fierce with new players setting up business with larger capital, finance companies need to strategically think ahead by increasing capital, setting up systems to cope with the competition and explore new markets. The future for this category of financial institutions lies in determining the appropriate customer mix and business mix to increase profits at high rates, with a strong focus on fee-based revenues.

Banking in terms of conventional methods need to be revamped and the regulatory authority should allow investment-banking products to be introduced into the market. In order to facilitate this, the government has to allow an independent rating agency to be set up. The classification of the financial institution in A,B,C, and D categories is meaningless in this market place as some C category companies have a stronger balance sheet as well as compliance record and management than some "A" and many "B" category institutions. An independent credit rating agency will enable a balanced rating based on the financial strength of an institution and not on the capital base alone. In turn this will be a stronger encouragement for the public to deal with the institutions that have the higher ratings, thus compelling the weaker players to improve their operations. The market will force it to correct itself.

The recent retail led boom has helped the banking and financial sector overcome the stalemate in corporate lending and has been the fuel for growth in this sector. However, this trend has massive competition. Therefore, sustainability for the players is getting exceedingly difficult. The future will also depend on collaboration between the financial institutions, which should inevitably lead to mergers.

Non banking financial institutions (NBFI) should be allowed to expand their product base so that their fee based income will increase to occupy larger share in the total income. New instruments along the lines of investment banking products should be encouraged. Mutual funds management should be allowed to NBFIs. A clear demarcation of activities should be adhered to as per the directives and the regulator should have strict guidelines enforcing these rules.

Conclusion

The finance sector has shown maturity in recent years. The positive trend is also due to the strict regulatory guidelines. However, innovation in this sector is lacking. In order to be competitive in this market, finance companies need to collaborate and start thinking and planning mergers to create a larger capital base. The future for small capital base companies is limited. There has to be a paradigm shift in the regulations to facilitate development in the financial sector. Financial innovation can only take place if it is allowed from the regulatory angle; otherwise, redefining the wheel and calling it an innovative product will continue to be the trend in the banking and financial sector. India's example and development of its financial sector and reform measure is the closest we can relate to. However, we have not been able to develop our market as India has prudently or market growth wise despite our liberalization process starting around the same time.

Bibliography

Aurora Ferrari et al. *Access to Financial Services in Nepal*. The World Bank, 2007

"Economic Survey" Ministry of Finance (various years from 1995-2005)

"Monetary Policy" Nepal Rastra Bank 2061/62, 62/63. 63/64

"Quarterly Economic Bulletins" Nepal Rastra Bank

Various Directives to Banks and Finance Companies, Nepal Rastra Bank

IMF "Country Report" various years.

Golden Jubilee. 2005 "Nepal Rastra Bank in Fifty Years." Kathmandu

South Asia Financial Performance and Soundness Indicators Volume I, II , and III. The World Bank, 2005

Chapter VII

Micro-Finance Business in Nepal

Dr. Harihar Dev Pant*

Microfinance, though not a panacea, has proven to be a powerful tool for poverty alleviation during the last three decades. It is one of the only development tools with the potential to be financially self-sustaining. Microfinance has recently become the favorite intervention for development institutions, due to its unique potential for poverty reduction and financial sustainability. It has changed the lives of people and revitalized communities in the world's poorest and also the richest countries. It helps the poor and low-income clients deal with their basic needs. Anyone who has access to microfinance services is more resilient and better able to deal with everyday demands. Microfinance has evolved, over the period, as an economic development approach intended to benefit low-income women and men.

What is Microfinance

Financial services generally include savings and credit; however, some microfinance organizations also provide insurance and payment services. The term, microcredit, refers to the making of tiny loans to poor people in underdeveloped countries, like Nepal and Bangladesh. The amounts are sometimes only tens of dollars. The borrowers are small farmers, shopkeepers, artisans, and other small commercial enterprises. In addition to financial intermediation, many micro-finance institutions (MFIs) also provide social intermediation services such as group formation, development of self-confidence, and training in financial and management capabilities among members of group. Thus the definition of microfinance often includes both financial intermediation and social intermediation. Microfinance is not simply banking; it is a development tool as well.

How Microfinance Works

The most common microfinance product is a micro-credit, usually less than $ 100. These tiny loans are enough for hardworking micro-entrepreneurs to start or expand small business such as vegetable farming, weaving baskets, raising chickens, or buying wholesale products to sell in a market. Income from these businesses provides better food, housing, health care and education for entire families, and, most important, additional income provides hope for a better future. In addition, the poor, like all of us, need a secure place to save their money and access to insurance for their homes,

* Chairperson, Nirdhan Utthan Bank Ltd

businesses and health. MFIs are now innovating to help meet these needs, empowering the world's poor to improve their lives. The global repayment rate for micro-credit loans is higher than 95 percent, which allows MFIs to re-lend these funds to even more clients. By giving the world's poor a hand up, not a handout, microfinance can help break the cycle of poverty in as little as a single generation.

Evolution of the Microfinance Industry

Microfinance emerged in the 1970s as social innovators began to offer financial services to the working poor–those who were previously considered "unbankable" because of their lack of collateral. Once given the opportunity, not only did clients of MFIs expand their businesses and increase their incomes, but their high repayment rates demonstrated that the poor are capable of transforming their own lives, given the chance. This model of lending disproved all conventional thinking about banking.

Microfinance also arose in 1980s as a response to doubts and research findings about state delivery of subsidized credit to poor farmers. During this period, the subsidized, targeted credit model, supported by many donors, was the object of steady criticism, because most programs accumulated large loan losses and required frequent recapitalization to continue operating. It became more and more evident that market-based solutions were required. This led to a new approach that considered microfinance as an integral part of the overall financial system. Emphasis shifted from the rapid disbursement of subsidized loans to target population toward the building up of local, sustainable institutions to serve the poor.

At the same time, local NGOs began to look for a more long term approach than the unsustainable income generation approaches to community development. Professor Mohammud Yunus led the way with a pilot group lending scheme for landless people of Bangladesh. This later became the Grameen Bank, which now serves more than 7 million clients and is a model for many all over the world. The award in the year 2006 of the Noble Prize to Professor Muhammud Yunus and his Grameen Bank of Bangladesh has directed world attention to the phenomenon of microfinance which Professor Yunus and his bank have pioneered. Accion International supported the development of solidarity group lending to urban vendors in Latin America.

Poverty Lending vs Financial Systems Approach

Microfinance is marked by a major debate between two leading views: the poverty lending approach and the financial systems approach. The poverty lending approach concentrates on reducing poverty through credit. Under this approach donor-and government-funded credit is provided to poor borrowers, typically at below-market interest rates. The goal is to reach the poor, especially the extremely poor–the poorest of the poor- with credit to help overcome the poverty and gain empowerment. Except for mandatory savings required as a condition of receiving a loan, the mobilization of local savings is normally not a significant part of the poverty lending approach of microfinance. The financial systems approach emphasises large-scale outreach to the economically active poor–both to borrowers who can repay micro-loans from household and enterprise income stream, and to savers. The financial systems approach focuses on institutional self-sufficiency because, given the scale of the demand for microfinance, this is the only possible means to meet widespread client demand for convenient, appropriate financial services.

Microfinance in Nepal

Microfinance has made good stride in Nepal. It gained momentum during the last one and half decade starting in early 1990s as a result of initiatives taken by social workers to start microfinance services through NGOs, supported by Nepal Rastra Bank's regulatory framework. Some of these microfinance NGOs have transformed themselves into microfinance banks. Nirdhan is a pioneer NGO to start microfinance and has transferred itself successfully into a microfinance bank named as Nirdhan Utthan Bank, the leading microfinance institution in Nepal. By now the microfinance industry has achieved success in providing services to more than one third of Nepalese poor. The microfinance sector is also becoming more institutionalized.

As of mid-July, 2007, a total of 392,770 clients have accessed microfinance services from 10 microfinance banks, and 257,956 clients from 47 microfinance NGOs. Similarly, 3392 Saving and Credit Cooperatives (SCCs) have 403,126 members and 215 Small Farmer Cooperatives Limited (SFCL) have 133,851 members. However, if more than one million members of different user groups and groups, like DLGSP, organized by different UN agencies are included, the number of microfinance clients exceeds 2 million. Of them, microfinance banks and NGO clients come from low income households, whereas saving and credit cooperatives, small farmer cooperatives limited members and user groups and groups organized by UN organisations come from all income groups.

Microfinance is stated to have started in Nepal on Chaitra 20, 2013 B.S. with registration as 1st cooperative in Rapti Doon area of Chitwan district – Bakhan Credit Cooperative Ltd. However, cooperatives had ups and down until 1991, as only 830 primary cooperatives came in operation during 35 years, from 1955 to 1991. Cooperatives did not make much progress until enactment of Cooperative Act in 1991. But they started expanding fast after enactment of this cooperative law, following the re-emergence of democratic government in Nepal. Some of the cooperatives specialize in savings and credit and they are known as saving and credit cooperatives (SCCs) and some of these SCCs are also licensed by the Nepal Rastra Bank for banking operations. Their number increased to 4,349 by mid-July 1998 and to 9,720 by mid-July, 2007, of which 3,392 were credit and saving credit cooperatives and 215 were small farmers cooperatives limited.

Nepal government and Nepal Rastra Bank initiated targeted credit programmes as important element of poverty alleviation strategy in mid-1970s. Small Farmers' Development Programme (SFDP) and Priority Sector Credit Programme (PSCP) were the main programs of such nature. Both these programs aimed at improving the socio-economic status of the rural poor. SFDP was developed as a group based approach whereas PSCP was based on individual lending.

The SFDP started as an institutional undertaking in Nepal in the mid-70s at the initiative of Agriculture Development Bank when FAO/Asian Survey on Agrarian Reform and Rural Development (ASARRD) organized multi-agency and multidisplinary field workshops in a number of countries including Nepal. The outcome of this workshop in Nepal was a comprehensive list of recommendations, including the quick initiation of field action projects. A field action project was established in Sakhuwa Mahendranagar of Dhanusha district in the central Terai. Five months later, in March 1976, similar action project was also initiated in Tupche, Nuwakot district, in the central hill district of Nepal. The SFDPs expanded very fast and their number of offices and clients reached 589 and 182,000 respectively by the end of 1995 of which 20% clients were women.

The PSCP was initiated by the Nepal Rastra Bank in 1974 under which commercial banks were directed to lend at least 5% of their total deposits to low income people which was later raised to 12% of their loans and advances. The PSCP was redesigned in 1981 as Intensive Banking Programme on area approach basis. In 1982, it was linked with women development programme of the government as Production Credit for Rural Women (PCRW).

However, since both priority sector and small farmer were directed credit programs run by government owned banks and their financial sustainability was not considered seriously, both these programs were not successful. So these programs had either to be dropped or re-modeled. Priority sector programme was discontinued in 2005 and SFDP was, later in 1990s, converted into Small Farmer Cooperative Limited (SFCL) . SFCLs are now managed by their members.

Out-reach of Microfinance in Nepal

Outreach of microfinance clients in Nepal varies between 800,000 and more than 2 million depending on how it is defined. If all members of SCCs, SFCLs and groups organised under different UN programs and user groups are included in microfinance, the number of microfinance clients would exceed 2 million households, more than the number of poor households in Nepal. However, if their members are excluded total microfinance clients from among the poor and low income groups may be somewhere between 800,000 and 1,000,000. In geographical term, 12% in eastern, 17% in central, 16% in western, 11% in mid-western and 6% in far-western regions are availing microfinance services. However, most of the microfinance service is concentrated in the Terai and cities. In the Terai also, a large number of the poorest of the poor households are still left out of the microfinance services. Of the total outreach, about 440,000 households are estimated to have access to microfinance in the hills and mountains, and that also mostly through SCCs and SFCLs.

Of the 1.2 million credit clients, 9 microfinance banks (MFDBs), including 5 grameen banks, have 392,770 clients, 47 microfinance NGOs (known as FINGOs) have 257,956 clients, 3392 SCCs 403,126 and 219 SFCLs 129,900 clients. Of these institutions, MFDBs and FINGOs have 100% women as their clients, follow Grameen methodology (Grameen Bank Financial System of Bangladesh) and provide loan on group guarantee and without any physical collateral. Of the microfinance clients, MFDBs and FINGOs are supposed to provide their service mostly to the poor. Since SCCs and SFCLs have to provide their services, as per their cooperative philosophy, to all sections of the community, they cannot focus exclusively on the poor and low income population. Besides clients belonging to above mentioned institutions, there are more than 1 million group members organized under different UNDP programs. Since these groups also are organized on holistic basis, and they also are not focused on the poor and low income people, no more than one third could be counted as microfinance clients. That is why it is difficult to include all of their members as their microfinance clients. However, they provide their service to a large number of the poor also. So if we define microfinance as providing services to the poor and low income households, then in that case, more than two third of SCC, SFCL and UN organized group and user group members may come from non-poor segment and hence not accepted as microfinance clients. If this estimate is correct, then microfinance outreach may be around 800,000 (37%) and 1,000,000 (48%) of about 2.1 poor households. Still, we can say that progress made during last one and half decade in microfinance sector is satisfactory. Now onwards, our attention has to

be directed to cover all needy and poor clients, especially in the hills and mountains and the poorest of the poor in the Terai and also in the cities.

Regulatory Framework for Microfinance

Regulatory framework is very important for promotion and development of the microfinance industry. On regulation side, the central bank's role is crucial. Nepal Rastra Bank, as central bank of the country, has always remained positive, since it introduced priority sector credit program in mid-1970s, in providing financial services to the poor and low income people. Later in early 1990s, it allowed NGOs, even in absence of a legal framework, to work as MFIs, out of which the present day private sector microfinance development banks have evolved. Nepal may be one of the few countries which has allowed NGOs to work as regulated MFIs. It has made special provision to license microfinance banks with very small capital, only 5% of the capital needed to establish commercial banks. Cash and liquidity ratios are fixed lower than fixed to other banks and financial institutions. It has waived licensing procedures to open MFDB branches, provided prior permission to work in the district is obtained. However, other prudential regulations, including classification of loans, loan loss provisions, minimizing risk on the transactions, corporate governance are same as to other banks and financial institutions, which, I feel, is necessary for maintaining financial discipline and good governance. In my view, the central bank's deprived sector lending (minimum 3% of their total loans and advances) directive to commercial banks has been instrumental for promotion and development of the microfinance in Nepal. Without this regulation, most of the microfinance institutions would have neither been established nor developed to present level.

However, all the regulations are not friendly to development of microfinance. The big MFIs, especially MFDBs, require large amount of financial resources. Presently they are getting on-lending fund from commercial banks under deprived sector lending scheme and from wholesale lending institutions, like RMDC, at concessional interest rates for one year period which is renewed after expiry of the term. If the banks stop to lend to them or charge market interest rates, the MFIs will be in big problem. Since MFIs' repayment of their lending depends on continuity of their financing, they need permanent source of funding. So they should be allowed to accept public deposit, as provided by the Bank and Financial Institution Act, under certain conditions, without disturbing financial discipline. This will help not only reduce their dependence on others but will also be helpful to mobilize resources in rural areas where other financial institutions are almost nonexistent. Reporting formats, common to MFIs, commercial banks and other financial institutions, provided by the Rastra Bank is not friendly to the MFIs. They should prescribe appropriate, somewhat different, reporting and accounting formats to the MFIs. The Rastra Bank's regulation requiring the MFIs to open branches in contiguous districts has proved to be a hindrance in extending microfinance services to other areas.

Government's Role in Promoting Microfinance Industry

The government's role in promotion and development of microfinance sector has been mixed. The Tenth Plan stated to use microfinance as a strong tool for creating employment and reducing poverty. The Three Year Interim Plan also mentioned to use agricultural, rural and microfinance, in coordination with other poverty alleviation programmes, as a powerful instrument for creating employment and reducing poverty. However, the government did not not devise any effective program to implement microfinance programme during the 10th Plan period. No strategy and programme has

been devised to implement the Three Year Plan objective on microfinance. In fact, so far as promotion and development of microfinance is concerned, the government appears neutral,. The government has neither helped, nor put any obstruction in promotion and development of microfinance. Microfinance has reached this level of development as a result of the public initiative.

Problems and Challenges

Microfinance is mostly concentrated in the Terai and certain city areas. To provide it to all needy people all over Nepal, especially in the hills and mountains, is the biggest challenge for this sector. Given poor infrastructure, difficult terrain and dispersed population, expansion of microfinance in inner areas of hills and mountains appears very difficult, unless some support is provided by the government and or donor agencies.

Institutional sustainability is another big challenge for microfinance industry. Most of MFDBs and FINGOs are making profit, that also marginal, because of on-lending fund received from commercial banks and wholesale lending fund at below market rate. If they have to pay interest at market rate, for example 9- 10%, all of these institutions will incur losses. If they incur losses, it will be difficult to raise capital to expand their services to more clients and other areas. So, some ways and means will have to be devised to make these institutions more efficient, less expensive and profitable.

Capacity building (including establishment of proper accounting, financial and governance system, financial analysis system etc) is also a big challenge for the microfinance sector, specially small NGOs, cooperatives and community based organizations. Without development of the institutional capacity, this sector would not be sustainable in the long run. However, this work needs huge financial resources. Mobilising resources for capacity building is a big problem.

The MFDBs licensed by Nepal Rastra Bank as class D financial institutions require big amount of resources for on-lending purpose. Presently, they are meeting this requirement by borrowing from commercial banks under deprived sector lending scheme and Rural Microfinance Development Centre. Given their huge fund requirement at ever increasing rate, and if somewhat, commercial banks stop providing loan or start charging market interest rates, the MFIs will face big problem for resources. This has become a big problem even recently, when commercial banks have started raising interest rates, citing problem of lack of liquidity

Non-availability of on-lending fund, especially to small cooperatives, NGOs and community based organizations at local level, is another important problem of this sector. Provision of wholesale funds by Kathmandu or region based wholesale organizations, like RMDC, is not practical for expanding microfinance in the hills and mountains and even certain far flung areas of the Terai. A new mechanism will have to be developed to provide on-lending funds at local level.

Supervision, monitoring and auditing are basic pre-requisites for sound health of financial institutions. There is no regular monitoring and supervision system for SCCs except annual external auditing to be submitted to district cooperative office.

It is said that though microfinance institutions are focused on the poor, they do not reach to the poorest of the poor. This is a common allegation, not only in Nepal but all over the world. Since the poorest of the poor are usually illiterate and with low resource base, they cannot take risk to borrow from the banks and financial institutions. However, if the

poverty is to be reduced, it is essential to bring them within the gambit of microfinance and we will have to make the microfinance " inclusive". But to bring them within the fold of microfinance is a big challenge. Unless their capacity is built to make them able to use financial services, it would be very difficult to link them with microfinance. Some outside support, mainly from the government, will be required to raise their absorption capacity.

Microfinance is necessary but not sufficient condition for creating self-employment, enterprise development and poverty reduction. Business Development Service (BDS) is required to achieve these objectives which cannot be provided by MFIs alone. Coordinated approach of integrating BDS, MF services and business literacy is required to achieve these objectives which is very challenging to implement.

Conclusion

To conclude, microfinance has made satisfactory progress during the last one and half decade. This progress was achieved purely at the public initiative. It has mostly concentrated in the Terai and cities. There is strong need to expand it to the hills, mountains and far flung areas of the Terai. However, strong support, including policy and finance, from the government and other agencies would be necessary to extend it to all places within Nepal.

Chapter VIII

Performance and Challenges of Financial Cooperatives in Nepal

T. M. Sharma*
B. P. Ghimire**

Introduction

Cooperative is a voluntary association of people with limited means, owned and controlled by the members for mutual benefits through collective efforts. It is an appropriate means for mobilizing limited resources of members for group benefits and interests. Mutuality is the essence of cooperative form of business. Self help through the mutual help is the inherent philosophy behind the cooperative movement. Several informal associations of people for mutual help have been traced in Nepalese society from the very beginning in different forms like Dhikuri, Parma, Dharmabhakari, Guthi etc. They are the informal and traditional cooperative organizations that existed in Nepal. However the formal cooperative movement started with the establishment of Cooperative Department in 1953 after the advent of democracy.

The modern cooperative movement initiated from Rapti Valley (Chitwan District) as a part of flood relief and resettlement program. At the beginning 13 credit cooperative societies established in 1956 were provisionally registered under the executive order of the then government; they got legal recognition after the enactment of Cooperative Societies Act, 1959. The first Co-operative Societies Act was revised several times and it was replaced by Sajha Societies Act in 1984. After the restoration of multiparty democracy the Sajha Societies Act was also replaced by the Co-operative Act, 1992. The Cooperative Act is under the process of amendment.

Need and Rationale

Cooperatives are the best means of mobilizing small residual resources of the rural poor farmers. They are also regarded a way of living of the poor farmers. They are used as the means of bringing social and economic development of the weaker section of the community. The rationale of cooperatives can be justified as follows.

- Cooperatives as the important sources of institutional credit provide financial assistance to the members.

* Registrar, Dept. of Cooperatives
** Agricultural Economist, Department of Cooperatives

- They eliminate middlemen and protect their members from the exploitation of money lenders.
- They encourage savings and investment among the members and other people.
- They supply better quality goods and services at cheaper rates.
- They generate employment opportunity to the people.
- They promote cottage and agro–based industries in the country.
- They are the means of fair economic distribution among the people.
- They help to maintain ethical /moral standard in the society through boycotting the social evils like gambling and liquor drinking.
- They develop the feeling of cooperation and mutual support among the people.

Theories of Financial Cooperatives

For a better understanding on the concept of cooperatives, the ICA has defined it as "An autonomous association of persons united voluntarily for the fulfillment of their common economic, social and cultural needs and aspirations through jointly owned and democratically controlled enterprise".

In the words of Charles Gide, "A cooperative is a group of persons pursuing common economic, social and educational aims by means of business enterprise".

Cooperatives are not merely a business but business with a social as well as an economic aim. It is a socio–economic system with dual objectives of economic gains and social reform. Now, it is accepted as a third sector of economy. It is neither a private nor a public economic system. Ideologically it occupies the middle ground between the other two sectors by adopting the most desirable features from both. The cooperative system has its own norms and values like self help, self accountability, democracy, equality, equity, unity, integrity, openness, social responsibility and care to other people.

The cooperative principles are the basic guidelines used for applying the above mentioned cooperative values in practice. In 1995, the International Cooperative Alliance adopted the following seven Cooperative Principles:

1. Open and Voluntary Membership

Membership in cooperative organization is never mandatory and coercion but always voluntary. The concept of open membership in cooperative is based on the philosophy of non–discrimination by age, sex, caste, politics and socio–economic status. However there must be certain degree of comparability among the members and a bond of association on which to base solidarity. For making association viable and ease delivery of service to the members with responsibility, the community based membership is desirable.

2. Democratic Ownership and Control

Democracy is measured by involvement of concerned members as well as counting the ballots. In a cooperative organization only the members, the actual users of services, have the right to nominate and elect directors, auditor, and managers. There is no discrimination among the members. There is a provision of one member one vote

irrespective of the number of shares owned by the member. The general body of the members assumes a supreme legislative, judiciary and executive authority.

3. Economic Participation of Members

In a cooperative organization, it is imperative for economic participation of each member to generate business force through resource mobilization. Every member must purchase at least one share to acquire cooperative membership. The legal status of the members is equal. However the profit distribution in cooperative is based on the investment by the members.

4. Autonomy and Freedom

Cooperatives are membership based socio–economic entities. They are autonomous for their operation and regulation. They make their own internal policy, laws and bye–laws. They are operated and controlled by the members. All members are responsible in organizational functioning. There is no external intervention in operations and decision making.

5. Cooperative Education and Training

There should be free flow of information among the members. All information are in such a form as to be readily understood and are made available to all members. Cooperative education and training is necessary for the members to make them informative and capable. It is necessary to transfer various skills to the members.

6. Cooperation among Cooperatives

Inter cooperative support is inevitable to generate competitive power among the cooperative organization. Competition is deemed to be necessary in every sector of economy to maintain good service and quality performance. Cooperation among cooperatives is necessary to face the global competition created by globalization.

7. Concern to Community

The membership in cooperative organizations is community based. Cooperatives are important constituents of community. They are formed to achieve a specific objective of the members and they should be responsible for members and community. Various reserves created by the cooperative organizations are used in social and cultural activities like education, health, family planning, sanitation, drinking water, irrigation, etc.

Regulation of Financial Cooperatives:

At the first time the Cooperative Societies Act, 2016 and Cooperative Regulations, 2018 were enacted for regulation and operation of cooperative societies in the country. The first cooperative law was revised several times and it was replaced by the Sajha Institution Act, 2041. After the restoration of democracy the Cooperative Act, 2048 was promulgated for the regulation of cooperative societies/unions in the country. The new Act has provided sufficient autonomy to the cooperative societies/unions to operate various types of business. The preamble of Cooperative Act has focused on the country' farmers, artisans, people possessing inadequate capital and low income groups, workers, landless and unemployed people or social workers on the basis of mutual cooperation and cooperative principles.

According to the Cooperative Act, 2048 every primary cooperative society has limited liability needs of least 25 persons from different families for legal existence. The cooperative movement of Nepal has a federal structure having the primary cooperative society at the bottom, district cooperative unions and central cooperative unions at the middle and national cooperative federation at the apex. In the Cooperative Act, 2048 there is a provision of elected board of directors for the day to day operation and management of the societies /unions. Cooperatives are community based socio-economic entity with open and voluntary membership. For acquiring a membership of the primary cooperative societies, every natural person must have to purchase at least one share. However there is a restriction to purchase more than 20 percent share of a society by a member. Every member has equal voting right irrespective of share numbers purchased by him/her.

As per the cooperative law the general body meeting exercises the judiciary, executive and legislative power simultaneously for the operations of the cooperative societies/unions. The general body elects the members of various sub-committees and endorses the appointment of auditor. There is a provision of accounting and supervision committee whose authority is to conduct internal audit of the society. The cooperative union/society has provided some legal privileges and exemptions from the government. Being a membership based organization, each cooperative society mobilizes financial and other resources of the members. In cooperative society, the transactions with non-members are deemed to be illegal. According to the Articles 26(ka) and 26(kha)of the Cooperative Act, 2048 the cooperative societies are allowed for limited banking activities with the approval from the Nepal Rastra Bank. Those cooperative societies approved from the Nepal Rastra Bank for limited banking activities have to comply the terms and conditions issued by the bank and the Department of Cooperatives. With consultation of Nepal Rastra Bank, the Department of Cooperatives has recently issued a standard of operation for cooperative societies/unions. Such standards include the various terms and conditions like formation and operation of cooperatives, area and scope of works for particular cooperative societies, saving collection from the members and interest rate, loan investment, liquidity rate and others.

Experience of Some Other Countries

The concept of cooperative is so versatile and universal. Cooperatives differ in terms of size and operating practice. However, cooperatives in different countries have gained a remarkable achievement. The following examples provide experiences and lessons to be learnt:

- About half of all the sugar production of India is through cooperatives.
- Iceland is referred to as cooperative–island due to well developed cooperative system in all branches of economy.
- The agriculture cooperatives of France have the second largest credit and banking system in the world.
- Cooperatives of Spain are the largest manufacturers of refrigerators and household appliances.
- Cooperatives of Poland are famous for housing construction and they share more than 75 percent of construction works of the country.

- The dairy marketing cooperatives of Gujarat (India) operate some of the largest and most modern milk processing plants in the world.
- In Malaysia the largest insurance system is a cooperative.
- In Scandinavian countries, agriculture cooperatives have by far the largest share of the market.
- In Canada, one third of the population are the members of credit cooperatives and the country's 75 percent grains is handled by marketing cooperatives.
- In several African countries, marketing cooperatives handle the bulk of major agricultural commodities.
- Cooperatives run buses and taxis in Israel, Canada, and several other countries in the world.
- There are successful school cooperatives in France, Poland, and the Philippines which supply books and other educational materials to the students.
- In Columbia, cooperatives are responsible for health care service for 15.5 percent of the population, marketing 33.78 percent of coffee and 35 percent of agriculture produce and holding 30 percent of banking service market.
- In Norway, cooperatives are responsible for production and marketing of 99 percent of milk, 76 percent of timber products, and export of 8.7 percent of fishery products.
- In the UK, the largest independent travel agency is a cooperative.
- In Singapore, consumers' cooperatives hold 55 percent share of the market.
- In Brazil ,cooperatives are responsible for production of 72 percent of wheat, 44 percent of barley, 43 percent of soybean, 39 percent of milk, 38 percent of cotton, 21 percent of coffee and 16 percent of maize.
- In Kuwait, the Union of Consumers' Cooperative Societies handles 80 percent of the national trade.

Status of Cooperatives Employment

All over the world, cooperatives provide over 100 million jobs i.e. 20 percent more than multinational companies. Some examples of countrywise employment record are as follows:

Table 1
Status of Cooperatives Employment

S. N.	Country	Employment
1	Nepal	15,828
2	Canada	160,000
3	Colombia	490,000
4	France	700,000
5	Germany	440,000
6	Kenya	250,000
7	Italy	1000,000

As shown by Table 1 and Table 2, the number of people in the cooperatives total 15,828. Among the categories, the majority of the people are employed in the multipurpose cooperatives followed by the saving and credit cooperatives.

Table 2
Cooperative Employment Status in Nepal

S. N.	Categories	Male	Female
1	Agriculture Co-operatives	283	136
2	Saving & Credit Co-operatives	3,320	2,038
3	Dairy Co-operatives	459	29
4	Small Farmers Co-operatives	152	56
5	Herbal Producers Co-operatives	0	0
6	Tea Producers Co-operatives	0	0
7	Coffee Producers Co-operatives	2	0
8	Health Co-operatives	47	49
9	Multipurpose Co-operatives	494	8,576
10	Consumers Co-operatives	39	44
11	Science & Technology Co-	21	9
12	Electric Cooperatives	1	0
13	Other Co-operatives	63	1
	Total	4,881	10,947

Source: Department of Cooperatives, Ashar, 2064,

Status of Cooperatives Membership

There are altogether 800 million members in cooperative societies in the world. Few examples of membership in various countries are as follows:

Table 3
Status of Cooperatives Membership

S. N.	Country	Membership
1	Nepal	12,59,747
2	Canada	110,00,000
3	Malaysia	54,00,000
4	Japan	425,83,333
5	Germany	205,78,720
6	USA	1211,05387
7	Finland	32,81,159
8	Norway	15,00,000
9	India	2390,00,000
10	Korea	20,00,000
11	Singapore	14,19,520

Status of Cooperatives and their Activities

In Nepal there are altogether 9,859 cooperatives having 1.26 million members with share capital of NRs.1046 million. The savings and investment status of the various cooperative societies are recorded as NRs.19,518 million and NRs.24,148 million respectively. The number of the savings and credit cooperatives are 3,392 having 403 thousand members with share capital, savings and investment status in Nepal recorded as NRs.450 million, NRs.8963 million and NRs.15099 million respectively. These co-operatives are also of different categories, like Saving & Credit Co-operatives, Coffee Producers Co-operatives, Dairy Co-operatives, Vegetable Producers Co-operatives, Tea Producers Co-operatives, Health Co-operatives, Multipurpose Co-operatives, Consumers Co-operatives, Science and Technology Co-operatives etc. The status of various categories of co-operatives societies are as follows.

Table 4
Number of Co-operative Institutions in Nepal

S.N.	Name	Number
1	National Cooperative federation	1
2	National Cooperative Bank	1
2	Central Cooperative Unions	5
3	District Cooperative Federations	49
4	District Cooperative Unions	83
5	Primary Cooperative Societies	9,720
	Total	9,859

Source: Department of Cooperatives, Ashar, 2064,

Table 5
Number of Primary Co-operatives Societies in Nepal

S. N.	Categories	Number of Co-operatives	Percentage
1	Agriculture Co-operatives	1,218	12.53
2	Saving & Credit Co-operatives	3,392	34.90
3	Dairy Co-operatives	1,564	16.09
4	Small Farmers Co-operatives	215	2.21
5	Herbal Producers Co-operatives	24	0.25
6	Tea Producers Co-operatives	22	0.23
7	Coffee Producers Co-operatives	66	0.68
8	Health Co-operatives	30	0.31
9	Multipurpose Co-operatives	2,532	26.04
10	Consumers Co-operatives	103	0.86
11	Science & Technology Cooperatives	84	2.33
12	Electric Cooperatives	226	2.51
13	Others Co-operatives	244	2.53
	Total	9,720	100.00

Source: Department of Cooperatives, Ashar, 2064,

Table 6
Membership of Co-operatives Societies in Nepal

S. N.	Categories	Male	Female
1	Agriculture Co-operatives	178,665	53,221
2	Saving & Credit Co-operatives	230,274	172,852
3	Dairy Co-operatives	59,952	30,500
4	Small Farmers Co-operatives	49,009	22,570
5	Herbal Producers Co-operatives	817	269
6	Tea Producers Co-operatives	512	532
7	Coffee Producers Co-operatives	937	619
8	Health Co-operatives	2,263	269
9	Multipurpose Co-operatives	280,031	98,478
10	Consumers Co-operatives	4,639	1,228
11	Science & Technology Cooperatives	5,263	1,098
12	Electric Cooperatives	6,723	1,295
13	Others Co-operatives	28,215	29,516
	Total	847,300	412,447

Source: Department of Cooperatives, Ashar, 2064,

Table 7
Saving & Investment Status of Various Co-operatives Societies in Nepal

Amount in NRs. '000

S. N.	Categories	Saving	Investment
1	Agriculture Co-operatives	251,241	335,883
2	Saving & Credit Co-operatives	8,962,913	15,098,546
3	Dairy Co-operatives	37,594	33,835
4	Small Farmers Co-operatives	217,140	592,253
5	Herbal Producers Co-operatives	823	15
6	Tea Producers Co-operatives	7,332	5,520
7	Coffee Producers Co-operatives	367	0
8	Health Co-operatives	26,100	42,428
9	Multipurpose Co-operatives	9,864,808	7,893,717
10	Consumers Co-operatives	8,534	16,219
11	Science & Technology Cooperatives	41,509	59,054
12	Electric Cooperatives	5,697	6,128
13	Others Co-operatives	93,459	64,149
	Total	19,517,518	24,147,747

Source: Department of Cooperatives, Ashar, 2064

Problems in Co-operatives Sector

The problems of the cooperatives sector include the following:

- Violation of co-operative principles, laws & bye–laws.
- Lack of co-operative knowledge among the co-operative cadres.
- Lack of regulatory standards for the co-operative societies/unions.
- Poor monitoring and supervision of co-operative societies/unions.
- Lack of business and professional capabilities among the co-operators.
- Liquidation of old and sick co-operative organizations and clearance of assets and liabilities of the liquidated societies.
- Sudden disappearance of directors after embezzlement of money.
- Check and release of collateral.
- Lack of integrity and professionalism among the promoters/directors.

Challenges in Co-operative Sector

The challenges pertaining to the cooperatives sector are:

- Balance between regulations, control, monitoring and self-discipline.
- Reliability of co-operative societies/ union and protection of interest of the members
- Wide scope of works and responsibilities of co-operative system with very limited physical and human resources.

- Gap between scientific working system, absence of transparent working style and perceived responsibility.
- Synchronization in managing limited professional manpower and new powerful cooperative societies
- Co-ordination and cooperation among the government, semi-government and non government sectors.
- Management of co-operative education based on the number & level of consciousness of the co-operative cadres.
- Reconciliation between the principles and practices of the saving & credit co-operative societies.
- Emerging globalization, openness and membership to WTO.

Problem Solving Measures

The reduce and problems of the cooperative sector, some measures include the following:

1. Formulation of overall comprehensive co-operative sector policies, plans and periodic programs.
2. Review of organization structure of MOAC and Co-operative Department.
3. Revision in Co-operative Act, Rules, Regulations and Bye-laws.
4. Development of institutional regulation & monitoring standards.
5. Extension of co-operative education & training in the new perspective.
6. Simplification in tax rebate provision for co-operative societies/unions.
7. Development & implementation of government co-operatives partnership programs.
8. Physical and financial incentives for employees' motivation.

Conclusion

Cooperatives economy is neither public nor private; it is the third sector of economy. In Nepal it is one pillar of economy out of the three pillars i.e. public, private and cooperative sector. The contribution of cooperative sector in GDP is about 1 percent where as its contribution is estimated at 7 percent in financial sector of the country. According to article 26(1) of the Cooperative Act, 2048 all cooperatives, whether financial and non-financial, are authorized to collect the savings and to provide loan within members. However the financial (savings and credit) cooperative societies can play a vital role in mobilizing the saving of the rural and poor people. To meet the working capital deficiency of the rural cooperatives there should be a policy to mobilize the residual savings of the urban based financial cooperatives. The production and service oriented cooperative societies have to upgrade the quality and consider price to compete with the global competitive market. There is no other appropriate means except the cooperative system of economy to uplift the living standard of the rural and poor people of Nepal.

Selected References

A. F. Laidlaw, 1980. "Cooperatives in the year 2000." (A paper prepared for 27th Congress of ICA.)

Agrawal Dr. Govind Ram, 2007. "Project Management in Nepal." MK Publishers and Distributors, Bhotahity, Kathmandu.

Department of Cooperatives, 2007. "Cooperatives Statistics of Nepal."

Department of Cooperatives, 2007. " Sahakari Sachetana."

Department of Cooperatives, 2004. " Aantarik karya Sanchalan Nirdesika."

KC Fatta Bahadur. "Business Organization and Office Management." Sukunda Pustak Bhawan, Bhotahity, Kathmandu

National Cooperative Development Board, 2006, " Sahakari Sambad"

www.ICA Cooperatives.

Chapter IX

The Evolution of Post-Office Savings Banks in Nepal

Shree Dhar Gautam[*]

Introduction

The postal service, even in the digital age, remains, for millions of people, the most accessible and sometimes a chosen means of communications. Being a Governmental service and one of the oldest one, it, in the course of time, has introduced different kinds of products to facilitate and fulfill the needs of the people. Post-office savings bank system is one of such products. Post-Office Savings Bank (POSB) in Britain was first established on 16th September 1861 A.D. This revolutionized savings, particularly among the working classes. Its success had wide repercussions: the colonies and other foreign countries also setup POSBs. In India it was established in 1882 A.D. as a "Bank of Poor's" The following year, it was established in Austria. In USA, it was established as a "depository" in 1911 A. D. It was established in 1939 A.D. in Germany. It was introduced relatively late in Nepal only in 2033 B.S. POSB was developed as a worldwide movement. In 1924 A.D., first worldwide organization of POSBs was founded in Milan, Italy by the name of International Saving Bank Institute. It was renamed in 1994 A.D. as World Saving Banks Institute (WSBI). Now, WSBI has 108 members from more than 91 countries throughout the world.

In Nepal, the Post-Office Saving Bank was set up as a cash depositor with the objectives of encouraging savings and utilizing them for national development process. The bank was established under the general guidance of the Post Office Saving Banks Regulations, 2033 (POSBR, 2033) which was formulated under the Acts 42 Ka and 42 Kha of Postal Act, 2019. In the beginning, four district post offices had started the banking operations in 2033 B.S. Now we have 117 POSBs in Nepal. 70 District Post Offices, 4 Regional Postal Directorates, 1 General Post Office and 42 Area Post Offices are running POSBs of which only 54 Post Offices have got investment permission.

Synergy effects in savings were expected by the POSBs, but unfortunately till 2060 B.S, the bank was nearly slipping. It was almost forgotten by the people. Only when a policy of investment to the postal employee was adopted in 2060 B.S., it began to draw attention from the public. Last year, for the first time, POSB has been able to generate profit. The

---

[*] Post Office Saving Bank

saving deposits have increased from Rs 17.5 million in 2059/60 to more than Rs 700 million in 2063/64.

Evolution

Until 1951, Nepal had limited foreign relations. After the establishment of democracy in 1951, the openness increased interactions with other countries and Nepalese people learnt many things from abroad in different disciplines. It was learnt that POSBs in this region and on the other parts of the globe were operating successfully and were being instrumental for their country's development processes. Our neighboring countries were also getting important achievements from the POSBs. Believing that the bank would be helpful to the poor and rural people and help reduce poverty, it was introduced. Nepal had adopted the National Communication Plan 2028 B.S. with a perspective to enhance communication system to fight against poverty and change the socio-economic condition. The Plan, among other things, had adopted policies to strengthen the postal system and expand the nation-wide coverage. It also aimed to make the postal system economically sustainable.

The objective of POSBs in Nepal was to encourage and cultivate habits of savings among the ordinary people even with a small amount of money and mobilize the saving deposits for national development activities. The POSBs also wanted to offer banking facilities to the rural people where other banking activities were absent. It was expected that they would develop capabilities of the poor and the degree of exploitation in the society would be decreased.

The evolution process of our POSBs can be outlined as follows:

a) The idea of establishment of POSBs in Nepal was evolved by the experiences learnt from other countries.

b) The 4th Five year plan (2027-2032) outlined policy to make post an economically self-sufficient organization.

c) The National Communication Plan 2028 developed policy to make post as more fast, reliable and a nation-wide operator with appropriate structural improvements.

d) Keeping in mind the aforementioned policy, Postal Act 2019 was amended in 2030.12.11. B.S. That had added the Act 42 Ka and 42 Kha which allowed government to establish POSBs in any post office.

e) The 5th Five Year Plan (2032-2037) had emphasized on the establishment of POSBs. Accordingly in 2033, for the first time, four POSBs were established at four district post offices. At the end of this Plan, 21 more POSBs were established.

f) The 6th Five Year Plan (2037-2042) had emphasized on the expansion of the POSBs. Therefore, 25 more POSBs were expanded and the total no. of such banks at the end of the Plan Period reached to 50.

g) The National Communication Policy and Program was formulated in 2045, which also emphasized to expand the POSBs.

h) To make the POSBs more effective, a workshop was organized in 2045, which was represented from Nepal Rastra Bank and postal officers from different districts. The workshop had made different suggestions.

i) Post Office Saving Bank Advisory Committee (POSBAC) which comprises of Secretary of Ministry of Information and Communications as Chairman, representatives from Nepal Rastra Bank, Ministry of Finance, and Postal Service Department, had ordered Central Money Order Office (CMOO) to develop an investment policy for POSBs in 2051 B.S.

j) An Investment Policy, which allowed investment up to Rs 10,000 to postal permanent employees at an interest rate of 18% p.a., was approved in 2054.

k) The investment could not be put into practice because the interest rate was quite high in comparison to other commercial banks. Therefore the interest rate was reduced to 10% p.a. in 2056 B.S.

l) An Investment Manual was approved by the Government in 2060. Then the investment activities came into practice. Many postal employees started to borrow money from POSBs, and in a short period of time, it became popular among the employees. The investment ceiling was raised from Rs 10,000 to Rs 25,000, Rs 25,000 to Rs 50,000 and Rs 50,000 to Rs 100,000 in a short span of time.

   The investment was made against the request made by an employee along with a commitment paper and his/her office's acceptance to cooperate with the bank's requirements.

   In 2063/64 Rs 201.5 million was invested to the employees and Rs 18.3 million was gained as interest. Till now, the investment has been 100% success with no defaulter at all. The investment by employees of other departments under MOIC was allowed in 2063.

m) In 2060, Postal Services Department published a Working Manual for operation of post offices which also contains the detail processes of the POSB operations.

n) Because of rapid growth of saving deposits, Postal Services Department in consultation with NRB has stated to keep excess fund at appropriate private banks (instead of government owned banks with low interest rate), which give competitive interest rate, services and have sound financial position. Nabil Bank and Himalayan Bank are selected as appropriate banks for the year.

o) Now, there are 117 POSBs in Nepal of which only 58 POSBs have got permission of investment because of security and other reasons.

Administration and Operation

The basic instrument of administration and operation of the POSBs is the Post-Office Saving Bank Regulations 2033 (POSBR 2033), formulated by the authority given by the Postal Act 2019. Post-Office Operation Manual, 2060 and Post Office Saving Bank Investment Manual, 2060 are also helpful for the management of the POSBs.

POSBR, 2033 has prescribed provisions and procedures mainly on the following subjects: opening of POSBs, formation of Post-Office Saving Bank Advisory Committee

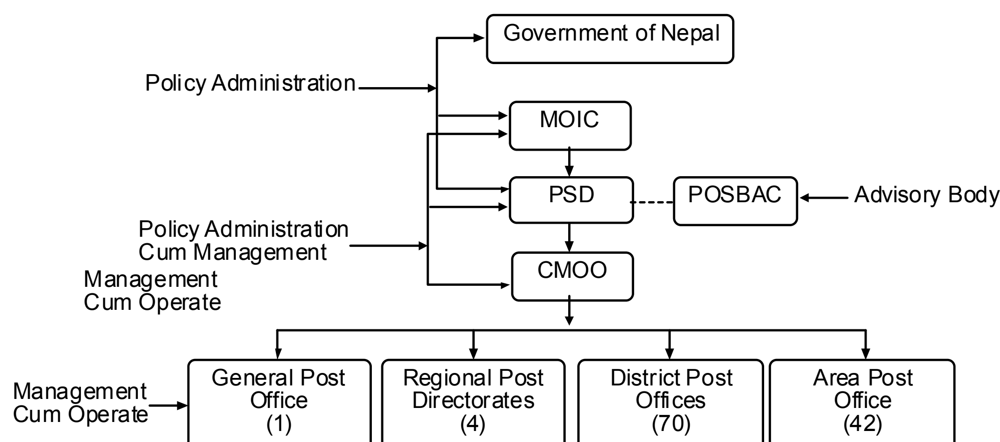
(POSBAC) and its functions, types of saving accounts, procedure to open accounts, pass-book issuance, deposits, withdrawal, claim on deposit, cheque payment, functions and duties of banks, interest management, customer's securities, investment, auditing etc.

According to the POSBR 2033, only the Government can open POSB in any post office. Ministry of Information and Communication, POSBAC, Postal Services Department (PSD), Central Money Order Office and each POSB operating units are all involved in the process of administration and operation of the POSBs.

Structure

The structure of POSB Management System is as follows:

Figure 1 : Structure of POSB Management System



The above structure shows that MOIC, POSBAC and PSD are more responsible for policy management functions. POSBAC is a permanent and important advisory body. The main function of this body is to advise and help PSD for the effective operation of the POSBs. It also studies and examines the functions performed by the POSBs and devises policy suggestion to PSD.

The role of the MOIC is to issue policy decisions and general directions for better POSBs operations. It also plays supervisory roles.

The role of PSD is that of a facilitator and supervisor. It helps in policy decision making as well as monitors, coordinates and supervises the banking operations. It also develops policies for fund management.

The Central Money Order Office is involved in central coordinating, supervisory, controlling and supplying of office materials. In fact, it is the central manager of POSBs and reporter to PSD. It studies, analyses and forwards proposals for policy decisions. It also performs the job of fund management.

The chief of each POSB operating post offices are made responsible for the entire management and operation of the bank within his/her office. He/ She should be responsible for deposit management, record keeping, security, investment management,

auditing etc of the POSB. He/ She should equally be responsible for operations of his/ her post office.

In this banking system, three types of accounts can be opened, i.e. individual, joint and under-aged. This bank pays interest rate of 5% to general customers and 6% to senior citizens (age more than 70 years). It draws 9 % interest from investments to employees and 4.3% and 3.55% respectively from time deposit and call accounts of commercial banks. One can open an account by Rs 100 and minimum balance in the account should be at least Rs 100. A minimum of Rs 20 can be withdrawn and Rs 10 can be deposited at a time. The upper limit of deposit in Kathmandu General Post Office is prescribed as Rs 10 lakhs, other Regional Postal Directorates and District Post Offices Rs 5 Lakhs and Rs 1 Lakh in Area Post Offices. A permanent postal staff can borrow a sum up to Rs 100,000.00 without any collateral and should pay back that amount within a period of five years.

Deposit Mobilization and Investment Disbursement

One of the objectives of the POSB was to use the deposited amount for the development of the socio-economic infrastructure of the country. In the initial stage, each post had to send excess money beyond Rs 2000.00 to Central Money Order Office (CMOO). CMOO had the practice of deposit in such collected amount from different POSBs to fixed account of government owned commercial banks. The generated interest was re-deposited in an account in Nepal Rastra Bank. That account was used for payment of interest to the POSB account holders. If the amount in that account in NRB was insufficient to pay the interest, the Ministry of Finance had to pay it (the interest amount). That system continued until an investment policy to the postal employee was adopted in 2060.

In 1951, necessity of new investment policy was realized by the POBAC and in 2054, a policy of investment to postal permanent employees at 18% of interest rate was approved but it could not materialize till 2060. When a reduced interest rate of 10% was adopted and an Investment Manual was approved in 2060, the scheme got momentum and in a very short period of time it became effective and popular. The investment ceiling was raised from Rs 10,000.00 to Rs 100,000.00 within a year, because of high demand and increased deposits.

Table 1 shows the increasing popularity and increased performance of the POSBs. The figures show that the economic performance of the bank is positive. The investment policy has changed the bank from loss orientation to profit orientation. The number of account also is increasing, which indicates that the bank is being popular among the people.

Table 1 : Performance of POSBs

Year	Total Deposit (Rs)	Profit/Loss (Rs)	Total no. of Accounts
059/60	17,521,108	-1130559	6,954
060/61	35,749,969	-1210063	7,804
061/62	189,774,844	-730054	11,105
062/63	448,226,991	+3109075	25,925
063/64	700,328,431	+573875	34,283

Investment was made to postal employees since 2060. From that point of time, POSB has become active and popular also among depositors.

Following chart shows the condition of the investment disbursement.

Table 2 : Investment Data

Year	Investment Amount (Rs)	Paid of Fund (Rs)		No. of Borrowers	No. of paid off Borrowers
		Principal	Interest		
060-062 Ashad	89,087,000.00	41,127,817.00	3,456,437.00	5101	1997
062/063	226,981,000.00	99,944,624.00	12,125,567.00	3775	2578
063/064	201,484,000.00	144,300,956.00	18,303,592.00	2788	2273

Each POSB needs to send 10% of their deposited amount to Central Money Order Office. Some POSBs cannot invest because of low demand of borrowings under their jurisdiction. The amount of savings is also increasing rapidly. All these factors lead to increase in idle money. Therefore, a financially sound commercial bank was selected and deposited the idle money with competitive interest rate to create balance in financial status of the POSBs.

International Organization of Postal Saving Banks

The first worldwide organization of the saving bank was International Saving Banks Institute (ISBI) The ISBI was established in 1924 AD in Milan, Italy at the occasion of the First International Thrift Congress. In its resolutions, the Congress stated that the creation of a permanent ISBI would be:

> *"Advantageous and indispensable for the better mutual acquaintance of all savings banks and for the increased development and coordination of their activities"*

One of the first activities of the Institute was the organization of an International Savings Banks Congress. The Institute also proclaimed 31 October as World Thrift Day.

In 1994 AD, the international Savings Banks Institute was dissolved. The newly created World Savings Banks Institute (WSBI) was established in Brussels on 9 June 1994 to be managed by a World Saving Banks Institute-European Saving Banks Group (WSBI-ESBG) Common Secretariat.

The European Savings Banks Group was set up in 1963 as the Savings Banks Group of the European Economic Community. The Association changed its name to European Savings Banks Group in 1988.

The WSBI has 108 members from more than 91 countries throughout the world. But till now Nepal has not became its member.

There have been 21 WSBI World Congresses since the first event in 1924. Since World War II, WSBI World Congress has taken place once in every three years.

The WSBI is the only global representative of savings and retail banks for Asia-Pacific, the Americas, Africa and Europe. It is a non-profit international banking association. As

the international voice of savings and retail banking, WSBI works closely with international financial institutions and donor agencies. It fosters members' cooperation by means of training, consultancy services etc.

It is learnt that POSB in many countries have played vital role in infrastructure development activities. It helped to develop the country through saving mobilizations. It also helped to cultivate habit of savings and use that savings when necessary. The WSBI is a big forum, from where one can learn and interact on many issues especially from the field of financial and economic perspective.

Prospects of the Post Office Saving Banks

The POSBs have following prospects:

1. It can be a great instrument to decrease poverty because, with the cultivation of habits of savings, worthless and unnecessary expenses will be controlled. The savings will be quite useful in future for study, housing, medical treatment, wedding etc. Also, by the mobilization of the savings, physical, social and economic infrastructures can be developed and that ultimately will enable to decrease poverty.

2. Saving banks can be instrumental in rural and remote parts of the country, where other banking facilities do not exist. As it is easy and little amount of money can be kept and withdrawn, it can be popular among urban poor. Thus, this bank can be a bank of the poor and help in raising their living standards.

3. By the use of modern technologies, this bank can become more dynamic and competitive. We can design a system, which connects each of the post bank as well as post office electronically and transfer data instantly. Such instant information makes us capable for monitoring centrally and serving people locally with international connectivity. Because of its global relations and connections, it can be a global bank and generate more deposits and profits.

4. The evolutions of ICT have made it possible to operate different kinds of new products like e-payment, e-banking, e-commerce and remittance related services by the post office. Post office's money order and remittance services can be more convenient to operate by the use of this bank. ATM and other counter services can also be operated nation-wide as well as globally.

5. The POSBs can collect lots of fund as savings deposit and can be invested for infrastructure development as electricity generation, transportation infrastructure development, and many more. We can use our own resources with our own convenience and necessity rather than using the different kinds of conditional investments according to the donor's interests which can violate our requirements. If government can pay due attention to its potentiality, this bank can become one of the biggest bank and serve the people of Nepal.

6. The global trend is that the counter services of the post offices are being fast, reliable and multifunctional by the use of ICT and other technologies. The POSBs are also becoming effective and popular. Because of vast network of the post office, the POSBs can reach to every person not only domestically but also internationally and serve people effectively. The POSBs can be instrumental for savings as well as for commerce and payment services.

7. POSBs can contribute greatly to make postal system economically sustainable.

Challenges

Following are the challenges of POSBs:

1. Challenge of investments: POSBs are generating more deposits day by day, but because of lack of expertise, experiences, trained employees and physical facilities, these deposits are lying idle. That may lead to a loss for the bank.
2. There is high competition, but our postal saving bank is running under the government department. In such situation, POSBs, lacking immediate decision power, will not be able to respond quickly with the market situation and lag behind.
3. Low use of technology resulting in low quality and low competitiveness is another challenge.
4. Problem of security: There are crores of rupees in many post offices. Transactions are increasing, but like in other banks, POSBs do not have proper security system, which may invite big accidents.
5. Postal savings banks do not have matching physical infrastructures; to overhaul the whole system a large amount of money is required.
6. Saving banks needs to be audited regularly. But because of no expertise with audit agency, the POSBs have not been audited since more than 10 years. In such a situation, there may be some possibilities of malfunctioning and mishandling of the funds by the postal employees.
7. Till now, the bank has not been able to draw attention of the government. But without the government's attention, it is difficult to carry on this bank forward.
8. Nepal has not joined WSBI because of financial constraints. As a result, we have been slow to learn from global experiences and have not been able to receive any assistance from abroad.
9. POSBs lack professional, trained and experienced manpower. Since post office is one of the most neglected and unattractive areas, postal employees are flocking outside. There are about 25% seats vacant now. This has caused serious problems to run POSBs.
10. Lack of proper resources is another challenge to POSBs. Although we are operating banks, we have not been able to arrange minimum requirements that have practiced by other banks. Similarly, because of lack resources, we are not in the position to motivate our employees. Because of high risk in the banking job, employees do not want to work in POSBs without any extra benefits.

Recommendations

1. POSBs should be made autonomous from full government control in quick response to the market environment and it should be made financially independent.

2. Ministry of Finance or Nepal Rastra Bank or some other financial body should be made responsible for fund management: the management of the fund collected by POSBs through savings. Likewise, this bank needs to be publicized to make it known to all who want to make savings.

3. This bank should be expanded throughout the country even to remote rural locations. Likewise, the Government should make it an important tool for poverty alleviation purposes. This Bank should be branded as “Poor’s Own Treasure” and encourage savings.

4. This banking system needs to use modern information technologies to make it fast, reliable and transparent. Use of central processing system, use of ATMs, application of electronic bank transfer system etc can change this bank into a modern competitive bank.

5. With the use of modern technology, this bank should be made a part of commercial activities of the country by using e-payment system, e-banking, e-cards, (debit cards, credit cards) etc.

6. The part of human resource development is quite weak now; therefore, it should be given high priority and make this bank a professional’s organization. Programs of trainings, further studies, participation in different kinds of seminars, workshops etc. should be adequately added.

7. The management of this bank should be separated from postal management and run independently. A minimum standard to operate the bank should be fixed with all others requirements. The bank should join the WSBI and draw more lessons from abroad.

8. Government should make a plan to use the savings to build the infrastructures of the country such as electricity generation, transportation improvements, industrialization etc. The mobilization of internal resources should be encouraged. And the Government should not encourage receiving such loans from abroad, which have different kinds of conditions against our national interests.

Selected References

Baral, Tika Datta. "Nepalma Hulak Byabastha." First Edition, Kathmandu, 2048

Postal Act, 2019. "Legal Books Management Committee." First Edition, Kathmandu, 2045

Manandhar , Jeet Bahadur "Hulak, An introduction." Kathmandu, 2048

Post Office Savings Bank Regulations, 2033, Department of Press, Kathmandu, 2033

Khanal, Rajan; Bishnu Lamsal. "Hulak Samuha Digdarshan." Kathmandu, 2053

"The Post." World Post Day Supplement, Q*uarterly Journal* Postal Services Department, Kathmandu, 2061

"Post office Saving Bank." Investment Manual, Central Money Order Office, Babar Mahal, Kathmandu, 2060

"Post Office Operation Manual." Postal Services Department, Kathmandu, Nepal, 2060

Different Web sites on internet regarding World saving Bank Institute (WSBI) and Post Office Savings Banks.

Chapter X

Stock Market and Mutual Fund in Nepal

Dr. Bijay K.C.*
Mr. Ashok R. Pandey*

Introduction

One of the financial instruments whose popularity has soared tremendously over a period of last twenty-five years is the mutual funds. Mutual funds today have emerged as the most popular means of investment in the stock market worldwide. Almost 70% of all investments in stocks in the USA today are in mutual funds. These mutual funds are also growing rapidly in India and many other countries in Asia.

A mutual fund is a collection or pool of money of investors invested in a variety of different securities like stocks, bonds, money market instruments, and other assets and managed professionally by a company on behalf of the investors. Mutual fund provides investors the benefits of services of professionals who manage the funds by diversifying it to a wide variety of securities that may not be affordable and possible for a single investor.

There exists a vast scope for investment in mutual fund in Nepal. Recent policy of the government to allow foreign investment through mutual funds managed by commercial banks is expected to attract many investors to mutual funds in Nepal. Nepal Rastra Bank, the Central Bank, is in the process of permitting commercial banks in Nepal to establish mutual funds consisting of a portfolio of one third investment in Nepalese stocks, another third in the stock market of India and the remaining third on stocks from third countries that could be in the region outside of India or worldwide from the major developed markets of the world. Although nothing concrete has been received from the Nepal Rastra Bank, the rumor mill is rife with rumors that the above arrangement is indeed being allowed with the banks as the sponsors for the mutual funds to be established.

This paper discusses the significance of mutual fund as an instrument for investment, assesses the significance of stock market in the Nepalese economy, and analyzes the current trends and developments in mutual funds that are of particular interest to Nepalese investors. It then goes on to evaluate the appropriateness of mutual funds in the conditions prevailing in the markets of Nepal along with the problems and challenges facing the mutual fund industry.

---

* Dr KC and Mr. Pandey are Professors at South Asian Institute of Management, Lalitpur, Nepal.

Mutual Funds as Investment Instrument

A mutual fund pools together the individual holdings of small personal investors, and works with the total sum. A mutual fund firm invests in a broad range of stocks or other securities on behalf of a large number of individual clients. These small investors mostly purchase mutual fund shares through individual investments or retirement and other savings plans for the future. It therefore allows small investors to diversify holdings (and thereby decrease risk) by creating a vehicle for a small amount of capital to be invested in a large number of different securities. It also provides other benefits to the small investor by providing professional management, stock selection, diversification not only in terms of number of stocks purchased but also in stocks purchased from various sectors to achieve a full scale diversification. Additional advantage of a mutual fund investment is also the lower cost of management involved in most cases. In a mutual fund, the fund manager who is also known as the portfolio manager, trades the fund's underlying securities, realizing capital gains, and collects the dividend or interest income. The investment proceeds are then passed along to the individual investors. The value of a share of the mutual fund, known as the Net Asset Value (NAV), is calculated daily based on the total value of the fund divided by the number of shares currently issued and outstanding.

In the last two decades, one investment vehicle that has expanded beyond all expectations is the mutual fund or the managed fund as it is known in Australia and New Zealand. A mutual fund is also an investment vehicle where all dividends are passed on to the investors in the mutual fund and the investment company does not receive any payment in the form of dividends or capital gains. It derives its name from history where there existed mutual insurance companies and mutual banks. In a mutual insurance company the dividends were all paid to the owners of insurance policy, while in a mutual bank the dividends were paid to the depositors that were treated as the de facto shareholders in both the cases. The total investment in mutual funds today in the USA alone is about 7 trillion dollars. This mode of investment is also getting increasingly popular in India with the stock market in India getting to stratospheric heights and total investments are in excess of Rs. 1200 billion and increasing. In the heyday of the stock market boom in the 1990s, these instruments were crucial in bringing many more small investors into the stock market especially in the US. Today, it is estimated that the number of people investing in mutual funds in the United States is nearly 100 million, which includes around half of all households. A study conducted in 56 countries to examine where financial innovation has flourished in this industry has found the fund industry is larger in countries with stronger rules, laws, and regulations, and specifically where mutual fund investors' rights are better protected. The industry is also larger in countries with wealthier and more educated populations, where the industry is older, trading costs are lower and in which defined contribution pension plans are more prevalent. The industry is smaller in countries where barriers to entry are higher. These results indicate that laws and regulations, supply-side and demand-side factors simultaneously affect the size of the fund industry.

One recent report on the mutual fund industry in India suggests that the mutual fund industry in India is extremely short term. In fact there is scarcely an investment that remains with a scheme for even a period of 18 months. A fund manager recently commented that if an investor stays on with a mutual fund for a period of 18 months then it should be assumed that he is either dead or has forgotten about the investment. The factors contributing to this state of affairs are the apparent lack of long-term institutional investment in equity and the continued use of mutual funds corporations for treasury

management purposes. Treasury management leads to an extraordinary focus on liquid and shorter term fixed-income schemes. Provident funds and insurance companies have generally focused on the fixed-income sector. Ownership of mutual funds is dominated by corporations estimated at 60-80 per cent of the total assets under management. Retail investors understandably prefer high-return, low-risk products, including the ones guaranteed by the government. This explains the popularity of national savings products and Life Insurance Corporations annuity schemes. There is some distrust for mutual funds caused by events at UTI and the fallout of the tech boom, among other factors.

Distributors are said to lack the incentives needed to target the retail market. There is strong competition for what are now mostly corporate sales, and not all funds can levy the kind of loads that would induce distributors to handle retail customers. It has also been noted that the Indian asset management industry has grown in size - 2.5 times in the past 10 years, increasing at a rate slightly faster than in the UK but slower than in the US. A number of recommendations, ranging from encouraging longer term investments to developing a better regulatory framework for mutual funds, have been made.

Significance of Stock Market in the Nepalese Economy

During last one and half decade stock market in Nepal has made some noticeable progress. For example, between the fiscal year 1993/94 and 2005/06, the number of listed companies in Nepal Stock Exchange Limited increased almost two fold from 62 to 135 and the value of stock listed rose almost by seven times from Rs.14 billion to Rs.96 billion. Likewise, the number of securities listed with the exchange has increased five times from 43 million to 226 million and the number of annual transactions increased 600 times from around nine thousands to 5.8 million. During this period NEPSE index jumped to 386. Despite this, stock market in Nepal is yet at a developing stage and has yet to make its presence felt in the overall economy of the country.

The level of stock market development and its impact on the national economy can be measured by using various indicators such as size of stock market, liquidity, concentration, and volatility which are presented in Annex 1.

Impact of stock market in any economy can be judged from its size and liquidity. Generally large stock market size indicates developed stock market. In Nepal the number of companies listed with the Nepal Stock Exchange Limited increase from 66 in 1993/94 to 135 in 2005/06 and the number of listed securities from 43 million to 226 million during the period. Although the number of companies and scrip listed with the stock exchange shows an increase in the size of stock market in Nepal, the market capitalization ratio indicates relatively low importance of stock market to the national economy. The market capitalization ratio has, on an average, been only around .08 for the period between 1993/94 and 2005/06. It is interesting to note only about one-tenth of the companies registered with the Office of the Company Registrar as public limited company are listed with the Nepal Stock Exchange Limited during the period. Most of the companies that are listed with the exchange belong to banking, finance, and insurance sectors. While only few companies from the trading, hotel, manufacturing, and aviation sectors are listed with the exchange, very few companies from power, information technology, and construction sectors have entered the organized stock exchange of the country. This indicates that firms tend to avoid stock market as an alternative source of long-term capital in Nepal.

Liquidity in the stock market parlance refers to the convenience and ease in buying and selling securities in the market. By allowing investors to alter their investment portfolios

conveniently any time at low cost, liquidity makes the financial assets less risky. Liquidity, measured in terms of total value of shares traded in the stock market as a percentage of gross domestic product, indicates the extent of ease in trading in stock market in a country. Evidence shows that countries with relatively liquid stock market tend to grow much faster than countries with illiquid markets.

Liquidity as measured in terms of value of shares traded and turnover ratio has been very low in the stock market in Nepal. The value of shares traded accounted, on an average, only for about 0.0037 of gross domestic product during the period between 1993/94 and 2005/06 and was always below 0.004, except in the fiscal year 2000/01, 2004/05 and 2005/06. Similarly, the turnover ratio has remained very low at 0.042, and also highly fluctuating, during the period between 1993/94 and 2005/06.

Besides concentration in stock market in Nepal is also quite high making the market quite illiquid. Concentration ratio, measured by computing the share of ten largest stocks to total market value of shares, was on an average around .67 over the past 13 years which indicates that the market value of shares of ten largest companies account for two-third of the total market value. The concentration ratio is as high as .8 when it is computed on the basis of turnover. This indicates that the stock market in Nepal is highly dominated by largest ten companies in terms of either market capitalization or turnover. It is interesting to note that of the ten largest companies dominating the market in 2006 nine are commercial banks, indicating that the stock market in Nepal is highly dominated by the commercial banks. High concentration is not desirable as it adversely affects liquidity in the stock market.

In recent years volatility in the stock market in Nepal has shown a rising tendency. High volatility in the stock market denotes risk in equity investment. However, it should be understood that high volatility does not necessarily imply undeveloped stock market. It is generally expected that stock markets, when well developed, absorb risks in financial assets and offer higher return with less volatility. Put simply, it means that as an indicator of a country's stock market development less volatility is preferred to high. Volatility, measured as a twelve-month, rolling standard deviation of market returns, was high during the initial years in the stock market in Nepal but it was on decline till 1996/97 indicating that equity prices stabilized during this period. From 1998/99 onwards volatility in the stock market had wider fluctuation but it showed a tendency to rise consistently till 2001/02. A high ratio indicates the ability of the stock market to provide liquidity and handle risk. Volatility, when measured as a ratio of value-traded-ratio to volatility, showed an increasing trend during last three years indicating inability of stock market in Nepal to handle risk relatively to volume of trading of shares.

Taken together these ratios i.e. market capitalization, value of shares traded to gross domestic product, turnover, concentration ratio, and volatility indicate that the stock market in Nepal is very small relative to its economy, highly illiquid and risky and has low impact in the national economy.

Mutual Fund in Nepal

The mutual fund industry in Nepal started about 15 years ago when the NIDC Capital markets issued an open ended mutual fund, NCM Mutual funds, for Rs. 10 per unit in 1991/92. With the realization that participation of small savers only in capital market cannot handle the intricacies of the stock market, the NCM First Mutual Fund 2050 was issued with the objectives to involve institutional players in the development of stock

market and give stability to it. Its purpose was largely to stabilize the market and increase confidence in the nascent financial markets. (Citizen Investment Trust also issued mutual funds during late 1990s.)

The size of the Fund was limited to a maximum of Rs.100 million with face value of Rs.10 per unit and 100 units as minimum number purchased. The funds so collected were invested in equity, debentures, bonds and short-term tradable securities. The fund allowed up to 90 per cent of the amount collected to be invested in bonds, debentures and shares and up to 30 per cent but not less that 10 per cent in short-term securities.

The investment criteria were:

1. The fund of this scheme would be invested in financially sound companies in general listed or to be listed.
2. Fund should not be invested in risky business
3. The fund looked for good returns from capital gain, dividend and interest
4. Investment would be done in existing companies or newly privatized public entities
5. Specific investment areas of the funds would be banking and financial institution, tourism, trading, construction areas, services and in manufacturing
6. The funds involved in one company shall not be more than 10-% of the total size of the fund

Valuation of the units was done on daily basis. The fund was expected to give on an average a return of around 19% p.a. Management fee of the fund was 1% on the assets & 5% on the profit besides other incurred expenses. The then Nepal Arab Bank (now Nabil Bank) was selected as the custodian and banker to the issue. The management company was allowed to acquire and hold the assets in its own name. It was allowed to acquire assets and to resell them with the funds of the investors, and also to take all the necessary actions in context with the management of the fund. It was however, not allowed to give loans or guarantees other than equity, debenture, bonds and money market instruments backed by securities on behalf of the fund. It was also not allowed forward buying or selling.

With a view to define the strategic guidelines for the investment policy a separate fund management committee consisting of five members out of which three were from the management company and two from outside, one industrialist and one chartered accountant, was formed to safeguard the interest of the investors. The committee was required to publish the quarterly reports. The sale and repurchase of the mutual fund units was based on the net asset value calculated by the management company and controlled by the custodian from time to time. Costs of the mutual fund included:

i. Management fee of 1% on the funds assets value as confirmed by the auditor. The fixed management fees were to cover all the expenses besides custodian fee, transaction fees and auditing fees. The fixed management fees were charged quarter yearly as down payment.

ii. Management fee of 5% on the income minus fixed management fee, transaction fees, custodian fees and auditing fee. Income was defined as increase in the value of the fund which includes capital appreciation, dividend and interest.

iii. Custodian fee of .5 % on the value of the securities hold by the custodian payable quarter yearly as down payment.

iv. Costs in context with transaction buy and sell of securities on behalf of the fund. Pre operating expenses in context with the issue was also borne by the fund and amortized over a period of 10 years.

Although the fund was a continuous scheme, the management company, if the situation so arose, was allowed to terminate the management activities with a prior approval of concerned authorities.

Due to the lack of adequate knowledge about mutual funds among the investors, NCM Mutual Funds faced problems right from the beginning. The stock market at that time was ill prepared for an open end mutual fund that permitted unlimited purchase and redemption of shares in a market where broker manipulation was high and investor confidence low. When the market began to fall, almost all the shares were redeemed and in some cases the market was falling so quickly that redemption itself created problems for the asset management company. Initially Rs. 3 crore was collected under the scheme from 1293 unit holders. It started buying of units at net assets value in order to give liquidity facilities to the unit holders and selling at NAV plus 2%. Within a short period NAV price of a unit went up to Rs13.92. In June 1994 , the NAV value per unit went up in the range of Rs.14. The fund size reached up to Rs. 15 crore. But later with the decline in the NEPSE index investors started the selling of units continuously. The NAV rate in October 1994 was Rs 14.59 which came down to Rs 13.15 in November 1994 and to Rs 12.79 in January 1995. By July 1995 it was Rs 11.32.

During the period, the management company had to repurchase Rs.10 crore worth of fund. The fund size came down to Rs.6 crore in June 1995 with 1756 unit holders having 52,69,800 units. As the outflow of fund continued and the stock market plummeted, the fund faced liquidity problem and had to stop the buying and selling of the units. Efforts were made to provide liquidity to unit holders through listing the units with the stock exchange. However this did not prove worthwhile as listing was not allowed by stock exchange. With the investment of kitty fund of Rs. 3.03 crore provided by Nepal Rastra Bank and Rs 1.5 crore by NIDC, the funds purchased back 39,92,600 units in 1995/96 with 12,57,200 remaining outstanding in the market. The fund also published amended prospectus in April 1997.

In 2003 NIDC Capital Market Ltd. restructured the mutual funds and issued NCM Mutual Funds 2059. This mutual fund was made closed ended and were listed with the Nepal Stock Exchange Limited. In 2003, the fund refunded Rs 17.43 per unit and issued NCM Mutual Fund 2059 of Rs.10 crore. It provided opportunity for existing unit holders to buy two units of new Mutual Fund for additional investment of Rs 2.57 per unit. The main features of the new fund were as follows:

- 15% of it was reserved for the Management Company and the trustee institution, each investing 7.5% to form the seed capital of the fund. The total amount contributed by NRB was refunded and the amount equivalent to it is held by NIDC Capital Markets Ltd.
- It charged management fee of 2% on total assets and 5% on operating profit
- The trustee institution was Nepal Industrial Development Corporation and Trustee fee of.5% of total assets was charged.

- The investment criteria included:
  - 65% in shares and preference shares
  - Up to 15% in debt instrument
  - Up to 20% short term and medium term loan to institutions
- Buying and selling of the mutual fund units was done at the Nepal Stock Exchange. However, if due to any reason what so ever if it is felt that the trend prevalent in the stock market is affecting the price of the unit, then the Management Company & the trustee can buy & sell the units through the Stock Market.

Liquidity of the funds in market was provided by listing it at the Nepal Stock Exchange. Dividend will be distributed from the profit, interest earned, capital gains of the fund. In case the profit is not enough to give dividend, then it shall be given from the retained earning and if that too is insufficient, then it will be paid to the investor out of the earning / sources of the management company. The mutual fund has been providing 5% dividend every year. In 2005/06, it declared 8% dividend.

Problems of Mutual Fund in Nepal

Mutual funds in Nepal faced problems right from initial years of its issuance. One of the major problems was that the stock market was not ripe for the mutual funds. First mutual funds appeared in the market without any clear policy and regulations to guide its operation by the regulatory agencies. It was a time when the government was preparing for revising the structure of stock market by replacing the then Securities Exchange Centre with a new set-up with Securities Board of Nepal as an apex body with the responsibility of policy formulation, supervision and monitoring and Nepal Stock Exchange Limited as an entity with the responsibility to facilitate, supervise and control securities transactions. There was no trust act which is vital for regulating transaction of mutual funds. Development of market for mutual funds suffers from the problem of inadequate and weak regulatory framework even today.

Another problem is that the Nepal Stock Exchange (NEPSE) is still in its infancy with only about 150 stocks traded in the stock exchange. The stock index, NEPSE Index, has been established for the last 15 years and has displayed rapid growth even though it has had a tumultuous ride in the interim period. It maintained the open cry system of trading till recently and the open cry system of trading has now given way to a fully computerized system of trading. It has often been reported that with the open cry system, the system was usually manipulated with investors getting less than market prices at times of sale while they had to pay higher prices during purchases with the brokers making the difference. With the computerization of the financial markets and the concomitant transformation, it is expected that the manipulation of stock prices witnessed during the earlier years will now be somewhat relieved and investors can have greater confidence in getting the best price during sales and purchases. Mere computerization, however, may not be sufficient to curb excessive manipulation of the earlier years and a mechanism must exist whereby suspicious trades are unearthed and brokers engaging in manipulation met with strong punitive measures. Stock markets develop with confidence in the system for investors and a lack of confidence in the system could result in a catastrophe at a later stage once

investors become fully familiar with the nuances of stock investing including gaining knowledge of measures of valuation.

Despite over two decades of history, the stock market in Nepal suffers from low levels of trade and problems of liquidity and float. The problem of low float is caused by the high percentage of promoter's ownership of stocks that may be in the vicinity of 75% to 85% in almost all cases. The rules and regulations do not permit promoters to sell their shares. The public investors owning shares in the public companies have received exceptionally high returns both through price increases of individual shares as well as the receipt of bonus shares from time to time. These high returns elicit a reluctance to dispose of the stocks of companies resulting in very low float overall.

Another problem facing the development of market for mutual funds is the absence of system for appropriate pricing of securities. The Nepalese stock market is unique in one respect. When companies issue bonus shares, there is only a mechanical change where a part of the retained earnings gets transferred to total paid up capital. In effect it is only a mechanical change and does not affect the company in anyway. The market value as a result should remain the same and when bonus shares are issued, the same market value should now be shared by a larger number of stocks. The logical conclusion is that the price per share of stock should go down in proportion to the increase in the number of shares. In the Nepalese stock market however, when bonus shares are issued, the price of the stocks rise and the investor benefits in two ways: first by the distribution of stocks that increases the investor's ownership of stock and secondly from the price rise of each individual share of stock. These high returns inhibit the investor from selling stock even though the valuation of the stock may be judged to be astronomically high in comparison to standards and norms of neighboring countries. There are stocks in the Nepalese market with normal growth that have a market value to book value ratio of over 20. These are high levels by any standard. It is obvious that the trading in the NEPSE is extremely sparse and the overvaluation witnessed is largely because of a large amount of money following small volume of stocks. For proper valuation in the NEPSE it is imperative to have a much higher turnover. The series of steps contemplated by the Government of Nepal through the Nepal Rastra Bank with respect to bank lending against shares, reduction of promoters' shares in the individual stocks, increases in deposit rates in banks on account of the credit crunch and the correction that the NEPSE index is currently facing may result in a situation where float and turnover could increase that would be better for the future of the financial markets in Nepal.

Low turnover in the stock market is also a major hindrance to the development of market for mutual funds in Nepal. In an efficient stock market the prevalence of large number of buyers and sellers wiling to trade in large quantities of stocks with market information flowing freely to those investors results in proper pricing of shares in the market place over a period of time even though at any given time the market could be over or undervalued. The low turnover of trading in the stock market in Nepal is a major factor as to why stocks tend to be overvalued in the market.

As analysis of tables presented in Annex 2 and 3 indicate that the ratio of total trading volume as a percent of market capitalization based on the data for the largest and most widely traded stocks in the NEPSE based on data of 2002 is only 2.09%. A large number of stocks in the NEPSE however are scarcely traded. It is prudent to assume that the ratio of total trading volume to the market capitalization would be even lower than the value suggested above. Even if the above value of 2.09% were to be truly representative of the overall ratio, this would be almost 25 times less than

India's and 11.5 times less than Malaysia's whose turnover was the lowest of any of the countries considered.

Nepal suffers from all of the problems faced by emerging markets such as the prevalence of high macro-economic uncertainties where government policy changes regularly and unexpectedly, low float in stocks where there is a tendency to hoard stocks. Almost all companies were started with only 15% of public participation by law while the 85% belonged to promoters. The promoters were not permitted to sell their shares and rightly so in order to protect the investing public. If promoters were permitted to sell shares at the outset some promoters may have sold the shares and the companies could well have been stranded with no one available to run the companies. After a period of 5 years the promoters should have been permitted to sell a part of the shares and bring their share down to 51%. If such steps had been permitted then the float may have increased. However, what could also have occurred is that the share value could have fallen because of the selling pressure of a sizable amount of promoters shares. As a result the promoters should have been permitted to sell their shares in a phased manner.

Recently the promoters have been permitted to sell their shares and bring the ownership of the promoters up to 51%. The promoters have now been permitted to sell the shares but there is still no compulsion to sell the shares in their possession. As long as the trading remains thin and margin lending is permitted through commercial banks and finance companies, the situation will be such that a large sum of money starts chasing few stocks waiting to be sold, and this situation means the returns from the promoter's holdings will continue to be high compared to the returns from alternate businesses and this will continue to push prices to absurd levels. It is about time the flow of artificial money to the stock market is impeded and the prices of stocks would in all likelihood fall. Once this process starts, many of the investors and promoters who have deposited the stocks in safe deposit vaults in banks would gradually like to take profits now rather than wait for the uncertainties of the future. These developments would gradually goad promoters to reduce their current positions and increase float in the NEPSE that will be a welcome adjustment to the investment scenario.

Conclusion

A mutual fund pools together the individual holdings of small personal investors. A mutual fund firm invests in a broad range of stocks or other securities on behalf of a large number of individual clients. These small investors mostly buy mutual fund shares through retirement plans or other savings plans for the future. It thus permits small investors to diversify holdings by devising a vehicle for a small amount of capital to be invested in a large number of different securities.

Based on the foregoing discussion, the time may be ripe for a credible start to the mutual fund industry in Nepal. Since the stock market has a low float and very low turnover as defined by the total trade as a percentage of market capitalization, the closed end fund will be a better vehicle as a start. If there is selling pressure or broker manipulation the closed end fund will sell at a discount to NAV but it will not in any way impact the management of the fund. However the size of the mutual funds in Nepal will likely be much smaller compared to the size of mutual funds in India and it is likely that the expense ratio will be high that would potentially reduce the effective return to the investors.

Annex 1
Indicators of Stock Market Development in Nepal
1993/94 to 2005/06

Years	Market Capitalisation to GDP Ratio	Value of Shares traded to GDP	Value of Shares traded to Market Capitalisation	Value-traded ratio to volatility
1993/94	0.07	0.002	0.0311	0.001
1994/95	0.06	0.005	0.0813	0.011
1995/96	0.05	0.001	0.0170	0.004
1996/97	0.05	0.002	0.0328	0.012
1997/98	0.05	0.001	0.0142	0.003
1998/99	0.07	0.005	0.0632	0.017
1999/00	0.12	0.003	0.0268	0.005
2000/01	0.10	0.006	0.0583	0.006
2001/02	0.09	0.004	0.0444	0.003
2002/03	0.08	0.001	0.0163	0.005
2003/04	0.09	0.004	0.0518	0.077
2004/05	0.12	0.009	0.0735	0.122
2005/06	0.17	0.006	0.0357	0.173

Annex II

Trade Value and Market Value for Companies, 2059

	Name of Company	Market Capitalization (mln)	Trade Value (mln)	Trade (%)	Closing Price
1	Standard Chartered Bank	4873	60.2	1.24	1435
2	Nabil Bank	3496	84.7	2.42	712
3	Himalayan Bank	3081	24.9	0.81	790
4	Nepal Investment Bank	1506	22.59	1.5	890
5	Nepal Bangladesh Bank	1440	67.6	4.69	400
6	Bottler's Nepal (Balaju)	1364	3.56	0.26	700
7	Everest Bank Limited	1121	31.3	2.79	426
8	NIC Bank	1050	23.8	2.27	210
9	Nepal Bank	1046	16.2	1.55	275
10	Bank of Kathmandu	1029	95.0	9.23	222
11	Hotel Soaltee	652	4.8	0.74	75
12	Nepal Lever	842	2.1	0.25	915
13	Nepal SBI Bank	426	21.2	4.97	296

Annex III

Number of Shares of Large Co's Traded in NEPSE

	Name of Company	Shares Outstanding (mln)	Share Traded ("000)	Share Traded as %
1	Standard Chartered Bank	3.3958	40.88	1.20
2	Nabil Bank	4.9101	119.09	2.43
3	Himalayan Bank	3.9000	26.04	0.67
4	Nepal Investment Bank	1.6921	26.398	1.56
5	Nepal Bangladesh Bank	3.6000	125.21	3.48
6	Everest Bank Limited	2.6315	71.15	2.70
7	NIC Bank	5.0000	99.69	1.99
8	Bank of Kathmandu	4.6351	352.52	7.61
9	Hotel Soaltee	8.6933	53.89	0.62
10	Nepal Lever	0.9202	1.6	0.17
11	Nepal SBI Bank	1.4392	43.1	2.99
Total number of Outstanding shares and trades		40.8173	959.968	2.35%
Total Market Capitalization and Trade Value		21,926	457.95	2.09%

Chapter XI

Credit Information Bureau in Nepal: Analysis of Critical Success Factors

Anil Chandra Adhikari*

Introduction

The availability of credit is the engine that drives credit growth. In developed economies, businesses and consumers have a relatively easy access to credit. One of the reasons for this is the ability of the financer to assess the credit risk of the applicant in a quick and efficient manner. This ability results from the highly developed systems of formatted and standardized information on the financial state and behavior of the companies and individuals in hands of specialized agency like Credit Information Bureau. Successful credit economies have as their backbone credit bureaus which play an important role in the area of credit risk management and the promotion of sound credit culture in the financial system of the country.

Empirical literature suggests that on average a firm can increase its assets by nearly 5%-8% for every 10% increase in credit penetration. Credit penetration is conclusively proved to be influenced by the amount of credit information sharing. The longer that credit bureaus have been in existence in a country, the greater the probability of higher credits penetration. It is recognized globally that a matured and developed financial sector must have effective and efficient financial systems to manage credit risks in order to sustain the financial needs of the government, industry and consumers. Credit bureaus are core to lending and relationship management in majority of the mature economy around the world. Without existence of the highly developed systems of credit reporting and information that facilitated the easy access of credit, it is doubtful whether those economies would have enjoyed dynamic growth rates and have been as mature as they are today.

This explains why more and more developing economies have taken the cue from the developed economies in establishing credit bureau. According to survey data collected by World Bank, almost 60 countries have credit bureau. At present, the region with the highest coverage is Latin America where 17 countries including all the large economies (Argentina, Brazil, Chile, Columbia, Mexico) have established credit bureaus. Credit bureau started in early 1900 in the United States and Canada and later in Europe in 1930.

---

* CEO, Credit Information Bureau, Nepal

Credit bureaus collect and collate personal financial data on individual and businesses, from data furnishers with which bureaus have the relationship. Data furnishers are businesses, utilities, debt collection agencies, public institutions and the courts (i.e. public records) that a consumer and business has had a relationship or experience with. The data provided and supplied by the data furnishers as well as collected by the bureau is then aggregated into the credit bureau data repository or files. The resulting information is made available on request to contributing companies for the purpose of credit assessment. It is released under legally permitted conditions to the bureau's participating members when they make inquiries about the borrower. This specific information is meant to help its members (credit providers) to determine if the consumer applying for credit has the ability and propensity to pay. Different financial institutions employ different lending policies and attach varying degrees of importance to the details given in the credit reports. Using the same information from the credit reports and other sources, one lender may say "Yes" while another may say "No". Thus by providing this credit information, the credit bureau helps lenders make improved lending decisions quickly and objectively, manage risk effectively and guard against fraud.

To put in an encapsulated form, credit bureau is a clearing house for credit history information, a repository of factual information that contains credit application and repayment records. The effectiveness of credit bureau varies depending upon the number of factors including data availability, data quality, operating ability and legislation. Supportive legislation and a sound technical infrastructure are crucial to effective operation. The service provided by credit bureau always starts with a basic credit report containing all relevant data within the bounds of prevailing legislation followed by many advanced services such as credit scoring and fraud control in the later stage as the credit market advances.

Evolution of CIB in Nepal

Credit Information Bureau was established in Nepal in 14 May, 1989 with the sole objective of improving the functionality of the country's financial system. With an alarming proportion of the non performing assets (NPAs) in the economy, it became imperative to arrest accretion of the fresh NPAs in the banking sector through an efficient system of credit information on borrowers as a first step in credit risk management and controlling NPAs. In this context the requirement of an adequate, comprehensive and reliable information system on the borrowers through an efficient data base was felt by the Nepal Rastra Bank (NRB), Central Government, credit institutions and other players in the banking and financial sector of the country. The answer took shape when the Credit Information Bureau was incorporated under Nepal Bankers' Association in 1989 as a non-profit organization to provide vital credit information service to its member institutions, in order to allow them to make informed and objective credit decisions.

The alarming proportion of NPAs carried over by two leading national banks and the subsequent liberalization of the financial sector even more necessitated the presence of credit information bureau in the country. The increased credit risk problems which emerged because of the sector specific deficiencies like permissive banking practices, absence of risk based pricing methodologies, lack of customer risk rating models, absence of credit rating agencies, absence of credit risk transfer instruments, lack of transparency among the banks and financial institutions (FIs) and lack of many other credit risk management tools made the strengthening of credit information bureau a first and preliminary step in the direction towards restraining the fresh NPAs and enhancing the functionality of financial system in the country.

The CIB's operation was initially guided by the NRB directive which was insufficient. Many litigation cases followed against CIB that challenged its very existence and its legality for blacklisting and disclosure of information. Legal challenges, poor compliance, and inadequate enforcement led to strengthen its regulatory framework. NRB came out with new amendments to consolidate the functioning of CIB and gave a legal framework for its operation through Nepal Rastra Bank Act 2058, Article 88. It was reorganized as a public company in order to strengthen its independence and increase its operational efficiency. It was renamed as Karja Suchana Kendra Limited as per the new directive and got registered as the Company in 2004 under the Company Act 2053 and started its operation as an independent and autonomous entity from April 2006. The major shareholders of this public limited company are commercial banks with 60%, finance companies with 15%, development banks with 15% and NRB with 10% shares.

The major functions of CIB as stipulated in NRB directives 2062 are as follows:

- Collect, collate, consolidate, update and store the credit information received from the banks and financial institutions and provide the information upon request by them. The credit information also could be shared with international institutions as per the consent and recommendation of NRB.
- Maintain a list of borrowers referred to as blacklist who default on the payments, misuse it or who are engaged in commercial criminal activities related with the banks and financial institutions.

In the initial phase of its operation, only the banks were required to submit the adverse loan repayment information on credit in excess of Rs.0.5 million and blacklist defaulted borrowers with credits in excess of Rs. 2 million. At present, the scope of participating institutes have been increased to development banks and financial companies (in addition to commercial banks) making it mandatory for all of them to send the information of the borrower borrowing equal to or more than NRs 2.5 million in a prescribed format to CIB on a quarterly basis. Also the banks and financial institutions must receive credit information of the potential borrower from the CIB, before the new credit extension, renewal, restructuring, and /or rescheduling of NRs 1 million or above facility.

Credit information bureau has been working together with banks and financial institutions to bring down the level of NPAs and contribute to reshape the economy of the country. The NPA that remained nearly 7-8 percent of GDP presented a major risk to the banking and finance sector and to the economy at large. Over the past few years with the assistance of credit information bureau, the major banks have been able to stem their operating losses and recover significant amounts of outstanding loans. Till the end of Asadh 2064 (July 2007), the total number of blacklisted borrowers registered in CIB were 3,339 with total outstanding amount of $476 million. The two public banks– Rastriya Banijya Bank and Nepal Bank Limited-together have 2,611 blacklisted borrowers with the NPAs of $336 million. Thus they constitute nearly 70.58% of the total NPA of the economy. Out of total 3,339 blacklisted borrowers, 1,104 borrowers have settled their cases so far and are de-listed from the black list thus releasing a total amount of $86.6 million to the economy. At present (Asadh end/2064), there are 2,235 blacklisted borrowers with outstanding amount of $389 million. The NPA of the financial sector is in decreasing trend and the many banks have managed to bring down their NPA (NPA to gross loan) level to less than 3% in recent years.

The credit enquiries have increased since the last few years because of the sudden surge of banking and financial institutions in the country. Financial sector has made a hallmark progress both in terms of number of financial institutions and beneficiaries of financial services. By mid January 2007, the NRB licensed bank and non bank financial institutions totaled 203. Out of them 19 were commercial banks, 35 development banks, 72 finance companies, 11 micro credit development banks, 19 saving and credit operatives and 47 NGOs. By mid July 2007, the numbers of commercial banks increased to 23 with parallel increase of development banks and finance companies.

Recent average growth of 13% of loans and advances of the financial sector have increased the credit inquiries by 15.66% and new borrowers (above 2.5 million) by 27.33%. The year 2007 saw the number of borrowers above 2.5 million reaching to 37,948 & credit reports disseminated by CIB increasing to 45,159.

Table 1 : Growth of Credit Borrowers Rs.2.5 Million or above (CIB Data base)

Items	Mid-July		
	2005	2006	2007
Number of Borrowers	28472	32453	37938
% Increase	16%	14%	17%
Average % Increase 15.66%			

Table 2 : Growth of Credit Enquiries (CIB Database)

Items	Mid -July		
	2005	2006	2007
Number of Borrowers	24612	32782	45159
% Increase	11%	33.2%	37.8%
Average % Increase 27.33%			

The major focus of the Bureau is to increase the operating efficiency which has been substantially improved since the last year. The credit inquiries of the banks are reported back within 24 hours and nearly 40% of the inquiries are answered back the same day. Given the fact that the Bureau still operates manually, it has ensured to mobilize the required resources to deliver the queries within shortest time possible. But the Bureau has to ensure the quality of the reporting as well where the reports delivered should be current and updated. In case of dated credit report of the borrower, reporting credit enquiries get delayed because of the time taken to receive the updated information from the concerned banks.

Need and Rationale

The increased competition in finance and banking sector usually leads to a number of unforeseen difficulties and increased problems of borrowers' over-indebtedness, reduced loan repayment incentives and growing arrears of financial institutions. Weakening performance of lending institutions in a competitive market is due in part to the absence of information sharing in these markets because growing numbers of financial institutions increase the level of asymmetric information between lenders. Credit information bureau

plays a crucial role toward improving credit market performance and acts as the information brokers that increase the transparency of credit markets. Motivated by industry survival amidst increasing competition, a wide array of lending institutions are becoming increasingly aware of the essential role that credit information bureau play toward the creation of an efficient financial system. Benefits of information sharing include an improved pool of borrowers, reduced default rates, and lower interest rates. The benefits of the credit bureau improve the credit access for the poorest borrowers.

The goal of the credit information bureau is to ease a problem fundamental to the credit markets: asymmetric information between borrowers and lenders. The practical consequence is a better risk management, which enables banks and other financial institutions to increase their lending volume and extend credit to underserved segments of the population. The establishment of the credit information bureau assists in the development of sound credit risk management practice among the lenders and borrowers, consequently contributing to a more stable and efficient financial system in the country. The lender's improved access to accurate and reliable credit information will enable them to make more informed credit decisions while strengthening credit discipline of the borrowers. The availability of consolidated credit information reduces processing time and costs to the lenders, which are expected to, in turn, reduce financing cost of the borrower.

Assuming that the credit market is competitive, information sharing lowers lender costs through lower default rates. While the demand for credit has risen exponentially, there has been a parallel increase in competition, and credit delinquencies. In such an environment, risk assessment is of critical importance, not only in deciding on what business to book and the speed at which a credit grantor does so, but also in determining the appropriate pricing. A credit information system thus improves the efficiency of financial systems through improving risk assessment of loan applicants, which then improves portfolio quality, which in turn reduces rates of arrears. In a competitive credit market, these efficiencies are passed onto borrowers in the form of a lower cost of capital. Improved information flows thus enhance the efficiency and stability of the entire financial system.

With 23 commercial banks and more than 150 financial companies competing for a limited market for the banking & financial services in the country, competition is very strong. Financial institutions compete to gather deposits and to expand their market share. Deposits and loan growth in recent years have risen rapidly. Consequently, all the associated market and credit risk have grown accordingly. The banking sector of the country has the fundamental weaknesses such as high lending risks where borrowers rely on high leverage, high levels of explicit and implicit bad debts, the short term nature of bank's funding sources, a weak culture of honoring debt and penalizing those who default, weak institutional capacity for credit risk and project analysis and substantial gaps in the legal and regulatory framework, among others.

However, an efficient and effective CIB will help alleviate these overtime.

Table 3 : Banking Sector Weaknesses and Impact of CIB

Banking Sector Weaknesses	Effect of an Efficient & Effective CIB
High NPA levels (explicit and implicit)	Will reduce NPAs, increase profitability and generate more internal capital.
Weak credit culture	Will promote honoring of obligations and

	penalizing of defaulters
Weak transparency and poor governance practices.	Will promote greater transparency in financial accounts and reduce access to funding for the non-transparent
Because of the structure of the economy, bank loans are seasonal, cyclical and of short tenor.	Greater borrower information and transparency could open up new lending opportunities and products.
Relatively high interest rates due to credit risk premiums, high NPAs and lack of collectible collateral	With more competition for good borrowers and more information on all borrowers, rates should decline.
Lack of reliable financial information about borrowers; hence, reliance almost solely on real state as collateral.	With increased knowledge of debtor characteristics and more transparent financial accounts, bankers should be able to rely more on loans backed by inventories or receivables.
Lack of term funding sources	With more confidence in their lending decisions, banks can offer longer term loans.
Insufficient IT infrastructure in many banks and financial institutions	Will encourage banks to upgrade IT in order to have access to CIB's database
Staff untrained in risk management	Will encourage lending officers to discriminate more carefully among potential debtor/clients and price risk accordingly.
Information and judicial asymmetries	Will increase the amount of data available on borrowers so that creditors can make more informed decisions, which will reduce the foreclosure burden on courts and incidence of bribery.
New banking products to attract clients	With few credit risk to worry about, banks can diversify their product lines, e.g., to credit cards, mortgages

Introducing an efficient and effective CIB will not be a “quick fix” for the problems shown but overtime it will help increase transparency, remove a degree of uncertainty from the banking system, and provide the basis for improved assessment of credit risks.

Apart from restraining NPA, the CIB has a major role to play in the growth of SME market in the country. While the sustained and long term growth of SME sector in Nepal remains constrained by a number of factors that include skills shortage, scarcity of capital goods, poor management, lack of data on the sector, resistance to change and marketing difficulties especially for export oriented SMEs, by far the biggest problem facing the sector is the unavailability of the adequate financing facilities. This sector is characterized by information asymmetries, the creditors' search cost, information acquisition and processing costs exceeding the returns. Hence there is the risk aversion by the banks towards extending credit to small and medium enterprises. It is relatively easy to lend to large corporates where the economies of scale, published financial information, collateral and credit worthiness parameters favor such type of lending. As the small business can not offer adequate collaterals, the banks are unable to determine whether the borrower possesses technical, managerial and marketing skills that will allow him to generate adequate cash flows and repay the loan on time. The process of financial intermediation therefore breaks down for SME borrowers.

SMEs in Nepal contribute 90% of the industrial GDP and engage 87% of the labor force. SME has emerged as the prime driver of new employment and has contributed substantially in the GDP growth. And it has been diversified the economic base of the country. Nepals economy is totally dominated by the small businesses. About 90% of the agricultural enterprises in Nepal are marginal or small. And more than 90% of the industrial establishments in the country are SMEs. These two sectors contribute to 90% of the country's employment. Constraints of SME access to credit also apply to capacity of the financial system to create and sustain a commercial credit bureau. While lending to large companies requires a detailed analysis of the potential borrowers' financial standing, for smaller loans, payment history is found to be sufficiently a good predictor of the probability of default.

Table 4 : Problems of SME and Impact of CIB

Constraints to SME Access to Credit in Nepal	Effect of an Efficient and Effective CIB
Lack of information on SME borrowers.	A CIB will contain broader and deeper SME database.
Limited capacity of banks to analyze SME borrowers properly.	CIB information and reports will give creditors more tools to mitigate risk and price loans appropriately.
High interest rates	With more reliable data on borrower payment history, uncertainty will be reduced and rates should decline.
High collateral requirements	With more borrower data, credit risk will decline and less collateral should be needed.
Dearth of funding sources for SMEs	Better SME borrowers should find willing lenders.
Lack of term lending	CIB will make market more transparent making lenders more confident about longer term credits.
Non transparent ownership of SMEs	Will become clearer with CIB users deeper database.
Opaque financial statements of SMEs	A CIB will help persuade SMEs to clarify their finances if they want funding.

The data in CIB enables lenders to use automated decision systems, including scoring, for consumer and small business loans. By automating the credit decisions, lending institutions are able to institute drastic cuts in the costs and time involved in the loan preparation. This in turn will allow total volume of credit to expand. Without a bureau, banks must use flawed demographically based application scores, which have little success in predicting default rates. Banks are more willing to lend against "behavior scores" which are based on borrowing and repayment histories and have been effective in reducing credit risk around the world. The use of scoring systems based on the borrower's credit history allows banks to decrease their costs by, first, lowering the cost of processing loan applications and second, by improving their ability to predict defaults and successfully manage credit risk portfolio.

One of the major reasons for the establishment of CIB in Nepal is to facilitate and strengthen the banking supervision. Nepal Rastra Bank could monitor the financial

institutions' use of credit reports in lending as part of the supervision process and use credit reports to support both on-site and off-site supervision duties. Statistical models could be used to analyze data and see the trends in banking and credit and calculate total indebtedness of borrowers with the financial system. As a matter of fact, CIB in Nepal was established in response to a virtual banking crisis prompted by defaults of large borrowers. Monitoring credit risks concentrations and informing individual banks of these risks remain a key objective for CIB. Information from the credit bureau can serve both objectives to allow banks to better assess the creditworthiness of borrowers and at the same time to the NRB to use the credit reports for the banks' supervision and systematic risk monitoring.

The NRB could use the credit bureau information for macroeconomic intelligence. This information can be considered by region, by sector and by quality of borrower and can be used to analyze the credit market and interest rate developments in detail. This information may be invaluable for NRB to understand the transmission of monetary policy and guide monetary policy decisions. The credit information bureau information can also be used by tax authorities to improve fiscal control and to analyze the effect of different tax policies on credit flows.

Thus, the CIB has a lead role to play in the growth of credit market in the country by benefiting consumers, bank & financial institutions, small and medium enterprise and regulator all alike.

Table 5 : Benefits of CIB

Entities	Benefits of CIB
Consumers	Faster and easier access to credit.
	Reduced cost of borrowing for applicants with demonstrated credit performance.
Small & Medium Enterprises	Reduces SMEs high risk perception among lenders
	Reduces cost of borrowing
	Faster, cheap & easier access to credit
	More economic development
Banks and Financial Institutions	Increased market penetration
	Operating efficiencies
	Shift to information based banking
	Comprehensive risk review of clients
	Enables differential pricing based on payment behavior
Nepal Rastra Bank (Regulator)	Reduces NPAs and default probability levels in the economy
	Provides credit risk monitoring mechanism
	Facilitates credit expansion without increasing risk

As bank lending has been on the rise in the past years, credit risks become more of a problem, and bank products such as mortgages and credit cards come into the market, the demand for better information on borrowers will tend to increase. Thus market will pressurize for greater need for highly efficient and effective CIB, one that is trusted, technically secure and easily accessible in real time. Banks are eager to expand their lending but want better assurances about asset quality.

In the face of growing loan demand and the impending credit assessment requirements of Basel II, banks have no way out but to develop a better understanding of analyzing and managing credit risk versus simply collateralizing loans; credit information from CIB is an essential ingredient in this process. Banking and Financial Sector Reform Program have set high priorities in increasing transparency, thus increasing the utilization of CIB.

Nepal has seen a rapid rise in credit market in the last couple of years and this trend is expected to increase with the stability in political and economic fronts of the nation. Liberalization of the economy and the proliferation of the banking and financing institutions coupled with growing business potentials in every sector have led to increased credit off takes in both commercial and consumer sector. There has been a huge surge in percentage of population taking this opportunity in favor of credit for financing housing, automobiles, motorcycles and consumer durable. The trend shows that consumerism is on the swing and credit culture is here to stay permanently in the lives of Nepalese people. Credit taking is not an issue of aversion and stigma any more but a vehicle for the better lifestyles. More credit flows into the market again increases the utilization of CIB.

Critical Success Factors for the Growth of CIB in Nepal

A. Enabling Legislation to Regulate Information Sharing and Create Rights and Obligation of All Parties (Legal and Regulatory Framework)

Nepal has no broad law that regulates information sharing. CIB operation has so far been completely governed by the NRB Act 2002, Article 88 where key provisions include (i) obligatory participation of financial institutions in CIB, (ii) a requirement to obtain a credit report before extending a loan and (iii) NRB oversight and regulatory authority over the operations of CIB. The current directive of NRB has blacklisting as the major focus area and all the details are revolved around this blacklist. This directive has become very controversial because of its sheer impacts on the growth of the business sector in Nepal. The extended list of parties that are affected by the blacklist will be denied the credits and will eventually be forced out of the business.

Without the appropriate legislation and regulation to enable the sharing of the data and information, a credit bureau is, for all practical purposes, ineffective. Governments can promote supportive environment for credit bureaus by enacting and enforcing laws that ease sharing of credit information; the relevant laws include bank secrecy regulations, data protection laws and consumer protection provisions. Laws & regulations must protect consumers and ensure that data is not misused by creating a balance of privacy protection and effective information sharing. The purpose is to allow responsible sharing of credit information while protecting the rights of individuals and firms. There is no legal framework prevailing in the country for the consumer rights and the rights to access and correct information. A legal environment for the operation of credit bureau is not clearly defined in the country. However, the NRB Act exempts operations of the CIB from bank secrecy provisions.

Since it is expected to see the rapid growth in retail and SME lending in the coming years, concerns about the data protection and consumer rights will be raised. As the market for mortgages and credit cards grows, the demand by creditors for more information on borrowers will grow concomitantly. Existing Credit Bureau Law in Nepal is not adequate for the information sharing that is necessary for the burgeoning credit market. The examples of other countries illustrate that enabling legislation must clearly

define the data that could be collected, retention period of the data (positive information), rights and obligations of credit bureau and other stakeholders and laws relating to information sharing. More transparent and equitable banking and data protection legislation, debtor and creditor related laws permitting enforcement of bankruptcy and some other regulatory requirements are prerequisites for the creation of effective credit information systems.

Box 1 : Essential Components of CIB Law

- The obligation, responsibilities and the rights of CIB, of the sources of information, of the users of information, and of the subjects of information.
- Responsibility for accuracy of submitted data, mechanisms for testing accuracy of data, and procedures in case of dispute on completeness or accuracy of data.
- Procedures for the creditor to notify the CIB if a legal or physical person is late in payment or has a delinquent account.
- The types of information permissible for CIB to collect and distribute. This includes the personal identification information, bankruptcies, payment records (including disputed and delinquent amounts), accounts both open and closed, duration of the retention of the credit history etc of the borrower.
- Definition of the sources and users of personal and business information and the associated payment data.
- The kinds of institutions that will be allowed to be shareholders/members of CIB. This may include the entities from within and outside the banking sector.
- Restrictions on access to the data
- Notification of the subject of the credit report if adverse action has been taken as a result of the report, such as denial of the credit or the denial of the employment.
- The right of subject of a report to request a copy of the data in their file and the sources of that information, the names of the requesters of the report on them in past one year and the summary of the subject's rights.
- Dispute resolution either through arbitration or court order

The legislation has to properly balance the ability of the institutions to exchange credit information while simultaneously protecting the individual's rights to privacy. In the Nepalese context, this could be done through enacting special credit reporting laws, which clearly incorporate the following major characteristics:

Open System: Reporting and access are open to financial institutions and non bank creditors such as utilities (telecommunication, electricity, water supply etc.), debt collectors, retailers and others. Public information access should be open to all market participants at a reasonable cost. The NRB Act, directives and guidelines may not be sufficient to address the huge customer base from different sectors. The CIB may need to have the Charter Act to address these regulatory problems.

Positive and Negative Information: Legislation has to enforce the sharing of both positive and negative information and laws have to be enacted that prohibits the banks to poach

the other banks good customers. The lenders usually hesitate to share the positive information about their best borrowers for the fear that the competitors might lure them.

Type of Data: The law should provide the clear guidelines on the kinds of data that can be collected. Data accumulation can be simplified if the regulation does not prohibit CIB from collecting any data that is relevant, accurate and meet certain quality standards.

Consumer Protection: Regulations regarding consumer protection is very vital since it gives the consumers the right to check their own information and complain to the bureau if they find any discrepancies in their credit report. Such a regulation will be an incentive for a borrower to settle its obligations in time and also provide an opportunity to prevent a fraud where any person attempts to use his name in a fraudulent activity. Further, allowing borrowers to access their own data will place a responsibility on reporting institutions to report data correctly and timely. Moreover, the borrower should have the right to dispute any error records and get any error records corrected. Regulation also has to focus on the issues of consumer grievance, dispute resolution, time to address the dispute, penalties to lenders for sending wrong information and bureau for inaccuracies in data recording, On the other hand, the lenders and the reporting agencies can make an inadvertent mistake while recording the information. In such cases, they have to be provided appropriate protection against legal action if they are found to act in good faith and due diligence.

There is a likelihood of suit, prosecution or other legal proceedings being filed against CIB, or the staff and officers of the CIB, its registered members (banks and financial institutions), or the staffs and officers of the registered members, for any damage alleged to have been caused or likely to be caused, in respect of anything done in good faith or intended to be done by CIB or its members, in discharge of their functions, in relation to collection, furnishing or dissemination of credit information. In such eventualities, CIB and its members need to be protected by way of including substantive provision in the legislation to be enacted in respect of establishment, functioning and regulations of CIB.

Length of Information Retention: The provision should be made in the regulation about the time frame the borrowers information has to be retained in the bureau database. If these records are deleted prematurely or immediately after settlement, it will reduce the predictive power of the lenders. Retaining and incorporating historical data will not be harmful to borrowers since CIB does not comment anything regarding granting or denying credit. Cut off date about the information storage so as to give the borrower a fresh start has to be stipulated. This includes the public records relating to the bankruptcy.

Permissible Purpose: Regulation has to permit the sharing of individuals information only for some identified purpose such as credit approval and other permissible services.

Authorized Access: Only authorized parties should be made to access the data for the permissible purpose. The provision may be made to write down the names of all parties who have accessed the data from bureau in order to ensure the borrowers for the compliance of authorized access.

Consent: Individuals' compliance in sharing their private information should be sought in any form in order to waive off any future legal cases emanating from consumer protection right. Regulation has to enforce the lenders to include Consent Clause of the borrowers to share the information while lending.

Enforcement: Legal and regulatory framework weakens without the strong enforcement agency and credit information bureau falters without effective regulation. Thus, it is critical that the regulatory body be strong enough to enforce the regulation and make the bureau work.

B. Appropriate Technology Infrastructure to Compile and Deliver Credit Reports

Credit information industry is data driven and the system has to be augmented continuously in order to capture the increasing volume of data. The information needs to be collected electronically in order to increase the speed of delivery and reduce mistakes. The efficient technology platform should be designed around the three basic requirements; first is collecting, validating and merging data; second is distributing the data through on–line system; and the third is providing the adequate physical and system security to the data stored.

The system built should ensure the accuracy and confidentiality of the stored records. It should enable lenders to send the data on-line in electronic formats. Back up systems should also be made available to store the data in case lenders send the data through other portable storage devices (DVDs, magnetic tapes, etc.). The system built should be such that it does not allow CIB to change the data supplied by the lender thus eliminating CIB's liability in case of error. Minimum information requirements will have to be filled up by the lenders before electronically uploading the files to CIB, and CIB has the right to accept or reject any files based on the quality of information sent. The system will automatically process to check the completion of all minimum mandatory fields confirming to the standard format and the quality of the data. This saves CIB from much of the data entry works and possibility of entry errors from its staff. The standard data requisition forms will be made available with minimum stipulated information needs which meets all national and local legislative requirements and is approved by NRB, the regulator.

The protection against hackers, procedure for backing up data, mechanisms for information retrieval in case of disaster or total system failure, automated periodic testing of hardware and software parameters has to be given the utmost priority. Security policy and disaster preparedness programs must be put in place.

The CIB at present has inadequate technological infrastructure. It maintains its database in poor software application system and is in the process to upgrade this system in order to provide fast, reliable, secured and error free information transaction to banks and financial institutions. The existing system provides web-based access to banks and FIs who could load their initial borrower data from their system to the CIB server whereas edited files and quarterly reports are sent either through email or hard copies to CIB, which is loaded manually to the CIB system again. There is no two-way on-line system between CIB and its member banks thus creating the delay in the updates of the information.

The present oracle-based platform is a mere transformation of old dBase system where the emphasis was placed more on transforming from an old character based system to implementing a Graphical User Interface to cater to increasing MIS capabilities. Once the software was put in place, no efforts were made to improve the software to increase its features and functionalities to meet the needs. The present system architecture works on client server technology, which is not robust and can not meet the growing demands of CIB. There are many operational problems with the existing system such as system administrator has to install the Oracle client and configure each of the machines to be

installed for making credit information system work. This means, Oracle client has to be installed in each workstation of the bank by the system administrator which is a huge exercise looking at the increasing number of banks and financial institutions in the country. The system administrator has to be specially trained in Oracle to run the system Thus the system is not user friendly and requires technical skills and incurs substantial maintenance costs.

As the immediate solution, CIB has recently introduced browser based on-line system to banks and financial institutions which redevelops the entire software to transform it to three-tier platform. The main objective is to put the on line transfer of information between banks and CIS system through a common internet browser present in any PC. The upgrade also involves the development and integration of many modules that is related with the operation such as billing, customer information and product development.

In the technology front, another critical factor that contributes to the growth of CIB is the awareness among the lending agencies to automate their systems accordingly in order to make them compatible with CIB system for the on-line data transfer. Not all banks are fully automated. Many have inadequate electronic data and the inadequate networking and computerization magnifies the data collection difficulties. Lack of networking capability of banks with CIB system will hinder the process of data collection and dissemination irrespective of how advanced CIB system is put in place. CIB could derive the total benefits only if there is parallel growth of technical and IT capability of the lending agencies. The financial institutions have to be aware of this and automate their system to properly integrate with CIB system.

C. Scope of Information (Positive and Negative)

Credit information systems are most effective and enhance risk prediction if they contain both positive and negative information. CIB should store the information not only on defaults but also on all opened and closed credit accounts including the amount approved as well as information on repayment. The CIB should adopt to most advanced information sharing arrangement that may include the debtor’s overall loan exposure and guarantees, data from the past credit history other than defaults and arrears and debtor characteristics such as employment, income or line of business. Both positive and negative credit information such as payment history, number and kinds of accounts, number and frequency of late payments and any collection or bankruptcies has to be included.

There is strong empirical evidence that systems that collect both positive and negative payment histories permit more accurate risk assessments. Information should include not only the data on defaults and delinquencies but also on loan paid on different time. Only negative databases have several shortcomings compared to those with complete (both positive and negative) information. Negative information alone has less predictive power than positive information and negative information combined and the decision tools such as credit scoring are difficult to develop without positive data. Databases with only negative information then tend to focus only on reducing “willingness to pay” and not on enhancing predictions on repayment probabilities. The sharing of positive information allows the debtor to create vital “reputation collateral” often in the form of credit score which can provide valuable information to the credit market and signal a borrower’s credit worthiness to a large pool of lenders. The positive information helps to mitigate borrower over-indebtedness, lower default rates in the overall credit market, and to reduce equilibrium interest rates. Lack of positive information in the report poses a significant

threat to the sustainable growth of retail and SME credit market in the country. So far, CIB does not provide the historical (positive) information but only the latest exposure (negative) information of the borrower available at the end of the last reported quarter.

Another critical factor for the growth of CIB is the threshold level of credit information collection. Credit information systems are most effective and enhance risk prediction if they contain data on large segment of the population. The more ubiquitous their coverage, the better they can serve financial institutions in evaluating applicants for credit. High threshold or cut off will exclude most consumer credit information which hurt small borrowers who benefit most from positive credit reports and reputational collateral. Existing higher limit of 2.5 million on loan size for which information is collected has substantially reduced the bureau's outreach and many smaller loans go unreported.

The CIB needs to include data from all sources, including other non-bank financial institutions, retailers, and non-financial firms that issue trade credit. CIB should expand its user base to non- bank creditors such as telecommunication, electricity, micro-finance that will further enrich the composition of CIB database. This kind of cross industry data base will develop the predictive power of the inquiry data base as the credit patterns and the payment schedules of the clients on other industries may be indicative on the future defaults on bank credits. Important sources of credit data also include retail credit, trade credit and information from the non-regulated financial institutions such as independent credit card issuers. CIB should dedicate significant resources to obtain data from other sources such as court records and diverse public database, which may not otherwise be readily available. The database always needs updating and fine-tuning and it needs to grow in depth and breadth as the volume and type of the users change.

Given economies of scale consideration, it also makes sense to create regional networks for national credit information providers, which in turn could be linked by internet with the global players. Setting up of the regional hub and sharing the information with regional credit bureaus will help to reduce cross border financial crimes and disappearance of promoters in neighboring countries, mostly in India.

D. Timely Data Submission and Update

More accurate data frequently gathered should be the operating principle of any credit bureau. The credit information update cycle should be as short as possible in order to maintain the accuracy and timeliness of the information.

Information in CIB is collected on quarterly basis. Time lag in sending the information by banks and financial institutions and processing that information in CIB will result in providing obsolete information to the lenders. The updated and quarterly reports are received through email and hard copies. They do not arrive on time and only 30% of the information happens to arrive by the end of next quarter. Thus, there is the serious problem in updating the information which gets obsolete before it arrives to CIB. Among those delayed information, most of the files have to be rechecked, revalidated and many of them have to be returned back to the lenders for the verification. Even the initial hard copies do not arrive on time. In spite of the fact that initial borrowers' information could be sent through on-line, many banks especially government-owned banks, Nepal Bank Limited and Rastriya Banijya Bank, and other small banks and FIs resort to sending the information in hard copies making the data entry more cumbersome and difficult. This delays the whole process and makes the data obsolete thus losing its value to the creditors.

E. Standardized, Accurate and Complete Data

Lack of standardization in data formats may be a stumbling block in enriching the quality of data that eventually restrains the growth of CIB. It is essential that banks and FIs store customer information in a format that allows the credit bureau to easily extract the information to upload to its own system to further match and merge with other data. Correct information such as name, address, date of birth is essential to enable the merging of credit reports for the given borrower to form a complete credit history of that borrower. The banks and financial institutions store data in different formats and styles. Some banks choose to store data in single strings rather than in structured database, while some banks use surname first and others with initials and some with only surname. Addresses in Nepal are equally challenging. Residential addresses are not correct and many use office address, post box and c/o etc. Date of birth is also put in different orders. This lack of consistency among banks in data formats creates problem during information searching. There is no referral identity for the borrower as in developed countries.

F. Government and NRB Support to Enforce Basic Regulations for the Bureau

In Nepal, the credit information market is not demand driven. Many banks' and financial institutions still seem reluctant to ask for credit information from CIB before lending and are hesitant to share their borrower's credit information to CIB. Current mandatory requirements of NRB should be continued and more strict regulations and punitive actions should be in place for any breach of NRB directives relating with the sharing of credit information.

G. Public Awareness

Because CIB is the first of its kind in the country, people in general have no experience and little familiarity with its functions. The CIB must therefore institute extensive consumer awareness exercise to help the consumers comprehend the utility of an effective credit registry for credit decisions. The CIB in Nepal is known for the wrong reasons which are detrimental to its growth. The consumers have the wrong notion that CIB is an entity established to publish the list of blacklisted borrowers. This wrong notion has to go from the people's mind in order to enhance the image of CIB. People have mostly been hearing from the media about the court cases pending against CIB relating with blacklisting. This kind of media coverage where CIB is projected as the entity with iron fist has certainly sullied the image and made people apprehensive about its revered objectives of information gathering entity only.

In emerging economies like Nepal, where the CIB is still at its nascent stage, it takes many years for it to evolve, flourish and gain acceptance among its users and subscribers. There is the need for the people to be educated about the CIB, its objectives, responsibilities and its importance for the economy. The public needs to be educated about the benefits of information sharing and how their credit information are preserved and protected in the Bureau. The Bureau must help overcome lender's distrust of their information and consumers must be assured of the security of their information. Lenders fear that by sharing positive information, their competitors will learn about and poach their good customers. These perceptions need to be changed. The users and lenders must be assured that the CIB is a safe and secured entity. The CIB should explain the role and nature of credit information sharing process to mitigate general concerns about sharing of personal information and inform them about its obligations to respect the privacy of consumer data.

Issues and Problems

* The major obstacle in the efficient and effective operation of CIB in the country is an unwillingness or reluctance on the part of commercial banks and financial institutions to (a) expose the extent of their own bad loans and (b) expose the information about the past records of good borrowers (c) exchange proprietary or confidential information with others for fear of loss of their comparative advantage and market share. In spite of the fact that banks are sharing the exposure data, there is the discontent in sharing the positive information. One issue is the concern of lenders that in sharing their positive customer information through a credit bureau, information may be misused by a competitor.
* Another serious problem faced by the CIB is the quality of the data in its database. Many borrower records have no complete borrower's identification, inaccurate identification and inaccurate & old exposure information which ultimately diminishes the quality of data available with CIB. The problems in confirming customer identity (lack of unique identifier) and difficulty in confirming business ownership and legal status have affected the quality of data.
* Difficulties also pertain to delays by government/regulator to create the appropriate legal regime for credit bureau and confusion prevailing whether to go for Charter Act or simple modifications on the existing NRB directive. There is lack of appropriate laws for data collection, management & usage, lack of clarity with respect to privacy and confidentiality of information and lack of definition as to who has access to data in CIB. Lack of all this will remain the major impediment to build an efficient & effective CIB.
* Ongoing domestic political instability that produces (a) cautious and fear, preventing normal business transactions, including loan issuance and repayment, or (b) conflict that damages incomes/collateral is another obstacle.
* Another problem is the lack of confidence in financial institutions, such that banks are risk averse and do not lend or lend only at high risk premium and multiples of collateral, shutting out SME sector and entrepreneurs. Banks are risk averse due to insufficient borrower payment records, lack of authentic documents and an anti-creditor bias in the court system.
* The regulator is not effective in overall supervision and control of the financial system, contributing to the non-compliance of the NRB directives to a greater degree. Noncompliance and corporate indiscipline may hamper the credit information sharing to develop an open system.
* Apart from CIB's own technology infrastructure, another problem stems in the technical front where many banks and financial institutions do not have IT system in place. Compatibility remains another issue while interfacing with CIB system. CIB can not go on-line unless all the lending institutes upgrade their IT and make their system compatible for the data transfer.
* Poor capacity building and institutional development of CIB (lack of business know how, technical expertise, international exposure etc) also act as constraints. Current management and technical staff may not have the experience or the skills required to bring about the major changes that would be required to develop and operate a fully functional credit reporting service. This should not be read as a criticism of current management's effectiveness or ability to manage the present service. It is simply recognition that managing a modern credit reporting service of international standard requires a trained and an experienced team of professional credit bureau personnel.

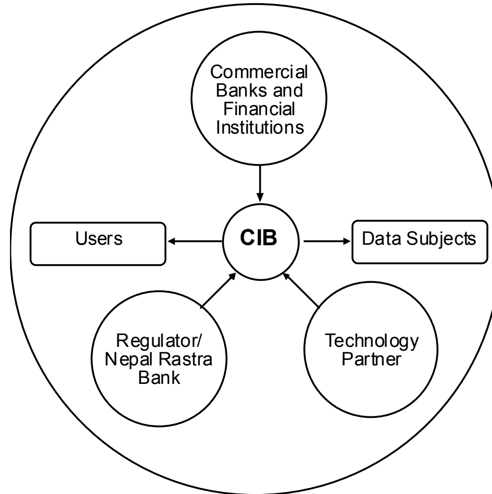
* Another problem relates to the culture or history that (a) discourages individual risk taking, competition, and market mentality, (b) values secrecy and discourages information sharing and (c) has little experience dealing with banks and instead borrows from informal sector yielding little debt payment history for the CIB.
* Lowering of threshold is necessary to penetrate the credit market and enrich the data banks. But it has been observed that banks and financial institutions are not ready to cope up with the historical massive volume of files and data to be sent to CIB due to their poor record keeping, poor IT infrastructure and absence of separate credit information cell to manage the information flow to CIB on a regular basis.
* There is the lack of awareness even among many banks and FIs about the importance of credit information sharing. Unless made mandatory, many banks and FIs lack seriousness to share their credit information to CIB. The lenders still fail to see the importance of credit information sharing in enhancing their portfolio quality and adding more values to their services.
* Blacklisting is inhibiting the growth of credit market. The extended list of parties that are affected by the blacklist provisions has serious repercussions on the growth of credit market in the country. Labeled as “draconian” by the business community, it has contributed to restrain the growth of entrepreneurial culture in the business and investments. Apart from this, the borrowers are inclined to give minimum or inaccurate personal identification and business information in order to avoid the impacts of blacklist provisions on their other businesses.
* Some blacklist provisions may lead to false data and encourage fraudulent practices. Empowering the authority to the Board of Directors of banks and financial institutions to recommend delisting any borrower from the blacklist on the ground of “enough convincing reasons” may lead to unethical practices to provide false data and engage in fraudulent practices.
* Article 88, Sub Article 1 (Cha) introduces another conflict of interest where CIB, which is now a public limited company with partial ownership by financial institutions, is made to conduct inspections of banks & FIs. This requirement seems completely out of place and is contradictory to the basic theme on which CIB is established. This responsibility should be solely rested upon the NRB and other government agencies rather than on CIB.

Strategic Steps to Improve Credit Information Bureau

A. Set up Strategic Alliance with International Technology Partner

The success of any credit bureau depends largely on its structural orientation that fits well in the environment that it works with. The existing ownership structure model where creditors own and operate the bureau is perhaps the best model in the Nepalese context but additional stakeholder could be further included in it to make CIB highly effective and growth oriented.

Figure 1: Structure of CBI



The additional stakeholder should come in the form of technology partner who may have the stake in CIB operations. There are many advantages of this model as it addresses all the current needs of CIB. The participation of technology partner will bring the technology, expertise, resources and other know-how required for the efficient operation of CIB. The participation of commercial banks implies their commitment to share data and ensures CIB's sustainability. NRB's participation gives more credibility to the venture. The inclusion of technology partner in the venture ensures CIB's commitment to provide best state of the art credit information services to the clients and boost clients' confidence on the accuracy, quality and security of the system.

While selecting the technology partner, it is always good to analyze what CIB needs and intends to achieve from the partnership. As far as technology is concerned, it can be built in-house or outsourced from the international solution provider. Decreasing cost of hardware and software systems and ability of developers to customize the solution as per the local needs of operator has attracted many operators to buy it from external sources rather than built in house. The local software developers (like Worldlink, Mercantile & others), though fairly good in developing programs, are least exposed to credit bureau management system and have no expertise on it. They can not invent, add value and create solution on the existing system.

Table 4: International Standard Practice and CIB in Nepal

International Standard & Best Operational Practices for Credit Information Bureau Management	CIB in Nepal	Solution
Full spectrum positive and negative reporting of consumer and business loans.	No. Planned to begin soon.	Legal & regulatory provision
Flexible, adaptable systems.	No	Technology upgrade/ Scalable system design

System enquiry response times of less than five seconds.	24 hours	Technology upgrade/ Web based online system
On-line maintenance and data matching programs.	No	Technology upgrade
Customer focused & constant attention to emerging trends in credit and financial services.	No	Operational expertise in analyzing trends in finance & banking sector.
No minimum amount exclusion on loan information.	All loans less than Rs. 2.5 million are excluded.	Legal & regulatory provision to cover all loans/, high capacity system design to capture high volume data.
Database enrichment from on-line enquiry data.	No. Planned to begin soon.	Technology upgrade/on-line system
Widespread bureau customers (credit providers).	No. Only banks and financial institutions	Legal & regulatory provision for user diversification, operating efficiency & technology upgrade
Coverage of credit active population and business in excess of 90%.	No. very limited coverage	Legal & regulatory provision, operating efficiency & technology upgrade
Open access communications systems providing a range of on-line enquiry access options to bureau customers including internet, dial up access and mainframe to mainframe links, or batch processing.	No.	Flexible technology llatform availing the open enquiry access systems.
Standardized report formats.	Yes.	Regulatory provisions empowering CIB to develop new report formats as required by the market.
Proactive research and development of new products and services.	No.	R&D center for the development of new value added products.
Extensive range of products and services.	No.	Operational expertise in marketing, finance & new product developments.
Secure, robust system backup and data security.	Yes but requires best international practices in data & system security management.	Highly sophisticated data protection system to be introduced/technology upgrade
Sophisticated data error detection and editing.	No.	Technology upgrade
Extensive on-line and face to face customer training systems.	No.	Operational expertise in on line customer service.

Data subject access and correction procedures. Usually a consumer relations department with provision for personal interviews and toll free telephone access for data subjects.	No.	Operational expertise
Dual language credit reporting system, English and Nepali.	No.	System upgrade.

The immediate need for CIB now is to introduce on-line system to facilitate the transfer of credit information between banks and CIB. Improving the IT infrastructure and ensuring data confidentiality and security will remain the prime concern of CIB. Looking at the complexity and sensitivity of the data held by CIB, there is the need to introduce the best international practices in data security and confidentiality in order to gain acceptance among other global and regional credit bureau operators. The existing CIB falls short of best international practice and does not deliver the service standards that are required. System functionality is limited and the range of products and quality of service delivery falls well short of those provided by the leading private sector bureaus.

Technology partner has the expertise to reinvent the whole system and add more value on it. Technology partner brings the proven technology solution and application support systems customized for local needs which will focus on areas of financial infrastructure and credit bureaus, central bank interfaces and inter-bank information exchanges. The technology thus acquired will enhance the competitive advantage of businesses by fusing analytics and technology to provide customized solutions in predictive modeling. Its participation not only can provide the required technology and technical expertise but also more importantly can lend its reputation, crucial business know-how and expertise to continuously develop new value added services as the bureau grows and market matures. The solution will include special data integration & data quality management components not only for credit bureau itself but also for its members, thus enabling banks and financial institutions to transfer data from their proprietary system to credit bureau.

In particular, a reputed and experienced foreign partner is expected to offer the following:

* Credit bureau domain expertise and in-depth experience in Credit Bureau IT & operations management;
* Domain expertise in banking and finance, legal issues, credit risk, operations, analytics and econometrics that helps determining structure and quality of the data to be collected, readiness of institutions for bureau membership, assessing the existing infrastructural capabilities and challenges in the country's financial environment;
* Experience in business, financial and demographic data management, set-up of mechanisms for unique and universal identification of companies and individuals;
* On-field experience with emerging markets' credit environment, risk management expertise and strategy focus through strong regional presence;
* Exposure to and consulting on the legislation and regulatory issues in emerging and developing markets across the region and globally.

Experience elsewhere has shown that the active ongoing participation of one of the major international credit information at a board and operational level can be of benefit by bringing a broad level of practical experience to bear on any issues that may arise. The possibility of equity participation for a system supplier may provide additional flexibility in negotiating software license, fees, set up costs and access to new products. Technology partner's long term associations as the equity partner will help to build confidence among the banks and finance institutions of the country and encourage them to continuously support CIB initiatives to develop the products and services that meet their needs in the future.

Equity partnership such as in India and Sri Lanka where CIBIL and CRIB have tied up with Dun and Bradstreet, have contributed to the significant growth of the respective credit bureaus in the last few years. The credit bureaus in Thailand, Malaysia, Pakistan and other regional countries have set up strategic alliance of one kind and another with international technology partner. Bhutan is the new country in the list, which has recently signed up with Dun & Bradstreet to introduce the latest credit bureau system in the country.

B. Develop the Charter Act

A Charter Act should be in place that addresses all the relevant issues of credit information sharing such as consumer protection, data retention, permissible purpose, authorized access, issues of consent, enforcement, open system and others. The legal and regulatory framework for governance of CIB should encompass the following points:

- Register, license and regulate credit bureaus, data providers and credit information recipients.
- Maintain proper standards of conduct and acceptable credit reporting practices.
- Regulations & rules for the proper functioning of the institutes.
- Protect the integrity of the credit reporting system against any abuses.
- Impose penalties for the breach of this act.
- Define permissible credit bureaus activities
- Data privacy and protection provisions.

Given the broad legal framework in Nepal and the lack of clarity with regard to which laws will apply to a future CIB and when private information sharing is permitted, the necessary conclusion is that a separate CIB law should be passed. It would provide clarity and protect stakeholders; it would define precise and specific delegation of rights, boundaries and allowable practices; it would help legitimize and accelerate the process. Clear cut limits of liability will protect the CIB from lawsuits that could arise when a defaulter sues CIB because his reputation has been sullied by the information contained in the CIB data base and released to creditors.

Litigation could also arise regarding the accountability of commercial banks for sending incomplete, untimely or false personal information to the CIB. To prevent the stifling of the credit expansion, creditors need to be protected from judicial interpretations of the vague laws that in the past have resulted in creditor's claims being denied. Many cases have been pending in the court because of the defaulters taking the advantage of broad

provisions of different kinds of laws of the country to convince courts that they are exceptions to this law, thereby avoiding payment of their obligations and being labeled as defaulters or blacklist.

So, CIB needs to be legally empowered with exclusive charter act if it is made to face legal issues independently. For this, the parliament of Nepal should pass a new law on CIB where issues such as security, confidentiality, accuracy and trustworthiness of the information are addressed and the legal rights and duties of all stakeholders are clearly defined. While amendments on the existing NRB directive might be a solution for the short term, it would not be in the CIB's long-term interest or commercial safety to leave a gap in the legal framework.

C. Extend the Scope & Diversify the Database

Provision should be made in the Charter Act to empower CIB with wide powers to collect credit information from all sources including utilities and non-banking financial institutions and make those agencies statutorily obliged to provide whatever credit information the Bureau wishes to collect from them. Existing legislation regulates information exchange only within the context of banks and financial companies. Once the Charter Act is enacted, the law will permit the information exchange from the other sectors as well. The introduction of new users can have a profound effect on the composition of the bureau databases and, therefore, the predictive nature of the data. The credit data relating to borrower's information should be augmented along with other forms of information such as electoral rolls, identity records, court judgments, telephone numbers, and company registration numbers. This additional information will be very useful in developing value added products and for data mining and modeling. It takes many years to bring the maturity in the database before applying its usage in the various kinds of products and services.

With the upgrade of the technology and on-line system in place, the threshold level should be brought down substantially to expand the coverage of the borrowers in the economy and include SME and consumer financing. The minimum loan size increases the scope of information that helps to penetrate the SME credit market. The objective is to facilitate inclusion of the informal sector in the formal economy.

To maintain useful representative data in the Credit Bureau, it is important to constantly encourage further data sharing between users of the services. The most important stage in the development of the database is the persuasion of lenders to share not just accounts with poor payment history (negative data) but also those with good payment history (positive data). The sharing of positive data is a trigger to the development of more advanced and effective products that help both lenders and consumers. Consumers with good credit histories can borrow to more equitable limits, receive lower interest rates and get access to more credit products. Lenders can make better lending decisions, use risk-based pricing methods more effectively, actively manage credit lines, collect debt more successfully and reduce fraud. Because of the overall level of consumer indebtedness that can be calculated it is easier to determine the probability of default and the potential loss, both aspects that help in adherence with Basel II.

Frequency of information collection should be increased to make the information current and updated. Quarterly information collection period should be reduced and the Bureau should collect information on a monthly basis. The long gap in the data collection

diminishes the accuracy and timeliness of the information. The on-line interface will reduce the processing time and provide more timely credit information to banks.

D. Conduct Awareness Campaign

For the Credit Bureau to get the acceptance from the lenders, consumers and general public, there is the need to educate them about its objectives and how it benefits the people and economy alike. Consumers in this part of the region are not accustomed to sharing their personal information and are least exposed to these kinds of practices. Lenders are usually scared of their competitors who will know about their good borrowers whereas general borrowers get worried about the confidentiality and security of their information. It is an irony that in spite of its seventeen years of operations, CIB still is unfamiliar to the people of the country about its functions and role in the economy. Even many institutions involved in the finance sector are unaware of its major activities.

Apart from upgrading the system and making the Bureau efficient and effective, there is the need to put the parallel efforts in building the awareness among the lenders and their clients, the general public, government officials, policy makers, regulators, and other potential participants in the Credit Bureau through various sources of media.

Table 5 : Awareness Focus Area

Entities	Awareness Focus Area
Banks & Financial Institutions	Sharing of positive information.
	Benefits of credit information sharing for credit market growth.
	Security & confidentiality.
	Credit control methods & procedures.
	Co-operation and participation.
General Public	Obligations and concerns of Bureau for the security and confidentiality of consumer data.
	Emphasize the importance of borrower consent to enable data sharing.
	Benefits of the Bureau to the consumer.
Regulators, Government officials & Policy Makers	Their roles in extending support to Bureau in making laws, policy & regulations conducive for Bureau's growth.
	Importance of Bureau to the economy and the government.
	Highlight the need for appropriate privacy and data protection legislation.

Way Forward

Some recommendation for enhancing the effectiveness of CIB are the following:

- Set up strategic alliance with technology partner. Build appropriate technology platform to meet the existing demand and future potential needs of the finance sector.

Upgrade the existing system to expedite the on-line data transfer between CIB and its members.

- No minimum amount exclusion on loan information. Cover all credit active population and business.
- Increase the scope of information and diversify user base. Include the members from across the industries (utilities and other non financial institutions).
- Update and correct all the existing credit information and blacklist data. Enrich the quality of the data in the database.
- Drive the banking & finance sector with innovative products and services that brings efficiency in the operation of the banking and financial institutions.
- Work with NRB to make required changes in existing Act and Directives and develop the Charter Act to empower CIB to enhance its efficiency & effectiveness. Put more emphasis on developing legislation required to facilitate information flows among diversity of users from across the industries.
- Work closely with lenders and other concerned authorities to develop the necessary algorithms and methodology for the standardization of data.
- Create awareness among the people about the role of CIB in promoting financial sector growth and the relevance of storing the people's proprietary information. Develop the confidence of banks & financial institutions, general public and regulator on CIB.

Action Plans

CIB has taken recourse of the local vendor to upgrade its existing system to make it on-line to facilitate the data transfer between CIB and member banks. The system is already in place and the member banks can now transfer data on line.

IFC will assist CIB through its Technology Assistance Program in the areas of institutional development and capacity building. This includes development of regulatory framework and vendor partner selection. Technology Assistance Program will begin from January 2008.

CIB is expected to set up strategic alliance with technology partner by the middle of 2008. And the new system starts rolling from the middle of 2009. By the end of 2009, the country will have in place a highly advanced Credit Information Bureau of the international standard providing various kinds of credit information services to banks and financial institutions of the country.

Some additional regulatory provisions have to be made in the existing NRB Directive to comply with the immediate operational requirements of CIB before the enactment of Charter Act. The draft for the regulatory changes has been prepared for the submission to NRB for its final approval. Charter Act will take final shape after the consultation with IFC experts to comply with international regulatory benchmarks. Charter Act is expected to be ready by July 2008.

CIB is planning to bring out various awareness programs to the people through different medias.