FINANCIAL STABILITY REPORT

Nepal Rastra Bank

Central Office

Baluwatar, Kathmandu

July 2012

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(July 2012| Issue No. 1)

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Published by:

Nepal Rastra Bank

Central Office

Banks and Financial Institutions Regulation Department

Baluwatar, Kathmandu

Nepal

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FOREWORD

Financial stability has been key challenge to the central banks especially at the aftermath of global financial crisis and they have also been mandated to ensure smooth functioning of the financial system in the country. This requires an understanding of the key macroeconomic trends, banking system dynamics, and sources of risk in the financial system. As the central bank of the country, Nepal Rastra Bank has been entrusted with the responsibility of promoting and maintaining financial stability in the country. In order to assess whether the financial market is performing efficiently and effectively, it is necessary to have a deep look at the trend of financial soundness indicators and adopt the warranted policy measures. Thus preparing the financial stability report can be a way to better understanding of overall performance and resilience of the financial system, which would ultimately contribute to maintaining financial stability. In this context, the NRB has initiated the preparation of Financial Stability Report (FSR) from 2012 onward on a half yearly basis.

As we know, financial stability reports provide information on the structure of financial systems, recent trends in banking and finance, and the impact of the global economy on local financial markets. It is our first attempt to present the Financial Stability Report to share information and ensure transparency in the functioning of the banking system. The report outlines Nepal Rastra Bank's assessment of risks and threats that could jeopardize financial stability in Nepal and the capacity of the system to withstand potential shocks. It also reports the regulatory and supervisory developments, including the measures undertaken by the Bank to ensure financial stability. This publication aims to promote greater understanding among various stakeholders of the financial system on issues and developments affecting financial stability.

This FSR is prepared by Financial Stability Unit and Financial Stability Working Committee under the guidance of the Financial Stability Oversight Committee (FSOC), which is chaired by senior Deputy Governor of this bank. This assessment is based on the data of mid-July 2012 unless otherwise stated; and it is divided into five main chapters along with a brief executive summary of the report in the beginning. Chapter One presents introduction on financial stability. Chapter Two deals with the global and domestic macroeconomic outlook and its impact on stability. Chapter Three covers the developments and status of financial institutions. Chapter Four deals with the current trend and developments in financial markets. Finally, the Fifth Chapter discusses about financial sector policies and infrastructure.

This publication has come out with the hard work of our staff and senior officials. In this context, I would like to thank the Financial Stability Oversight Committee (FSOC), Financial Stability Working Committee and Bank and Financial Institutions Regulation Department of this bank, particularly the Financial Stability Unit and the whole team for bringing out this report.

I would like to offer my thanks to them all for their enthusiastic involvement and valuable contribution in this work. I recognize the tiring efforts done by the officials of Financial Stability Unit, notably Executive Director Mr. Bhaskar Mani Gnawali, Director Mr. Purna Bahadur Khatri, Deputy Director Mr. Ramu Paudel, Ms. Niva Shrestha, and Mr. Buddha Raj Sharma in bringing out this report on time. I would also like to thank for the assistance provided by Director Dr. Bhubanesh Prasad Pant and Assistant Director (Computer) Mr. Sanu Bhai Maharjan of Research Department for their valuable contribution to bring this report in this shape.

I hope this report will facilitate the path of our financial stability effort in the days to come. This should also be useful for those interested in research on financial stability and in the area of Nepalese financial economics.

Dr. Yuba Raj Khatiwada
Governor

ACRONYMS

ABBS	Any Branch Banking System
AMC	Asset Management Company
AML	Anti Money Laundering
BAFIA	Bank and Financial Institution Act
BFIs	Banks and Financial Institutions
BIA	Basic Indicator Approach
BIS	Bank for International Settlement
CAR	Capital Adequacy Ratio
CD Ratio	Credit to Deposit Ratio
CDS	Central Depository System
CFT	Combating Financing of Terrorism
CIC	Credit Information Centre
CIT	Citizen Investment Trust
DCGC	Deposit and Credit Guarantee Corporation
DFID	Department for International Development
DOEC	Department of Cooperative
DRT	Debt Recovery Tribunal
ECC	Electronic Cheque Clearing
FINGO	Financial Intermediary Non Governmental Organization
FIU	Financial Intelligence Unit
FSB	Financial Stability Board
FSR	Financial Stability Report
FSI`	Financial Soundness Indicator
FSS	Financial Sector Stability
FSTAP	Financial Sector Technical Assistance Project
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GFSR	Global Financial Stability Review
GON	Government
ICT	Information Communication and Technology
ILMF	Institution-wise Liquidity Monitoring Framework
IMF	International Monetary Fund
INR	Indian Rupees

IT	Information Technology
NBL	Nepal Bank Limited
NCHL	Nepal Clearing House Limited
NEPSE	Nepal Stock Exchange
NOP	Net Open Position
NPL	Non Performing Loan
NRB	Nepal Rastra Bank
PCA	Prompt Corrective Action
RBB	Rastriya Banijya Bank
ROA	Return on Asset
ROE	Return on Equity
RSRF	Rural Self Refinancing Fund
RTGS	Real Time Gross Settlement
SACCOS	Saving and Credit Cooperatives
SLR	Statutory Liquidity Ratio
SOL	Single Obligor Limit
SSA	Simplified Standardized Approach
STR	Secured Transaction Registry
STRs	Suspicious Transaction Reports
T-Bills	Treasury Bills
TTRs	Threshold Transaction Reports
USD	United States Dollar
WB	World Bank
WEO	World Economic Outlook

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EXECUTIVE SUMMARY

1. Financial stability is a situation in which the principal components of the financial system viz. financial institutions, market, and infrastructure are performing their functions smoothly and are capable of withstanding various shocks without any disruption in the operation of the financial system. Financial stability has been a prime policy concern for central bankers especially in the aftermath of Global Financial Crisis (GFC). Moreover, the recently unfolded Euro sovereign debt and financial crisis is seeking an appropriate and timely policy response to address the crisis. The emerging post-crisis issues are focused at a more integrated approach to financial sector regulation with focus on systemic interconnectedness among various financial sector entities apart from micro prudential surveillance of individual institutions. Promoting financial stability seeks for a greater coordination among macro-economic policies, monetary stability, soundness of the financial sector, presence and quality of a financial sector safety nets, and efficient regulatory governance.

2. In the context of today's globalised world, threats to financial stability in one economy may spillover to other economies leading to GFC. Therefore, initiatives should be taken both at the national and global levels to preserve financial stability. International institutions like International Monetary Fund (IMF), World Bank (WB), and Bank for International Settlements (BIS) track, and promote financial stability globally. A recent initiative by G-20 leaders to establish the Financial Stability Board (FSB) is expected to improve financial system vulnerabilities and enhance coordination among financial regulators and supervisors to address risks in the financial system.

3. Nepal Rastra Bank (NRB), being the Central Bank of Nepal, has been entrusted with the responsibility of maintaining financial stability in the country. NRB aims to fulfill its role in maintaining financial stability through monetary policy, prudential regulation, and supervision of

individual financial institution, oversight of the whole financial system, crisis management and resolution, among others.

4. The nature and intensity of the impact of the global crisis on Nepal is considered to be different from those in some of the developed economies. The financial sector remained resilient and functioning, despite slight volatility of liquidity and interest rate of banks and financial institutions (BFIs) because of low growth of remittance inflow and excessive investment in real estate sector. The stress on the balance sheets of banks and financial institutions was because of their inefficiency to foresee the risk in real estate sector and lack of efficiency in portfolio management. No solvency issues with any of the financial institutions required direct financial support from the Government as in developed countries.

Global Outlook

5. The world economy has not recovered fully from the recent financial crisis that originated from the USA coupled with European debt crisis. IMF has recently made a downward revision in economic growth of advanced as well as emerging and developing economies amid increased risks and uncertainty to global growth prospects. The revised estimate of global output for 2012 is 3.5 percent while the world economy is projected to grow by 3.9 percent in 2013. Inflationary pressure has been moderating in many parts of the world as demand softens and commodity prices recede. However, upside risk persists, as global inflation is likely to be largely influenced by food and energy prices in the days to come.

Studies shows that risk to global financial stability increased due to weak confidence on global financial system. Major risks to global growth include fiscal weakness and sovereign debt problems in the euro area, continued high unemployment in many advanced economies, banking sector default risks prevailing in some regions and continuance of high energy, food and commodity prices. *IMF's World Economic Outlook October 2012* suggests that in order to address the prevailing financial risk, concerned authorities should give top priority in enhanced risk based prudential regulation and supervision and macro prudential measures.

6. The exposure of the Nepalese financial system to the global markets is relatively low. However, with the growing integration of Nepal with the world economy especially in the area of trade and service and dependency on foreign employment, the country indirectly being exposed to the global forces, shocks and vulnerabilities. Moreover, financial shocks that are transmitted to India through exchange rate channel also transmitted to Nepal due to fixed exchange rate regime in Nepal with India. Therefore, the contagion impact of the global macroeconomic shocks on the Nepalese financial sector cannot be ruled out.

Domestic Outlook

7. Real GDP growth increased by 4.6 percent in 2011/12 compared with 3.9 percent in 2010/11. A timely monsoon boosted agricultural output, while the services sector benefited from robust growth in remittances. Industrial sector performance remained lackluster, mainly due to power shocks and sluggish growth of capital expenditure of the government.

8. The Nepalese economy experienced inflationary pressure since the last few years. However, average inflation declined to 8.3 percent, mainly due to lower food prices compared to previous year. Yet, non-food and core inflation remained persistently high throughout the year—hovering around 9 percent on average. On overall inflation, non-food prices appear to have been driven by multiple increases in administered fuel prices, exchange-rate depreciation, and rising wages and salaries. Therefore, anchoring inflation expectations and containing overall inflation have become imperative.

9. The overall budget deficit has come down substantially in recent years due mainly to a sluggish growth of expenditure, especially capital expenditure relative to resource mobilization in 2012. Revenue gains were notable, particularly in the second half of the year as tax administration reforms bore

fruit. Customs, VAT, and income tax all exceeded budget targets. An early surge in current spending was contained through austerity measures, while capital spending continued to under-perform the budgeted level due to capacity constraints.

10. The balance of payments stood in a record surplus of Rs.127.70 billion driven by elevated level of remittances and service income. The remittance to GDP ratio stood at amount for 2012 is 22.3 percent. In terms of GDP, Nepal has remained the sixth highest receiver of workers' remittances in the world in 2012.

11. The outlook for 2012/13 is challenging owing to continued political uncertainty, and late monsoon, delayed budget, and India's slowdown. Therefore, growth for 2012/13 is projected to be around at 4 percent.

Financial Institutions

12. Nepalese financial system has witnessed rapid growth in terms of number of institutions and services since the last three decades with the adoption of liberalization policy in 1980. The institutional network and the volume of operations of the financial system has expanded and diversified, with the number of depository institutions and contractual saving institutions reaching 272 and 28 respectively in mid-July 2012. The monetary policy is directed towards maintaining financial stability including price, exchange rate and balance of payment stability, increasing access to finance and consolidating financial sector by emphasizing merger policy, good governance as well as improving regulatory and supervisory system.

13. In mid-July 2012 the commercial banks remained the key player in the financial system contributing 51.1 percent of the system's total assets followed by NRB, development banks, Employee Provident Fund, finance companies and Citizens Investment Trust.

14. The soundness of financial institutions was maintained with adequate capital, liquidity and profitability buffers and improvement in asset quality.

The banking sector is adequately capitalized with the overall industry average capital ratio of 18.2 percent. The CAR of the of A, B and C class institutions stood at 11.5 percent, 20.5 percent and 23.1 percent respectively in mid-July 2012 which are well above the minimum regulatory requirements.

15. The asset quality of commercial banks has shown some signs of improvement with the reduction of NPL ratio from 3.2 percent in mid-July 2011 to 2.6 percent in mid-July 2012. The average NPL ratio of BFIs stood at 6.1 percent with finance companies having the highest ratio of 10.7 percent followed by development banks with 4.9 percent.

16. Loans for housing and non-housing construction, together with real-estate loans account for about 17 percent of the loan portfolio of commercial banks—going up to 21 and 25 percent for development banks and finance companies, respectively. As 70 percent of total loans and advances provided by BFIs are secured by fixed assets comprising mainly of land and buildings, sluggishness in real estate sector would severely affect the value of such securities. As most of the BFIs do not have strict, fair and periodic revaluation policy and practice, deterioration in the value of such securities affects the quality of assets. Therefore, considering the high exposure of BFIs either directly or indirectly in real estate loans and slowdown of real estate sector, the asset quality might further deteriorate.

17. During 2011/12, Nepalese BFIs experienced comfortable liquidity against severe liquidity crisis in 2010/11. Various policy measures were taken by NRB to resolve the liquidity problems. An increase in remittances, export earnings and low growth of credit also helped to improve deposits and thereby liquidity in 2011/12.

18. Though the liquidity pressure had moderated, liquidity risk may hit banks any time, as they are subject to growing competition, poor asset liability management practices, poor corporate governance and high dependence on corporate deposits. Further, there are concerns that liquidity conditions may

change rapidly in response to external shocks, such as a decline in remittances and the change in exchange rates. A negative shock to remittances, due to a slowdown in Malaysia, Gulf countries and India could lead to liquidity stresses. Furthermore, credit growth in the recent times, however, has been mostly marked in sectors like infrastructure and commercial real estate, both of which require longer term funding. The resultant asset liability mismatches would require careful monitoring on an ongoing basis.

19. Low growth of credit, huge credit exposure of banks in real estate sector (either direct or indirect) and decline in real estate transactions as well as price led to the deterioration in interest income as well as total income of commercial banks. Lending to productive sector and business opportunities of BFI's are hampered by the poor business climate, power shortages, weak governance, and difficult labor relations which also remain major impediments to growth and investment, thus hampering the profitability.

20. The stress tests results of commercial banks as of mid-July 2012 on credit, liquidity and market shocks reveal banks' ability to withstand high shocks. Among the 32 existing commercial banks, a standard credit shock would push capital below the regulatory minimum in 22 banks, and 2 commercial banks would be under-capitalized. Sustained deposit withdrawals over five consecutive days would render 5 banks illiquid, and liquidity ratios of 17 banks would fall below 20 percent in the event of sudden large withdrawals by institutional depositors. Given the amount and nature of exposure, commercial banks are relatively less vulnerable to market shock. While the resilience of the commercial banks to credit and market shocks have improved over time, the liquidity scenario analysis shows some potential risk.

Micro Finance Institutions

21. The micro finance sector in Nepal has expanded, become more diversified in recent years and has been instrumental to enhance access to finance, reduce

poverty, empower women and uplift living standard of poor and underprivileged groups. Some cases of duplication and multiple lending practices have been witnessed in these sectors. In order to avoid duplication/multiple banking practices, collecting information and sharing the information among micro finance institutions would be very important intervention.

22. The number of cooperatives providing financial services is increasing. Though these institutions are contributing in enhancing access to finance, the present regulation and supervision is not sufficient for regulating their transactions. Such activities need sound regulatory and supervisory measures to ensure financial health. However, regulatory and supervisory mechanism is weak due to lack of technical capabilities. In the absence of stringent measures, such institutions might be performing as 'shadow banking', which affect the formal banking activities. In this context Micro Finance Authority Bill has been proposed where there is a provision of establishing second tier institution for regulating and supervising scattered micro finance institutions in the country.

Financial Markets

23. With the improvement in the liquidity situation in the Nepalese financial market, the short-term and long-term interest rate in the market declined significantly in 2011/12 compared to that of 2010/11.

24. The security market of Nepal, which was experiencing bearish trend for last couple of years showed some signs of improvement in 2011/12. NEPSE index, year on year (y-o-y) basis, increased by 7.4 percent to 389.74 points in mid-July 2012. In terms of transaction volume, market and portfolio, Nepalese capital market is still in its infant stage of development. The dominance of BFIs in the security market shows that this market has high concentration risk which may ultimately affect overall financial stability of the system. Further, as there is dominance of equity market in Nepalese capital market, development of bond market, derivative market and mutual

fund is lacking for market diversification. Furthermore, development of other institutions related to capital market such as credit rating agency and modern trading system in securities is crucial in order to reform the Nepalese capital market.

25. NRB has been attempting to maintain an orderly forex market through monitoring of foreign currency transaction, prudential regulations and intervention in the domestic foreign exchange market. In 2011/12, NRB purchased US dollar 3.19 billion from commercial banks through forex market intervention. With the growing demand of Indian Rupees, NRB purchased Indian Rupees equivalent to Rs 213.95 billion by selling USD 2.66 billion in the Indian money market.

Financial Sector Policies and Infrastructure

26. Sound regulatory policies and robust arrangement for regulations of financial system are the fundamental requirements in order to ensure financial stability. As Nepal remains committed to the adoption of global best practices, NRB's regulatory approach for the financial sector aims to make the financial system safe, credible and less vulnerable to crises. NRB's recent policies on financial sector are focused mainly on capital adequacy, financial consolidation, liquidity, safety nets, risk management, corporate governance, asset quality, access to finance and, financial inclusion.

27. With the rapid development in Information Communication and Technology (ICT), method of payment and settlement of transactions have been migrated from conventional paper based payment instruments to electronic payment instruments. NRB is effortful in developing and promoting sound and efficient payment system through introducing Real Time Gross Settlement System (RTGS) and validating e- payment. The inception of electronic cheque clearing system providing clearing of interbank cheques replacing the traditional manual and paper based clearing is a breakthrough in the Nepalese payment and settlement system which has resulted in significant

reduction of tedious and time consuming manual process of cheque clearing, both for the banks and for the customers.

28. As a part of financial safety net mechanism, policy provision has been introduced for insuring deposit up to Rs. 2,00,000 in licensed banks and financial institutions with Deposit and Credit Guarantee Corporation (DCGC). Though there are some issues to be resolved in the pricing, coverage and, payout mechanism etc. This mandatory provision has played an important role in enhancing public confidence on BFIs.

29. NRB is coordinating with concerned authorities for the capacity building and establishment of supporting institutions like Credit Information Centre, Debt Recovery Tribunal, Credit Rating Agency, Asset Management Company, Secured Transaction Registry etc.

30. NRB is also working on formulating and amending required laws and regulations to facilitate prudential financial practices. Amendment of Nepal Rastra Bank Act, 2002 and Bank and Financial Institutions Act (BAFIA), 2006 that address major issues related to liquidation procedures of financial institutions is under way.

31. To sum up, the macroeconomic indicators of the country remained satisfactory in 2011/12. Economic growth remained higher in comparison to the past two years. Inflation stood at lower level and the government revenue mobilization remained higher than the previous year. Nepalese financial sector remained less affected by the global financial crisis and financial system participants performed their functions without any major disruption.

32. Improvements have been witnessed in the overall soundness of the banks and financial institutions. Strengthened regulatory and supervisory system, cautious and accommodative monetary policy, strong remittance inflows were some of the major factors contributing to the overall stability of the financial system. However, high exposure of BFIs in realty sector, shadow

banking practices, high dependency on remittance, high interest spread and, interconnected markets are some threats to financial stability of the country. Unstable socio-political environment, weak macroeconomic conditions, capacity constraints at the NRB to regulate and supervise more than 200 financial institutions, inadequate legal mechanism to resolve problematic financial institutions, slow reform process of two state owned banks, sluggishness in real estate sector, poor information management system, inadequate and underdeveloped financial infrastructure are some challenges and constraints inherent in Nepalese financial sector for maintaining stability.

CHAPTER 1

INTRODUCTION

Background

1. Financial stability has been a prime policy concern in recent years, especially after the global economic and financial crisis, which caused enormous damage to national economies. Moreover, recently fueled Euro sovereign debt and financial crisis is seeking an appropriate way to address the crisis. Promoting financial stability seeks for a greater coordination among macro-economic policies, monetary stability, soundness of the financial sector, presence and quality of a financial sector safety nets and efficient regulatory governance.

2. Financial system becomes unstable when economic activity is hindered and the system is endangering the economy itself. Financial Sector Stability (FSS) warrants that the financial system has the capability to allocate funds efficiently and absorb shocks as they arise, thereby preventing disruption of real sector activities and the financial system. FSS implies a strong financial system capable of withstanding economic shocks that is able to ensure intermediary function, settlement of payments and diversification of risk. Under FSS, the economic mechanism of price formation, fund allocation and risk management operate properly in support of economic growth.

3. The concept of financial stability has emerged in the light of systemic risk. Systemic risk reflects the interconnectedness among the participants in the financial system from the classic contagion effects arising from the failure of a single bank that then spread to other banks.

4. A growing body of literature has been exploring the linkage between monetary and financial stability and the changing role of the central bank. Many central banks are seeking or have already obtained a formal mandate to pursue financial stability in addition to their monetary stability mandate, typically price stability. Traditionally, central bank relies solely on two

mostly known tools. The first is interest rate to achieve price stability, support economic growth and employment. The second is micro prudential regulations, such as capital adequacy ratio (CAR), single obligor limit (SOL), non-performing loan (NPL) ratio, credit-deposit (CD) ratio and good governance, which are used to focus on risks in individual banks with an eye on depositors and investors' protection.

5. Experience of the recent global financial crisis, however, has revealed the weaknesses of relying on the above-mentioned two policy tools. With regard to interest rate policy, it is a central bank's main instrument to achieve price stability generally but it might not be the effective tool to capture excessive price movements of particular assets. On the other hand, micro prudential measures are not sufficient to prevent systemic risks. Individually every bank may be safe and sound, but their joint behavior may pose risks to the overall financial system.

6. For a financial system to function on a stable basis, a combination of stable macroeconomic conditions, effective regulatory and supervisory systems, and a robust market infrastructure are essential. These can be regarded as the three crucial pillars of financial stability. Shocks or disturbance, to any elements of any pillars are threats to the stability in the financial system.

Box 1.1: Financial System Stability Pillars

Pillar **1**		**Pillar 2**		**Pillar 3**
Macroeconomic Conditions • Monetary Policy • Debt Structure • Exchange Rate Regime • Economic Growth	↔	**Regulatory and Supervisory Conditions** • Regulatory Framework • Supervisory Efficacy • Safety Nets • LOLR & Contingency Planning	↔	**Market Infrastructure Conditions** • Money & Exchange Markets • Payments & Settlements and Arrangements • Accounting, & Auditing and Arrangements

Source: IMF May 2004

7. Despite the increased focus on financial stability issues, there is not a single generally accepted definition of financial stability. Financial Stability is defined in terms of its ability to facilitate and enhance economic processes, manage risks and absorb shocks. Moreover, financial stability is considered a continuum, changeable over time and consistent with multiple combinations of constituent elements of finance.

8. On the other hand financial stability has been defined as an absence of instability, a situation in which economic performance is potentially impaired by fluctuations in the price of financial assets or by an inability of BFIs to meet their contractual obligations. Such types of definitions focus on real economic costs, potential damage of BFIs and interconnectedness, systemic risk and contagion effects.

9. As many central banks began publishing Financial Stability Reports, they have also adopted country specific definitions in order to provide some guidance to their objective of safeguarding financial stability. Table below displays some of these definitions from selected central banks around the world.

Box 1.2: Country Specific Definitions of Financial Stability

Australia	*A stable financial system is one in which financial institutions, markets and market infrastructures facilitate the smooth flow of funds between savers and investors.*
Canada	*Financial stability is defined as the resilience of the financial system to unanticipated adverse shocks, which enables the continued smooth functioning of the financial intermediation process.*
ECB	*Financial stability can be defined as a condition in which the financial system – comprising of financial intermediaries, markets and market infrastructures – is capable of withstanding shocks, thereby reducing the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities.*
India	*Financial stability could be best perceived as containment of the likelihood of failure of individual financial firms or any systemic stress.*
Malaysia	*Financial stability describes the condition where the financial intermediation process functions smoothly and there is confidence in the operation of key financial institutions and markets within the economy.*
South Africa	*Financial stability is defined as the smooth operation of the system of financial intermediation between households, firms and the government through a range of financial institutions.*
Srilanka	*Financial system stability can be defined as the resilience of the financial system to internal and external shocks, be it economic, financial, political or otherwise.*
Sweden	*The Risk bank defines financial stability as meaning that the financial system can maintain its basic functions – the mediation of payments, the conversion of savings into funding and risk management – and also has resilience to disruptions that threaten these functions.*

Source: Financial Stability Report and websites of Central Banks.

10. A glance at the country specific definitions financial stability indicates a situation either in terms of absence of crisis in the financial system and/or resilience of the financial system to crisis/shock. It may be defined as the situation where the principal components of financial system viz. financial

institutions, market and infrastructure are performing their functions smoothly and are capable of withstanding various shocks without any disruption in the operation of the financial system.

Global Initiatives for Financial Stability

11. It has been observed that in the context of globalized world, a threat to financial stability in one economy may spillover to other economies leading to global financial crisis. Therefore, initiatives should be taken at national and global levels to maintain financial stability. International institutions like IMF, World Bank (WB), Bank for International Settlements (BIS) track and promote financial stability globally. Establishment of Financial Stability Board (FSB) by G20 leaders was one of the significant initiatives undertaken post-crisis to promote financial stability globally. The FSB coordinates the work of national financial authorities and international standard setting bodies and develops and promotes the implementation of effective regulatory, supervisory and other financial sector policies. The FSB was established to address the issues of financial system vulnerabilities and to drive the development and implementation of strong regulatory, supervisory and other policies.

Financial Stability and Nepal Rastra Bank

12. As experienced by other countries around the world, Nepalese financial sector is also experiencing the trend of deregulation, globalisation and financial innovation. The proliferation of BFIs in terms of products and services as a result of advancement in information, communication and technology (ICT) has created more competition and challenges in the stability of the financial system. Furthermore, with the growing integration of Nepal with the world economy especially in the area of trade and services as well as dependency on foreign employment, it is increasingly being exposed to the global forces, shocks and vulnerabilities.

13. As a regulator and supervisors of the financial system, maintaining financial stability has become a major policy concern for the central banks worldwide and so does for Nepal.

14. Even in the case of low integration with global financial market, Nepal is exposed to domestic and external shocks. Volatility in remittance flows, increase in international oil price, high level of imports relative to exports, pegged exchange rate regime, frequent volatile liquidity, real estate sluggishness and other supply shocks have impacted the stability of the financial sector.

15. NRB, being the Central bank of Nepal has to play a vital role in achieving the goal of financial stability in the country. Accordingly, the NRB Act, 2002, which replaced the previous NRB Act, 1956 explicitly, expressed financial stability as one of its objectives.

Box 1.3: Objectives of NRB Act, 2002

Objectives of NRB as per NRB Act, 2002

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

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

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

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

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

16. Moreover, since the last few years NRB has also announced 'financial stability ' as one of the objectives of monetary policy. Furthermore, NRB's Strategic Plan, 2012-2016 has identified Financial Sector Stability as one of strategic pillars to achieve its major objectives. NRB aims to fulfill its role

in maintaining financial stability through monetary policy and prudential regulation, supervision of financial institutions, oversight of the whole financial system, crisis management and resolution.

17. NRB is effortful in adopting micro prudential as well as macro prudential measures to maintain financial stability. However, support from the fiscal authority (government), other regulators and other market participants are also equally important in order to maintain financial stability.

Need and Objectives of Financial Stability Report

18. Central banks have a mandate to ensure smooth functioning of the financial system in the country. This requires understanding of key macroeconomic trends, banking system dynamics and sources of risk in the financial system. *Financial Stability Reports* provide information on the structure of financial systems, recent trends in banking and finance, and the impact of the global economy on local markets. It gives valuable insights for the better understanding on the overall performance of the financial system. Therefore, financial regulators and central banks in over 80 countries publish *Financial Stability Reports* about the soundness and resilience of their financial systems. At a global level the IMF has been publishing the *Global Financial Stability Report*, which provides important insights on market dynamics in crisis and non-crisis periods and on the implications of new instruments for financial stability. Likewise, BIS produces valuable quarterly reports on global financial markets and capital flows.

19. In the context of Nepal in order to ensure whether the market is performing efficiently and effectively, it is necessary to have a deep look on the trend of financial soundness indicators and adopt the warranted policy options. Thus, preparing a financial stability report is one avenue of having a better understanding of overall performance and resilience of the financial system. Generally, the aim of this report is to promote greater understanding among various stakeholders of the financial system on issues and developments affecting financial stability.

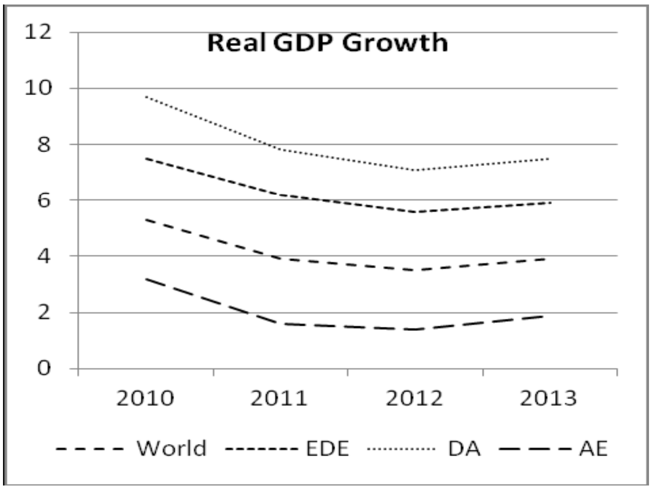
CHAPTER 2
MACRO ECONOMIC OUTLOOK

Global Macro Economic Outlook

1. IMF has recently made a downward revision in economic growth of advanced as well as emerging and developing economies amid increased risks and uncertainty to global growth prospects. Major risks to global growth include fiscal weakness and sovereign debt problems in the euro area, continued high unemployment in many advanced economies, banking sector default risks prevailing in some regions and continuance of price hike of energy, food and other commodity prices.

2. Global economic growth is expected to slow down further in 2012 as compared to 2010 and 2011 and estimated to grow slightly in 2013 according to *IMF's World Economic Outlook (WEO)* Update, July 2012, reflecting the setbacks of the global recovery. The revised estimate of the global GDP for 2012 is 3.5 percent while it is projected to grow by 3.9 percent in 2013. Real GDP growth in advanced economies is estimated to grow by 1.4 percent in 2012 and 1.9 percent in 2013. Likewise, growth in emerging and developing economies is estimated to expand by 5.6 percent in 2012 and 5.9 percent in 2013. Similarly, activities in developing Asia also weakened modestly in response to global slowdown and uncertain demand prospect from advanced economies. The

Figure 2.1: Global Real GDP Growth

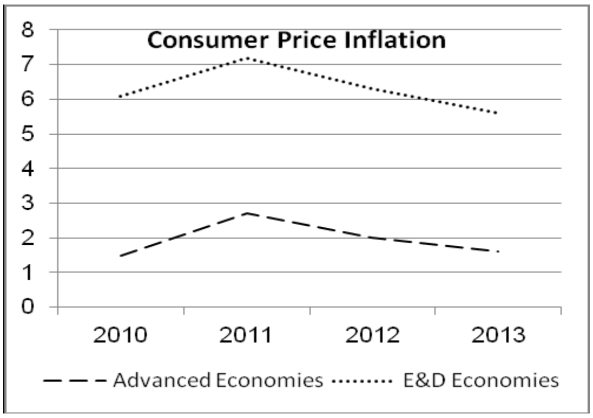


real GDP growth for this region is estimated to be 7.1 percent in 2012, down from 7.8 percent in 2011 and 9.7 percent in 2010.

3. GDP growth in China is projected to be about 7.8 percent in 2012 and then strengthen to 8.25 percent in 2013 as domestic demand growth, especially investment growth picks up with the policy easing now under way. Growth in India is projected to remain between 5 to 6 percent in 2012–13, more than 1 percentage point lower than earlier projection in *WEO*. The downgrade reflects both an expectation that current drags on business sentiment and investment will persist and there will be a weaker external environment.

4. Global inflation has been moderating in many parts of the world as demand softens and commodity prices recede. As per the projection of *IMF's WEO, 2012,* consumer price inflation in advanced economies is expected to stand at 2 percent and 1.6 percent in 2012 and 2013 respectively, lower from 2.7 percent in 2011. Similarly, the consumer price inflation in emerging and developing economies is estimated to stand at 6.3 percent in 2012 and then at 5.6 percent in 2013 as compared to 7.2 percent in 2011. Global inflation is likely to be largely influenced both by food and energy prices in the days to come.

Figure 2.2: Global Consumer Price Inflation



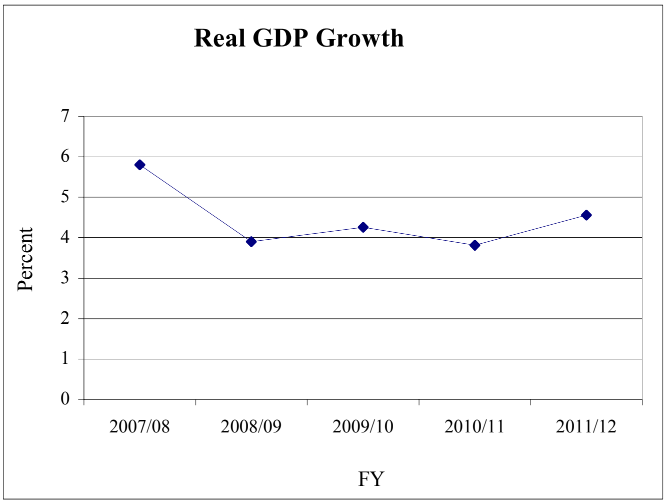
5. As per *Global Financial Stability Report (GFSR) July 2012*, risk to financial stability increased due to fragile confidence on global financial system as a result of euro zone crisis. The report observes that sovereign yield in southern Europe has risen sharply amid further erosion of the investors' base. Likewise the analysis of *GFSR* has indicated that, elevated funding

and market pressure pose risks of further cuts in peripheral euro area credit. Though the European Central Bank's three-year refinancing operations eased funding strains and led to a broad rally across asset market, the rally proved short-lived amid growing unease about the strength of the global economy. Risk aversion increased sharply due to mounting fears about the potential exit of Greece from Euro area and rising concern about the health of Spanish banking system. *IMF's WEO October 2012* suggests that in order to address the prevailing financial risk, concerned authorities should give top priority in enhanced risk-based prudential regulation and supervision and macro prudential measures.

Domestic Macro Economic Outlook

Domestic Growth

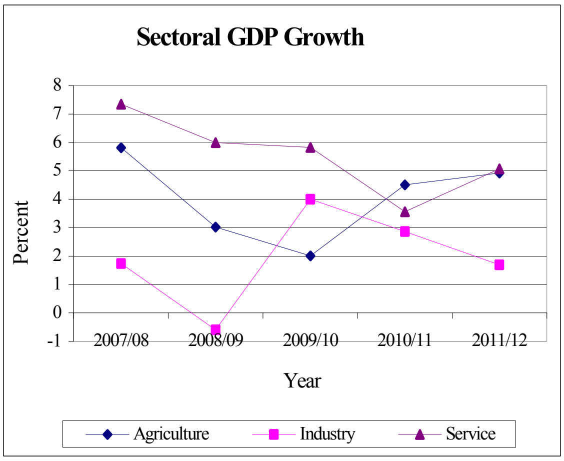
Figure 2.3: GDP Growth Rate



6. The real GDP at basic price is expected to grow by around 4.0 percent in 2012/13 as compared to its growth of 4.6 percent in 2011/12. Lower agricultural production due to weaker monsoon, continued political uncertainty and sluggish growth of public expenditure are some of the reasons for low growth. The growth of 2011/12 is attributed to satisfactory performance of agriculture sector supported by favourable monsoon along with the use of improved seed and technology. Furthermore, service sector's performance also contributed in the said growth in 2011/12.

7. The agricultural sector grew by 4.9 percent in 2011/12 compared to 4.5 percent in 2010/11. However, given the cyclical nature of favorable monsoon and its early sign, agriculture is not likely to perform better in 2012/13. The industrial sector witnessed a sluggish growth of 1.7 percent in 2011/12 lower than the growth rate of 2.9 percent in previous year. The supply side constraints inherent in the Nepalese economy including energy shortage are the main reasons behind this sluggish growth of the industrial sector. The service sector witnessed better performance with a growth of 5.1 percent in 2011/12 owing to improvement in the performance of sub sectors viz hotel & restaurant, transport, storage, communication, health and social services.

Figure 2.4: Sectoral GDP Growth



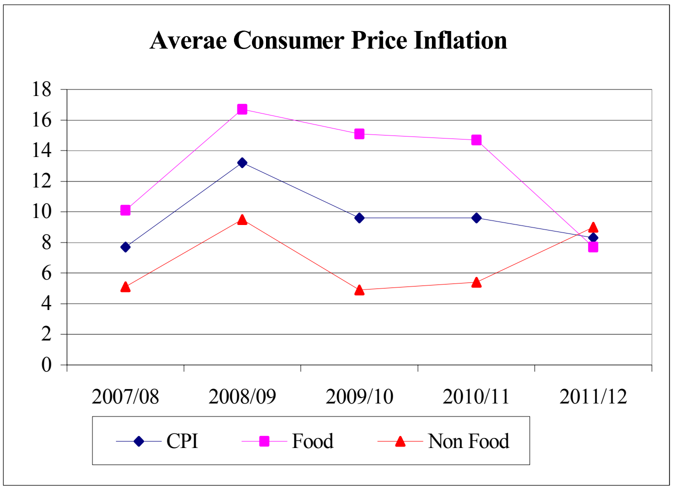
Consumption, Saving and Investment

8. In 2011/12, the ratio of total consumption to GDP was estimated to be 90.0 percent compared to 91.4 percent in the previous year. Likewise, the ratio of total saving to GDP was estimated at 10.0 percent in the review year compared to 8.6 percent in the previous year. In the review year, the ratio of gross investment to GDP was estimated at 32.8 percent compared to 32.5 percent in the previous year.

Inflation

9. The average consumer price inflation was observed to be 8.3 percent in 2011/12, down from 9.6 percent in the previous year largely due to lower food prices. Though the food price moderated slightly, the non food inflation is on an increasing trend exhibiting increment of 9 percent. The rise of non-food prices was the outcome of increment in fuel prices, exchange rate depreciation and rising wage and salaries.

Figure 2.5: Average Consumer Price Inflation



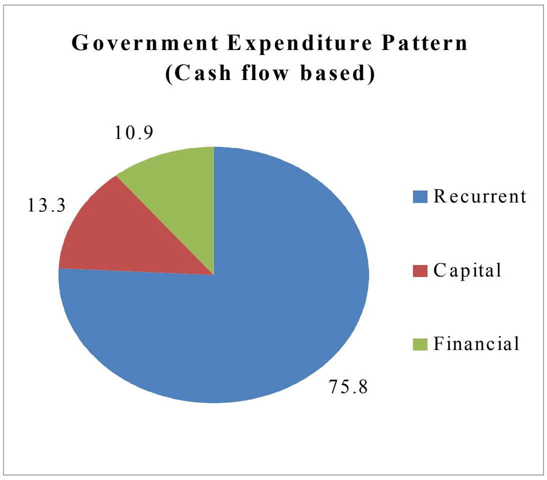
Government Finance

10. The fiscal position of the government showed a mixed outcome as capital expenditure was discouraging and, revenue mobilization was encouraging. As a result, the budget deficit has narrowed down significantly from 50.5 billion in 2010/11 to around 9 billion in 2011/12. The ratio of budget deficit to GDP remained at 0.6 percent in 2011/12.

11. Notable improvement has been observed in revenue mobilization of the government in 2011/12. It increased by 22.2 percent against 11 percent in 2010/11. The expansion of economic activities with timely announcement of budget for 2011/12, growth in imports, tax administration reform and control of revenue leakages attributed to the significant growth of revenue mobilization.

12. Expenditure pattern is not very much satisfactory even though the government budget was announced in time. The recurrent expenditure has been increasing while capital expenditure has continued to be weak. In 2011/12, the current expenditure was about 75.8 percent of the total budget estimate. Likewise the capital expenditure stood at 13.3 percent and recurrent expenditure stood at 10.9 percent of annual budget estimate. Moreover, delay in capital expenditure and its concentration during the last month of fiscal year could not yield optimum outcome because of lower productivity and possible misuse of resources.

Figure 2.6: Government Expenditure Pattern



13. Government net domestic borrowing stood at Rs. 18.68 billion in 2011/12 which accounts 1.2 percent of GDP. Another issue on the fiscal front includes complying the ceiling of overdraft mentioned in the NRB Act through effective monitoring and control mechanism.

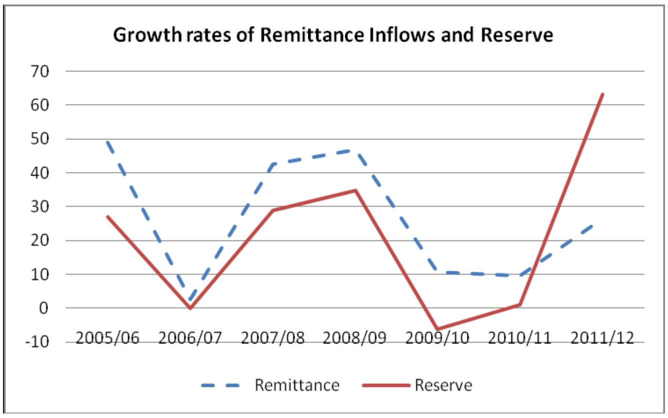
External Sector

14. Merchandise export recorded a growth of 15.4 percent to Rs. 74.26 billion in 2011/12 compared to 5.8 percent growth in the previous year. Likewise merchandise imports surged significantly by 16.5 percent to Rs. 461.67 billion. The significant increment in import is mainly attributed to high import payment of gold and petroleum products. Due to high growth of imports compared to exports, total trade deficit went up by 16.7 percent to Rs. 387.41 billion. The ratio of export to import decreased marginally to

16.1 percent in 2011/12. India, which is the major trading partner of Nepal, covered around 65.1 percent of total trade in the review year.

15. In 2011/12 current account imbalances improved owing to elevated level of remittances and service income. As a consequence, the overall balance of payments witnessed a historical surplus of Rs. 127.70 billion in 2011/12 against the surplus of Rs. 2.18 billion in 2010/11. As a result, the existing foreign exchange reserve is sufficient for financing merchandise imports of 11.6 months and merchandise and service imports of 10.3 months

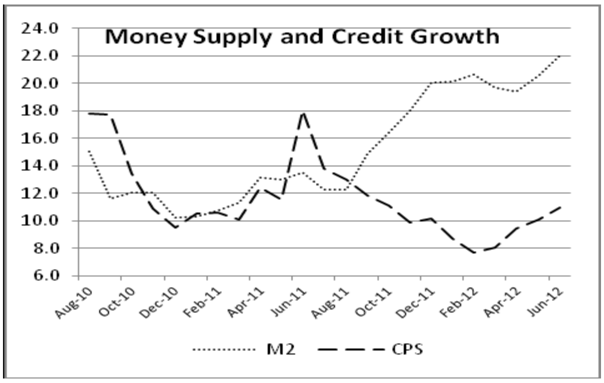
Figure 2.7: Growth Rates of Remittance Inflows & Reserve



16. With the growth in foreign employment and appreciation of USD, worker remittances increased by 41.8 percent in 2011/12 to Rs. 359.55 billion at mid-July 2012 against the growth of 9.4 percent in previous year. This amount forms 23.1 percent of GDP. The growth rate of reserve is closely associated with the growth of remittances in Nepal since the last few years. The fluctuating growth rate of remittance is the reason for uncertainty in the foreign exchange reserve position which may increase risk to external sector stability. Moreover, since the growth of financial sector and its services is partly due to ample remittance inflows into the country and the remittance inflow is found to be correlated with the liquidity situation of the banking sector, fluctuations in remittance may also increase financial sector stress.

Monetary Situation

Figure 2.8: Money Supply and Credit Growth



17. Monetary Policy in Nepal is directed to ensure financial stability including price and external sector stability for sustainable economic growth. The Policy also aims to increase access to finance and consolidate financial sector through monetary and credit management in 2011/12. Monetary aggregates expanded rapidly but the credit growth remained weak amid volatile liquidity situation in 2011/12. Broad money supply (M2) increased by 22.7 percent in 2011/12 compared to a growth of 12.3 percent in the previous year mainly due to a higher growth of net foreign assets. Similarly, narrow money supply (M1) increased by 18.5 percent during the review year as compared to 5.2 percent increase in the previous year.

18. Domestic credit increased by 8.0 percent in 2011/12 as compared to 14.6 percent in the previous year. A lower growth of claims on private sector coupled with net savings in government account due to lower level of public expenditure relative to resource mobilization resulted in a lower growth of domestic credit during the review year. Claims on private sector increased by 11.3 percent in 2011/12 compared to a growth of 13.9 percent in the previous year. The slow growth in credit to private sector is contributed by the policy measures such as sectoral credit limit implemented to curb the excessive credit flow to unproductive sector and the reduction of credit by financial institutions having high credit to deposit ratio to bring such ratio within the stipulated limit.

19. Reserve money increased by 36.4 percent during the review year compared to an increase of 7.2 percent in the previous year. Despite a fall in NRB's

claims on government and claims on banks and financial institutions, a significant rise in net foreign assets contributed to the expansion in reserve money during the review year.

20. Deposit mobilization of banks and financial institutions increased by 22.9 percent (Rs. 188.59 billion) in 2011/12 compared to 12.9 percent (Rs. 94.13 billion) in the previous year. The deposit mobilization in 2011/12 is attributed to a surge in inward remittances income, timely government budget and improvement in trade balance. In the review year, deposit mobilization of commercial banks and development banks increased by 26.7 percent and 34.0 percent respectively whereas deposit mobilization of finance companies decreased by 7.5 percent. The deposit mobilization of finance companies decreased mainly due to the shifting of deposits to commercial banks and development banks in reaction to the action taken by NRB to some problematic institutions and merger of some finance companies with commercial banks and development banks.

Liquidity Situation

21. Reflecting the excess liquidity in the financial system in 2011/12, short-term interest rates have reached to the bottom level. If the situation persists for a long time, it may lead to sharp fall in deposit rates, which, in turn, discourage savings and divert resources from formal to informal channel. Moreover, such a situation increases the risk of capital flight.

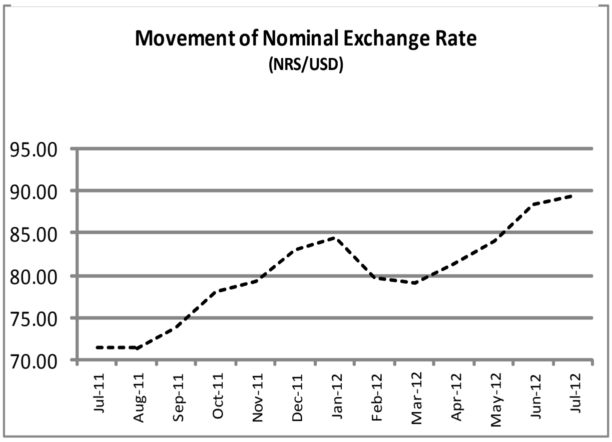
22. Property markets, especially real estate, continue to pose significant risk to financial stability. The analysis of the credit composition as of mid-July 2012 reflects that about 11.0 percent of total outstanding credit of banks and financial institutions is concentrated in real estate sector. However, the true real estate exposure may be slightly higher than the reported figure. The big proportion of overdraft loan which constitute about 17.0 percent of outstanding credit of BFIs may be used in unproductive sector including real estate. Likewise, security structure of BFIs credit reveals that about 72.6 percent of the total lending is made against the collateral of house and land.

Against this backdrop, the continued slowdown in real estate has serious implications for asset quality of BFIs. This has been reflected in the increasing trend in non-performing assets to some extent. If slowdown in real estate sector continues for a long time when the demand for credit in other sectors is weak, many financial institutions may face difficulties maintaining NPA and liquidity at appropriate level.

Exchange Rate

23. Nepalese rupee depreciated sharply by about 20 percent against US dollar during 2011/12. The nominal depreciation contributed to improve export competitiveness, stimulated remittance inflows and helped to narrow down real exchange rate misalignment. However, it has increased risk of inflation and uncertainty to external sector. It has largely inflated the foreign debt liability of government also. SDR and US dollar denominated debt liability of government comprises of about 90 percent of the total external debt of GON. Since Nepal follows fixed exchange rate regime with Indian currency, the exchange rate solely depends on movement of INR vis–a–vis convertible foreign currency. This indicates the necessity to review appropriateness of the current fixed exchange rate regime and make it relatively flexible, moving towards managed float. However, the strong economic ties with India and trade concentration, current state of high inflation in Nepal and the increased risk to inflation from possible pass through from recent exchange rate depreciation makes the case for 'wait and see' position until the time is ripe.

Figure 2.9: Movement of Nominal Exchange Rate



CHAPTER 3

FINANCIAL INSTITUTIONS

Structure of the Financial System

1. A strong financial system promotes economic growth, mobilizes and allocates resources efficiently, establishes efficient payment system and effective transmission mechanism, makes capital more productive and creates employment opportunities. It reduces vulnerability to financial crisis and lowers the economic and social costs of financial disruption.

2. The financial system in Nepal comprises bank and financial Institutions (commercial banks, development banks, finance companies and micro finance institutions), co-operatives, contractual saving institutions. (Employee Provident Fund and Citizen Investment Trust), insurance companies and postal saving banks. At the end of 2011/12 the number of financial institutions stood at 293 comprising 265 banks and financial institutions licensed by NRB, 25 insurance companies, one Employees Provident Fund, one Citizen Investment Trust and one Postal Saving Bank.

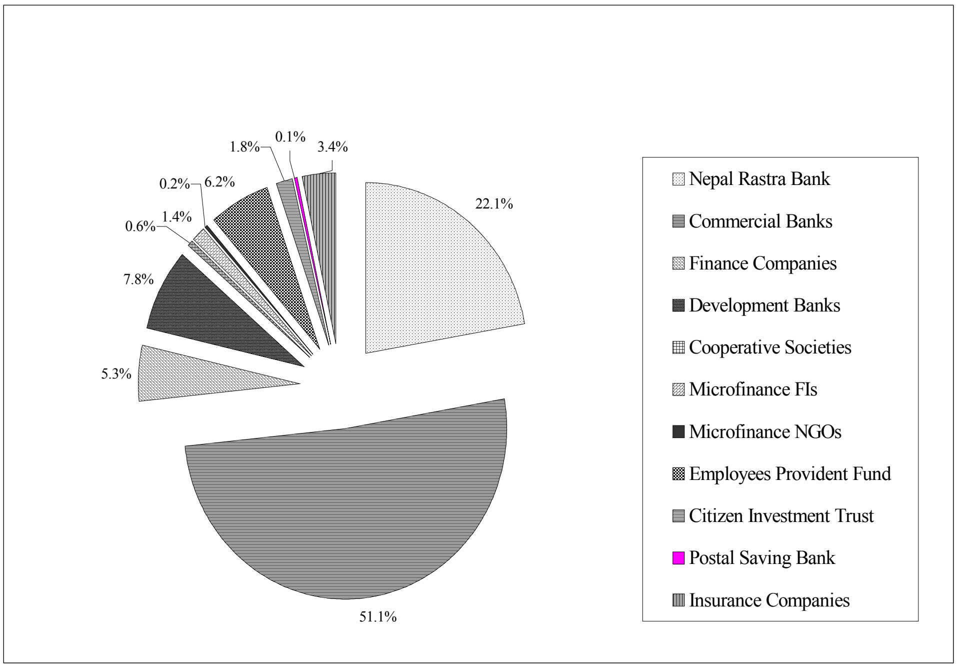
Table 3.1: Number of Banks, Financial Institutions and Other Institutions

Banks and Financial Institutions	(mid-July 2012)
Commercial Banks	32
Development Banks	88
Finance Companies	69
Micro-Finance Institutions	24
NRB licensed Cooperatives (with limited banking activities)	16
NRB licensed NGOs (with limited banking activities)	36
Insurance Companies	25
Employees Provident Fund	1
Citizen Investment Trust	1
Postal Saving Bank	1
Total	293

Source: Nepal Rastra Bank

3. The ratio of total assets/liabilities of the banking system and other non bank institution to GDP remained at 132.3 percent in mid-July 2012. The commercial banks remained the key player in the financial system contributing 51.1 percent of the system's total assets followed by NRB with 22.1 percent, development banks with 7.8 percent, Employees Provident Fund with 6.2 percent, finance companies with 5.3 percent and Citizens Investment Trust with 1.8 percent as of mid-July 2012.

Figure 3.1: Share of Banks and Financial Institutions in Nepalese Financial System



4. There are different regulators active in the financial system of Nepal. NRB licenses, regulates and supervises deposit taking bank and financial institutions. The Insurance Board regulates and supervises insurance companies. Similarly, capital market and commodities market are regulated by Securities Board of Nepal. Likewise, EPF and CIT are under the purview of Ministry of Finance.

Commercial Banks

5. The number of class 'A' commercial banks licensed by the NRB reached 32 at mid-July 2012. With the implementation of new branch expansion policy by NRB, the number of branches of commercial banks operating in the country increased to 1425 in mid-July 2012 from 1245 in mid-July 2011. Among the total bank branches, 49.7 percent are concentrated in the Central Region followed by Western with 17.9 percent, Eastern with 17.8 percent, and Mid-Western with 8.4 percent and Far-Western 5.9 percent.

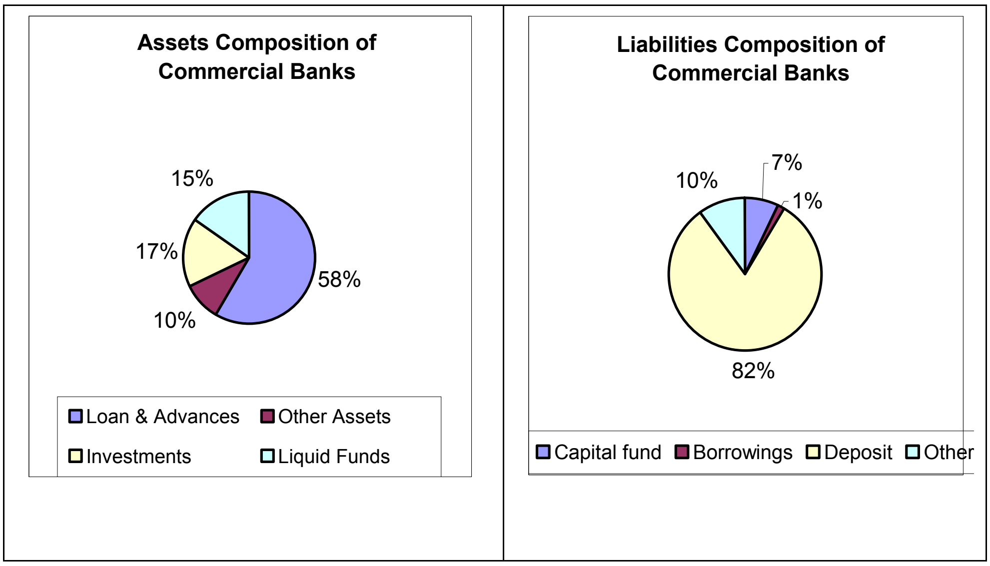
6. The total assets/liabilities of commercial banks increased by 21.5 percent and reached Rs. 1,067,096 million in mid-July 2012 as compared to an increment of 11.6 percent in the previous year.

7. The share of loans and advances to total assets remained 58.3 percent in mid-July 2012. Similarly, share of investment and liquid funds to total assets stood at 17.0 percent and 15.2 percent respectively. In mid-July 2012, the loans and advances increased by 17.9 percent compared to 12.4 percent in previous year. As of mid-July 2012, the total outstanding amount of loans and advances including bills purchase and loan against collected bills of commercial banks reached Rs. 622,575 million. In the review period, the total investment including share and other investment of commercial banks increased by 21.2 percent while liquid fund increased significantly by 65.0 percent amounting to Rs. 161,785 million.

8. The growth of loans and advances and its dominance in the asset structure require commercial banks to monitor the credit risk exposure and strengthen their credit risk management measures.

9. The composition of liabilities of the commercial banks shows that deposit occupies a dominant share of 81.3 percent followed by other liabilities with 10.0 percent, capital fund with 7.2 percent and borrowings with 1.5 percent in the mid-July 2012.

Figure 3.2: Compositions of Assets/Liabilities of Commercial Banks



10. In the review period, total deposit of commercial banks exhibited a growth of 26.2 percent compared to a growth of 9.0 percent in the previous year and reached Rs. 867,978 million. Saving deposits comprise the major share (35.1 percent) in total deposits followed by fixed deposits, call deposits and current deposits.

11. In the review period, the borrowings of commercial banks increased by 37.6 percent to Rs.15, 507 million compared to an increment of 25.6 percent in the previous year. The capital fund of commercial banks increased by 30.6 percent compared to the previous year and reached Rs. 77,143 million in mid-July 2012.

12. Since deposit is the main source of funding, commercial banks are required to monitor the concentration of deposits in order to avoid potential liquidity problems in case of sudden withdrawals.

Reform Process of State Owned Banks

13. The reform process of two state owned banks namely Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB) was initiated under Financial Sector Technical Assistance Project (FSTAP), which was implemented during April 30, 2003 to December 31, 2011 with the loan and grant of Government of Nepal (GoN), World Bank and Department for International Development (DFID).

14. Both the banks had witnessed improvement in the financial performance after the implementation of reform programs under FSTAP. The non-performing loan of NBL and RBB was recorded at 5.4 percent and 7.9 percent respectively and negative net assets were decreased to Rs. 1.69 and 4.74 billion respectively in mid-July 2012. Also, the branches of the both banks are computerized and are operating Any Branch Banking Services (ABBS). Both the banks are now operating in profit.

15. The capital planning and implementation schedule submitted for reducing negative capital fund of NBL and RBB has been approved and the government has injected Rs 1.29 billion via subscription of rights issue in NBL and Rs 4.32 billion in RBB as per the plan that would partially cover their capital deficiency.

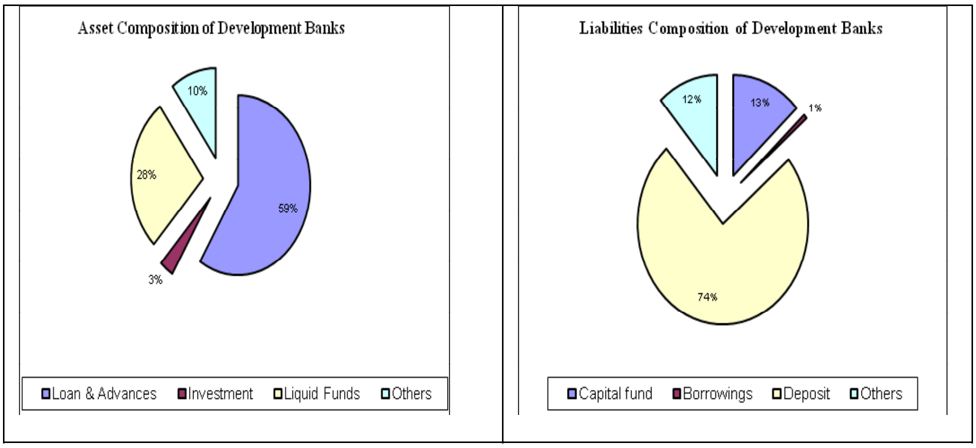
Development Banks

16. The total number of development banks increased to 88 in mid-July 2012 from 87 in the previous year, out of which 19 are national level while the remaining are regional and district level. As of mid-July 2012, there are altogether 687 branches of development banks operating in the country.

17. The total assets to liabilities of development banks increased by 22.3 percent and reached Rs. 170,894 million in the review period as compared to Rs. 139,736 million in the previous year. The entry of new development banks along with business expansion resulted in an increase in the total assets and liabilities.

18. Deposit constituted 74.5 percent of liabilities followed by capital fund (13.3 percent), others (11.5 percent) and borrowing (0.7 percent) in mid-July 2012. In the previous year the respective shares of deposit, capital fund and borrowing were 69.3 percent, 16.1 percent and 3.4 percent respectively. Likewise, on the assets side, loans and advances constituted 58.9 percent, liquid funds 27.7 percent and investment 3.0 percent in mid-July 2012. The respective shares were 63.7 percent, 21.0 percent and 4.2 percent in the previous year.

Figure 3.3: Compositions of Assets/Liabilities of Development Banks



19. During the review period, the deposit collection of development banks increased by 31.4 percent and reached to Rs. 127,300 million as compared to Rs. 96,887 million last year. Deposit in previous year had increased by 25.9 percent. Similarly capital fund increased by 0.8 percent and reached Rs. 22,702 million. In the same period borrowings decreased significantly by 74.6 percent and reached Rs. 1,193 million in mid-July 2012 from Rs. 4,700 million in previous year.

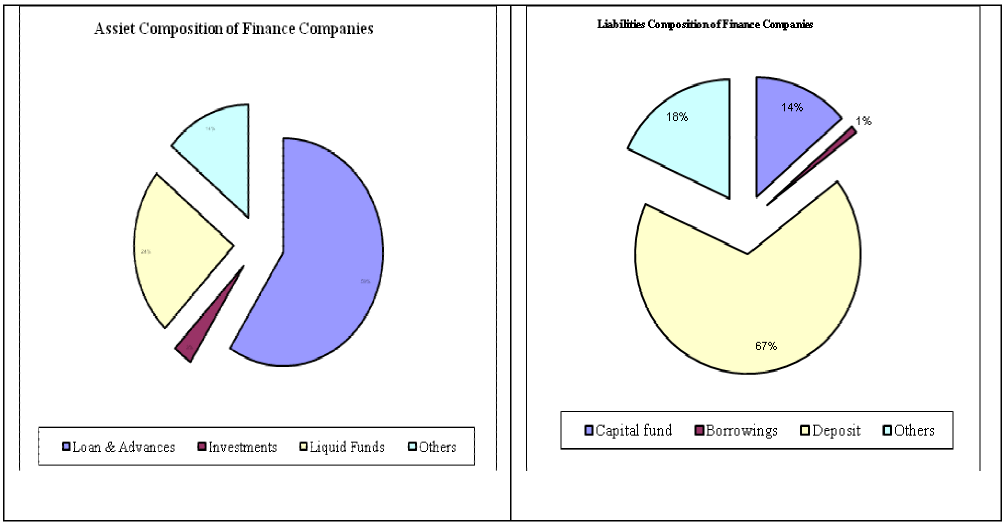
Finance Companies

20. The number of finance companies decreased to 69 in mid-July 2012 from 79 in previous year. The merger of 7 pairs of finance companies and up-

gradation of one finance company to development bank is the primary reason behind the reduction in the number of finance companies. As of mid-July 2012, there were altogether 292 branches of finance companies operating in the country.

21. The decrease in the number of finance companies resulted in the shrinking of total assets to liabilities of the finance companies by 10.7 percent. It decreased to Rs. 112,973 million from 126,617 million in mid-July 2011. Among the total liabilities, deposits held the largest share of 67.4 percent followed by capital fund (13.6 percent), others (18.1 percent) and borrowings (1.0 percent). The respective share of deposit, capital fund and borrowing were 67.5 percent, 17.2 percent and 11.7 percent in the previous year. On the assets side, loan and advances formed 59.0 percent of total assets followed by liquid funds (23.8 percent), investments (3.1 percent) and others (14.1 percent) in mid-July 2012. The respective share of loan & advances, liquid funds and investments were 68.7 percent, 16.2 percent and 4.5 percent in mid-July 2011.

Figure 3.4: Compositions of Assets/Liabilities of Finance Companies



22. The total deposit mobilization by the finance companies in the review year decreased by 10.9 percent and reached Rs. 76,116 million from Rs. 85,477 million in the previous year. Similarly, capital fund decreased by 29.7 percent to Rs. 15,318 million from Rs. 21,818 million. Likewise, borrowing decreased by 75.4 percent and reached Rs. 1,106 million from Rs. 4,506 million in mid-July 2012.

23. In the review period liquid fund increased by 31.0 percent to Rs. 26,884 million from Rs. 20,511 million in the previous year. Likewise, loans and advances declined by 23.4 percent in contrast to the growth of 28.5 percent in the previous year. The total outstanding amount of loans and advances including bills purchased and loan against collected bills amounted to Rs. 66,644 million in mid-July 2012 as compared to Rs. 87,032 million in the previous year. Likewise, the investment including share & other investment decreased by 38.4 percent to Rs. 3,529 million in mid-July 2012 in contrast to the increment of 29.3 percent in the previous year.

Micro Finance Services

24. Micro finance services are being catered through two different sectors that is formal, and informal. Institutions, which are registered as per the prevailing acts and licensed, regulated and supervised by Nepal Rastra Bank and Government of Nepal, are considered as formal institutions.

Micro Finance Development Banks

25. There are 24 micro-finance development banks operating as "D" class financial institutions consisting of 5 Grameen Bikas Banks (Rural Development Banks), 16 private sector development banks replicates of Grameen Banking and 3 wholesale lending micro finance institutions.

26. Total assets to liabilities of "D" class micro finance development banks as of mid-July 2012 recorded a growth of 39.6 percent to Rs. 30.01 billion as compared to mid-July 2011. Total deposit mobilization of these institutions stood at Rs. 5.13 billion and total borrowing at Rs.16.57 billion by mid-July

2012. Similarly, total loan and investment reached Rs. 17.70 billion and Rs.2.19 billion, respectively.

27. Likewise, as of mid-July 2012 the total outstanding loan and advances of micro finance development banks increased by 21.0 percent and reached Rs. 17,738 million compared to Rs. 14,650 million in mid-July 2011.

NRB Licensed Limited Banking Cooperatives

28. The number of cooperatives permitted for limited banking activities by NRB as of mid-July 2012 is 16. Out of them, National Cooperative Development Bank is involved in wholesale lending while the other 15 are retail lenders. The total assets to liabilities of these institutions amounted to Rs.11.36 billion at the end of the review year. Similarly, total deposits, total loans and advances mobilized by these cooperatives stood at Rs. 8.52 billion and Rs. 6.39 billion respectively. The total investment comprising investment on government securities, fixed deposits and other investments stood at Rs. 0.77 billion in mid-July 2012.

NRB Licensed Non-Government Organizations

29. There are altogether 38 NGOs licensed by NRB undertaking limited banking transactions. These are registered under Institutions Registration Act, 1977 and carry out limited banking transactions in accordance with the provision of the Financial Intermediary Act, 1999. Total deposit and investment of these institutions as of mid-July 2012 amounted to Rs. 1.85 billion and Rs. 4.36 billion respectively.

Rural Self-Reliance Fund

30. The Rural Self Reliance Fund (RSRF) was established in 1991 by the combined effort of GON and NRB. Total capital of this fund reached Rs.0.44 billion comprising Rs.0.19 billion and Rs.0.25 billion of GON and NRB respectively. It provides short term loans to Co-operatives and FINGOs whereas long-term loans are provided to development banks and

micro finance development banks. The current limit per borrower has been kept at Rs 60,000 for the loans disbursed through this fund. As of mid-July 2012, total loan of Rs 741.6 million has been disbursed to 680 institutions of 60 districts through this fund benefiting some 32 thousand households. The recent repayment rate of this fund is about 94 percent.

Other Cooperatives

31. Savings and Credit Co-operatives (SACCOS) and other co-operatives doing savings and credit activities are registered as per the prevailing acts but not licensed, regulated and supervised by the NRB. As of mid-July 2012, there were altogether 26,501 cooperatives operating in Nepal out of which 11,851 were in the category of saving and credit cooperative. These saving and credit cooperatives have a deposit base of Rs. 109.94 billion and investment of Rs 94.78 billion

32. Department of Cooperatives (DOEC) regulates these types of cooperatives. The present regulation and supervision is not sufficient for regulating their banking activities. Banking activities need sound regulatory and supervisory measures to ensure financial health. However DOEC lack technical capabilities and resources in monitoring and supervising the growing number of cooperatives. In the absence of stringent measures, such institutions might be performing as shadow banking, which affect the formal banking activities.

33. In this context, Micro Finance Authority Bill has been proposed where there is provision of establishing second tier institution for regulating and supervising scattered micro finance institutions in the country. Furthermore, the draft Act to convert Rural Self Reliance Fund into National Micro Finance Fund has been finalized.

34. There is a complaint that lending rates of institutions providing micro finance services are exorbitant, that the margin between the cost of fund and lending rate is too high and that some of the poor borrowers have difficulty

to borrow at such a high rate. Though the essence of micro finance institutions is undertaking of social business, these days micro finance institutions are moving towards commercialization. These trends may have negative impact on overall stability of the financial system.

Informal Sectors

35. Various informal saving and credit groups, self-help groups, Dhukuties and local money-lenders among others, can be grouped in this category. Since there is no mechanism for registering these sectors/groups, data on their transaction volume and activities of these sectors are not available. However, it is believed that significant volume of transaction is being done by the informal sector. These sectors need to be regularized in order to bring their transactions in the formal channel.

Financial Soundness Indicators (FSI)

Capital Adequacy

36. The review of commercial banks' capital adequacy ratio showed signs of improvement in mid-July 2012 with a capital adequacy ratio of 11.50 percent compared to 10.59 percent in the previous year. It is the negative capital adequacy ratio of NBL and RBB, which stood at -5.46 percent and -9.35 percent that had pulled down the overall capital adequacy ratio of the commercial banks. Likewise, the capital adequacy ratio of B and C class institution was observed to be 20.5 percent and 23.05 percent respectively, higher than required minimum capital adequacy ratio. Further, the core capital ratio, which represents the high quality capital of institutions, stood at 10 percent, 19.61 percent and 23.05 percent for A, B and C class institution respectively, indicating that Nepalese financial sector is well capitalized.

Assets Quality

37. In mid-July 2012, the average NPL ratio of A, B and C class institutions stood at 6.08 percent with finance companies having the maximum of 10.7 percent followed by development banks with 4.9 percent and commercial banks with 2.6 percent. The asset quality of commercial banks has shown some signs of improvement with the reduction of NPL ratio from 3.19 percent in mid-July 2011 to 2.6 percent in mid-July 2012. NPL ratio of three state owned commercial banks was 6.54 percent on average and the same for private commercial banks was 1.7 percent on average in July 2012. Similarly, the average of total non-performing loan net of provision to capital stood at 4.33 percent, 4.62 percent and 5.29 percent respectively for A, B and C class institutions.

38. Wholesalers and retailers sector is the highest receiver of loans and advances from BFIs with 20.20 percent of the total loan as of mid-July 2012. This was followed by the production sector with 19.8 percent. Similarly, 'finance, insurance and real estate' and other sectors received 10.15 percent. Though majority of the people depend on agriculture for livelihood and this sector contributes to around 35 percent of GDP, the loan flowed towards this sector was found to be just 3.6 percent.

39. As of mid-July 2012 out of total loan and advances 85.71 percent was secured by fixed and current assets, and out of which 72.55 percent was secured by fixed assets. As more than 70 percent of total loan and advances provided by BFIs is secured by fixed assets comprising mainly land and buildings, sluggishness in realty sector would severely affect the value of such securities. Further, most of the BFIs have no strict, fair and periodic revaluation policy and practice, deterioration in the value of such securities affects the quality of credit and thus increases NPL and decreases profitability as well as liquidity, which in turn may affect financial stability.

40. With regard to product-wise classification of loan and advances, demand and working capital loan comprises around 23.48 percent followed by

overdraft loan, term loan and real estate loan. The real estate loan was formed 11.75 percent of the total loan of BFIs. However, the major portion of loan provided in overdraft and in working capital product may indirectly expose BFIs to realty sector. One of the challenging issues of the system is excessive lending to the real estate sector both directly and indirectly. Loans for housing and non-housing construction, together with real-estate loans account for 16.92 percent of the loan portfolio of commercial banks—going up to 21.09 and 25.35 percent for development banks and finance companies respectively. Overexposure to this sector is further worsened by decline in real estate prices and slowdown in transaction that is posing stress to the banking sector. Indirect exposure of BFIs in realty sector through collateral is nearly two-thirds of total assets though data reveals that direct exposure to this sector is very low. Decline in real estate prices and slowdown in transaction may have significantly damaged banks' balance sheets but is not being reflected in reported NPLs.

Profitability

41. Low growth of credit, huge credit exposure in real estate sector (either direct or indirect) and decline in real estate transactions as well as price, excess liquidity resulting in lower returns, unstable socio-political environment and growing competition led to the deterioration in interest income as well as total income of BFIs adversely impacting in the profitability of the institutions. In mid-July 2012, return on Asset (ROA) of A, B and C class institutions were recorded to be 2.04 percent, 1.09 percent and 0.22 percent respectively. Likewise, return on equity (ROE) recorded to stood at 22.44 percent for A class institutions and 7.52 percent and 1.60 percent for B and C class institutions respectively.

Liquidity

42. During 2011/12, Nepalese BFIs experienced comfortable liquidity against severe liquidity crisis in 2010/11. The various policy measures taken by NRB to resolve the liquidity problems along with increase in remittances,

export earnings and low growth in import can be attributed to the increased domestic deposits in 2011/12 resulting in improved liquidity position. The liquid asset to deposit ratio of A, B and C class institutions recorded stood at 33.3 percent, 40.13 percent and 38.39 percent respectively, which is above the regulatory requirement of 20 percent.

43. As at mid-July 2012, the credit to deposit ratio stood at 71.73 percent, 79.04 percent and 87.56 percent for A, B and C class institution respectively. Similarly liquid assets to total asset of A, B and C class institutions was observed to be 27.08 percent, 29.89 percent, and 25.87 percent respectively.

44. Though the liquidity pressure had moderated, liquidity risk may hit banks at any time, as they are subject to growing competition, poor asset liability management practices, poor corporate governance and high dependence on corporate deposits and remittance.

Stress Testing of Commercial Banks

45. Stress testing is a risk management tool used to evaluate the potential impact on a bank of a specific event and/or movement in a set of financial variables. NRB has prepared a standard module to carry out stress testing of the banks based on the framework of International Monetary Fund (IMF) and Basel Committee on Banking Supervision. The banks need to assess their soundness in the case of key risk areas such as credit risk, market risk, and liquidity risk. The stress testing results of commercial banks as of mid-July 2012 on various shocks have been discussed below.

Credit Shock

46. The stress testing results for commercial banks as of mid-July 2012 revealed that a standard credit shock would push the capital adequacy ratio of 22 among 32 commercial banks below the regulatory minimum. The number of such banks in 2011 was 20. Standard credit shock has been defined as 15 percent of performing loans deteriorating to substandard, 15 percent of substandard loans deteriorating to doubtful, 25 percent of doubtful loans

deteriorating to loss and 5 percent of performing loans deteriorating to loss. However, there is a significant improvement in the response to credit shocks, particularly those calibrated to real estate loans. In case of 25 percent of performing loans of real estate and housing sector is directly downgraded to loss loans, CAR of 8 commercial banks will come below the required 10 percent level. The number of such banks undertaking the test in 2011 was 16. The improvement is due to the decrease in banks' loans to the realty sector over the last couple of years.

Liquidity Shock

47. The number of banks that may turn illiquid after five days of standard withdrawal shock is 5 in 2012 compared to 15 in mid-July 2011. The excess liquidity in the system is the reason behind this improvement. Standard withdrawal shock is the withdrawal of customer deposits by 2 percent and 5 percent in the first two days and 10 percent each in the following three consecutive days. Likewise, if there is a withdrawal of deposit by 15 percent, 14 commercial banks' liquid assets to deposit ratio will be below 20 percent. This is an improvement from 22 commercial banks in the previous year.

48. Furthermore, the shock on withdrawal of deposits by top 5 institutional depositors, 17 out of 32 commercial banks' liquid assets to deposit ratio will be below 20 percent. This shows that commercial banks are vulnerable to fluctuation in institutional depositors.

Market Shock

49. The stress testing results revealed that all the commercial banks' (excluding two state owned banks) CAR was above the regulatory requirement when calibrate through interest rate, exchange rate and equity price shocks. Since the banks do not bear interest rate risks as they pass them directly to their clients, they were found to be less affected by interest rate shock. Also, they were safe from exchange rate risks as the net open position to foreign

currency is lower for a majority of them. Furthermore since commercial banks are not allowed to make equity investments except in their subsidiaries, the impact of fluctuation in equity price is also lower.

Other Financial Institutions

Insurance Companies

50. Insurance sector is also one of the emerging sectors in the financial system comprising 3.4 percent share in total asset and liabilities of the financial system. As of mid-July 2012, there were altogether 25 insurance companies established under Insurance Act, 1992. Among these, 8 offer life insurance services, 16 perform non-life insurance services and one company renders both life as well as non-life insurance services. According to the ownership structure, 3 insurance companies are operating under foreign investment and 2 insurance companies are in joint ventures with foreign insurance companies. Likewise, 19 insurance companies belong to the private sector whereas one company is under the government ownership. The total assets to liabilities of these companies increased by 15.8 percent from last year to Rs. 70.89 billion in mid-July 2012. Total premium collection of these companies was estimated to be Rs. 19.70 billion (excluding National Insurance Corporation) by mid-July 2012 as compared to Rs. 17.61 billion last year.

Employees Provident Fund

51. Employees Provident Fund (EPF), which was established on 16 September 1962 under the EPF Act, 1962, manages the provident fund of government employees, army, police, teachers, and government corporations and of some private companies. Total assets to liabilities of the EPF increased by 19.6 percent to Rs. 127.48 billion in mid-July 2012 from Rs. 106.58 billion last year. The fund collected by the EPF increased by 21.8 percent and stood at Rs.124.59 billion in mid-July 2012 compared to Rs.102.33 billion in mid-July 2011.

Citizen Investment Trust

52. Citizen Investment Trust (CIT) was established on 18 March 1991 under CIT Act, 1991. This Trust mobilizes the private and institutional savings, extends loans and advances, and also works as an issue manager of securities. The Trust is under GoN's Ministry of Finance. Total assets to liabilities of the CIT increased by 41.5 percent to Rs. 38.07 billion in mid-July 2012 from Rs. 26.91 billion of last year. Fund collection, the major component in the liabilities side, increased by 33.3 percent to Rs. 31.39 billion in mid-July 2012. It was Rs. 23.55 billion last year. On the assets side, loan/advances of CIT reached Rs. 9.66 billion in the review year from Rs. 4.36 billion last year.

Postal Savings Bank

53. The Postal Savings Bank was established under GoN's Postal Service Department and came into operation in 1976. Out of a total of 117 licensed offices by mid-July 2012, only 68 postal savings offices mobilized deposits. Total deposit collected by these offices was Rs. 1.28 billion by mid-July 2012. Similarly, the number of total accounts stood at 54,796. As of mid-July 2012, the total investment made by its 59 offices engaged in investment related activities was Rs. 0.48 billion.

CHAPTER 4
FINANCIAL MARKETS

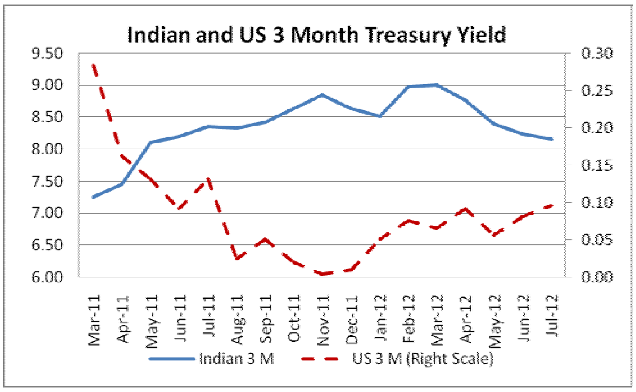
International Scenario

1. After a slow recovery from the world economic crisis, a series of shocks have emerged in the global financial system, which increased the risk to financial stability. Continued market stress in the Euro area periphery and signs of an economic contraction in the euro area as a whole are among such shocks. *IMF GFSR Market Update, July 2012* cautions for the intense financial market risk that emerged from spillover from the euro area crisis and uncertainties on the fiscal outlook and federal debt ceiling in the United States.

2. A flight to safe assets led to a collapse of yields on government bond in the U.S., Germany, and Switzerland, and pushed the dollar to a 20 month high against major currencies. Sovereign debt yield in the euro periphery rose sharply. Positive sign of easing financial conditions and recovering confidence in response to the European Central Bank's longer term refinancing operations (LTROs) has also diminished.

3. The 10-year US treasury yields recorded 1.47 percent in July 2012, after registering the highest yield of 3.47 percent in June 2011. It had hovered around 4.0 per cent in June 2009. However, 3-month US treasury yield has improved to 0.10 percent after recording the lowest of 0.005 percent in November 2011. This reflects the recent policy changes of Federal Reserve

Figure 4.1: Indian and US 3 Month Treasury Yield



Bank known as "Operation Twist". Such rate was 0.283 percent in March 2011. In case of India, government 3-month Treasury bill rate slightly moderated to 8.16 percent after exhibiting upward trend. The 3-month yield rate which stood at its highest of 9.0 percent in March 2012 had gone up by 1.75 percentage point a year ago.

4. The 3-months LIBOR rate of USD showed an upward trend since 2011, whereas 3-months AUD and EURO rates declined significantly. The value of USD against the major international currencies has remained more or less similar.

Figure 4.2: Libor Rate

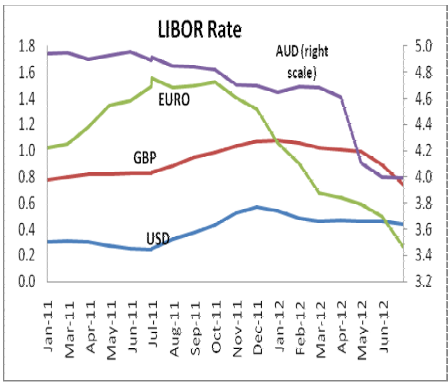
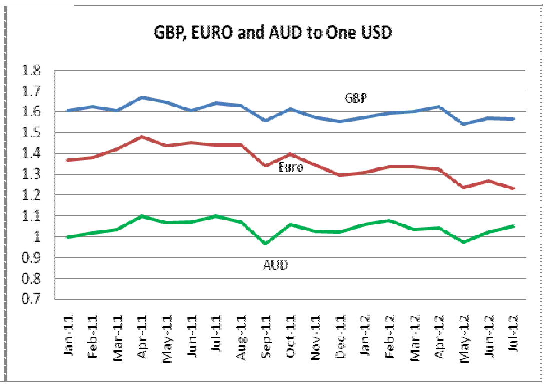


Figure 4.3: GBP, EURO and AUD to One USD



However, in September the USD witnessed a sign of depreciation against the major international currencies.

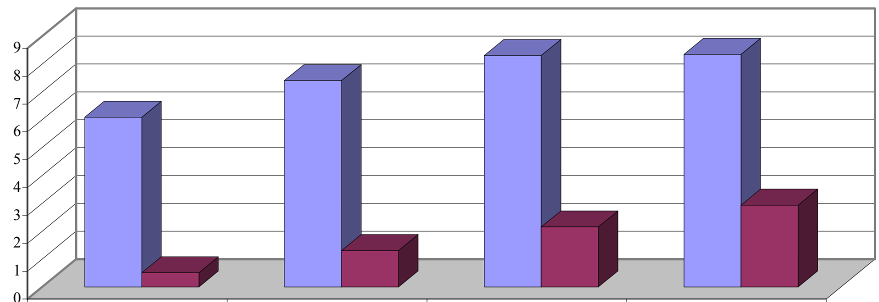
Domestic Scenario

5. With the improvement in liquidity situation in the market, the short term and long term interest rate in the market declined significantly in 2011/12 compared to that of 2010/11. The weighted average interbank transaction rate declined from 8.44 percent in 2010/11 to 1.28 percent in 2011/12.

6. Treasury bill (T-Bills) is one of the most liquid and largely traded instruments in Nepalese money market. As of mid-July 2012, the T-Bills outstanding amounted to Rs 131.62 billion, which comprises about 63

percent of the total internal debt liability of Nepal Government. In 2011/12, T-Bill worth Rs. 17.28 billion has been issued as mentioned in the budget speech of GON. The yearly average discount rate of 28-days, 91-days, 182-days and 364-days T-Bills remained at 0.5172 percent, 1.3067 percent, 2.1569 percent and 2.9414 percent respectively. As illustrated by the chart below, in 2011/12 the average interest rate of all types of T-Bills declined sharply as compared to that of 2010/11. The easing of liquidity in the market owing to accommodative monetary policy, high remittance inflows and timely budget are the main reasons behind the sharp drop in interest rates as compared to that of 2010/11.

Figure 4.4: Weighted Annual Average Discount Rate of T-Bills



	28-days	91-days	182-days	364-days
2010/11	6.0963	7.4139	8.3122	8.3512
2011/12	0.5172	1.3067	2.1569	2.9414

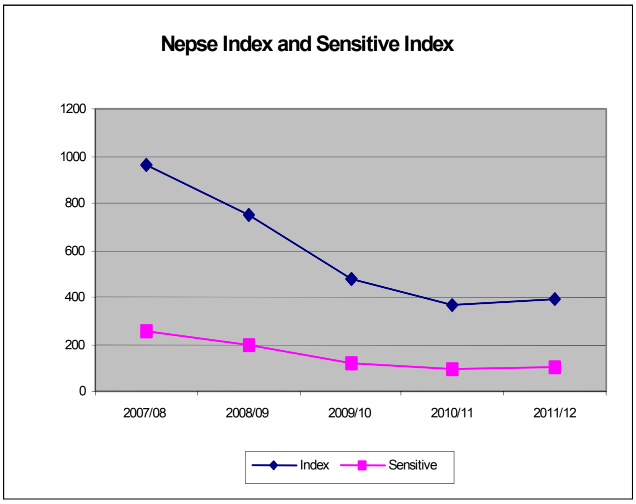
2010/11 2011/12

7. Development bonds amounting to Rs. 14 billion was issued through auction in 2011/12, comprising of Rs. 3.5 billion with maturity of 2 years and Rs. 10.5 million with maturity of 3 years. The coupon rate of 3-year maturity bonds was 8.5 percent and that of 2-year maturity bonds was 8.0 percent. Likewise in the previous year, National Saving Bond (NSB) worth Rs. 5 billion with maturity of 4 years with a coupon rate of 9 percent was issued. The sale of Foreign Employment Bond amounted to Rs. 8.66 million in 2011/12.

Securities Market

8. The security market of Nepal, which was experiencing bearish trend for the last couple of years showed some signs of improvement in 2011/12. NEPSE index, year on year (y-o-y) basis, increased by 7.4 percent to 389.74 points in mid-July 2012. The index had dropped by 24.0 percent in the previous year and stood at 362.85 points as at mid-July 2011. Likewise, NEPSE sensitive index stood at 98.77 point in mid-July 2012 compared to 89.44 in mid-July 2011. With the bullish trend in Nepse Index, the value of transaction in the securities market also increased remarkably in 2011/12. The transaction value increased by 54.2 percent to Rs.10.28 billion during 2011/12 as compared to Rs. 6.66 billion in the previous year.

Figure 4.5: Nepse Index and Sensitive Index



9. The y-o-y market capitalization increased by 13.8 percent to Rs. 368.26 billion in mid-July 2012, which is equivalent to 23.6 percent of GDP. As in the previous year, the banks and financial institutions comprise a major share of 68.9 percent in total market capitalization while the share of manufacturing and processing companies, hotels, business entities, hydropower and other sectors stood at 3.2 percent, 1.8 percent, 0.3 percent, 5.3 percent and 20.5 percent respectively.

10. Total paid-up capital of the listed companies stood at Rs. 110.61 billion in mid-July 2012 which was 10.4 percent increment over mid-July 2011. Such an increase in paid-up capital was due to the additional listing of securities

at the NEPSE. In 2011/12, additional securities comprising ordinary share of 11 companies worth Rs. 3.57 billion, bonus share of 61 companies worth Rs. 4.21 billion and right share of 33 companies worth Rs. 2.40 billion were listed at the NEPSE. In addition, government securities of Rs. 15 billion and commercial banks' bond of Rs. 0.70 billion were also listed in the NEPSE.

11. The total number of companies listed at the NEPSE reached 216, which is an increment from 209 in mid-July 2011. Of the total, 85.19 percent of the listed companies in NEPSE is represented by BFIs. The dominance of BFIs in the security market exposes this market to concentration risk which may ultimately affect overall financial stability of the system. Further, though NEPSE facilitates trading of all kinds of shares, bonds, debentures and mutual funds in Nepal, however, the market is primarily dominated by trading of equity shares.

Foreign Exchange Market

12. The Foreign Exchange Market basically comprises market players, foreign exchange policies, instruments and its smooth operations. The position of the foreign exchange market players are as follows:

Table 4.1: Number of Foreign Exchange Market Players

Name of the Forex Market Players	Number	Type of Forex Transaction
Licenses Commercial	32	L/C, foreign currencies buying and selling, IC buying and selling. Open Agency in the foreign banks. *
Development Banks and Financial Institutions	61	Inward remittance, IC buying and selling, Foreign currency buying and selling.**
Money Changer	165	Foreign currencies exchange
Money Transfer	51	Inward remittances
Hotels	100	Accepting foreign currencies
Travels	1504	do
Trekking	1281	do
Airlines (Domestic as well as Foreign)	34	do
GSA/PSA of Foreign Airlines	52	do
Cargo and Courier	298	do
Others	67	do

* For A and B class Institution as stated in the NRB's Unified Directives for the Banks and Financial Institutions.

** For B, C and D class License Institutions

Source: Foreign Exchange Management Department, Nepal Rastra Bank

13. The total reserve of the banking system increased by 61.5 percent to Rs. 439.46 billion in mid-July 2012 from a level of Rs. 272.15 billion as at mid-July 2011. Out of the total reserve NRB's reserves increased by 76.2 percent to Rs. 375.52 billion in mid-July 2012.from a level of Rs. 213.10 billion as at mid-July 2011.

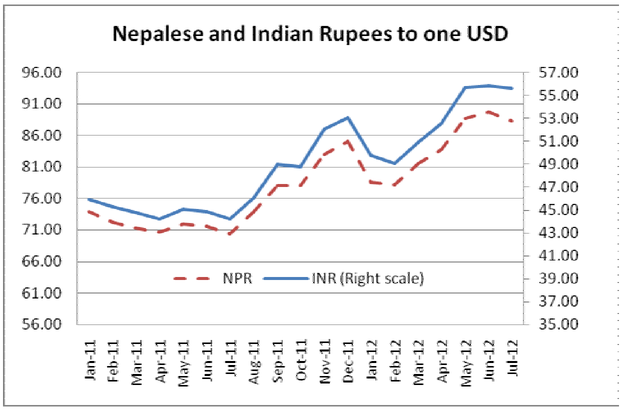
Table 4.2: Total Forex Reserve

	Mid-July (in billions)			Percent Change	
	2010	2011	2012	2010/11	2011/12
Nepal Rastra Bank	205.37	213.09	375.52	3.8	76.2
Commercial Bank	63.52	9.06	63.93	7.0	8.3
Total Reserve	268.89	272.15	439.46	1.2	61.5

Source: Nepal Rastra Bank

14. Nepalese currency depreciated against USD during 2011/12. The exchange rate of one USD stood at Rs 88.60 in mid-July 2012 compared to Rs 70.95 in mid- July 2011, witnessing a depreciation by 19.9 percent in mid-July 2012 form the level of mid-July 2011.

Figure 4.6: Nepalese and Indian Rupees Exchange Rate



15. NRB attempts to maintain an orderly forex market through monitoring of foreign currency transaction, prudential regulations and buy & sale transaction in the domestic foreign exchange market.

16. In 2011/12, NRB purchased US dollar 3.19 billion from commercial banks. Net liquidity of Rs. 174.30 billion was injected through the purchase of USD 2.42 billion from foreign exchange market in the previous year.

17. In 2011/12, NRB purchased Indian Rupees equivalent to 213.95 billion by selling USD 2.66 billion in the Indian money market. Because of the widening trade deficit with India on account of increase in the import of petroleum products attributed to a higher amount of INR purchase in 2011/12. Lower quantity of USD has been sold in 2011/12 due to depreciation of INR against USD however, the amount of INR purchased increased in the same period.

Table 4.3: USD sold and INR Purchase

(Rs. in million)

Fiscal Year	Sale of USD	Purchase of INR	Equivalent NPR
2007/08	1730.0	70602.5	112964.0
2008/09	1,520.0	73,400.6	117,440.9
2009/10	21900	102093.2	163349.2
2010/11	2740.0	123845.2	198152.3
2011/12	2660.0	133718.6	213949.8

Source: Nepal Rastra Bank

18. As parallel market transaction of foreign currency is a common phenomenon in developing countries and in countries adopting controlled foreign exchange regime to a large extent, the existence of such market in Nepal cannot be ignored. Cross border transaction through Hundi is also a matter of concern in Nepalese context. While the size of such markets is yet to be estimated, the possible growth of such markets will have unfavorable impact considering the size of our foreign exchange reserve.

19. Foreign remittances have become a major source of foreign currency inflow in the nation. With the growth in foreign employment and appreciation of USD, worker's remittance increased by 41.8 percent in 2011/12 to Rs 359.55 billion mid-July 2012 against the growth of 9.4 percent in previous year. The annual remittance inflow for the past three years is as follows:

Table 4.4: Annual Remittance Inflow

(Rs. in billion)

Particulars	Annual		
	2009/10	2010/11	2011/12
Annual Remittance inflow	231.73	253.55	359.55
Increase in Remittance inflow (%)	-	9.4	41.8

Source: Nepal Rastra Bank

CHAPTER 5

FINANCIAL SECTOR POLICIES AND INFRASTRUCTURE

Financial Sector Policies

1. Sound regulatory policies and robust arrangement for regulating financial system are the fundamental requirements in order to ensure financial stability. NRB is entrusted with the responsibility of regulating, inspecting, supervising and monitoring banks and financial institutions. Accordingly, NRB has been issuing various policies, directives, guidelines and circulars. Some of the important banking legislations and policies in this regard are as follows;

    - Nepal Rastra Bank Act, 2002
    - Bank and Financial Institutions Act, 2007
    - Company Act, 2007
    - Asset (Money) Laundering Prevention Act, 2012
    - Banking Offence and Punishment Act , 2008
    - Foreign Exchange (Regulation) Act, 1963
    - Supervision By-laws, 2003
    - Unified Directives issued to licensed institutions
    - Forex Circulars issued to licensed institutions
    - Merger By-Laws, 2012

Regulations

2. NRB's directives and circulars encompass regulations relating to capital, asset quality, liquidity, corporate governance, risk management etc. The objectives of these regulations are to strengthen the health and soundness of the banks and financial institutions, enhance public confidence and ultimately contribute in maintaining stability in the financial system.

Capital Adequacy

3. With a view to adopting international best practices, Nepal is implementing Basel II framework starting from the simplest form of the available approaches with the vision to move towards the more complex and risk sensitive approaches as the market gradually gains maturity. This regulatory capital requirement has been implemented in full fledge in A class institutions since 2008 and the same capital standard has been implemented for national level B class institutions on parallel basis since 2010/11.

4. Currently Simplified Standardized Approach (SSA) is used for measuring credit risks and Basic Indicator Approach (BIA) and Net Open Position Approach (NOPA) are used for measuring operational and market risks respectively. The main objective of this framework is to develop safe and sound financial system by the way of sufficient amount of qualitative capital and risk management practices. Based on its risk-weight assets, a licensed financial institution shall have to maintain the following capital adequacy ratio:

Table 5.1: Minimum Capital Adequacy Ratio

Institution	Minimum CAR	
	Core capital	Capital fund
"A" Class	6.0	10.0
"B" and "C" Class	5.5	11.0
"D" class	4.0	8.0

NRB expects banks to operate above the minimum regulatory capital ratios. Whenever NRB is not convinced about the risk management practices and control environment, it has the authority to require banks to hold capital in excess of minimum. Furthermore, as a part of NRB's continuous effort to enhance regulatory framework, homework is being done to adopt some of the provisions of BASEL III

Financial Consolidation

5. In order to develop sound, efficient and robust financial institutions with strong capital base by encouraging financial consolidation, Merger Bylaws, 2011 has been issued. The bylaws include several incentives, regulatory relaxations and an indirect provision of forceful merger as well. A separate desk has been established in Bank and Financial Institution Regulation Department to facilitate the merger process. NRB has taken the policy of encouraging merger and accordingly many BFIs are showing interest for financial consolidation. After the introduction of this byelaw**,** three financial institutions have been merged in two commercial banks; likewise seven development banks and five finance companies are merged with each other and formed six development banks. In addition to this, the bank has already provided letter of intent to merge one development bank and five finance companies with each other to form one development bank and two finance companies.

Liquidity

6. The BFIs that collect public deposits shall have to maintain a deposit of 5 percent of total deposit liabilities as CRR. Furthermore, with the objective of ensuring sufficient liquidity in the financial system, Statutory Liquidity Ratio (SLR) has been fixed at 15 percent, 11 percent and 10 percent of total deposit for A, B and C class institutions respectively. For D class institution collecting public deposits, the SLR requirement is 4 percent. Furthermore, NRB is in the process to introduce a better monitoring system to detect future liquidity problems along with a Prompt Corrective Action (PCA) program with appropriate liquidity triggers. This proposed system aims to ensure that all BFIs maintain an adequate level of high quality liquid assets that can be converted into cash to meet its liquidity needs.

7. Likewise, in order to mitigate liquidity risk there is a provision that the total loan and advance of BFIs should not exceed 80 percent of its deposit and core capital.

Risk Management

8. In order to provide guidelines to commercial banks on risk management system, NRB has issued Risk Management Guidelines (RMG). The RMG sets out minimum standards that shall be expected of a risk management framework. Guidelines on stress testing has been issued so that banks itself carry its stress testing and also to manage liquidity of banks. Institution-wise Liquidity Monitoring Framework (ILMF) is about to implement so as to increase the capacity of forward looking analysis. To increase the effectiveness in Risk Based Supervision, the current supervision mechanism is reanalyzed and modification work is being carried out. Also, to increase the effectiveness on Early Warning System and to prepare the contingency plan, Bank Resolution Framework has been prepared including the stepwise tasks on Crisis Management.

Deposit Mobilization

9. Since high dependency on institutional deposits may lead to liquidity problems, a limit has been imposed for institutional deposit collection. The A, B and C class licensed institutions are allowed to collect institutional deposits from a single firm, company or any other corporate bodies not exceeding 20 percent of their total deposits.

10. Further, in order to enhance healthy business practices, the A, B and C class institutions are barred from opening interest bearing deposit accounts with each other.

Corporate Governance

11. Guidelines on services and fees and commission on services charged by BFIs have been issued to maintain transparency and welfare of public. The guideline, among others states that banks and BFIs should establish information and grievance hearing desk to address grievances of customers.

12. Guidelines on compensation packages for chief executive officer of BFIs have been issued in order to enhance equitability and transparency in the financial system.

13. A policy provision has been made so that promoters, chief executive officers or managerial level officials of licensed institutions are barred from borrowing any personal loan except education loans, over draft, home loan or home appliances loans from any licensed institutions to avoid systemic risk arising from conflict of interest of banker and entrepreneur.

14. A policy discouraging a single person from being the Chairman and CEO of the financial institution has been issued.

15. Declarations of loan by promoter and family members from BFIs have been made mandatory.

Financial Inclusion and Access to Finance

16. A provision of interest free loan up to Rs. 5 million and Rs.10 million to BFIs for opening a branch in district headquarters and outside district headquarter of 22 remote districts has been made for a specified period to enhance financial inclusion through expansion of financial institutions in areas where there is lack of access to finance.

17. Policy provision has been made where BFIs will be granted to open branch in Kathmandu valley only after opening one branch in specified remote districts and one in other district.

18. Similarly, provision has been made to provide interest free loan up to Rs. 1.5 million for class "D" financial institutions for extending their financial services by opening a new branch in the 9 specified districts with limited financial access. Under this provision, Rs. 60.65 million has been provided to BFIs of which Rs. 40 million has been provided to five commercial banks for their seven newly opened branches, Rs.2.5 million to two development

banks for their three newly opened branches and Rs. 1.5 million to one micro finance development bank for a new branch opened in 2011/12.

Deprived and Productive Sector Lending

19. The policy of increasing the deprived sector loan by 0.5 percentage point every year up to 3 years by BFIs has been made. Accordingly, for fiscal year 2011/12 commercial banks, development banks and finance companies are required to lend 3.5 percent, 3 percent and 2.5 percent respectively of their total loans to the deprived sector.

20. As a policy to promote productive sector lending, commercial banks are required to prepare and submit a plan to provide minimum 20 percent loan from their total loan and investment on various productive sectors like agriculture, energy, tourism, household and small industries within mid-July 2012 and also, minimum 10 percent loan should be provided to agriculture and energy within mid-July 2013.

21. As a result of the policies implemented to increase the loan in productive sectors the loan floated in such sectors are increasing. In 2011/12, the total loan flow from the BFIs increased from 2.6 percent to 3.6 percent. Likewise, in mid-July 2012 the loan in productive sector has increased by 21 percent and its share on total loan has increased from 18.4 percent to 20 percent as compared to that of the previous year.

Refinance

22. Multiple refinancing windows including normal and special refinancing have been opened as a policy response to ease the acute liquidity shortage faced by the financial institutions in 2010/11. With the banking system enjoying surplus liquidity in 2011/12, the Special Liquidity Refinancing facility has been repealed. Further to increase credit flow to the hydroelectricity projects from BFIs, provision for refinancing hydropower projects has been introduced.

23. In 2011/12, to increase the credit flow on productive sector, BFIs were facilitated by refinance loan amounting to Rs. 868.6 million against collateral of good loan. This facility helped to increase the loan to the productive sector. Likewise, refinance facility amounting Rs. 1277.1 million has been provided for hydropower projects.

24. BFIs are allowed to deduct the amount of refinance loans out of their total credit while calculating the credit to deposit (CD) ratio if such loans are floated for hydro projects of up to 25 MW. Likewise, if BFIs float the loan by taking long-term loan in foreign currency for the duration of five years or more, then such long term loan is counted as resource mobilization for purpose of calculating CD ratio.

E-Banking

25. NRB has issued comprehensive regulation on electronic banking, which governs internet and mobile-based services like branchless banking, mobile banking, internet banking and card services offered by BFIs. The directive largely describes the nature and quality of services and security measures that banks are required to comply with. With the directive in place, BFIs are now required to acquire NRB's permission to launch products related to e-banking, mobile banking and branchless banking.

Licensing Policy

26. Rapid growth in number of BFIs concentrating in urban areas has been witnessed in the country during the last decade. Considering the fact that large number of BFIs amidst limited market and supervision can lead to unhealthy competition, a moratorium on licensing of A, B and C class institution has been imposed until another policy provision is announced. However, licensing of D class institutions is still open so as to promote establishment of financial institutions in rural areas. Besides that, an initiation is going on for developing a differential licensing policy for rural and urban areas.

27. Financial services provided by the D class institutions and their role in financial outreach with inclusion has been recognized a lot, however, NRB believes that these services are insufficient to fulfill the objective of poverty alleviation through micro-finance activities. The financial services in the rural areas need to be more focused towards poor people and their social needs. Considering the fact of higher demand of financial services in the unbanked areas through more socialization and financial inclusion with rural and poor people, NRB has been allowing approval for the establishment of micro-finance institutions in the context of a moratorium on licensing of other BFIs. Principally, there is no doubt that micro-finance institutions should be operated in a commercially viable manner. But, since such institutions are operating in the sector of poverty alleviation as per the Grameen Banking principle, they should not forget their social obligations. Taking into account this fact, the NRB has serious concern on their present structure of high interest rate and believes it will be corrected by themselves and no intervention would be required.

Security Market

28. Considering the probability of erosion in investors' confidence and adverse impact on economic stability from fluctuation in share prices, liberal policies have been initiated by NRB relating to loan renewal and margin call for loan against pledging of shares. Accordingly, loan against share could be extended based on average share price of last 180 days or latest market price whichever is lower, and BFIs would determine the margin themselves to minimize the risk while extending such loans. A positive sign has been seen in the capital market after the implementation of this provision.

29. Provision has been made under which credit can be extended on the guarantee of broker and on the basis of share sale/purchase receipt for maximum period of one year by BFIs by changing the existing provision of pledging original share certificate to access such type of loan.

30. A provision has been made whereby licensed “A”, ”B” and “C” class BFIs could establish a subsidiary company with at least 51 percent ownership for mutual fund or merchant banking activities after approval from Nepal Stock Exchange Ltd and following existing policy provisions on investment.

Real Estate

31. Ceiling for individual residential home loan have been raised to Rs. 10 million from existing ceiling of Rs. 8 million. The time limit to bring down the real estate loan to 25 percent by BFIs has been extended by one more year to mid-July 2013. Real estate borrowers are allowed for renewal of such loan up to mid-July 2013 upon the payment of all interest dues. Some positive signals have been observed in real estate business because of policies adopted by this bank for sustainable improvement of this sector.

Anti-Money Laundering/Combating Financing of Terrorism (AML/CFT)

32. A comprehensive Money (Asset) Laundering Prevention Act, 2008 has come into force to combat money laundering and terrorist financing and fulfill our international commitment against money laundering and financing of terrorism. As provisioned by the act, Financial Intelligence Unit (FIU) has been established within NRB to function as a central national agency responsible for receiving, analyzing and disseminating the financial information in order to combat the potential offence of Money Laundering and Financial Terrorism.

33. In order to control financial crimes and fraud, NRB has issued directives to licensed institutions and accordingly it has started receiving a number of Threshold Transaction Reports (TTRs) and Suspicious Transaction Reports (STRs)

Foreign Exchange

34. In the context of liberalization with full convertibility of Nepalese rupee in current account transactions, gradual liberalization of capital account with

more liberal foreign exchange rules and regulation to facilities the Nepalese entrepreneurs for foreign investment has been under discussion.

35. Commercial banks and "B" and "C" class financial institutions of national level are free to fix their exchange rates with convertible foreign currencies other than INR.

36. Under the travel expenses facility, the ceiling of foreign exchange facility provided as per passport facility to Nepalese citizens visiting third countries excluding India has been increased to USD 2,500.

37. A policy provision has been made allowing Nepalese individuals and organizations to open and operate bank account in foreign countries. Under this provision exporters are allowed to open bank account abroad up to the limit of 5 percent of their export earnings under specified terms and conditions.

38. The policy provision has been introduced such that banks and financial institutions can extend their credit in foreign currency to hydropower projects and in different foreign currency denominated instruments with prior approval of NRB.

39. Policy provision has been introduced such that equivalent of up to USD 1000 foreign currency received from relatives, friends, resident overseas and tips received from tourists can be easily exchanged from licensed institutions by showing identity card.

Recent Developments

40. Monetary Policy for 2012/13 incorporated new policies along with few policy change to achieve the objectives in maintaining price, external and financial sector stability, promoting financial access and facilitating high and sustainable economic growth in the country.

Box 5.1: Highlights of Monetary Policy 2012/13

- CRR increased to 6 percent for commercial banks, 5.5 percent to development banks, 5 percent to finance companies and 2 percent to micro-finance development banks. Earlier, it was 5 percent for all BFIs.
- Bank rate increased by one percentage point to 8 percent
- Introduction of Base Rate System in lending.
- Refinancing rates for agriculture and hydropower lowered to 6 percent from 7 percent. BFIs to initially issue loans under the facility at rates of up to 9 percent.
- Refinancing facility to migrant returnees on loans taken for commercial purposes.
- Merger and acquisition of the rural development banks will be completed in order to raise their capital base and strengthen their capacity to extend their financial services to deprived sector.
- Arrangement to be made to set up a Micro finance Authority as a regulatory institution for the regulation, inspection and supervision of micro finance institutions.
- National Financial Literacy Policy and Financial Sector Development Strategy to be formulated. Financial Stability Unit to be set up at the central bank and it will bring out Financial Stability Report.
- For overseas travelers, foreign currency facility for each travel increased to US$ 2500 for public and US$5000 for entrepreneur. Earlier, there was a cap of US$ 5000 for a year.
- Commercial banks allowed to invest up to 30 percent of the amount parked in agency banks abroad in low risk instruments such as call deposit and certificate of deposit.
- Interbank lending transaction set at maximum of 7 days and
- PAN number has been mandatory while taking loan exceeding a set limit.

41. The overall macroeconomic indicators of the country remained satisfactory in first half of 2012/13 including, as indicated the significant improvement in financial soundness indicators. The confidence of the people in the financial system has been gradually improving as a result of various new policy measures adopted both in monetary and financial aspects and efforts made by the NRB towards financial sector consolidation and strengthening of regulatory and supervisory norms. Despite the efforts, economic growth seems to be lower than expected and challenges remain in the financial sector.

42. The half-yearly review of the monetary policy has released already with the assessment of macroeconomic situations and outlook of the country. Recent initiatives and efforts made by the NRB for the development, as well as to

secure financial stability have been listed out in that review report with the implementation status of already taken policy measures.

Base Rate

43. The NRB has made it mandatory for all commercial banks to make public the base rate at least on a monthly basis. Under the provision, BFIs will have to determine lending rates on the basis of the base rate, a system that makes interest rate on credit transparent and ultimately narrow down the spread. International experience showed base rate has been effective in controlling the interest rate by lowering the spread rate of BFIs. The spread rate of BFIs still remains high and it has not been in the acceptable level. Maintaining high spread rate for a long period may be a challenge for the central bank to ensure financial stability. In the present context of liberalization of interest rate, the NRB does not intend to intervene into this system but if the present scenario of higher spread continues further, NRB would take necessary steps to rectify the system.

Mobile and Branchless Banking Services

44. Policy provision has been introduced allowing BFIs to provide banking services in unbanked areas and rural areas through e-banking and mobile devices to promote financial services, including the access. Similarly, NRB has been promoting branchless banking for the expansion of banking services to the unbanked population instead of focusing on opening more branches. Branchless banking has been recognised as an important tool to increase banking access to the people living in geographically difficult-to-reach places in Nepal.

IT Guidelines

45. With the high dependency of BFIs on information technology, issues such as with changes in technology, migrating system from one to another, maintaining adequate internal control system, limiting access to system and data from unauthorized access, securing electronic transactions, meeting

legal requirements, managing outsourcing services, and managing other IT related risks have emerged in the banking sector. Therefore, in order to promote sound and robust technology and risk management and to strengthen system security, reliability, availability and business continuity in commercial banks, NRB has recently issued Information Technology (IT) Guidelines. As per the guidelines all commercial banks operating in the country are required to formulate IT security policy, legalize parking of data in foreign land, have disaster recovery plan and have, business continuity plan in place so that customers do not have to suffer in case of unforeseen events.

ICAAP Guidelines

46. In order to address risk identified by BASEL II and inherent risk associated with individual banks, guidelines on Internal Capital Adequacy Assessment Process (ICAAP) have been issued for commercial banks. As per the guidelines, banks are required to set policies, methodologies and procedures for assessing its capital adequacy relative to its risk profile.

Financial Infrastructure

Payment and Settlement System

47. Payment and Settlement System is a mechanism through which financial transaction are smoothly cleared and timely settled. Safe and efficient payment system creates credibility in the financial system, which is one of the prerequisite for maintaining financial stability. With the rapid development in ICT, method of payment and settling transactions have migrated from conventional paper based payment instruments to electronic payment instruments. Since developing secure, healthy and efficient system is one of the objectives of NRB, NRB is effortful in developing and promoting sound and efficient payment system through introducing Real Time Gross Settlement System (RTGS) and validating E- payment.

48. NRB has given approval to Nepal Clearing House Limited (NCHL) to start Electronic Cheque Clearing (ECC) system. The ECC system provides means to electronically transfer cheque images through a secure medium, thus completely replacing the traditional physical routine of moving paper-cheques among the banks and clearing house, which result in significant reduction of tedious and time consuming manual process of cheque clearing, both for the banks and for the customers.

49. Nepal Central Depository and Clearing Ltd was established at the imitation of NEPSE to provide centralized depository, clearing and settlement services in Nepal. The operation of CDS is expected to bring revolution in the Nepalese capital market. The safety and security of physical holding to electronic medium will eliminate thefts, interceptions and subsequent misuse of certificates while the flow of securities will also be looked due to instant transfers. Hence, the transparency level of trading in this platform is expected to be more secure, clear and easy.

Financial Safety Net

50. As a part of financial safety net mechanism, policy provision has been introduced, for insuring deposit up to Rs. 2,00,000 of small depositors of licensed banks and financial institutions with Deposit and Credit Guarantee Corporation (DCGC). Moreover, as per the policy the insured amount to be increased is to be Rs. 500,000 gradually. Deposit amounting to Rs. 194 billion of 6.9 million depositors have been insured till mid-April 2012 from 193 BFIs that comprises around 35 percent of total individuals' deposits. Though there are some issues to be resolved in the pricing, coverage, payout mechanism, this mandatory provision played an important role in restoring public confidence on banks and financial institutions.

Institutional Set up and Capacity Building

51. Supporting institutions like Credit Information Centre (CIC), Debt Recovery Tribunal (DRT), Credit Rating Agency (CRA), Assets Management Company (AMC), and Secured Transaction Registry (STR) also play a vital role in the development of strong financial system. NRB is coordinating with concerned authorities for the capacity building of CIC, DRT, etc and establishment of these types of supporting institutions.

Legal Framework

52. Strong legal framework facilitates smooth functioning of BFIs and thereby contributes in maintaining financial stability. NRB is working on formulating and amending required laws and regulations to facilitate prudential financial practices. Amendment of Nepal Rastra Bank Act, 2002 and Bank and Financial Institutions Act (BAFIA), 2006 that addresses major issues related to liquidation procedures of financial institutions is under way.

Annex 1

Structure of Nepalese Financial System

(Mid-July, 2012)

Rs in Million

Particulars	2009/10			2010/11			2011/12		
	Total assets/ Liabilities (Unaudited)	Percentage (share in total)	Ratio of Total Assets to Nominal GDP (%)	Total assets/ Liabilities (Unaudited)	Percentage (share in total)	Ratio of Total Assets to Nominal GDP (%)	Total assets/ Liabilities (Unaudited)	Percentage (share in total)	Ratio of Total Assets to Nominal GDP (%)
Financial institutions	1296715.8	89	108.6	1452668.9	88	106.1	1819355.2	88.4	116.8
Nepal Rastra Bank	296625.6	20.3	24.8	322043.9	19.5	23.5	455682.5	22.1	29.2
Commercial Banks	763226.3	52.3	63.9	853490.5	51.6	62.3	1052450.7	51.1	67.5
Finance Companies	109998.2	7.5	9.2	118578.2	7.2	8.7	109687.5	5.3	7
Development Banks	102208.9	7	8.6	129617.4	7.8	9.5	160360.2	7.8	10.3
Cooperatives	6975.2	0.5	0.6	8076	0.5	0.6	11358.8	0.6	0.7
Micro credit Financial Institutions	17681.6	1.2	1.5	20862.9	1.3	1.5	29815.5	1.4	1.9
Micro credit non-governmental Organizations	2382.6	0.2	0.2	4667.4	0.3	0.3	4360	0.2	0.3
Contractual Savings Institutions	160498.1	11	13.4	194703.3	12	14.2	236434.3	11.5	15.2
Employees Provident Fund	90390.3	6.2	7.6	106584.5	6.4	7.8	127475.8	6.2	8.2
Citizen Investment Trust	22647.8	1.6	1.9	26905.4	1.6	2	38068.5	1.8	2.4
Insurance Companies	47460	3.2	4	61213.4	3.7	4.5	70890	3.4	4.5
Postal Saving Bank	1085.9	0.1	0.1	1152.4	0.1	0.1	1152.4	0.1	0.1
Total	1460682.4	100	122.4	1653192	100	120.7	2061301.9	100	132.3
Nominal GDP (Rs Million)			1193679			1369430			1558170

Annex 2
Statement of Assets and Liabilities
(Mid-July, 2012)

Rs. In million

	Liabilities	Class "A"	Class "B"	Class "C"	Total
1	**CAPITAL FUND**	77,142.6	22,702.2	15,318.2	115,163.0
	a. Paid-up Capital	65,983.3	21,224.2	17,096.2	104,303.8
	b. Calls in Advance	4,325.3	276.0	156.9	4,758.3
	c. Proposed Bonus Share	0.0	52.2	44.3	96.5
	d. General Reserves	18,708.7	1,555.7	1,803.7	22,068.1
	e. Share Premium	213.3	80.7	65.6	359.6
	f. Retained Earning	-19,595.1	-764.1	-3,962.5	-24,321.8
	g. Others Reserves Fund	7,507.0	277.5	114.0	7,898.5
2	**BORROWINGS**	15,507.2	1,193.0	1,105.7	17,805.9
	a. NRB	4,286.7	0.0	0.0	4,286.7
	b.Interbank Borrowing	1,970.7	651.1	675.2	3,297.0
	d. Foreign Banks and Fin. Ins.	2,175.8	332.1	0.0	2,507.9
	e. Other Financial Ins.	146.2	204.4	430.5	781.1
	f. Bonds and Securities	6,927.8	5.4	0.0	6,933.2
3	**DEPOSITS**	867,978.3	127,300.1	76,115.8	1,071,394.1
	a. Current	93,304.4	2,657.1	31.6	95,993.1
	Domestic	83,148.3	2,643.4	31.6	85,823.3
	Foreign	10,156.1	13.6	0.0	10,169.7
	b. Savings	304,786.8	60,924.7	35,011.7	400,723.1
	Domestic	298,957.4	59,836.2	34,524.8	393,318.4
	Foreign	5,829.3	1,088.5	486.9	7,404.7
	c. Fixed	298,835.7	37,454.3	35,847.5	372,137.6
	Domestic	264,970.6	36,753.6	35,847.5	337,571.7
	Foreign	33,865.1	700.7	0.0	34,565.8
	d. Call Deposits	161,784.1	25,427.8	786.6	187,998.5
	Domestic	151,241.3	25,409.6	786.6	
	Foreign	10,542.8	18.2	0.0	
	e. Others	9,267.2	836.2	4,438.4	14,541.8
	Domestic	8,002.9	836.1	4,438.4	
	Foreign	1,264.3	0.1	0.0	
4	**Bills Payable**	1,599.4	18.9	8.1	1,626.4
5	**Other Liabilities**	92,665.2	13,438.0	17,557.0	123,660.2
	1. Sundry Creditors	15,909.0	373.0	959.1	17,241.1
	2. Loan Loss Provision	22,094.0	4,781.5	6,998.5	33,874.0
	3. Interest Suspense a/c	19,491.9	3,068.9	3,495.4	26,056.2
	4. Others	35,170.4	5,214.6	6,104.0	46,489.0
6	**Reconcillation A/c**	-3,672.9	3,894.2	1,316.5	1,537.8
7	**Profit & Loss A/c**	15,876.8	2,347.4	1,552.2	19,776.5
	TOTAL LIABILITIES	**1,067,096.6**	**170,893.8**	**112,973.5**	**1,350,963.9**

Continue

	Assets	Class "A"	Class "B"	Class "C"	Total
1	**LIQUID FUNDS**	161,785.5	47,387.4	26,884.0	236,056.9
	a. Cash Balance	26,026.9	3,646.2	1,347.0	31,020.1
	Nepalese Notes & Coins	25,398.0	3,609.1	1,346.2	30,353.3
	Foreign Currency	628.9	37.1	0.8	666.8
	b. Bank Balance	127,706.2	20,316.7	16,582.4	164,605.2
	1. In Nepal Rastra Bank	110,572.6	5,968.6	3,916.1	120,457.3
	Domestic Currency	109,814.5	5,964.6	3,916.0	119,695.2
	Foreign Currency	758.1	4.0	0.0	762.1
	2. "A"Class Licensed Institution	6,784.5	10,461.5	9,038.3	26,284.3
	Domestic Currency	6,101.5	10,301.7	9,038.2	25,441.4
	Foreign Currency	683.0	159.8	0.1	842.9
	3. Other Financial Ins.	187.7	3,834.1	3,628.0	7,649.8
	4. In Foreign Banks	10,161.4	52.5	0.0	10,213.8
	c. Money at Call	8,052.4	23,424.5	8,954.6	40,431.6
	Domestic Currency	2,865.4	23,298.6	8,954.6	35,118.6
	Foreign Currency	5,187.0	125.9	0.0	5,313.0
2	**INVESTMENT IN SECURITIES**	131,017.9	3,728.2	2,558.3	137,304.4
	a. Govt.Securities	127,213.0	3,701.2	2,336.9	133,251.1
	b. NRB Bond	3,030.3	0.2	169.5	3,200.0
	c. Govt.Non-Fin. Ins.	270.8	0.0	0.0	270.8
	d. Other Non-Fin Ins.	120.0	26.8	51.6	198.4
	e Non Residents	383.8	0.0	0.3	384.1
3	**SHARE & OTHER INVESTMENT**	50,254.8	1,626.0	970.3	52,851.1
	a. Interbank Lending	0.0	0.0	0.0	
	b. Non Residents	1.8	0.0	3.1	4.9
	c. Others	48,304.2	1,337.6	923.0	50,564.8
4	**LOANS & ADVANCES**	612,322.6	100,611.1	66,627.2	779,560.9
	a. Private Sector	577,113.2	99,510.9	64,520.9	741,145.0
	b. Financial Institutions	28,302.7	1,022.5	2,064.0	31,389.3
	c. Government Organizations	6,906.7	77.6	42.3	7,026.6
5	**BILL PURCHASED**	9,607.0	10.7	16.5	9,634.2
	a. Domestic Bills Purchased	3,165.4	10.7	16.5	3,192.7
	b. Foreign Bills Purchased	3,466.1	0.0	0.0	3,466.1
	c. Import Bills & Imports	2,975.4	0.0	0.0	2,975.4
6	**LOANS AGAINST COLLECTED BILLS**	645.9	0.0	0.0	645.9
	a. Against Domestic Bills	593.5	0.0	0.0	593.5
	b. Against Foreign Bills	52.4	0.0	0.0	52.4
7	**FIXED ASSETS**	19,818.7	3,904.5	3,423.3	27,146.4
8	**OTHER ASSETS**	76,147.9	8,164.9	9,005.5	93,318.3
	a. Accrued Interest:	20,790.3	3,247.8	3,583.6	27,621.8
	Financial Institutions	282.9	74.8	123.5	481.3
	Government Enterprises	620.6	120.7	85.1	826.3
	Private Sector	19,886.8	3,052.4	3,375.0	26,314.2
	b. Staff Loans / Adv.	14,554.3	550.2	297.6	15,402.1
	c. Sundry Debtors	15,511.3	649.5	711.8	16,872.6
	d. Cash In Transit	364.1	1.9	2.8	368.8
	e. Others	24,927.9	3,715.5	4,409.7	33,053.1
9	**Expenses not Written off**	447.8	68.9	70.2	586.9
10	**Non Banking Assets**	1,638.5	276.0	310.6	2,225.1
11	**Reconcillation Account**	3,410.1	3,917.2	1,311.6	8,638.9
12	**Profit & Loss A/c**	0.0	1,198.8	1,796.1	2,994.9
	TOTAL ASSETS	**1,067,096.6**	**170,893.7**	**112,973.6**	**1,350,963.9**

Annex 3

Aggregate Statement of Sector wise, Product wise and Security wise Credit

Rs. In million

Sectorwise		Class "A"	Class "B"	Class "C"	Total
1	Agricultural and Forest Related	23,209.6	3,694.4	1,671.0	28,575.0
2	Fishery Related	1,775.6	39.6	12.8	1,828.0
3	Mining Related	2,358.7	193.2	160.7	2,712.6
	Agriculture, Forestry & Bevarage Production Related	41,212.2	3,018.7	2,277.7	46,508.6
4	Non-food Production Related	102,759.9	4,120.0	2,950.2	109,830.2
5	Construction	61,312.2	12,038.3	8,956.6	82,307.2
6	Electricity,Gas and Water	12,752.1	1,322.3	136.2	14,210.5
7	Metal Products, Machinary & Electronic Equipment & Assemblage	8,401.6	1,561.4	888.5	10,851.6
8	Transport, Communication and Public Utilities	25,206.6	8,992.2	5,175.8	39,374.6
9	Wholesaler & Retailer	127,671.1	21,289.1	10,546.8	159,507.0
10	Finance, Insurance and Real Estate	62,184.8	9,938.9	8,045.8	80,169.5
11	Hotel or Restaurant	15,285.0	3,865.9	1,790.4	20,941.3
12	Other Services	30,521.7	5,344.0	3,029.5	38,895.2
13	Consumption Loans	37,780.1	6,086.2	5,441.8	49,308.1
14	Local Government	1,271.7	31.7	52.7	1,356.0
15	Others	68,872.3	18,968.5	15,513.2	103,354.0
	TOTAL	**622,575.2**	**100,504.5**	**66,649.8**	**789,729.5**

Product wise		Class "A"	Class "B"	Class "C"	Total
1	Term Loan	87,203.3	12,569.3	10,596.6	110,369.2
2	Overdraft	107,443.6	26,173.7	0.0	133,617.3
3	Trust Receipt Loan / Import Loan	35,342.8	101.1	0.0	35,443.9
4	Demand & Other Working Capital L	155,371.1	12,733.8	17,285.7	185,390.7
5	Residential Personal Home Loan (Up	35,647.6	9,288.0	5,714.1	50,649.7
6	Real Estate Loan	69,685.5	11,905.1	11,180.7	92,771.2
7	Margin Nature Loan	6,274.2	2,002.5	2,057.0	10,333.7
8	Hire Purchase Loan	32,002.6	10,406.7	6,589.7	48,999.0
9	Deprived Sector Loan	23,601.3	3,576.8	1,790.0	28,968.1
10	Bills Purchased	9,765.5	8.6	16.5	9,790.7
11	Other Product	60,238.1	11,738.9	11,419.4	83,396.4
	TOTAL LOAN & ADVANCES	**622,575.6**	**100,504.5**	**66,649.8**	**789,729.8**

Collateral Wise		Class "A"	Class "B"	Class "C"	Total
1	Gold and Silver	21,213.1	1,774.5	313.3	23,300.9
2	Government Securities	2,385.1	54.0	2.7	2,441.8
3	Non Governmental Securities	5,015.7	1,530.2	1,075.9	7,621.9
4	Fixed Deposit Receipts	7,243.2	1,344.6	1,882.7	10,470.5
4.1	Own	6,731.5	1,344.6	1,882.7	9,958.8
4.2	Other Licences Institutions	511.7	0.0	0.0	511.7
5	Collateral of Properties	526,067.9	91,056.6	59,750.1	676,874.6
5.1	Fixed Assets	423,201.7	90,497.0	59,281.6	572,980.2
5.2	Current Assets	102,866.2	559.6	468.6	103,894.3
6	Against security of Bill	9,815.8	8.5	3.7	9,828.1
6.1	Domestic Bills	646.6	8.5	3.7	658.9
6.2	Foreign Bills	9,169.2	0.0	0.0	9,169.2
7	Against Guarantee	14,372.1	1,751.5	856.5	16,980.1
7.1	Government Guarantee	2,268.5	88.8	65.6	2,422.9
7.2	Institutional Guarantee	8,242.7	650.1	346.6	9,239.3
7.3	Personal Guarantee	774.3	109.4	280.7	1,164.4
7.4	Collective Guarantee	153.2	902.8	23.2	1,079.2
7.5	International Rated Foreign	163.2	0.0	8.1	171.3
7.6	Other Guarantee	2,770.3	0.3	132.4	2,903.0
8	Credit Card	393.7	0.0	1.5	395.2
9	Others	36,068.6	2,984.5	2,763.3	41,816.4
	Total	**622,575.2**	**100,504.5**	**66,649.8**	**789,729.5**

Annex 4

Aggregate Profit & Loss Account

Rs. In million

Expenses	Class "A"	Class "B"	Class "C"	Total
1 Interest Expenses	52,642.8	11,219.0	8,317.8	72,179.7
1.1 Deposit Liabilities	51,958.6	10,839.4	8,098.3	70,896.4
1.1.1 Saving A/c	13,924.5	4,469.0	2,950.4	21,344.0
1.1.2 Fixed A/c	28,072.5	4,325.7	5,000.1	37,398.3
1.1.2.1 Upto 3 Months Fixed A/c	1,535.5	205.9	189.0	1,930.4
1.1.2.2 3 to 6 Months fixed A/c	1,371.6	189.5	152.0	1,713.1
1.1.2.3 6 Months to 1 Year Fixed A/c	9,137.3	2,285.7	2,265.2	13,688.2
1.1.2.4 Above 1 Year	16,028.1	1,644.5	2,393.9	20,066.5
1.1.3 Call Deposit	9,952.0	2,044.8	147.5	12,144.2
1.1.4 Certificate of Deposits	9.6	0.0	0.3	9.9
1.2 Others	684.2	379.6	219.5	1,283.3
2 Commission/Fee Expense	166.5	5.7	1.6	173.8
3 Employees Expenses	12,127.3	1,567.3	861.3	14,555.9
4 Office Operatiing Expenses	8,651.4	2,163.8	1,244.0	12,059.1
5 Exchange Fluctuation Loss	5.2	7.0	0.0	12.3
5.1 Due to Change in Exchange Rates	3.7	7.0	0.0	10.7
5.2 Due to Foreign Currency Transactions	1.5	0.0	0.0	1.5
6 Non-Operatiing Expenses	523.3	77.7	20.2	621.2
7. Provision for Risk	7,965.0	2,291.2	3,909.6	14,165.8
7.1 Loan loss Provision	7,670.5	2,058.3	1,868.8	11,597.6
7.1.1 General Loan loss Provision	2,442.5	106.6	218.8	2,767.8
7.1.2 Special Loan Loss Provision	5,142.2	1,933.5	1,569.0	8,644.7
7.1.3 Additional Loan Loss Provision	85.8	18.2	81.0	185.1
7.2. Provision for Non-Banking Assets	209.5	210.9	273.9	694.3
7.3. Provision for Loss on Investment	55.9	21.5	42.3	119.7
7.4. Provision for Loss of Other Assets	29.1	0.5	1,724.7	1,754.3
8 Loan Written Off	1,556.3	52.3	62.2	1,670.8
9 Provision for Staff Bonus	1,909.0	241.8	157.2	2,307.9
10 Provision for Income Tax	5,428.5	648.4	491.5	6,568.3
11 Others	47.2	13.4	3.7	64.4
12 Net Profit	15,876.8	2,354.2	1,552.2	19,783.3
TOTAL EXPENSES	106,899.2	20,641.9	16,621.3	144,162.4

Income	Class "A"	Class "B"	Class "C"	Total
1. Interest Income	85,435.8	17,036.9	11,661.8	114,134.5
1.1. On Loans and Advance	77,346.5	14,481.1	10,320.5	102,148.2
1.2. On Investment	6,239.2	148.6	136.9	6,524.7
1.2.1 Government Bonds	5,635.4	102.0	116.8	5,854.2
1.2.2 Foreign Bonds	51.1	0.0	0.0	51.1
1.2.3 NRB Bonds	508.9	7.5	8.4	524.7
1.2.4 Deventure & Bonds	43.8	39.2	11.7	94.7
1.3 Agency Balance	564.5	143.5	140.8	848.8
1.4 On Call Deposit	548.7	1,684.5	640.1	2,873.3
1.5 Others	736.8	579.1	423.6	1,739.5
2. Comission & Discount	5,279.2	547.2	195.6	6,022.0
2.1 Bills Purchase & Discount	254.3	5.0	0.0	259.3
2.2 Comission	4,072.4	239.0	83.7	4,395.2
2.3 Others	952.4	303.1	111.9	1,367.4
3 Income From Exchange Fluctuation	2,994.5	17.8	47.7	3,060.1
3.1 Due to Change in Exchange Rate	799.0	3.1	47.7	849.8
3.2 Due to Foreign Currency Trans.	2,195.6	14.7	0.0	2,210.3
4 Other Operating Income	2,309.3	837.5	534.4	3,681.2
5 Non Operating Income	1,076.5	201.3	88.3	1,366.1
6 Provision Written Back	8,092.4	732.8	2,269.7	11,094.9
7 Recovery from Written off Loan	1,184.1	1.4	27.8	1,213.3
8 Income from Extra Ordinary Expenses	527.3	68.2	0.0	595.5
9 Net Loss	0.0	1,198.8	1,796.1	2,994.9
TOTAL INCOME	106,899.2	20,641.9	16,621.3	144,162.4

Annex 5

Financial Soundness Indicators (FSIs) of A, B and C Class Institutions

(Mid-July, 2012)

in Percent

	Indicators	"A" Class	"B" Class	"C" Class
1	Regulatory capital to risk-weighted assets	11.50	20.50	23.05
2	Regulatory Tier I capital to risk-weighted assets	10.00	19.61	22.26
3	Non performing loan to total gross loan	2.63	4.90	10.72
4	Non performing loans net of provisions to capital	4.33	4.62	5.29
5	Sectoral distribution of loans to total gross loans			
	Agricultural and Forest Related	3.73	3.68	2.51
	Fishery Related	0.29	0.04	0.02
	Mining Related	0.38	0.19	0.24
	Agriculture, Forestry & Bevarage Production Related	6.62	3.00	3.42
	Non-food Production Related	16.51	4.10	4.43
	Construction	9.85	11.98	13.44
	Electricity,Gas and Water	2.05	1.32	0.20
	Metal Products, Machinary & Electronic Equipment & Assemblage	1.35	1.55	1.33
	Transport, Communication and Public Utilities	4.05	8.95	7.77
	Wholesaler & Retailer	20.51	21.18	15.82
	Finance, Insurance and Real Estate	9.99	9.89	12.07
	Hotel or Restaurant	2.46	3.85	2.69
	Other Services	4.90	5.32	4.55
	Consumption Loans	6.07	6.06	8.16
	Local Government	0.20	0.03	0.08
	Others	11.06	18.87	23.28
6	Return on assets	2.04	1.09	0.22
7	Return on equity	22.44	7.52	1.60
8	Interest margin to gross income	73.77	78.39	79.43
9	Noninterest expenses to gross income	48.41	51.67	50.61
10	Liquid assets to total assets	27.08	29.89	25.87
11	Liquid assets to total deposit	33.30	40.13	38.39
12	Credit to deposit ratio	71.73	79.04	87.56
13	Net open position in foreign exchange to capital	1.47	0.00	0.00

Annex 6
Stress Testing Results for Commercial Banks

	Mid-Jul 2012	Mid-Jul 2011
Credit shocks	***No. of banks with CAR < 10%***	
15 Percent of Performing loans deteriorated to substandard, 15 Percent of Substandard loans deteriorated to doubtful loans, 25 Percent of Doubtful loans deteriorated to loss loans., 5 Percent of Performing loans deteriorated to loss loans.	22	20
All NPLs under substandard category downgraded to doubtful. All NPLs under doubtful category downgraded to loss.	2	2
25 Percent of performing loan of Real Estate & Hosing sector loan directly downgraded to substandard category of NPLs.	2	4
25 Percent of performing loan of Real Estate & Hosing sector loan directly downgraded to Loss category of NPLs.	8	16
Top 2 Large exposures down graded: Performing to Substandard	2	5
Liquidity shocks	***No. of banks illiquid after 5 days***	
Withdrawal of customer deposits by 2% 5% 10% 10% and 10% for five consecutive days respectively.	5	15
	No. of banks with liquid assets to deposit ratio < 20%	
Withdrawal of deposits by 5%	0	5
Withdrawal of deposits by 10%	6	13
Withdrawal of deposits by 15%	14	22
Withdrawal of deposits by top 2 institutional depositors.	9	16
Withdrawal of deposits by top 3 institutional depositors.	12	20
Withdrawal of deposits by top 5 institutional depositors.	17	22
Withdrawal of deposits by top 2 individual depositors.	0	1
Withdrawal of deposits by top 3 individual depositors.	0	1
Withdrawal of deposits by top 5 individual depositors.	0	1

Annex 7

Composition of Financial Stability Oversight Committee

Committee Members	Status
Mr. Gopal Prasad Kaphle, Deputy Governor	Chairperson
Mr. Maha Prasad Adhikari, Deputy Governor	Member
Mr. Lila Prakash Sitalula, Executive Director, Foreign Exchange Management Department	Member
Mr. Ashwini Kumar Thakur, Executive Director, Finance Company Supervision Department	Member
Mr. Bishnu Nepal, Executive Director, Development Bank Supervision Department	Member
Mr. Bhaskar Mani Gnawali, Executive Director, Bank and Financial Institutions Regulation Department	Member
Mr. Lok Bahadur Khadka, Executive Director, Bank Supervision Department	Member
Dr. Min Bahadur Shrestha, Executive Director, Research Department	Member
Mr. Narayan Prasad Poudel, Act. Executive Director, Micro Finance Promotion and Supervision Department	Member
Mr. Purna Bahadur Khatri, Director, Bank and Financial Institutions Regulation Department	Member Secretary
Registrar, Department of Cooperative	Member (Invitee)
Chief Executive, Insurance Committee	Member (Invitee)
Chief Executive, Security Board	Member (Invitee)
Administrator, Employee Provident Fund	Member (Invitee)
Chief executive officer, Citizen Investment Trust	Member (Invitee)
Related Sectors Experts (maximum 2)	Member (Invitee)

Annex 8

Composition of Financial Stability Sub Committee

Committee Members	Status
Mr. Purna Bahadur Khatri, Director, Bank and Financial Institutions Regulation Department	Coordinator
Mr. Ram Chandra Gautam, Deputy Director, Bank Supervision Department	Member
Ms. Sushma Regmi, Deputy Director, Foreign Exchange Management Department	Member
Mr. Narendra Singh Bista, Deputy Director, Development Bank Supervision Department	Member
Dr. Ram Sharan Kharel , Deputy Director, Research Department	Member
Mr. Laxmi Prasai, Deputy Director, Finance Company Supervision Department	Member
Mr. Ram Hari Dahal, Deputy Director, Micro Finance Promotion and Supervision Department	Member
Mr. Ramu Paudel, Deputy Director, Bank and Financial Institutions Regulation Department	Member Secretary
Ms. Niva Shrestha, Deputy Director, Bank and Financial Institutions Regulation Department	Member Secretary*

* *Former Member Secretary*