Part II

Financial System

Development Finance

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Introduction and Definition

The term 'development finance' is more related to the finance that has a development objective. For the economic development of any country, optimum utilization of natural resources, technological development, formation of capital and capital market development are equally important. Among these, capital formation is the most important element. The introduction of development finance is crucial for generating capital in a country like Nepal where the majority (86 percent) of the people live in the rural areas.

It is argued sometimes that financial development is impossible without economic development. Similarly, economic development is also impossible without financial development. So, there is a casual relationship between economic development and financial development. The role of development financial institutions should be directed towards supporting the infrastructures required for economic development.

Defining the term 'development finance' is not an easy task, because the concept of 'development' varies from country to country, situation to situation. According to European Development Finance Institution (EDFI) "Development finance is a specialized sector of the financial industry that aims to bridge the gap between commercial investments and state-sponsored development aid, in the form of public and private-sector development projects. Whereas Commercial Banks (CBs) often serve as vehicles for private individuals or companies to invest in relatively low-risk projects usually in mature western economies, development banks play a hugely important role in servicing the investment needs in developing and reforming economies. The financial support these banks bring to such relatively high-risk projects also serve as impetus for the involvement of private-sector capital, bringing in such diverse actors as CBs, investment funds and private individuals or companies. In addition, development banks often act in cooperation with governments and other organizations in providing funds for technical assistance, feasibility studies, and business and management consultancy, as well as serving as channels for policy implementation in the areas of responsible governance, compliance with environmental regulations and good business practices in relation to staff and the wider community."[1]

"Development finance institutions or 'DFIs' are specialized development banks that are wholly or partly-owned by national governments. They serve to implement their government's foreign development policy while retaining strong operational independence. They provide funds for foreign or domestic investors to initiate or develop projects in

industry fields or countries which do not fall into the traditional arena of CBs or where the risk associated with a particular project or country makes such investments harder to bear for the business community alone. DFIs are equally fundamental in the small and medium enterprise (SME) sector where micro-loans, traditionally viewed as high-risk, form the bulk of investment activity."[2]

Now a days 'micro-finance', as part of development finance, is considered as one of the most powerful and effective financial products for poverty reduction. Micro-finance includes micro-savings, micro insurance services and micro credit to the rural poor people. Micro finance has been defined by the World Bank as follows: "It is the provision of financial services to low income clients including self-employed. It includes both financial and social inter-mediation. It is not simply banking. It is a development tool". Prof. Mohammed Yunus, the founder father of the Grameen Bank, has tried to establish micro credit as a human right.

The origin of the term micro finance is of the late eighties. At the time of introduction it was understood as smaller credit to poor people, particularly in Bangladesh. The Grameen Bank of Bangladesh initiated the term 'micro-credit' which today is known as 'grameen system of rural financing'. Practically, any small amount that goes to the poor people as credit is known as micro credit, which has specific objectives in the light of income generating activities. But 'micro finance' has wider scope than 'micro credit'. Many scholars, practitioners, donors and authorities have defined 'micro finance' in many ways. Some of the important ones are presented below:

Micro finance can help enhance the ability of poor households to increase incomes, build assets and reduce their vulnerability in times of economic stress. The real power of micro finance has in its ability to empower the individual.

– Mr. Tadao Chino, Ex-President, ADB-Manila.

Micro finance is the provision of a broad range of financial services such as savings (deposits), loans, payment services, money transfers and insurance to poor and low-income households and their micro-enterprises.

– Dr. Richard Vokes, Ex-Country Director, Nepal, ADB Manila.

Micro finance comprises formal and informal financial institutions, small and large that provide small sized financial services, savings, credit and micro-insurance to the poor.

– Mr. Ulrich Wehnert, GTZ Ex-Nepal Representative

The ultimate aim of expanding micro finance outreach is to reduce the vulnerability of the poor by helping them increase income, build assets and chart their own paths out of poverty with self-respect, self determination and sustainability.

– Elizabeth Littlefield, Director and CEO, CGAP

In the Nepalese perspective 'development finance' is viewed as financing to the rural and agriculture sector including micro-finance. Financing from the CBs under the priority sector as well as investment from the specialized development banks, which are focused on the upliftment of the rural, agricultural and productive purposes, is known as development finance. The prime objective of priority sector lending from the CBs is to help reduce the poverty under which financing to the specialized sector of the economy like agriculture, industry and service sector can be enhanced.

Institutional Version of Micro Credit

Nepal Rastra Bank (NRB), the central bank, in its regulation, has stated that a loan up to Rs.30,000 provided by Micro Finance Development Bank (MFDB) is considered as micro credit and savings mobilized by the groups of MFDBs are considered as micro savings. On the other hand Rural Self-Reliance Fund (RSRF) has recognized a loan up to Rs.40,000/- per borrower given to the deprived people as micro credit and a group loan up to Rs.100,000/- given to the members in joint liability is also known as 'micro credit' project loan. In this way, efforts have been made to define and set the borderline of micro credit.

Relevance and Importance

In the history of Nepalese financial system, the government-owned two big CBs, Nepal Bank Limited and Rastriya Banijya Bank, mostly provided credit to the business sector only. For a long time access to the institutional credit was concentrated only to the big business houses and entrepreneurs. In this context, the NRB formulated a policy in May 1974 to include the institutional credit to the poorest sector of the economy and directed all CBs to lend compulsorily at least 5 percent to the 'small sector'. With this policy intervention, the NRB has been very active in the promotion of rural financial institution and the monetary policy of the bank has also been directed towards achieving its goals like poverty reduction, social upliftment of the people and appropriate allocation of the fund.

The priority sector credit program has helped the access of institutional credit required for cottage industries, enterprises and farmers. It has also helped in making remarkable achievement in production, employment, income generation and economic activities. Development finance policy of the central bank has always been found towards supporting the rural development and has been production-oriented. The importance and relevance of such finances in Nepal are still valid.

In the past, NRB had played an important role in building the rural financial system by way of participating in the equity of many financial institutions. Among them were two development finance institutions (DFIs), Agriculture Development Bank of Nepal (ADB/N) and Nepal Industrial Development Corporation (NIDC), which were established to provide medium and long term loans, to participate in equity capital, to undertake underwriting and provide other ancillary services to the development of agriculture and industry. The NRB has been helping these DFIs through refinance facility and also through direct investment on their share capital. The objectives of these institutions are not similar to that of the CBs. The establishment of NIDC in the year 1959 and ADB/N in the year 1968 is a milestone in the history of development finances in Nepal. The NIDC, which is still in operation, provide financial services to various industries that are under national priority and are important whereas ADB/N finances to the agricultural sector as well as to the poorer sector of the economy including micro finance. Looking at the overall poverty scenario in Nepal, the importance of development finance, rural and micro finance in particular, is highly relevant. This is because, there exists a wide gap of rural credit supply. ADB-Manila has assessed that such gap remained to the tune of Rs.13 billion annually.[3] The rural credit survey of 1992 has also revealed that informal sector dominated (80 percent) the rural finance.[4]

Micro finance is considered as one of the most effective financial tools for poverty reduction. The importance of micro-finance, particularly in the poverty-stricken countries, has also been increasing. This has led the policy makers of many countries to adopt national micro-finance policies and programs. The increased number of micro finance practitioners around the globe is an indication that micro finance sector can play an important role not only to help attain the government's policies on poverty reduction but also to help increase the income level of poor people through various types of income generating activities. Micro credit is the key for running such activities. The Micro Credit Summit Campaign (MCSC) held in 1997 has committed to reach 100 million poorest families with micro credit by the end of 2005.[5] As reported to the MCSC, as of December 31, 2003, 67.6 million poor people were reached by micro-credit and other financial services, out of which 41.6 million were among the poorest of the poor.[6] Altogether 2,572 micro-finance institutions (MFIs) were included in this statistics and such statistics were verified by the third parties.

Developments and Current Situation

The NRB, since its establishment, has been pro-active in creating conducive environment for development finance. Despite its traditional central banking function, it has played an instrumental role in the establishment of development finance institutions (DFIs) in the country and provided resources through capital injection and refinance. The NRB, until the recent past, has been playing an important and crucial role in the promotion of rural financial institutions as well as making the rural finance policy more rural-friendly. The details of NRB activities in development finance are given below:

Nepal Industrial Development Corporation (NIDC)

The NIDC was established in the year 1959 with the objectives of providing financial services to the private sector's industrial enterprises in the form of medium and long-term loans where it can also participate in the equity investment and underwriting of the industry enterprises as well. The principal categories of industries financed by the NIDC include manufacturing and tourism sector, particularly the hotel industry. Its lending to industries comprises direct loans, guarantee for loans and share participation. Realizing the importance of financial resources required for industrialization, the NRB participated in the equity share of the NIDC as early as in 1959 as a token of its promotional role towards development finance. Besides participating in the equity capital, the NRB has also extended refinance facilities to the NIDC from time to time. It has also subscribed debentures of the NIDC amounting to Rs.50.0 million.

The main sources of funds of the NIDC are paid-up capital, long-term loans from domestic and foreign financial institutions. The NRB's refinance to the NIDC comprises major stake into its resources. Refinancing to the NIDC started as early as 1962/63 with Rs. 1 million. The NRB invested Rs. 50 million on debentures issued by the NIDC, which was repaid back in FY 2003/04. Looking at the liquidity problems encountered by the NIDC in the recent past, the NRB has also re-scheduled its refinance facilities to the Corporation by five years. The outstanding on such refinance to the NIDC stood at Rs.773.4 million at the end of Jan. 2005. The equity investment of the bank in the NIDC is Rs.47.4 million.

Table 1

Development Finance Activities of Major Development Banks (As at mid-July 2004) (Amount in Rs. Million)

	NIDC	ADB/N	Other DBs[1]	Total
Capital[2]	1,570.1[3]	2,032.6	555.9	4,158.6
Total Deposits	522.5	23,950.0	4,954.7	29,427.2
Total Development Credit	2,065.5	19,686.8	1,189.8	22,942.1
% of development credit to total credit	(100.0)	(67.2)	(28.9)	-

1 12 development bank. excluding 9 MFDBs
2 Including reserves and loan loss provisions.
3 Excluding losses of Rs.976.5 million
Source: NRB and ADB/N.

Agriculture Development Bank (ADB/N)

The Agriculture Development Bank is the largest development finance institution which was established in 1968 under the Agriculture Development Bank Act 1967. Its main objective is to ensure agricultural credit to farmers and cooperatives for the overall development of the agricultural sector. The bank provides short, medium and long-term credit to individuals, cooperative societies and corporate bodies for agricultural development, and development-financing activity has been one of the core programs of ADB/N since its inception.[7] Its share in the institutional rural credit supply has remained at more than 50 percent.[8] The ADB/N is the only development finance institution that has a nationwide network of branches. Before the establishment of ADB/N, there were 2 special development finance organization in the government sector known as Co-operative Development Bank (CDB) set up in 1963 and Land Reforms Savings Corporation (LRSC) set up in 1966. Both of the organizations were merged with the ADB/N (CDB in 1968 and LRSC in 1973).

Initially, the NRB participated in the equity investment of ADB/N amounting to Rs.2.5 million which further increased to Rs. 30 million until 1995. Until 1995, the ADB/N remained the single largest rural financial institution in Nepal. It has penetrated into the rural economy through financing to the rural people as well as from various innovative programs in this sector. For example, the bank's Small Farmer's Development Project (SFDP) was started in 1975 with the objective of social and economic upliftment of the small and landless farmers. Initiated in 1993, SFDPs have been transforming into the Small Farmer's Co-operative Limited (SFCL). The SFCL is a new institution managed by the members themselves. Since 1984 the ADB/N has also been allowed to do commercial banking in selected urban areas with an aim to mobilize resources domestically and channel funds to the agriculture and rural sector.

The ADB/N's borrowings from the NRB started in FY 1968/69 with an amount of Rs.2.0 million. During the last four decades, the bank's borrowing from the NRB increased to Rs.2.0 billion, which has now been paid back. Since FY 1997/98 the NRB has been providing long-term refinance facility to ADB/N for the development of commercialization of crops like tea, cardamom, apple, raw silk, cut flower, tissue culture, dried ginger, herbs etc. Under this new policy the ADB/N took refinance from NRB amounting to Rs.237.5 million

as of mid-July 2004. Such facility has been provided to the bank as per the national requirements envisaged in the Plan documents because financing to such areas requires huge amount as well as longer repayment period.

Table 2
Credit Outstanding of ADB/N (Mid-July)
(Amount in Rs. Million)

Financing Areas	2000	2001	2002	2003	2004	Annual Growth (2000-2004)
Agro Crops	2841	3160	3424	3714	3696	7.5
Marketing	1690	2227	2862	3826	4285	38.4
Agri, Tools	2011	2412	2561	2476	2350	4.2
Irrigation	297	244	252	193	185	(9.4)
Bio-gas	288	293	276	243	227	(5.3)
Agri. Industries	2092	2364	2604	2535	2661	6.8
Godown	153	236	281	275	292	22.7
Agri-Business	2796	3121	3532	3907	3912	10.0
Horticulture	242	240	238	231	210	(3.3)
Tea/Coffee	424	424	505	504	594	10.0
Others*	57	61	138	670	1275	534.2
Total:	**12,891**	**14,782**	**16,673**	**18,624**	**19,687**	**13.2**

* Includes finance on land development, housing and non-agribusiness
Source: ADB/N.

The development finance operations of the ADB/N, which amounts to Rs.19.9 billion (as of mid-July 2004), are mostly spread over agro-industry, agribusiness and marketing. Financing of the bank is mainly concentrated in eastern and central region of the country. After FY 1990/91, ADB/N had accelerated the pace of its overall activities. The bank's achievement in the last 10 years has surpassed the total achievement made by the bank in the last three decades. But in the recent years, the ADB/N also has huge backlogs of overdue. However, the bank has adopted various measures to speed up its loan repayments since the last couple of years. Restructuring programs are being initiated in the bank under the financial sector reform program.

Share capital, public deposits and domestic and foreign borrowings are the main financial sources of ADB/N of which deposits contribute the most (61.3 percent as at mid-July 2004) to it.

The 'Small Farmer's Development Project' was introduced in 1975 with the funding of the FAO and was internationally rewarded.[9] Financing in group-guarantee in SFDP is regarded as a new innovation in rural finance. The Project is oriented towards the social and economic upliftment of the small and landless farmers. The SFDP is based on group lending and spread over 75 districts of the country. The ADB's 410 offices (as at mid-July 2004) have contributed a lot to the benefit of rural poor, especially through rural and agricultural finance. To institutionalize and sustain the program in the longer run, the SFDPs are now converting into co-operatives known as 'Small Farmers Cooperative Limited (SFCL).' Started in FY 1993/94, there were 165 SFCLs in operation as of mid-Jan 2005.[10] In addition, a new wholesale financing institution called Sana Kisan Bikas Bank (SKBB) was also established in 2002 to help cater to the wholesale credit need of the SFCL. It is a development bank in the field of micro finance which is also responsible for the strengthening and capacity building of its partner organizations (POs). GTZ-Rufin has been supporting SKBB for its capacity development program.

Banking Promotion Board (BPB)

In order to develop banking habit among the people and banking system in the country, the NRB set up the Banking Promotion Board in July 1968 with the representatives of the banks, the government and the trading communities. The main objective of

the Board was to promote banking activities all over the country through creating awareness among the general public on banking services both in terms of deposit mobilization and credit extension for productive as well as consumption purposes. In this context, the Board studies and analyzes the existing policies and programs related to banking promotion and disseminates necessary information through its regular activities like radio program, publication, services, workshop and other support services. One of its important activities was the organization of first ever 10-day national level Banking Development Seminar in Kathmandu that took place in January 1969. The purpose of the seminar was to generate public awareness, to exchange ideas and opinions and to innovate new ideas in the field of banking. Many useful suggestions of the seminar were incorporated in policy measures, which include interest free loan to new bank branches and compensation to loss making branches in the rural areas. The Board also set up a separate banking publicity sub-committee which broadcasts banking program from Radio Nepal regularly since its establishment. The promotional role played by BPB in the past has definitely led to increase the banking habit amongst the rural people. Presently, the BPB is functional where all CBs including NIDC and ADB/N are the members.

Deposit Insurance and Credit Guarantee Corporation (DICGC)

The Credit Guarantee Corporation (presently known as Deposit Insurance and Credit Guarantee Corporation) was established in 1974 at the initiative of Nepal Rastra Bank and with the joint investment of Nepal Rastra Bank, Nepal Bank Ltd. and Rastriya Banijya Bank to provide credit guarantee to the two CBs for priority sector loans. In order to persuade the CBs to extend loan in non-traditional banking such as rural sector, it was considered essential to provide guarantee compensation against default on rural lending. The Corporation's paid-up capital is Rs.30 million, of which 60 percent is held by the NRB. The Credit Guarantee Corporation charges 1 percent premium per annum on the outstanding amount of priority sector loan and guarantees up to 75 percent of the loan. The scope of the Corporation's guarantee has been confined to the priority sector credit of CBs for more than three decades. The Corporation has also started guaranteeing loans for cattle since FY 1987/88. The Corporation's guarantee exposure under the priority sector up to mid-July 2004 stands at more than Rs. 1995.7 million, which has exceeded its ability to cover the risks. The Corporation is contemplating on widening the guarantee coverage by introducing deposit insurance schemes. However, until now, it has not commenced the scheme yet. After the phasing out of the priority sector lending, the scope for the credit guarantees of the Corporation has also been limited.

Agricultural Projects Services Centre and National Productivity and Economic Development Centre

The NRB, in the past, had also promoted Agricultural Project Services Centre (APROSC), now known as National Agriculture Research Centre (NARC), and the Economic Services Centre (ESC) in 1974. APROSC is no more in existence. ESC is in operations under the name of National Productivity and Economic Development Centre Limited (NPEDC), which started functioning in 1993. Presently, the NPEDC is also acting as a secretariat of National Productivity Council.

These two centres were basically designed to conduct research activities in the field of agriculture and industries so that DFIs would be benefited by the projects designed by these centres and perform effectively and efficiently. The NRB was the major founder of these institutions.

In the context of open and liberalized economic policy pursued by the nation for attainment of sustainable development, productivity and quality, the NPEDC has to function on a self-sustaining basis which calls for improved professionalism and competitiveness. The Centre also has to support services to the government and the private sector in order to create a sound industrial base and promote productivity awareness in the country. The NPEDC's main areas of emphasis in the changed context will be the following: developing the capability to undertake project engineering services, providing consultancy services to industries for enhancing productivity, increasing bilateral co-operation between National Productivity Organizations, undertaking sub-sector policy and planning studies and establishing an industrial information system.

Priority Sector Credit: From Mandatory to Phasing-out Policy

The CBs have been involved in micro-finance since 1974. Financing to the 'small sector' and priority sector is a mandatory credit requirement of the NRB and the CBs are required to invest certain percentage of their credit portfolios into this sector. This mandatory requirement is still in practice and known as Priority Sector Credit Program (PSCP) and Deprived Sector Credit Program (DSCP). Initially, this program was called 'Small Sector Credit Program' which was later renamed as 'supervised credit.' In the year 1981, this program was further amended as 'Intensive Banking Program' (IBP). For the first time, the IBP incorporated the provision of group lending at joint liability. Actually, this was the beginning of non-collateral based micro financing in Nepal. The priority sector includes financing in agriculture, cottage industries and services sector where the banks can finance up to Rs.2.0 million per schemes in agriculture and services sector and Rs.2.5 million in cottage industries. As per the requirements of the country, this sector has undergone many amendments from time to time. Originally, the banks were required to invest 5 percent of the total deposit into this 'small sector' effective 1974, which was increased to 7 percent of the total deposits in 1976 and the small sector included the agriculture sector, cottage industries and services sector as defined by the NRB. While introducing a new concept of financing in priority sector, known as IBP, the NRB had also changed the deposit-based mandatory requirement for this sector into credit-based. Henceforth, the banks were required to invest 8 percent of the total credit outstanding which later increased to 10 percent in 1985 and 12 percent in 1991. Those banks that failed to meet the target set by the NRB are subject to pay heavy penalties. The provision of such mandatory credit requirements for the CBs and penalty for the defaulters is incorporated in the Banks and Financial Institutions Ordinance and the Nepal Rastra Bank Act. A separate priority sector credit manual was also incorporated in 1981 and a national level Co-ordination Committee on priority sector credit was constituted under the chairmanship of the Executive Director of Development Finance Department (now Micro Finance Department) in NRB. The Committee is still functional and is responsible for the co-ordination of the policies and programs in this sector.

Initially, various co-ordination committees at the grass-root level were also formed to expand the priority sector credit program. A number of development agencies were also included for providing services, including credit, to the poor people. A national level Co-ordination Council was also constituted under the chairmanship of the Governor of the NRB. But the Council was found non-functional and was later converted into the Priority Sector Co-ordination Committee, which is presently operational at the Micro-Finance Department.

The priority sector financing has been regarded as one of the best target and objective-oriented development finance programs in Nepal. Although such financing has its own downside and has experienced some criticisms, quite a number of rural people benefited from it.

The latest decisions taken by NRB on 'priority' and 'deprived sector' are as follows:

(a) Finance from the CBs on 'captive generator' is added in priority sector credit with effect from FY 1994/95.

(b) Banks' finance on public taxi service (one taxi per driver) is also added in priority sector, if that is provided to the driver himself, effective from FY 1994/95.

(c) Finances from the CBs up to Rs.5.0 million for the purchase of raw materials and machineries required for export and pre-export industries are also added in priority sector, effective from FY 1996/97.

(d) In FY 1998/99, the NRB permitted CBs' lending on Rural Micro Finance Development Centre's (RMDC) equity to be counted as 'deprived sector lending.'

(e) From FY 2001/02 CBs' lending on foreign employment credit up to Rs.100,000 is treated as 'deprived sector lending.'

(f) From FY 1999/00 the deprived sector lending for the CBs has included the following:

(1) CBs' lending up to Rs.30,000/- to the poorest, weak and deprived people of the society.

(2) CBs' direct lending on employment oriented and income generating projects up to the above limit.

(3) CBs' investment on Rural Development Banks' (RDBs) equity.

(4) CBs' lending to RDBs and other poverty alleviation related development bank's and micro

financial institutions (MFIs) for on lending to micro credit.

(5) CBs' lending to co-operatives, NGO's and Small Farmer's Co-operatives (SFCs) that are licensed for limited banking activities from NRB.

(g) To stimulate private sectors' investment on hydropower project, CBs' lending on small and medium scale hydropower projects up to Rs.100 million are added on priority sector from FY 2001/02. This has been reflected in the Monetary Policy of the NRB for the FY 2001/02.

(h) CBs' lending on self-help scheme up to Rs. 40,000 to disabled people is also counted as priority sector. This policy was made effective from FY 2001/02.

(i) CBs' lending to micro finance development banks (MFDBs) that are responsible for providing micro credit up to the limit of Rs.30,000 per family is counted as deprived sector effective from FY 2001/02.

(j) From FY 2002/03 the CBs' lending on priority sector (9 percent requirement) has been phased out gradually. According to such policy, the CBs are required to invest in the priority sector as illustrated below:

Fiscal Year	Requirement Percentage
2002/03	7.0
2003/04	6.0
2004/05	4.0
2005/06	2.0
2006/07	0.0

(k) The NRB has also decided that deprived sector lending requirement for the CBs remained unchanged.

(l) Since February 4, 2005 MFDBs' lending on solar home system (SHS) and bio-gas has been included in deprived sector lending and the credit ceiling for such financing has also been increased from Rs.30,000/- to Rs.50,000/-

Both PSCP and DSCP schemes have the provision for direct and indirect financing. Under the direct mechanism, CBs provide credit to the beneficiaries as retail lending whereas under indirect financing they provide loan to MFIs for on-lending purposes. In this mechanism, the CBs are also known as 'wholesale micro-financier'. The priority sector lending modality is regarded as the NRB's commitment towards the development of rural finance. During the past three decades of priority sector financing, a number of programs were also included under the priority sector such as Production Credit for Rural Women (PCRW), Micro Credit Project for Women (MCPW), Cottage and Small Scale Industry (CSI) Project, Banking with the Poor and Bisheswor with the Poor. Various micro credit projects, funded by international agencies, are also included in this program. The details of these programs are presented in the undergoing pages.

Presently, Nepal is implementing a World Bank funded Financial Sector Reform Program (FSRP). This reform also includes the re-engineering of the NRB. As part of the FSRP starting from the year 2002/03 to the next 5 years, the NRB has declared a phasing-out policy of the three decade-old PSC program (12% requirement) of the CBs, leaving the DSC program untouched. According to the phasing-out policy, the CBs' credit to priority sector will not be a mandatory by the end of FY 2006/07 but the banks may voluntarily invest into this sector.

Deprived Sector Credit Program (DSCP)

In 1990, the NRB introduced the 'Deprived Sector Credit Program' in order to meet the micro credit demand of the poorer and weaker section of the society. The NRB, while introducing the DSCP, segregated priority sector into two segments i.e. 9 percent for PSCP and 3 percent for DSCP. Table 2 depicts the total credit outstanding of the CBs in PSCP and DSCP (Table 3).

In this program CBs are required to lend from 0.25 (for newly established bank) to 3.00 percent (for those banks having more than 3 years of existence) of their total loan portfolio to the poorest sector. This is a mandatory program and if the banks fail to achieve the target, they are penalized for the shortfall. The penalties are charged as per the NRB Act and such penalties are deposited into NRB's profit and loss account.

Production Credit for Rural Women (PCRW)

The UNICEF launched this program in FY 1981/82 in selected districts of the country with the objectives of uplifting the socio-economic conditions of rural women through training, community development and provision of credit. In 1982 the agreement was signed between HMG/N and IFAD (International Fund for Agriculture Development) to provide a loan of SDR 4.75 million and a grant

Table 3

Commercial Banks' Finance on Priority Sector and Deprived Sector

(Outstanding as of Mid-July 2004)

(Rs. million)

Banks	PSCP	DSCP	Total
Bank of Kathmandu	605.2	241.8	842.1
Everest Bank	447.1	172.9	620.0
Himalayan Bank	873.6	385.2	1,258.8
Nabil Bank	607.3	271.6	878.9
Bangladesh Bank	813.6	307.7	1,121.3
SBI Bank	820.9	212.5	1,033.4
Standard Chartered Bank	690.8	188.2	879.0
Investment Bank	424.0	232.0	656.0
Nepal Bank Ltd.	1,794.1	609.0	2,403.1
Rastriya Banijya Bank	2,461.5	1,067.5	3,709.0
NCC Bank	413.2	106.5	519.7
NIC Bank	256.6	78.1	334.7
Lumbini Bank	198.4	69.6	268.0
Machhapuchhre Bank	175.7	28.9	204.6
Kumari Bank	190.0	96.0	286.0
Laxmi Bank	93.6	9.8	103.4
Siddhartha Bank	320.4	6.5	324.9
Total	**11,361.9**	**4,083.7**	**15,445.6**

Source: Bank Supervision Department, Nepal Rastra Bank.

from FINIDA of US $1.0 million to extend the program to 37 districts in Nepal. The project was executed directly by the Women Development Division of the Ministry of Local Development and the credit part was channelized by NRB through three participating banks: ADB/N, Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL). As of mid-July 1995, the program was extended to 67 districts and altogether 68,000 women were benefited from the project. The project implementation period is already completed and the repayment of credit from the PFIs is going on. Till 1998 the credit disbursement from NRB was Rs.234.6 million to PFIs. The outstanding loan amount under PCRW as at mid-Jan., 2005 is Rs.158.4 million. Among the 3 PFIs, NBL has paid back its loan to NRB. Likewise, NRB has also paid Rs.76.2 million (as of mid-Jan., 2005) to HMG/N, as per the repayment schedule of the project. The PCRW is the first micro credit project in Nepal which has empowered rural women.

Micro-Credit Project for Women (MCPW)

The MCPW project was a complementary program to the PCRW project. This project was launched in September 1993 with the loan agreement between HMG/N and ADB/M. The ADB/M provided SDR 3.54 million as loan under this project out of which SDR 2.55 million was allocated for the credit component. The utilization of the project credit component was more than 90 percent. With two years of the extension, the project period had already been completed in July 2002. This program also targeted poor women of rural and urban areas where 25,000 women from the rural and urban sector from 15 districts have been benefited directly. Under this program, the participatory banks (RBB and NBL) disbursed the loan amounting to Rs.195.2 million within the project period. The NRB has also repaid Rs.31.3 million to HMG/N as of mid-January 2005 and the outstanding amount to be repaid to HMG/N stood at Rs.170.8 million. The total disbursed loan amount to both PFIs has already been recovered; thus, there is no outstanding remaining with the PFI banks. The major outcome of MCPW is the impact that led to women groups to be organized as co-operatives. More than 82 women savings and credit co-operatives were formed and registered at the Co-operative Department out of which 25 savings and credit co-operatives have been able to become as POs of RSRF. Similarly, 27 FINGOs formed by the women groups under the MCPW have got limited banking license from the NRB.

Cottage and Small Industries (CSI) Project

The cottage and small industries (CSI) are the major source of employment, output and exports in the industrial sector in Nepal. The CSI development had been a priority under the Fifth, Sixth and Seventh Five-Year Plans. The Project was launched in 1982 with the World Bank (IDA) assistance of US $6.5 million in two zones (three districts in Kathmandu valley and six districts in Gandaki zone) and offering an opportunity to test innovative approaches to credit delivery, product and skills development and commercial services to cottage industries. The NRB as an apex institution directly administered the project and included three participating banks: Nepal Bank Ltd., Rastriya Banijya Bank and Agricultural Development Bank to promote, appraise and supervise the CSI subprojects, which were responsible for channeling the term loans to the CSI, related market agents and inputs supply companies. The NRB provided refinance facility up

to 80 percent of the eligible sub loans to the participating credit institutions from the project funds. The NRB also provided credit guarantee scheme of up to 75 percent of the principal amount under the CSI. The CSI-I, which achieved most of its quantitative targets for lending component and nearly full disbursement, was initially considered a success.

As a follow-on operation to the first Cottage and Small Industries Project (CSI-I), The second Cottage and Small Industries Project (CSI-II) amounting to US $ 10 million was approved by IDA on May 13, 1986 and became effective on July 31, 1987. The scope and scale of CSI-II was increased from 9 to 27 districts. The project contained too many components and involved too many agencies. The project was launched and substantially enlarged in scope and complexity, before the final results of the first project began to surface. The project objectives were defined too broadly and the activities under each component were not well coordinated to support each other to achieve the common objectives. Under the CSI-II, the role of NRB was not well defined, and its role from active project management, supervision and follow-up was merely limited to providing refinance and administering credit guarantee scheme.

Soon after the project was launched in 1987, loans made under CSI-I became due for repayment and the borrowers began to default on payments rapidly. Alarmed by the poor collection performance, the IDA tightened the recovery requirements, which in turn caused two out of the three banks to become ineligible to provide new loans under the project. Against this background, it was agreed that the project activities be halted prematurely as of June 30, 1992, some three years prior to the closing date. The greatest achievement under the CSI Project was that it brought about greater awareness and created favorable environment to establish cottage and small industries in the project areas and a remarkable growth of export-oriented woolen carpet industry in particular. Besides financing over five thousand industrial projects to the tune of Rs.368.9 million, this project had generated employment to 54,348 people. Based on the concept of project financing, the CSI-Project had also generated awareness of development finance among the CBs to some extent. The NRB has repaid all CSI loans amounting to Rs.200.9 million to HMG/N in FY 2003/04, which was taken from the Government under 1st and 2nd phase before the maturity period (CSI-II phase repayment was due on FY 2006/07).

Rural Self-Reliance Fund (RSRF)

Rural Self-Reliance Fund was established in February, 1991 by His Majesty's Government with the objective of uplifting socio-economic status of deprived group of rural area by providing institutional wholesale credit to the financial intermediaries i.e. Saving and Credit Cooperatives (SACCOPs) and Financial Non-Governmental Organization (FINGOs). The operation of the Fund is being carried out by the board of directors under the chairmanship of the Deputy Governor of Nepal Rastra Bank. Initially, Rs.20.0 million (Rs.10.0 million in 1991 and Rs.10.0 in 1992) as a capital grant was allocated by HMG/N to the Fund. HMG/N again in the year 2004 made available additional Rs.20.0 million to the Fund as capital grant, making the Government's contribution to Rs.40.0 million in total.

The NRB also made available Rs.100.0 million from its annual profit of FY 2001/02 and has also committed to contribute 5 percent of its profit each year. It provided Rs. 74.8 million in FY 2002/03 and Rs. 78.6 million in FY 2003/04 totalling Rs. 153.4 million. Acting as a trustee of the Fund, the Micro Finance Department of the NRB is performing the secretariat's work as per HMG's mandates.

The RSRF is the first wholesale micro finance institution, not only in Nepal, but also in the Asia-Pacific Region. It provides wholesale credit to SACCOPs and FINGOs and longer term credit to the development banks (DBs). The RSRF's finances to DBs banks should deal with areas which have national priorities like tea plantation and processing, cardamom plantation and processing and cold storage and on-lending to MFDBs. Some of the criteria that needs to be fulfilled by SACCOPs and FINGOs to get loan from the Fund are as follows:

(a) The organization should be registered under existing Nepalese law that is, co-operative society under the Cooperative Act, 1992 and non-governmental organization under the Society Registration Act 1979. The FINGOs should also have business license from the NRB.

(b) The organization should have been mobilizing savings and providing credit from and to at least 70 percent of its own members prior to one year after the registration of the organization.

(c) The organization should be situated in rural areas and under poverty mapping of National Planning Commission where there is no bank and FIs and where the majority of the population include Dalits and depressed caste and tribes.

(d) An individual or family need to have up to 15 Ropanis of land in mountain region or up to 1 Bigha of land in Terai region with no regular income, cannot feed himself or the family, has taken loan from other bank and FIs for income-generating activity and have no outstanding loan. Dalits, deprived sector women, members of self-reliant group of the deprived sector would be the target group to receive credit from the Fund.

(e) The Fund shall provide credit to viable organization according to its credit manual.

(f) The interest rate of the Fund is eight percent per annum to the FIs with the provision of a return of 75 percent on timely payment by the FIs to the fund.

The loan from the RSRF is provided only for 3 years period and will be given for 3 times only. The maximum limit of such loan is Rs.1.0 million for the first loan, Rs.1.5 million for the second loan and Rs.2.5 million for the final loan.

The RSRF provides long-term credit to DBs and MFDBs based on the business plan. It provides line of credit to such institutions if their business plans are found viable and worthy. The Fund is providing longer term loan to ADB/N for tea plantation and processing purposes for a maximum period of 15 years and 3 years for the MFDBs on wholesale credit for on-lending purposes to the deprived sector people. The Fund's activities during the last 13 years are presented below (Table 4).

As of mid-January 2005, the Fund disbursed loans amounting to Rs. 77.8 million to 50 non-government organizations (NGOs) in 26 districts and 167 cooperatives in 40 districts. Out of the disbursed loan, the Fund has already recovered Rs. 53.3 million and the loan remained as outstanding to Rs. 24.5 million. The credit recovery rate is 90.8 percent. As of mid-January 2005, altogether 9292 households (about 55,000 people) from 47 districts have been directly benefited. Likewise, the Fund has disbursed loans amounting to Rs. 92.2 million to the ADB/N for tea cultivation and processing purposes and Rs. 20.0 million to Eastern and mid-Western Regional Rural Development Banks for on-lending to micro-

Table 4

Activities of Rural Self-Reliance Fund (RSRF)

(As of mid-Jan. 2005)

(Rs. million)

(A) SACCOPs+FINGOs (wholesale credit)			
	FINGOs	**SACCOPS**	**Total**
Credit Approved	21.2	74.0	95.2
Credit Disbursed	18.8	59.0	77.8
Credit Repaid	16.2	37.1	53.3
Credit Outstanding	2.7	21.8	24.5
Credit Overdue	2.2	1.2	3.4
Overdue Percentage	11.9	8.3	9.4
Repayment Rate (Percentage)	88.1	91.9	90.8
Districts Covered (No.)	26	41	47
Beneficiaries (households) No.	3810	5482	9292
(B) ADB/N and MFDBs (longer term credit)			
	ADB/N	**MFDBs**	**Total**
Credit Approved	194.0	20.0	214.0
Credit Disbursed	92.2	20.0	112.2
Credit Repaid	-	5.0	5.0
Credit Outstanding	92.2	15.0	107.2
Repayment Rate (Percentage)	0	100	100.0

Source: Micro Finance Department, NRB.

credit out of the approved amount of Rs. 214.0 million.

Rural Development Banks (RDBs) and Micro Finance Activities

In 1992, HMG, closely based on the Grameen Banking model of Bangladesh, established two regional level rural micro-finance development banks with the major share participation of NRB (66.75 percent and 58.5 percent), one each in the Eastern and Far-Western development regions. By June 1996, other three RDBs, one each in the other three development regions were also established. The NRB altogether has invested Rs.195.0 million as equity into these 5 RDBs. Establishment of RDBs is a major breakthrough in the micro finance sector development in Nepal. The main objective of the RDBs was to provide credit to the poorer households, mainly to women. The RDBs' credit is provided for micro-level income generating activities on group guarantee basis. Each group has to follow weekly repayment schedule. Clients and their transaction activities are observed closely and loans are supervised regularly. These 5 rural development banks are the largest micro finance operators in Nepal. Apart from the RDBs, there are 4 MFDBs operating

in the private sector, namely, Nirdhan, CSD, Deprosc and Chhimek which all have followed the 'Grameen' model of Bangladesh. The activities of MFDBs during the last 12 years are presented in the table below:

Table 5
Micro Finance Outreach: Rural Development Banks (RDBs) * (As at mid-July)
(Amount in Rs. million)

	2004	2003	2002
Centre (No.)	4900	4803	4682
Groups (No.)	34552	34240	32822
Members (No.)	166815	169440	163960
Borrowers (No.)	146277	152719	149549
Total loan disbursed	10740	8970	6840
Total loan repaid	9390	7680	5650
Total loan outstanding	1350	1290	1190
Group fund balance	410	280	400
Personal saving balance	50	40	30
Branch expansion (No.)	147	165	160
VDC covered (No.)	966	987	950
Districts Covered (No.)	43	43	42
Staffs (No.)	1020	1094	1108

* 5 RDBs
Source: Micro Finance Department, NRB.

Table 6
Micro Finance Outreach: Private Sector's MFDBs* (As at mid-July)
(Amount in Rs. million)

	2004	2003	2002
Centre (No.)	3973	3199	2405
Groups (No.)	21347	18435	15031
Members (No.)	103215	86489	69033
Borrowers (No.)	100458	67842	56513
Total loan disbursed	4020	3000	2670
Total loan repaid	3400	2520	2290
Total loan outstanding	620	480	380
Group fund balance	180	150	140
Personal saving balance	20	70	10
Branch expansion (No.)	84	70	-
VDC covered (No.)	795	644	448
Districts Covered** (No.)	32	29	17
Staffs (No.)	467	324	361

* Nirdhan, CSD, Deprosc and Chhimek.
Source: Micro Finance Department, NRB.

Under the structural reform program implemented in Oct. 2001 in 5 RDBs, HMG/N and NRB made available Rs.163 million to cover accumulated losses of 4 rural banks. After the reform, two RDBs (Western Region Rural Development Bank and Eastern Region Rural Development Bank) generated profit. Likewise, some improvements have also been noticed in other three rural development banks. Various prudential norms such as productivity measures, appointment of the executive directors through open competition, cost reduction scheme like Voluntary Retirement Scheme (VRS) have been implemented by the NRB to make these banks viable and self-reliant. Under the VRS, HMG/N and the NRB provided Rs.6.4 million to Far Western Rural Development Bank for its downsizing by 43 employees. However, the VRS did not work as per expectation. Then it was re-introduced with the support of the NRB. Altogether 68 employees took the VRS from the bank. As per the 15-point restructuring program of the RDBs, the NRB has started divestment of its equity from those RDBs which generated profit. Accordingly, with the objective of gradual privatization of the profitable rural development banks, the NRB has initiated to divest its share from the Western Regional Rural Development Bank (WRRDB), Butwal by divesting 51-percentage share out of its total 61-percentage share with the bank. The first phase of the privatization program of WRRDB has been completed. The Bank's clients and staff purchased altogether 41.0 percentage share. Under the second phase of the divestment program, the remaining 10.0 percent share was purchased by the Nirdhan Uthan Bank. Privatization of RDBs is a new concept having a different objective compared to privatization of other public enterprises (PEs) that was undertaken in the past by HMG/N.

The WRRDB, Butwal has declared a 10 percent dividend to its investors in FY 2003/04 for the first time after privatization, which has made history in the micro finance sector. Another profitable RDB, Eastern Regional Rural Development Bank (ERRDB), Biratnagar, also announced its privatization program in 2004 and the process of privatization has already been started from mid-December, 2004. NRB's 56.75 percentage share out of its total 66.75 share with the bank will be divested under the program. Out of the 56.75 percentage share, 41.75 percent is allocated for the bank's clients, 5.00 percent for the banks' staff and 10.00 percent for the public. The divestment of shares from the RDBs is a new

step towards developing the private sectors' involvement in micro finance sector. However, the NRB, as a token of commitment for the micro finance sector development, has taken a policy of keeping 10 percent equity with these banks.

As the largest micro finance operators in the country, the RDBs have provided micro finance services to more than 270,000 deprived people, all women, during the last 12 years. As of mid-January 2005, 5 RDBs operating in the five development regions have disbursed loan amounting to Rs.10.7 billion and recovered Rs.9.4 billion. These banks provided micro credits to 166,815 women member clients all belonging to deprived sector. The RDBs have covered 966 village development committees of 43 districts through 4799 centres. The detailed activities of RDBs and its replicating banks are presented in Tables 5 and 6 above.

Revolving Line of Credit Facility to Rural Development Banks

The NRB has provided refinance/revolving line of credit facility to banks and other financial institutions viz. NIDC, ADB/N and RDBs. However, after the promulgation of new NRB Act 2002 refinance facility from the NRB can be provided up to the maximum period from six months to one year only with sufficient collateral. After the promulgation of new NRB Act, 2002, access to the re-finance window of the NRB has become more difficult and the NRB will not be permitted for longer-term refinance as per the provision of the Act. Before the enactment of the Act, the NRB had made available under revolving facility Rs. 20.0 million to ERRDB, Rs. 10.0 million to Central Regional Rural Development Bank (CRRDB), Rs.50.0 million to WRRDB and Rs.10.0 million to Far Western Regional Rural Development Bank (FWRRDB). Out of the total of Rs. 90.0 million refinance facility to RDBs, as of mid-January 2005, Rs. 10.00 million is yet to be recovered from FWRRDB. It is worth mentioning here that the NRB is found to be very positive in facilitating rural financing institutions through its monetary policies including the refinance window. Even at the present time, the NRB has kept its refinance window very accessible particularly in agriculture finance, micro finance and industrial and export credit. The current year's monetary policy of the NRB has further curtailed its refinance rate by 1 percent point keeping the rate at 3 percent per annum. Since its early days of operations, the NRB used to provide refinance at cheaper rate to ADB/N, NIDC and CBs under the priority sector lending.

Community Ground Water Irrigation Sector Project (CGISP)

Under the loan agreement between HMG/N and ADB/M signed on November 17, 1998 the CGISP project was conducted in March 1999 in 12 districts of eastern and central Terai region of Nepal with the loan assistance amounting to SDR 21.9 million. Out of this amount HMG/N has allocated SDR 9.93 million to the RSRF of the NRB, which is also the implementing agency for the credit component of the project, for the installation of shallow tubewells (STWs) in groups and individual basis for the purpose of irrigation facility and crops production. The main objective of this project, as envisaged in the 20-year long-term Agricultural Perspective Plan (APP) 1995, is to increase agricultural productivity and raise income of small and marginal farmers through community based shallow tubewell irrigation system. About 657,000 individuals (of which 50 percent are below the poverty line) from 110,000 marginal families were estimated to have benefited from the project through the installation of 15,000 STWs (1500 in individual basis) without subsidy. Nepal Bank Limited, ERRDB, CRRDB, Sahara Nepal Saving and Credit Cooperative Ltd, Deprosc Development Bank, Chhimek Development Bank, Arunodaya Savings and Credit Cooperative Ltd., Mahuban, Parsa and Krishak Upakar Saving and Credit Cooperative Ltd., Madi, Chitawan have been accredited as the participatory financial institutions (PFIs) of this project. Under the new policy adopted by RSRF, while selecting a new institution for PFI, any institution can now apply at any time. Initially the selection process was done on bi-annual basis. Similarly, the PFIs can extend credit to water user's group (WUG) on STWs installation and production credit within their working license area. The interest rate on STWs credit and production loan is based on market competition. Thus, the PFIs are free to fix their interest rate on STWs credit and production loan.

Financing on irrigation in community based water users group is a new concept not only in Nepal but also for MFIs. Because of this new scheme the project had undergone various operational level constraints at the outset. To overcome such constraints

the RSRF has incorporated various financing mechanisms and adopted conducive policies to run the project smoothly and without much delays. The CGISP model is recognized as one of the most successful and best-fit irrigation model in Terai region where the majority of the people have land, less than a hectare in size. The project is the first STWs irrigation project which is based on zero-subsidy. But it has committed to provide the project area with more than 680 km of access roads. It also has the objective of making Water Users Association (WUA) more development focused and competent.

Under the CGISP project, as of mid-January 2005, Rs. 57.7 million has been invested in 2,215 STWs comprising 2,207 STWs on groups and 8 STWs on individual basis. Altogether 9,404 marginal farmers' families have been directly benefited and 6,935 hectares of land have been irrigated through STWs credit. The project will be completed by July 2005 as per the original schedules. However, it has been recommended to ADB/M for two years extension.

Third Livestock Development Project (TLDP)

Livestock is the second largest income source for livelihood of people in Nepal after agriculture. Taking this fact into consideration, HMG/N with the loan assistance of Asian Development Bank (ADB/M), undertook Third Livestock Development Project (TLDP) in 1996. The primary objective of this project was to raise livestock productivity and consequently raise the living standard of the people involved in this business and to manage and develop livestock market. Under the loan agreement between HMG/N and ADB/M on December 23, 1996, covering 26 districts (in three different phases of the project) of western, mid-western and far-western development region of the country targeting marginal and middle income level people, the Project had a target of extending SDR 3.5 million livestock credit to the farmers living in the project area. The higher income level farmer also falls under the target group for running livestock schemes on commercial basis. HMG/N had provided the loan amount to NRB at 4 percent per annum and NRB to PFIs at 6 percent per annum.

The Project's total loan from ADB/M amounted to SDR 12.5 million, out of which SDR 3.5 million was allocated to NRB for the credit component. After the mid-term evaluation, this amount has further descended to SDR 2.0 million for the credit component. The project period was completed on July 15, 2004. The TLDP has been awarded three times by ADB/M for its outstanding performance during the project period. The loan repayment period of the NRB to HMG/N has already started from January 2005 and will end by July 2034. The repayment from PFIs to NRB started from January 2002.

The NRB was the implementing agency of the project for credit component and Department of Livestock, HMG/N was responsible for rest of the two components, viz., that is, a) improvement of livestock productivity and b) institutional strengthening and organizational development. During the seven-year period of the project, a total amount of Rs. 179.0 million to 17 PFIs (2 PFIs have not taken loan) has been disbursed. The NRB, as per the project agreement, had to provide 80 percent of the total loan disbursed by the PFIs. The PFIs themselves invested the remaining 20 percent. The disbursement under the project was totally based on the field inspection and report therein. During the implementation period, the NRB had undergone many changes in the 'Credit Manual' designed for it. The interest rates of the PFIs on such credit were kept at market rates. It is estimated that additional 143,809 livestock have been raised through bank credit and altogether 10,605 families have received such credit. As of mid-January 2005 out of the total disbursement loan, Rs. 79.4 million has been recovered from the PFIs and an amount of Rs. 91.0 million has remained as outstanding.

Poverty Alleviation Project in Western Terai (PAPWT)

The PAPWT is financed under the loan agreement between HMG/N and the International Fund for Agriculture Development (IFAD) signed on December 12, 1997. The project was implemented primarily with a goal of alleviating poverty in 8 districts of Western Terai, namely Kapilvastu, Rupandehi, Nawalparasi, Banke, Bardiya, Dang, Kailali and Kanchanpur. To achieve this target 16 branches of PFIs, comprising of Western Regional Rural Development Bank, Mid-Western Regional Rural Development bank, Far-Western Regional Rural Development Bank, Nirdhan Utthan Bank Ltd. and Centre for Self-help Development

were selected for micro credit delivery through which the branches were also expected to run in a sustainable basis. Later in FY 2003/04 a new policy was formulated under which any branch of those PFIs within the Project area could disburse loan out of the revolving fund which would later be reimbursed by the NRB.

The Project is the first micro credit project that was based on 'credit plus' approach of financing. The credit plus approach includes the other support services like shallow tubewells, village roads, education with vocational training, housing for 'Mukta Kamaiyas' (bonded labor) along with the micro credit. The Project has as of mid-July 2004 covered 29,000 borrowers of the small and marginal deprived sector. The loan amounted to SDR 2.57 million and the Project was physically completed in December 2004. Based on pre-financing model of payment, the selected branches will get resources from the NRB for on-lending to their clients. Such financing was based on the viability plan of the selected branches of PFIs submitted to NRB. The Credit Approval Committee of the project within the NRB was responsible for the approval of the viability plan. The ultimate target groups of the project were the poorest of the poor people from below the poverty line. The Ministry of Local Development (MoLD) was the major project implementing body, which was responsible for overall project management. The project offices located at the project area are mainly responsible for mobilizing the groups, which later would get credit line from the selected PFIs. The NRB was acting as a credit component implementing body and solely responsible for the credit management. HMG/N has provided loan to NRB at 3 percent per annum and NRB provided PFIs at 4 percent.

The credit component implementation period of this project was completed on December 31, 2004. The loan repayment period of NRB to HMG/N is 18 years based on half yearly installment, which will start on January, 2006 to July 2023. As of mid-January 2005, the incremental investment to PFIs under the credit component amounted to Rs. 131.4 million. Out of this amount, the PFIs repaid Rs. 39.9 million to the NRB. The outstanding amount stood at Rs. 91.5 million as of mid-Jan. 2005. Altogether 20,000 families from below the poverty level has benefited directly by this project.

Rural Micro-Finance Project (RMP)

Funded by ADB/M this project was signed in May 1999 and will be completed in June 2005. With a loan amount of SDR 14.2 million, the RMP aimed at improving the socio-economic status of poor women through the wholesale credit to the PFIs, including RDBs, for on-lending to income generating activities and institutional strengthening of MFIs. The major outcome of the Project was the establishment of a wholesale micro-credit institution called Rural Micro Finance Development Centre (RMDC), in Oct. 2000, under Development Bank Act, 1995. The RMDC is the major implementing agency of the RMP. The NRB is responsible for co-ordination with the Government and the RMDC in principle. The Project was implemented with objectives of making MFIs sustainable and reaching out to the poor people with micro credit at greater speed up of scales. But this objective has been partially achieved. On the other hand, although the project has abundant resources for on-lending, the RMDC even could not utilize the ADB/M's loan fully. It has utilized less than 20 percent (as of mid-July 2004) of the total available credit component under the Project. The conservative and poor micro-friendly attitude towards larger MFIs, was mainly responsible for such poor utilization. It has also undermined the prospects of RDBs in outreaching as well as scaling-up of operation of micro-finance. This has also set back RDBs' expansion of micro-finance activities to help support the poverty alleviation program of the government. As a result, the major MFIs, RDBs in particular, were in great difficulties in getting resources from the other financial institutions, too. The RMP, due to too many conditions put by ADB/M, could not move rapidly until July 2004. Thus, with the recommendations from the NRB, HMG/N has recently made various amendments in discharging the loan from the RMDC at a greater speed. The important one is the curtailment in interest rate charged by HMG/N to the RMDC by 2 percentage points. The RMDC has also reduced its rate to 5 percent from the original rate of 7.5 percent for wholesale credit to its POs. Likewise, there are improvements in increasing the credit ceilings to Rs.80.0 million per POs and amendment in the repayment conditions for eligibility. With this improvement the project has been recently extended by two years ending on June 30, 2007. It is expected

that this improvements and expansion of the project period by two years would help in utilizing the ADB/M credit line at greater strength.

NRB's Association with the Regional Centres

In order to exchange ideas and share experiences on rural finance with international association NRB has established cordial and strong relations with the Asia Pacific Rural and Agricultural Credit Association (APRACA). The NRB is the founder member of the APRACA (established in October 1977 with the collaboration of FAO) and has continuously been an active member of the Executive Committee. Likewise, it is also a founder member of the Centre for International Co-operation and Training in Agricultural Banking (CICTAB) set up in 1983. The CICTAB is an association based on SAARC region and APRACA has 63 member institutions from 25 countries of the Asia-Pacific region. The events conducted by these institutions have played creative role in strengthening development finance activities in member countries. The NRB, as a member institution in the past, has organized various activities including General Assembly and Excom Meeting of the APRACA.

The role of the APRACA in shaping the development finance—micro and rural finance—remained very strong and effective. Nepal has 4 member institutions in APRACA with the NRB as an Excom member representing Nepal. The CICTAB has six member institutions from Nepal, where the NRB is represented to the Managing Committee of it. The CICTAB's Head Office is located at Pune, India.

Development Finance: Comprehensive Analysis and Interpretation

It is believed that 1.2 billion people around the globe live in absolute poverty.[11] The majority of the Asian population are also poor and the dimension of the Asian poverty is much more diverse as compared to the poverty status of the developed countries. Thus, poverty reduction strategy has become one of the major development concerns of most of the Asian countries, including Nepal. As per the Tenth Plan (2002-2007) Nepal has 38% of the total populace (24 millions) living below the poverty level. Recognizing this fact the Plan has also set out poverty reduction as its single target. It has also recognized micro finance as one important tool to achieve its target. The Tenth Plan has set a target of Rs.101 billion rural credit to be disbursed during the plan-period of which 50% will be disbursed by the MFIs.[12]

In the past three decades 'development finance' in different forms has been a national agenda for rural development. The NRB, as the central bank of the country, was directly involved on it. Thus in the past and until now, it has taken monetary policy stances to make such finance run smoothly. The micro financing model of development finance is the currently on-going program where NRB is involved directly as well as indirectly. Micro credit (from small credit to micro finance) has successfully been tested, experimented and implemented in Nepal as a poverty reduction program focused on the people below the poverty level. Reducing the alarming situation of the poverty in Nepal to a reasonably sustainable level is also a major concern of the government plans and programs.

After 1991, Nepal adopted liberal financial system and CBs and other financial institutions are prudently regulated by the NRB. This sector is also kept open to the private sector. The policy has further led to the growth of 17 CBs (12 are in the private sector), 59 finance companies, 29 development banks (5 RDBs), 21 co-operatives and 49 FINGOs for limited banking as of mid-February 2005. Both the Interest rate and foreign exchange rates have been left to be determined by the market forces. As there is no more control on branch expansion from the NRB, many loss-making rural branches of CBs have been merged with another viable branch or most of them have been almost closed down. On the other hand, this situation has created a gap or vacuum in savings and credit activities in rural areas where poverty incidence is very high. This situation has further created a serious problem in flowing institutional credit to poor people, making it more difficult to achieve the objective of the Tenth Plan.

The phasing out of the decade-old priority sector lending from the CBs has further distorted the credit supply in the rural areas. The banks are not in a situation to flow credit voluntarily into this sector as priority sector had never been their interest. The rural sector of Nepal has gradually become less accessible to the financial institutions because of the security threat. The ADB/N, too, which has a wide branch network throughout the country, is slowly moving

into safer areas and it has already closed down many of the rural branches. This has further put the rural credit delivery system in a big dilemma in Nepal.

Development finance was envisaged by the NRB as a financial tool for poverty reduction for over a period of four decades. But immediately after the liberalization, banks and financial institutions have stopped financing the rural sector because financing to rural sector was too risky for them.

Financing infrastructures like road, communications, hydropower and irrigation system requires huge capital. Development banks and financial institutions' resources may not be sufficient for it. Thus, HMG/N should be responsible for creating the environment of infrastructure development. By nature, development finances require huge amount and longer term maturity for payment looking at the existing resource base of the newly established DBs and NIDC and ADB/N. It is quite difficult to forecast whether or not the existing Nepalese DBs will be quite competent to supply the huge capital for development projects. Apart from that, rural finance in Nepal has remained a shadow financing segment for most CBs and other financial institutions. Thus, rural finance needs wider changes in attitudes as well as the formulation of policy stances in order to smoothen it in the coming years.

Outcome and Impact

The NRB has always been playing a crucial role in flowing resources to the deprived and poorer sector of the economy through development finance policy. It has undertaken various policies on development finance including rural and micro finance to generate employment and increase production and income of the poorer people. One of the most important policies on development finance was the introduction of priority sector in the early 70s. Later in 1984, the NRB also instructed productive sector credit program in the CBs whereby they were instructed to flow 25 percent credit out of the total credit outstanding into this sector including the priority sector. This sector had included the priority sector credit also, where the banks were then required to invest 8 percent of the total credit. Thus the productive sector included 8 percent of the priority sector requirement and 17 percent requirement in the productive sector.

The productive sector credit requirement for the CBs was mandatory but the shortfall on it was not penalized. This requirement had further increased to 40 percent with effect from 1990[13], which included the 12 percent requirement in the priority sector, and remaining 28 percent in other productive sector. The other productive sector included finance on industries, export and pre-export, godown and cold storage, hire purchase and public transportation, investment on shares and debentures of industries, insurance companies which have national priorities, agricultural tools and equipment etc. With the introduction of the productive sector credit, the CBs were forced to divert their funds into development finance. The main objective of introducing this requirement was to divert the usurious banks' credit into productive purposes which would generate employment opportunities, too. Had the NRB not introduced such policy, CBs would have never been involved in development finance. Presently, this policy (other than priority sector) is not in practice; thus the latest data is not available. However, the bank finances on such sector were found very enthusiastic and promising till July 2001. The table below shows that bank finances on the productive sector always remained more than the stipulated requirement of the central bank.

As of mid-July 2004, MFIs in the organized sector have outreached more than 247,000 rural clients (borrowers) below poverty level. Out of the total disbursed amount of Rs.14.8 billion, the net outstanding loan amount is Rs.2.0 billion (see Tables 4 and 5). Out of this 247,000 borrowers covering

Table 7
Commercial Bank's Finance on Productive Sector: Comparative Performance (As of midJuly 2001)
(Rs. in million)

Mid-July	Total Credit*	Productive Sector Credit	Percentage to Total Credit
1994	27347	12282	44.9
1995	36779	19423	52.8
1996	50891	27167	53.5
1997	58378	29616	50.7
1998	68618	35644	51.9
1999	81759	43005	52.6
2000	96325	54111	56.1
2001	109022	59412	54.5

* Including credit of ADB/N's commercial banking.
Source: Bank and Financial Institutions Regulations Department, NRB.

43 districts the five RDBs have outreached to 147,000 borrowers. During the last eleven years Rs.10.7 billion has been disbursed and Rs.9.4 billion is repaid and outstanding stands at Rs.1.4 billion. The RDBs, during the period, have collected Rs.410.0 million as group savings which reflects the empowerment of poor women. The four private sector's MFDBs over a period of ten years have disbursed Rs.4.0 billion and repaid Rs.3.4 billion from slightly over 100,000 borrowers. The private sector's MFDBs also have collected Rs.180.0 million as group savings during that period. Indeed, micro finance has resulted in positive impact on the empowerment of rural women.

This achievement of the organized sector's MFIs is certainly remarkable. But this much is not sufficient enough to cater to the whole gamut of rural households by rural and micro finance. Most of the poor households are yet to be covered by financial services. In the past, the number of MFIs in Nepal was not adequate to flow the financial needs to the remaining poor households, and their service areas were also limited.

The closure of many CBs, branches from the rural sector and hesitation of emerging new financial institution to remain in the rural areas are the latest threats for rural credit delivery system in Nepal. Liberalization of financial market has definitely led the market to grow at the institutional base; however, their presence in the rural sector is still thinner and almost negligible.

Problems and Challenges

Poverty in Nepal is widespread with 38 percent of the total population living below the poverty line.[14] The incidence of poverty is more severe in the rural (44 percent) and mountain (56 percent) areas. Agriculture still remains the prime occupation for majority (80 percent) of the population in Nepal. The 10th Plan has a target to reduce the present level of poverty by 8-percentage point to 30 percent level at the end of Plan period (2007). The majority of the population (88 percent) still live in the rural areas where agriculture remains the major source of employment and livelihood. But the overall performance of this sector could not remain strong.[15] It is quite noteworthy that the agricultural sector share to GDP over the last 10 years has significantly declined from 49 to 39 percent. However, the number of labor engaged in agriculture and allied activities has changed little over this period (about 80 percent of employment). This has denoted the low productivity of labor indicating poverty increment in future. In fact, the small size of land holding and fragmentation of land in particular are mainly responsible for low agricultural growth (1.75-percent growth rate over the period of 1990-95). More than two thirds of the total land holdings have less than one hectare of land and they own only 30 percent of the total farm area. The average size of land holding per household in this category is only 0.42 ha.[16]

The Rural Credit Survey of 1991/92 has revealed that only 20 percent households have access to formal financial institutions and 80 percent had access to the services of the informal sector.[17] It indicated two important policy failures of the organized sector: one is the insufficient infrastructure and another is the inefficiency of the existing financial institutions to deliver rural credit. The question raised by the above survey remains still valid in the context of credit delivery in rural areas. Although there has been significant improvement in the number of rural financial institutions thereafter, the majority of the population has been deprived of rural finance. It is estimated that there is a supply gap of Rs. 13 billion per annum to meet rural credit demand.[18]

Remarkably, upward changes are seen in the number of banks and financial institutions after the onset economic liberalization and financial reform in the country. However, their penetration in the rural sector is not satisfactory because their presence is mostly concentrated in urban areas. The CBs hesitate to go to rural areas because of high operating cost and inadequate infrastructure required for a bank.

Development financing (rural, agriculture and micro financing) has never been a business opportunity to most of the CBs in Nepal. Thus, during the period where CBs were required to invest a minimum amount of their total portfolios in the priority sector, the banks' finance in this sector had never exceeded the minimum percentage as prescribed by the central bank. On the other hand, the joint venture CBs, despite the provision of indirect financing, remained passive on financing agriculture and micro finance. Instead, they prefer to pay heavy penalties to the NRB incase of failure to meet the minimum lending requirement for priority and deprived sector.

Table 8
CBs' Finance for Priority Sector (PS): Comparative Performances (As of Mid-July 2004)
(Rs. million)

Mid-July	Total Credit	PS Credit	PS Percentage to Total Credit
1994	26,269	2,130	8.1
1995	36,768	2,797	7.6
1996	48,268	3,683	7.6
1997	55,184	4,676	8.5
1998	65,090	5,893	9.0
1999	77,866	7,183	9.2
2000	81,759	9,521	11.6
2001	96,325	11,178	11.6
2002	109,022	13,704	12.6
2003	115,727	11,387	9.8
2004	157,784	15,446	9.8

Source: Bank and Financial Institutions Regulations Department, NRB.

In the development finance sector, the NIDC and the ADB/N are also encountering financial constraints within the institutions, having high ratio of NPA. The negative financial positions of the NIDC and its huge percentage of non-performing assets constraints the flow of development finance. The ADB/N also has huge percentage of overdue as well as resource problem.

Likewise, the MFIs of Nepal are also facing internal and external problems. They are facing challenges on financial sustainability and shortage of loanable funds. The operational cost of MFIs is very high which hinders MFIs from becoming self-sustained. Self-sufficiency means MFIs need to cover all administrative costs and loan losses out of its operating income. But, most government-owned RDBs in the country are in great difficulties, particularly with respect to operating on a self-sufficient basis. Out of 5 RDBs, only 2 are in profit. On top of that, the MFIs are not in a position to charge market based interest rate because of the threat by the insurgency.

The future of such financial institution, from the sustainability point of view, will however, depend on financial performance. The financial positions of some of the Nepalese MFIs are not at the satisfactory level. Three out of five RDBs that are in losses and the private sectors' MFDBs are also not in a position to make immediate profit. Those institutions that have received grants (in different forms) are normally running at marginal break-even point. The present financial position of the MFDBs have posed a serious question that until and unless these MFDBs will not be in a position to charge interest rate to cover their costs the question of their existence will be doubtful. This is because smaller the credit size, higher is the cost of fund and so is the delivery service. On the other hand, the MFDBs have little access to the wholesale lending institutions. Access to the CBs' fund has also become difficult these days to most of the MFDBs. The security threat out of the insurgency problem has added additional cost to rural financing institutions.

In this background, at least two immediate policy stances are needed to implement in order to make MFIs viable, competent and micro finance friendly. Firstly, a policy is required for continued support from the government in social mobilization and group-formation, as the primary objective of MFDBs' is to help alleviate poverty. Secondly, it is important to create a wholesale fund for financing micro finance in the longer term possibly at the minimum interest rate. In addition to the above, there are various aspects in the micro finance sector that have to be addressed by the government and the central bank through appropriate policy stances.

The NRB has in the past experimented with various development finance policies from 'small sector' to 'priority sector' and 'productive sector' as well. Micro financing is the latter attempt in this development. It is true that there is a great need of micro finance in the rural credit delivery system of Nepal. At the present context of internal conflict by which most of the rural people directly and indirectly have been affected, the thrust for micro finance is much more needed and crucial.

Reaching out to remote places and motivating the rural people are other challenges to MFIs in Nepal because the country has a diverse topography and thin population density. Therefore, the achievements so far made by these MFDBs are highly commendable. There is a dire need for development finance in Nepal for the wide expansion of micro finance services in order to generate income and employment.

Corrective Actions and Policy Options

The NRB has always been positive and pro-active in creating policy environment for rural and micro

finance. Realizing the status of low coverage by the 'priority sector lending' to small sector and deprived sector, the NRB introduced "deprived sector credit program" in 1990. Under this program the CBs, until now, are required to invest a minimum of 0.25 percent (for new banks) to 3.00 percent (for those banks having more than three years of existence) of their total loans and advances to the hardcore poor.

The efforts on creating regulatory environment in the micro finance sector are an advanced step towards correcting policy on micro finance operation. This policy correction has established Nepal as a pioneer in the micro finance sector development in the world. The NRB has adopted various policies on bank licensing and introduced prudential regulation effective from mid-April 2003. It has also strengthened its system for supervision and monitoring MFIs. The introduction of prudential regulation for MFDBs is a major breakthrough in the MF sector.

The major challenge to micro finance is how to make this industry viable, sustainable and profitable. Reaching out to the majority of people with micro and rural finance and making the financing institutions viable, sustainable and profitable are two different aspects of micro finance. Both aspects are equally important in making rural financing accessible to rural people on a sustainable basis. Regarding the latter aspect of micro finance in Nepal, in October 2001 the NRB initiated an important policy correction step known as 5-year Restructuring Programs for the RDBs. The on-going restructuring program for the RDBs is managed internally by HMG/N and the NRB. A top-level committee for the co-ordination and directives was constituted in 2001 under the chairmanship of the Deputy Governor of NRB. The committee is solely responsible for the implementation and monitoring of the restructuring plans and programs. After the restructuring, one out of the four ailing RDBs came into profit and NRB has decided to divest its share to the private sector, mostly the clients. The RDB Restructuring, 2001 has a 15-point reform package which is directed towards making micro finance business viable, sustainable and accessible to most of the poorer and weaker section of the society. After the restructuring of the RDBs, one major policy shift came into picture, i.e., the change of ownership-pattern in the banks. Prior to the restructuring, the NRB used to play a key role as the largest equity holder. This shift in policy will definitely motivate the private sector to play a significant role in micro finance.

Micro-finance practices in Nepal dates back to 1974. However, the efforts on creating legislative and regulatory environment for this was made possible only after the introduction of Development Bank Act,1995 and Financial Intermediaries Act, 1998 which has also enabled the private sector for micro finance business.

Introduction of Prudential Regulation

The NRB introduced, with effect from mid-April 2003, prudential regulation for MFDBs. Presently, there are 9 MFDBs in operation, out of which 5 RDBs are in the government sector and 4 in the private sector. Before the enactment of Banks and Financial Institution Act- 2003 (BFI Act), there were two legal frameworks for the micro-finance operation. Development Bank Act 1995, among others, also permitted MFDB to do micro-finance business, whereas Financial Intermediaries Act, 1998 (1st amendment 2002) facilitates NGOs for doing limited financial intermediation like small savings, group savings, micro-credit and agent banking. With the introduction of the BFI Act (now BAFIO, 2005) all MFDBs fall under category 'D' of financial institutions.

The details of the NRB's prudential regulation for MFDBs are presented below:

Capital Requirement for Establishing MFDB

To open a national level MFDB, a minimum paid-up capital of Rs.100.0 million is required. Likewise, for the MFDB to be operated within 4 to 10 districts excluding Kathmandu valley requires Rs.20.0 million as its minimum paid-up capital. The lowest capital requirement for the MFDB is Rs.10.0 million. Such MFDB can operate only in 3 districts excluding Kathmandu Valley.

Limit for Promoter's Stake at MFDB

A minimum of 15 promoters are required to promote a MFDB. The promoters of MFDB can hold a maximum stake of 70 percent. At least 30 percent shares should be allocated to the general public, which should be issued within 2 years of the operation of the bank. The promoters can off-load their stake with the permission of the NRB after

meeting the following two conditions: (a) public issue has been done; and (b) listing of shares at the Stock Exchange has already been done for the last 3 years.

Provision for Foreign Stake Holding

Foreign institutional investors can hold a minimum of 10 percent to maximum of 51 percent stake at the MFDB. However, such stake should not effect the public allocation i.e. 30 percent. But foreign individuals are restricted to have equity at MFDB.

Individual Share Holding Limit

Any individual, firm, family, group, houses, company falling in the same group cannot hold more than 15 percent share of MFDB. Such limit is also applied to the promoters.

Licensing Procedures

The NRB, if it finds the proposal for establishing MFDB technically and financially viable from every aspect, will issue banking license to such MFDB within 4 months of the application submitted with cash deposit to NRB by the promoters. An amount equivalent to 20 percent of the promoter's shares should compulsorily be deposited with the NRB's account at the time of application. Another 30 percent of such amount should be deposited at the time of receiving 'letter of intent' from the NRB. The remaining 50 percent of the promoter's commitment should be deposited at the time of getting business license from the NRB. The NRB does not provide any interest on such deposits. On the other hand, if the proposal is found non-viable and the promoters could not submit the required documents and also they failed to deposit cash amount within the timeframe given, the NRB will reject such proposal and notify to the applicants within the timeframe as mentioned above.

Graduation of MFDB

A MFDB (that presently falls under grade D) can be graduated if it fulfills all requirements for upgrading from grade 'D' to 'C' and likewise from 'C' to 'B' and 'B' to 'A', but it can not be upgraded directly from 'D' to 'B' and 'A'.

Priority for License

A MFDB, to be operated in rural areas, is given top priority for business license by the NRB.

Prudential Regulation

The NRB has introduced, effective from mid-April 2003, prudential regulation for MFDB operating in the country. With the objectives of making micro-finance business more viable and sustainable as well as competent and effective in delivering services, the prudential regulation of the NRB has been designed in line with the Basle's prescription for CBs. However, there is some relaxation for micro-finance activities in the Nepalese context. Some important highlights of the regulation are presented below:

(i) Capital Adequacy: Based on weighted risk assets (WRA), a MFDB is required to keep its capital adequacy at the ratios presented in the table below. Primary capital includes paid-up capital, general reserves, retained earnings & premium on shares. The secondary or tier-II capital includes other reserves, which are not reflected in tier-I capital or primary capital. The losses should be deducted from the capital, if any, for calculation purposes.

	Ratios Required (In Percentage of WRA)	
Fiscal Year	**Primary Capital (Tier-I)**	**Total Capital Adequacy**
2003/04	2	4
2004/05	3	6
2005/06 onwards	4	8

The risks associated with the assets of MFDBs are categorized as under:

Assets	Weighted Risk (Percentage)
1. Cash in vault	0
2. Cash with NRB	0
3. Balance with CBs & financial institutions	20
4. Investment on NRB's & Govt. securities	0
5. Any other investments	50
6. Loan & advances (Micro-credit)	100
7. Fixed assets	100
8. Other assets	100

(ii) Cap on Mobilizing Financial Resources: The MFDBs can mobilize financial resources up to the maximum limit of 20 times of the core capital (Tier-I capital). Such financial resources include group savings, special savings and borrowings.

Likewise, MFDB which has already exceeded the limit of 20 times at the time of regulation issued (mid-April, 2003) should also bring down their position to the limit as prescribed by the NRB within the time frame given by the NRB. For the calculation of capital adequacy, MFDBs are monitored biannually (mid-July and mid-Jan.)

(iii) Liquidity Requirement: The MFDBs should compulsory maintain a minimum liquidity balance of 2.5 percent of their savings deposits as a liquidity ratio, out of which 0.5 percent should be kept as cash reserve requirement. Liquidity includes cash at vault, investment on govt. securities, investment on the NRB-bonds and balance held at licensed CBs and financial institutions. For monitoring purposes, such liquidity ratio is calculated in each month based on daily averages. If the MFDBs fail to keep the minimum requirement, they are subject to pay heavy penalty to the central bank as stated in the NRB Act 2002.

(iv) Loan Classification and Provisioning for Loan Losses: Based on the aging of overdue the MFDBs' credit is classified into 4 groups as given below. After the classification, the MFDBs are required to allocate provisions on annual basis as specified in the following table:

Loan Classification	Basis of Classification (Aging of Overdue)	Provisions Required (% of the Loan)
Good	No overdue and overdue by 3 months	1
Sub-standard	above 3 months - 9 months overdue	25
Doubtful	above 9 months - 1 yr. overdue	50
Bad	overdue by more than 1 yr.	100

(v) Business Operation Area and Branch Expansion Policy: The MFDBs are given autonomy for the expansion, closure and merger of their branches within the approved geographical working area. However, the bank should seek prior-approval from NRB while expanding their existing geographical working area that is licensed by the NRB. The opening-up of a new branch should be based on the business plan and their respective boards should approve such plan.

(vi) *Single Borrower/Member Limit:* The MFDBs can extend up to NRs.30,000 per member of the group as micro-credit for income generating activities. This is simply because all deprived sector loans are limited to Rs.30,000 per borrower as upper limit for micro credit. However, they can extend up to Rs.100,000 to the graduated members for running micro and small enterprises if that is found viable and feasible. The bank can invest up to 25 percent of the total credit and investment on such schemes.

(iv) Good Governance: The present regulation has also tried to establish corporate governance culture within the MFDBs. In this regard a number of disciplines have been chalked out. In short, some of the standards set by the NRB for good corporate governance practices are presented below:

a. Minimum qualification requirement for promoters, member of the Board of Directors and Chief Executive Officer.
b. Restriction on family related borrowings.
c. Code of conduct for Board Members, CEO and staff.
d. Restriction to staff for affiliating themselves to any political parties and their sister-organizations.
e. Segregation of internal and external audit.
f. Declaration of property by banks' officials for transparency purposes.

The basic objective of any regulation should be thrived into the practices of good corporate culture, which should be transparent, competent and maintains healthy financial condition of the institutions regulated. The importance of good corporate governance in any MFDBs is directly motivated by the healthy supply of rural financial services based on sound practices. But it is a gradual process, which needs to change in attitudes, behavior and self-awareness. Strong commitments from the top management and high values and deep organizational culture are also equally responsible for the practices of good corporate governance. It is equally difficult to make it practically feasible, especially in developing countries like Nepal. The lesser the presence of transparency in operation and policies, the higher the chances of unaccountability and irresponsibility. Under such circumstances, no one will expect good corporate governance in any organization. The NRB's regulation on this aspect is also a beginning. Transparency, accountability and responsiveness to the public are the fundamentals for having good corporate governance in any public organization.

Future Agenda

It was expected at the time of phasing out of 'priority sector' that CBs would also volunteer on

development finance. Liberalization of the financial market would make the Nepalese rural financial system more competitive, prudent and rural friendly. The establishment of RDBs in the five development regions and the other 4 replicating banks would also strengthen the micro finance sector rapidly. The establishment of RMDC would also help support the MFDBs including 5 RDBs. But, all these expectations are yet to be achieved.

With a view that mandatory development finance requirement for the CBs does not work in reality, NRB had phased-out such requirements in the year 2002. However, no improvements are seen thereafter in the voluntarily credit expansion into this area. The total outstanding credit of this sector has declined from Rs.15.5 billion (as of mid-July 2004) to Rs.11.9 billion (as of mid-Oct. 2004) within a period of six months after the phase out. This has further created a great vacuum in rural credit supply. The operation of savings and credit cooperatives (not licensed by the NRB) are not monitored by the NRB but their role in rural and micro credit delivery could be remarkable. The NRB still has issued license to 49 FINGOs for limited banking operations. The FINGOs Act 1998 has confined their activities in the micro finance sector in a limited way. Thus, there is utmost need of a policy that would address the overall development of micro finance sector for its integration and coordination.

With the growing number of rural financial institutions it is imperative that these institutions should properly be monitored, supervised and coordinated. Accordingly, the NRB is formulating a National Micro Finance Policy to address all issues and challenges relating to the micro finance sector. This has been announced in the current monetary policy for the FY 2004/05. In this connection, the NRB has already set-up a top level 'Steering Committee' under the Chairmanship of Deputy Governor who looks after the Micro Finance Department. Various key personnel from the ministries, Planning Commission, Poverty Alleviation Fund, Social Co-ordination Council and the private sector's micro finance experts are members of the Steering Committee. The Executive Director of the Micro Finance Department is responsible as the member-secretary. This Committee will be responsible for the implementation of the micro finance policy and will also co-ordinate, monitor and be involved in research activities of the micro finance sector development.

Conclusion

Unlike the views of many market-economy experts, it is the duty of any government or central bank to smoothen the system of rural credit supply. The government and the central bank should formulate policy so as to stimulate micro finance institutions and CBs to adopt appropriate micro and rural financing plans, strategies and programs. The time has also come to provide resources to MFIs for capacity building and institutional support.

Despite various efforts on strengthening institutional credit to the rural people it is interesting to know that majority of the rural households have thinner access to formal financial institution. Moreover, the supply side analysis of rural finance in Nepal has also indicated that there is a wide gap between demand for and supply of credit. These two facts have demonstrated tremendous opportunities to many rural financial institutions for the future. The policy commitments of the government in the Tenth Plan have also motivated MFIs to continue their business-operation at a greater extent. Only, the ongoing insurgency problem in the country de-motivated CBs and even ADB/N to remain in rural areas. This is reflected in the closure of many rural branches of ADB/N, RBB and NBL. For example, the ADB/N has as of mid-July 2004 only 347 branches compared to 542 in 2002.[19] Thus, the expansion of development finance, agricultural, rural finance and micro finance in particular, if handled carefully, is possible in the future. The present modalities of rural credit operation can also be changed and for such purpose DBs including ADB/N and other MFIs could finance their beneficiaries through savings and credit co-operatives, FINGOs and village banks and also through the consumers' groups and societies that are present in local areas and are not much affected by the current insurgency problems and internal conflict. In this context, the commitments from the government as well as from the NRB are highly desirable. The National Micro Finance Policy should be formulated in such a way that policy makers, practitioners, donors and investors should adopt a single window approach to develop the micro finance sector. During the last four decades, development finance in different nomenclatures has never been a business opportunity to most financial institutions and remained as a risky area of financing. The banks' finances to the

agricultural sector formed only 2.3 percent of the total credit at the end of the Ninth Plan period.[20] This indicated that CBs are not interested in financing this sector. However, the share of industrial finance of the CBs, which remained at around 42 percent of the total credit during the 9th Plan period, indicated its wider scope. But the question arises: do the CBs' finances on industry have really created enough opportunity for employment generation and capital formation? The creation of employment opportunity and capital is more important in any development finance activity. This has not been taken into account in the development finance sector in Nepal. It has also been reflected in the activities of newly established DBs. The NRB's requirement for this sector was also considered as imposition. Thus, those efforts introduced in this sector in the past did not work properly in outreaching development finance at a greater scale. The ultimate goal of development finance (which includes rural and micro finance) is to increase the access of rural people to all types of financial services from the organized sector.

Thus, the challenges in front of the government and the NRB include the strengthening of the existing MFIs and making these institutions viable and sustainable. It has been demonstrated that micro finance is an effective and powerful tool to reduce poverty in developing countries. The MFIs could also become a catalyst for rural development through credit delivery services to the poor people in Nepal.

Endnotes

1. See EDFI (2004) for details.
2. *Ibid.*
3. This is based on data provided in ADB/M (2002).
4. This figure is taken from NRB (1994).
5. Those who live less than US $1 a day is considered as poorest of the poor as recognized by the CGAP.
6. See Daley (2002) for further elaboration.
7. This is elaborated in SKBB (2004).
8. See NPC (2003).
9. The SFCL was awarded by the CGAP & IFAD in 2003. For details see GTZ-Rural Finance Nepal (2004).
10. The figures are taken from SKBB, *op.cit.*
11. This is the estimation of the World Bank as provided in Micro Credit Summit 2002, New York.
12. See NPC (2003).
13. The Ninth Plan (1997-2002) had also set this target to increase to 55 percent. However, the NRB did not issue any circular on it.
14. The nationally defined poverty line is Rs.4,404 (at the price of 1995) per capita per annum (approximately US $63.00 approx.) as stated by the NPC.
15. Details are provided in ANZ Ltd. (2001).
16. For more on this, see NPC (1998).
17. This is given in NRB (1994).
18. Details are given in ADB/M (2002).
19. This is taken from ADB/N (2003).
20. See NPC (2003).

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Supervision Framework

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Introduction

Supervision of banks and financial institutions is one of the prime responsibilities of the supervisory authority. Effective supervision of these institutions is an essential component of a strong economic environment. The task of supervision is to ensure that banks operate in a safe and sound manner and that they hold capital and reserves sufficient to support the risks that arise in their business. Strong and effective banking supervision contributes in enhancing effective macroeconomic policy along with financial stability in any country. While the cost of banking supervision is high, the cost of poor supervision has proved to be even much higher.

Banks are supervised in order to achieve both long-term financial stability and sector efficiency. This is done through the promotion of safe and efficient banking practices and institutions-to support sound private business development and meet individual bank customer needs. A weak regulatory framework and poor supervision provide grounds for inefficient and unsafe banking practices, which increase the risk of bank failure. Preventing systemic risk, protecting small depositors and containing financial crimes are concrete steps in attaining these objectives. They require that the supervisors enforce fundamental discipline in the banking system with the support of well-crafted laws and regulations and the presence of strong in-house supervisory expertise. Like most banking supervisory authorities the world over, at the backdrop of the inspirations of the above mentioned supervisory motives, Nepal Rastra Bank (NRB) has adopted a two-prong approaches to monitor and supervise the financial health of the financial institutions under its purview through off-site surveillance and on-site inspections. However, NRB's main approach to supervising banking institutions is to concentrate on corporate governance, market discipline and management oversight. Along with them, I also share the view that perhaps there should be existence of appropriate institutions and efficient infrastructure to facilitate the operation of the banking system.

The views expressed in this paper are those of the author and do not necessarily reflect the views of the Nepal Rastra Bank.

Objectives of Supervision

Good macroeconomic policy and a stable and growing real economy are the preconditions for a sound banking system. A sound banking system is a precondition for a healthy macro economy and efficient macroeconomic policy formulation. Central Banks need to supervise banking institutions because banks play a critical role in the working of a market economy. The balance sheets of banks are virtually a

mirror of the economic and commercial life of a country. The key consideration for the involvement of a central bank in supervision is to maintain the confidence in the banking system. While maintaining this basic condition, it is also to the interest of the country to see that credit and other banking services are readily available at competitive prices. Another aspect of central bank supervision in Nepal's context, although not universally practiced, had been to intervene in credit distribution to meet certain social and other objectives.

The basic objective of NRB supervision is to conduct a direct assessment of the overall condition of the banking institutions based on off-site and on-site evaluation of the institution's capital, assets, management, earnings, liquidity and a review of their records, systems and internal control and to determine whether the institution has complied with relevant mandatory and regulatory requirements. It also helps to facilitate the detection of frauds, malpractices, abuses of power by management and staff and undesirable trends and imprudent practices, such as deterioration in the quality of loan portfolio and the concentrations of risks.

Since the last two decades, the world of finance has undergone profound changes as evidenced by the rapid technological development for processing and transmitting data, the growing internationalization of financial system, the increasing phenomena of financial innovations coupled with competition and deregulation. This new financial environment has necessitated the development of new and the adaptation of existing supervisory policies, practices and procedures.

Philosophy of Nepal Rastra Bank Supervision

The philosophical foundation of Nepal Rastra Bank supervision is based upon the core principles for effective supervision developed by the Basle Committee on Banking Supervision consisting of 12 member countries, namely: Belgium; Canada; France; Germany; Italy; Japan; Luxemburg; Netherlands; Sweden; Switzerland; United Kingdom; and United States. The Committee has been examining how best to expand its efforts aimed at strengthening prudential supervision in all countries so as to improve the strength of financial systems. These principles are minimum requirements, and in many cases may need to be supplemented by other measures designed to address particular conditions and risk inherent in the financial systems.

However, the philosophical foundation of NRB supervision is based on following fundamental perceptions:

- The key objective of supervision is to maintain stability and confidence in the financial system resulting into reduced risk of loss to depositors and other stakeholders;
- Supervision is conducted and pursued on the basis of market discipline by enhancing good financial discipline, corporate governance and enhancing market transparency and surveillance;
- Supervisors are presumed to have operational independence along with necessary means and powers to gather information both on and off-site and the authority to enforce its decisions;
- Supervisors must have a good knowledge of banking business;
- Supervisors must ensure to the extent possible, that the risks incurred by banks are being properly managed;
- Effective banking supervision requires that the risk profile of individual banks be assessed and supervisory resources allocated accordingly;
- Supervisors must ensure that banks have resources appropriate to undertake risks, including adequate capital, sound management capabilities, and effective control systems and accounting records;
- Close cooperation with other supervisors and auditors is essential.

Banking supervision should foster an efficient and competitive banking system that is responsive to the public need for good quality financial services at a reasonable cost. It should be recognized that there is a trade-off between the level of protection that supervision provides and the cost of financial intermediation. But however, supervision cannot and should not provide an assurance that the banks will not fail. In a market economy, bank failures are a part of risk taking. The way in which failures are handled, and their costs borne, is basically a political matter involving decisions on public funds, to be committed in supporting the banking system. Such matters cannot be the responsibility of the supervisors. But however, they should have in place adequate arrangements for resolving problem bank situation.

For strengthening effective supervision certain infrastructure elements are of paramount significance.

Where such elements do not exist, supervisors should seek to persuade their government to put them in place. It is very essential that the licensing process establishes the same high standards as the process of on going supervision which is very much lacking in the context of NRB supervision.

Similarly, there is some lacking in the foundation necessary to achieve a sound supervisory system in our context. The existing supervisory systems have not been able to take into account the nature of and risks involved in the local banking market. The systems do not consider the extent it needs to supplement international standard with additional requirements to address particular risks and general conditions prevailing in its own market. Furthermore, the dynamic functions of banking supervision in our context have not been able to match up with changes in the market place. Hence, it has been essential for strengthening NRB supervision that supervisors must be prepared to reassess periodically their supervisory policies and practices in the light of new trends or developments. A sufficiently flexible legislative framework is necessary to enable them to do so. There are certain preconditions necessary for effective banking supervision. Those prerequisites include:

1. Sound and sustainable macro-economic policies.
2. A well-established and developed public infrastructure.
3. Effective market discipline.
4. Procedures for effective and efficient resolution of banking problems.
5. Appropriate level of systemic protection.

Hence, in order to strengthen the supervisory capability of the Bank and to ensure the financial stability and to ensure healthy financial sector development in Nepal, a stronger and more effective central bank is essential. Proper banking supervision is particularly important to ensure prudent banking practices, to help develop healthy financial intermediation which can support the growth of the economy. For this purpose, it is very pertinent that we have a glimpse at the core principles of effective supervision. They are stated in 7 different groups hereunder.

Pre-conditions for Effective Supervision

· Clear identification of responsibilities and objectives for each agency involved in supervision along with operational independence and adequate resources, and suitable legal framework for on-going supervision of banking institutions.

Licensing Process and Approval for Changes In structure

- There must be clearly defined permissible activities of institutions that are licensed and subject to supervision.
- The right to set criteria to accept and reject applications for establishment, should be vested with the licensing authority. The licensing process should at least consist of an assessment of ownership structure of banking institution, directors and senior management, its operating plan and internal controls and its projected financial position including its capital base etc.
- Supervisors must have the authority to review and reject any proposal to transfer significant ownership in existing banks.
- Supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by bank so as to control exposure of the bank to undue risks.

Arrangement for On-going Supervision in View of Risk in Banking and Development and Implementation of Prudential Regulations

- Supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks and financial institutions.
- Evaluation of credit granting standards and credit monitoring process of the banks.
- Evaluation of asset quality and adequacy of loan loss provisioning and reserves.
- Assessment of concentration of risks and large exposures.
- System to prevent abuses arising from connected lending.
- System to assess the adequacy of policies and procedures for identifying, monitoring and controlling country risk and transfer risk in the international lending and investments by banks.
- Assessment of system prevailing in banks to measure, monitor and to control market risks accurately and adequately.
- Evaluation of the appropriateness of the comprehensive risk management process including appropriate board and senior management oversight.
- Determine that banks have in place internal controls that are adequate for the nature and scale of their business along with clear arrangements

for delegating authority and responsibility, proper accounting for assets and liabilities and reconciliation process safeguarding assets and appropriate independent internal and external audits.

- Determine that banks have adequate policies, practices and procedures in place.

Mechanism for On-going Banking Supervision

- Prevalence of effective on-site and off-site banking supervision system.
- Maintenance of regular contact with bank management and a thorough understanding of the institutions' operations.
- Prevalence of proper means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.
- Mechanism of independent validation of supervisory information either through on-site examinations or use of external auditors.
- Supervision of banks on a consolidated basis.

Disclosure Requirements for Banking Institutions

- System to ensure that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisors to obtain a true and fair view of financial condition of the bank and profitability of its business and publishes on a regular basis financial statements.

Formal Powers of Supervisors

- Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to comply with prudential requirements along with the ability to revoke the banking license or recommend its revocation in extreme circumstances.

Cross Boarder Supervision

- Prevalence of global consolidated supervision over their internationally active banking institutions, primarily at their foreign branches, and joint ventures.
- Establishment of good contact and information exchange with various other supervisors involved, primarily host country supervisory authorities.
- Requirement for the local operations of foreign banks to be conducted to the same high standards as is required of domestic institutions.

Now I would like to deal in very brief upon NRB supervision process and method.

NRB Supervision Process and Method

Prior to the inception of Nepal Rastra Bank Act, 2058, the supervisory role of Nepal Rastra Bank had been governed by section 23 A of Nepal Rastra Bank Act, 2012 which had vested NRB with all the authority to inspect and supervise all the banks and financial institutions operating in the Kingdom of Nepal. It had authorised NRB to inspect and supervise any financial institution at any time on site or off-site basis. The same Act had also made it mandatorily binding upon all the directors, office-bearers and employees of the bank and financial institutions to make available all the information, reports and all other documents sought by NRB.

Section 22 of the same Act had also authorized NRB to issue any directive as regards regularization of money, banking operation, and credit floatation. Similarly, penalty provisions under section 32 and 34 of the same Act had empowered NRB to lay down any penalty specified in these sections.

Based upon all these mandatory provisions, the Bank had been conducting its supervisory functions both on-site and off-site. However, those were conducted in very traditional manner and it could not have been effective. The inspection & supervision function had been conducted in such a manner to cover 20% of all the commercial banking branches in numbers and 75% of the total credit portfolio of NBL and RBB. Similarly, the inspection at the corporate level for all banks and financial institutions were conducted in such a manner to cover all the banks and financial institutions once in 3 to 5 years. But however, although the smaller banks and other institutions had been inspected as mentioned above, NBL, RBB, Nepal Industrial Development Corporation (NIDC) and Agriculture Development Bank (ADB/N) could not be inspected as mentioned above. There had been a very long gap in corporate level inspection of these 4 big institutions. Similarly, in the past off-site supervision was also not prevalent so as to monitor and supervise the financial position and compliance status periodically. Even in the cases where inspection had been conducted, there were very long gap in the submission of inspection reports and implementation of enforcement actions recommended in the inspection reports.

To sum up, I would like to mention some issues in brief which had contributed significantly in making

NRB's supervisory functions ineffective in the past. They are mentioned hereunder:

(1) Regulatory Fragmentation: The banking sector in Nepal had been operating under several laws and suffering from an excessive segmentation that is not conducive to the development of sound competition across the country.

(2) Excessive Government Involvement: Undue political interferences and excessive government involvement in the operation of banking sector had created adverse effect on them. Development priorities are reflected in many regulations. Even though interest rates had been deregularised, the limitations on interest rate spread had been prevalent. Commercial banks have also been obliged to go for directed lending. Access to banking services in rural areas remains a concern of the authorities. Hence, these regulations also constrain effective banking operations.

(3) Poor Governance and Transparency Procedures: Good corporate governance principles and transparency practices were almost non-existent in the past resulting into many instances of conflict of interest, insider trading and connected lending. Several government bureaucrats and NRB officials, including some involved in banking regulation and supervision, held positions on bank boards as government representations. Bank boards had no leading shareholder and most of them lacked professionalism. Cross holding of bank shares was also a major concern. The government and NRB in some cases maintain close control over financial institutions' activities and management through its ownership.

Similarly, limited public awareness of the poor financial health of the banks has caused considerable moral hazard problems in the sector. Financial accounts and annual statements, when disclosed, are neither timely nor reliable. Moreover, there was lack of convergence with international standards in the case of accounting and auditing practices as well.

(4) Poor Banking Culture: A good banking culture was almost non-existent. Prudential regulations did not require banks to define credit policy and procedures, and only quite a few banks had established satisfactory internal guidelines. Even if some kind of financial analysis were made, credits were not disbursed on the basis of creditworthiness. Although there were regulations on capital adequacy, income recognition and loan classification and provisioning requirements, they were very much lenient and compliance status was not closely monitored. The legal framework for land records and bankruptcy were also inadequate. Court actions against defaulters used to be delayed and assets liquidations were rarely successful.

(5) An Inadequate Legal Base: NRB is entrusted with regulating and supervising the banks and financial institutions in Nepal but it had no autonomy from the His Majesty's Government (HMG/N), Ministry of Finance. The existing system did not provide legal protection to supervisors, nor operational independence and adequate resources for supervision, resulting into a general inability or reluctance to enforce corrective measures necessary to prevent and resolve banking problems. Moreover, most of the old regulations did not define financial or legal penalties and did not mandate specifications to be taken by the banking authorities.

(6) An Inadequate Organizational Structure: The supervisory functions were shared among four departments placed under two deputy governors. Regulation and supervision side of banks were under one and the same of non-bank financial institutions were under another deputy governor. Practically, cooperation among the four departments was poor and required improvement. Similarly, the procedure for bank licensing had not been stringent. The cooperatives to conduct banking activities are authorized even by HMG/N, Ministry of Agriculture.

(7) Limited Resources: Previous supervisory practices were geared towards ensuring that NRB regulations were complied with by the banks. Many of the regulations had no prudential content. Risk based supervision were not the key supervisory concerns and no rating system of banks had been defined. In addition, very few computers were available in the supervision departments and the level of computer literacy still low. In general, the staff policy did not ensure the recruitment of quality staff and promotion was driven by seniority, appointment criteria were not on the basis of merit and competence and the salary scale was tied up to low public sector and civil service rates. The staff rotation policy was also counter productive for this important activity, which required stability for officers to develop skills, master techniques, acquire experiences, as well as

fosters commitment. Training part had also not been effective. Supervisory departments were used as the platform for obliging certain key personnel who had blessings of favoritism and were again transferred after getting training opportunities. These factors had contributed to low morale and poor performances.

(8) Limitation on Auditing and Accounting Compliances: Information on operations, performance and status of bank and other financial institutions or overall transparency of the whole financial system were very limited. Publishing of financial statements, their performances and audit report etc. were not (and still are not in some cases) very regular. The prevailing weak accounting and audit practices have also indicated that the timeliness and reliability of financial data, particularly of NBL, RBB, NIDC and ADB/N is extremely poor.

In cognizance with the impact of above-mentioned factors on the effectiveness of supervisory role of NRB, the Bank in collaboration with HMG/N under the prevailing national financial sector reform programme has initiated certain drastic measures so as to strengthen its supervisory role in the financial sector of the country. Now, I would like to shed some lights on some of the major steps undertaken by NRB.

Present Status of NRB Supervision

(1) Promulgation of Nepal Rastra Bank Act, 2058: The new Nepal Rastra Bank Act, 2058 has been promulgated effective from Magh 17, 2058 with the objective of strengthening NRB supervision as one of the main objectives of this Act. This Act has made NRB fully autonomous and free from government interference. This Act has made several provisions so as to avoid political interferences and to bring professionalism in the Board of NRB itself by specifying qualifications and code of conduct for governor, deputy governors and other directors along with the provision of audit committee in NRB with the intention to enhance good corporate governance in NRB as well. Similarly, various other provisions to facilitate effective supervision have been incorporated in the Act. Specifically section 84 of the Act authorizes NRB to conduct on-site inspection as well as off-site supervision of all the banks and financial institutions at any time through its own manpower or other outsource professionals. In order to enhance the effectiveness of inspection and supervision by NRB, report submission time has also been specified in the Act along with the provisions that every inspection report is required to be presented in the NRB Board for necessary instructions regarding the corrective measures to be initiated. The Act has also widened the role of NRB supervision to seek cross Boarder supervision mechanism vide section 85. Besides, the Act has also incorporated various financial' as well as legal penalty provision in case of non compliances of NRB regulations and mandatory provisions by the banks & financial institutions to the ultimate provision of cancellation of operating license along with the authority to suspend the board of the concerned institutions and take it over by NRB vide Sections 86, 99 and 100. Similarly, the new Act has also provided legal protection to supervisors in case of conduct of their duties in good faith by section 107. The recent amendment in section 86 of the same Act has further strengthened the supervisory authorities of NRB. It has bestowed NRB with additional enforcement authorities in case of banks and financial institutions that have been identified as troubled institution by NRB Supervision.

(2) Promulgation of an umbrella Act: For proper and smooth operation of bank and financial institutions an umbrella Act named as Banks and Financial Institutions Ordinance, 2061 has been promulgated so as to avoid regulatory fragmentation in the operation of different financial institutions. All the fragmented provisions relating to supervisory authority of NRB have been brought into once place which had been scattered in different enactments. This has made possible the concerted and converged supervision. This Act has made enough provisions so as to ensure good corporate governance mechanism and financial discipline in the bank and financial institutions. The Act has also incorporated various provisions for ensuring professionalism in their boards and management teams. It has also bestowed the central bank with enough supervisory and enforcement authorities so as to ensure strengthened supervisory functions on the part of NRB. Similarly, it has also made enough provisions to ensure adequate risk management systems in those institutions.

(3) Issuance of prudential regulations: Nepal Rastra Bank has issued several prudential regulations to be applicable from the start of FY 2058/59 so as to ensure financial stability and solvency, disclosure on asset quality and connected lending, and to enhance

transparency in the financial statements published by banks and financial institutions. These regulations included regulations regarding capital adequacy, loan classification and provisioning requirements, concentration of credits and connected lending, transparency and disclosure requirements and accounting systems to be followed, risk management, corporate governance and code of conduct for bank directors, chief executive and staff, enforcement regulations and cross holding by banks and financial institutions. NRB has also recently issued other regulations regarding periodical reporting requirements and mechanism for divestment of shares by the promoters of the banks and financial institutions. Similarly, NRB is also exercising on revision of the licensing requirement so as to accommodate stringent criteria of fit and proper test for the promoters along with other requirements. All these regulations have been issued in consultation of World Bank consultant working in NRB and are basically guided in principle by the Core Principles of Bank supervision prescribed by Bank for International settlements (BIS). NRB has also come a step forward in enhancing public awareness and transparency and adherence to international Auditing and Accounting Standards by issuing the regulation on disclosure requirements and asking the banks to stick by mandatory provisions as regards publication of financial statements and conducting of Annual General Meeting within the stipulated time period specified in the concerned enactments. These regulations have also made necessary provisions to avoid poor banking culture and encourage professionalism in the bank management.

Similarly, Nepal Rastra Bank is on its way in preparing the Roadmap for proceeding towards the implementation of Basel II Accord. It has formulated a high level monitoring team to oversight upon the functioning of the Core Group formulated to prepare the roadmap towards Basel II implementation. The Core Group has been working on it in co-ordination with banks and financial institutions operating in the country.

(4) Strengthening the NRB supervisory functions: NRB has been working seriously in strengthening its supervisory functions. It had appointed a consultant for two years under World Bank assistance and has been working towards strengthening NRB supervision both on-site and off-site. An On-site Inspection Off-site supervision Manual of international standard has already been prepared and implemented. The consultant has also provided training to all the bank and non-bank supervisors based upon the same inspection manual. Nepal Rastra Bank has also started on its own initiative to train its supervisory manpower nationally as well as internationally. It is also in the process of seeking the consultancy services of the Supervision experts under NRB Reengineering package so as to enhance its supervisory capabilities.

In the meantime, NRB has also come up with Inspection and Supervision Regulation based upon the mandatory provisions incorporated in the Nepal Rastra Bank Act so as to strengthen its supervisory effectiveness. This regulation has prescribed for the mechanism of regular supervisory function for the Bank Supervision Department and Financial Institutions Supervision Department in the Nepal Rastra Bank. This regulation has spelled out the duties and responsibilities of the supervisors, mechanism for off- site supervision and on-site inspections at regular intervals. The regulation has also made a provision for setting up an Enforcement Unit within each supervision department so as to facilitate regular monitoring on the status of enforcement of each and every instructions issued by the NRB through its Off-Site Supervision or On- Site Inspections. This regulation has also made a provision for publication of quarterly and annual off–site Supervision and Enforcement Status Report that is supposed to be submitted to the Governor as well as the Board of Directors of NRB.

In accordance with the provisions made in the Inspection and Supervision Regulation, the NRB has taken certain measures on its own initiatives to strengthen its risk based supervision mechanisms. It has made arrangement for off-site supervision of all the banks and financial institutions every year based upon NRB regulations, mandatory provisions, auditors' reports and operating performances since last few years. It has also started taking stringent enforcement actions based upon finding on on-site inspection and off-site supervision. It has also initiated certain actions to enhance the role of internal and external auditors in the supervision of banks and financial institutions. Similarly, NRB has also introduced the system for rating all the banks every year on the basis of CAMELS rating system.

(5) Strengthening supervisory manpower: NRB has also initiated its actions to enhance the supervisory capability of the supervisors by recruiting new professional manpower, by providing additional trainings and necessary physical facilities. Under the current Financial Sector Reform program, NRB has taken various measures in NRB reengineering in the field of Human Resources Development, strengthening supervision, enhancing physical facilities and logistic supports etc.

Conclusion

Banks are supervised in order to achieve both long-term financial stability and sectoral efficiency. A weak regulatory framework and poor supervision provide backgrounds for inefficient and unsafe banking practices, which increase the risk of bank failure. Preventing systemic risk, protecting small depositors, and containing financial crimes are concrete steps in attaining these objectives. They require the supervisors enforce fundamental discipline in the banking system with the well-crafted laws and regulations and the presence of strong in-house supervisory expertise. Last but not the least, the autonomy in the mandatory provisions rather than in practice may not pay good returns. Hence, despite all the steps for strengthening supervision as mentioned above, the courage to implement the autonomy in practice is also a necessary component in making supervision effective. The commitment to implement all the supervisory regulations and supervisory instructions without any prejudice towards any particular side in practice on the part of Nepal Rastra Bank, the only Monitory Authority of the country, is of paramount importance on the one hand and on the other, the full-hearted support from HMG/N as well as the judiciary system of the country are also very necessary so as to strengthen NRB's supervisory effectiveness and enhance financial discipline and good corporate governance in the financial system of the country.

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Payments System

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Background

The establishment of "Kaushi Tosha Khana" in the regime of King Prithivi Narayan Shah and "Tejarath Adda" in the regime of Prime Minister Ranoddip Singh was the milestone for the development of banking system in Nepal. In commercial scale, Nepal Bank Ltd., the first commercial bank of Nepal, is the foundation of modern financial system in the country. Currently, Nepalese financial system comprises of a central bank, Nepal Rastra Bank (NRB), 17 commercial banks, 24 development banks, five rural development bank, 59 finance companies, 21 saving and co-operatives and 45 NGOs (permitted to perform limited banking activities as lending institutions)[1], insurance companies, Nepal stock exchange, Citizen Investment Trust, Employee's Provident Fund and Postal Saving Service.

Nepalese financial system is still in evolutionary phase. The existence of unorganized money market consisting of landlords, shahukars, shopkeepers and other indigenous individual money lenders (sarafis) are the barriers for development of financial system in the country. Besides, the presence of financial institutions mostly in the urban areas makes the presence of unorganized money markets in the rural areas. Recently, it has been felt that, these unorganized institutions could mobilize a wide range of different financial sources.

Nepal Bank Ltd., the oldest bank in the country was established in 1937 A.D. with the objectives to accept deposits, to extend credit facilities for the promotion of trade, cottage industry and agriculture, to render customer related services, i.e. issue of bill of exchange, hundies etc., to invest in government bond and securities to perform agency functions and to act as banker to the government.[2] However, single commercial bank was not enough to cater the financial needs of the country overtime, and therefore another commercial bank, Rastriya Banijya Bank emerged in 1966. The outcry change in the banking sector was perceived when the financial system reforms started in 1984 with the autonomy to fix interest rates by commercial banks with some limitations, which was then fully liberalized in 1989 leaving them to the market forces. In nexus to the financial system liberalization, foreign capital was accepted in the banking business for the first time in 1984, with the establishment of the Nepal Arab Bank Limited as a joint venture with foreign and local capital participation. After the establishment of Nepal Arab Bank Ltd, first joint venture bank of Nepal, (now NABIL Bank Ltd.), Nepal entered into the modern financial system.

NRB was established as a central bank in 26 April 1956. The bank was empowered by Act to have direct control on all financial institutions (established under NRB approval) within the country. NRB

introduced the NRB Clearing House in 1968 and joined the Asian Clearing Union (ACU) in 1974. NRB as well as some commercial banks have taken membership of SWIFT message system. Since 2000 A.D. NRB had started the clearing of foreign currencies also.

The development of payment system in a country is one of prime indicators that determine the level of country's economy. As payment system plays an important role in an economy, the central bank must consider many aspects in payment system development. Cash and paper based instruments such as cheques, commercial bills are the most used payment system in the country till now. The domestic payment system mostly comprises of cash for small-value transfer as well as cheques, drafts and telex transfers for large-value transfer by the organized enterprises, business-houses etc. So, cash transactions remain a popular payment instrument in Nepal. The rural areas - which cover more than 75 percent of country's area and population, often use only the cash as payment instrument. As far as domestic payment system is concerned, the NRB conducts clearing-house for inter-bank payment system through nine branches of NRB in different cities. The payment system of the commercial bank branches, which are member of clearing-house, is also settled through clearing-houses. The settlement is based on multilateral transactions among the clearing members.

To ensure better financial system in the country, the central bank is empowered to have direct control over commercial banks and other financial institutions. However, the legal framework of the payment system is yet to be much developed. In the absence of specific legal guidance, the payment system is mainly based on the couple of Acts such as Nepal Rastra Bank Act, 2001, Umbrella Act, 2004, Foreign Exchange (Regulation) Act, 1962 and Negotiable Instrument Act, 1977. Nevertheless, NRB has occasionally made arrangements regarding the effective payment procedures in accordance with the legal authority under the said Acts. Besides, the Foreign Exchange (Regulations) Act spells out some payment system regulations on payment for Exports, Receipt of Payments of Exported Goods, Restricting on Making & Obtaining Payments etc.

Relevance and Importance

An efficient banking system becomes a top priority as country moves towards a free market economy. A good working banking system allows private sectors savings to be retained in the country, which further promotes investment needed for growth. In addition, an effective banking system allows for price stabilization and positive real interest rates making deposit money more attractive as compared to cash. With the increment in the number of commercial banks and other financial institutions as well as new payment products in the country, there is a need to have efficient banking system. The central bank provides central bank money to support their monetary policy goals, maintenance of the financial system stability and promotion of efficiency of financial system; it should have ability to make payments safely and efficiently. Sound and efficient payment mechanism enhance the allocation of resources, facilitates growth and improve social welfare. Payment system plays a fundamental role in the economy by providing a range of mechanisms through which transactions can be easily settled. As such, banknotes are part of this broad notion of payment systems. In spite of expanding role of its various substitutes, the banknote is still a fundamental payment instrument in economic life. Over the last couple of decades, the powerful forces of liberalization, technological innovation, globalization and consolidation have affected financial markets. Payment arrangements have been affected by these interrelated forces, which continued to be important and may become more so in future, through a number of channels.[3]

Prevailing Payment and Settlement System

Due to small size of economy and low level of business volumes, the payment and settlement system is not highly developed in the country. The domestic payment system comprises cash for small-value transfer and cheque, drafts, telex transfers for large value payments in all organized enterprises, contractors and business houses. Recently most of the joint-venture banks have started issuing ATM cards, credit cards, and debit cards as well as Internet banking and mobile banking. The use of traveler cheques in domestic currency is not familiar to the users in the country.

The operation of the clearinghouse is the only systemic payment unit in the banking system in the country. The payment system of the commercial bank branches, which are member of the clearinghouse, is also settled through the

clearinghouse. At present, 22 banks are the representative members and 73 bank branches as normal members of the clearinghouse totaling 95 bank branches participating in clearing house. Of the, ten banks have been accorded ABBS Membership (Any Branch Banking System). All clearing member banks need to have a transaction account with NRB.

Since the establishment of the clearing house in 1968, the NRB clearing House has been facilitating clearing of cheques, drafts and similar payment orders in Nepalese rupees as well as in foreign currencies such as USD, Euro, JPY, SGD, FER, CAD, AUD etc. but recently, such clearing currencies are limited to USD, GBP, EURO and JPY only. The operation of the system is purely manual in the present context.

Payment System Activities in the Domestic Market

The payment system in the domestic market has not been clearly defined by any regulation; except for some process regarding the payment instrument is defined by the Negotiable Instruments Act (NIA). NIA is the codification of a long settled practice on custom and usage relating to payment and transfer of money of the merchants of European continent. The sole objective of this law is to set rules relating to payment and transfer of money through instruments instead of currency notes or coins itself, thus making monetary transaction easier.

Promissory Note, Bills of Exchange and cheques have been legally recognized as negotiable instruments in the country. However, negotiable instruments such as bearer share certificates, bearer debenture/bonds, dividend etc. are yet to be practiced in Nepal. As such, activities under payment system in the domestic market are mainly issuing of promissory note, postal savings, Nepal Stock Exchange, National Savings Bond, Development Bond, Treasury Bills, Citizens Saving Certificates etc.

(a) Promissory Note: Promissory Note is an instrument in writing containing an unconditional undertaking to pay a certain sum to or to the order of a specified person or to the bearer of the instrument and is duly signed by the maker. However, the bank note or currency note is not considered as a promissory note as this is dealt under separate stature.

(b) Postal Savings Service: To promote the saving habits among the rural people the concept of Postal Savings Bank was introduced in 1977 A.D. Although, its network is spread over 75 districts of the country, the volume of the saving is relatively low.

(c) Nepal Stock Exchange: After restoration of democracy in 1990, the policy has taken for the financial liberalization. In this regard, for the development of Stock Market in the country, the Nepal Stock Exchange Ltd. (NSEL) replaced the Securities Exchange Centre in 1992.

The number of listed companies in the NSEL increased from 108 to 114 in FY 2003/04. The NEPSE index slightly gained to 222.0 in 2004 July from 204.9 in 2003 July. Market capitalization as well as annual turnover was increased in 2004 July in comparison to 2003 July in spite of uncertainty prevailed in business environment and deteriorating law and order situation.

(d) National Saving Certificate, Development Bond and Citizen Saving Certificate: On behalf of the government NRB issues the government bonds like National Saving Certificate, Development Bond and Citizen Saving Certificate to financing government budget deficit. National Saving Certificate and Citizen Saving Certificate are issued generally for five years period with fixed interest especially for the non-banking sector as well as Development Bond is issued generally for three years period especially for banking sector at fixed interest rates.

During the year 2002/03 government mobilized Rs. 6.4 billion, Rs. 400 million and Rs. 303 million by issuing respectively Development Bond, National Saving Certificates and Citizen Saving Certificates.

(e) Treasury Bills: After the implementation of financial liberalization policy, the monetary policy stance shifted to indirect method from direct method. In this regard, NRB emphasizes on open market operation as the monetary policy instrument. Since 1988, auctioning of the treasury bills was introduced as open market operation. In the beginning, 91-day treasury bills were issued once a month of irregular interval and auction of treasury bills is done once a week since 1989. The primary issue takes place throughout the week. NRB announces the amount of treasury bills to be auctioned and the deadline for submitting the bids with the discount rate enlisted in the previous auction before two to three days of each auction. After examining the bids, allocation is made on the basis of first priority to the lowest

interest bidder. If the bid is abnormally higher than the trend or if the open market operations committee feels the bid distortion to the market situation, it can impose discretionary cut0off rate for each auction. Settlement takes place on the day of the auction, by charging directly on the banks' reserve accounts in NRB.

During the FY 2002/03 the government mobilized Rs. 1.8 billion. Liquidity amounting to Rs. 12.3 billion was mopped up during FY 2002/03 from secondary market trading of government securities. The repo transaction amounted to Rs. 46 billion in cumulative terms in the FY 2002/03.

Payment Instruments

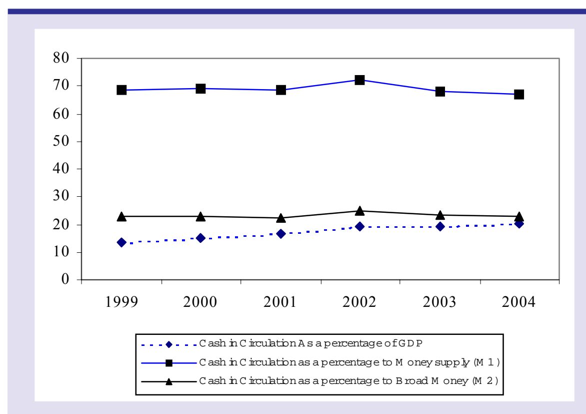
The payment instruments that are used domestically in Nepal are cash, cheques, draft, telex transfer (TT), traveler's cheque, Nepalese Rupee credit and debit card and ATM system. Currently, ATM system, credit card and debit card have been becoming increasingly popular due to the collaboration of system arranged by the commercial banks with the departmental store and big business houses. Over the last decade, the Nepalese payment system has made some progress in replacing cash by other instruments like cheque, draft and TT and even the plastic card, but it is more concentrated in the urban areas including the capital city.

(a) Cash: Major portions of the settlement of purchasing and services transactions are made by cash (banknotes and coins). Cash payment remains the most convenient method for making small-value payments, when payment is made at the point of sale.

Figure 1 illustrates the ratio of currency in circulation to gross domestic product (at producer's prices), which is still around 13 percent in 2003. Currency in circulation to Money supply (M_1) and Broad Money (M_2) is respectively 68 percent and 23 percent in 2003. By this figure we can say that cash is still the most convenient method to payment. The ratio of currency in circulation to money supply as measure by M_1 or narrow money (comprises such as demand deposit, currency outside deposit money banks) or to broad money measure by M_2 (comprising of M_1 and quasi-money, which includes time, savings and foreign currency deposits will reflect the use of cash or cashless transaction in the country. Lower the ratio partly reflects the use of cashless transactions and vice-versa.

Figure 1

Currency in Circulation as a percentage of GDP, M_1 & M_2



However, larger transactional amounts are settled in non-cash instruments - the larger the amount, the higher tendency.

Cheques/Banker's Cheque

Cheque is the second most important payment instrument for small value and large value payments. The depositor directs the bank to make payment through the cheques. Since cheque is regarded as the most developed credit instrument in the money market, most of the modern business transactions consistently have been using cheques in settling their accounts.

Figure 2 illustrates the trend of cheque transaction. Quantity as well as volume of cheque transaction is rapidly increasing.

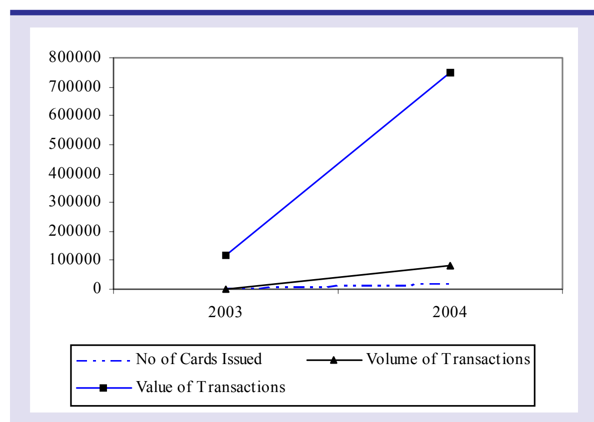
Banker's cheques are issued as a service extended for customers and a means of transacting business for the Bank. The cheques should be printed on security paper, pre-numbered as well as prepared in conjunction with a manifold set of forms, which include an advice to the customer, advice to payee and a register copy.

Manager's cheques remain in outstanding for a period over six months from the date of issue and should be transferred to Bills payable under their respective subsidiary accounts. The operating branch should approve all debits to these accounts.

(b) Draft, TT, MT: Draft, telex transfer and mail transfer are another popular method of payment for the large-value payments. The issuance of foreign currency draft, TT and MT is the subject to NRB regulation. The draft, which remains outstanding for more than six months from the date of issue, should

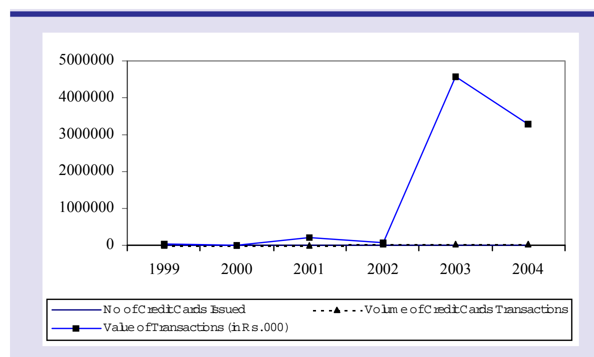
Figure 2

Transaction of Cheques of Commercial Banks



Figrue 3

Transactions of Credit Card



be transferred to bills payable. A mode of payment through mail transfer is cost effective but the time involve in this method make this system less popular. However, TT is mostly used instrument in Nepal.

The transactions through these methods in total are in decreasing trend from 2001. The volume of transaction is decreased by 11.3 percent and 33.4 percent in 2002 and 2003 respectively. However, the value of transaction was increased by 109 percent in 2002 and decrease by 59 percent in 2003 in compared to previous year.

Electronic Payment

Although, Nepal's two largest banks viz. Nepal Bank Ltd. and Rastriya Banijya Bank do not offer any modern electronic payment facilities to its clients, some joint venture banks as well as newly established private owned banks do offer electronic payment services. The electronic payment includes the Credit Card, Debit Card, Automated Teller Machine (ATM), Internet and Mobile Banking facilities.

Credit Card

Although the terminology credit card is new to most of the Nepalese people, the volume and usage of credit card is increasing. The security of funds compared to cash and discounts available with the use of cards attracts the people to use the cards.

Figure 3 illustrates the increment trends in the usage of credit cards. Number of credit cards issued by the commercial banks has increased by 27 percent, 28 percent and 12 percent respectively in 2002, 2003 and 2004 compared to its previous year. Because of the data available for 2004 is of up to September 2004, the increment trends looks downward. The quantity of transaction and volume of transaction is also rising rapidly over time.

The commercial banks issue the credit cards for the high-income group customers. Generally, lower-income group people do not have access to such card facilities.

All cardholders are charged with a minimum initial enrolment fee, annual fee ranging from respectively Rs. 1000 to Rs. 1500 and Rs 750 to Rs 1000, as fixed by card issuing companies.

Debit Card

Currently, Nabil Bank, Nepal Investment Bank and Everest Bank are issuing the debit cards since 2003. The issue of debit cards has increased by 187 percent to 79880 cards in year 2004 compared to previous year. Total value of debit card transactions has increased by more than 500 percent to Rs. 749742 thousand in 2004 in compared to previous year.

Figure 4 illustrates the transaction trend of debit card in the country. The volume of transaction is rising rapidly.

Automated Teller Machine (ATM)

With the beginning of new millennium majority of large joint venture and private commercial banks established the ATM services in the country. Currently, there are more than 17000 ATM cards issued by the different commercial banks. The Nepal Investment Bank has however stopped the issuing ATM cards.

Figure 5 illustrates that the tendency of ATM cards in number, quantity of transactions and volume of transactions are increasing rapidly.

The account holders (current and saving account) with minimum balance are eligible to get ATM cards. Generally, ATM cards are available with minimum cost whereas transactions are free of cost. An increase in ATM terminals may lead to decrease in the number

of cheque, credit card and debit card transaction. Availability of ATM terminals is usually a convenient channel for cash withdrawal by the public. Likewise, it may also provide other payment service function such as on-line fund transfer.

Internet & Mobile Payments

The rapid growth of e-commerce and the use of the Internet have led to the development of new payment mechanism capable of exploiting the Internet's unique potential for speed and convenience. Similarly, the broader usage of mobile phones has encouraged banks and non-banks to develop new payment and the channel through which the payment instruction is entered into the payment system defines mobile payments.[4]

As of now Kumari Bank Ltd. is providing the Internet banking while Nepal Bangladesh Bank Ltd. is providing Mobile Banking (SMS Banking) as well as some other commercial banks are in pipeline to provide Internet Banking/Mobile banking in near future.

Nepal Rastra Bank Clearinghouse

Structure, Operation and Administration

(a) Participating in the System

All commercial banks, development banks, and co-operatives licensed by NRB (limited banking transaction in the case of co-operatives) are eligible to participate in the clearing system. In case of commercial banks and development banks its' head office or branch will be a representative member and other branches will be ordinary member and in case of co-operatives, of the total co-operatives one co-operative will be representative member and all other co-operatives have to make settlements through that member co-operative. All clearing member banks are needed to have a transaction with NRB. Inter-bank clearing & settlement in Kathmandu as well as outside Kathmandu is operated fully on manual paper based.

(b) Types of Transactions Handled

The NRB clearinghouse facilitates clearing of cheques, drafts and similar payment orders in Nepalese rupees as well as in foreign currencies.

(c) Operation of the System

NRB, Banking Office, Thapathali premises is the venue for clearing in Kathmandu, whereas NRB, Branch office premises for the outside

Figure 4

Transaction of Debit Card

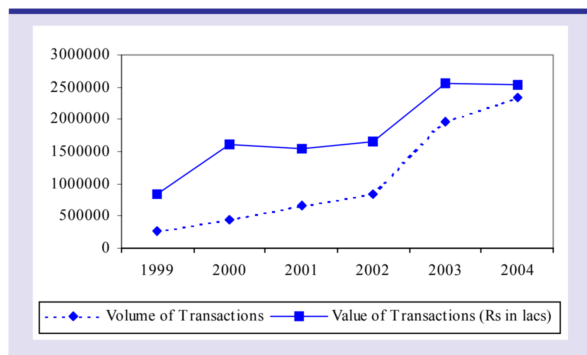
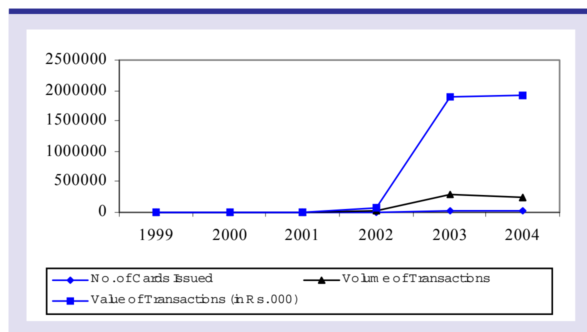


Figure 5

Transaction of ATM



Kathmandu Valley. The Bank of Kathmandu, Butwal is authorized by NRB to act as Clearinghouse in Butwal. The clearinghouse meets twice on each business day. The first meeting is scheduled at 10:00 a.m. and second meeting at 2:00 p.m. The payment instruments such as cheques, drafts etc. are presented at first meeting and final settlements are made on the second meeting. In case of non-acceptance of such instruments it will be returned on the second meeting. The clearinghouse is in operation with the "same day settlement" system. If any member falls to overdrawn during the settlement process, the concerned member is not permitted to participate the clearinghouse until the balance is not recovered.

(d) Operation Procedure

- All representative members should prepare a summary sheet of their total presentation and submit to clearinghouse, then clearinghouse prepare a settlement of clearing transaction and provide a copy to each member which will show the total volume and value of clearing transaction of that day.

- After checking the 1st settlement copy the members have to submit a separate adjustment summary sheet within 2:00 p.m.
- An ordinary member should inform on the same day to their representative bank if any cheque/ draft is not honored. Then representative member should prepare a statement of returned cheques and submit it to clearinghouse within 2:30 p.m. on the same day.
- All representative members meet at 3:00 p.m. at clearinghouse with details of transactions. Clearinghouse will prepare 2nd settlement sheet with adjustment, if any, and provide to members.
- After correcting the mistakes (if any), clearinghouse will prepare a final settlement of clearing transaction of the day and provide debit/ credit advice to representative members.

In case of any dispute, the matter may be referred initially to the clearinghouse officer. In the event that the officer is unable to resolve any dispute, reference shall be made to the senior management of the banks involved. If senior management could not resolve the problem, the clearinghouse committee shall then be convened.

(e) Settlement Procedure

Each member bank must maintain a transaction account with a minimum balance subject to decision of clearinghouse on the basis of clearing transaction with NRB. The net clearing figure of each member bank shall then be debited and/or credited to its account. Where the transaction/clearing account is overdrawn, the bank shall reconstitute it within 24 hours to create a credit balance out of which claims on it shall be paid.

Unpaid items, which have been presented through the clearinghouse, must be returned through the clearinghouse itself. The member banks must be informed regarding the clearinghouse details of unpaid items on the same day of the clearing latest by 2:30 p.m. The clearinghouse officer will then raise a separate debit voucher regarding the returned item to be debited/credited to respective member bank's account.

All instruments that are not returned shall automatically be deemed to have been paid by the drawee bank. Each unpaid item should bear, on an attached slip, reasons for the refusal of the payment. Such statements should be written in full and not abbreviated.

(f) Pricing Policy

There are three types members i.e. representatives member, ordinary member and ABBS (Any Branch Banking System) member. Representative members/ ABBS Members and Ordinary members are charged member fee NRs. 2,000.00 and Rs. 500.00 annually respectively. As of now there are 22 representative members and 73 ordinary members, totaling 95 bank branches participating in the clearinghouse. Of them, 10 banks have been accorded ABBS Membership. The member banks do not have to pay any amount regarding the payment and settlement activities on domestic cheques, drafts etc.

But, the member banks are required to pay for the communication charges such as telex, mail, courier etc. regarding the inter-bank clearing of foreign cheques, drafts etc. However, NRB do not make any service charge to member banks.

(g) Management of Risk in Clearinghouse System

As required by any financial institution, the precautionary measures are taken into account to minimize the risks. In the domestic payment system, the member banks are obliged to open an account with a minimum balance at the central bank and this would take, to a certain extent, the risk arising from liquidity shortage. As far as the systemic risk is concerned, this is minimized to a larger possible as the summary form is balanced in the presence of all the member banks and then only is signed by the clearinghouse officer. The system hardly incurs credit risk, since the payment instructions are executed only if there are sufficient funds in the participant's account. There will be no credit risk involved if payments are accepted while recipients are notified after the payments are settled.

(h) Volume of Transaction

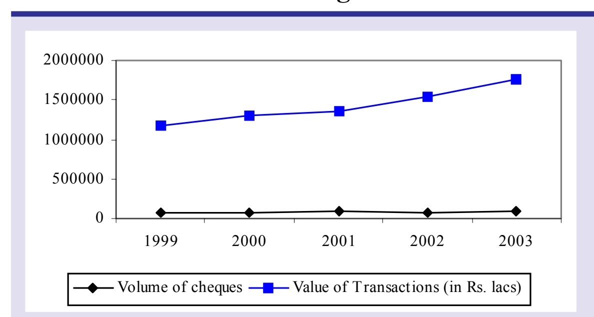
Fig. 6 illustrates the trend of transactions of NRB clearinghouse. Volume and value of the transactions are in increasing trend. The volume of cheque transactions decreased by 5.8 percent in 2002 and increased by 3.9 percent in 2003 in compared to previous years. As well as the values of the transactions are increased by 14 percent each both in 2002 and 2003 respectively as compared to previous year.

(i) Structure of Cheque Clearing System in NRB Clearinghouse

Cross Border Payment System

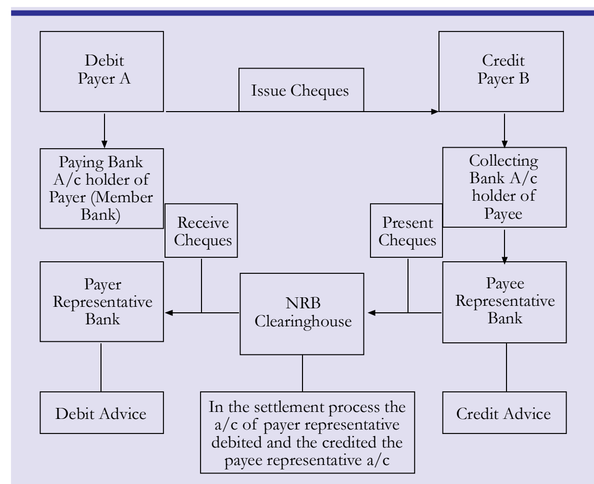
Cross border payment system in Nepal is still at its primitive stage. Most of the commercial banks use traditional payment instruments. The Foreign Exchange Management Department of NRB monitors the foreign currency transactions. Recently, NRB started the local clearing for the payments in eleven foreign currencies (2001).

Figure 6
Transactions of NRB Clearinghouse



Payment System for Indian Currency

The externally payment system has been separately arranged for Indian currency to that of other convertible currencies in the country. Although, under the Foreign Exchange (Regulation) Act, 1962 the Indian currency comes under the definition of foreign currency, the exchange regulation towards Indian currency is liberal due to the bilateral payment arrangement, open border, geographical proximity and the historical and cultural relations between Nepal and India. For the purposes of receipt and payment accompanied by documents, it is convertible to both the Nepalese and Indian citizens. However, for retail



transactions, a maximum of INRs. 25,000 can be exchanged at a single time. For trade purposes, telex transfers are the prevailing method for advance payment, deferred payment, and bills of transport, letter of credit, with the bills of transport being the most popular method. The trade payment between Nepal and India is settled in Indian rupees. Payments for the import and export of commodities from India are effected in cash through drafts and TTs. Thus, a letter of credit is not an essential element. A letter of credit is essential only if payment is to be made in US dollars for some specified Indian machinery and industrial raw materials to be imported from India. Nepalese commercial banks have maintained their Indian currency agency accounts in Indian banks to settle the above payments.

Payment system for Other Convertible Currencies

Foreign exchange regime in Nepal is partially liberalized. Current account transaction is convertible under the regulatory framework while capital account transaction is not convertible. As Nepal is a member of the Asian Clearing Union (ACU), all the trade payments among member countries except India are settled through the clearing system of the Union in ACU dollars. Moreover, some restrictions are imposed on the usage of foreign currencies since the Rupee is not convertible. Same modes such as drafts, mail transfer; telex transfer, SWIFT transfer, credit cards and ACU dollars are in practice for cross border payments for convertible currencies.

Asian Clearing Union (ACU)

The ACU was established in 1975 with the purpose of:

- Providing the facility to settle on a multilateral basis, payments for current international transactions among the participating countries,
- Promoting the use of participants' currencies in current transactions between the respective territories thereby effecting economies in the use of participants' exchange reserves, and
- Promoting monetary cooperation among the participants and closer relations among the ACU banking systems.

Central banks of Bangladesh, Bhutan, India, Iran, Myanmar, Nepal, Pakistan and Sri Lanka are the members of ACU, where Nepal is one of the founder members.

When ACU started its operations in 1975 all individual transactions were required to be cleared through the concerned central banks. According to the ACU agreement, all payments relating to trade and trade related transactions among member countries should be routed through the ACU payment systems. Under system, payments arising on trade transaction with member countries are first settled by the respective commercial banks with their central banks and thereafter request to settle the same is made to the corresponding bank of the member country (receipt bank). In turn, the respective central bank advises the central bank of recipient member country to settle that payment with the corresponding recipient commercial bank. The central bank of the recipient's member country then settles the payment with their local commercial bank if the recipient's member country then settles the payment with their local commercial bank and instructs the ACU to credit their accounts as well as to debit the paying member central bank's accounts maintained at ACU head office. Interest is debited or credited to the account at the end of the day, depending on debit or credit balance in the account. All the settlements are made in US dollars.

The ACU head office maintains accounts in ACU dollar for each member central bank and updates the debit and credit entries as advised by the respective member central banks. At the end of the settlement period, i.e. two months, the ACU informs the net position of each bank (debit or credit) for the final settlements among member central banks. There is no cross border fund transfers during the settlement period i.e. two months. The cross border settlements takes place only after final settlements are made among themselves by member central banks.

Transaction under Asian Clearing Union

The total transaction, which was settled through ACU, amounted to Rs 1,002.3 million (ACU dollar 13.23 million) during the calendar year 2003 (January-December). The amount was higher by 998.1 million (ACU dollar 13.18 million) against that of the previous year. Total exports of goods settled under the ACU registered a rise of Rs. 529.3 million (ACU dollar 7.00 million) to Rs. 531.1 million (ACU dollar 7.01 million). Similarly, total imports increased by Rs. 468.8 million. In ACU dollar terms, imports transactions were higher by Rs. 6.2 million.

Some Comprehensive Analysis and Interpretation

As explained above cash, cheque, draft, telex transfer, mail transfer and traveler's cheque are the most used domestic payment instrument and credit card, debit card and ATM are also being widely used in urban areas mostly in Kathmandu valley.

Regarding the cross border payment instrument draft, telegraphic transfer and SWIFT are most popular.

Since more than 75 percent people live in the rural areas and these areas are not facilitated with banking network, most of the people prefer to use cash instead of other instruments. The currency in circulation to narrow money (M_1) is still 70 percent in Nepal, which proves that the cash is predominant in the payment system. Over the last decade Nepalese payment system has made some progress replacing the cash by using credit cards, debit cards and ATMs in urban areas and cheque, draft and TTs in rural areas. Since November 2002, the banking sector in Nepal has continued to make further improvements in computerization and "shared EFT network" for ATMs and EFTPOS devices has begun operation. Right now, ATM issued by eight commercial banks have come under the same network. It has thus facilitated the provision that any ATM cardholder of those banks can use any ATM of commercial banks, which use the same technology. But, as these commercial banks are big client oriented; the general people are yet far away from the access of these facilities. Besides the cash, cheque is the most used payment instrument. Mostly, the businessmen, government enterprises are using cheques for both small as well as large value payments. Draft is another important method of payment. Businessmen and the people of rural areas mostly use draft. As a matter of fact draft is the only safest mode of payment for the people in rural areas.

Regarding the cross border payment, draft and TTs are mostly used and a letter of credit is used if the payment is to be made in US dollars in the case of payment between Nepal and India. Letter of credit is also most popular method of payment regarding the other convertible currencies. Financial institutions use the SWIFT for the funds transfer and/ or other financial transactions.

The settlement of financial claims takes place at the time when cheques are present to NRB clearinghouse by the representatives of the participating banks. So, the system followed is real time net settlement. This refers to simultaneous transmission, processing and net settlement of financial claims.

Regarding the settlement of securities, both bilateral and multilateral methods of payments are used. Most of the cross border transaction takes place bilaterally. Draft, TTs and SWIFT are the most used payment method for bilateral settlement. Draft and TTs are mostly used by the NRB whereas SWIFT is mostly used by commercial banks. Among the cross border payment and settlement Indian currency is used for the transaction with India whereas convertible currencies are used for the transaction with other nations. Multilateral settlement takes place through ACU.

Role of NRB in Payment and Settlement System

Central bank plays a key role in payment system. Money is fundamental to the functioning of market economy. Today, any widely used form of money is denominated in a given currency. By sharing a currency, the individuals of a community have in common a measure of economic value, a means to store value, and a set of instruments and procedures to transfer this value. However, the value of money lies in trust, there can be no absolute guarantee that confidence in the currency can be preserved over time. It may be shaken by a monetary crisis or by the malfunctioning of the payment system. As a result, maintaining trust in the currency, facilitating its circulation becomes a major public interest. The central bank is the institution designated to pursue this public interest.

Likewise, payment systems play a fundamental role in the economy by providing a range of mechanisms through which transactions can be easily settled. Bank notes are the part of this broad notion of payment systems. In spite of the expanding role of its various substitute the banknote is still a fundamental payment instrument in the economic life.The NRB is effortful for creating an environment for sustainable development through price stability, strengthened balance of payments, secured, healthier and efficient payment systems and reform and promotion of the banking and financial system.

Therefore the Monetary Policy for 2004/05 has focused mainly on timely reforms in payment system in the banking offices of the NRB which will be carried out in the context of the gradual modernization of the payment system." In this regard NRB emphasizes a detail study on clearinghouse management and improvements in the reconciliation process.

Generally, commercial banks maintain the clearing account and statutory reserve requirement account with the NRB. By the implication of monetary policy NRB can influence the money supply as well as credit creation of the banks through changes in reserve money, required reserved ratio and open market operation (OMO). Changes in the requirement of clearing account with NRB will affect the overall bank liquidity ultimately, which affect the payment system.

It is the lags in clearing and settlement that affects the level of float or items in transit, forcing the commercial banks to maintain a certain degree of liquidity or clearing balances that are necessary. The willingness of NRB to provide daylight overdrafts could reduce the need to hold high amount of clearing balances. In addition, the degree of decentralization of clearing accounts to the district offices also affects the level of liquidity. NRB in consideration of the above points acts upon accordingly so as to efficiently conduct its monetary management activities.

The efficiency and effectiveness of monetary policy, thus, are affected by the efficiency and reliability of the payment system.

The transmission mechanism as well as quick and accurate recording of transactions is two major areas of concern for the implementation of monetary policy. These are influenced by the payment and settlement system. First, the transmission mechanism in Nepal moves from the treasury bill auctioning rate to inter-bank rates, market liquidity, changes in the lending rates, credit availability and finally to real variables. The efficiency and effectiveness of this mechanism is vitally affected by the payment and settlement system. Secondly, in view of the fact that monetary aggregates are targets, it is extremely important that these values reflect current conditions. Delays and inefficiencies in the payments and settlement system can distort these variables significantly.

The development of payment system in a country is one of indicators that determine the level of country's economy. As payment system plays an important role in an economy, the NRB must take high considerations of the importance of payments systems in supporting economic growth. Since there is a very close interconnection between the financial institutions, the failure of one of them may jeopardize the solvency of others. This calls for keeping vigilance on update information of payment system technology. Due to the rapid advancement of

technology, especially in financial services, such as banking, investment and insurance etc. the world becomes borderless and also made financial sector more complex. In this light, NRB has to take more responsibility in enhancing an effective payment system as there has been continuous expansion of the banking system and also the introduction of new technology in payment and settlement system.

Besides, in order to encourage economic activities in the country, it is high time that NRB engages itself in the timely monitoring of the payment system thereby minimizing the problems incurred during settlements. In the absence of a Special Act it has been difficult to efficiently conduct payment and settlement activities in the country at present, as such time has now come that NRB comes forward with payment and settlement system.

Payment System Oversight

The robust payment system is a key requirement in maintaining and promoting economic and financial stability. They contribute towards promoting economic activity and improving macroeconomic management as well as the micro objective, particularly in the core area of payment systems. But payment systems can also involve significant exposures and risks for participants and users when payment systems failures occur. In addition, this can be a channel for transmission of disturbances from one part of the economy or financial system to another, disrupting the smooth function of the payment system and stability of the financial system and thereby disordering of the entire economy. This systemic risk is an important reason for the close interest and observation that central banks have always taken in the oversight of payment systems.

It has become an internationally accepted in a principle that central bank should disclose the key aspects of their policy on oversight of payment systems. The oversight of payment systems is an integral part of its wider responsibility for monetary and financial stability. The maintenance of the stability of the financial system is the matter of concern for central bank regarding the payment and settlement infrastructure.

Nepal Rastra Bank Act, 2001 under section… has entrusted the responsibility of supervision and control over banks and financial institutions to NRB. Regarding the sound healthy and efficient operation of financial system NRB regularly inspect and supervise the bank and financial institutions through Inspection and Supervision Department. But, there is no any specific provision regarding the oversight of payment and settlement system in Nepal.

It will be relevant here to quote the Ferguson Report which noted that: "because of consolidation, central bank oversight of payment system is becoming more closely linked with traditional bank safety and soundness, supervision at the individual firm level. Increasing cooperation and communication between banking supervisors and payment system oversees may be necessary both domestically and cross border."

It also added "central banks and bank supervisors should carefully monitor the impact of consolidation on the payment and settlement business, and should define safety standards where appropriate. In particular, central banks, in conjunction with bank supervisors, may need to consider various approaches, possibly including standards, that could be used to limit potential liquidity, credit and operational risk stemming from concentrated payment flows through a few very large players participating in payment systems."

Due to the rapid development in financial sector in Nepal, the risk and efficiency related concentration might arise; it would be beneficiary to take advance policy measures regarding the payment and settlement system oversight.

Problems and Challenges

The payment system in Nepal is virtually dominated by cash transactions. Bank drafts, cheques, SWIFT payments and plastic card based transactions (ATM cards, credit cards and debit cards) are also available but their use is very much limited due to:

- Bank drafts attract relatively high service and transaction costs and, are also relatively slow (incur several days) in respect of affecting the required fund transfer.
- Cheques carry inescapable credit and documentary validity risks, and also take at least two days to clear up to ten days and more for cheques outside the Kathmandu valley. The legal provisions in Nepal for suing for due performance on the basis of dishonored cheques are not satisfactory.
- Plastic cards initiated transactions are rising but are mostly available to bank account holder. Non-bank account holders have access to meager

amount that can be transacted through plastic card. There are only about three million bank accounts out of a population of about twenty six million.

The challenge for the development of Nepal's payment system is to find a solution, which meets the needs of, banks and other sector of economy-more pertinently the NRB and ordinary consumers. The central bank - NRB is in effort to reduce the volume of cash in circulation and to obtain more efficient management of macro-economic conditions through efficient management of Open Market Operation.

A number of innovative product for making payment such as e-money, Internet and mobile payments have been developed in recent years. Developments in these products have been evoking considerable interest over the last few years. E-money does not exist in Nepalese financial market, some financial institutions initiate to introduce Internet and mobile payment system in the market. Their use is however very low compared to cash and traditional non-cash payment instruments. E-money and/or internet and mobile payment instrument as a potential substitute for cash for making small value payments, raises policy issues for central banks as regards the possible implications for central bank's revenues (seigniorage), their implementation of monetary policy and their payment system oversight role.

Regarding the payment systems relating to retail payment, large value payments as well as electronic based payment, NRB as a central bank has to look forward on its legal, oversight, security, law enforcement, payment system aspect and cross-border issues have to be dealt in time.

Technological Innovations in Payment System in Nepal

At the outset, broadly two types of payments system solution scenarios can be envisaged for introducing technology innovation/investment in payment system:

- The establishment of a multi-functional national electronic payments network. But this would be too expensive eyeing at the current volume of demand or transaction. Or,
- To begin at first hand, introduce some automation of current cheque clearing in the Kathmandu Valley, thus addressing a very small component of the national payment system.

In response to this, a more 'grass root' solution can be initiated based on

1. Automation of the current cheque clearing in the Kathmandu valley and,
2. Introduction of domestic Credit Remittance payment instrument in both paper and electronic format so as to improve bill payment facilities especially by public utilities.

The automation of the Clearing System and introduction of Credit Remittance Payment Instrument in electronic format is envisaged to increase the overall economic efficiency of Nepal as the following:

- Decrease in volume of cash in circulation leading to increased management of M1 and M2.
- Increase in the variety of payment instruments available to consumer/retail economic entities.
- Increase the monetization of the economy through the conversion of 'cash' or gold as a medium of stored value to interest bearing bank accounts.
- Decrease in the cost of bill collection as currently imposed by default on multiple national service providers through the lack of any acceptable and universally available (in Nepal) alternative to cash payments at an acceptable cost.
- Improvements in the efficiency, accuracy and accountability of payments made to/from the government by converting paper based and physically deliverable payment orders to an electronic equivalent which can be immediately and authoritatively traced, audited, authorized and reconciled against budgeting provisions and expected government cash flows.
- Provide an infrastructure, technical, legal and procedural platform for immediate payment systems improvement in Nepal as foundation future payment system developments consistent with participation in the global market place.

Endnotes

[1] Gorkhapatra Daily, November 11, 2004

[2] Forty Years of Nepal Rastra Bank, page 22.

[3] The role of central bank money in payment system, August 2003, BIS, CPSS.

[4] Survey of developments in electronic money and internet and mobile payments, March 2004, BIS, CPSS.

Financial Sector Development

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Prior to the establishment of Nepal Rastra Bank (NRB) in 1956, Nepal Bank Limited (NBL), a semi-private commercial bank established in 1937, was the first formal banking institution in the Kingdom of Nepal. Being a pioneer of the banking history, it was but natural that the NBL took care of all the Kingdom's banking activities at that time. The then socio-political evolution helped expose the country to the external sector, and planned development of a mixed-economic approach. As such, the starting of the first five year Development Plan and the establishment of the NRB as a central bank of the Kingdom of Nepal, was a good coincidence of the mid-1950s.

At the time of establishment of the NRB, the domestic monetary and financial activities were characterized by virtual non-existence of the formal money and capital markets; extensive non-monetization in the economy; very limited banking services; dual currency system of Nepalese currency (NC) and Indian currency (IC), etc. Thus, the NRB Act, 1955 visualized the ground realities by envisaging the traditional as well as very basic central banking activities for the primary objectives; these included:

- *Issuance of Nepalese currency for facilitating the economic welfare of the people;*
- *Circulation of the Nepalese currency throughout the Kingdom;*
- *Maintaining the exchange rate stability of the Nepalese currency;*
- *Mobilization of the capital for the development, among others, the industrial sector of the economy; and*
- *Development of the banking system (NRB Act, 1955).*

The Nepal Rastra Bank as the Nepalese central bank is a friend, philosopher and leader of the overall banking and financial institutions. The NRB from the very beginning has been acting as: banker to the banks; adviser to His Majesty's Government of Nepal (HMG/N), regulator and supervisor of the banks and financial institutions. Since the NRB does not directly deal directly with the people like other banks and financial institutions, it provides necessary resources for the overall economic activities through the financial intermediary institutions. Looking at the major functional areas, the NRB is a foreign exchange controller, public debt manager, price collector and controller, money supplier/ manager, government economic advisor, macroeconomic analyzer together with financial sector regulator and supervisor.

It is obvious that the role of the NRB as a central bank is related with the financial system in particular and the economy in general.

Structure of Financial System in Nepal

Regulator	Participants
Nepal Rastra Bank	17 Commercial Banks. 25 Development Banks. 59 Finance Companies. 11 Microfinance Development Banks 20 Financial Cooperatives. 47 Non-governmental Organizations (NGOs)
	Non-banks Financial Institutions like Credit Guarantee and Deposit Insurance Corporations with equity participation.
HMG/N	117 Postal Saving Banks, Specialized Financial Institution(s) like Employees Provident Fund, Citizen Investment Trust, etc.
Securities Exchange Board	Nepal Stock Exchange Limited
Insurance Board	18 Insurance Companies

The overall financial system in Nepal as elsewhere, has been functioning well. This paper attempts to deal with those banks and financial institutions that are directly under the regulation and supervision of the NRB. Also some of the micro-indicators, which measure the development of financial sector like M2 (broad money)/Gross Domestic Product (GDP) ratio, currency/broad money ratio, money multiplier, composition and share of the total banking assets, etc. will be discussed later on.

Nevertheless, there have been debates on the role of central banks regarding the objectives such as (i) macroeconomic objectives (final targets), (ii) long-term strategic objectives of financial sector development, (iii) sectoral/microeconomic objectives, (iv) developmental and promotional activities, (v) separate independent agency out of the central bank for supervisory role, etc.

Similarly, the goals of monetary policy in general include both stability of inflation and exchange rate and for sustainable economic growth. Moreover, the main contribution that a central bank can make through its monetary policy to economic management in the long-run is to maintain low inflation. No doubt, low inflation provides a necessary environment for sustainable economic growth and development. In this context, some central banks explicitly set inflation target within a target band. There is also a growing consensus that central banks are more effective, in maintaining low inflation and performing the core functions, when they are more independent.

A number of industrial countries have recently practiced by dividing the functions of the central bank in separate agency. The modern twin-functions of this central bank bear the responsibility for the conduct of monetary policy including financial system stability and regulation of the payment system, while the new supervisory agency is responsible in undertaking the prudential regulations and supervision of deposit taking banks and financial institutions. In most of the countries, however, the central banks retain both the responsibility for conducting monetary policy and prudential regulation and supervision of the financial sector.

According to the NRB Act, 2002 which replaced NRB Act 1955, the major objectives of NRB are as follows:

- *Formulation of monetary and foreign exchange policies in order to maintain the stability of price and balance of payments for sustainable economic development;*
- *Promoting stability and liquidity required in banking and financial sector;*
- *Developing secure, healthy and efficient payment system;*
- *Regulating, inspecting, supervising and monitoring the banking and financial system; and*
- *Promoting entire banking and financial system of Nepal and enhancing its public credibility.*

The NRB Act, 2002 (hereafter called the Act) empowers the Bank to operate as: (i) note-issue manager, (ii) banker to HMG/N, banks and financial institutions, (iii) manager of the clearing and payment system for banks and financial institutions, (iv) agent

of the Kingdom of Nepal in dealing with international monetary organizations like International Monetary Fund (IMF), (v) manager of public debts and foreign exchange reserves, (vi) foreign exchange controller, (vii) issuing liscence to commercial banks and other financial institutions, (viii) regulator and supervisor of financial system, (ix) formulation and implementation of monetary and exchange rate policies and (x) economic adviser to the government.

Among others, NRB as mandated by the, Act to submit its: (a) audit report; (b) report of self activities; and (c) report on economic and financial position to the HMG/N within four months from the end of each fiscal year (mid-July). Likewise, NRB in required to publish its monthly balance sheet within fifteen days from the date of completion of each month. The Act also makes NRB mandatory to make public the monetary policy report which includes:

(i) Comprehensive review and evaluation of the monetary policy introduced and followed by the bank in the preceding years, and

(ii) Justification and analysis of the monetary policy that the NRB is going to introduce in the following year.

In assessing the role of NRB in the financial sector development of Nepal, it is but natural to review briefly the policy formulation and implementation as well as institutional growth in the financial sector. As such, a brief overview of the NRB's activities, which might, directly or indirectly, have an impact on the overall financial sector development is a useful reference in evaluating its role. It is therefore, a decade-wise quick review of the NRB in such activities is an instructive reference.

1st Decade (1956–65)

The 1st decade of the establishment of NRB was basically an evolutionary process. The circulation of NC was the prime agenda for which the Bank had initiated branch expansion approach in view of establish in NC chests. Likewise, the Foreign Exchange (Regulation) Act, 1963 helped to stabilize the exchange rate of NC against IC with the emergence of NRB as the custodian of the Kingdom's foreign exchange reserves. Similarly, the major macroeconomic statistics like GDP, monetary, international trade, prices, etc., have also been either supplemented or compiled and published by the NRB.

2nd Decade (1966–75)

The NRB had initiated for the first time the monetary policy and its instruments such as liquidity, cash reserve requirement (CRR), margin rates, interest rate, refinance rates, etc. As such, the NRB had taken steps to control and regulate the credit creation capacity of the commercial banks. The NRB had become successful in establishing the NC as the sole legal tender and controlled the foreign exchange reserve management. During this decade, the NRB had practiced the monetary policy instruments in view to mobilize more deposits and provide more credit to productive sectors through the use of both deposit and credit rates as well as credit margins.

Because of the global inflationary pressure due to petroleum price hike, the NRB had no better options other than to rely on the preventive measures to help decline the aggregate demand through excess deposit mobilization, productive use of such resources, and the productive use of foreign exchange reserves. The NRB had changed the interest rate of deposit and credit in view to mobilize deposit and to lend on productive sector. During the 2nd decade, the NRB did not only follow the controlled activities but also helped to establish banking, financial and non-financial institutions with direct equity participation. As such, the Commercial Bank Act, 1974 was promulgated and commercial banks were authorized to extend medium and long-term credit for feasible projects which was not applicable in the past. During this decade, the NRB started to provide refinance facilities a cap of 80.0 percent of the amount of credit provided to export and import to commercial banks to encourage banking credit flow. NRB had also made provision of refinance to Agriculture Development Bank (ADB/N) and Nepal Industrial Development Corporation (NIDC).

Institutional Developments in the First Decade

- Nepal Bank Ltd. (NBL) 1937*
- Nepal Rastra Bank (NRB) 1956*
- Nepal Industrial Development Bank 1957* (converted into NIDC in 1959)
- Cooperative Bank 1963* (merged with ADB/N in 1968)
- Employee's Provident Fund (EPF) 1962*

* Date of establishment

The NRB for the first time introduced the cash reserve regulation with the approval of HMG/N and prescribed 8.0 percent of the total deposit liabilities of commercial banks. Also to combat the global impact of inflation - through import prices to aggravate the domestic price situation - NRB imposed statutory liquidity ratio (SLR) together with credit limit aiming at encouraging the flow of credit to private sector. The Bank also took a policy shift of mobilizing resources through pricing policy rather than administrative measures, resulting in a substantial upward revision in the interest rate with lifting the credit limit. Towards institutional development, Agriculture Project Services Centre (APROSC) (1975) and Credit Guarantee Corporation (CGC) (1974) were established with the initiation and equity participation of the NRB.

meet the prescribed PSC, commercial banks were subject to penalise.

Based on the macro-economic situation and for the sectoral developments, the NRB made use of necessary changes in the interest rate, CRR, liquidity requirement, credit ceiling, margin rates and the credit policy. For the first time, the NRB allowed commercial banks to lend on long-term with a cap of 15.0 percent of their total liabilities. Similarly, the Bank introduced the opening up the letter of credit (L/C) for imports by commercial banks from third countries excluding some selected goods. Also, the NRB introduced educated unemployed loan scheme in which commercial banks could provide loans of Rs 10–25 thousand per person. The concept of productive sector credit was introduced in which commercial banks had to lend 25.0 percent of their total credit including the revised 8.0 percent credit to priority sector. In view to discourage import through imports credit, and thereby to keep money supply in desirable level, the NRB had also adopted a limit of credit/ deposit ratio for commercial banks.

Institutional Developments in the Second Decade

- Rastriya Banijya Bank (RBB)[1966*]
- Agriculture Development Bank (ADB/N)[1968*]
- National Insurance Corporation[1967*]
- Land Reform Savings Corporation [1968*] (merged with ADB/N in 1973)
- Nepal Insurance Corporation[1968*]
- Credit Guarantee Corporation[1974*]
- Agriculture Project Services Centre[1975*]

* Date of Establishment

3rd Decade (1976–85)

The NRB had accelerated the banking expansion and the development activities in this decade. Looking at the improving macroeconomic situation, the NRB made downward revision in the interest rate in view to expand banking credit to agriculture, industry, export promotion, etc. Also, the Bank granted some flexibility to the commercial banks for setting the interest rates within a band on saving and fixed deposits. Similarly, selective credit policies with credit ceilings and also the directed credit programs were revised. The NRB as the leader of the financial sector, in view to realizing the socio-economic responsibility, had prescribed, for the first time, the priority sector credit (PSC) as compulsory lending for the commercial banks and it was set at 7.0 percent of the total deposit liabilities. Failure to

Institutional Developments

- Securities Marketing Centre [1977*] (converted into SEC in 1984 and into NEPSE in 1992)
- Postal Saving Offices [1977*]
- Nepal Arab Bank Limited [1984*]

* Date of Establishment

4th Decade (1986-95)

Large fiscal deficit, overvaluation of the exchange rate, deceleration in export, sluggish economic growth, etc. of early 1980s caused macroeconomic instability, which ultimately helped to initiate, among others, financial sector liberalization. In view of attaining a reasonable economic growth, the policy options were to adopt stabilization measures for the short-run through demand compression and supply inducing measures for the medium to long-run. The Structural Adjustment Program (SAP), which was introduced in 1987, aimed at tightening monetary policy with the

Institutional Developments in the Fourth Decade

Commercial Banks
- Nepal Indusuez Bank Ltd. 1986*
- Nepal Grindlays Bank Ltd 1987*
- Himalayan Bank Ltd. 1993*
- Nepal SBI Bank Ltd. 1993*
- Nepal Bangladesh Bank Ltd. 1994*
- Everest Bank Ltd. 1994*
- Bank of Kathmandu Ltd. 1995*

Rural Development Banks
- Eastern Rural Development Bank 1993*
- Far-Western Rural Development Bank 1993*
- Western Rural Development Bank 1995*
- Mid-Western Rural Development Bank 1995*

Finance Companies
- Nepal Housing Development Finance Co.Ltd. 1992*
- Nepal Finance and Savings Co.Ltd. 1993*
- NIDC Capital Markets Ltd. 1993*
- National Finance Ltd. 1993*
- Annapurna Finance Co. Ltd. 1993*
- Nepal Share Markets Ltd. 1993*
- Peoples Finance Ltd. 1994*
- Himalayan Finance & Saving Co.Ltd. 1994*
- United Finance Ltd. 1994*
- Union Finance Co. Ltd. 1994*
- Himalayan Securities & Finance Co.Ltd. 1994*
- Mercantile Finance Co. Ltd. 1994*
- Kathmandu Finance Ltd. 1994*
- Investa Finance Ltd. 1995*
- Narayani Finance Ltd. 1995*
- City Finance Ltd. 1995*
- Nepal Housing & Merchant Co. Ltd. 1995*
- Paschhimanchal Finance Co. Ltd. 1995*
- Universal Finance & Capital Markets Ltd. 1995*
- Samjhana Finance Co. Ltd. 1995*
- Goodwill Finance & Investment Co. Ltd. 1995*
- Shree Investment & Finance Co. Ltd. 1995*
- Siddhartha Finance Ltd. 1995*
- Lumbini Finance & Leasing Co. Ltd. 1995*
- Yeti Finance Ltd. 1995*
- Standard Finance Ltd. 1995*
- ACE Finance Co. Ltd. 1995*
- International Leasing & Finance Co. Ltd. 1995*
- Maha Laxmi Finance Ltd. 1995*
- Lalitpur Finance Co. Ltd. 1995*

* Date of Establishment

use of credit ceiling, CRR and SLR. However, in early 1990s following the economic policy liberalization, the financial sector was further liberalized with the shift from direct monetary policy instruments into indirect ones. The second phase of SAP was known as Enhanced Structural Adjustment Facility (ESAF) and had been implemented in 1992 aiming at imposing ceilings on net bank credit to the government and government enterprises in order to encourage bank credit to private sector.

The NRB also lifted the provision of SLR in view to offer more independency to commercial banks for their portfolio selection. The CRR was historically high in 1989, which was 12.0 percent of the total deposit liabilities, and taken as a cushion for expansionary monetary aggregates. However, with the partial convertibility in the current account in 1992 the demand for credit surged up leaving no effective option to NRB other than SLR and therefore, NRB backtracked the already lifted instrument like SLR at a higher side of 36.0 percent including CRR. The SLR helped create the environment of (i) government issuing bonds at lower interest rates, (ii) increased intermediation cost, (iii) credit to private sector crowdedout and (iv) incompatibility with liberal financial policy. As such, the NRB completely abolished the provision of SLR in 1993.

A substantial improvement in the BOP, and hence, net foreign assets of the banking system, widening fiscal deficit resulted the expansion of credit to the government ultimately caused higher monetary expansion. In such a situation, there was insufficient monetary instruments to mop up excess liquidity, and therefore, the NRB started issuing its own bonds (NRB bonds) in 1991. The open market operations (OMOs) became very effective indirect monetary policy instrument after the introduction of auction system in 1988. Moreover, the auction was started on weekly basis in 1989. Also, the holding the Treasury Bills (TBs) by NRB and others had shown an upside - down trend, which has been considered, a good indicator elsewhere for better monetary management. The Nepalese currency has been made fully convertible on the current accounts by accepting the obligations of Article VIII, sections 2,3 and 4 of

the IMF Articles of Agreement on 1994. It was obvious that the NRB had allowed to open foreign currency deposit in the banking sector based on the foreign currency-earning source.

During the period, all together 10 financial cooperatives and 17 non-government organizations (NGOs - with microfinance activities), with limited banking transaction, came into operations under the license provided by the NRB.

5th Decade (1996-05)

The NRB as a regulator and supervisor of the banking and financial sector has been effortful to ensure a healthy, and efficient financial sector by improving regulation on par with international standard. As such, the capital adequacy, single borrower limit, loan loss provisioning, professionalism of the promoter, standardised capital base, total deregulation in interest rate, open licensing policy, phasing out the directed credit, etc., are the major prudential regulatory reforms undertaken by the NRB. In this regard, Banks and Financial Institutions (BFI) ordinance, 2004 has come into effect as an umbrella act in view to amuluging the existing banks and financial institutions acts. Banks and financial institutions are to be classified as A, B, C and D as per the minimum paid-up capital requirement prescribed by NRB which is also based on the geographical areas to be covered. Similarly, the overall functions are also mentioned for each category of banks and financial institutions. The BFI ordinance aims to ensure reliable and quality banking and financial services through healthy competition among banks and financial institutions together with protecting the interest of depositors. The BFI ordinance also aims at facilitating the establishment, operation, management and regulation of banks and financial institutions with appropriate legal provisions. It is expected that the ordinance would be instrumental in promoting financial sector and thereby, strengthening the economy.

It has been observed that within the financial sector, banking sector particularly the public sector banks remained more problematic due mainly to the aging factor and also inefficient operation. For this, under the World Bank assisted Financial Sector Reform Program, the management, of the NBL and RBB have been handed over to the foreign team/ persons in contact. Also, the re-engineering of NRB in view to enhancing the efficiency of the accounting and auditing, on-site and off-site inspection and supervision, restructuring the manpower management and reform of MIS have also been initiated. Similarly, a corporate and financial governance (CFG) project is under implementation to making the financial sector dynamic, capable and effective. A number of draft legislations like, Insolvency, Secured transaction, Asset Management Company, Anti-money laundering, etc. are in their final stages. Nepal's accession to the World Trade Organization (WTO), among others, has opened financial sector services, which further intensifies the liberal and competitive regime. The poverty reduction growth facility (PRGF), a concessional credit provided by the IMF, has been effective from 2003 in line with Nepal's macroeconomic restructuring, economic growth through social sector policy as a broader objective of poverty reduction.

Looking at the regional and global trend as well as the internal conflict situation, the Bank has attempted to reduce the intermediation cost of commercial banks by significantly reducing the CRR. Similarly, to help encourage banking credit to sick industry, export credit, rural credit and also for general purposes, the NRB, in the recent years, has also been reducing the refinance rate. Open market operations have been used as the flexible short - term monetary instruments. The TBs with maturities of 28-day, 91-day, 182-day and 364-day, tap sale, Repo, reverse-Repo, outright purchase and sale aiming at market-reflecting rate are the major instruments and procedures in the open market operations.

Briefly, the overall financial sector reform process includes privatization, opening up of new banks/ financial institutions, self-governance, prudential measures, loan recovery process, restructuring, consolidation of regulation and supervision, automation, promoting intermediation, attracting foreign investment, facilitating forex transaction, gradual opening up of capital account, and so on. The NRB as a central bank has been contributing through the sequential financial sector liberalization, extending financial services to the people, who were previously beyond the reach of banking and financial services, and the process of deregulation to micro finance activities. Similarly, the micro-finance activities are encouraged through the establishment of micro-finance development banks, micro-finance institutions and non-government organizations together with the contribution made by the NRB in the self-reliance fund (SRF). Moreover, NRB has also been playing a

Institutional Developments in the Fifth Decade

Commercial Banks
- Nepal Credit & Commerce Bank [1996*]
- Nepal Industrial & Commerce Bank [1998*]
- Lumbini Bank Ltd. [1198*]
- Machhapuchhre Bank Ltd. [2000*]
- Kumari Bank Ltd. [2001*]
- Laxmi Bank Ltd. [2002*]
- Shiddhartha Bank Ltd. [2002*]

Development Banks
- Malika Development Bank [1998*]
- Siddhartha Development Bank [1998*]
- Nepal Development Bank [1999*]
- Uddyam Development Bank [1999*]
- Development Credit Bank Ltd. [2001*]
- United Development Banks Ltd. [2001*]
- Nepal Cottage and Small Ind. Dev. Bank [2001*]
- Narayani Ind. Development Bank [2001*]
- Pashimanchal Bikas Bank [1995*]
- Madhymanchal Grameen Bikas bank [1996*]
- Nirdhan Utthan Bank [1999*]
- Rural Microfinance Development Center [1999*]
- Deprosc Development Bank [2001*]
- Chhimek Development Banks [2001*]
- Shawalamban Development Bank Ltd. [2002*]
- Sana Kisan Vikas Banks [2002*]
- Sahayogi Bikas Bank [2003*]
- Pasupati Bikas Bank [2004*]
- Karnali Bikas Bank Ltd. [2004*]
- Triveni Bikas Bank Ltd. [2004*]
- Annapurna Bikas Bank Ltd. [2004*]
- Bhrikuti Bikas Bank Ltd. [2004*]
- Shurechha Bikas Bank Ltd. [2004*]
- Bageswari Bikas Bank Ltd. [2004*]
- Sanima Bikas Bittiya Samstha Ltd. [2004*]
- Gauri Sankar Bikas Bittiya Samstha Ltd. [2004*]
- Gorakha Bikas Bank Ltd. [2004*]
- Mt. Everest Development Fin. Institute [2005*]

Finance Companies
- Merchant Finance Co. Ltd. [1996*]
- Bhajuratna Finance & Savings Co. Ltd. [1996*]
- General Finance Ltd. [1996*]
- N.B. Finance & Leasing Co. Ltd. [1996*]
- Alpic-Everest Finance Ltd. [1996*]
- Nepal Shreelanka Merchant Bank Ltd. [1996*]
- Nepal Merchant Banking & Finance Ltd. [1996*]
- Nava Durga Finance Co. Ltd. [1997*]
- Pokhara Finance Ltd. [1997*]
- Janaki Finance Ltd. [1997*]
- Central Finance Co. Ltd. [1997*]
- Premier Finance Co. Ltd. [1997*]
- Arun Finance & Saving Co. Ltd. [1997*]
- Multipurpose Saving & Investment Finance Co. Ltd. [1998*]
- Butwal Finance Co. Ltd. [1998*]
- Shrijana Finance Ltd. [1999*]
- Om Finance Ltd. [2000*]
- Cosmic Merchant Banking & Finance Ltd. [2000*]
- World Merchant Banking & Finance Ltd. [2001*]
- Capital Merchant Banking & Finance Ltd. [2002*]
- Crystal Finance Ltd. [2002*]
- Royal Merchant Banking & Finance Ltd. [2002*]
- Guheshworil Merchant Banking & Finance Ltd. [2002*]
- Patan Finance Ltd. [2002*]
- Kist Merchant Banking & Finance Ltd. [2003*]
- Fewa Finance Ltd. [2003*]
- Everest Finance Co. Ltd. [2003*]
- Birgunj Finance Ltd. [2003*]
- Prudential Merchant Banking and Finance Ltd. [2004*]
- Investment Credit & Finance Co. Ltd. [2004*]

* Date of Establishment

Concentration of Banking and Financial Institutions

Bank/Financial Institutions	Total Number	Concentration Ratio (%) Kathmandu	Out of Kathmandu
Commercial Banks	17	70.6	29.4
Development and Microfinance Development banks	36	26.5	73.5
Finance Companies	59	64.4	35.6
Financial Cooperatives	20	35.0	65.0
Micro-finance NGOs	47	31.9	68.1

catalytic role in micro-finance by involving in the wholesale credit operations through the Rural Micro-credit Development Center (RMDC) and the Small Farmers Development Bank (SFDB).

During the period, all together 10 financial cooperatives and 47 NGOs with micro-finance activities came into operations licenced by the NRB.

Looking at the concentration of banks and financial institutions as a whole, one can easily observe the urban concentration. Moreover, looking at the branch network of banks and financial institutions, it is obvious that even the branches out of the Kathmandu valley almost all of them are operating in urban areas. During the last few years, most of the rural branches of the banks are either closed or merged with urban branches due to security region. It is but natural that due to the lack of sufficient markets and economic activities, banks and financial institutions may not be feasible in the remote areas, since the opening of branch is based on financial viability. As an alternative, a small unit of such institutions may be appropriate for the subsistence economic activities. Due to economic power concentration and economic freedom in mobilizing and utilizing resources, Kathmandu valley, among other urban centers, is still the best choice of place for banks and financial institutions. Until and unless, economic decentralization takes place significantly outside Kathmandu, a regional policy-bias simply may not be effective for encouraging banks and financial institutions to be established. However, due to micro-finance nature, development banks and NGOs with micro-finance and financial cooperatives are concentred outside Kathmandu valley.

Equity Participation

In view to developing the domestic financial markets, NRB has been taking equity participation not only in the financial institutions but also in the research oriented non-financial institutions dates back to mid-1970s. The following table shows an instructive example of active participation of NRB in the share capital investment of various banks/financial/non-financial institutions. Since the NRB Act, 2002 does not permit the NRB to have an equity participation of more than 10.0 percent of the total equity of concerned institution, it is mandatory for the NRB to offload gradually such investment, at least, to the capped limit.

The NRB has already initiated to offload its share capital from the rural development bank(s) in a gradual process, which may apply to other institutions also to oblige the legal mandate.

Institutions	NRB's Investment (Rs in Million)	NRB's Investment as % of Total Share Capital
Agriculture Development Bank, Nepal	30.00	1.98
Nepal Industrial Development Corporation	47.45	11.41
NIDC mutual fund	10.30	-
NIDC debenture	50.00	-
Nepal Domestic and Small-scale Industrial Development Bank	16.00	18.18
Citizen Investment Trust	16.00	40.00
National Insurance Corporation -life insurance	0.80	29.30
National Insurance Corporation -non-life insurance	1.00	55.56
Deposit Insurance and Credit Guarantee Corporation	20.50	47.13
Nepal Stock Exchange Limited	12.08	34.61
Agriculture Project Services Centre	5.00	62.50
National Productivity and Economic Development Centre	2.50	31.65
Nepal Development Bank	16.00	11.11
Rural Microfinance Development Centre	21.05	26.31
Eastern Rural Development Bank	40.10	66.83
Central Rural Development Bank	37.90	63.17
Western Rural Development Bank	36.60	61.00
Mid-Western Rural Development Bank	44.40	74.00
Far-Western Rural Development Bank	40.10	68.55
Total	**447.78**	**--**

Ratio & share in %	Period average					
	1975-79	1980-84	1985-89	1990-94	1995-99	2000-05
M2/GDP ratio	17.7	26.1	27.7	32.3	39.6	52.9
Currency/M2 ratio	45.3	34.5	30.3	29.6	28.8	24.0
Money multiplier	2.1	2.4	2.5	2.5	2.6	3.0
Share in total banking assets	100.0	100.0	100.0	100.0	100.0	100.0
-NRB	51.6	45.4	45.9	44.6	37.0	30.9
-Commercial Banks	48.4	54.6	54.1	55.4	63.0	69.1

An efficient financial system facilitates economic growth through mobilization and efficient allocation of resources. The status of financial sector can be evaluated in terms of M_2 /GDP ratio, currency/ M_2 ratio, deposit/M_2 ratio, money multiplier, shares in total banking assets, etc.

M2/GDP Ratio

This ratio is the major indicator of financial deepening. A higher ratio indicates greater financial sector development. It implies that people prefer to hold monetary assets, if they feel more confident and convenient to hold such assets keeping in mind the sense of liquidity, risk, return, etc.

Looking at the growth trend of M2/GDP ratio, one can easily observe that the growth pattern is in favor of increasing financial deepening. It is however, over the time, the GDP growth rate itself was not so much encouraging compared to money supply growth, which ultimately helped maintain a higher ratio. Nonetheless, the level of M2/GDP ratio (52.9 percent) in Nepal is more or less at the same level with the average ratio of low income countries. The M2/GDP ratios during late 1990s were tentatively 58.0 percent in low income countries, 65.0 percent in middle income countries and 88.0 percent in high income countries.

Currency/M_2 Ratio

Currency ratio and deposit ratio explain the similar point but in opposite way. In other words, deposit ratio equals to 100 minus (-) currency ratio. Currency in circulation to M_2 ratio is an indicator reflecting the financial deepening and intermediation. A low currency ratio shows an active role of financial intermediaries on mobilization of financial resources in terms of time (saving and fixed) and demand deposits. As such, the currency ratio has significantly declined to 24.0 percent during period of 2000-05 from that of 45.3 percent in the period 1975-79 which showed some improvements.

Money Multiplier

It is an important indicator showing the strength of the central bank. The money multiplier reflects the responsiveness of money supply to the reserve money/monetary base. A smaller money multiplier indicates a less powerful central bank in terms of independence in conducting the monetary policy and vice-versa. A smaller money multiplier implies that a central bank is unable to bring a large change in money supply with a small change in the balance sheet of central bank known as reserve money. However, the money multiplier has slightly been improved during the referred period from 2.1 to 3.0. Such money multiplier on average was 4.0 in low income countries, 7.0 in middle income countries and 14.0 for high income countries during late 1990s.

Assets Structure

With respect to the question of productivity and profitability, it is but natural that central bank is not a profit making entity. The central bank's profit is something like the profit of a liquor store. In other words, if there are more weaknesses in the financial rector, the central bank could retain a higher profit, though it is not a healthy tradition. This is because, among others, if the government cannot reduce deficit financing depending on the internal banking sector borrowing and if the other banking sector than the central bank are declined to participate, it is easy for the central bank to make profit. However, such profit is a sign of weak financial system. Fortunately, NRB Act, 2002 has fixed the limit on the overdraft facility as well as the holdings of government securities. Similarly, the financial deepening is reflected by the share of central bank and other banks and financial institutions assets over the total financial sector assets. In the initial phase of financial sector development,

NRB had a dominating share of central bank assets over the total banking assets. Looking at the share of the NRB and commercial banks (excluding the other banks and financial institutions), there is a good indication that the share of the NRB has been declining and the share of commercial banks has been increasing over the time. Obviously, it is a signal towards a healthy development of banking sector as well as financial deepening.

Concluding Remarks

Some of the key macro-indicators, though improving slowly, have shown inefficient financial sector in Nepal reflecting a less effective and less independent central bank compared to developing countries in conducting monetary policy. The evidences are low M2/GDP ratio, high currency/ money (M2) ratio, low money multiplier, and high share of central bank assets over the total banking assets in comparison to the similarly placed economic group. For the betterment of the professional central banking, the accountability and responsibility of the supervisory authority should be made more transparent. Similarly, the measurement of monetary phenomenon related inflation should clearly be tied up with the core inflation so that monetary policy could take care. In other words, the overhead inflation is difficult to defend by monetary policy. The NRB should have a clear and prudential guiding and leading role for the growing financial sector in the days to come, which will facilitate it becoming more competitive.

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Legal Framework

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Introduction

Any corporate body has its fundamental, organizational and operational paradigm guided by a legal parameter to achieve its statutory objectives. Nepal Rastra Bank (NRB) has its own objectives and jurisdiction statutorily prescribed for its scope of operation. Despite the fact that Nepal has short history of banking development, the NRB has been functioning as an equipped, sound and modernized organization. However, the history of minted coin goes back to the period of Lichchhabi and Malla regimes which continued for a long period as monetary unit in the Kingdom in this or that form. The modern history of currency began with the establishment of the Mint Department in 1933 and it worked singly till it was supplemented through the issuance and circulation of the paper currency since 1945 with the establishment of the Treasury called Muluki-Khana which inherited another Government office called the Tejarath Adda that was established to lend money to the Government employees. The first commercial bank of Nepal, Nepal Bank Limited was established in 1937 for carrying out the commercial banking transactions and a central bank or monetary authority could be established only in 1956.

The above discussion outlines a long monetary history running without systematic and organizational development in Nepal. Nepal was far back both in conceptual and structural development of monetary and banking system. The need for the organized institutions for the overall development of the country was not really appreciated. Consequently, the country was suffering from enormous economic problems such that the banking transactions were quite limited, the economy was pre-dominantly non-monetized and Indian currency notes were widely circulated dominating the national economy. The need to monetize economy, to develop banking institutions and habit, and to mobilize capital for development activities was felt urgent along with the advent of the planned development in 1956. As a result, a central bank was felt needed to be set up to eliminate all the non-monetization well as other financial problems. Thus, Nepal Rastra Bank, the central bank of Nepal, was established in 1956 with the following objectives:

- To ensure proper management for the issuance of the Nepalese currency notes,
- To make proper arrangement for the circulation of the Nepalese currency throughout the Kingdom,
- To develop banking system,
- To stabilize exchange rate of the Nepalese currency, and
- To mobilize capital for development of trade and industry in the Kingdom.

The country put its pace ahead with the step of the promulgation of the law, Nepal Rastra Bank Act, 1955, which paved way for the establishment of apex monetary authority, the Nepal Rastra Bank. Since it was assigned above stated objectives, the role of the Bank was diversified into three primary sectors: currency issue and circulation, development of banking system and mobilization of capital for development. So, the Bank had to carry out both monetary and financial infrastructure development function of the Kingdom. The Act continued for a long run up to 2002, having been amended nine times.

The change in economic concept for open and liberal economy provided new dimension to the Nepalese banking and financial sector. The 1980's decade introduced three foreign joint ventures in banking organization and the 1990's decade came as the flourished age for the development of banking and financial institutions. This development and the huge amount of capital collected by these institutions in the form of public deposits pressurized the NRB to keep constant regulation and supervision for the stability of credible, sound and effective banking and financial system as well as for the protection of the interest and benefit of the depositors including other stakeholders in this sector. At the same time, the global economic moves and trends brought new kind of concept, roles and jurisdictions of central bank, which were not unnoticed in Nepal. The country thus adopted a welfare, liberal and equitable policy in the Article 25 of the Constitution of the Kingdom of Nepal, 1990 as follows:

- " (1) It shall be the chief objective of the State to promote conditions of welfare on the basis of the principles of an open society, by establishing a just system in all aspects of national life, including social, economic and political life, while at the same time protecting the lives, property and liberty of the people.
- (2) The fundamental economic objective of the State shall be to transform the national economy into an independent and self-reliant system by preventing the available means and resources of the country from being concentrated within a limited section of society, by making arrangements for the equitable distribution of economic gains on the basis of social justice, by making such provisions as will prevent economic exploitation of any class or individual, and by giving preferential treatment and encouragement to national enterprises, both private and public"

The Tenth Develop Plan of the nation has also mentioned : "Strengthening the financial system is of critical importance for private sector development, to ensure that national savings would be mobilized and intermediated at competitive interest rates to meet the private sector's financing needs, as its role in the economy progressively expands. Nepal's financial sector is in a critical stage. The main problems of the banking system are inefficiency, inadequate financial discipline, as well as political and other influences in lending decisions. These have resulted in poor loan quality, high spreads and high lending rates to borrowers, and increasing non-performing assets. To address these problems, a Financial Sector Strategy has been prepared and is being implemented. The reform agenda in the financial sector currently underway involves, among others, (i) restructuring and privatizing State-owned banks, (ii) improving auditing and accounting standards, (iii) strengthening monitoring and regulatory functions and capacity of the NRB, (iv) strengthening legislative and institutional framework for effective loan recovery, and (v) improving loan quality and banking discipline. The reform program in the non-banking sector is expected to include the restructuring of the two government-owned development banks, (Agricultural Development Bank and Nepal Industrial Development Bank), as well as ensuring healthy growth of the finance companies and the macro-finance sub-sector. They will be brought under a transparent and more accountable regulatory framework. And the Government will also reform the rural development banks with a view to minimizing its involvement in rural finance."

Besides this, the necessity was felt for the organizational autonomy and competence of a central bank under the then working Act. The dependency of the Board to the Government, director members (Deputy Governors) having no voting rights, lack of specific requirement for their eligibility and their tenure at the mercy appeared as obstacles for discharging their duty and assuring responsibility. The central bank had minimum focus on price stability and payment system. Having limited regulatory and remedial powers against banking and financial institutions was another hindrance observed during the period. The Act was also felt to be lacking major

principles of central banking organization and functions in comparison to the global environment and responsibilities assigned to such organizations. All these situations and problems high lighted the denial for a legally and structurally competent, sound and effective central bank, which could centralize itself on monetary policy and banking regulation for attaining price stability and maintaining public credibility sound and in tact. On the other hand, the achievement of all the objectives stipulated in the previous Act successfully pushed the nation to realize new jurisdictions and objectives of the NRB attuning to the global and domestic economic requirements.

All these factors played a vital role for the enactment of the new legal instrument. As a result, Nepal Rastra Bank Act, 2002 came as a land-marking legal instrument for the institutional autonomy and modernization of the central bank, clearly specifying the bank's objectives, its competent jurisdictions and autonomy. It has been welcomed as a great starting point of a new age in the history of banking and financial sector in Nepal. The new Act has adopted basic principles of autonomy and good governance in mandatory form, which have been discussed in respective topics of the paper. Likewise, the Banks and Financial Institutions Ordinance which was promulgated in 2004 by replacing major five Acts operating in the banking and financial sectors has brought other innovative changes in that sector. The Ordinance has introduced new grading and rating system of banking and financial institution in accordance with the capital and performance as well as having equipped the NRB with exclusive regulatory and supervisory powers. Consequently, the NRB is no more a passive, dependent organization carrying out orders but an apex monetary and regulatory authority having the role of a responsible coordinator, regulator and the best councillor and facilitator for the development of the banking and financial system. The Act has manifested the spirit of the Constitution, Tenth Plan policy and overall banking and financial requirements.

Organizational Framework and Good Governance

The organization of any corporate body must suit its objectives and functions. The nature, composition and formation of such organization outlines its competency in jurisdiction and operation. An independent and competent structure of any organization is the basic requirement for ensuring its success with good corporate governance. Nepal Rastra Bank Act, 2002 has, in this regard, laid down basic legal and operational propositions for the Bank to run it as an autonomous and independent organization. This can be visualised in the provision of the formation of the Board and its functional capacity. The Board of Directors is formed of seven dignitaries consisting of the Governor, two Deputy Governors, Secretary of Ministry of Finance and three directors as experts compulsorily fulfilling the required educational and experience eligibility criteria as mentioned below:

"20. *Qualifications of Directors:* In order to be appointed to the post of Governor, Deputy Governor and Directors, a person shall have to meet the following qualifications:

(a) A Nepalese citizen;
(b) Having higher moral character;
(c) Having working experience in economic, monetary, banking, financial and commercial law sectors after having attained at least master's degree in economics, money, banking, finance, commerce, management, public administration, statistics, mathematics and law.
(d) Not disqualified under section 21.

21. *Disqualification of Directors:* None of the following persons shall be eligible for appointment to the Office of the Governor, Deputy Governor and Director:

(a) Member or official of a political party, or
(b) The person blacklisted in relation to transaction with a commercial bank or financial institution, or
(c) An official currently engaged in any commercial bank or financial institution, or
(d) A person having five percent or more shares or voting right in a commercial bank or financial institution, or
(e) A person rendered bankrupt for being unable to pay debts to creditors, or
(f) A lunatic person, or
(g) A person convicted by a court in an offence involving moral turpitude."

These provisions have restricted the possibility of the appointment of those who are not professionals and inexperienced. Specific educational qualification, experience, renownedness, area division for appointment and conflict of interest factors have

guaranteed that the Bank will be run by trusted and qualified personalities. Similarly, appointment of Governor, from among the three dignified personalities recommended by the committee formed under the chairmanship of Finance Minister including one former Governor and another renowned expert, before a month of the expiry of the term of the incumbent; disqualifying people from occupying any post in the Board who have significant interest in commercial banks or financial institutions or one who is blacklisted or insolvent; inclusion of majority of outside independent experts as directors in the Board for the first time in the history of the Nepalese public organization, and guarantee of their term unless specifically charged with justifiable inquiry have historically ensured the Board its autonomy, competency and responsibility towards the Bank. Establishment of the Board as an ultimate apex body providing leadership through strategic guidance, control, regulation and monitoring has further strengthened the Bank's independent functionalism. The Board of the Bank has been charged with maximum duties and powers and, at the same time, the individual and collective responsibility and accountability of directors has been enforced statutorily. This provision has opened way for maximum exercise and exploitation of expertise, skill and education of the directors to the benefit of the Bank.

Another aspect of good governance has been clearly vested in the section 27 of the Act that says "His Majesty's Government shall depute the Senior Deputy Governor of the Bank as Acting Governor to discharge the functions of the Governor in cases where the Governor dies or resigns from office, falls sick, goes on leave or is unable to discharge his duties due to any reason." This provision has visualised that the post of the Governor is the most responsible and acting on the post can not be made in the absence of the Governor in person rather only in the absence of the incumbent.

The NRB, unlike in the past, has been empowered to operate within the scope of its objectives and jurisdiction without any interference. The Board of Directors is free to play its faculty, expertise and horizon for the achievement of the objectives of the Act. The Board is required to be totally responsible, accountable and transparent in the exercise of its powers within jurisdiction strictly following the principles of good governance. The Bank is responsible itself to all of its activities, where it can neither escape transferring its responsibilities nor be forced for any action against its spirit. The relation with the Government is another epoch-making development in the Act. The Government and the Bank will be working together without any pressure to one another for the common objective of overall economic development of the country. Its autonomic jurisdiction can be best exemplified in the section 75 of the Act that contains statutory limit of credit to be forwarded to the Government, as follows:

"(1) Except otherwise provided in this Act, the Bank shall not provide any type of financial assistance to His Majesty's Government or an institution under the full or substantial or partial ownership of His Majesty's Government.

(2) Subject to the limits specified in this section, the Bank may extend credit to His Majesty's Government with a condition to repay within one hundred eighty days.

(5) At no time the amount of overdraft provided by the Bank to His Majesty's Government shall be more than five percent of the revenue income of His Majesty's Government in the preceding fiscal year. While computing such revenue income, the amount of borrowing, grants or any other form of financial assistance or income received from the sale of property shall not be included while computing the revenue income".

The good governance and accountability mechanism can also be found in the mandatory formation of Audit committee with specified duties such as,

(a) To submit its report and recommendations to the Board on accounts, budget and auditing procedures and control system of the Bank;

(b) To ascertain whether or not the auditing and preparation of periodic balance sheet and other documents of the Bank have been carried out properly;

(c) To supervise the implementation of the appropriate risk management adopted by the Bank;

(d) To audit managerial and performance work of the Bank in order to be assured that the prevailing laws applicable to the Bank have been fully complied with;

(e) To frame by-law for auditing of the Bank in accordance with the prevailing laws and international auditing standard and to submit it to the Board for approval, upon the convenorship of a board member; mandatory provision for maintaining professional ethics and honesty, code of conduct, official responsibility, confidentiality and prior disclosure of interest are other good governance principles included in the Act. The statutory division of jurisdiction between the Board and the Governor is another significant point of good governance which has not only controlled any type of possible dispute but also made it easier to evaluate both the organs by their functions.

Functional Framework and Good Governance

NRB has a glorious history of successfully achieving its objectives set in its establishing Act. The use of dual currencies is presently insignificant, the economy has been greatly monetized; the domestic banking system and institutions have developed to the satisfying level for the country; capital collection and mobilization has become a normal task and the banking has become an usual experience at any part of the Kingdom. The primary objects set in the previous Act have now turned to be traditional functions. Realising this fact, the new Act has assigned other challenging objectives matching the national and international economic environment and modernized functions. Hence, this part of the paper will deal with the objectives and functions of the Bank with a reference to the principles of good governance.

The section- 4 of the prevailing Act specifies Bank's objectives as follows:

(a) To formulate necessary monetary and foreign exchange policies in order to maintain the stability of price and balance of payment for sustainable development of economy, and manage it;
(b) To promote stability and liquidity required in the banking and financial sector;
(c) To develop a secure, healthy and efficient system of payment;
(d) To regulate, inspect, supervise and monitor the banking and financial system; and
(e) To promote entire banking and financial system of the Kingdom of Nepal and to enhance its public credibility of the system.

Similarly, the functions of the bank have been outlined distinct by in the Act as follows:

(a) To issue bank notes and coins;
(b) To formulate necessary monetary policies in order to maintain price stability and to implement or cause to implement them;
(c) To formulate foreign exchange policies and to implement or cause to implement them;
(d) To determine the system of foreign exchange rate;
(e) To manage and operate foreign exchange reserve;
(f) To issue license to commercial banks and financial institutions to carry on banking and financial business, and to regulate, inspect, supervise and monitor such transactions;
(g) To act as a banker, advisor and financial agent of His Majesty's Government;
(h) To act as the banker of commercial banks and financial institutions and to function as the lender of the last resort;
(i) To establish and promote the system of payment, clearing and settlement and to regulate these activities; and
(j) To implement or cause to implement any other necessary functions which the Bank needs to do to carry out in order to achieve the objectives of the Bank under the Act.

The Act provides exclusive powers in relation to the monetary policies of the Kingdom of Nepal. It has full powers to formulate, implement and cause to implement monetary policy; it can operate open market transaction; it can issue directives to the commercial banks and financial institutions to maintain compulsory reserve with the Bank in proportion to the deposits accumulated with them, borrowed fund or other liabilities; and conduct discount transactions, make available loan and refinance to commercial banks and financial institutions at discount rate including arrangement of payment system. The Bank has power to issue currency in the form of legal tender.

The Bank can exercise sole powers to formulate and implement foreign exchange policy of the Kingdom of Nepal and its authority to purchase and sell foreign exchanges, gold and precious metals through the means such as spot and forward exchange rate, swap, option or other similar types of instruments, in addition to its capacity to mobilize foreign exchanges reserve and issue debt bond against gold or foreign currency with the approval

of the Government. Similarly, the Bank regulates foreign exchange by issuing license to deal in foreign exchange transactions, framing rules and by-laws, necessary order and directives, prescribing system of determining the foreign exchange rates of the Nepalese currency and conditions of transactions including inspection and supervision.

The Bank is to responsible to the Government as the banker, financial advisor and its agent. It is the Bank's duty to advise the Government on consulted matters such as economic and financial matters, policies, overdrafts, internal debt, external debts and related law reforms. The Bank can submit proposals to the Government for enacting new law or amending the existing laws on the subjects relating to the objectives of the Bank or in areas of its jurisdiction or its competence. The Bank has limitations in the provision of any type of financial assistance to the Government or its institutions. It can only extend statutorily specified credit with a condition to repay within one hundred eighty days only in Nepalese currency against negotiable debt securities and a special long term credit on only upon the account of subscription and similar payments resulting from or incidental to the membership of the Kingdom of Nepal with international organisation. Similarly, the amount of overdraft provided by the Bank to the Government can not exceed more than five percent of the revenue income in the preceding fiscal year.

Another sector the Bank exercises its sole power is regulation and inspection of commercial banks and financial institutions. Any person, firm, company or institution requires compulsory approval and license from the Bank in order to accept any type of deposit or to provide loan or to conduct banking transactions. The Bank has powers to grade, upgrade or degrade or fix the functions of any commercial bank or financial institution upon the criteria fixed for the purpose. It has sole power to regulate the functions and activities of commercial banks and financial institutions. It can frame rules and byelaws and issue necessary orders, directives and circulars as mandatory norms to the concerned commercial bank and financial institution in relation to banking and financial system, currency and credit. It can similarly issue directives to the commercial banks and financial institutions on its account system, credit and investment, risk management, corporate good governance, credit to prescribed sector, transparent information system and other related matters.

The Bank has full powers for licensing, supervising and regulating commercial banks and financial institutions. Inspection and supervision is a fundamental part of the banking regulation to check the soundness and productivity of the commercial banks and financial institutions. Such functions are carried out in accordance with international standards basically following the BASEL principles for supervision and principles of corporate governance. The negative findings of the inspection can result in corporate or personal penalty in accordance with the volume and degree of the offence. The Bank also has authority to take control of commercial banks and financial institutions, to declare them problematic institution, to order reformation programme, to suspend or dismiss the Board, to remove the directors or official, to prevent some or all businesses, order to divest or liquidate, or if the Bank finds situation improving, revive the commercial bank or financial institution to previous position.

The regulatory and supervisory powers to the Bank has been widened recently by the amendment in the NRB Act by ordinance. It has entrusted following powers over the Bank:

- to declare any commercial bank or financial institutions as problematic one
- to require to frame new capital structure
- to require to frame new corporate structure
- to require to frame new operational structure
- to require to frame new management structure
- to require to divest shareholdings and alter the rights of shareholders
- to require to manage limits to benefits and interests
- to control the management
- to initiate reformative efforts and actions
- to appeal for liquidation
- to require to transfer the assets or liabilities to other institution, etc.

All these jobs are carried out considering the best interest of the depositors, creditors, shareholders and people in general. It is mandatory that all the rules, regulations, by-laws and directives pronounced by the Bank, are publicly disclosed. Such legal attempts are made following the principles of respect to the rights of stakeholders, interest of depositors, equal treatment of shareholders, fair and transparent

internal governance and financial discipline to be followed by the financial corporate bodies.

Similarly, establishment of Information Network and Information Centre which facilitate an integrated exchange of the flow of information in regard to the credit flows from commercial banks and financial institutions containing the information of the name-list of the bad debtors and black listed help in ensuring fairness and appropriateness of credit flow, credit policies and required reforms to promote banking and financial system of the Kingdom of Nepal. The NRB authority is likewise empowered to exchange co-operation and information with concerned foreign supervisory authority on reciprocal basis for further development and stability of financial system there are other contributing factors to the soundness of the Bank's activities and its effort to maintain and develop effective and healthy banking and financial system.

The internal administration and governance of the NRB requires to be sound, fair and transparent. It should be based on good administrative norms, financial disciplines and disclosure. The NRB, should be strictly limited to the laws and provisions prescribed by the laws. The Bank should maintain its accounts and records adequately, reflecting its operations and financial condition in accordance with international accounting standards. It is also statutorily required to prepare for each fiscal year annual report including its balance sheet, profit and loss accounts and other related particulars and submit to His Majesty's Government that report including auditing report, report on its activities and report on economic and financial position of the Bank within prescribed time of four months from the date of the completion of each fiscal year. The Bank is also required to publish report on monetary policy each year for the information of general public incorporating the following information:

(a) Comprehensive review and evaluation of the monetary policy introduced and followed by the Bank in the preceding year;
(b) Justification and analysis of the monetary policy that the Bank is going to introduce in the following year.

It is also the Bank's duty to submit the following reports to His Majesty's Government within four months from the date of completion of each fiscal year:

(a) Auditing Report,
(b) Report on activities of itself,
(c) Report on economic and financial position,

Another feature of good internal governance is the introduction of auditing system including financial, managerial and performance audit at internal, external and international levels in accordance with the account system of international practice with a standing Audit Committee with jurisdiction to regularly evaluate, assess and apprise the existing auditing system, procedures and outcomes for further policy, performance and action recommendations. The Management Committee under the Board to be chaired by the Governor including two Deputy Governors and one senior officer is entrusted with the duty of evaluating the country's monetary and financial condition on a periodic basis including the Bank's administration and operation, operation of monetary and other regulated policies, the soundness of the banking system of the country, condition of money, capital and foreign exchange market, implementation of such policies and impact they may have and situation on the banking system, and on other significant business of the Bank; events that have contributed to conduct the overall business of the Bank in a smooth and systematic manner.

Legislative and Adjudicative Framework

NRB is empowered to exercise delegated powers to legislate various rules, by-laws, directives and guidelines subject to the NRB Act and BFI Ordinance. These legislative powers have widened the scope of NRB's authority, jurisdiction and national trust over the Bank. The Act has stipulated the Bank's powers to frame the following legal and other matters as legal instruments in additions to the jurisdictions mentioned above:

"*110. Power to Frame Rules and Bye-laws:* (1) In order to implement the objectives of this Act, the Bank shall, having obtained approval of His Majesty's Government, frame necessary Rules on the following matters: (a) Foreign Exchange Transaction; (b) Refund of the burnt, torn, defaced or mutilated bank notes and coins; (c) Transaction of business between His Majesty's Government and the Bank;

(2) In order to implement the objectives of this Act, the Board may frame bye-laws on the following matters: (a) The venue and time of the meeting of the Board and procedures relating thereto, (b) Formation of sub-committees by the Board as

per necessity and procedures of such sub-committees, (c) Appointment, promotion, transfer, dismissal, remuneration and facilities, pension, gratuity, provident fund, leave, conduct and discipline and terms and conditions of service, of the employees of the Bank, (d) Delegation of authority by the Board to the Governor, by the Governor to the Deputy Governor or other employees of the Bank, (e) The terms and conditions for the lease, agreements to be concluded on behalf of the Bank, (f) The use of the seal of the Bank, (g) The accounts, ledger, registrars, books and other record and documents to be maintained by the Bank and the format thereof, (h) Internal auditing and inspection of the Bank, (i) Supervision of commercial banks and financial institution, (j) The particulars to be submitted by commercial banks and financial institutions, (k) Cash deposit of the Bank or responsibility of the cash, (l) The case to be filed on behalf of the Bank or operation of other transaction of business, (m) Credit control, (n) The Bank's system of expenditure,

(3) Except the subject matters referred to in sub-sections (1) and (2), the Governor shall issue the order, direction, procedures and guidelines to be issued under this Act.

111. Guidelines to be Framed and Introduced: The Bank may, in order to fulfil the objectives of the Act, frame and introduce necessary guidelines from time to time subject to this Act, or Regulations or bye-laws framed under this Act."

Similarly transparent rules, apparent mode of behaviour and procedural fairness are to be justifiability proved before the exercise for the enactment of any of above mentioned delegated powers. This has surely contributed to the development of a system desired by the Act, whereas the NRB was mostly working as a recommendatory authority under the previous Act.

The Act has expected full obedience towards the bank and banking system. It has covered overall aspects of banking behaviour and banking disciplines which are categorised into professional discipline, corporate discipline, financial discipline, regulatory discipline and operational discipline. Deviation from such prescribed disciplines is regarded to be violation of norms resulting in the corrective and penal actions either in economic and professional penalties or in judicial action. Whoever accepts deposits or gives credits or issues debenture or other financial instruments in contravention to this Act or the Rules or bye-law framed there under or an order or directive issued there under; or whoever charges or gives interest against the policy determined by the Bank or issues fake, fraudulent, counterfeit or duplicate or copied currency or distributes or circulates such currency or carry out the business of foreign exchange or is involved in such acts, it shall be deemed to have committed offences under this Act.

The Bank is entrusted power to impose fine and punishment over individual portfolio-holders in the cases of violation of Bank's regulation to the violating Director, official or employee ranging from written reprimand to dismissal from the service. Such action should be only the corrective reaction against the violation of order or directive issued by the NRB under this Act or under the regulation or bye-law or action against the interest of the depositor or general public or against failure to submit the documents, particulars, required data. Such action of the NRB is to be based up on the recognized principles of justice providing due regard to nature of the offence, amount of fine or proposed punishment that may be imposed on the basis of nature of offence, and summary of the facts related to the offence with pre information to the charged.

The penal initiatives and actions can appear in both corporate and/or individual level. The corporate actions covers corporate penalties including from corporate charges, economic penalties, restriction on business, functional limitations, prohibition and restriction on the distribution of benefit, control over management, declaration of problematic institution, structural reformation, amalgamation, liquidation to ssuspension and revoking of license provided for banking and financial transactions. The Bank has power to take disobedient institution under its control after suspending the Board if reliable source makes the Bank convinced about grave violated of the Act or Rules and Bye-laws framed thereunder or orders or directives issued thereunder and at the same time if it was found that they have failed to honour their liability or there are probabilities of such failure or it has not been properly operated or have acted prejudicial to the interests of shareholders or depositors from the Bank's inspection and supervision report.

All these functions are to be carried out with prescribed guidelines, rules and norms guarantying fairness, transparency and international practices. The NRB is required to publish audited accounts annually of the commercial bank or financial institution of which it has controlled the management either itself or by other means. The NRB is equally required to be responsible in its functions, duties and exercise of penal actions. But it does not mean that the entrusted goes also to unfairly, untimely and undue interference over the corporate and commercial activities and transactions of the commercial banks and financial institutions. The NRB has to be a watch dog guarding, protecting, caring and nurturing the banking and financial sector being responsible and accountable.

The offences stipulated by section 95 of the NRB Act will be filed to court by His Majesty's Government as plaintiff up on the information of the Bank. The court has judicial power to impose both criminal and/or civil punishment for the offenders according to his nature and degree of crime committed. The Act has stressed good governance by providing statutory opportunity to the commercial bank or financial institution or the Director or official or employee not satisfied with the punishment imposed by the Bank under sections 99 and 100 to file an appeal at the Appellate Court within thirty five days from the date of punishment. However, anyone charged with violation of banking laws will be sure to have opportunity to give clearance before deciding any action against them or giving punishment. Another important fact in this regard is that the Government will be plaintiff in major offences and the punishment can be both civil and criminal in accordance with the nature of offence.

Conclusion

The Bank's autonomy, its delegated legislative authority, policy making and regulatory power and internal governance is to be exercised being based on the norms, values and principles of good governance and procedural justice including consistency, fair treatment, financial discipline, professional ethics and disclosure philosophy. The discussion makes it clear that the NRB is to satisfy the following institutions in the exercise of its jurisdictions and powers:

- Responsibility and accountability to the Court
- Responsibility and accountability to the Government
- Responsibility and accountability to the Parliament
- Responsibility and accountability to the People or Disclosure
- Responsibility and accountability to the Laws
- Responsibility and accountability to the International Sector

Failure in its role to the satisfaction of the authorities and people may result in financial and economic impasse in the respective systems of the Kingdom. Therefore, due exercise of these autonomy and powers provided to the Bank with consideration is sure to provide us a new scope and dimension to the achievement of Act's objectives promising and contributing both to the sustainable development and bright future of the Nepalese banking and financial system.

Financial System and Economic Development

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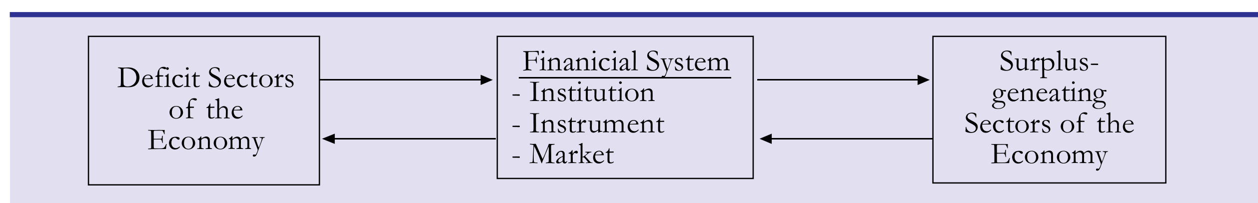
Introduction

The existence of banks and other non-bank financial institutions in a formal and organized way is collectively known as the financial system of a country. Financial system can be grouped into banking and non-banking financial institutions. The banking system is made up of commercial banks and investment banks. Commercial banks are primarily in the business of accepting deposits and extending credits. The non-banking financial institutions comprise of development banks, finance companies, saving and credit unions, building societies, discount houses, leasing companies, mortgaged companies, insurance companies, pension funds and provident funds. Few of these non-bank financial institutions are also engaged in the business of accepting deposits from the general public. However, the central authority can impose certain restrictions on accepting deposits by these institutions. Only commercial banks are authorized to conduct full-fledged banking services. The other non-bank financial institutions can operate conditional or limited banking services, which may vary from country to country. Some other non-bank financial institutions such as insurance companies, pension and provident funds are, sometimes, categorized as contractual saving institutions and they mobilize savings on contractual basis.

Financial institutions, financial instruments and financial markets are the three interrelated aspects of the overall financial system. A wide variety of financial institutions may exist in the financial market. Each market serves a different set of customers or deals with a different type of security. All these financial institutions collectively build-up the financial market. A financial market is a place where all financial securities or instruments and financial services are transacted or exchanged and serviced. Financial institutions help to mobilize savings by issuing liabilities in form of different types of financial instruments. People and organizations

Figure 1

The Process of Financial Intermediation



wanting to borrow money are brought together with those having surplus funds in the financial market.

Transfers of capital between savers and those who need financial resources take place in different ways: direct transfer, indirect transfer through investment banks and indirect transfer through financial intermediaries. Financial market can be further divided into money market and capital market on the basis of the nature of the instrument dealt in the market. Money market basically involves the trading of short-term securities with maturity period of one year or less. Capital market is the market for long-term debt and corporate stocks. Capital market can also be classified as primary market and secondary market. Newly issued securities are traded in primary market whereas secondary market facilitates the trading of existing securities in the market.

It is well known that an improved financial system can foster the efficient allocation of financial resources to their optimum uses. Among the economic problems experienced by the developing countries, lack of access to financial resources is the major one. Financial system plays vital role in meeting financial needs of productive units through generating saving from the surplus-generating units of the economy. A formal financial intermediary can be more efficient in allocating financial resources in productive ways. It is, therefore, argued that an effective and efficient financial system is more important for the nation's economic development process. However, the levels of financial and economic development are not easily measurable and the link between the two may not be always easy to establish. A number of indicators or proxies have been introduced to link financial development with growth. Narrow money (M_1) to GDP ratio, broad money (M_2) to GDP ratio, bank credit and credit to private sector are some of the widely used financial deepening indicators, which can be used to measure their effects on economic development as measured by growth indicators such as GDP, GNP and per capita income. A strong correlation between these indicators can imply that the development of financial sector leads to economic development. To arrive at this conclusion and to highlight the areas of additional research, this paper aims at addressing the effects of financial development on economic growth in the Nepalese context.

The rest of the paper is organized as follows. Section II contains a brief literature review on the empirical work undertaken on the financial liberalization, financial deepening and the importance of financial system to economic growth. Section III advocates on the core subject matter of the Nepalese financial system with decisions, developments and current situations. Sections IV and V contain comprehensive analysis, interpretations, outcomes and impacts based on sample data used in the study and the statistical results. Sections VI, VII and VII of this paper deal with problems and challenges, corrective actions, policy options and future agenda. Finally, section IX offers some conclusions.

Relevance and Importance: Review of Literature

The role of financial system is considered to be the key to economic growth. A well-developed financial system promotes investment by identifying and financing lucrative business opportunities, mobilizing savings, efficiently allocating resources, helping diversify risks and facilitating the exchange of goods and services. Economists have generally reached a consensus on the central role of financial system in economic development. The theoretical argument is that policies to develop the financial system are expected to raise economic growth and, therefore, more developed countries have more developed financial systems. Government-imposed restrictions and policies hinder financial development and ultimately reduce economic growth. In developing countries, examples of these restrictions and policies include interest rate ceilings, high reserve requirements, directed credit programs, credit rationing and high inflation taxation. These conditions are collectively referred to as financial repression and such policies undermine economic growth. Encouraging competition within the system, developing a strong and transparent institutional and legal framework for financial system services, establishing a prudent regulatory and supervisory mechanism and ensuring strong creditor rights and contract enforcement are some of the key factors that lead to build-up a sound financial system in the country. Therefore, it is argued that countries should adopt appropriate macroeconomic policies, which are critical for the growth and development of the financial system.

Most of the countries in the world have started to liberalize their financial sectors since the last quarter of the twentieth century. Macroeconomic policies

were then directed toward ensuring more liberalized financial systems. Therefore, financial sector reform was considered to be one of the principal agendas for the policymakers. A number of studies have examined the consequences of financial sector liberalization, but the causes of financial liberalization have received less attention. In examining the causes of financial liberalization, Abiad and Mody (2003) identify three sources of reforms: shock; learning; and ideology and structure. Shock changes the balance of decision-making power and an immediate change in the policies may be required. Learning, a process of making further reforms more probable, allows for sustained changes in the system. Ideology and structure considerations may include political orientation, forms of government, rules, legal system and the country's degree of openness to international capital and trade. Financial sector liberalization is a gradual process and more liberalized financial systems require better tools and techniques to assess financial system's strengths and vulnerabilities. The international financial turmoil of the second half of the 1990s has further highlighted the importance of continuous monitoring of financial systems.

A growing body of literature has affirmed the importance of financial system to economic growth. A number of studies have shown that countries with higher levels of financial development grow faster than those with lagging financial systems. However, the level of financial development is not easily measurable. Studies attempting to link financial deepening with growth have chosen a number of proxies. Different indicators will proxy different aspects of financial system. In some earlier studies, indices such as ratio of financial institutions assets to GDP and rural population per rural bank branch were used in measuring the level of financial development. Initially, the indicators were based on monetary aggregates. However, monetary aggregates are more related to the ability of the financial system to provide transaction services than to the ability to channel funds from savers to borrowers. Researchers have shifted from narrow money measures (M_1) to broad money measures (M_2 or M_3), which are generally referred to as liquid liabilities of the banking system. However, a higher ratio of broad money to GDP is associated with greater financial liquidity and such ratio will decline as the financial system develops. People have more alternatives to invest in longer-term financial instruments. More recently credit to private sector has been favored as an alternative measure of financial intermediation. However, it only reflects developments in the banking systems and, therefore, is considered as a partial indicator of financial development. As industrialized countries experience significant non-bank financial development, stock and bond markets indicators are also considered in measuring the level of financial development. Some other studies used combined measures of market structure, financial products, financial liberalization, institutional environment, financial openness and monetary policy instruments, which provide a richer description of financial development.

Traditional measures of financial development such as the level of real interest rates and the ratio of broad money to GDP overlook important factors such as the openness of the country to capital flows, the extent of public borrowing from the domestic financial system, the development of non-bank financial intermediation and the competitiveness of the banking sector. King and Levine (1993a) relate GDP per capita growth to nine different indices of financial deepening: narrow money to GDP, broad money to GDP, quasi money to GDP, central bank domestic credit to GDP, commercial bank domestic credit to GDP, gross claims on the private sector to GDP, commercial bank domestic credit to total domestic credit, claims on non-financial private sector to total domestic credit and claims on the private sector by non-deposit money banks to GDP. King and Levine (1993b) also use four measures of financial development indicators. The first measure, DEPTH, measures the size of financial intermediaries and equals liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and non-bank financial Intermediaries) divided by GDP. The second measure of financial development, BANK measures the degree to which the central bank versus commercial banks are allocating credit. Bank equals to the ratio of bank credit divided by bank credit plus central bank domestic credit. PRIVATE, the third measure of financial development, equals the ratio of credit allocated to private enterprises to total domestic credit. The fourth measure, PRIVY equals credit to private enterprises divided by GDP. They find that there is a strong positive relationship

between each of the four financial indicators and the three growth indicators (long-run real per capita growth rates, capital accumulation and productivity growth). There is a statistically significant and economically large empirical relationship between the level of financial development and future growth indicators. Insufficient financial development has sometimes created a "poverty trap" and thus become a severe obstacle to growth even when a country established other conditions. Levine et al. (1999) improve upon past measures of financial development and they construct three indicators: LIQUID LIABILITIES, COMMERCIAL-CENTRAL BANK and PRIVATE CREDIT. The first two measures LIQUID LIABILITIES and COMMERCIAL-CENTRAL BANK are respectively the same as DEPTH and BANK proposed in the previous research works. PRIVATE CREDIT, the third measure of financial intermediary development, is somewhat different from PRIVATE and it excludes credits issued by the central bank. PRIVATE CREDIT equals to the value of credits by financial intermediaries to the private sector divided by GDP and this is their preferred measure. Johnston and Pazarbasioglu (1995) use a combination of three variables to reflect the different aspects of financial development: the interest cost of capital (real interest rate), the volume of intermediation (the ratios of credit to private sector to GDP and of broad money to GDP) and financial sector efficiency (gross spread between the average lending and deposit rates and the ratio of base money to deposits.) Pill and Pradhan (1995) look into four indicators of financial development: broad money, base money, bank credit to the private sector and real interest rates. They identify three stages of financial development: financially repressed economy, domestically liberalized economy and internationally liberalized economy. They conclude that credit to the private sector is the most appropriate financial deepening indicator that can be expected to be directly correlated with financial development. Some authors also argue that banks and markets provide complementary financial services to the economy and they suggest that establishing a legal environment that credibly protects the right of investors is much more important.

A comprehensive index of financial development is proposed by Gelbard and Leite (1999). They suggest that a thorough assessment of financial system should consider at least six areas: the market structure and competitiveness of the system, the availability of financial products, the degree of financial liberalization, the institutional environment under which the system operates, the degree of integration with foreign financial markets (financial openness) and the degree of sophistication of the instruments of monetary policy. They measure all the indices on a scale basis and countries have been grouped into four broad categories: underdeveloped, minimally developed, somewhat developed and largely developed. The conclusion is that the higher the value of the index, the higher is the degree of financial development and both the level and the change in financial development have an effect on per capita GDP growth. Khan and Senhadji (2000) suggest that financial depth is measured by four alternative indicators: domestic credit to the private sector as a share of GDP (fd_1), fd_1 plus the stock market capitalization as a share of GDP (fd_2), fd_2 plus the private and public bond market capitalization as a share of GDP (fd_3) and stock market capitalization (stock). They examine the empirical evidence on the relationship between financial development and economic growth. Their results confirm the strong positive and statistically significant relationship between financial depth and growth. However, they also suggest a number of areas for future research, which include the choice of extensive indicators of financial depth, the use of an appropriate estimation method to establish the relationship between financial depth and growth, legal and regulatory reform measures and inter-linkage between domestic and international financial markets. Creane et al. (2003) suggest six themes, each of which reflects a different facet of financial development: development of the monetary sector and monetary policy; banking sector size; structure and efficiency; quality of banking regulations and supervision; development of the non-banking financial sector; financial openness; and the institutional environment. Based on the comprehensive index, they group the level of financial development into three categories: high, medium and low. They conclude that countries with high levels of financial development tend to have: a greater use of indirect monetary policy instruments, a smaller degree of public ownership of financial institution, smaller or no monetary financing of the fiscal deficit, stronger prudential

regulation and supervision, higher quality of human resources and stronger legal environment.

It is generally agreed that the development of financial system is a critical path of the growth process and it is also a good predictor of future growth. Financial structure, the mix of financial instruments markets and institutions, arises to mitigate the effects of information and transaction costs and thereby increases saving mobilization rates. In organizing the functions of financial system, Levine (1997) summarizes the primary functions into five broad areas: to facilitate the trading, hedging, diversifying and pooling of risk; to allocate resources; to monitor managers and exert corporate controls; to mobilize savings; and to facilitate the exchange of goods and services. He proposes the following theoretical approach to finance and growth.

Figure 2
The Approach to Finance and Growth

The figure sketched above shows that the emergence of financial markets arises due to the costs involved in acquiring information and making transactions. Different types and combinations of information and transaction costs are ameliorated by financial system. A particular friction motivates the need of distinct financial contract, market or institution. Financial institutions and intermediaries perform certain financial functions, which ultimately affect economic growth through two different channels. In the capital accumulation channel, the financial system affects capital formation either by altering saving rates or by reallocating savings among different capital producing technologies. Technological innovation, the second class of growth channel, focuses on the invention of new production processes in which financial system affects growth by altering the rate of technological innovation. Therefore, a particular market friction in the economy is the starting point that drives the need for a financial system. The financial system comprising of financial institutions and intermediaries performs certain financial functions to have desired affects on savings and allocation decisions and such decisions influence economic growth through different channels.

To sum up, the findings of these empirical researches works on financial system and economic development, it can be revealed that the development of financial system is possible in a more liberalized and market-oriented environment. Different issues and challenges associated with the system may drive the need for liberalizing the financial sector. These issues and challenges may be country-specific in nature and the pace of financial liberalization may differ from country to country depending on the degree of openness of the economy, legal framework and political stability. Economists have proposed a number of indicators and proxies to measure the level of financial development. These indicators may not be equally important to all the economies. Advanced economies have evolved a variety of financial markets in addition to having well-developed banking sectors and commercial banks in these countries are forced to compete with other financial institutions such as security markets, foreign exchange mortgage and leasing companies, insurance companies, pension funds and many others. The case of developing countries may be quite different from that of the advanced countries and the choice of financial deepening indicators depends on market structure, institutional environment and financial openness. To promote growth in the economy an efficient and well-functioning financial system is equally important and the efficiency of the financial system can be increased by increasing the depth and breadth of financial markets and by reducing the sensitivity of the financial system to adverse shocks.

A priori in this regard is that the development of financial system leads to economic development in one way or other way around.

Financial System: The Nepalese Context

The Need for Reform in the Financial Sector

The ultimate objective of economic policies is to achieve high and sustained economic growth. Economic policies or systems differ in the ways in which decisions are taken. In a planned or command economy all the economic decisions are taken by the central authorities. By the end of the 1980s, planned economies were proved to be unable to raise living standards of the people. The failure of planned economies (the Soviet Union, Central and Eastern European Countries) suggests that market oriented economies are superior to command economies because they provide a better and more flexible device for coordinating economic decisions. The command economies are usually associated with socialist or communist economic systems and these economies have moved from central planning to more competitive and market oriented economic policies. In a market economy, the individuals take the major economic decisions and there is no government intervention. The allocation of resources is the outcome of independent decisions made by consumers and producers acting through the medium of markets. Markets achieve maximum efficiency in the allocation of scare resources. The government initiates the policies to encourage private sector investment in promoting economic actives. The market mechanism dictates the decisions related to production, distribution, consumption and price. The government's role in the economy is to create an environment conducive to the private sector investment. Markets are highly competitive and no one has vested power to dictate the market. The increasing level of competition improves both the quality and the price of goods and services. Consumers and individuals have a number of alternative choices. The economy is supposed to respond quickly to changing demand and supply conditions. Efficient investors can absorb substantial share in the total market and those who are unable to compete are forced to exit the market.

Most of the countries around the globe have realized the need for initiating market-based economic policies for the better functioning of the economy. The advantages associated with liberal and market-led economic policies have forced the policy-makers to replace or revise the traditional way of commanding the economy by the central authority, usually the government. Financial sector liberalization and the globalization have become the two key economic policies in transforming centrally planned economies to more competitive and market oriented economies. A workable model of transformation requires a move from a sellers' to a buyers' market through price liberalization and a hard budget constraint through privatizing and eliminating various government support mechanisms. The need for reallocation of resources from old to new activities and restructuring within surviving firms arises for the better functioning of a profit maximizing market behaviour by all economic agents. During the 1980s, most of the countries in the world adopted liberalized, market-oriented and private-sector friendly economic systems and the economic principle of government's involvement in economic activities was challenged by a new thought of encouraging private sector investment.

Financial Sector Liberalization: Decisions and Developments

In the Nepalese context, the government has initiated liberal economic policies since the mid 1980s. The Nepalese financial system has undergone rapid structural changes in the last two and half decades. The history of banking in Nepal is not very old as the first ever bank, Nepal Bank Limited (NBL), was established in 1937. With the establishment of Nepal Rastra Bank (NRB) as the Central Bank of the country in 1956, the Nepalese financial system gained momentum. Industrial Development Bank was established in 1957 as the first development bank, which was converted into Nepal Industrial Development Corporation (NIDC) in 1959. Within a decade of the establishment of Nepal Rastra Bank, a number of financial institutions came into operation. Rastriya Banijya Bank (RBB), the second commercial bank, fully owned by the government was established in 1966. Agricultural Development Bank (ADB/N) came into operation in 1968 with the objective of providing long-term and medium-term credit facilities to agriculture sector. There were only two commercial banks and two development banks until 1983.

The pace of financial liberalization actually started in the mid 1980s when the government allowed the entry of commercial banks in joint venture with foreign bank. With the need to modernize banking services through the transfer of technology and managerial skills, NABIL Bank Limited was established in 1984 as the first joint-venture bank in Nepal, which was later followed by the establishments of Nepal Investment Bank Limited and Standard Chartered Bank Nepal Limited. With the establishment of NABIL Bank Limited, foreign capital was accepted for the first time in the Nepalese banking business. Another reform measure initiated in the year 1984 was to allow Agriculture Development Bank branches to conduct commercial banking businesses in the urban areas. In reforming the exchange rate management, basket system was introduced in 1986 and the Nepalese rupee was pegged to a basket of currencies of its major trading partners. The interest rate structure of commercial bank was completely deregulated in 1989.

The process of financial liberalization gained momentum in 1987/88 when Nepal entered into a three-year (1987/88-1988/89) Structural Adjustment Programme (SAP) with the International Monetary Fund. The general thrust of this programme was to increase the role of market forces in the financial system. In order to introduce greater flexibility in the interest rate structure, the NRB has initiated regular auctions of treasury bill since the fiscal year 1988/89. The NRB has also redesigned its rediscounting rates in the form of three windows: basic rate, selective rate and lender of the last resort rate in 1989. With the objective of reducing the dependence of commercial banks on the NRB for short-term borrowing requirements, a call money market was established during the fiscal year 1988/89. During the period, it was felt necessary to make some efforts to improve financial and organizational structure of the two state-owned commercial banks. An in-depth study was carried out in the form of the Commercial Bank Problem Analysis and Strategy Study (CBPASS). Some of the CBPASS recommendations were implemented in 1990/91, which included re-capitalization of the banks, repayment of government guaranteed loans and issue of government securities for provision for loan loss. The NRB, since 1989, has started to set a comprehensive short-term monetary programme framework (reserve money programming) and to use indirect instruments of monetary policy. A Credit Information Bureau was established in 1989 under the aegis of Nepal Bankers' Association with the objective of disseminating credit information among its member institutions. Prudential norms on capital adequacy, single borrower limit, loan classification and provisioning were also introduced for commercial banks. Encouraged by Structural Adjustment Programme, Nepal again entered into another three-year Enhanced Structural Adjustment Facility (ESAF) with the International Monetary Fund in the fiscal year 1992/93. These programmes envisaged a greater role and reliance on private sector. During that period, the major thrust of financial liberalization was directed toward the following aspects: to allow market forces to play a greater role in the financial system; to enhance private sector participation in the development of the financial system; to increase competition and thereby efficiency of the financial system; to improve and increase financial instruments; and to develop capital market.

With the objective of meeting consumer financing requirement, the need for specialized institutions was felt and the Finance Company Act 1985 was enacted. Nepal Housing Development Finance Company Limited, the first finance company in Nepal, came into operation in 1992. Finance companies are the third largest group of deposit taking financial institutions in Nepal and they are the creation of the early 1990s. Hire purchase financing, housing and leasing are the core business areas for these companies. The concept of rural development banking model (Grameen Banking) was introduced in 1993 with the establishment regional-based rural development banks-Eastern Rural Development Bank Limited and Far- Western Rural Development Bank Limited. These rural development banks have been following the operating model of Grameen Bank, Bangladesh and they have been providing credit facilities to the rural poor women. By the end of 1995, three other rural development banks were established in each of the other development regions. Further initiatives taken to promote financial development included the establishment of development banks in private sector under the Development Bank Act 1996. The NRB has also licensed some cooperatives and non-government organizations to conduct limited banking businesses.

Current Situation

By the end of the fiscal year 2003/04, the financial sector in Nepal included 17 commercial banks, 25 development banks (including 5 rural development banks), 59 finance companies, 21 cooperatives (with limited banking) and 44 non-government organizations (with limited banking) and some other non-bank financial institutions. The other non-deposit taking financial institutions include 17 insurance companies, one Employee Provident Fund, one Citizen Investment Trust, one Deposit Insurance and Credit Guarantee Corporation, one Nepal stock Exchange Limited, one Credit Information Bureau, 116 postal saving offices and one Rural Self-Reliance Fund (RSRF). Commercial banks, development banks, finance companies and cooperatives and non-government organizations licensed to carry out limited banking businesses come under the regulatory and supervisory jurisdiction of the NRB. The institutional presence of deposit-taking financial institutions over the period is depicted in the following table.

Within a short period of span, say 20 years, the Nepalese financial system has grown significantly both in terms of business volume and the size of markets. A number of financial institutions with varied nature of operations came into existence offering a wide range of financial services. Since the second half of the 1980s significant achievements have been made in the Nepalese financial system. The primary objective of initiating different reform measures was to enhance efficiency in financial services.

A competitive, efficient and healthy financial system is vital for enhancing growth, efficiency and maintaining stability of the overall economy. Although the Nepalese financial system is getting widened today as compared to that of few years ago, some of the issues and challenges still need to be addressed. A study conducted by the World Bank has revealed a number of serious issues and challenges in the Nepalese financial system. Excessive government involvement in the banking system, weak corporate governance and organizational culture, poor lending practices, fragmented legal framework, weak central bank, inadequate disclosure, accounting and auditing standards, high level of non-performing loans and political intervention are some of the major challenges particularly associated with the Nepalese banking system. An urgent need of undertaking important measures to strengthen and deepen the financial system was realized. Under the loan assistance of the World Bank and grant assistance of the Department for International Development (DFID, UK), Financial Sector Technical Assistance (FSTA) Project has been implemented since 1998. It was felt that the government and the central bank need to reorient their activities from being active participants in the financial sector and should proceed towards being a stronger regulator and supervisor of the overall financial system. Under the Financial Sector Technical Assistance Project, the banking sector

Table 1

Banks and Financial Institutions Licensed by Nepal Rastra Bank

Mid-July	Commercial Banks	Development Banks	Finance Companies	Cooperatives*	Non-governmental Organizations*	Total
1983	2	2	-	-	-	4
1993	8	4	4	-	-	16
1994	8	4	7	1	-	20
1995	10	6	22	7	8	53
1996	10	7	34	11	21	83
1997	11	7	42	16	29	105
1998	11	7	44	22	34	118
1999	13	12	44	35	30	134
2000	13	13	46	35	7	114
2001	15	17	48	34	15	129
2002	16	21	54	34	25	150
2003	17	22	57	34	40	170
2004	17	25	59	21	44	166

* With limited banking businesses.
Source: Nepal Rastra Bank.

reform strategy has incorporated the following aspects.

- Initiate strong corporate governance by ensuring that banks are owned and managed by private investors and professionals by implying the progressive withdrawal of HMG/N from the ownership of all financial institutions and also refraining from promoting financial institutions primarily with the equity participation of the government or government owned institutions.
- Enhance the authority and the ability of the Nepal Rastra Bank for effective supervision of banks and non-bank financial institutions and enforce regulations as well as move towards increased autonomy of the central bank.
- Improve the existing legal and judicial processes for enforcing financial contracts.
- Improving auditing and accountancy standards within the banking sector.
- Promote financial discipline through adequate disclosure and competition.

Re-engineering of the NRB; restructuring of NBL and RBB; and capacity building in the financial sector are the broad components of the Project. For the NRB re-engineering programme, the American firm IOS partners was selected as the consultant and the consultant started its job in March 2003. Human resource development, banking supervision and inspection, accounting and audit, oversight functions of NBL and RBB contracts, research, information technology, legal, internal audit and support for other departments and training programmes for the NRB staffs are the major areas identified to be improved under re-engineering of the NRB. In order to resolve the over-riding problems of NBL and RBB, the management of these banks has already been handed-over to foreign strategic partner. The management group of ICCMT consulting firm of Bank of Scotland (Ireland) has started its work in NBL since July 2002. The management of RBB has been carried-out by a management team consisting of foreign and local consultants since January 2003. For monitoring and supervising the work and progress of the management team of these two largest banks, a Monitoring and Surveillance Team (MST) has been formed at the NRB. In reforming the financial sector, the NRB is supposed to focus on the following reform measures under this Project: reform in the financial sector legislation; strengthening bank supervision and inspection; enhance competition in the banking sector; restructuring and privatization of NBL and RBB; reform on auditing and accounting capabilities; broad-based banking; streamlining ownership structure; establishment of Bankers' Training Institute; restructuring of Credit Information Bureau; establishment of Assets Management Corporation; revamping research and financial monitoring strength of the central bank; broadening and deepening the financial system in Nepal; and restructuring NIDC and ADB/N in the second phase.

Reform in financial sector legislation includes the enactment of a new Nepal Rastra Bank Act, 2002 and Debt Recovery Act, 2002. With the enactment of the Nepal Rastra Bank, 2002, the central bank of the country has become an independent body in executing its policies for ensuring sound, efficient and healthy financial system through prudent regulatory and supervisory mechanism. A Debt Recovery Tribunal (DRT) has already been formed under the Debt Recovery Act, 2002. The Debt Recovery Tribunal has been established with the objective of improving the existing legal and judicial processes of recovering problem loans of banks and financial institutions. Regulatory provisions on blacklisting the borrower and credit information have been revised and the Credit Information Bureau has already been registered as a public limited company in 2004. In the year 2003, Banks and Financial Institutions Ordinance has been enacted and the new legal framework has replaced different fragmented legal framework governing the operations of banks and financial institutions such as Agriculture Development Bank Act 1967, Nepal Industrial Development Corporation Act 1989, Commercial Bank Act 1974, Finance Company Act 1985 and Development Bank Act 1996. Some other legal frameworks governing the issues of establishing the Asset Management Corporation, business Insolvency, secured transactions and merger and acquisition have also been considered to be enacted in the time to come.

Nepal Rastra Bank has already designed new policy and prudential norms for the establishment of new banks and financial institutions and for their healthy operations. The Banks and Financial Institutions Ordinance, 2004 has made a provision of categorizing deposit-taking financial institutions into four categories: A, B, C and D. With the

enactment of a single or umbrella act governing the functions of deposit-taking financial institutions in Nepal, the issues related to the establishment, operation and exit of banks and financial institutions have been clearly spelt-out in the new legal framework. The minimum start-up capital for different types of banks and financial institutions has been fixed in the following ways.

Commercial banks and other depository institutions accept money from the general public in the form of different types of deposits. The functions of these institutions differ from that of other enterprises, calling for special treatment of these institutions by the state. The failure of one of them may affect the financial health of other institutions in the system. Inter-bank contagion and loss of public confidence may create severe problem in the entire system. Therefore such institutions are subject to a special regime of licensing, regulation and supervision, which is referred to as prudential regulation (Asser 2001, p.8). The responsibility of regulating and supervising commercial banks and other depository institutions is generally entrusted to the central bank of the country. However, some countries (e.g. Australia, England, Japan, Korea, Norway, Sweden) consolidate the prudential regulation of banks and other financial institutions under the roof of an independent regulatory agency. In order to ensure compliance with prudential banking standards, the regulatory authority should be an independent body in executing its regulatory and supersensory functions. The prime objective of prudential regulation of banks and financial institutions is to ensure financial stability in the system. In the Nepalese context, the Nepal Rastra Bank Act, 2002 states the objectives of achieving financial stability and maintaining a secured healthy and efficient domestic payment system. The NRB is, therefore, legally empowered to regulate and supervise banks and financial institutions under its jurisdiction. However, an assessment of Nepal's compliance with the Basel Core Principles for Effective Banking Supervision Conducted by the World Bank in 1999 concluded that the NRB fails to comply fully with two-third of the criteria and is unable to fulfill its supervision mandate. Under the Financial Sector Technical Assistance (FSTA) Project, some progress has been made in strengthening the regulatory and supervisory capabilities of the NRB. The NRB is supposed to be more autonomous for its functioning under the new legal framework. It has framed new licensing policy in 2002 for opening a new commercial bank or financial institution. The NRB has given emphasis on policy issues rather than administrative controls in its new licensing policy. The new licensing policy clearly spells out the following aspects: (a) minimum paid-up capital required, (b) share ownership structure, (c) depositing amount of share capital committed by the promoters, (d) special provisions on minimum paid-up capital for establishing bank/financial institution in economically backward regions of the country, (e) promoters' educational qualification, working experience and financial disciplinary aspects, (f) provisions on sale or transfer of the promoter shares, and (g) application processing time. Some of these provisions have already been incorporated in the Bank and Financial Institutions Ordinance, 2004. From time-to-time, the NRB has been revising the regulatory norms for commercial banks and financial institutions.

Table 2
Categorization of Banks and Financial Institutions

Category	Required Minimum Paid up Capital (Rs. in Million)				
	National Level	Regional Level*	4-10 Districts*	1-3 Districts*	1 Districts*
"A"	1000	250	X	x	x
"B"	320	x	50	20	x
"C"	150+50	xx	Xx	xx	20 10++
"D"**	100	60	20	10	x

* Except Kathmandu Valley.
** Financial institutions carrying micro-finance activities only.
\+ Applicable to financial institutions performing leasing business.
Source: Ministry of Finance.

Some major regulatory directives issued to commercial banks and other deposit-taking financial institutions cover the areas on capital adequacy ratio, loan classification and provisioning, single borrower and sectoral credit limits, accounting policies and financial statements, risk management, corporate governance, enforcement of regulatory directives, provisions relating to investment in shares and debentures, submission of periodic statistical returns, transfer and sale of promoters' shares, credit information and blacklisting provisions, provision relating to the appropriation of net profit and dividend declaration, resource mobilization, reserve requirement and liquidity ratio and branch expansion policy.

The NRB has revised some of the regulatory norms that are not in consistent with the market oriented economic policies. The provision relating to the interest rate spread has been abolished and the mandatory requirement of investing in priority sector for commercial banks has been phased-out. From the fiscal year 2007/08 onwards, priority sector lending requirement will not be mandatory for commercial banks. The NRB, as a supervisor, is responsible for safeguarding the soundness of banks and financial institutions and encouraging competition among them. The NRB conducts periodic on-site and off-site supervision to ensure that banks and financial institutions comply with the prudential regulatory directives, rules, laws and regulations. To sum up, Nepal has a reasonably diversified financial system with a large number of varied institutions playing active role. Significant changes have taken place in the Nepalese financial system during the last two decades. Though the process of liberalizing financial markets began in the mid 1980s, the Nepalese people have not yet reaped the potential gains of the government's efforts to liberalize and reform the financial sector. The institutional presence of varied nature of banks and financial institutions has been increasing since the initiation of liberalized and market-oriented reform measures. Financial sector reform is a continuous process and it continues to address new and emerging challenges that may arise in the time to come.

Comprehensive Analysis and Interpretation

A country's financial system may be bank-dominated or market based. The bank-dominated financial system is characterized by an important participation of banks in industry. Such financial system is often considered as an administered or state-engendered system. The market-based financial system is defined as a liberalized system. Financial systems based on the stock market as those of the USA and the UK are characterized by a strongly developed stock market. Some early researches indicate that as economies develop, self-financed capital investment first gives way to bank-intermediated debt finance and later to the emergence of equity markets. Many profitable investment opportunities require a long-term commitment of capital and stock markets that facilitate in raising long-term financing from external sources. At low levels of economic development, commercial banks are the dominant financial institutions. As economies grow, specialized financial intermediaries and equity markets develop and prosper. However, there is no unique definition of stock market development. It is a multifaceted concept, involving issues of market size, market liquidity and integration with world markets and no single measure captures all the aspects of stock market development. Demirgüç-Kunt and Levine (1996) describe market size, market liquidity, market volatility, market concentration, asset pricing efficiency, regulatory and institutional development and conglomerate index in measuring the level of stock market development. They find that large markets tend to be less volatile, more liquid and less concentration in a few stocks than smaller markets. They also find that institutionally developed markets with strong information disclosure laws, internationally accepted accounting standards, and unrestricted capital flows have larger and more liquid markets.

The Nepalese stock market is still in its infancy stage in terms of market size, liquidity and number of listed companies. With a view to reform the capital market, His Majesty's Government (HMG/N) converted the Securities Exchange Center Limited into Nepal Stock Exchange Limited (NEPSE) and formed Securities Board in 1993 under the provisions of the Securities Exchange Act 1983. NEPSE started its trading operation on 13 January 1994 and investors were allowed to deal in securities only through licensed brokers. Over the past 10 years, the Nepalese stock market has made some progress. Despite the progress, the stock market is still at a developing stage and has to make visible impacts on the economic growth of the country.

Table 3
The Nepalese Stock Market: Some Indicators
(Rs. in Million)

Mid-	Market Capilization		No. of Listed	Annual Turnover			Paid-up	NPESE	
July	Amount	%of GDP	Comapnies	Amount	%of GDP	% of Mkt.Cap.	Value	Index	INDEX
1988	1089.0	1.4%	27	7.7	0.0%	0.7%	524.0	NA	0.7%
1989	1509.0	1.7%	36	30.0	0.0%	2.0%	684.0	NA	1.2%
1990	1775.0	1.7%	41	25.3	0.0%	1.4%	789.0	NA	1.1%
1991	2516.0	2.1%	46	27.3	0.0%	1.1%	1049.0	NA	1.1%
1992	2120.0	1.4%	55	36.9	0.0%	1.7%	1273.0	NA	1.1%
1993	3806.0	2.2%	62	79.8	0.0%	2.1%	1483.0	NA	1.5%
1994	13872.0	7.0%	66	441.6	0.2%	3.2%	2182.2	226.0	3.5%
1995	12963.0	5.9%	79	1054.3	0.5%	8.1%	2961.8	195.5	4.8%
1996	12295.0	4.9%	89	215.6	0.1%	1.8%	3358.5	185.6	2.3%
1997	12698.0	4.5%	95	416.2	0.1%	3.3%	4476.5	176.3	2.7%
1998	14289.0	4.7%	101	202.6	0.1%	1.4%	4959.8	163.4	2.1%
1999	23508.0	6.9%	107	1500.0	0.4%	6.4%	6487.4	216.9	4.6%
2000	43123.3	11.4%	110	1157.0	0.3%	2.7%	7347.4	360.7	4.8%
2001	46349.4	11.3%	115	2335.9	0.6%	5.0%	7919.1	348.4	5.6%
2002	34703.8	8.2%	96	1540.6	0.4%	4.4%	8690.2	227.5	4.3%
2003	35240.4	7.7%	108	576.0	0.1%	1.6%	11898.0	204.9	3.2%
2004	41424.8	8.4%	114	2144.3	0.4%	5.2%	12016.0	222.0	4.7%

Note: INDEX is the ratio of the average of the ratio of market capitalization to GDP, the ratio of annual turnover to GDP, and the ratio of annual turnover to market capitalization.
Source: Nepal Rastra Bank and Nepal Stock Exchange Limited.

Stock market size and liquidity are the two major indicators used by Demirgüç-Kunt and Levine in measuring the level of stock market development. We can also apply these measures to approximate the level of the Nepalese stock market development. Market capitalization ratio, which is the ratio of market capitalization to GDP, is frequently used as a measure of stock market size. The number of listed companies is also considered as an additional measure of stock market size. Annual turnover to GDP ratio and annual turnover to market capitalization or turnover ratio are the measures of liquidity. As indicated in table 3 the market capitalization ratio remained within the range of 1.4 to 11.4 percent during the period 1988 to 2004. The highest ratio observed during the period is 11.4 percent in 2000. In countries with developed stock markets this ratio is greater than 100 percent and in many developing countries it is in the range of 20 to 40 percent (K.C. 2004, p.30). The number of listed companies, which stood at 27 in 1988, increased to 114 by the end of the fiscal year 2003/04. However, the number of listed companies may not be a good indicator of the stock market size as it may vary with the size of economy. The total value traded to GDP ratio measures the organized trading of equities as a share of GDP and this ratio always remained below 1.0 percent during the period between 1988 and 2004. The annual turnover to market capitalization or turnover ratio was 0.7 percent in 1988 and it increased to 8.1 percent in 1994, being the highest one during the review period. This ratio remained at the 5.2 percent level in the fiscal year 2003/04. The paid up values of listed securities amounted to Rs. 12016.0 million by the end of the fiscal year 2003/04, which accounted for about 2.4 percent of the total GDP. The NEPSE Index continued to fall to 163.4 in 1998 from 226.0 in 1994. It went up to 360.7 in 2000. Over the period between 2000 and 2003, the index showed a declining trend and reached 204.9 in 2003. However, in the year 2004 the index increased to 222.0. As shown in the table, the INDEX increased from 0.7 percent in 1988 to 4.7 percent in 2004. The INDEX is an equally weighted single indicator of the three stock market development indicators: the ratios of market capitalization to GDP, annual turnover to GDP and the annual turnover to market capitalization. The INDEX increased substantially from 1.5 percent in 1993 to 3.5 percent in 1994 mainly due to the opening of trading floor by Nepal Stock Exchange Limited in January 1994. In developed economies such as Hong Kong, Japan,

the UK, the USA, Singapore and Switzerland such INDEX has been found to be in the range of 52 percent to 73 percent (Kunt and Maksimovic, 1996 p. 348). By analyzing some of these indicators we can conclude that the Nepalese stock market has been developing gradually over the sample period. However, in terms of market size and liquidity, the Nepalese stock market still remains underdeveloped as compared to that of the other developed economies.

Most of the developing countries have a special characteristic of bank-dominated financial system. Capital market and stock market are at the initial stage of development and the banking system dominates the entire financial system. Commercial banks, being the core financial intermediaries in almost all the countries, absorb the vast majority of the total financial system assets. In terms of total assets and branch network, commercial banks are the largest components in the financial system. Though the Nepalese financial system is reasonably diversified with institutional arrangement of varied nature of financial institutions, commercial banks are the major players in the system and they place substantial share in the structure of the financial system.

As of mid-July 2003, total assets of the financial system amounted to Rs 565.4 billion. Commercial banks comprised the largest share of 54.0 percent, followed by the NRB (22.3 percent) and development banks (10.0 percent). Total assets of commercial

Table 4
Total Assets of the Nepalese Financial System (Mid-July 2003)

Banks and financial Institutions	Total Assets (Rs in Million)	Percent
Nepal Rastra Bank	126308.4	22.3%
Commercial Banks	305561.7	54.0%
Development Banks	56670.4	10.0%
Agriculture Development Bank	5371.3	0.9%
Nepal Industrial Development Corporation	41794.3	7.4%
Rural Development Banks	2205.4	0.4%
Other Development Banks	5249.7	0.9%
Micro-credit Development Banks	2049.7	0.4%
Finance Companies	22116.5	3.9%
Cooperatives (Limited Banking)	2650.4	0.5%
Non-Government Organizations (Limited Banking)	137.3	0.0%
Insurance Companies	13794.3	2.4%
Employee Provident Fund	35594.0	6.3%
Citizen Investment Trust	2574.0	0.5%
Total	565407	100.0%

Source: Nepal Rastra Bank.

Table 5
Market Shares of Deposit-Taking Banks and Financial Institutions (mid-July 2003) In Percent

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

Source: Nepal Rastra Bank.

banks accounted for more than half of the system's total assets. Excluding assets of the NRB, total assets of the financial system stood at Rs. 439.1 billion, of which commercial banks have a dominating share of about 70 percent. Therefore, the Nepalese financial system is basically dominated by the banking system particularly the commercial banks. The deposit-taking banks and financial institutions in Nepal comprise of commercial banks, development banks, finance companies, cooperative (with limited banking) and non-government organizations (with limited banking), all licensed by the NRB. Some key indicators of these banks and financial institutions are presented in the table 5.

The total assets of all deposit-taking banks and financial institutions have been estimated at Rs 381.6 billion as at mid-July 2003, of which commercial banks contributed 80.0 percent. Of the total deposit liabilities, commercial banks shared 80.0 percent. In the structure of the total outstanding credit of all deposit-taking banks and financial institutions, the share of commercial banks was 72.0 percent. Similarly, commercial banks were also found to be the leading financial intermediaries in the composition of total investment and liquid fund. Commercial banks absorb the major and dominating market shares in the overall banking/financial businesses. From the above table, it can be concluded that commercial banks are the largest financial intermediaries in the Nepalese financial market.

A complete set of banking or financial survey is not readily available in Nepal. The NRB has started to project liquid liabilities of the financial system by constructing banking survey consisting of monetary authorities, commercial banks and other deposit taking institutions. However, new monetary aggregate to accommodate the deposit liabilities of other deposit-taking institutions is yet to develop. Narrow money (M_1) and broad money (M_2) are the only monetary aggregates available to approximate the overall size of the financial system. In examining the level of financial development in Nepal, one needs to rely on monetary survey (monetary authorities and commercial banks). Lack of access to complete set of time series data has forced this study to focus on banking system indicators only.

DEPTH, the first measure, equals broad money (M_2) divided by GDP and it measures the size of financial intermediaries. Broad money (M_1 plus time deposit of the banking system) represents the liquid liabilities in the financial system. Broad money to GDP ratio, a typical measure of financial depth, captures both monetization and penetration of the banking system in mobilizing savings. Over the period 1975-2004, broad money as a percentage of GDP increased from 12.4 percent to 56.4 percent, indicating that the overall size of the financial intermediary as well as well as monetization of the economy is deepening. However, this may not accurately reflect the provision of financial services in the economy. BANK measures the degree to which commercial banks versus central bank are allocating credit in the economy. During the sample period, BANK increased from 57.1 percent in 1975 to 92.6 percent in 2004. The increasing trend of this ratio implies that commercial banks are more likely to provide financial functions of saving mobilization, resources allocation, exerting corporate control, managing risk and facilitating the trading to goods and services than the central bank. However, this ratio has some weaknesses because commercial banks may not be the only financial intermediaries in providing efficient financial functions in the system and they may also lend to the government or government owned enterprises. PRIVATE measures more accurately the role of financial intermediaries in channeling funds to the private sector and, therefore, it is favoured as a preferred measure of financial development. PRIVATE showed an upward trend, with the ratio reaching 68.3 percent in 2004 from 40.3 percent in 1975. PRIVY, the fourth measure, partially accommodates concerns about the allocation of credit to private sector. During the period, credit to private sector as a percentage of GDP rose from 4.7 percent in 1975 to 32.1 percent in 2004. These four indicators of financial development were widely recognized by King and Levine in a number of their research works undertaken previously. Some early researches also focused on using narrow money (M_1) to GDP ratio as an indicator of financial development. M_1/GDP ratio increased from 8.1 percent in 1975 to 19.1 percent in 2004. This ratio indicates the degree of monetization. The indicators based on monetary aggregates advocates the ability of the financial system to provide transaction services. In a country like Nepal where the economy is not fully monetized, broad money to GDP ratio does matter in measuring the level of financial development. Among all these measures, credit issued to private sector is considered to be the most

Table 6

Indicators of Financial Intermediary Development in Nepal, 1975-2004

Mid-July	DEPTH	BANK	PRIVATE	PRIVY	M_1/GDP	Pvt. /Total	FINDEX
1975	12.4%	57.1%	40.3%	4.6%	8.1%	57.6%	8.5%
1976	14.5%	63.9%	35.3%	4.1%	8.4%	52.9%	9.3%
1977	18.7%	69.1%	36.1%	5.0%	10.7%	48.8%	11.8%
1978	19.1%	61.3%	33.3%	5.4%	10.4%	50.0%	12.3%
1979	17.3%	62.5%	33.6%	5.1%	9.6%	50.3%	11.2%
1980	22.6%	63.9%	40.8%	8.2%	12.1%	58.9%	15.4%
1981	24.7%	66.1%	45.6%	9.8%	12.6%	62.1%	17.2%
1982	24.1%	66.2%	42.3%	8.5%	11.7%	61.0%	16.3%
1983	27.3%	58.6%	30.9%	8.0%	12.9%	51.1%	17.6%
1984	26.6%	56.4%	31.5%	8.1%	12.6%	53.4%	17.3%
1985	26.4%	56.3%	31.2%	8.7%	11.8%	51.6%	17.5%
1986	27.2%	55.3%	32.8%	9.3%	12.6%	56.1%	18.2%
1987	27.4%	57.1%	34.3%	9.8%	12.7%	57.0%	18.6%
1988	27.9%	62.6%	39.1%	10.8%	12.5%	58.7%	19.3%
1989	29.8%	63.3%	38.2%	11.6%	13.2%	58.4%	20.7%
1990	30.5%	62.0%	38.4%	11.3%	13.8%	60.9%	20.9%
1991	31.3%	68.5%	39.6%	11.7%	13.5%	55.5%	21.5%
1992	30.6%	73.7%	41.6%	12.1%	13.0%	54.8%	21.3%
1993	34.0%	71.0%	42.0%	12.6%	13.9%	57.6%	23.3%
1994	35.0%	73.4%	50.1%	15.2%	14.3%	67.0%	25.1%
1995	36.9%	74.9%	57.4%	19.6%	15.0%	75.4%	28.3%
1996	37.2%	75.1%	60.7%	22.3%	14.7%	79.1%	29.8%
1997	37.0%	75.9%	62.5%	23.1%	13.7%	80.5%	30.0%
1998	42.0%	79.1%	64.8%	25.5%	15.0%	80.6%	33.8%
1999	44.7%	81.4%	66.0%	26.5%	14.9%	79.9%	35.6%
2000	49.0%	84.8%	68.2%	28.8%	16.1%	78.8%	38.9%
2001	52.2%	84.8%	66.8%	30.9%	17.2%	76.7%	41.5%
2002	53.0%	82.7%	63.9%	31.6%	18.3%	75.1%	42.3%
2003	54.1%	87.4%	65.6%	33.2%	18.4%	73.4%	43.6%
2004	56.4%	92.6%	68.3%	32.1%	19.1%	72.7%	44.3%

Notes: FINDEX averages the ratio of broad money to GDP (DEPTH) and the ratio of commercial banks' credit to private sector to GDP (PRIVY).

DEPTH = Liquid liabilities to GDP (M2/GDP).
BANK = Bank credit divided by bank credit plus central bank domestic credit.
PRIVATE = Credit allocated to private sector to total domestic credit (excluding credit to banks).
PRIVY = Commercial banks' credit to private sector divided by GDP.
Pvt./ Total = The ratio of private sector credit to total credit issued by commercial banks.

Source: Author's calculations based on data from Annex 1 and 2.

important indicator of financial development from economic development perspective. Increased credit to private sector leads to promote economic activities. Productive firms and enterprises used to access bank credits only when they have profitable investment opportunities in hand. Private sector can make the best use of credits it obtains from banks and financial intermediaries. A high ratio of private sector credit to total credit indicates that banks are able to channel their loanable funds in more productive ways. Over the period covering 1975 through 2004, commercial banks' credit to private sector as a percentage of total credit increased from 57.6 percent to 72.7 percent. This indicates that the major portion of commercial banks' credit portfolio is being utilized in extending credit to private sector. The indicators DEPTH and PRIVY are averaged to yield an index called FINDEX, which measures the significance of the banking sector in our sample period. This indicator has been used in studying the effect of the

financial sector on the growth of the economy (Kunt and Maksimovic, 1996 p. 351). The case of developed countries is quite different and this indicator (FINDEX) appears to be above 100 percent. In many developing countries banks are the significant financial intermediaries and this situation equally prevails in the context of Nepal. Over the sample period 1975 to 2004, the trend of FINDEX is increasing and it goes up from 8.5 percent in 1975 to 44.3 percent in 2004. With these few observations it can be revealed that the direction of financial development in the Nepalese context shows the right and positive track. However, the level of financial development is much more below as against that of other developed economies. In the following sections, we will try to explore the effect of financial development on economic growth based on some of the models previously applied by different authors in their respective studies.

A flourishing body of empirical work aiming at testing the positive relationship between financial development and economic growth find that financial development indicators explain a significant portion of economic development. Different models suggest that financial intermediation has a positive effect on growth. The models are based on regression analysis. The basic model proposed by Khan and Senhadji (2000) has the following form:

$$Y_1 \ \beta_0 + \beta_1 FD_i + \beta_2 X_i + e_i$$

Where Y_i is the rate of growth of country i, FD_i is an indicator of financial depth, X_i is a set of control variables and e_i is the error term. A similar model described by Levine et al. (1999) takes the following form:

$$GROWTH_i = \alpha + \beta \ FINANCE_i + Y \text{'}[CONDITIONING \ SET]_i + \varepsilon_i$$

Where the dependent variable, GROWTH, equals real per capita GDP growth , FINANCE equals indicators of financial intermediary development, CONDITIONING SET represents a vector of conditioning information that controls for other factors associated with economic growth and ε_i is the error term.

In this section an attempt is made to examine the relationship between financial development indicators and economic development indicators. The effect of financial development indicators on economic growth in Nepal is examined through the estimation of the ordinary least square (OLS). The sample range of the estimated equation is 1975-2004 and most of the data in this study are taken from the publications of the NRB and HMG/N. The regression equation is specified as:

$$Y = \alpha + \beta FD + u$$

Where, Y is the economic growth indicator (dependent variable), FD is the financial development indicator and u is the error term. However, this linear function has the chance of non-stationary of the variables. Hence, the equation is converted into the log-linear form so that the slope coefficients indicate the constant percentage changes in dependent variable as a result of a one percent changes in independent variable. We obtain the following log linear equation assuming that the error term, u, tends to zero.

$$\ln Y = \alpha + \beta \ln FD$$

Real GDP (RGDP), nominal GDP (NGDP), per capital real GDP and per capita nominal GDP have been used as the economic development indicators or the dependent variables in the model. The financial development indicators or the independent variables includes narrow money (M_1), broad money (M_2), commercial banks' total credit and commercial banks' credit to private sector. A priori or the theoretical expectation is that the level of economic development as measured by different growth indicators is explained by financial development indicators. The statistical results of the regression equations are summarized in the table 7.

From these results it is seen that the slope coefficients are positive, implying that for a constant percentage increase in the financial development indicators, the economic development indicators increase by some positive values. Real GDP has been chosen as the first indicator of economic development. M_1, the independent variable, has an estimated slope coefficient of 0.29, which indicates that a one percent increase in M_1 is associated with 0.29 percent increase in real GDP. Similarly M_2 has a coefficient of 0.25, indicating that with a one percent increase in M_2, real GDP, on the average, increases by 0.25 percent. Total credit and credit to private sector issued by commercial banks have beta values of 0.23 and 0.21 respectively. If the total credit and private sector credit issued by commercial banks increase by, say one percent, real GDP will increase by 0.23 percent and 0.21 percent respectively. Nominal GDP has been introduced as the second

Table 7
Regression Results, 1975-2004

Equation	Independent variable	Constant	Slope	r	r^2	Adjusted r^2
Dependent Variable: ln RGDP						
1	ln (M_1)	9.3137	0.2855	0.9960	0.9921	0.9918
		(203.5859)	(59.3012)*			
2	ln (M_2)	9.4265	0.2513	0.9958	0.9916	0.9913
		(208.8026)	(57.6196)*			
3	ln (Total credit)@	9.7062	0.2340	0.9967	0.9933	0.9931
		(269.2898)	(64.5054)*			
4	ln (Credit to private sector)@	9.9934	0.2151	0.9963	0.9926	0.9924
		(300.8745)	(61.4832)*			
Dependent Variable: ln NGDP						
5	ln (M_1)	3.3565	0.8589	0.9977	0.9954	0.9952
		(31.8650)	(77.4832)*			
6	ln (M_2)	3.7018	0.7555	0.9967	0.9934	0.9931
		(30.6555)	(64.7575)*			
7	ln (Total credit)@	4.5464	0.7030	0.9970	0.9939	0.9937
		(44.0242)	(67.6411)*			
8	ln (Credit to private sector)@	5.4160	0.6455	0.9955	0.9911	0.9908
		(49.3057)	(55.7953)			
Dependent Variable: ln (Per Capita RGDP)						
9	ln (M_1)	5.8253	0.1416	0.9823	0.9650	0.9637
		(49.1334)	(27.7774)*			
10	ln (M_2)	6.1188	0.1245	0.9810	0.9623	0.9609
		(54.5162)	(26.7324)*			
11	ln (Total credit)@	6.3732	0.1160	0.9828	0.9658	0.9646
		(65.2509)	(28.1195)*			
12	ln (Credit to private sector)@	6.6405	0.1068	0.9843	0.9689	0.9678
		(79.0891)	(29.5369)*			
Dependent Variable: ln (Per Capita NGDP)						
13	ln (M_1)	-8.0535	0.7150	0.9959	0.9918	0.9915
		(-28.1891)	(58.2164)*			
14	ln (M_2)	-6.5716	0.6287	0.9945	0.9891	0.9887
		(-21.8225)	(50.3184)*			
15	ln (Total credit)@	-5.2664	0.5850	0.9949	0.9898	0.9894
		(-19.7845)	(52.0328)*			
16	ln (Credit to private sector)@	-3.8830	0.5372	0.9936	0.9873	0.9868
		(-14.5107)	(46.6024)*			

Notes: @ Issued by commercial banks.
* Indicates statistical significance at 0.1 percent.
Figures in parentheses are t-values.
Number of observations = 30.
Source: Author's calculations based on data from Annex 1 and 2.

indicator of economic development. Nominal GDP will increase by about 0.86 percent if M_1 increases by 1 percent. M_2 has an estimated coefficient of 0.76 percent. Compared to that of the slope coefficients of monetary aggregates, total credit and private sector credit issued by commercial banks have relatively smaller slope coefficients of 0.70 and 0.65 respectively.

In establishing the relationship between per capita real GDP, the third indicator of economic development, and other financial development indicators it has been found that the slope coefficients are in the range of 0.11 to 0.14. Hence, a one percent increase in these financial development indicators will cause real per capita GDP to grow by 0.11 to 0.14 percent. M_1 appears to have the largest slope coefficient of 0.14 as compared to that of other financial development indicators. In the regression model, the fourth indicator of economic development is per capital nominal GDP. M_1, the first indicator of financial development, has an estimated slope coefficient of 0.72. Hence, a one percent increase in M_1 will cause per capita nominal GDP to increase by 0.72 percent. The slope coefficient of 0.63 associated with M_2 implies that per capita nominal GDP will go up by 0.63 if M_2 increases by one percent. Similarly, total credit and credit to private sector issued by commercial banks have estimated slope coefficients of 0.59 and 0.53, implying that a one percent increase in commercial banks' credit causes per capita nominal GDP to increase by more than a half percent.

Both the coefficient of determination (r^2) and the unbiased coefficient of determination (Adjusted r^2) are reasonably high and remain in the range of 0.95 to 0.99. The coefficient of determination measures the overall goodness of fit of the estimated regression model. It shows that more than 95 percent of the variation in economic development indicators (dependent variables) has been explained by financial development indicators (independent variables). Though, r^2 or adjusted r^2 is a meaningful measure of the extent to which the variation in one variable determines the variation in the other, this criterion should not be overemphasized. In explaining the parameters we cannot attach any economic meaning to the intercept. However, the signs of the slope coefficients are in accordance with the theoretical or priori expectation. The slope coefficients measure the percentage change in dependent variable with respect to given change in independent variable. Examining the results we observe that the slope coefficient in each of the equations is positive. One interesting thing to be examined here is whether the slope coefficients on independent variable are zero. Do the results conclude that there is relationship between financial development indicators and economic development indicators? A one-tailed test can be carried out to test the significance of the slope coefficients. The null hypothesis can be postulated that financial development indicators provide no information on economic development (H_0: â=0). The alternative hypothesis is that financial development indicators provide information on economic development (H_1: â>0). Applying t-test, the calculated t-values are found to be more than the tabulated value of t-statistic at 0.1 percent level of significance ($t_{0.001}$ = 3.408 for 28 d.f.). Therefore, the t-statistics for the slope coefficients are statistically significant. We may reject the null hypothesis in favour of the alternative hypothesis and it can be said that independent variables add significantly to the predictive power of the model.

Outcome and Impact

Liberalized policies have been found to be positive in deepening the Nepalese financial system. However, the stock and capital markets have been found under-developed and the financial intermediaries such as banks dominate the entire financial system. The impact of liberalized and market-oriented policies on financial sector is positive and the policies to develop financial markets lead to economic growth through credit availability channel. By analyzing the time series data of the last thirty years, liquid liabilities and the banking credit of the system have been continuously increasing. This trend supports the fact that the Nepalese financial system has been deepening over the period. Most of the financial development indicators proposed in this paper are strongly correlated with the economic growth indicators. The overall impact of the increasing liquid liabilities of the system on economic growth has been found to be positive. Therefore, financial deepening will facilitate economic growth through different channels.

Problems and Challenges

Problems and challenges in the financial system are ultimately reflected in macroeconomic variables

such as economic growth and stability indicators. It has already been discussed that the Nepalese financial system is dominated by the banking system. The two state-owned commercial banks- NBL and RBB have dominant role in the banking system, which account for about 46 percent of the commercial banking system's assets. Excessive government ownership in the banking system has led to poor internal governance, weak management, fragile financial health and unhealthy politicization of these state-owned banks. These state-owned banks suffer from a number of problems such as lack of business strategy, lack of prudent banking practices, poor information and accounting system, poor board and management practices, counterproductive union activities, inadequate compensation package and over-staffing. Under the Financial Sector Technical Assistance (FSTA) Project, the government and the central bank have already initiated some reform measures to improve the financial and organizational health of these banks through a comprehensive restructuring plan. The ultimate objective of the reform programme is to withdraw government ownership and to privatize these banks in order to ensure a fundamental change in their governance. The government-owned two development banks—ADB/N and NIDC—also suffer from similar problems and challenges.

The increasing level of non-performing loans (NPLs) has become another serious concern in the Nepalese banking system. Increase in NPLs will deteriorate both the quality of the credit portfolio and the banks' profitability. It is estimated that about 60 percent of the total loan portfolio of NBL and RBB fall under the category of NPLs. The overall size of NPLs in the Nepalese banking system has been estimated as high as 30 percent and the ratio of NPLs to total GDP is estimated to be at least 7 to 8 percent. Unsound banking practices, lack of appropriate policies, processes and procedures, high risk and connected lending practices, lack of appropriate credit appraisal mechanism and monitoring system have forced to undermine the banks' credit portfolios. Some progress has been made so far in improving the existing legal and judicial processes for resolving the NPL problem. The enactment of Debt Recovery Act 2004, the establishment of Debt Recovery Tribunal and the strengthening of Credit Information Bureau and the establishment of the proposed Asset Management Corporation are expected to reduce NPLs and to avoid future shocks in the banking system. The NRB has also designed some new prudential regulatory norms with the objective of managing credit-exposure risk and maintaining the quality of assets at the desired level.

Weak corporate governance, lack of competition, the absence of a sound banking culture and asymmetries in information have led to poor banking environment in the Nepalese context. The other non-banking financial institutions such as finance companies, development banks, co-operatives and NGOs, are rapidly growing in a sizable number, indicating the need for an effective regulatory and supervisory mechanism to be enforced by the central bank. For this, the NRB should be well equipped with adequate and well-trained manpower. In maintaining the overall stability of the financial system, the role of the NRB as a regulator and supervisor needs to be further strengthened. Broader and deeper reforms are required in the central bank to ensure strong regulatory and supervisory body capable of leading the financial system. Only an effective and prudent regulatory and supervisory system can tackle the vulnerabilities to the likely instability and other uncertainties affecting the evolving financial system. In a liberalized economy, the role of regulating and supervising agencies is supposed to be more vital in maintaining financial stability and thereby facilitating the pace of economic development.

Though the Nepalese financial system has grown rapidly over the period, it still lacks competitive environment. The lack of competition is reflected in high interest rate spread of commercial banks. At present, all the banks and financial institutions licensed by the NRB are free to fix their interest rates. The un-weighted interest rate spread of commercial banks has remained in the range of 8.75 to 9.0 percent over the last few years. As of mid January 2004, the maximum interest rate on lending was 17.0 percent whereas the maximum interest rate on deposit offered by commercial banks was only 7.5 percent. During the last six years, the NRB has been continuously reducing its refinance rate. During the period from 1998 to 2004, the refinance rate has been brought down to 5.5 percent from 9.0 percent. Bank rate policy as an instrument of monetary policy gives a signal to commercial banks to revise their

existing interest rate structure. The interest rate spread needed to cover the difference between the costs of fund and the lending rate is very high in the Nepalese context as compared to that of other developed countries. The existence of inefficient banks in the system is the primary source of such high interest rate spread and productive units of the economy have enjoyed marginal benefits from banks and financial institutions. The larger intermediation cost in the Nepalese financial system has remained as one of the serious problems or challenges.

The banking services for the poor are quite inadequate. The Rural Credit Survey Conducted by the NRB in 1991/92 with the technical assistance of Asian Development Bank had estimated that the proportion of institutional borrowers among the borrowing households was only 20 percent. Most of the policies aimed at benefiting the poor such as priority sector lending program and branch expansion policies were found to be too broad and they created considerable disincentives within the system. These policies are felt to be more sharply focused to minimize their negative effects and enhance their benefits for poor and rural communities. The institutional set-up such as rural development banks, Rural Micro-finance Development Center (RMDC), Rural Self-Reliance Fund (RSRF) and other micro credit development banks has been considered to be more effective in enhancing credit delivery mechanism in the rural areas. The existing network of rural credit delivery mechanism is, however, not adequate to address the financing need of the entire rural communities.

This section reviewed some of the major problems and challenges inherent to the Nepalese financial system. There is no panacea to address all of them. Such problems and challenges increase the exposure of financial institutions to a variety of internal and external threats. Therefore, the initial priority in ensuring sound and safe financial system is to synchronize macroeconomic management policies with financial sector policies. A comprehensive set of corrective actions and policy options is required to address these problem and challenges and to build-up sound, efficient, safe and growth-induced financial system.

Corrective Actions and Policy Options

An efficient, sound and healthy financial system is essential for ensuring high and sustainable economic growth in the country. Weaknesses in the financial system create obstacles in achieving the objective of macroeconomic policy. Globalization and liberalization of financial markets have further broadened the nature and the effects of emerging issues. Financial liberalization, if managed properly, can produce desired results in developing the financial system. The nature of issues may be country-specific and strategies or policies to address them must be adapted to fit into the country's circumstances. In order to stabilize the financial system and to restore public confidence, the central authority is, sometimes, required to adopt some forceful measures. Financial system soundness has become crucial for restoring macroeconomic stability and most of the IMF-supported programs on financial sector policies are directed towards reestablishing efficient financial system through implementing broad reform measures. The IMF focuses on this area as part of its surveillance, technical assistance and policy development work. The broad-based corrective actions should include setting up appropriate institutional frameworks, removing non-viable financial institutions from the system, strengthening viable institutions, dealing with value impaired assets, improving prudential regulations and supervisions and promoting transparency in financial market operations.

In a bank-dominated financial system, the banking sector has to play a vital role in the economic development process of the country through mobilizing and allocating limited resources. The banking system must be prudent with commercial orientation. The organization and financial health of the two state-owned banks have been deteriorating and for the efficacy and efficiency of the banking sector, these two state-owned banks must be restructured as a first step in dealing with the issues of the Nepalese financial system. The financial system still lacks competitive environment and the non-banking sector is yet to grow in terms of size, structure and the volume of business. Lack of competent, qualified and experienced managerial team has remained as one of the serious concerns in the system. The role of central bank as a regulatory and supervisory body needs to be further strengthened. The banking services targeted to the poor and deprived sector people are not adequate. Looking from these perspectives, these issues can be

broadly classified into three categories. The first set of issues is microeconomic in nature and includes poor banking practices such as inadequate capital, failure of loan policy, inadequate assessment of credit, insufficiently diversified loan portfolio, lending to connected borrowers and excessive maturity. Overstaffing and the existence of trade unions have also been chronic problems, particularly in state-owned commercial banks and financial institutions. The second set of issues includes the degree of volatility due to the movements in assets prices and the exchange rates. The third category is system related, indicating that the environment is not conducive to the development of an efficient financial system. System related issues in the financial system include lack of competition, excessive government intervention, inadequate legal framework, under-developed securities market and inadequate regulatory and supervisory mechanism.

The corrective actions and policy options should, therefore, address these issues and challenges. The broad thrusts of policy options should aim at the following: creating a sound, stable and healthy financial system, broadening and deepening the financial system, adequate information disclosure, efficiently mobilizing financial resources to promote sustained and broad-based growth momentum, building the institutional capacity to tackle the problems in the financial system by improving the legal and judicial frameworks and increasing the autonomy and capability of the central bank's regulatory and supervisory roles. To sum up, the corrective actions and policy options should cover the following major issues.

- Improve the organizational and financial health of the state-owned banks and financial institutions.
- Facilitate the new entry of financial institutions in the private sector.
- Make the debt recovery system effective and improve the quality of assets.
- Strengthen the rural credit delivery mechanism.
- Build up the capacity of the financial sector by improving legal, judicial and institutional base.
- Enhance the regulatory and supervisory capacity of the central bank.
- Make the financial system competitive, broad-based and growth- induced.

The existing reform measures under the Financial Sector Technical Assistance (FSTA) project focuses on these issues. In order to implement these reform measures more effectively, the implementing agencies or the concerned authorities must be fully committed. Economic growth is possible once the financial system follows the desired track.

Future Agenda

There is no doubt that accelerated economic development will require progress in financial system with the right mix of financial sector policies. Financial development will benefit economic growth, but there are still ongoing debates regarding the choice of variables or indicators on how to develop financial markets and how precisely their development adds economic value in the societies. A number of models applied in this area indicate the positive relationship between finance and development, but they differ in measuring financial depth and in identifying channels through which financial development affects growth. The core objective of assessing financial development should be to evaluate the extent to which financial intermediary functions are realized in practice.

In this paper an attempt has been made to establish the relationship between financial development and economic growth. Some aspects of the concept under consideration have been addressed, but much remains to be done. This paper examines the relationship by using limited data from the banking sector only. In examining the link between these two, the collection of better quality data and more extensive indicators of financial development can provide a richer analysis. Though the financial system in Nepal is largely dominated by the banking system, a comprehensive analysis also requires the use of data on non-bank financial institutions and stock market conditions. The use of comprehensive data on market structure (banking and non-banking financial system), interest rate spreads, market capitalization, liquidity, legal and regulatory frameworks, accounting practices and payment systems can better explain the effects of financial services on economic growth through transmission mechanism. Therefore, to make this kind of relationship more strong, it is essential to use comprehensive time series data representing the overall financial system. The use of limited data representing the banking sector only may not be enough to assess the extent to which the level of financial development reflects the level of economic development in an economy. Therefore, one of the

issues that require further study is to incorporate time-series data from non-bank financial institutions.

To properly judge the link between finance and economic development, an appropriate estimation method is required. The findings based on multiple variable models are more reliable in empirically testing the hypothesis. This paper lacks the use of multiple variables, which depends on the availability of time-series data and the choice of variables. Limited variables have been applied due to the limitation of time series data, suggesting that there exists much room for further research in this area. In conducting further research, one can try to lengthen time series data by incorporating extensive indicators of economic development such as capital accumulation, capital formation and productivity growth. Therefore, the choice of variables in assessing the effects of financial development on economic growth always insists for further research in this area.

The other issues that we have not addressed in this paper are: to incorporate the inter-linkages between domestic and international financial markets; and to make cross-country comparison. However, the constraints and the legal provisions associated with the Nepalese financial system are inconsistent in incorporating such link and this will not be possible unless the domestic market is completely made free to the foreign investors and vice versa. A cross-country comparison can reveal the extent to which the financial market is efficient in comparison to that of other countries. Some of the issues still remaining uncovered and requiring for further research can be pointed out as follows.

- The choice of variables used in measuring financial depth and economic development.
- The use of data covering the entire financial system.
- The use of extensive model in measuring the effects of financial development on economic growth.
- The incorporation of the inter-linkages between domestic and international financial markets.
- Cross-country comparison.

Conclusions

This paper examines the relationship between financial development indicators and economic growth with a view to identify some outstanding issues. Recent literature on finance and growth suggests that financial system arises to perform some important and core financial functions in the economy. Different theories have been proposed in empirically testing the efficiency of capital allocations with an improved financial system, which implies higher economic growth. Liberalization of financial sector leads to competitive environment in which banks and financial institutions render a range of services to satisfy the needs of different customer segments. One important finding is that liberalized and market-based policies are the prerequisites for the development of financial system. Many studies have shown that for the pace of financial sector development, market-oriented economic policies are preferred over government-controlled economic environment. However, in a more liberalized economic environment, the need for an effective mechanism of regulation and supervision is equally important. A sound agency carrying effective and comprehensive regulatory and supervisory functions can minimize the effects of financial system shocks to a large extent. This will equally lead to ensure stability in the financial system. Nepal has been gradually experiencing a series of economic reform measures since the mid 1980s. This has resulted in widening and deepening the financial system both in terms of the volume and nature of financial businesses. However, some problems and challenges associated with the financial system have been appeared to be more crucial for the better functioning of the system. It has been revealed that the Nepalese financial system is basically bank-dominated. Capital markets and stock markets have not been developed in full scale of operations and the banking institutions, particularly the commercial banks, appear to be the major financial intermediaries in satisfying financing need of productive units of the economy. The non-bank financial institutions have not yet been developed in terms of size of the business compared to that of commercial banks. In examining the relationship between financial development and growth, banking indicators have been used and the relationship is examined by using ordinary least square (OLS) method of regression analysis. As there is no unique and universally accepted indicator of financial development and there are still some debates related to this issue, we apply some proxies of the related areas in testing the relationship between the two parameters. The results in this paper confirm the strong and statistically significant relationship between

financial depth and economic growth. The result is robust to four different financial development indicators covering the banking system. The effect in each case is powerful, although the size of the effect varies with the particular indicator under consideration. By examining the relationship through different regression equations, I find that monetary aggregates, particularly, narrow money has strong explanatory power in predicting the level of economic development. It is also revealed from the study that financial development indicators such as liquid liabilities (M_1 and M_2), Commercial banks' total credit and credit to private sector better explain economic growth indicators in nominal term rather than in real terms. The conclusion is that all these financial development indicators used in this study are positively related with the economic growth indicator. The test of significance of the elasticity coefficients also confirms that there exists the relationship between financial development and economic growth.

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Annex I

Banking and Financial Development Indicators

Rs in Million

			Central Bank's Claims					Commercial Bank's Claims				
Mid-July	M1	M2	Government	Government Enterprises	Commercial Banks	Private Sector	Total	Government	Government Enterprises	Private Sector	Foreign Bills	Total
1975	1337.7	2064.4	466.2	136.2	368.9	21.6	992.9	100.4	432.5	761.8	27.3	1322.0
1976	1452.5	2524.0	578.2	116.1	24.1	22.6	741.0	119.6	451.2	693.6	46.5	1310.9
1977	1852.9	3223.0	482.9	178.2	55.4	39.5	756.0	479.9	332.8	824.7	54.0	1691.4
1978	2060.6	3772.1	844.4	259.4	174.1	33.5	1311.4	351.5	609.3	1037.6	78.8	2077.2
1979	2504.9	4511.4	994.9	354.1	168.9	31.7	1549.6	371.8	725.8	1299.9	185.2	2582.7
1980	2830.4	5285.3	1104.6	372.1	264.4	48.9	1790.0	371.2	758.9	1867.6	171.5	3169.2
1981	3207.8	6307.7	1091.3	398.7	468.1	58.8	2016.9	324.8	1001.9	2439.3	162.0	3928.0
1982	3611.5	7458.0	1504.6	449.8	137.8	61.9	2154.1	641.8	893.6	2576.3	111.6	4223.3
1983	4348.9	9222.4	3016.7	489.1	74.0	64.3	3644.1	1161.0	1213.1	2634.8	143.5	5152.4
1984	4931.5	10455.2	3639.7	576.4	152.1	94.8	4463.0	1482.9	1045.4	3079.2	163.0	5770.5
1985	5480.0	12296.6	4577.3	708.0	388.0	159.3	5832.6	2018.3	1314.2	3877.3	297.4	7507.2
1986	7029.3	15159.0	5820.2	794.3	533.9	123.0	7271.4	1818.7	1865.0	5044.9	269.0	8997.6
1987	8120.2	17498.2	6544.6	845.4	520.3	161.8	8072.1	2326.8	1965.7	6117.9	319.7	10730.1
1988	9596.6	21422.6	6479.4	879.1	357.4	367.5	8083.4	3222.2	2022.5	7941.2	337.6	13523.5
1989	11775.4	26605.1	8773.9	809.5	160.1	277.2	10020.7	3771.4	3072.7	10079.8	340.6	17264.5
1990	14223.0	31552.4	10583.2	778.9	50.5	160.4	11573.0	3582.4	3254.9	11527.2	552.6	18917.1
1991	16283.6	37712.5	9901.0	730.6	37.2	555.6	11224.4	7343.1	2830.7	13553.1	683.6	24410.5
1992	19457.7	45670.5	10155.5	747.8	34.0	510.9	11448.2	9198.6	4079.5	17633.2	1247.4	32158.7
1993	23833.0	58322.5	13836.7	559.9	47.8	514.2	14958.6	9998.0	4189.9	21115.8	1339.0	36642.7
1994	28510.4	69777.1	15002.2	495.3	29.2	539.3	16066.0	8894.1	4243.9	29653.0	1445.3	44236.3
1995	32985.4	80984.7	17443.5	731.7	15.4	633.9	18824.5	8197.8	4318.7	42379.2	1286.8	56182.5
1996	36498.0	92652.2	20442.9	1149.3	364.6	940.0	22896.8	7548.4	5060.0	54584.8	1821.2	69014.4
1997	38460.3	103720.6	21934.7	1495.5	6.5	1489.0	24925.7	7746.2	5533.1	63169.7	2062.7	78511.7
1998	45163.8	126462.6	21986.9	1621.8	5.5	1186.2	24800.4	10280.7	5607.1	75643.9	2266.0	93797.7
1999	51062.4	152800.1	22776.1	1450.9	5.5	1367.4	25599.9	12659.1	7463.1	89433.1	2413.5	111968.8
2000	60979.8	186120.9	20598.3	1626.6	45.1	2104.5	24374.5	18176.7	8684.3	107343.1	1980.7	136184.8
2001	70576.9	214454.1	23798.1	1681.0	5.5	3340.5	28825.1	25393.0	10225.4	123417.4	1883.6	160919.4
2002	77156.2	223988.3	30432.7	1670.6	1043.7	3226.9	36373.9	29143.8	12760.5	130088.4	1326.5	173319.2
2003	83754.1	245911.3	23817.4	1557.5	947.4	2883.7	29206.0	39469.3	13104.4	148073.2	1175.6	201822.5
2004*	94291.7	279125.1	13194.0	1494.0	572.1	1914.6	17174.7	42662.7	15161.3	157089.8	1242.7	216156.5

* *Estimated*

Source: Quarterly Economic Bulletin, Vol. XXXVIII, No. 1 & 2, Nepal Rastra Bank.

Annex II

Economic Development Indicators

	Rs in Million		Population	In Rupees	
July	RGDP	NGDP	in Million	Per Capita RGDP	Per Capita NGDP
1975	91237.10	16601.00	12.84	7108.20	1293.37
1976	95254.00	17394.00	13.18	7228.86	1320.04
1977	98123.70	17280.00	13.53	7253.70	1277.41
1978	102443.20	19727.00	13.89	7376.79	1420.51
1979	104871.80	26128.00	14.26	7356.00	1832.69
1980	102443.50	23351.00	14.64	6999.49	1595.46
1981	110990.50	25530.00	15.02	7389.51	1699.73
1982	115179.00	30988.00	15.33	7512.12	2021.08
1983	111755.10	33821.00	15.65	7140.29	2160.90
1984	122569.60	39290.00	15.98	7671.69	2459.18
1985	130172.10	46587.00	16.31	7981.51	2856.49
1986	136239.90	55734.00	16.65	8183.35	3347.70
1987	138922.60	63864.00	16.99	8174.46	3757.87
1988	148405.00	76906.00	17.35	8554.49	4433.08
1989	156478.00	89270.00	17.71	8836.05	5040.93
1990	163893.00	103416.00	18.08	9066.18	5720.74
1991	174908.00	120370.00	18.49	9459.60	6510.01
1992	183371.00	149487.00	18.91	9699.08	7906.84
1993	188780.00	171474.00	19.33	9765.45	8870.23
1994	204397.00	199272.00	19.77	10340.65	10081.37
1995	209976.00	219175.00	20.21	10389.14	10844.28
1996	221930.00	248913.00	20.67	10738.97	12044.65
1997	233040.00	280513.00	21.13	11028.43	13275.05
1998	240816.00	300845.00	21.61	11145.65	13923.96
1999	251758.00	342036.00	22.09	11395.67	15482.05
2000	267096.00	379488.00	22.59	11823.90	16799.30
2001	279749.00	410789.00	23.15	12084.19	17744.67
2002	278848.00	422301.00	23.67	11780.22	17840.53
2003	286480.00	454935.00	24.20	11836.32	18796.27
2004	296459.00	494883.00	24.75	11979.09	19996.85

Notes:
** = Estimated*
NGDP = Nominal GDP at Producers' Current Prices RGDP = Real GDP at 1994/95 Prices
Population has been estimated on the basis of growth rates revealed by the National Population Census 1981, 1991 and 2001.
Real GDP for the period1975-1987has been calculated on the basis of GDP deflator (1994/95=100).
Source: Economic Survey (1992, 1998 & 2001) and Nepal Population Report 2002, HMG/N,

Annex III
Growth Rates

			Commercial Banks Credit				Per Capita	
Mid-July	M1	M2	Total	Private Sector	RGDP	NGDP	RGDP	NGDP
1976	8.6%	22.3%	-0.8%	-9.0%	4.4%	4.8%	1.7%	2.1%
1977	27.6%	27.7%	29.0%	18.9%	3.0%	-0.7%	0.3%	-3.2%
1978	11.2%	17.0%	22.8%	25.8%	4.4%	14.2%	1.7%	11.2%
1979	21.6%	19.6%	24.3%	25.3%	2.4%	32.4%	-0.3%	29.0%
1980	13.0%	17.2%	22.7%	43.7%	-2.3%	-10.6%	-4.8%	-12.9%
1981	13.3%	19.3%	23.9%	30.6%	8.3%	9.3%	5.6%	6.5%
1982	12.6%	18.2%	7.5%	5.6%	-3.0%	21.4%	1.7%	18.9%
1983	20.4%	23.7%	22.0%	2.3%	9.7%	9.1%	-4.9%	6.9%
1984	13.4%	13.4%	12.0%	16.9%	6.2%	16.2%	7.4%	13.8%
1985	11.1%	17.6%	30.1%	25.9%	4.7%	18.6%	4.0%	16.2%
1986	28.3%	23.3%	19.9%	30.1%	2.0%	19.6%	2.5%	17.2%
1987	15.5%	15.4%	19.3%	21.3%	2.0%	14.6%	-0.1%	12.3%
1988	18.2%	22.4%	26.0%	29.8%	6.8%	20.4%	4.6%	18.0%
1989	22.7%	24.2%	27.7%	26.9%	5.4%	16.1%	3.3%	13.7%
1990	20.8%	18.6%	9.6%	14.4%	4.7%	15.8%	2.6%	13.5%
1991	14.5%	19.5%	29.0%	17.6%	6.7%	16.4%	4.3%	13.8%
1992	19.5%	21.1%	31.7%	30.1%	4.8%	24.2%	2.5%	21.5%
1993	22.5%	27.7%	13.9%	19.8%	2.9%	14.7%	0.7%	12.2%
1994	19.6%	19.6%	20.7%	40.4%	8.3%	16.2%	5.9%	13.7%
1995	15.7%	16.1%	27.0%	42.9%	2.7%	10.0%	0.5%	7.6%
1996	10.6%	14.4%	22.8%	28.8%	5.7%	13.6%	3.4%	11.1%
1997	5.4%	11.9%	13.8%	15.7%	5.0%	12.7%	2.7%	10.2%
1998	17.4%	21.9%	19.5%	19.7%	3.3%	7.2%	1.1%	4.9%
1999	13.1%	20.8%	19.4%	18.2%	4.5%	13.7%	2.2%	11.2%
2000	19.4%	21.8%	21.6%	20.0%	6.1%	10.9%	3.8%	8.5%
2001	15.7%	15.2%	18.2%	15.0%	4.7%	8.2%	2.2%	5.6%
2002	9.3%	4.4%	7.7%	5.4%	-0.3%	2.8%	-2.5%	0.5%
2003	8.6%	9.8%	16.4%	13.8%	2.7%	7.7%	0.5%	5.4%
2004	12.6%	13.5%	7.1%	6.1%	3.5%	8.8%	1.2%	6.4%
Average	15.8%	18.4%	19.2%	20.2%	4.1%	12.4%	1.8%	9.9%

Source: Author's calculations

Financial Sector Reform

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Introduction

Financial sector is the backbone of the economy. Financial sector of any economy works as a facilitator for achieving sustained economic growth through providing efficient financial intermediation. Modern financial system is important in the economy in order to pool and utilize financial resources, reduce costs and risks, expand and diversify opportunities, increase the allocative efficiency of resources and promote the productivity and facilitate the economic growth. While sound and healthy financial system contributes to the growth of the real sector on a sustainable basis, uncertainty and fragility in the financial system adversely affect the objectives of economic development in general and poverty reduction in particular, as evidenced by the financial crises in different parts of the world over the years. The financial crisis of Japan of early 1990s, Mexican crisis of mid 1990s and Asian financial and economic crises of 1997 and Latin American events of 1997-98 have exhibited that crises may occur at any moment as and when the financial architecture and systems become weak. The history of financial crises has warned the government to be ensured on the stability of financial system, sustainability on economic growth and stability on socio-political front as well. An economy growing over a weak financial architecture is prone to collapse any time for its own reason. Insolvency of Enron, Collapse of Baring and WorldCom have made the financial regulators to think over the soundness of the system in order to making it capable to absorb the risks, volatility and shocks arising in the system either of its own or of contagion.

There is no doubt that the financial system needs to be structured on the strong base and should be complied with adequate international norms and best international practices. Financial supervisors should be legally strong, professional and responsible for enforcing such best practices. But the scenario is still weak in various developing economies. For instance, in the prudently managed system, the supervisors need to be satisfied that at first instance each bank and financial institution has to comply with the core principles of Basel Accord. Financial Sector Assessment Program (FSAP) conducted by the World Bank and the IMF in various developed and underdeveloped financial markets in 1999 highlighted that most of the developing countries were still in the vulnerable situation as they were not complying with those Basel core principles. The case was not distinct to Nepal as out of 25 core principles and 30 norms of Basel Accord 1988, Nepal was only compliant to one core principle and largely compliant to merely 7 core principles and norms (Lacombe & Olaso 1999). Hence, the indicators of the financial sector of Nepal as well as the procedures exercised in the system had indicated that the system was weak,

vulnerable and risky up to recent past. Therefore, a reform strategy was felt necessary to be launched in the economy. In this way, the financial sector reform (FSR) has been adopted as a strategy aimed at making the financial system well diversified, sound, competitive and supportive to the attainment of development objectives of the economy.

It is widely accepted that in order to establish a modern financial system three basic foundations are required in any market oriented economy (Williamson, 1999). These foundations are also required to be structured systematically. Among these, the first is liberalization of the financial sector, which seeks to put the private sector rather than the government to play the active role in mobilising financial resources and providing of financial services. The second foundation is the establishing of a system of prudential regulation and supervision, designed to restrain the private actors from going against the interest of stakeholders and general public. The third foundation is the strengthening of the institutional infrastructure and building capacity of the system as a whole.

As in most of the countries, the banking institutions predominate the financial system of Nepal. Among these institutions, the banking sector's share in the total deposits and lending is not only significantly high but that the problems and stakes in this sector are also accordingly challenging. The share of deposit and credit of the banking sector on total deposits and credit of the system are 82 percent and 72 percent respectively in mid July 2004.[1] On the other hand the negative level of capital fund, high level of NPA, poor risk management skills, governance weaknesses and other several deficiencies have been found in the banking system. So, with the view to addressing the huge problems and challenges of this sector, the strategy paper of the government on financial sector reform has focused more on the banking sector as the overriding component of the overall financial sector reform strategy in Nepal. But it does not mean that other areas have been neglected. The other areas such as insurance sector, securities market and corporate sectors are also being strengthened side by side by the government.

Overview of the Nepalese Financial Sector -Past and Present

With the economic liberalization initiated in mid-1980s, the Nepalese financial system witnessed significant developments in the growth of financial institutions. For instance, the financial system which consisted of only two commercial banks and few other financial institutions before liberalization doubled within a decade and become more than hundred in another decade. The institutional strength was further enhanced in the later periods. In this way, during the post-liberalized regime spanning almost two decades, the financial system has reasonably developed, diversified, and enriched. As of December 2004, the financial system consisted of 17 commercial banks, 28 development banks, 5 regional rural development banks (RRDBs), 116 postal saving banks, 59 finance companies, 21 saving and credit cooperative societies involved in limited banking activity, 45 non-government micro-credit institutions, one stock exchange with a network of brokers and securities dealers, 17 insurance companies, one employees' provident fund, one credit guarantee and deposit insurance corporation, and one Citizen Investment Trust. Of these institutions, the commercial banks, development banks, RRDBs, finance companies, financial cooperatives and NGOs are under the regulatory framework of Nepal Rastra Bank (NRB). While the Insurance Board (IB) regulates the insurance companies and the Securities Board (SEBO) regulates the stock exchange, the other institutions are under the overall regulation of the government.

Along with the numerical growth and other institutional developments of the financial sector, the deposits and credits are expanding though the qualitative aspects of the financial system still require much improvement as reflected in the inadequacy of the banks and financial institutions in providing increased benefits to the general public and in contributing adequately to the economic development through raising income level, creating employment opportunities and building internal strength for the growth of the institutions themselves.

Though various reform efforts were undertaken in the past, to create a healthy financial sector as a pre-requisite to sustained economic growth by eliminating the various institutional and structural deficiencies that still characterize the system, further FSR measures need to be continued, initiated and implemented.

Past Reform Efforts and Outcome

Reform Measures During 1980s

Till early-1980s, the banking sector was not opened up freely for the private sector in order to enable them to own its majority ownership. Only two commercial banks then in operation were the Rastriya Banijya Bank (RBB) and the Nepal Bank Limited (NBL), with the HMG ownership of a hundred percent at the former and fifty-one percent at the latter, functioning with their network of branches across the country. Three joint-venture commercial banks came into operation during the 1980s. By that time, the fully government-owned and majority owned commercial banks had begun to exhibit serious portfolio problems and its severity was deepening. It was not because of their expansionary stages but because of the weak operational performance, mismanagement and imprudent lending decisions that these banks went through during those days. The Commercial Banks Problem Analysis and Strategy Study (CBPASS) was carried out in FY 1989/90 to assess the real financial position of these two banks so as to help these banks to assess their current financial situation, planning for the further course of action and developing operational strategy for making them capable, dynamic and competitive in the context of national need. The study was conducted under the technical collaboration of UNDP and implemented after 1990. Economic reforms under Stand-by Arrangements and the Structural Adjustment Facility (SAF) of the IMF and the Structural Adjustment Lending (SAL) programs of the World Bank during the later period of 1980s also incorporated various measures aimed at improving the financial and monetary sector of the country. The reform measures in the financial sector were concentrated on strengthening financial and operational performance, improving the legal and institutional environment, enhancing the capacity of the central bank to supervise the banking system, implementing the improved regulations, and rationalization of branch expansion policies. Accordingly, the following reform activities were completed in non-coordinated basis:

- Joint venture banks were allowed to enter into the Nepalese economy in 1984.
- ADB/N was permitted to carry out commercial banking functions in 1984.
- Commercial banks were allowed to accept foreign currency deposits from July 1985.
- Open market operations (OMO) initiated as indirect measure for monetary control in 1988.
- Auction of treasury bills on weekly basis started from November 1989.
- Initiation for deregulating interest rates in the financial sector in 1989.
- Credit Information Bureau (CIB) was set up in 1989 to disseminate credit information.
- Legislative changes were enacted to permit the NRB to supervise NIDC in 1990.
- Amendments to the Commercial Bank Act and the NRB Act were made in 1989 and that in the NIDC Act in 1990.

In fact, the reform measures of 1980s were in the right direction for improving the environment during that period. These efforts are also significant in terms of initiating liberalization in the system and creating bases for further improvements. Despite the efforts of 1980s, it was exhibited that those reforms measures could not improve the system substantially as the reforms lacked comprehensiveness and sustainability and were initiated on the piecemeal basis.

Reform Measures During 1990s

As the result of the liberal economic policy thrust adopted in the eighties, the financial sector had benefited from several competition-enhancing measures like the new liberal entry policy for banks and non-banks, autonomy in determining the interest rates, implementation of prudential regulatory measures, etc. The reform measures were continued during 1990s, initially supported by the IMF's ESAF which, however, could not be fully implemented as only 50 percent of the approved amount (SDR 33.6 million) was drawn. Some of the reform measures introduced included the withdrawal of statutory liquidity ratios, granting of the maintenance of the foreign exchange exposure to commercial banks, and provisions for allowing to open further personal foreign currency accounts. Similarly, cash reserve ratio and refinance rates were reduced several times. With a view to introducing private sector culture and strategic alliance, the shareholding of the government in the NBL was offloaded. HMG's majority stake was reduced to 40.49 percent in the NBL. With a view to strengthening and improving the performance of the two commercial banks, as per the CBPASS report HMG provided Rs. 443 million for re-capitalization and further Rs. 3.12 billion for provisioning and repayments of bad debts in 1991.

To improve the soundness of the banks HMG made a payment of Rs. 400 million toward government-guaranteed bank loans to public enterprises and second payment of Rs. 260 million in 1991. Some technical assistance was also provided by the IMF to strengthen the banking supervision and inspection function of the NRB. The recommendations of CBPASS II (1992) began to be implemented. Consequently, the recovery targets were fixed in NBL and RBB and the Inspection Department of NRB was also expanded with additional human and other resources.

Accordingly, some standardization on regulatory norms were also designed on piecemeal basis in order to regulate commercial banks with respect to capital adequacy (1991), abolishment of Statutory Liquidity Ratio (SLR) requirement (1993), loan classification, provisioning requirements and liquidity norms (1996), definitions of core capital and supplementary capital (1996), increment in the capital (1996) etc. Some other norms such as opening secondary market for treasury bills (1991), issuance of NRB bond to mop up excess liquidity (1991), re-discounting of treasury bills with NRB (1993), introducing a full convertibility in current account (1993), establishment of Eastern Rural Development Bank (1993), were also established on case-by-case basis.

The system was also enriched by introduction of new laws such as Foreign Investment and Technology Transfer Act, 1992 and several rules and byelaws on securities markets by SEBO. All these efforts helped to facilitate the growth of financial institutions, directly and indirectly.

In addition, in order to develop and maintain managerial capabilities in the banks and financial institutions, some chairpersons, board of directors, and CEOs were also appointed from among the professionals of the NRB and HMG. All these attempts and initiatives could not exhibit the aspired performance. In the given situation, a "Reconciliation Project", was undertaken by the NRB in 1999 with the help of the Nepalese auditors to study RBB and to identify the real financial soundness and quality of financial statements. This study revealed many discrepancies regarding the financial strength and soundness of the bank. The financial indicators of RBB and NBL were exhibiting poor conditions. Thereafter, to verify such findings, a study of RBB and NBL was conducted by KPMG, an International Auditor's Group, in 2000. The two studies portrayed extremely serious position of these banks. The report highlighted that RBB and NBL were having serious shortfalls in all aspects of their governance, management, and operations and were found technically insolvent. The KPMG report also showed that loan assets in those banks were extremely risky and highly overstated. To sum up, the KPMG report highlighted the following aspects of RBB and NBL:

- Severe governance and management shortfalls,
- Dysfunctional lending processes,
- Extremely poor information systems, accounting and record keeping practices,
- Poor strategic planning, business planning and budgeting,
- Low morale of employees and numerous human resource issues,
- A negative net-worth, and
- Technically insolvent.

Hence, it was a matter of grave concern for the country's financial sector as these two banks represented approximately half of the total assets of the banking system with wider branch network in the country at that time. Therefore, it was apparent that without implementing a comprehensive reform program in the financial system, it was impossible to create a sound and healthy economy.

Problems of the Nepalese Financial System and Importance of Current Comprehensive Reform Program

The reform measures would be instrumental in improving the soundness of the structure and making positive breakthrough in the competitiveness and effectiveness of the financial system. A sustainable growth cannot be assured in the absence of safe, sound and efficient financial system in the economy. It was also realized that without additional reform measures, the efforts the authorities have made to date to improve the efficiency of financial intermediation, the gains of the past reform efforts and the progress of those that have been achieved toward gaining stability can not be continued and justified in the future. In this context, the reform in all the areas of central banking, commercial banking, and non-banking systems has been vital and needs to be properly implemented in the continuous manner.

A breakthrough in the system was the promulgation of NRB Act, 2002. After the promulgation of the NRB Act 2002, the central bank now has the clearly defined responsibility, authority and accountability. The central bank aims at boosting up the contribution of the financial system towards achieving the national goals of macroeconomic stability and financial discipline to a greater extent through increasing efficiency in mobilizing and allocating financial resources, enhancing savings and investment levels, channelling the resources towards productive investments and allocating the available resources to the deficient segments of the economy for enhancing overall competitiveness. But the system still has various structural deficiencies. The astounding level of NPA, which was 30.4 percent in the banking system in 2002 (RBB 55.07%, NBL 56.27%) and is still nearly 23 percent in July 2004, has compelled the banks to bear high profile of risk. The negative net-worth of the two largest commercial banks, which amounted to Rs. 29.60 billion in mid-July 2002, (Rs. 30.2 billion in July 2004) had made the overall capital fund of the whole banking system negative by Rs. 38.79 billion. This had threatened the stability and sustainability of the system. Weak and poor legislative regime governing financial system had been the bottleneck affecting the faster growth of financial institutions. Quick service delivery to general public and quick recovery from defaulting borrowers have become difficult to date. The risk profile exhibited through higher default rate has minimized the scope of reducing interest spread between lending and borrowing rates. Adequate institutional strength required to support the financial system is still lacking. Due to increment in inefficient banking activities, the intermediation function has been overburdened with non-core activities in the system. The securities market, insurance sector and other contractual saving institutions are also suffering from various legal and structural deficiencies.

On the other hand, the pre-dominance of informal financial sector has stood as a question mark to the policy makers that their efforts have not been adequate for providing low price funds to enthusiastic entrepreneurs throughout the country. Concentration of banking institutions in urban areas is pointing out to the need for more focused policy interventions for channelizing resources in the rural sector. As monitoring and supervision cost of the banking institutions is high, the practice of retail banking is gradually being reduced and replaced with wholesale one which has ultimately discouraged the small deposit and lending in the system. The system is lacking banking professionals and skilled managers as well and the gap has created operational inefficiencies, managerial deficiencies, unhealthy competition, and poor banking culture in the system. HMG's involvement in the financial institutions has been significant to date and it will take some time for it to be replaced by the private sector. These institutions are not easily saleable in the market and require restructuring to attract private investors. There is still a long way to travel to reform the whole financial system with satisfactorily tangible outcomes.

It should always be borne in mind that without a healthy and efficient financial system in the economy, credit delivery and allocative efficiency of the system will not be improved. Not only this, without a healthy financial system, a stable financial growth along with high and sustainable economic growth cannot be achieved. Therefore, an efficient, stable and healthy financial sector is needed for promoting economic growth and attaining rapid progress in the poverty reduction. In this regard, a concrete understanding for improvements of the system was developed and a clear road map was drawn for it in 2000 when the financial sector strategy paper of the government was announced in 2000. Later on, the budget program of HMG/N of 2001/2002 incorporated the reform program. Accordingly the NRB Act was enacted from 2002 and a comprehensive reform program was widely executed.

Thrust of Current Comprehensive Reform Program

Drawing on the inadequacies of the piecemeal attempts of the past reforms, it has been felt necessary to initiate and expedite the process of comprehensive reform and other improvement measures. Hence, the moves toward current comprehensive financial sector reform program reflect the strategic change to eliminate the extremely difficult situation that the financial system of Nepal has undergone. The thrust of the comprehensive reform program is to create a competitive, market friendly, well diversified and prudently managed financial system capable to lead the desired growth of the economy.

With the reform initiatives have come the changes in the attitude towards the state-owned commercial

banks as more emphasis now has been placed on commercial orientation, privatization, managerial culture, greater autonomy and accountability. Therefore, HMG came out with the financial sector reform program by encompassing a wider coverage of issues for their improvement. In the mean time, Nepal had already applied to get membership of the World Trade Organization (WTO). Within the WTO environment, member countries are required to strengthen their system so that it will be efficient, healthy and sound to compete in the global context on which restrictions on flow of goods and services need to be eliminated gradually. Accordingly, the financial sector also needs to be opened up for global competition and needs to be exposed to international arena. For this, the financial sector was demanding further globalization, liberalization, modernization, privatization and competition, the five pillars of market economy. Therefore, the comprehensive reform initiative has aimed at enhancing these five pillars and maintaining a healthy system in the economy. To accomplish the reform in various areas of the system, HMG has obtained financial assistance from IDA, DFID, and ADB so that the financial sector reform program could be launched with a wider coverage, prospective and well-defined set of objectives.

The Financial Sector Reform Strategy Paper (FSRSP) of the Government

The clearly identified and addressed agenda of reform in the financial sector have been announced on the Financial Sector Reform Strategy Paper (FSRSP) of the government. This financial sector strategy paper of the government was approved by the cabinet on Oct 3, 2000 and was announced publicly on November 22, 2000.This is also known as the financial sector strategy statement of HMG/N. According to the FSRSP, the objectives of initiating the reform are the following:

(i) Strengthen the central bank,
(ii) Build and maintain strong banking and non-banking sector,
(iii) Improve existing legal and judicial aspects of financial system,
(iv) Improve auditing and accounting standards within the banking sector,
(v) Promote financial discipline through adequate disclosure and competition,
(vi) Initiate more focused interventions toward the programs for the upliftment of the poor,
(vii) Re-orient the activities of HMG and NRB from being active participant (owner) of the financial institutions to a regulatory body.

The strategy paper of HMG has assigned an important and enhanced role, responsibility and accountability to the central bank. The government has fully supported the efforts of the NRB in strengthening banking supervision and enforcing the regulations. Obviously, the NRB has been assigned to focus and handle the following reform activities in the financial sector:

(i) Reforming the financial sector legislations and regulations,
(ii) Strengthening of bank supervision and inspection,
(iii) Restructuring and privatization of RBB and NBL,
(iv) Enhancing competition in the banking sector and streamlining of ownership structure,
(v) Discouraging multiple banking practices,
(vi) Reforming the auditing and accounting capabilities,
(vii) Creation of broad-based banking,
(viii) Establishment of Bankers' Training Institute, Assets Management Corporation (AMC) and Credit Rating Agency in Nepal,
(ix) Restructuring of Credit Information Bureau,
(x) Strengthening of Regional Rural Development Banks,
(xi) Revamping research and financial monitoring strength of the NRB,
(xii) Meeting sectoral financing requirements and establishment of development banks at the regional level,
(xiii) Broadening and deepening of financial system in Nepal and
(xiv) Initiating restructuring program for ADB/N and NIDC.

The Cost Structure and Current Project Design

Cost Structure of the Project

The cost component and the sources of its financing need to be clarified before launching any project. For launching the comprehensive financial sector reform program HMG had requested the World Bank to finance it. In this regard, the World

Bank has already approved the financing for two phases of the project and the contract agreements have already been signed. If further assistance is required to complete the program, HMG will have to approach the World Bank. Hence, the reform program in Nepal has been launched with the financial assistance of the International Development Association (IDA) of the World Bank group and a grant of DFID. It is worthwhile to mention here that the World Bank has upgraded Nepal as a country eligible to receive financial assistance from 'low case' to 'base case' level from 2003. It has provided a provision of further enhancements depending on the progress of reforms.

The first phase of Financial Sector Technical Assistance Project (FSTAP) credit agreement was signed on April 30, 2003 with a closing date of June 30, 2007. The cost of the first phase project is estimated to be US $ 30.1 million. The funding of the project is allocated as follows : IDA Credit: US $ 16 Million, DFID Grant: US $ 10 Million and HMG/N Grant: US $ 4.1 million. The financial assistance has been used to cover the cost of management teams in RBB and NBL, reengineering of NRB and capacity building of the financial system.

Similarly, the second phase of the financial sector technical assistance credit agreement was signed on June 10, 2004, with a closing date of April 29, 2009. The estimated cost of the second phase of the project is US $ 75.5 million. The funding of the project is allocated as: IDA Credit: US $ 68.5 Million, Grant: US $ 7.0 Million. This financial assistance has supported the on-going reform programs to restructure and right size the RBB and NBL and strengthen the supervisory capacity and computerization works.

In this way, the total cost of the project has reached US$ 105.6 million, i.e. Rs. 7.55 billion (calculated at the selling rate of January 15, 2005), which is 1.6 percent of GDP (in current market prices of FY 2003/04, i.e. Rs.472.42 billion)

Project Design and Components for Financing

The FSTAP has provided due consideration for the improvement and development of the three weaker dimensions of the Nepalese financial system. Accordingly, the components and sub components of the project have been prepared and designed by the government for financing purposes. The major components of the FSTAP are as follows:

(1) Re-engineering of Nepal Rastra Bank,
(2) Restructuring of RBB and NBL, and
(3) Capacity building in the financial sector.

These three broad components have aimed at accomplishing all the programs as mentioned above in the Financial Sector Strategy Paper of the HMG/N, announced on November 22, 2000.

The first component of the FSRP is the Re-engineering of Nepal Rasta Bank. It comprise of tasks such as enhancing capabilities of NRB on its human resource, bank operations, accounting and auditing, Research Department support, information technology support, support to Legal Department and supervision and surveillance of the management teams in RBB and NBL. The second component is to restructure NBL and RBB. This includes the cost for the management teams placed in those banks, some IT support and trainings. The third component is the capacity building program of the financial sector. This comprises of support fund for capacity building for Bankers' Training center, Credit Information Bureau, Financial Journalism and support for co-ordination and support team (CST) of the project. This segment also comprises other non- funded activities and policy interventions within the program mandates.

The second phase of the loan and grant assistance has supported the on-going efforts in improving the financial sector which is expected to ensure continued macroeconomic stability and promote private sector led economic growth. This assistance is being utilized particularly in (a) right sizing Rastriya Banijya Bank and Nepal Bank Limited through the implementation of VRS (b) strengthening NRB's monitoring and supervision capacity through human resource development and installation of computer and information technology system and (c) supporting the professional management team at Rastriya Banjya Bank and Nepal Bank Ltd for the extended periods.

Current Progresses within Comprehensive FSRP

At the moment, Nepal is passing through the initial stages of the comprehensive financial sector reform program. A significant homework has been completed within the FSRP and a lot of activities have been launched and some very important accomplishments have been achieved to build a strong financial architecture in Nepal. The following are the major developments attempted within a short span of time, i.e., during 2002-2004.

Re-engineering of Nepal Rastra Bank

Attainments on Re-engineering of NRB

NRB has a big role to play as the supervisor and regulator of the financial system and monetary controller of the economy. But, the NRB was weak in the past (up to 2001) due to existence of the following three basic weaknesses in the system. The first was the weak and outdated legal framework governing the functions, role and responsibilities of NRB. The NRB had no position to adequately discharge its responsibilities. It was handicapped by a lack of autonomy, lack of clearly defined core functions and an excessive number of poorly trained and unproductive employees. The second weakness was the financial system dominated by government owned and directly operated banks, leading to difficulty to perform the role of a supervisor and regulator of the system. The third related to the lack of standardized regulations and standardized risk based inspection and supervision system and practices.

Therefore, to make the central bank independent, sound, strong, professional and well equipped in order to manage the system prudently and effectively, a modern central bank law was necessary. In this regard, the task was initiated within the financial sector reform program by promulgating a strong act for the functioning of NRB in 2002. In this new Act, the supervisory role of NRB has been made clear. Similarly, more responsibility and accountability has been provided to the NRB. Accordingly, a series of new standard prudential rules and regulations have been prepared and issued for regulating the financial system.

In the reform program, the inspection and supervision functions have been strengthened. The NRB Inspection Byelaw 2059 has been effective from March 18, 2003 and as per the provision set forth under section 11(Ka) of this byelaw, it has made the 'on site inspection manual' effective from the same date. This is a risk based On-site Inspection Manual. The methodology, as prescribed in this manual, is being implemented by the NRB. Similarly, effective from January 15, 2004 the Off-site Supervision Manual has been implemented. For the preparation of these manuals Ms. Fredrika P Santos, a consultant, was hired. She had assisted to the NRB in preparing those standardized manuals. For strengthening the implementation aspects of offsite surveillance, Mr. Jerry Coleman, another consultant, was hired in April 7, 2003 and for strengthening on-site supervision Mr. Richard L. Ortega was hired from May 29, 2003 for about one year. In this way, new inspection manuals on on-site inspection and offsite supervision have been prepared and placed and international experts are still being hired to uplift the skill among on-site and offsite supervisors of the NRB.

To enhance the professionalism, efficiency and productivity of the staffs of the NRB, human resource (HR) functions have been restructured. NRB had obtained technical skill from a foreign human resource consultant for the improvements on HR fronts from March 31, 2003 for a year. The HR expert, Mr. Alexder L. Sim, has addressed various weak areas that needed improvement and has also provided a series of recommendation to strengthen the HR function of the NRB. Accordingly, the NRB has begun to tackle those HR issues. In order to right size the staff strength, the VRS has been launched under two phases. Effective from March 31, 2003 the first phase of the VRS was launched and completed by May 5, 2003. Under this VRS scheme, 370 employees opted for retirement. Similarly, under the second phase of the VRS, which was initiated in March 31, 2004 with last date of May 5, 2004, another 102 staffs have been retired. The bank still needs to lower down the staff level to right size the bank. For this purpose, alternative solutions are being explored.

To enhance the skill and knowledge of the employees, training needs of all departments have been identified. Training programs for inspection and supervision staffs have been conducted.

The NRB's corporate re-organization model was developed and implemented since December 15, 2003. This new corporate structure is based on the classification of NRB's functional activities. It has divided the functional areas of NRB into four groups (monetary and foreign exchange policy; banking operations; regulation and supervision and support services). Internal Audit Department has been made active and effective. The Internal Audit department is supervised by the Governor. In this way the functional duplication of works among departments has been eliminated now.

The NRB has begun to offer competitive prices in the market in order to hire and retain the professional staffs in the organization. It is important

to motivate the manpower and retain the experienced and skilled staffs within the organization. To get rid off from the stagnant practices of the past, the benefit packages were reviewed and necessary adjustments were made by the NRB in 2003. The NRB has adopted this practice as a continuous process in the bank. Such periodic reviews on the incentives will help the NRB in retaining the professional staffs in the Bank.

The personnel byelaw has been reviewed to enable the bank to hire and retain the professional staff to enhance the capacity of the central bank. For this purpose, new employees' rules have been drafted and it will be implemented in the near future.

Similarly, in order to improve efficiency of the departments, the functions of the departments have been restructured in 2003 and job responsibilities of officers have been prepared. The NRB Re-engineering Program is also aimed at strengthening of some departments in the coming years. For this, various experts are being recruited such as one consultant for Banking training centre, one for Credit Information Bureau, seven international supervisors for inspection and supervision, two human resource advisors for HRD, six chartered accounts for account and audit and one restructuring advisor (Privatization Advisor) for NBL and RBB (that is to be recruited very soon).

The IT/MIS are being installed and improved. To design, install and launch appropriate systems and procedures on IT in the NRB, Mr. Krish R. Krishnan, a consultant from USA, has been hired and placed from August 9, 2004. To computerize the supervisory departments, procurement of hardware has been completed and further re-engineering of processes is being initiated.

The strengthening of supervisory functions has resulted on the better performance and wider coverage of inspection and supervision of banks and financial institutions. After launching of the reform program, NRB has been able to complete the inspection and supervision of all the 17 banks of the system at list once within the two-year period. To implement Basel II by 2007, a group of bank professionals is working on it. In order to conduct a detail study and recommend the policies for further liberalizing the system under WTO norms, core groups and teams are working on it.

The NRB has begun to announce the monetary policy for each year since 2002. The Inspection Reports of the banks have been begun to be published and disseminated to the interested groups. Most of the publications have been publicly made available in the NRB's web (www. nrb.org.np).

All these developments are clearly manifesting positive signs toward capacity building program in the NRB.

Progress on Restructuring of NBL and RBB

The restructuring of NBL and RBB is the second most important component of the comprehensive financial sector reform program. In order to restructure these two big troubled banks, the notice for the procurement of management teams was published in *The Economist* on September 30, 2000. After evaluating the applicants, Earnest and Young, ICC Bank Plc, Price Water-house Coppers and Development Partnership were short listed in the first round for the NBL management team. Similarly, Deloitte Touché Tohmatsu, The DFC group, Arthur Andersen and GMA Capital markets were short listed in the first round for the RBB management team. Finally, after evaluating the technical and financial proposals submitted by these consultancy firms, the contract was awarded to Deloitte Touché Tohmatsu (DTT), USA on January 31, 2002 for the management of the RBB and ICC Bank Plc on June 17, 2002 for the management of the NBL. After the disagreement of the assignment by the DTT, which was later concluded with an amicable solution, another management team was placed in the RBB. The ICC Bank Plc, ICC consulting resumed the assignment in NBL from July 22, 2002.

In the meantime, the NBL, as a problematic bank, was taken over by the NRB on March 8, 2002. The Board of Directors were suspended and a new Management Committee was formed in NBL, exercising the power vested in Section 86 of the NRB Act, 2002. On the other hand, effective August 1, 2002, full authority was provided to the NRB to appoint all the Board of Directors in RBB for facilitating the restructuring works in the bank.

After placing the foreign management teams in these two banks, the operational and profitability positions have been improved within the two-year period. The results are encouraging. The major accomplishments to date on restructuring of these banks have been explained below.

Restructuring of NBL

As a component of bank restructuring program of FSRP, an ICC Bank Management Team

"ICCMT" consisting of international bankers from Bank of Scotland (Ireland) Ltd. was appointed in the NBL, initially for two years. Under the leadership of Mr. Craig McAllister, the ICCMT had assumed its assignment in NBL on July 22, 2002.

In order to organize the restructuring program in the NBL, the contract between ICC consulting and NRB was carefully prepared. The contract document was comprehensive and well structured for two years. This comprised of conditions of the contract, description of services of the management team, objectives of the management teams, key operating policies, immediate actions to be taken by the management team, on-going assignments, reporting requirements and time based performance indicators of the management team. The whole contract period of two years was divided into four phases. The first phase, of one and half month's period, had aimed at completing the quick assessment of financial position and preparation of the management plan for restructuring of the bank. The second phase of four and half month's period was targeted to design and launch comprehensive plans and programs, specially restructuring programs on human resource, loan portfolio management, asset and liabilities management, accounts, MIS/IT , and improving employees relation issues. The third phase, with a period of six months, was focused on the ongoing of the restructuring program and assessing the need for further improvements. The major objective of this phase was to be able to produce timely and regularly accurate financial statements, complete audit, split good and bad bank, reduce the level of NPA, install IT architecture, transform labor unions into efficiency units, launch VRS and right-size the bank, and improve the operational areas. The fourth phase of twelve months was designed to pursue on going improvement and preparing for privatization.

Except for some activities on capitalization, computerization, successor planning and reporting requirements, the management team has completed almost all the tasks as prescribed on the contract. The management team completed the financial analysis of the NBL within 45 days. The activity on the preparation and submission of management plan and the budget plan for the Bank was completed within the stipulated time. To-date, the team has come up with clear vision, mission, goals and objectives of the bank. Asset-Liability Management Committee (ALCO), Executive Committee (EXCO), Credit Committee (CC), Relation Management Division (RMD), Credit Administration and Review Division (CARD), Special Asset Group (SAG), and several special Task Forces have been established to create, apply and reinforce internationally accepted norms and modalities in the bank. The norms and modalities are focused toward identifying bank risk and enhance the loan risk rating systems in the bank. New Credit Policy Guide, Guidelines for Credit Decision Process, and Problem Loan Guide have been prepared and implemented from 2002. A continuous negotiation and dialogue with big defaulters has been initiated and around Rs. 4.2 billion of loan categorized as NPA has been recovered in cash within the two-year contract period. Similarly, in order to improve the quality of loan portfolio, distressed and delinquent loans worth Rs. 3.6 billion have been rescheduled/ restructured within this period. Despite the best efforts of the management team, loan recovery of the bank cannot be considered as satisfactory as the bank still has NPA worth Rs. 9,640.1 million in July 2004. Out of total loan portfolio of Rs 17,937.7 million this forms 53.74 percent which is extremely high. Hence, the management team still needs to make more serious efforts to loan recovery.

On accounting and auditing fronts, new accounting manual and chart of accounts have been introduced in the bank. Around 300 employees in the NBL have received the accounting trainings within the two-year period. The pending audits of FY 2000/01 and 2001/02 were completed in 2003 year and the financial audit of 2002/03 and 2003/04 have also been completed in time. NBL has been able to produce and publish the quarterly financial statement since 2003.

A detailed Human Resource Master Plan and Skill Enhancement Plan has been prepared and implemented. The bank had altogether 5652 employees at the end of July 2002, where as the actual requirement was merely 3630 at that moment. Therefore, to right size the bank, the first phase of the VRS was launched from September 17, 2003 to November 16, 2003. This program has been very successful as it was able to reduce the staff level by 1,462. Later on, the second phase VRS was made effective from 27 August 2004 to 15 September 2004. This VRS reduced another 198 staffs in the

bank. In this way, on January 2005 the staff strength has been reduced to 3,604 and it has come down to the targeted size. Within this period the bank also consolidated and rationalized the branch network, reducing the number of branches to 116 from 206 in 2001. After the branch rationalization, the required number of employees of the bank has further come down. Therefore, the bank has reassessed its requirements and has announced the third phase of the VRS effective from. February 25, 2005 to March 14, 2005. This program has been successful as 600 employees have opted for retirement within this scheme

Staff motivation and moral factors have been improved in the bank. Staff compensation package was revised and increased from July 16, 2004. Around 700 employees were promoted with two years. To fill the skill gap, around 100 new employees in managers and assistant managers' position were recruited from the market at the end of 2004. Around 2,720 employees were imparted trainings for skill enhancement during the project period. All these reform measures have enhanced the level of performance of the employees in the bank. The changed management is systematically and adequately administered in the bank.

In the restructuring process, installation of IT platform in the Bank is an activity of significant importance. For this purpose, many activities were required to be completed. In this connection, the IT plan was prepared, requirements of the bank were assessed and procurement process initiated in the first year of the assignment. The opening of bids in the NRB for the supply, delivery and installation and commissioning of information system to Nepal Bank Limited was completed on March 19, 2003. The process of evaluation of bids was completed on April 28, 2003. After obtaining the no-objection letter from the WB on May 20, 2003 the consultant was invited for negotiation. Negotiation with ICICI InfoTech India Ltd, for the supply of Integrated Banking Software was completed and contract was signed on September 10, 2003. Equipments arrived on February 29, 2004 and these equipments began to be installed from April 14, 2004 beginning from the Lalitpur Branch. The installation of IT platform expanded from Lalitpur Branch after completing pilot test only from February 2005. It has been observed that the IT installation work is one of the complicated and complex areas in the restructuring process and took a lot of time.

The financial indicators exhibit the turnaround position that has been achieved within the two-year period. In the first year of the assignment, the loss position of the bank was reduced to Rs. 251 million in FY 2002/03 from that of Rs. 3,255 million in FY 2001/02. In the second year, that is, in FY 2003/04, the bank has been able to achieve a net profit of Rs. 710 million. In this way, the profitability position has been achieved in the bank. Interest income to loan and advances ratio increased to 7.52 percent in 2003 from 5.67 percent that of 2002. It has further increased to 10.17 in 2004. The interest expenses as percent of the total deposits was reduced to 2.87 in 2004 from 4.58 percent a year earlier. The same ratio was 4.97 percent in 2002. Net profit to total income was negative till FY 2002/03, which turned into positive by 27.12 percent in 2004. Despite various efforts for improvements, the NPA in NBL is still 53.74 percent, the cumulative loss at Rs. 10.33 billion and a negative capital of Rs. 8.90 billion at the end of FY 2003/04. These indicators highlight that the bank still has to travel a long distance in order to restore the sound financial health in the acceptable level. Considering all these factors and need of further restructuring works, the NRB has extended the contract period for another one year to July 22, 2005.

There are still a lot of areas to be improved in the NBL. After solving all the major problems of the bank it can survive on its own. Not only this, it will also be attractive to the private investors and can be fully privatized at the attractive prices.

The restructuring process is expected to be successful as it would introduce a new credit culture, sound HR development program, scientific, and modern IT/MIS platform to instill profit-oriented atmosphere, and an in-built self-monitoring mechanism and customer service culture within the contract period of ICCMT.

Restructuring of RBB

The restructuring of RBB is another very important component of the reform program. For this purpose, the NRB completed the process of appointing a CEO and his team members of the management team in RBB on an individual basis. The contract between NRB and CEO Mr. Bruce F Henderson for consulting services was signed on

December 21, 2002 after which he resumed his work from January 16, 2003. The contract with other team members was concluded in February 2003. By February 19, 2003, a full team was placed at the RBB.

The contract was similar as to the contract of the NBL as the problems and issues on restructuring were almost similar to each other. The restructuring activities, tasks and performance indicators were also structured accordingly in the contract document. The distinction between these two contracts was that the former had made the firm responsible, whereas the later was on individual basis and making the CEO responsible on overall basis to accomplish the entire restructuring works.

Since resuming the assignment by the new management team in the RBB, the team had prepared and submitted the Management Plan on April 1, 2003. To date, this plan has been used as a base plan to restructure the bank. The financial analysis was completed in time and the report was submitted to the NRB on May 1, 2003.

On the accounting and auditing fronts, the management team prepared zero-based Budget Plan for FY 2002/03 and FY2003/04. A strict budget monitoring system has been introduced and reinforced the best practices in the bank. A Budget Procedure Manual was prepared on May 27, 2003 and implemented in the bank. A new Chart of Accounts complying with the international accounting standards has been prepared and implemented. A new accounting manual has been prepared and implemented. Financial statements have been re-casted and updated up to FY 2003/2004. The pending audit of FY 2001/02 was completed by the team within a few months and the audits of FY 2002/03 and FY 2003/04 have been completed in time. The management team has been able to prepare and publish the financial statements regularly on a quarterly basis.

The credit management aspects are also improving. New credit policy guidelines has been prepared and implemented to restore the best practices in credit management. New business areas have been explored and new lending has been started to creditworthy clients in order to generate the income stream. The management team has established seven core teams in order to make adequate efforts toward loan recovery and loan administration. This recovery team comprises five recovery units in regional levels, one unit for Kathmandu Main Office (KMO) and one unit for consortium loans. As at mid-July 2004, that is, within the one and half year's period, the team was able to recover Rs. 3.3 billion of loans in cash of those categorized as NPA. Loans worth Rs. 1.8 billion have been restructured. Despite all these efforts the loan recovery aspects are not encouraging in the bank because the bank still has Rs. 14.47 billion NPA in the books as at mid-July 2004 and by such a pace of cash recovery, it will take a long time to bring down the level of NPA at the acceptable level.

Significant improvements have taken place on HR development fronts. Organizational restructuring and functional restructuring have been completed. In order to right size the bank, the employees' need assessment study was completed in time. Moreover, the number of branches required for the bank for operation had been identified. Accordingly, branch rationalization as well as the VRS was adopted. As at mid July 2002, the bank had 5583 employees, whereas the number of employees required was merely 3365. Therefore, in order to downsize the staff level, the first phase of the VRS was announced on September 15, 2003, as a result of which out of the eligible 1515 employees, 1319 opted for retirement. This program was very successful in the bank. In order to bring the staff level to the right size, a further reduction of staff level was necessary. Therefore, the second phase of the VRS was launched effective from September 8, 2004 to October 8, 2004, on which another 182 employees opted for the VRS. After launching of these two VRSs, the staff strength has come down to 3704 at mid January 2005. The bank still needs to reduce the staff level to maintain the proper size. In order to improve the quality of HR, the reward and punishment system has been introduced. Departmental actions were initiated for the employees involved in fraudulent and dishonest activities in the past. Promotion system was initiated for good performers. The new staff bye law has been prepared and implemented which has opened up new avenues for faster promotion and HR development.

The bank has prepared a comprehensive IT plan in order to install modern IT / MIS system in the bank. The procurement aspect has been completed. Computer hardware and software are being received and tested in the bank. It is expected that by the end

of January 2006, the bank will have the computer networks of Integrated Bank Information System (IBIS) in 47 branches covering around 80 percent of the deposit and credit businesses.

The bank was suffering from negative net interest income position till FY 2002/03 because of the immature long-term deposits that were collected in the past at the high cost. By FY 2003/04, the bank has been able to report a positive net interest income position. The financials of the RBB are also improving after the initiation of the restructuring activities. The bank was making a loss since the last few years and even in FY 2002/03 it had made a net loss of Rs. 4.84 billion. The loss position is no more in the bank now. The bank has been able to make a net profit of Rs. 1.02 billion in FY 2003/04. Consequently, the negative capital fund of the bank has begun to decrease. On the other hand, the quality of credit has begun to improve. Although the overall financial position of the bank has not come to the sound and prudent level, it is improving. The level of NPA, however, has come down to 57.64 percent in 2004 from 60.15 percent in 2003; this is one of the most critical areas demanding further improvements. The capital fund of the bank, which was negative by Rs. 22.39 billion in mid-July 2003, has been slightly reduced to Rs. 21.03 billion. The severity of problems and the extent of financial sickness are deeper in RBB in relation to NBL. Unless and until the government injects additional fresh capital, the capital position will not improve in a few years' time. Therefore, it has been observed that the RBB will require more focused restructuring efforts than that of the NBL. Moreover, it will take more time to the RBB compared to the NBL to restore its financial health at an acceptable level.

Hence, continuous restructuring efforts are ongoing at the RBB. To sum up, a significant development in the restructuring process has been achieved and it is expected that the profitability and financial condition of the bank will be significantly improved in the coming days. After restructuring of these banks, it can be expected that the public will be benefited from better and qualitative services as well as competitive prices from these banks. The services offered by these banks in the rural areas can be continued for the benefit of the rural population.

Capacity Building in the Financial Sector

The capacity building program of the comprehensive financial sector reform is aimed at strengthening financial legislative framework, introducing new institutions, strengthening the institutional infrastructures, strengthening regulatory and supervisory system, fostering competition and enhancing the rural credit delivery mechanisms in the system. The following are the major accomplishments of the FSRP in these areas.

Legislative Reforms

- *Enactment of NRB Act, 2002*

The forty six year old NRB Act, 1955 has been revamped and replaced with a new NRB Act, 2002 on January 30, 2002. It has bestowed sufficient powers to NRB for efficient management of monetary policy, improving financial infrastructure, strengthening and improving financial markets and their supervisions. The new NRB Act has provided more autonomy, authority and accountability to the central bank. It has clarified the objectives of the central bank, provided greater autonomy, addressed governance system and clarified the relationship with the government in terms of lending and policy matters. As a result of enactment of the new NRB Act, supervisory, oversight, and regulatory functions have been strengthened substantially. NRB has been stricter than in the past in penalizing the banks and financial institutions for non-compliance of NRB's rules and regulations.

- *Enactment of Bank and Financial Institution Debt Recovery Act, 2002*

The promulgation of Bank and Financial Institution Debt Recovery Act, 2002 is another outcome of legislative reform program. HMG has also approved the by-laws of the said Act. Accordingly, the Debt Recovery Tribunal was established on June 19, 2003. This legislative framework is a new attempt to make loan recovery aspect more effective and reduce the level of NPA of the banking system. This development has facilitated in speeding up the recovery of the debts owed to banks. Currently, the Debt Recovery Tribunal is receiving the distressed loan cases and working on it. To hear the appeal on the cases decided by the Tribunal, an Appellate Tribunal has also been set up.

- *Enactment of Bank and Financial Institutions Ordinance, 2004*

Similarly, a Bank and Financial Institutions Ordinance, 2004 has been effective from February 4, 2004. By this Act, the fragmented legal bases such

as Commercial Bank Act 1974, Finance Companies Act, 1985, Development Bank Act, 1996 and other laws governing some deposit-taking financial institutions have come under the single legislation. This has also tightened the regulatory rules governing those financial institutions.

- *Enactment of Public Debt Act 2002 and amendments in Foreign Exchange Regulation Act*

To enhance the legislative regime, the Public Debt Act, 2002 was promulgated on July 8, 2002 and the Foreign Exchange Regulation Act has been amended within last two years to make it up-to-date according to the requirement of the system.

- *Preparation of other drafts of Acts*

The major problem faced by the Nepalese banking system is the high level of NPA. To facilitate the banks to improve their loan recovery, to improve quality of asset portfolio and to reduce the level of NPA, a special type of institution is necessary. For this, efforts are underway to incorporate an Asset Management Corporation (AMC) in Nepal. A draft of AMC Ordinance has been submitted to HMG/N. The setting up of the AMC will help the banks to resolve the NPA problems and, instead of managing distress loans, banks will be able to engage in the core banking activities.

The drafts of the Secured Transactions Ordinance and Insolvency Ordinance have been prepared and submitted to the HMG/N. The drafts of Securities Ordinance, Company Ordinance and Anti-Money Laundering Ordinance have been prepared by the government and are in the process for enactment. The enactment of these acts will foster the legislative regime in the economy.

Regulative Reforms

There is no doubt that prudential regulations have played a very significant role in maintaining soundness in the financial system. It has been observed that financial crisis in most of the cases are outcomes of poorly regulated and managed financial markets. The financial crisis of Mexico (1994-95), Asia (1997-98), Ecuador (1990) and other countries have highlighted that each and every country needs to have a strong financial sector, enhanced supervision and regulation and inbuilt crisis prevention mechanisms. For this, an internationally adopted rules and regulations for the financial intermediaries and financial markets need to be prepared and enforced in the system. So, the regulative reform is vital for the strengthening of the system. As explained above, the Basel core principles were not fully complied and a regulative reform was necessary in the system. Therefore, in order to comply with the best practices, the NRB formulated and issued various prudential regulations for banks and financial institutions beginning from March 2001. These regulations are being strengthened and implemented gradually to date in order to ensure a safe, sound and efficient financial system. These new directives are based on Basel Accord 1988. These directives meet the international standards and cover the following areas:

i. Capital adequacy,
ii. Loan classification and provisioning,
iii. Credit concentration and single obligor limits,
iv. Accounting policies and formats of financial statements,
v. Management and minimization of risk,
vi. Good corporate governance,
vii. Compliance with the directives issued in connection with inspection and supervision,
viii. Provisions relating to investment in shares and securities,
ix. Reporting requirements,
x. Provisions relating to purchase and sale of promoters shares,
xi. Other relevant provisions such as branch expansion, profitability and distributing dividends,
xii. Regulations on consortium financing and
xiii. Regulations on credit information and blacklisting.

More importantly, the NRB has adopted the proactive safeguarding strategy in addressing the issues of the financial system. Therefore, other necessary directives are being issued as per the requirement to bring about the desirable institutional growth, enhance fair competition, make operational improvement, and maintain a sound health of institutions within the system. The new additions to the black-listing norms and introduction of penalty clauses and the guidelines on the write-off policy of the banks are some examples in this regard.

Capacity Building on Off-site and On-site Surveillance

A series of activities have been launched for strengthening the monitoring and surveillance capabilities of the NRB. The first attempt had begun with acquiring technical assistance for the preparations

of regulatory norms and in preparation of inspection and supervision manuals in 2000. For this, the NRB had obtained project preparation fund from the World Bank under which the NRB appointed banking expert Ms. Fredrika P Santos as a consultant for assisting in preparing the risk based Inspection and Supervision Manuals. Under this assistance, on-site inspection manual for banks and non-banks were prepared and implemented in 2002. Apart from this:

- More than 100 supervisors and staff of the NRB have been trained in 2002.
- Several chartered accountants were recruited to strengthen accounting and audit capabilities in the central bank.
- University toppers are joining the bank on a regular basis.
- The NRB has initiated its re-engineering process under FSRP. NRB concluded agreement with the IOS Partners, USA, on February 6, 2003 to assist in the re-engineering program. This team, *inter alia,* had comprised of one foreign expert for on-site inspection and one for off-site inspection for one-year period. The important element in the strengthening of inspection and supervision aspect includes the upgrading of the supervision and overall aspects in the bank. Similarly, to enhance the capability in human resource management and bank restructuring aspects, two other foreign experts were employed in the bank in 2003. This type of technical assistance has been considered to be worthwhile for exploring the new areas of monitoring, building supervisory capability, and strengthening of the internal strength of the central bank.

One of the main issues in the Nepalese financial sector was the overwhelming role played by the government and regulatory authorities as an owner and operator of financial institutions. Due to this situation the authorities had failed to play an adequate role as the supervisor and regulator of the system. Consequently, the weak financial institutions were permitted to conduct business without adequate oversight of the government and the central bank. To overcome such a situation and to avoid direct intervention of regulatory body in commercial lending decisions, the NRB completely withdrew its representatives from the Board of Directors of commercial banks and development banks in 2003. In this process, the surveillance system of NRB has been strengthened and professionalized.

Fostering Competition within the Financial System

To enhance competition in the banking system, many measures have been undertaken. Some are still being initiated. To make financial sector attractive to foreign investors, the 50 percent ceiling on ownership by foreigners has been increased up to 75 percent. To enhance the competitive capabilities among commercial banks and financial institutions, a new bank and non-bank licensing policy has been introduced. The NRB has recognized the fact that competitive environment is critical for ensuring the financial intermediation to benefit the borrower, depositors and other users of financial services. The objectives are being achieved through more focused interventions and market-oriented policies. In order to improve the compliance position and to prevent the system from unfair competition, adequate clauses for initiating legal actions and monetary penalties have been declared by rules and regulations.

Efforts to enhance competitive pressure should rely on market-oriented approaches rather than mandates such as those for limitations on interest rates and spreads and priority sector lending etc. Such regulations had increased distortions in the market and further burdened those banks already having difficulty carrying out their normal commercial business. Therefore, the priority sector lending program is being gradually phased out beginning from 2003. It has been declared that this program will be completely phased out by 2008. Effective from December 17, 2003, NRB has removed the restriction on limitations of interest rates on lending as well as the spread on buying and selling rates for commercial banks on foreign exchange. This has permitted banks to have better price for credit risk and expand their profit opportunities.

In order to foster competition in the market, the new entrants should not be restricted by any means to enter into the market. So, the new licensing policy for banks and financial institutions was developed and the door was opened for all the qualified promoters. The licensing policy for commercial banks was publicly announced on May 16, 2002, for development banks on May 21, 2002 and finance companies on May 29, 2002 covering the qualification of promoters, required paid-up capital, technical assistance and other requirements. Accordingly, 10 new development banks and 10 finance companies

have got license for operation within two years. After the enactment of BFI Ordinance, 2004 the new capital requirement for bank and various classes of financial institutions was announced on April 17, 2004.

As per the provision of NRB Act, 2002, the NRB has started to announce the monetary policy for each year. Through the monetary policy announcements the NRB is gradually lowering down the CRR and refinance rates for the commercial banks. It has helped the bank to reduce the cost of fund. This has released more liquidity in the system to expand the credit at more competitive prices. All these developments have exhibited positive impact to foster the competitive environment in the financial market.

Strengthening of CIB and Information System

Without building ancillary institution to coordinate the specialized function in the financial market, the system could not be fertile enough to grow. To date, Nepal does not have any credit rating agencies, and to provide at least some information on the credit performance of big clients, the CIB has a great role in the system. Therefore, to strengthen the role of CIB, the reform measures have been initiated. In this connection, some preliminary works on the preparation of legal documents to restructure the CIB were completed. In the meantime, the bye-laws of the CIB have been prepared and implemented to regulate its functions. The CIB was registered as a company on September 21, 2004 on the Company Registrar's Office and it is being operated by the private sector banks.

Under the provision set forth in the NRB Act, 2002 the CIB's bye-laws have come into effect to strengthen the CIB functions and powers. To strengthen the procedural aspects for CIB, a new directive to banks and non-bank financial institutions has been issued on September 18, 2003, covering all the systems and procedures of blacklisting by the CIB. This more transparent and strict system has been adopted to restrain the willful defaulters and compelling them to repay the loan of banks and financial institutions. The blacklisting procedures are being reviewed and simplified in order to enable and facilitate the system for better performance.

Computerization works have been completed in the centre. In order to modernize and strengthen the CIB, a foreign consultant is being hired and placed in the CIB under the technical assistance program very shortly.

Programs for Poverty Reduction and Rural Credit Delivery

For this, more focused interventions have been initiated within this reform program. These include strengthening of 'Swabalamban Kosh' (Self-Help Fund) for enhancement of micro-credit facilities through micro-credit institutions and strengthening of Regional Rural Development Banks (RRDBs).

Accordingly, the ADB-funded Rural Micro-finance Project is being run through the Rural Micro-finance Development Centre (RMDC). The Centre has been effortful in assisting and promoting the rural micro savers and borrowers, though the problems relating to the current conflict situation have stood in its smooth way of operations.

To strengthen and restructure the ADB/N, a diagnostic study has been completed with the technical assistance of the ADB by Price Water House Coopers, an international consulting firm. On the basis of this study, an institutional strengthening plan has been devised and put into implementation in a phase-wise manner. Meanwhile, a performance contract has also been concluded between HMG/N as well as the management and the board of the bank. With regard to NIDC, the Cabinet has decided for its privatization with a pre-requisite package of restructuring, stating that failing in achieving this would result in its eventual liquidation.

The phase-out schedule for commercial banks' Priority Sector Lending was declared on December 23, 2002. However, the deprived sector lending has been continued as usual. The micro-finance institutions and development banks are being encouraged to fill the gap in micro-credit lending activities. The disadvantaged group and the poor will be helped through these developed and efficient rural and micro-credit delivery mechanisms. In order to strengthen the micro credit institutions and their supervisory system, a preparatory work for establishing the second tier institution (STI) is being initiated.

Strengthening of Rural Development Banks

The financial sector reform strategy paper of HMG/N has assigned the NRB to undertake organizational and financial strengthening program in the rural development banks. The policy thrust of the paper was to encourage development finance via the private sector participation including divestiture of RRDBs. Accordingly, to strengthen

the financial soundness of RRDBs, additional capital has been injected. To develop professionalism in the management and also to strengthen the operations, the NRB published an advertisement on December 30, 2002 for the appointment of CEOs in RRDBs. Subsequently, professional CEOs have been appointed in the RRDBs. Similarly, the privatization process has been initiated by off loading the stake of Western Rural Development Bank held by NRB. Out of 61 percent that was held by the NRB 51 percent is off loaded. Out of this 51 percent, 37 percent is allocated to the Western Rural Development Bank's group members, 5 percent to employees of the bank and 9 percent to micro finance financial institutions at the price of Rs.107.72. Accordingly, it has been decided to offload the shares held by NRB in Eastern Rural Development Bank within FY 2004/05. In this process, a similar modality has been applied to dispose 56.75 percent stake of the NRB out of the total holding of 66.75 percent.

Strengthening of Accounting and Auditing Capabilities

The auditing and accounting capabilities of the financial system are being strengthened. To enhance such capabilities, the process of obtaining technical assistance completed for various institutions. The NRB procured accounting and auditing consultants under the NRB re-engineering program, the NBL and the RBB were facilitated within the management contract and the ADB benefited by performance contract. The prevailing weak accounting and auditing practices of the NRB, RBB, NBL, ADB are improving. The capacity of preparing and publishing reliable financial data of the banks and financial institutions are improving. Audit committee within the banks are being activated under the chairmanship of the non-executive director.

To build a prudent system in banks and financial institutions, accounting policies, auditing procedures, disclosure requirements and requirements for long form reports (LFR) have been clearly addressed in the new directives of NRB that have been issued to banks and financial institutions. To obtain better performance, a list of qualified auditors for banks and financial institutions has been prepared and published on July 31, 2002. For this purpose, 78 qualified auditors under Class A and 28 under Class B have been categorized. HMG/N has appointed Lodha Company, an affiliate of BDO International as an international auditor to conduct the IAS compliant audit of NRB for FY 2002/03. Moreover, the government concluded a Country Financial Accountability Assessment Report with the donor support to streamline the financial accountability structure of its institutions.

The Institute of Chartered Accountants of Nepal has recently prepared the Nepalese Accounting and Auditing Standards and these standards are being reviewed along the lines of international banking practices so that they could be applied in the financial system. Accordingly, the formation of the Accounting Board and Auditing Board has also helped establish a framework to facilitate the IAS-compliant accounting and auditing practices in the country.

Improvements in the Financial Statistics

For monitoring the financial statistics, a new software package has been provided to all the commercial banks to enable them to prepare timely report and submit it to the NRB for the publication of financial information on time. Precise formats have been used to disseminate the information and reports. The monetary penalty has been clearly spelled out on the Banks and Financial Institutions Ordinance and regulations of NRB for not reporting on time and non- compliance issues. The time required to compile and publish the financial statistics has been reduced significantly and the quality of reporting has improved significantly from 2004.

The research and statistical wing of the NRB are being strengthened.

Establishment of Monitoring System within FSRP

A well organized structure has been made and implemented to facilitate the smooth operation and monitoring of the reform program. With the Cabinet level decision of the HMG/N of March 26, 2001, a Top-level Co-ordination Committee (TLCC) under the coordinatorship of Honorable Vice Chairman of National Planning Commission (NPC) has been formed. This is a very high level Committee within FSRP which comprises other members as follows: Governor of the NRB, Secretary from the Ministry of Finance, and an Honorable Member from the NPC. This Committee facilitates in coordinating the program with other HMG's plans and programs and deals with policy

issues for successful implementation of the program. It provides policy guidelines on various issues of FSR. The NRB, as an implanting authority of HMG/N, is executing the financial sector technical assistance project. A Monitoring and Surveillance Committee under the co-ordination of Executive Director of Banks and Financial Institutions Regulation Department of NRB has been formed to observe the processes and evaluate the performance, make suggestions and implement the policies under guidance by the TLCC of FSRP.

A Monitoring and Surveillance Team (M&ST) has been formed at the NRB to monitor and evaluate the progress and report the activities and analyze the issues of the RBB and NBL management teams. The bank restructuring advisor from IOS Partners, USA, has build up the capacity of NRB counterparts on bank restructuring issues and processes to meet the future challenges. A Co-ordination and Support Team (CST) has been constituted at the NRB to deal with procurement and financial issues within the FSRP. On the other hand, a NRB Re-engineering Steering Committee has been formed to monitor the progress and facilitate the activities in the NRB's re-engineering process. This Committee consists of relevant department chiefs from NRB.

Securities Markets

Financial sector also includes sectors like insurance and capital markets. But these are not regulated by the NRB. The stock exchange, being the important player of the capital market, has a significant role in the Nepalese financial market. On top of that, HMG/N has initiated various programs in reforming the securities market in Nepal. The Corporate and Financial Governance Project (CPG Project), launched with the loan assistance from the Asian Development Bank, intends to develop the market in a standard and efficient manner.

Insurance Sector

So far as the insurance sector is concerned, the insurance business has been encouragingly flourishing over the last few years, as there are already 17 insurance companies operating in Nepal. They are both in the areas of life and non-life. The Insurance Board regulates the sector with its own statutory authority. The largely government-controlled Rastriya Beema Sansthan is the oldest corporate entity in this sector. Recently, the creation of the Insurance Pool has paved the way for the smooth handling of the terrorist incident-related insurance cases.

Issues and Future Agendas within the FSRP

To resolve all the problems of the overall financial system in a short span of time period is not a easy task. Moreover, the reform process is also affected by a multi-dimensional phenomenon. It requires a lot of efforts, devotion, cost and time to complete it. All the reform initiatives have exhibited significant improvements, but due to various reasons it took a little longer time to accomplish such activities than earlier expected. The existing environment of conflict, disturbances in economic performance and uncertainty within business environment is not supportive in this regard. Despite the obstacles and problems in economic and non-economic fronts, the achievements and accomplishments of FSRP to date can be regarded as a great leap on the improvements of the system. There are still many works to be completed for building a sound financial infrastructure in Nepal. The following are some of the issues to consider in order to achieve better performance of the financial sector reform program.

Issues and suggestions in NBL & RBB Restructuring

- Despite the various efforts, the level of NPA has not decreased at the prudent level. The level of NPA should be lower than 5 percent where as the levels of NPA in these banks are still above 50 percent. The loan recovery efforts do not show that the NPA problem would be solved within 3-4 years period in these banks. Therefore, more efforts are required to recover the NPA. In this connection judicial, political and social support and efforts would be beneficial to overcome this problem more quickly.
- The delay in the establishment of AMC has created significant problem to quick recovery of financial health and cleaning up the balance sheet of both the banks. The inbuilt support from the system itself is a pre-requisite to enhance the performance of the system. Therefore, the AMC should be established as soon as possible.
- Both the banks have high level of negative net worth. Hence, a capital plan needs to be worked out and the shareholders of these banks, including HMG, need to inject the capital to the level required by the regulatory authority.
- Both the banks still lack modern IT/ MIS. The IT platform needs to be installed as soon as possible as it has been extremely delayed in the

reform process. Unless and until the computerization work will not be completed, the quality of service, customer care, disclosure arrangements and MIS will not be improved in the banks. The public will feel visible improvements in the banking operations only after computerization. If any institution is prepared to restructure in the future, it will be wise to initiate the task relating to IT/MIS first before placing the management teams in any institutions.

- The successor planning has not been properly addressed by both of the management teams. Therefore, both the banks need to implement successor planning in the bank capable to replace the foreign management teams.
- Both of the banks need to capture all the functional areas in the restructuring process. The NBL still needs to modernize, re-structure the systems, procedures and operations of KBO and branches as well. Similarly, the RBB should provide attention to modernize its Bishal Bazar's office as well as other branches.
- Both of the banks still need to rationalize the branches and right size the staff strength. Besides launching of various VRSs with high cost, the staff level has not been maintained in the right size. Therefore, a compulsory early retirement scheme or other some modalities based on best international practices needs to be worked out and implemented.
- Both the banks need to implement business plan for new business and new lending activities. New lending business needs to be linked up for utilizing the fund available through recovery of loans. Specially, the NBL has very poor performance in exploring new businesses and making new loans. Unless and until the banks can explore the income streams of high yield and generate adequate income for the bank, the banks cannot restore its financial health quickly. The reduction in the cost only will not be enough to improve the profitability of the banks.
- Privatization is the ultimate solution for the long run survival of these banks. Therefore, a privatization road map needs to be prepared and discussed and finalized. Both of the banks need to be restructured for some more years so that these can be sold in a benefited manner and need to be privatized immediately after the restructuring process.
- There is an issue on distributing of the profit. The banks should not distribute the bonus unless and until the negative capital is eliminated from the balance sheet. It is not prudent to distribute the profit with capitalizing the losses. Therefore, the Bonus Act needs to be amended in this case.

Issues and Suggestions on NRB Reengineering

- The professional skill of regulators, supervisors and economists needs to be strengthened by providing adequate training and up-dates of information on the global financial market developments as well as economic fields. Although the reform program had envisaged a lot of program for training and skill development for NRB's employees, such programs have not been launched to date. These aspects should be expedited by HMG/N and the NRB.
- The NRB need not compromise or hesitate in penalizing banks and financial institutions that do not comply with the rules and regulations of the NRB. The early warning signals of problems banks and financial institutions need to be addressed in time and appropriate actions needs to be initiated before the situation worsens.
- The reports provided by the HR consultants need to be implemented. The NRB still needs to be rightsized and appropriate mechanism needs to be designed to make the staff level at the right size.
- The IT and MIS system in the NRB still need to be improved and extended to all the areas of the bank for the overall improvement of the organization.
- The NRB should not hesitate to exercise the powers provided by the Act and the implementation aspects should be enhanced.
- The preparatory works for Basel-II, which should be implemented from 2007, have not been completed. Therefore, the process should be expedited as soon as possible. Similarly the preparatory works for preparing the financial sector under the WTO norms need to be completed in time.

Issues and Suggestions on Capacity Building of the Financial Sector

- The draft acts, which are in the pipeline, need to be enacted as soon as possible. Similarly new acts on asset securitization, futures trade, merger and

acquisition, trustee act, and bankruptcy act need to be drafted.

- The financial system should exercise its full efforts to lower down its intermediation cost and level of NPA.
- The system needs additional institutional richness for building a sound financial infrastructure in the system. The system still lacks important institutions such as AMC, credit rating agencies, institutions on factoring and securitization and notary office.
- Globalization, liberalization, privatization, modernization and competition are the five pillars for strengthening the financial sector. Therefore, priority should be accorded and no compromise should be granted in these areas.
- Transparency, disclosure and good corporate governance need to be strengthened continuously.

Issues and Suggestions in Securities Market Development

The existing securities legislation is lacking clear and adequate provisions regarding the securities market regulation. Basically, the major deficiencies of the securities legislation are duality in regulation of public issue of securities, lack of clear demarcation between regulatory functions of SEBO and NEPSE, overlapping regulatory provisions and lack of basis of co-ordination between SEBO and other government regulators, inadequate enforcement provisions, lack of provisions regarding the establishment of market infrastructures, lack of clear entry and exit norms for securities market intermediaries, lack of provisions to regulate market intermediaries' services like share registration, underwriting etc., and lack of regulation for the operation of collective investment scheme, etc.

The SEBO is regulating the market with limited resource base. Its sources of capital are the budgetary support from HMG/N, charges on public issue approvals and renewal charges and stock broker/dealer license fees. From these sources, very limited resources are obtained. Due to limited capital resources, the SEBO is unable to recruit skilled and technical manpower as its permanent staff. The SEBO also has not been able to get membership of International Organization of Securities Commission (IOSCO). Membership of such Organization would be necessary to provide exposure to the international market.

The Stock Exchange is mostly owned by the government and the government-controlled organizations. Its Board is under the chairmanship of the Ministry of Finance, the line ministry of SEBO. Besides, the Stock Exchange also lacks broader participation and necessary professionalism. In such a situation, the role of the regulatory authority and its effectiveness has suffered.

The securities market is dominated by the equity share. The market has not become attractive to risk averter and risk neutral investors due to the few corporate bonds and mutual funds in the market. Owing to the lack of benchmark interest rate provided by the government securities market and lack of trustee mechanism, the corporate bonds' issue practice is yet to become popular.

The market has limited infrastructures to improve the market standard and to fasten the securities trading, clearing and settlement systems. Besides, some market intermediary services like share registry underwriting, investment counseling, etc. are lacking.

Due to the lack of standard accounting and auditing system, the securities market information could not become reliable and consistent, thereby adversely affecting the investor's confidence in the market.

Many corporate bodies, which have entered the market, have not established credible governance practices including in the area of public reporting. Their audited financial information is not disclosed on time. Most of the companies other than in the bank and finance sector are unable to conduct their AGM timely. This is gradually eroding the investors' confidence in the market. Therefore, the Nepalese securities market is also demanding reform initiatives.

The Insurance sector also needs to be modernized, strengthened and developed gradually.

Conclusion

The overarching goal of FSRP is to create a well-regulated prudent, market-oriented, competitive and strong financial system in Nepal. It is considered that the FSRP is the most important component of HMG's overall economic reform program. After the completion of the FSRP, the financial system would be able to contribute, to the maximum extent, to maintain macroeconomic stability, to lead the private sector for higher economic growth, to reduce poverty, to enhance rural banking, to create employment opportunities, to raise income levels and

to maintain the pace of development at the sustainable level. Therefore, it can be expected that, through this consolidated reform initiatives, the people of Nepal can reap the potential benefits of the financial sector in the coming days.

Despite various economic and non-economic problems facing the country, the progress made on comprehensive financial sector reform seems to be satisfactory. Unless the overall issues of the system are addressed comprehensively, the achievements cannot be sustained for a long time. There are still a lot of agenda items in implementing further reform so as to maintain a healthy, competitive and efficient financial system in Nepal. Since the financial sector reform program is being considered as a vital element of HMG's comprehensive economic reform program in realizing the goals of economic growth and poverty reduction, it must be strengthened in the coming days in order to reinforce the private sector-led growth. The complete restructuring of the RBB and the NBL is the need of the day, which should not be compromised in any respect. In order to reduce the burden of the debt for restructuring of these banks, a self-financing strategy can be adopted by these banks for further restructuring periods. If these management teams will be able to generate adequate returns through operating professionally, it will be justifiable to bear a small portion of their costs from the net profits too. After restructuring of these banks, they should be privatized immediately.

Since globalization, liberalization, privatization, modernization and competition are the five pillars for strengthening the financial sector, these concepts should be adhered to at all the time in developing the strategy for the financial system. The financial assistance provided by the development partners has a significant impact in the development process of the economy. In this regard, the financial assistance received from the donor agencies should be used very economically to achieve the national goal and the expected results of the reform strategy.

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Financial Sector and Development Planning

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Introduction

Development economics has changed rapidly in the course of one generation. Twenty-five years ago, development economists gave utmost emphasis to planning and allocation mechanisms, which separated the development community from the core of mainstream market-oriented economics. Academicians who underscored development issues were often on the side-lines to the cutting edge in the economics literature. However, that has all changed in recent years and development issues are now becoming very important. As part of this transformation, the term 'development' (which connotes a directed process) has been to a large degree superseded by the term 'emerging markets'. The very term accords priority to the private sector and the market-oriented model of contemporary economics. In no other area is the change in thinking more telling than in the analysis of the role of the financial sector in the development process.

The modern literature on economic growth started with Robert Solow's work in the mid-1950s. The early theoretical and empirical literature stressed on the role of capital and labor resources and the utilization of technology as the sources of growth. To a large extent, any possible role of the financial sector in the growth process was ignored. On the contrary, development economists up until the 1970s would often advocate explicit manipulation of the financial sector for attaining development objectives. Credit subsidies to favored sectors were the rule rather than the exception. A couple of prominent economists began to conduct studies relating to the contribution of the financial structure to growth and the benefits of liberalization.[1] It was gradually acknowledged by economists that credit allocation, interest rates ceilings and high reserve requirements were detrimental to growth. Generally, high inflation, negative real rates and inflation taxes generate distortions that lead to extensive resource misallocations and discourage saving and the use of intermediaries. The term 'financial repression' was introduced to refer to restrictive policies that hindered the operation of the financial sector.

In recent years, there have been significant liberalizations. Support for directed credit, interest rate ceilings and government ownership of financial institutions have also vanished. The prevailing paradigm is that competitive private sector capital markets should be able to collect savings at market rates of interest and allocate capital to the most efficient private sector projects.

Empirical investigations of the relationship between financial sector development and economic growth began to appear in the 1990s.[2] Economists now agree that well-developed, market-oriented financial sector contributes to economic growth. Studies have demonstrated that the depth of financial

sector development and greater provision of financial intermediary services are associated with economic growth.

A strong and sound financial sector can promote economic growth, mobilize and allocate resources efficiently, make capital more productive and create jobs. It lessens vulnerability to financial crisis and defrays the economic and social costs that accompany financial disruption. An efficient financial sector mobilizes savings and provides an array of financial institutions and financial instruments to satisfy a broad range of needs, including those of the poor, and ensures, *inter alia*, that smaller businesses have access to financial services which will provide them with opportunities to grow.

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

Against this backdrop, the paper begins with a review of financial sector liberalization policies undertaken by the least-developed countries (LDCs) in the 1980s.[3] Some of the core elements of the liberalization program are highlighted followed by its impact. The second part of this paper focuses on Nepal's development plans and shows the significant role attached to the financial sector, especially in the latter development plans. The overall objectives of each of the Plans are summarized together with the major financial sector measures undertaken by the NRB for boosting the efficiency of the financial sector. Then, some quantitative data are presented to analyze the growth of the financial sector since the establishment of the NRB.[4] Before listing out a few challenges for the NRB as well as the financial sector as a whole in the concluding part of this paper, the East Asian financial crisis, the most severe crisis to hit Asia in the last 50 years, is examined together with some useful lessons drawn for Nepal's financial sector.

Financial Sector Policies in LDCs

Financial-sector policies in the LDCs have undergone drastic changes during the last three decades. During the 1960s and 1970s, governments intervened extensively in financial markets in order to control the cost and allocation of finance, although the nature and degree of intervention differed widely across the LDCs.

The pre-reform policies in the LDCs included controls over interest rates, and most of these countries used various types of lending directives, rediscount facilities or special lending schemes designed to increase the volume of bank credit extended to the priority sectors such as agriculture, often at preferential interest rates. Government ownership of banks was also prevalent.[5] Government-owned banks pursued a variety of non-commercial objectives, such as lending to state-owned enterprises (SOEs) and small farmers. In some LDCs, the government issued directives to the government banks to undertake major branch expansion programs. Governments undertook a policy of administered interest rates and directed credit. There also existed stringent restrictions on movements of capital across national frontiers. As a result, the financial institutions functioned generally in a repressed regime.

During the 1980s, however, as part of the International Monetary Fund (IMF) standby agreements of Structural Adjustment Program (SAP), a process of financial liberalization was undertaken by a number of LDCs, often in parallel with programs designed to address major institutional deficiencies in their financial systems. The programs included, among others, the privatization of government-owned banks and the relaxation of restrictions on entry or private sector and/or foreign banks in the domestic markets.[6] Attention began to be accorded to the restructuring of insolvent financial institutions and strengthening of the financial infrastructure, especially the regulatory and supervisory framework. Again, new banking legislation, comprising stronger prudential regulations was enacted that was accompanied by institutional reforms to strengthen the supervisory capacities of the central banks.

In more recent years, efforts have been made by many LDCs to promote the diversification of their financial systems, especially by encouraging the development of primary-securities markets such as money and capital markets. These efforts have involved the development of institutions, such as stock exchanges, through which trade in these securities can be conducted.

The major policy elements of financial liberalization programs in the LDCs in general are delineated below.[7]

Reform of Interest Rates and Market-based Instrument of Monetary Control

Two major arguments prevail in favor of liberalization of controls over interest rates and allocation of credit: promotion of efficiency and viability of banks. In a financially repressed regime credit is allocated to projects of low productivity, while projects of high productivity cannot materialize owing to scarcity of funds. This results in inefficiency in the allocation of investible resources and thereby to low growth. The second argument is that, if banks are compelled to lend at low rates of interest to unprofitable sectors, they incur massive losses. This policy, it is thus inferred, is bound to lead to bankruptcy of banks in the long run and thus is unsustainable. This argument appears to be quite universally accepted.[8]

Interest rate liberalization, together with the removal of allocative credit directives and the commercial lending policies by public sector banks was intended to enhance the efficiency of credit allocation, by allowing the price mechanism and the commercial judgement of bankers to determine credit allocation.[9] An important premise of liberalization is that there is demand for loans from creditworthy borrowers with profitable investment opportunities, which would be denied credit under a repressed financial system as administrative control or the non-commercial lending policies of public sector banks channel the available credit to the less efficient borrowers, such as loss-making SOEs. Thus, liberalization seems to permit a reallocation of credit towards the users most capable of generating higher rates of return to capital. Liberalization could also lower the pressure on banks to accommodate less creditworthy borrowers and thus lead to an improvement in the quality of their loan portfolios.[10]

In most LDCs, interest-rate reforms were undertaken in phases. In the first phase, controlled deposit and lending rates were augmented to levels that were closer to prevailing inflation rates, so as to lower or remove negative real rates of interest. Moreover, preferential lending rates applied to priority industries were removed and in the subsequent phases, administrative controls over interest rates were abolished, permitting banks and financial institutions to fix their own deposit and lending rates.

For monetary policy purposes, central banks in a number of LDCs substituted direct monetary-policy instruments such as credit ceilings and interest-rate controls with indirect or market-based instruments such as open market operations.

Withdrawal of Directives on Credit Allocation and Approval of Foreign Entry

Sectoral credit directives and other allocative controls over the composition of bank-lending portfolios have been abolished in most of the LDCs, allowing financial institutions more commercial discretion in the distribution of credit.

In some LDCs, there was a reduction on the restriction on the types of commercial activity that various categories of financial institutions were permitted to undertake. This permitted, for instance, DFIs to diversify away from their original specialized markets and to accept deposits. Moreover, the liberalization of foreign-exchange markets considerably expanded the range of commercial operations that financial institutions undertake, with banks and some other types of financial institution undertaking foreign-exchange transactions and accepting foreign currency deposits.

Foreign entry seems to put competitive pressure on local banks, forcing them to become more efficient by lowering their costs. Empirical studies show that overall foreign banks do not threaten financial stability. Although foreign banks have the potential to transmit shocks from their home countries, the lending normally does not fall considerably during local financial crises, particularly when compared with that of domestic banks.[11] Moreover, facilitating the entry of reputable foreign financial firms to the domestic market needs to be welcomed since they bring competition, improve efficiency, and lift the quality of the financial infrastructure.[12]

With respect to the LDCs, entry requirements were eased to stimulate greater competition and to increase the participation of the private sector in financial markets. This has involved either removing legal restrictions on the participation of the private sector in domestic financial markets or amending banking legislation in order to make the legal framework for private-sector participation more transparent.

To assure that foreign bank participation is always a force for improvement, retaining a liberal entry regime will be crucial. Procuring all the benefits of foreign banks' technology and know-how in financial services provision calls for adequate infrastructure, including good information, a proper framework for secured lending, and sufficient transparency. Foreign banks could introduce improve risk management techniques and 'import' supervision from their parent country regulators. At the same time, increased competition from foreign banks can reduce the franchise value of incumbent financial institutions and generate instability. While adequate regulatory and supervisory arrangements would be a natural policy response, many LDCs have had problems in setting up of good legal and institutional frameworks. The solution might be to make greater utilization of the benefits of foreign entry, while focusing institutional development efforts on a few core aspects rather than attempting to build a broad regulation and supervision apparatus.

A number of LDC governments have privatized or plan to privatize government-owned financial institutions, particularly the commercial banks. Foreign banks purchased equity stakes in government-owned banks many of these countries. The outcomes have been quite positive as competition has been enhanced in the banking sector in these countries.

Impact of Policy Liberalization in LDCs

There is some proof that liberalization has generated greater competition in financial markets in several LDCs, partly due to new entrants and partly due to the removal of controls over interest rates.[13] However, the effects of greater competition on the provision of financial services have been rather uneven, with the majority of the new entrants restricting their operations to the urban areas. Banks have started to compete more vigorously for deposits, providing more attractive deposit rates and new savings products. They have also started to improve customer services. For instance, many banks are investing a lot in computer technology to speed up transactions, while others are extending their operating hours. The corporate credit market is also likely to have become more competitive with the advent of banks that are oriented towards this sector. Still, financial markets in many of these countries are oligopolistic: the dominance of the government-owned and the large foreign banks has not been seriously challenged, and the new entrants have not covered certain sections of the credit markets that have long been poorly served by the more established financial institutions.

Whether liberalization has led to a more efficient allocation of credit is difficult to assess. Though lending portfolios based on commercial criteria are likely to give rise to a more efficient allocation of credit than those determined by administrative controls, liberalization *per se* has probably had only a modest impact on resource allocation in financial markets for two reasons. Firstly, one of the principal avenues of credit misallocation has been the lending of the government-owned commercial banks, many of which have accumulated massive losses from non-performing assets (NPAs). The removal of administrative controls will not be adequate to enable these financial institutions to function along commercial lines and thus allocate credit more efficiently: they need major managerial, operational and balance sheet restructuring.

Secondly, the credit markets for small-scale farmers and enterprises encounter problems from acute imperfections emanating from informational deficiencies. This type of market failure is not amenable to a market-oriented solution. In liberalized financial markets, the banks have rendered only those services that can be undertaken on a commercial basis, that is, those from which they hope to obtain a profit commensurate with the risk involved. As a result, the banks have focused on supplying short-term credit to the larger corporate customers and to traders who can provide suitable collateral, investing in government debt and trading foreign exchange. Most banks have been reluctant to extend credit to small-scale enterprises or to small holder farmers, arguing that this is not commercially feasible due to the administrative costs involved, the high default rates experienced and the lack of realizable security that these borrowers can provide.

Thus, financial liberalization has not always brought about the expected gains: there have been very few innovations in financial markets, competition is limited by oligopoly and liberalization may exacerbate urban bias.[14] Again, it has been acknowledged that financial liberalization is just one component of a successful development strategy. Appropriate macroeconomic policy, institutional

development, and structural reform must accompany financial liberalization and create the stable environment needed for it to succeed.

Nepal's Development Plans

In Nepal, the process of planned economic development commenced in 1956 with the inception of the First Five-Year Plan (1956-61). Nine periodic plans have been implemented so far and the Tenth Plan (2002-07) is in progress. The principal objectives of each of the Plan together with policies relating to the financial sector are discussed at length below.

First Plan (1956-1961)

It was only in 1955 that a Planning Commission was set up in order to exploit as much as possible the resources of the country in a planned manner. The First Five Year Plan came into effect in FY 1956/57 covering the period up to FY 1960/61. Top priority was accorded to the development of the means of transport and communication in the context of the geographical needs of the country. The other areas of priority included agriculture, social services and other development programs.

Although very little progress took place in road, power and industrial development, considerable progress was made in the education and health sector. Further, the First Plan did stimulate pubic interest in support of planning. The Government was made aware of the requirement for planned development.

The Nepal Rastra Bank (NRB) was set up as a central bank with an authorized capital of Rs. 10 million fully subscribed by His Majesty's Government (HMG) on April 26, 1956, the same year which also marked the beginning of Nepal's First Five Year Plan. The NRB Act, 1955 gave the power to the Bank to have direct control over banking institutions within the country. The objectives within which the central bank was established included: a) ensuring proper management of the issuance of Nepalese currency notes, b) making proper arrangement for the circulation of Nepalese currency throughout the kingdom, c) stabilizing the exchange rates of the Nepalese currency, d) mobilizing capital for development and e) encouraging trade and industry in the kingdom.

One of the initial challenges for the NRB soon after its establishment was to increase the circulation of the Nepalese currency by replacing the use of Indian currency. The implementation of the Nepalese Currency Circulation Act in 1958 and the enactment of the Foreign Exchange Control Act in 1960 were important steps in the direction of making the Nepalese currency a legal tender all over the country.[15] It was in June 1960 that the two currencies, Nepalese and Indian rupees, were declared convertible without limit at the exchange rate of Nepalese Rs. 160 for Indian Rs. 100. Nepalese currency notes were also issued by the NRB for the first time in 1960.

Recognizing the significance of financial resources in the industrialization process of the country, the NRB participated in establishing the Nepal Industrial Development Corporation (NIDC) in 1959 whose primary objective was to provide financial assistance to private industrial enterprises in the form of medium to long-term loans, to participate in the equity investment and underwriting.

During the interim period of one year from mid-July 1961 to mid-July 1962, emphasis was accorded to the collection of statistical data and preparation of the Second Plan.

Second Plan (1962-65)

At the time the Second Plan was prepared, knowledge of economic conditions in Nepal was extremely limited. Because of the lack of survey and data on agricultural output and national income and other economic variables, the economic conditions could not be appropriately ascertained. The absence of data also prevented the formulation of a long-term perspective plan.

Due to the above shortcomings, the Second Plan accorded priority to activities that would set up the base for more comprehensive future plans. Emphasis was accorded to the collection of data on economic conditions, organizational reform and improvement, and the development of the economic infrastructure. The Three-year Plan also focused on four long-term socio-economic objectives, that is, expansion of national production, maintenance of economic stability, acceleration of employment opportunities, and establishment of social justice. The other areas of priority were transport and communications, and in agriculture, agricultural extension work and irrigation.

Acknowledging that monetary measures had little impact as the banking sector was not developed, the Second Plan document had very little to say on the policies relating to financial sector development. The issue of price policy was highlighted in this Plan

and it was stated that steps would be undertaken to contain the price rise. The factors responsible for the rise in prices were highlighted together with a summary of price control measures applied by developed countries. The Plan also acknowledged the unreliability of price data.

Adequate availability of agricultural credit was also given focus. Accordingly, the primary objective of the Agricultural Credit and Co-operative Bank, established in 1963, was to make available loans to co-operative societies and to individual peasants who required finance for agricultural development.

During the Second Plan, because of the efforts undertaken by the NRB to convert to a single currency system, the quantity of Nepalese currency in circulation rose considerably. As a result, narrow money (M1) increased by an average annual rate of 22.9 percent from Rs. 244.2 million in mid-July 1962 to Rs. 446.3 million by mid-July 1965 due to the replacement of Indian currency. Broad money (M2), on the other hand, rose by an annual average rate of 20.9 percent and private sector credit by 25.1 percent.

Third Plan (1965-70)

The principal objective of the Third Plan was to develop the prerequisites for rapid economic growth. A long-term target of doubling national income in fifteen years was set. The Plan focused on agricultural production, institutional reform, economic infrastructure, industrial development, foreign trade and social justice.

As in the Second Plan, emphasis was also accorded to price policy. Some measures to stabilize prices within the Plan period were also delineated. One of them was the curtailment of money supply expansion as money supply had risen considerably over the Second Plan period. The Plan stated that instead of increasing foreign exchange reserves with the associated expansion of money supply, attempts would be undertaken to use more of the foreign exchange receipts to purchase necessary imports for the country's industrial development. The Third Plan also acknowledged the importance of strengthening the financial institutions in Nepal in order to mobilize internal and external resources most efficiently.

The move to set up other financial institutions for boosting the agricultural, industrial and trade sectors was also actively initiated in the Third Plan in which the NRB played a very instrumental role. Consequently, the Rastriya Banijya Bank (RBB) was established in the public sector in 1966. With the operations of this second commercial bank, it was possible for the NRB to accord more attention to important areas of economic, monetary and fiscal development.[16]

As the Cooperative Bank could not effectively provide loan facilities to both the cooperative societies and individual farmers, the Agricultural Development Bank was established in 1968 to provide loans to individual farmers, cooperatives and corporate bodies. The Cooperative Bank, set up in 1963, merged with this Bank.[17]

However, as concentration of the financial institutions was more on providing loans to the larger farmers than the small farmers, the large farmers were the principal beneficiaries of the public credit programs during this Plan period.[18]

Insurance activities were also initiated during the Third Plan with the setting up of the first insurance corporation, National Insurance Corporation, in 1967. The activities of the NIDC with regard to providing financial and technical assistance to the private sector were also expanded.

A notable change in exchange rate took place on June 6, 1966 when the Indian currency was devalued by 36.5 percent. The Nepalese rupee appreciated in terms of the Indian currency as the Nepalese authorities opted not to devalue the Nepalese currency.[19] Consequently, the exchange rate was fixed at NRs. 101.00 per IRs. 100.00. An immediate positive impact of this measure was the success attained in eliminating the problem of dual currency.

It was during the Third Plan that with the fifth amendment of the NRB Act in 1966, the central bank was made more active in mobilizing resources through changes in the interest rates from time to time. Effective August 31, 1966 the NRB issued directives to the commercial banks to raise their deposit rates in order to attract savings into the banking sector and make the deposit structure in Nepal competitive with that of India. The commercial banks were also directed to increase their lending rates. As a result, the deposit rates of the commercial banks increased by 1 percentage point in savings, and by 2 percentage points in one year fixed deposits. Though these rates had been fixed on an *adhoc* basis in the absence of proper analysis of the impact of the interest rates on the different

sectors of the economy, this action became a paramount step in the exercise of interest rate as a monetary policy instrument.

The cash reserve requirement (CRR) for commercial banks was for the first time announced in December 1966 with the introduction of the Cash Reserve Regulation, 1966. Accordingly, commercial banks had to maintain with the NRB a minimum amount of cash reserve equivalent to 8 percent of their total deposit liabilities.

While M_1 increased by an average annual rate of 11.4 percent during the Plan period, M_2 supply increased by 14.8 percent due to a significant rise in time deposits by 38.0 percent. The average annual rate of growth of private sector credit, on the other hand, was 20.9 percent, rising from Rs. 110.5 million in mid-July 1965 to Rs. 258.9 million in mid-July 1970.

Fourth Plan (1970-75)

The major objectives of the Fourth Plan were to a) maximize output, b) to set up the base for sustained and long-term economic growth (that is, transport, communications, power, etc.), c) to promote and diversify foreign trade, d) to achieve accelerated pace of development with economic stability by containing the price level and e) to make proper utilization of manpower resources and to curb population growth. The Plan stated that for maintaining general economic stability, suitable monetary and fiscal measures would be resorted to, accompanied by control of the price level and improvement in the terms of international trade.

The Fourth Plan also focused on providing agricultural credit to the farmers in easy terms in order to enable the farmers to raise production and to utilize modern agricultural inputs. As a result, the relevant institutions (such as the Cooperatives, the ADB/N and the Land Reforms Savings Corporation) were strengthened to supply institutional agricultural credit for inputs at the village level.

It was during the Fourth Plan on October 22, 1974 that the Commercial Bank Act 1974 was promulgated and permission was given to commercial banks to advance short and long-term credit with a time frame of 5 to 10 years to agriculture, industry, trade promotion, canal construction and electricity.[20] This expanded the scope of the lending activities of the commercial banks.

The NRB realized that two decades after its establishment and based on its experiences on commercial banking activities the beneficiaries of institutional credit were primarily the modern sectors of the economy dominated by the rich and influential class of the society and the poorer sections of the society were not getting access to such services. Thus, it felt necessary to intervene and effective April 14, 1974 commercial banks were required by the NRB to invest 5 percent of their deposit liabilities in small scale agricultural and cottage industries.[21] This measure was also aimed at channeling commercial banks' credit to more productive and employment-oriented areas.

After the sixth amendment of the NRB Act, 1955, in 1974, the NRB discontinued the practice of providing direct loans to industrial units and began channeling the loans through commercial banks and development banks

The NRB for the first time directed Nepal Bank Limited to increase its capital base to Rs. 40 million by mid-April 1975. RBB was also directed to raise its capital fund to Rs. 20 million by mid-July 1975. Consequently, the capital base of these banks was strengthened.

During the Fourth Plan period, M1 and M2 registered an average annual growth rate of 12.2 percent and 16.4 percent, respectively. The rise in M2 was ascribed to the significant rise in time deposits by an annual average rate of 28.3 percent. Private sector credit rose by 25.6 percent. The commercial banks' total deposits and loans to the private sector posted an annual average growth rate of 23.8 percent and 25.5 percent, respectively.

Fifth Plan (1975-80)

While the overriding objective of the Fourth Plan was to maximize output, the objective of the Fifth Plan was not only to maximize output, but also to make such output consistent with the minimum felt-needs of the people. Hence the Plan gave priority to the objectives of the people-oriented production, the optimal utilization of manpower and the regional balance in the development process.

The Fifth Plan acknowledged that improved agricultural practices demanded improved seeds, tools and chemical fertilizer. If agricultural credit were not available, the small farmers would be the greatest

sufferers. Hence, the Fifth Plan set the target of providing agricultural loan to the extent of Rs.1.4 billion through 573 guided co-operatives and 453 guided village committees, covering more than 3000 village Panchayats throughout the kingdom. Because the first year of the Fifth Plan was designated as the "Agricultural Development Year" a special arrangement was made to provide agricultural credit against the tenancy rights certificate as collateral on an experimental basis.

During the Fifth Plan period, M1 augmented at an average annual rate of 16.4 percent. Increase in net foreign assets by an annual average rate of 18.6 percent and augmentation in domestic credit by 21.7 percent were the major expansionary factors influencing M1. Time deposits, the contractionary factor, soared by 28.0 percent. Consequently, M2 rose by 20.7 percent. The private sector credit also went up by an average annual rate of 20.9 percent during the Plan period.

Some crucial foreign exchange policies were undertaken during the Fifth Plan. The aims of the dual exchange rate (DER) scheme that became effective in 1978 were to diversify trade to overseas countries and to restrict imports of luxury goods. Under this scheme, there were two exchange rates under this scheme. The first rate was Rs. 11.90 per US$ (basic) with the second rate at Rs. 15.90 per US$.[22] Though nonessential imports were curtailed under this scheme, the DER system encouraged imports and importers in comparison to exports and exporters. The importer could import at Rs. 15.90 per US$ any amount of luxury goods and the private sector focused towards the more lucrative import business. Moreover, owing to the rapid rise in imports and almost stagnant exports to India, there was a chronic scarcity of Indian currency during the period of the DER scheme. Consequently, because of its adverse effects, the DER scheme was replaced by the Single Exchange Rate (SER) scheme in September 1981.

Under the SER scheme, all the transactions were to be conducted at a uniform rate of Rs. 13.20 per US$. There were no attractive incentives for exports exporting to overseas countries, excluding exporters of a small group of exportable commodities.[23]

Sixth Plan (1980-1985)

The Sixth Plan's objectives included increasing production at a faster rate, augmenting productive employment opportunities and meeting the minimum needs of the people. The development strategies to obtain these objectives were through prioritizing agricultural development and emphasizing the development of cottage and small industries as well as focusing on export trade and tourism development.

The Sixth Plan stated that suitable fiscal and monetary measures would be implemented to prevent the price from going higher than the desired level. It was also mentioned that credit in the unproductive sector would be contained in order to keep money supply within the required limits. Subsequently, the NRB established a credit-planning cell for strengthening monetary control and for monitoring credit expansion.

The rate of growth of M1 was projected to be limited within the rate of 12.0 percent per annum during the Sixth Plan period for containing inflation within a predetermined range and maintaining equilibrium in the balance of payment situation. In this respect, the Plan accorded emphasis to the utilization of the credit monitoring instruments available with the NRB and keeping the deficit finance within narrow limits. However, the annual average rate of increase of M1 was 14.2 percent that exceeded the target by 2.2 percentage points owing to the worsening budgetary situation of HMG as it started borrowing heavily from the banking sector from the second year of the Plan. M2, on the other hand, grew by an annual average rate of 18.4 percent. The average annual growth rate of private sector credit was 16.6 percent during the Plan period.

Since 1981, the principal mechanism for the implementation of the priority sector credit policy was through the Intensive Banking Program that was based on the 'Area Development Approach' and advanced credit to all beneficiaries within a specific geographical area on the basis of project viability and depended on the regular supervision of the credit projects. It also provided credit to the poor who could not put any collateral on the basis of group guarantee.[24] Priority Sector Coordination Committee was constituted for proper monitoring of loans and for better coordination among the concerned agencies.

A new foreign exchange system based on the trade-weighted basket, with the US dollar as the intervention currency, was introduced in June 1, 1983

to adjust the exchange rate mechanism towards a more flexible arrangement. The Indian currency was included in the 'currency basket' effective from May 1986. The move towards a basket of currencies was necessitated by the excessive volatility and misalignment of exchange rates during the early 1980s. This made the exchange rate of the Nepalese rupee move pragmatic and Nepal's exports more competitive, besides cushioning the economy from the potential shocks of larger doses of devaluation. In managing the value of the Nepalese rupee, emphasis was given to ensuring a fair degree of stability in the day-to-day rates.

It was during the latter part of the Sixth Plan that Nepal embarked on a financial liberalization program with the dismantling of the entry barrier for commercial banks with the amendment in 1984 of the Commercial Bank Act 1974.[25] Immediately after that, Nepal-Arab Bank Limited, the first joint venture bank with foreign collaboration, started its operations. After amending the Commercial Bank Act, 1974, the Finance Company Act 1985 was enacted to widen and deepen the financial market.

The partial deregulation of interest rates began in November 16, 1984 when initially the commercial banks were entrusted the responsibility to raise interest rates from 1 percentage point to 1.5 percentage points from the minimum administered rates. Again, a key change in the Foreign Exchange Regulation Act 1962 took place during the Sixth Plan when the NRB permitted the commercial banks to accept deposits on convertible foreign exchange currencies effective mid-July 1985 from foreign institutions, agencies and individuals other than Nepali, Indian and Bhutanese nationals.

Seventh Plan (1985-90)

The three-fold objectives of the Seventh Plan included: (a) augmenting production at a higher rate; (b) generating opportunities for productive employment, and (c) satisfying the minimum basic needs of the people.

With regard to policies pertaining to the financial sector, detailed monetary and credit policies were spelled out. These included the following: (a) maintaining annual growth rate of money supply at a maximum of 13.0 percent to maintain internal and external balance of the economy; (b) framing a policy relating to interest rate determination by the banks and financial institutions on their deposits and loans after conducting a detailed study; (c) according priority to mobilization of savings through development bonds in order to fulfill the resource requirements of the financial institutions; (d) expanding the priority sector loans implemented by the banks, export loan programs and small farmer development programs of the Agricultural Development Bank; (e) granting permission to set up banks with joint foreign collaboration as well as by the domestic private sector; (f) and constituting a high-power committee of the concerned institutions under the convenorship of the NRB with representatives from the commercial banks, non-banking financial institutions and Sajha organizations to monitor and follow-up on the program of these institutions to ensure that these institutions carry out their functions properly.

As the country encountered serious balance of payment problems between 1983 to 1985 with the balance of payment registering a deficit of upto to almost 2 percent of GDP and the country's foreign exchange reserves just sufficient to just two months of merchandize imports, the policy alternative was to employ demand compressing stabilization measures in the immediate run and adopt structural measures in the long run. Thus, the Nepalese currency was devalued by 14.7 percent in November 1985 and the stabilization program was resorted to in 1986 which assisted in compressing the fiscal deficit and improving the balance of payments. In 1987 the Structural Adjustment Program (SAP) was introduced that aimed at achieving 4-5 percent GDP growth, containing current account deficit to less than 8 percent of the GDP, lowering net domestic borrowing of the government to less than 1 percent of the GDP and restricting the price rise at 5 percent by the end of the program in 1991.

The average annual rate of growth of M1 was 21.1 percent during the Plan period as against the target of 13.0 percent for maintaining internal and external balance in the economy. M2 rose by an annual average rate of 20.8 percent during the Plan period. The rate of growth of domestic credit from the banking system was 18.9 percent exceeding the target of 16 percent. Credit to the private sector grew by 23.9 percent falling short of the target of 27.0 percent.

In the process of interest rate deregulation effective May 29, 1986 commercial banks were free

to set interest rate to any extent from the minimum level fixed. Finally, it was in August 1989, that interest rates were fully deregulated. The aim of deregulation the interest rate was to keep real deposit rates positive and thus stimulate savings. Hence, commercial banks and term lending institutions were free to fix deposit and lending rates on their own discretion.

An important move in the development of an indirect system of monetary control took place when the sale of treasury bills through auction system was introduced in November 25, 1988.[26]

Emphasis was accorded to the establishment of prudential norms as early March 1, 1989 when the NRB began setting single borrower limits.[27] The aim of setting single borrower limit was to reduce the risk factors of over-concentration of bank resources in the hands of selected people and to make the bank funds available to as maximum persons possible. A directive was also given by the NRB to commercial banks with respect to classification of loans into four categories (good, substandard, doubtful and bad) to improve asset quality.[28] Likewise, the commercial banks were directed to maintain sufficient reserve fund out of their profit on the basis of these four categories. In March 22, 1991 commercial banks loans were reclassified into six categories.[29]

With regard to capital adequacy requirement, as it was recognized that sufficient provision of capital assisted banks in the risk-bearing process and in employing new and advanced technology, capital adequacy ratio was initially introduced by linking it to the total deposits of commercial banks. The NRB directed the commercial banks to maintain their capital base (paid-up capital, general reserve and undistributed profit) to at least 2.5 percent of total deposits by mid-July 1989, 3.5 percent by mid-July 1990, 4.5 percent by mid-July 1991 and 5.5 percent thereafter.[30]

A credit information bureau was set up on May 14, 1989 whose objective was to provide the pertinent credit information to all member banks with respect to credit defaulters. The bureau's responsibility was to record information on credit over and above Rs. 2.0 million.

It was in 1990 that the Commercial Banking Problem Analysis and Strategy Study (CBPASS) with the objective of rectifying the different problems of the two government-owned commercial banks (RBB and NBL) was completed. Certain recommendations were implemented by HMG to strengthen these banks.[31]

As the interim government that was formed in 1990 was entrusted with the two-fold functions of framing a constitution and holding general elections, the task of formulating the Eighth Plan was postponed by two years. The major objectives of monetary policy during the two-year period were to regulate the rate of money supply at a level sustainable at the actual growth rate of national production and the national economy, to strengthen the financial base by incorporating reforms in the financial sector, to make the bank interest rates more realistic by enhancing the efficacy of indirect monetary control measures.

Similarly, policies were undertaken to provide additional incentives to low-income families in the course of providing loans. From FY 1991/92 onwards, the NRB directed the commercial banks to lend a specific percentage of their total outstanding credit to the Deprived Sector. Initially, the NBL and the RBB were directed to invest 2.75 percent of their outstanding credit to the deprived sector while the joint-venture banks had to invest 0.25 percent of their outstanding credit.[32]

Likewise, some measures were initiated relating to the liberalization of foreign exchange regime during this interim period. For instance, beginning December 1991, any Nepalese nationals possessing valued sources of convertible foreign exchange earnings were free to operate bank accounts in five currencies.[33] On March 4, 1992 the Nepalese rupee was made partially convertible in the current account. Again in July 12, 1992, the proportion of convertibility was increased to 75 percent from the earlier ratio of 65 percent. Moreover, effective July 12, 1992, convertible foreign exchange earners from merchandise exports and tourism business were permitted to deposit 30 percent of their earnings in convertible foreign currency account.[34]

Eighth Plan (1992-1997)

The broad aim of the Eighth Plan was to give a definite direction to the social and economic upliftment of the citizens of the country by tackling the challenges of economic stagnation, increasing poverty, structural anomalies, environmental degradation and rapid population growth. The principal objectives of the Plan were to attain

sustainable economic growth, alleviate poverty and reduce regional disparity.

With respect to the financial sector, a detailed chapter on money, banking and credit was incorporated in the Plan document. The principal objectives of banking and credit policy were to mobilize internal resources, maintain internal and external balance, generate healthy and competitive monetary environment, and disburse credit to prioritized sectors such as agriculture, cottage and small industries.

Policy measures were adopted during the plan period to regularize the monetary and banking sector via indirect measures without intervening directly in accordance with the concept of liberal and market oriented economic system. Similarly, measures were undertaken to encourage the commercial banks and financial institutions to run on a competitive basis and they were free to determine interest rate and other conditions on their own. HMG also adopted the policy to limit credit from the banking sector with the aim of reducing the budget deficit and channeling more credit to the private sector. Moreover, with the objective of providing more bank credit to the private sector, the NRB completely abolished the statutory liquidity ratio (SLR) effective July 16, 1993.[35] The provision of cash reserve ratio of 12 percent (8 percent as balance with the NRB and 4 percent as cash in vault) was kept unchanged.

During the Eighth Plan, the average annual growth rate of M1 was 14.8 percent exceeding the target of 13 percent by 1.8 percentage points. While in the early part of the Plan, the rise in net foreign assets emanating from the huge balance of payments surplus was the primary cause for high monetary expansion, in the latter part, the domestic credit from the banking sector utilized by HMG in a larger amount was a responsible factor for monetary expansion. Credit to the private sector rose at an annual average growth rate of 29.9 percent during the Plan period, which exceeded the target of 27 percent. Because of the high rate of growth of time deposits, the average annual growth rate of M2 was 18.0 percent for the Plan period.

It was in October 1992 that Nepal entered into agreement with the IMF for the adoption of the Enhanced Structural Adjustment Facility (ESAF).[36] Due to a high inflation rate of 21 percent and current account deficit of 8 percent of GDP in FY 1991/92, the objective of ESAF was to compress excess demand through stringent monetary policy. Thus, with the aim of tightening monetary expansion, ceilings were set on bank credit to the government, to non-financial government enterprises and on net domestic assets of the NRB.[37] However, the programs under the ESAF could not be carried out timely and appropriately because of some lapses in structural reform measures envisaged under the ESAF program.

During the Eighth Plan period, some actions pertaining to the liberalization of foreign exchange regime were initiated. For instance, on February 12, 1993, full convertibility in the current account was implemented and followed by an array of measures to liberalize the capital account as well.[38] Subsequently, Nepal attained the Article VIII status of the IMF charter.

With the aim of mobilizing internal resources and providing more competitive services in the financial sector, priority was accorded to the setting up of financial institutions during the Plan period. Consequently, as of mid-July 1997, 11 commercial banks and more than 40 finance companies were involved in banking transactions during the plan period.

The Eighth Plan document also stated that rural banks would be gradually set up in order to make a smooth disbursement of credit in rural areas. Hence, as the rural poor were either deprived from the credit facilities or were not able to use the services directed to them due to lack of rural orientation and effective targeting in these credit programs, the five Rural Development Banks, replications of the Grameen Model of Bangladesh, were introduced in 1992 with the setting up of the Eastern and Far Western Rural Development Banks in 1992, followed by the Central and Mid-Western Rural Development Banks in 1995 and finally the Western Rural Development Bank in 1996. The unique characteristics of these banks are that they are based on the area approach, identify the target group and group lending approach, require no physical collateral, collect principal and savings on a weekly basis, and render services solely to the poor women. While the NRB possessed more than 60 percent of the equity, the rest was held by HMG, banks and financial institutions.

Ninth Plan (1997-2002)

The broad objective of the Ninth Plan was alleviation of poverty and improvement in the standard of living of the poor community. Certain

strategies were laid down to attain this objective including speeding up the industrialization process through the advancement of such sectors such as agriculture, industry and tourism on the basis of comparative advantage, streamlining the development and expansion of modern sectors through liberal market-oriented policies while emphasizing the instrumental role of the government in developing and building the rural sector, recognizing cooperative as a crucial mechanism for the development and expansion of economic sectors such as agriculture, industry and trade, among others.

On the monetary policy front, the three-fold objectives as laid down in the Ninth Plan included a) maintaining the growth rate of money supply in line with the economic growth rate and the target of price and the balance of payments surplus; b) limiting the growth rate of credit flow to the extent of the limited growth in money supply; c) increasing resources from the banking sector to the private sector by pursuing the policy of providing no overdraft facility to the government sector; and d) lowering the tendency of the ADB/N, NIDC, finance companies, rural development banks and commercial banks to take assistance from the NRB in order to avoid their financial resource crisis.

The policy relating to credit and financial institutions comprised, among others, the following: a) adoption of an open entry policy to maintain financial development and stability and for making banking and other financial institutions competitive, healthy and strong; b) gradual transfer of the ownership of HMG in commercial banks, development banks and other financial institutions to the private sector; c) gradual increase in the provision to invest compulsorily by the commercial banks in the productive sector for generating new opportunities of productive employment; d) gradual promotion of the prevailing level of credit flow to the deprived class by the commercial banks; e) increasing the efficiency of NIDC and the ADB/N for long-term industrial and agricultural development; f) framing new institutional arrangement to expand the number of financial intermediaries for providing micro-credit at the local level to raise income and employment opportunities for the majority of low income people and create condition for equitable economic development.

The programs pertaining to the above policies included the following: (a) services of rural development banks, Small Farmer Development Program, micro-credit project for women and non-government organizations (NGOs) with similar objectives would be extended in a sustainable and effective manner for increasing the flow of institutional micro-credit; (b) amendments would be made in the existing Act, rules and regulations pertaining to operation and establishment of banking and financial institutions; (c) the core capital base of commercial banks, development banks and finance companies would be raised for strengthening their financial and investment position; (d) relevant laws would be formulated for developing an offshore financial intermediation center; (e) Debt Recovery Act would be formulated and enacted for making the debt recovery system effective; (f) an arrangement of necessary legal provisions with regard to the entry of new financial institutions, merger and take-over of existing banks and financial institutions would be made; (g) an institutional arrangement of credit rating for debt instruments would be made; (h) legal provision would be made to promote the autonomy of the central bank, other banks and financial institutions; (i) the government ownership in RBB, NBL and NIDC and other financial institutions would be gradually transferred to the private sector; (j) specialized autonomous institutions would be encouraged to be set up to fulfill the growing credit need of the priority sector; (k) foreign exchange system would be more liberal and Nepalese currency would be gradually made convertible in the capital account also; and (l) for providing access to credit for the growing foreign trade of the country, an export-import bank (EXIM bank) would be set up.

During the Ninth Plan period, the annual average growth rate of M_1 and M_2 was 15.0 percent and 16.8 percent, respectively, exceeding the target of 13.0 percent and 14,8 percent, respectively. Credit to the private sector rose by an annual average rate of 15.7 percent in comparison to the target of 20 percent. The recession in economic activities and the deteriorating security conditions in the latter years of the Plan period were the responsible factors. Total domestic credit rose by 15.5 percent as against the target of 16.1 percent.

Although some of the measures delineated in the Plan document were implemented, some are

ongoing while others did not materialize.[39] The programs pertaining to the establishment of an Export-Import Bank and a credit rating institution, among others, were not implemented.

During the course of the Ninth Plan, that is, on November 2000, a financial sector reform strategy paper was launched by HMG wherein a comprehensive plan for far-reaching reforms in the financial sector was outlined. The paper recognized the need for HMG and the NRB to reorient its activities to becoming a stronger regulator and supervisor of the overall financial system from being active participants in the financial sector. Priority was accorded to the active role of the NRB in implementing the financial sector reform to establish its authority as the chief regulatory and supervisory body.[40]

It was at the final year of the Ninth Plan that the new NRB Act was promulgated since the old NRB Act did not permit sufficient powers for effective monetary policy management, strengthening and improving financial markets and their supervision, and facilitating the growth of the financial sector.[41] The new NRB Act was enacted in January 2002 that rendered more autonomy, authority and accountability to the central bank. It aims at boosting up the contribution of the financial system towards attaining the national goals to a larger extent through increasing efficiency in mobilizing and allocating financial resources, enhancing savings and investment levels, channeling the resources towards productive investments and allocating the available resources to the deficient segments of the economy.[42] The supervisory, oversight and regulatory functions of the NRB have been fortified considerably with the enactment of this Act. The central bank has been tougher on banks and financial institutions that do not comply with the NRB's regulations.[43]

The NRB developed and issued a number of prudential regulations for implementation and subsequent enhancement of the health of the financial institutions during the Plan period. For instance, ten directives were issued to the commercial banks in 2001.[44] A new licensing policy for commercial banks was publicly announced on May 16, 2002 and included such aspects as the promoters' qualification, required paid-up capital, and technical assistance, among others.[45]

For revitalizing sick industries and to provide some relief to industrial and tourism sectors through the commercial banks and development banks, a provision of refinancing for their sick industry loans was introduced in FY 2001/02. Although there has been high demand from the industries for the use of this facility, this facility has not been utilized as per the target since the industries could not satisfy the conditions laid down for this purpose.[46]

Despite the foregoing measures, in aggregate, the reform programs were not implemented as envisaged in the Plan and the financial sector appears to have been adversely affected due the poor impact on the industry, trade and tourism sectors emanating that was attributed to internal and external factors. Moreover, the mechanism for the proper identification of investment opportunities seemed weak while the recovery rate was low.

Tenth Plan (2002-2007)

The principal goal of the Tenth Plan is poverty alleviation. The Plan estimates to bring down the percentage of people living under poverty line from 38 percent at the end of the Ninth Plan to 30 percent by the end of the Tenth Plan. The Plan has acknowledged that positive macro economic indicators alone are not adequate to bring the poverty incidence down to the targeted level. The macro strategy of the Tenth Plan is, thus, the creation of the fundamental basis to promote economic opportunities through high, sustainable and broader economic growth and a fair system of distribution of opportunities to attain the fixed target of poverty alleviation by controlling population growth rate and according priority to good governance.

The major objective of the monetary policy as outlined in the Tenth Plan is the maintenance of macroeconomic stability by ensuring adequate liquidity in the economy and enough credit flow to the private sector to achieve sustainable and high growth rate in the economy supported by price stability and favorable balance of payments. The two-fold strategies include (a) enhancement of standard of banking services and maintenance of financial sector stability and (b) formulation of programs and policies of banking, credit and financial institutions in favor of rural areas. With regard to the first strategy, some of the policies incorporated include the following: (a) total autonomy to the NRB in the conduct and operation of monetary policy; (b) augmentation in open market operations for short term monetary management; (c) reduction in credit

to the government from the banking system to enable the private sector to use the large share of total bank credit; (d) strengthening of the monitoring, supervision and regulatory mechanism for the rapidly growing financial sector; (e) gradual privatization of the government-owned banks; (f) making institutional arrangement so that debt recovery of financial institutions becomes effective; (g) development of credit rating system for attracting national and foreign investors; and h) establishment of deposit insurance system.

With regard to the second strategy of encouraging banks and financial institutions towards the rural areas, the major programs and policies include the following: (a) establishment of cooperative banks through amendments in the cooperative act; (b) management of 'Micro-credit Insurance' for the development of micro-credit as well as for minimizing the risk factors faced by the deprived group involved in micro-credit business; (c) strengthening and restructuring the credit operations of the ADB/N, NIDC, the Employee's Provident Fund, the Citizen Investment Fund and the Insurance Corporation for increasing rural and industrial credit; (d) privatization of the rural development banks and persuading them to provide banking services in the potentially hilly areas; (e) adoption of policy of gradual phase-out of the priority sector lending program but keeping the deprived sector credit program intact; and (f) expanding rural credit flow through small credit units, non-governmental organizations and micro-credit institutions in order to raise income and employment opportunities for the poor communities.

Some of the other programs spelled out in the Tenth Plan include setting up of the Debt Tribunal under the Debt Recovery Act, establishment of Asset Management Company, formulation of an act pertaining to all deposit institutions by integrating the various acts, and establishment of a modern clearing house to promote the payments system.

During the first two years of the Plan, M_2 grew by an annual average rate of 11.2 percent while M_1 rose by 10.3 percent. The average annual growth rate of M_2 and M_1 is targeted at 14.5 percent and 11.5 percent, respectively for the entire Plan period. The monetary sector's credit to the private sector augmented by an annual average rate of 13.8 percent during the first two years in comparison to the Plan's annual average growth of 20 percent for the five-year period. Private sector credit did not go up as expected due to the deteriorating security condition.

Some policy measures delineated in the Plan document have already been initiated during the first two years of the Plan period. For instance, the structural reform of the rural development banks is continuing. In this context, as per the policy of handing over the profit-making rural development banks to the private sector, the process of transferring 51 percent of the NRB's share out of its 61 percent share in the Western Rural Development Bank, Butwal, has already been initiated. Similarly, this same modality is being used with regard to the privatization of the Eastern Rural Development Bank, Biratnagar where the process of transferring 57.8 percent out of the total NRB's share of 67.8 percent to the private sector has commenced.

It was for the first time that, in accordance with the provision made in the NRB Act, 2002 the NRB made public its annual Monetary Policy and Program for FY 2002/03 on July 16, 2002 incorporating some significant measures for financial sector development.[47] One was the progressive removal of the priority sector lending program in five years' time, thereby making commercial banks free from this role and, consequently, encouraging development banks and micro-credit institutions to penetrate into rural areas.[48] Initially, a two-percentage points cut in the priority sector-lending requirement was effected in FY 2002/03.[49] Another was the abolishment of the interest spread of 5 percent effective July 22, 2002 to generate more competition.[50] This measure appears to have generated competition among commercial banks for deposit mobilization and credit expansion.

Other important policy announcements of the Monetary Policy and Program for FY 2002/03 included, among others, a) allocation of Rs. 100.0 million from the profit of FY 2001/02 by the NRB to the Rural Self-Reliance Fund (RSRF) for long-term credit flow to the prescribed sectors and thereafter 5 percent of its net profit annually; and b) revitalizing sick industries by providing a refinance facility of Rs. 1.5 billion for these industries.

While for FY 2003/04, capital adequacy ratio to be maintained by the banks and financial Institutions based on the risk-weighted assets was set at 11.0 percent, with the core capital at 5.5 percent, this same

ratio has been fixed for FY 2004/05 owing to the difficulties encountered in the prevailing situation.

The cash reserve ratio, which has been utilized in the recent past to lower the cost of resources of commercial banks and to manage the liquidity, has been reduced to 5.0 percent for FY 2004/05 from the earlier 6.0 percent as this ratio has been progressively reduced in the neighboring countries to complement the prevalent use of indirect monetary tools and prudential regulatory measures.[51]

Modifications pertaining to refinance rates have also been made in the Monetary Policy for FY 2004/05. While the refinance rate for rural development banks and export credit in local currency including agricultural credit has been revised downward to 3.0 percent from 4.5 percent, the refinance rate to commercial banks against their sick industry loans has also been lowered to 1.5 percent from 2.0 percent. The refinance rate for export credit in foreign currency and the bank rate has been kept unchanged at 2.0 percent and 5.5 percent respectively.

A new directive on blacklisting and credit information system was issued to commercial banks and financial institution on September 18, 2003. This directive was updated on June 4, 2004 and has assisted the banks and financial institutions in developing a good credit culture. Similarly, a directive on consortium financing, encompassing the procedures, role and responsibilities of consortium members and the consortium leader, has been effective from July 16, 2004

As the legislative framework of the country was weak and outdated during the course of the financial liberalization process, a number of legislative reforms have also taken shape during the first two years of the Tenth Plan. The government has approved the by-laws of the Debt Recovery Act after it received Royal Seal. The Debt Recovery Tribunal was set up on June 19, 2003 in order to make the loan recovery effective and lower the NPA of the banking system. A draft of AMC was prepared by the NRB and sent to the government on December 24, 2002. The creation of the AMC is expected to assist in decreasing the banking system's NPAs.

The Bank and Financial Institution Ordinance, that seeks at maintaining legal consistency in all deposit-taking institutions became effective from February 4, 2004 and has also tightened the regulatory rules governing those financial institutions.

A draft of Secured Transaction Ordinance and Insolvency Ordinance was submitted to HMG on January 1, 2003 for review and consideration. The draft ordinance relating to Anti-Money Laundering has been prepared and is the process of enactment.

Presently, the country is in the midst of the financial sector reform process under the Financial Sector Technical Assistance Project (FSTAP). The major components of this reform process include, among others, the NRB's reengineering and the restructuring of the NBL and the RBB.[52] The progress in some of the areas is briefly given below.[53]

With reference to the reengineering of the NRB, strengthening of inspection and supervision functions of the NRB has already been initiated. On-site inspection manual has been revised and updated and off-site manual has been prepared and implemented. A total of 473 employees have retired under the first two phases of the Voluntary Retirement Scheme (VRS) scheme. The NRB's corporate reorganization has been completed and has been effective since December 15, 2003.[54]

Restructuring of the NBL and the RBB was necessitated by the poor financial health of these two banks which in turn was due to a number of factors. In the first place, the lending policies of these banks overlooked the basic commercial principles, with credit extended, often due to government directives or pressure through informal channels, to borrowers who would not have been considered as creditworthy had commercial criteria been applied. These banks were utilized as instruments for political patronage, with pressure exercised on their officials to provide credit to politically favored borrowers and to prevent these institutions from foreclosing on defaulters.

Two, a large part of the lending was to government-owned enterprises, the majority of which encountered losses. Some of the SOEs were not only unable to service their original loans but also required regular infusions of credit from their bankers to continue trading.

Three, the quality of loan portfolios was worsening due to poor loan appraisal, monitoring and recovery procedures, insufficient loan documentation and loan security and by poor internal controls.

On top of the problems generated by the NPAs, the financial condition of these two banks revealed high operating costs and inefficiency. These

banks became overextended with regard to staffing levels and branch networks.

With regard to the restructuring of NBL, the management team of ICC, comprising international bankers from the Bank of Scotland (Ireland) took command over the management of the NBL on July 22, 2002. Asset and Liability Management Guidelines was submitted to the NRB on August 31, 2003 that incorporated important aspects such as managing liquidity risk, interest rate risk, foreign exchange risk, trading procedures etc. Some committees and task forces have been established to create, apply and reinforce internationally accepted norms and modalities in the bank. Quarterly financial statements have started to be published on a regular basis. Moreover, a total of 1,662 employees (1,464 under the first phase and 198 under the second phase) opted for the VRS.[55]

Focus was also made on lowering the NPA of the NBL which went down to 53.7 percent of total outstanding loans in mid-July 2004 compared to 60.5 percent in mid-July 2003. However, the absence of the Asset Management Company has obstructed in reducing the NPA. Again, lack of cooperation from the big defaulters has hampered the recovery efforts. As the Kathmandu Banking Office of the NBL has displayed an unsatisfactory performance, in the extended contract the NRB made an additional arrangement for a member of the management team to be assigned to restructure this Office.[56]

With respect to the restructuring of the RBB, after the signing of the contract with the CEO of the management team on December 21, 2002, a new Credit Policy Manual (incorporating collateral requirements, credit approval process and problem loan management, among others) was prepared in November 25, 2003. Several core teams have been set up in the RBB to concentrate on loan recovery and loan administration. The NPA was 57.6 percent of the total outstanding loans in mid-July 2004 compared to 60.2 percent in mid-July 2003.

There were 1319 employees who opted for the VRS scheme (effective date of September 17, 2003) during the first phase and 182 applicants who chose this scheme during the second phase (effective date of September 8, 2004).

Overall Financial Development

Increase in Banking Activities

Since the establishment of the NRB, banking activities in Nepal have increased tremendously as demonstrated by the growth of assets and the number of bank branches in rural areas. M1 soared from Rs. 174.1 million in mid-July 1960 to Rs. 93.8 billion in mid-July 2004 while broad money rose to Rs. 277.1 billion in mid-July 2004 from Rs. 200.6 million in mid-July 1960. The commercial banks' assets went up from Rs. 84.4 million in mid-July 1960 to Rs. 309.2 billion in mid-July 2004. Similarly, the commercial banks branches have grown from 16 in mid-July 1960 to 431 in mid-July 2004.

With respect to financial intermediation, outstanding deposit mobilizations by commercial banks has soared to Rs. 232.6 billion in mid-July 2004 from Rs. 72.3 billion in mid-July 1960. During the same period, outstanding amount of domestic credit inclusive of the NRB expanded considerably to Rs. 251.1 billion in mid-July 2004 from Rs. 28.4 billion in mid-July 1960. Net foreign assets of the banking system reached Rs. 108.8 billion in mid-July 2004 from Rs. 171.9 million in mid-July 1960. This vertical deepening of the financial system is quite impressive.

That a stronger financial sector has been created is also reflected in various financial indicators. The total deposits of commercial banks, for instance, increased from 2.3 percent of GDP in mid-July 1965 to 47.0 percent of GDP in mid-July 2004. Greater savings in the banking sector provide more scope for higher investment in economy both by the private sector as well as the government. Commercial banks' private sector credit to GDP ratio has witnessed a similar trend, rising from 1.9 percent in mid-July 1965 to 34.1 percent in mid-July 2004. This demonstrates the rising trend in the participation of the private sector in the country's development process. There has also been increased financial deepening as measured by the M2 to GDP ratio, from 8.7 percent in mid-July 1965 to 55.9 percent in mid-July 2004. The increase in this ratio implies further expansion in the financial intermediary sector relative to the rest of the economy as it denotes faster accumulation of a wide range of financial assets.

While the credit-deposit ratio of the commercial banks have taken an upward trend, the liquidity deposit ratio of commercial banks have gone down. Credit deposit ratio increased from 44.6 percent in mid-July 1960 to 64.3 percent in mid-July 1985 and further to 75.5 percent in mid-July 2004; liquidity-deposit ratio, on the other hand, has plunged from 69.1 percent in mid-July 1960 to 48.1 percent in mid-

July 1985 and further to 34.4 percent in mid-July 2004.

An important role of the financial sector relates to its function as a provider of essential funding for the real sectors. The largest beneficiary of credit from the banking sector has been the industrial sector followed by the commercial sector. Of the total commercial bank credit, while the share of the industrial sector was 37.9 percent in mid-July 2004, the share of the commercial sector was with 26.8 percent. In mid-July 1977, the shares of the industrial sector and the commercial sector were 7.6 percent and 58.2 percent respectively.[57] It seems very ironic that although agriculture is the major sector of the Nepalese economy, credit to this sector has not improved to the extent desired. In mid-July 2004, 3.6 percent of the total bank credit went to the agricultural sector, compared to 1.8 percent in mid-July 1977.[58]

Rise in Number of Financial Institutions and Financial Services

As a result of the measures undertaken n the financial sector and thereby creating a hospitable environment for the entry of new financial institutions, a large number of financial institutions has been set up and competition has been boosted to some extent. As of mid-January 2005, there were 17 commercial banks, 28 development banks (performing micro-credit and other transactions), 59 finance companies, 32 saving and credit cooperatives that received permission from the NRB for undertaking limited banking operations, 47 NGOs that have received license from the NRB to undertake financial intermediary transactions, 5 Regional Rural Development Banks, 2 national level development banks concerned with providing wholesale credit to the institutions undertaking micro finance transactions, 18 insurance companies, and one each of the Employees Provident Fund, Citizen Investment Trust and Nepal Stock Exchange Limited.

To generate more competition in the banking sector, the previous 50 percent ceiling on ownership has been raised to 66.67 percent. Moreover, on a case-by-case basis, foreign investors can invest up to 75 percent of paid up capital. Out of the seventeen commercial banks six are joint-venture banks (Nabil Bank Limited, Standard Chartered Bank Nepal Limited, Himalayan Bank Limited, Nepal Bangladesh Bank Limited, Everest Bank Limited and Nepal SBI Bank Limited) with foreign collaboration. These banks, taken together, constitute about 39 percent of the total deposits and 29 percent of the total private sector loans of the banking system.

With the increase in the number of financial institutions, the financial services offered by these institutions have also risen. Different types of loans have been introduced such as educational loans, foreign employment loans, hire-purchase loans and housing loans. The foreign joint venture commercial banks have brought with them new management skills and technology.

Some of the new banks have introduced longer opening hours, slashed queues in banking halls and provided more personalized services. Some innovations occurred and new products were made available such as credit and debit cards and automated teller machines (ATMs). The majority of these innovations have been possible with the advancements in the technology that have also facilitated links among various branches of one bank, hence bringing faster and better service to the banks' clients. Cheque clearing has been expedited. Competition for deposits and corporate clients have increased in the city areas.

Still, the impact of new banks on the cost, quality and range of financial services has been limited due to some factors. In the first place, although the major government and semi-government owned bank lost some of their market share, they still hold a share adequate enough to exercise a degree of oligopoly. Secondly, the slow speed of reforms of the government-owned banks retarded improvements in the cost and quality of their services. Third, the new entrants (both foreign and domestic banks) have avoided the core areas of the rural sector; hence, the benefits that have taken place have been limited to the rural areas. Moreover, owing to the relocation and closure of some of the branches of the RBB, NBL and the ADB/N emanating from the worsening security condition, there has been a significant decline in the availability of banking services to the rural areas.

To conclude this section on the entry of new banks, a few words on Nepal's commitments to the WTO prior to its officially becoming the 147th member of the WTO seem appropriate. The commitments in financial services have been made with reference to the General Agreement on Trade in Services (GATS) and the Annex on Financial Services. But, all the commitments are conditional

upon entry requirements, domestic laws, rules and regulations as well as the terms and conditions of the NRB and the Insurance Board.

Financial services can be conducted in Nepal through a locally incorporated company. Branches are to be given a green signal for wholesale banking as of January 1, 2010. Still, only those financial institutions that acquire a rating of at least 'B' from reputed global credit rating agencies such as Moody's and Standard and Poor's will be allowed to seek commercial business in the country.

East Asian Financial Crisis and Lessons to Nepal's Financial Sector

Since the early 1970s, there have been at least eight crises instigated by speculative movements of capital, and these have been focused in the emerging markets: the Southern Cone financial crisis in the late 1970s, the Third World debt crisis of the early 1980s, the savings and loan debacle in the US in the late 1980s, the so-called ERM (Exchange Rate Mechanism of the European Monetary System) crisis in 1992, the Mexican crisis of 1994-5, and its follow-on crisis in Latin America (the so-called 'Tequila Effect'), the East Asian crisis of 1997, the Russian meltdown of 1998, and the collapse of the *real* in Brazil and its impact on the rest of Latin America.[59] The focus of this paper is on the East Asian crisis as it offers some lessons for Nepal that was in the midst of the financial liberalization process when the crisis struck East Asia.

In Asia, a full-scale financial crisis swept Thailand, Republic of Korea, and Indonesia and to a lesser extent Malaysia during the second half of 1997. It started when the Thai devaluation of July 2, 1997 led to a withdrawal of capital from the region as a financial panic set in and these developments in Thailand caused investor to look more critically at weaknesses they had previously ignored. Consequently, the IMF, the World Bank and governments had to intervene to provide financial support to rescue these countries from the severe crisis. While there were country-specific special factors leading to the financial crisis, there were some common features: a) huge current account deficits, financed with short-term flows, exposed East Asian economies to sudden reversals; b) liberalization of domestic financial markets allowed banks and corporations to assume unhedged foreign borrowing positions that left them vulnerable to sudden currency fluctuations; c) companies, in the absence of fully developed bond and equity markets, borrowed heavily from banks to finance their rapid expansion, and in the process became highly leveraged and left them vulnerable to interest rate surges; and d) weak and inadequately regulated financial system could not handle the rapid growth of domestic credit and price risks appropriately.

Again, the crisis prevailed for a longer time than predicted as financial sector reforms such as closure of institutions and stringent capital adequacy requirements brought about higher interest rates initially and severely constrained access to credit. Simultaneously, contractionary fiscal policy in the backdrop of falling output and employment led to huge curtailment of domestic demand. The outcome was the inability of real sector enterprises to create funds. Consequently, the debt-servicing capacity of the real sector weakened. Moreover, the burden of large volumes of NPAs also continued to plague financial sector institutions, partly due to high exposure to real estate, the prices of which plummeted. For instance, the NPAs of the Thai banks stood at 46 percent of total lending in February, 1999.

The policies initiated by the crisis-stricken countries to deal with the problem of NPAs included: (a) setting up of Asset Management Companies; (b) allocation of public fund to banks and other financial institutions; and (c) building up of a framework for the promotion of autonomous, non-courtroom negotiations between creditors and debtors. To implement these policies, these governments either revamped existing organization, or developed new ones to implement the above policies in 1998 and 1999. In Thailand and Indonesia, it was necessary to revise bankruptcy laws, since they were not functioning properly. For this reason, negotiations between creditors and debtors were delayed. For both countries, it was only in 1999 that revised bankruptcy laws were enacted, contributing towards smoother negotiations between creditors and debtors on NPAs.

The focus of the crisis-stricken countries (Indonesia, Korea, Malaysia and Thailand) was on tackling the problem of insolvent financial institutions by closure, merger or recapitalization; addressing the corporate debt overhang; and improving corporate governance. The broad principles of financial and corporate restructuring were similar, but the actual patterns of implementation differed. Banks were required to fulfill the international standards of capital

adequacy, loan classification, loan-loss provisioning, accounting and disclosure.

The East Asian crisis renewed the validity of matching the resources with lending. GDP growth went up, foreign exchange reserved increased, currencies were stable and interest rates fell in the four crisis-affected countries (Indonesia, Korea, Malaysia and Thailand) three years after the onset of the crisis. By undertaking reform measures, most of the crisis-affected countries reestablished their successes on new foundations in the financial sector, and in the governance and financing of their corporate sectors.

The East Asian crisis demonstrated that globalization brings both ample opportunities and risks. Thailand, Indonesia and Korea as well as other countries had benefited considerably from the openness of the respective economies as well as the huge inflows of capital since the beginning of the nineties. Still, weak financial systems and sudden changes in market sentiment seem to enable an external shock to create a banking crisis, and then a total all-encompassing crisis, including economics, social, and political issues, in a short time.

The financial sector of Nepal was less susceptible to the direct impact of the East Asian crisis because of the low foreign private capital inflows and limited commercial debt. Moreover, the Nepalese financial market was at its nascent stage of development.

Nepal can, however, learn a number of lessons from the experiences of crisis-stricken countries, especially with regard to the banking sector where NPAs have been escalating in recent times. The banks need to conduct qualitative reviews of their portfolios as part of the risk management system.[60]

The East Asian crisis has shown that countries should adopt a cautious approach towards liberalization of the capital account, keeping in mind the vulnerability it brings with it. Prudent norms of behavior and an effective regulation of the banking and financial sector needs to be in place before the country could move towards capital account liberalization. Capital account liberalization should be undertaken as an integral part of economic reforms and coordinated with appropriate macroeconomic, exchange rate and financial sector policies.

More care should be taken to limit the extent of a country's foreign debt to levels where it can be serviced with a margin of comfort. The careful management of foreign reserves should also be a high-priority policy objective.

Other areas of reforms should focus on institutional arrangements for financial sector supervision, enactment and enforcement of appropriate legislation and rules of behavior by private business in both financial and real sectors, and transparency in corporate reporting systems.

It is very difficult to predict a crisis. Moreover, for crisis emanating solely from contagion effects, there may not exist any early warning signals as these crises emanate from unanticipated market response. However, there are some major shortcomings that make economies susceptible to financial crises. The likelihood of a currency or banking crisis goes up when the economy is overheated; inflation is high, the real exchange rate appreciates, current account deficit has widened, domestic credit escalates, and asset prices get inflated. A rapidly rising ratio of broad money to international reserves, equity price declines, worsening in the terms of trade and an upsurge in world interest rates can also signal vulnerability.

Conclusions and Challenges

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

Reforms introduced in the banking sector are a continuous process aimed at improving financial strength and functional efficiency of the commercial banks and bringing them up to the international standards. Financial sector reform is a core element for the success of Poverty Reduction Strategy Paper (PRSP) and Poverty Reduction Growth Facility (PRGF) supported programs, which should push for faster economic growth and poverty reduction.

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

adequate monitoring and control by the NRB has been made more challenging.

The Periodic Plans, particularly the Ninth and the Tenth Plan, have acknowledged that a sound financial system is an essential ingredient for sustainable economic growth and reduced poverty. Accordingly, policies and programs such as lifting restrictions on foreign bank entry, facilitating mergers and takeovers, completing privatization of banks and non-banks and supporting the development of micro-finance institutions have been outlined in these Plans. While some of the programs enunciated in these Plans are yet to be met, the attainment of the goals pertaining to the financial sector would only be desirable if it is preceded by a strengthened central bank that is capable of regulating and supervising the financial sector.

In the long run, it is the supervision and regulation function that is crucial in safeguarding financial stability. In this context, the country needs to prepare for a tightening of the prudential norms as the new Basel Accord becomes effective in 2007 and a fuller response to the current financial environment emerges. Upgrading technical skills, technology, research and human capital and fortifying internal rules of governance and responsibility assume a renewed priority in the fast changing scenario.

In Nepal, the rural areas have not benefited from the increase in the number of financial institutions as these institutions have concentrated in a few urban areas. Although many micro-credit programs and projects have been launched with the twin objectives of poverty alleviation and employment generation, the results have not been satisfactory so far. Hence, a difficult task of checking whether or not the rural areas are the actual beneficiaries from the operations of the different institutions active in micro-financial services exists.

Although the Nepalese banking industry has been an important driving force behind the nation's economic development, there are a few issues regarding the efficiency of the banking system that raise concerns, especially during a period of generalized uncertainty. For instance, the level of NPAs continues be high by international standards. The response to the debt recovery and asset restructuring initiatives has also been rather slow. In this respect, the experiences and lessons of the East Asian financial crisis, as discussed above in this paper, would be very useful.

Another vital issue concerns the timing of capital account convertibility. Capital account convertibility entails some risk of capital flight and possible macroeconomic instability emanating from movements of short-term, cross-border capital flows. Such risks and vulnerability remain contained as long as prudent macroeconomic policies are undertaken and the financial system is sound and flexible to rapidly adapt to the changing situations. Thus, a reduction in fiscal deficit, moderation in inflation, a sustained dynamic export performance, strengthening of domestic financial institutions, and a further build- up of foreign exchange reserves constitute some of the pre-conditions for a move towards capital account convertibility. Moreover, strengthening the prudential supervision of financial institutions, and putting in place appropriate institutional arrangements for speedy foreign exchange and payments clearing systems constitute major elements in ensuring a smooth transition to full convertibility. Being a small developing country dependent on agriculture and reliant on a few agricultural products, Nepal will not be able to absorb the external shocks if full convertibility in the capital account takes place now.

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

The worth of a nation's financial sector is its capability to furnish the appropriate types of institutions and financial instruments that can support economic growth. Generally, a financial sector will mirror the health of the real sector that it serves. The challenge to the NRB is to create a financial system that is supportive of growth, and dynamic enough to change and meet the evolving needs of a real economy.

Endnotes

[1] These include the studies of Goldsmith (1969) and McKinnon (1973).

[2]One of them was King and Levine's (1993) cross-country studies for the post-war period.

[3] Nepal is one of the fifty countries designed by the United Nations as 'least developed countries'. The other countries include Afghanistan, Angola, Bangladesh, Benin, Bhutan, Burkina Faso, Burundi, Cambodia, Cape Verde, Central African Republic, Chad, Comoros, Democratic Republic of the Congo, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Haiti, Kiribati, Lao People's Democratic Republic, Lesotho, Liberia, Madagascar, Malawi, Maldives, Mali, Mauritania, Mozambique, Myanmar, Niger, Rwanda, Samoa, Sao Tome and Principe, Senegal, Sierra Leone, Solomon Islands, Somalia, Sudan, Timor-Leste, Togo, Tuvalu, Uganda, United Republic of Tanzania, Vanuatu, Yemen, Zambia. For details, see UNCTAD (2004).

[4] Although the financial institutions in Nepal include, among others, commercial banks, development banks, finance companies, rural development banks, saving and credit cooperatives with permission from the NRB for undertaking limited banking operations, non-governmental organizations (NGOs) with license from the NRB to conduct financial intermediary transactions, and insurance companies, the focus of this paper is on commercial banks. Moreover, though some monetary data are available as of mid-July 1957, financial sector data from mid-July 1960 onwards have been considered to maintain consistency.

[5] This is illustrated by Brownbridge and Gayi (1999) who undertook a study on the progress and limitations of financial sectors reforms in eight LDCs (Madagascar, Malawi, Tanzania, Uganda, Zambia, Bangladesh, Laos and Nepal) during 1995-97.

[6] Examples of Asian LDCs that relaxed restrictions on entry of private sector and/or foreign banks into domestic markets include Nepal and the Lao People's Democratic Republic.

[7] This part of the paper is based on the study by Brownbridge and Gayi, *Op. cit*.

[8] The theoretical arguments are expounded in Ghosh and Ghosh (2003).

[9] The objectives of interest rate liberalization are elaborated in Fry (1988).

[10] This issue is discussed in Gelb and Honohan (1991).

[11] For more on implications on foreign bank entry, refer to Clark *et.al* (2003).

[12] However, opening up is preceded by some drawbacks including a heightening of risk in some dimensions, and requires careful monitoring. It also leads in a loss of business for domestic financial firms. Yet, access to financial services in what is crucial for development, not who provides them.

[13] For more on this justification, please refer to UNCTAD (1996).

[14] Some of the limitations of financial liberalization are elaborated in Chandavarkar (1992).

[15] The 'Foreign Exchange Control Act' was replaced by the 'Foreign Exchange Regulation Act' in 1962.

[16] Set up in 1937, the Nepal Bank Limited (NBL) was the first commercial bank to be established in Nepal.

[17]The ADB/N is the premier lending institution focusing in agricultural and rural credit in Nepal. Its Small Farmer's Development Project introduced in 1975 focused on the social and economic upliftment of the small and landless farmers. Beginning in 1984, the ADB/N has been permitted to directly enter the general banking business (with certain restrictions).

[18] Details are provided in Gaudel (2003).

[19] The decision was based on the favorable trade balance of Nepal with India and adequate reserves of Indian currency with the NRB.

[20] Prior to this, credit was restricted to be provided for a period exceeding a year.

[21] The Small Sector Program was renamed as 'Priority Sector Credit' in 1976.

[22] All receipts from overseas exports were converted at the second rate. Analogously, all imports were converted at the second rate, excluding imports of certain development goods like petroleum products, chemicals, fertilizers, certain raw materials, and machinery required for industrial and agricultural development, which were provided at the basic exchange rate. For more on dual exchange rate, see Pant (1994).

[23] The rate of subsidy was 10 percent of f.o.b. value for exportable items other than leather and leather goods for which the rate of subsidy ranged between 10 and 20 percent.

[24] Of the total loan under the priority sector, 60 percent was provided to small families. In the initial years of the Sixth Plan, it was made compulsory to the commercial banks to finance minimum of 7 percent of the total deposit liability to the projects under the priority sector. This proportion was increased to 10 percent in FY 1982/83 and the same proportion was maintained in FY 1983/84. However, as the commercial banks could not attain this level, it was lowered down to 8 percent in FY 1984/85.

[25] When the financial reforms program began in Nepal in the mid-1980s, there were just two commercial banks (the RBB and the NBL). Both of these banks were highly regulated. There was absence of competition in the financial sector. The NPAs of these banks were high and interest rates were controlled. There were no non-bank financial institutions excluding ADB/N and NIDC, some insurance companies and Employees Provident Corporation.

[26] Since the introduction of the auction mechanism, 91-day treasury bills were offered once a month at irregular intervals. In July 1989, 182-day treasury bills were introduced.

[27] According to the directive, effective March 1, 1989 commercial banks could lend a maximum of 50 percent of their capital base in case of fund-based credit and 100 percent in case of non-fund-based credit. A provision was also made for slowly reducing this ratio to 25 percent for fund based and 50 percent for non-fund-based lending by mid-July 1992.

[28] Those credits (both principal and interest) that were overdue for less than six months were classified good; those which were overdue for greater than six months and upto one year were classified as substandard; those with maturity period exceeding more than one year and upto five years were doubtful; and those exceeding the maturity period by more than five years were bad.

[29] These were (a) good loans, when overdue period was not exceeded; (b) acceptable loans, if overdue period was exceeded by one month; (c) evidence of substandard loans, when overdue period ranged from one month to six months; (d) substandard loans, if overdue period ranged from six months to one year; (e) doubtful loans, when overdue period ranged from one year to five years, and (f) bad loans, if overdue period exceeded five years.

[30] In March 1991, this system was modified and the capital adequacy ratio was linked with the total risk weighted assets and total off-balance sheet transactions.

[31] These included, among others, a) recapitalizing these banks and enabling them to make adequate provision for non-guaranteed bad debts; b) setting up separate Loan Recovery Departments in RBB in March 1991 and in NBL in May 1991; c) issuance of guidelines on a new system of loan classification and accounting policies for interest suspension and provisioning (based on CBPASS methodology) to all commercial banks in May 1991; and d) fixing debt recovery targets for the two banks.

[32] Another important policy development during this period was that the NRB began to issue its own bond from December 31, 1991 to mop up excess liquidity in the economy.

[33] These currencies included US dollar, Pound sterling, Deutsche mark, Japanese yen and Swiss franc.

[34] Effective March 1, 1994, foreign exchange earners from export and tourism were permitted to deposit 100 percent of their earnings in foreign currency account.

[35] The SLR was intermittently imposed between 1974 and 1992.

[36] The major macroeconomic objectives of the ESAF program included, among others, the attainment of a real GDP growth of about 5 percent, a reduction in inflation to about 8 percent by undertaking tighter monetary and fiscal policies and more liberalization of trade, industrial and foreign exchange regimes.

[37] Ceilings on net bank credit to the government and government enterprises were set to ensure more flow of credit to the private sector.

[38] The major measures included entitlement to the exporters to retain cent percent of their export earning in convertible currency, freedom to open bank account in convertible currencies, provision of usance credit in some areas, freedom to the commercial banks to provide credit in convertible currencies, and freedom to foreign investors to repatriate cent percent of their profit and equity capital in convertible currency. Again since May 1993, Nepalese nationals and organizations that earn income in foreign currency were permitted to retain the income in foreign currency accounts in Nepal.

[39]The majority of the reform measures are being implemented in the Tenth Plan period.

[40] Some of the main components of the reform program as outlined in the paper included, among others, the following: a) providing more autonomy to the NRB; b) strengthening the inspection and supervision capacity of the NRB; c) amending legal provisions with respect to the financial sector; d) improving the management of RBB and NBL in the first phase and initiating the reform programs for other financial institutions in the second phase; e) improving the accounting and auditing system of the financial sector; f) setting up of the credit rating agency and the Assets Management Company; and (g) strengthening rural development banks.

[41] The NRB Act 1955 was primarily suited for a central bank in a government-controlled economy with a bank supervisor to supervise government-owned banks. As a result, the structure, architecture and legislative framework of this Act was not appropriate for a modern central bank and banking system. The NRB was not autonomous legally or operationally. The Government had the power to issue directives with which the NRB had to comply as long as it was considered to be of national interest. With respect to lending to the Government, the Act placed no restrictions over the lending amount and the duration within which such loans must be repaid.

[42] The prime objectives of monetary policy as laid out in the NRB Act include: a) attaining domestic price stability, b) securing a reasonable surplus in the balance of payments stability in order to facilitate a sustainable economic growth; c) maintaining financial sector stability; and d) developing a secure, healthy and efficient payment system.

[43] Again, to address some deficiencies of the NRB Act relating to bank restructuring, the new NRB Ordinance has been enacted in September 2004.

[44] These directives covered, among others, issues such as the minimum capital fund to be maintained by commercial banks, loan classification and loan loss provisioning, single borrower limit, accounting policy and structure of financial statements investment in share and securities, submission of data to the NRB, and transfer or sale of shares of the bank's promoters.

[45] According to this policy, for instance, in order to set up a new commercial bank at the national level, it is mandatory to have either joint venture of technical service agreement with a foreign bank or financial institution for a minimum of three years.

[46] This policy has been continued for the fourth consecutive year for FY 2004/05 with the refinance facility amounting to Rs. 1.0 billion and refinance rate of 1.5 percent.

[47] For details, please refer to NRB (2002).

[48] The Priority Sector Lending Program which was initiated in 1974 under the name of 'Small Sector Program' appeared suitable only in the context of a small number of commercial banks and controlled financial regime as in the post. With the upsurge in the number of financial institutions in the context of open and liberal economic policy, this Program has become controversial. Thus, for generating a professional environment for commercial banks and reemphasizing indirect instruments of monetary policy, the Priority Sector Lending Program is being progressively phased out.

[49] The time schedule of the phase-out of the priority sector credit is as follows:

Fiscal Year	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Portion of total outstanding credit (in %)	7	6	4	2	2	Not compulsory

The deprived sector requirement has remained intact.

[50] Earlier on July 30, 1998, the NRB had issued a directive to the commercial banks to restrict the interest spread to 5 percent with the aim of reducing the financial intermediation cost of commercial banks.

[51] Beginning FY 2003/04, a single, uniform compulsory ratio of 6 percent had been incorporated to bring about uniformity and simplicity in the earlier differentiated compulsory rates with regard to the various domestic deposit liabilities.

[52] While the first phase of the FSTAP credit agreement was signed on April 30, 2003 the second phase was signed on June 10, 2004. As compared to the first phase of loan and grant assistance that was utilized for the (a) re-engineering of the NRB, (b) restructuring of the RBB and the NBL, and (c) capacity-building in the financial sector, the second phase is to be used primarily for (a) right-sizing RBB and NBL through the voluntary retirement scheme (VRS), (b) strengthening NRB's monitoring and supervision capacity and (c) supporting the management team at the RBB and the NBL.

[53]Not all the areas of this reform process have been covered and elaborated as they are dealt separately in other parts of this volume.

[54] The new corporate structure is based on the classification of NRB's functional activities into four groups (monetary and foreign exchange policy, banking operations, regulation and supervision, and support services).

[55] The effective dates of the first and the second phase of the VRS schemes were September 17, 2003 and August 27, 2004, respectively.

[56] The contract has been extended for one year beginning July 23, 2004.

[57] The credit to the services sector and for general use and services formed 10.0 percent and 19.7 percent, respectively, of the total bank credit in mid-July 2004.

[58] In the present context, the non-availability of adequate banking and financial services in the rural sector could be ascribed to the closure of some branches of the government-owned banks in the rural areas due to the security problem. In view of this problem, the NRB has been according priority to the expansion of micro-finance service which appears to be a more reliable and accessible mechanism for increasing the access of the deprived people to the institutional credit.

[59] This list is given in Bello, Walden *et.al* (2000).

[60] An important lesson from the Korean experience of the 1997 crisis was a renewed recognition of the significance of the financial industry for the overall economy. In the process of pursuing economic development from the 1960s, the main functions of the financial industry, such as credit screening, had been ignored to a large degree.

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Appendix 1
Some Monetary Aggregates
(In Rupees Million)

At at end of Plan Period	Net Foreign Assets	Monetary Sector's Claims on Private Sector	M_2	M_1	Time Deposits	Total Deposits of Commercial Banks	Private Sctor Claims of Commercial Banks
1960 July*	171.9	32.3	200.6	174.1	26.5	72.2	32.2
1st Plan	206.9	46.0	235.6	205.4	30.2	75.3	45.6
2nd Plan	449.5	110.5	489.7	446.3	43.4	129.8	106.9
3rd Plan	1,007.2	258.9	975.3	763.3	212.0	405.0	251.7
4th Plan	1,029.1	783.4	2,064.4	1,337.7	726.7	1,174.0	761.8
5th Plan	2,231.9	1,916.5	5,285.3	2,830.4	2,454.9	3,351.6	1,867.6
6th Plan	1,897.6	4,036.6	12,296.6	5,480.0	6,816.6	8,560.1	3,877.3
7th Plan	9,338.9	11,687.6	31,552.4	14,223.0	17,329.4	21,942.5	11,527.2
8th Plan	40,191.1	64,658.7	103,720.6	38,460.3	65,260.3	81,660.6	63,169.7
9th Plan	88,419.1	133,315.3	223,987.6	77,155.5	146,832.1	183,728.1	130,088.4
2004 July	108,800.7	172,517.4	277,122.7	93,786.3	183,336.4	232,576.3	168,692.8

Data as at mid-July 1960 and mid-July 2004 have been included for the sake of comparison.
Source: NRB.

Appendix 2
Average Annual Growth Rate
(In Percent)

As at end of Plan Period	Net Foreign Assets	Monetary Sector's Claims on Private Sector	M_2	M^1	Time Deposits	Total Deposits of Commercial Banks	Private Sector Claims of Commercial Banks
2nd Plan	24.6	25.1	20.9	22.9	7.0	18.0	24.4
3rd Plan	20.5	20.9	14.8	11.4	38.0	26.9	21.0
4th Plan	1.9	25.6	16.4	12.2	28.3	23.8	25.5
5th Plan	18.6	20.9	20.7	16.4	28.0	23.7	20.9
6th Plan	-1.5	16.6	18.4	14.2	22.8	20.7	16.3
7th Plan	39.7	23.9	20.8	21.1	20.6	20.8	24.6
8th Plan	15.0	29.9	18.0	14.8	20.1	19.5	30.1
9th Plan	17.8	15.7	16.8	15.0	17.9	18.0	15.7
10th Plan*	11.2	13.8	11.2	10.3	11.8	12.3	13.9

*Average of first two years of the Plan period.
Source: NRB and computations.

Appendix 3
Some Ratios
(In Percent)

As at End of Plan Period	M_1/GDP	M_2/GDP	Deposit/ GDP	Private Sector Loan/GDP	Credit/Deposit Ratio	Liquidity/ Deposit
1960 July*	-	-	-	-	44.6	69.1
1st Plan	-	-	-	-	60.6	60.1
2nd Plan	8.0	8.7	2.3	1.9	82.4	33.0
3rd Plan	8.7	11.1	4.6	2.9	74.3	42.7
4th Plan	8.1	12.5	7.1	4.6	104.8	42.3
5th Plan	13.1	24.5	15.5	8.6	84.0	36.0
6th Plan	12.2	27.3	19.0	8.6	64.3	48.1
7th Plan	13.8	30.5	21.2	11.1	70.1	42.9
8th Plan	13.7	37.0	29.1	22.5	86.8	43.5
9th Plan	18.3	53.0	43.5	30.8	78.5	41.4
2004 July	18.9	55.9	47.0	34.1	75.5	34.4

*Data as at mid-July 1960 has been included for the sake of comparison.
Note: GDP figures are available only from 1964/65.
Source: NRB, Central Bureau of Statistics and computations.

Money, Foreign Exchange and Capital Markets

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Introduction

Over the course of transforming saving into investment, money, foreign exchange and capital markets play a crucial role in pooling financial resources, allocating them to the most productive sector of the economy, and managing risks associated with credit, foreign exchange, and investment. The money, foreign exchange, and capital markets, hereafter collectively called financial markets, are the important dimensions of the financial system. The financial markets perform the core functions of exchanging funds from surplus units to deficit units at lower information and transaction costs. In addition, information production, separation of ownership and management, good governance and corporate control, instant adjustment of prices for the available information and accurate pricing of risks are some other functions carried out by the financial markets. The financial market participants comprising a large number of individuals, domestic and foreign private institutions, and governments use a range of instruments in mobilizing funds from surplus units to deficit units of the economy. Short-term, long-term and foreign financial claims are transacted in money, capital and foreign exchange markets, respectively.

The banks and other financial intermediaries rather than capital markets are the main sources of corporate funds in the least developed countries (LDCs). Despite the presence of large number of deposit money banks and other financial intermediaries in the financial system of these countries, a substantial share of the economy is yet to be monetized, and savers and investors have to rely on informal sector for their transaction. Since the beginning of 1980s, market-based reforms have been initiated in many LDCs to make financial markets more efficient and capable of reducing poverty. Such reforms are mainly directed towards financial market liberalization and improvement in regulation and supervision of banks and financial institutions.

The global financial markets are integrating throughout the world dismantling the barriers of flexible exchange rate and international capital flows. Theoretically, when domestic financial markets integrate with such foreign markets, the country will have better access to a large pool of foreign funds on the one hand and, on the other, domestic companies and individuals will have a greater range of choices for diversifying their investment in international markets. In this context, the Nepal Rastra Bank (NRB) has focused its activities on introducing international accounting standards and auditing practices, and improving transparency in financial information disclosure to make the domestic financial markets robust and thereafter to integrate them with the international financial markets. For this, the current account has been liberalized and the adoption of capital account convertibility, in which foreign assets can be converted into domestic assets and domestic

assets into foreign assets without permission from the regulatory authority, is under consideration.

The NRB has shifted from using direct tools of monetary control to indirect ones. The monetary policies formulated, targets fixed and instruments used to maintain financial stability are determined by the depth and resilience of these markets. The money, foreign exchange, and capital markets are closely linked and any turbulence inflicted in one market spreads instantly to the other markets. The changes in the prices of assets in the money market affect the behavior of the participants in the other markets. The short-term interest rate is determined in the money market and addition of risk premium to interest rate on short term risk-free monetary assets like treasury bills gives a benchmark return on fixed-interest securities of capital market. Similarly, the required rate of return on equity investment depends on interest rate on fixed income security plus some premium for risk associated with the equity investment. In other words, the higher risk inherent in equity investment is compensated by higher return on such investment. The required rate of risk-adjusted return and the cost of production of any commodity are determined in these markets.

With the increase in financial and economic integration, changes in the exchange rates, interest rates and equity prices in foreign financial markets also cause relevant changes in the domestic exchange rates, interest rates and equity prices. Ultimately, the domestic prices and quantity demanded in the domestic market are determined by the economic conditions prevailing in the foreign financial markets and competition among domestic and international financial market participants increases.

Literature Review of Financial Markets in LDCs

Economic Development and Financial Markets

The government or central bank, the so-called regulatory authority particularly of developing countries, intervened extensively in money, foreign exchange, and capital markets for their creation, promotion, and smooth functioning. The governments of most LDCs after World War II emphasized on the development of domestic banks and other financial intermediaries to manage their increasing development expenditure from public deposits. Even today, these financial institutions are the main suppliers of funds to the governments in some LDCs. The statutory regulatory policies were designed to divert funds to the government treasury at the cost of commercial lending. The government securities were sold to government-owned commercial banks, central bank, and other financial institutions through private placement. The captive buyers used to purchase these securities at interest rates fixed by the regulatory authority to maintain their prescribed statutory liquidity reserve. Similarly, the exchange rates were also fixed by the government in order to stabilize their domestic currencies. Thus, the regulatory authorities in LDCs controlled the prices of financial assets through the control of interest and exchange rates.

Financial economists have a consensus view on the positive relation between saving, investment, and growth; however, they have divergent views regarding the causality of growth and financial market development, and degree and nature of involvement of regulatory authority for the development and functioning of such markets. In this context, Habibullah (1999) evidences that in some Asian countries including Nepal economic development reflected in economic growth leads the financial development measured in the ratio of broad money to gross national product (M2/GNP). This implies that economic development has preceded the financial market development in the case of Nepal. But several other studies conducted in other LDCs reveal that the financial development has preceded the economic development.

The stock market development measured by market liquidity, market capitalization and total turnover is correlated with current and future economic growth, capital accumulation, and productivity growth, as evidenced by Levine and Zervos (1996). The efficient money, foreign exchange and capital markets increase investment to the most productive sector of the economy and thereby increase output through saving mobilization. Such markets also price the risk associated with any investment accurately.

Need for Money, Foreign Exchange and Capital Markets Liberalization

McKinnon-Shaw (1973) evidences linkages of saving and investment with economic growth through real positive interest rates. McKinnon and Shaw criticized the so-called "financial repression in

LDCs", popularized financial liberalization and advocated positive real interest rate to increase saving, investment and growth. They have defined "financial repression" as control of interest and exchange rates, provision of directed credit to priority sector, restriction on the entry of banks and financial institutions into the financial system and use of direct instruments of credit control. These policies were thought detrimental to the efficient functioning of money, foreign exchange, and capital markets.

The crucial role of financial markets in augmenting saving and investment was impeded by the negative real interest rates that prevail in the most "repressed financial markets." Thus, many regulatory authorities in the world have started liberalizing their financial systems, and have gradually reduced their role in money, foreign exchange, and capital markets since the late 1970s. In addition, most central banks have increased their dependency on money, foreign exchange, and capital markets to conduct monetary policy by using market-based instruments of monetary control.

Global Wave of Reforms in Money, Foreign Exchange, and Capital Markets

Many developing countries have initiated market-based reforms in their financial system to make money, foreign exchange, and capital markets efficient, robust, deeper, and integrated since the early 1980s. The reduction in direct credit to uncreditworthy borrowers, restructuring of distressed banks, strengthening prudential regulation and supervision, introducing auction system to sell government securities and easing the entry of foreign banks and financial institutions into the domestic financial system are the important reform agendas of most of the developing countries. These reforms are directed to strengthen these markets and most central banks have decreased their intervention in them. They have confined their role in maintaining solvency of the financial institutions and stability of the money, foreign exchange, and capital markets.

These regulatory policy reforms are directed towards protecting the depositors, ensuring bank solvency, improving macroeconomic stability, ensuring competition, stimulating growth and improving resource allocation. They focused on gradually lifting the direct control of these markets and making them efficient in reflecting the scarce value of financial assets in market prices.

The Need for Regulatory Intervention in Money, Foreign Exchange, and Capital Markets

The regulatory interventions have positive impact in financial markets, as evidenced by Stigtliz and Uy (1996) from East Asian Countries such as the Republic of Korea, Hong Kong, Singapore and Taiwan (China). Stiglitz and Uy conclude that regulatory intervention in the financial markets through prudential regulation is imperative for the smooth functioning of these markets. But directed credit, at administered rates through financial intermediaries to finance government plans and programs at the cost of commercial lending, impedes the development of these markets.

Since the early 1980s, global emphasis has shifted from government to private sectors and from banks to financial markets. Nepal also initiated open and market oriented private sector development in the late 1980s. Accordingly, Industrial Policy of 1992 was announced and the Eighth Plan (1992-1997) was initiated; the Privatization Act of 1997 was also enacted. Since the early 1990s, the role of His Majesty's Government of Nepal (HMG/N) has changed from replacing or repressing markets to facilitating and regulating them. The reforms, initiated in areas like agriculture, forestry, hydropower, tourism, aviation and banking and finance, have been directed towards making them competitive and market-oriented. The entry of banks and financial institutions into financial system was made easier for the introduction of foreign capital, technology, and knowledge. Because of the results of policy reforms in the financial sector, along with the establishment of some commercial banks with 50 percent foreign equity participation, many domestic commercial banks, finance companies, development banks, rural development banks, financial cooperatives and Non Governmental Organization (NGOs) also came into operation in the early 1990s. Domestic financial markets started integrating with their foreign segments.

The NRB, the promoter of financial market institutions since its establishment in 1956, changed its role as a regulator of the banks and financial institutions. It introduced prudential regulations regarding capital adequacy ratio, loan classification and provisioning. The NRB also departed from the use of direct tools of monetary control to indirect

measures in the mid-1980s for which the development of deep and broad-based financial markets has been desired. It accelerated the pace of financial reforms in the 1990s but took a gradual approach. The NRB withdrew all directors, who had been nominated by the Bank to represent the Bank at boards of different banks and financial institutions.

The Relevance and Focus of the Study

This study is mainly focused on money, foreign exchange, and capital market indicators and their ratios with contemporaneous Gross Domestic Product (GDP) levels. The market indicators related to monetization, financial intermediation, foreign exchange market integration, market capitalization and annual turnover are used in the analysis of financial market developments. Due to the unavailability of time series data of capital market, the study has covered the period between 1994 and 2004. However, the historical development of money, foreign exchange, and capital markets before the establishment of the NRB is covered. The level of total liquid liabilities, total credit disbursement of commercial banks and their ratios to GDP are assumed as the measures of money market development. The inter temporal changes in market performance indicators and nominal GDP over the last 25 years are measured in terms of the mean ratio and their variability in standard deviation over the periods of 10 years before and 15 years after the liberalization. The study primarily focuses on the changes in the informal financial market activities and the performance indicators of formal money, foreign exchange and capital markets after liberalization.

Informal Financial Markets and Liberalization

The financial market failure in rural areas has become a common phenomenon, as formal financial markets do not exist at all in some remote areas of the country. In other parts, the segmentation of financial markets between formal and informal has impeded competition and the potential borrowers have been denied credit. The majority of the population that lives in rural areas has no access to retail banking services provided by the modern bank. The financial services of modern commercial banks are not cost effective as the average loan size is small and its monitoring is costly in such areas. Moreover, the risks associated with such investment are high and unmanageable, as most clients have no collateral acceptable to the banks. So, the large commercial banks established in the private sector are reluctant to expand their credit services to the rural areas. The NRB has worked out different strategies for linking urban and rural markets based on its research studies such as 'Agriculture Credit Survey 1969/70,' 'Agriculture Credit Review Survey 1976/77', and 'Nepal Rural Credit Review 1991/92.' The continuation of priority sector lending until 2007, provision of deprived sector credit and establishment of Rural Self-Reliance Fund have helped to increase the size of the formal rural financial markets. Despite the closure and merger of rural branches of RBB, NBL, and Agriculture Development Bank of Nepal (ADB/N), the NRB expects credit market activities in rural areas to increase due to the establishment of micro-financing institutions viz., regional rural development banks, financial NGOs, financial cooperatives, and postal saving banks.

Financial Liberalization and Money Market Indicators

The NRB has been promoting banks and financial institutions since its inception exactly fifty years ago to increase monetization of the economy, to broaden and to deepen the money, foreign exchange, and capital markets. Before the mid-1980s, the NRB adopted the supply-led policies and encouraged the establishment of banks and financial institutions throughout the country for economic development. The banks and financial institutions focused primarily on promoting economic development rather than making profit. It used direct monetary measures to contain price volatility and to increase credit flow to the targeted sectors of the economy in order to increase output and employment. The institutional setup and instruments used were biased towards the development of deposit taking institutions that increased the commercial banks' domination in the financial markets. In mid-1980s, NRB took a U-turn step in its policy matters and departed from the controlled financial regime towards market-oriented reforms. The pace of reforms was accelerated since the early 1990s once multiparty democracy was reinstated and the elected government came into power in the early 1990s. The NRB adopted 'demand induced' regime under which the banks and financial institutions were established according to the demand for their services in the financial markets. The entry of foreign banks and financial institutions into the financial system has been made easier.

During the course of fifty years, the original NRB Act was amended many times and ultimately in 2002, the new NRB Act of 2002 replaced the original Act incorporating the objectives that need to be achieved. High operating expenses resulted from over staffing and over extended branches, weak prudent management and the failure to adequately diversify the loan portfolio of Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB) resulted in distressed financial health of these banks. Further, the macroeconomic shocks emanated from decreasing income of tourism sector due to the Maoist insurgency aggravated the overall health of the financial system. The NRB has been initiating to restructure itself and the other two state-owned banks, namely, NBL and RBB, under the financial sector reform program to keep them under financial market discipline. Moreover, in line with market reforms, the prudential regulation regarding capital adequacy ratios of bank and financial institutions, lending policy, loan classification and provisioning for non-performing loans (NPLs) and international accounting standard has been enacting.

The policies and programs of NRB have been directed towards encouraging competition in the financial markets by increasing the number of banks and financial institutions. The interest rates and exchange rates have been determined by the market to reflect the true scarce value of the financial assets. The sale of treasury bill through the weekly auction, the limit on the amount of government securities held by the NRB to be within 10 percent of previous year's tax revenue of the government, and a ceiling for the government overdraft from the central bank are also directed towards financial market development in the country. Moreover, the downward revision of the bank rate, margin rate and refinance rate and substantial reduction in the amount of directed credit since the beginning of the 1990s should have freed more resources for the markets. Such policy initiatives of the NRB should have a positive impact on money markets and such changes over the period are expected to be reflected in money market development measures and their ratios to GDP.

The ratio of currency in circulation to narrow money supply (M1)[1] is expected to decline reflecting the increasing public confidence on banks' demand deposits as the medium of exchange. Similarly, the ratio of M1 to broad money (M2)[2] decreases with increase in collection of saving by the formal sector and the ratio of M2 to GDP increases with the rise in the monetization of the economy. The ratios of the private sector bank credit to total credit and GDP go up with the increase in the financial intermediary activities of banks and financial institutions. The overall size and efficiency of the banking system reflected in the above ratios are assumed to be the proxies for money market development.

Foreign Exchange Markets Before and After Liberalization

The NRB has made various changes in foreign exchange policies in connection with the exchange rate determination and current account convertibility since mid-1980s and such policy changes should have an impact on the performance of foreign exchange market. The international market integration, international reserves, exchange rate stability, current account surplus/deficit, diversification of trading partners and commodities, and the size of trade are some of the measures of the foreign exchange markets. The ratios of current account balance and total trade to GDP and international reserves to total import are some of the other measures of foreign exchange market development. The increasing ratio of total trade to GDP indicates the increasing economic integration. Likewise, foreign exchange rate and reserves, the ratios of foreign exchange reserve to total import and current account deficit to GDP are the indicators that reflect external stability of the money, foreign exchange, and capital markets. Moreover, competition in foreign exchange market should have increased as the number of banks and financial institutions involved in foreign asset transactions has increased. The spread of buying and selling of US $ is analyzed and compared before and after 1985.

Capital Market Indicators After Liberalization

The directives related to banks and financial institutions' governance, listing of banks and financial institutions, the allocation of shares between promoters and minority shareholders, change in limit on foreign equity participation and market exit of insolvent institutions have pervasive impact on the capital markets. The banks and financial institutions are required to be listed within three years of

operation and are required to offer 30 percent of their total equities to the public.

The size and liquidity of the capital market is important for NRB to conduct its monetary policy. The ratios of total paid-up capital and market capitalization (M-Cap) to GDP measure the size of the equity market and the ratios of total turnover to total paid-up value, M-cap and GDP measure the liquidity in the market. Nepal Stock Exchange (NEPSE), the only formal security exchange center in Nepal, started its operation in 1994. Its establishment has attracted investors to invest in shares by providing liquidity to the shares of the listed companies and options to diversify their investment. The bond market, an important segment of the capital market, is measured in size. The total outstanding domestic loans with their break down into sovereign and private components and their ratios to GDP are important for the NRB in order to conduct open market operations (OMO).

Evolution of Money, Foreign Exchange, and Capital Markets

Transition from Barter System to Commodity Money and Coins

The money market development was initiated from the use of commodity money that facilitated transaction of goods and services in Nepal. Despite many difficulties related to the use of commodity money, it reduced transaction cost by avoiding double coincidence of needs and replaced the barter system. Gradually, the coins substituted the commodity money. The ancient metallic coins with blurred images without any inscriptions are the evidences of primitive money used in Nepal. The dates and denominations are unclear in such coins. The silver coins circulated in the 12th century facilitated trade, encouraged specialization on the one hand, and on the other served as the store of value. However, some historical evidences of using precious metals in the 5th century as medium of exchanges and store of value are found in studying the history of evolution of the financial markets in Nepal.[3]

The issuing of financial claims by the borrowers of the fund and buying such claims by lenders dates back to the 9th century which is evidenced by a historical event that a merchant named Sankhdhar repaid the debts of all debtors in the country. Money dealers called Tanka Dhari specialized in dealing with money during the 14th century. The Kausi Tosha Khana installed in King Prithivi Narayan Shah's regime and Tejarath Adda of Rana regime were the historic financial institutions. However, these institutions, which never used to accept the public deposits, the basic function of deposit taking financial institutions, initiated the money and capital market development in the country.

Early Stage of Predominant Informal Markets (1937-1955)

The NBL, established in November 1937 under Nepal Bank Act 1937, was the first financial intermediary working as a commercial bank to provide full fledged banking functions in the country. It had a total paid up capital of Rs.842,000 of which the share of the government and the private sector was 51 percent and 49 percent respectively. Before the establishment of the NBL, indigenous bankers used to make monetary transactions like accepting deposits and providing credits only through the informal financial markets. Moreover, the development of trade was hindered due to the absence of formal financial institutions for the settlement of payments.

Pre-liberalization Era (1956-1985)

The establishment of NRB, as the central bank of the country on April 26, 1956 under the NRB Act, 1955 with objectives of eliminating the dual currency system, managing the issue and circulation of Nepalese currency, and developing the financial system to encourage trade and industry in the country, was the important event in the financial history of Nepal. The NRB concentrated in the development of monetary instruments and formal financial institutions to regulate away the informal money, credit, and foreign exchange markets for the promotion of domestic formal financial markets. Informal money, foreign exchange and capital markets had replaced their parallel forms in the organized sector before the establishment of the NRB. These informal markets continued to develop as a legacy of the past development. Further, the informal market flourished in rural areas due to the deficient supply of and higher demand for financial services in such areas.

Money markets were highly segmented with multiple interest rates, and the Indian currency was the legal tender in Nepal. However, *Sadar*

Mulukikhana had already issued Nepalese notes in 1945. The NRB focused on circulation of Nepalese currency, stabilization of exchange rate of Nepalese currency against Indian currency and establishment of banks and financial institutions to augment saving during the early years of its establishment. The Acts, making Nepalese currency the legal tender in Nepal and abolishing foreign currency circulation, were introduced under the NRB's initiation. The NRB issued Nepalese notes in 1960 and fixed an interest rate of 4 percent for saving deposit of commercial banks in 1961.

During the pre-liberalization period, interest rates on lending and deposits, and exchange rates for buying and selling of foreign currencies were fixed by the NRB. The policies regarding the entry of private banks and financial institutions into the financial system were stringent. The direct instruments of monetary policy were in use. Directed credit, high margins, reserve requirements, and credit ceilings were the regulatory measures adopted before the mid-1980s. Until mid-1980s, the NRB endeavored to establish the commercial banks, other banking institutions and non-bank financial institutions recognizing their importance in saving mobilization, so that it could have equity participation in most of the money and capital market institutions as the long-term supply of funds was lower than long-term demand of funds.

Early Phase of Liberalization (1986- 1995)

During the late 1980s and 1990s, the NRB changed its policy gradually towards financial liberalization. The NRB liberalized the licensing policies of deposit taking financial institutions, started using market-based instruments of monetary policy, and eased all other regulatory measures. Many banks and financial institutions came into operation because of policy changes. The commercial and financial institutions were free in fixing interest rates on lending and deposits maintaining a spread fixed by the NRB . However, along with the fast growing money markets, the long-term supply of funds was growing faster than the long-term demand of funds. These developments in financial markets are evidenced by the increasing ratios of broad money supply to GDP, private sector credit to GDP and long-term debt to GDP with decreasing long-term interest rates.

Despite the NRB's vigorous attempt to abolish the informal markets, the formal financial markets have not completely substituted the informal markets. In the course of fifty years, financial markets are more integrating, interest rates are declining, attraction of savers and borrowers has shifted to the formal financial institutions, and control of the central bank over the financial system has increased. Under the NRB's direction, commercial banks and other financial institutions used to invest in government securities at the interest rate prescribed by the government.

In the absence of developed secondary market, liquidity of shares and bonds issued was low. The NRB itself was the issuer, buyer, and dealer of the government securities and the NRB used to provide liquidity by purchasing such security from the secondary market to increase the investors' confidence on bond market. Similarly, the Security Market Center (SMC) was the regulator and the center for exchanging shares of public companies. The banks and financial institutions were the holders of these securities. To address these genuine problems of the nascent market, the Security Exchange Act, 1993 was introduced.

The On-going Phase of Liberalization

The elimination of credit controls, deregulation of interest and exchange rates, easy entry of banks and financial institution into the financial system, privatization of financial and non-financial institutions, autonomy of NRB and liberalization of foreign investment are the important dimensions of the financial liberalization in Nepal. The management of NBL and NRB, the two major players in the financial markets, has been contracted out to foreign teams to resolve their non-performing loan that was above sixty percent of their combined total loan portfolio in FY 2001/02. The new licensing policy for commercial banks, increase in paid-up capital of commercial banks to Rs1.0 billion by 2009 and the provision of 30 percent of the total paid up capital of commercial banks, finance companies and development banks for public offering are other policy initiatives undertaken during the liberalization period. The NRB has been constantly making downward revisions in bank rate, refinance rate and reserves and margin ratio since the early 1990s. All directed credits, except deprived sector lending, are going to be phased out by 2008. The limit of foreign equity participation in commercial banks has been raised to 75 percent and the repatriation of dividend

and other gains from foreign investment is made easier.

Market Participants and Instruments

The financial institutions and instruments are crucial in mobilizing the funds from the surplus spending units to the deficit spending units. The performance of the financial institutions and the availability of the suitable range of instruments determine the smooth functioning and efficiency of money, foreign exchange, and capital markets. The major financial institutions and important instruments available in the financial system are briefly discussed below.

Financial Institutions

While the NRB, commercial banks (CBs), other banking institutions (OBIs), non-bank financial institutions (NBFIs) and financial auxiliaries are the financial institutions operating in the organized sector on the one hand, moneylenders, indigenous bankers, shopkeepers etc. are making financial transactions in the unorganized sector on the other. The indigenous moneylenders, property owners, self-help groups, relatives, and friends are suppliers of funds in the informal rural markets. Thus, the majority of the population, who is living in rural areas, has no easy access to the formal financial institutions.

The brokers, dealers, and their associations are the important institutions for the exchange of the financial assets as such institutions bring the lenders and the borrowers together in the markets. Similar to the real estate brokers, the financial stockbrokers match buyers and sellers of the financial assets. The underwriters have important roles in issuing ownership and debt instruments in the primary markets. The regulatory authorities like HMG/N, NRB, SEB and Insurance Board have significant role in enhancing market discipline to maintain financial stability in the financial markets.

Nepal Rastra Bank (NRB)

The NRB, the apex regulatory and supervisory organization of CBs and OBIs, was established in 1956. In addition to the regulatory and supervisory functions, the NRB formulates and implements the monetary policies to stabilize the economy internally and externally. It manages the liquidity reserves of the credit institutions and constantly oversees their operations. The NRB conducts open market operations in order to manage the liquidity in the economy and to stabilize the exchange rate in the foreign exchange market. It plays crucial roles in making the financial market competitive and avoiding unhealthy competition. The NRB introduced the treasury bills auction system in 1988 in order to make the money market competitive. Since the monetary policy stance of NRB shifted from direct to indirect methods of control in 1989/90, it has been using market-based instruments like bank rates, reserve requirements, and open market operation in place of direct instruments of monetary policy.

The NRB has to coordinate with HMG/N to bring necessary legislation in order to make financial markets efficient. It must be independent and strong for the overall development of the financial system in which money, foreign exchange, and capital markets are functioning. The NRB is trying to integrate the unorganized financial sector with organized sector by supporting the financial cooperatives and NGOs and encouraging banking services in rural areas.

Table 1
Banks and Financial Institutions and Their Market Shares as at mid-July, 2004

Banks and Financial Institutions	Market Share	
	Rs in Million	In Percent
Commercial Banks	309230.9	69
Development Banks	45,451.9	10
ADB/N	37,823.4	8
NIDC	1,491.9	0
Other Development Banks	6,136.6	1
Micro Financial Institutions	7,600.3	2
Rural Development Banks	2,363.2	1
Cooperative Societies	2,341.3	1
Micro Credit Development Banks	2,600.8	1
Financial NGOs	295.0	0
Finance Companies	27,260.8	6
Insurance and Penson Funds	59,883.1	13
Employee's Providend Fund	40,849.0	9
Citizen Investment Trust	4,434.1	1
Insurance Companies	14,600.0	3
Grand Total	449,427.0	100

Source: NRB Research Department.

Commercial Banks

Commercial banks are the deposit money banks that accept demand deposits that are freely usable as a means of payment. There are 17 commercial banks in the Nepalese financial system. Of the total, six such banks have foreign investment. There were 9 joint venture banks a couple of years ago before foreign investors divested their shares from three commercial banks. The NBL and the RBB are the two stated-owned banks. HMG/N sold 10 percent

of its ownership in NBL in 1998 and reduced its ownership to 41 percent. The RBB, established in 1966, is fully owned by the government.

HMG/N opened the Nepalese commercial banking sector for foreign investment in the early 1980s. In 1984, Nepal Arab Limited, renamed as Nabil Bank Limited in 2002, established by Nepalese financial institutions, viz., Rastriya Beema Sansthan, NIDC, and SEC and Dubai Bank Limited, was the first joint venture commercial bank. Nine banks are fully owned by the domestic private investors. The RBB and NBL hold more than 50 percent of total commercial banks' assets. In addition to all commercial banks, 32 branches of ADB/N are engaged in commercial banking activities. The commercial banks are the major players of the financial markets in Nepal with 81 percent share in total deposits and 72 percent in total credit.

During the pre-liberalization era there was government monopoly in the credit market and liberalization reduced it by increasing the number of private banks and financial institutions. In the initial period of the financial liberalization, many commercial banks came into operation. Further, due to the competition between domestic and foreign banks, the quality of banking services has improved. Electronic and internet banking, Automated Teller Machine (ATM) services and many new products are the outcome of liberalization. Commercial banks had a share of 68.8 percent (Rs. 309.2 billion) in total financial assets as at mid-July, 2004.

The development of commercial banks has contributed substantially to the development of capital market in Nepal. Poudel (2000) concludes that commercial banks in Nepal have contributed significantly to market capitalization and annual turnover and the ratios of these capital market performance indicators to contemporaneous GDP levels have been increasing since 1994. However, such ratios were very low as compared to some of the other developing countries. The number of commercial banks listed in NEPSE was 14 with paid up capital of Rs. 6.0 billion and market capitalization of Rs. 42.4 billion as at mid-April 2005. The annual turnover of the shares of commercial banks was Rs. 126.2 million in 2004.

Other Banking Institutions (OBIs)

The OBIs include ADB/N, NIDC, five regional rural development banks (RRDBs), 30 other development banks, 59 finance companies, 20 financial cooperatives (FICOOPs), 47 financial non-governmental organizations (FINGOs) and 117 branches of Postal Saving Bank as at mid-June 2005. The total sources of fund of OBIs in fiscal year FY 2003/04 was Rs.80.3 billion. The paid-up capital, time deposits, retained earnings, borrowings, and other liabilities are the sources of funds and investment in shares, government securities and fixed deposits, and loans and advances in agriculture, industry, and housing are the main uses of funds of OBIs. The OBIs listed in NEPSE include 44 finance companies and 6 development banks. With an increase in the number of listed OBIs, their primary and secondary share market transactions have been increasing significantly since the mid 1990s.

Development Banks

The ADB/N, the largest development bank in terms of capital fund and loan outstanding, has been mandated for development banking activities and supply of credit to individual farmers and cooperatives. The NIDC supports industrial activities by providing credit guarantees, hypothecating loans, and underwriting services. These two specialized banks were established under separate Acts but now are under the Bank and Financial Institutions Ordinance (BFIO) 2004. Recently, in April 2005, HMG/N has made decision to restructure ADB/N as a public limited company with paid up capital of Rs. 1.58 billion. Likewise, reforms are undergoing in NIDC to improve its financial position that has been plagued since the early 1990s due to exceptionally high NPL of 92 percent of the total loan outstanding. The RRDBs, partially owned by the HMG/N, provide micro credit to rural women. The other development banks are relatively of small size and 6 of them have focused on micro financing. The development banks have 11 percent and 18 percent share in total deposit and advances respectively and the cooperatives operating under NRB regulation have 1 percent market share in both deposits and advances.

Finance Companies

The finance companies provide various forms of long-term lending and long-term deposit taking services, such as hire purchase, some limited leasing activities and mortgage financing. Nepal Housing Development Finance Company, the first finance

company, came into operation in 1992. However, the Finance Company Act that governed the establishment and operations of these companies was enacted in 1985. The Act allowed them to raise time deposits with maturity of 90 days to six years, but did not allow them to raise current or saving deposits. The BFIO 2004 has classified finance companies as "C" class financial institution. Six finance companies have been designated as the sole official distributors and secondary market dealers for the National Saving Certificates. The performance of finance companies, in terms of deposit mobilization, loans, and advances, repayments and earnings, has remained satisfactory since the last couple of years. The total sources and uses of funds of finance companies increased by 23.3 percent to Rs. 27.3 billion in FY 2003/04 compared to the same in the preceding year. The paid up capital of finance companies listed in NEPSE was Rs. 1.5 billion and market capitalization Rs. 2.6 billion. The total turnover value of finance companies in 2004 was Rs. 29.1 billion.

Rural Developments Banks

The regional rural development banks (RRDBs), one each set up in each development region under HMG's initiation, provide micro finance services in the five development regions. These banks supplement the larger scale development lending of ADB/N and NIDC to agriculture and industry. HMG/N and the NRB, the major promoters of these banks, held more than 75 percent of the total paid up capital during the early phase of their establishment. The NRB has divested its shares from Western Rural Development Bank (WRDB) and Eastern Rural Development Bank (ERDB). The RRDBs provide loans to rural women who have neither access to commercial banks nor collateral for borrowing from other banks and financial institutions. Despite the high cost of fund, these banks are popular among targeted the poor women due to the other services packaged with micro credit.

Saving and Credit Co-operative Societies (SACCOS)

In mid-July 2004, the total number of savings and credit co-operative societies (SACCOS) reached 2365, of which 21 have obtained permission from the NRB to undertake limited banking functions. The newly established National Cooperative Bank regulates SACCOS. The SACCOSs have 1 percent market share in total deposits and advances. The demand for services of SACCOS has increased in rural areas as branches of NBL, RBB and ADB/N have been closed down or merged or transferred to urban centers due to the deteriorating law and order situation or the ongoing reforms of these state owned banks.

Financial Non-government Organizations (FINGOs)

As at mid-April 1999, 25 FINGOs had been licensed to conduct limited banking business and their number has increased to 47 as at mid-June 2005. These NGOs, which have their objectives defined by regulation, can receive preferential loans from the government's Self-reliance Fund, currently managed by the NRB, and from the commercial banks in order to lend to low income groups. FINGOs mobilize foreign financial and other resources as grants, soft loans and other support like skills and technical knowhow. The NRB monitors the objectives, provisions and conditions that are implemented. The FINGOs provide credit plus other social services and are popular among the rural poor.

Postal Saving Banking Service

The postal saving banking service has been initiated since 1977 to provide saving services in rural areas where savers are reluctant to go to commercial banks or their services are out of the reach of the formers. Currently, 117 postal saving offices provide postal saving services. The total deposit collected by the postal saving offices as at mid-April, 2005 was Rs. 103 million. Recently, new regulations are issued by HMG/N in April 2005 to expand their services.

Non-Bank Financial Institutions (NBFIs)

Insurance companies, Employees' Provident Fund (EPF) and Citizen Investment Trust (CIT) are included in NBFIs. The EPF, National Insurance Corporation (NIC) and CIT are the state owned NBFIs, which have substantial proportion of government investment and accept funds in different forms such as monthly provident fund contribution, insurance premium and voluntary contribution. The system of payment from the NBFIs to the savers is different and based on the nature of the institutions. The NBFIs mainly use their funds in buying government securities, making fixed deposit in CBs and lending to the savers at interest rates higher than what savers get from these institutions. Among

NBFIs, insurance companies are regulated by the Insurance Board and others by HMG/N. The system of prudential regulation and supervision of NBFIs is not as strong as it is in other economically advanced countries.

Insurance Companies

There are 19 insurance companies including Deposit Insurance and Credit Guarantee Corporation (DICG) operating in the financial system. The NIC and DICG are partially owned by the government and all other insurance companies are established in the private sector. Among the private insurance companies, namely, the Oriental Insurance Company Limited, the National Insurance Company Limited and American Life Insurance Company have full foreign investment; the other three private insurance companies in joint venture and the rest have full domestic investment. The NIC, which has been issuing life and non-life insurance policies, is the first insurance corporation in the country and the DICG established in 1974 provides guarantee service and compensates the loan losses incurred by commercial banks while lending to the priority sector. The Insurance Board, Nepal regulates all insurance companies except DICG.

These companies collected the total life insurance premium of Rs. 2.2 billion during FY 2003/04, which was 57.6 percent higher than the amount collected in the preceding year. The total life and non-life insurance premium collected during FY 2003/04 was Rs. 4.9 billion, which was estimated at 1.7 percent of the non-agricultural GDP. The investment portfolio of insurance companies is highly required by the Insurance Board and such companies have to invest in most secured assets like government bonds, fixed deposit account of commercial banks, shares and in other instruments prescribed by the Board. The total investment of all the insurance companies in Nepal stood Rs. 12.4 billion as at mid-November, 2004. The number of insurance companies listed in NEPSE was 13 with total paid up value of Rs. 1.1 billion and market capitalization of Rs. 2.6 billion, as at mid-January 2005 and their annual turnover value was Rs. 5.4 million in 2004.

Employees' Provident Fund (EPF)

The Employees' Provident Fund (EPF) was created in 1962. Under the provident fund arrangement, the compulsory deduction of 10 percent of the salary and the amount equal to the deduction contributed by the employer are deposited in separate account. The total amount earns interest and is withdrawable under specified circumstances like retirement, unemployment, and death. In addition, after contributing for five years to the EPF, the participants could receive loans of a specific percentage of his account for well-defined purposes. The loans carry interest and have to be repaid within a specified period; while the coverage is mandatory for most of the public sector employees, the private companies may also enlist their employees. The total asset of the EPF was Rs. 40.8 billion as at mid-July 2004, which was 9 percent in term of the total financial assets of the CBs, OBIs and NBFIs. The uses of funds of EPF is mainly confined in government securities, fixed deposit of CBs and OBLs, loan financing to the employees and shares of listed companies.

Citizen Investment Trust

The CIT was set up in FY 1990/91. Individuals can contribute voluntarily a tax-free amount with a maximum of 10 percent of their salary in a mutual fund. In contrast to the EPF, where the contributions are compulsory, participation in the CIT's saving plan is optional. The total assets of CIT was Rs. 4.4 billion as at mid-July 2004 which was one percent of the total financial assets.

Financial Auxiliary

The equity market in Nepal was initiated in 1975 with the establishment of the SEC, which was designed as the broker and underwriter for government bonds. In 1993, the SEC was converted into the NEPSE, a non-profit organization operating under the Security Exchange Act. The NEPSE has the authority over the trading functions while the regulating authority over capital markets is with the Security Board (SEBO). HMG/N (40.9 percent), the NRB (49.5 percent), the NIDC (8.8 percent) and some other small licensed members own the NEPSE. Trading on the floor is limited to listed corporate securities and government bonds. At present, 26 member brokers and 3 security dealers are operating at the NEPSE and the total number of companies listed reached 124 as at mid-June 2005.

Financial Market Instruments

On the basis of maturity, financial instruments are divided into money and capital market instruments.

Financial instruments maturing within one or less than one year are named money market instruments and other instruments having maturity period longer than one year are called capital market instruments. Money market instruments have the least default risks and the average size of transaction is relatively large. The public holds liquid assets in the form of demand deposit and currency for their transaction purposes. In holding such assets, the economic agents lose return in the form of profit or interest income. However, depositors in Nepal put their money in various deposit accounts of banks and other banking institutions, as the options to invest in capital market instruments are limited.

The money and capital market instruments are mainly issued in the primary markets and are exchanged in the secondary markets. There is no specific physical location for the exchanges of the money market instruments (MMIs) that are mainly traded through private placement.

Money Market Instruments

The money market instruments facilitate the exchanges of goods and services through efficient payment system. The currency in circulation and demand deposits known as narrow money (M1) reflect transaction, speculative and precautionary demand for money. The saving and time deposits, the major components of the broad money (M2), are the main sources of funds of the deposit money banks and OBIs. The saving and fixed deposits of less than one year, treasury bills (T-bills), and other short-term securities are the commonly used MMIs in our money market. The supply of MMIs increases liquidity in the market and has positive impact on the price level. Interbank exchanges of money, which are of large denominations and privately placed, are the important instruments of the money market. The price of money market instruments is determined by the supply of and demand for loanable fund.

Open market operation (OMO), an important instrument of monetary policy in managing liquidity in the economy, is carried out in the money market with the use of different money market instruments. The issue of NRB bond in 1990 to mop up liquidity, introduction of weekly treasury bill auction system, and the establishment of exchange rate equalization fund are the important decisions made by the NRB for the development of money market in Nepal.

Currency Trade in the Foreign Exchange Market

The US Dollar, Pound Sterling, Japanese Yen, Swiss Franc, Dutch Mark, Canadian Dollar, Australian Dollar, French Franc, Italian Lire, Austrian Schilling, Swedish Kroner, Euro and Indian Rupees are mainly traded in the Nepalese foreign currency market and their daily exchange rates are quoted. Among the convertible foreign currencies, the US Dollar is mostly used in the market.

The Nepalese currency has depreciated from Rs. 12 per US dollar in 1980 to Rs. 72 per US dollar in 2004. However, the exchange rate Rs. 1.6 per Rs. 1 IC has been constant since 1993. The exchange rate fluctuation has profound impact on the value of financial assets traded in the financial markets.

The exchange rate of Nepalese currency is pegged with Indian currency and adequate balance of foreign exchange reserve has been supporting the peg. A substantial increase in income from workers' remittances and official capital inflows has maintained a surplus in the balance of payments. The level of foreign exchange reserve, which reflects the country's ability to pay for import and converting of domestic assets into other foreign assets, and the exchange rate signaling the value of domestic currency are important exchange market indicators from the standpoint of external stability of the financial markets.

Capital Market Instruments

The shares, government bonds, corporate bonds, insurance policies and loans are the different types of capital market instruments available in our financial system. As a financial instrument, the asset of one economic agent is the liability of the other and it helps to flow the funds from the purchasers to the issuers of the financial claims. Moreover, the long-term financial instruments transfer funds from one economic agent to the other for a sustained period. The long-term deposits, insurance premium, provident fund and loans, the capital market instruments of indirect financing, are mainly issued by the financial intermediaries. The bonds and equities, the instruments of direct financing, are the common instruments used in the capital markets.

The NRB, the fiscal agent of HMG/N, issues government bonds, and households, banks and financial institutions, and private companies are the buyers of such bonds. The commercial banks and finance companies are the dealers of government

bonds. Since the NRB departed from the use of direct instruments of monetary policy to market-based instruments, it has emphasized the development of new debt market instruments for liquidity management of the economy.

The share market of Nepal is bank-dominated and the CBs and OBIs have the major shares in total shares outstanding, market capitalization and annual turnover. The regulative directive issued by the NRB to banks and OBIs to issue shares of 30 percent of their total paid-up capital to the public has increased the supply of the shares in the issue market. The other directives of the NRB related to capital adequacy, corporate governance and risk management of banks and financial institutions have increased the demand for the shares of such financial companies in the secondary market.

The trends of share transactions of commercial banks, finance companies, development banks and insurance companies have been increasing and primary and secondary market transactions of real sector companies have been exhibiting relatively low performance since the mid-1990s. The ratios of total paid-up value and total market capitalization to GDP, which measure the size of share market, are less than 10 percent and the other ratios, which measure the stock market liquidity like total annual turnover to GDP and market capitalization are comparatively low.

Macroeconomic and Regulatory Environment

Macroeconomic Environment and Financial Markets

The total population of the country is 24.7 million with per capita income of US $ 270. The real GDP, highly dependent on the agricultural sector, grew by 6.1 percent in FY 1999/00, and negative by 0.3 percent in FY 2001/02. On average, the growth rate was 4.4 percent over the last 15 years compared to 6-8 percent of India and China during the same period. Fiscal deficit exceeding 2 percent of GDP, total public debt being more than 50 percent of GDP and volatile and negative economic growth rates in the beginning of the millennium gave rise to a situation of an unfavorable macroeconomic environment for the development and stability of the financial markets.

The economy faced unfavorable balance of payment (BOP) situation during early 1980s and such difficulties pushed the country to shift its economic policy from inward looking and import substituting to outward looking and export oriented. Thus, the country adopted liberal economic policies since mid-1980s. The Structural Adjustment Program (SAP) and Enhanced Structural Adjustment Facility (ESAF) supported by the IMF were introduced to address the macroeconomic problems prevailing in the country. The tourism, hydroelectricity and manufacturing sectors attracted foreign direct investment (FDI) but its growth has remained low compared to that of the neighboring countries. The fiscal deficit as percentage of GDP was as high as 5.9 percent in FY2000/01 and decreased to 3.6 percent in FY 2002/03. The total public debt as percentage GDP was 64.6 percent in FY 1999/00 and increased to 69.5 percent in FY 2001/02. Inflation was lower than 5 percent and foreign exchange reserves have remained at a comfortable level in the last couple of years. The foreign exchange reserve increased from Rs. 65.7 billion as at mid-July 2000 to Rs. 107.9 billion at the same point of time in 2004.

Nepal has not yet liberalized its capital account but is heading towards capital account convertibility, which will make the financial market competitive and more vulnerable to external socks. The Nepalese currency is pegged with the Indian currency ensuring

Table 2
Macroeconomic Indicators

	1999/00	2000/01	2001/02	2002/03	2003/04
Economic growth rate (in percent)	6.1	4.7	-0.3	2.7	3.5
Inflation (in percent)	2.8	3.3	2.9	4.8	5
Fiscal deficit (as percent of GDP)	4.7	5.9	5.4	3.6	3.7
Total Public debt(as percent of GDP)	64.6	63.3	69.5	67.5	66.3
Foreign Exchange Reserve (as at mid-July in billion Rs)	65.7	75.1	80.7	87.0	107.9

Source: Economic Survey 2003/04 Ministry of Finance (2004)

exchange rate stability. The levels of adequate international reserves and surplus in the BOP during the last couple of years have defended the peg.

Financial Sector Regulations and Reforms

The number of banks and financial institutions has increased after Nepal started liberalizing its financial sector. The total deposits, lending, and total sources and uses of funds of OBIs have increased substantially while the CBs have been loosing their market shares. The deposit growth rates of OBIs have remained higher than that of CBs in the last 15 years. Moreover, the market shares of state owned banks in terms of deposit have gone down steadily since the mid-1990s. The legislative regime governing the financial system was weak and poor. The regulation, supervision, and follow up of such institutions were weak and financial sector had to face severe problems. For example, the NBL and the RBB have larger market shares in terms of total assets, total lending, and total borrowing but these state owned banks had NPL as high as 60 percent of the total loan outstanding in 2002/03 and those banks still have high proportion of such loans. The net-worth of these two banks is negative. The amount of NPL is as high as 50 percent of their total lending as at mid-January 2005.

The predominance of informal sector, higher interest rate spread between lending and deposit, and concentration of banks and financial institutions in urban areas are major problems encountered in the financial system. The high rate of defaults of principal and interest payments of loans against overvalued collateral, poor corporate culture and governance in the banking system resulting from the government intervention in the financial system necessitated financial sector reform in Nepal. Moreover, the NBL, RBB, NIDC, and ADB/N are not saleable to the private sector without reforms and improved regulation of banks and financial institutions. Excessive government ownership of the NBL, RBB, NIDC and ADB/N, NRB's deficiencies in regulation and supervision, inadequate and poor quality of banking services and increasing gap between the demand for and supply of rural financial services are the prominent issues of financial system in Nepal.

Despite the increase in the number of banks and financial institutions, the growth of rural credit and saving is not as expected. The commercial banks' branches in the rural areas are closing down due to the security problems. The micro-financing institutions could be better substitutes for these rural branches of commercial banks. Financially, the micro-credit banks are not sustainable in Nepal. The operating cost of these institutions is high and contribution of rural deposit to total sources of funds is low. The foreign sources of funds such as grants and soft loan is decreasing as international non governmental organizations (INGOs) are withdrawing their services from rural areas on the ground of deteriorating law and order conditions.

Under the financial sector reform, the enactment of new NRB Act has provided autonomy to the NRB. The supervisory, oversight and regulatory functions are strengthening. The NRB's authority and accountability are made clear in the new NRB Act. Similarly, the enactment of BFIO and the establishment of Debt Recovery Tribunal in 2003 for the enactment of Debt Recovery Act 2003 are the other reform measures initiated to address the problems of the financial system. Increase in the paid up capital of banks and financial institutions, fixation of minimum qualification for the promoters and issuing a code of conduct for the governing body of banks and financial institutions are the other reform measures initiated. In addition, directives in regard to capital adequacy ratios, loan classification and loan loss provisioning are issued in order to improve the financial health of banks and financial institutions.

Free entry of banks and financial institutions into the banking system has increased competition among banks and has avoided political favoritism. Thus, the loans are allocated in accordance with commercial considerations rather than directions from the authority.

The banks and financial institutions have been predominating the secondary share market activities since its inception. The number of listed banks and financial institutions, the amount of their listed shares, market capitalization of such institutions and their secondary market transactions are in increasing trends.

The Quantitative Indicators of Money, Foreign Exchange, and Capital Market Development

The analysis of the money, foreign exchange, and capital market is based on the data for the period between 1980 and 2004. The value of total currency

in circulation, total deposits, total assets of NRB and commercial banks and other financial institutions and private sector credit are of mid-July of the respective years. All values including that of GDP used in calculating the financial ratios are nominal values. Similarly, data related to trade, paid-up value, market capitalization, and total turnover of listed companies are in nominal terms. The total paid up value and market capitalization measure the size of capital market development and the total annual turnover measures the liquidity of the market. The ratio of the total debt to GDP measures size of bond market. The ratios of the paid up capital, market capitalization, total annual turnover and total amount of marketable bonds to GDP are calculated to analyze the capital market development.

All stock data are of mid-July and flows like total export, import, and total turnover are based on annual sum of the respective fiscal year commencing from mid-July. The NRB, HMG/N and NEPSE are the main sources of the data. The descriptive statistical measures namely mean, maximum, minimum, and standard deviation are used in the analysis. Money market activities before and after liberalization are compared and stock market activities after 1994 are covered. The ratios of the quantitative measures of the money, foreign exchange, and capital markets to contemporaneous GDP values are compared. The whole period of 25 years is divided into first period (1980-1989), second period (1990-1999) and third period (2000-2004) and one observation of variables for every year of the analysis period is taken. The secondary market activities of NEPSE are analyzed in a single period of between 1994 and 2004.

Key Macroeconomic Variables

The financial market activities have close relation with macroeconomic variables like GDP, consumption (C), saving (S), investment (I), import (M) and export (X). The ratios of consumption, saving and investment to GDP have changed significantly since the early 1980s. With the increase in the number of banks and financial institutions, the saving as percentage of GDP has increased. The gap between saving and investment also has increased persistently reflecting the increasing demand for investible fund. Similarly, the increasing ratio of total trade (TT) as percentage of GDP reflects the increasing Nepalese financial market integration to international markets and the pace of integration has become faster after the 1990s.

First Phase (1980-1989)

The MR of consumption to GDP was as high 89 percent with standard deviation of 1.7 percent during the first phase as the availability of the financial services was not widespread throughout the country. The ratios of saving, investment and total trade to GDP were relatively low. The ratio of import to GDP was high compared to the ratio of export to GDP during the first phase. The minimum saving to GDP ratio was 8.6 percent in 1982. The investment to GDP ratio showed the most fluctuations with SD of 6.3 percent.

Table 3 (a)

First Phase (1980-1989)

	Mean Ratio	SD	Maximum	Minimum
C/GDP	0.890	0.017	0.914	0.860
S/GDP	0.110	0.017	0.140	0.086
I/GDP	0.117	0.063	0.217	0.057
E/GDP	0.054	0.010	0.067	0.034
M/GDP	0.189	0.030	0.246	0.159

Second Phase (1990-1999)

The MR of consumption to GDP decreased to 87. 5 percent and the MRs of investment, export, and import increased to 23.2 percent, 10 percent, and 30 percent respectively. The maximum and minimum ratios of saving to GDP were 14.8 percent in 1994 and 7.9 percent in 1990 respectively. The MRs of export and import to GDP in the second phase were 10 percent and 30 percent respectively. These ratios have increased with greater volatility. The maximum and minimum export to GDP ratios was 11.9 percent in 1999 and 7.1 percent in 1990 respectively. The maximum ratio of import to GDP was 37.6 percent in 1999.

Table 3 (b)

Second Phase (1990- 19999)

	Mean Ratio	SD	Maximum	Minimum
C/GDP	0.875	0.025	0.921	0.852
S/GDP	0.125	0.025	0.148	0.079
I/GDP	0.232	0.028	0.273	0.184
E/GDP	0.100	0.016	0.146	0.071
M/GDP	0.300	0.045	0.376	0.225

Third Phase (2000-2004)

The MR of consumption to GDP further went down to 86.7 percent and such ratios of investment

export and import to GDP increased to 24.2 percent, 12.7 percent, and 29.5 percent respectively in the third phase.

The decrease in consumption and consequently the increase in saving helped increase the supply of the financial assets in the financial markets over the last 25 years. Similarly, the increasing MR of investment to GDP demanded more funds to meet the growing investment demand. The increase in investment indicates an increase in economic activities. The increasing MRs of export and import to GDP indicate better international market integration. Nepal's membership of WTO and BIMSTEC in 2004 and its firm commitment in implementing SAFTA indicate faster and greater market integration in the future.

Table 3 (c)
Third Phase (2000-2004)

	Mean Ratio	SD	Maximum	Minimum
C/GDP	0.867	0.016	0.884	0.848
S/GDP	0.133	0.016	0.152	0.116
I/GDP	0.242	0.021	0.267	0.205
E/GDP	0.127	0.015	0.147	0.114
M/GDP	0.295	0.019	0.317	0.261

The Financial Market Indicators

The increasing ratio of currency held by the public (CHP) to M1 indicates the use of currency for the exchange of goods and services replacing the barter system. The high ratio also indicates the inadequate number of money market institutions namely commercial banks and other short- term deposit taking institutions to cater the demand deposit services of the public. The currency to M1 ratio is high in Nepal as the rural people have to walk a long distance to deposit and withdraw money from the commercial banks. Moreover, people in urban areas deposit their money in saving account as they can withdraw small amount of money from the saving account on their demand and earn some interest. With the increase in monetization of the economy the ratio of M2 to GDP increases and the ratio of currency in circulation to total deposit decreases. The ratio of M2 to GDP was relatively low and the ratio of currency in circulation to deposit was high compared to the money market indicators of other LDCs. The ratio of bank credit to private sector to total credit, a good measure of money market activities, remained low in the first phase due to higher share of government in the total lending of banks and other financial institutions.

The proportion of total domestic debt (DD) to total sovereign debt (TD) is lower than total foreign debt (FD). However, the ratio DD as percent of GDP has increased persistently over the last 25 years. HMG/N used to borrow from commercial banks and other financial institutions at rates fixed below the market rates in the first phase. Gradually, bonds were issued at rates close to the market rates in the second phase. The ratio of total paid up capital and market capitalization of the listed companies to GDP remained low compared to these indicators of capital market development of other LDCs.

Money Market Indicators

The First Phase (1980-1989)

The MR of CHP to M1 was 57.0 percent with 2 percent standard deviation during first phase. The share of CHP to M1 was maximum at 60 percent in 1988 and minimum at 53 percent in 1986. The MR of M1 to GDP was 12 percent with 1 percent SD in the first phase. The maximum and minimum M1 to GDP ratios were 13.2 percent in 1989 and 11.7 percent in 1981 respectively in this phase. The ratio of M1 to GDP increased steadily during this phase reflecting increasing monetization and people's confidence in the demand deposit services provided by the banking system of the country. The MR of M2 to GDP was 26 percent with 2 percent SD in the 1980s. The maximum and minimum ratios of M2 to GDP were 30 percent in 1989 and 23 percent in 1980 respectively. The mean ratio of M2 to M1 was 2.1 times with SD of 12 percent. The maximum and minimum ratios of M2 to M1 were 2.3 times in 1989 and 1.9 times in 1980 respectively.

Table 4 (a)
Descriptive Money Market Statistics (1980-1989)

	Mean	Maximum	Minimum	SD
CHP/M1	0.57	0.60	0.53	0.02
M1/GDP	0.12	0.13	0.12	0.01
M2/GDP	0.26	0.30	0.23	0.02
M2/M1	2.12	2.26	1.87	0.12
PSC/GDP	0.09	0.12	0.08	0.01

The mean ratio of private sector credit to GDP was 9 percent with SD at 1 percent in the first phase. The maximum and minimum ratios of private sector

credit to GDP were 8 percent and 12 percent in 1989 and 1980 respectively [Table 4 (a)].

The Second Phase (1990 –1999)

The MR of CHP to M1 increased to 68 percent with 5 percent SD in the second phase reflecting greater volatility than the first phase. The ratio of CHP to M1 was the maximum at 72 percent in 1999 and the minimum at 56 percent in 1990.
The MR of M1 to GDP was 14 percent with standard deviation 1 percent. The minimum and maximum M1 to GDP ratios were 16 percent and 13 percent in 1998 and 1992 respectively. The MR of M2 to GDP was 40 percent with 16 percent SD in 1990s. The maximum and minimum ratios of M2 to GDP were 83 percent and 31 percent in 1999 and 1990 respectively. The mean M2 to M1 ratio increased to 2.8 times with SD 1.1 times. The maximum and minimum ratios of M2 to M1 were 5.8 times in 1999 and 2.2 times in 1990 respectively. The high ratio of M2 to M1 in the 1990s reflected more money deposited in time and saving accounts of the public.

The share of demand deposit in total money supply is small. The ratio increased from 11 percent in 1991 to 26 percent in 1999 [Table 4 (b)].

Table 4 (b)
Descriptive Money Market Statistics (1990-1999)

	Mean	Maximum	Minimum	SD
CHP/M1	0.68	0.72	0.56	0.05
M1/GDP	0.14	0.16	0.13	0.01
M2/GDP	0.40	0.83	0.31	0.16
M2/M1	2.80	5.77	2.22	1.06
PSC/GDP	0.18	0.26	0.11	0.06

The Third Phase (2000- 2004)

The MR of CHP to M1 decreased to 64 percent with 6 percent standard deviation in the third phase indicating further increase in the volatility of the ratio. The maximum share of CHP to M1 was 69 percent in 2000 and the minimum share was 55 percent in 2001. The mean ratio of M1 to GDP was 18 percent with SD 1 percent in the third phase. The minimum and maximum ratios of M1 to GDP were 19 percent and 16 percent in 2004 and 2000 respectively. The mean ratio decreased to 2.8 times and its SD was 42 percent in the first 5 years of 2000s. The maximum and minimum ratios of M2 to M1 were 3.0 times and 2.0 times in 2001 and 2000 respectively. Likewise, The mean ratio of broad money to GDP was 50 percent with SD of 9 percent in the first five years of 2000s. The maximum M2 to GDP ratio was 56 percent in 2004 and the minimum M2 to GDP ratio was 33 percent in 2000.

Likewise, the ratio of the private sector credit to GDP increased further during the third phase from 29 percent in 2000 to 35 percent in 2004. The mean ratios of private sector credit to GDP were 18 percent in the second phase and 32 percent during the third phase [Table 4 (c)].

Table 4 (c)
Descriptive Money Market Statistics (2000-2004)

	Mean	Maximum	Minimum	SD
CHP/M1	0.64	0.69	0.55	0.06
M1/GDP	0.18	0.19	0.16	0.01
M2/GDP	0.50	0.56	0.33	0.09
M2/M1	2.77	3.04	2.03	0.42
PSC/GDP	0.32	0.35	0.29	0.02

Foreign Exchange Market Indicators

Market Integration

With the increase in the number of banks and financial institutions, trade as percentage of GDP has increased substantially due to diversification in products and trading partners. The exchange rate of Nepalese currency vis-a-vis other trading currencies has become stable compared to the volatility of the early 1960s. The NRB used to fix the exchange rate of the Nepalese currency against other currency before the 1990s. It took a gradual approach in letting the market determine the exchange rates. Despite the presence of informal credit, foreign exchange, and loan markets, the exchange rate of the Nepalese currency markets remained relatively stable, remittances through formal channels increased substantially, and informal segments of these markets gradually contracted during the second phase. The exchange rate of Nepalese currency is pegged with Indian currency and the markets adjust its rates against other currencies.

The Change in Buying and Selling Rates (1980-2004)

The Nepalese currency has been depreciating constantly since the early 1980s. The exchange rate

of US $ 1 in terms of Nepalese rupees was Rs. 12.10 in July 1980, Rs.17.80 in July 1985, Rs. 29.30 in July 1990, Rs. 50.94 in July 1995, Rs. 71.10 in July 2000 and Rs. 78.60 in July 2002. The Nepalese currency lost its value by more than 6-fold during in the last 22 years. However, the Nepalese currency appreciated vis-à-vis US $ and US $ 1 was equivalent to Rs. 71.24 in the beginning of April 2005. The differences between buying and selling rates increased after the mid-1990s.

Spread of Buying and Selling Rates

The spread between buying and selling rates have been increasing since the early 1980s and it has increased more with the onset of liberalization. It is still in a rising trend indicating less competition in the foreign exchange markets. The spread between buying and selling was Rs. 0.2 in 1980 and was constant until 1990. Since 1990 it started increasing and reached Rs. 0.49 in July 1995 and Rs. 0.7 in July 2004.

Foreign Exchange Reserves

Although there was current account deficit persistently, a favorable balance of payments resulted due to the capital account surplus. The total trade as percent of GDP increased and diversified but its deficit with India has not narrowed as expected. Nepal has been endeavoring to decrease its deficit by exporting hydropower to India and welcoming more tourists from People's Republic of China to improve its current account deficit with the neighboring countries. Remittances from foreign employment, and multilateral and bilateral loans and grants are the major sources of foreign exchange reserves.

Capital Market Measures

The floatation of shares started in 1937 when Nepal Bank Ltd and Biratnagar Jute Mill offered their shares to the public. Similarly, the first government bond was issued in 1964. The introduction of Company Act of 1964, establishment of Security Exchange Center Ltd in 1976, enactment of the Security Exchange Act in 1983 and its amendment in 1992, establishment of Securities Board of Nepal in 1993 and conversion of Security Exchange Center into NEPSE in 1994 are the milestones of capital market development in Nepal. The capital market indicators, namely the number of companies listed, total paid up amount, market capitalization and total turnover value have increased significantly since the establishment of NEPSE in 1994. At the end of mid-July 2005, there were 121 companies listed in NEPSE with total paid-up capital of Rs. 14.6 billion and market capitalization (M-cap) of Rs. 47.1 billion. The size measured by the ratios of total paid up capital (PC) and M-cap to GDP, and liquidity measured by the ratios of total turnover (TTO) to PC, M-cap and GDP have increased significantly. However, the share market activities have been adversely affected by the deteriorating law and order conditions of the country since the late 1990s.

The banks and financial companies have been dominating the share market activities in terms of total number of companies listed, their PC, M-cap, and annual TTO since the establishment of the NEPSE. Due to higher concentration of banks and financial institutions in the market, the movement of NEPSE index is dictated by the prices of these companies.

The development of bond market is in progress in Nepal. The size of the government bond market is relatively large since HMG/N has been borrowing from the market. The private bond market is almost of non-existent.

Share Market

The number of companies listed at the NEPSE, total paid up value, market capitalization, and annual turnovers of the listed companies have increased substantially since the mid-1990s. The government has been gradually lifting its control over ownership, prices, and resources distribution and trade flows, and supporting the private sector to increase its control over such economic activities. Such policy initiatives have been conducive to the development of capital market.

Paid-up Capital of Listed Companies

The total paid-up value of listed companies has increased significantly with increase in the number of companies listed at the NEPSE. The number of companies listed increased to 114 as at mid-July 2004 and the amount of listed shares stood at Rs. 12.0 billion. These companies included 11 commercial banks, 41 finance companies, 13 insurance companies, 4 development banks, 29 manufacturing and processing companies, 4 hotels, 8 trading and 4 other groups of companies. The average annual growth

of paid -up capital was 19.0 percent over the last 11 years and the growth rates were highest during the mid-1990s. The total paid up capital of the listed companies was Rs. 2.2 billion in 1994. After the NRB directed the banks and financial institutions to be listed within three years and to increase the capital fund of such institutions, the growth rate has become steady.

Despite the NRB's regulatory role of increasing the paid-up value of the banks and other financial institutions, namely commercial banks, finance companies and development banks which have contributed more than 50 percent to total amount of the listed share, the ratio of total paid-up value to GDP was lower than 3 percent until mid-July 2004. However, the ratio has been increasing from 1 percent in 1994. The low ratio of paid-up capital to GDP is attributable to the underperformance of companies such as manufacturing and processing, trading, tourism, hotels, and other groups that have been adversely affected by the deteriorating law and order condition since the mid-1990s. The ratio is expected to rise after the completion of the privatization and listing of shares of state owned corporations like Nepal Telecommunication Corporation (NTC), Nepal Electricity Authority (NEA) and Royal Nepal Airlines Corporation (RNAC) that HMG/N has already initiated.

Market Capitalization

The market capitalization, one of the commonly used indicators of capital market measures, increased by three times to Rs. 41.4 billion in 2004 from Rs. 13.9 billion in 1994. The commercial banks, development banks, and finance companies contributed substantial shares in total market capitalization and total annual turnover. The market capitalization as percentage of GDP, a measure of market size, increased to 9 percent in 2004 from 7 percent in 1994. The ratio went up to 11 percent in 2000 and 2001 due to reduction in the GDP. It went down to 8 percent in 2002 and 2003.

Annual Turnover of Listed Companies

The shares of commercial banks, finance companies, insurance companies, and development banks contributed substantial proportion to the total annual turnover in terms of total number and value of transactions during FY 2003/04. The total annual turnover increased to Rs. 2.1 billion in FY 2003/04 from Rs. 441.6 million in FY 1993/94, the year when NEPSE started its operation.

The ratios of annual turnover to total paid up value and market capitalization, the measures of stock market liquidity, increased to 36.0 percent and 8.0 percent respectively in 1995 and went down to 4 percent and 1 percent in 1998. These ratios further increased to 18 percent and 5 percent respectively in 2004. The regulatory measures such as limitation on free trading of shares held by the promoters, directors, auditors, and managers are enforced to avoid market manipulation. Absence of active mutual funds, inadequate disclosure requirements of the listed companies, restrictions imposed on secondary market transactions for foreigners, heavy dependence on banks and financial sectors for secondary market transaction are some of the factors responsible for the small annual turnover. The NRB has regulated the transaction of promoter shares of banks and financial institutions to avoid speculation and maintain stability in the market. For the secondary market transactions, owners of such shares are required to complete a three-year locking period and get prior approval from the NRB.

Share Price Movement (1994-2004)

The share price movement over the last ten years remained volatile. The NEPSE index went up during the first five months of the operation of the floor trading in February 1994, reached at a peak of 360.7 in July 2000, and went down to 204.9 in July 2003.

During FY 2001/02, the economy did not perform well and the growth rate remained negative by 0.5 percent due to the external and internal shocks. Moreover, investors had lost their confidence in the stock market due to the increasing risks attributable to the deteriorating law and order conditions because of which the demand for shares decreased.

Bond Market

The higher ratio of total foreign debt (FD) to GDP than that of domestic debt (DD) indicates excessive reliance of HMG/N on foreign loans. The size of the bond market is greater than the size of the equity market in terms of their total outstanding amount. HMG/N's debt has been increasing since the late 1950s when the First Plan was initiated in 1956. HMG/N started the work of building infrastructure and spent huge amount in construction, education, health, agriculture, electricity and public works that required debt financing since the rate of revenue collection was very low. It borrowed from the market at the administered rate of interest.

However, external official flow of capital was high in the form of soft loans and grants. Among other causes, like high risks associated with private bond investment, the low real interest rate determined by HMG/N impeded the development of private bond market.

Government Bond Market

The NRB, as a fiscal agent of HMG/N, issues various types of debt securities having maturity period ranging from 28 days to many years. Some government securities are tax exempted and have targeted buyers and others are taxable and sold to individuals and institutions. As per the agreement between HMG/N and NRB, the latter receives 0.05 percent of the total amount of outstanding securities as commission for managing the government debt.

The share of NRB in total amount of outstanding debt securities of HMG/N as at mid-July 2004 stood at 18.5 percent (Rs. 15.1 billion). Development Bond (DB), National Saving Certificate, (NSC), Treasury bill (T-bill), Special Bond (SB) and Citizen Saving Certificate (CSC) are the debt instruments issued by the NRB. T-bill occupies the highest share of 60.1 percent (Rs. 49.4 billion), followed by DBs with 21.6 percent (Rs. 17.5 billion), NSCs with11.1 percent (Rs. 9.0 billion), SBs with 5.2 percent (Rs. 4.2 billion) and CSCs with 1.5 percent (Rs. 1.2 billion). The SBs are the non-marketable bonds issued for the special purpose. The DB, NSC and CSC are the long-term marketable securities that have collectively 34.1 percent (Rs. 27.8 billion) contribution to the total government debt security.

Since the NRB Act 2002 restricted the NRB's holding of HMG/N securities to a limit of 10 percent of previous year's total tax revenue, the NRB has sold the securities in the market to comply with the prescribed limit. Thus, the total amount of marketable securities has increased since FY 2002/03. The marketable government securities are used by the NRB in open market operations to inject and withdraw liquidity in the economy. Long-term government bonds have been useful instruments of monetary control since the NRB adopted market based indirect tools of monetary management. The NRB has licensed 46 banks and financial institutions to act as market makers of the Government securities. These include 4 commercial banks, 6 development banks, 32 finance companies, and 2 cooperatives. Among them, 34 market makers are operating in the Katmandu Valley and the rest out of the Valley. These individuals are the targeted buyers of National Saving Bonds (NSBs) and banks and financial institutions for Development Bonds (DBs). If targeted buyers under subscribe the issued amount, other buyers are allowed for bidding.

Corporate Bond Market

The corporate bond market in the country is virtually non-existent in Nepal. A few companies have issued corporate bonds to the public and their secondary market transactions are very limited. The NBFIs are the major sources of funds and such institutions purchase bonds mostly in OTC markets. The exchange of government bonds at face value in the secondary markets does not signal the benchmark prices of risk-free bond, and pricing of corporate bonds in the markets has become difficult. Moreover, the absence of the credit rating agency in the financial system is the other institutional deficiency for the development of corporate bond market in Nepal.

Synopsis of the Money, Foreign Exchange and Capital Markets

Money Markets

From 1950 until 2004, the formal financial sector has enlarged substantially and its impact on the real sector economic activities has remained positive. Until the mid-1980s, the state played a dominant role in the money, foreign exchange, and capital markets. HMG/N, as one of the participants in the market, borrows at a rate close to market-determined rate of interest rate. Law and caps restrict excessive government borrowing from central bank for government overdraft and its holding of government securities have been fixed to keep government under market discipline. The primary issue of T-bills by auction and their secondary market transaction at market rate of discount are the milestones of money market development. The commercial banks are shifting from borrowing from NRB to inter-bank lending and borrowing. New money markets instruments have been introduced in the markets.

The banks and financial institutions used to provide financial services as social obligors rather than profit makers. Now their perception has reversed and the private sector has started playing a leading role in financial decision-making and markets are replacing the role of the state. The state only regulates and facilitates the money, foreign exchange and capital

markets. Banks and financial institutions are getting more freedom in making their lending decisions. The priority sector credit except deprived sector credit will be completely phased out by 2006. Thus, the NRB has been successful in changing its role from being promoter and owner of banks and financial institutions to a regulator; its intervention in the financial markets is indirect.

Foreign Exchange Market

The exchange rate of the Nepalese currency vis-à-vis other currency particularly with the Indian currency was unstable during the 1950s. But it has become relatively stable since the early 1990s. The exchange rate between NRs. and IC has been fixed at Indian Rs. 1 is equivalent to Nepalese Rs. 1.6 since the mid-1990s. When the market started determining the buying and selling rates of US $ in 1985 the Nepalese currency depreciated and gradually the rate stabilized. The Nepalese rupee has appreciated in terms of US $ since last couple of years. The pegging of Nepalese currency with IC is supported by the surplus BOP and adequate level of foreign exchange reserves. The workers' remittances have increased significantly when arrangement was made for transferring money from overseas countries through banking channels. The spread between buying and selling of US $ increased after 1995 when commercial banks enjoyed greater freedom in determining these rates.

Capital Markets

The government bond market is larger than private bond and equity markets. The pace of equity market development has become faster after the mid-1990s when the NRB issued directives to banks and financial institutions to issue publicly 30 percent of their total shares. Thus, the primary as well as secondary share markets are dominated by the banks and financial institutions in terms of the amount of initial public offering, total turnover and M-cap. The adverse effect of the deteriorating law and order condition is reflected in the decreasing demand for share of companies in tourism and manufacturing sectors. The number of brokers, dealers and market makers has not increased despite a substantial increase in the number of companies listed and the total annual turnover. The NEPSE index has observed a fluctuating trend during the last 10 years since it started transacting shares in 1994.

Problems and Challenges Ahead

Infrastructure and Macroeconomic Policies

The economy is dichotomized into modern and rural sectors and the latter sector is relatively large in terms of population and economic activities. The policies initiated after the mid-1980s were market oriented but not effective as financial markets were non-existent or in embryonic stage. The low economic growth and its dependency on agriculture and decreasing income from tourism and export, higher propensity to consume and closure of manufacturing industries are some of the problems encountered in the macroeconomic side. The export base is narrow and import is high resulting in increasing trade deficit. The globalization and increasing economic integration have increased the potentiality of tourism, hydropower, agriculture and service sectors in the country. For harnessing these potentialities, the restoration of peace and development of infrastructure are the challenges. However, bilateral and multilateral development partners of Nepal are declining to extend full financial support due to the deteriorating non-economic condition of the country.

Political Instability

The political instability prevailing in the country since the mid-1990s has hampered the financial market development. It has caused the output loss resulting from the decrease in the economic activities on the one hand and on the other the increase in political risk has discouraged both domestic and foreign investment. The expenditure on infrastructure and other development activities is decreasing and security expenses are increasing. The rehabilitation of people fleeing away from the rural areas in search of secured place in urban areas has become a challenge.

Resolution of Non-performing Loans

For the smooth funding of money, foreign exchange, and capital markets, the financial health of market players is important. The major state owned banks, namely NBL and RBB which have more than 50 percent share in total commercial banking assets, have been plagued with mounting non-performing loans since the late 1990s. Similarly, the ADB/N, the major financial service provider in the rural areas, also has the problem with the NPL. The resolution of NPL of the state owned banks has become a

problem to the government. The foreign management has contracted out the management of NBL and RBB, the Debt Recovery Tribunal has started its operation, the Asset Management Company Act, the Secured Transaction Act and Insolvency Act have been drafted and the NRB has been strengthening its regulatory and supervisory capability to improve the financial health of banks and financial institutions. Despite these various measures taken in past couple of years, the resolution of the NPL of state owned banks has become a daunting task in the financial system.

Supply of Rural Funds

Banks and financial institutions established in the private sector are reluctant to extend their service to rural areas raising questions on financial viability of rural branches. The average size of rural loans is very small, credit risk is high, collateral is not marketable and cost of loan administration is also very high in rural areas. The supply of funds in this area is substantially lower than their demand. The Tenth Plan's objective to reduce poverty from 38 percent in the beginning of the Tenth Plan to 30 percent at the end of the Plan has been almost achieved to due the rise in workers' remittances. The deposit growth of commercial banks and financial institutions remained substantially high and such institutions have excessive liquidity due to remittance flow and unavailability of profitable projects for financing. In contrary to this, the supply of credit has not improved in the rural areas where the majority of the poor lives. Of the total households in the rural areas only 8 per cent have access to institutional credit.[4] The rural workers who are creditworthy and seeking jobs in overseas are denied credit as their loan size is bigger for micro financing institutions and they cannot meet the lending criteria fixed by the commercial banks.

Protection of Small Assets Holders

The rights of small depositors of bank and shareholders of listed companies in money and capital market need to be guaranteed by laws and regulations. Moreover, skillful and knowledgeable human resources are needed to regulate the institutional players of the money, foreign exchange and capital markets in order to protect the right of such small asset holders fully. A strong legal and regulatory framework is yet to be designed; for its strong enforcement, the supply of skillful human resources is not available. The spread of deposit and lending has not gone down as expected but interest rate on deposit has been decreasing since the mid-1990s. Likewise, the spread between buying and selling rates of US $ has been increasing despite the increasing number of banks and financial institutions. The market rate of interest has also been decreasing and the government bondholders are expecting premiums, but they have to sell their bonds at face value. Similarly, the prices of underlying assets of banks and financial institutions do not match the market prices of their shares. The market price of shares of some commercial banks is speculative and the real value is far below the market prices due to weak regulation of the NEPSE to narrow the gap between market value, book value and face value of the share prices of the listed companies.

Inadequate Laws and Special Services

The financial laws related to insolvency, resolution of the non-performing assets of bank and financial institutions, money laundering and security transactions are inadequate. The judicial system in Nepal lacks separate commercial benches and the courts do not have adequate human resources and required skills. Adequate and clear laws and an efficient judiciary are the prerequisites for the smoothing functioning of money, foreign exchange and capital markets. The unavailability of credit rating agency, special commercial courts and actuaries for the valuation of insurance companies are also impeding the financial market development.

Conclusion and Suggestions

The size, depth, volatility and international integration of money, foreign exchange and capital markets have increased after liberalization. These market performance indicators are lower than those of other countries. Nepal is moving towards a free market economy allowing market forces to determine the prices of the financial assets. The rural sector of the economy does not possess enough infrastructures to adopt market principles of price determination based on the demand for and supply of financial assets. There is an acute shortage of supply of financial products. The increased supply of subsidized credit in rural financial markets to meet high demand for funds inhibits the development of rural money and capital market development as lower interest rate discourages saving. Some suggestion for

enhancing the money, foreign exchange and capital markets in Nepal are given below.

- The support of HMG/N and multilateral agencies for the development of rural financial markets is essential for the establishment and development of roads, telecommunication, education, and skill developing institutions. The role of NRB in providing credit at a rate below the market rate should be eliminated.
- There are many informal rural financial institutions involved in financial intermediary functions without any license from the NRB. Such institutions need to be formalized and the NRB should provide more logistic support to these informal institutions.
- The informal activities conducive to the development of money, foreign exchange and capital markets should be formalized to increase monetization of the economy.
- The establishment of banks and financial institutions should follow the development of infrastructures like construction of roads, supply of electricity and telecommunications.
- The policies regarding the entry and exit of banks and financial institutions into the financial system are required to be reviewed to make these procedures simple.
- The shares of HMG/N in institutions like Nepal Electricity Authority, Nepal Telecommunication Company and ADB/N need to decrease gradually by selling these shares to the public.
- The respective regulatory authority of NBFIs should allow these institutions for secondary market transactions in the NEPSE.
- The act of adopting international accounting, auditing and disclosing practices has improved in financial companies but such practices are equally important for all companies listed in the NEPSE.
- The tax rates on corporate income, dividend, capital gain and interest income need to be revised timely for adjusting with the Indian rates. The effective tax rates need to be lower than the Indian rates.

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Endnotes

[1] M1 is the currency held by the public and demand deposit held by the commercial banks.

[2] M2 is the narrow money plus time deposit held by commercial banks and other banking institutions

[3] Details are given in NRB (1996).

[4] This is given in NRB (1994).

Appendix 1

Some Macroeconomic Indicators (1980-2004)

Mid-July	C/GDP	S/GDP	I/GDP	X/GDP	M/GDP	TT/GDP
1980	0.891	0.105	0.057	0.059	0.162	0.221
1981	0.901	0.100	0.062	0.048	0.159	0.207
1982	0.914	0.086	0.078	0.034	0.187	0.221
1983	0.901	0.099	0.087	0.043	0.165	0.209
1984	0.866	0.134	0.078	0.059	0.166	0.225
1985	0.894	0.106	0.078	0.055	0.168	0.223
1986	0.860	0.140	0.114	0.067	0.246	0.313
1987	0.885	0.115	0.202	0.064	0.217	0.282
1988	0.901	0.099	0.198	0.055	0.211	0.266
1989	0.886	0.114	0.217	0.058	0.205	0.263
1990	0.921	0.079	0.184	0.071	0.225	0.296
1991	0.904	0.096	0.208	0.114	0.266	0.380
1992	0.892	0.108	0.212	0.116	0.262	0.378
1993	0.865	0.135	0.231	0.113	0.301	0.413
1994	0.853	0.147	0.224	0.089	0.320	0.408
1995	0.852	0.148	0.252	0.091	0.340	0.430
1996	0.862	0.138	0.273	0.091	0.376	0.467
1997	0.860	0.140	0.253	0.098	0.317	0.415
1998	0.862	0.138	0.248	0.119	0.291	0.410
1999	0.864	0.136	0.205	0.146	0.367	3.400
2000	0.848	0.152	0.243	0.147	0.359	2.976
2001	0.850	0.150	0.241	0.114	0.307	2.508
2002	0.880	0.120	0.241	0.118	0.335	3.432
2003	0.884	0.116	0.258	0.119	0.339	3.606
2004	0.878	0.122	0.267	0.117	0.336	3.369

Source: Ministry of Finance (2004).

Appendix 2
Some Measures of Money Markets

Year	CHP/M1	M1/GDP	M2/GDP	M2/M1	PSC/GDP
1980	0.571	0.121	0.226	1.867	0.082
1981	0.561	0.117	0.231	1.966	0.091
1982	0.572	0.117	0.241	2.065	0.085
1983	0.560	0.129	0.273	2.121	0.080
1984	0.558	0.125	0.265	2.120	0.081
1985	0.597	0.118	0.264	2.244	0.087
1986	0.532	0.126	0.272	2.157	0.093
1987	0.596	0.127	0.274	2.155	0.096
1988	0.599	0.125	0.279	2.232	0.103
1989	0.541	0.132	0.298	2.259	0.116
1990	0.559	0.138	0.305	2.218	0.113
1991	0.716	0.135	0.313	2.316	0.117
1992	0.701	0.130	0.306	2.347	0.121
1993	0.684	0.139	0.340	2.447	0.126
1994	0.690	0.143	0.350	2.447	0.152
1995	0.682	0.150	0.369	2.455	0.188
1996	0.686	0.147	0.372	2.539	0.219
1997	0.711	0.137	0.370	2.697	0.225
1998	0.661	0.155	0.426	2.738	0.251
1999	0.717	0.144	0.830	5.769	0.264
2000	0.691	0.162	0.329	2.031	0.289
2001	0.555	0.172	0.522	3.039	0.309
2002	0.625	0.183	0.530	2.903	0.316
2003	0.679	0.184	0.541	2.936	0.332
2004	0.673	0.190	0.560	2.951	0.349

Source: NRB (2004).

Appendix 3
Total Public Debt as Ratios of GDP 1980-2004

Mid-July	FD/ GDP	DD/GDP	TD/GDP
1980	0.048	0.037	0.084
1981	0.057	0.065	0.122
1982	0.073	0.089	0.161
1983	0.096	0.061	0.157
1984	0.106	0.045	0.151
1985	0.141	0.034	0.175
1986	0.151	0.041	0.191
1987	0.178	0.068	0.247
1988	0.199	0.117	0.315
1989	0.240	0.158	0.398
1990	0.272	0.155	0.427
1991	0.364	0.097	0.461
1992	0.391	0.126	0.516
1993	0.427	0.085	0.511
1994	0.449	0.087	0.536
1995	0.449	0.079	0.529
1996	0.447	0.082	0.529
1997	0.432	0.104	0.536
1998	0.488	0.103	0.592
1999	0.463	0.129	0.591
2000	0.502	0.143	0.646
2001	0.487	0.146	0.633
2002	0.521	0.174	0.695
2003	0.490	0.186	0.675
2004	0.495	0.168	0.663

Source: Ministry of Finance (2004).

Appendix 4
Some Share Market Indicators (1994-2004)

Year Mid-July	PC/ GDP	M-cap/ GDP	TT/ GDP	T TO/ M-cap
1994	0.010	0.066	0.002	0.032
1995	0.012	0.054	0.004	0.081
1996	0.012	0.046	0.001	0.018
1997	0.015	0.044	0.001	0.033
1998	0.015	0.043	0.001	0.014
1999	0.018	0.064	0.004	0.064
2000	0.019	0.114	0.003	0.027
2001	0.020	0.113	0.006	0.051
2002	0.023	0.082	0.004	0.044
2003	0.025	0.077	0.001	0.016
2004	0.024	0.084	0.004	0.052

Source: Ministry of Finance (2004) and Nepal Stock Exchange (2004).