Towards Consolidation, Inclusion and Stability

FINANCIAL STABILITY REPORT

Nepal Rastra Bank

Central Office

Baluwatar, Kathmandu

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This fourth issue of the Financial Stability Report is based on the provisional data of Bank & Financial Institutions (BFIs) and other financial institutions as of mid-Jan 2014. Data used in its analysis may thus differ from the most recent statistics or audited final data published by BFIs. All the findings, interpretation and conclusions expressed in this report do not necessarily reflect the views of Nepal Rastra Bank or its Board of Directors only. The colors, boundaries, denominations or any other signs and symbols used in the report do not imply any metamorphic judgments. This report, unless or otherwise stated elsewhere, covers the developments and risks during six months of 2013/14.

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GOVERNOR

Foreword

The global financial crisis that erupted in 2008 is in the process of healing and recovery now. But the lesson on financial stability it taught is still drawing the same level of attention of central banks and policy makers. Deepening and broadening financial sector, growing global financial integration, financial innovation and evolution of new financial products along with massive use of electronic technology in financial services have made central bankers' job even more challenging. Moreover, the presence of shadow banking has added further complexities in the financial system. While the structural impediments to financial stability require institutional reforms, the operational ones regularly analyzed and corrective measures taken, this report will definitely add value to that direction.

Nepal Rastra Bank has been entrusted with the responsibility of promoting and maintaining financial stability in the country. In order to assess whether the financial market is performing efficiently and effectively, it is necessary to have a deep look upon the behavior of banks, the performance of financial system and the trend of financial soundness indicators and adopt the warranted policy measures. Thus, preparing financial stability report can be a right way to better understanding of overall performance and resilience of the financial system which would ultimately contribute to maintaining financial stability.

In this context, it has been our regular practice to present the Financial Stability Report to share information and ensure transparency in the functioning of the financial system. This Report, forth in the series of such publication, is prepared by Financial Stability Unit (FSU) and Financial Stability Working Committee (FSWC) under the guidance of the Financial Stability Oversight Committee (FSOC), which is chaired by senior Deputy Governor of this bank. This assessment is based on the data of mid-Jan 2014 unless otherwise stated.

This report is divided into six main chapters. Chapter 1 presents macroeconomic development. Chapter 2 deals with the overall financial system performance and stability. It also includes the study on financial stability indicators of financial system as a whole. Chapter 3 covers the status and performance of commercial banks, development banks, finance companies and micro finance financial institutions, including stress testing scenarios of commercial banks and development banks. Chapter 4 examines the status of limited banking cooperatives and financial non-government organizations, saving and credit cooperatives, Rural Self Reliance Fund and other contractual saving institutions such as EPF, CIT, postal saving banks and insurance companies and their impact on financial stability,. Chapter 5 encompasses the current trend and developments in the financial markets. Finally, the sixth chapter discusses financial sector policies, including the macro prudential policy measures and payment and settlement system.

This publication has come out with the hard work of our staff and senior officials. In this context, I would like to thank the FSOC, FSWC and the Bank and Financial Institutions Regulation Department of this bank, particularly the FSU for preparing this report. I would like to offer my special thanks to the officials of FSU, notably Executive Director Mr. Bhaskar Mani Gnawali, Directors Mr. Purna Bahadur Khatri and Mr. Basu Dev Adhikari, Deputy Directors Mr. Vishrut Thapa and Mr. Ramu Paudel, and Assistant Director, Mrs. Mila Devi Barahi in bringing out this report in this form. I would also like to thank Deputy Director Mr. Krishna Gopal Shrestha (Computer) of Foreign Exchange Management Department for his valuable contribution.

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

Dr. Yuba Raj Khatiwada

Acronyms

ADBL	Agriculture Development Bank Limited
AE	Advanced Economies
ATM	Automatic Teller Machine
BAFIA	Bank and Financial Institution Act
BCAP	Basel Core Principle Assessment Program
BCP	Basel Core Principle
BFIs	Bank and Financial Institutions
CAR	Capital Adequacy Ratio
CBS	Central Bureau of Statistics
CBs	Commercial Banks
CD Ratio	Credit to Deposit Ratio
CEO	Chief Executive Officer
CIT	Citizens Investment Trust
CPI	Consumer Price Index
CRR	Cash Reserve Ratio
CYFI	Child and Youth Finance International
DBSD	Development Bank Supervision Department
DOC	Department of Cooperatives
EA	Euro Area
ECB	European Central Bank
EDA	Emerging and Developing Asia
EMDE	Emerging Market and Developing Economies
EMEs	Emerging Market Economies
EPF	Employee Provident Fund
FINGO	Financial Non-government Organization
FMD	Foreign Exchange Management Department
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicators
GBBs	Grameen Bikash Banks
GBP	Great Britain Pound
GDP	Gross Domestic Product
GFSR	Global Financial Stability Review
GoN	Government of Nepal
IC	Insurance Companies
IFIs	Informal Financial Intermediaries
ILMF	Institution-wise Liquidity Monitoring Framework
IMF	International Monetary Fund
INR	Indian Rupees

IPO	Initial Public Offering
LCY	Local Currency
LHS	Left Hand Side
LIBOR	London Interbank Borrowing Rate
LLP	Loan Loss Provision
LMFF	Liquidity Monitoring and Forecasting Framework
MFFI	Micro Finance Financial Institutions
MFIs	Micro Finance Institutions
NBA	Non-banking assets
NBL	Nepal Bank Limited
NC	Nepalese Currency
NCDB	National Cooperative Development Bank
NEPSE	Nepal Stock Exchange
NGO	Non-government Organization
NIDC	Nepal Industrial and Development Corporation
NPA	Non-performing Assets
NPLs	Non-performing Loans
NRB	Nepal Rastra Bank
OMOC	Open Market Operation Committee
PCA	Prompt Corrective Action
POS	Point of Sales
PSB	Postal Saving Bank
RBB	Rastriya Banijya Bank
RHS	Right Hand Side
ROA	Return on Assets
ROE	Return on Equity
ROSC	Reports on Observance of Standards and Codes
ROSCAs	Rotating Savings and Credit Associations
RSRF	Rural Self Reliance Fund
RWA	Risk Weighted Assets
SA	South Asia
SOBs	State Owned Banks
SCCs	Saving and Credit Cooperatives
SEBON	Security Board of Nepal
SLR	Statutory Liquidity Ratio
SOL	Single Obligor Limit
U.S	United States
UNCDF	United Nations Capital Development Fund
WEO	World Economic Outlook
WESP	World Economic Situation Prospects

Chapter One

Macroeconomic Development

Global Economic Development[1]

1.1 According to IMF's *World Economic Outlook (WEO),* April 2014*,* global economic activities have strengthened and expected to continue to improve, largely on account of recovery in the advanced economies (AE). Whereas emerging market economies (EME) are facing dual challenges, slow growth and tight financial condition. In many emerging market and developing economies (EMDE), stronger external demand from the AE has been expected to lift the growth despite of persistent structural weakness with EMDEs. The global economic growth is still sluggish and uneven across the economies. Some global economies have shifted focus towards growth through the monetary policy support while others have adopted structural reform measures. In some economies, vulnerabilities have been associated with weakening credit quality and larger capital flows.

1.2 Global economic activity and world trade picked up in late 2013. Final demand in AE expanded broadly as expected. In EME, export rebound was the main driver behind better activity, while domestic demand generally remain subdued, except in China. Growth in the United States (U.S) is expected to improve following an improvement in domestic demand supported, partly by a reduction in fiscal drag as a result of the recent budget arrangement. Likewise, the euro area (EA) is turning to the corner from recession to recovery. Growth in the EA is projected to strengthen but the recovery will be still uneven. The pick-up in growth will generally be more modest in economies under stress, despite some upward revisions including in Spain. The high debt burden and financial fragmentation will hold back domestic demand in the EA. Elsewhere in Europe, activity in the United Kingdom has been buoyed by easier credit conditions and increased confidence. Whereas in Japan growth is expected to slow more gradually. Overall, growth in EMDE is expected to increase after few months of recovery in economic activities. Similarly, growth in China rebounded strongly in late 2013, due largely to acceleration in investment but expected to moderate slightly in 2014-15. Finally, growth in India picked

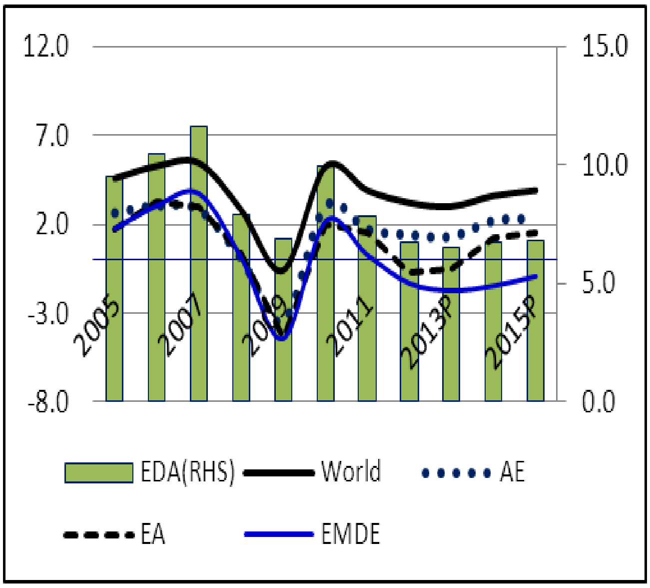
[1] Global analysis parts are written based on the publication by IMF's *WEO* & *GFSR and,* WB and UN's WESP, 2014.

up after a favorable monsoon and higher export growth and is expected to improve further with stronger structural policies supporting for investment.

1.3 Many other EMDE have started to benefit from stronger external demand. The tighter financial conditions and policy stance in other EMDE in mid-2013 as well as the political uncertainty and bottlenecks for further investment, particularly in Brazil, Russia, Middle East and North Africa is expected to grow slow in 2014.

1.4 Global economic activities have broadly strengthened and it is expected to improve further in 2014-15. Growth forecasts have been slightly cut down by the *WEO,* April 2014*,* but highlighted significant improvement in AEs. The *WEO* has projected the global GDP growth for 2014 to be 3.6 percent and its projection for 2015 stands at 3.9 percent. The AEs have been estimated to grow by 2.2 percent in 2014 and 2.3 percent in 2015. The key improvement driver in AEs noted are fiscal tightening, and prudential measures in financial sector regulation and supervision. In contrast, the near-term outlook for the EA has been estimated to be encouraging and would remain at 1.2 percent in 2014 and 1.5 percent in 2015. Financial stress in EA has been moderated significantly in response to the policy actions, but still economic activity has been estimated to be in a weak position. Likewise, growth in EMDE has been estimated to expand by 4.9 percent in 2014 and 5.3 percent in 2015. Similarly, activities in Emerging and Developing Asia (EDA) observed some improvement in response to the pace of global recovery. The real GDP growth for this region has been estimated to be 6.7 percent in 2014 and 6.8 percent in 2015.

Figure 1.1: Global Real GDP Growth
(In percent)

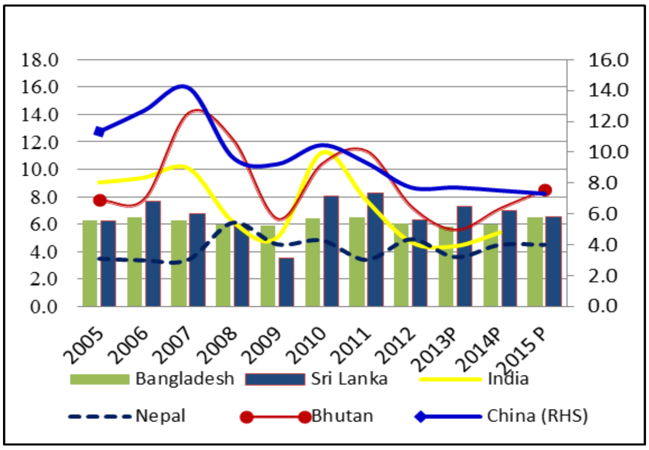


1.5 According to the United Nation’s *World Economic Situation Prospects (WESP)* 2014, global growth underperformed in 2013 but is expected to improve in 2014 and 2015, if U.S. monetary policy doesn’t derail emerging economies. The prospect stated that most developed economies continued to grapple with the challenge of taking appropriate fiscal and monetary policy actions in the aftermath of financial crisis. A number of EMDE, which have already experienced a notable slowdown, encountered new domestic and international head wings in 2013. A sign of improvement has been noted in some economic regions. For example the EA is starting to grow, the U.S continues to recover and some emerging economies including China, seem to have least stopped a further slowdown or will be accelerating again.

1.6 The main reasons for the revision of weakening growth in major world economies include infrastructure bottlenecks, capacity constraints, slower external demand, volatile commodity prices, financial stability concerns, and in some cases, weaker policy support. The impact of tight fiscal and financial conditions in various economic regions and possible fear of expansion of U.S. economy, among others, are also responsible for the growth forecast. The available indicators have pointed out to uneven growth of economies, particularly in AE, since the EA is still lagging behind the U.S., Japan and other many developed economies.

Figure 1.2: Real GDP Growth in South Asia and China

(In percent)



1.7 The GDP growth in EMDE, including the EDA has been expected to pick up gradually at a moderate pace along with the strengthening of external demand and continued robust domestic demand in these countries. For EDA as a whole, growth is estimated to pick up modestly in 2014 and 2015, largely as a result of recovering external demand and continued solid improvement in domestic demand. South Asia (SA) has been expected to see a turn around after economic softening if improvements take place in the investment environment.

1.8 The South Asian region is currently categorized as the slowest growing sub-region among Emerging Market Economies (EMEs), with GDP expanding by only 4.8 percent in 2013 from 4.7 percent in 2012, which is well below the potential. Growth is projected to improve to 5.3 percent in 2014 and 5.8 percent in 2015. In SA, India's growth has been estimated to recover from 4.4 percent in 2013 to 5.4 percent in 2014 and 6.4 percent in 2015, supported mainly by slightly stronger global growth, gradual improvement in export competitiveness, and implementation of recently approved investment projects. Pickups in exports and measures to curb gold imports have contributed toward lowering current account deficit. Likewise, policy measures to bolster capital flows have further helped reduce external vulnerabilities.

1.9 Among the SA economies, Bhutan has been noted a highest rate of real GDP growth to 6.4 percent in 2014 and is projected to grow by 7.6 percent in 2015. The real GDP growth in Bangladesh and Sri Lanka has been expected to remain mostly stable averaging around 6.5 percent in 2015. In Nepal, GDP growth decelerated to 3.6 percent in 2013, agricultural output growth slowed sharply to 1.3 percent, the lowest rate in the past five years, while services grew by 6.0 percent on improvements in wholesale and retail trade and in hotels and restaurants. Industry continued to languish, growing by a mere 1.6 percent. The growth prospect is more optimistic than in 2013, considering the political stability, the favorable monsoon, and expected strengthening in remittance inflows. The real GDP growth for Nepal is projected to be 4.5 percent both in 2014 and 2015 by *WEO,* somewhat less than the government's target of 5.5 percent. However, CBS recently published preliminary estimates show that Nepalese economy has been estimated to grow by 5.2 percent in 2013/14 owing to favorable agriculture sector and improving political and business climate. The South Asian Region accounts for 2.0 percent of world exports and 1.7 percent of global foreign direct investment. It continues to be regarded as the least integrated regions of the world and just 5.4 percent of its trade has been intraregional, compared with 26.4 percent in South East Asia and 51.0 percent in East Asia.

1.10 Among the fast growing EMDE, China's real GDP growth has been estimated to stay at around 7.5 percent in 2014 and 7.3 percent 2015. In China, growth recovered somewhat at the end of 2013 and it has been expected to remain robust in 2014. The reform measures recently announced by the Chinese government, related with investment, tax (fiscal reform) and financial sector reform have been expected to improve the allocation of capital and efficiency of investment further. However, due to the concerns about over-investment, credit quality, the continuation of withdrawal of monetary support for the economy through slower credit growth and higher real borrowing cost may hinder the economy for the expected growth target.

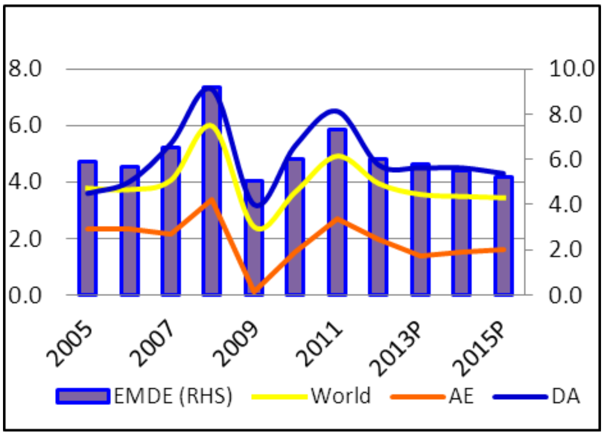
Global Inflation

1.11 The *WEO* report reiterates the risk from persistently low inflation in AE, especially in the EA. Inflation is projected to remain below target for some time, as growth has not been expected to be high enough very soon. Longer-term inflation expectations are more likely to drift down in response, leading to even lower-than-expected inflation, or possibly even deflation.

1.12 Global inflation is subdued as cost pressures related to commodity price continue to ease and demand factors in AE remain weak. Despite of loose monetary conditions and slow recovery in economic activities, global consumer prices increased modestly in 2013. Low income country inflation slightly declined whereas in high income countries inflation remains weak. Unconventional monetary policy helped major high income economies to avoid disinflation but Japan is still caught in disinflationary trap. Monetary policy globally and especially in developing countries is increasingly embracing inflation targeting and loose policy stance. Such stance in developing countries has been found (*WEO,* April 2014) counterproductive, particularly in countries operating at full capacity.

Figure 1.3: Global Inflation

(In percent)



1.13 However, inflation remained tame worldwide, partly reflecting output gaps, high unemployment and a continued financial deleveraging in major AE. Among AE, inflation decelerated in the U.S during 2013 and is expected to remain below 1.4 percent in 2014 and 1.6 percent in 2015. Inflation decelerated in the EA, but has dipped to 1.3 percent, which raised some deflationary concerns in the region. In Japan, the large expansionary policies aiming to reflate the economy managed to end the decade-long deflation in 2013, as the consumer price index (CPI) is estimated to increase by 0.4 percent, and is projected to reach 2.8 percent in 2014 and 1.7 percent in 2015. Among EMDE, inflation rates are eased to single digits in most of the countries leaving around double digits in only about a dozen economies scattered throughout different economic regions. Several economies in South Asia and Africa will continue to face high inflation rates, mainly owing to elevated inflationary expectations, rapid credit growth, localized food price pressures and structural bottlenecks such as energy shortages. On the other hand, most economies in East Asia continue to face benign inflation in 2014.

1.14 With these developments, global inflation is estimated to stay at around 3.5 percent in 2014 and 3.4 in 2015. The slowdown in prices of certain food and fuel items and related developments will help contain inflation pressure of major commodities, despite the expected reacceleration in global activity. The *WEO* has projected that inflation in AE will stay to 1.5 percent in 2014 and 1.6 in 2015. Inflation will gradually increase in the major

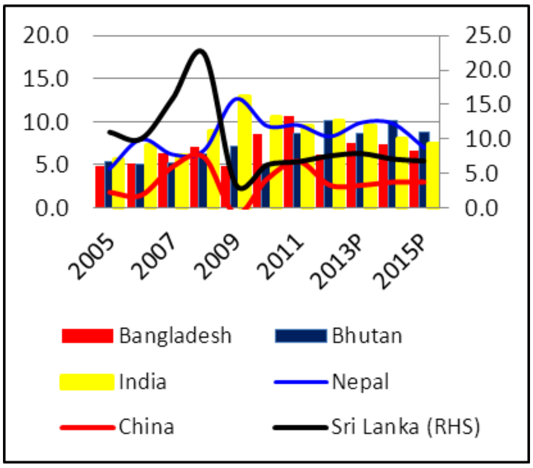
AE in the medium term. Among the AE, U.S. seems to be in a new part of the inflation cycle. The U.S. services inflation is stabilizing at a low level than it was in the 1990s and 2000s. Goods inflation, on the other hand, is in a new down cycle. This seems to point to weakness abroad. It all points to a normalizing U.S. domestic economy but more vulnerability abroad.

1.15 Inflation pressure is projected to remain contained in the EMDE, supported by recent slowdown and lower food and energy prices. Inflation in EMDE is estimated to stand at 5.5 percent in 2014 and 5.2 percent in 2015. Inflation has been projected to gradually ease in EMDE to 5.5-5.2 percent in the medium term during 2014-15. However, inflation pressure in some economies and regions, spurred by food prices in some cases, such as in South Asian countries has been projected to remain fairly high because of higher food prices and other structural supply side deficiencies.

1.16 Although inflation remained sticky in the AE, price pressure moderated across other regions such as EA and Central Asia. In contrast, some regions, for instance, the Middle East, have witnessed high prices reflecting both supply disruptions caused by civil and armed strife as well as the measures addressed to adjust large macro-economic imbalances. In South Asia, consumer price based index remained relatively high but the wholesale prices index-based inflation moderated significantly, especially in India. The high inflation pressure in South Asia mainly reflect an upward adjustments to domestic fuel prices implemented time to time over the past few months.

Figure 1.4: Inflation in South Asia and China

(In percent)



1.17 In most South Asian countries, consumer price inflation moderated slightly over the past year as aggregate demand pressures declined and international commodity prices eased. Inflation remains, however, significantly higher than in other world regions and, in most cases, well above the respective central bank's comfort zone. The continued strong upward pressures on prices can be attributed to several factors, including persistent supply bottlenecks, entrenched inflationary expectations, ongoing weakness of local currencies (particularly in India, the Islamic Republic of Iran, Pakistan, Sri Lanka and Nepal), and despite the attempts by several governments (India and Pakistan) to reduce their food and fuel subsidy bills.

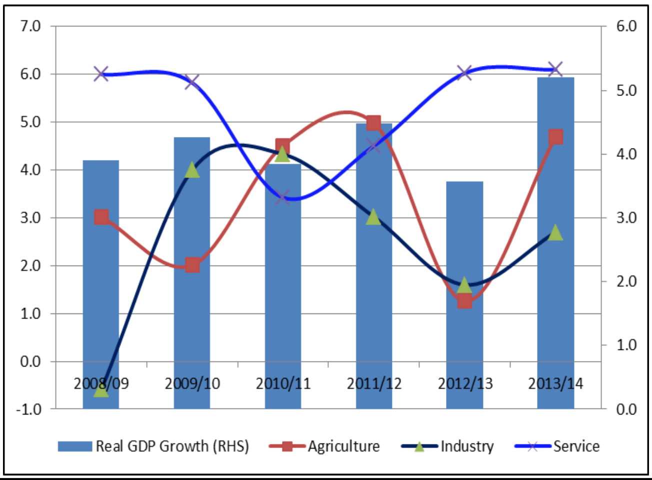
1.18 In South Asia severe supply shortages and a sharp depreciation of the national currencies pushed consumer price inflation in 2013. Inflation is projected to decelerate slowly in 2014 and 2015, but an easing of the sanctions could lead to a more rapid decline. Although inflation eased to 6.2 percent in 2013 as global commodity and oil prices broadly stabilized, it is expected to rise slightly to 6.4 percent in 2014 before easing back to 6.2 percent in 2015 due to country-specific factors such as currency depreciation, pressures on food prices, and energy price adjustments. In India, consumer price inflation has remained stubbornly high at close to 10.0 percent in 2013, even as domestic demand weakened further. Inflation in India is projected to be moderating during 2014 and by contrast, inflation slowed moderately in Bangladesh, Nepal, Pakistan and Sri Lanka during 2013, with full-year averages ranging from 7.5 to 9.8 percent. While the baseline scenario foresees a gradual decline in inflation across South Asia in 2014 and 2015, upside risks remain high. Those include poor harvests, further depreciation of national currencies, and pressures stemming from significant subsidy reductions (particularly in India, Pakistan and Sri Lanka). At the mean time, the RBIs recent move towards inflating targeting regime for bringing the inflation between 6-8 percent within one year may further support to decelerate the inflation in the South Asian region.

Domestic Macroeconomic Development

Economic Growth

1.19 According to the preliminary estimates of Central Bureau of Statistics (CBS), the real GDP at basic price is expected to grow by 5.2 percent in 2013/14 compared to the growth of 3.5 percent in 2012/13. Satisfactory performance of agricultural sector due to favorable monsoon and smooth supply of agricultural inputs and better performance of industrial and service sectors accompained by lessen political uncertainity and improved industrial relation are some of the factors responsible for higher growth.

Figure 1.5: Real GDP and Sectoral Growth

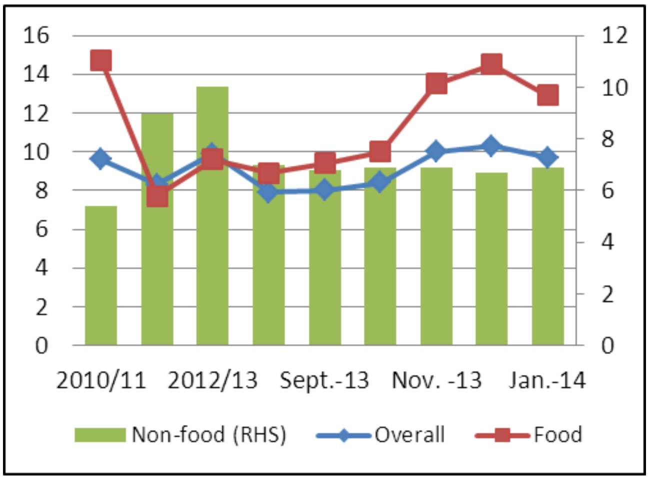


1.20 The agriculture sector is estimated to grow by 4.7 percent in 2013/14 compared to a growth of 1.1 percent in 2012/13. Better performance of agriculture sector is mainly attributed to the favorable monsoon and timely use of fertilizer and improved seeds. Similarly, the industrial sector witnessed 2.7 percent growth in 2013/14 compared to a growth of 2.5 percent in the previous year. Despite persistent energy shortage, improved labor relation and better political situation are the main reasons contributing to such growth in industrial sector. Likewise, the service sector is expected to grow by 6.1 percent in 2013/14 compared to its growth of 5.2 percent in 2012/13. The improvement in the growth of service sector is attributed to better performance of some sub sectors viz. wholesale and retail trade, hotels and restaurants, transport, storage and communication and education among others. For 2013/14, the ratio of total consumption to GDP is estimated at 91.1 percent compared to 89.9 percent in the previous year. In the review year, the ratio of gross investment to GDP is estimated at 37.1 percent compared to 36.9 percent in the previous year.

Inflation

1.21 The year-on-year inflation, as measured by the consumer price index (CPI), increased by 9.7 percent in mid-Jan 2014 compared to 9.8 percent in the corresponding month of the previous year. During the review period, the price index of food and beverages group increased by 12.9 percent whereas the index of non-food and services group increased by 6.9 percent. The indices of food and beverages and non food and services had increased by 9.6 percent and 10.2 percent in the same period of respectively in 2012/13.

Figure 1.6: Average Consumer Price Inflation



1.22 Major factors contributing to rise in price index of food and beverage group are increase in prices of cereal grains & their products, vegetables, meat & fish, fruits and hard drinks. Similarly, important factors leading to slow down in non-food inflation are lower increase in prices of housing & utilities, transport, communication and miscellaneous goods and services.

Government Finance

1.23 Government expenditure structure and the size of budget deficit have important implications to the growth and stability of the nation. A prudent fiscal policy is thus required for favorable development of the economy. The fiscal position of the government showed positive outcomes, as capital expenditure and revenue mobilization, both have been increasing during the first six months of 2013/14. As the growth rate of resource mobilization has been higher than that of total expenditure, budget surplus (on cash basis) has surged to Rs. 56.1 billion in first six months of 2013/14 compared to Rs. 40.4 billion in the corresponding period of the previous year.

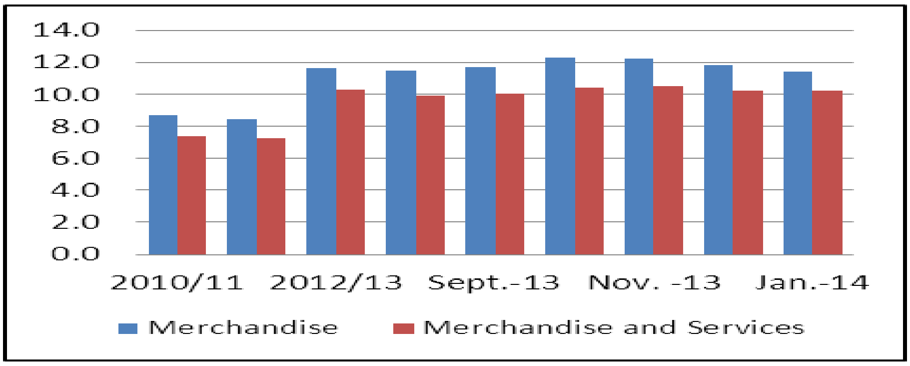
1.24 Government revenue mobilization has increased by 21.5 percent to Rs. 163.4 billion during the first six months of 2013/14. Such revenue had increased by 21.2 percent in the corresponding period of the previous year. During the first six months of 2013/14, total government expenditure has increased by 25.4 percent to Rs 134.4 billion. Such expenditure had decreased by 5.4 percent in the corresponding period of the previous year. The timely announcement and implementation of budget for 2013/14 resulted into a significant increase in total government expenditure during the first half of 2013/14. Of the total government expenditure, the share of recurrent expenditure, capital expenditure, financial expenditure and expenditure from freeze accounts stood at 82.4 percent, 6.9 percent, 10.7 percent and 0.1 percent respectively as of mid-Jan 2014. Outstanding domestic debt stood at Rs 212.73 billion as of mid-Jan 2014. Such debt had stood at Rs 208.96 billion in mid-Jan 2013. Government has settled Rs. 4.2 billion of domestic debt in the first half of 2013/14.

External Sector

1.25 Merchandise exports increased by 15.0 percent to Rs. 45.1 billion during the first six months of 2013/14 compared to its growth of 9.3 percent during the corresponding period of the previous year. Likewise merchandise imports increased by 23.1 percent to Rs. 333.9 billion in the review period. Such imports had risen by 25.2 percent during the corresponding period of the previous year. Consequently, total trade deficit went up by 24.4 percent to Rs. 288.8 billion during the review period. Given the high growth of imports relative to exports, the ratio of export to import declined to 13.5 percent during the first six months of 2013/14. Such ratio stood at 14.5 percent in the corresponding period of the previous year. The share of India in total foreign trade stood at 66.0 percent during the first six months of 2013/14.

1.26 The overall BOP recorded a surplus of Rs. 77.2 billion during the first six months of 2013/14 compared to a surplus of Rs. 7.8 billion during the same period of the previous year. Existing foreign exchange reserve is sufficient for financing merchandise imports of 11.4 months and merchandise and service imports of 10.2 months as at mid-Jan 2014.

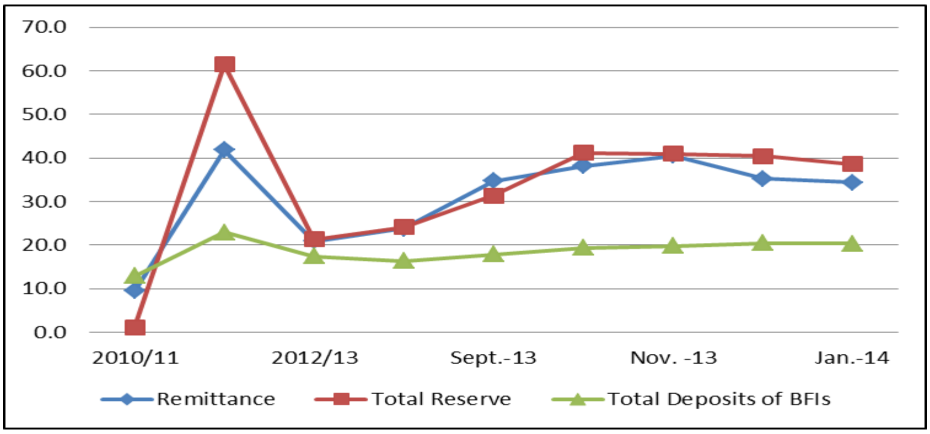
Figure 1.7: Import Capacity of Reserve (In months)



1.27 The current account and BOP performance of Nepalese economy is largely driven by the volume of merchandise imports and inflow of remittances. Workers' remittances grew by 34.4 percent to Rs 265.6 billion in the first half of 2013/14 compared to 21.8 percent of the corresponding period of the previous year.

1.28 During the first six months of 2013/14, total reserves increased by 17.1 percent to Rs. 624.6 billion. Such reserve had grown by 2.6 percent in the corresponding period of the previous year. The growth rate of reserves is closely linked with growth of remittances in Nepal since the last few years. The fluctuation in the growth rate of remittances creates uncertainty in the foreign exchange reserve position, which may create risk to external sector stability. Remittance inflow is also contributing to the expansion of financial sector and deposit mobilization; hence remittance inflows is found to be correlated with the liquidity situation of the banking sector.

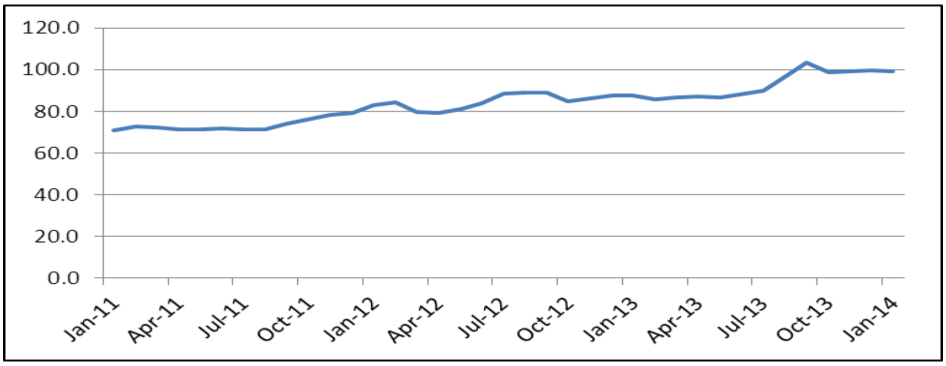
Figure 1.8: Growth Rate of Remittance Inflows & Reserve



Exchange Rate

1.29 Nepalese currency depreciated by 3.2 percent against US dollar during the first six months of 2013/14 in contrast to an appreciation of 1.7 percent in the same period of the previous year. The depreciation of Nepalese rupee against US dollar contributed to improve export competitiveness and stimulated remittance inflows. However, it increased

Figure 1.9: Movement of Nominal Exchange Rate (NRs/US$)



net domestic assets and money supply, inflationary pressure and uncertainty in the external sector. It inflated the foreign debt liability of the government. The depreciation of Nepalese rupee against US dollar increased the growth rate of remittance inflows and export during the first six months of 2013/14.

Monetary Situation

1.30 The monetary policy for 2013/14, formulated in the context of low economic growth and high pressure on prices despite having BOP surplus and comfortable foreign exchange reserves. Broad money supply (M2) increased by 9.0 percent during the first six months of 2013/14 compared to an increase of 4.8 percent in the corresponding period of the previous year. The growth of broad money is due mainly to the increase in NFA. Soaring remittance inflows accompanied by an increase in foreign assistance resulted into higher growth of net foreign assets in the review period. Similarly, narrow money supply (M1) increased by 8.9 percent during the review period in contrast to a 0.5 percent decrease in the corresponding period of the previous year.

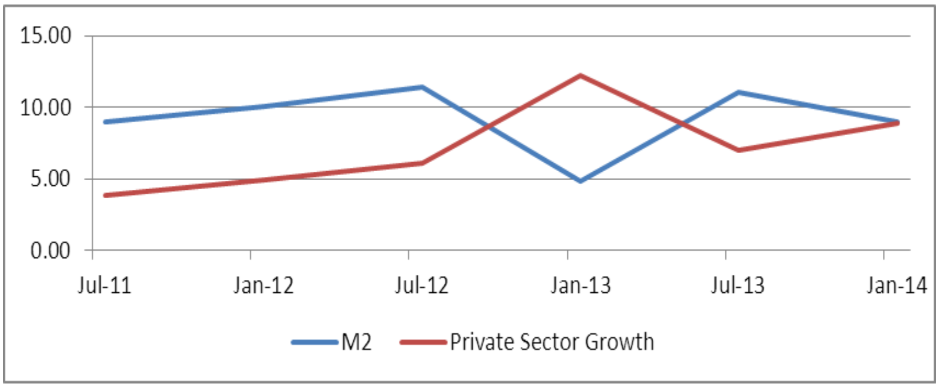
1.31 Domestic credit increased marginally by 1.1 percent during the first six months of 2013/14. It had increased by 6.1 percent in the corresponding period of the previous year. During the first six months of 2013/14, claims on private sector increased by 8.9 percent compared to a growth of 12.3 percent in the corresponding period of the previous year. Reserve money increased by 2.2 percent during the first six months of 2013/14 as against a decrease of 14.6 percent in the corresponding period of the previous year. Increase in currency in circulation along with the increasing balance of commercial banks at NRB contributed to a growth of reserve money in the review period.

1.32 Deposit mobilization of banks and financial institutions increased by 8.0 percent (Rs. 95.4 billion) during the first six months of 2013/14. Such deposit mobilization had increased by 5.3 percent (Rs. 54.1 billion) in the corresponding period of the previous year. In the review period, deposit mobilization of commercial banks, development banks and finance companies increased by 7.2 percent, 13.9 percent and 8.4 percent respectively compared to increment of 4.6 percent, 7.4 percent and 5.8 percent, respectively, in the corresponding period of the previous year.

Liquidity Situation

1.33 In the first half of 2013/14, excess liquidity had been a persistent problem in the banking system. Major reasons has been surge in remittance inflow accompanied by depressed growth in private sector credit. While managing liquidity, NRB mopped up Rs. 8.50 billion through outright sale auction and Rs. 118.50 through reverse repo

Figure 1.10 Money Supply & Credit Growth Rate



operations in the review period. During the review period, NRB injected net liquidity of Rs. 168.93 billion through the net purchase of USD 1.69 billion from foreign exchange market (commercial banks). Net liquidity of Rs. 103.34 billion was injected through the purchase of USD 1.19 billion in the same period of the previous year. The NRB purchased Indian currency (INR) equivalent to Rs. 143.06 billion through the sale of USD 1.44 billion in the Indian money market during the review period. INR equivalent to Rs. 122.04 billion was purchased through the sale of USD 1.40 billion in the same period of the previous year.

1.34 In order to accommodate GON's growth target of 5.5 percent for FY 2013/14, the Monetary Policy for 2013/14 reduced cash reserve ratio (CRR) of BFIs by 1 percentage point setting 5.0 percent, 4.5 percent and 4.0 percent for “A”, “B” and “C” class institutions, respectively.

1.35 The statutory liquidity ratio (SLR) to be maintained by BFIs has been revised in 2013/14. Commercial banks are now required to maintain SLR of 12.0 percent, whereas development banks and finance companies are required to maintain SLR of 9.0 percent and 8.0 percent, respectively. Such ratio for "D" class financial institutions collecting deposits from general public has been kept unchanged at 4.0 percent.

Macroeconomic Issues

1.36 Macroeconomic risk in Nepalese economy has declined marginally during the first six months of 2013/14. Economic growth is expected to reach near the targeted level. Agriculture sector performed well due to favourable monsoon while non-agriculture sector is also expected to improve mainly due to optimistic political environment. Inflation, however, has remained slightly above the targeted level during the review period. Sharp depreciation of NRs vis a vis US dollar and high food inflation had put pressure on the price in the first half of 2013/14.

1.37 External sector risk has been mitigated to some extent. Exports growth has been encouraging in the review period, however, imports have continued its rising trend causing trade deficit to expand by 24.4 percent in the review period. During the six months of 2012/13, such deficit had increased by 28.4 percent. Notwithstanding, BOP remained in surplus, driven mainly by encouraging inflows of remittances, contributed by foreign employment and exchange rate depreciation of NC vis a vis US dollar. The total foreign reserves as of mid-Jan 2014 are sufficient to import goods and services of more than ten months.

1.38 Monetary sector risk remains moderated. The monetary aggregates grew as targeted but the excess liquidy remained as a persistent problem in the review period. Meanwhile the private sector credit growth has remained sluggish. The challenge faced by the NRB is to increase credit flows to the productive sector for broad based and sustainable growth. The fiscal sector risk has declined slightly during the period. The capital expenditure increased along with revenue mobilization due to timely announcement of full budget, however the low performance of capital expenditure than the targetted level is a matter of concern.

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Chapter Two

Financial System Performance And Stability

Global Financial Stability Perspectives

2.1 The global financial condition is improving slowly, and economic policies are in the stages of normalization process. A comprehensive programme of regulatory reforms and supervisory actions since the crisis has made the global financial system more resilient. Currently, European financial system has been putting in place a comprehensive set of measures to strengthen further the region's financial system. Emerging markets have coped relatively well to date with occasional bouts of turbulence, in part reflecting the positive impact of both past and more recent reforms.

2.2 Despite the improved global economic outlook, financial system needs to continue strengthening financial resilience. Financial markets should be prepared for the possibility of sharp adjustments in interest rates, exchange rates, valuations of financial instruments, market volatility and liquidity. Some emerging markets may experience a combination of slower growth, capital outflows and higher borrowing costs which may expose vulnerabilities, associated with the rapid growth of credit in recent years and increased use of foreign currency borrowing by the non-financial corporate sector.

2.3 Good progress has been made in addressing some of the issues related with the financial stability, although the reforms are still ongoing. The challenge for the countries will be to complete the transition to a new regulatory structure effectively and to develop a solid foundation for the crisis management framework. Providing legal protection to financial sector regulators and supervisors as well as to public officials involved in crisis management and resolution is an important prerequisite for the success of the reforms.

2.4 The emerging markets financial systems have deepened and have become globalized. These markets introduced new asset class segments, including local currency sovereign debt, with increased direct participation of global investors. The investor base has been tilting toward making capital flows more sensitive to global financial conditions. However, emerging market economies can improve their resilience by deepening their financial systems.

2.5 Despite the progress so far achieved in the financial sector stability, some downside risks to financial stability persist globally. Corporate leverage has risen, accompanied in many emerging market economies by increased exposure to foreign currency liabilities. In many financial markets, including other several emerging market economies, assets valuation could come under the pressure if interest rate rose more than expected and adversely affected the investors' sentiment. Therefore, the momentum in the global economy is shifting away from EMDE to AE after years in the doldrums. Some of the EMDE has been suffering from large trade deficits, capital flight and depreciating currencies, and their growth rates are slowing. Likewise, in emerging market economies, increased financial market and capital flow volatility remain a major concern for the stability.

2.6 A combination of deeper policy commitments, renewed monetary stimulus, and continued liquidity support can reduce the financial sector risks. The improvement in global financial conditions can only be sustained through further policy actions that address underlying stability risks and promote continued economic recovery. Therefore, continued improvement requires further balance sheet repair and a smooth unwinding of public and private debt overhangs. The GFSR estimates that if progress in addressing these issues falters, risks could reappear in global financial stability.

2.7 The prolonged accommodative monetary policies on a global level and an extended period of low rates do not give rise to fresh credit excesses. Financial supervision should be tightened to limit the extent of such excesses; and regulation will need to play a more proactive role in this cycle at both the macro and microprudential levels. Similarly, restraining a too rapid rise in leverage and encouraging prudent underwriting standards will remain key objectives. The GFSR said, policy makers must remain alert to the risks stemming from increased cross-border capital flows and rising domestic financial vulnerabilities to avoid the financial instability.

2.8 Despite the overall progress in global economy, it is undergoing a number of transitions on the path to greater stability. The U.S monetary policy has begun to normalize, EME are transitioning to more sustainable growth in the financial sector and EA is strengthening bank capital positions to a stronger framework for integration. The *GFSR,* of April 2014, analysis has highlighted that financial markets continue to be supported by extraordinary monetary accommodation and easy liquidity conditions toward self-sustaining growth, marked by increased corporate investment and growing employment. The shift from liquidity driven to growth driven market require avoiding financial stability risks and financial rebalancing. Likewise in EME private and public balance sheets have become more leveraged since the beginning of the financial crisis and became more sensitive to changes in domestic and external conditions.

Nepalese Financial System

Overall Performance of the Financial System

2.9 Nepalese financial system is turning in the direction of stability after correcting major financial soundness indicators for example the assets quality, liquidity and capital adequacy ratio of BFIs. Likewise, many proactive measures taken and enforced by the regulatory and supervisory agencies supported to stabilize the financial market in recent years. As a result, improvement has been experienced in capital base, liquidity position, credit quality, management of non-interest expenses, private sector credit to the productive sectors, deposit mobilization and overall sector-wise credit exposure in the financial sector. Despite such overall progress, vulnerable liquidity positions, unwanted credit exposures, particularly in the short-term non-economic activities and unproductive areas of the economy and, in overall decelerating profitability of BFIs due to high cost and excess liquidity have been remaining the major concerns to be addressed timely.

2.10 Similarly, lack of sound corporate governance practices, unwanted strong interconnectedness among financial institutions and promoters are also the major challenges of financial sector in the near term perspectives of financial stability. Growing risk from the shadow banking and repeated type of unsettled problem in the problematic financial institutions may pose further risk to systemic stability. However, despite all these risk and challenges, Nepalese financial system has been broadly regulated and moving on track toward stability.

2.11 Despite of several positive outcomes and move toward financial consolidation, the assets quality of the banks have not been improved. Although NPL level shows less than 4.0 percent in industry average, a sizeable number of BFIs report high ratios of NPLs. Real estate concentration is still high, with more than two third of loans collateralized by real estate but proper collateral valuation is missing ever. Liquidity risk is a concern owing to poor corporate governance and risk management, and dependence on remittances and wholesale deposits. Frequent repetition of issues and problems in the supervision reports of individual BFIs indicates that banks have been running with various types of problems. Similarly, poor assessment of risks (credit, liquidity, interest, foreign exchange and operation) and lack of analysis of overall financial soundness indicators of BFIs in these reports also reflected that NRB's supervisory capacity is missing in many aspects. For example, loan classification and provisioning is not based on a forward looking expected loss approach, loan reviews are missing asset quality review. Likewise, deprived sector lending requirement is expected to increase the access of credit to low income groups, most BFIs are lending such loans to microfinance institutions (MFIs) and cooperatives and making adjustments in their financial statements, which does not reflect the right direction for stability.

2.12 The more appetite seen in the past two years towards consolidation and merger by smaller institutions and financially poor BFIs particularly, the finance companies and district level small development banks. It may raise the risk upon financial stability concerns if post consolidation stringent measures are not implemented strictly. As the profitability of small BFIs is in declining trend from the intense competition with the larger and better capitalized banks, merger activity involving stronger BFIs has picked up with encouraging results but comparatively less encouraging outcomes of merger with the weak financial BFIs. Hence, stronger regulatory and supervisory oversight is needed to ensure that the merger does not result in a larger, weaker institution as most small BFIs may be too weak to be viable for a merger and could eventually fail. Were this risk to realize, panic and bank runs could spread toward the better managed institution, including non-bank financial institutions which are investing in banks' shares or holding bank deposits. Until and unless there is no effective safety net and crisis management framework, vulnerabilities may create "Too-Many-to-Fail" (TMTF) may create systemic risk in the financial system.

2.13 The merger policy unveiled by the NRB at a recent past as the means of financial sector consolidation is expected to correct the recent troubles such as low volume of turnover, high interest rate in lending, high interest rate spread, inefficient management, lack of project financing practice, inadequate working fund and unhealthy competition among BFIs. It is believed that merger will create synergy by lowering operating costs, reaping benefits of economies of scope and scale expanding and diversifying market share. Moreover, it has been expected that The merger of institutions will not only promote the financial capability but will also promote out-reach and competitiveness through shared skills. However, despite of encouraging consolidation of number of BFIs in the banking sector in a very short span of time of around two years the major balance sheets indicators of BFIs, which involved in consolidation showed not much encouraging results in reducing operating costs and non-interest expenses. However, net profit increased marginally but despite of increment in capital base, risk weighted assets increased and capital adequacy ratio has not been improved as expected in those BFIs.

Table 2.1 Number of Merged BFIs (As of mid-Jan, 2014)

BFIs	Merged	Merging	New/ Upgraded/ Renamed
Commercial Banks	4	1	4
Development Banks	12	11	15
Finance Companies	7	20	4
Total	**23**	**32**	**23**

2.14 Since, the unveil of merger bylaws, 55 financial institutions have merged with each other and formed 23 institutions which is a significant achievement for the consolidation of banking sector. Finance companies are leading institutions in the merger process in terms of numbers; 23 finance companies accounting 39.7 percent of total finance companies have been reduced from the financial system through the consolidation process. Since finance companies have comparatively remained weak in terms of capital adequacy, corporate governance, asset quality and profitability, these institutions are appearing most of the times as forerunner upon the role of merging institutions. However, reductions in numbers of “A” and “B” class financial institutions are not as expected. Therefore, although, the merger process have supported in reducing the number of BFIs significantly in a short period of time, the objectives of financial stability through the creation of sound, strong and stable banking system in terms of capital and efficiency has not been achieved as expected and it is yet to be materialized.

Financial Inclusion: Bank Branches and Branchless Banking

2.15 Financial crisis highlighted the profound importance of finance for the globalized economy. As 2.5 billion people worldwide still lack access to formal banking services, credit facilities, or savings instruments, bringing this largely ignored missing market into the formal financial system would enrich and strengthen the global economy. In Nepal, the unbanked, who live primarily in rural areas and semi-urban areas, comprise nearly 75.0 percent working-age population. In some parts of the country it might be up to 100.0 percent and as much as 90.0 percent of the population lacks access to the formal financial system in many parts of the country. This impedes their participation in the economic activities by restricting their ability to buy goods and services, to borrow and save, or to invest.

2.16 In general, a single, universal solution does not work everywhere as in Nepal too,due to its hard and difficult topography, regional disparities, level of business/economic activities, availability of basic physical infrastructures services for the delivery of financial services in a cost effective way. Therefore, financial inclusion is very much challenging. In Nepal it has been estimated that about 75.0 percent of population have their own mobile phones, but have no access to formal banking services. Harnessing this technology to expand financial inclusion would be economically empowering, particularly for smallholder farmers and merchants in rural communities, who could use their mobile phones to access market-price data, transfer cash, make retail purchases, deposit income, and pay bills – all while tending their fields or shops. This would encourage saving, which is crucial to building a business and providing investment capital to others. And legal, regulated options for safeguarding savings and accessing credit would reduce reliance on the black market or the informal economy, where financial exploitation flourishes.

2.17 Regulators and local private institutions in Nepal can collaborate to create safe and accessible banking and credit instruments. That is how some Latin American and African countries developed a regulatory framework that has enabled banks to build a network. For example, a state-owned Indonesian bank, Bank Rakyat Indonesia, is providing micro-financing services to millions of people, while in India; new 'no-frills' savings accounts have attracted many customers. Similarly, other homegrown examples of regulatory success stories come from Mexico, Peru, Bolivia, Uganda, South Africa, the Philippines, Thailand, and Mongolia. Hence, opening the financial system to the poorest people will unlock the economic and social potential to the benefit of all in Nepal.

2.18 In Nepal ensuring financial inclusion is a difficult task. Thus require a holistic approach encompassing strategies for awareness raising, financial education, and technical advice on different dimensions of money management, debt counseling, saving mobilization, provision of affordable credit services, research and development. In order to promote financial inclusion, Nepal needs to develop and apply specific strategies to expand the outreach of their services using combinations of lending methodologies, market led approaches to new product development, fostering linkages with local communities and promoting the use of technologies etc. Despite several challenges, there has been significant progress toward financial inclusion in Nepal. Continuity and sustainability of the achievements to date has been the main challenges in Nepal. In this way, several policy measures are needed to continue keep financial sector as vibrant and dynamic as it could be to enable the use of existing opportunities while overcoming the challenges for financial access and inclusion.

2.19 In view of this for financial inclusion, NRB is conducting access to finance survey, creation of systematic client profile, reaching the unreached, linking clients with non-financial service providers, mainstreaming the operation of financial cooperatives in coordination with DOC, capacity development of financial service providers towards industry needs, innovation on new product development and diversification, mainstreaming revolving fund and promoting adoption of modern technologies among financial institutions and others. Nepal’s financial sector has grown rapidly over the past two decades, with the country witnessing a substantial growth of financial institution, both licensed and non-licensed. Despite this growth, many adults remained unbanked and with zero or scarce access to financial services, primarily in rural areas. NRB embarked on a strategic five-year action plan (2012-2016) to undertake a major program to reform the financial sector, highlighting financial inclusion as a strategic priority. Nepal can also study how countries have successfully implemented an integrated approach to increase financial inclusion in rural areas and need to proceed toward developing a financial inclusion strategy and learn how other countries tackle geographical outreach constraints, and more importantly how coordinated efforts from different agencies and government bodies can lead to financially inclusive societies.

2.20 As of mid-Jan 2014, the Nepalese financial system has been delivering financial services and promoting financial inclusion through 31 licensed commercial banks 87 development banks, 58 finance companies, 35 micro-finance financial institutions, 15 NRB permitted cooperatives undertaking limited banking transactions and 30 NRB permitted FINGOs. Similarly, 25 insurance companies and one each of the EPF, CIT and PSB have been supporting to financial access/inclusion through insurance and saving/investment activities. Likewise, 2541 BFI branches as of mid-Jan 2014 are delivering financial services as compared to 2492 in mid-July 2013. On the other, few numbers of branches of non-bank financial institutions such as co-operatives and FINGOs are also delivering the financial services, especially in the rural areas. BFIs are currently serving 12,131,298 depositors and 884,536 borrowers. Similarly, non-banking financial institutions such as MFFIs are serving peoples in the remote areas who have account with them as members. Furthermore, licensed co-operatives and FINGOs have been serving members and contributing to financial access and inclusion.

Table 2.2: Branches of BFIs (Mid-Jan, 2014)

Financial Institutions	Number of branches		% share		Percentage Change (Mid-Jan 2014)
	Mid-Jul 2013	Mid-Jan 2014	Mid-Jul 2013	Mid-Jan 2014	
BFIs					
Commercial Banks	1486	1508			
Of Which: 1) SOBs	506	511	20.30	20.11	0.99
2) Private Banks	980	997	39.33	39.24	1.73
Development Banks	764	787	30.66	30.97	3.01
Finance Companies	242	246	9.71	9.68	1.65
Total	2492	2541			1.97

2.21 The participation by private sector bank branches in remote areas is minimal despite of continuous efforts from the NRB for financial inclusion. Only 59 branches out of 1508 branches of commercial banks were present in 17 least branch districts and there is almost non-presence of BFIs other than state owned commercial banks in nine least branch districts of Nepal that is except in Jumla, Rasuwa, Salyan, Rolpa, Darchula and Humla, which is a big concern for financial access and inclusion.

Table 2.3: Banks' Presence in Least Banked Areas (Mid-Jan, 2014)

BFIs	17 Least Branches Districts		Total Branches	
	Branches	Share (%)	In Total	Share (%)
State Owned (Class "A")	78	42.6	511	20.1
Private Banks (Class "A")	59	32.2	997	39.2
Development Banks (Class "B")	41	22.4	787	30.9
Finance Companies (Class "C")	5	2.7	246	9.7

2.22 Despite the progress of financial deepening indicators, the access and inclusion expectation has not been met over the one decade. As a result, only about 30.0 percent of the adult population have a bank account in the formal financial institutions which is fairly below as compared with other countries in the world and especially with South Asian countries. Remote areas remain very poorly-served by formal financial institutions compared with urban areas.

2.23 While reviewing the financial access and inclusion in different regions of Nepal, western region witnessed the highest increment in bank branches (by 21 branches) in aggregate compared with the number of branches in mid-July 2013. However, in terms of classification of BFIs, "A" class banks expanded maximum branches (13 branches) in central region, and B class added maximum branches (18 branches) in western region. Finance companies also added 3 branches again in central region.

Table 2.4: Region-wise Branches of BFIs (Mid-Jan, 2014)

Region/BFI Class	Class "A"	% share	Class B	% share	Class "C"	% share	Total
Eastern	275	18.2	108	13.72	27	10.98	410
Central	749	49.7	306	38.88	141	57.32	1196
Western	264	17.5	282	35.83	68	27.64	614
Mid-western	132	8.7	67	8.51	8	3.25	207
Far-western	88	5.8	24	3.05	2	0.81	114
Total	1508	100	787	100	246	100	2541

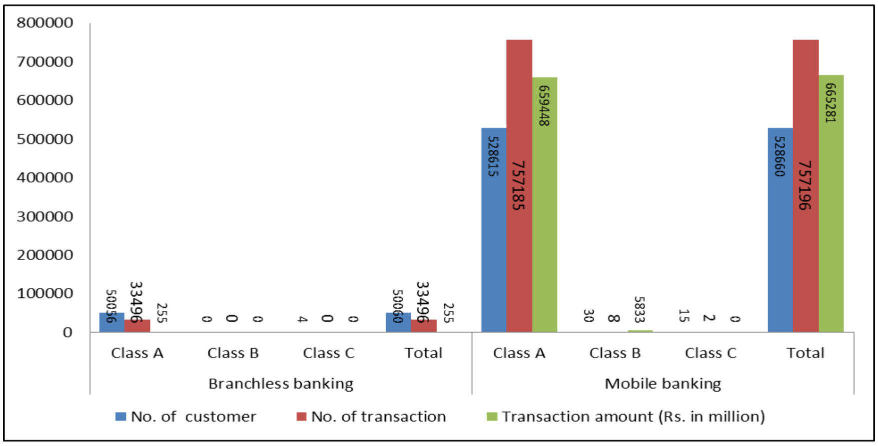
2.24 The growth observed in total numbers of ATM terminals, numbers of debit cards and credit cards issued shows that banking is getting more automated. Similarly, e-money is gaining more popularity. Automation has made the banking more convenient for the users but at the same time, has also introduced a large variety of banking frauds and offences.

Table 2.5: Use of Financial Instruments (Mid-Jan, 2014)

Financial Instruments					Growth (%)			
	Class "A"	Class "B"	Class "C"	Total	Class "A"	Class "B"	Class "C"	Total
No. of ATM	1,279	250	36	1,565	3.23	7.30	33.33	4.40
No. of Debit Card	3,371,282	347,623	36,580	3,755,485	5.58	-2.09	9.02	4.85
No. of Credit Card	54,064	-	-	54,064	40.11	-	-	40.11
No. of Deposit Accounts	9,016,952	2,502,195	612,151	12,131,298	6.37	7.17	3.42	6.38

2.25 Branchless banking and mobile banking are cheaper means of banking system. Significant use of such banking increases access to banking system as well as decreases cost of operation of BFIs. Branchless banking is increasing in terms of number of banking centers and users in each review period. Branchless banking service has emerged as an effective

Figure 2.1: Branchless and Mobile Banking (As of mid-Jan, 2014)



tool to provide retail banking services in rural and semi-urban areas with the facilities providing cash deposit and withdrawal, fund transfers, bill payments and topping up of mobile phone accounts through POS terminals. Branchless banking customers increased by 65.0 percent in mid-Jan 2014 compared to mid-July 2013. But the involvement of "B" class and "C"class BFIs has been zero in such banking activities. Mobile banking services are showing encouraging trend in terms of the number of customers and number of transactions . The number of users increased by 16.7 percent in the first half of 2013/2014. As a result of this, the total transaction amount increased drastically from Rs. 19,997.97 million to Rs. 665,281.00 million.

Interest Rate Stability: Base Rate and Spread Rate

2.26 Interest rate is a very important indicator for the financial stability and investment activities. Too high or too low interest rates are both against the sound health of economy and the financial system. Too higher interest rates squeeze in whereas too low interest rates induce speculative investments, risk to inflation and discourage savings. The fluctuations in market interest rate decrease confidence among investors. Hence, it is necessary to keep interest rate within a moderate range for a durable time period. The concept of interest rate stability explains the same phenomenon of maintaining interest rate within a moderate range for a longer period of time. Interest rate stability has been one of the objectives of NRB. Since 2023 B.S., NRB has been directing BFIs on determining interest rate so as to keep interest rates more or less stable. NRB has time and again come up with different modules related to interest rate determination.

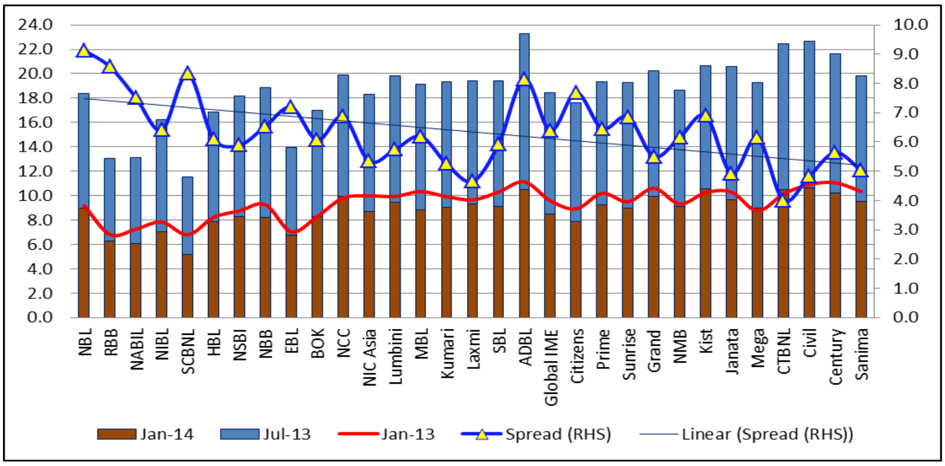
Box 2.1. : NRB's Policies on Interest Rate

1971-72	BFIs can determine the interest rate themselves with the approval of NRB such that the rate is not below the floor rate determined by NRB.
1984-85	Interest rate can be fixed at an additional rate of 1.5 percent or 1 percent to rate provided on saving deposit and fixed deposit respectively.
1986-87	Interest rate can be self-determined within the range of minimum deposit rate and maximum lending rate fixed by NRB.
1992-93	Interest rate can be self-determined both for deposit and lending.
1993-94	Interest spread rate should be maximum of 6.0 percent
1998-99	Weighted average interest spread rate should be maximum 5.0 percent.
2002-03	Interest spread rate limit discontinued.
2013-14	Interest spread rate should not be more than 5.0 percent

2.27 Base rate and interest rate spread are two tools NRB is recently using to ensure interest rate stability. Base rate is the cost of fund banks need to bear since collection of saving till disbursement of loan. It is the minimum rate below which banks are suggested not to lend. Nepalese financial sector has entered into base rate regime from mid-Jan 2013. Banks are required to publish their base rate on a quarterly basis. Since the implementation of base rate regime, base rate of BFIs showed fluctuating trend. Standard Chartered Bank has set the minimum base rate of 5.2 percent and Civil Bank Limited has set the maximum base rate of 10.6 percent in mid-Jan 2014. The maximum base rate in mid-July 2013 was 12.8 percent of ADBL followed by 12.1 percent of Civil Bank Ltd. Among state owned banks, NBL, RBB and ADBL has set base rate of 8.97 percent, 6.3 percent and 10.5 percent respectively in mid-Jan 2014. Their base rates were 9.4 percent, 6.8 percent and 12.8 percent respectively in mid-July 2013. Hence, the base rate for the review period is in declining state. Interest rate spread should either remain constant or decline with the trend in base rate. However, no correlation between base rate and interest rate spread is tracked yet.

2.28 Till date, Nepalese financial sector was set free to fix the deposit and lending rate as determined by market. But abnormal widening of interest rate spread regardless of liquidity position of country has forced the NRB to regulate the spread. Highly risky investment sectors, near-to-two digit inflation, high operating costs, heavy reliance on

Figure 2.2: Base Rate and Spread Rate of CBs

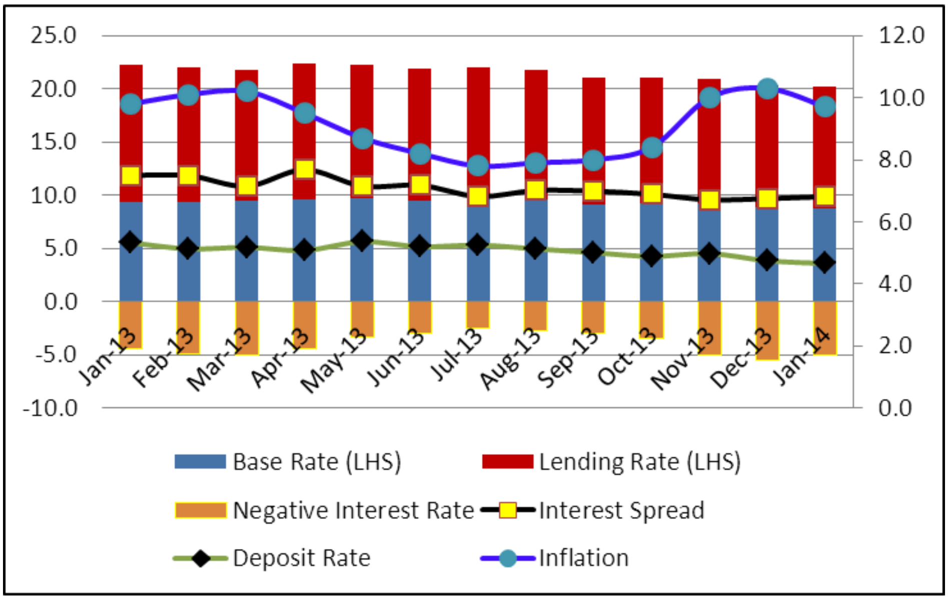


interest income for survival, inefficiency of BFIs, diseconomies of scale due to small market size, poor access to finance weakening the negotiating power of borrowers etc. are seen as the major reasons for the wide interest rate spread in this context. Interest rate spread of state owned banks are higher than that of private banks. Average interest rate spread is still above 6.8 percent in the review period.

2.29 Under such circumstance, with the objective to control randomness in fixing interest spread and to make base rate implementation more meaningful, NRB has decided to regulate the spread. It has directed BFIs to bring their interest spread rate at 5.0 percent by the end of 2013/14. BFIs are also directed to publish their spread in a month-wise basis. Banks seem to be reluctant in decreasing their spread consistently. But, the banks immediately need to act on decreasing the spread or otherwise urgent decrease may have adverse effect on their balance sheets.

2.30 Both deposit and lending rate remained more or less stable in the review period compared to that in mid-July 2013. The liquidity relaxation in the market that continued from 2011 and less investment opportunities for financial sector has declined market

Figure 2.3: Interest Rate and Inflation



interest rate slightly which in turn supported to adjust in interest spread marginally. However, the lending rates could not fall as expected in the review period since mid-Jan 2013. The rate has been declined by 1.3 percentage point to 11.5 percent in mid- Jan 2014 from 12.8 percent in mid-Jan 2013. Moreover, the optimum relaxed liquidity position of the banking sector also encouraged banks to reduce the deposit rate further by 0.6 percentage points to 4.7 percent from 5.3 percent a year ago. What indicates the further decline in the already too low deposit rate (5.3 percent) to 4.7 percent in mid-Jan 2014? Either there is no further demand for credit or banks may have been reluctant to extend the credit in the long term economic projects on which the investors should have to wait for more time to get return on investment. The NRB's effort to reduce the spread and measures to extend the credit in productive sectors may not have been worked well as expected due lack of demand for the credit in productive areas of economic sectors. The price stability situation is out of mark due to various reasons, particularly from the supply side in the past few years and thus the interest rate stability has been dispersed as the general publics have been losing in an average 4.0 percent return on deposit due to higher level of inflation. Likewise, the ineffective base rate system in determining the actual interest rate in lending should also require monitoring in a timely manner.

Size of the Overall Financial System

2.31 Nepalese financial system constitutes of banking system and non-banking system. Banking system includes commercial banks, development banks, finance companies and micro finance financial institutions, cooperatives and FINGOs both performing limited banking activities under the regulatory and supervisory jurisdiction of the NRB. The non-banking system comprises of other financial institutions like pension funds—Citizen Investment Trust (CIT), and provident fund—Employee Provident Fund (EPF) operating under the regulatory jurisdiction of Ministry of Finance. Similarly, it also comprises of insurance companies under the regulatory and supervisory purview of Insurance Board, cooperatives under the purview of Department of Cooperatives and Nepal Stock Exchange Ltd. (NEPSE) and 14 Merchant Banking Institutions under the Security Exchange Board of Nepal (SEBON).

2.32 The rapid growth of BFIs observed in the last couple of years has come to a halt recently. For the last two years, banking system of Nepal is experiencing an encouraging restructuring and consolidation, particularly through the merger. As of mid-Jan 2014, the total number of financial institutions stood at 285 comprising of 176 banks and financial institutions of "A", "B" and "C" categories, 81 financial intermediaries licensed by the NRB, 25 insurance companies and one each of EPF, CIT and Postal Saving Bank. Total number of "A", "B", "C" and "D" class financial institutions increased to 211 in mid-January 2014 from 207 in mid-January 2013. The significant increase in number of micro finance financial institutions ("D" Class) by 12.9 percent has contributed to such an increase in total number of BFIs despite decline of "A" and "C" class BFIs marginally due to merger process in the review period. However, the number of "B" class financial institutions reached to 87 in mid-Jan 2014 from the 86 in mid-Jan 2013.

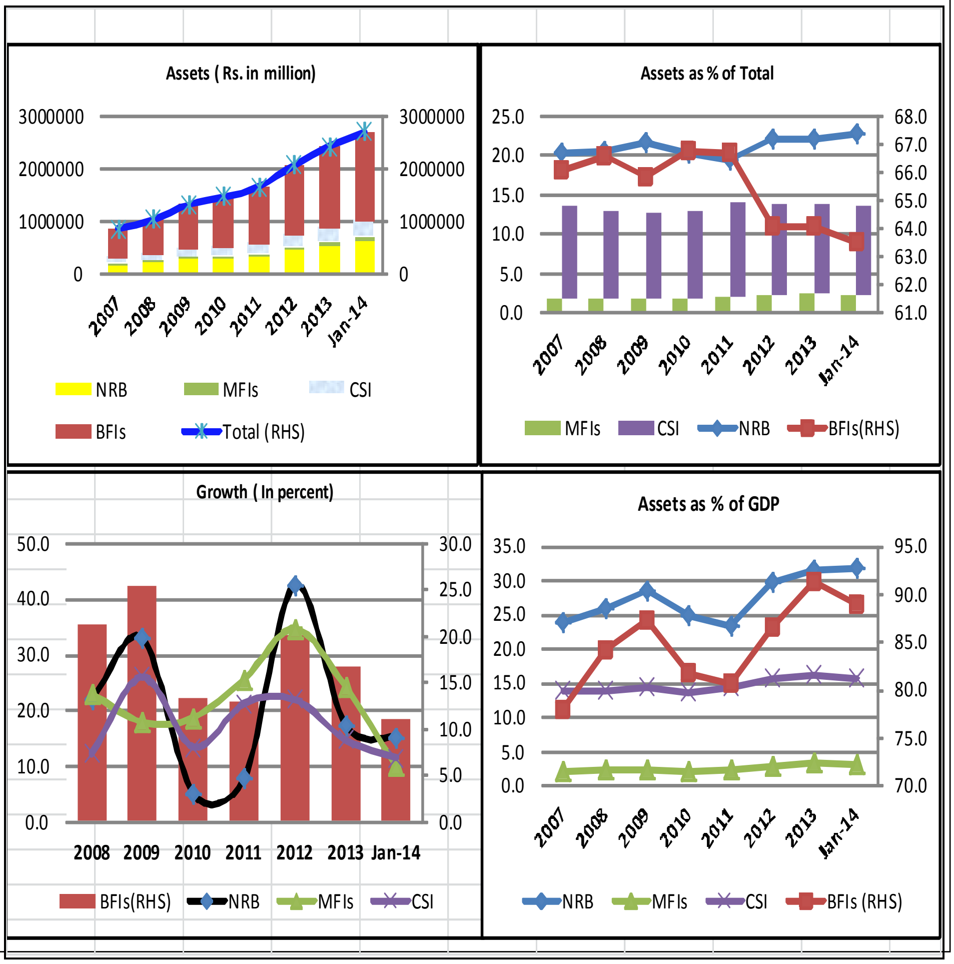
Table 2.6: Number of BFIs and Other Institutions

Banks and Financial Institutions	July 2012	January 2013	January 2014
Commercial Banks	32	31	31
Development Banks	90	86	87
Finance Companies	67	59	58
Micro Finance Financial	25	31	35
Sub-Total	**214**	**207**	**211**
NRB permitted Cooperatives	16	18	16
NRB permitted FINGOs	34	31	30
Insurance Companies	25	25	25
Employees Provident Fund	1	1	1
Citizen Investment Trust	1	1	1
Postal Saving Bank	1	1	1
Total	**292**	**284**	**285**

2.33 The total size of banking and non-banking financial institutions in GDP continued to expand in the review period compared to that in mid-July 2013. The ratio of total assets & liabilities of Nepalese financial system reached 139.8 percent of GDP in mid-Jan 2014. Such ratio stood at 124.0 percent if only BFIs including NRB are taken into account. Total assets and liabilities of commercial banks remained at 70.8 percent of GDP followed by the NRB (31.9 percent), development banks (12.2 percent), finance companies (5.8 percent), MFFIs (2.2 percent), cooperatives (0.9 percent), and FINGOs (0.2 percent). Further, such ratio for contractual saving institutions stood at 15.8 percent comprising 8.3 percent of EPF, 2.5 percent of CIT, 4.9 percent of insurance companies and 0.1 percent of postal saving bank.

2.34 In terms of total assets and liabilities in mid-Jan 2014, banks and financial institutions represented 88.7 percent of total financial system of Nepal. Such share stood 11.3 percent for the contractual saving institutions. In terms of share in total assets, the commercial banks remained the key player in the financial system occupying 50.6 percent of the system's total assets followed by NRB (22.8 percent), development banks (8.8 percent) and finance companies (4.2 percent). In case of contractual saving institutions, on the same basis, EPF was a dominant institution (5.9 percent), followed by CIT (1.8 percent), insurance companies (3.5 percent) and postal saving banks (0.1 percent) as of mid-Jan 2014. The share of MFFIs including the saving and credit cooperatives accounted for 2.3 percent including 1.6 percent of MFFIs, 0.1 percent of micro-credit non-government organizations (FINGOs) and 0.6 percent of saving and credit cooperatives permitted by the NRB undertaking for limited banking transactions.

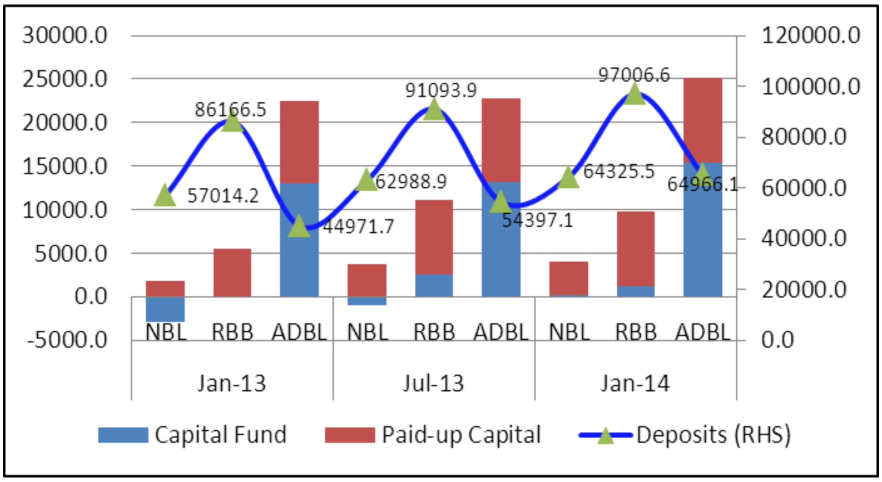
Figure 2.4: Structure of the Financial System (Mid-Jan, 2014)



Performance and Reform of State Owned Banks

2.35 Nepal Bank Limited (NBL), Rastriya Banijya Bank (RBB) and Agriculture Development Bank Limited (ADBL) are the three state owned commercial banks, which occupied 15.9 percent share in GDP in terms of total assets & liabilities among the BFIs ("A", " B" and "C" class). The share of BFIs with the GDP in aggregate in terms of total assets & liabilities reached to 88.8 percent in mid-Jan 2014.

Figure 2.5: Capital Fund, Paid-up Capital and Deposits of SOBs (Rs. in million)



2.36 The state owned commercial banks are serving 26.0 percent of total deposit account holders and 44.0 percent of total borrowers. Their market share in terms of total assets stood at 17.9 percent whereas in total deposit and loan & advances reached to 16.7 and 14.5 percent respectively in mid-Jan 2014. Hence, the market share as well as the share with assets & liabilities to GDP in aggregate balance sheet of financial sector explains the impact that state owned banks can levy on financial stability of Nepalese financial system. Although, financial and regulatory position of ADBL, especially in terms of capital base and capital adequacy remained satisfactory NBL and RBB had faced the difficult situation since a decade; however the financial soundness indicators, especially the assets quality have been gradually improving in this period. The reform of these two state owned banks have been one of the objectives of financial sector reform in the past and it has established a positive impact despite many others dissatisfactory results in the financial sector regulation and supervision in overall.

2.37 The reform process of two state owned banks-NBL and RBB that was gaining momentum till mid-July 2013 started to slow down right from August 2013. Capital base of NBL is increasing and has turned positive but capital base of RBB declined in the review period due to increase in retained earnings by negative figure. The capital base of NBL, RBB and ADBL as for mid-Jan 2014 are Rs. 130.65 million, Rs. 1.27 billion and Rs. 15.45 billion respectively. The capital was Rs. -964.16 million, 2.50 billion and 13.13 billion respectively as in mid-July 2013.

2.38 The total paid up capital of RBB has already met the target of Rs. 8.5 billion in mid-July 2013. However, on contrary to the plan of increasing core capital to Rs. 2.4 billion by mid-July 2013, it has reached its core capital only to Rs. 1.7 billion by mid-Jan 2014. Similarly, total capital reached Rs. 1.27 billion in comparison to planned Rs. 4.44 billion in mid-Jan

2014. The reduction in actual capital is due to negative retained earnings of Rs. 8.59 billion. Total capital adequacy ratio and core capital adequacy ratio remained 3.1 percent and 2.3 percent respectively in mid-Jan 2014 whereas it was planned to be 4.2 percent and 7.8 percent respectively.

Box 2.2: Completed Task of RBB Capital Plan

- Bank has converted 1.0 percent preference share that it held, into ordinary share.
- The dividend on such share that is payable to government is capitalized.
- The SDR loan obtained from World Bank with maturity period of 30 years has been capitalized.
- Debenture equal to 50.0 percent of core capital has been issued to increase supplementary capital and thus to increase total capital.
- However the merger plan with NIDC development bank has been cancelled due to policy amendment by government.

2.39 As per the capital plan of NBL for 2013/14 to reach total capital to Rs. 603.24 million, total capital has crossed the target and reached Rs. 663.26 million in mid-Jan 2014. Comparing to the target of Rs. 4.0 billion, paid-up capital reached Rs. 3.96 billion and the deficit amount is due to the pending allotment of shares to its staff members. Capital adequacy ratio is 0.9 percent in comparison to the target of 0.8 percent and NPA ratio is 5.6 percent in comparison to target of 5.8 percent. Therefore, these encouraging indicators towards gradual improvement of NBL reflects the positive symptom in the banking sector reform in Nepal.

Box 2.3: Completed Task of NBL Capital Plan

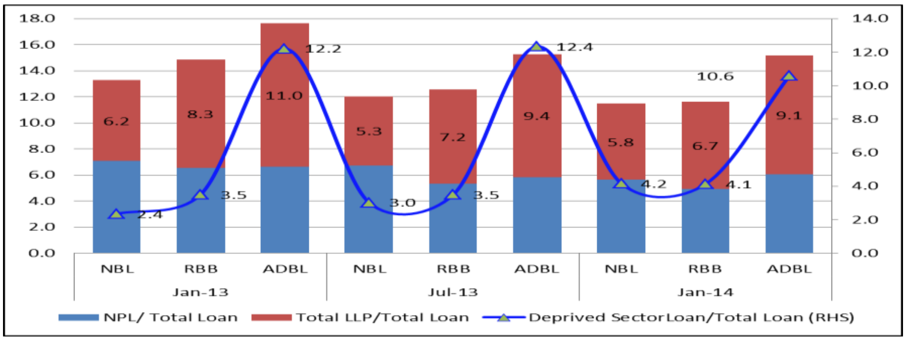
- Bank has issued right share to accumulate the necessary capital. Nepal government purchased the right share in proportion to the share owned by government and 5.0 percent of the share is in the process to be distributed among the employees of the bank.
- Bank is under the process to sell its NBA and request government to exempt the capital gain tax on such sales and if such tax is not exempted, then to request government to invest amount equivalent to tax amount in such right share issued.

2.40 In aggregate, the credit expansion by state owned banks is 63.1 percent of total deposit in the review period which is far below the regulatory limit of 80.0 percent. However, credit to deposit ratio of ADBL is beyond the limit i.e. 89.2 percent. The ratio was 107.9 percent in mid-Jan 2013 and 101.0 percent in mid-July 2013. The risk part is still not minimized in state owned banks in terms of assets & liabilities management. Similarly, these banks have poor risk analysis while making investment and credit flows to the customers.

2.41 NPL ratio of state owned banks is improving from 6.7 percent in mid-Jan 2013 to 5.6 percent in mid-Jan 2014. NBL, RBB and ADBL have the NPL ratio of 5.6, 4.9 and 6.1 percent

Figure 2.6: Non-performing Loan and Loan Loss Provisioning of SOBs

(In percent)



respectively. If NPL ratio of NBL and ADBL could be brought within the regulatory limit of 5.0 percent, NPL ratio of banking industry can further be decreased from current ratio of 4.3 percent. Along with improvement in NPL ratio, LLP to total loan is also improving showing a declining trend from 8.8 percent in mid-Jan 2013 to 7.4 percent in mid-Jan 2014. The decline is due to decreased NPL that require more provisioning but increased performing loan that require less provisioning.

2.42 State owned banks have a large branch network coverage in financial system that cover 33.9 percent of total commercial bank branches as of mid-Jan, 2014. Their branches increased from 506 in mid-July 2013 to 511 in mid-Jan, 2014. There are only 80 ATMs of state owned banks operating throughout the country that shows their slow and poor response towards automation of banking system.

2.43 State owned banks are the major investors in deprived sector lending among BFIs. Though aggregate industrial average of deprived sector lending is 4.7 percent of the total loan, state owned banks have invested 6.7 percent of their total loan in mid-Jan 2014. The investment percent is more or less constant from mid-Jan 2013.

2.44 State owned banks highly rely on interest based income. Out of total income 82.4 percent of total income is contributed by interest income and cost management and efficiency of state owned still remain very poor compared to the private sector banks and with the international standards. However, an encouraging improvement has been noticed in operating expenses of RBB these days. The operating expense that was 446.08 million in mid-Jan 2013 has been declined to 254.27 million in mid-Jan 2014. Such reduction resulted in aggregate deduction of operating expenses of state owned banks to 638.51 million in mid-Jan 2014 from 718.96 million in mid-Jan 2013.

2.45 Hence, state owned banks hold a major portion of share in total banking sector. The ups and downs in performance of these banks can alter the performance indicators of banking system as a whole. Therefore, timely reform of these BFIs is must for improving the performance indicators of financial sector and maintaining the financial stability. Likewise, the quality of manpower which is a key for the success of these banks, require to re-structure and continue to recruit new manpower from the market and replace the old manpower with the new talent and energetics.

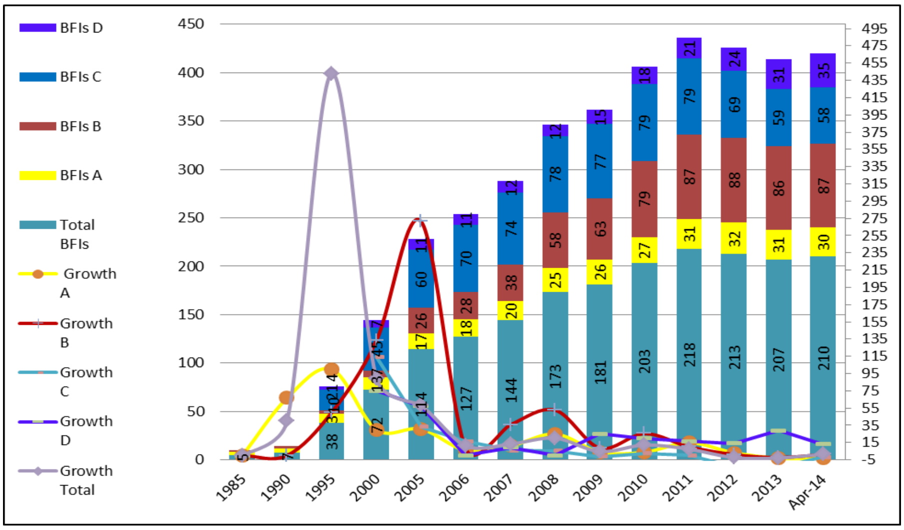
Structure and Performances of Nepalese Banking System

2.46 Nepalese banking system in terms of number and structure changed significantly since 1985. The establishment and growth of number of BFIs reached its peak in 1995 to 38 from only 3 BFIs till to 1985. The impact of economic liberalization and its direct impact on the financial sector have been observed in that period in terms of establishment of banks and financial institutions. Then after along with the pace of financial liberalization, the establishment of BFIs took its speed each year and the number of BFIs reached to 218 in 2011. While the global financial system was deeply ridden in a risk with the financial crisis, Nepalese financial institutions were rapidly emerging with the argument and support from the policy makers that Nepal will not get affected by such crisis as its economy is not directly linked with those crisis ridden institutions and economies.

2.47 Nepal experienced a notable growth in the number of BFIs in a very short span of time but at the same time the size of economy did not expanded as expected. The regulator and supervisor of the banking system was not able to develop and expand its capacity to supervise those BFIs during that period nor was able to conduct any research and studies about the future of Nepalese banking sector stability and its direction. The unwanted adverse impact was straight forward as supposed in the financial sector and it was experienced since 2010, as many BFIs get started to be in trouble and unable to return the public deposit and many more BFIs get affected adversely from the excessive exposure to short term real estate financing as well as lack of good corporate governance during that period.

2.48 The pace of establishment of BFIs stopped in 2012 after the moratorium for licensing adopted and consolidation process of banking sector was adopted in 2011. Another regime in the financial sector policy has been adopted with the merger and acquisition policy to support the objective of reducing the number of BFIs. Again, it is very difficult to predict about the stance and direction of Nepalese financial sector where it is going and reach as there is always lack of sound and prudential licensing policy as well as very much conflicting objectives, goals and function of all types of BFIs. A stable financial system is

Figure 2.7: Number of Banks and Financial Institutions Licensed By NRB



determined by a sound and strong banking system as it brings with it a greater percentage of share in the total financial system of each in country globally. Nepal cannot separate from that universal landscape of financial sector structure but always lacks the clear vision and strategies and it is expected that the upcoming financial sector development strategies, the amendments of BAFIA and NRB Act as well as related laws and legislations will mark about all these aspects related to the financial sector structure and adopt a long term financial sector vision and strategies with concrete policies/actions without changing the regulatory regime in a short period of time.

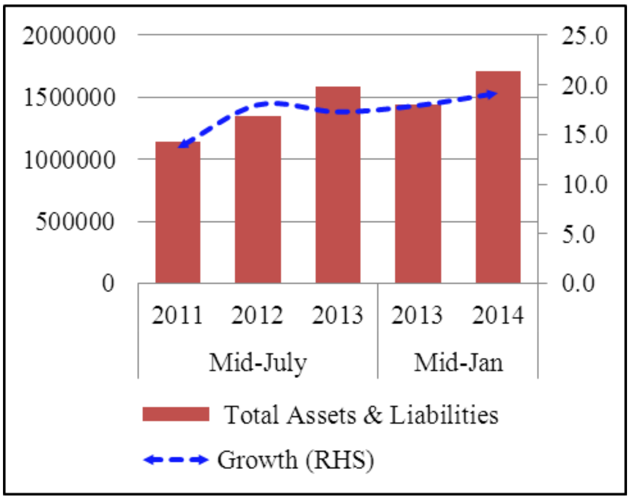
2.49 In the context of initiation of economic reforms in general and changes in policies and regulations of the banking sector in overall, the market structure of Nepalese banking sector, conducts of the banks and their performance, especially during the last decade has changed, though the changes have not been significant in every aspect, particularly with the economic development and growth. There exist strong inter-linkages amongst structure of the market, banks' conduct and their financial performance. While market share of a bank depends directly on its market size, asset base, selling efforts, and past financial performance, its selling efforts vary directly with market share, asset base, and past financial performance. On the other hand, returns on assets of a bank vary directly with its market share, but inversely with its asset base and selling efforts. The nature of ownership has significant influence on market share, selling efforts and financial performance of the banks. As compared to the state owned banks, market share of the private banks is comparatively not so much strong in Nepal. But private banks make greater selling efforts which helps them to have better financial performance compared to their public sector counterparts in Nepal.

2.50 The number of banks within it the Nepalese banking system contracted recently. Activities in the system expanded in terms of the types of banking services offered, financial instruments supplied, and distribution channels via which services and products are offered to the public. The process of change from government ownership and reversion to private ownership in the banking system continued. The competition between the banking system and non-banking financial institutions (which constitute a competitive threat) increased during the years, but is still low by worldwide standards. However, the concentration of the banking sector increased, continuing a trend that has been evident after the 1990s.

2.51 The size of the balance sheet (total assets and liabilities) of BFIs expanded significantly in the review period by 19.2 percent and reached to Rs. 1713.2 billion. The major components of liabilities of the BFIs constituted by deposits, other liabilities, capital fund and borrowings. Total deposit constituted by 79.0 percent share while other liabilities and capital fund constituted by 11.0 percent and 8.5 percent in total composition of liabilities structure of BFIs. Likewise, borrowings and bills payable constitutes only 1.4 and 0.1 percent share respectively. Total deposit of the BFIs grew by 20.3 percent and reached to Rs. 1353.1 billion in mid-Jan 2014. Capital fund which is one of the major components of BFIs grew by 14.0 percent in the review period as compared to 14.4 percent in mid-July 2013. The paid-up capital, a major

Figure 2.8: Total Assets & Liabilities of BFIs

(Rs. in Million)



item of capital fund grew by 11.4 percent and reached to Rs. 124.5 billion in the review period bearing about 7.0 percent share in total liabilities structure of BFIs. The relaxation in liquidity and high growth of remittance income brought positive impact in higher deposit growth of BFIs. Similarly, the NRB's policy to reach the paid-up capital as per the regulatory capital requirement of BFIs also supported BFIs to expand the balance sheet in the review period. From the point of financial stability perspectives BFIs are not adequately capitalized to absorb the shocks as they hold higher percentage of deposits on their total liabilities portfolio. The BFIs may face a difficult situation in case of abnormal shocks with deposit withdrawal, hence it is recommended to increase the capital base of BFIs and make them financially strong and sound with higher capital fund constituted by paid-up capital and general reserve.

Table 2.7: Major Balance Sheet Indicators of BFIs (Rs. in million)

Indicators	Mid-Jul 2011	Mid-Jul 2012	Mid-Jul 2013	Mid-Jan 2012	Mid-Jan 2013	Mid-Jan 2014
Capital Fund	103407.5	115162.9	131723.8	108783.3	23822.1	145113.1
Deposits	869951.4	1071394.1	1250060.8	952724.3	136930.1	1353132.4
Loan & Advances	698778.9	779560.9	945698.7	728369.9	115243.8	1028038.9
Non-Banking Assets	1549.6	2225.1	3731.3	551.9	334.1	4099.7
Office Operating Expenses	10983.4	12059.1	14717.3	5572.1	6521.3	6598.8
Provisioning	11094.1	14165.8	14852.4	8796.9	8565.1	8116.1
Net Profit	20643.7	19783.3	25977.7	7188.5	10082.7	12333.5

2.52 The bank, which is completely safe for the depositors and possesses an optimal asset and liability structure, is just one of the several steps in designing the optimal structure. There are several types of models in the literature that consider the optimization of the banking assets and liabilities structure. First, there are models, which mathematically describe what could be an ideal bank, but are not in themselves proved sound in the real existence to mitigate the risk. The financial crisis of 2008 had underscored the fact that sophisticated asset and risk management models can still prove inadequate for ensuring that banks asset portfolios have adequate quality. Recognizing that every bank has to operate under constantly changing circumstances it is useful to regularly review optimal asset and liability structure, because asset profitability and liability costs are likely to change. For example, minimizing cash holdings and claims to the central bank, which are not interest bearing and thus do not generate any income, placing funds on the interest bearing correspondent accounts and providing interbank loans to increase profitability, creating a portfolio of highly liquid investment-grade securities from local and foreign issuers, which provides profitability that is higher than money market rates, placing funds in the short-term financial instruments on the international financial market with fixed income and risk parameters are some of the recent best practices in the area of management of assets and liabilities structure in the banking institutions.

2.53 In case of Nepal, currently, there is no clear understanding of how banks choose their capital structure and what factors influence their corporate lending behavior. Lending at large banks is less subject to changes in cash flow and capital and shift in deposit supply affects lending at small banks that do not have access to large internal capital market. Similarly, large banks following mergers tend to increase their lending. Bank size seems to allow banks to operate with less capital and, at the same time, engage in more lending in Nepal is more risky from the financial stability point of view and with the international comparisons. Similarly, banking institutions do not care to establish a sound link between risk management, capital structure and lending, is another challenging missing part in assets and liabilities management of banks.

2.54 The assets structure of banking industry has been constituted by loan and advances bearing about 60.0 percent share in total assets structure. Other assets item includes liquid funds, non-banking assets, investments, fixed assets and other assets. The non-banking asset has been also in the increasing trend in the recent days due to increase in provisioning and risk weighted assets of BFIs. The large percentage of assets and liabilities structure of the BFIs has been constituted by deposits and loan and advances. Although, large percentage share of total deposit is formed with fixed and saving accounts and comparatively lesser with current, call and other, the banks capacity of managing the assets has been largely dependent upon sustainable sources of deposit collection and betterment in quality of loan and advances. All assets, except fixed assets, mainly loans and advances affects profitability positively, while negative net-worth have significant negative effect on profitability.

Figure 2.9 : Assets Structure of BFIs

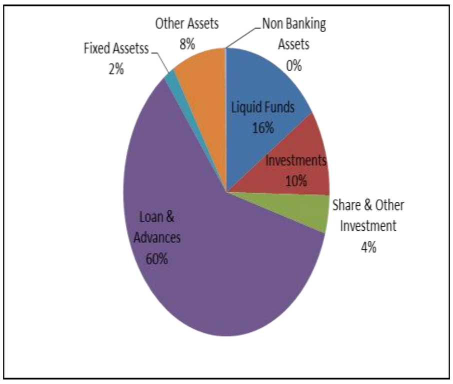


Figure 2.10 : Liabilities Structure of BFIs

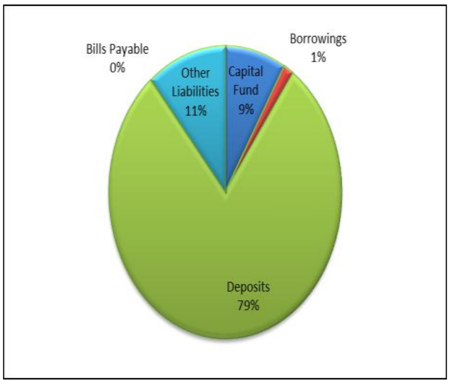
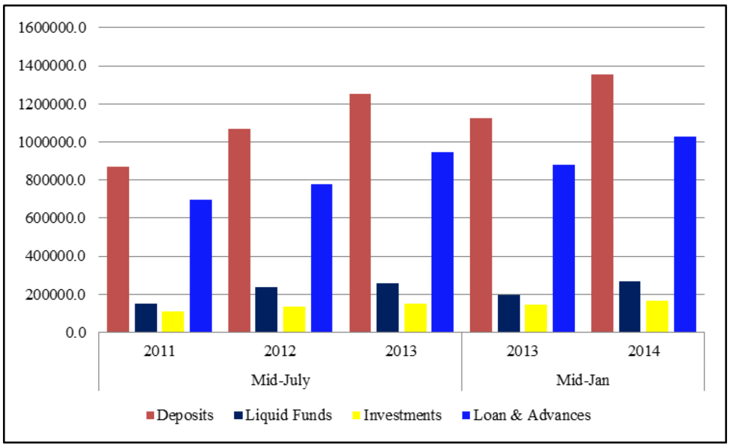
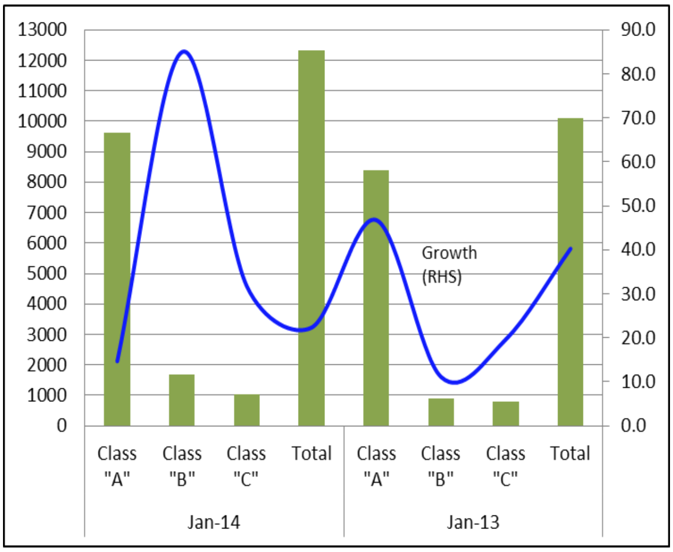


Figure 2.11: Major Balance Sheet Indicators of BFIs
(Rs. in million)



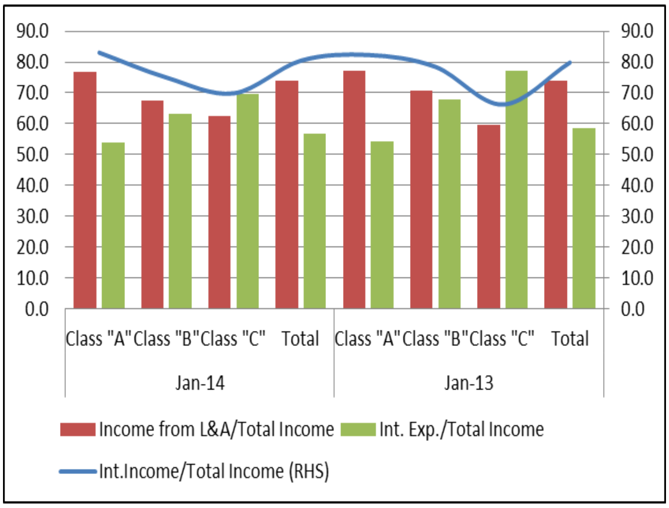
2.55 Therefore, BFIs should focus on sustainable source of deposits and this will enhance their performance in provision of loans and advance. Amongst the major assets items of the balance sheet, growth of loan and advances stood at 16.8 percent in the review period against the growth of 21.3 percent in mid-July 2013. Whereas, total deposit grew by 20.3 percent in the review period against 16.7 percent growth in mid-July 2013. As a result, deposit growth in the review period with the favorable external sector surplus, the overall liquid fund of the banking system grew by 37.5 percent against the growth of only 9.8 percent in mid-July 2013. The higher growth of liquid fund in the banking system contributed to excess liquidity in overall by mounting the balance with the NRB with 68.0 percent as compared to the growth of 8.6 percent in mid-July 2013. The excess surplus of liquidity in the banking system significantly increased the cost of fund and made reluctant the banks to decrease the interest rate in credit and keep maintaining the higher spread in the review period.

Figure 2.12: Net Profit of BFIs (Rs. in million)



2.56 Most financial institutions in the country, including some established few banks, reporting encouraging financial performance for the second consecutive quarter of the current fiscal year, stakeholders of these institutions and the banking industry as a whole are expressing satisfactions about the future of Nepalese banking sector. The overall profitability of the banking sector increased by 22.3 percent to Rs. 12.33 billion in mid-Jan 2014 from the level of Rs. 10.01 billion in mid-Jan 2013. The commercial banks profitability constituted by 78.1 percent share to Rs. 9.6 billion in the total profitability of the banking sector. The high gap between the interest charged on loan and advance, and deposits, the banks' net interest income has increased in the review period. Apart from it, the increase of credit demand from the private sector, especially the industrial production sector, construction sector, wholesale and retail sector, transportation, communications, and public services sector in spite of the fragile economic condition, also backed the banking sector, in coming out with a such favorable growth.

Figure 2.13: BFIs Share of Income/Total Income
(In percent)

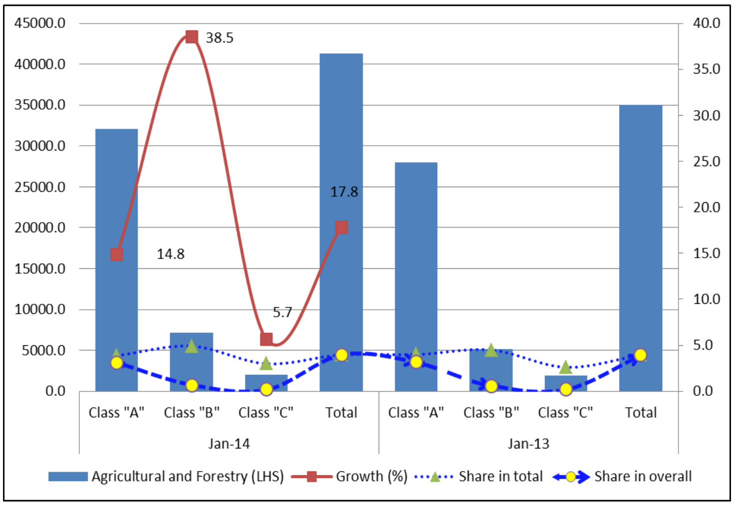


2.57 The growing competition among the BFIs and the noticeable increase in the number of banks and financial institutions have saturated the market share, which a few years back used to be above 50.0 percent, for the few top commercial banks. In spite of the diversification of market share, not all BFIs have been able to earn profit and increase in the profitability situation due to increase in provisioning upon bad loans. And even those banks that have shown positive results have earned their profits from write-back of provisioning made earlier and not from their regular banking business. However, there seems to be certain other structural and fundamental factors that are adversely affecting the profitability of the sector in a more permanent way. And a lot of these factors have to do with more stringent regulations aimed at making the financial system safer and more resilient. For instance, a restriction on a bank's credit-deposit ratio, despite of lowering CRR in 2013/14 left banks with lesser funds at their disposal for lending, has also increased the cost of fund and excess liquidity by constraining the capacity of BFIs. Therefore, such prudential measures require re-checking before to go for implementation and ask compliance for BFIs.

2.58 Traditionally, Nepali banks generated higher returns through wide margins and core lending spread. However, the era of cheap-money under the low interest rate regime and high leverage banking model that delivered high returns with low risks through the last decade saw a decisive end. As in around the world, the banking sector in Nepal is witnessing a phase of re-regulation in which BFIs will operate under a tougher regulatory environment than they have experienced in the past. Likely, provisions will include making banks raise extra capital to increase their buffer against losses, and to use less short-term borrowed money to finance their businesses, which in turn would make them less vulnerable to crunches and crises. The low business volumes, rising funding costs and the increased regulatory costs of higher capital levels and liquidity buffers are the new normal to banks in these days.

2.59 Total credit of BFIs sector-wise, product-wise and security-wise increased by 17.1 percent in mid-Jan 2014 from the level of Rs. 887.26 billion in mid-Jan 2013. In the review period, such exposure of commercial banks increased by 18.1 percent and development banks by 26.7 percent against the decrease of 7.8 percent of finance companies. Similarly, the credit to private sector from BFIs increased by 17.5 percent in the review period compared to a growth of 23.5 percent in mid-July 2013 Whereas, the credit to private sector from BFIs increased by 17.3 percent in mid-Jan 2014 compared with mid-Jan 2013. Of the total credit from BFIs, the credit to industrial production sector increased by 19.5 percent to Rs. 212.91 billion, forming 20.1 percent share in total credit exposure of BFIs. Similarly, credit to agriculture sector increased by 17.8 percent to Rs. 41.32 billion. However, the share of agriculture sector on total credit exposure remained just about to 4.0 percent by constituting 3.1 percent, 0.7 percent and 0.2 percent of commercial banks, development banks and

Figure 2.14: Credit from BFIs to Agriculture and Forestry Sector
(Rs. in Million)



finance companies. In the review period, the credit to construction sector increased by 20.4 to Rs. 105.69 billion, and to wholesale and retail trade sector by 22.2 percent to Rs. 224.64 billion. Out of total credit, sum of real estate credit (including the residential housing loan) increased by 26.6 percent, constituting 15.3 percent share in mid-Jan 2014 against 16.5 percent share in mid-Jan 2013.

2.60 The residential housing loan which is accounted out of real estate loan increased by 32.9 percent in mid-Jan 2014 whereas the real estate loan decreased by 6.3 percent in the same period. Similarly, margin loan and hire purchase loans increased by 13.0 and 14.7 percent in mid-Jan 2014 bearing only 7.0 percent share in total credit exposure of BFIs.

Figure 2.15: Credit from BFIs (Rs. in Million)

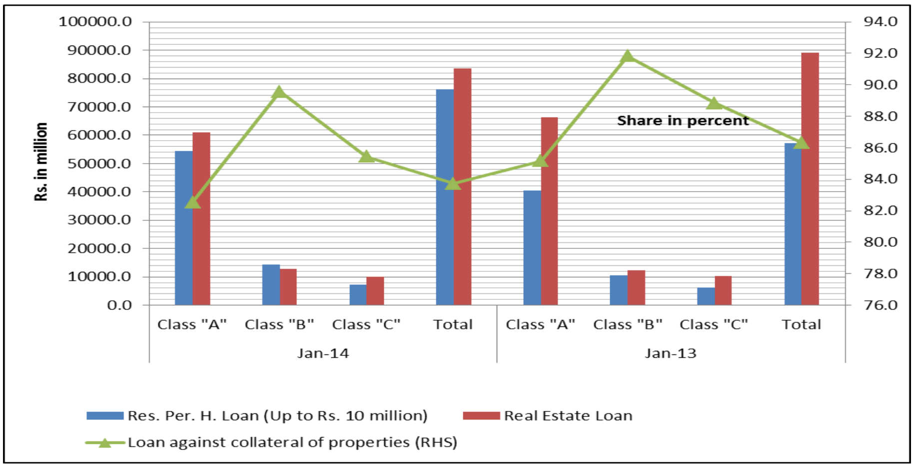
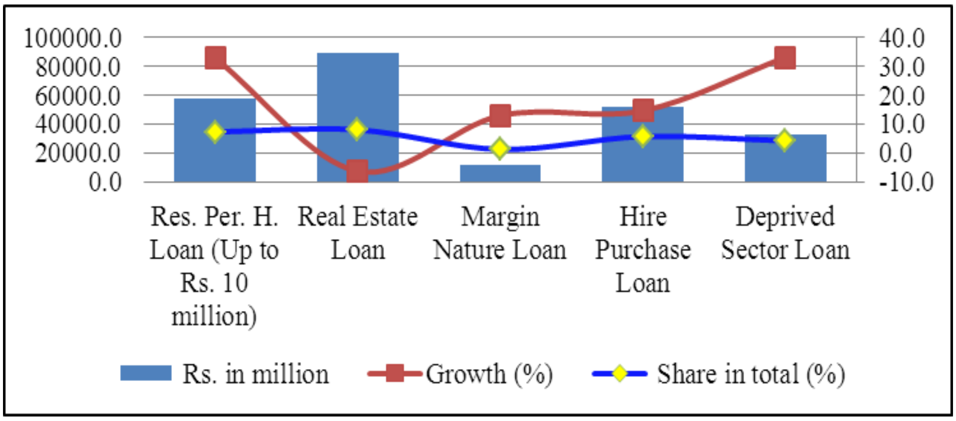


Figure 2.16: Main Sector-wise credit from BFIs (Rs. in Million)



The deprived sector loan, an important loan among the product-wise loan of BFIs increased by 33.2 percent to Rs. 33.1 billion in mid-Jan 2014 forming just 4.2 percent share in total credit exposure of BFIs. Therefore, while viewing the credit exposure of BFIs, the real estate and margin nature credit is coming down to desirable limit, however if the real estate exposure added to residential housing loan, it is still high which may create risk to financial stability if house prices fall down. On the another side, although the credit exposure to risky areas of economic sectors has been coming down , the loan against collateral of land and building (properties) is still high bearing more than 80.0 percent share in total.

Figure 2.17: Product-wise Credit Exposure from BFIs (Mid-Jan, 2014)

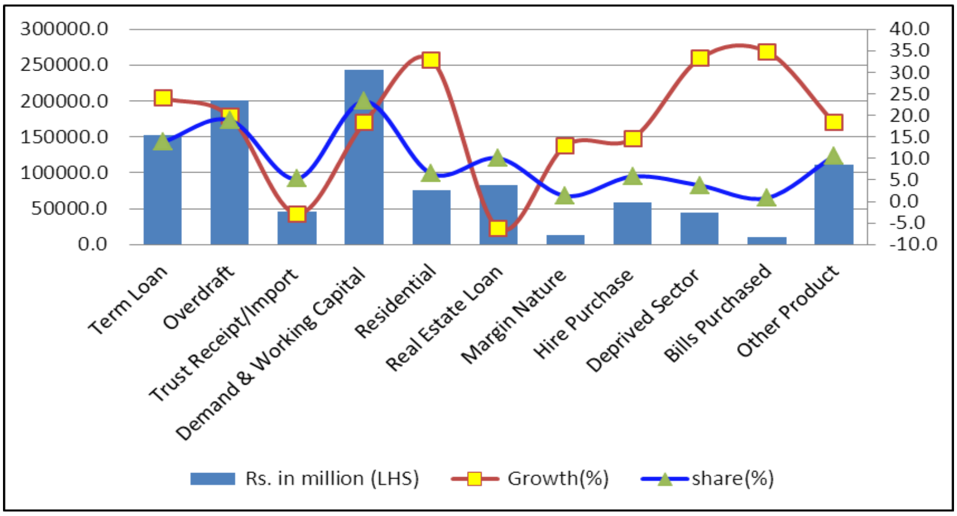
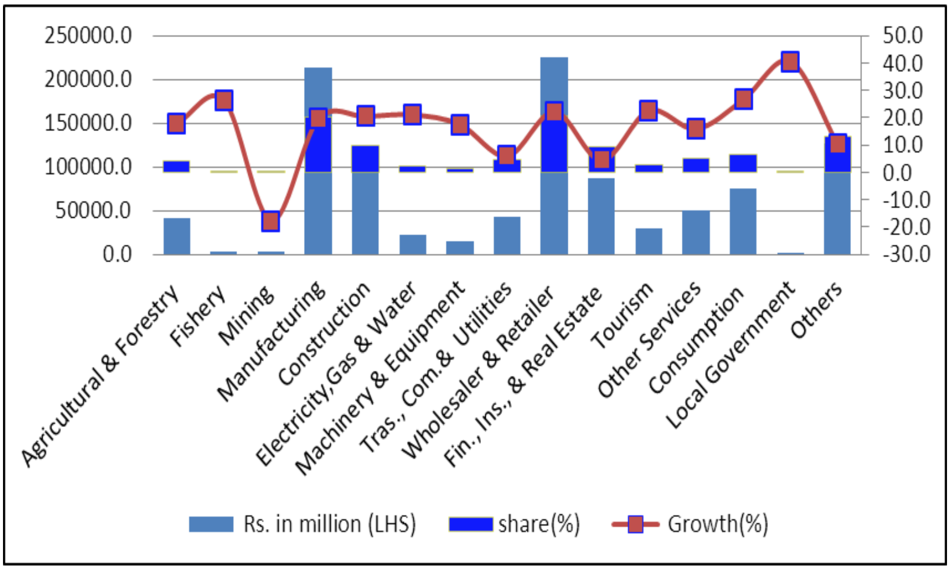


Figure 2.18: Sector-wise Credit Exposure from BFIs (Mid-Jan, 2014)

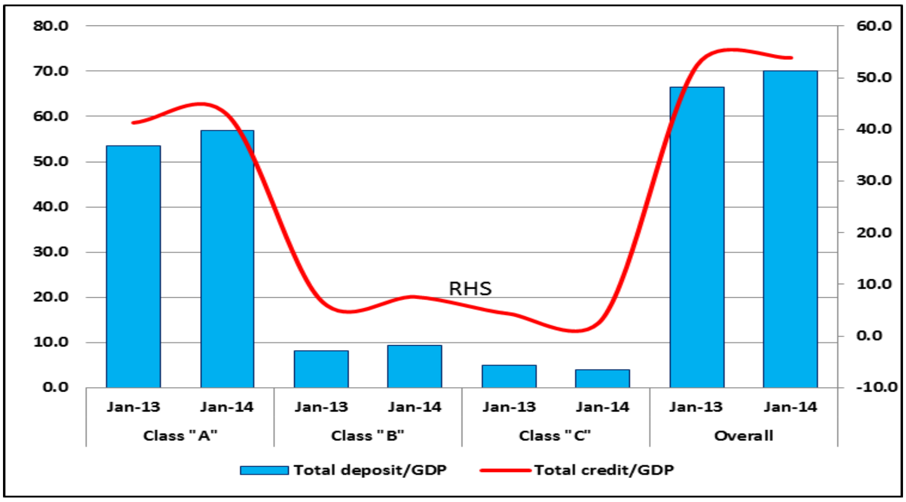


Financial Soundness Indicators (FSI)

2.61 As of mid-Jan 2014, the share of total deposit to GDP reached 79.5 percent in comparison to 73.5 percent in mid-July 2013. Similarly, share of total credit to GDP reached 61.1 percent. Factors such as mergers, IPO issuance by new banks, and increment in paid-up capital by banks as per their capital plan continued the increment in paid-up capital and total capital as well. Paid-up capital increased from Rs. 119.50 billion in mid-July 2013 to Rs. 124.46 billion in mid-Jan, 2014. Similarly, total capital increased from Rs. 131.33 billion in mid-July, 2013 to Rs. 145.11 billion in mid-Jan 2014. In mid-Jan 2014, the major banking sector indicators of BFIs showed an improved situation. The overall share of total deposit to GDP ratio, credit to GDP ratio and total credit to total deposit ratio continued to increase. The overall liquidity position of BFIs as measured by cash and bank balance to total deposit ratio slightly declined mainly due reduction in CRR and increment in credit to total deposit ratio. In total deposit, saving deposit contributed a largest share followed by fixed deposit and current deposit. The investment in government securities also remained satisfactory contributing by around 12.0 percent in the review period.

2.62 The overall banking sector indicators related with credit and deposit expanded in the review period partly due from the increase of deposit in the banking sector. The total

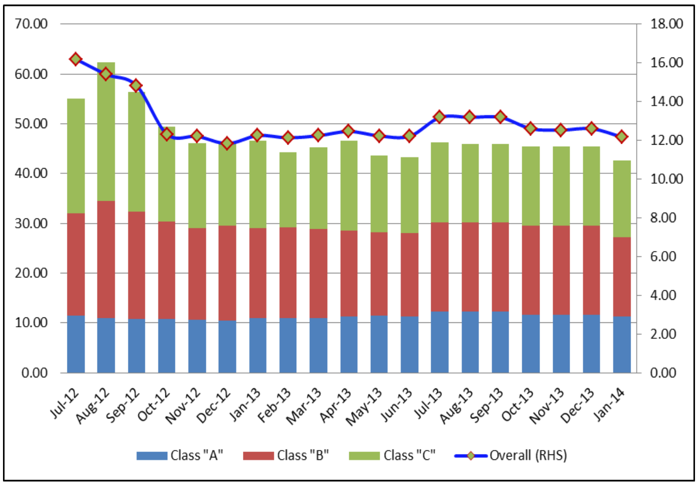
Figure 2.19: Deposit and Credit as percentage of GDP



deposit as percentage of GDP reached to 70.2 percent while credit as percentage of GDP stood at 53.9 percent. The higher growth of deposit in the review period pushed up the total deposit of the banking system as compared with the total credit. The standard credit to deposit ratio of the banking sector remain below the NRB regulatory requirement indicating that most of the BFIs deserves the capacity to extend further credit if demanded from the economic sectors. However, the credit to deposit ratio of "B" and "C" class institutions in totality exceeds the NRB regulatory provision. The NRB's methodologies of monitoring the credit to deposit ratios of the banking sector do not match with the international best practices of calculation and understate the ratio which stood below 69.0 percent in the review period. From the financial stability point of view, NRB should reconsider revising such methodology to promote the prudential regulation and supervision as well as to follow the international best practices.

Capital Adequacy

Figure 2.20: Capital Adequacy Ratios of BFIs



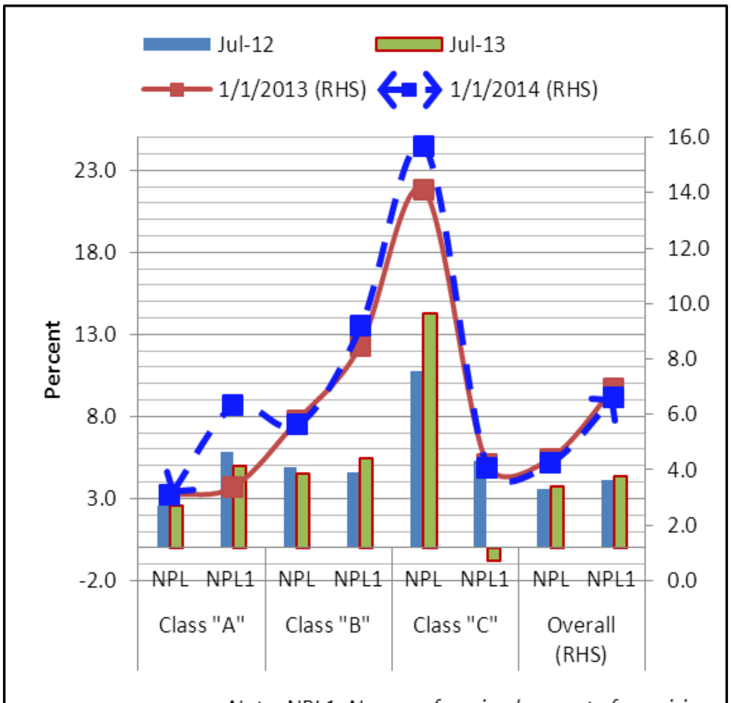
2.63 Regulatory capital adequacy ratio (CAR) for commercial banks, development banks and finance companies stood at 11.0 percent, 10.0 percent and 10.0 percent respectively in mid-Jan 2014. Similarly, commercial banks, development banks and finance companies need to maintain regulatory requirement of paid-up capital of Rs. 2.0 billion, Rs. 640 million and Rs. 200 million respectively. Total capital adequacy ratio (CAR) of the banking system stood at 12.2 percent in mid-Jan 2014, compared to 13.2 percent in mid-July 2013. Among two state owned banks - NBL and RBB, both banks' total capital has increased from negative figure to positive figure. However, total capital of RBB decreased in comparison to the figure in mid-July 2013 due to negative retained earnings. This decrease in capital also led to decreased aggregate CAR in the review period.

2.64 The commercial bank's CAR reduced to 11.3 percent. The decrease in CAR of development banks to 15.9 percent and that of finance companies to 15.4 percent also led to decrease in aggregate CAR. It was 17.9 percent and 16.1 percent respectively in mid-July 2013. The deteriorating capital adequacy ratio for "B" and "C" class institutions was due to negative capital, particularly of problematic banks and finance companies in the review period. However the overall CAR of “A”, "B" and "C" class financial institutions remained above the standard requirements set by NRB which indicates that financial sector is still well capitalized.

Assets Quality

2.65 NRB opt keep the NPL ratio within 5.0 percent. The total NPL ratio of BFIs declined marginally to 4.3 percent in mid-Jan 2014 from the level of 4.4 percent in mid-July 2013. The total NPL of finance companies declined to but was still at the highest at 15.7 percent. However, such ratio was 4.6 percent for development banks and to 2.6 percent for commercial banks in mid-July 2013. The average of total non-performing loan (net of provision) to capital for BFIs reached 6.6 percent during the review period comprising 6.3 percent, 9.2 percent and 4.1 percent of "A", "B" and "C" class institutions respectively.

Figure 2.21: Assets Quality Indicators of BFIs



Note: NPL1: Non- performing loan net of provisions

2.66 Regarding the exposure of BFIs in terms of sector wise credit, wholesalers and retailers sectors received the highest volume of loan (21.6 percent) followed by the manufacturing related sector (20.5 percent). Finance, insurance and real estate sectors received 8.4 percent of the total credit. Though the majority of the people depend on agriculture for their livelihood and contribution of agriculture to GDP is more than one third, yet this sector formed merely 4.0 percent of total loan in the review period.

2.67 To have a growth related overview towards the sector-wise credit, investment in sectors such as fishery related sectors, manufacturing (production) related sectors, electricity, gas and water, wholesaler and retailer sector, metal products, machinery and electric equipment sector etc. increased in the review period in comparison to that in mid-July 2013 whereas investment in consumption sector and real estate sector have not been increased significantly. Hotel business that was facing a sluggish period till mid-July 2013 due to fall in attraction in tourism sector seems to have once again gained the momentum. This is indicated by the increased investment in this sector in review period. With the decreasing profitability in this sector, the demand of investment was also declining. In comparison to investment of Rs. 80.17 billion in mid-July 2012, in mid-July 2013, only Rs. 25.09 billion was invested. But in mid-Jan 2014, Rs. 29.35 billion has been invested which is a 17.0 percent increment. This overview shows that investment has been directed towards productive sector rather than consumption sector in the review period.

2.68 Product-wise, a biggest share (23.5 percent) of investment is in demand and working capital loan followed by overdraft loan (19.3 percent) and term loan (14.6) percent. Consumption related products such as real estate loans (8.0 percent), residential home loans (7.3 percent), and hire purchase loans (5.7 percent) and margin lending loans (1.3 percent) share a small percent of total loans.

2.69 An encouraging growth has been noted in investment to productive sectors. A two digit increment is observed in growth rate of loans in productive sectors such as term loan (11.3 percent), demand loan (10.7 percent), and deprived sector loan (11.4 percent). Real estate loan has decreased by 3.0 percent and margin lending loan increased by 1.6 percent. A continuous decline in real estate loan has been observed every review period. Only few new real estate projects are coming into operation following the sluggishness in real estate sector; old real estate investments are on their way to maturity. This may be the reason for continuously declining real estate loan. Residential home loan has been an attractive investment for banking sector which has increased significantly in the review period.

2.70 In terms of collateral-wise, still 44.5 percent of total loan is backed by actual real estate which once again shows that lending is still based on traditional practices. Banks as well as borrowers don't tend to come out of their comfort zone and try other collaterals such as security of bill and guarantees, gold and silvers that require a different risk assessment mechanism or even risk free collaterals such as of government securities. Despite of the apparent sluggishness in real estate sector, the over concentration of credit to such single sector may make the financial stability vulnerable to risk. Investment against government securities as collateral decreased drastically by 60.0 percent. Personal guarantee, guarantee by internationally rated banks and domestic bills are emerging as new popular collaterals for banking sector in the review period with a growth rate of 144.4 percent, 139.7 percent and 147.7 percent respectively.

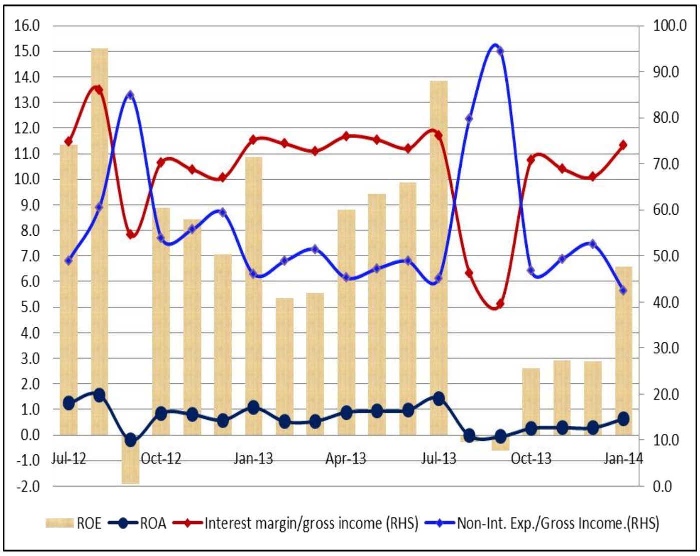
Profitability

2.71 Interest rate spread has decreased in mid-Jan 2014 compared to that in mid-Jan 2013. Despite such scenario of decline in interest spread, net profit of BFIs increased by 41.9 percent (without adjustment of net loss) compared to mid-Jan 2013. Hence, excess interest spread is no more the reason behind increment in profit figure which once used to be the matter of concern. The increase in profit might be also mainly due to increment in loan forwarded and gain in foreign country transaction.

2.72 However, the increased net profit couldn't meet the increment in assets and equity. ROA thus decreased to 0.6 percent from 1.1 percent and ROE decreased from 10.9 percent to 6.6 percent in review period compared to figures of mid-Jan 2013. It has been seen that ROE and ROA those remained fairly stable in other months improve in the second quarters of the fiscal years. The trend of strictly collecting accrued interest incomes at quarter ends is the main reason behind such sudden raise in ROE and ROA in quarters.

2.73 Interest income and specifically interest income from loan and advances occupied the biggest share in BFIs income i.e. of 74.0 percent. Gain from foreign currency transaction occupied 10.0 percent of total income. Commission based income contributed only 5.0 percent to total income that showed that despite passing a long banking history, banking purpose is still concentrated to the traditional activities of lending and deposit mobilization only. A lot of effort is still required on financial literacy for channelizing economic activities through banking channel. It seems that BFIs are serious in reducing their operating and administrative expenses in response to the obvious reduction in profit as the result of interest margin limitation. Non-interest expenses to

Figure 2.22: Profitability Indicators of BFIs



gross income ratio have decreased subsequently to 42.5 percent in mid-Jan 2014 from 45.2 percent in mid-July 2013. The decrease is by 5.91 percent in mid-Jan 2014 in comparison to the ratio in mid-Jan 2013.

Liquidity

2.74 Nepalese financial sector has been overwhelmed with the situation of excess liquidity since around two years and more. Total liquid asset to deposit ratio of BFIs stood at 32.1 percent in mid-Jan 2014 compared to 32.8 percent in mid-July 2013. The liquid asset to deposit ratios for "A", "B" and "C" class institutions were recorded at 31.2 percent, 35.7 percent and 36.7 percent in mid-Jan 2014. The ratios were 32.5 percent, 34.6 percent and 33.2 percent respectively for "A", "B" and "C" class in mid-July 2013. Hence the ratios for all BFIs stood above the regulatory requirement but it has been increasing the cost of fund for BFIs and both the NRB's and BFIs liquidity management function seems does not work in stabilizing the excess liquidity.

2.75 As at mid-Jan 2014, the credit to deposit ratio of BFIs stood at 76.8 percent. The credit to deposit ratios for "A", "B" and "C" class institutions stood at 75.3 percent, 80.5 percent and 90.1 percent respectively. Such ratios were 74.2 percent, 82.8 percent and 90.1 percent for "A", "B" and "C" class "BFIs respectively in mid-July 2013. The decreased liquid assets to deposit ratio and increased credit to deposit ratio of BFIs indicate that BFIs, especially commercial banks have mobilized liquidity that was excess with them. Despite the liquidity pressure being moderated at present, liquidity risk is likely to hit banks at any time, as they are operating under growing competition, poor asset/liability management practices, poor corporate governance and high dependence on corporate deposits and remittance as well as huge amount of government balance with NRB since mid-July 2012.

Figure 2.23: Liquidity Indicators of BFIs

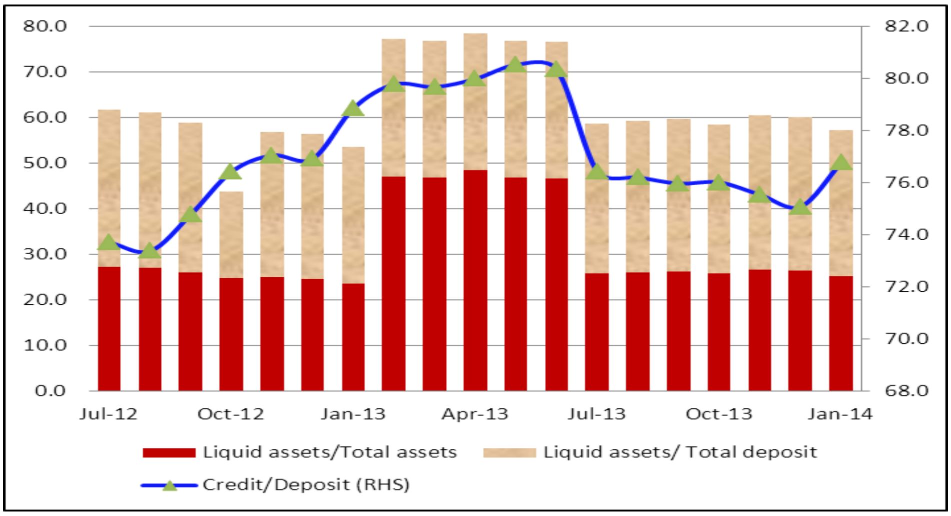


Table 2.8: Financial Soundness Indicators of BFIs (in percent)

Indicators	Class "A"		Class "B"		Class "C"		Overall	
	Jan-13	Jan-14	Jan-13	Jan-14	Jan-13	Jan-14	Jan-13	Jan-14
Credit and deposit related indicators								
Total deposit/GDP	53.5	56.9	8.1	9.4	4.9	3.9	66.5	70.2
Total credit/GDP	41.3	42.8	6.8	7.6	4.3	3.5	52.4	53.9
Total credit/ Total deposit	77.2	75.3	84.2	80.5	88.8	90.1	78.9	76.8
Lcy credit/Lcy deposit and core Capital	74.4	67.9	72.4	70.4	76.7	78.8	74.3	68.9
Fixed deposit/Total deposit	32.9	32.2	4.6	28.1	4.3	45.9	41.7	32.4
Saving deposit/Total deposit	38.0	37.2	49.3	52.3	46.0	44.5	39.9	39.6
Current deposit/Total deposit	9.6	10.1	1.8	1.8	0.0	0.7	7.9	8.5
Assets quality related indicators								
NPL/ Total loan	3.2	3.1	5.8	5.6	14.1	15.7	4.4	4.3
Total LLP/Total loan	3.6	3.6	5.1	4.8	10.6	16.3	4.4	4.6
Res. Per. H. Loan (Up to Rs. 10 mil.)	5.8	6.6	9.1	9.9	8.6	10.7	6.5	7.3
Real estate exposure/Total loan	9.5	7.4	10.7	8.7	14.2	14.8	10.0	8.0
Deprived sector loan/Total loan	3.9	4.8	3.5	4.7	2.7	3.3	3.7	4.7
Liquidity related indicators								
Cash and bank balance/Total deposit	12.3	15.4	16.4	16.7	21.3	22.9	13.2	16.0
Investment in Gov. security/Total deposit	15.0	14.5	2.3	1.9	2.6	3.6	12.6	12.2
Liquid assets/Total assets	23.2	25.1	25.5	27.4	23.6	24.4	23.6	25.3
Total liquid assets/Total deposit	28.8	31.1	34.6	35.6	33.4	36.7	29.9	32.0
Capital adequacy related indicators								
Core capital/RWA (%)	9.6	9.8	17.1	15.0	16.9	14.7	11.0	10.8
Total capital/RWA (%)	11	11.3	18.0	15.9	17.6	15.4	12.3	12.2
Wt. avg interest rate on deposit	5.33	4.7						
Wt. avg interest rate on credit	12.83	11.5						

Overall Financial Stability Concerns

2.76 Although, the overall macroeconomic situation of Nepal improved duly with the improvement in GDP growth, stabilization in inflation, favorable balance of payments and international reserve, depreciation of Nepalese currency and increase in competitiveness for export but lack of capacity to enhance the competitiveness as well as persistently high level of inflation and lack of investment in mega projects which are expected to be core for the creation of income and employment has been reflected the major challenges for the economy. Likewise, slow growth of private as well pubic investment has been noticed another major challenge for the banks to extend the credit. Furthermore, from the macroeconomic point of view BFIs has been facing major challenges due to the stagnant of economic activities in productive sectors as well as lack of demand for credit. As a result, BFIs are holding excess liquidity and that has been resulted in increasing their cost of fund.

2.77 After a long time of liquidity crunch, excess liquidity has now emerged as a new challenge for banking sector at the backdrop of limited new investment avenues and slow capital expenditure. Slowdown of investment has remained more responsible for excess liquidity and higher inflow of remittance growth also added for the emergence of this situation. Banks are obliged to pay interest on their deposits but it has been hard to extend all the available deposits in income generating activities. NRB conducted OMO through reverse repo and outright sale auction to mop-up the excess liquidity from the market but it is not the final solution. In the current context where political situation is becoming investment friendly, such excess liquidity might be a good opportunity for making investment in larger projects despite of sinking economic growth, political instability, power cut, insecurity and labor problems which are spoiling operating as well as investment environment for Nepalese banking sector. Therefore, inducing investors to conduct economic activities that are directly related to banking sector is an another major challenge for the financial sector.

2.78 The recurring forgery issues happened by bank employees and the top level management have once again attracted the concern of corporate governance and situation of internal control on the top list of financial stability endeavor. Despite several regulations, which NRB has been coming up with and updates, monitoring and supervision capacity has been noticed to require further reform to capture such fraud activities which are not under control yet.

2.79 Due to excess liquidity, interest on deposit fell down, resulting into negative real interest rate. However, interest on lending could not fall compared to deposit. Widening interest rate spread even in the state of excess liquidity and slow response of BFIs to NRB’s call for reducing spread within the limit of 5.0 percent have invited the need of punitive measures from the side of central bank against BFIs. There is still slow movement in housing and real estate business. A big portion of investment of banking industry is trapped in these sectors. The declining profitability and increasing non-performing loans of BFIs especially of development banks and finance companies cannot be corrected unless these two sectors improve their performance.

2.80 Remittance inflows, BOP surplus and resulting increase in excess liquidity of the banking sector possess challenge to the financial stability. Though NRB is mopping liquidity frequently, it has some limitations and it is not the final solution. To solve the excess liquidity problem, BFIs should invest such liquidity in various projects. Due to excess liquidity interest and deposit fell down, resulting in to negative real interest rate. However, interest on lending found not fall compared to deposit.

2.81 NRB has brought the new provision for BFIs requiring procurement of debts of problematic BFIs with whom they have interbank transactions. They have to procure debts worth more than the transaction amount and make immediate payment of half of that amount for payment of deposits of customers when a bank or financial institution faces problems. The selection of performing loans and maintaining the same status of loan are two big issues, BFIs are facing in these days. Several times, BFIs have been forced to increase provisioning after facing problems in many loans. In the environment of deficiency of technical skills of project appraisal, banks have to incur higher costs in following the projects they have selected as the loans. Therefore, manpower capacity and governance issues still remains major concern of risk to financial stability.

2.82 Rising NPA level especially of development banks and finance companies has attracted the attention of national regulatory bodies as well as international organizations. In addition, no quick actions by BFIs even though assessing the peril ahead are the issue of major concern. The existing level of NPA should be seriously addressed by proper strategies but formulating appropriate strategies have been understood a tough job in the current volatile financial environment which requires to address timely for protecting the institutions from the major risk of default. The need of establishing Asset Management Companies who help in liquidating non-banking assets and receivables and thus in risk management has been a long issue since the decade of 2000 and also one of the incomplete component among many of the financial sector reform program yet not materialized.

2.83 In the aftermath of financial liberalization, financial institutions are getting interlinked to each other nationally and internationally day by day. Payment and settlement system, interbank activities and sovereign debt are primarily generating linkages between financial system within and beyond the national boundaries. Such growing interconnectedness is making the financial sector vulnerable to systemic risk and has created likeliness of contagion. However, interconnectedness can also help in diffusing the impact of shocks by diversifying risk among the partners of interconnection network. Nepalese financial sector requires a mechanism for measuring and monitoring the degree of interconnectedness among the financial intermediaries within as well as across the nation and the vulnerabilities posed by such interconnectedness. Similarly, regulators and policy makers should shift the attention towards developing firewalls to prevent propagation of contagion from one bank or financial system to another so that interconnectedness could be handled at its best.

2.84 Despite all this, the major challenge the financial sector has been facing today is from within the system too. Lack of professional management, increasing unproductive assets, loan recovery problems, rising costs, dissatisfied staffs due to pay scale gap, unsustainable profit targets, inadequate risk management practices, among others, are some other major challenges that can be added to the list of financial stability related concerns and risks to the financial system of Nepal which has are to be addressed for safeguarding financial stability..

2.85 Likewise, the strong regulatory and supervisory authority for various types of micro finance institutions and co-operatives and timely study on shadow banking activities and co-operatives business from which the financial sector has been facing risk, require timely address and enforcement of policies, rules, regulation and laws.

2.86 As mentioned in earlier editions of the report, multiple banking practices, poor under writing standards, insider trading, non-collateralized and unsecured interbank lending and excessive misuse/siphoning of overdraft loans to the influential individuals, lack of analysis of macroeconomic variable and their potential shocks, lack of credit rating agencies, lack of internal credit rating of borrowers by bank,,weak infrastructure and limited capacity of deposit guarantee scheme, low effectiveness on the implementation of the verdicts of Debt Recovery Tribunal, and lack of reliable and scientific data reporting by the banks are still the challenges need to be addressed.

2.87 The regulatory oversight provided for in the Insurance Act enables Insurance Board (Beema Samitee) systematize, regularize, develop and regulate the insurance business while at the same time ensuring that the interests of policyholders are protected. By benchmarking with other regulators locally, regionally and internationally, the regulatory oversight provided by Insurance Board enables foster a culture of stability which in turn helps stimulate demand for insurance services. In turn this will result in increased contribution of insurance sector to the country's GDP.

2.88 Considering the development of insurance industry and its connection with the financial system of Nepal, it has been revealed that insurance companies have poor compliance with the prudent rules and regulations as issued and directed by Insurance Board of Nepal. Similarly, the huge amount of investment made by the insurance companies in different segments, including the deposits in various banks and financial institutions need to remain safe with sufficient liquidity. Similarly, the insurance companies should maintain further transparency in terms of disclosure, access to information on collection of insurance premium, investment in different areas and products as well as the recovery of the investment. Likewise, the insurance industry also requires further consolidation by making the individual companies financially strong and offering better service quality.

2.89 Total premium collection and total investment of the insurance companies are in increasing trend. The performance of Nepalese insurance industry on aggregate is satisfactory but requires a strong surveillance on their operation to avoid systemic risk. In this context, Nepalese insurance industry needs to be more professional, accountable, fair, transparent, integrity, competitive, innovative and efficient in order to provide effective services. Insurance industry should also move toward International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICP) and update insurance accounting standard following international best practices. The IAIS continues to develop global standards, principles and guidelines in a wide range of regulatory issues. This has implications for insurance supervision and regulation as it requires a sharper focus on supervisory systems and practices in tandem with internationally accepted practices in order to continually cope with the changing environment. For the insurance industry to remain competitive, the regulatory environment must effectively respond to the changing market needs and supervisory models.

2.90 Similarly, in the context of growing insurance business, including the companies, a solvency regime is also required to tackle with the problems that surface in insurance companies. The Board has recently implemented Solvency Margin Directive 2013 for Life Insurers. Both the prudent regulation and strong supervision are required in Nepalese insurance, having essential framework in place. Therefore, strengthening the rules and regulations formulated by the Insurance Board can be instrumental for this sector to withstand possible financial market shocks.

2.91 The Insurance Board takes cognizance of the need to have a stable insurance industry in Nepal that will boost both investor and public confidence. Further a stable insurance industry is envisioned to enhance competitiveness and promote insurance inclusiveness. To attain stability of the industry, the Board intends to enhance its regulatory and supervisory roles through, among others, implementation of risk based supervision and review regulatory framework.

2.92 The Nepalese insurance market is constraint by many challenges. Some of the key challenges include low and irregular income, low level of insurance awareness, small size of market, unhealthy competition among the insurers, shortage of competent human resources, low risk retention capacity of insurers due to low capital base, lack of reinsurance company in Nepal, limited access to reinsurance market, lack of need based innovative policies, almost all the insurers particularly the non-life insurance companies have concentrated their businesses in selected urban areas only, weak legal and regulatory framework, among other hurdles. Similarly the paid up capital of insurance companies is too low. For the effective implementation of Board's mandate, Board considers human resources as the most important and most valuable assets. Though it has been continuously trying to develop the pool of adequate and high skilled professionals, but the same has not been happening due to one or other reasons. Most of the existing employees are yet to have effective training with professional expertise in regard to insurance supervision, basically implementation of Insurance Core principles (ICPs).Further lacks the special expertise in the field of Actuary, Economist, Experts, Risk Management and Information Technology. The Board thus needs to recruit such skilled manpower so as to effectively carry out its operation. At the same time Board has another big challenge to develop and implement human resource retention policy attracting the new employees and retaining the existing employees offering extra benefits.

2.93 Despite the significant coverage in PF contributing government employees in EPF networks, a large number of the private sector formal workers and employees are not covered by existing provident fund scheme. Informal sector employees and self-employed people are not covered by the existing retirement benefit plan/social security system. EPF need to be transformed into the social security fund like pension fund in order to meet international practices. The supervision of retirement fund managed by the private sector become complicated since the approval process is governed by Income Tax Act, 2002 only for tax deduction purpose and they are not registered under any other act. Investment of fast growing fund of the EPF in productive sector is becoming challenging due to lack of economically viable projects.

2.94 There is mismatch between the rate of return to the member of EPF and inflation rate of the country due to the financial market volatility in fixing the interest rate. EPF requires some reform in the areas to extend the coverage in order to cover informal sector employees and transform the scope and functions to private sector into the social security as well as to improve the existing fund management practices of the EPF. Similarly, it requires enhancing the technical skill and capacities to invest the long term saving in productive infrastructure project in order to meet the EPF target to invest such fund in infrastructure project up to 30.0 percent in next five years. Furthermore, for improving the existing business processes and service delivery system as well as to develop assets and liability maturity plan for sustainable financial stability, EPF needs to maintain the minimum cash and bank balance of the total resources. Likewise, portfolio management and reducing the NPL at standard level are the key challenges of EPF.

2.95 Both the EPF and CIT have the similar concerns. In case of CIT, present retirement schemes are not being able to address the old age security fully due, particularly of the existing centralized office structure of CIT, which is not being sufficient to provide prompt service at regional participants. It has not extended its branch in any other places. Due to this, it is not being able to increase its coverage as per the expectation and low coverage of contributors also resulted due to lack of awareness to save for future.

2.96 The main sector of investment of CIT is fixed deposit of commercial banks and there is low opportunity to get potential sector to make secured investment which is challenging to provide expected rate of return to the contributors of CIT. Likewise, less availability of long term and high credit worthy instrument for investment and lack of proper environment/opportunity to make best investment, less security provided by the GON to make investment in infrastructure like road, hospital , tourism and industrial sector. Furthermore, most of the fund of CIT is invested in unproductive sector. Organizations other than CIT and EPF are also running similar voluntary retirement fund program under the income tax act 2002 with the approval of tax department. In this competitive environment, CIT needs to increase the facilities provided to the participants with a prompt and quality service. Likewise, lack of strategic partner to make investment in foreign countries, lack of corporate framing by GON, absence of free pricing in the IPO, lack of active institutional investors in the capital market and volatility of the market has been noted the challenges for CIT in playing a role of market maker in capital market toward promoting the financial stability.

Concerns Associated with Deposit Taking Institutions

2.97 Credit flow to productive sector (agriculture, industry) has not been adequate and the present structure of the banking system is not conducive to large volume and long term financing. Small capital base of BFIs, single borrower limit, among others have constrained BFIs' capacity and willingness to invest in big infrastructure projects like roads, hydropower, etc. Demand of long-term funds for such projects are likely to grow as the economy further develops. However, there is still a big scope for product diversification. Available financial products largely remain limited to deposits and loans. Lack of deep interbank and money market creates difficulty in managing liquidity risk and also weakens the transmission mechanism of monetary policy. BFIs growth has been mostly limited to urban areas, especially in main city areas. As a result of these consequences, large section of population is still deprived from access to formal financial services and there is always lack of robust regulatory and supervisory framework for MFIs. The level of financial literacy is poor in the country, as a result of this there is limited but inadequate mechanism for protecting consumers for financial services.

2.98 Stability in macroeconomic environment (price, exchange rate, growth, BOP, etc.) is essential for financial stability. Existing regulatory and supervisory framework is inadequate compared to international standards. Rapid growth and long list of number of BFIs has strained the supervisory capacity of the NRB. Inadequate financial safety net framework and almost non-existence of macro prudential surveillance for the banking sector are pushing the financial sector toward risk. Similarly, lack of effective crisis management framework, including proper problem bank resolution mechanism and lack of proper coordination mechanism among financial regulators is not supportive in enhancing the efficiency of the financial system compared to other countries. Likewise, lack of well-developed online and card based payment system as such cash and check are still dominant modes of payment are remaining the major risk for the theft and financial fraud, which are ultimately mounting the risk to financial stability endeavors. Government, the biggest user of the payment system, largely uses traditional methods of payments for collecting revenues and making disbursements and lack of centralized interbank money market always creating risk in interbank transaction and settlement. An OTC market is active, but is based on bilateral limits rather than collateralized lending. Also an interbank repo market, which can significantly enhance liquidity management and monetary policy operations, is absent. Public debt operations conducted by NRB are manual and auction process of treasury bill/bonds is entirely manual and all securities are issued on paper certificates.

2.99 Moreover, lack of a reliable system for maintaining credit history of borrowers has increased the risk premium associated with lending. Need of credit rating agencies to facilitate appropriate pricing of risks and market monitoring is not materialized. Similarly, lack of robust debt recovery framework, lack of professionalism among the board of directors, dominance of directors with business interests often result in conflict of interest particularly because business sector is the main user of funds and gaps in legal and oversight framework have created challenges in controlling malpractices like connected lending, multiple banking, etc in BFIs.

2.100 Inadequate risk management practice in the banking system has generated financial stability concerns. Therefore, there is need to improve governance within enforcement authorities, and raising their accountability. Provision allowing NRB board of directors and officials, after resigning or retiring, to work in the BFIs in executive position, has been creating governance challenges in BFIs.

2.101 Accounting and auditing standards need to be aligned with International standards. Weak legal and institutional framework for safeguarding the parties involved in financial transactions requires further strengthening. Similarly, lack of experience and expertise in judiciary in dealing with financial disputes need to improve for strengthening the financial stability.

2.102 Major non-compliances observed during the onsite inspections in BFIs are loan provided exceeding the Single Obligor Limit (SOL), improper loan classification resulting into inadequate loan loss provision, improper utilization of loan amount, loan provided to dummy projects/clients, weak follow-ups regarding credit utilization, weak corporate governance, lack of internal policies and weak implementation of the policies, poor documentation of loan and other related official documents. Similarly, BFIs found poor assessment quality of projects and investments. Likewise, the weak financial analysis of borrower in order to determine their repayment capacity and creation of new loan limit to repay the existing loans as well as credit concentration in real estate sector (although heading is different for reporting) with wrong reporting of loan products are found creating the major risk of default of the BFIs.

2.103 The connected and unwanted practices of insider lending and interconnectedness are found as other major problems in the BFIs. Such type of business activities have been significantly increasing despite the effort to control such activities due to the reason of poor internal control mechanism and insufficient collateral backup as well as low quality collaterals with overvaluation, lack of business plan, higher deposit concentration and with the connection of related parties which are not reported in the same group etc.

2.104 Financial stability related concerns remained more or less similar among the deposit taking financial institutions. Development banks and finance companies found systemically more risky compared to commercial banks and micro finance financial institutions also have problem with multiple banking and business out of the principle of micro credit. The regulator should enforce good corporate governance and ask for the thin institutional set up and arrangements with competent human resources to mitigate the first hand risk in those institutions.

2.105 Increasing operational risks but less concern of regulator and supervisor as well as the institutions themselves have been found a critical factor in increasing problematic institutions in the short period of time. Lack of enforcement in promoting self-regulation and practice of presenting two different audited financials: one for tax purpose and another for their internal use clearly indicate that financial system performance is being presented wrongly and sometimes it is very difficult to understand about their assets quality and NPL.

2.106 Similarly, multiple banking practices and ever-greening of loan has been frequently imposing risk to the financial system of Nepal. Such practices should be avoided and monitor by the regulator and supervisors and adopt the good practices of code of conducts. Similarly, to address the operational risk NRB conducted a program entitled "Identification of Operation Risk and Its Mitigation" for Board of Directors and senior management of regional level development bank by the DBSD and it is recommended that such types of program should be regularly conducted for the board members, senior management, internal and external auditors of the BFIs on different issues to reduce the banking sector risk and promote financial stability education.

2.107 Nepal’s deposit taking financial institutions are running with low capital backup (limited capital or small capital base) and high cost of fund with increasing competition from commercial banks and other financial institutions and with each other. Similarly, lack of qualified manpower and higher percentage rate of discrimination in the job responsibilities and perks as well as financial facilities to the lower and middle level staff members has been creating dissatisfaction towards the institutions leading to fraud and forgery of theft and unethical work, like wrong transaction on good for payments transaction in H and B Development Bank etc. Such type of discrimination in job responsibilities and salary in and among the BFIs has been remaining a greater risk for the sustainability of the institutions and system itself.

2.108 Although, the financial sector regulator has identified such discrimination, these issues have not been addressed as expected. Furthermore, professional work culture that emphasizes high quality and timeliness on output has been lacking. Weak incentive system discourages the staff from putting hard work to upgrade their competency level. Greater International cooperation is needed to enforce the system in the financial sector both in regulation as well as in supervision areas. Provisions of international training, organization of workshops, seminars and talk program allow the participants of the financial sector to share the developments in their respective countries and can understand the risk associated with it so that financial system foundation could be strong both from the side of demand and supply.

Chapter Three

Deposit Taking Institutions

Commercial Banks

3.1 As in mid-Jan 2014, share of total assets and liabilities of commercial banks on total GDP reached to 70.8 percent from 66.7 percent in mid-Jan 2013. It occupied 51.6 percent of total assets and liabilities of total financial system in the review period. The dominance of commercial banks in total banking sector in terms of assets and liabilities as well as in terms of balance sheet component has been broadly remained stable in the higher share ratio. The total assets and liabilities of commercial banks increased by 20.3 percent to Rs. 1365.0 billion in mid-Jan 2014 from Rs. 1134.8 billion in mid-Jan 2013. It was an increment of 7.7 percent compared to mid-July 2013.

3.2 Despite of the large decline in retained earnings by 20.5 percent, total capital of commercial banks increased by 12.6 percent to Rs. 106.57 billion in mid-Jan 2014 as compared to that in mid-July 2013. The paid-up capital increased by 4.0 percent at this period.

3.3 Total deposit of commercial banks occupied 56.9 percent of total GDP and loan and advances occupied 42.3 percent of total GDP. Total deposit grew by 7.5 percent to Rs. 1097.06 billion in mid-Jan 2014 whereas such increment was less than a half of the growth rate of 17.6 percent obtained in mid-July 2013 . Loan and advances reached Rs. 814.77 billion which is an increment of 8.8 percent in total loan and advances figure of mid-July 2013. Private sector has been the major recipient of loan.

3.4 After loan and advances, investment in government securities has emerged as a good solution for commercial banks to utilize the excess liquidity. Investment in government securities increased by 9.7 percent (Rs. 158.93 billion) in mid-Jan 2014 from Rs. 144.86 billion in mid-July 2013. In the context where major balance sheet indicators such as capital, deposits, lending, investments, liquid funds etc. are showing positive growth, borrowing decreased by a noticeable rate of 8.4 percent to Rs. 20.87 billion in mid-Jan 2014 in comparison to that in mid-July 2013. Such decrease is due to excess liquidity prevailing in the financial system. Borrowing by means of bonds and securities increased by 12.1 percent as issuance of debentures and bonds is in trend.

3.5 NBA decreased by 0.2 percent in mid-Jan 2014 from Rs. 2.04 billion in mid-July 2013. The aggregate NPL to total loan ratio of commercial banks had slightly increased to 3.1 percent in mid-Jan 2014 in comparison to the ratio of 2.7 percent in mid-July 2013. The three states owned banks in total have NPL ratio of 6.0 percent where as that of private commercial banks is only 3.0 percent in mid-Jan 2014. As in mid-July 2013, average NPL ratio of three state owned commercial banks was 5.0 percent, whereas such ratio for private commercial banks was 2.0 percent. Hence, credit quality of commercial banks has slightly deteriorated. However, NPL ratio is below regulatory limit of 5.0 percent.

Table 3.1: Assets Quality Indicators of CBs (Mid-Jan, 2014)

	NBL	RBB	ADB	Private Banks	Total
Non-Performing Loan (Rs. in million)	2193.08	2566.00	3508.14	17283.57	25550.79
Total Loan and Advances (Rs. in million)	38898.25	52112.46	57975.71	665779.5	814765.9
NPL/Total Loan Ratio (in percent)	6.0	5.0	6.0	3.0	3.0

3.6 Despite the regulation of NRB to BFIs to invest 12.0 percent of total loan in agricultural and electricity sector, only 3.9 percent of total loans of commercial banks had been diverted in agricultural sector and 2.3 percent in electricity, gas and water sector. In addition, such investments are in declining trend. Manufacturing (Producing) related sector availed 24.0 percent of total loan and retailer and wholesaler sector utilized 22.7 percent of total loan. Likewise, out of total loan 8.4 percent and 7.0 percent was forwarded to real estate sector and consumption sector respectively.

3.7 While comparing with the product-wise loan data with the past commercial banks found discouraged to invest in real estate lending as such lending has declined to and stood at 8.3 percent in mid-Jan 2014 in a one year period. Investment in business purpose loans such as term loan, overdraft loan, demand and other working capital loan increased by a significant percentage of 27.7 percent, 19.7 percent and 20.8 percent respectively. The remarkable growth of 34.7 percent and 15.3 percent in residential and hire purchase loan shows that banking sector, especially the CBs have still higher attraction in such loans (retail lending) for the short term profitability and performance. Similarly, commercial banks have forwarded 4.3 percent of total loan in deprived sector in the review period.

3.8 Collateral-wise, loan against real estate as collateral has been in the increasing trend. Out of total loan 82.5 percent of total loan has been disbursed against the collateral backup of fixed and current real assets.

3.9 Net Profit of the commercial banks increased to Rs. 9.63 billion compared to Rs. 8.27 billion in the same period of previous year. Out of total 31 commercial banks only one bank faced net loss in the review period. However, other measurements of profitability such as ROA and ROE decreased in comparison to the figures of same period in previous year because the profitability could not increase proportionate to the increase in assets and equity in the review period. Total assets increased by 20.3 percent whereas net profit increased only by 16.5 percent. Interest spread remained a major determinant of total income in mid-Jan 2014 by contributing 38.2 percent of total income. Spread income increased by 11.4 percent in review period whereas it increased by 32.8 percent in mid-Jan 2013 in comparison to the that of mid-Jan 2012.

Stress Testing Analysis

Credit Shock

3.10 Based on the data as of mid-Jan 2014, the stress testing results of 31 commercial banks on various shocks are examined. The test result found that there is growing credit risk in commercial banks. The stress testing results of commercial banks as of mid-Jan 2014 revealed that a standard credit shock would push the capital adequacy ratio of 28 out of total 31 commercial banks below the regulatory minimum benchmark of 10.0 percent. The number of such banks were 28 in mid-Jan 2013 and 27 in mid-July 2013. Stress testing was conducted based on different scenarios such as deterioration of various categories of loan to substandard, doubtful, loss loans and among others. It has been found that in case if 25.0 percent of performing loans of real estate and housing sector is directly downgraded to loss loans, capital adequacy ratio of 9 commercial banks will come below the required level of 10.0 percent, compared to 5 banks in mid-July 2013 and 13 banks in mid-Jan 2013. Thus, the results showed that the risks of exposure to real estate and housing sector further deteriorated than that in mid-July 2013.

3.11 Likewise, if top 2 large exposures (loans) were downgraded from performing to substandard category, the capital adequacy ratio of 3 commercial banks would fall below the required level whereas the number of such commercial banks was 2 in mid-July 2013. The overall credit shock scenario revealed that banks' credit quality has been deteriorating on contrary to the expectation despite the various measures taken during the review period. Furthermore, banks are likely to face a difficult situation in case of slowdown in recovery, downgrade of loans to loss category of NPLs and increase in provisioning.

Liquidity Shock

3.12 Though the liquid assets to deposit ratio of the total banking system as well as the commercial banks have not significantly changed during the review period, the stress test results found that 22 commercial banks may turn into a vulnerable situation in case of withdrawal of deposits by 15.0 percent or more. Those banks having significant portion of institutional deposits may face liquidity strain in case of withdrawal of their deposits by their top institutional depositors. The number of banks that may turn illiquid after withdrawal of deposit by 2.0 and 5.0 percent for first two consecutive days and 10.0 percent for 3 consecutive days has increased significantly to 16 in mid-Jan 2014 from 5 in mid-July 2013. Such number was 19 in mid-Jan 2013.

3.13 Similarly, if there was a withdrawal of deposit by 5.0 percent, 10.0 percent and 15.0 percent, the number of banks whose liquid asset to deposit ratio would fall below the regulatory minimum of 20.0 percent have stood at 2, 12, 22 respectively in mid-Jan 2014 in comparison to 1, 4 and 16 respectively in mid-July 2013. The numbers of such banks were 7, 20 and 26 respectively in mid-Jan 2013. With the shock of withdrawal of deposits by top 3 and 5 institutional depositors, liquid assets to deposit ratio of 15 and 20 commercial banks would be below 20.0 percent in mid-Jan 2014. In mid-July 2013, numbers of such banks were 14 and 21 compared to 21 and 25 in mid-Jan 2013. These findings of liquidity shock show that liquidity position of commercial banks did not improve much as compared to mid-July 2013 despite excess liquidity, though it improved significantly as compared to mid-Jan 2013 as a result of improvement in the general macroeconomic and financial situation including the situation of liquidity in the banking system of Nepal.

Market and Combined Credit and Market Shock

3.14 The stress testing results revealed that all the commercial banks (excluding two state owned banks) have maintained CAR above the regulatory requirement when calibrating through interest rate, exchange rate and equity price shocks. Also, they were safe from exchange rate risks as the net open position to foreign currency was lower for a majority of them. Furthermore, since commercial banks are not allowed to make equity investments except in their subsidiaries, the impact of fluctuation in equity price is also lower. When going through market shock, 29 out of 31 commercial banks (excluding two state owned banks) could maintain their capital adequacy ratio above the regulatory requirement of 10.0 percent. The banks did not bear interest rate risks as they pass it directly to their clients; so, they are found to be less affected by interest rate shock as well.

3.15 The combined credit and market shocks based on a scenario of 25.0 percent of performing loan of real estate and housing sector directly downgraded to substandard category of

NPLs and fall of the equity prices by 50.0 percent demonstrated that 3 banks would be affected. However, if 15.0 percent of performing loans deteriorated to substandard, 15.0 percent of substandard loans deteriorated to doubtful loans, 25.0 percent of doubtful loans deteriorated to loss loans and the equity prices fall by 50.0 percent, the CAR of 3 banks would remain above the regulatory minimum, CAR of 2 banks would remain below zero percent and CAR of 26 banks would lie between 0 and 10.0 percent.

3.16 The resilience of commercial banking system of Nepal towards key stress testing scenario analysis showed a sound and strong financial system through all three kinds of credit, liquidity and market shocks. The overall vulnerability test in aggregate of all 31 commercial banks showed that commercial banking system stood in less vulnerable position since the vulnerability test found that no bank in aggregate was in problematic situation after these shocks. However, the test showed high chances of vulnerability in public sector banks and moderate chances in private sector banks.

3.17 Commercial banks hold a major share in financial sector in terms of total asset/liabilities and in terms of major balance sheet items too. The FSIs show that financial ratios of commercial banks are under the regulatory requirements of central bank. But these ratios are deteriorating when compared with those of previous years. For example, capital adequacy ratio, return on assets, return on equity, liquidity assets to total assets, liquid assets to total deposits and percent of loan forwarded are decreasing whereas credit to deposit ratio and NPL ratio are increasing when compared with the data of mid-July 2013. Private commercial banks seem to be performing well. That is the reason why despite of weaknesses in indicators of state owned banks, aggregate indicators indicate financial soundness in commercial banking sector. Focus on status of state owned banks will further improve the indicators.

Development Banks

3.18 Total assets and liabilities of development banks held 12.2 percent of total GDP. Total assets and liabilities of development banks increased by 26.7 percent to Rs. 235.92 billion in mid-Jan 2014 compared to the figure of mid-Jan 2013. Such a growth was 11.5 percent compared to mid-July 2013. Likewise, the capital fund of development banks increased to Rs. 27.42 billion in mid-Jan 2014 compared to Rs. 23.82 billion in mid-Jan 2013. The capital adequacy ratio stood 15.9 percent in mid-Jan 2014 which was a decrease by 2.1 percentage point from the level of 18.0 percent in mid-Jan 2013. The reason behind such fall in CAR was the increase in risky assets. The CAR of development banks has deteriorated since mid-Jan 2013 and paid-up capital of development banks increased by 6.5 percent in mid-Jan 2014 compared with mid-July 2013.

3.19 Borrowings have declined to Rs. 1.91 billion by 30.6 percent of total loan in comparison to 2.8 billion in mid-July 2013 as the result of current situation of excess liquidity in the financial market. While compared with the data of mid-Jan 2013, deposit increased by 32.5 percent whereas lending increased by 26.7 percent only. The idle liquid fund increased by 38.5 percent in comparison to mid-Jan 2013. A major portion of 26.0 percent of total assets is maintained as liquid funds. Credit forwarded out of total deposit decreased to 80.5 percent which was 84.2 percent in mid-Jan 2013. Despite such situation of sluggish growth rate in lending, decrease in credit to deposit ratio, and a huge sum of liquid fund maintained, interest income increased by 20.4 percent in mid-Jan 2014 whereas interest expenses for mid-Jan 2014 increased only by 12.01 percent when compared with figure of mid-Jan 2013. This clearly exhibits the widening interest rate spread in development banks.

3.20 Loan loss provisioning increased by 20.7 percent to Rs. 7.06 billion within the period of six months up to mid-Jan 2014 compared to the increment of only 11.3 percent of total loan forwarded in mid-Jan 2013. Increase in non-performing loans has resulted in such high increment in loan loss provisioning. Likewise, the non-performing loan in figure increased by 36.0 percent to Rs. 8.2 billion in mid-Jan 2014 from Rs. 6.04 billion in mid-July 2013. NPL to total gross loan percent increased to 5.6 percent in mid-Jan 2014 compared to 4.6 percent in mid-July 2013. Total amount of non-banking assets of development banks increased sharply by 188.4 percent to Rs. 963.4 million in mid- Jan 2014. Increasing risk weighted assets, increasing non-banking assets and increasing NPL indicates the deteriorating asset quality of these banks in the review period of mid-Jan 2014.

3.21 In terms of sector-wise loan, almost 5.0 percent of total loan has been forwarded to agricultural and forest related sector. More than 50.0 percent of total loan is concentrated within three sectors such as construction sector (12.0 percent), wholesaler and retailer sector (19.1 percent) and others sector (20.0 percent). Investment in real estate sector declined by 0.7 percent to Rs. 12.5 billion in mid-Jan 2014 from Rs. 12.6 billion in mid-July 2013. Likewise, in terms of product-wise loan, business loans such as term loan (12.3 percent), overdraft (25.8 percent) and working capital loan (13.3 percent) occupied 51.5 percent of total loan portfolio. Investment in real estate sector has increased by a very minimal percent of 2.8 percent whereas deprived sector loan has increased by 54.3 percent. 4.3 percent of total loan is forwarded as deprived sector loan whereas regulatory requirement for the development banks is 3.5 percent. Similarly, in terms of collateral-wise loan, 89.6 percent of total loan has been forwarded against collateral backup of real estate. Such percent was 91.8 percent in mid-Jan 2013 and 91.8 in mid-Jan 2014 as well. Such a large volume of loan backed by real assets as collateral has increased uncertainty for this sector that goes hand in hand with uncertainty in real estate sector.

3.22 Net profit of development banks increased to Rs. 518.95 million in mid-Jan 2014 from Rs. 218.56 million in mid-Jan 2013. The increment is supported by increment in return on equity to 1.83 percent.

3.23 DBSD has just started doing CAMELS rating of the development banks during the on-site inspection process. The Off-site Unit of the department conducts CAELS rating on a quarterly basis. Status of CAELS rating as on mid-Jan, 2014 is mentioned below:

Table 3.2: CAELS Rating of Development Banks (Mid-Jan, 2014)

S. No.	Particulars	Ratios (in percent)
1	Capital Adequacy Ratio	15.46
2	Credit to Deposit (LCY) and Core Capital	70.29
3	Non-Performing Loan to Total Loan	5.60
4	Net Liquid Asset /Total Deposit	34.59
5	Return on Assets (ROA)	0.22
6	Return on Equity (ROE)	2.04

Stress Testing Analysis

3.24 Stress testing of the development banks having deposit above Rs. 2 billion had started from mid-Jan 2013. However, NRB has issued circular on Jan 2014 on stress testing that all the national-level development banks are required to conduct stress tests and to report it to NRB on a quarterly basis. Among 20 national-level development banks, one bank has been declared problematic and it is under the management control of NRB. Likewise, another development bank is in the process of merger with a commercial bank. Therefore, 18 national-level development banks stress test result found that development banks remained less vulnerable to credit shocks and liquidity shocks in aggregate however, some banks found more vulnerable to combined effect of both credit and liquidity shocks. Position of banks after stress testing scenarios is shown in the following table.

Table 3.3: Stress Test Results of Development Banks

Credit Shocks	No. of BFIs having CAR<10% (out of 18)
Credit shock—15 percent of performing loan deteriorated to substandard loan	3
Credit shock—5 percent of performing loan deteriorated to loss loan	5
Credit shock—all NPLs under doubtful category downgraded to Loss category	1
Credit shock—25 percent of performing loan of real estate and housing sector loan directly downgraded to loss category	2
Credit shock—top 5 large exposure downgraded from performing loan to substandard loan	2
Liquidity Shocks	
Liquidity shock—withdrawal of deposits by 10 percent	1
Liquidity Shock- Withdrawal of deposits by 15 percent	5
Withdrawal of deposits by 20 percent	12
Withdrawal of deposits by top 5 institutional depositors.	1

3.25 NRB's circular dated September 16, 2013 has made the national-level development banks compulsory to calculate base rate from mid-Jan 2014 on a monthly basis. Likewise, NRB's circular dated October 13, 2013 states that interest rate spread is to be calculated on a monthly basis and published on a quarterly basis starting from mid-Jan 2014. In the review period, one national-level and three regional-level development banks attracted prompt corrective action due to shortfall in capital adequacy ratio with no systemic risk in the banking sector. Liquidity position of all the development banks was in a comfortable position (more than 20.0 percent) in the review period.

3.26 By mid-Jan 2014, nine development banks and twelve finance companies merged with each other and became 9 national-level development banks. Likewise eight regional-level development banks merged with each other and became four upgraded regional level development banks and two development banks merged with commercial bank. Among those 13 merged institutions, 8 institutions have NPA greater than 5 percent. As most of these mergers took place between financially weak institutions, it may take a longer time for the positive outcome of the mergers. Likewise, the statement holds true even in case of the profitability of these institutions and seven merged institutions are making losses as on mid-Jan 2014.

3.27 As on mid-Jan 2014, development banks' exposure on real estate sector amounted to Rs. 12.69 billion only that comes around 8.70 percent of total loans and advances. The ratio was 9.7 percent in mid-July 2013, reflecting a decreasing trend. In the review period, all the development banks remained in a comfortable position in terms of liquidity. Ratio of net liquid asset to total deposits stood at 32.1 percent in mid-Jan 2014.

3.28 In the review period, one national-level and three regional-level development banks attracted prompt corrective action. The main cause for taking prompt corrective action is the shortfall in capital adequacy ratio. Of this four, one regional-level development bank's capital adequacy ratio found negative which has been declared problematic and remaining three banks have positive capital adequacy ratios but below the regulatory requirement of 11.0 percent, the actions taken to them differed based on the triggers they are charged.

3.29 In the review period, 19 regular, 12 special and 2 follow up inspections have been conducted by DBSD. Due to constituent assembly election held on December, 2013 there has been slow down in the speed of regular inspection. Based on the regular inspection reports, numerous actions have been taken to the institutions, their board members and managerial staff. In this period, fine has been imposed to the chief executive officer of one development bank and board members of three development banks have been taken other non-monetary actions. Similarly, in the review period, 7 institutions failed to maintain minimum cash reserve ratio and 5 institutions failed to maintain deprived sector lending limit as directed by NRB. For these, those institutions were charged a fine.

Finance Companies

3.30 Finance companies hold 5.8 percent of GDP in terms of total assets and liabilities as in mid-Jan 2014 whereas such share was 6.2 percent of GDP in mid-July 2013. The share of finance companies in total GDP is declining continuously because their assets and liabilities are declining with increasing GDP. The decline in assets and liabilities are due to mergers, liquidations and decrease in balance sheet items at individual level. In fact, the financial position of finance companies has been found weakening in each review period due mostly to their higher exposure in real estate business and investment in other financially risky projects.

3.31 The total assets and liabilities of finance companies show a vulnerable trend. It declines in mid-July 2013 and increases in mid-Jan 2014, however, with a reducing growth rate. The total assets and liabilities of finance companies showed slight improvement in mid-Jan

2014 and increased by 5.7 percent to Rs. 112.25 billion compared to mid-July 2013, however, it declined by 3.31 percent compared with mid-Jan 2013. Likewise, the same trend is followed by deposit mobilization, loan advancement and investments as well. Deposit of finance companies occupies 3.9 percent of share in total GDP. Finance companies mobilized aggregate deposit of Rs. 74.65 billion in mid-Jan 2014 which is a growth of 8.2 percent compared with mid-July 2013. Current deposit (Rs. 157.14 million) remarked a huge growth by five times the deposit collected in mid-July 2013.

3.32 Loan and advances of finance companies of Rs. 65.78 billion accounted for 3.5 percent of total GDP. It grew by a nominal growth rate of 2.3 percent in mid-Jan 2014 from mid-July 2013. Financial institutions are the major recipient of loan from finance companies that aggressively grew by 241.8 percent in the review period. The investment of finance companies was Rs. 2.7 billion in mid-Jan 2014 which was Rs. 2.24 million in mid-Jan 2013. Of such investment, investment in government securities has been dominant one while other investments such as investment in share and debentures are negligible.

3.33 Capital fund of finance companies is in declining state. Increasing negative retained earnings are pulling their capital base downward. Capital fund decreased to Rs. 11.13 by 7.03 percent in mid-Jan 2014 compared to the figure of mid-July 2013. Such a decrease is 23.6 percent compared with mid-Jan 2013. As the reflection, the aggregate capital adequacy ratio of finance companies decreased in mid-Jan 2014 to 15.4 percent compared to 17.8 percent in mid-Jan 2013 and 16.1 percent in mid-July 2013. Still the capital adequacy ratio is above the regulatory capital adequacy ratio. The core capital ratio of such companies was 14.7 percent in mid-Jan 2014 in comparison to 16.9 percent in mid-Jan 2013 and 15.3 percent in mid-July 2013.

3.34 The credit to deposit ratio of finance companies was increasing till mid-July 2013. Though it managed to decrease to 90.1 percent in mid-Jan 2014 from 95.4 percent in mid-July 2013, it is still higher than regulatory limit of 80.0 percent. The situation of NPL of finance companies is getting worrisome in each review period. The share of non-performing loan to total gross loan worsened to as 15.7 percent in mid-Jan 2014 compared to 14.1 percent in mid-Jan 2013 and 14.3 percent in mid-July 2013. On the other hand, the average non-performing loan to net of provision of loan stood at 4.1 percent that was -0.77 percent in mid-July 2013 compared to 4.3 percent in mid-Jan 2013. Non-banking assets of finance company have increased more than two fold to Rs. 1.10 billion in mid-Jan 2014 from Rs. 429.5 million in mid-Jan 2013. The amount was Rs 310.59 million and Rs 752.98 million in mid-July 2012 and mid-July 2013 respectively. Loan loss provisioning reached to Rs. 10.95billion in mid-Jan 2014 from Rs. 10.79 billion in mid-July 2013. This shows the deteriorating assets quality of finance companies.

3.35 Increasing credit to deposit ratio beyond the regulatory limit and deteriorating loan quality has exposed the finance companies to the risk of liquidation. Many finance companies already went into liquidation and many are still in line. The situation of poor lending quality alarms the risk of some more finance companies getting into liquidity trouble and some more depositors losing their deposits in coming days.

3.36 An encouraging improvement has been noticed in profitability of finance companies in terms of net profit figure. Both the ROA and ROE in comparison to data of both mid-Jan 2013 and mid-July 2013 improved and net profit in increased to 758.05 million in mid-Jan 2014 in comparison to net profit of 10.33 million in mid-July and net loss of 799.33 million in mid-Jan 2013. Most of the items of expenses and income have decreased in review period compared to that in mid-Jan 2013 and mid-July 2013 but less decrease in income in comparison to decrease in expenses led to net profit.

3.37 Liquidity cushion of finance companies has been increasing that is indicated by increasing liquidity to total assets and liquidity to total deposit ratio. Considering the distribution of loan to the different sectors, only 3.0 percent of total loan had been forwarded to agriculture sector and a very minimal share of 0.3 percent had been forwarded to electricity, gas and water sector. However, loan to wholesalers and retailers sector received 14.4 percent of total loan and advances which was among the highest percentage of loans and advances distributed by the finance companies in mid-Jan 2014 followed by construction sector which stood at 14.3 percent.

3.38 In terms of product-wise loan portfolio, deprived sector lending received only 3.0 percent of total loan from finance companies on contrary to regulatory requirement of 4.0 percent. Demand and working capital, term loan and real estate loan contributed 24.3 percent, 13.1 percent and 14.8 percent respectively. Finance companies' exposure in real estate sector has decreased in all means i.e. in terms of sector-wise, collateral-wise and product-wise loan. Loan against real assets as properties have decreased by 11.4 percent from mid-July 2013. However, real estate loan still hold a significant share of 14.8 percent of total loan in mid-Jan 2014.

3.39 When compared with the figure of mid-Jan 2013, a remarkable growth of 69.9 percent is noticed in loan against collateral of "others" category. As the collateral heads under 'others' category is not distinct, it will be difficult to draw the rational conclusion. Seven finance companies are declared problematic and one is under prompt corrective action up to mid-Jan 2014. Separate problematic institution resolution desk has been created in the finance company supervision department to look after these institutions. Reasons behind current status of these institutions are poor assets quality culminating from poor corporate governance practices such as rampant insiders lending, poor risk management, non-compliance with internal policies and procedures. To improve the financial health of these institutions, directives such as reduction in credit, reduction in non-performing loan, completion of due diligence audit have been issued.

Micro Finance Financial Institutions (MFFIs)

3.40 As of mid-Jan 2014, the number of micro finance financial institutions, (also known as micro finance development banks) operating as "D" class financial institutions has grown up by 11 as compared to mid-Jan 2013 reaching the number to 35. Out of total MFFIs, 5 are Grameen Bikas Banks (Rural Development Banks) and 30 are private sector micro finance development banks who replicate the 'Grameen Banking Model'. Among them, 4 are concentrated in wholesale micro finance business. The number of branches of MFFIs reached 776, creating employment to more than 4 thousand persons till mid-Jan 2014. As compared with mid-Jan 2013, the total number of members of MFFIs increased by 31.6 percent to 14,86,128 in mid-Jan 2014. Out of total members, some 13.0 percent members are with 5 GBBs. The total loan disbursed by the MFFIs as of mid-Jan 2014 rose by 38.1 percent to Rs. 167.91 billion as compared to that of the previous year. Out of total loan, the GBBs disbursed Rs. 38.64 billion with an increment of 13.6 percent in the review period.

3.41 As of mid-Jan 2014, total capital of MFFIs increased by 43.1 percent to Rs. 4.75 billion compared to mid-Jan 2013. The share of GBBs stood at 6.9 percent with Rs. 327.32 million. Paid-up capital rose by 49.1 percent to Rs. 2.77 billion and the ratio of paid-up capital to total capital stood at 58.3 percent. The paid-up capital of GBBs stood at Rs. 407.1 million, sharing 14.7 percent of the total paid-up capital. Among these MFFIs, 9 of them are operating in loss with one of them having negative capital fund. As per the NRB directives, “D” class financial institutions are required to maintain at least 4.0 percent as core capital and 8.0 percent as capital fund based on risk-weighted assets.

3.42 Total assets of MFFIs in the review period grew by 33.4 percent to Rs. 42.34 billion. Out of the total assets, the GBB shared 13.4 percent. Total loan and advances of the MFFIs grew by 45.4 percent to Rs. 28.21 billion as compared to the previous year. The amount disbursed by the 5 GBBs during the period stood at Rs. 3.58 billion. The ratio of loan and advances to the total assets stood at 66.6 percent. Out of the total loans, four wholesale lending institutions disbursed Rs. 7.27 billion sharing 25.8 percent. The remaining loan accounted individual loans. Among the MFFIs, only one bank holds non-banking assets of Rs. 0.71 million during the review period. Likewise, investment of these banks in mid-Jan 2014 rose by 11.0 percent to Rs. 3.27 billion. In this category, the investment of GBB stood at Rs. 208.5 million. Out of total investment, the ratio of investment in government securities by the MFFIs stood at 3.6 percent.

3.43 Total deposits collected by these banks from their members rose by 53.1 percent to Rs. 9.14 billion in the review period. The share of GBBs in the total deposit mobilization by MFFIs stood at 12.0 percent stake. As comparing to total liabilities of these institutions, the share of deposit mobilization remained at 21.6 percent. Likewise, total borrowings of these banks during the review period increased by 34.0 percent to Rs. 23.48 billion. The

GBBs borrowed Rs. 3.08 billion during the period. As compared to total liabilities of MFFIs, the share of borrowings remained at 55.5 percent. Out of the total borrowings, the share of borrowing from NRB remained at less than one percent while major borrowings belong to commercial banks, development banks and finance companies.

3.44 Regarding the asset quality, the total amount of overdue loan, including interest, of these institutions declined by 15.5 percent to Rs. 913.96 million compared to the same period last year. The share of overdue loans of GBBs accounted Rs. 754.30 million with a significant share of 82.5 percent of total overdue loans of MFFIs. The number of overdue loanee has decreased by 45.8 percent to 30,611 persons during the review period. Out of this, the number of overdue loanees of GBBs share 64.8 percent. Likewise, the amount of loan loss provision of these institutions also rose by 17.2 percent to Rs. 753.4 million during the review period. The GBBs had loan loss provision of Rs. 320.56 million during the period.

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Chapter Four

Cooperatives, FINGOs And Other Financial Institutions

NRB Permitted Limited Banking Cooperatives and Financial Non-Government Organizations

4.1 The number of cooperatives permitted for conducting limited-banking activities by the NRB was 16 as of mid-Jan 2014. Among these, National Cooperative Development Bank (NCDB) has been permitted for wholesale business while remaining other 15 cooperatives are involved in retail lending. The total assets of these institutions increased by 37.5 percent to Rs.17.15 billion and total capital increased by 27.4 percent to Rs. 1.76 billion, of which share capital alone holds some 71.8 percent. On the other hand, total deposits of these cooperatives also increased by 35.6 percent to Rs. 12.56 billion in mid-Jan 2014. Loans and advances increased by 35.5 percent to Rs. 10.72 billion. Similarly, the total investment of these cooperatives increased by 33.8 percent to Rs. 1.29 billion. Out of this investment, fixed deposit shared some 23.6 percent while rest of the amount was invested in other instruments, like government bonds, share and debentures, etc.

4.2 As of mid-Jan 2014, there were altogether 30 financial intermediary non government organizations (FINGOs) with their 282 branches operating throughout the country. There were 385 branches of 33 FINGOs in mid-Jan 2013. The FINGOs are registered under the Institutions Registration Act, 1977 and carrying out limited banking activities with the permission of NRB in accordance with the provision of the Financial Intermediary Act, 1999. The number of members of these institutions s declined to 4,69,214 from 5,41,408 in mid-Jan 2014. The outstanding loan of these institutions stood at Rs. 4.29 billion, while total deposit amount was Rs. 2.44 billion. These figures were Rs. 5.81 billion and Rs. 2.96 billion respectively in mid-Jan 2014. NRB has already set a deadline of 2015 July for the FINGOs to be transformed into"D" class financial institutions.

Rural Self-Reliance Fund (RSRF)

4.3 The Rural Self Reliance Fund (RSRF) was instituted in 1991 with the joint efforts of the Government of Nepal and NRB. The objective of the Fund is to work for gradual poverty reduction by providing wholesale credit mainly to the cooperatives involved in fulfilling the lending needs of the poor section of the society at a subsidized interest rate. The total seed capital of the Fund stands at Rs. 543.4 million with Rs. 290 million contributed by the government and rest of Rs.253.4 million by the central bank. The loan limit per borrower has been set at Rs. 90,000 for the loans disbursed through the cooperatives. As of mid-Jan 2014, total loan amounted to Rs. 1.40 billion has been sanctioned through this Fund to 879 institutions throughout 66 districts benefitting some 43 thousand deprived-households. The sanctioned loan amount was Rs. 1.18 billion for 720 institutions throughout 62 districts benefiting some 37 thousand households in mid-July 2013. The loan recovery rate stood at 93.5 percent in mid-Jan 2014.

Saving and Credit Cooperatives

4.4 The development of cooperatives as a whole and, particularly, the saving and Credit Cooperatives in Nepal has not generated expected outcomes. Intrinsic weight should be

Box 4.1: Current Status of SCCs (As of mid-Jan 2014)

Number of Cooperatives: 30,087

Number of Saving and Credit Cooperatives: 12,961, and Share of SACCOs: 43.07 percent

Number of Members: 44, 26,965; of *which:* Women Members: 44.98 percent.

Number of Employee: 52,739

Share capital: Rs. 35.39 billion; *of which*: Saving and Credit Cooperatives: 72.20 percent and Capital Fund:. 4.73 billion

Total Deposit: Rs. 162.30 billion; *of which*: Saving and Credit Cooperatives: Rs. 121.94 billion (75.13 percent)

Total Loan and Advances: Rs. 140.03 billion; *of which*: Saving and Credit Cooperatives: Rs. 106.67 billion (76.05 percent)

Other Investment: 86.26 million

attached to rational mobilization of public money into the productive sector, poverty alleviation and employment rather than into profit-maximizing motive. Even after conceptualizing the various development models of cooperatives, problems began to emerge when cooperatives started attracting deposits by offering higher rate of interest. NRB, being the apex body of financial institutions with an objective of developing a secure, healthy, efficient system of payments as well as boosting the public confidence in the country's entire banking and financial system, has been closely watching the operation, particularly the lending connections of Saving and Credit Co-operatives, regulated and supervised by the Department of Cooperatives (DOC) with a view to ensure financial stability.

4.5 As of mid-Jan 2014, there were altogether 30,087 cooperatives operating in Nepal out of which 43.1 percent (12,961) co-operatives were undertaking saving and credit activities (SCCs), 24.6 percent (7,385) were agriculture cooperatives, 13.6 percent (4,103) multi-purpose cooperatives and the rest were found to be focusing on activities like dairy, consumer and, among others.

4.6 The total memberships of SCCs were 2.35 million, with an average membership of 181 per cooperatives. The males and females employed in these cooperatives stood at 15,277 and 15,557 respectively. The total share capital of SCCs was Rs. 25.54 million with an average share capital of Rs. 1.97 million as of mid-Jan 2014. These SCCs had a deposit base of about Rs. 121.94 billion and investment of Rs 106.72 billion..

Table 4.1: Summary Indicators of Cooperatives (Mid-Jan, 2014)

Types of Cooperatives	Number	Deposits (Rs. in Million)	Share Capital (Rs. in Million)	Fund (Rs. in Million)	Loan and Advances (Rs. in Million)	Others (Rs. in Million)
Saving and Credit	12,961	25,546.3	2,571.2	121,940.7	106,673.2	50.35
Multipurpose	4,103	6,380.2	1,078.8	29,254.1	24,940.8	20.78
Agriculture	7,385	1,867.3	470.1	3,372.4	4,778.2	12.30
Others	5,638	7,727.9	1,591.2	352.3	3,872.1	2.84
Total	**30,087**	**41,521.7**	**5,711.3**	**154,919.5**	**140,264.3**	**86.3**

4.7 The outstanding loan extended to the members for various purposes such as micro enterprises, cereals and cash crops, livestock, dairy services, and poultry, among others as of mid-Jan, 2014 was Rs. 8.62 billion. The major sources of loanable fund were deposit, share capital from the members and borrowings from wholesale lending institutions however; all the cooperatives do not have access to wholesale loans. A recent committee formed by the GoN for the investigation of fraud and embezzlement in the financial transaction of cooperatives have highlighted that many cooperatives are being run as family business, with family members working as directors and audit committee member. The cooperatives are found transferring fixed assets like land, buildings and shares as collateral in the name of board members or other companies they have promoted. Additionally, member's deposits in such cooperatives, especially the cooperatives working in urban areas, for example, in Kathmandu Valley have been found that funds have been invested in unproductive activities and real estate business. However, cooperatives working in rural areas have been found to be running smoothly. They are mostly found involving in production and employment oriented activities and have indeed succeeded to fill up the financing gap of beneficiary of rural households.

4.8 The DOC statistics shows that all types of cooperatives, including the saving and credit, across the country has deposits worth Rs 162.30 billion as of mid-Jan 2014. Of the total deposits, saving and credit cooperatives have dominant share. These cooperatives hold Rs. 121.94 billion, which is equivalent to 9 percent of the total deposits of "A", "B" and "C" class banks and financial institutions in Nepal. As the share of cooperatives of total assets reached around 7.0 percent with the total assets of whole financial system and about 11.0 percent with the GDP, cooperatives, in principle, are supposed to operate in specific community or geographic region for the mutual benefits of their members and collect savings from or lend to the members only. If these institutions run without the cooperative principle, financial stability could be under threat because of cooperatives and it may create systemic risk in the financial system of Nepal..

4.9 Some of the credit and savings cooperatives have command over a wide range of depositors and credit-users in different communities. Their turnovers, as reported by them, exceed that of finance companies, which gives an idea about the size of cooperatives. They can play significant role as well as pose threat to the entire financial sector. Growth in number of institutions naturally brings both the opportunities and risks. As a natural law, control and proper regulation should always become stricter as the number and size of the institutions grow. Hence, there is an urgent need of a control mechanism on the cooperative business. Considering their growing size and influence, these cooperatives should be strictly monitored and supervised with standard regulatory norms. The issue related to regulatory and supervisory framework for these co-operatives should be addressed as early as possible with the formulation and implementation of sound measures to ensure financial health and stability.

4.10 A sound regulatory and supervisory authority can control malpractices of cooperatives. In the absence of such arrangement in regulation and supervision, haphazard investment practices, including those in riskier real-estate projects, are reportedly going unabated in recent years, creating threats to the financial sector and the economy as a whole. These threats are more serious for economically vulnerable depositors associated with the cooperatives.

4.11 Credibility and security are the key factors critical in the context of saving and credit cooperatives in Nepal. Executive members should analyze how much risk they can absorb in the given situation. There is an imperative need to devise a customized mechanism of credit analysis and evaluation before making investment decisions. The executives should build professionalism in analyzing calculative risks instead of speculative risks. A code of conduct based on the standards of corporate governance and social responsibility of business - one of the principles of cooperatives—should be developed and implemented effectively under the supervision of a well-functioning regulatory authority.

Other Financial Institutions

Insurance Companies

4.12 Insurance sector is also one of the emerging sectors in the financial system comprising 6.0 percent share in total assets and liabilities of the financial system. Due to several reasons, Nepalese insurance market has not been effective and efficient in comparison to foreign insurance market. At present only about 6.0 percent of Nepalese are insured and around 3.1 million people are involved in various insurance activities. The insurance policies for both life and non-life segments are progressively increasing over the period. Similarly premium collection and its contribution to GDP are also increasing over the period. Likewise, the investment of both the life and non-life insurance companies is significant. As of mid-march 2014, there were altogether 25 insurance companies established under Insurance Act, 1992. Among them, 8 insurance companies offer life insurance services, 16 companies offer non-life insurance services and one provides both the life and non-life insurance services. According to the ownership structure, 3 insurance companies are operating under foreign investment and 2 insurance companies are operating as joint venture with foreign insurance companies. Likewise, 19 insurance companies belong to the private sector, whereas one is under the government ownership.

4.13 The total assets and liabilities of these insurance companies increased by 10.8 percent in mid-march 2014 which is Rs. 93.78 billion as compared to mid-July 2013, which was Rs. 84.65 billion, of which life insurance and non-life insurance account for Rs. 75.57 billion (80.0 percent) and 18.20 billion (20.0 percent) respectively.

4.14 Total premium collection by the insurance companies has been gradually increasing over the years. Premium collected for life insurance contributed more than 60.0 percent of total premium collection. The premium collection was Rs. 15.27 billion in 2009/10 and increased on an annual average by about 17.0 percent for the next 3 years to Rs. 24.24 billion in 2012/13 comprising of Rs. 15.89 billion from life insurance and Rs.8.35 billion from non-life insurance companies. The premium collection in 2013/14 up to mid-March 2014 was Rs. 18.61 billion comprising of Rs. 11.75 billion from life insurance and Rs.6.86 billion from non-life.

4.15 The investment made by the insurance companies over the year has been gradually increasing. On the investment side, it was Rs. 31.53 billion in 2008/09. It has been observing an increasing trend over the years. The total investment made by life as well as non-life insurance companies reached Rs. 75.73 billion as of mid-March 2014 comprising of Rs. 63.78 billion and Rs. 11.95 billion by life and non-life insurance companies respectively. The growth rate of investment for the last five years was about 10.0 percent per annum.

Table No 4.2: Main Indicators of Insurance Companies[2]

Main Indicators	Life	Non-Life	Total
Paid Up Capital (Rs. In Million)	3,630.00	2,499.70	6,129.70
Investment (Rs. In Million)	63,776.40	11,949.90	75,726.30
Number of Office of Insurance Companies	458	226	684
Number of Staff of Insurance Companies	1,598	1,781	3,379
Gross Insurance Premium (Rs. In Million)	11,754.10	6,855.90	18,610.00
Number of Effective Policies including Foreign Employment Insurance Policies	4,374,045	572,959	4,947,004
Number of Insurance Agents	160,633	4,766	165,399
Re-Insurance			
Gross Reinsurance Premium (Rs. In Million)	318.29	2,304.40	2,622.69
Reinsurance Commission (Rs. In Million)	112.73	546.39	659.12
Gross Claim from Reinsurance (Rs. In Million)	136.84	932.25	1,069.08
Claims			
No. of Claims made	8,026	28,784	36,810
No. of Claims paid	8,624	22,721	31,345
No. of Outstanding Claim	2,919	15,874	18,793
Amount of Claim Paid (Rs. In Million)	1,033.39	2,205.57	3,238.96

Employees Provident Fund (EPF)

4.16 Among the various institutions which have adopted Provident Fund as one of the social security schemes in various countries, one that caters to the long term saving for the old age income security in Nepal is Employees Provident Fund (EPF), incorporated under Employees Provident Fund Act, 1962. It is also known as Karmachari Sanchaya Kosh (KSK). EPF has received associate membership of ISSA in 1980 for Nepal by representing social security institution of Nepal. Since then, being single member institution of ISSA in Nepal,

[2] As of mid-April 2014

it has been taking active participation in meetings, seminars and training organized by the ISSA. As per the provision of the Employees Provident Fund Act, 1962 the EPF is an autonomous body under Ministry of Finance (MOF), Government of Nepal. Employees Provident Fund (EPF) has been making a number of innovations in terms of social welfare facilities and fulfilling in-service needs of the subscriber. Hence, it's a rescuer of an employee in times of financial emergency.

4.17 According to the provision of the EPF Act, 10.0 percent of monthly salary and the employer makes matching contribution are mandatory for the government sector employees. But voluntary for private sector organization with 10 or more employees and the lump sum amount of accumulated fund will be refund to members after their retirement or death. However, EPF has not any provision for pre-retirement withdrawal, but it has permitted withdrawal loan to its members as per their requirement. EPF is also providing some special social security benefits to its members. Hence, it seems that provident fund is the bedrock of Nepal's social security system. The contribution to PF is exempt from Income Tax.

4.18 The total numbers of regular contributors to EPF is 483 thousand. However, the membership of EPF has been increasing gradually over past year. It is only covered less than 4.0 percent out of nearly 11,779 thousand formal and informal sector workers and 23.4 percent of the total wage and salary based employees and approximately 2.0 percent of the total population of Nepal.

Table 4.3: Number of Contributors in EPF

Sector	Number of Members
Civil servants	89,000
Nepal Army	93,000
Nepal Police and Armed Police Force	92,000
State owned Enterprises and Corporate Sectors	121,000
Teachers of Schools including Private Schools	88,000
Total	**483,000**

4.19 The governance structure of EPF is an autonomous body which has been operating under Ministry of Finance (MOF), Government of Nepal. There is separate Board of Directors (BOD) with seven members nominated by the Government of Nepal from different sectors. The Board of Directors of EPF is the top most level in the hierarchy of the organization structure. EPF have many other committees' such as Investment Promotion Committee, Risk Management Committee, Audit Committee, Recruitment and Promotion Committee etc. GON appoints the Administrator as Chief Executive Officer for carry on a regular work of EPF. The Administrator is accountable towards the Board. Under the

Administrator there are two Chief Officers (Deputy CEO), ten departments, seven branches located at different place of the country and one service center at Kathmandu.. Total Number of employees working in EPF is 450. From the Governance point of view, EPF has been already implemented Risk Management Guidelines, Investment Policy, Account Manual and trying to implement Corporate Governance Guidelines within this Fiscal Year and HR Plans and Policy by next year. Other than the Board level committee, there is also some management level committee to manage the financial soundness of EPF such as Assets Liability Co (ALCo), Loan and Investment committee, Senior Executive Forum (SEF).

4.20 As of mid-April 2014, the total fund mobilization by EPF reached to Rs. 162.19 billion including cumulative PF deposit, reserve fund and other liabilities and provisions, whereas the total fund was Rs. 145.70 billion in mid-July 2013. The total fund at EPF has been on the increasing trend over the periods in each year due to ever increasing membership, periodic increment in the pay scale of members and compounding of the interest on deposits. However, on an average, it has increased annually at the rate of 17.0 percent, but the growth rate of the total resources stood negative by 2.1 percent in mid-July 2013. However, the estimated amount of total resources for 2013/14 is Rs. 170.70 billion by the EPF.

4.21 EPF has formulated the investment policy and portfolio limit to ensure productive, secured and profitable investment. The EPF has committed to invest more than Rs. 26 billion in long term national priority projects like hydropower as of mid-March 2014. Similarly, EPF as a contractual saving scheme has invested around Rs. 154.67 billion in different infrastructure projects in total. Thus, it is expected to have positive impact on economic development through various income and employment generating activities. EPF has also provided loan to other public enterprises including Nepal Airlines Corporation (NAC) and Nepal Oil Corporation (NOC) Rs. 5 billion and Rs. 12.35 billion respectively for the development of tourism industry as well as for smooth supply of petroleum products. The dependency on fixed deposit investment in commercial bank has been reduced by around 15.0 percent in last five years. Similarly, project financing in different projects has been increased by 6.0 percent in the same period. Hence, it might be a good indicator of EPF investment portfolio has been diversified in these days.

4.22 The EPF has a very low share of cash and bank balances out of its total sources of fund. Though, the operating expenses also show a satisfactory position as it has been maintained below 5.0 percent of gross income, it has been estimated to be in the increasing trend. In the same way, credit (project financing and member's loan) to deposit (PF fund) ratio of EPF has also been found under the acceptable practice.

4.23 EPF has empowered the Board of Director to determine the annual rate to be credited to member's account. Considering the total fund mobilized, total amount of investment, return from investment and annual administrative cost, it fixes the annual interest rate.

At present the current interest rate to PF deposit is 8.0 percent. Besides this, EPF declares the annual bonus to PF members on the basis of profit earned by it. Accordingly, a member PF account has been credited by 0.75 percent PF deposit out of the profit of 2013/13. EPF has been providing four different types of loan to its members, namely: (i) Special Loan (ii) House Loan (iii) Education Loan and (iv) Revolving Loan.

Table 4.4: Sector-wise Investment by EPF (Rs. in million)

Sector	Unit	2010/11	2011/12	2012/13	2013/14	Mid-April 2014
Government Securities	Amount	7027.6	13471.3	14950.5	1373.7	1,5030.1
	%	8.1	13.17	12.59	9.83	9.72
Equity in Banking and Financial	Amount	1000.3	1118.5	2197.9	2173.6	2173.6
	%	1.2	1.09	1.85	1.56	1.41
Fixed Deposit	Amount	30910.0	25980.0	23880.0	27800.0	24340.0
	%	35.6	25.40	20.11	19.95	15.74
Project Financing	Amount	3625.4	6334.9	10738.3	15563.9	22819.8
	%	4.2	6.19	9.04	11.17	14.75
Members Loan	Amount	43787.2	55043.0	66632.1	79765.7	89951.3
	%	50.5	53.81	56.10	57.23	58.16
Building and Housing	Amount	364.2	346.1	373.2	356.4	356.0
	%	0.42	0.34	0.31	0.26	0.23
Total loan and Investment	**Amount**	**867147.0**	**102293.3**	**118772.0**	**139363.2**	**154670.8**
	%	**100.00**	**100.00**	**100.00**	**100.00**	100.00

Table 4.5: Sources and Uses of EPF (Rs. in million)

Sources	2010/11	2011/12	2012/13	2013/14	Mid-April 2014
Provident Fund	86704.7	102328.2	121449.6	1407099.0	156249.8
Reserve Funds	3175.3	3151.1	29713.0	3478.0	4378.5
Other Liabilities and Provisions	510.8	1105.2	13418.0	1515.5	1565.1
Total Sources	**90390.8**	**106584.5**	**1257527.0**	**145703.4**	**162193.4**
Loan and Investment	86714.7	102293.3	1187718.0	139363.2	154670.8
Fixed Assets	502.8	580.1	6754.0	835.8	851.4
Cash and Bank Balance			47392.0	3890.2	4696.6
Other Current Assets	3173.3	3711.1	15662.0	1614.1	1974.6
Total Uses	**90390.8**	**1065845.0**	**1257530.0**	**145703.4**	**162193.4**

4.24 As at mid-April 2014, EPF has been provided around Rs. 89.95 billion as different loan schemes. It was around Rs. 79.77 billion in mid-July 2013 which has been estimated to gradually increase in the coming years. EPF has also been providing four types of social security benefits to its members, namely: i) Accident Indemnity scheme, ii) Funeral Grant scheme, iii) Employees Welfare scheme, and iv) Medical Reimbursement plan. EPF has been provided around Rs. 27.2 million as different social security schemes up to mid-April 2014. It was around Rs. 37.25 million in 2013/14.

Citizen Investment Trust (CIT)

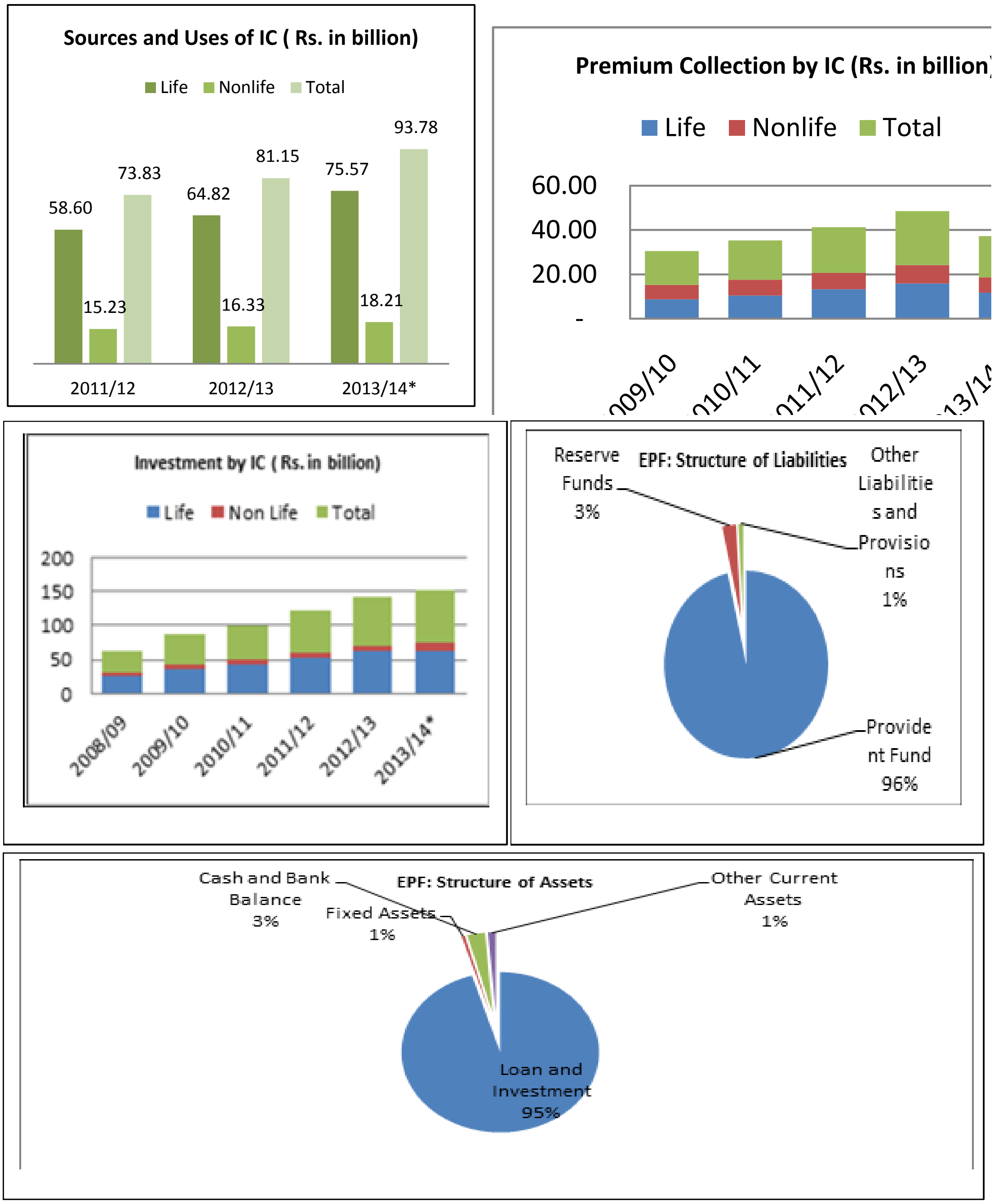
4.25 Total sources/uses of fund of CIT increased by 12.2 percent to Rs. 47.97 billion in mid-Jan 2014 compared to Rs. 42.76 billion in mid-July 2013. Total investment increased by 1.8 percent to Rs. 27.34 billion in mid-Jan 2014 compared to 27.30 billion as of mid-July 2013. Similarly, loan and advances increased by 24.4 percent to Rs. 14.61 billion in mid-Jan 2014 compared to Rs. 11.7 billion in mid-July 2013. Fund collection comprises of a major portion of CIT sources of fund of 94.46 percent. It increased by 12.36 percent to Rs. 45.31 billion in mid-Jan 2014 in comparison to Rs. 40.3 billion in mid-July 2013.

4.26 On the investment side, around 45.5 percent of total available source has been made as fixed deposit in various BFIs. Such percent was around 51.08 percent of total source in mid-July 2013. As such, CIT has minimized the vulnerabilities to liquidity problems as well as concentration risk if the BFIs fail to cash or refund the deposit on demand by CIT. The percentage is still high may be due to the unavailability of opportunities particularly for the investment in longer term projects. Although the capital base of CIT had been strengthening gradually till mid-July 2013 and reached Rs. 300 million, no addition was made to capital base in mid-Jan 2014. The liquid fund of CIT increased by 112.2 percent in mid-Jan 2013, mainly because of narrowing investment opportunities.

Table 4.6: Saving Mobilization by CIT (Rs. in million)

Schemes and Programs	**Mid-Jan 2014**
Employees Saving Growth Retirement Fund	28400.8
Citizen Unit Scheme	700.8
Gratuity Fund	8613.3
Investors' Account Scheme	2062.9
Insurance Fund of government employees	2998.2
Insurance Fund of teachers	2463.2
Insurance Fund of NARC employees	48.5
Total	**4531.02**

Figure 4.1: Financial Indicators of Other Financial Institutions (IC, EPF and CIT)



Postal Savings Bank (PSB)

4.27 Postal Savings Bank was established under GoN's Postal Service Department and came into operation in 1975/76. As at mid-Jan 2014, out of a total 117 licensed offices, 68 PSBs mobilize deposits. According to the PSB, their only source of fund is the public deposit and the only investment they make is in form of loan to employees of post office that is under ministry of communication. Depositors can open an account at minimum balance of Rs. 100. Likewise, the depositors are provided interest ranging from 5.0 to 6.0 percent and PSB provides loan of up to Rs. 300,000 charging 10.0 percent interest rate with collateral to its officials. The PSB provides loan to the postal employee payable in five-year period. The recovery of the loan amount has been almost 100 percent. The PSB has been offering other various financial services such as money order services, remittance service and insurance service, but the later one is slowing down due to the competition and establishment of many more remittance companies in the private sector. Perusing banking norms, effective service delivery, trained manpower, competition with the banks and financial institutions, suitable organization structure for financial transactions, prudential deposit, credit, investment and recovery related policies are some of the risk that PSBs are facing in its business.

Table 4.7: PSB Major indicators

Indicators	July 2013	Jan 2014.	Growth (In percent)
Total Assets/Liabilities to GDP (in percent)	0.1	0.1	
Total deposit accounts in number	58558	62562	6.84
Total Assets/Liabilities (Rs. In billion)	1.43	1.54	7.62
Outstanding Investment (Rs. In million)	507.62	471.67	-7.08
Outstanding Deposit (Rs. In billion)	1.36	1.54	13.51

Informal Financial Intermediaries (IFIs)

4.28 Informal Financial Intermediaries are that segment of financial system that addresses the diversified needs of finance (deposit, lending, remittance etc.) of the society on the core basis of inter-personal relationship rather than relying on interaction between a formal organization and a deserving anonymous client. Local money lenders, Rotating Savings and Credit Associations (ROSCAs), landlords, neighbors, traders, various informal saving and credit groups, self-help groups, users groups, hundi, Dhukuties, Mothers Club, unregulated cooperatives etc. are playing the role of informal financial intermediaries.

4.29 Despite Nepalese financial sector becoming deeper and number and type of financial intermediaries growing rapidly, problem of informal financial intermediaries is getting complicated instead of being controlled. Nepalese formal banking sector is urban centric in nature and dominate among the wealthiest only. Its process and procedures are perceived to be most cumbersome among financial institutions. These are two reasons why informal financial sector is gaining its momentum in Nepalese financial sector.

4.30 Informal sector is popular mostly among borrowers. It's amazing that despite of the cheap rates banks offer, borrowers from marginalized groups as well as wealthy groups prefer taking loan from money lenders, relatives or friends even at a very high rate. Similarly, a retailer would hand over his savings of the day to wandering savings collector of a cooperative rather than make the frequent deposits in the bank down the road. The misconception among the public regarding the procedures involved is generally blamed for why they hesitate approaching a bank branch nearby. However, the fact also can be that where banking sector serves only a limited economic class of society, the problem of access becomes more acute for small businesses and low-income households despite several attempts from government side. The informal money lenders are fast at sanctioning the loan and they require less collateral as well. So, informal lenders are preferred source of fund for meeting daily expenses as well as for working capital even among the wealthy households.

4.31 Not only deposits and lending, remittance sector is also one of the major sectors hit by informal channels. Despite the entrance of money transfer operators and the growth in formal remittance flows they have generated, the bulk of remittances enter the country informally usually through family and friends even among households with bank accounts. Family and friends are regarded to be a safer mechanism. A large portion of such remittance income is used for consumption or to pay loans from informal sector. The reason why informal sector dominates remittance market can be the lack of trust of people on formal channel and the huge charges formal channel charge.

4.32 It is believed that informal financial sector transacts a major volume of money and its failure can hit a hard stroke on financial stability. Besides, the higher interest rate charged in this sector, the exploitations of its consumers and the crimes conducted keep informal financial sector in headlines. But in the absence of sufficient researches in this sector and in the lack of ample of data to conduct researches, it is hard to make any estimates related to this sector.

4.33 Government's efforts to increase access to formal financial services have not achieved their target because the deeply rooted informal sector tightens its grasp more it is tried to be controlled. Hence, it is now necessary to conduct research on why people prefer informal way of financing to formal financial institutions. It is necessary to find out the manner in which formal banking sector can borrow and adapt the features of informal financial sector. Second idea can be to develop a link between the formal financial sector and these informal sectors to reach their large client base. The financial literacy, customer friendly banking procedures and increased network of financial intermediaries are the basic requirements to encourage access to formal financial services.

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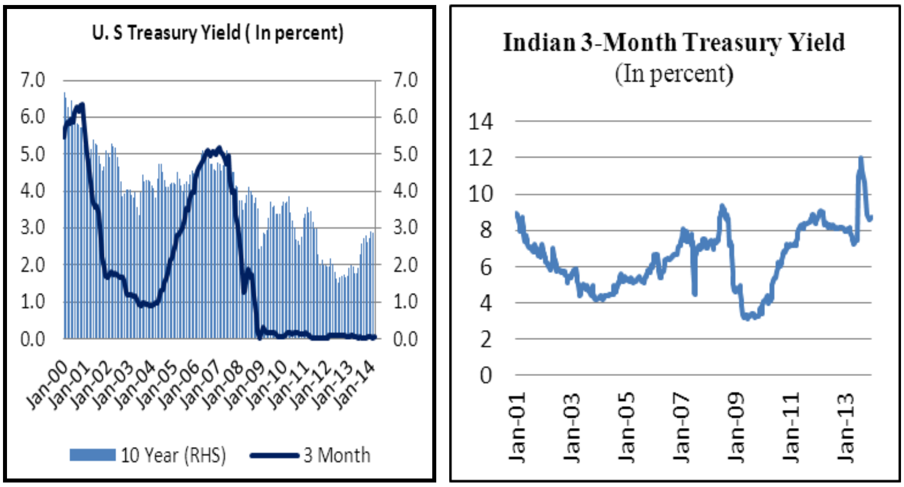
Chapter Five

Financial Market

Global Financial and Money Market Perspectives

5.1 The 10-year US treasury yields reached to 2.9 percent in January 2014 from the level of 2.3 percent in July 2013, after contracting to the lowest yield of less than 2.0 percent from June 2012 to June 2013. It had hovered around 4.0 percent in June 2009. It is in the increasing trend since August 2013 but still the trend is not in the encouraging position.

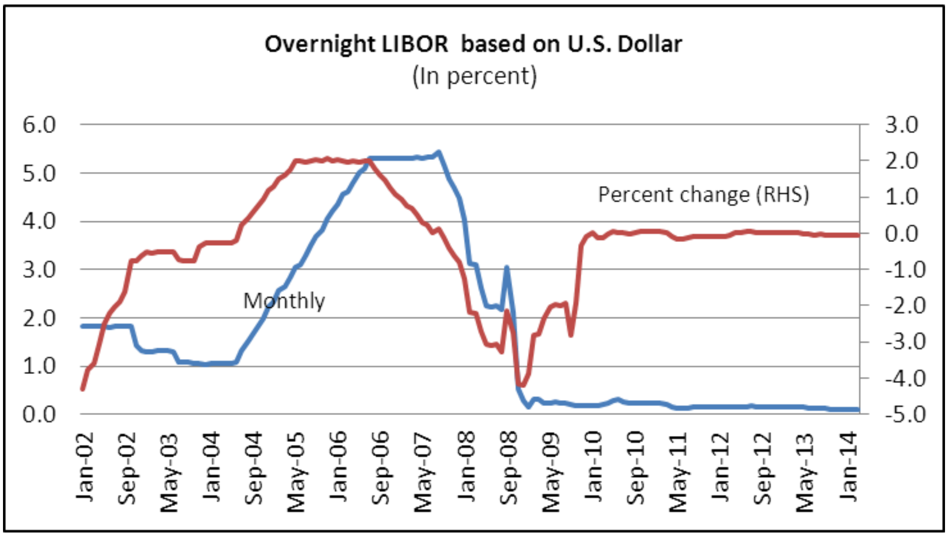
Figure 5.1: U.S. and Indian Treasury Yields



Likewise, 3-month US treasury yield has been in the increasing trend since October 2013 and reached to 0.07 percent after recording the lowest of 0.01 percent in December 2011, but again the yield has not improved and the rate has been remaining persistently too low (below 1.0 percent) after October 2008. Similarly, the U.S. Fed Funds daily discount rate has not improved since mid-August 2010. It has been hovering below 1.0 percent since then. In case of India, government's 3-month T-bill rate has been gradually increasing; it stood 5.4 percent in July 2010, to 8.4 percent in July 2011, and 11.3 percent in July 2013 and 8.7 percent in January 2014.

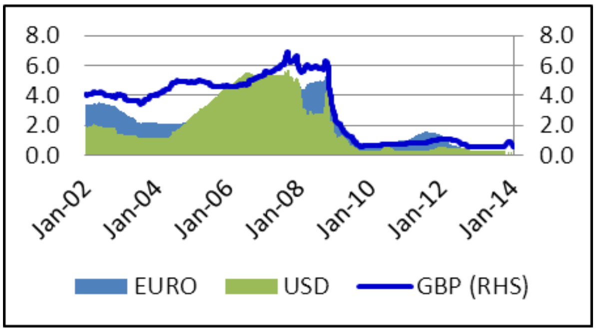
5.2 The overnight LIBOR rate for USD further declined and stood at 0.1 percent in January 2014 from the level of 0.2 in January 2013. The rate has not been improved after 2008. It is gradually in a declining position, hovering between 0.1 to 0.2 percent since that time.

Figure 5.2: Overnight Libor Rate



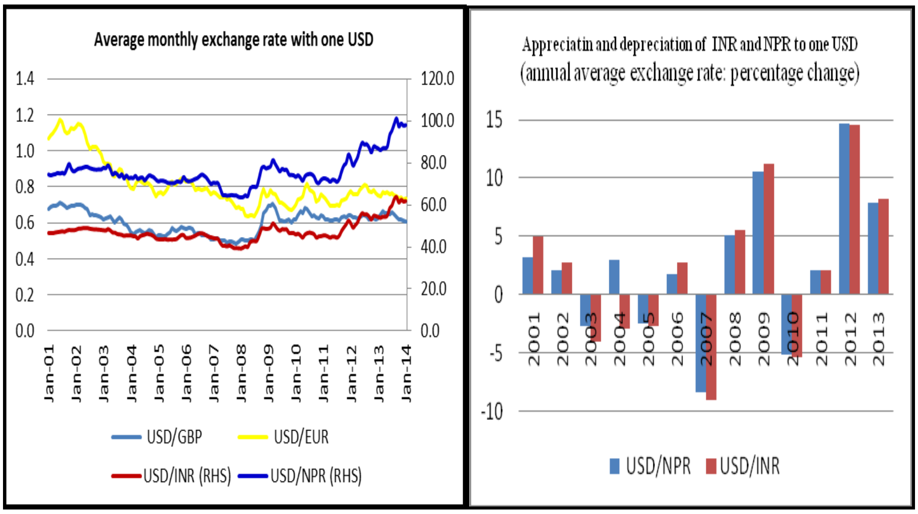
5.3 The LIBOR rate for major international currencies remained flat in 2013. The LIBOR rate with Euro declined slightly and stood at 0.2 percent in January 2014 from 0.3 percent of July 2013. However, the rate with GBP and USD remained almost the same as of July 2013 and stood 0.5 percent and 0.2 percent in January 2014. This sort of trend in LIBOR rate with major international currencies, particularly with USD, shows that the global economic slowdown has not been improved yet, as expected. The 3-month Libor rate in USD showed a slightly upward trend in 2013 Similarly, 3-month GBP and EURO rates also improved slightly over the period.

Figure 5.3: Libor Rates with Major Currencies
(In percent)



5.4 The policy makers around the globe, especially the central banks and financial market regulators have focused their attention on the relative strength of their currencies. The

Figure 5.4: Exchange Rates



exchange rate of major international currencies with one USD remained fluctuating during 2013. The average exchange rate of one USD to GBP remained quite stable in 2013, but appreciated slightly from July 2013 and stood at 0.6071 in January 2014. The yearly average rate of INR with USD depreciated sharply both in 2012 and 2013 by about 14.0 percent and reached to INR 61.8 in January 2014 from the level of INR 54.2 in January 2013. The average rate of INR with one USD was 57.8 in July 2013 from the level of INR. 53.4 in July 2012. Since 2001, both the INR and NPR had been appreciating or depreciating simultaneously with one USD. Such rate of appreciation and deprecation has been slightly different in some years. After appreciation in 2010 by around 5.5 percent, the exchange rate of both currencies with USD has depreciated more steadily in recent years.

5.5 Renewed volatility in emerging-market currency and securities markets is unlikely to be the catalyst to derail the upswing in global economic activities. As momentum is picking up in most regions within the high-income world. The U.S. is at the core of the broad-based global growth pick-up. It is expected that the sharp adjustment in emerging-market valuations as a natural phase of risk repricing and potential demand for U.S. financial assets. As central bank around the world has been taking the steps away from ultra-accommodative policies, it is expected that those currencies with stronger fundamentals, political stability and/or credible central banks to outperform those whose fundamentals are weak and external positions are vulnerable. Increased volatility in FX markets amid global portfolio rebalancing has weighed heavily on the currencies of emerging markets with pronounced structural fragilities, already weak investor sentiment and subdued growth prospects.

5.6 The global foreign exchange analysis and outlook as reflected in the IMF's and World Bank assessment reports that the USD will strengthen against the major currencies in 2014, supported by widening and increasingly attractive growth and interest rate differentials. The ongoing normalization of monetary conditions in the U.S. reflecting an improved economic outlook, will continue to away near-term capital flows, and more relevant, opening the debate about the timing and sequence of upward moves in administered short-term interest rates by the U.S. Federal Reserve, the Bank of England and the European Central Bank (ECB). As commodity price adjustments are not following a uniform pattern, instilling an added dose of volatility and uncertainty to major other currencies of the world such as AUD. However, as the global economy improves the Australian dollar (AUD) should also stabilize.

5.7 The likelihood of crude oil price decline is on global investors' radar screens whereas copper prices have experienced a somewhat volatile range trading path. It has been estimated that the oil exporting nations might see their commodity-linked currencies adversely affected by a downward directional trend. The exchange rate of EUR has been supported by the ongoing economic recovery and a return of flows; however, the fundamental backdrop continues to struggle whereas GBP will continue to strengthen owing to the improvement in the U.K. economic outlooks and fundamentals. In the Asia/Pacific region, China remains a factor of stabilization in times of disorderly global currency adjustments. With USD $3.8 trillion in foreign exchange reserves the CNY maintain enough power the exchange rate with USD at leisure. However, it has been estimated that the gradual appreciation phase may be temporarily interrupted should the process of asset price correction in emerging-market assets escalate further. For emerging Asian currencies, those who are more vulnerable from a political, current account or fundamental perspective are most at risk.

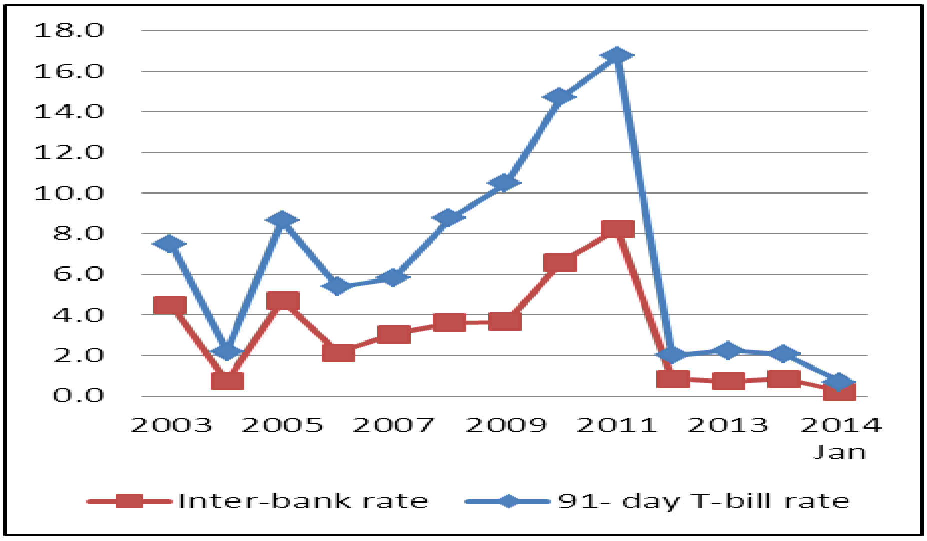
5.8 The INR's surprising stability in recent months was upset by pressures on emerging market economies. However, the RBI's rate hike helped to stabilize the currency, as did the notion that India would stay its hand on further hikes in the near term, which should be less deleterious for foreign equity and fixed income investors. While temporary government measures have helped significantly reduce the current account deficit, a weaker rupee remains necessary to ensure a sustained rebalancing of external accounts. RBI tightened monetary policy despite an easing in inflation in order to set the economy firmly on a disinflationary path. The RBI acknowledges that curbing price gains has a priority over promoting economic growth and aims to guide consumer price inflation to below 8.0 percent by January 2015 as part of its gradual process to move toward an inflation-targeting monetary policy framework. The RBI noted that conditional on enduring disinflation further monetary tightening is not anticipated in the near term. With the services sector performance soft and industrial production declining, the country's economic growth outlook remains still not encouraging. Nevertheless, an improving agricultural performance, a recuperating export sector, combined with an anticipated pick-up in investment and efforts to clear structural bottlenecks might translate into a modest acceleration in real GDP growth, which will ultimately reflect positive signs to the Nepalese economy for competitiveness and greater monetary and financial market stability.

Domestic Financial Market

Money Market

5.9 The repo rate, 91-day T-bill rate and inter-bank rate are the most important measure of short term money market rate and liquidity situation in the financial market of Nepal, whereas excess reserves in the NRB show their liquidity position. All these measures show, BFIs are facing excess liquidity and both the efforts from the BFIs and NRB in managing the excess liquidity are yet to be materialized. Both the short term and long term interest rates in the money market continue to remain in the decreasing trend since

Figure 5.5: Inter-bank and T-bills Rate



2011. The monthly weighted average 91-day T-bills rate declined to 0.5 percent in mid-Jan 2014 from 1.2 percent of mid-July 2013. Likewise, the weighted average inter-bank rate among commercial banks declined to 0.2 percent, from 0.9 percent of mid-July 2013.,T-bill is one of the risk free and highly liquid instruments which give an avenue for banks and financial institutions to maintain their liquidity and short term investment, however due to excess liquidity in the market these rates remained at lowest level. On the other, the repo rate, one of the measure of the important indicator of shortage of liquidity in the money market remained quite below from 1.0 percent and the weighted average T-bills rate of 364-days stood at 1.06 percent in mid-Jan 2014.

Figure 5.6: Average Repo Rate (28-days T-bill Rate)

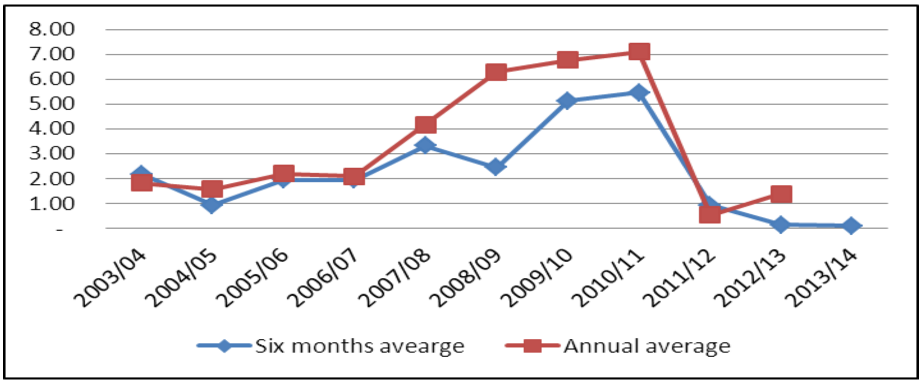
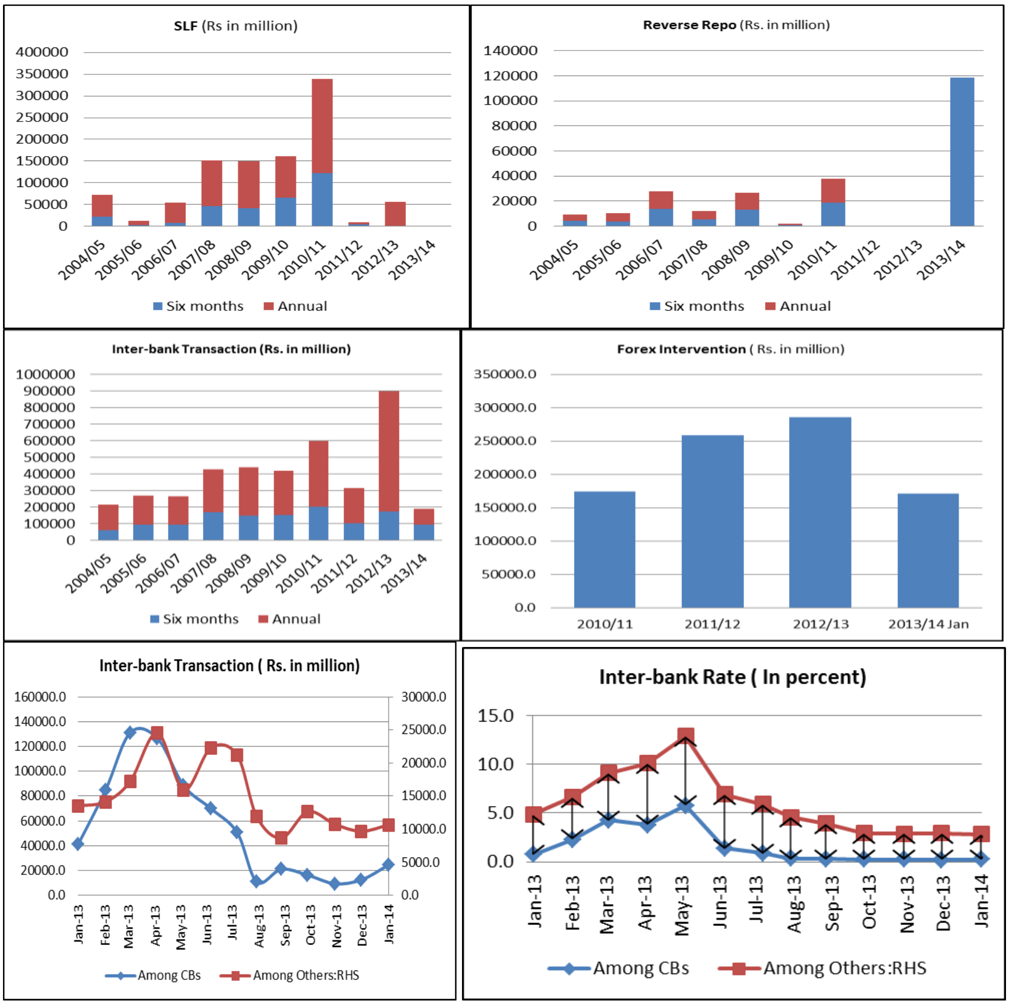


Figure 5.7: Money Market Indicators



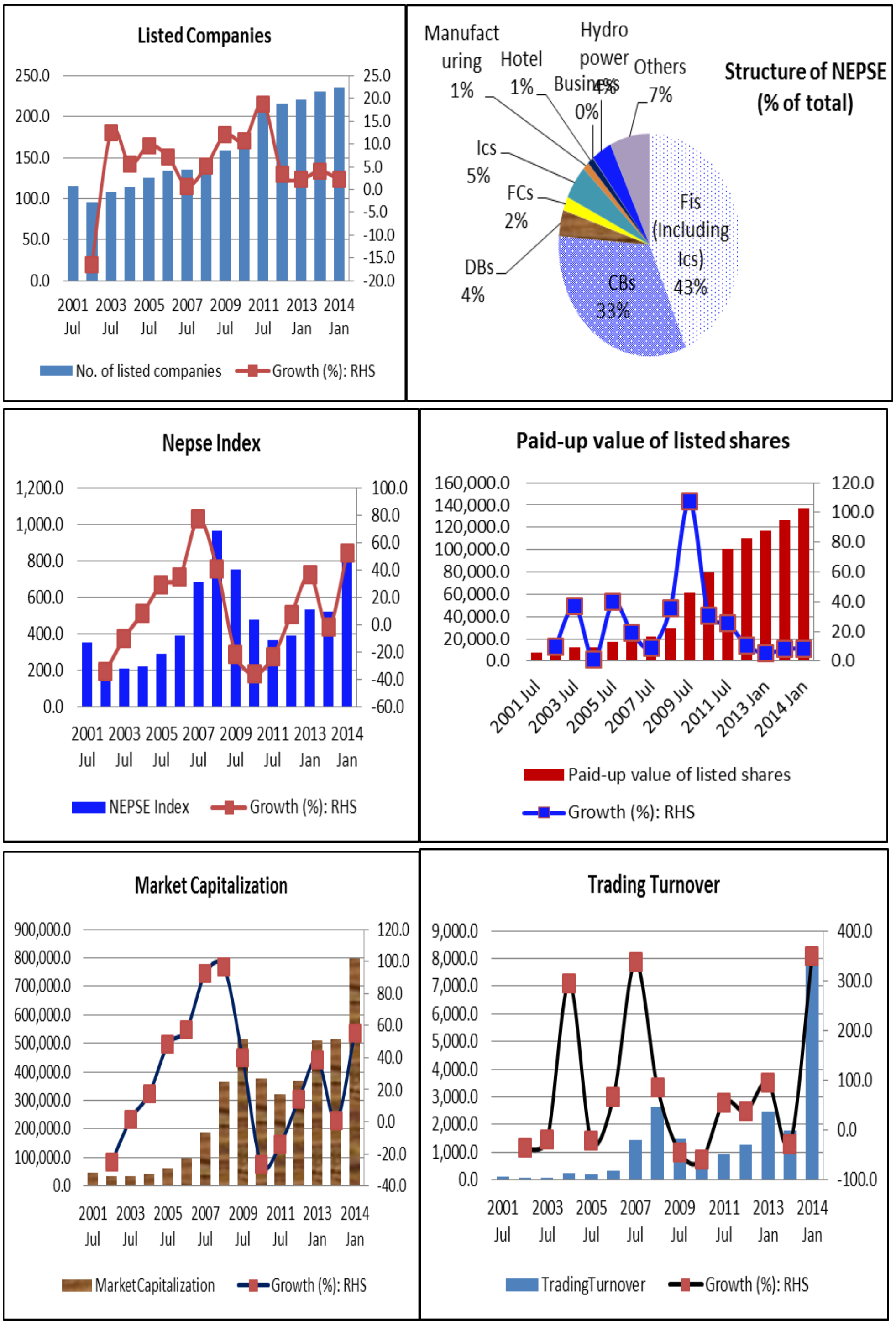
Securities Market

5.10 There was remarkable improvement in NEPSE index and capital market transactions till to mid-Jan 2014. The NEPSE index increased by 51.9 percent to 787.1 points in mid-Jan 2014 from the level of mid-July 2013 whereas it was increased by 35.4 percent to 529.7 points in mid-Jan 2013 from the level of mid-July 2012 . NEPSE sensitive index stood at 193.4 points in mid-Jan 2014, as against 130.3 points in mid-July 2013. The NEPSE overall index is gradually increasing from 2011/12 due to the positive hopes and aspirations of investors on the political situation after election to the second Constitution Assembly and on the expectation of market friendly economic policies and programs. Despite these hopes, though stock market have been gradually moving in the direction of bullish trend, the economic situation as well as the performance of corporate institutions has not been that satisfactory which the stock market have shown in different times. Therefore, the unreasonable growth of NEPSE index might fall down sometime if it did not get corrected timely. The excess liquidity in the banking sector and higher growth of remittance has been fuelling the NEPSE to move in upward trend, which have created risk in the whole financial system. Therefore, timely action from the regulatory authorities might work well for its unhealthy growth and transaction.

5.11 The market capitalization increased by 55.4 percent to Rs.799.76 billion in mid Jan 2014. As a result, the ratio of market capitalization to GDP stood at 41.5 percent in mid-Jan 2014 as compared to 26.7 percent in mid-July 2013. Of the total market capitalization, the share of banks and financial institutions (including insurance companies) stood at 77.0 percent while that of manufacturing and processing companies, hotels, business entities, hydropower and other sectors stood at 2.0 percent, 1.9 percent, 0.1 percent, 6.4 percent and 12.6 percent respectively. Total number of companies listed at the NEPSE increased from 230 in mid-July 2013 to 235 in mid-Jan 2014. Of the total listed companies as of mid-Jan 2014, the number of banks and financial institutions (including insurance companies) stood at 203 followed by production and processing industries (18), hotels (4), business entities (4), hydropower (4) and other companies (2).

5.12 Total paid-up capital of the listed companies stood at Rs. 136.81 billion in mid-Jan 2014 which represent with an increase of 8.5 percent over mid-July 2013. This is a reflection of increase in the number of listing of additional securities at the NEPSE. In a one year period since mid-Jan 2013 to mid-Jan 2014, additional securities comprising ordinary share worth Rs. 4.9 billion, bonus share worth Rs. 1.5 billion and right share worth Rs. 4.1 billion were listed at the NEPSE. In addition to this debentures worth Rs. 1.1 billion were also listed at the NEPSE.

Figure 5.8: Stock Market Indicators



Foreign Exchange Market

5.13 Nepalese foreign exchange market is the combination of licensed commercial banks, development banks, finance companies, money transfer, money exchange and various other companies such as airlines, hotels, travel and trekking agencies that are involved in foreign currency transactions. The Nepalese forex market is regulated and guided by Foreign Exchange Regulation Act and Rules, Bylaws and, circulars as issued by the NRB under the said legislative framework in order to regulate the foreign exchange market. The NRB has the responsibility to maintain an orderly forex market through monitoring of foreign currency transaction, issuing prudential regulations and intervening in the domestic foreign exchange market. Nepal has adopted fixed exchange rate regime with Indian currency and an open market exchange rate regime with other foreign currencies. Commercial banks are free to fix the exchange rate of convertible currencies based on the above mentioned regime. Commercial banks can perform the transactions of letter of credit, buying and selling of foreign currencies, provide foreign currency under passport facilities as prescribed and are also involved in inward remittance activities. They are allowed to open Nostro account in foreign banks in concerned countries.

5.14 Financial institutions of "B" and "C" class may issue IC/NC debit and credit card, as sub-agent of licensed banks. The development banks, other than national level, may also buy foreign currency, but they have to sell it to the commercial banks and or the NRB only. Likewise, BFIs may buy Indian currency from the public by obtaining approval and sell it to the public banks and financial Institutions as well. Money changers are allowed to buy and sell convertible and Indian currency and also to provide foreign currency under passport facility subject to the foreign exchange license. Money transfers companies are heavily engaged in inward remittance activities only. Other institutions like hotels, travel and, trekking agencies, hospitals and airlines, among others may accept convertible foreign currencies only in exchange of their services by obtaining prior approval of the NRB. For the smooth operation of the Nepalese foreign exchange market, 31 commercial banks, 76 financial institutions, including "B" and "C" categories, 164 money changers, 47 money transfer companies, 116 hotels, 1621 travel agencies, 1447 trekking agencies, 90 airlines (domestic and foreign including GSP/PSA of foreign airlines, 301 cargo and courier companies and 73 other service providers did foreign exchange transaction in Nepal till-to mid-Jan, 2014. Altogether, 3966 institutions have been involved in the foreign exchange market in Nepal.

Table 5.1: Number of Institutions performing Foreign Exchange Transactions

Name of the Institutions	Jan- 2013	Jul-2013	Jan-2014
Commercial Banks	32	32	30
Development Banks / Finance Companies	61	61	76
Money Changer	165	165	164
Money Transfer	47	47	47
Hotels	100	109	116
Travels	1504	1578	1621
Trekking	1281	1389	1447
Airlines (Domestic as well as Foreign and GSA/PSA)	104	88	90
Cargo and Courier	298	301	301
Others	67	71	73
Total	3659	3842	3966

Foreign Exchange Reserve

5.15 The gross foreign exchange reserves of the banking system increased considerably by 17.1 percent to Rs. 624.6 billion in mid-Jan 2014 from a level of Rs. 533.29 billion as of mid-July 2013. As the exchange rate regime with Indian currency is fixed, the exchange rate of Nepalese currency to foreign currency fluctuates as Indian Rupee fluctuates with the US Dollar. NRB fixes and maintains the cross rate to check the inflows and outflows of foreign currency. The apparent high/low fluctuation of reserves corresponds to downward and upward fluctuations of reserves determined particularly by high/low balance of payment surplus. Further, the fluctuation in the reserves could also be governed by a sharp appreciation/depreciation of NPR against major international currencies coupled with surge in remittance inflows and in imports. The monthly average middle rate of NPR depreciated by 13.1 percent to Rs. 99.20 per US Dollar in mid-Jan 2014 from the level of Rs. 87.7 in mid-Jan 2013. The depreciation of Nepalese currency resulted in exchange fluctuation gain of Rs. 11.1 billion till to mid-Jan 2014.

5.16 In terms of US Dollar, the gross foreign exchange reserves grew by 13.4 percent to US Dollar 6.36 billion as at mid-Jan 2014 compared to a level of US Dollar 5.61 billion in mid-July 2013. The level of reserve since mid-July 2011 has been gradually increasing due to the improvement in remittance inflow, tourism receipts and among others. The convertible reserves of the banking system reached Rs. 484.71 billion in mid-Jan 2014 compared to a level of Rs. 414.02 billion as at mid-July 2013 due mainly to the growth in the volume of reserves held by BFIs. The share of convertible and non-convertible (INR) reserves of the banking system remained at 76.9 percent and 23.1 percent respectively.

5.17 The share of the NRB in gross foreign currency reserves slightly slipped and stood at 83.9 percent in mid-Jan 2014 from a peak of 85.5 percent in mid-July 2012. Growth in the volume of holdings by BFIs for transaction as well as for investment motives accounted for such a fall in the NRB's share in gross reserves in this period. Likewise, the growth in INR demand for imports from India could be a reason for the decline in NRB share in total reserves. The import capacity of current reserve remained stable and sufficient to cover 11.4 months of merchandise imports and 10.2 months of merchandise and service imports. In mid-July 2012, such import capacity was sufficient for 11.7 months and 10.1 months respectively.

Exchange Rate and NRB's Intervention in Foreign Exchange Market

5.18 The Nepalese currency based on six month average exchange rate depreciated by 13.8 percent to Rs 99.41 per US Dollar as at mid-Jan 2014 from a level of Rs. 87.32 per US Dollar as at mid-Jan 2013. NPR had depreciated by 11.4 percent and 7.9 percent against US Dollar during the same period in 2011/12 and 2010/11. The six month average selling price of INR per US Dollar remained at IRs. 99.79 in mid-Jan 2014 while it was IRs. 87.62 during the corresponding period of last year. Since May 2013 the INR started to depreciate sharply with US Dollar and that resulted in upward pressure in NPR depreciation due to the pegged exchange rate regime with Indian currency. Over the periods, particularly since 2011 both the INR and NPR are fluctuating sharply with the US Dollar. The depreciation of both the currencies occurred faster in early 2013 as compared to 2012.

5.19 NRB purchase net of US Dollar from banks and financial institutions (BFIs) through forex market intervention increased significantly by 63.4 percent to equivalent of Rs. 168.93 billion compared with 103.34 billion in mid-Jan 2013. The higher amount of purchase of US Dollar through intervention also illustrated that financial market has been flush with excess liquidity and it further shows that BFIs have been holding more foreign currency with them as compared with previous periods.

5.20 NRB has been purchasing INR from Indian money market by selling USD since 2001/02 to meet the mounting INR demand. The volume of INR purchased grew by 17.2 percent to IRs. 89.41 billion by selling US Dollar 1.44 billion up to mid-Jan 2014 compared to the purchase of IRs.76.27 billion by selling US Dollar 1.4 billion in mid-Jan 2013. In 2012/13, NRB had purchased IRs. 171.52 billion by selling US Dollar 3.12 billion in the Indian money market.

5.21 The widening of trade deficit with India emanating from a surge in imports of petroleum products and other consumers goods has been attributed to a higher amount of INR purchase in recent years. Likewise, the additional investment in Indian treasury bills and a rise in the volume of imports from India were the responsible factors behind the surge in INR purchase. Despite the marginal increase in the volume of US Dollar (USD 40.0 million) while selling to purchase INR, significant amount of INR (IRs. 13.14 billion) was acquired till to mid-Jan 2014, was mainly due to the depreciation of Indian currency against the US Dollar.

5.22 As parallel market transaction of foreign currency is a common phenomenon in developing countries and in countries adopting controlled foreign exchange regime, the existence of such market in Nepal cannot be ignored. Cross border transaction through Hundi is also a matter of concern in Nepalese context. While the size of such markets is still to be estimated, the possible growth of such markets may have unfavorable impact considering the size of Nepal's foreign exchange reserves.

Figure 5.9: Indicators of Foreign Exchange Market and Forex Reserve

Chapter Six

Financial Sector Policies and Infrastructures

Financial Sector Policies

6.1 Nepal Rastra Bank, as a regulator of financial sector, is entrusted with the responsibility of maintaining financial stability. In pursue of this responsibility, NRB has been issuing policies, directives, guidelines and circulars in diversified sectors such as licensing, capital adequacy, asset quality, liquidity, corporate governance, risk management, access to finance and financial inclusion, among others. NRB is undertaking the functions of regulating, inspecting, supervising and monitoring BFIs in frequent intervals of time and ensure that BFIs are operating within aforementioned rules, regulations and policies.

Licensing Policy

6.2 The moratorium imposed on licensing of “A”, “B” and “C” class financial institutions continued in the review period. However, “D” class institutions are receiving the license on a selective basis as microfinance financial institutions can be an effective means for financial inclusion and poverty elimination in rural areas. A work group has been formed to review the existing licensing policy in terms of current situation, market dynamics, geographical topology and implementation of Basel III both in domestic banking system and in the international financial market.

6.3 Acquisition Bylaws, 2070 has been formulated and is under the process of approval. Acquisition facilitates the easy exit for those BFIs that are trying to quit. Small and problem BFIs vanishes in large acquiring BFIs and acquiring BFIs strengthen their financial, technical and human resource and other positions through such acquisition.

Capital Adequacy

6.4 Currently, Class “A” institutions are reporting under the framework of Basel II issued through Directive no. 1 of the Unified Directives. The framework is under parallel run for national level development banks. Remaining financial institutions are reporting under the framework of Basel I. With reference to the gradual implementation of Basel III according to the need and feasibility, consultative document has been prepared and presented to the committee.

6.5 National level “A”, “B” and “C” class BFIs need to maintain minimum paid up capital requirement of Rs. 2.0 billion, Rs. 640.0 million and Rs. 200.0 million respectively as per the latest licensing policy. All BFIs are strictly instructed to meet the minimum required paid up capital within mid-July 2014. NRB's capital requirements seek to ensure that risk exposures of BFIs are backed by an adequate amount of high quality capital which absorbs ongoing risks. This ensures that BFIs further promote their cushion of assets that can be used to meet claims in liquidation.

Liquidity

6.6 In order to limit the shocks BFIs may face during the situation of liquidity crunch, all BFIs are restricted from accepting institutional deposit more than 60.0 percent of their total deposit. Those who already have crossed the limit should bring the deposit within the limit by mid-July 2014. Initially, PCA (Prompt Corrective Action) was based on capital adequacy. But recently discussion is being under study to add liquidity as the extra cushion added to the criteria for imposing PCA. Draft of amended bylaws on PCA is under discussion. Similarly, in order to make the liquidity forecasting more realistic, Liquidity Monitoring and Forecasting Framework (LMFF) has now covered development banks and finance companies as well. In order to well manage open market operations and for better liquidity management, draft of Open Market Operation Bylaws has been prepared and issued. Draft of Basel III framework has been prepared to strengthen the liquidity position.

Corporate Governance

6.7 Matter of corporate governance has always been the topic of strong importance because most of the shocks and threats to BFIs are generated from within the BFIs. Corporate governance is essential in each area. The rules on corporate governance for BFIs are defined in NRB’s Directives and Basel II.

6.8 In the review period, there has been made a new addition to directives for “D” class financial institutions on corporate governance that if any firm or company is blacklisted, till blacklisted or till three years of release from such blacklisting, such firms/company will not be qualified for nominating promoter for any BFI.

6.9 Similarly, a new circular has been issued on foreign shareholding that only foreign banks and financial institutions can invest in shares of Nepalese banking sector. Those being invested by foreign individuals or companies other than BFIs must be sold to Nepalese citizen or institution within mid-July 2015. In order to purchase foreign owned shares of licensed institutions, approval must be taken from NRB. In order to restrict CEO’s and top level management to obtain loan for the companies owned by them from the BFIs they are engaged in, provisions have been made on draft of directive.

Risk Management and Supervision

6.10 During the review period, some additions have been made to policies on risk management. In order to shift supervision mechanism from current model to risk based model, under the technical assistance of IMF, risk-based onsite supervision manual has been prepared. Stress testing that was mandatory only for commercial banks earlier, has been made applicable to development banks and finance companies as well. Among the categories of risk classified in directive no. 5 of unified directives of NRB, operational risk has also been added to risk category.

6.11 BFIs are directed to develop internal control system and information system in order to mitigate the operational risk. Guidelines on information technology system have been issued to all BFIs. For the first time, BFIs need to have their information system get audited and the audit report should be submitted within Jan 2015. Regular Supervision is conducted to insure that guidelines on IT and system audit are followed. Likewise, In order to mitigate risk related to liquidity, institutions are directed to classify their assets and liabilities on the basis of different time intervals of maturity as follows:

i) Maturity period up to 90 days
ii) Maturity period more than 90 days up to 180 days
iii) Maturity period more than 180 days up to 270 days
iv) Maturity period more than 270 days up to 1 year
v) Maturity period more than 1 year.

6.12 Directives have been issued on discouraging multiple banking and regular supervision is being done to ensure the same. In order to make the offsite supervision of BFIs more efficient, supervision bylaws have been amended and off-site supervisions are conducted according to the amended bylaws. Institution-wise Liquidity Monitoring Framework (ILMF) is about to be implemented so as to increase the capacity for forward looking analysis. Similarly, in the course of implementing dynamic provisioning concept in loan loss provisioning system, concept paper has been drafted on dynamic provisioning and the draft is under discussion.

Problem Bank Resolution and BCP

6.13 In order to effectively implement the Early Warning System and to prepare the contingency plan, Problem Bank Resolution Framework has been prepared and Problem Institution Resolution Division has been established to properly address problem banks and financial institutions. Self-Assessment on Basel Core Principle Assessment Program (BCAP) has been accomplished. The action plan will be implemented soon by the NRB once final report on assessment is received. The assessment will help in evaluating the implementation status of Basel Core Principles in Nepal and will also help in formulating strategies in coming days.

Interest Rate System

6.14 The concept of base rate that was applied to commercial banks only has been implemented to development banks and finance companies as well in order to make lending interest rate transparent and competitive. With the objective of correcting the unnatural widening interest rate spread, NRB has directed 'A', class banks to bring average interest spread rate between credit and deposit to 5 percent within mid-July 2014. Other BFIs are entitled to report their interest spread monthly. Other BFIs are entitled to report their interest spread monthly. Their spread should also be published in their website every month.

Financial Sector Interconnectedness

6.15 Complex financial inter-linkage between real sector, financial sector and government has become a hallmark of modern Nepalese financial sector. Such interconnectedness has, in one hand, facilitated the ease in liquidity management, smooth operation of payment and settlement system, efficient intermediaries of savings and scale benefits. In another hand, it has paved the transmission path for financial contagion. The spillover of losses, shortage of liquidity and insolvency in one financial institution endangers the financial sector stability as a whole. Interconnectedness can not be avoided as it is vital for well-functioning of financial system and the negative impact it will certainly have on financial sector stability can not also be neglected. In such situation, the only way in front of policy makers and regulators is to tackle the interconnectedness so as to get best outcome out of it.

6.16 Domestic financial sector interconnectedness arises mainly from the interbank deposits and lending, investment by a single promoter in more than one BFI, private placements, consortium lending etc. Interconnectedness also generates between financial sector and government through investments by BFIs in government bonds, debentures, National Certificate of Savings, and National debentures, mobilization of government deposits and lending facilities etc. The cross border interconnectedness of Nepalese financial sector is limited because the financial sector is not much involved in cross border interlinked activities. Major of its transactions are limited to payment and settlement system only. However, the real sector gets easily infected by cross border financial contagion and cross border shocks can get propagated to Nepalese financial sector through real sector. Similarly, Nepalese economies heavily rely on foreign aid and FDI for its survival which also leads Nepalese economy to volatility with the ups and downs in foreign economy.

6.17 It is necessary to maintain control over the intensity of linkage, build up necessary fire walls to prevent contagion from being propagated, measure the existing interconnectedness, identify and strengthen capital base of "too big to fail" financial institutions and most important of all, anticipate the risk from interconnectedness. For these purposes, policies addressing interconnectedness are required.

6.18 In Nepalese banking sector, there are no concrete provisions that address interconnectedness neither in Unified Directives, BAFIA or any other regulatory policies. However, some provisions in Unified Directives unintentionally attempts to monitor or limit the extent of domestic interconnectedness.

a) Directive no. 3/070.1 has limited the fund in the form of single obligor limit. BFIs could provide to a group of individual and institutional borrowers that are interconnected. Directive no. 3/070.6 defines the criteria for considering individual and institutional borrowers as interconnected and classifying them under the same group as related party transaction. Directive no. 3/070.7 directs BFIs to send report on groups of interconnected borrowers.

b) Directive no. 6/070.1.2.kha restricts the promoter of BFIs to have direct or indirect link in transactions of a customer if he/she has financial interest with that customer. Directive no. 6/070.2.gha restricts the CEO of any BFIs to get involved in business related to any BFIs other than the BFI he/she is employed in. According to directive no. 6/070.1.3 same person can not be the promoter of more than one BFI at a time. Directive no. 6/070.1.12 has restricted the presence of more than one person from same family tree to participate in BFI in the position of promoter or CEO. Directive no. 6/070.6 imposes limitations on loan forwarded to employees, shareholders, CEO and those under the family tree of promoter.

c) Directive no. 8/070.3.4 and 8/070.3.5 and directive no. 8/070.8.1 limits the investment option and investment amount of BFIs in other institutions or organizations. Directive no. 9/070.2 makes it compulsory for BFIs to report on interbank transaction. Directive no. 10/070.7 limits the proportions of promoter share an investor can hold within the financial institutions. Directive no. 10/070.19 has removed the provision of cross holding of shares. Directive no. 16/070.2 has limited the institutional deposit that a BFI can accept to 20.0 percent of its total deposits. Directive no. 16/070.2 clearly restricts BFIs from depositing in each other's interest earning accounts.

6.19 These provisions are only not enough to address the current problem prevailing in the Nepalese banking system. Interconnectedness should be defined in a broad sense in the banking sector policies, directives and Acts to address them. Interconnectedness is not the only problem that has been emerged from the banks and financial institution's business practices rather in many cases it is connected with the regulatory and supervisory authorities influences, lack of enforcement of code of conducts, use of insider information and dissemination to press and BFIs etc. Likewise, on the other hand, Nepal's financial sector interconnectedness problem broadly prone to systemic risk due mostly both from demand as well as supply side driven factors. Moreover, the communication of financial stability has been almost non-exists as compared with other central bank's practice of communication.

Financial Sector Assessment Program

6.20 Financial and banking reforms have become an important part of economic reforms in Nepal, with the rapid expansion of financial institutions and weak infrastructure. A new focus on financial sector stability is reflected in a range of recent developments and the World Bank–IMF Financial Sector Assessment Program (FSAP), and the related Reports on Observance of Standards and Codes (ROSC) as tools to prevent crises, and promote economic and financial development viewed the important international best practices in financial sector regulation and supervision. Financial Sector Assessment Program (FSAP) that was implemented with the aim to provide strategic and policy level aid in strengthening the role of financial sector in financial stability and economic development of the country, has been accomplished. Nepal's enrolment in the financial sector assessment program comes at a time when the IMF, in a 2010 report, has identified systematic risks building up in the financial sector due to rapid credit expansion, which may adversely affect loan quality, real estate exposure of financial institutions accumulated from a real estate boom, and high liquidity risk with some banks experiencing stress. Lately, problems seen in credit and savings cooperatives have also drawn attention.

6.21 Nepal´s participation in the financial sector assessment program is expected to benefit and mitigate some of the consequences of the financial sector risks. The financial assessments provide recommendations on how to reduce risk, improve supervision and strengthen crisis management. The FSAP assessments generally include two components: a financial stability assessment, and a financial development assessment. Under financial stability assessment, IMF team examines soundness of the banking and other financial sectors, conducts stress test, rates the quality of banks and insurance companies, among others, and evaluates the ability of supervisors, policymakers and financial safety nets to respond effectively in cases of systematic stress. On the other hand, financial development assessment includes inspection of the quality of legal framework and financial infrastructure, identification of obstacles to the competitiveness and efficiency of the financial sector, and examination of financial sector´s contribution to economic growth and development. It is expected that, all these expectation and outcomes of FSAP will heavily depend upon the rigorous analysis on FSAP report and how it will show the direction of Nepalese financial sector for further reform. As Nepal is far behind as compared with other countries in the area of research on financial economics, it is hoped that the FSAP analysis and recommendation may support the NRB and other financial sector regulators to move forward strategically for restructuring and strengthening the financial sector and stability.

Access to Finance and Concerns of MFFIs

Access to Finance

6.22 To facilitate an effective and efficient supervision of MFFIs, a separate set of Unified Directives has been issued for MFFIs. It has been made mandatory for MFFIs to exchange credit information with "A", "B" and "C" class financial institutions for credit transactions of more than Rs. 50,000.00. Similarly, other licensed co-operatives and FINGOs also require exchanging credit information with financial institutions within their territory while extending credits.

6.23 To enhance financial inclusion and access to finance, a provision of granting interest free loan up to Rs. 2 million has been made for MFFIs for opening branch in 22 remote districts where presence of micro finance service is minimal. Such facility can be enjoyed for up to two branches established within first six months of this fiscal year.

6.24 Female owned project loan up to Rs. 500,000.00 is categorized under deprived sector loan given that loan is forwarded against the collateral of same project. In order to encourage the small and medium enterprises, for project loan up to Rs. 1 million forwarded by BFIs, refinance is provided by NRB at 5.0 percent. There has been made provision to charge penal at the rate of bank rate to those "D" class institutions that don't invest the fund obtained from BFIs within stipulated time.

6.25 A program namely "Mobile Money for the Poor" is operating under the assistance of United Nations Capital Development Fund (UNCDF). Through a program "Access to finance" running under mission "Inclusive growth in Nepal" assisted by Danish Government, financial access is planned targeting seven districts in Eastern region.

6.26 On the policy front, legal frameworks regarding the establishment of *Micro Finance Authority* and *National Micro Finance Fund* are under-way; the merger process of five rural development banks is at the final stage; a separate unified directive for 'D' class MFIs has been already put in place; revision of directives issued to cooperatives licensed by the NRB is under consideration; FINGOs have already been asked to transform themselves into 'microfinance financial institutions within a stipulated time frame; formulation of *National Financial Literacy Policy* is underway and different *public awareness programs, including 'NRB with Students' program* are being carried-out on the financial literacy front; and priority has been given to set a separate credit information agency for the micro finance institutions. All these initiatives are expected to promote financial discipline and corporate governance; increase financial soundness and ultimately contribute for the financial stability as a whole.

Concerns of MFFIs

6.27 In response to the policy adopted for the FINGOs to upgrade themselves as MFFIs, 19 FINGOs have applied for upgrading so far. Under the joint cooperation of Grameen Swabalamban Kosh and Nepal Government, Micro Enterprise Development Program has been operated. As per the program, loans are being provided from the fund for promoting productive micro enterprises/business.

6.28 Although the rapidly expanding micro finance sector is being widely accepted as an effective tool of enhancing access to finance, reducing poverty, empowering women and uplifting the living standards of the poor and under-privileged groups, their concentration mostly in urban and accessible areas accompanied with multiple financing and duplication in some cases, duplication even among the donors in some cases, comparatively higher interest rates being charged with the poorest section of the society, deviation from the social responsibility in many cases and more concentration on the middle and upper middle class rather than the deprived sector are some of the major weakness witnessed in this sector. Though the essence of micro finance institutions lies on social business, these institutions at present are moving towards commercialization by giving up all the social obligations leading to negative impact of micro finance business on overall stability of the financial system.

6.29 Increasing trend of out of track banking practices by the cooperatives has brought challenge to the financial system. This kind of activities done by the cooperatives could also increase risk in the system as their deposit mobilization is increasing rapidly. Lack of stringent regulatory and supervisory mechanism for various types of micro finance institutions established and operated under different Acts is also emerging as another challenging issue. Saving and credit activities of cooperatives should be monitored regularly and minutely, micro credit reporting system should be introduced and an appropriate regulatory body should be there to ensure the compliance of minimum financial standards of the cooperatives as well.

6.30 Financial viability is necessary for the long run sustainability of MFFIs. They are generally resource deficient. The capital base of most of the MFFIs is comparatively small as compared to other BFIs. As MFFIs generally borrow fund from BFIs, the price they charge for their financial services is relatively high. At the same time MFFIs mostly engage in small-sized business transactions with relatively higher overhead cost. As the interest rate in conventional banking system increases, it further pushes up the interest rate of MFFIs, making micro finance services more costly to the needy clients.

6.31 An effective policy response to address the issues such as multiple financing, duplication and higher interest rates may somehow address prevailing problems of MFFIs in Nepal. Likewise, some kind of code-of-conduct and good governance practices guideline are must for developing professionalism, healthy competition and uniform practices in the MFFIs. By the time of formulating code-of-conduct and guidelines, some policy incentives are also necessary to encourage their business in the productive sector particularly in the remote and inaccessible areas. Besides, legal framework regarding the client protection, a separate mechanism for credit information sharing, and a kind of institutional arrangement for the capacity enhancement of the employees working with the MFFIs are some of the other important issues that need to be addressed. All these measures may enhance the activities of the MFFIs in a more productive and effective way in the rural credit sector and thereby rural financing effort.

Promotional Activities by NRB

6.32 With the motive to operate financial literacy programs, books namely "Vidhyarthi Sanga Nepal Rastra Bank" and "Nepal Rastra Bank: Then, Now and Ahead" have been published and distributed.

6.33 It has now been made mandatory to open at least three branches outside the valley to establish a branch within Kathmandu Valley and among them, one branch should be in one of the least branch districts. Among the remaining two branches, at least one should be outside the head quarter or municipality. Within the Kathmandu Valley also, priority will be given to establishment of branches outside the ring road area or in V.D.Cs.

6.34 As a part of promotional role, NRB has been involved in different activities to promote financial literacy in the country. Different audio visual programs have been made and disseminated in 2013 through the national television channels and the process is still continued. As NRB is also associated with different international organizations involved in the areas of access to finance and financial literacy, different financial literacy-centric programs are being organized. In this concern, NRB has formally joined Child and Youth Finance International (CYFI) in 2013 and has been involved in its activities like celebrating 'Global Money Week' each year. To mark this week in March 2014, NRB organized an intensive interaction program in Kathmandu on financial literacy, specially focused on child and youth. During the same program, NRB also released a musical CD comprising 6 financial literacy songs and a hand-book entitled 'NRB with Students' as a reference material for basic financial literacy. These materials are to be distributed during the 'NRB with Students' program in different schools on a regular basis. Moreover, a financial literacy rally was also organized in Kathmandu on March 15th gathering more than 1000 people comprising students, staffs of bank and financial institutions and other stakeholders. At the request of NRB, other banks and financial institutions also organized different financial literacy activities during the Global Money Week. On the policy front, NRB is also working for framing a new policy/strategy on financial literacy.

Monetary Policy

6.35 Monetary Policy for 2013/14 is geared towards restraining the demand-side pressure on prices by limiting the monetary expansion within the target level. In addition, it is also oriented towards facilitating the achievement of high and sustainable economic growth through efficient allocation of resources. The half yearly review of the policy was released on 3 March 2014. The status of implementation and the revised projection of inflation, BoP and other economic indicators, which need to be implemented for the remaining period of the fiscal year, are also included in this review report.

6.36 The mid-term review of the monetary policy revised the estimated annual inflation upwards from 8.0 to 8.5 percent. Though the growth rate of money supply and monetary aggregates remained in targeted rate, the pressure on food prices forced the central bank to make upward revision of inflation. Despite the decreasing trend of interest rate on credit and conducive political environment for investment, the growth of gross domestic credit has been lowered to 14.6 percent from the previously projected 17.1 percent on the basis of performance and outlook upto six month of 2013/14. CRR, SLR, bank rate, refinance rate and special refinance rate as mentioned in the Monetary Policy of the current fiscal year 2013/14 have been kept unchanged.

6.37 Likewise, as per the program and polices of monetary policy, the NRB made it mandatory also for national level B and C class banks to make public the base rate on a monthly basis. Under the provision, BFIs will have to determine lending rates on the basis of the base rate. The base rate for B and C class banks came into effect from mid-Jan 2014.

6.38 On overall, the mid-term review of monetary policy 2013/14 shows that majority of the objectives and programs have been implemented successfully however inflation rate remained above the targeted level due to international and domestic supply side bottlenecks. Deposit mobilization has increased in the periphery of limited credit expansion which has led market into the situation of excess liquidity. In addition to this BOP remained in a strong surplus position and the short term interest rates declined substantially. Similarly, the mid-term review of monetary policy has planned to revisit the margin lending policies in this current context of excess liquidity and lack of investment opportunities for BFIs but probability of high exposure and flying investment to share market in this prevailing environment of negative real interest rate on deposits, keeping in mind the volume of loan against share and possible volatility in share prices. Likewise, the mid-term review of monetary policy has said that it will be more focused on directing investment in productive sector without any adverse effects on monetary, external and financial stability in remaining period of the fiscal year.

6.39 On the other hand, in order to make OMOC more active and effective, LMFF shall be amended as per the need in near future. In order to manage the liquidity fluctuations in long term, appropriate tools for liquidity management will also be developed and discussion about other instrument is underway in OMOC. Similarly, in order to measure the monetary situation and to analyze the implementation status of programs , polices and targets, monetary policy has started internal review process and discussion in each months from the current fiscal year.

Financial Sector Development Strategy

6.40 It is now well-recognized that a competitive, stable, prudentially sound financial system plays a very important role in the development process by ensuring efficient accumulation and effective allocation of financial resources. Therefore, it is increasingly visualized that charting the future direction of financial sector would be very important to ensure a sustainable future of the financial system in Nepal. Despite the regulatory and supervisory provisions of the NRB, the financial system has witnessed the risk based lending, concentration in urban areas, and the problems of corporate governance, thus demanding for a long term direction to ensure the financial stability and growth in the country. Majority people of the country are still out of formal banking services. Poverty level exists for around 23.8 percent of the population, mostly in the rural areas. Geographical dispersion demands for an innovative model of banking services in the rural areas, among others.

6.41 Improvement through policy interventions are felt in enhancing the ability of the financial sector to meet the obligation of the financial needs of the private sector in a sustainable manner for the growth of the economy strengthening the linkages between the monetary policy and the fiscal policy to strengthen the financial sector and promote external sector of the economy; developing sound legal framework to support the operation of the financial sector; strengthening the regulatory and supervisory capacity of NRB to ensure that the financial system is prudent, sound and resilient to absorb risks; expanding the financial access and outreach to unbanked areas and to contribute in alleviating the poverty in the country; promoting competition, innovation, transparency and disclosures and sound corporate governance in the financial sector; and promoting regional linkages and integration in order to share information, knowledge, risks, opportunities and capacity building for regional stability, among others. In this context, to adderess the potential issues and dilemma by improving the overall strength of financial sector, the preparation of the Financial Sector Development Strategy is underway.

Annex 1

Structure of the Nepalese Financial Sector

(Total Assets/Liabilities)
(2007- 2014)

(Rs. in million)

Financial Institutions	2010	2011	2012	2013	2014
Nepal Rastra Bank	296,625.6	319,692.6	455,826.5	534,897.9	642,871.8
Commercial Banks	763,226.3	853,490.7	1,052,450.7	1,242,881.4	1,377,058.5
Development Banks	102,208.9	129,617.4	160,360.2	199,954.8	228,194.2
Microfinance Development Banks	17,681.6	20,862.9	29,815.5	35,774.9	108,377.1
Finance Companies	109,998.2	118,578.2	109,687.5	100,856.7	4,281.8
Financial Co-operatives	6,975.2	8,150.6	11,652.4	15,415.1	1,664.2
Financial NGOS	2,382.6	4,937.6	4,260.0	5,560.0	3,107.6
Contractual Saving Institutions					
Employees Provident Fund	90,390.3	106,584.5	125,752.8	145,283.4	160,327.1
Citizen Investment Trust	22,647.8	26,905.4	38,068.5	42,753.6	48,624.7
Insurance Companies	47,460.0	61,213.4	73,825.0	84,650.4	94,960.0
Postal Savings Bank	1,085.9	1,152.4	1,276.4	1,397.2	1,530.0
Total	1,460,682.4	1,651,185.7	2,062,975.5	2,409,425.3	2,670,997.0
Market capitalization	376,871.0	323,484.3	368,262.1	514,492.1	
Total (incl. market capitalization)	1,837,553.4	1,974,670.0	2,431,237.6	2,923,917.5	
Percentage Share					
Financial Institutions					
Nepal Rastra Bank	20.3	19.4	22.1	22.2	24.1
Commercial Banks	52.3	51.7	51.0	51.6	51.6
Development Banks	7.0	7.8	7.8	8.3	8.5
Microfinance Development Banks	1.2	1.3	1.4	1.5	4.1
Finance Companies	7.5	7.2	5.3	4.2	0.2
Financial Co-operatives	0.5	0.5	0.6	0.6	0.1
Financial NGOS	0.2	0.3	0.2	0.2	0.1
Contractual Saving Institutions					
Employees Provident Fund	6.2	6.5	6.1	6.0	6.0
Citizen Investment Trust	1.6	1.6	1.8	1.8	1.8
Insurance Companies	3.2	3.7	3.6	3.5	3.6
Postal Savings Bank	0.1	0.1	0.1	0.1	0.1
Total	**100.0**	**100.0**	**100.0**	**100.00**	**100.00**

Sources: Monthly Financial Statistics, Quarterly Economic Bulletins and NRB staffs' Calculation, BFRID, NRB

Annex 2

Aggregate Statement of Assets and Liabilities of BFIs (Aggregate)

(2011- 2014)

(Rs. in million)

		mid-July		mid-Jan			Percentage Change	
		2012	2013	2012	2013	2014		
		1	2	3	4	5	5/4	5/2
	LIABIILTIES							
1	**CAPITAL FUND**	**115163.0**	**131724.3**	**108783.3**	**127300.4**	**145113.1**	**14.0**	**10.2**
	a. Paid-up Capital	104303.8	119506.9	101424.5	111730.9	124463.3	11.4	4.1
	b. Statutory Reserves	22068.1	26038.2	21139.0	25321.3	32058.8	26.6	23.1
	c. Retained Earning	-24321.8	-22344.2	-26766.3	-21367.2	-21052.2	-1.5	-5.8
	d. Others Reserves	13112.8	8523.4	12986.1	11615.4	9643.2	-17.0	13.1
2	**BORROWINGS**	**17805.9**	**26999.3**	**20353.3**	**21426.3**	**24171.0**	**12.8**	**-10.5**
	a. NRB	4286.7	2884.3	4355.6	711.8	1966.7	176.3	-31.8
	b. "A" Class Licensed Institution	3297.0	10466.6	5788.5	10179.9	7312.0	-28.2	-30.1
	c. Foreign Banks and Fin. Ins.	2507.9	2954.3	2478.8	2189.7	3091.9	41.2	4.7
	d. Other Financial Ins.	781.1	2438.3	1630.7	1611.5	2550.3	58.3	4.6
	e. Bonds and Securities	6933.2	8255.9	6099.6	6733.4	9250.1	37.4	12.0
3	**DEPOSITS**	**1071394.1**	**1250062.0**	**952724.0**	**1125005.9**	**1353132.4**	**20.3**	**8.2**
	a. Current	95993.1	111686.5	75164.2	89231.5	114801.1	28.7	2.8
	b. Savings	400723.1	471215.4	344091.5	449158.9	536159.4	19.4	13.8
	c. Fixed	372137.6	423478.4	363408.6	378134.3	438015.8	15.8	3.4
	d. Call Deposits	187998.5	225704.8	157072.6	192754.3	243072.2	26.1	7.7
	e. Others	14541.8	17976.8	12987.2	15726.9	21083.9	34.1	17.3
4	**Bills Payable**	**1626.4**	**1561.6**	**783.8**	**2005.6**	**1520.4**	**-24.2**	**-2.6**
5	**Other Liabilities**	**123660.2**	**140770.3**	**125326.6**	**141312.7**	**171911.2**	**21.7**	**22.1**
	1. Loan Loss Provision	33874.0	42223.8	38128.4	38742.3	47445.7	22.5	12.4
	2. Interest Suspense a/c	26056.2	27920.7	31569.1	28951.8	32143.5	11.0	15.1
	3. Others	63730.1	70625.8	55629.1	73618.6	92322.0	25.4	30.7
6	**Reconciliation A/c**	**1537.8**	**7290.0**	**3131.6**	**9043.9**	**4265.5**	**-52.8**	**-41.5**
7	**Profit & Loss A/c**	**19776.5**	**26544.7**	**7189.0**	**11013.8**	**13088.5**	**18.8**	**-50.7**
	TOTAL	**1350963.9**	**1584952.3**	**1218291.5**	**1437108.6**	**1713202.0**	**19.2**	**8.1**

		mid-July		mid-Jan			Percentage Change	
		2012	2013	2012	2013	2014		
		1	2	3	4	5	5/4	5/2
	ASSETS							
1	**LIQUID FUNDS**	**236056.9**	**259224.9**	**193635.3**	**194724.4**	**267705.3**	**37.5**	**3.3**
	a. Cash Balance	31020.1	35728.2	23637.8	27712.4	34888.1	25.9	-2.4
	Nepalese Notes & Coins	30353.3	34876.1	22819.7	26861.4	34086.3	26.9	-2.3
	Foreign Currency	666.8	852.1	818.1	851.0	801.8	-5.8	-5.9
	b. Bank Balance	164605.2	173856.7	139621.1	121372.2	181920.5	49.9	4.6
	1. In Nepal Rastra Bank	120457.3	130802.8	95445.3	70321.9	118386.6	68.3	-9.5
	2. "A" Class Licensed Institution	26284.3	23269.1	17703.2	23658.7	28776.0	21.6	23.7
	3. Other Financial Ins.	7649.8	5673.4	9154.6	6264.2	5906.6	-5.7	4.1
	4. In Foreign banks	10213.8	14111.4	17317.9	21127.4	28851.3	36.6	104.5
	c. Money at Call	40431.6	49640.1	30376.4	45639.8	50896.7	11.5	2.5
2	**INVESTMENTS**	**137304.4**	**151340.0**	**125857.2**	**144665.8**	**166689.9**	**15.2**	**10.1**
	a. Govt.Securities	133251.1	149700.8	124784.1	143841.9	165005.0	14.7	10.2
	b Others	4053.3	1639.2	1073.1	823.9	1685.0	**104.5**	**2.8**
3	**SHARE & OTHER INVESTMENT**	**52851.1**	**66725.5**	**47680.1**	**60521.4**	**73234.3**	**21.0**	**9.8**
4	**LOANS & ADVANCES**	**779560.9**	**945698.4**	**728369.9**	**879892.4**	**1028038.9**	**16.8**	**8.7**
	a. Private Sector	741145.0	915010.0	703247.3	850740.8	999705.0	17.5	9.3
	b. Financial Institutions	31389.3	21910.2	18251.1	20120.8	22108.7	9.9	0.9
	c. Government Organizations	7026.6	8778.2	6871.5	9030.8	6225.1	-31.1	-29.1
5	**BILL PURCHED**	**9634.2**	**9007.9**	**7192.2**	**6938.8**	**9484.9**	**36.7**	**5.3**
6	**LOANS AGT. COLLECTED BILLS**	**645.9**	**1015.5**	**416.2**	**453.7**	**1498.8**	**230.4**	**47.6**
7	**FIXED ASSETS**	**27146.4**	**28916.8**	**26009.4**	**28914.1**	**29852.1**	**3.2**	**3.2**
8	**OTHER ASSETS**	**93318.3**	**104448.2**	**92102.0**	**104736.7**	**120557.4**	**15.1**	**15.4**
	a. Accrued Interests	27621.8	30638.6	33471.8	30666.7	34869.6	13.7	13.8
	b. Others	65696.6	73809.6	58630.1	74070.0	85687.7	15.7	16.1
9	**Expenses not Written off**	**586.9**	**622.0**	**551.9**	**849.6**	**594.1**	**-30.1**	**-4.5**
10	**Non-Banking Assets**	**2225.1**	**3731.3**	**2322.8**	**2566.4**	**4099.7**	**59.7**	**9.9**
11	**Reconciliation Account**	**8638.9**	**10394.1**	**-9788.7**	**9518.2**	**9262.1**	**-2.7**	**-10.9**
12	**Profit & Loss A/c**	**2994.9**	**3827.7**	**3943.3**	**3327.1**	**2184.4**	**-34.3**	**-42.9**
	TOTAL	**1350963.9**	**1584952.3**	**1218291.9**	**1437108.6**	**1713202.0**	**19.2**	**8.1**

Sources: Monthly Financial statistics and NRB staffs' Calculation, BFRID, NRB

Annex 3

Statement of Assets and Liabilities of BFIs

(mid-Jan 2014)

(Rs. in million)

	Liabilities	Class "A"	Class "B"	Class "C"	Total
1	**CAPITAL FUND**	**106,569.1**	**27,416.5**	**11,127.6**	**145,113.1**
	a. Paid-up Capital	82,800.8	25,103.7	16,558.7	124,463.3
	b. Statutory Reserves	27,300.4	2,525.9	2,232.5	32,058.8
	c. Retained Earning	(11,491.2)	(961.9)	(8,599.2)	(21,052.2)
	d. Others Reserves	7,958.9	748.7	935.6	9,643.2
2	**BORROWINGS**	**20,874.0**	**1,911.9**	**1,385.1**	**24,171.0**
	a. NRB	1,966.7	-	-	1,966.7
	b. "A" Class Licensed Institution	4,786.9	1,140.0	1,385.1	7,312.0
	c. Foreign Banks and Fin. Ins.	3,091.9	-	-	3,091.9
	d. Other Financial Ins.	1,778.4	771.9	-	2,550.3
	e. Bonds and Securities	9,250.1	-	-	9,250.1
3	**DEPOSITS**	**1,097,058.7**	**181,424.8**	**74,648.9**	**1,353,132.4**
	a. Current	111,069.6	3,214.4	517.1	114,801.1
	b. Savings	408,052.2	94,902.7	33,204.5	536,159.4
	c. Fixed	352,799.4	50,932.2	34,284.1	438,015.8
	d. Call Deposits	209,956.7	31,797.1	1,318.4	243,072.2
	e. Others	15,180.8	578.4	5,324.7	21,083.9
4	**Bills Payable**	**1,498.6**	**20.2**	**1.6**	**1,520.4**
5	**Other Liabilities**	**130,312.6**	**19,528.3**	**22,070.3**	**171,911.2**
	1. Loan Loss Provision	29,432.3	7,060.2	10,953.1	47,445.7
	2. Interest Suspense a/c	22,879.2	3,469.3	5,795.1	32,143.5
	3. Others	78,001.1	8,998.8	5,322.2	92,322.0
6	**Reconciliation A/c**	**(1,350.2)**	**3,725.9**	**1,889.7**	**4,265.5**
7	**Profit & Loss A/c**	**10,063.8**	**1,897.1**	**1,127.5**	**13,088.5**
TOTAL LIABILITIES		**1,365,026.6**	**235,924.6**	**112,250.8**	**1,713,202.0**

	Assets	Class "A"	Class "B"	Class "C"	Total
1	**LIQUID FUNDS**	**181,759.8**	**61,259.1**	**24,686.3**	**267,705.3**
	a. Cash Balance	28,870.2	5,002.1	1,015.8	34,888.1
	Nepalese Notes & Coins	28,124.6	4,946.0	1,015.6	34,086.3
	Foreign Currency	745.6	56.1	0.2	801.8
	b. Bank Balance	140,566.9	25,252.6	16,101.0	**181,920.5**
	1. In Nepal Rastra Bank	105,454.0	9,097.2	3,835.5	118,386.6
	2. "A" Class Licensed Institution	6,155.0	13,325.0	9,296.0	28,776.0
	3. Other Financial Ins.	187.9	2,749.1	2,969.5	5,906.6
	4. In Foreign banks	28,770.0	81.3	-	28,851.3
	c. Money at Call	12,322.7	31,004.4	7,569.6	50,896.7
2	**INVESTMENTS**	**160,558.2**	**3,401.6**	**2,730.1**	**166,689.9**
	a. Govt.Securities	158,928.4	3,371.5	2,705.1	165,005.0
	b Others	1,629.9	30.1	25.0	1,685.0
3	**SHARE & OTHER INVESTMENT**	**69,804.5**	**1,860.5**	**1,569.3**	**73,234.3**
4	**LOANS & ADVANCES**	**814,765.9**	**146,014.5**	**67,258.4**	**1,028,038.9**
	a. Private Sector	791,394.0	142,531.9	65,779.1	999,705.0
	b. Financial Institutions	17,208.4	3,443.1	1,457.3	22,108.7
	c. Government Organizations	6,163.6	39.5	22.0	6,225.1
5	**BILLS PURCHASED**	**9,463.7**	**11.8**	**9.5**	**9,484.9**
6	**LOANS AGT. COLLECTED BILLS**	**1,498.8**	**-**	**-**	**1,498.8**
7	**FIXED ASSETS**	**21,715.1**	**5,096.7**	**3,040.3**	**29,852.1**
8	**OTHER ASSETS**	**98,856.7**	**12,185.9**	**9,514.8**	**120,557.4**
	a. Accrued Interests	25,367.9	3,618.0	5,883.8	34,869.6
	b. Others	73,488.8	8,568.0	3,631.0	85,687.7
9	**Expenses not Written off**	**472.3**	**59.6**	**62.2**	**594.1**
10	**Non-Banking Assets**	**2,034.7**	**963.4**	**1,101.6**	**4,099.7**
11	**Reconciliation Account**	**3,660.1**	**3,693.3**	**1,908.7**	**9,262.1**
12	**Profit & Loss A/c**	**436.8**	**1,378.2**	**369.5**	**2,184.4**
	TOTAL ASSETS	**1,365,026.6**	**235,924.6**	**112,250.8**	**1,713,202.0**

Sources: Monthly Financial Statistics and NRB staffs' Calculation, BFRID, NRB

Annex 4

Major Financial Indicators of MFFIs (D Class Financial Institutions)

(Rs. in million)

	Liabilities	mid-July		mid-Jan			Percent		
		2012	2013	2012	2013	2014			
		2	3	4	5	6	3/2	5/4	6/5
1	CAPITAL FUND	2816.6	3801.33	2231.0	3318.3	4749.6	35.0	48.7	43.13
2	BORROWINGS	16586.4	20216.25	10635.7	17521.4	23480.7	21.9	64.7	34.01
3	DEPOSITS	5235.2	7221.62	2676.9	5963.3	9140.5	37.9	122.8	53.28
4	Bills Payable					1.8			
5	Other Liabilities	2502.9	3009.70	1196.5	2834.1	3472.7	20.2	136.9	22.53
6	Reconciliation A/c	2236.6	688.57	2034.4	1675.1	831.7	-69.2	-17.7	-50.35
7	Profit & Loss A/c	629.8	837.88	261.1	414.1	662.1	33.0	58.6	59.91
	Total	**30007.5**	**35775.3**	**19035.5**	**31726.2**	**42339.0**	**19.2**	**66.7**	**33.45**
	Assets								
1	LIQUID FUNDS	5843.5	6322.82	3449.1	5737.4	7443.2	8.2	66.3	29.73
2	INVESTMENT IN SECURITIES EXCEPT SHARES	128.7	116.17	51.2	128.7	116.2	-9.7	151.2	-9.71
3	SHARE & OTHER INVESTMENT	2040.6	2963.62	1424.8	2816.5	3154.5	45.2	97.7	12.00
4	LOANS & ADVANCES	17738.3	23401.73	11033.7	19402.1	28211.9	31.9	75.8	45.41
5	FIXED ASSETS	340.2	444.56	243.7	380.5	574.1	30.7	56.2	50.87
6	OTHER ASSETS	1594.9	1685.83	643.6	1541.6	1929.6	5.7	139.5	25.17
7	Expenses not Written off	0.7	9.83	143.6	10.6	11.1	1301.7	-92.6	4.45
8	Non-Banking Assets					0.7			
9	Reconciliation Account	2234.8	699.60	2029.2	0.0	797.5	-68.7	-100.0	797.5
10	Profit & Loss A/c	85.8	131.22	15.8	1611.0	100.2	52.9	10118.6	-93.78
	Total	**30007.5**	**35775.4**	**19036**	**31726.2**	**42339.0**	**19.2**	**66.7**	**33.45**

Sources: Monthly Financial Statistics and NRB staffs' Calculation, BFRID, NRB

Annex 5

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

(mid-Jan 2014)

(Rs in million)

		Class "A"	Class "B"	Class "C"	Total
Sector Wise Credit					
1	Agricultural and Forest Related	32119.3	7184.0	2014.7	41318.0
2	Fishery Related	2388.8	149.7	35.8	2574.3
3	Mining Related	3113.1	242.7	83.0	3438.8
4	Manufacturing (Producing) Related	197804.9	10394.5	4708.9	212908.4
5	Construction	78536.7	17548.4	9613.5	105698.6
6	Electricity, Gas and Water	19264.1	2631.4	211.6	22107.1
7	Metal Products, Mach. &Ele. Eqp.	11219.2	2438.0	793.0	14450.2
8	Tras., Com. and Public Utilities	24904.1	12093.9	5843.8	42841.8
9	Wholesaler & Retailer	187087.2	27880.3	9681.6	224649.1
10	Finance, Insurance and Real Estate	69198.8	12497.6	5480.2	87176.6
11	Hotel or Restaurant	21868.5	5589.4	1892.1	29350.1
12	Other Services	40534.5	7282.0	2424.0	50240.4
13	Consumption Loans	58139.9	10758.3	5883.3	74781.4
14	Local Government	1097.3	45.1	48.0	1190.4
15	Others	78452.0	29248.3	18554.4	126254.6
Total sector wise Loan		**825728.4**	**145983.6**	**67267.9**	**1038979.9**
Product Wise Credit					
1	Term Loan	124932.7	18025.7	8839.3	151797.8
2	Overdraft	162716.9	37687.3	7.5	200411.7
3	Trust Receipt Loan / Import Loan	45404.7	7.2	0.0	45411.9
4	Demand & Other Working Capital Loan	208107.0	19447.0	16318.7	243872.7
5	Res. Per. H. Loan (Up to Rs. 10 mil.)	54516.7	14409.0	7216.6	76142.3
6	Real Estate Loan	60883.2	12698.5	9923.3	83505.0
7	Margin Nature Loan	6957.5	2890.8	3297.4	13145.7
8	Hire Purchase Loan	37860.3	14650.7	6738.4	59249.4
9	Deprived Sector Loan	35845.2	6242.0	1984.4	44071.6
10	Bills Purchased	9866.9	11.8	9.5	9888.1
11	Other Product	78637.1	19913.7	12932.7	111483.5
Total Product wise Loan		**825728.4**	**145983.6**	**67267.9**	**1038979.9**

		Class "A"	Class "B"	Class "C"	Total
Collateral Wise Credit					
1	Gold and Silver	25965.5	3334.4	381.5	29681.4
2	Government Securities	1159.3	21.4	18.9	1199.6
3	Non-Governmental Securities	4906.4	2493.8	1559.7	8959.9
4	Fixed Deposit Receipts	7786.1	1635.1	1513.6	10934.8
	Own	7042.13	1635.07	1513.56	10190.8
	Other Licenses Institutions	743.99	0.00	0.00	744.0
5	Collateral of Properties	681589.56	130759.67	57468.03	869817.3
	Fixed Assets	530443.50	130472.02	57086.55	718002.1
	Current Assets	151146.07	287.65	381.48	151815.2
6	Against security of Bill	10974.73	7.77	18.05	11000.5
	Domestic Bills	2478.53	7.77	18.05	2504.3
	Foreign Bills	8496.20	0.00	0.00	8496.2
7	Against Guarantee	21619.47	3068.15	645.10	25332.7
	Government Guarantee	2037.34	97.04	68.16	2202.5
	Institutional Guarantee	13964.94	1293.13	280.83	15538.9
	Personal Guarantee	2079.08	171.72	95.48	2346.3
	Collective Guarantee	232.82	1462.63	38.58	1734.0
	Int. Rtd. Foreign Bank's Guarantee	258.76	17.09	0.00	275.8
	Other Guarantee	3046.52	26.54	162.04	3235.1
8	Credit Card	439.12	0.00	0.00	439.1
9	Others	71288.34	4663.34	5663.02	81614.7
Total Collateral wise Loan		**825728.41**	**145983.60**	**67267.93**	**1038979.94**

Sources: Monthly Financial Statistics and NRB staffs' Calculation, BFRID, NRB

Annex 6

Aggregate Profit & Loss Account of BFIs (Aggregate)

(mid-Jan 2014)

(Rs. in million)

Expenses	Class "A"	Class "B"	Class "C"	Total
1 Interest Expenses	25270.5	6648.6	3199.8	35118.8
1.1 Deposit Liabilities	24677.5	6563.4	3165.4	34406.3
1.1.1 Saving A/c	6706.7	3053.1	1318.7	11078.5
1.1.2 Fixed A/c	13737.3	2559.5	1798.5	18095.2
1.1.2.1 Up to 3 Months Fixed A/c	632.0	68.2	24.0	724.2
1.1.2.2 3 to 6 Months fixed A/c	520.0	105.9	45.4	671.3
1.1.2.3 6 Months to 1 Year Fixed A/c	5362.6	1304.2	911.9	7578.7
1.1.2.4 Above 1 Year	7222.7	1081.2	817.1	9120.9
1.1.3 Call Deposit	4217.6	950.8	48.1	5216.5
1.1.4 Certificate of Deposits	16.0	0.0	0.1	16.1
1.2 Others	592.9	85.1	34.4	712.5
2 Commission/Fee Expense	197.6	2.4	2.2	202.2
3 Employees Expenses	6807.8	1113.9	414.1	8335.8
4 Office Operating Expenses	4876.4	1276.1	446.3	6598.8
5 Exchange Fluctuation Loss	65.7	1.4	1.8	68.9
5.1 Due to Change in Exchange Rates	50.2	1.4	1.8	53.5
5.2 Due to Foreign Currency Transactions	15.4	0.0	0.0	15.5
6 Non-Operating Expenses	53.2	50.0	0.9	104.2
7. Provision for Risk	4559.4	2374.3	1182.4	8116.1
7.1 Loan loss Provision	4360.5	1938.8	983.9	7283.2
7.1.1 General Loan loss Provision	1338.0	298.3	130.8	1767.0
7.1.2 Special Loan Loss Provision	2965.9	1579.7	851.4	5397.0
7.1.3 Additional Loan Loss Provision	56.7	60.8	1.8	119.2
7.2. Provision for Non-Banking Assets	56.8	200.6	107.3	364.8
7.3. Provision for Loss on Investment	0.0	0.8	19.4	20.2
7.4. Provision for Loss of Other Assets	142.1	234.1	71.7	447.9
8 Loan Written Off	41.1	48.7	54.2	144.0
9 Provision for Staff Bonus	1157.5	198.1	56.4	1411.9
10 Provision for Income Tax	3611.8	607.0	169.0	4387.7
11 Others	1.5	32.8	0.3	34.6
12 Net Profit	9627.0	1671.3	1035.1	12333.5
TOTAL EXPENSES	**56269.5**	**14024.7**	**6562.5**	**76856.6**

Income	**Class "A"**	**Class "B"**	**Class "C"**	**Total**
1. Interest Income	46750.4	10517.9	4585.5	61853.8
1.1. On Loans and Advance	43220.0	9461.3	4102.1	56783.4
1.2. On Investment	1694.7	60.1	46.2	1801.0
1.2.1 Government Bonds	1484.9	54.3	40.5	1579.8
1.2.2 Foreign Bonds	7.9	0.0	0.0	7.9
1.2.3 NRB Bonds	112.6	1.8	3.3	117.7
1.2.4 Debenture& Bonds	89.2	4.0	2.4	95.6
1.3 Agency Balance	423.8	99.9	41.8	565.6
1.4 On Call Deposit	235.8	701.5	272.4	1209.7
1.5 Others	1176.1	195.0	122.9	1494.0
2. Commission& Discount	3320.2	302.1	62.2	3684.5
2.1 Bills Purchase & Discount	115.1	0.2	0.0	115.3
2.2 Commission	2667.3	173.5	38.2	2879.0
2.3 Others	537.8	128.4	24.0	690.2
3 Income From Exchange Fluctuation	2114.0	42.9	0.0	2156.8
3.1 Due to Change in Exchange Rate	-5371.9	1.8	0.0	-5370.0
3.2 Due to Foreign Currency Trans.	7485.8	41.0	0.0	7526.8
4 Other Operating Income	1666.3	577.1	235.3	2478.7
5 Non-Operating Income	374.6	543.4	152.8	1070.8
6 Provision Written Back	1734.8	862.8	1246.4	3843.9
7 Recovery from Written off Loan	298.8	5.0	3.1	306.9
8 Income from Extra Ordinary Expenses	10.4	21.2	0.1	31.7
9 Net Loss	0.0	1152.4	277.1	1429.5
TOTAL INCOME	**56269.4**	**14024.7**	**6562.5**	**76856.6**

Sources: Monthly Financial Statistics and NRB staffs' Calculation, BFRID, NRB

Annex 7

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

(mid-Jan, 2014)

(In percent)

	A Class	B Class	C Class	Total
Capital Adequacy Ratios				
Regulatory capital to risk-weighted assets	11.34	15.88	15.38	12.18
Regulatory Tier - 1 capital to risk-weighted assets	9.76	15.04	14.67	10.75
Non-performing loan to total gross loan	3.09	5.62	15.66	4.26
Non-performing loan net of provisions to capital	6.31	9.20	4.06	6.63
Sectorial Distribution of Loans to Total Gross Loan				
Agricultural and Forest Related	3.89	4.92	3.00	3.98
Fishery Related	0.29	0.10	0.05	0.25
Mining Related	0.38	0.17	0.12	0.33
Agricultural, Forestry and beverage Production Related	23.96	7.12	7.00	20.49
Nonfood Production Related				
Construction	9.51	12.02	14.29	10.17
Electricity, Gas and Water	2.33	1.80	0.31	2.13
Metal Products, Machinery & Electronic Equipment & Assemblage	1.36	1.67	1.18	1.39
Transport, Communication and Public Utilities	3.02	8.28	8.69	4.12
Wholesaler & Retailer	22.66	19.10	14.39	21.62
Finance, Insurance and Real Estate	8.38	8.56	8.15	8.39
Hotel or Restaurant	2.65	3.83	2.81	2.82
Other Services	4.91	4.99	3.60	4.84
Consumption Loans	7.04	7.37	8.75	7.20
Local Government	0.13	0.03	0.07	0.11
Others	9.50	20.04	27.58	12.15
Others				
Returns on Assets	**0.71**	**0.22**	**0.68**	**0.64**
Returns on Equity	7.72	1.83	5.98	6.58
Interest Margin to Gross Income	74.18	72.53	75.47	74.01
Non-Interest Expenses to Gross Income	41.45	46.43	47.15	42.48
Liquid Assets to total Assets	25.05	27.41	24.40	25.33
Liquid Assets to total Deposits	31.16	35.64	36.69	32.07
Credit to Deposit Ratio	75.27	80.49	90.11	76.79

Sources: Monthly Financial Statistics and NRB staffs' Calculation, BFRID, NRB

Annex-8

Stress Testing Results for Commercial Banks

(2012-2014)

	Mid-Jul 2011	Mid-Jan 2012	Mid-Jul 2012	Mid-Jan 2013	Mid-Jul 2013	Mid-Jan 2014
15 percent of Performing loans deteriorated to substandard, 15 Percent of Substandard loans deteriorated to doubtful loans, 25 Percent of Doubtful loans deteriorated to loss loans. 5 Percent of Performing loans deteriorated to loss loans.	20	23	22	28	27	28
All NPLs under substandard category downgraded to doubtful. All NPLs under doubtful category downgraded to loss.	2	3	2	3	2	3
25 percent of performing loan of Real Estate & Hosing sector loan directly downgraded to substandard category of NPLs.	4	6	2	3	2	3
25 percent of performing loan of Real Estate & Hosing sector loan directly downgraded to Loss category of NPLs.	16	16	8	13	5	9
Top 2 Large exposures downgraded: Performing to Substandard	5	7	2	3	2	3
Withdrawal of customer deposits by 2%, 5%, 10%, 10% and 10% for five consecutive days respectively.	15	12	5	19	5	16
Withdrawal of deposits by 5%	5	2	0	7	1	2
Withdrawal of deposits by 10%	13	9	6	20	4	12
Withdrawal of deposits by 15%	22	20	14	26	16	22
Withdrawal of deposits by top 2 institutional depositors.	16	12	9	17	10	11
Withdrawal of deposits by top 3 institutional depositors.	20	18	12	21	14	15
Withdrawal of deposits by top 5 institutional depositors.	22	19	17	25	21	20
Withdrawal of deposits by top 2 individual depositors.	1	0	0	2	1	0
Withdrawal of deposits by top 3 individual depositors.	1	0	0	2	1	0
Withdrawal of deposits by top 5 individual depositors.	1	0	0	2	1	0

Sources: Monthly Financial Statistics and NRB staffs' Calculation, BFRID, NRB

Annex 9

List of Merged Banks and Financial Institutions (as of mid-July, 2013)

S.N	Merged and Merging BFIs		Name of BFI (after merger)	Date of operation (after merger)
1	Himchuli Bikash Bank Ltd. (B class)	Birgunj Finance Lltd. (C class)	H&B Development Bank Ltd. (B class, National Level)	6/15/2011
2	Business Development Bank Ltd. (B class)	Universal Finance Ltd. (C class)	Business Universal Development Bank Ltd. (B class, National Level)	4/3/2012
3	Kasthamandap Development Bank Ltd. (B Class)	Shikhar Finance Ltd. (C class)	Kasthamandap Development Bank Ltd. (B Class, National Level)	4/13/2012
4	Machhapuchhre Bank Ltd.	Standard Finance Ltd. (C class)	Machhapuchhre Bank Ltd.	7/9/2012
5	Global Bank Ltd.	IME Financial Institutions Ltd. (C Class) and Lord Buddha Finance Ltd.(C class)	Global IME bank Ltd.	7/9/2012
6	Infrastructure Development Bank Ltd. (B Class)	Swastik Finance Ltd. (C class)	Infrastructure Development Bank Ltd. (B class, National Level)	7/10/2012
7	Annapurna Development Bank Ltd. (B Class)	Suryadarshan Finance Ltd. (C Class)	Supreme Development Bank Ltd. (B class, National Level)	7/13/2012
8	Pashupati Development Bank Ltd. (B class)	Uddhyam Bikash Bank Ltd. (B Class)	Axis Development Bank Ltd. (B class, National Level)	7/13/2012
9	Viborbikash Bank Ltd. (B class)	Bhajuratna Finance and Savings Company Ltd. (C class)	Vibor Bikash Bank Ltd. (B class, National Level)	9/2/2012
10	Butwal Finance Ltd. (C class)	Alpic Everest Finance Ltd. (C class) and CMB Finance Ltd. (C class)	Synergy Finance Ltd. (C class, National level)	12/6/2012
11	Shine Development Bank Ltd. (B class)	Resunga Bikash Bank Ltd. (B class)	Shine Resunga Development Bank Ltd. (B class, 10 District Level)	3/17/2012
12	Prudential Finance Coy. Ltd. (C class)	Gorkha Finance Ltd. (C class)	Prudential Finance Company Ltd. (C class, National Level)	3/18/2013
13	Nepal Industrial and Commercial Bank Ltd.	Bank of Asia Ltd.	NIC Asia Ltd.	6/30/2013
14	Diyalo Bikash Bank Ltd. (B class)	Professional Bikash Bank Ltd. (B class)	Professional Diyalo Bikash Bank (B class, 10 District Level)	6/30/2013
15	Araniko Development Bank Ltd. (B class)	Surya Development Bank Ltd. (B class)	Araniko Development Bank Ltd. (B class, 10 District Level)	7/14/2013
16	Global IME Bank Ltd.	Social Development Bank Ltd. (B class) and Gulmi Bikash Bank Ltd. (B class)	Global IME Bank Ltd.	7/14/2013

S.N	Merged and Merging BFIs		Name of BFI (after merger)	Date of operation (after merger)
17	Prabhu Finance Ltd. (C class)	Samhbridhi Bikash Bank Ltd. (B class) and Baibhav Finance Ltd. (C class)	Prabhu Bikash Bank Ltd. (B class, National Level)	7/14/2013
18	Royal Merchant Banking and Finance Ltd. (C class)	Rara Bikash Bank Ltd. (B class) and Api Finance Ltd. (C class)	Apex Development Bank Ltd. (B class, National Level)	7/15/2013
19	Manakamana Development Bank Ltd. (B class)	Yeti Finance Ltd. (C class), Valley Finance Ltd. (C Class)	Yeti Development Bank Ltd. (B class, National Level)	7/15/2013
20	Reliable Finance Ltd.(C class, National level)	Shubha LaxmiFinance Ltd. (C class, national level), Nepal Consumer Development Bank Ltd.(B class, 10 district level)	Reliable Development Bank Ltd. (B class, national level)	
21	Reliance Finance Ltd.(C class, National level)	Lotus Investment Finance Ltd. (C class, National level)	Reliance Lotus Finance Ltd. (C class, National level)	
22	Siddhartha Finance Ltd. (C class, National level)	Imperial Finance Ltd. (C class, National level)	Siddhartha Finance Ltd. (C class, National level)	
23	Civil Bank Ltd. (A class)	Axis Development Bank Ltd. (B class, national level-after merger of 10 district level Pashupati Bikash Bank Ltd., 3 district level Udhyam Development Bank Ltd.), Civil Merchant Finance Co. Ltd. (C class, national level)	Civil Bank Ltd. (A class)	
24	Biratlaxmi Development Bank Ltd. (B class, 3 district level)	Khadbari Development Bank Ltd. (B class, 1 district level)	Biratlaxmi Development Bank Ltd.(B class, 10 district level)	

Sources: BFRID, NRB

Annex 10

Composition of Financial Stability Oversight Committee

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

Annex 11

Composition of Financial Stability Sub-Committee

Committee Members	Status
Mr. Purna Bahadur Khatri, Director, Bank and Financial Institutions Regulation Department	Coordinator
Mr. Ram Chandra Gautam, Deputy Director, Bank Supervision Department	Member
Ms. Sushma Regmi, Deputy Director, Foreign Exchange Management Department	Member
Mr. Narendra Singh Bista, Deputy Director, Development Bank Supervision Department	Member
Mr. Ram Hari Dahal, Deputy Director, Micro Finance Promotion and Supervision Department	Member
Mr. Bigyan Raj Subedi, Deputy Director, Research Department	Member
Mr. Nischal Adhikari, Deputy Director, Finance Company Supervision Department	Member
Mr. Ramu Paudel, Deputy Director Bank and Financial Institutions Regulation Department	Member Secretary