Nepal Rastra Bank
BANK SUPERVISION DEPARTMENT

BANKING SUPERVISION

ANNUAL REPORT
2001-2002

Foreword

Effective supervision is prerequisite for growth and stability of financial system. This fact was further reinforced by the financial crisis observed in South Asian Countries during the period of 1996 to 1998.

Banking system of Nepal has undergone significant change since liberalization of the financial sector in mid eighties. It has improved in quantitative as well as qualitative terms. Though banking system in Nepal is not so multifaceted when compared to that of developed countries, it has definitely grown to become more complex in recent years.

Supervisory strength at present is capable of meeting the existing challenges however, preparation for effective and efficient supervision even in the complex market situation, which is inevitable in future is necessary. In this regard efforts are being made for strengthening supervisory capability. Quality manpower is main focus of our recruitment policy. Licensing policy for establishment of banks was also revised. Nepal Rastra Bank, Bank supervision Byelaw is being implemented which shall be effective in regularizing supervisory function. Efforts are being made for strengthening the off site supervision system as an early warning system.

This report is first effort of its kind to disseminate information to all concerned about activities and developments in the area of Bank Supervision. Efforts made by the concerned staff in this regard are praiseworthy. I hope this report will be helpful to all interested parties

Dr. Tilak Bahadur Rawal
Governor

Preface

This annual supervision report of the commercial bank is the first attempt of its kind from the bank supervision department. The bank supervision department has been an important wing of the central bank of Nepal since it was formed in 1984. It has assumed even more importance in recent years in wake of private banks flowing in the financial system and discovery of frauds and forgeries within the banking system worldwide and of course Asian crisis experienced during 1996 to 1998.

The degree of infrastructure, manpower and efficiency required for supervisory functions, by its very nature, depends on prevailing practices and development in the sector that is supervised. It follows that the nature, scope and extent of the job of a supervisor is changeable and runs parallel to the development in the sector being supervised. The change has to be supported by proper legislations, regulations, infrastructure, manpower and more importantly willingness on the part of supervisors to keep pace with the new development.

With Liberalization of financial sector in mid eighties number of banks and financial institutions have been increasing. These institutions provide services of varied nature by using advanced technologies. In this context supervisory function of the Nepal Rastra Bank has become more challenging. NRB has recognized and accepted these challenges. Steps are taken to strengthen supervisory capacity by increasing efficient and professional manpower and introducing new technologies. Meanwhile, It was also felt necessary to disseminate information amongst the interested parties about the developments in Banks supervisory function. This report highlights the developments related to supervisory function as well as trends observed in the commercial banking during the financial year 2001-02. It is expected that the report will meet the information requirements of all concerned in this regard.

As this is the first attempt to publish annual report by the department, any suggestions and recommendation to improve the report from various concerned parties will be highly appreciated and department is eager to incorporate the suggestions and recommendations in coming year.

Bir Bikram Rayamajhi
Executive Director

CHAPTER ONE

1. Recent Development in the Banking System of Nepal:

1.1. Current Scenario of Banking Sector:

Financial system of Nepal is still in its primary stage of development. Small and fast growing financial sector comprises of commercial banks and other financial institutions like development banks, finance companies, cooperatives etc. So far, development of financial services in the country is uneven. In some regions of the country, fast and advanced banking services are available while other regions are fully deprived of banking services.

At present there are altogether 17 commercial banks in Nepal. Rastriya Banijya Bank is fully owned by HMG of Nepal while in case of Nepal Bank Ltd, HMG of Nepal is major shareholder. There are six joint venture banks in collaboration with the foreign investment partners and remaining seven banks are fully owned by Nepalese investors. As can be seen from the table given below most of commercial banks were established during late eighties and early nineties due to liberalization of financial sector. Number of financial institutions is also growing. Non-banking financial system comprises of 55 finance companies, 21 development banks (including rural development banks), 34 licensed cooperative institutions and 15 non-government organizations. Keeping in view, such fast growth of financial institutions separate department for supervision of financial institutions was established in 1998. At present there are separate departments for supervision of commercial banks and financial institutions namely bank supervision department and financial institution supervision department.

Table no.1 List of Commercial Banks.

S.N.	Name of Bank	Established date
1.	Nepal Bank Limited	1937
2.	Rastriya Banijya Bank	1966
3.	Nabil Bank Limited	1984
4.	Nepal Investment Bank Limited	1986
5.	Standard Chartered Bank Nepal Limited	1987
6.	Himalayan Bank Limited	1993
7.	Nepal SBI Bank Ltd	1993
8.	Nepal Bangladesh Bank Limited	1994
9.	Everest Bank Limited	1994
10.	Bank of Kathmandu Limited	1995
11.	Nepal Credit and Commerce Bank Limited	1996
12.	Lumbini Bank Limited	1998
13.	Nepal Industrial and Commercial Bank Limited	1998
14.	Machhapuchhre Bank Limited	2000
15.	Kumari Bank Limited	2001
16.	Laxmi Bank ltd.	2002
17.	Siddartha Bank Ltd.	2002

From the perspective of resource mobilization, total deposits collected by the commercial banks during the review period were Rs.165, 479 million while loans and advances disbursed during the same period was Rs.103125 million. The following table shows the tendency of growth of deposit and credit of previous four years.

Table no.2 Trends Of Deposit And Credits

(Rs. In Million)

Year	Deposit	Growth (%)	Credit	Growth (%)
1997-98	81703	-	58378	-
1998-99	102598	25.57	68618	17.54
1999-00	140379	36.82	88695	29.25
2000-01	165424	17.84	100320	13.10
2001-02	165479	0.03	103125	2.80

On capital market front, shares of commercial banks are regarded blue chip stocks. Most of commercial banks are able to make profit and distribute dividends. Stock exchange bulletin also points out that active participation of banking industry stocks in capital markets have made them most influential factor in stock markets. Out of total market capitalization of Rs. 34,704 million of stocks listed in the Nepal Stock Exchange Ltd., Rs.21227 million i.e., about 61.17% is contributed by banking industry.

To strengthen financial sector of the country, Nepal Rastra Bank has started the financial reform process. Nepal Bank Limited and Rastriya Banijya Bank, the two senior banks of country were under heavy accumulated losses resulting complete erosion of its capital. Management of these banks is already given to foreign management team. New prudential regulations has been issued regarding capital adequacy, loan loss classification and provisioning, single obligor limit, corporate governance etc.,

1.2 New Set Of Regulations: A Step Toward Financial Sector Reform

Last year, Nepal Rastra Bank has issued new sets of regulations in line with international standards to address and minimize risks in financial business. These regulations cover capital adequacy, loan classification and provisioning, single obligor limit, accounting policies and financial statements, liquidity risk, interest rate risk, foreign exchange risk, corporate governance, implementation of regulatory directives, regulation regarding investment in earnings assets etc.

According to new capital adequacy regulation, the risk based capital ratio of the commercial banks is to be increased gradually from 8 percent (then) to 12 percent up to 2004. Risk weightage on balance sheet assets and off-balance sheet transactions are also revised. Additional control measures have been taken to measure the capital fund, especially the tier 2 (supplementary) capital. Financial instruments like redeemable preferred stock hybrid instruments, subordinated debt instruments etc. are also included within the definition of capital fund.

The new regulation also address upon the classification of loan and advances and provisioning. Loans are classified as performing and non-performing loans. Regulation provides for "Overdue period of outstanding loans and advances' as minimum criteria for classification of loans and advances. Existing grades of loans have been reduced from 6 to 4 Performing loans includes pass loans only, while non-performing loans includes substandard, doubtful and bad loans. Provisioning requirements are changed as under:

S.N.	Classification	Provisioning (Percentage)
1	Pass	1%
2	Substandard	25%
3	Doubtful	50%
4	Bad	100%

Provision of 12.5 percent is to be made on all restructured and rescheduled loans. Repayment of principal and interest amount by overdrawing current accounts resulting in debit balances or by exceeding limit of overdraft facility is not allowed. Additional provision of 20 percent should be made for the loans, which are disbursed against personal guarantees only.

The new regulation on single obligor limit reduces the fund-based limit to a single customer (or group) from the then 35 percent of capital fund to 25 percent of core capital and non-fund based limit from 50 percent of capital funds to 50 percent of core capital. The regulation also addresses the cases when bank will be over exposed on the single industry or single sector of economy.

The new regulation also aims to disclose true and fair picture of the banks through their financial statements. Accounting policies and formats of the financial statements redefined and restructured to cope with best international practices. New disclosure requirements have enhanced quality of commercial bank's financial statements.

The new regulations direct the commercial banks to report regularly to the central bank regarding on maturity mismatches, interest rate risk and foreign exchange risk. The central bank regulation also sets limit on net open position of foreign currency to 30 percent of their core capital.

The directives, regarding corporate governance, sets code of ethics for directors, chief executives, and employees of the banks. One of the provisions in the regulation is to form the internal audit committee under the chairmanship of non-executive board member to enhance the internal control system. The shareholders having more than one percent shares, the directors and employees of the banks are prohibited from availing credit facilities.

Nepal Rastra Bank has also issued regulations regarding the 'investment' of the commercial banks. According to the new regulation, the banks are free to invest in government and NRB securities. Investment in shares and bonds of public companies in excess of 30% of bank's core capital is not allowed. Similarly, investment in unlisted shares & bonds as well as securities of institutions licensed by the NRB is not allowed.

1.3 Development related to banking legislation:

Nepal Rastra Bank Act, 2002 was enacted with following objectives.

- To formulate necessary monetary and foreign exchange policy to maintain the stability of price, to consolidate balance of payments for sustainable development of the economy;
- To promote stability, liquidity and growth of the banking and financial sector;
- To develop a secure, healthy and efficient system of payment,
- To regulate, inspect, supervise and monitor the banking and financial system; and
- To promote entire banking and financial system of Kingdom of Nepal and to enhance its public credibility.

In the context of growing complexities of financial system, supervisory function of Nepal Rastra Bank has become more challenging. To this end, enactment of Nepal Rastra bank has given more autonomy to Nepal Rastra Bank. As envisaged by the act, commercial banks should be under regular supervision of NRB by performing on site as well as off-site examination.

To strengthen supervisory function of NRB, Act has entrusted NRB Board with more responsibility. Inspection reports of banks is to be submitted to The

Governor within prescribed time limit and it has to be presented before Board. Board is authorized to take appropriate action on the basis of such report. NRB is also authorized to exchange cooperation with foreign supervisors on reciprocal basis to facilitate supervision of banks and financial institutions under its jurisdiction.

This Act regularized functioning of Credit Information Bureau (CIB) established under Nepal Banker's association. CIB was brought under umbrella of Nepal Rastra Bank by aforesaid Act. Byelaws and regulatory framework of this institution is under consideration.

Act has empowered NRB to take enforcement actions against Banks and financial institutions in case of non-compliance. Enforcement actions as envisaged by the Act are as under:

- Warning the bank;
- Obtaining written commitment from BOD for taking corrective action;
- Suspension or cancellation of services currently provided by bank;
- Restriction on distribution of dividends;
- Restriction on collection of deposits or lending activities of bank
- Partial or complete restriction on bank's transactions;
- Suspension or revocation of bank's license.

1.4. Reforming Public Sector Banks:

Nepal Bank Ltd and Rastriya Banijya Bank are pioneer banks of the country. These banks have largest branch network with more than 300 branches across the country. Service provided by these banks in rural areas of country is commendable.

Both these banks have high deposit base. Table given below also reveals this fact. Market share of these banks in deposits and credits is still more than 40%.

Table no. 3 Market share of public sector banks as at end of FY 2001-02

(Rs. in Million)

Particulars	Total of Banking sector	Public sector			Market share (%)
		RBB	NBL	Total	
Deposits	165477	38993	34264	73257	44.27
Credit	103125	27037	19253	46290	44.88

However, these banks have also suffered from gross mismanagement over the years. Non-performing Assets of banks were 55.56% of total loans at the end of FY 2001-02. Huge accumulated losses of banks have resulted in complete erosion of its capital fund. Even Net Interest income for FY 2001-02 of these banks is negative. Improvement of these banks is one of important objectives of financial reform process. To this end, Management of these banks is already handed over to banking experts of international standard.

1.5 Bank Licensing Policy

The Bank licensing Policy in Nepal has taken entirely a new shape after the introduction of new provisions on establishment of commercial banks in

October 2002. Previously the focus was mainly on the amount of paid up capital, distribution of shares and foreign participations.

Now, the requirement of paid up capital for a bank at national level has been increased to Rs. 1 billion. The ceiling on foreign investment has also been increased from 50 percent to 67 percent. The new directive also spells out qualifications to be the promoter of commercial bank. Accordingly, a defaulter or blacklisted borrower cannot be a promoter. Likewise, not less than one third of promoters should have at least bachelor degree in economies, Account, Finance, law, banking or statistics and twenty five percentage of total number of promoters should have job experience in bank or other financial institutions. Director of one bank or non-bank financial institution is prohibited to hold similar post in other bank or non-bank financial institution. Similarly, security brokers market makers and auditors are also prohibited from holding a post of director in a bank. For obvious reasons, the directive also states that promoter's share can be sold only after passing of three years from the date when the shares of bank are listed on the stock exchange.

The new directive also contains the detail of procedural requirement, which have to be duly complied with by prospective bankers in Nepal.

Such provisions are outcome of the experience gained by the central bank in previous days when two private sector banks almost reached stage of close down. Although these banks are under the process of revival, such a scenario would have serious impact on the development of banking practice in Nepal which is still in its, a bit farther than, initial phase.

The new bank licensing procedure, adopted by the central bank, is expecting to bring forth only the banks that will be more stable and efficient.

1.6 Phasing Out Priority Sector Lending:

Priority sector lending or directed lending may be defined as lending to those people or sectors who/which are normally deprived of lending by organized institutions. The financial institutions would normally concentrate to urban sector and a big lending. They tend to avoid financing low volume large number loans due to low profitability, high operational cost and difficulty in monitoring. Also the trading sector gives instant return but production sector on the other hand takes relatively a long time to generate returns. This very nature of the production sector normally does not attract finance from financial institutions. However, it is necessary to invest in production sector for the long-term benefit of the economy as well as for financial upliftment of the mass of people living below the poverty line. To this end, Nepal Rastra Bank could have played and has in fact played an important role using the tool named as directed lending.

A review of the history in this regard shows us that Nepal Rastra Bank issued its first directive on directed lending on 1975 requiring banks to direct their five percent of total deposit to small sector. An amendment on this directive came shortly after that which increased it to Seven percent. Based on this a comprehensive directive on priority sector lending was issued which again increased the ratio to 10 percent of total deposit. On 1986, the priority lending was connected with total lending of bank and new directive was issued entailing 25 percent of total lending to be directed towards production sector inclusive of 8 percent to priority sector. On 1989 this percentage were increased to 40 and 12 respectively. In the next year, deprived sector lending was also introduced.

In this way the priority sector lending has a long time existence in Nepalese banking sector, beginning much before the establishment of private sector banks. The objective is very clear, to facilitate the financially poor people living in any area of the country have easy access to the advantages of banking system of the country. Now lets see what exactly is the requirement under the directed lending.

In order to qualify for including in priority sector a loan should be used in identified sectors or purposes and the amount to a particular borrower should not exceed the given limit. In other words the purposes and the amount is the determinant factors here. Broadly speaking the following loans given to each party are qualified as priority lending:

1. Loan up to Rs 2 million to agriculture, service and domestic industry.
2. Loan up to Rs 5 million to import of machinery and raw material by export oriented industry.
3. Loan up to Rs 100 million to establish power project of national priority.
4. Loan up to Rs 20 million for tea plantation, packaging, cold storage, and technical education institutes etc.
5. Loan up to Rs 10 million to produce computer hardware or software, electric or solar vehicle or to purchase captive generator.
6. Loan up to Rs 1 to purchase vehicle to drive by borrower himself as public transportation.

The deprived sector lending included the investment in share of rural development bank or RMDC, loan to individual up to Rs 30,000 and lending to recognized cooperatives, NGOs and development banks. Such organized financial institutions work as intermediary between the commercial banks and deprived people.

Those banks, which do not comply with these requirements, are imposed with a cash penalty computed on the shortfall of the amount of priority sector lending.

The table below shows the investment made by all commercial banks in priority sector during previous five years.

Table no.4 Priority and Deprived sector lending

Rs. million.

Loan	Mid July 1998	Mid July 1999	Mid July 2000	Mid July 2001	Mid July 2002
Total loan	55,032	68,912	82,889	96,935	105,732
Investment in priority sec.	7,731	9,269	11,445	13,116	14,138
Priority Sector loan to total loan	14.05%	13.45%	13.81%	13.53%	13.37%
Investment in deprived sector loan	1,327	2,763	3,047	3,492	3,507
Deprived Sector loan to total loan	2.41%	4.01%	3.68%	3.60%	3.32%
Cash penalty	7	18	30	3	0

The above table shows that investment on deprived sector is around 2 to 4 percentage of total loan and advances made by commercial banks in Nepal, and on overall priority sector it is 13 to 14 percentages.

Process of Phasing out

Under the memorandum of understanding between Nepal and ADB in 1998, Nepal Rastra Bank has conducted a special study on the status and other aspects of priority sector lending in Nepal. The study revealed that out of the total annual demand of Rs 18 billion only Rs 5 billion of credit is being supplied to rural sector of Nepal. The study also revealed that the rural development bank and other micro credit financing institutions are themselves not sound and viable and therefore are not able to reach various parts of rural Nepal. Under such a situation, it may be against the national interest to part with the directed lending immediately. At last the study has suggested continuing with the directed lending for at least 3 to 5 years and gradually phasing out, only after alternate solutions are identified to overcome the problems on practical aspects of micro financing. Following the suggestions, in 2002, Nepal Rastra Bank came with a policy to gradually expand development banks and other micro financing institutions to cater the need of rural areas and dispense with the compulsory provision of directed lending. However, the directed lending on the deprived sector will exist. Accordingly on financial year 2001/02, the priority sector lending which was 9 percent previously, will be 7 percent and gradually come down to 6, 4, 2 and 1 percentage. It will be completely withdrawn from financial year 2006/07.

The commercial banks will certainly feel a great relief with this liberty. However the needs for micro finance in rural sector is still in growing phase and somehow that should be taken care of. It is good to see that the number of other

Financial intermediaries, which mostly concentrate on micro financing, is increasing, but it is still to see how far they will success in reaching with their services to remote rural parts of Nepal while keeping themselves financially sound and surviving.

CHAPTER TWO
Supervisory framework

2.1 Inspection and supervision Byelaw

Nepal Rastra Bank, Inspection and Supervision Byelaw 2059 was approved by Board of Nepal Rastra Bank and it has been implemented. The aforesaid byelaw has laid down broad framework for functioning of Bank supervision department. Major provisions laid down by above byelaw can be summarized as under:

- Inspection and supervision work should be performed in planned manner by preparing plan of action at the beginning of each financial year. Byelaw has laid down minimum requirements of such plan of action. Performance of department also needs to be reviewed vis-à-vis the above plan on the quarterly basis.
- On site inspection needs to be performed on the basis of on site inspection manual.
- While performing on site inspection more emphasis needs to be given to the review of management, policies and procedures, internal control etc. instead of examining transactions only.
- Discussion of the findings of on site inspection with the management of commercial banks before finalization of the report is mandatory.
- CAMELS rating of the commercial bank should be done after completion of on site inspection and same should be used for internal purposes.
- Off site supervision is to be taken as early warning system to identify potential problems in commercial banks as well as for the compliance of applicable provisions.
- Byelaw seeks to streamline inspection reports of the commercial banks. Minimum requirements of both on site and off site reports have been prescribed.
- Time period for submission of the Inspection reports (both on site and off site) has been specified to discourage unnecessary delays.

2.2 A comprehensive inspection and supervision manual into force:

As required by Nepal Rastra Bank Act 2002, NRB has implemented comprehensive inspection manual for conducting examination of banks and financial institutions. The manual covers areas of capital adequacy, loan portfolio management, treasury operation, management information system, and internal control system and information technology. The manual has comprehensively discussed techniques of preliminary review, analytical review, system appraisal, and detailed verification procedures for conducting on site inspection. Manual guides bank examiners on in site inspection procedure and risk concerns in detail on each area of inspection. Well-developed supervision questionnaire helps examiners to focus on relevant area of inspection and widens their vision with regard to specific area. Finally manual provides guidelines to examiners for preparation of inspection report.

2.3 Focusing on Corporate level inspection:

Focus of onsite examination of commercial banks in Nepal is shifting gradually from branch level examination of transactions to corporate level examinations. More emphasis is given to the review of management practices, policies and procedures, risk inherent in banks & management strategy to combat such risks, internal control system etc.

While performing on site examination examiners is required inter-alia to review risks of all kinds inherent in financial business namely credit risk, market risk, liquidity risk, operation risks and management strat3egy to mitigate such risks. Inspectors are also required to perform CAMELS rating of the banks so as to enable effective supervisory planning and policy decisions. As comprehensive review of commercial banks is not possible by examination of transactions at branch level only; corporate level inspection is felt to be more necessary.

2.4 Emphasis On Off-Site Supervision System

Nepal Rastra Bank is focusing its effort towards strengthening offsite supervision with following objectives:

(a) Identifying potential problems of the commercial banks so as to enable supervisory authorities to take appropriate decision within appropriate time;

(b) Monitoring compliance of various prudential regulations issued by NRB to ensure long term stability of commercial banks;

(c) Support and strengthen quality of on site examination.

To achieve aforesaid objectives, standard formats for periodical reporting of required data by commercial banks have been developed. Data so received from commercial banks are to be analyzed and consolidated off site report is to be prepared. Nepal Rastra Bank, Inspection and Supervision Bye law 2003 has laid down minimum requirements of such reports. Time limit for preparation of reports is also prescribed so as to avoid unnecessary delays.

CHAPTER- THREE
Supervisory Activities in 2002

3.1 Plan of action, 2001/2002:

	1		2	3	4	5
	Headings		Ist qtr	IInd qtr	IIIrd qtr	IVth qtr
1.	Improvement in effectiveness of the Implementation of newly issues Regulations.		√	√	√	√
2.	Preparation of quarterly annual offsite reports					
3.	On the basis of Data received from the commercial banks, necessary process will be developed to CAMEL Rating and Early warning devices for internal purpose.		√	√	√	√
4.	On-site Inspection of following banks:					
	I	Nepal Investment Bank Ltd.	√	√		
	II	Standard Chartered Bank Nepal Ltd.	√	√		
	III	Himalayan Bank Ltd.	√	√		
	IV	Everest Bank Ltd.			√	√
	V	Lumbini Bank Ltd.			√	
	VI	Machhaputchhre Bank Ltd.	√		√	√
	VII	Kumari Bank Ltd.			√	√
	VIII	Bank of Kathmandu Ltd.	√			
	IX	Nepal SBI Bank Ltd.	√			
5.	Special Inspection as and when necessary.		√	√	√	√
6.	Branch Inspection: NBL: 15 RB: 15		√	√	√	√
7.	Follow-up Inspection: Nabil Bank Ltd. Nepal Bangladesh Bank Ltd. Nepal Credit and Commerce Bank Ltd. NIC Bank Ltd.		 √ √ √ √	 √ √ √ √	 √ √ √ √	 √ √ √ √
8.	Other regular functions Calculation of Interest spread Calculation of Priority sector lending Calculation of Liquidity		√ √ √ √	√ √ √ √	√ √ √ √	√ √ √ √

3.2 Preparation of Basel II Implementation

The Basel Committee has come out with new capital accord, which have been set to replace the existing capital accord published on 1988. The new accord obviously is very complex to implement. In a country like ours where banks are operating in low volume of transactions always striving to lower the cost for earning even small profits, it is hard to pursue the banks to follow the new accord exactly in the manner envisaged by the Basel Committee. A high level Basel II preparatory core committee and a working group have been formed by the Nepal Rastra Bank to comprehensively study the provisions of new accord and its possible impact. In this regard an interaction program was also held with the banks chiefs to make them aware of the new development.

There is no doubt that the new accord though complex carries a lot of virtues and will be a milestone in improving banks internal mechanism and supervisory process. It will be beneficial to the supervisory authority of Nepal as it has recently started focusing on risk-based supervision and the internal risk measurement concept an envisaged in new accord is very helpful in this regard.

The banks so far has shown positive attitude towards the implementation of Basel II.

3.3 Major Enforcement Actions:

Major enforcement actions taken by the department cam be summarized as under:

- Management of Nepal Bank Ltd was taken over by the NRB due to huge losses incurred by the bank resulting in complete erosion of its capital.
- Management of Lumbini Bank was also taken over by the Nepal Rastra bank due to non fulfillment of NRB directives as also due to conflict amongst its shareholders.
- Prior clearance of the NRB Supervision department was made mandatory for publishing of the Annual Accounts of the commercial banks. In process of such approval Banks were directed inter-alia, to provide for additional loan loss provisions in case of inadequate provisions, restrictions were imposed on the distribution of dividends.
- Chairman of one of the commercial banks was removed on being blacklisted.

3.4 Supervisory Challenges in Banking Sector:

The banking sector of Nepal has experienced a rapid change after the economic liberalization and specially from 1984 July when Nepal Arab bank ltd (now Nabil Bank Ltd) established as the first joint venture bank in Nepal. Then one after another, several joint venture banks were established in Nepal by 1995 march. Then after local, national and regional level banks also came into the field. One can see from the dates of banks establishment that within the span of almost a decade thirteen commercial banks were established in Nepal most of which concentrate in Kathmandu valley. The Nepal Rastra Bank had allowed the growth in number of commercial banks so that the needs for financial services that was growing with the boom in the economy could be fulfilled and the banks were also eager to operate in Nepal in view of pleasant working environment and good operating result. However the Asian crisis of June 1997 and disturbances caused by domestic violence brought the economic growth down to record level. most banks found it hard to pursue most of their borrowers to be regular in repayment of interest. Mean while Nepal Rastra Bank also issued new set of directives to be applicable from Mid July 2001 onwards, which repeals most of previous directives. The regulation now have become more stringent particularly in capital ratios, loan loss provisioning, single obligor limit, income recognisation etc.

The two large banks, Nepal banks ltd. and Rastriya Baniyja Bank, which started their operations since 1937 Nov and 1966 January, are not able to cope with the developments in banking sector specially in the area of automation.

In such a scenario, the supervisors who are entrusted with the job of ensuring financial stability within the economy and depositors' interest protection have a lot of challenges to face.

This topic discuss the problems and challenges being faced by off-site and on-site supervisors for commercial banks in Nepal. The supervisory challenge may for the purpose of this discussion be defined as the obstacles in performing effective and efficient supervision of banks caused by bank managements, legal and social environment, banking culture, policies, practices and procedures and other factors.

a. Poor corporate governance:

Though it has been sixty- five years since the first bank was established in Nepal, prudential banking practices has not been properly developed in the country. Most of the promoters contributing to establish a bank by way of holding bulk shares make no difference between investing money in a trading or manufacturing firm and that in the banking. They seem to be influencing in the whole functioning of the bank right from the recruitment of staff to lending decisions though they may not know anything about bank management and risks inherent in banking business. Nepal Rastra bank has issued directives on corporate governance on mid July 2001, which interalia prohibit banks to advance loans to promoters, directors or their interest. Financial statements (mid july 2002) of private banks show that there is an outstanding of Rs 170.31 million towards loans to promoters and Rs 27.5 million towards influential shareholders. In addition to the undue influences, the banks are also eager to show a good profit in their books by all means without considering the adverse impact in the long term operation of the bank.

b. Uneven development in banking sectors

There is a vast difference on facilities available in rural and urban areas. Even the basic facility like electricity is not available in many parts of countries where banks' branches are operating. Data transmission from outside Kathmandu valley is still difficult. Some joint venture banks however have introduced sophisticated banking software and computer networking system .Two large banks are still collecting, compiling and analyzing data manually. This makes the application of uniform practices to all commercial banks impossible. In case of these two banks bank supervision division has all the time experienced huge lag in reporting. This renders all the supervisory efforts for consolidated analysis of financial performance and trend of whole commercial banks useless. These two banks can't even be ignored due to the fact that they hold almost 44 % of total commercial banks' deposits and 45 % of loans and advances.

Nevertheless some private banks have also been found to be weak in correct and timely report submission, which it seems, is the result of unplanned expansion of branches and carrying out voluminous transactions without sufficient infrastructure.

c. Lack of proper human resource policy:

Lack of proper human resource policy and practices is eminent in banking industry and in NRB itself. Particularly there is lacking a vision / strategic plan to build strong manpower and particularly to fill the temporary or permanent vacancies of core staff. In most of the banking institutions the absence of a core staff in a department disturbs whole functioning of that department. This is mostly obvious in two large public sector banks. But nevertheless other private banks also suffer from this problem now and then. From the supervisory point of view, this results in improper reporting and/or delay in report submission. In addition temporary or permanent vacancies of core staff is also followed by improper answers or no response to queries made about any transaction or events.

3.5 Frauds and Forgeries in banking industry:

The cases of frauds and forgeries in banks in Nepal are relatively negligible. Previously a number of forgery case were observed in letter of credit transactions, which have been substantially minimized issuing strict rules and regulations by the Nepal Rastra Bank in this regard. Other types of frauds that have been observed in past include fraudulent credit to deposit account and withdrawal of cash using fake drafts and cheques. Such frauds can largely be prevented by establishing effective control by the bank's management itself. During their on-site examination of a bank if supervisors discover any lapse in the control system which may allow fraudulent activities without being noticed, the bank management is warned of the lapse and suggested to take appropriate measures. The bank is also suggested to make appropriate provisions against any loss arising out of such fraudulent activities if the same has not already been charged to profile loss account.

The external auditor of a bank through the special purpose report to e sent to Nepal Rastra Bank by him after completion of auditing job, is required to report on any case of fraud or forgery came to his notice during the audit. Beside, a directive to commercial bank also requires the banks to report immediately any case of fraud discovered in the bank.

3.6 Self assessment of core principles for banking supervision

NRB has adopted core principles for effective supervision as guideline for supervision of commercial banks. Meanwhile formal assessment regards implementation of these principles is also in process.

These principles in the context of our country is briefly discussed in the given paragraphs:

Preconditions for banking supervision

Nepal Rastra Bank Act 2002 has legally recognized Nepal Rastra Bank as the only supervisory agency for all commercial banks in the country. Powers and duties of Nepal Rastra Bank as a supervising agency have been clearly laid down. Commercial Banks Act, 2031(as amended up to 2049) also recognized NRB as a supervisory agency of the commercial banks.

Licensing and structure

All banks and financial institutions are under supervision of the Nepal Rastra Bank. NRB has power to set the criteria for the licensing of banks and reject the application of the establishment, which do not the aforesaid criteria. Minimum requirements laid down by Basel principles for such criteria have also been accommodated. Establishments are not allowed to use the word bank without obtaining license from NRB.

Any significant change in the ownership structure of bank without prior approval of Nepal Rastra Bank is not allowed.

Prudential requirements

Minimum capital requirements as required by the principles has been laid down clearly defining components of I Tier and II tier capital by issuing directives in this regard. Clear directives has been issued regarding loan loss provisioning, single obligor limit, accounting policies, insider lending etc. Risk management policies and other internal control systems of commercial banks are periodically reviewed for effective supervision.

Methods of ongoing supervision

Bank supervision department has both on site and off site supervision system in place. Standard formats are prescribed for regular reporting of statistical data of the banks, which is verified, on onsite examination to establish reliability of data. Corporate level examination of banks is done to ensure supervision of the banks on consolidated basis.

Information requirements

Banks are required to publish their data on quarterly basis and annual reports with complete disclosure in the statutory formats laid down by the NRB. Banks are generally inspected every year with gap of not more than two years to ensure that the data submitted by the banks are reliable and up to date and bank maintains records as per the consistent policies and practices to ensure availability of true and fair picture of the banks earnings and financial position.

Formal powers of the supervisors

Banking supervisors are entrusted with the clearly laid down powers under the Nepal Rastra Bank Act 2002 and Commercial Banks act 1974 to take corrective actions when there are regulatory violations or depositors are threatened in any other ways.

Cross Border Banking

Foreign banks do not have any branches in Nepal nor do any Nepalese bank have any branch outside Nepal.

CHAPTER FOUR

A REVIEW OF PERFORMANCE OF BANKS:

In this Chapter, performance trends of Public sector banks (i.e., Nepal Bank Ltd and Rastriya Banijya Bank) and other private and joint venture banks have been separately discussed. This segregation was felt to be necessary in view of assets size, exceptionally large branch network of two banks and manual data processing by them, which may not be giving correct figures.

An analysis of all the banks (private as well as public sector) has also been given in brief which may show the fact but may not be helpful in drawing correct perception about the financial trend of commercial banks.

Analysis is based on the audited and published annual reports of the banks except for the RBB and NBL for which audited results were not available.

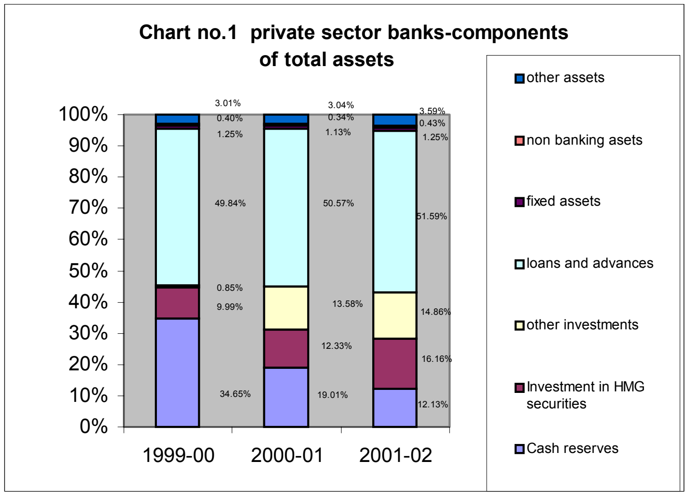
4.1 Balance sheet structure and growth rates:

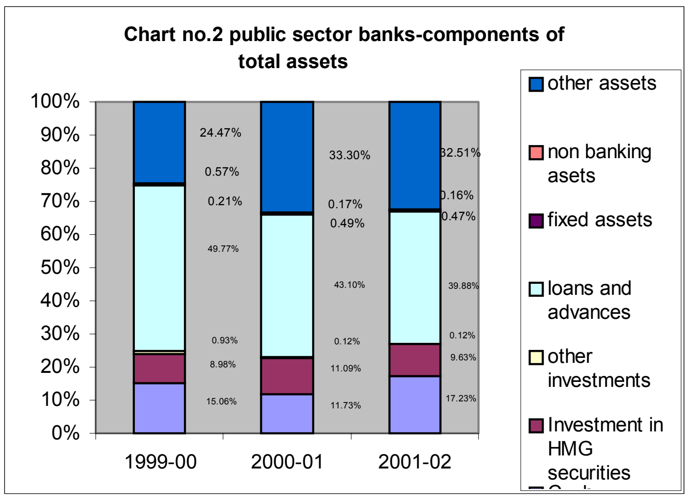
Total Assets of the public sector banks as on the end of financial year ending on mid July 2002, stood at Rs. 116,077 million, with an increase of 4.67% (PY12.26%) from the previous year. Share of investments and loans and advances in the total assets were 9.75 % and 39.88% respectively. As can be seen from the table given below, share of Earning assets (i.e., investments and loans & advances) in the total assets of the bank have shown gradual but consistent decline over the years from 58.87% in FY1999-00 to 49.63% in FY2001-02. Loans and advances of the banks registered decline by 3.15% during the year compared to decline of 2.80% during the previous year. Total investments of the banks also declined by 8.94% compared to the growth of 26.89% during the previous year. However, Cash reserves have increased significantly during the year by 53.82% compared to the decline of 12.58% during the previous year. Such decline in the earning assets accompanied by the increase in the ideal cash reserves is indicative of the deteriorating financial condition of these banks.

Table No. 5: COMPARATIVE BALANCE SHEET

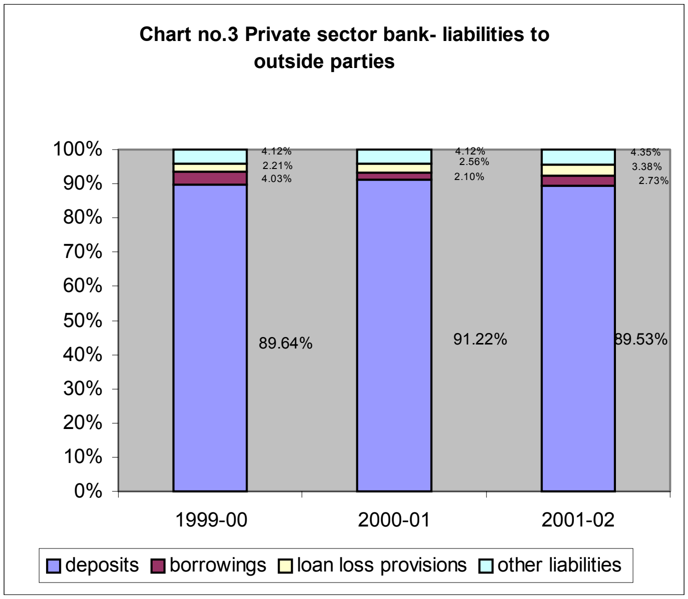
Rs. In million

	Public			Private			Total		
Liabilities	1999-00	2000-01	2001-02	1999-00	2000-01	2001-02	1999-00	2000-01	2001-02
Capital	1552	1552	1552	2662	3862	5036	4214	5414	6588
Reserves and surplus	-6090	-18286	-26504	2085	2402	2132	-4005	-15884	-24372
Deposits	73552	76392	73257	66827	89032	92220	140379	165424	165477
Borrowings	365	358	369	3007	2046	2815	3372	2404	3184
Loan loss provisions	7858	18810	24704	1649	2503	3485	9507	21313	28189
Other liabilities	21550	32071	42699	3068	4020	4483	24618	36091	47182
Total liabilities	**98787**	**110897**	**116077**	**79298**	**103865**	**110171**	**178085**	**214762**	**226248**
Assets									
Cash reserves	14875	13004	20003	27479	19743	13366	42354	32747	33369
Investment in HMG securities	8875	12295	11181	7925	12806	17799	16800	25101	28980
Other investments	923	138	140	674	14104	16366	1597	14242	16506
Loans and advances	49170	47794	46290	39525	52526	56835	88695	100320	103125
Fixed assets	565	544	542	995	1174	1374	1560	1718	1916
Non banking assets	208	190	189	315	352	476	523	542	665
Other assets	24172	36932	37732	2384	3160	3955	26556	40092	41687
Total assets	**98788**	**110897**	**116077**	**79297**	**103865**	**110171**	**178085**	**214762**	**226248**

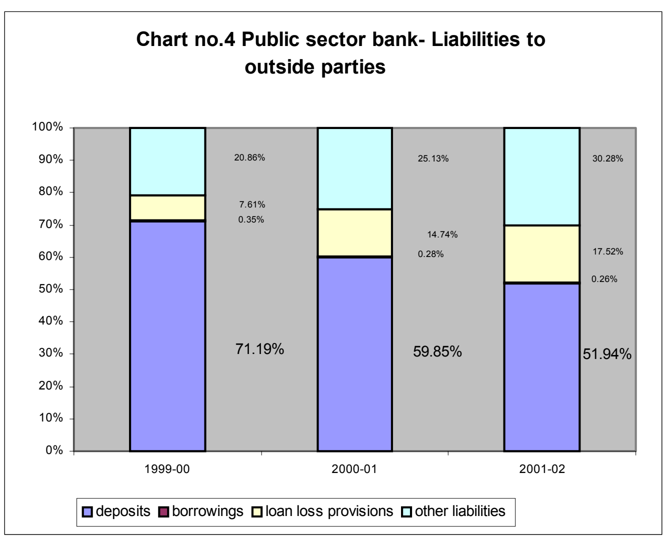




Total Assets of the Private sector banks as on the end of financial year 2001-02 stood at Rs. 110,171 million, with an increase of 6.07% from the previous year which was much low when compared to the growth of 30.98% during previous year. Share of investments and loans and advances in the total assets were 31.01% and 51.59% respectively. Earning assets (i.e., investments and loans & advances) of the banks constituted 82.60% of the total assets compared to 76.48% during the previous year. Loans and advances of the banks have registered growth of 8.20% during the financial year compared to the growth of 32.89% during the previous year. Investments in the HMG &NRB securities and other investments registered growth of 38.97% and 16.04% respectively against the growth of 61.62% and 1992.58% during the previous year. Such increase in the other investments during previous year may be due to the direction issued by NRB requiring disclosure of money at call and short notice having maturity period of more than 7 days as investment which was earlier shown as money at call and short notice. Non banking assets of these banks have also increased by 35.23% to Rs 476m during the year which indicates that there have been increasing cases of credit defaults requiring enforced takeovers. Even though there was slow down in the economy due to depression in the tourism industry because of internal and external security problems as well as discontinuity of major garment industries, private sector banks were successful in achieving marginal growth in their assets.



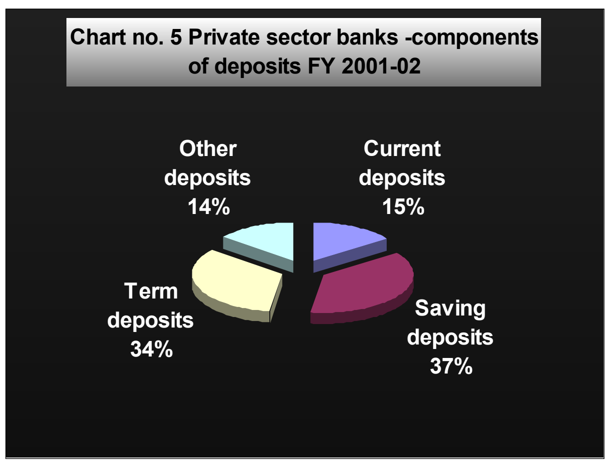
On the liabilities side deposits continued to be major source of funding for the commercial banks. In case of the private sector banks deposits form 83.71% (PY85.72%) of the total sources of funds, while the capital funds form second biggest source contributing 6.51%(PY6.03%) of the total funds of the bank. Increasing tendency of borrowing from the market was also observed during the year as borrowings increased by 37.59% (PY-31.96%) from the previous year. Loan loss provision of the banks also showed an increasing trend. There was growth of 39.23% (PY51.79%) in the provisions from the previous year. In case of public sector banks deposits formed 63.11% of the total sources of funds while the owner's funds (capital and reserves) in the total sources of funds of the banks continued to be negative. Loan loss provisions of the increased significantly over the year by 31.33% (PY 139.37%)

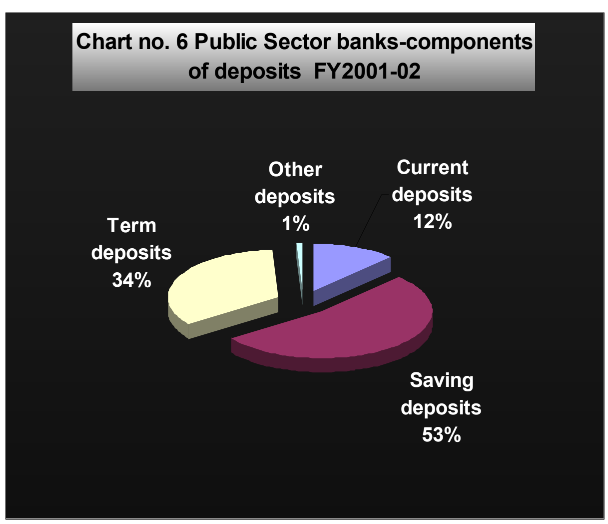


4.2 Deposits:

Mobilization of the savings of the general public in the form of deposits and its channelization to various productive sectors of economy is the primary function of any commercial bank. Therefore, deposits usually form the major source of funds for the banks. At the end of the financial year 2001-02, total deposits of the commercial banks (as a whole) stood at Rs. 165477 million comprising 73.14 % (P.Y.77.03%) of total sources of funds. Out of the total deposits given above 13.90%(P.Y.13.27%)were current deposits, 44.13% (P.Y.42.57%) were saving deposits, 33.78%(P.Y.35.93%) were term deposits and 8.18% (P.Y.8.22%) were in other deposits. Share of non-interest bearing deposits in total deposits was 15.47% (P.Y. 16.11%) and of the interest bearing deposits was 84.53% (P.Y. 83.89%). There was decline of 3.95% in the non-interest bearing deposits from the previous year while interest-bearing deposits increased by 0.80% from the previous year.

In case of private sector banks total deposits at the end of financial year 2001-02 stood at Rs. 92,220 million comprising 83.71 % (P.Y 85.72%) of total sources of funds. Out of total deposits 15.22% (P.Y.13.39%) were in current deposits, 37.04%(P.Y. 35.27%) in saving deposits, 33.60%(P.Y. 36.82%) in term deposits and 14.13% (P.Y.14.52%) were in the other deposits of these banks. Interest bearing deposits were 82.61% (P.Y.82%) and non-interest bearing deposits were 17.39% (P.Y.18.00%). There was only marginal increase in non-interest bearing deposits by 0.052% while interest bearing deposits have registered growth of 4.35% resulting in overall growth of 3.58% in the Total deposits from the previous year.





Deposits of the Public sector banks at the end of FY2001-02 stood at Rs. 73257 million comprising 63.11% (P.Y. 68.89%) of total sources of funds of these banks. Out of total deposits given above 12.24% (P.Y.13.13%) were in current deposits, 53.06% (P.Y. 51.10%) were in saving deposits 34% (P.Y. 34.90%) were in term deposits and 0.70% (P.Y. 0.87%) was in the other deposits of these banks. Non interest bearing deposits have declined by 9.978% and interest bearing deposits declined by 3.154% resulting in overall decline of 4.103% from the previous year. As a result of such change interest bearing deposits were 86.94%(P.Y.86.09%) and non-interest bearing deposits were 13.06% (P.Y.13.91%) of total deposits.

4.3 Credits:

Investment in loans and advances being one of the primary functions of all commercial banks, loans and advances normally constituted major portion of total assets at 45.58% (49.80% in FY1999-00). Total loans and advances of all commercial banks stood at Rs. 103,125 million with the increase of 2.80% from the previous year despite overall slow down of economy.

In case of private sector banks, share of loans and advances in the total assets of banks was 51.59% generating 61.70% (P.Y.57.35%) of the total income of these banks. Total loans and advances of the banks at the end of financial year 2001-02 stood at Rs. 56835 million with an increase of 8.20% from the previous year.

Loans and advances of public sector banks for the same period were Rs46290m registering decline of 3.15% from the previous year. Share of loans and advances in the total assets of banks was 39.88% generating about 58.12% (80.24% in FY.1999-00) of the total income of these banks.

Asset quality

Analysis of the trends of loans and advances could not be completed without considering the quality of these assets. The asset quality means the capacity of assets to generate income as well as the recoverability of the principal amount. NRB has laid down minimum criteria for the classification of assets based on the overdue period of the advances. Assets with inherent credit weaknesses are classified as non-performing assets (NPA), which are further, classified into three categories, namely, substandard, doubtful and loss assets requiring provisioning of 25%, 50% and 100% respectively.

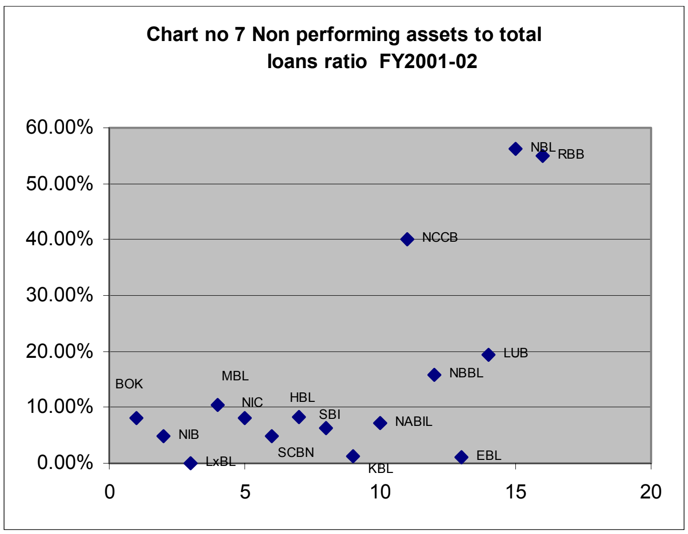
Table no.6 Statement showing Non performing assets of the banks

	Public		Private		Total	
	2000-01	2001-02	2000-01	2001-02	2000-01	2001-02
Non Performing Assets	22710	25717	5930	5640	28640	31357
Total Loans and advances	47794	46290	52526	56835	100312	103125
NPA/Loans and Advances	47.52%	55.56%	11.29%	9.92%	28.55%	30.41%
Specific provision	11352	24454	2092	2705	13444	27158
Net non performing assets	11358	1264	3838	2935	15196	4199

At the end of FY.2001-02, gross NPA's of the private sector banks stood at Rs. 5640 million with the decline of 4.91% from the previous year. Net NPA's (Gross NPAs less loan loss provision thereon) of these banks also declined by 23.52% to Rs. 2935 million during FY2001-02 due to increase in specific loan loss provision by 29.30% from the previous year to Rs. 2705 million in FY.2001-02. Gross Non-performing assets of these banks constituted 9.92% (PY11.29%) of the total loans and advances. Out of total non-performing assets 47.62% were substandard, 27.24% were doubtful and 25.14% were in the category of the loss assets. Banks have written off loans and advances amounting to Rs492m as irrecoverable during the FY2001-02.

Gross NPAs of the public sector banks as at the end of FY2001-02 was Rs. 25717 million registering an increase of 13.25% from the previous year. Net NPAs of these banks at the end of FY2001-02 was Rs.1264 million with a decline of 88.87% from previous year. Such heavy decline in the Net NPAs can be attributed to heavy increase in the specific loan loss provisions by 115.42% from Rs. 11352 million in FY2000-01 to Rs. 24452 million in FY 2001-02. Gross NPA to total loans and advances ratio of banks stood at 55.56% (PY.47.52%), which indicates the deteriorating asset quality of these banks.

Chart no.7 given below better explains comparative NPA positions of the commercial banks as at the end of financial year financial year 2001-02.



4.4 Investments:

Investments in the commercial banks comprising of Government securities, shares and debentures of various companies call deposits etc. As at the end of FY2001-02, stood at Rs. 45486 million with the increase of 15.61% from the previous year.

Investment deposits ratio of the banks stood at 27.49%up from 23.78% of the previous year. Investments in the government securities constituted 63.71% of the total investments of the commercial banks. There was increase in Investment in the government securities by 15.45% (P.Y.49.41%) from the previous year to Rs. 28980 million. Other investments of the commercial banks also increased during the same period by 15.90% (P.Y.791.8%) to Rs. 16506 million. Heavy increase in the other investments in the financial year 2000-01 from the previous year could be attributed mainly to the direction issued by he NRB, which required money at call and short notice which has maturity period of more than 7 days to be shown as other investment, instead of showing it as money at call and short notice as per existing practice.

Total investments of Private sector banks at the end of FY2001-02 were Rs. 34165 million with an increase of 26.95% from the previous year. Investment to deposit ratio of the banks stood at 37.05% up from 30.23% of previous year. Investments in the government securities constituted 52.09% of total investments. There was increase in Investment in the government securities by 38.97% (P.Y.61.62%) from the previous year to Rs. 17799 million. Similarly other investments of the commercial banks also increased during the same period by 16.04% (P.Y.1992.58%) to Rs. 16366 million.

Public sector banks (NBL & RBB) recorded decline in the total investments by 8.94% to Rs. 11321 million during from the previous year. Total investments to deposit ratio of banks also declined to 15.45% in FY 2001-02 from 16.28% in the previous year. Government securities constituted about 98.76% of the total Investments There was decline in Investment in the government securities by 9.06% to Rs. 11181 million from Rs. 12295 million in previous year. Other investments of these banks increased marginally during the same period by 1.45% to Rs.140 million.

4.5 Other Assets

Other Assets (Assets other than cash and cash equivalents, credit and investments) of the commercial banks as a whole at the end of FY 2001-02 stood at Rs. 44268 million with an increase of 4.52% from the previous year. Out of above, fixed assets of the Banks were Rs. 1916 million with increase of 11.53% (P.Y.10.13%) when compared to the previous year; Non Banking assets were Rs 665 million with growth of 22.69% (P.Y. 3.63%) from the previous year. Interest accrued on the loans and advances but not yet received amounted to Rs. 24152 million registering increase of 20.85% from the previous year. Out of total interest accrued on loans and advances Rs. 23745 million were in the interest suspense account increase of 28.91% from the previous year.

Other assets of the private sector banks at the end of FY2001-02 stood at Rs. 5805 million with an increase of 23.88% from the previous year. Out of above fixed assets of banks amounted to Rs. 1374 million registering growth of 17.04% from the previous year. Non-Banking assets amounted to Rs. 476 million registering significant growth by 35.23% from the previous year this indicates increasing number of credit defaults requiring enforced takeovers. Interest accrued on loans and advances amounted to Rs. 1852 million registering growth of 17.85% from the previous year. Out of total interest accrued on the loans and advances Rs. 1647 million was in interest suspense account with growth of 74.10% from the previous year.

In case of public sector banks other assets at the end of FY 2001-02 stood at Rs. 38463 million with marginal increase of 2.12% (P.Y. 46.29%) from the previous year. Out of above, fixed assets of the banks amounted to Rs. 542 million registering negative growth of 0.37% (P.Y.-3.72%) when compared to previous year. Non-Banking assets amounted to Rs. 189 million registering negative growth of 0.53% (P.Y. -8.65%) from the previous year. Interest accrued on the loans and advances amounted Rs. 22208 million registering growth of 20.62% from the previous year. Out of the total interest accrued on loans and advances Rs. 22098 million were in interest suspense account with an increase of 26.46% from the previous year.

4.6 Liquidity:

Liquidity management is a critical factor influencing the financial health of the banks. Banks in Nepal are required to maintain minimum cash reserves as per the norms prescribed by the Nepal Rastra Bank and the Bank Supervision department closely monitoring on weekly basis. In addition to prescribing minimum cash reserve requirement, maturity pattern of the sources and uses of funds of the banks is subject to the regular scrutiny on quarterly basis for any maturity mismatches which may result in unforeseen crisis for the banks. Total cash reserves (including cash, balance with bank, money at call and short notice) of the commercial banks (as a whole) for the financial year ending 2001-02 stood at Rs. 33373 million. There was increase by 1.91% (P.Y.-22.68%) when compared to the previous year. Out of above, money at call and short notice declined by 58.68% to Rs. 4612 million. Cash balance of the banks increased by 12.47% to Rs. 4987 million. Balance with

NRB increased by 83.78% to Rs. 18816 million while the other bank balances declined by 28.32% to Rs. 4954 million at the end of FY 2001-02.

Total cash reserves of private sector banks, as at the end of financial year 2001-02 was Rs. 13368 million. Cash reserves have registered negative growth of 32.30% (P.Y.-28.15%)when compared to the previous year. Out of the above, money at call and short notice declined by 67.74% to Rs. 3069 million; Balance with NRB of these banks registered growth by 16.10% to Rs5819m while the balance with other banks registered decline of 42.47% to Rs. 2006 million. Cash balance of the banks stood at Rs 2472m with an increase of 42.89% from the previous year.

Total cash reserves of the public sector banks as at the end of FY 2001-02 stood at Rs. 20003 million. There was heavy increase of 53.82% in the cash reserves of these banks, which also indicates the situation of idle funds in these banks, which may adversely affect the earnings. Out of total cash reserves given above, money at call and short notice amounted to Rs. 1543 million with decline of 6.42% when compared to previous year. Cash balance of these banks declined by 6.99% to Rs. 2515 million from the previous year. NRB balance of these banks were Rs. 12997 million with growth of 148.68% while other bank balance of the banks declined by 13.92% to Rs. 2948 million when compared to the previous year.

4.7 Capital Adequacies:

Strong capital base is the prerequisite for the safety and soundness of any bank, since; any losses arising out of the unexpected risks have to be borne by the bank out of its own capital. It is for this reason, Basel Capital Accord, 1988 stresses on the creation and maintenance of the strong capital base in proportion to the Risk Weighted Assets of the banks. At present, Banks in Nepal are required to maintain minimum risk weighted capital adequacy ratio of 9%, which is to be increased to 12% from the beginning of FY2004-05.

In line with the Basel Capital Accord, capital is defined in two tiers, collectively known as capital fund. Capital fund of the banks consists of permanent or core element called 'core capital' and less permanent element called 'supplementary capital'. Banks at present are required to maintain core capital and total capital fund ratios of 4.5% and 9% respectively in proportion to their Risk Weighted Assets.

Core capital of the commercial banks as a whole as at end of FY2001-02 was negative at Rs. 18435 million due to heavy accumulated losses.

During the given financial year, public sector banks of the country have failed to meet the capital adequacy requirements due to huge amount of accumulated losses of these banks resulting in the negative core capital to the tune of Rs. 25392 million, which was Rs. 17128 million (negative) during the previous year.

Private sector banks of the country complied with the minimum risk adjusted capital requirements of 9% except for Nepal Credit and Commerce Bank Limited, which had negative core capital of Rs. 150 million. The over all risk adjusted capital ratio maintained by these banks stood at 13.25% up from 11.18% during the previous year.

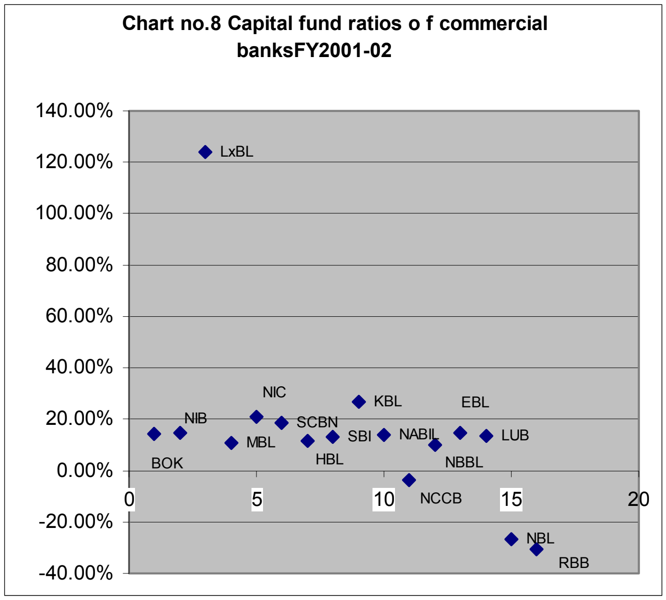
Table no. 7 Capital fund table

	Public		Private		Total	
	2000-01	2001-02	2000-01	2001-02	2000-01	2001-02
Core capital	-17128	-25392	6111	6957	-11017	-18435
Supplementary capital	0	0	2105	2614	2105	2614
Total capital fund	-17128	-25392	8216	9571	-8912	-15821

4.7.1 Capital Base:

The aggregate capital base (core capital as well as supplementary capital), of the commercial banks as a whole as on the end of FY.2001-02 was negative at Rs. 15821 million against Rs. 8912 million (negative) of previous year registering an increase of 77.52% in the total negative core capital.

Capital base of private sector banks amounted to Rs. 9571 million with the increase of 16.49% from the previous year. Core capital of these banks amounted to Rs. 6957 million with an increase of 13.84% from the previous year.



Supplementary capital of the banks on the same date was Rs. 2614 million registering growth of 24.18% from the previous year.

However core capital of two public sector banks (RBB & NBL) was negative, at Rs. 25392 million due to heavy accumulated losses of these banks, registering increase in negative capital by Rs. 8264 million (48.25%) from the previous year. Such huge negative balance in the core capital of these public sector banks have consumed the core capital of commercial banks as a whole as a result of which core capital of commercial banks as a whole is also negative.

4.7. 2 Risk profile of the on and off balance sheet items:

Total on balance sheet assets of the commercial banks as a whole has grown by 5.35% from the previous year too Rs. 226249 million at the end of FY.2001-02, while the equivalent risk weighted on balance sheet assets have declined by 1.39% from Rs. 150321 million to Rs. 148238 million.

Table given below shows the movement of the risk profile of the on balance sheet assets of commercial banks between FY2000-01 and 2001-02. As shown therein bulk of bank's total assets at 63.36% (PY69.37%)at the end of FY.2001-02 were found in the high-risk category of 100%. Moreover, as between the two periods there was movement of assets from 20% and 100% risk category to the zero risk category assets with the overall increase of 64.94% in zero risk category assets from the previous year.

Table no.8 Comparative change in the Riskiness of Bank's portfolio of On balance sheet assets

	Public				Private				Total			
	2000-01		2001-02		2000-01		2001-02		2000-01		2001-02	
Risk weights	On balance sheet assets	% of total asset	On balance sheet assets	% of total asset	On balance sheet assets	% of total asset	On balance sheet assets	% of total asset	On balance sheet assets	% of total asset	On balance sheet assets	% of total asset
0	14638	13.20%	26694	23.00%	19758	19.02%	30039	27.27%	34396	16.02%	56733	25.08%
20	9862	8.89%	4238	3.65%	21519	20.72%	21932	19.91%	31382	14.61%	26170	11.57%
100	86396	77.91%	85146	73.35%	62588	60.26%	58200	52.83%	148984	69.37%	143346	63.36%
	110896		116078		103865		110171		214762		226249	

Between the period of FY2000-01 and 2001-02 total on and off balance sheet assets of the banks rose by 3.68%, while equivalent risk weighted assets declined by 1.39% which suggests that the overall risk profile of the banks have undergone gradual improvement during the period. As can be seen from the table average combined risk weighted assets to the total on and off balance sheet assets have shown an decline from 66.07%during FY 2000-01 to 62.84% during FY 2001-02. However, despite decline in risk-weighted assets, capital adequacy ratios remained negative due to negative capital base.

On balance sheet assets of the private sector banks have grown by 6.07% from Rs. 103867 million at end of FY2000-01 to Rs. 110171 million in FY.2001-02 while the equivalent risk weighted assets have registered decline by 1.68% from Rs. 73482 million in FY.2000-01 to Rs. 72249 million in FY.2001-02. As can be seen from the risk profile table of on-balance sheet items bulk of the bank's total assets i.e. 52.83% (PY60.26%) at the end of FY2001-02 was found in the high-risk category of 100%. As is clearly evident from the table there was notable movement of assets from high risk category i.e., 100% risk assets to the zero risk category assets as a result of which share of zero risk category assets in the total on balance sheet items grew from 19.03% in FY.2000-01 to 27.27% in the FY.2001-02. Total on and off balance sheet of the banks rose by 3.45%, while equivalent risk weighted assets have declined 1.68%. Average combined risk assets of the banks have registered slight decline from 56.40% in FY. 2000-01 to 53.61% in FY.2001-02. Total capital ratio of the banks have improved during the year from 11.18% to 13.25%in FY2001-02 due to the increase in the capital base of these banks as well as reduction in the risk weighted assets during the review period.

On balance sheet assets of the public sector banks have registered growth of 4.67% from Rs. 110897 million in FY.2000-01 to Rs. 116077 million in FY.2001-02 whereas the equivalent risk weighted assets have declined by 1.38% from Rs. 86948 million to Rs. 85744 million. As is evident from the Risk profile table given below bulk of bank's total assets i.e., at and 73.35% (PY 77.91%) at the end FY. 2001-02 respectively, were found in the high risk category of 100% even when there was movement from 20% and 100% risk category assets to zero category assets resulting in the increase in share of zero risk category assets in total on balance sheet assets from 13.20% in FY 2000-01 to 23.00% in FY 2001-02. Total on and off balance sheet of the banks rose by 3.95% while equivalent risk weighted assets have declined by 1.16%. Even though Average combined risk assets of the banks have registered slight decline from 77.00% in FY.2000-01 to 73.22% FY.2001-02 there was no improvement in the capital adequacy ratios, due to increasing accumulated losses of these banks resulting in ever-rising negative core capital.

Table no.9.Total On and off Balance sheet Assets of the banks, Equivalent Risk weighted Assets and Average
Combined Risk weighting

	Public		Private		Total	
	2000-01	2001-02	2000-01	2001-02	2000-01	2001-02
A. Total On- and Off Balance Sheet Assets	115371	119928	130286	134780	245657	254708
B. Total Risk weighted Assets	88834	87806	73482	72249	162316	160055
C. Average combined risk (B/A)	77.00%	73.22%	56.40%	53.61%	66.07%	62.84%
D Capital Fund	-17128	-25392	8216	9571	-8912	-15821
D Capital Adequacy ratio	-19.28%	-28.92%	11.18%	13.25%	-5.49%	-9.88%

4.8 Earnings and profitability:

Public as well as private sector banks have demonstrated a sharp decline in profitability during 2001-02. As envisaged, downfall in tourism market and discontinuity of major garment companies had an adverse impact over banking business. In addition, the new directives, which came into, effect from the beginning of the financial year 2001-02, requiring the banks, interalia, to recognize interest income only on cash basis and prohibiting capitalization of unpaid interest has also resulted in the lower profitability than the previous year. However the impact of such amendment is one time phenomenon and its effect will offset from next year. Earnings of the commercial banks have been analyzed in detail under the head of net profit, operating profit, Total income, Net interest income, operating expenses etc.

Table no.10 Indicators of Financial Performance

Rs. in million

Particulars	Public sector banks			Private sector Banks			Total		
	1999-00	2000-01	2001-02	1999-00	2000-01	2001-02	1999-00	2000-01	2001-02
Net profit	-2666	-9261	-8093	1344	1418	711	-1322	-7843	-7382
Operating profit	-404	-1382	-2457	2655	3285	2493	2251	1903	36
Total Income	6517	5994	4694	6954	8840	8756	13471	14834	13450
Total Expenditure	9183	15255	12787	5610	7422	8045	14793	22677	20832
Interest Income	5817	5217	3405	5640	7126	6816	11457	12343	10221
Interest expended	4776	4406	4060	3074	3875	3610	7850	8281	7670
Interest Spread	1041	810	-655	2566	3250	3206	3607	4060	2551
Other Income	700	777	1289	1313	1715	1940	2013	2492	3229
Operating expenses	1840	2740	2519	1148	1543	1727	2988	4283	4246
Wage bill	1496	2257	1994	391	548	684	1887	2805	2678
Provisions and contingencies	2566	8108	6206	1376	1998	2224	3942	10106	8430
Provision for loan loss	2566	5375	6206	455	887	1426	3021	6262	7632
Provision for taxes	0	0	0	680	842	573	680	842	573
Other non operating expenses	0	0	1	11	6	493	11	6	494

4.8.1 Net Profit:

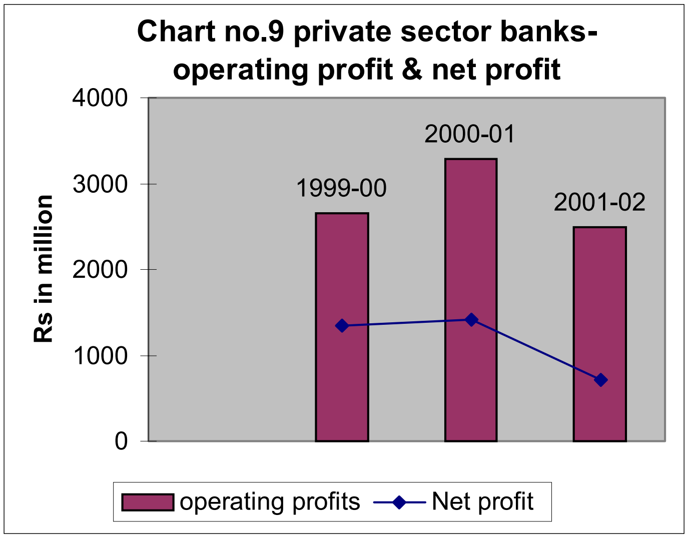
Net profit after taxes of the commercial banks, as a whole for the financial year ending on mid July 2002 (FY 2001-02) was negative at Rs. 7382 million i.e., banks have incurred losses during the given period. Figures show that there has been improvement over last year with reduction in Net losses by Rs. 461 million (5.88%) from the previous financial year.

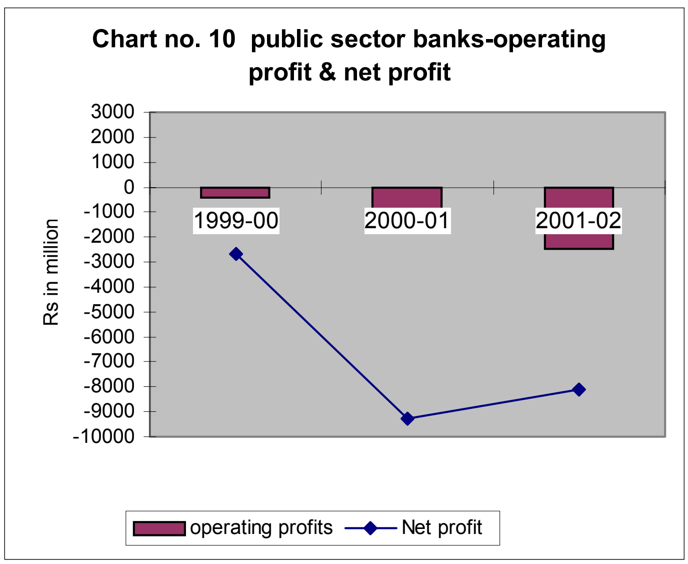
The fourteen Private sector banks have, in total, earned Net profit after taxes of Rs. 711 million during the given period recording shortfall by Rs. 707 million (i.e, by 49.86%) from the previous year.

Public sector banks (RBB and NBL) have recorded Net losses amounting to Rs. 8093 million during the financial year, which is comparatively lower than the previous year by 12.61%.

4.8.2 Operating profit:

Operating profits (Earnings before provisions and contingencies and net non operating income) of commercial banks, as a whole, for the financial year ending on Asar 2059 (FY2001-02) was Rs. 36 million. There was sharp decline in the operating profits of banks by Rs. 1867 million (98.11%)in comparison to previous year. Private sector banks have earned operating profits of Rs. 2493 million during the financial year, which was lower by Rs.792 million (24.11%) from the previous year. Operating result of the public sector banks was negative to the extent of Rs. 2457 million during the financial year. Operating losses increased significantly during the given period by Rs. 1075 million i.e., by 77.79% from the previous year.

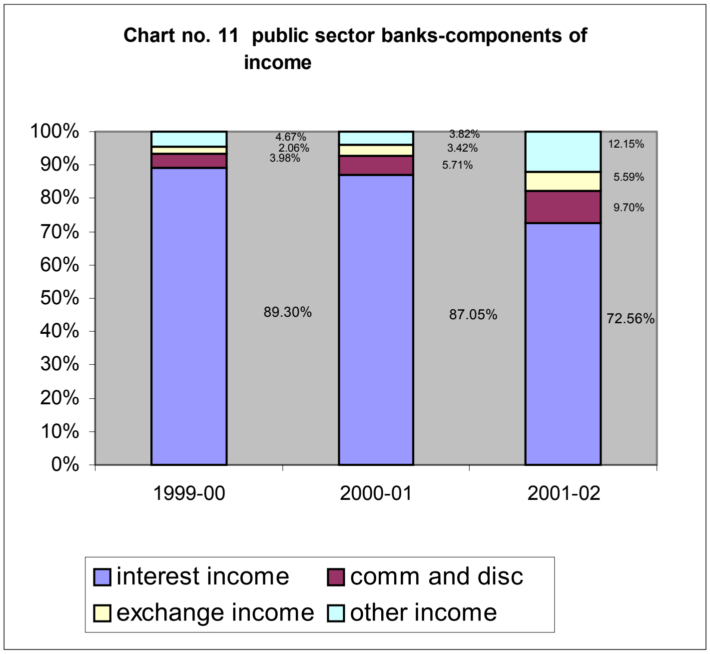


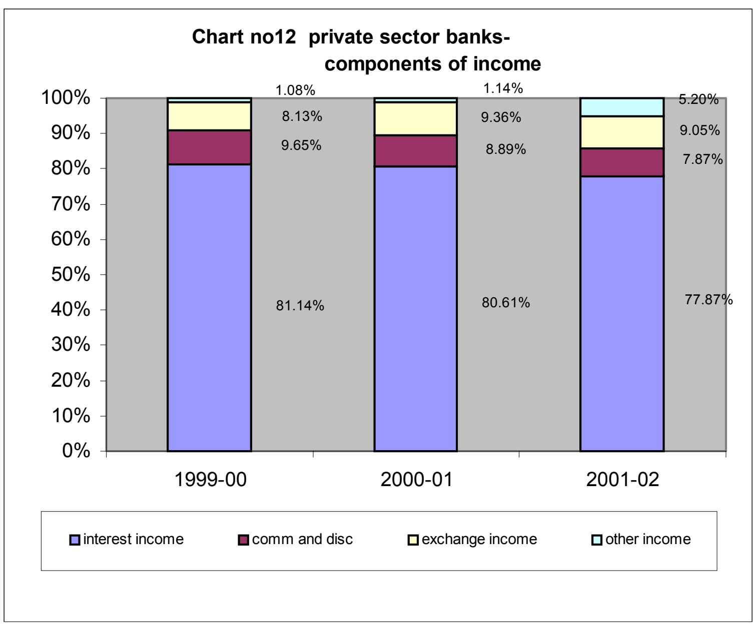


4.8.3 Total Income:

Total income of commercial banks as a whole for the FY.2001-02 comprised of Interest income (76%), Commission and discount income (8%), exchange income (8%) and other income (8%). Share of interest income in the total income of banks have declined gradually from 83% in FY1999-00 to 76% in FY2001-02 which also means that the share of non interest income in the total income of the banks have increased during the same period. During Financial year 2001-02, total income earned by commercial banks as a whole amounted to Rs. 13450 million, which was lower by Rs. 1384 million (9.33%) from the previous year.

Private commercial banks have earned total income of Rs. 8756 million, which is lower by Rs. 84 million (0.95%) from the previous year. Total income of public sector banks for the financial year 2001-02 was Rs. 4694 million, which was lower by Rs. 1300 million (21.69%) from the previous year.



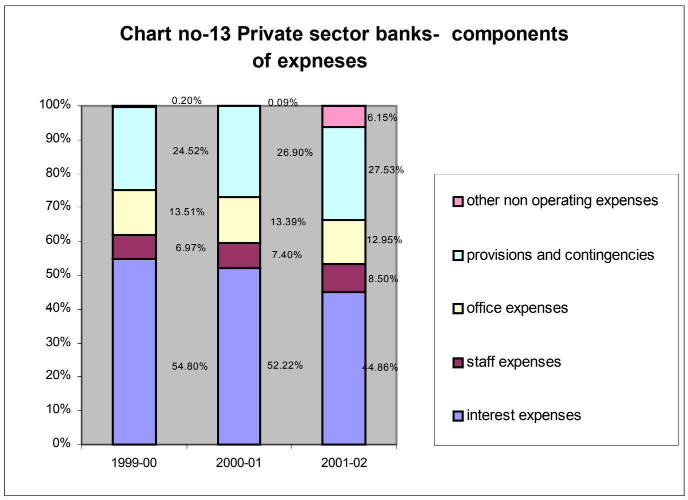


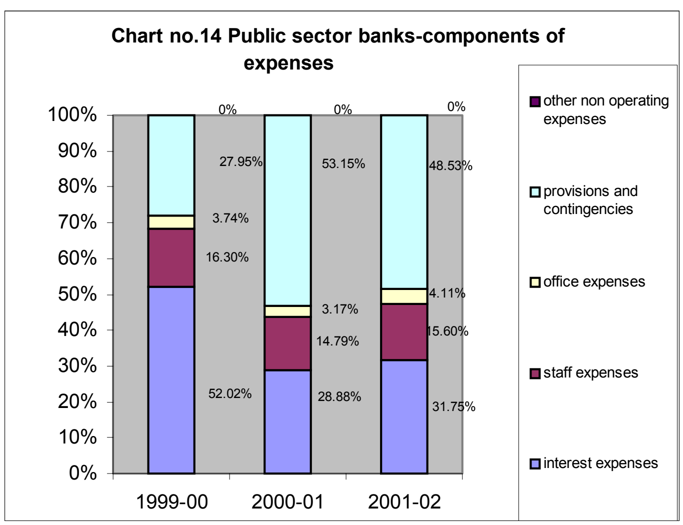
4.8.4 Total expenditure:

Total expenditure of the commercial banks as a whole at the end of financial year 2001-02 was Rs. 20832 million. There was a decline in total expenditure by Rs. 1845 million (8.14%) from the previous year. However, the ratio of total expenses to total income remained high at 154.88% (PY152.87%) in FY2001-02.

Total expenditure of private sector banks stood at Rs. 8045 million. There was an increase of Rs. 623 million (i.e., by 8.39%) when compared to previous year. Total expenses to total income ratio was 91.89% against 83.95% of the previous year. As can be seen from graph interest expenses constituted biggest share of total expenditure 45% followed by employees and office expenses and provisions and contingencies at 27.53% and 21.45% respectively.

Total expenditure of the public sector banks stood at Rs. 12787 million with a decline of 16.18% from the previous year. Total expenditure to total income ratio of these banks too high at 272% (PY254%). If we observe the components of total expenditure, interest expenses held highest share at 31.75% followed by provisions and contingencies of 48.53% and employees &office expenses 19.70%.





4.8.5 Net Interest Income:

Interest Income: Interest income from loans and advances and investments earned by the commercial banks, as a whole during the financial year 2001-02 was Rs.

10221 million. There have been decline in the interest earned by the banks by Rs. 2120 million (i.e., by 17.18%) from the previous financial year.

Private sector banks have earned interest income of Rs. 6816 million, which is lower by Rs. 210 million (4.35%) from the previous year.

Interest income earned by public sector banks amounted to Rs. 3405 million. Interest income of these banks has declined significantly by Rs. 1811 million (i.e., by 34.73%) from the previous year.

Such decline in the interest income of the banks can be attributed to the New NRB regulation requiring interalia, recognition of the interest income on the cash basis only, except for the interest recovered within 30 days (earlier 90 days) of the end of the financial year and prohibition of capitalization of unpaid interest on loans and advances. As can be seen from the figures given above interest income of public sector banks registered huge decline in comparison to private sector banks which is also indicative of the fact that interest recovery in these banks is very poor

*Interest expenditure :*Interest paid on deposits and borrowings by the commercial banks as a whole, amounted to Rs. 7671 million, registering altogether decline of Rs. 611million (i.e., by 7.38%) from the previous year.

Private sector banks have incurred interest expenditure amounting to Rs. 3610 million, which was lower by Rs. 265 million (6.84%) from the previous year.

Public sector banks have incurred interest expenditure of Rs. 4060 million during the FY 2001-02, which was lower by Rs. 346 million (7.85%) from the previous year.

Interest spread Interest spread (net interest income) of commercial banks as a whole for FY 2001-02 amounted to Rs2551m registering decline of Rs. 1509 million (i.e, 37.17%) from the previous year.

Table no.11 Interest spread

Private sector banks	1999-00	2000-01	2001-02
Interest earned on Rs 100 of loans	10.85%	9.95%	9.76%
Interest expended on Rs100 deposits	4.45%	4.2%	3.86%
Net spread	6.40%	5.75%	5.90%
Public sector banks			
Interest earned on Rs 100 of loans	10.8%	9.62%	5.99%
Interest expended on Rs100 deposits	6.36%	5.59%	5.23%
Net spread	4.47%	4.03%	0.76%

Interest spread of private sector banks for the period was Rs. 3206 million demonstrating decline over the last year by Rs. 44 million (i.e., 1.35%). However the figures of two public sector banks tells altogether a different story. The situation is so alarming that even net interest income is negative (that is, interest expenses of these banks were higher than the interest income). During the previous year the negative interest income of these banks was Rs. 655 million, registering decline of Rs. 1465 million (i.e., by 180.86%) from the previous year, which is beyond the imagination of a running banking institution. Such sharp decline in the interest-spread was mainly due to heavy decline in the interest earned on Rs. 100 of advances from 9.62 in (FY2000-01) to 5.89 in (FY2001-02) whereas cost per Rs. 100 of deposits was comparatively stable. (See table no. 11) In addition to the above, the interest spread (relative figure) of the public sector banks was very low at 0.66%, for the Credit/Deposit ratio of 62.14% due to which net interest income of the banks was negative for the positive interest spread ratio.

Table no. 12 Credit Deposit ratio of commercial banks

	1999-00	2000-01	2001-02
Public sector banks			
Loans and advances	48273	47422	45523
Deposits	73073	76392	73257
C/d ratio	66.06%	62.08%	62.14%
Private sector banks			
Loans and advances	37982	50932	55336
Deposits	66827	89032	92220
C/d ratio	56.84%	57.21%	60.00%

4.8.6 Non-Interest income:

Banks were able to make good earnings under this head during the FY2001-02.Out of total non interest income of Rs. 3228 million, Commission and discount income, exchange income and non operating incomes of bank were 35.5%, 32.7% and 31.8% as against 45.3%, 41.45% and 13.25% during the previous year i.e., share of non-operating income have increased significantly during the year. Non-interest income of commercial banks altogether has increased by Rs. 736 million (29.53%) from the previous financial year.

Non-interest incomes of the private sector banks during the given period amounted to Rs. 1940 million with an increase of Rs. 225 million (i.e., by 13.12%) from previous year. Public sector banks have earned non-interest income amounting to Rs. 1289 million during FY2001-02 registering remarkable growth by Rs. 512 million (65.89%) from the previous year.

4.8.7 other operating expenditure:

Other operating expenditure (overheads) of banks comprising staff expenses and office expenses were Rs. 4246 million during the FY2001-02 with marginal decline of Rs. 37 million (i.e., 0.86%) from the previous year.

Other operating expenses of private sector banks amounted to Rs. 1727 million with an increase of Rs. 184 million (i.e., by 11.92%) from the previous year. Ratio of other operating expenses to the total income for the given period stood at 19.72% against 17.45% during previous year.

Other operating expenses of the public sector banks during the same period were Rs. 2519 million, which was lower by Rs. 221 million (8.07%) from the previous year. Ratio of other operating expenses to total income stood at 53.66% against 45.71% during the previous year.

4.8.8 Wage bill:

Commercial banks as a whole have paid Rs. 2677 million towards staff expenses during 2001-02, which was lower by Rs. 127 million (4.53%) from the previous year.

Wage bill of the private sector banks during FY 2001-02 amounted to Rs. 684 million, registering an increase of Rs. 136 million (24.82%) from the previous year. Wages of the banks to total income ratio for the same period stood at 8% against 6% during the previous year.

Wage bill of public sector banks during FY2001-02 amounted to Rs. 1994 million, which is almost three times of expenses incurred by fourteen private banks towards their staff. Even though there was decline in the wage bills by during the FY 2001-02 by Rs. 263 million (11.65%)from the previous year, wage bill to total income ratio of banks have increased to 42% during given period against 38% during the previous year.

4.8.9 Provisions and contingencies:

Provisions and contingencies provided during the financial year 2001-02 comprising of the loan loss provisions, bonus for staff and income tax provisions of commercial banks, as a whole was Rs. 8430 million. There was altogether decline in the provisions and contingencies during the year by Rs.1676 million (16.58%) against the increase of Rs. 6164 million (156%) during the previous year.

Provisions and contingencies in case of private sector banks were Rs. 2224 million. There was increase of Rs. 228 million (11.31%) during FY2001-02 against increase of Rs. 622 million (45.20%) during previous year. Ratio of provisions and contingencies to the total income of banks for the year stood at 25.40% against 22.60% during the previous year.

Provisions and contingencies of public sector banks for the FY2001-02 amounted to Rs. 6206 million. There was decline in provisions and contingencies by Rs. 1902 million (23.46%) during the given period against the increase of Rs. 5542 million (216%) during previous year. Ratio of provisions and contingencies to total income of banks was at 132% against 135% during the previous year.

4.8.9.1 Loan loss provision:

Loan loss provisions of the commercial banks for FY.2001-02 stood at Rs. 7632 million. There was increase in the loan loss provisions during FY.2001-02 by Rs. 1370 million (21.88%) against increase of Rs. 3241 million (107.28%) during previous year.

Loan loss provisions of private sector banks during FY2001-02 stood at Rs. 1426 million. There was an increase in loan loss provision during the year by Rs. 539 million (60.77%) against the increase of Rs. 432 million (94.94%) during the previous year. Loan loss provisions to total income ratio of banks for the financial year 2001-02 was 16.28% against 10.03% during the previous financial year.

Loan loss provisions of the public sector banks for financial year 2001-02 stood at Rs. 6206 million registering increase of Rs. 831 million (15.46%) against increase of Rs. 2809 million (i.e., 109.47%) during previous year. Ratio of loan loss provision to the total income for FY2001-02 stood at 132% as against 120% during the previous financial year. Such high ratio of loan loss provisions to total income also explains the cause for the huge gap between the net profits and operating profits of the public sector banks (see chart no.8)

4.8.9.2 Provision for income tax:

Provisions for the income tax of private sector banks, for FY2001-02 amounted to Rs. 573 million registering decline of Rs. 269 million (31.95%) from the previous year, which is also a reflection of declining profits in the banking sector.

Since public sector banks incurred heavy losses during the year, they have not created any provision for income tax for the given period, however Nepal Bank Ltd have made payment amounting to Rs. 141 million towards prior period income tax liabilities which was debited to the profit and loss appropriation account of the year.

4.9 Other non operating expenses:

Other non-operating expenses of banks stood at Rs. 494 million, which was higher by Rs. 488 million from the previous financial year. Non-operating expenses of private sector banks amounted to Rs. 493 million higher by Rs. 487 million from the previous financial year. Such increase in non-operating expenses was mainly due to the bad debts written off to the profit and loss account by the banks during the financial year amounting to Rs. 469.10 million (NABIL Rs. 441.5 million, NCCB Rs. 27 million and SCBN Rs. 0.5 million). Ratio of non-operating expenses to total income during the FY2001-02 was 5.63% against 0.08% during the previous year. Non operating expenses of public sector banks was Rs. 1.6 million comprising mainly of loss on sale of investment against 0.015million during the previous year.

4.10 Off-balance sheet Activities:

Off-balance sheet activities of the banks comprising mainly of letter of credit, guarantees, foreign exchange contracts, acceptances endorsements etc of all commercial banks registered decline of 2.94% from the previous year to Rs. 29351m in FY.2001-02. As a result of such decline, ratio of the contingent liabilities to the total assets also declined to 12.97% in FY 2001-2002 from 14.08% in previous year. Guarantees and the letter of credit constituted the highest share of the off-balance sheet exposure of the banks at 44.70% (P.Y.38.6%)and41.8%(P.Y.31.4%) respectively. There was increase in the transactions relating to guarantees and letter of credit by 12.31% and 29.52% when compared to the previous year. However the forward exchange contracts registered decline of 54.07% to Rs. 812 million from the previous year.

In case of public sector banks there were overall decline in the off-balance sheet exposure by 13.96% from the previous year to Rs. 3850m as at the end of FY 2001-2002. As a result of such decline, ratio of off balance sheet exposure to the total assets of bank also declined to 3.32% from 4.04% in the previous year. Guarantees and letter of credits constituted the major portion of the total off balances sheet exposure at 42.19%(P.Y.51.13%) and 34.73%(P.Y.37.43%). Transactions relating to Guarantees and letter of credit have declined by 29.01% and 20.17% from the previous year to Rs1624m and Rs1337m respectively.

Off-balances sheet exposure of the Private sector banks registered overall decline of 1.02% from Rs. 25764m in FY 2000-2001 to Rs. 25500m during FY 2001-2002. As a result of such decline ratio of off-balance sheet exposure to total assets also declined from 24.8% to 23.15% Transactions relating to guarantees and letter of credit constituted highest portion of the total off balance sheet exposure at 45.10%(P.Y. 36.5%) and 42.90%(P.Y. 30.3%). There was growth in the transactions relating to guarantees and letter of credits by 22.38% and 40.18% from the previous year to Rs. 11495m and Rs.10942m respectively. Amounts outstanding in the forward exchange contracts declined by 54.05% to Rs. 812m.

CHAPTER-FIVE

5.Capacity Building For Supervision

With the liberalization of financial sector in mid eighties number of commercial banks is increasing. Every day new technology is arriving, which has increased complexities of financial sector, and have made supervisory role of Nepal Rastra Bank more challenging. To cope up with such challenges improvement in supervision capacity both in terms of quantity and quality is necessary. Proper organization structure, well qualified and trained manpower, necessary infrastructure are prerequisite for effective supervision system.

5.1 Restructuring of Banking Supervision:

Inspection and supervision of commercial banks has been fulfilled by Bank supervision department. This department was established in 1984. Prior to its establishment supervision functions were performed by inspection division established in 1974 as a part of banking operation department.

Keeping in view increasing challenges in supervisory functioning, adjustments in structure of supervision department is carried out from time to time to meet changing needs. During the year Bank supervision department was restructured and divided into following five divisions to ensure effective checks on work of each division within the department for smooth and effective workflow:

(a) On site Inspection division

(b) Off site inspection division

(c) Enforcement division

(d) Policy planning division

(e) Internal administration division.

Despite reduction in total number of staff, Number of skilled and qualified staff in the department was increased during the review period. Nepal Rastra Bank, Inspection and supervision Byelaw was adopted to regulate the functioning of the Department. Accordingly, Supervision work is to be carried out in the planned manner by preparing plan of action at beginning of each financial year. Code of conduct, duties and responsibility of supervisors were clearly defined. Inspections are to be performed on the basis of inspection manual. Reporting requirements are clearly defined. Broad framework of the inspection report as well as tie limits have been prescribed. Inspection report is to be submitted to governor within prescribed time and it should be presented before Board. Board is authorized to take appropriate actions on basis of such report.

5.2 Staff training and development:

Well-qualified and trained staff is prerequisite for effective supervision. With the arrival of latest technologies and increase in complexities of financial system it is necessary to conduct regular training programs to keep their knowledge up to date as to technological and other developments relating to financial system. To give better exposure selected officers of the department were sent to various international forums like World Bank, IMF, SEANZA, BIS-FSI, SEACEN Center, Toronto center, etc. In house training seminars, interaction programs, workshops and other kinds of skill development programs are also conducted.

5.3 Relationship with External agencies:

Nepal Rastra Bank has been representative of the country in various Regional and International agencies like World Bank, IMF, Asian Development Bank, SEANZA, SEACEN, etc. Employees of the NRB have been regular participants of seminars workshops training etc organized by such international agencies.

CHAPTER-SIX

OTHER RELEVANT ISSUES

6.1 Frame Work for Contingency Planning for Banking Systemic Crisis

Development of a robust business recovery plan is essential to any business. Particularly in banking sector it assumes a great importance and the event of September 11th, 2001 has also reinforced it. Nepal, though, well known as a peaceful country, has recently faced a series of domestic violence, which also includes attack in some remote bank branches and destruction of ledgers and other documents. These events have also reinforced the necessity of business recovery plan in banks of this country. There is, in fact, no regulation or directive requiring banks to establish a robust business plan. Nevertheless, Banks in Nepal have for their own safety and reputation, developed business recovery plan which in some cases is very sound and efficient and in some other banks is moderate which is acceptable in terms of their size and earnings. The new inspection guidelines have rendered the review of the existence of proper recovery plan in banks mandatory. This recently introduced guideline for banking supervisors requires them to report on the adequacy of the existing plan of the bank that is examined on-site

While developing the business recovery plan for a bank, cost factor involved with this cannot be ignored. Given the small size of our economy and banking transaction, it may not be feasible for all commercial banks to develop a business resumption plan that meets high standards at high costs. In other words, the basic principle that expenses should not exceed the expected benefit equally applies in this case. Banks operating in least developed countries like ours are compelled to compromise on the quality and coverage of business resumption plan. In the initial phase the concentration is mostly on maintenance of proper back up to resume sudden failure of IT system in banks. Nevertheless, some banks presently have recovery plan capable of resuming the operation in any case of disaster so far foreseeable.

6.2 Money Laundering

Money laundering may be define as the method of hiding, mixing or disguising the proceeds of criminal activities through financial institutions for the purpose destroying the origins of the proceeds. This is a tool, which is normally used by persons involved in illegal activities such as drug trafficking, organized crime, tax evading, political bribery, corruption etc. The events of September 11 have revealed another dimension of the problem of money laundering bringing to light the close relationships between money laundering and terrorism.

A money laundering activity may be divided into three stages for its effective vigilance:

(a) The first stage is the disposal of cash proceeds of illegal activity. In this stage, the money is introduced into the financial system in a manner that avoids suspicion. For example, depositing large amounts of money in several batches.

(b) The second stage is to hide true character of the money, through a series of transactions. The audit trail is erased by transferring the money to off-share laundering centers with strict secrecy law or to bearer bonds, or to shell holding companies.

(c) The last stage is that one where the laundered money is integrated into the financial system.

The adverse effects of money laundering are not only on the country's economic but also on political & social structures. A legitimate business may be hampered if such money enters into a company, as the company can easily offer the products below market rates or even below cost. The money laundering activity can affect currencies & interest rates as such money is reinvested where the chances of detection is less rather than where the return is higher. Such investments are not necessarily economically beneficial to the country leading to economic distortion & instability. For example, the fund may be invested in hotels or construction project not because of actual demand of such investments but for short-term interest of launderers. This may adversely affect the economic growth especially in the economy where the size of illicit fund is huge. Since the money laundering is a global phenomenon, it may put the country to reputation risk particularly to the recipient of such money.

A bank may suffer severe consequences from money laundering. Besides the reputation & legal risk, such activities may also undermine the relationship with correspondent banks. Since the money involved in laundering activities is a normally huge, bank particularly small ones may tempt to compromise on the policies regarding deposit mobilization & customer selection.

Thus, money laundering is not only harmful to the financial system but its impact may also extend to national economy as a whole.

In an underdeveloped economy like ours, money-laundering activities may seriously harm the whole economic system. We although, do not have any legislation specially enacted to combat such activities. This is a national issue, however, the banking supervision in Nepal realizes that they can't be indifferent to the use made of banks by criminals. Towards this end, banks are required to follow the principles set out by the Basel Committee on December 1988, on prevention of criminal use of the banking system for the purpose of money laundering. The principles of customer identification & cooperation with law enforcement authorities have been fully adhered to and other principle which prevent banks from offering services in transactions supposed to be associated with money laundering activities is also being observed by bank on ethical ground.

Bank supervisors who conduct on-site examination of banks are also frequently asked to observe for such matters, but such matters have not come to the notice of central bank so far. Nevertheless, specific legislation is under the process, which will provide firmly against money laundering activities.

6.3 Credit Information

Credit Information Bureau was established under the umbrella of Nepal Banker's Association to facilitate sharing of credit information amongst the commercial banks. Credit information bureau is responsible for collection and documentation of credit information regarding the borrowers in default and declaration of such borrowers on the regular basis. Parties so black listed are prohibited from availing loans and advances from other banks. Availability of the credit information has facilitated supervision work to a great extent. At the same time it also helps in the reduction of the Non-performing assets of the commercial banks since capacity and character of prospective borrowers can be easily assessed before granting credit facility.

6.4 Coordination with external and internal auditors:

The Bank Supervision Department in Nepal Rastra Bank is working with close relationship with the external auditors of banks. Though the main objective is different, the works carried out by auditors are of great help to supervisory authority. Auditors here usually spend a lot of time in banks examining all the books of accounts, supporting documents and other areas of supervisory concerns. Before giving their final opinion, auditors provide a preliminary report, which explains in detail the findings, major or minor, in every heads of the financial statement, which can be used as an important source of information about banks.

A recent directive on corporate governance by this bank has somewhat rendered the internal auditor an independent status. With the help of regular interaction with internal auditor of banks, they are being encouraged to become more transparent and independent of management influence so that any imprudent conduct of management whether willful a not, could be unearthed timely. Thus, in recent years, coordination with external and internal auditors has been given a great importance and it has started showing positive signs towards timely detection of unethical use of depositor's money and thus helping in taking appropriate action.

6.5 Long form audit report revised:

Statutory auditors of commercial banks are required to submit Long Form Audit Report (LFAR) to NRB on completion of audit. Since auditor spend lot of time in commercial banks in course of their audit, the supervisory authority can use information available with them for more effective discharge of supervisory function. Keeping this in view, Prescribed format of LFAR has been recently revised. Focus of new format is on the review of systems and procedures of the commercial banks.

Accordingly, auditors are required to give brief introduction about their work which shall include briefing about the composition of the audit team and audit plan of the auditor, review of the audit work, sampling procedures used and audit standards used in the performance of the audit. Such information will be of great help in forming opinion as to how auditor reached conclusions given by him in the report and hence help in objective analysis of information and comments made in the audit report. Brief analysis of the main financial indicators is to be given like depositors structure, Non-performing Assets Significant changes in various headings of profit and loss account etc.

Auditors are required to perform comprehensive review and comment on the Risk Management system existing in banks relating to credit risk, liquidity risk, Interest rate risk, foreign exchange risk and other risks prevalent in commercial banks. Minimum requirements for such review and comment is also laid down for example in case of review of credit risk management system auditor is required to comment upon various aspects of credit activities and possible risk inherent therein and management system to minimize the same, adequacy/inadequacy of internal control system in area of credit, whether proper analysis was done or not before disbursement of loans, adequacy/ inadequacy of the credit administration follow up and supervision. Various aspects to be covered while doing such review have been given to enable comprehensive review.

Auditors are also required to review and comment on the internal control system of the commercial bank in respect of the areas laid down by the prescribed format as well as on the compliance of various legal provisions pointing out specific cases of default. To minimize fraud and forgeries auditors are required to review the control measures taken by bank and comment thereon and report any cases of fraud or forgery that comes to their notice in course of their audit.