

# Financial Sector Reforms in Nepal

Ganesh Kumar Shrestha \*

---

*Financial sector is the backbone or engine of growth of any economy. It mobilizes and allocates financial resources most productively and efficiently and induces investment, increases employment opportunities and productivity, achieves growth targets and attains overall macro-economic development. In a global financial system, each country has to reform its financial sector. The reform process should be properly sequenced. Nepal initiated financial sector reform in mid-1980s and HMG/N and Nepal Rastra Bank have been implementing comprehensive Financial Sector Reform Program since 2001.*

*HMG/N has strongly committed for the reform of the financial sector in general and RBB, NBL, ADB/N and NIDC in particular. Much depends on the proper implementation of the Financial Sector Reform Program. The financial sector may invite financial crisis which may easily transfer to other sectors of the economy. As such, we have to be extra cautious for the financial liberalization and reforms of the financial sector.*

---

## INTRODUCTION

Financial sector reform means gradual liberalization of financial market and its players and opening of all types of depository institutions and other non-depository financial institutions to the private sector. Depository institutions include commercial banks, development banks, finance companies, co-operative banks etc. Other financial institutions include life and non-life insurance companies, pension funds/provident funds/retirement funds, mutual funds, unit trusts, mutual savings banks, mutual funds, savings and loan associations, credit unions, mortgage banks, money market mutual funds, deposit insurance corporation/company, credit guarantee corporation/company and so on. In most developing and transition economies, the financial sector is dominated by the banking sector, which is a largest mobilizer of deposits and provider of credit. Deposits, commercial papers, certificate of deposits, shares, stocks, bonds, bankers' acceptances, premiums from insurance policies and employer and employees contributions are primary liabilities of financial institutions. Business and commercial loans, mortgages,

---

\* Executive Director, Corporate Planning Department, Nepal Rastra Bank

government securities, municipal bonds, corporate bonds, corporate stocks, and money market instruments are primary assets of financial institutions.

Financial sector reform also means competition, transparency, financial discipline and governance. The process of financial sector reform begins with deregulation of interest rates on deposits and lending, phasing out of margin rates, statutory reserve requirements, and targeted credit programs, opening up of financial industry to private sector (domestic and foreign), permission to open foreign currency accounts to commercial banks, current account convertibility and completes with free entry and exit barriers to foreign investors in banking, securities trading, insurance services and financial information services, full capital account convertibility, application of international financial standards and best practices (capital adequacy, loan loss provision, auditing, disclosures etc.) central bank's prudential regulatory oversight, supervision and enforcement of depository institutions and privatization of government-owned banking and financial institutions,

Financial sector is regarded as the backbone or engine of growth of any economy whether developed or developing or in transition or emerging. It plays a very important role in the development of all sectors of the economy and actually works as a lubricator by providing financial resources. It operates as an intermediary between financial surplus units and financial deficit units i.e. lenders/savers and borrowers/spenders. It provides different avenues to savers to invest their savings in financial products and services as per their needs and makes funds available to borrowers/investors in most competitive prices. Financial markets provide playing field to financial institutions and their customers (depositors, borrowers, investors etc.) with all types of financial instruments such as deposits, loans and advances, securities, insurance policies, corporate bonds and shares etc. A modern financial sector provides electronic banking services (e-banking), ATM services, credit cards, debit cards, innovative insurance products and services, attractive pension schemes and derivatives, hedging and financial futures. It can provide a wider range of financial services at lower costs while minimizing financial risks to a large number of customers

In a highly developed and sound financial system, all types of customers, whether large or small, rich or poor, and local or foreigner get benefited with their suitable financial products and services and insurance policies. It helps the economy by mobilizing and allocating financial resources most productively and efficiently. It helps to induce investment, increase employment opportunities and productivity, achieve growth targets and attain overall macro-economic development.

But pre-mature financial sector liberalization may bring undesired risks and uncertainties in the financial industry. The financial industry has not forgotten the Mexican financial crisis of 1995 and the East Asian financial crisis of 1997 and 1998, which had a contagion effects in other countries. The negative impact of the financial crisis or turmoil in East Asia had been felt not only in East Asian financial markets but also in Russia and Brazil. But it had a positive impact on the

financial markets of Europe and the USA. As a result of financial crises of the 1990s banking systems in many countries collapsed, fast growing economies suddenly felt sharp recessions and the booming international capital flows dwindled to a trickle. It has been well recognized that a pre-requisite for preventing a financial crisis is the existence of a healthy financial sector with a good regulatory framework and strong supervision system of the whole financial sector. Foreign capital or foreign investment generally flows to those countries where there are well-developed financial markets and free mobility of capital and other financial assets. The liberalization process of financial sector should be prudent and well sequenced.

Financial policy makers/planners, financial supervisors/supervision authorities and monetary authorities should be very cautious while reforming the financial sector. It should be in a systematic and sequential order. It can play a crucial role in the overall economic development by mobilizing savings and transforming it into productive resources. The recent World Bank study has revealed that countries with fully open financial services sectors grow on an average by 1 percentage point faster than other countries and more open and competitive financial markets increase economic growth rates by 1.3 to 1.5 percentage points. (Dam, 2002) In the same way, another recent WTO study of 27 emerging market economies found that allowing foreign financial firms to establish locally and engage in broad spectrum of financial activities contributed to greater financial stability. (Dam, 2002)

#### REVIEW OF LITERATURE ON THE ROLE OF FINANCIAL SECTOR AND FINANCIAL MARKETS

There is a large number of literature and studies on the role of financial sector and financial markets in the promotion and development of financial assets, savings and economic growth. These studies include Gurley and Shaw (1955), Goldsmith (1969), McKinnon (1973) and Shaw (1973). McKinnon (1973) and Shaw (1973) consider role of government intervention in the financial markets as a major constraint to savings mobilization, investment and growth. The government's control of interest rates on deposits and loans even impedes the capital formation and low interest rates lead to capital flight. They opined that an increase in real interest rates increases the inflow of foreign capital for investment and economic growth. Collier (1990) argues that the opening of the domestic financial markets to foreign competition provides an incentive to domestic banking institutions to adopt efficient means of banking services. Stulz (1999) and Mishkin (2001) claim that financial liberalization promotes transparency and accountability reducing adverse selection and moral hazard while alleviating liquidity problems in financial markets. They argue that international capital markets help to discipline policy makers, who might be tempted exploiting captive domestic capital markets. Bekaert, Harvey and Lundblad (2001) claim that financial liberalization and the financial development greatly facilitate economic growth.

As there are several supporters of deregulation and liberalization of the financial sector, there are many financial experts/professionals who favor some controls on financial markets. Stiglitz (1999) clamors to developing countries to put some limits on capital inflows to moderate boom-bust pattern in financial markets. Krugman (1998) argues that capital controls might help developing countries in managing, at least temporarily, retreat of foreign investors. The liberalization measures tend to increase financial fragility and susceptibility to exogenous shocks over which domestic policies have limited controls (Demirguc-Kunt and Detragiache, 1998). Sometimes investors overreact in financial turmoil and withdraw their investments at the smallest signs of financial problems even when macro-economic fundamentals do not warrant it and thus aggravate the financial turmoil (Calvo and Mendoza, 2000). Soros (2002) and Stiglitz (2002) criticized the functioning of the international financial system

*Box: Recent Experience of Financial Sector Reform in South Korea*

Although Korea has a developed financial sector and it has a long history of financial sector reform, the country was almost paralyzed during the East Asian financial crisis. It was found that there was a lack of market discipline. A lack of financial transparency among financial institutions and corporations, “brand-name” lending practices, and inadequate credit analysis and risk management skills were a few structural problems that caused financial crisis. The regulation and supervisory frameworks were not upgraded. The market mechanism did not function properly and there was a government intervention in the financial sector. To reform the financial sector, the Presidential Committee on Financial Reform was launched in early 1997 and the committee recommended a sweeping series of reforms for the Bank of Korea and for the financial supervisory structure.

The committee recommended the establishment of the Financial Supervisory Organizations (FSO) in August 1997 and the draft Act was presented to the National Assembly and the Assembly passed the Act on the Establishment of FSO in December 29, 1997. The Financial Supervision Commission (FSC) began to serve on April 1998, as Korea’s supreme financial regulatory and supervisory organization for banking, non-banking, securities and exchange, and insurance services. The Financial Supervisory Service (FSS) worked as an executive body of the FSC. The FSC/FSS closed down financial institution deemed non-viable. It also merged few financial institutions. The Korean Government earmarked US\$ 57 billion to purchase non-performing loans and support re-capitalization efforts of domestic financial institutions through the Korea Asset Management Corporation (KAMCO) and the Korea Deposit Insurance Corporation (KDIC). The FSS strengthened prudential regulations. The new regulations included the Prompt Corrective Action (PCA) procedures, which means if any bank failed to meet the 8% capital adequacy ratio and a certain level of CAMELS rating will be automatically suspended, liquidated or merged. The FSS required the adoption of international best practices in accounting and disclosure standards. The deposit insurance or guarantee system was further improved.

## FINANCIAL SECTOR REFORM IN NEPAL

The reform or liberalization of financial sector is a continuous process. It takes a long period to complete the process of financial reform. Even in a most developed financial market, innovation in financial products and services takes place, which necessitates the changes in rules and regulations in the financial markets. The financial sector reform of Nepal was initiated in mid-1980s and it is still being continued. The financial sector reform process in Nepal has been analyzed in three phases, which are as follows:

### *Phase I (1984-1990)*

The first phase of the financial sector reform was initiated in mid-1980s under the liberal economic policy of HMG/N. Under this policy, HMG/N first opened up the banking sector to foreign investors. In 1984, the Nepal Arab Bank Limited was established as the first joint venture commercial bank of the country. The bank was established with 50 percent equity participation of a foreign bank. The establishment of this joint venture bank brought foreign investment in the banking industry and modern banking practices and technical skills. The Nepal Indosuez Bank Limited and Nepal Grindlays Bank Limited were established in 1985 and 1987 respectively as joint venture commercial banks. The banking operations of these three international commercial banks helped the economy to get modern banking services. It enhanced the competitive environment in the banking sector especially in the Kathmandu valley where more than 50 percent of the economic activities of the country take place.

In July 1985, commercial banks were allowed, for the first time, to accept current and fixed deposits on foreign currencies (U.S. dollar and sterling pound). Before May 26, 1986, the interest rates of commercial banks were totally controlled by Nepal Rastra Bank (NRB), the central bank of Nepal. Both deposits and lending rates were being heavily regulated by NRB. On May 26, 1986, NRB deregulated the interest rate regime and authorized commercial banks to fix interest rates at any level above its minimum prescribed levels. These bold steps of NRB had a far reaching impact in the development of the financial sector of the country, which was clearly evidenced in the growth of the assets and banking activities of commercial banks. Effective 29 May, 1986, the liquidity requirement was also lowered to 9 percent from 25 percent (NRB, 1996).

Under the Structural Adjustment Program of the IMF, the financial sector was further liberalized in 1987. The focus of NRB was placed on indirect monetary control. The emphasis was laid on increased financial intermediation, deepening of financial markets and increase in the role of market forces in the financial system. The auction mechanism was introduced for the first time to sell treasury bills (NRB, 1996).

The Agriculture Development Bank of Nepal (ADB/N) and the Nepal Industrial development Corporation (NIDC) were allowed to issue debentures to increase their financial resources. ADB/N also issued agriculture savings bonds in 1985. These debenture and bond were introduced as new financial instruments to develop the financial markets of the country. HMG/N also sold national savings certificates outside the financial system for the first time. The ADB/N was also allowed to open commercial banking branches in urban areas. Commercial banks were allowed to determine their lending rates except for exports and productive sector credits. They were granted virtually freedom to fix their interest rates on deposits in July 1989 except for the priority sector credit. The Credit Information Bureau was established in 1989 (NRB, 1996).

NRB strengthened its regulation and supervision of banking and financial institutions. Commercial banks were required to increase their capital adequacy ratio (CAR) gradually. They were required to maintain CAR of 2.5 percent by mid-July 1989 and 3.0 percent by mid-July 1990. Regulation on single borrower limit was also introduced. There were some new regulations issued on refinance policy and reserve requirements. The Finance Company Act was enacted in 1986 to increase competition in financial markets and especially for the merchant banking and leasing services and to provide loans for hire purchase, term finance and housing construction. But finance companies were not established during the first phase of the financial sector reform (NRB, 1996).

There was a new development on the capital market opened its floor for corporate share trading in November 1994. The Securities Exchange Center (SEC) also started to provide some merchant banking services. The trading in the capital market was limited due to listing of very few company's shares in the SEC. There was a limited transaction of government securities. The activities of contractual saving institutions such as the Employees Provident Fund (EPF) and insurance services sector did not make any new initiatives.

### *Phase II (1991- 1998)*

After the restoration of democracy, the democratic governments under its open and liberal economic policy gave more emphasis on the liberalization of the financial sector. As a result, the Nepalese financial sector has grown very rapidly since 1990s. There has been a dramatic rise in the number of banking and non-banking financial institutions. Till mid-July 1990, there were 5 commercial banks, 2 development banks, 2 insurance companies, and other few financial and quasi-financial institutions. As at mid-July 2000, there were 11 commercial banks, 2 development banks, 5 regional rural development banks (RRDBs), 44 finance companies, 2 insurance companies, 29 savings and credit co-operative societies and 30 NGOs licensed by NRB and few other financial and quasi financial institutions (EPF, Deposit Insurance and Credit Guarantee Corporation, Citizens Investment Trust, Nepal Stock Exchange Limited, Securities Board, Insurance Board, Credit

Information Bureau). There has been a tremendous increase in the volume of financial transactions and financial markets as well.

The commitments of HMG/N in the financial sector liberalization gave the needed boost in the confidence of the private sector for the establishment of commercial banks in the private sector. The Himalayan Bank Limited and Nepal SBI Bank Limited were established in 1993 and Nepal Bangladesh Bank Limited and the Everest Bank Limited in 1994. All of them were established as joint venture commercial banks. The Nepal Housing Development Finance company was established in the public sector as the first finance company under the Finance Company Act 1986. Soon after the establishment of the first finance company, five finance companies were established in the private sector in 1993. The rural development banks were established in five development regions to provide micro-finance services to the poor and the ultra-poor women. To provide limited banking services in the un-banked rural areas, saving and credit co-operative societies started to get operating licenses from NRB since 1993 and by 1995, there were 10 such financial institutions. Even the NGOs got licenses for micro-credit operations in 1994 and within two years' period, 30 NGOs got operating licenses to undertake limited banking transactions. The separate act for development banks was felt necessary and it was enacted in 1996.

The establishment of finance companies not only improved competition in the deposit and credit services, they also helped in the capital market through listing their shares. Their shares are being traded along with the shares of commercial banks. They have been providing merchant banking services such as underwriters and market makers.

To make the financial sector more liberal, the current account convertibility is very important. Nepal received the article VIII status of the IMF on May 30, 1994. The move towards financial liberalization helped the country to receive this status. Under this status, Nepal is obliged to keep the commitments towards the current account convertibility.

NRB further liberalized the restrictive measures for providing banking and non-banking financial institutions and especially development banks and finance companies more freedom in their business operations. The commercial banks were required to increase CAR to 3.5 percent at mid-July 1991 and 4.0 percent at mid-July 1992. The credit ceiling was removed in 1991 except for government and non-financial government enterprises under the policy of indirect monetary control and Nepal entered into the Enhanced Structural Adjustment Facility (ESAF) in October 1992. NRB laid more emphasis on open market operations as main monetary policy instrument (NRB, 1996).

Under the financial sector reforms, 3 joint venture commercial banks were established and they started to provide modern banking services to their customers. They started to compete with Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB), one fully owned and another 51% owned by HMG/N and among themselves to provide modern and efficient banking services. As a result, they attracted most of the good clients/customers (depositors and borrowers) of the RBB

and NBL. They were already ailing even before the establishment of joint venture commercial banks. Because of new developments, their financial, managerial and organizational problems became more serious. To study their financial, managerial and organizational problems and to prescribe necessary recommendations, NRB sought the financial and technical help of the UNDP and the study team presented the Commercial Banking Problem Analysis and Strategy Study (CBPASS) reports.

The *CBPASS I* recommended HMG/N to address the following critical areas:

1. Full repayment of Government guaranteed loans to state-owned enterprises and removal of lending obligations.
2. Partial re-capitalization of NBL and RBB.
3. Establishment of a new Rural Finance Institution to assume priority sector lending of NBL and RBB.

To strengthen and improve their performance, HMG/N provided Rs 443 million for the re-capitalization of NBL and RBB. HMG/N provided Rs 3.12 billion for provisioning and repayment of bad debts. HMG/N made payment of Rs 660 million for the government guaranteed bank loans to public enterprises

The *CBPASS II* report identified *four critical areas* where RBB and NBL had to make necessary improvements.

1. Loan Recovery 2. Credit 3. Personnel 4. Branch Operations and MIS
  1. The CBPASS II report had revealed that an estimated 5 percent of the assets of NBL and 8 percent of RBB were problem loans and the recovery of these problem loans would significantly improve their liquidity, profitability and capital base. .
  2. Both NBL and RBB earned a negative spread on all new loans. Their capital and ability to earn profits to meet essential obligations would continue to be at risk until lending practices are improved.
  3. NBL and RBB faced critical human resource issues- overstaffing, lack of skills, demoralized staff, ineffective utilization of human resources, and counter-productive work culture.
  4. Their low cost sources of funding i.e. current and savings accounts were found eroded and valuable customers were defecting to JV banks. Their cost structure was very high and it was nearly 4% of their assets. The reason for this higher administrative cost was overstaffing of 40 to 50 percent in the branches. Critical branch-level information was not available and other data unreliable and untimely.

The CBPASS II report recommended following new systems for full implementation by the Board and Top Management of NBL and RBB:

1. Prompt approval of changes.
2. Timely commitment of required financial and human resources.
3. Active support of new systems.
4. Active monitoring of implementation.
5. Adherence to new systems and practices.
6. Removal of key obstacles.
7. Recognition of improved results.

They also recommended for 3 years or more of technical assistance required to fully address operational weaknesses of NBL and RBB to make them healthy and effective banking institutions. They also cautioned the concerned authorities to continue the institutional process in the near future to avoid another government-sponsored financial restructuring program.

Both the CBPASS I and CBPASS II reports were implemented half-heartedly by concerned authorities. Both Banks were re-capitalized but their management and organizational structures could not be improved. HMG/N continued borrowing from NBL and RBB. They started to be run as any government enterprises. As a result, their financial health started to deteriorate and the HMG/N, NRB and the Top Management of NBL and RBB became just silent spectators and waiting for more serious financial, managerial and organizational problems in the future.

At mid-July 1998, the number of commercial banks reached 15. There were 2 development banks and 5 regional rural development banks. There were 29 co-operatives and 30 NGOs licensed by NRB for limited banking transactions. The capital market increased due to listing the shares of commercial banks and finance companies. The insurance activities also increased because of the entry of new insurance companies in the private sector.

### *Phase III (1999-March 2004)*

Financial sector reforms introduced in the last one and a half decades made significant improvements in certain sectors such as liberalization of interest rates, creation of a basic regulatory and supervisory frameworks, development of a longer-term government securities market, secondary market of government securities, establishment of several types of banking and financial institutions, functioning of stock exchange, competitive environment in the insurance services due to establishment of more insurance companies etc. But serious problems remained with two largest commercial banks (RBB and NBL) and two largest development banks (ADB/N and NIDC). The World Bank, the IMF and the Asian Development Bank (ADB) found some weaknesses in NRB's regulatory and supervisory capacity to effectively and efficiently regulate and supervise banking and other financial institutions. There were Government mandates seriously distorting operating incentives of the banking sector. Commercial banks requirement to lend in the priority and deprived sectors, problems in opening of new branches to private banks, and restrictions on entry of foreign banks in the financial market.

Taking into account these serious problems in the financial sector, HMG/N adopted the Financial Sector Strategy Statement in December 2000. It has clearly mentioned about the needs for the strengthening and autonomy of NRB so that it can regulate and supervise commercial banks and financial institutions. It has pointed out the needs for the enactment of new NRB Act to increase the independence and authority of NRB to supervise of financial institutions and take over the management of troubled banks and severely punish those financial

institutions, which are found engaged in serious irregularities. It has also pointed out the need of having the Deposit Taking Institution Act, which is an umbrella act of all deposit taking institutions. Some of the main elements of financial sector reform strategy published by HMG/N in December 2000 are as follows:

1. Implementing restructuring plans for the two large commercial banks-the RBB and NBL
2. Identifying restructuring strategies for the two development banks, ADB/N and NIDC.
3. Strengthening banking sector regulation and accounting and auditing standards.
4. Strengthening the NRB's supervisory capacities and its ability to enforce compliance with prudential regulations.
5. Improving the regulation and supervision on non-bank deposit taking institutions.
6. Modernizing the legislative framework with a view to reducing legislative overlap and the segmentation and fragmentation.
7. Strengthening corporate governance and the framework for loan recovery.
8. Phasing out the role of NRB and commercial banks in providing directed credit.

As per the commitment of HMG/N to reform RBB and NBL, the Nepal Banking Reform Project was started by HMG/N and NRB with funding assistance from the World Bank (IDA) and DFID (UK). The KPMG Barents Group, the international expert team associated with the Banking Reform Project, started the reform project since 15 November 1999. They completed their study in FY 1999-00. They broadly recognized that Nepal's financial sector still faced following systemic problems:

1. Poor bank governance
  - Political interference and
  - Insider lending
2. Lack of rational banking strategies as well as modern skills and international banking experience to support them
3. Lack of independent, capable supervision
4. Weak financial and management information
5. Weak legal and accounting practices
6. Difficult and deep-seated issues of RBB and NBL to be addressed

The KPMG Barents review of the RBB and NBL found that both banks were deeply impaired in virtually all areas of their operations.

1. Overall bank governance and management weak by modern standards
2. Deep flaws in lending process, loan files and loan portfolio
3. Primitive financial accounting with large pockets of "double counting", unsubstantiated assets, and major items that should be written off by international standards
4. No business strategies, weak planning and budgeting processes, lack in foundation, follow-up, rewards and penalties

5. Low morale of employees, low pay scales, low skills and counter-productive union-oriented activities
6. Primitive management information, record keeping and control systems

The governance and management of RBB and NBL took politically driven decisions. They had negative net worth and insufficient capital adequacy. Their human resource management was found extremely weak in all areas. Their situation was clearly worse than in 1992 when the CBPASS report revealed their financial, managerial and organizational problems and weaknesses.

The KPMG Barents Group recommended following actions to be taken for RBB and NBL:

1. Support Government efforts to create an independent, commercially-run banking system and declare banking reform policies fostering sound banking system
2. Upgrade Board, senior management and staff skills, capabilities and processes
3. Design and invest in comprehensive bank restructuring programs
4. Support and assist in implementing long-range plans to correct environmental weaknesses
5. Support central bank strengthening and independence and provide full enforcement powers
6. De-politicize and commercialize the banking system

The KPMG report concluded that loan assets of RBB and NBL were highly overstated and extremely risky. As a result, both of them were technically insolvent. As of mid-1998, they had losses of around US\$450 million, which was equivalent to around 46% of the annual budget of HMG/N or 8.6 percent of GDP. The assessment confirmed that the management of two banks was basically dysfunctional. It recommended the reduction of the role of HMG/N in the financial sector as a direct owner of banking and financial institutions beginning with RBB and NBL.

As per the recommendation of the KPMG report, NRB removed the NBL Board on March 8, 2002, on account of failure to manage the bank properly and replaced it with an NRB-appointed Board. In mid-July, the management of NBL was handed over to ICC Bank Ireland. For RBB, an international banking expert has been selected after Deloitte Touche Tohmatsu broke the contract. There are several international and domestic banking and financial experts who have been working in RBB. These banking and financial experts have already completed HRD Plan, Loan Policy and Guidelines, Computerization Policy and Programs, Portfolio Review and Loan Recovery and Restructuring of RBB and NBL. Both of them have implemented VRS plan and reduced their staff considerably.

HMG/N has enacted the NRB Act, 2002, the Debt Recovery Act, 2002 and the Banking and Financial Institution Ordinance, 2004. The Public Debt Act and the Foreign Exchange Regulation Act were amended in 2002. The draft of the Secured Transaction Ordinance has been sent to HMG/N for its approval, which would address the weaknesses in the legal enforcement mechanism and judiciary capacity.

The Credit Information Bureau is going to be established as a public limited company. The Debt Tribunals have already started its operation. The Asset Management Company is going to be established. The ADB has completed the studies of ADB/N and NIDC and has recommended for the restructuring of ADB/N and privatization of NIDC. NRB has issued prudential regulations to all banking and financial institutions including micro-finance development banks. The supervision manuals both for on-site and off-site have been prepared and implemented. The NRB has started the re-engineering process. The first phase of VRS is complete and the second phase of VRS has been announced. There is a special drive for the improvement of professionalism in the bank. The bank is going to formulate its long-term strategic plan in the near future. It will turn the central bank into a modern central bank.

There has been new development in the financial markets as well. New money market instruments are being introduced. The activities of the inter-bank call money market are increasing. The secondary market for government securities and company shares is being expanded. The repurchase agreements (Repos) have helped to expand secondary market of government securities. The holders of government securities can turn their securities to liquid assets. Commercial banks have introduced credit cards and debit cards. Some of them have even managed to provide ATM and electronic banking services. The clearing-house is going to be automated in the future and the modern payment, clearing and settlement system, which is one of the most important elements of the modern financial system.

Even the insurance services sector has developed with the establishment of joint-venture insurance companies. There are altogether 17 life and non-life insurance companies in the country. They have been competing and trying to attract their customers with new and innovative insurance products and services. The number of listed companies in the Nepal Stock Exchange reached 111 and the market capitalization, as of mid-February 2004 stood at Rs 39.11 billion. The trading of shares has increased tremendously. Several companies have issued preference shares and debentures. It clearly shows that new financial instruments are being introduced. But the NEPSE index decreased to 202.65 from 236.01 two year's earlier.

As a result of these financial sector reforms and new financial sector developments, as of mid-March 2004, the number of commercial banks reached to 17. There were 56 finance companies, 14 development banks, 11 micro-finance development banks, 34 savings and credit co-operative societies and 44 financial intermediary NGOs. The number of insurance companies increased to 17. Development banks and especially rural micro-finance development banks (RMFDBs) have tried to fill up the gaps created by the closure of commercial bank and ADB/N branches due to law and security problems (Maoists' insurgency). All districts of the terai (low land) region and few hill districts have been already covered by these newly established RMFDBs.

The deposits/GDP ratio of commercial banks rose to 44.9 percent at mid-July 2003, which was only 34.1 at mid-July 1998. Likewise, the credit/GDP ratio

increased to 27.4 from 22.8 during the same period. But the total liquid fund/total deposit ratio declined to 20.2 from 33.6. The capital adequacy ratio improved to 5.8 from 4.8 during the same period. The deposits of the banking sector rose to Rs 189.39 billion from Rs 90.84 billion. The total gross insurance premium increased to Rs 2.93 billion in FY 2002-03 from 0.57 billion in FY 1992-93

#### FUTURE REFORM ACTIVITIES IN THE FINANCIAL SECTOR

1. Reforming the financial sector laws and regulations.
2. Strengthening of NRB's regulatory and supervisory functions.
3. Restructuring and privatization of RBB and NBL
4. Enhancing competition in the banking sector.
5. Implementing international accounting standards in NRB.
6. Establishment of the Banker's Training Institute.
7. Restructuring of the Credit Information Bureau
8. Strengthening of the regional rural development banks and their privatization.
9. Restructuring of ADB/N and NIDC.
10. Revamping research and financial monitoring system of NRB.
11. Broadening and deepening of financial system in Nepal  
(Rawal, 2004)

#### PROGRESS ON RESTRUCTURING OF RBB AND NBL

The share of RBB and NBL in the assets and liabilities of the banking sector is around 50 percent. Although international financial experts have been managing these banks, the performance especially for reducing NPA is not satisfactory. The management teams were supposed to bring NPA level to 5% level. The NPA/total credit ratios of RBB increased from 20.17% in FY 1997-98 to 60.15% in FY 2002-03. It increased by 5 percentage points in FY 2002-03 than the previous year. Likewise, the NPA/total credit ratio of NBL also increased from 27.46 percent to 60.47 percent in FY 2002-03, which shows the rising trend (Rawal, 2004). Both of them had negative net-worth since FY 1998-99 and the negative net-worth figures continuously increased in the last five years. Although financial performance of both the management teams is totally unsatisfactory, they have improved in other areas. People are questioning the returns of such a huge expense. Is it going to be a futile exercise? Suppose they brought down the NPA level to a satisfactory level. But what will happen after the management teams leave the banks?

#### FUTURE STRATEGY AND ACTIONS

The reform of the financial sector is a gigantic task for all stakeholders. Although we have crossed few miles but we have to proceed further ahead. We have to consolidate the achievements and look upon new path. The Tenth Plan has

formulated plan, program, strategies and activities for the financial sector. The Financial Sector Reform Program (FRSP) has outlined its agenda and goals. The success of the FRSP in achieving its agenda and goals will have a far-reaching impact in the whole economy and especially for the macro-economic stability. It will greatly help to attain the growth targets and the objective of poverty reduction of the Tenth Plan. The financial sector is changing rapidly. New financial products and instruments are getting introduced. Nepal has joined the WTO. It has to open its financial sector to the foreigners. With the ailing commercial banking and development banking sector and the small fund available with HMG/N for the re-capitalization and modernization of these banks, could the Nepalese financial sector compete with internationally competent financial institutions under the General Agreement in Trade in Services (GATS)? The country has to open its banking and insurance services. Financial institutions are mushrooming in the last decade. Now it is the proper time for their mergers. Even now, most of the financial institutions are being run by non-professional people. For this, NRB has to improve its regulations and implement them. The capital base of financial institutions is still very low. There is no clear-cut policy for the establishment of development banks.

The financial market is still underdeveloped. The laws related to the stock exchange needs amendment. Likewise, the laws governing the insurance services also needs amendment. We have to devise new pension funds schemes because the existing EPF cannot be sustained in future. There are thousand of savings and credit co-operative societies, who have been mobilizing deposits from their members. They have mobilized almost Rs 20 billion. But there is no government institution/body to properly regulate their activities. Till now 92 such co-operatives have run away with the public deposits of around Rs 150 million. The Registrar of Co-operatives is found helpless and the legal system is inadequate to punish such people. All over the world whether they are known as deposit taking institution but the present Banking and Financial Institution Ordinance does not cover such grass-root institutions. The number of micro-finance NGOs has reached 44. What will happen when their number crosses 100 or 200? Has the NRB capacity to supervise so many micro-finance or micro-credit institutions? Why can't we draft a special law for all types of micro-finance institutions including micro-finance development banks? Most of the RRDBs are making huge losses. They eroded their equity capital. They are not being run properly.

Several branches of commercial banks have been closed due to security problems. Most of the remaining branches in the rural areas will be closed down by the private sector buyers of RBB and NBL in the future. How are we going to provide banking services in such areas? The priority sector credit is getting phased out and later the deprived sector credit will also be phased out. What alternative mechanism do we have? The activities of the stock exchange are very limited to the Kathmandu valley. How and when is it going to expand its activities? Although there are 17 insurance service providers, their insurance service is very much limited because of their lower capital base. The National Insurance Corporation is

another government-owned financial institution, which is ailing due to political interference and managerial weaknesses. Excluding co-operatives, there are three different regulators /supervisors for financial institutions. There is no co-ordination among these regulatory and supervisory institutions. The problem of one sub-sector is easily transmitted to other sub-sectors. When are we going to establish a single roof for all types of financial institutions?

We do not have a good training institute for the training of staffs about the new management skills. We still lack the Cyber Act for the electronic transactions. Many countries have enacted the separate Electronic Commerce or E-Commerce Act. In the same way, there are countries with the separate Cheque Act or the Payments Act. We still do not have the Bankruptcy Act and the Mergers and Acquisitions Act. The Negotiable Instruments Act needs amendment. These laws and related by-laws are very necessary for the smooth functioning of our financial industry.

Although new NRB Act has given more autonomy to NRB, there are different clauses, which need to be amended. It is also the same in case of newly implemented Banking and Financial Institution Ordinance. We have to improve the MIS of financial institutions. We have to strive hard for the financial reform to bear fruits for the benefit of the whole economy.

#### CONCLUSION

Financial sector reform plays a crucial role in the economic growth of the country. It is regarded as the engine of growth. It works as the lubricator for the economic engine. As the apex financial institution of the country, NRB has a big role to play. The Insurance Board and Securities Board also have to play their roles to expand security services. The Nepalese commercial banks and especially RBB and NBL are in distress. Financial experts have been invited to sort out existing problems and run them as vibrant and sound banking institutions. But their problem is still very acute. They need correct diagnosis and surgical operations. Because of the cumulative weaknesses of the past, they are in serious trouble. HMG/N, NRB and the World Bank are very serious to turn them into sound and efficient banking institution. The ADB/N and NIDC are other financial institutions, which need helps from HMG/N and NRB. There is no alternative financial institution in place of the ADB/N. The political interference and quick changes in the Board members and CEOs of the ADB/N and NIDC have caused serious problems.

HMG/N has strongly committed for the reform of the financial sector in general and RBB, NBL, ADB/N and NIDC in particular. Much depends on the proper implementation of the Financial Sector Reform Program. The financial sector may invite financial crisis which may easily transfer to other sectors of the economy. As such, we have to be extra cautious for the financial liberalization and reforms of the financial sector.

## REFERENCES

- Basyal, T.R. 2002. Financial Sector Reform: Need and Strategy, "*Arunodaya*" pp. 291-303.
- Basyal, T.R. 2001. "Reforming Nepal's Financial System: Rationale and Measures" *Nepal Rastra Bank Annual Bulletin* English Section, pp. 7-13.,
- Bekaert, G., C. Harvey and C. Lundblad. 2001. "Does Financial Liberalization Spur Growth?" *NBER Working Paper No. 8245* (Cambridge Massachusetts, National Bureau of Economic Research.
- Booz-Allen and Hamilton, 1990 & 1992. "*Commercial Banking Problem Analysis and Strategy Study (CBPASS I) and (CBPASS II)*", Kathmandu, 1990 and 1992.
- Calvo, G, and E. Mendoza. 2000. "Rational Contagion and the Globalization of Securities Markets", *Journal of International economics*, Vol. 51 (June) pp. 79-113.
- Dam, Kenneth W. 2002. Transforming China's Financial Sector into an Efficient Engine of Growth, Beijing, 2002.
- Gurley, John & Edward Shaw. 1955. "Financial Aspects of Development and Growth", *American Economic Review*, (September) 515-38.
- IMF. 2001. "*Nepal: Recent Economic Developments*", Washington D.C., IMF Country Report No. 01/173, October IMF. 2001.
- Kaminsky, G.L., & Sergio L. Schmukler, 2003. "Short-run Pain, Long-Run Gain: The Effects of Financial Liberalization". *IMF Working Paper*, wp/03/34.
- KPMG Barents Group, 2000. *Nepal Banking Reform Project*, Kathmandu.
- Krugman, P. 1998. "Saving Asia: It's Time to Get Radical", *Fortune*, Sept. 7, pp. 74-80.
- Mckinnon, R.I. 1973. Money and Capital in Economic Development, Brookings Institution, Washington D.C., 1973.
- Mishkin, F. 2001. "Financial Policies and the Prevention of Financial Crises in Emerging Market Countries", *NBEF Working Paper* No. 8087 (Cambridge, Massachusetts: National Bureau of Economic Research.
- Nepal Rastra Bank. 1996. *40 Years of the Nepal Rastra Bank (1956 - 1996)*, Kathmandu, 1996.
- Nepal Rastra Bank. 2003. *Banking and Financial Statistics*, No. 41, Mid-July 2003.
- Rawal, T. 2004. "Policy Paper on Financial Sector Reform". Nepal Rastra Bank, Kathmandu, 2004.
- Shaw, E.S. 1973. "Financial Deepening in Economic Development", Oxford University Press, New York, 1973.
- Sook-Pyo Hong. 2000. "Financial Reform and Supervision in Korea". *Capacity Building Seminar on Banking Sector Reform*, Kuala Lumpur, August 2000.
- Stiglitz, Joseph. 1993. *The Role of the State in Financial Matters. The Proceedings of the World Bank Annual Conference on Development Economics* .pp 19-52.

