

# **“Key Challenges of the Financial System in Nepal”**

**Keynote Speech Delivered by**

**Dr. Chiranjibi Nepal, Governor, Nepal Rastra Bank**

**at the Seminar organized by Nepal Economic Association on 13 April 2015**

**Respected Chairman,**

**Immediate Past President Professor Dr. Madan KDahal,**

**President of Nepal Bankers' Association,**

**Distinguished Members and Guests,**

**Ladies and Gentlemen,**

1. It gives me an immense pleasure to address this august gathering after recently assuming the post of the Governor of Nepal Rastra Bank. Given my background from academia and concurrently assuming the post of the vice president of Nepal Economic Association (or NEA for short), I feel privileged to be here as the keynote speaker. Let me extend my sincere gratitude to President of NEA Professor Dr. Bishwambher Pyakuryal and the NEA community for organizing this event. I would also like to utilize this opportunity to thank the Government of Nepal for appointing me as the Governor of Nepal Rastra Bank, an institution that has the tradition of integrity, objectivity and professionalism.
2. The structure of this keynote presentation is provided in four parts: First is introduction including macroeconomic situation; background to domestic financial system; evolution of BFI Sector in Nepal; Second are the four key challenges namely financial sector stability; productive sector lending; financial sector access and shadow banking; Third is the way forward which includes discussion on activities for enhancing coordination in the domestic financial sector and financial sector development strategy; and Fourth is concluding remarks.
3. Before I proceed to deliver my keynote presentation, I would like to share the macroeconomic situation of the country. The economic growth over the last five years remained 4.5 percent on average. In the current year, the economy is expected to grow at 5 percent compared to the growth of 5.5 percent last year. The economy experienced an inflation of 9.3 percent on average in the last five years and the current year signals a positive trend with inflation hovering over the range of 7 percent in the first seven months. We believe that inflation will be contained and domestic stability will be

maintained however the structural bottlenecks may also pose challenges to maintaining price stability. However, external sector management remains a challenging task despite the positive growth in remittance inflow and balance of payment surplus. Negative growth of exports and low growth of remittance have signaled caution to all the stakeholders on external sector management with FX Reserves in 2014 at \$6.94 billion.

**Ladies and Gentlemen,**

4. Now I would state that a well-developed financial system is important and contributes to economic growth through an efficient allocation of resources and saving mobilization. Furthermore a stable and sound financial system helps ensure good corporate governance and management of the risk inherent in financial intermediation. The role of financial intermediaries remains at the center not only in the developed economies but also in a developing economy like ours. I would note that this is essential to help pool resources and promote entrepreneurial practices. No country in the world has achieved a higher growth without having a developed and stable financial system and we have similarly been following that trajectory for the last few decades. The financial sector is categorized broadly into two categories of actors: those that provide direct financing, such as capital market (with bond and equity financing) and insurance market and those that provide indirect financing, such as banks and financial institutions (BFIs) through financial intermediation. However for the direct financing, instruments such as equity financing and bond issuance is presently not common in comparison to financing from BFIs; this is contributed as the formal financial system in Nepal started less than a century ago with the establishment of Nepal Bank Limited in 1937; with Nepal Stock Exchange (NEPSE) in 1994. Taking this into account and given that the responsibility of Nepal Rastra Bank, I will confine my discussion today to BFI development and challenges in Nepal and expand this to the overall financial system.
5. Despite the importance of the BFI sector in Nepal the sector has only picked up pace after the liberal economic policy initiated in mid-eighties and which was vigorously pursued after the restoration of democracy in 1990 – this paved the way for economic and financial sector liberalization reflected in BFI expansion. Thus, the economy witnessed the large presence of bank entrants in the previous two decades with increased participation from the private sector. This is illustrated by the presence of over 241 NRB

regulated institutions presently in the market compared to five in 1984, this represents an increase of 48 times in a time span of about three decades.

6. I would also provide standard statistics on the present level of domestic banking development such as ratio with GDP of financial sector assets, total deposits, private sector credit and broad money. Consequently, financial sector assets to GDP, total deposit to GDP ratio, private credit to GDP ratio broad money and have reached 99 percent, 73 percent, 60 percent and 81 percent respectively in 2014 from 22 percent, 18 percent, 8 percent and 27 percent in 1984. This is an encouraging development on the financial front in a period of only three decades and has contributed to access to banks as reflected in rising percentage of population with access to banking services: from 20.7 to 27.8 to 39.9 as reflected in the three NLSS conducted by Government of Nepal.

However with the sharp quantitative increase and their provision of credit, there had also been a reduction in the quality of credit, this puts BFI at risk of instability. This aspect was highlighted by CBPASS and KPMG study reports on RBB and NBL, and had initiated Financial Sector Reform Program in 2000 (2057) and Financial Sector Reform in 2002. Non-performing assets (NPA) for those two banks, a reflection on loans classified as bad, has been reduced from as high as 60% at start of the reform, to it being presently less than 5%. Presently NPA for the overall commercial banks is 3.76%. Interest rate spreads has also remained quite high – in 2014 it was 5.21%!

This situation, resulting from the massive growth in BFIs have led to risk in the domestic Financial System; there are four key challenges:

- Challenge # 1. Financial Sector Stability
- Challenge # 2. Productive sector lending
- Challenge # 3. Financial Sector Access
- Challenge # 4. Shadow Banking

These challenges are each elaborated below, along with the activities of NRB to reduce this risk.

**Ladies and Gentlemen,**

7. The *first* challenge is maintaining domestic financial sector stability. Nepal Rastra Bank as the regulatory authority of BFIs is committed to maintaining stability. Stability is

essential since it reflects BFI's ability to fulfill its primary functions (namely financial intermediation) and helps to enhance trust and credibility in the overall Financial System. The current level of regulatory framework is inadequate compared to international standards and is not commensurate with massive rise in number of domestic BFIs.

8. Nepal Rastra Bank maintains stability of the BFI sector mainly through supervision of NRB licensed institutions. In this regard, NRB is taking the following actions to address the challenge of the BFI Sector.

- Financial Sector Reform 2002 and FSR Programs, 2057 which was supported by the World Bank
- Diversification of loan portfolio to reduce exposure of non-productive sector.
- Single obligor limit (funded and non-funded reduced from 50% to 25%).
- Deposit Insurance upto Rs. 5 lacs
- Control on margin and real estate lending below 25%
- Initiated problem bank resolution.
- Gradual movement to risk based supervision from compliance based supervision.
- Initiations are taken to enhance governance such as separating bankers and businessman
- Initiations are being taken for enhancement of data collection and analysis through sophisticated strategic management information system
- Efforts are being made to strengthen supervisory capacity for effective supervision
- Efforts are being made for consolidation of banking system through mergers and acquisitions
- Efforts are being made to strengthen risk management in the banks(IT guidelines, risk management guidelines, stress testing guidelines, ICAP guidelines, Liquidity monitoring framework have been issued and banks are encouraged to have independent risk management function)
- Initiations have been taken for the adoption of advanced approach of BASEL II with movement to BASEL III (such as initiation of buffer capital).
- Regular publication of Financial Stability Report
- Directives issued for base rate and interest rate spread

9. While mentioning financial sector stability, it is important to highlight that effective internal control, minimization of conflict of interest and compliance of prudential norms are the hallmark of good governance. This is possible only when the board members of BFIs are well versed with the business practices and possess highest level of professionalism. However, this challenge is being faced in managing the banking sector of Nepal. In most BFIs, assessment of credit risk is inadequate, operational risk management approach is incomplete and there is absence of contingency plans. There is also dearth of payment and settlement activity such as NCHL. Also educating customers with respect to banking practices and overcoming the risks posed by technological sophistications are challenges to be addressed at the earliest. I would mention that NRB is being proactive and has taken over management of Nepal Bangladesh Bank and other such troubled financial institutions; we are committed and will do so again in the future in pursuance of stability.

**Ladies and Gentlemen,**

10. The *second* challenge is to direct credit for contributing economic growth and productive employment generation. Nepal Rastra Bank understands that the relationship between the real sector and the monetary sector is through the macro-financial link – in other words credit from the BFIs to the real sector enhances their growth and leads to employment generation. It is important to emphasize that growth has to be productive since data on credit disbursement suggest that unfettered lending by BFIs are providing disproportionate amount of credit to non-productive (consumption loans) areas. In this regard, Nepal Rastra Bank has strengthened its efforts to address issues pertaining to productive use of credit and have taken the following steps.

*Productive Sector Credit:* Banks and financial institutions are now required to extend 20 percent of their credit to productive sectors (there are agriculture, energy, tourism and small & cottage industries) with this to comprise at least 12 percent in agriculture and energy sectors by mid-July 2015. Development banks and finance companies are also required to extend 15 percent and 10 percent of their total credit respectively to the productive sector by mid-July 2016. Also and to ease availability of credit to productive sectors, banks and financial institutions are not allowed to extend more than 25 percent of their total credit to real estate sector including housing.

*Deprived Sector Lending:* For the purpose of NRB directive has defined "deprived" as meaning "low income and especially socially backward women, tribal people, Dalit, blind, hearing impaired and physically incapacitated persons, marginalized and small farmers, craft-men, labour and landless squatters family. All micro-credits to be extended for the operation of self-employment oriented micro-enterprises for the upliftment of economic and social status of deprived sector up to the limit specified by this Bank is termed as "deprived sector lending". In this regard commercial banks, development banks and finance companies are required to provide 4.5 percent, 4 percent and 3.5 percent of total credit to deprived sector respectively. In 2014 deprived sector credit of commercial banks was 5.2 percent. Further NRB takes the project loans provided by BFIs up to Rs. 0.5 million to enterprise run by women entrepreneurs as deprived sector loan.

- *General and Special refinance facility:* NRB also extends special refinance facility to BFIs at concessional interest rate against good loan extended to productive sector where loan extended by banks and financial institutions to export industries, cottage and small industries, sick industries, enterprises run by women and small enterprises run by people of specified communities can be refinance at very low interest rate (1 percent). I would mention that the general refinance facility at 4 % interest rate is given to agriculture, hydropower, livestock, fisheries and other stipulated productive sectors. Refinance facility is provided to BFIs for small & medium enterprises' loan up to Rs. 10 million.
- *Microcredit facility:* NRB also provides credit to rural people through local cooperatives on concessional interest rate from Rural Self Reliance Fund (created by the Government of Nepal and the Bank) along with interest subsidy to good borrowers.
- Agriculture Loan at 6% to Youth Farmers

### **Ladies and Gentlemen,**

11. The *third* challenge is for promoting greater access of BFI. It is clear that finance should support growth however there are a number of associated challenges including poor financial literacy, volatility in liquidity and interest rate, urban centric BFIs which is expanded to include poorly developed money and capital markets, have not been supportive in tapping the growth potentials of the economy. There is thus limited

financial access and inclusion, lack of good governance, limited supervisory capacity and lack of market monitoring.

In this regard, Nepal Rastra Bank has taken the following steps.

- Branch Opening Policy (BFIs can open one branch in the Kathmandu area after opening three branches out of valley)
- Encouraging the licensing of Micro-Finance Institutions in underserved areas
- Drafting the Financial Literacy Policy
- Strengthening consumer financial protection such as NRB has issued Directives to make transparency in the provisions like service charge etc.
- Enhancing financial literacy programs through audio-visual and print media.
- Organizing Financial Literacy programs such as NRB with Students throughout the country and Global Money.
- Banks and financial institutions are allowed to extend project loan up to Rs. 10 million in agriculture farming such as coffee, tea, orange, livestock and dairy products on the basis of viability of the projects.
- Steps are taken to extend some amount of collateral free loan to small farmers and business enterprises. Other regulators have also issued directives relating to capital market and insurance which are inclusive in nature. They include the following: Access to equity participation of local community in hydropower projects; deposit insurance for small depositors of up to Rs. 0.2 million; mutual funds catering financial instruments to the small savers; and mandatory crop and livestock insurance service for the farmers.

12. The *fourth* challenge deals with Shadow Banking. This term deals with institution, which are not authorized, licensed and thus not regulated. Some examples of these are cooperatives, where there are presently about 13,500 saving and credit cooperation institution, which are categorized as an informal financing institution having obtained license from Government of Nepal, and activities such as Dhukuti and Hundi, the prior is categorized as illegal financial activity with the later characterized as illegal money transfer activity. At this stage I would point out that the prior, informal activities are laudable and have supported the attainment of access of the general public, however by virtue of them not being regulated (and thus supervised) they have an impact on stability

of the financial system. NRB has realized this challenge and discussing alternative institution's to be a regulatory/supervisory body.

**Ladies and Gentlemen,**

13. NRB is cognizant of the challenges and has taken measures to mitigate these risks. However the BFI sector is developing (contributed by technological developments) with there being greater interconnectedness of other sector of the Financial System (there is Gradual implementation of Basel III, Financial Stability Unit (within NRB) and regular publication of Financial Stability Report). This implies that there is contagion of a shock in one area of the financial system to the financial system as a whole. This thus necessitates present greater coordination among regulatory head in the financial system as well as developing a roadmap of how is it visualized for steering the pathway of domestic financial sector development. In this regard I would mention that there are activities for enhancing Coordination in the Domestic Financial Sector – first, a Financial Stability Oversight Committee has been established at Nepal Rastra Bank under Chairmanship of senior Deputy Governor of NRB, with other Deputy Governor and relevant department heads as member with the heads of regulatory bodies (such as Insurance Board, Security Exchange Board of Nepal, Cooperative Department etc.) as invitee member; second a “High-level Financial Sector Coordination Committee” has been established at GON's Ministry of Finance; the committee is chaired by Honorable Finance Minister of GON's MOF with members being heads of regulatory bodies including myself.

There are also activities for producing a Financial Sector Development Strategy (FSDS) – a FSDS is necessary to overcome these challenges since the domestic financial system is more interlinked – this thus necessitates having a holistic perspective. For producing the draft a FSDS High-level Steering Committee has been established coordinated by Honorable Finance Minister; there is a Technical Committee under it coordinated by Deputy Governor of NRB. The aim of FSDS is to provide a guiding document for steering the Development of the domestic Financial Sector. In this regard I would inform that the final draft of the FSDS report has been produced by the Technical Committee and submitted to Ministry of Finance for further consideration.



14. **Mr. Chairman**, once again I take this opportunity to extend my sincere thanks to you, distinguished guests and other invitees for all your patience and support. As mentioned, NRB is aware of the vital role that the financial system plays in the economy. However the nature of the financial system is ever changing, and thus to address this, the relevant policies have to be similarly dynamic. In this regard, NRB is proactively addressing the present challenges relating to stability, productive sector lending, and access in the BFI sector, which I had been earlier mentioned. I would also like to stress on the fact that surpassing the challenges of financial system requires a close coordination among all the stakeholders. In this regard, we are giving greater emphasis for building a trustworthy relationship with government, private sector, regulated institutions and other financial system regulators, for promoting financial stability. It is noted that a future challenge to the financial system deals with the integrating with the external economy; this complicates the above four mentioned key challenges and necessitate greater coordination and cooperation with relevant international regulatory/supervisory authorities; for one example of such activity is hundi, the international money transfer by nationals through illegal means, where by virtue of it being unregulated, affects the stability of the whole financial system. Despite this upcoming challenge, I am confident that domestic Nepalese financial system will move ahead by keeping the public interest at the center.

Thank you.