A Policy Research Report on

Optimal Number Determination or Regulatory Reform

Nepal Rastra Bank

Research Department

Financial Institutions Division

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Foreword

The Nepalese financial system has expanded rapidly over the years. A number of new players have come to the market in the last two decades and half. This has reduced the role of the government owned banks, boosted confidence of depositors, and offered a number of products and services in the financial market. In the liberalized financial system, while the increased competition has eased the life of the consumers and significantly contributed to the financial development, there have been emerging challenges on the financial stability front. Given the number of increasing entry aspirants, there are opinions to restrict the entry of new bank and financial institutions.

This study prepared by the Financial Institutions Division of the Research Department has tried to answer the question whether Nepal should restrict the entry or move ahead on the path of regulatory reform. The study has rightly concluded that it is difficult to limit the market in a liberalized financial environment, and is also against the spirit of the open market economy. Open entry and exit rules in the financial system facilitate the market mechanism, spur competition, contribute to the development of financial sector, and ultimately work as a conduit of economic expansion.

The report team has put tremendous efforts to provide a logical framework to the question of optimal number determination or regulatory reform. The intra country comparison, cross country comparison, and theoretical underpinnings all have built a basis for encouraging entry in the market along with regulatory reform. The study has pointed out that free entry and exit can only be workable when regulatory reform is pursued simultaneously.

I thank the Research Department, and particularly the report team for bringing out such a wonderful paper. I hope this policy research report will facilitate the path of our regulatory reform in the days to come. This will also be useful for those interested in the area of the Nepalese financial system and bank regulation.

KBManandhar

Krishna Bahadur Manandhar
Acting Governor
Nepal Rastra Bank

Acknowledgement

This is a matter of pleasure for me to acknowledge the efforts put forth by the Financial Institutions Division (FID) of this Department in developing the policy research report on optimal number determination or regulatory reform. In context of the emerging challenges on the financial front, the FID has made rigorous efforts in developing this research report, which suggests that Nepal should move ahead on the path of regulatory reform. It is true that open entry and exit policies are the pillars of the liberal financial system. However, equally important is to enhance the resilience of the system. And for this, necessary financial infrastructures are needed to put in place. I believe the report has rightly pointed out this. The report has mainly identified that instead of restricting entry in the financial system, regulatory reform should be continued by addressing the issues relating to institution building, internal governance of the central bank, and corporate governance and disclosure practices of financial institutions.

I appreciate the untiring efforts of the report team for bringing out this report in a timely manner. Deputy Director Gunakar Bhatta deserves special thanks for his continuous endeavors, integrity and resourceful writing. Likewise, the hard work and sincerity of Assistant Director Hem Prasad Neupane in collecting a number of relevant information is praiseworthy.

At the end, I believe that this policy research report will be a valuable asset not only for the Nepal Rastra Bank, but will also be useful for all those interested in the Nepalese financial system.

Ram Prasad Adhikary
Executive Director
Research Department
Nepal Rastra Bank

Comments From Professor Gerard Caprio

Gunakar,

I at last read with great interest your report and must say that I found it to be excellent. Certainly you are correct in saying that neither the government, nor anyone else, has the tools to deduce what is the optimal number of banks. Even more so in a world of e-finance, this is virtually (no pun intended) impossible to do. Moreover, it would be shortsighted for officials to think that they can reduce entry in one area and increase it in another. Private banks will go where there are profits. The government can look to ways to subsidize financial services in remote areas, for example by building up high-speed internet connectivity, or otherwise facilitating it. More generally, it is easy to believe that remote areas in a rugged terrain area will mainly be served by internet and cell-phone based financial services. Are these expanding? Why not? Bricks and mortar-based banking may not ever work unless the population density justifies it.

There are a variety of arguments with which I am in agreement and won't repeat those here. Just a couple of points to mention:

1. Why the interest in raising capital requirements? Is it that the number of new entrants is worrisome? What are initial capital requirements? These might be too low if you are getting too many small banks. And what is the policy to foreign bank entrants? How many applications from them? How many denied, say over the last 5 years?
2. The report says the depositors run to weak banks as well as sound banks (p. 8). I haven't seen the former unless you mean to state banks. Clearly private banking has expanded in Nepal, and ensuring that the regulatory framework is suitable for safe expansion is important. This is the area, in addition to skills development, in which well-diversified foreign banks can make their greatest contribution.

Research shows that what matters for economic development and poverty alleviation is access to high quality of financial services for residents, not who provides them. The NRB is to be commended for its efforts to contribute to financial sector development, and this report is an important contribution to this effort.

Best,

Jerry

Professor Gerard Caprio is the former Director, Financial Sector Strategy and Policy Department of the World Bank. He is currently at the Williams College, US. The report team is much obliged to Professor Caprio for his kind comments and suggestions.

The Report Team

The report team consists of Gunakar Bhatta, Deputy Director and Hem Prasad Neupane, Assistant Director, both from the Financial Institutions Division, Research Department of Nepal Rastra Bank. While Gunakar authored the text, Hem contributed by soliciting necessary information.

The report team benefited from the relevant research materials provided by Honorable Acting Governor Krishna Bahadur Manandhar. The report team is grateful to Executive Director Ram Prasad Adhikary, and Directors Rameswori Pant and Nara Bahadur Thapa for their continuous guidance, suggestions, and comments. The report team would also like to acknowledge the thorough comments and suggestions by Executive Director Surendra Man Pradhan. More importantly, Gunakar on behalf of the report team extends sincere thanks to his Guru Professor Gerard Caprio of Williams College, US for his insightful comments and invaluable time.

The team is grateful to all the participants including the Acting Governor Krishna Bahadur Manandhar and Deputy Governor Bir Bikram Rayamajhi attending the interaction held on July 4, 2007 at the conference hall of the Bank. Executive Director Ram Prasad Adhikary and Director Rameswori Pant deserve special thanks for taking initiative to organize such an interaction program. Also Tap Prasad Koirala and Mani Ram Dangi from the Financial Institutions Division and Yogendra Thapa from the Information Technology Department deserve thanks for making the interaction a great success. The team would like to thank Computer Supervisor Amar Ratna Bjaracharya at the Research Department for his kind assistance in formatting this report.

The judgments in this policy research report do not necessarily reflect the views of the Nepal Rastra Bank. Once again, the report team is thankful to all those who have contributed to materialize this research report.

Abbreviations

ADB	Asian Development Bank
ADB/N	Agriculture Development Bank/Nepal
CBS	Central Bureau of Statistics of Nepal
CEO	Chief Executive Officer
CRA	Credit Rating Agency
CRS	Compulsory Retirement Scheme
EPF	Employees Provident Fund
EWS	Early Warning System
EXIM	Export-Import
FDIC	Federal Deposit Insurance Corporation
FSRP	Financial Sector Restructuring Project
FSTAP	Financial Sector Technical Assistance Project
GDP	Gross Domestic Product
IMF	International Monetary Fund
IPO	Initial Public Offerings
M2	Broad Money Supply
NBL	Nepal Bank Limited
NGO	Non Government Organizations
NIDC	Nepal Industrial Development Corporation
NPA	Non-performing Assets
NPLs	Non-performing Loans
NRB	Nepal Rastra Bank
RBB	Rastriya Banijya Bank
SAABA	Support System for Banking Analysis
SAARC	South Asian Association for Regional Cooperation
SCBNL	Standard Chartered Bank Nepal Limited
SEACEN	South East Asian Central Banks
SEER	System to Estimate Examination Ratings
SOCBs	State Owned Commercial Banks
VRS	Voluntary Retirement Scheme
WB	World Bank
WDR	World Development Report
WTO	World Trade Organization

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Overview and Summary

Nepalese financial system has witnessed a significant change over the last two decades. Not only the number of financial intermediaries increased, remarkable achievement has been attained on the financial deepening front as well. One of the salient features of the Nepalese financial development is the considerable participation of the private sector, which is necessary to enhance the efficiency and competition. Over the years, the banking industry has remained a profitable venture attracting a number of entry aspirants. Against the backdrop of the increased quantitative and qualitative expansion, there are questions over the sustainability and stability of the financial system that can result in particularly from the unwarranted influx of new entrants.

Viewing the challenges that can emanate from the increasing number of financial intermediaries, a number of reform initiatives under the financial sector reform program have been introduced over the years. Though the measures adopted under the financial reform program are aimed at addressing the issues of financial stability, infrastructure development, and capacity building, emerging challenge is to widen the financial outreach in the backward regions of the country.

This study has overviewed the banking sector development in Nepal considering the large role of the commercial banks in the financial intermediation. These banks account for almost 87% of the total assets of the financial intermediaries licensed by the Nepal Rastra Bank. An overview of the financial development has been made from the perspective of financial deepening, deposit-credit operation, concentration, ownership structure, and profitability. In the background of this development, intra country comparison is made to evaluate the level of financial access. And cross-country comparison is made to evaluate the depth, efficiency, stability and outreach of the Nepalese financial system in comparison to other neighboring economies.

The findings of the intra country analysis suggest that there are relatively under banked areas. Comparing the number of branch of commercial banks with population, the two least developed regions: Mid-Western and Far-Western do have very limited financial outreach. The analysis also reveals a positive relationship between low level of living and limited financial outreach. Development Regions undergoing a low living standard as measured by poverty incidence and educational index do also have very limited financial outreach. For example, Mid-Western Development Region that has the poverty incidence of 45 % and secondary school enrollment ratio of 16% has more than 87,000 population per branch of commercial bank and almost 68,000 population to total number of bank branches and financial intermediaries. Similarly, population per bank branch is almost 100,000 and population to total bank branch and financial intermediaries ratio is 78,000 in the Far-Western Development Region, which has the poverty incidence of 41% and secondary school enrollment ratio of 15%. However, the case is quite different for the Central Development Region where population per bank branch is about 39,000 and population to total bank branch and financial intermediaries ratio is 25,000. And this Region has relatively lower poverty incidence and higher secondary school enrollment ratio. Second to the Central Development Region, financial outreach is wider in Western Development Region.

The study also attempts to examine whether Kathmandu valley is overbanked, as it is discussed among those interested in the development of the Nepalese financial system. However, looking at the experience of other economies taken in the analysis, it is difficult to say Kathmandu Valley is overbanked. For example, population per bank branch is still higher in Kathmandu valley than the country level of Thailand and very similar to the country level of Sri Lanka. But, undoubtedly, financial outreach is wide in Kathmandu Valley compared to other areas of the country. The intra country comparison indicates that financial access particularly to the backward regions of the country is very much necessary even to bring out the people from the poverty trap. This is also supported by a recent World Bank study, which mentions that widening the financial access is very much necessary in Nepal.

In the second part of the analysis, cross-country comparison is made. For this, the level of financial development in neighboring countries: India, Pakistan, Sri Lanka, and Thailand, is taken as the indicative one. To compare with, indicators reflecting the depth, efficiency, stability, and access have been used. To test the level of financial deepening, Broad money/GDP and private sector credit /GDP ratios have been used. Efficiency is compared looking at the interest rate margin. Stability across countries is compared looking at the level of non-performing loans (NPLs). And the financial access is compared measuring the population per branch of commercial bank.

While the level of Nepal's financial development is relatively at par with other South Asian economies, it is behind Thailand and India. Both broad money to GDP ratio and private sector loans and advances to GDP ratio are lower for Nepal than India and Thailand. The competitiveness or efficiency indicator as measured by the interest rate margin also shows that Nepal's banking sector is less competitive than of India, and Thailand. A point to note from the policy perspective is that the high interest rate spread in Nepal compared to India may have also capital flow related implications given the open border. The NPL ratio, as a reflective of financial stability, indicates the seriousness of the problem of the Nepalese banking industry. This ratio is the highest among all the economies compared in the analysis. The high level of NPL in the Nepalese banking industry is not only riskier for the financial stability, but also is an indication of higher intermediation costs, charging more to the good borrowers to compensate the bad ones. And the negative capital adequacy of the Nepalese commercial banks also gives a low weight to the financial stability. Finally, Nepal significantly lags behind all the economies in the area of financial outreach. Population per bank branch is highest in Nepal among all. While population to bank branch ratio is 58,000 in Nepal, it is 16,000 in India, 20,752 in Pakistan, 13,973 in Sri Lanka, and 13,619 in Thailand. Even if we compare the population to bank branch and financial intermediaries ratio of Nepal i.e. 36,732 with the population to bank branch ratio of other economies, it does not make any substantial difference.

The analysis has shown that Nepal's banking sector has a large responsibility of widening the financial outreach by enhancing competition, reducing the level of NPLs, and further deepening the system. The analysis does not suggest that competition should be restricted particularly given the higher inertest rate spread of the Nepalese banks, and limited financial outreach in the country as a whole. And the relevance of the expanded banking sector is more for an economy like Nepal that has a low level of capital market development.

Further, theoretical underpinning also argues that restricting competition favors the incumbents, promotes regulatory capture, and signals policy inconsistency. Restricting competition does not support the public interest view of regulation rather it is consistent with the private interest view of regulation. The private interest view predicts that countries with powerful official supervisors, limits on bank activities, and restrictions on entry will tend to have higher levels of corruption with no corresponding improvement in bank performance or stability. However, it does not mean that there is limited role for the regulators. Rather their role has been expanded to increase the number of watchful eyes that are motivated to promote financial stability through private monitoring. Private monitoring broadly consists of (a) certified audit of bank accounts, (b) a majority of banks being rated by international Credit Rating Agencies, (c) the extent of an explicit deposit insurance scheme, and (d) the quality of bank accounting. In addition, enforcing disclosure requirements and making them widely available to public strengthens private monitoring.

Promoting a contestable financial sector–as characterized by lower entry barriers, fewer regulatory restrictions on bank activities, greater banking freedoms-is essential for improving depth, efficiency and access. Opening up is also accompanied by risks however, particularly a higher risk of financial crisis, and therefore needs to be synchronized with improvements in institutional improvements. Thus, the regulatory reform should be continued and be taken as a process, not as an event. Decisions about the optimum number of the financial intermediaries in a liberalized financial system is not decided by the central authority rather fixed by the market forces on their own. Also it is difficult to limit the market. Moreover, Nepalese banking industry has remained the profitable one, thus nurturing the competition in the financial sector. It is natural for entry aspirants to come and compete in the market that is in prosperity. Given this, the study has made some broader recommendations in the area of regulatory reform. These are in general: to encourage the private sector monitoring, enhance the disclosure requirements, and develop the financial infrastructures. Based on the broader set of recommendations, some immediate measures and some medium term measures are brought forward.

The immediate measures mainly include:

(a) Upgrading the education and experience requirements for promoters,

(b) Introducing some transparent measures regarding the financing sources of promoters. However, some measures have been introduced in the recent changes made in the licensing policy such as the requirement of tax clearance document for promoters, and borrowing fund not to be used to finance the promotership,

(c) Raising the minimum paid up capital to consolidate the banking system and to encourage the merger and acquisition. This has already been increased in the recent changes made in the licensing policy. However, for the further increase in the minimum paid up capital, a precaution should be taken so that professional promoters should not be discouraged from entering into the banking industry,

(d) Requiring banks to issue a special class of debt, subordinate debt compulsorily, which would be subordinate to all other claims, bar equity capital. In the case of bankruptcy, holders of this debt would lose their money first,

(e) Making a provision to link large loan limits with NPL ratio,

(f) Exploring to introduce some of the statistical early warning models. Models such as SAABA-expected loss model used by Banking Commission France, SEER risk rank-failure prediction model by the Federal Reserve System, Growth Monitoring System-growth tracking model by the FDIC, US have been used in those countries to assess future solvency of banks, predict probability of failure, and to identify potentially risky banks respectively,

(g) Enhancing disclosure practices also by involving associations of banks and financial institutions to facilitate consumers to choose the right kind of financial institutions,

(h) Exploring the possibility to allow Nepalese banks to open their branches in other countries,

(i) Enforcing actions against banks violating regulations and laws at a faster pace can promote the market discipline. There is a need of establishing and activating a mechanism to punish not only large equity holders and creditors but also the high paid CEOs or other managers when the bank solvency is threatened. Directors and managers should be held responsible for their bad personal performance. For this, necessary legal provisions can be introduced so as not to paralyze the enforcement actions because of undue interference,

(j) Introducing policies to widen the financial outreach in the under-banked areas of the country,

(k) Reorienting policies to encourage establishment of development banks in semi urban and rural areas. It is time to rethink whether these types of banks be allowed to establish in Kathmandu Valley, neighboring district Kavre, and other urban centers, where financial inclusion is relatively high. Similarly, it is also a matter to rethink the existing policy of allowing finance companies to open branches,

(l) Internal governance practice of NRB may need to be reframed to facilitate the improvement in regulatory functions,

(m) Extending the existing provision to bar the Governor, Deputy Governors, and Special Class Officers of NRB from joining banks and financial institutions as a director within one year from the date of retirement to the members of the NRB Board of Directors,

(n) Also any of the officer level staff who served the regulation and supervision wing of the bank during any period of time in the past ten years should be barred for certain period, say, one year after retirement from joining any NRB licensed bank/financial institution as a director or as an employee. Equally important is to have better pay to retain, and attract capable staff,

(o) Bringing out some stringent measures for IPOs and secondary market financing, and

(p) Introducing some public awareness programs at a wider level targeting the ordinary depositors. Such programs are introduced even in emerging market economies.

Likewise, the medium term measures consists of:

(a) Deposit insurance scheme to protect small depositors but with a very careful designing features,

(b) Establishment of Credit Rating Agency,

(c) Promoting capital market development, which can work as a spare tier in case of the bad times in banking system,

(d) Encouraging the entry of foreign banks. Entry of foreign bank can foster competition and force domestic banks to take reform measures. However, for this to happen, enhancing regulatory and supervisory capacity and building financial infrastructures are equally important,

(e) Developing regulations and policies to encourage investors and bankers to establish some specialized types of banks such as infrastructure bank, EXIM bank etc,

(f) Encouraging banks and financial institutions to resolve issues at the corporate level by overcoming the information asymmetry, enhancing the auditing and accounting standards, strengthening risk appraisal capacity, and ensuring corporate good governance,

(g) Addressing the issues at the broader level by enhancing the capacity of Debt Recovery Tribunal, and Credit Information Bureau, strengthening the judicial capacity, and further strengthening the capacity of NRB, and

(h) Developing the bank exit mechanism. The recent case of Nepal Bangladesh Bank has clearly suggested that Nepal needs an effective bank exit mechanism. This is necessary to address the problem of moral hazard and to promote a culture of market monitoring. Theories also suggest some failures are inevitable. So there needs to establish transparent rules for bank exit-that is, for intervention and resolution and to encourage market for merger and acquisition to minimize the risk of problem banks.

These recommendations should neither be taken as precise nor as panacea, but the conclusion follows that decisions about the optimal number of the financial intermediaries in a liberalized financial system is not decided by the central authority rather fixed by the market forces on their own. However, it is also true that in the Nepalese context, emerging challenges are ahead in maintaining financial stability. Therefore, the efforts should be oriented towards developing financial infrastructures, devising competitive policies, strengthening regulation and supervision to enhance and enforce disclosure requirements, widening the access of the financial services, easing entry and exit mechanisms, and most importantly enhancing the transparency, information disclosure, and corporate governance.

Chapter — 1

Introduction

Background

Financial system contributes to economic development through an efficient allocation of resources. In addition to the regularly quoted functions of saving mobilization and resource allocation, financial sector contributes to economic development by exerting corporate control, facilitating the payment system, and managing the risk inherent therein. A sound financial system not only facilitates financial intermediation, maturity transformation, payment systems, credit allocation, and financial discipline, it produces information necessary for intermediation, risk reduction and corporate governance monitoring.

Nepalese financial system has witnessed a significant development in the aftermath of the liberalization program initiated in the country in the mid-eighties. In the subsequent years of economic liberalization, financial development has accelerated. The situation has completely changed from the level of 2 commercial banks and 2 development banks, all owned by the government before the economic liberalization in 1984. Currently, the financial system consists of more than 200 banks and financial institutions licensed by NRB. Along with the expansion of the financial system, a number of challenges have emerged. These challenges in general relate to the sound and prudent management of the financial system. High level of NPLs, particularly of the two large banks NBL and RBB, is still at alarming level. Additionally, there is still high cost of financial intermediation and challenge remains to widen the access of the banking services in the nook and corner of the country. Nepalese banking system still has to demonstrate its competence in introducing a wider range of financial products, enhancing systemic efficiency and reducing the intermediation costs. These issues are sure to bolster in the coming days when the country has already committed to allow the foreign banks to open their branches for the wholesale banking purpose from 2010. Given this, this research work attempts to derive some policy lessons on the issue of whether we should determine the optimal number of financial institutions or should move ahead on the trajectory of regulatory reform.

Current Status of the Financial System

Nepalese financial system consists of Nepal Rastra (Central) Bank, depository corporations, and other financial corporations[1]. Depository corporations include

[1] This classification is in line with the IMF's Monetary and Financial Statistics Manual-200.

commercial banks, development banks, finance companies, micro credit institutions, cooperatives and NGOs licensed to undertake limited financial transactions (Table 1). Other financial corporations comprise insurance companies, Employees Provident Fund, and Citizen Investment Trust (Annex 1).

Annex (2) shows the structure of the Nepalese financial system. Commercial banks have the highest share in the total assets of the financial system. As of mid-July 2006, commercial banks' share is 56 percent followed by a 24 percent share of Nepal Rastra Bank. The share of other financial institutions is low. However, contractual savings institutions have a remarkable share of 12 percent. As shown in the table, total assets of the financial system is almost 120 percent of GDP and if the market capitalization to GDP is included, it stands exactly 136 percent of GDP in mid-July 2006.

Annex (3) shows the resource mobilization by the Nepalese financial system. Commercial banks have the highest share in total resource mobilization. Both deposits and lending of commercial banks are at a higher level than others. Commercial banks mobilize deposits 50 percent of GDP and loans and advances 30 percent of GDP. Development banks including ADB/N mobilize deposits 6 percent of GDP and loans and advances 5 percent of GDP. On the resource mobilization front, finance companies come next to the development banks[1]. Regarding the contractual savings institutions, Employees Provident Fund has the largest share in total assets.

As earlier mentioned, there is a major growth in the number of financial institutions during the last two decades. By mid-May 2007, NRB licensed bank and non-bank financial institutions totaled 205 consisting of 20 commercial banks, 37 development banks, 73 finance companies, 11 micro-credit development banks, 17 saving and credit co-operatives, and 47 NGOs (Table 1). Similarly, the financial market has deepened as measured by broad money to GDP ratio, which was 30 percent in 1990 and now it is around 60 percent. Commercial banks' private sector credit to GDP has also increased significantly during the last 15 years. It was 11 percent in 1990 and now it is above 32 percent. These indicators along with the availability of a wider range of financial products are clearly showing the evidence that along with the quantitative growth; there is also a qualitative growth in the financial system.

Table 1: Growth of the Financial Institutions

	Number of Institutions in mid-July							
Type of Financial Institutions	**1980**	**1985**	**1990**	**1995**	**2000**	**2005**	**2006**	**Mid-May 07**
Commercial Banks	2	3	5	10	13	17	18	20
Development Banks	2	2	2	3	7	26	29	37
Finance Companies	-	-	-	21	45	60	70	73
Micro Credit Development Banks	-	-	-	4	7	11	11	11
Saving and Credit Cooperatives	-	-	-	6	19	20	19	17
NGOs (Performing limited Banking activities)	-	-	-	-	7	47	47	47

[1] Before ADB/N's conversion into commercial bank, development banks' share was higher than finance companies.

Need and Rationale of the Study

Despite the current level of financial development, there are emerging issues relating to the level of financial development, financial widening, financial stability and the need of the regulatory reform. A question is raised on financial stability given the increasing number of financial intermediaries. The pertinent questions raised from some quarters are: does Nepal need more financial intermediaries, is the system prepared to face the upcoming challenges, and shouldn't there be entry restriction. Particularly, the issue of entry restriction or tighter entry requirements is hitting the market. Not only domestic financial players are concerned with the increasing number of intermediaries, but questions are also being raised by some donor agencies. A case in point is the IMF Article IV consultation report (February 2006). The report mentions possibly higher capital requirements, and other provisions for mergers, which could help the financial system, consolidate ahead of 2010 when competition would increase under WTO commitments. This is an indication that the size of the Nepalese financial system has also become a matter of concern for a number of stakeholders including those to the donors.

Nonetheless, there are questions on the financial deprivation of the large segment of the population residing in the remote areas of the country. In this regard, this study intends to derive some lessons on the financial development and regulatory reform. The question about the optimal number of the financial institutions is still beyond the paradigm. But a number of academicians and practitioners have developed a consensus that a competitive financial system is necessary. And this is also necessary for the financial development, which ultimately leads to economic growth (King and Levine: 1993). Thus, the current study is designed to address the issue of optimality or regulatory reform in three ways: analyzing the intra country level of financial development, making a cross country comparison applying the measures of depth, efficiency, stability and access, and drawing lessons from the theoretical groundwork.

In this analysis, attention is given more to the banking sector given the current level of the Nepalese financial development-commercial banks occupying significantly a large share (Chart 1). These banks account for almost 87% of the total assets of the banks and financial institutions licensed by NRB (Annex 4). Theories also recommend that banks be given special attention as they are subject to market failure specially arising from information asymmetries. On the asset side, they take on the risk of valuing projects and funding those borrowers whose ability to pay their loan is uncertain. On the liability side, the confidence of creditors and depositors who have imperfect information on the bank's actual position is essential to a bank's ability to refund their deposits and payment services. High leverage, and lack of liquidity and transparency of banks' assets lead to vulnerability. When a bank fails due to the lack of information, depositors run not only to the weak banks but to the sound banks too. This type of contagious run makes banking system fragile and could cause a systemic crisis[2].

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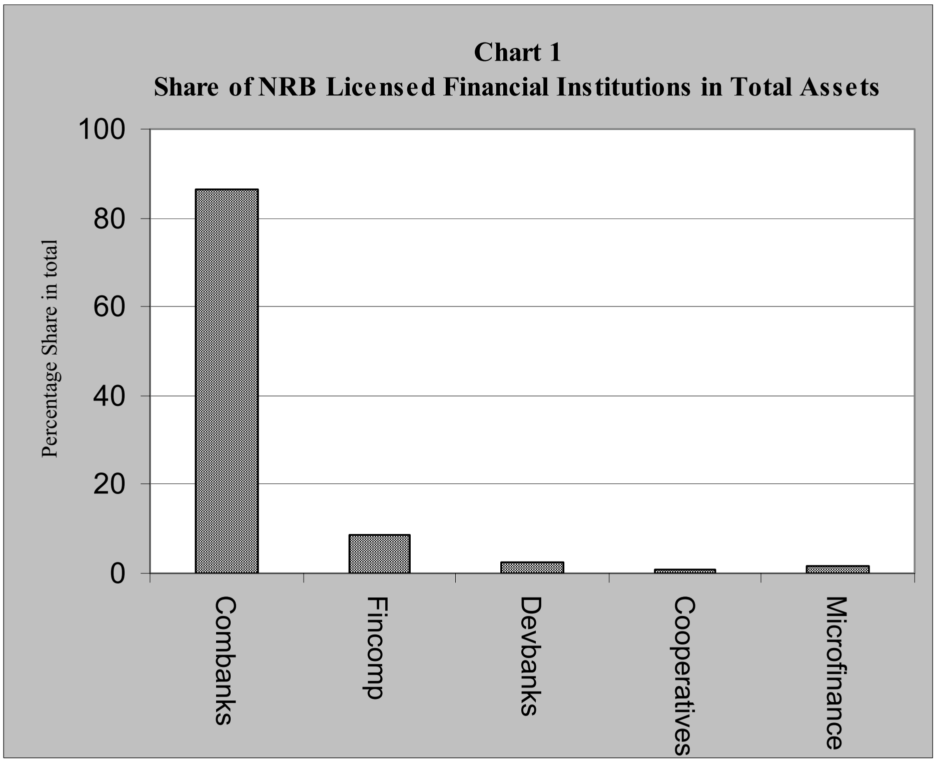
[2] Sundararajan and Balino (1991) define a financial crisis as "a situation in which a significant group of financial institutions have liabilities exceeding the market value of their assets, leading to runs and other portfolio shifts, collapse of some financial firms, and government intervention".



Data and Information

The data are secondary in nature**.** Data have been collected from various sources. However, just to mention, the main sources are: various publications of NRB, publications of CBS/Nepal, central bank websites of various countries, and ADB/World Bank publications. In the theoretical underpinning part, information relating to a number of dimensions of bank regulation has been collected.

Limitations of the Study

This study is a descriptive analysis. It mainly focuses on some of the major financial development indicators used in the relevant literature. The study is mainly designed to make a comparison within various development regions of the country on one hand and with some countries mainly in the South Asian region on the other. The study, instead of recommending any particular number for the optimality of financial institutions, tries to draw some policy lessons on regulatory reform based on a number of relevant studies.

Chapter — 2

Financial Development in Nepal

Evolution

Evolution of the organized financial system development in Nepal can be divided into three phases: 1937-1956, 1956-1985 and post-1985. Establishment of Nepal Bank Limited (NBL), the first commercial bank of Nepal, in 1937 is marked as the beginning of the development of the Nepalese financial system. Though the then Rana Prime Minister Ranodheep established Tejarath Adda in 1880 A.D., its role was limited in lending to the government staff and to some landlords. Therefore, establishment of NBL is taken as a historic move. Prior to the establishment of NBL, Nepalese people had to keep their savings either in cash or in Indian banks. External transactions were affected through Indian banks. The central banking functions were shared between Reserve Bank of India and Revenue and Minting Department in the Ministry of Finance of Nepal (Acharya, Khatiwada and Aryal: 2003).

Nepalese financial system underwent a major thrust after the establishment of Nepal Rastra Bank, the central bank, in 1956. A number of financial institutions of diverse nature and varying responsibilities were established in the public sector. These included Nepal Industrial Development Corporation (NIDC), Agriculture Development Bank (ADB/N), Employees Provident Fund (EPF), Rastriya Banijya Bank (RBB), Deposit and Credit Guarantee Corporation, Nepal Insurance Corporation and the Securities Marketing Center. NRB was directly involved in setting most of these institutions with equity participation. Besides this, NRB partially subsidized branch expansion of commercial banks during 1970s and 1980s i.e. from 2025 BS to 2046 BS (Annex 5).

The balance of payments crisis of 1983 compelled Nepal to adopt a number of structural reform measures. In this process, Nepal liberalized the financial system. Measures of financial repression were relinquished gradually. Allowing foreign banks to operate joint ventures in Nepal was a kick-start in this regard. Nepal Arab Bank Limited was established as the first joint-venture commercial bank in 1984. Two more joint ventures were established in the subsequent years. Nepal Indosuez Bank (currently Nepal Investment Bank) was established in 1986 and Nepal Grindlays Bank (currently Standard Chartered Bank Nepal Ltd) in 1987. Because of the induction of liberal policy, not only a number of foreign banks with local participation were established but also a number of private sector banks came into operation. By May 2007, there are altogether 20 commercial banks: 6 joint ventures, 3 government-owned, and others promoted by Nepali entrepreneurs.

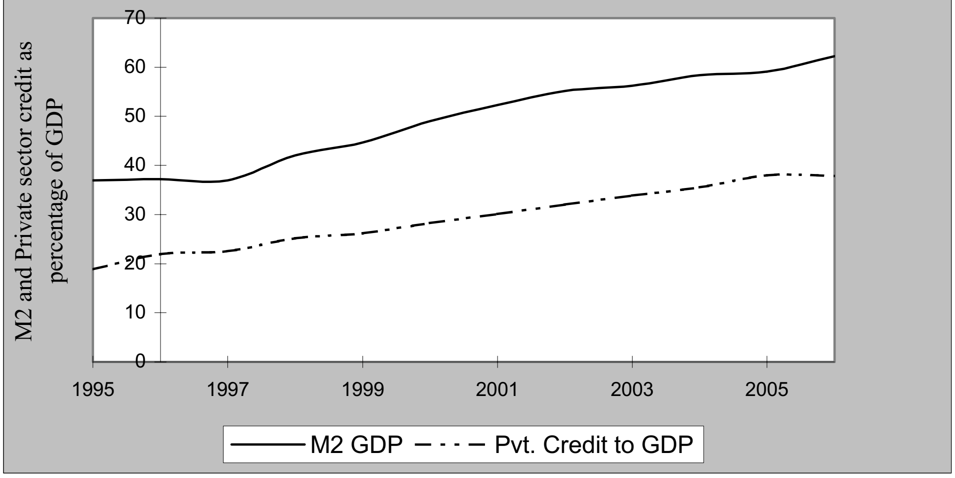
Performance in the Post-Liberalization Period

Post liberalization period shows the significant development in the financial sector of Nepal. There are major improvements in the area of financial deepening, deposit credit operation, total assets concentration, ownership diversification, and banking industry has emerged as a profitable venture.

Financial Deepening

Financial Sector liberalization took a momentum beginning1990s after the political regime shift in Nepal. The primary objective of the liberalization program was to improve financial sector efficiency by providing more scope to the market forces. Indicators relating to financial deepening and intermediation suggest substantial financial development during the last 12 years. Broad money to nominal GDP ratio is widely used as an indicator of financial sector deepening where higher values represent relatively a more developed financial sector. Nepalese financial sector witnessed a remarkable growth in financial deepening (Annex 6). Growth of broad money (M2) to GDP ratio significantly increased during the last ten years (Chart 2). It increased from 36.9 percent in 1995 to 59.6 percent in 2006. The currency to deposit ratio, which is in declining trend shows the increased financial intermediation. Likewise, the currency to M2 ratio is also in declining trend supporting the higher financial intermediation. On the assets side, a large growth in credit to GDP ratio has been observed during this period. Private credit to M2 ratio increased from 51 percent in 1995 to 60.8 percent in 2006. Credit to GDP ratio has almost doubled during 1995-2006. This shows that faster growth of private credit played important role in economic activities and financial deepening in the country.

Chart 2
Financial Deepening in Nepal



Deposit-Credit Performance of Commercial Banks

During the last decade, there has been a rapid growth in deposit collection of commercial banks. Table 2 shows nearly 14 times increase in deposit collection in nominal terms during1990-2006. As percentage of GDP, commercial banks' deposits went up from 22 percent in 1990 to 42.2 percent in 2000 and reached 49.8 percent in 2006. Commercial banks' outstanding credit as percentage of GDP increased significantly. While it was 15.4 percent of GDP in 1990, it increased to 39 percent in 2006. Similarly, credit-deposit ratio witnessed an expansion. It stood 78.2 percent in 2006 from 70.1 percent in 1990.

Table 2: Ratio of Deposit and Credit to GDP (Rs in million)

Mid-July	Total Deposit	Total Credit	GDP	Credit /Deposit	Deposit /GDP	Credit /GDP
1990	21885.0	15334.7	99702	70.1	22.0	15.4
1991	26687.5	17067.4	116127	64.0	23.0	14.7
1992	33328.5	22596.2	144933	67.8	23.0	15.6
1993	43543.1	26223.6	165350	60.2	26.3	15.9
1994	52168.5	34756.8	191596	66.6	27.2	18.1
1995	61045.5	46914.7	209974	76.9	29.1	22.3
1996	71207.6	61466.0	239388	86.3	29.7	25.7
1997	81542.4	70765.6	269570	86.8	30.2	26.3
1998	102401.6	83517.0	289798	81.6	35.3	28.8
1999	126773.6	99309.7	330018	78.3	38.4	30.1
2000	154530.3	118008.1	366251	76.4	42.2	32.2
2001	181203.4	135526.4	393566	74.8	46.0	34.4
2002	183728.1	144175.4	405632	78.5	45.3	35.5
2003	202733.8	162353.2	435531	80.1	46.5	37.3
2004	232576.3	184438.6	472424	79.3	49.2	39.0
2005	250464.9	212316.6	533538	84.8	46.9	39.8
2006	290427.6	227246.5	582948	78.2	49.8	39.0
Average						
1990-1995				67.6	25.1	17.0
1996-2001				80.7	37.0	29.6
2002-2006				80.2	47.6	38.1

Source: Nepal Rastra Bank, QEB, Vol.XXXVIII (P.10, Macroeconomic Indicators of Nepal Jan 2007 NRB), Economic Survey

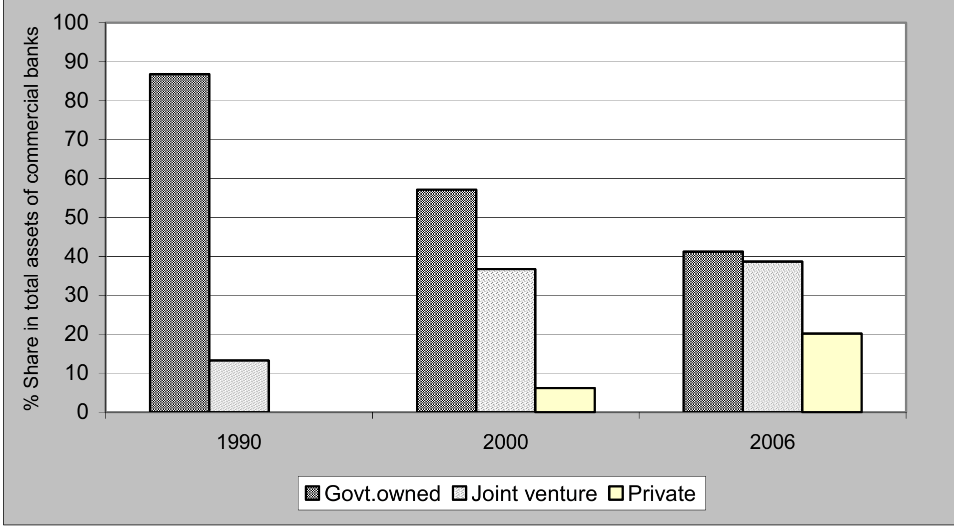
Market Share of the Largest Three Banks (Concentration)

Rastriya Banijya Bank, Nepal Bank Limited and Standard Chartered Bank (SCBL) remained among three largest asset holders till 2003. After 2003, Himalayan Bank Limited succeeds SCBL in asset holding. Bank concentration ratio has been assessed evaluating some of the major items from the sources and uses of funds of the commercial banks. The ratio of deposit, total loans and advances, and total assets were calculated to find their share in total (Annex 7). And these are found to be decreasing during 1990 to 2006. In 1990, deposit of three banks was 84.08 percent in total deposits of commercial banks. It gradually declined to 36.95 percent in 2006. Likewise, the share of these banks in total loans and advances declined from 89.15 percent in 1990 to 31.47 percent in 2006. More importantly, their share in private credit sharply declined from 89.62 percent in 1990 to 30.63 percent in 2006. As a result, the concentration ratio of total assets of three large banks went down from 92.03 percent in 1990 to 47.35 percent in 2006, exhibiting a positive indication for the sound, competitive and efficient financial system.

Ownership Structure of the Nepalese Banking System

On the ownership front as well, Nepalese banking system has witnessed a sea change after the financial reform introduced in the country. While the government owned commercial banks were holding almost 90 percent of the total assets of the commercial banks in 1990, their share has significantly come down to 40 percent in 2006. In this process, share of the joint venture banks and private banks is increasing over the years. While joint venture banks were holding around 13 percent of the total assets of commercial banks in 1990, it has reached 39 percent in 2006. It is more interesting for private banks. While these banks were nonexistent in 1990, their share in total assets reached 20 percent in 2006 (Annex: 8). Increasing share of the joint venture, and private sector banks in the total assets is an encouraging indication for the financial development of the country. This sort of diversification helps to foster competition and maintain financial discipline, if managed properly.

Chart 3
Changing Ownership Structure of the Banking System



Banking Business: A Profitable Venture in Nepal

All the stakeholders in the Nepalese financial system particularly government, Nepal Rastra Bank, incumbents and new entry aspirants give their big eyes to the growing banking business in Nepal. This sector has relatively become attractive because of the sound performance of the industry. If we take the figure of the last five years, growth of aggregate deposits, loans and advances, and net profit, all are encouraging. This faster and higher growth rate has made the business lucrative and thus increasing the number of entry aspirants. The average annual growth rate of net profit of commercial banks remained 44.2 percent during the last five years (Annex 9). Similarly, average annual growth rate of deposits was 15.3 percent in the same period. On the loans and advances front, such growth was 18.6 percent.

Financial Reform

Traditionally, Nepalese financial sector policies and institutions were developed on certain assumptions. These were (i) access to cheaper institutional credit could break the low equilibrium trap and induce investment, (ii) informal credit agencies were exploitative and credits obtained from these sources were seldom used for productive purposes, (iii) the government was required to intervene in the sector to ensure sufficient flow of rural credit, and (iv) commercial banks had a social responsibility to serve the rural clientele (ADB: 2000). As a result, the policy and institutional framework was deliberately designed to allow considerable government participation and control with limited competition. Reform initiatives undertaken in the past include easing of licensing policies, statutory requirements, foreign exchange exposure, and cash reserve ratios; liberalization of the interest rates; and introduction of various prudential and regulatory reforms. However, the past piecemeal approach has not succeeded in substantially extending access to the formal financial sector to rural people, much less to the rural poor. The reform measures were not embedded in a wider policy reform framework and financial sector development strategy, and as such were improperly sequenced. Importantly, they took place within a fragmented and nontransparent legal, regulatory, and institutional environment. And it was widely recognized that the financial sector, and the state-owned commercial banks (SOCBs) in particular, faced many problems (ADB: 2000).

Given this, Nepal embarked on the comprehensive financial reform program after publicly announcing the Financial Reform Strategy in November 2000. The major objectives of the reform program are to reengineer the central bank, restructure the troubled commercial banks i.e. NBL and RBB, and enhance the capacity of the overall financial system including the legislative reform (Box 1).

As outlined in the reform program, a number of reform measures have been introduced on the NRB reengineering front. These include prudential regulation and supervision manuals, unified regulation directives, preparation to adopt the BASEL II in regulation and supervision, reform on IT frontier, improvement in accounting standards, reduction in the number of staff through voluntary retirement schemes (VRS) and compulsory retirement scheme (CRS), introduction of new staff by-laws, and reorganization of organizational structure of the bank. Similarly, in the areas of restructuring the RBB and NBL, a number of significant changes have taken place. Huge reduction in the staff number, adoption of revised accounting and auditing standards, improvement in credit guidelines and credit policies, gradual computerization of transactions, and improvement in the profitability leading some reduction in the negative net worth are the positive outcomes. Though some progress has taken place in the

Box 1

Objectives of Financial Sector Reform

2.1 Objectives of Financial Sector Technical Assistance Project (FSTAP)-Phase I

- Helping to restructure and re-engineer the Central Bank (NRB) so that it can effectively perform its key central banking functions.
- Commencing commercial banking reform in the two large ailing commercial banks (RBB and NBL) by introducing stronger management that protects the financial integrity of the two banks and would take on a conservator role to prepare the banks for the next steps of restructuring.
- Supporting a better environment for financial sector reform in areas such as enhanced credit information, better financial news reporting and better training of staff in financial institutions.

2.2 Objectives of Financial Sector Restructuring Project (FSRP)-Phase II

- Helping to further strengthen the Central Bank of Nepal, NRB enhancing its capacity to oversee the development of a prudently operated financial sector in line with its own medium term vision through an ongoing program of bank supervision strengthening, accounting and auditing development, human resource re-engineering, information technology up gradation and other support.
- To substantially improve the two large banks' (RBB and NBL) operating capacity and commercial viability to move them as swiftly as possible into the private sector. Thereafter, develop the Government's oversight and supervisory capacity over them and other banking institutions.

Source: www.nrb.org.np

reduction of NPLs, there remains much more to be done. Legal hurdles, political instability, and strong opposition from defaulters remain the major stumbling block in reducing the level of NPA. Financial reform cannot realize its intended objectives unless the problem of NPA is resolved. Box 2 gives a highlight on this.

Box 2

NPL Problem: Waiting for Some Solid Actions!

- NPL problem has remained a striking issue of the Nepalese banking system. As of mid-January 2007, NPL of the Nepalese banking system is 14.08%, which is far higher than the international standard.
- Though the level of NPL has declined over the past few years, there is much more to be done particularly in case of RBB and NBL whose level of NPL is still 34.08% and 15.64% respectively.
- High level of NPL indicates the systemic crisis in the financial system. It is an indicator of insolvency, credit crunch, and abnormality. Economic growth cannot be guaranteed without financial development. Studies have shown a strong correlation between financial development and economic growth and financial development is not possible without a prudent and sound financial system. NPL below 5% is a prerequisite for the stable financial system.
- Past efforts have not completely become futile. The level of NPL has come down in both RBB and NBL. Reform programs have paid but are still far away from the minimum satisfactory standard.
- What is causing the NPL? Both internal and external factors. Internal factors are risk management deficiencies in the banks and financial institutions, weak corporate governance, poor accounting and auditing standards, poor recovery efforts and asymmetric information and moral hazard problems. External factors causing NPL are lack of financial discipline, weak credit culture, poor legislative framework, political influence and connected lending.
- What has been done? NRB introduced a number of policies to mitigate the problem of NPL. These are directives on good corporate governance, adequate capital in relation to risk weighted assets, monitoring the concentration of assets, formulating and implementing credit policy, and strengthening the credit information system and blacklisting procedures.
- However, some solid actions are the need of the hour.

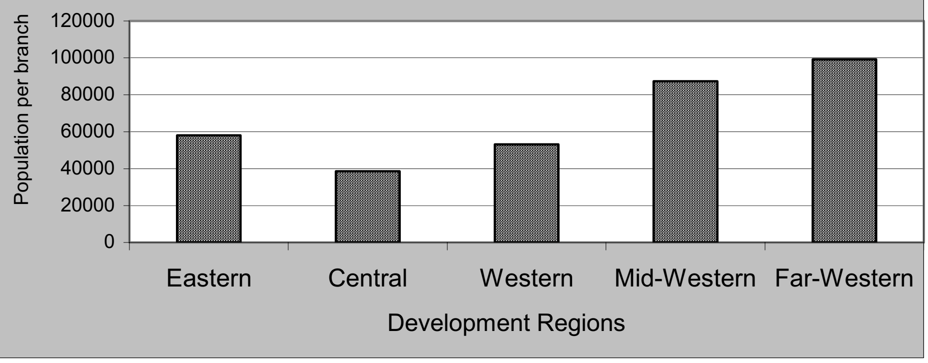
Chapter — 3

Intra Country Comparison

Regional Comparison

Despite the financial reform measures introduced in the country, the level of financial development indicates that it is still beyond the access of the people of the backward regions. Moreover, the current level of financial widening and deepening is not symmetrically distributed among the regions of the country. Regions they are far behind in a number of dimensions of economic development are under-banked. As shown in Annex 10, financial widening is very low in Mid-Western and Far-Western Development Regions compared to other Regions. The indicators explaining the level of financial access: population per branch of commercial bank or population per financial institution, are showing that there are relatively under banked regions in the country. This is also shown in Chart 4. The graph shows that population per branch of commercial bank is very high in both Mid-Western and Far-Western Development regions compared to other Development Regions in the country.

Chart 4
Population Per Branch of Commercial Bank



Further, if we try to show a relationship between the accesses to financial services and some other dimensions of economic development, it is more astounding. One can simply correlate this fact with the help of the data shown in Table 3.

Table 3: Socio-economic Indicators and Regional Distribution of Financial Institutions

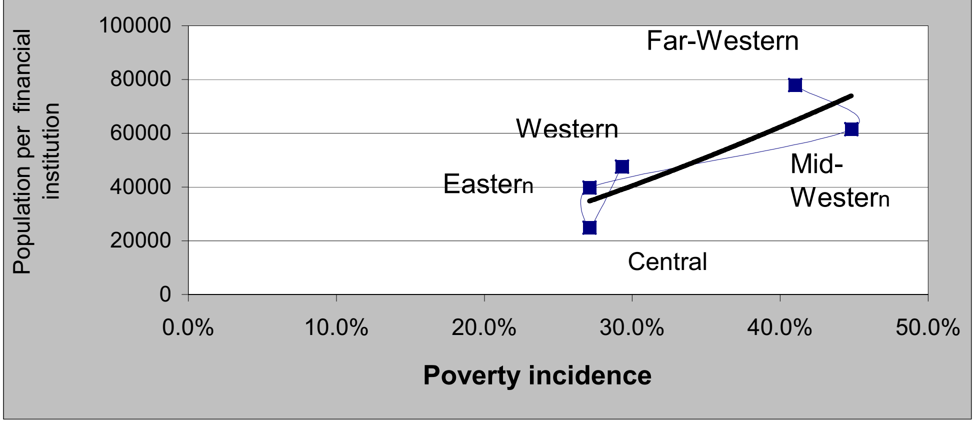
Indicators	Eastern	Central	Western	Mid-Western	Far-Western	Total
Population/branch of commercial banks*	**58098**	**38592**	**53151**	**87330**	**99235**	**52030**
Population/Total number of financial institutions**	**47629**	**24886**	**39748**	**61528**	**77971**	**36732**
Poverty Incidence	29.3%	27.1%	27.1%	44.8%	41.0%	30.8%
Secondary school net enrollment	28.4%	28.4%	28.0%	16.0%	15.4%	25.5%
Literacy rate	55.7%	52.9%	59.3%	49.4%	48.7%	54.1%

Source; CBS 2002 and authors' calculation

* Including ADBL's commercial banking branches **Commercial bank branches plus number of financial institutions of category B,C, and D.

In the table, some indicators of socio-economic development are compared with the population per branch of commercial bank since these banks have the largest share in the total financial system of the country. But a comparison is also made taking the number of all the financial institutions into account. Even from this perspective, there is a limited access of financial services to the people in the backward regions. Regions that are behind in the dimensions of economic development such as poverty and secondary school enrollment do also have limited access to financial services. The two poorest regions: Mid-Western and Far Western as shown by the poverty incidence are significantly behind in access to financial services (Chart 5). This suggests that socio-economic development and financial outreach are correlated. Thus, there is a need of regulatory reform to assist the process of socio-economic development of the country through financial inclusion.

Chart 5
Relationship between Financial Development and Poverty



Box 3

Banking Facility in Three Districts: How Striking is it?

To see how striking is the level of financial development and the level of economic development across various districts of Nepal, we have chosen three districts: Chitwan, Banke and Bardiya. While Chitwan, a district very near from capital Kathamndu enjoys relatively a better financial widening and higher per capita income, Bardiya, a district in Mid-Western has a low level of financial development and low per capita income. Even Bardiya lags behind its neighboring district Banke, which is relatively in a better position than many other districts in the country. The data presented below suggest that there is much more to be done in the area of financial inclusion.

As of mid-July 2006

Descriptions	Chitwan	Bardia	Banke
Commercial Banks' Branches	10	2	9
Number of Development Banks	4	0	2
Number of Finance companies	1	0	0
Population	472,048	382,649	385,840
Per capita Income (Rs.)	23,204	13,115	18,537
Population/bank branch and financial institution	31,470	191,325	35,076
Per capita deposit (Rs.)	12,834	1,213	8,300
Per capita credit (Rs.)	9,584	2,522	6,673

Source: BFI Statistics, NRB and NRB branch reports.
Koirala, Parasar. 2005. Economic Review, NRB.
Statistical Pocket Book. 2002. CBS.

Financial Development in Kathmandu Valley

Some people argue that Kathmandu valley is over banked. To see whether it is close to reality, we tried to assess two indicators: population per branch of commercial bank and population per financial intermediary in Kathmandu valley (Table 4). The first indicator shows that a branch of commercial bank is providing service nearly 14,000 population and the second indicator shows that population per financial intermediary including the commercial bank branches is 9,000 in Kathmandu valley. These evidences suggest that financial widening is high in Kathmandu valley, almost similar to the country level of Sri Lanka in the South Asian region. But we can't say exactly whether it is more or less compared to the financial widening in the capital city of other countries taken in the analysis.

Financial access to poor and backward regions is a challenge for the Nepalese financial system that is expanding over the years. This is also highlighted by the recent World Bank study (Access to Financial Services in Nepal: 2007). The study mentions access to financial services remains limited for many people in many parts of Nepal and in recent years has been declining. Despite government efforts, access to formal financial services is declining. While the banks serve mainly the urban areas and the wealthiest, rural area and poor section of the society largely depends upon informal sources of financing.

Table 4: Financial Services in Kathmandu Valley

District	Bank Branches	Population	Pop/branch
Kathmandu	89	1081845	12156
Lalitpur	20	337785	16889
Bhaktapur	9	225461	25051
Total	118	1645091	13941
Finance Companies in Kathmandu valley			47
Development Banks in Kathmandu valley			6
Total bank branches and financial institutions in valley			171
Population per bank branch & financial institution			9620
No of financial institutions in Kathmandu valley as % of total			32 percent

Source: NRB BFS 47. Statistical Pocket Book, CBS, 2002.

The study further adds competition from informal sector for lending is fierce even for wealthiest households with bank account, and formal sector is too slow, bureaucratic and requires extraordinarily high level of collateral. This study has further reinforces that widening the financial access particularly for the backward regions and poor is very much necessary.

Chapter — 4

Cross Country Comparison

In this section, cross-country comparison is made particularly to examine the level of financial development, efficiency, stability, and outreach. For the purpose, following indicators relating to commercial banks are used.

- Banks Assets/GDP, which provides a measure of the overall size of the banking sector and the level of financial development.
- Loans and advances to the Private Sector/GDP, which is a general indicator of bank activity in the private sector.
- Bank Net Interest Margin, equals the bank interest income minus interest expense over total assets. While many factors influence interest margins, tighter interest margins are frequently viewed as representing greater competition and efficiency.
- Market Capitalization as a Share of GDP, which equals the ratio of the value of domestic equities (that are traded on domestic exchanges) to GDP. This measures the size of the stock market relative to the economy. A larger market has better ability to mobilize capital and diversify risk.
- NPA to total loan, which measures the quality of the assets of the financial system. This is also an indicator of systemic efficiency and intermediation costs. High NPA means lower level of systemic efficiency and higher intermediation costs.
- Average population per bank branch measures the outreach of the financial services to the population. Though it is difficult to have any absolute value for this, large number of population per bank branch means less competition, financial services limited to a few and lower level of financial development.

Table 5: Cross Country Indicators in 2006

Indicators	India	Nepal	Pakistan	Sri Lanka	Thailand
Assets/GDP ratio %	78.94	73.54	106.15	67.32	121.83
Broad money/GDP ratio %	84.00*	59.57	44.30	43.10	96.51
Loans and advances/GDP ratio %	42.94	34.10	31.63	28.30	82.09
Market Capitalization to GDP	85.6 (BSE)	16.60	42.78	26.38	70.58 (2004)
Interest Rate Spreads	3.20	4.60	5.10	5.50	4.05
NPA to total loan %	3.30	14.22	8.00	6.00	8.25
Capital Adequacy Ratio	12.40	-5.30	11.90	11.90	13.49
Average Population per bank branch	16,000	57,900	20,752	13,973	13,619

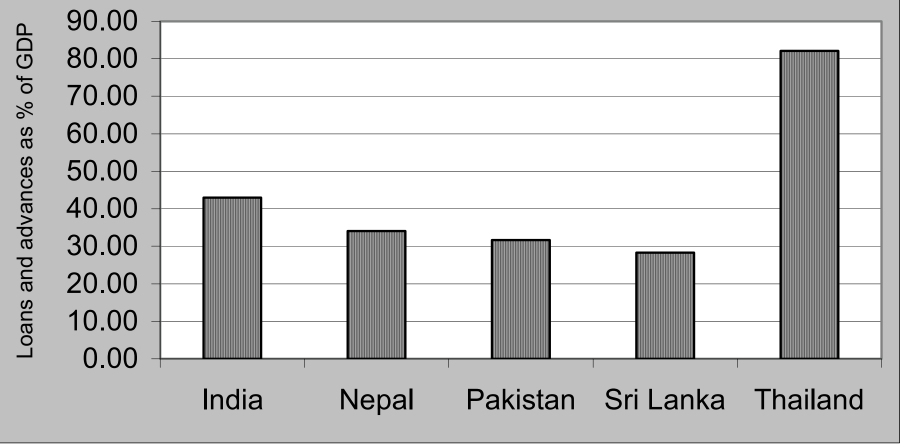
Source: Various publications and web sites of respective country's central bank, and IMF.

*Calculated on the basis of the GDP and M3 data available from Indian Economic Survey of 2006.

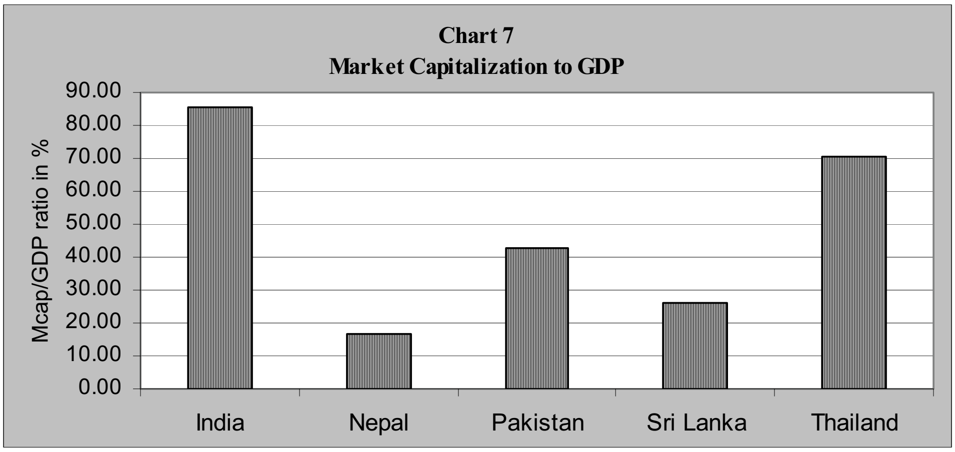
The comparison is made selecting mainly the neighboring countries of Nepal with a view that a number of dimensions of socio-economic development converge despite some structural differences. Low level of living, dependence on agriculture, geographical proximity and regional interdependence are the basis for selecting the countries in the South Asian Region for cross-country comparison. However, Thailand is selected, to make comparison with a country that has some different features compared to the South Asian ones. Thailand is a middle-income country and belongs to the East Asian region. But is comparable to derive some policy lessons since both Thailand and Nepal are the members of the SEACEN Research and Training Center.

In the cross-country comparison, Nepal relatively has a lower level of financial development as measured by total assets of commercial bank to GDP ratio. Though the Broad money/GDP ratio is higher than that of Pakistan and Sri Lanka, it is lower than India and significantly lower than Thailand. Another indicator of financial development is loans and advances to the private sector to GDP. This shows that Nepal is far behind Thailand and follows India (Chart 6).

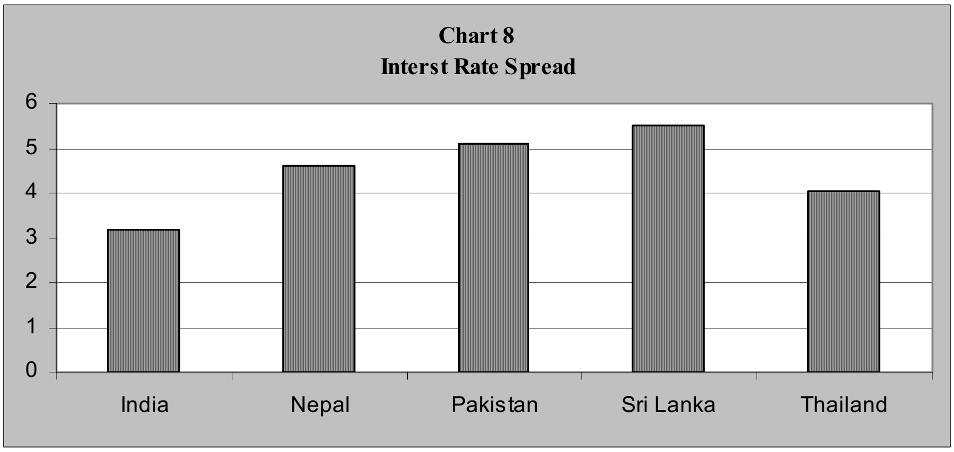
Chart 6
Loans and Advances to GDP Ratio



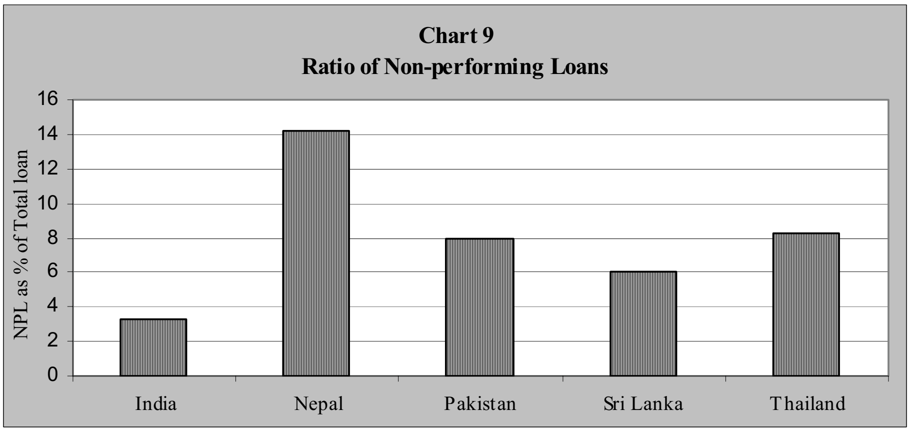
The market capitalization to GDP ratio indicates a very low level of market development in Nepal (Chart 7). Academicians and experts in the financial sector suggest that development of capital market is equally important since it supports in ameliorating risk, efficiently channelizing resources and most importantly works as a spare tier in bad times.



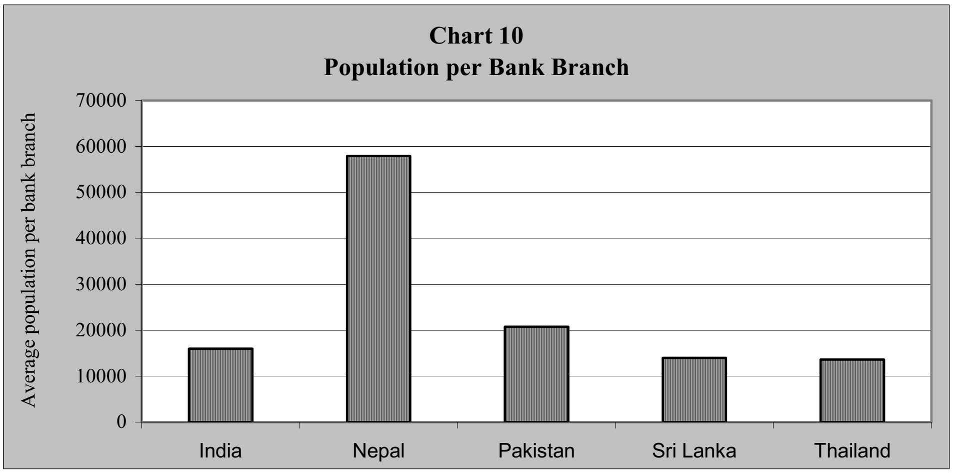
Looking for the competitiveness of the banking industry, we compared interest rate spread among countries (Chart 8). This indicator is showing that Nepal is behind India and Thailand. This reinforces the common view that Nepalese banking industry is less competitive and intermediation cost is high. And a high spread in Nepal can also lead to some capital flow repercussions given the open border with India.



The level of NPLs is compared to measure the stability of the financial system (Chart 9). High NPL of the Nepalese banks is suggesting the low quality of financial assets and also the lack of systemic efficiency leading to higher intermediation costs and posing risk to financial stability. Also the negative capital adequacy of the Nepalese banking industry poses challenges to the financial stability.



Another indicator deemed highly important in this analysis is population per bank branch. This is showing that Nepal is catering to the financial services needs of a large number of people by limited financial intermediaries (Chart 10) compared to other countries. When one branch of commercial bank is providing service almost to 60,000 people in Nepal, it is far less in other countries as mentioned in the Table 5. In addition, if we take the population to total number of financial institutions including those of the commercial banks' branch ratio, it is around 37,000 in Nepal (Annex 10). Even this is far greater than the population to commercial bank branch ratio in other countries. This clearly indicates that Nepal should think carefully in widening the financial services to accelerate the pace of financial inclusion, an idea already supported in the intra country analysis.



Further to facilitate the cross-country comparison, data on the financial development of above mentioned countries plus Malaysia are presented in Annex 11. Data on the annex are reflecting the level of financial development of these countries in two different periods. As earlier mentioned, Nepal's financial development is relatively at par with other SAARC countries and has increased remarkably during 1996-2005. However, it is far behind Malaysia and Thailand. Both Thailand and Malaysia have sustained financial development despite a major set back of 1997. Their case is supporting that countries can recover at a faster pace even after undergoing a major crisis if they have already achieved a certain level of financial development. A policy lesson is that financial development and stability requires sustained economic growth with low inflation, monetization of informal sector, expanding outreach of formal financial sector, and improving banking habits of the people.

In this groundwork, the cross-country analysis suggests that Nepal needs to focus its attention to develop the financial system in such a way that financial development, competition, stability, and outreach are promoted. Though the level of financial development is at par with some countries in the region, the indicators reflecting the level of financial outreach, stability, and competition show the weaker position. These do not suggest that Nepal needs to fix the number of financial institutions. But, from the regional perspective as well, it is evident that widening the financial outreach, promoting the financial stability, and fostering the competition in the financial system are necessary for Nepal.

Chapter — 5

Theoretical Underpinning

This section examines the relevant literature as the question whether optimal number of financial institutions should be determined or the regulatory reform should be pursued remains at the heart of the discussion. Though it is a difficult task to find any literature on optimal number determination in banking industry, there are some studies on the area of regulatory reform. The recent one is the *Rethinking Bank Regulation* (2006) by Barth, Caprio and Levine. Given this, this section reviews some of the theoretical aspects of regulation. There are two competing views on the need for the market regulation: the public interest view and the private interest view.

Pigou's classic treatment of regulation holds that monopoly power, externalities, and informational asymmetries create a constructive role for the strong *helping hand* of government to help offset market failures and thus enhance social welfare. The helping-hand view takes as given both that there are market failures and that the government can ameliorate these failures. Applied to banking, this view considers official supervision of banks, limits on bank activities, restrictions on bank entry, and a deposit insurance scheme as (potentially) appropriate policies that alleviate market failures and improve resource allocation.

But the private interest view or the grabbing-hand alternative is based on the assumption that government failure is at least as important as market failures. Accordingly, the grabbing- hand theory predicts that countries with powerful official supervisors, limits on bank activities, and restrictions on entry will tend to have higher levels of corruption with no corresponding improvement in bank performance or stability. This view therefore predicts that governments focusing more on empowering private-sector control of banks are more likely to promote bank development than governments taking a more hands-on approach to regulation.

Barth, Caprio and Levine: 2002 have discussed the impact of a number of regulatory measures. We have tried to derive some policy lessons from their publication, "Bank Regulation and Supervision: What works best?" Following discussions highlight these points:

- **Regulations on Domestic and Foreign Bank Entry**

The helping-hand view suggests that the government can play a positive role in screening entry. Since banks play such an important role in an economy, widespread failures would reverberate throughout an economy with devastating effects. By effectively screening bank entry, governments can promote bank stability. However, according to the grabbing-hand view, politicians and regulators use entry restrictions to reward friendly constituents, extract campaign support, and collect bribes. An open, competitive banking sector may be less likely to produce powerful institutions that unduly influence policymakers in ways that adversely affect bank performance and stability. Numerous empirical studies exist on banking-market structure, but they overwhelmingly examine only the United States. Many of these studies find that competition matters for static and dynamic efficiency improvements. Jayaratne and Strahan: 1998 (from Barth, Caprio, and Levine) provide evidence that when individual states within the United States created a more competitive (and diversified) banking sector by liberalizing their branching restrictions, the rate of economic growth within those states accelerated. Furthermore, Shaffer (1993 from Barth, Caprio, and Levine) finds evidence from an analysis of cross-sectional data for the United States that household income grows faster in markets where the banking sector is less concentrated.

Literatures are also showing that excessive restrictive entry rules may also result unsound banks. Protected banks become more vulnerable to loss and insolvency when the system is opened for the new entrants. *The goal of entry regulations is not to protect individual banks by providing them with monopoly rents but to bring about a banking system that efficiently serves the economy and the public interest.* Well-designed licensing procedures ensure that banks entering the system are sound and will be operated in a safe and prudent manner. It requires business plan, test the "fit and proper" quality of the owners, directors, and managers[1]. Competition improves efficiency, increases incentives for innovation and promotes wider access. Country experiences show that an efficient financial system requires a contestable system that is open to entry and exit-but not necessarily one with many competing institutions (WDR: 2002, p. 76).

Thus, the policy lesson is that aim of licensing should be to ensure adequate capitalization and sound management, not to limit entry or restrict competition (WDR: 1989, p. 92).

- **Regulations on Bank Activities**

There are a number of theoretical reasons given for restricting the degree to which banks can engage in securities, insurance, and real estate activities, or own non-financial firms. Among others, one of the reasons is that broad financial activities and the mixing of banking and commerce may lead to the formation of extremely large and complex entities that are extraordinarily difficult to monitor. Another argument is that large institutions may become so politically and economically powerful that they become “too big to discipline.” Finally, large financial conglomerates may reduce competition and hence efficiency in the financial sector. According to these arguments, a helping hand from the government can ease market failures and thereby enhance bank performance and stability by *restricting activities*.

However, there are alternative theoretical reasons for permitting banks to engage in a broad range of activities. First, fewer regulatory restrictions on the activities of banks permit the exploitation of economies of scale and scope in gathering and processing information about firms, managing different types of risks for customers, advertising and

[1] In this context, fit refers to technical expertise and proper refers to the character of the individuals.

distributing financial services, enforcing contracts, and building reputation capital with clients. Second, fewer regulatory restrictions may increase the franchise value of banks and thereby augment incentives for banks to behave prudently. Third, broader activities may diversify income streams and thereby create more stable banks. Finally, the grabbing-hand view holds that governments do not restrict bank activities to ease market failures. Instead, according to this view, regulatory restrictions promote government power, create a bigger role for corruption through the granting of exceptions to the rules, and thereby hinder bank performance and stability.

Barth, Caprio and Levine have established the empirical evidence that activity restrictions neither contribute to financial development nor promote financial stability. Therefore, a careful approach in this regard is required. A case in which restraints on competitive activities should be enforced is when a financial institution is in trouble and has a low capital base. This is necessary in order to avoid "gambling for resurrection" strategies (Vives: 1998).

- **Regulations on Capital Adequacy**

Traditional approaches to bank regulation emphasize the positive features of capital adequacy requirements. Capital, or net worth, serves as a buffer against losses and hence failure. Furthermore, with limited liability, the proclivity for bank owners to shift toward higher risk activities decreases with the amount of capital at risk relative to assets. However, there are counter arguments. A number of economists argue that actual capital requirements may increase risk-taking behavior. Thakor: 1996 (from Barth, Caprio, and Levine) demonstrates the conditions under which risk-based capital requirements increase credit rationing, with negative implications for economic growth. Also, Thakor and Wilson:1995 (Barth, Caprio, and Levine) argue that higher capital requirements may induce borrowers to shift to capital markets and in the process impair capital allocation. While Gorton and Winton: 1999 (Barth, Caprio, and Levine) show that raising capital requirements can increase the cost of capital. Thus, theory provides conflicting predictions on whether capital requirements curtail or promote bank performance and stability. Barth, Caprio and Levine point out that capital regulatory policies do not fit easily into the helping-hand/grabbing-hand taxonomy. Capital regulations may be designed to align incentives, and also reflect the ‘government knows best’ orientation of the helping-hand view. On the other hand, onerous capital regulations may reflect excessive government involvement, and reduce efficiency and competition.

- **Deposit Insurance System Design Features**

Demirguc-Kunt and Datragiache 2000, Demirguc-Kunt and Huizinga (2000) suggest designing explicit deposit insurance system to prevent moral hazard. Deposit insurance guarantees certain property rights for depositors. Recent work of Demirguc-Kunt, Kane, and Laeven: 2007 shows that 81 countries are currently adopting explicit deposit insurance scheme in any form[2]. However, they caution that whether to adopt explicit deposit insurance and what kind of system to adopt is country specific. Their

[2] Coverage of insurance varies from partial to unlimited. For example, it coves up to US$ 2193 in India but is full in Indonesia (Demirguc-Kunt, Kane, and Laeven: 2007)

study clearly states *that explicit deposit insurance schemes can lead to excessive risk-taking, reduced market discipline, and even increased financial fragility in countries with poor complementary institutions, including poor regulation and supervision, poor contract enforcement ability, and high levels of corruption*. They are arguing that unless the overall institution is strong, the adoption of explicit deposit insurance does not lead to increase confidence in the financial system. Analysis of individual design features indicates that keeping coverage low and narrow in scope reduces moral hazard problems. For example, there might be benefits from keeping coverage limits below one or two times the level of GDP per capita, introducing elements of co-insurance, subordinated debt holders without any insurance etc.

- **Supervisory Power, Independence, Resources, Loan Classification Stringency, Provisioning**

The helping-hand view of government suggests an important, powerful role for official regulators and supervisors. The line of reasoning essentially is as follows. First, banks are costly and difficult to monitor. Private agents may not have the ability or incentive to supervise banks and will attempt to free ride. Thus, there will be too little monitoring of banks, which implies sub-optimal performance and stability. Official supervisors can ameliorate this market failure. Second, because of informational asymmetries, some argue that banks are prone to contagious and socially costly bank runs. According to the helping-hand view, government supervision in such a situation can serve a socially efficient role. Third, since many countries choose to adopt a deposit insurance scheme, this situation: (1) creates incentives for excessive risk-taking behavior by banks, and (2) reduces the incentives for depositors to monitor banks. Thus, strong, official supervision will help prevent banks from engaging in excessive risk-taking behavior and thus improve bank performance and stability.

The grabbing- hand view highlights the potential negative implications of powerful government regulators and supervisors. As noted above, governments with powerful supervisory agencies may use this power to benefit favored constituents, attract campaign donations, and extract bribes. Powerful regulators/supervisors, according to this view, will be less focused on overcoming market failures and more concerned with currying political support and implementing their own narrow objectives. Thus, the grabbing-hand view predicts that powerful supervision and regulation will be positively related to corruption and will neither improve bank performance nor stability.

Barth Caprio and Levine have empirically established that strong supervisory measures without private monitoring are not related to bank development or efficiency or the level of non-performing loans.

- **Regulations on Information Disclosure and Fostering Private Sector Monitoring of Banks**

Many supervisory agencies encourage private monitoring of banks. For instance, supervisory agencies may require banks to obtain certified audits and/or ratings from international-rating agencies. Some countries make bank directors legally liable if information is erroneous or misleading. Some supervisory agencies compel banks to produce accurate, comprehensive and consolidated information on the full range of bank activities and risk-management procedures. Furthermore, some countries credibly impose a “no deposit insurance” policy to stimulate private monitoring of banks. Over the years, economists have advocated greater reliance on the private sector and expressed misgivings with official supervision of banks. The grabbing-hand view holds that banks will pressure politicians who, in turn, can unduly influence supervisors and regulators. Furthermore, in some countries, supervisors are not well compensated and hence quickly move into banking, resulting in a situation in which supervisors may face mixed incentives when it comes to strict adherence to the rules. Also, since supervisors do not have their own wealth invested in banks, they have different incentives than private creditors when it comes to monitoring and disciplining banks. Again, the results emphasize that those economies facilitating private-sector monitoring of banks have better performing banks than countries less focused on empowering private-sector corporate control of banks. Taken together with the results of official supervisory power, the results are less consistent with theories emphasizing direct government oversight and more consistent with theories emphasizing private-sector corporate control.

- **Government Ownership of Banks**

The helping-hand view argues that government ownership of banks facilitates the mobilization of savings and the allocation of those savings toward strategic projects with long-term beneficial effects on an economy. According to this view, governments have adequate information and sufficient incentives to ensure socially desirable investments. Consequently, government ownership of banks helps economies overcome private capital- market failures, exploit externalities, and invest in strategic sectors. Some economists even advocate government ownership of banks to promote economic and financial development, especially in underdeveloped countries. The grabbing- hand view, in contrast, argues that governments do not have sufficient incentives to ensure socially desirable investments. Government ownership tends to politicize resource allocation, soften budget constraints, and otherwise hinder economic efficiency. Thus, government ownership of banks facilitates the financing of politically attractive projects, but not necessarily economically efficient ones. The private interest approach of regulation argues that government ownership is generally positively related to the level of non-performing loans in an economy but not robustly linked with the other performance indicators.

Concurring with the ideas of Barth, Caprio and Levine in a broader perspective, Asli Demirguc-Kunt (1999) writes there are a number of determinants affecting the financial structure (Annex 12). Asli’s idea is that infrastructures are important to develop the financial structure. Similarly, Professor Mishkin has also lauded the role of regulatory reform for financial development and stability (Annex 13). From the theoretical groundwork what one can learn is that regulatory reforms come in the fore rather than the issue of optimal number determination. Determining the optimal number of financial institutions means fixing the required number of such institutions in an economy, which means saying goodbye to new entrants and protecting the incumbents.

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Chapter — 6

Way Forward/Recommendations

Nepalese financial system is at the embryonic stage. Within country comparison indicates that financial inclusion should be the priority agenda and access to financial services should not remain beyond the imagination of the people in the backward regions of the country. Cross-country comparisons, on the other, suggest that Nepalese financial system is relatively less competitive; less developed, burdened with higher level of NPLs, and undergoes a low level of financial widening. Enhancing the competitive strength of the system and widening the financial outreach is very much necessary. This is essential also to address the problem of poverty and accelerate the pace of economic development. The example of Bangladesh also shows that financial widening is associated with faster growth in incomes of the poor, helping them catch up with the rest of the economy as it grows (Box 4).

Box 4

Finance Helps to Reduce Poverty

Mohammad Yunus, the Nobel Peace Prize winner of 2006, has an interesting story behind his idea of laying the foundation of Grameen Bank. One day in 1974 when Professor Yunus was in field trip with his students of Chittagong University, he met a woman who was making bamboo stools. The woman told that she needs 22 cents to make the stools. But she doesn't have money. So, she borrows from a middleman and sells those bamboo stools to the same fellow leaving her only a meager profit of 2 cents. Professor Yunus thought deeply on the misery of a number of people like the woman making the bamboo stools who were being exploited by the middleman given their financial deprivation. This moment was the beginning of the foundation for Grameen Bank in Bangladesh. A noble idea of a Nobel prize winner has demonstrated that finance can reduce the poverty. It is estimated that the average household income of Grameen Bank members is about 50 percent higher than the target group in the control village, and 25 percent higher than the target group non-members in Grameen Bank villages. The landless have benefited most, followed by marginal landowners. This has resulted in a sharp reduction in the number of Grameen Bank members living below the poverty line, 20 percent compared to 56 percent for comparable non-Grameen Bank members. There has also been a shift from agricultural wage labor (considered to be socially inferior) to self-employment in petty trading. Such a shift in occupational patterns has an indirect positive effect on the employment and wages of other agricultural waged laborers. What started as an innovative local initiative, "a small bubble of hope", has thus grown to the point where it has made an impact on poverty alleviation at the national level ".

Source: Rajan and Zingales, Saving Capitalism from the Capitalists.
Grameen Bank Bangladesh http://www.grameen-info.org/bank

After delving into a number of studies, analyzing the current level of Nepalese financial development, carefully watching the state of the regional disparity and financial exclusion, and comparing the cross-country data, a conclusion is drawn that Nepal needs to widen the financial access and enhance the competitiveness of the systems as a whole. Though there are evolving challenges on the regulatory and supervisory front along with the increasing number of financial intermediaries, equally important are the issues of financial inclusion, adoption of new technologies and products, and fostering competition. Nonetheless, regulatory reform is the prerequisite for a sound and sustainable financial system. Here are some recommendations:

Broader Recommendations

- First and foremost, Nepalese financial system needs strong legal and information systems. Good court and legal system, guaranteeing the property rights, and developing financial infrastructures are highly important to facilitate the expansion and stability of the system.
- Limited financial outreach and lack of competitiveness do not indicate that Nepalese financial system requires entry restriction. Thus, timely reviewing the fit and proper standards for new entrants rather than restricting new entry is in the interest of the growth, expansion and stability of the system. Moreover, entry restrictions can reflect both policy inconsistency and regulatory capture.
- Third, governments have an important role to play as regulators. But empirical evidence suggests the best approach to regulation is one which empowers the markets, rather than creating all powerful regulators who may be subject to corruption and political and industry capture. Empowering the market entails enforcing accurate and timely information disclosure and providing the right incentives for market participants to make sure they remain vigilant monitors. For example, implicit deposit insurance, or forbearance policies, which distort risk-taking incentives can be avoided. Thus, role of the regulation and supervision should be to encourage market monitoring.
- Given the current level of the financial outreach, equally important is to facilitate the access to financial services, i.e., in expanding the availability of the range of financial services to a broader set of households, firms and sectors in the economy.

Based on this broader framework, following recommendations in the form of immediate measures and medium term measures are put forward:

Immediate Measures[1]

- A revision on respective Acts and policies may be needed to encourage professional promoters to enter the market. Upgrading the qualification and experience requirement for promoters develops the professionalism.

[1] Some of the measures suggested here have already been adopted in the recent change of the licensing policy made in late March 2007. Minimum paid up capital has been raised twofold to establish new banks, and financial institutions. In addition, promoters need to submit tax Clarence certificate, and borrowing fund cannot used to finance the promotership. Similarly, new circular has been issued regarding the IPO financing.

- Making some transparent measures regarding the financing sources of promoters can facilitate the screening process. Among others, it may be needed to look into the matters such as the financing sources of the promoters of a new bank/financial institution. Tax clearance from the tax office, and no criminal report and no corruption cases filed against the applicants from the police could be some disciplinary device[2].

- Raising minimum paid up capital is considered desirable to consolidate the banking system, encourage the merger and acquisition, and also to make the screening process easier. The recent increase in the paid up capital for bank and financial institutions is consistent with this. However, it is equally important to note that some risks are associated with raising capital requirements. Raising minimum paid up capital can lead to the riskier behavior to meet the high cost of financing since the cost of capital increases along with the increment in paid up capital. It can reduce efficiency and competition since new entry becomes difficult. And professional entrepreneurs may be barred from entering the market. Thus, a caution should be taken while raising the paid up capital whereby unprofessional promoters enter the market just by bringing more money and market access becomes difficult for the professional ones.

- A provision could be made requiring banks to issue a special class of debt, subordinate debt, which would be subordinate to all other claims, bar equity capital. In the case of bankruptcy, holders of this debt would lose their money first. This instrument would have to be issued in such a way that the debenture holders were at arm's length from the bank. Issuance of this instrument can be made compulsory on routine basis at some percentage of the risk-weighted assets. Regular issue of this debt promotes market monitoring.

- Enhancing disclosure practices to facilitate consumers to choose the right kind of financial institution can increase the private monitoring. In addition to asking banks and financial institutions to disclose their financial statements in a more frequent regular interval, NRB can make the inspection/supervision report public in a timely manner through newspapers or through other means of communication. Disclosure requirements to educate consumers are a must to promote market monitoring. Associations of banks and financial institutions could be asked to facilitate this. These associations could publish a consolidated financial performance report of their members on a monthly/quarterly basis.

- Private monitoring should be encouraged. Private monitoring broadly consists of (a) certified audit by licensed auditors, (b) majority of banks being rated by international Credit Rating Agencies, (c) the extent of an explicit deposit insurance scheme, and (d) the quality of bank accounting. In addition, enforcing disclosure requirements and making them widely available to public strengthens private monitoring.

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[2]However, some of these measures such as the requirement of tax clearance for promoters, and borrowing fund not to be used to finance the promotership have already been introduced in the recent changes made in the licensing policy.

- Supervisors should be inclined to disseminate information in a timely manner. Supervisory recommendation should facilitate the prompt corrective actions to the weak performers. Based on the supervisors' report, banks can be classified into different categories such as well capitalized, adequately capitalized, capitalized, undercapitalized, and critically undercapitalized. Prompt corrective action to undercapitalized banks not letting them to expand their business either accepting deposit or extend credit is necessary. Critically undercapitalized banks should be placed under conservatorship or liquidation after fixed time.

- Enforcing actions against banks violating regulations and laws at a faster pace can promote market discipline. There is a need of establishing and activating a mechanism to punish not only large equity holders and creditors but also the high paid CEOs or other managers when the bank's solvency is threatened. Directors and managers should be held responsible for their bad personal performance. For this, necessary legal provisions may also be required so as not to paralyze the central bank's enforcement actions because of undue interference.

- Actions to the banks and financial institutions should be taken side by side who exploit the small borrowers beyond the regulation and create hassles upon them. The concept of Ombudsman in the Reserve Bank of India can be an example in this regard.

- Making a provision to link large loan limits with NPL ratio can motivate banks to maintain asset quality and reduce the level of NPLs. Bangladesh has adopted this practice.

- It is necessary to be clever enough in handling the growing e-banking practices. Necessary regulations are required to address the problems that can emanate from the increasing use of technologies in banking. Information regarding the credit /debit card transactions, their interest rate, number of ATMs, transactions made through ATMs etc are also necessary to regulate the market.

- Financial inclusion should be the priority agenda. Instead of entry restriction, an environment could be created whereby new entrants are motivated to establish banks in the under-banked areas of the country. A lesson can be learnt from the recent initiative taken by India. India has planned to expand the branch network of rural banks, and to facilitate the issue of rural bonds through National Bank for Agriculture and Rural Development. Similar types of schemes can be helpful in mobilizing resources in the suburbs and rural areas of Nepal. This can also facilitate in mobilizing the remittance inflow toward development activities. Thus, there is a need to introduce a special policy for financial inclusion particularly for the under-banked areas. Incentives should be given to those opening new bank or expanding branches in under-banked areas.

- It may be needed to reorient policies to encourage establishment of development banks in semi urban and rural areas of Nepal. It is time to rethink whether these types of banks should be allowed to establish in Kathmandu Valley, neighboring district Kavre, and other urban centers, where financial inclusion is relatively high. An option could be that development banks in Kathmandu valley should be encouraged to go for merger and acquisition. They can be asked to relocate in under banked areas, or to follow the path of merger and acquisition, or upgrade themselves to commercial bank. Similarly, it is also a matter to rethink the existing policy of allowing finance companies to open branches.

- Introducing public awareness programs at a wider level targeting the ordinary depositors. Such programs are introduced even in emerging market economies. Lately, in 2003, Monetary Authority of Singapore introduced a program called "MoneySense". The rationale of the program is to let Singaporeans become more self reliant in their financial affairs and be equipped to exercise their rights as consumers so that they will be treated fairly by financial institutions (NRB Milestone: 2005).
- Internal governance practice of NRB may need to be reframed to facilitate the effective execution of regulatory responsibility. This may include further effective implementation of NRB staff code of conducts in general, and for the staff in regulation and supervision wing of the bank in particular. This will provide an upper hand in promoting market discipline.
- The existing provision to bar the Governor, Deputy Governors, and Special Class Officers of NRB from joining banks and financial institutions as a director within one year from the date of retirement should be extended to the members of the NRB Board of Directors.
- Also any of the officer level staff who served the regulation and supervision wing of the bank during any period of time in the past ten years could be barred from joining any NRB licensed bank/financial institution as a director or as an employee for certain period, say, one year after retirement. Equally important is to have better pay to retain, and attract capable staff and create an environment to develop professionalism of the employees. This may also require facilitating the development of a specialized career path for them.
- There may be a need to issue directives regarding the involvement of the NRB employees in the secondary market dealings of securities. To avoid conflict of interest and prevent any possibility of insider trading, NRB staff could be barred from buying shares of its own licensed bank and financial institutions in the secondary market. Moreover, large involvement of the central bank staff on stock dealing diverts their attention from regular work.
- Excessive margin lending by the bank and financial institutions can create a panic in both capital market and banking system particularly in view of the high level of NPLs of the Nepalese banking system and weak fundamentals of the stock market. In addition to the recent stringency introduced in the IPO financing, some sorts of restrictions may be required in secondary market financing. But equally important is to see whether such provisions are effective.
- Explore to introduce some of the selective statistical early warning models. Models such as SAABA-expected loss model used by Banking Commission France, SEER-risk rank-failure prediction model by the Federal Reserve System, US, Growth Monitoring System-growth tracking model by the FDIC, US have been used in those

countries to assess future solvency of banks, predict probability of failure, and to identify potentially risky banks respectively. In context of the emerging challenges in the Nepalese financial system, establishing a statistical early warning model can facilitate to identify and bring the deteriorating banks under monitoring and control at a faster pace.

- Explore the possibility to allow Nepalese banks to open their branches in other countries.

Medium Term Measures

- It is essential to establish a mechanism to protect small depositors even to reinforce the exit mechanism. Most depositors (except for the very largest) do not carefully monitor bank risk. Instead, they rely on government or central bank. This was also reflected in the recent case of Nepal Bangladesh Bank. However, this may result in subsidizing the riskiest banks-encouraging them to gamble with their depositors' money. This leads to a need of deposit insurance scheme but with a risk scaled insurance system in which the riskiest banks pay the highest insurance premiums.
- The theoretical as well as empirical evidences have shown there is no alternative of encouraging the entry of foreign banks in today's globalized world. Entry of foreign banks can foster competition and force domestic banks to take reform measures. However, for this to happen, enhancing regulatory and supervisory capacity and building financial infrastructures are equally important.
- Nepalese financial system is in urgent need of establishing a Credit Rating Agency (CRA). This will force all banks/financial institutions to be evaluated through CRA and promote market discipline. However, to make system more transparent and compatible in context of the WTO arrangement of allowing foreign bank branches to operate from 2010, efforts could be made to evaluate commercial banks through the international CRA. And to evaluate other financial institutions, local CRA can be established.
- Promoting capital market, mutual fund, and pension funds is equally important. A developed capital market can work as a spare tier even if there are bad times in the banking system. And a number of developing countries are also moving towards promoting the market-based system since private sector monitoring is enhanced through the direct involvement of economic agents in the market.
- A restructuring agency with special mandates can manage the non-performing assets of poor banks, and will facilitate in evaluating the system.
- Developing regulations and policies to encourage investors and bankers to establish some specialized types of banks such as infrastructure bank, export-import (EXIM) bank etc.
- Government and central bank should direct and encourage banks and financial institutions to resolve issues at the corporate level by overcoming the information asymmetry, enhancing the auditing and accounting standards, strengthening risk appraisal capacity, and ensuring corporate good governance.

- Government and central bank should address the issues at a broader level through enhancing the capacity of Debt Recovery Tribunal, and Credit Information Bureau, strengthening the judicial capacity, and further strengthening the capacity of NRB.
- Last but not least, the recent case of Nepal Bangladesh Bank has clearly suggested that Nepal needs an effective bank exit mechanism. This is necessary to address the problem of moral hazard and to promote a culture of market monitoring. Theories also suggest some failures are inevitable so the authority should establish transparent rules for bank exit, that is, for intervention and resolution. Entry and exit, competition, and active market discipline tend to result in a more resilient banking system. The closure of nonviable banks and downsizing of other problem banks will improve prospects for the remaining banks. Adequate capital and monitoring alone can fail to curb moral hazard problems if the exit mechanism does not exist there. Bank exit is the strongest disciplining device. Exit of weak banks from the system enhances competition. Detailed study of Latin American countries provides some general lessons regarding bank failure resolution framework (Annex 14). Thus, a policy lesson is to encourage market for merger and acquisition to minimize the risk of problem banks. But, again, a careful watch is needed not to encourage the practice of cartel and collusion whereby consumers are hurt.

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Chapter — 7

Conclusion

The aforementioned discussion has clearly shown that the level of financial development is low in Nepal. Within country statistics reveal that there are under-banked areas followed by the lower level of socio-economic development. And the cross-country comparison reveals that Nepal's level of financial development is low compared to the standards of similar other countries in the region. Though some indicators suggest that Nepal's financial depth is at par with other South Asian countries, the indicators revealing the level of competitiveness, efficiency and intermediation costs are weak for Nepal. Moreover, despite a number of financial intermediaries established over the years, the issue of financial inclusion whereby the banking services are accessed easily by the underprivileged sections of the society is not handled perfectly. In this situation, the challenge of the central bank is to maintain financial stability without hindering the competitive spirit of the market. In case the competition is repressed, the main beauty of the market system, incentive to innovate, will be suppressed.

Decisions about the optimum level of the financial intermediaries in a liberalized financial system is not decided by the central authority rather fixed by the market forces on their own. Also it is difficult to limit the market. Additionally, Nepalese banking industry has remained the profitable venture, thus nurturing the competition in the market. In such a situation, it is natural for entry aspirants to come and compete in the market that is in prosperity of the business cycle. However, it is also true that in the Nepalese context, emerging challenges are ahead in maintaining financial stability. But the efforts should be oriented towards developing financial infrastructure, devising competitive policies, strengthening regulation and supervision to enhance and enforce disclosure requirements, widening the access of the financial services, easing entry and exit mechanisms, and most importantly enhancing the transparency, information disclosure, corporate governance and better infrastructures. In case the regulations are designed to protect the incumbents, it will lead towards financial repression, which ultimately retards the growth not only of the financial system but also of the economy as a whole. Empirical evidences, as mentioned in the theoretical underpinning part earlier, also raise a cautionary flag regarding the regulatory strategies that place excessive reliance on restriction of banks. Theories and empirical evidences both are much more consistent with the grabbing-hand view than the helping-hand view of regulation. And suggest that regulatory and supervisory practices that (1) force accurate information disclosure, (2) empower private-sector corporate control of banks, and (3) foster incentives for private agents to exert corporate control work best to promote bank performance and stability. Thus, a policy lesson is that instead of restricting the bank entry, Nepal should move ahead on the trajectory of regulatory reform.

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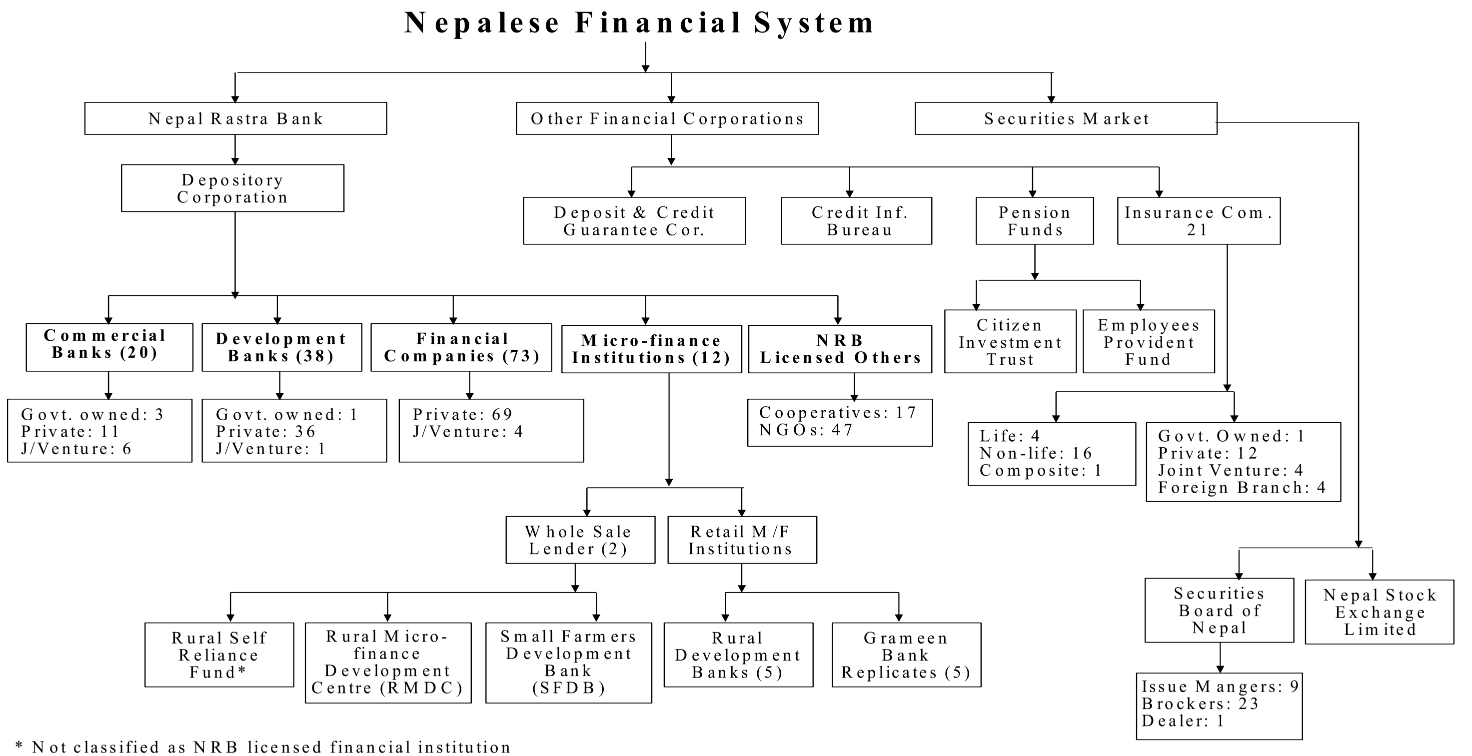
Annex 1

July 2007



* Not classified as NRB licensed financial institution

Prepared by: Financial Institutions Division, Research Department

Annex 2: Structure of the Nepalese Financial System

(Rs. in million)

	mid-July 2005			mid-July 2006		
	Total assets/liabilities	Percentage share in total	Ratio of total assets to nominal GDP (in percentage)	Total assets/liabilities	Percentage share in total	Ratio of total assets to nominal GDP (in percentage)
Financial institutions	**580498**	**89.3**	**108.8**	**615761.4**	**88.4**	**105.6**
Nepal Rastra Bank	142824	**22.0**	**26.8**	167606.8	**24.1**	**28.8**
Commercial Banks	340633	**52.4**	**63.8**	**387678.3**	**55.7**	**66.5**
Finance Companies	30515	**4.7**	**5.7**	***38841.0***	**5.6**	**6.7**
Development Banks*	57815	**8.9**	**10.8**	10611.0	**1.5**	**1.8**
Cooperatives	2411	**0.4**	**0.5**	***2834.0***	**0.4**	**0.5**
Micro-credit Financial Institutions	6300.0	**1.0**	**1.2**	8190.4	**1.2**	**1.4**
Contractual Savings institutions	**69210**	**10.7**	**13.0**	**80533.0**	**11.6**	**13.8**
Employees Provident Fund	45130	**6.9**	**8.5**	51060.0	**7.3**	**8.8**
Citizen Investment Trust	5830	**0.9**	**1.1**	6750.0	**1.0**	**1.2**
Insurance Companies	18250	**2.8**	**3.4**	22688.0	**3.3**	**3.9**
Total	**649708**	**100.0**	**121.8**	**696294.4**	**100.0**	**119.4**
Nominal GDP	**533538**			**582948**		
Ratio of Stock Market Capitalizitation to GDP (in percentage)	11.6			16.6		

* Excluding Agriculture Development Bank and Nepal Industrial Development Corporation in 2006.

Annex 3: Indicators Relating to the Nepalese Financial System

As at mid-July 2006 unless otherwise stated (Rs. in million)

	Commercial Banks	Develop Banks	Finance co.	Micro-fin Banks	NRB Licensed Cooperatives	NRB Licensed NGOs	Insurance Co	EPF	CIT	Total
Capital fund	-17742.1	4782	4314.8	830.4	324.8	0	19872.5		85.81	12468.21
of which Paid up capital	10571.7	3135.8	3356.7	570.9	228.4		1680		39.99	19583.49
Borrowings	9519.6	5226.2	1154.8	932.5	70.7	541.8	NA		0	17445.6
Deposits	291245.6	35902.6	24332.5	5324.9	2011	0	NA	48177	6376	413369.3
Others	134410.4	14289.4	8481.96	989.9	408	292.6	2815.1	2880		164567.4
P&L A/C	11272.7	0	572.1	119.7	62.8	59.9	NA			12087.24
Total	**428706.2**	**60200.2**	38856.2	8197.4	*2877.3*	**894.3**	**22687.6**	**51057**	**6847.2**	**620323.1**
Liquid funds	38842.1	5240.9	5386.7	1328.1	493.1	131.9	2125	0	0	53547.8
Total Investments	82173.8	2119.1	963.2	1672.6	161.5	50	16704	23550	5189.5	132583.7
Loans and advances	173383.4	31224.2	27078.9	4303	1665.4	439.8	NA	26393	628.55	265116.1
Others	121623.7	20440.7	5348.9	672.7	557.3	272.6	3858.6	1113.9	1029.2	154917.6
P&L A/C	12683.2	1175.3	78.5	221	0	0	NA	0	0	14157.96
Some ratios:										
Capital fund/GDP	-3.04	0.82	0.74	0.14	0.06	0.00	3.41	0.00	0.01	2.14
Paid up capital/GDP	1.81	0.54	0.58	0.10	0.04	0.00	0.29	0.00	0.01	3.36
Deposits/GDP	49.96	6.16	4.17	0.91	0.34	0.00	0.00	8.26	1.09	70.91
Liquid funds/GDP	6.66	0.90	0.92	0.23	0.08	0.02	0.36	0.00	0.00	9.19
Total investments/GDP	14.10	0.36	0.17	0.29	0.03	0.01	2.87	4.04	0.89	22.74
Loans and advances/GDP	29.74	5.36	4.65	0.74	0.29	0.08	0.00	4.53	0.11	45.48
Total assets/GDP	73.54	10.33	6.67	1.41	0.49	0.15	3.89	8.76	1.17	106.41
Credit/deposit	59.53	86.97	111.29	80.81	82.81					64.14
Per capita asset	16945	2379	1536	324	114	35				24518.7
Per capita deposit	11512	1419	962	210	79	0				14182.47
Per capita credit	6853	1234	1070	170	66	17				9410.858
NPL/Total loan (%)	14.22	5.29	7.66							
Number of financial institutions*	19	35	72	11	20	47	21	1	1	204
Number of bank branches	437									
Population/branch and financial Ins.	57895	722857	351389	2300000	1265000	538298	1204762			

*** as on January, 2007**

Annex 4: Share of NRB Licensed Financial Institutions in Total Assets

(Rs. in million)

	Mid-July 2006		
	Total assets/liabilities	Percentage share in total	Ratio of total assets to nominal GDP (in percentage)
Financial institutions	**448154.7**	**100.0**	**76.9**
Commercial banks	387678.3	**86.5**	**66.5**
Finance companies	38841	**8.7**	**6.7**
Development Banks*	10611	**2.4**	**1.8**
Cooperatives	2834	**0.6**	**0.5**
Microcredit financial institutions	8190.4	**1.8**	**1.4**
Nominal GDP		**582948**	
Mkt cap to GDP (in percentage)	**16.6**		

* Excluding Agriculture Development Bank and Nepal Industrial Development Corporation.

Annex 5: Branch Expansion of Commercial Banks

NRB, from time to time, directed branch expansion policy to increase the outreach of the banking sector throughout the country. Initially, the directed branch expansion policy was pursued by compensating the operating cost for three years of establishment in rural sectors. Such policy was continued till 1991. Following table shows that bank branches were expanded largely during the period of directed branch expansion policy. Later, the policy was reviewed and efforts were concentrated to strengthen economic operation of the bank branches. Then, the policy was diverted to motivate commercial banks to expand branches to rural areas on their own rather than the direct intervention. Commercial banks were allowed to open one branch in urban area after opening two branches in semi-urban or rural areas. This policy helped the commercial banks to sustain their operation. And currently commercial banks and development banks are allowed to open one branch in Kathmandu Valley after opening 1 branch outside the Valley. As of mid-July 2006, there are 437 branches including 47 commercial banking branches of Agricultural Development Bank Limited.

Branch Expansion of Commercial Banks

S.N.	Particulars	**Total Branches**
1	Before establishment of NRB (2013 BS)	13
2	Before establishment of RBB in 2024 BS	33
3	Before directed branch expansion policy (2025 BS)	63
4	During 2025-2034 BS	216
5	During 2034-2047 BS	441
6	During 2047-2056 BS	481
7	As of Ashadh end 2063 BS (including 47 commercial bank branches of the ADB/N)	437

Source: Various issues of Banking and Financial Statistics (BFS), Quarterly Economic Bulletin(QEB).

Annex 6: Indicators of Financial Deepening in Nepal (in percentage)

Indicators	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
M2/GDP	36.9	37.2	37.0	42.0	44.7	49.0	52.3	53.0	53.8	55.8	56.3	59.6
Currency to Total deposits	36.8	35.1	33.5	30.1	27.5	27.2	26.6	30.2	28.0	27.1	27.4	26.8
Currency to M2	27.8	27.0	26.4	24.4	22.9	22.6	22.5	24.8	23.1	22.8	22.9	22.4
Currency to GDP	10.3	10.1	9.7	10.3	10.2	11.1	11.8	13.2	12.5	12.7	12.9	13.3
Pvt. Credit to M2	51.0	58.9	60.9	59.8	58.5	57.7	57.5	58.1	60.2	60.8	64.3	60.8
Credit to GDP	17.7	20.4	20.8	22.8	23.9	25.4	26.6	26.8	27.3	28.2	30.7	34.1
Money multiplier	2.5	2.6	2.5	2.7	2.9	3.1	3.0	2.8	3.0	2.9	3.1	3.1

Source: Nepal Rastra Bank. Banking and Financial Statistics No. 37 and No. 47.

---------------------. Quarterly Economic Bulletin, Vol. XXXXI and other issues.

Annex 7: Market Share of the Three Largest Banks (in percentage)

Year	Capital Fund	Deposits	Investments	Loan & Adv.	Pvt. Credit	Total Assets
1990	73.23	84.08	95.16	89.15	89.62	92.03
1991	93.87	82.63	85.70	84.30	84.82	85.36
1992	91.09	78.67	90.86	85.70	86.24	81.68
1993	80.07	77.76	90.91	80.92	80.32	81.08
1994	78.89	74.99	86.48	78.29	78.17	79.44
1995	72.53	70.34	89.13	72.41	72.37	74.44
1996	69.09	65.32	67.81	70.69	70.76	71.53
1997	60.02	62.64	51.70	69.50	69.27	69.63
1998	55.45	62.04	72.71	67.11	67.37	68.35
1999	52.86	60.99	74.33	65.35	66.21	65.24
2000	49.96	55.86	73.18	59.14	59.21	61.83
2001	43.17	50.32	67.81	51.70	51.87	58.02
2002	38.23	48.00	60.22	48.86	48.71	58.06
2003	34.92	45.52	58.11	43.05	42.97	55.88
2004	47.81	42.50	38.44	42.14	41.89	56.26
2005	62.81	40.83	50.77	37.16	36.69	53.67
2006	61.59	36.95	45.09	31.47	30.63	47.35

Source: BFS 47, and Bhetuwal: 2005.

Annex 8: Ownership Structure of Commercial Banks

Name	Type	1990		2000		2006	
		Assets (Rs.)	% share in total assets	Assets (Rs.)	% share in total assets	Assets (Rs.)	% share in total assets
Nepal Bank Limited	Public	12502.6	50.01	46120	23.72	54133	16.19
Rastriya Banijya Bank	Public	9188.7	36.76	65049	33.45	83481	24.97
Total Govt. owned		**21691.3**	**86.77**	**111169**	**57.17**	**137614**	**41.17**
Standard Chartered Bank Nepal	JV	1232.7	4.93	18356	9.44	26798	8.02
Himalayan Bank Limited	JV			16781	8.63	31065	9.29
Nepal SBI Bank Limited	JV			5191	2.67	13736	4.11
Nepal Bangladesh Bank Limited	JV			7465	3.84	16722	5.00
Everest Bank Limited	JV			3412	1.75	16715	5.00
NABIL	JV/Private	1314.0	5.26	15902	8.18	24135	7.22
Nepal Investment Bank Limited	JV/Private	759.8	3.04	4180	2.15		
Total joint ventures (JV)		**3306.5**	**13.23**	**71286**	**36.66**	**129169**	**38.64**
Nepal Investment Bank Limited	JV/Private					22007	6.58
Bank of Kathmandu	Private			4481	2.30	12661	3.79
Nepal Credit and Commercial Bank Limited	Private			3540	1.82	8641	2.59
Lumbini Bank Limited	Private			1325	0.68	6735	2.01
Nepal Industrial and Commercial Bank Limited	Private			2670	1.37	10383	3.11
Machhapuchhre Bank Limited	Private					9256	2.77
Kumari Bank Limited	Private					9391	2.81
Laxmi Bank Limited	Private					5509	1.65
Siddhartha Bank Limited	Private					4901	1.47
Total Private sector				**12015**	**6**	**67476**	**20.19**
Grand TOTAL		**24997.8**	**100**	**194470**	**100**	**334259**	**100**

JV: Joint Ventures

Annex 9: Growth Rate of Deposits, Loans and Advances and Net Profit of Commercial Banks (Excluding NBL & RBB)

	Deposits					Loans & Advances					Net Profit				
Banks/Year	**2002**	**2003**	**2004**	**2005**	**2006**	**2002**	**2003**	**2004**	**2005**	**2006**	**2002**	**2003**	**2004**	**2005**	**2006**
NABIL	-3.0	-12.6	4.9	3.5	32.6	-13.1	12.8	6.1	26.3	17.5	-6.7	53.2	52.6	28.6	19.9
NINVB	-1.9	89.8	47.8	21.8	32.8	11.7	119.1	22.5	41.2	26.3	1.2	104.6	34.5	69.0	45.0
SCBL	2.6	18.4	12.8	-8.6	19.2	-2.3	5.1	10.7	22.1	8.4	11.2	5.8	9.8	-3.4	23.1
HBL	5.6	12.9	8.4	9.1	6.5	5.4	14.5	18.1	1.2	17.1	-16.3	-9.7	239.6	4.4	-31.7
NSBIL	-15.8	17.1	10.9	19.5	25.5	10.0	3.7	16.5	19.2	21.8	227.0	19.4	174.5	-96.6	2769.6
NBBL	10.9	10.9	20.9	-4.9	7.3	11.9	3.3	20.7	-14.8	3.1	-66.9	8.7	149.4	-45.7	371.6
EBL	19.4	22.6	20.4	25.2	36.7	32.5	26.8	21.4	29.1	27.9	22.4	10.4	188.1	1.7	38.0
BOK	0.2	7.6	25.5	15.5	16.6	15.0	-0.4	23.2	1.0	22.0	-85.8	782.8	152.4	-23.7	109.3
NCC	-1.7	15.8	38.8	11.3	-0.2	0.4	13.1	33.5	33.7	-1.6	-2258.7	-120.6	41.8	-15.3	-68.3
LUMBL	26.2	11.9	27.6	6.7	18.8	28.1	14.6	22.3	18.6	13.0	165.6	-191.0	-100.0		
NICB	-11.5	-0.7	63.7	21.3	40.4	-9.6	8.2	46.1	30.7	40.6	-85.9	280.9	-87.3	3197.0	36.8
MPBL	42.1	78.8	54.9	102.8	41.3	36.6	119.2	70.1	98.5	19.4	174.7	-136.2	195.4	157.3	37.3
KBL	273.4	113.0	91.7	30.2	24.4	323.1	91.4	72.8	48.8	25.3	-144.8	861.5	479.2	29.3	74.7
LAXBL		514.4	143.5	79.8	46.7		525.5	125.6	54.3	58.2		-2221.4	-79.3	103.8	2.4
SDBL			229.7	90.7	59.1			149.3	68.1	46.8			-2900.0	17.3	134.4
Total	**3.3**	**16.0**	**22.6**	**12.3**	**22.5**	**7.3**	**20.0**	**24.5**	**21.1**	**19.9**	**-49.9**	**161.9**	**69.3**	**8.0**	**31.6**
Average	**15.3**					**18.6**					**44.2**				

Annex 10: Regional Distribution of Financial Institutions

As of January 2007

	Eastern	Central	Western	Mid-Western	Far-Western	Total
Commercial banks' branches**	91	207	86	31	22	437
Development banks	3	18	10	3	1	35
Finance companies	4	58	9	0	1	72
Micro-credit banks	1	6	2	1	1	11
NRB Licensed cooperatives	2	11	2	2	2	19
NRB Licensed NGOs	10	21	8	7	1	47
Total numbers	**111**	**321**	**117**	**44**	**28**	621
Population*	5286890	7988612	4571013	2707244	2183175	22736934
Population/Commercial banks' branches	58098	38592	53151	87330	99235	52030
Population/Development banks	1762297	443811.8	457101.3	902414.667	2183175	649627
Population/Finance companies	1321723	137735	507890		2183175	315791
Population/Micro-credit banks	5286890	1331435	2285507	2707244	2183175	2066994
Population/NRB Licensed cooperatives	2643445	726237	2285507	1353622	1091588	1196681
Population/NRB Licensed NGOs	528689	380410	571377	386749	2183175	483765
Population/Total numbers	**47630**	**24887**	**39068**	**61528**	**77971**	**36613**

* Population Census 2001.

** Including ADB's commercial banking branches.

Annex 11: Financial Deepening in Some Selected Countries

Indicators	Nepal		India		Pakistan		Sri Lanka		Thailand		Malaysia	
	1996	2005	1996	2005	1996	2005	1996	2005	1996	2005	1996	2005
Broad money to GDP	38.7	56.3	45.6	67.5	36.7	45.1	37.6	42.3	80.8	95.9	88.5	106
Money Multiplier	2.6	3.1	3.3	4.6	3	3.3	3.4	5	8.1	4.6	3.5	9.9
Currency to M2	30	20	20.8	16.6	24.9	22.4	14.7	11.6	8.2	9.5	8.4	5.8
Currency to GDP	10.3	12.9	9.5	11.2	9.2	10.1	5.5	4.9	6.6	9.1	7.5	6.1
Credit to Pvt Sector to GDP	22.3	36.9	23.9	41.2	17.1	26	29.9	31.5	102	75.5	95.7	116
Credit to Pvt. Sector to toal credit	62.2	70.3	51.9	67.5	45.4	65.3	77.2	70.8	101	82.3	88.8	97.1

Source: State Bank of Pakistan 2005, Financial Sector Assessment Report.

NRB Research Department and authors' calculation.

Annex 12: Determinants of Financial Structure

Legal Environment

1. *Legal origin*

Common Law countries are more likely to have market-based financial systems than countries with other legal origins. Underdeveloped financial systems are more likely to have French Civil Law legal systems than other legal origins.

2. Legal codes

Countries with legal codes that rigorously protect the rights of minority shareholders tend to have market-based financial systems. Countries with legal codes that stress the rights of creditors and shareholders are much less likely to have underdeveloped financial systems.

3. *Enforcement*

Poor contract enforcement goes hand-in-hand with underdeveloped financial systems; contract enforcement is not strongly linked with whether a country's financial system is bank-based or market-based.

4. *Corruption*

There is a strong positive link between corruption and financial underdevelopment.

Countries with lower levels of corruption tend to have more market-based financial systems.

Regulatory Environment

1. Accounting

Countries with strong accounting standards tend to have market-based financial systems and are unlikely to have underdeveloped financial systems.

2. *Bank regulations*

Countries with regulations that restrict the rights of banks to engage in securities market activities, real estate, and insurance are more likely to have underdeveloped financial systems.

3. *Deposit insurance*

Countries with explicit deposit insurance systems are less likely to have market based financial systems.

Taxes

There is not a strong link between financial structure and tax distortions favoring either dividends or capital gains relative to interest income.

Macroeconomy

High-inflation economies are much more likely to have underdeveloped financial systems, but inflation is not strongly linked with whether a country's financial system is bank-based or market-based.

Source: Demirguc-Kunt, Asli and Ross Levine. 1999. Bank-Based and Market-Based Financial Systems: Cross-Country Comparisons.
http://www.worldbank.org/html/dec/Publications/Workpapers/wps2000series/wps2143.

Annex 13: Some Recommendations from Professor Fredrick Mishkin

LESSONS: BANKING REGULATION

! Accounting and Disclosure Requirements

! Improve Legal and Judicial Systems

! Restrictions on Connected Lending

! Restrictions on Foreign-Denominated Debt

- Problems of Increased Financial Instability, Difficulty of Recovery from Crisis

! Market-Based Discipline

- Credit Ratings of Financial Institutions
- Subordinated Debt

! Entry of Foreign Banks

- Foreign Banks Better Diversified
- Encourages Adoption of Best Practice

! Financial Liberalization

- Put in Proper Supervisory Structure Before
- Restrict Bank Lending Boom
- Commit to Full Liberalization

LESSONS: BANKING SUPERVISION

! Prompt Corrective Action

! Focus on Risk Management

! Limit Too-Big-To-Fail

! Adequate Resources and Statutory Authority (Respect) for Bank Regulators/Supervisors

! Independence of Bank Supervisory Agency

! Accountability of Bank Supervisors

LESSONS: CRISIS RESOLUTION

! Faster Banks are Closed or Recapitalized, Lower is the Cost

- Forbearance is Disastrous

! Punish Equity and Large Creditors

Source: Frederic S. Mishkin. http://info.worldbank.org/etools/docs/library/83724/mishkin.pdf.

Annex 14: Latin American Experience on Bank Restructuring

- Tighten excess criteria to liquidity of last resort. In particular, overgenerous (that is automatic, unlimited, and uncollateralized) central bank overdraft facilities should be phased out.
- Reinforce corrective regimes. Prompt correction can in part take the form of increasingly tight enforcement measures and restrictions on bank activities, to be applied automatically as the shortfall in capital ratio relative to the required level grows larger.
- Avoid bank interventions that give rise to risks from co-administration. In other words, there should be the clear definition of the rights of shareholders. This is a problem with arrangements under which the supervisory assumes the administration (directly or indirectly) of an open bank that is still the property of the shareholders. Such arrangements implicitly invite shareholders to argue in lawsuits that the bank was ruined by the authorities.
- Introduce efficient resolution techniques for a closed bank.
- Restrict the use of premium-based deposit insurance funds to closed bank resolution.

Source: World Development Report 2002