FINANCIAL STABILITY REPORT

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Nepal Rastra Bank

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Governor

Foreword

Financial stability has been a key challenge to the central banks especially at the aftermath of global financial crisis; and they have also been mandated to ensure smooth functioning of the financial system in the country. This requires an understanding of the key macroeconomic trends, banking system dynamics, and sources of risk in the financial system. As the central bank of the country, Nepal Rastra Bank has been entrusted with the responsibility of promoting and maintaining financial stability in the country. In order to assess whether the financial market is performing efficiently and effectively, it is necessary to have a deep look at the trend of financial soundness indicators and adopt the warranted policy measures. Thus, preparing the financial stability report can be a way to better understanding of overall performance and resilience of the financial system, which would contribute ultimately to maintaining financial stability. In this context, it is our second attempt to present the Financial Stability Report to share information and ensure transparency in the functioning of the banking system.

The report outlines Nepal Rastra Bank's assessment of risks and threats that could jeopardize financial stability in Nepal and the capacity of the system to withstand potential shocks. It also reports the regulatory and supervisory developments, including the measures undertaken by the Bank to ensure financial stability. This Report is prepared by Financial Stability Unit and Financial Stability Working Committee under the guidance of the Financial Stability Oversight Committee (FSOC), which is chaired by senior Deputy Governor of this bank.

This assessment is based on the data of mid-January 2013 unless otherwise stated; and it is divided into five main chapters along with an executive summary. Chapter One presents global economic and financial development. Chapter Two deals with the domestic macroeconomic situation. Chapter Three covers the developments and status of financial institutions and their impact on financial stability. This further discusses the financial soundness indicators and stress testing scenarios of commercial banks. Chapter Four deals with the current trend and developments in financial markets. Finally, the Fifth Chapter discusses financial sector policies and infrastructure.

This publication has come out with the hard work of our staff and senior officials. In this context, I would like to thank the Financial Stability Oversight Committee (FSOC), Financial Stability Working Committee and Bank and Financial Institutions Regulation Department of this bank, particularly the Financial Stability Unit for bringing out this report.

I would like to offer my special thanks to the officials of Financial Stability Unit, notably Executive Director Mr. Bhaskar Mani Gnawali, Director Mr. Purna Bahadur Khatri and Deputy Director Mr. Ramu Paudel, in bringing out this report in this form. I would also like to thank Director Dr. Bhubanesh Pant and Assistant Director Dr. Tap Prasad Koirala of Research Department for their valuable contribution to refine the report.

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

Dr. Yuba Raj Khatiwada

ACRONYMS

ABBS	Any Branch Banking System
AE	Advanced Economies
AMC	Asset Management Company
AML	Anti Money Laundering
AUD	Austrialian Dollar
BA	Bank Assets
BAFIA	Bank and Financial Institution Act
BE&BA	Bank Equities and Bank Assets
BFIs	Banks and Financial Institutions
BIS	Bank for International Settlement
CAR	Capital Adequacy Ratio
CBs	Commercial Banks
CD Ratio	Credit to Deposit Ratio
CFT	Combating Financing of Terrorism
CIC	Credit Information Centre
CIT	Citizen Investment Trust
DA	Developing Asia
DBs	Development Banks
DCGC	Deposit and Credit Guarantee Corporation
DOC	Department of Cooperative
EA	Euro Area
ECB	European Central Bank
EMDE	Emerging and Developing Economies
EPF	Employee Provident Fund
F.Deposits	Fixed Deposits
FCs	Finance Companies
FINGO	Financial Intermediary Non Governmental Organization
FIU	Financial Intelligence Unit
FSI`	Financial Soundness Indicator
FSR	Financial Stability Report
FSU	Financial Stability Unit
FTSE	A subsidiary of London Stock Exchange Group
GBP	Great Britain Pound
GDP	Gross Domestic Product
GFSR	Global Financial Stability Review
GON	Government
I_AD	Import in Advance Economies

I_EMDE	Import in Emerging and Developing Economies
ICT	Information Communication and Technology
ILMF	Institution-wise Liquidity Monitoring Framework
IMF	International Monetary Fund
INR	Indian Rupees
IT	Information Technology
JPY	Japanese Yen
LTV Ratio	Loan to Value Ratio
MFFIs	Micro Finance Financial Institutions
MFIs	Micro Financial Institutions
MP-Plus	Monetary Policy plus
MSCI	Morgan Stanley Capital International
NBL	Nepal Bank Limited
NCHL	Nepal Clearing House Limited
NEPSE	Nepal Stock Exchange
NGOs	Non-Governmental Organiztions
NIAE	Newly Industrialized Asian Economies
NLSS	Nepal Living Standard Survey
NPL	Non Performing Loan
NRB	Nepal Rastra Bank
PCA	Prompt Corrective Action
ROA	Return on Assets
ROE	Return on Equity
RSRF	Rural Self Refinancing Fund
RTGS	Real Time Gross Settlement
SA	South Asia
SACCOs	Saving and Credit Cooperatives
SLR	Statutory Liquidity Ratio
SOL	Single Obligor Limit
STR	Secured Transaction Registry
STRs	Suspicious Transaction Reports
T-Bills	Treasury Bills
USD	United States Dollar
WB	World Bank
WEO	World Economic Outlook
X_AD	Export in Advance Economies
X_EMDE	Export in Emerging and Developing Economies

Executive Summary

Global Economic Development

1. The *World Economic Outlook*, April 2013 of the International Monetary Fund (IMF) states that global prospects have improved recently and seen to have stabilized, but that recovery in advanced countries would remain uneven. Euro Area countries lag behind the global upturn. Economic activity in emerging and developing economies has picked-up, with continued support from policy measures renewing confidence. The *Global Financial Stability Report*, April 2013 vouched for improved financial stability with reduced tail risks in the monetary and financial space. This has caused risk appetite to increase and asset prices to rally. The report sounds of a warning signal by stating that if medium-term challenges are not addressed the rally in financial markets could turn unsustainable with resurgence in risks morphing into a chronic financial crisis phase. Strong positive political decisions in advanced countries have driven equity markets up. The IMF's assessment in the *World Economic Outlook (WEO)*, April 2013 assessment noted a three-speed recovery in the world economies. A two-speed strong recovery has been observed both in emerging market and developing economies. But in advanced economies, there appears to be a growing divergence between the U.S on one hand and the Euro Area on the other.

2. World economic growth is now pegged at 3.3 percent in 2013, moving up to 4.0 percent in 2014.While two major impending threats (disintegration of Euro-zone and sharp fiscal contraction in the US) have been averted with timely policy intervention, new threats to smooth global recovery continue to emerge; these would include – short-term risks - uncertainty from fallout of Cyprus and political developments in other countries. Likewise, *gro*wth in emerging and developing economies is estimated to expand by 5.3 percent in 2013 and 5.7 percent in 2014. Similarly, activities in developing Asia improved modestly in response to the pace of global recovery. The real GDP growth for this region has been estimated to be 7.1 percent in 2013 and 7.3 percent in 2014, higher from 6.6 percent in 2012 but lower than in earlier two years. For Asia as a whole, growth is estimated to pick up modestly to about 5.7 percent in 2013, largely as a result of recovering external demand and continued solid domestic demand. Growth in India by the IMF has pegged at 5.7 percent in 2013 and 6.2 percent in 2014, and this would be backed by

implementation of pro-growth measures and improvement in external demand conditions.

3. Despite some positive signs of improvement in world's major countries, the unemployment and inflation rates have been remaining high over the years and continued in 2012. The unemployment rate in advanced economies also remained high in 2012 and is estimated to stand above 8.0 percent in 2013 and 2014. With the pace of growth of the world economy slowing, global inflationary pressures have lessened. Global inflation has fallen to about 3.9 percent in 2012 from 4.9 percent in 2011, and it is projected to stay around this level through 2014

4. The *Global Financial Stability Report (GFSR*, April 2013) has stated that risks to financial stability have declined, providing support to the economy and prompting a rally in risk assets. These favorable conditions reflect a combination of deeper policy commitments, renewed monetary stimulus, and continued liquidity support. Global financial and market conditions have improved appreciably in the past six months. However, as global economic conditions remain subdued, the improvement in financial conditions can only be sustained through further policy actions that address underlying stability risks and promote continued economic recovery. The *GFSR* says that continued improvement will require further balance sheet repair in the financial sector and a smooth unwinding of public and private debt overhangs. In the EA, acute near-term stability risks have been reduced significantly. As per *GFSR*, banks in advanced economies have taken significant steps to restructure their balance sheets, but progress has been very slow and uneven in some European banks. Unconventional monetary policy in advanced economies has been providing essential support to aggregate demand. The global pace of reform process also reflects difficulties due to concerns about banks facing more structural challenges. While much has been done to improve financial sector regulations, the reform process remains incomplete.

5. Global financial market developments of 2012 attributes the important role of financial markets in a modern economy and also the significant responsibility that rests on the market operators, regulators and participants collectively in those markets to promote an efficient and fair market place. The global size of market expanded in 2012 and the world's total stock market capitalization reached to 67 percent of GDP. Progress in Europe, the end of China's growth slowdown and continued momentum in the US economy recovery has been expected to support global equities.

Domestic Economic Development

6. Nepal's real GDP at basic price is expected to grow by 3.6 percent in 2012/13 compared to the growth of 4.5 percent in 2011/12. The dismal performance of agriculture sector (growth of 1.3 percent in 2012/13) due to weaker monsoon and sluggish performance of the industrial sector arising from continued political uncertainty and energy shortage are some of the responsible factors for low growth of GDP in 2012/13. However, service sector witnessed a better performance with a growth of 6.0 percent in 2012/13 owing to improvement in the performance of some sub sectors viz. wholesale and retail trade, hotels and restaurants, transport, storage and communication and financial intermediaries.

7. The consumer price index (CPI) increased by 9.8 percent in mid-January 2013. Rate of growth of food price inflation has gradually declined whereas the growth of non-food price inflation has remained almost constant during the first six month of 2012/13. On a cash basis data, budget surplus surged to Rs. 40.44 billion during mid-January 2013 from Rs. 24.04 billion in the corresponding period of the previous year. On international trade, merchandise exports went up by 9.3 percent and imports increased by 25.2 percent during the first six months of 2012/13,. Nepalese currency appreciated by 1.7 percent during the first six months of 2012/13 against US dollar in contrast to a depreciation of 13.4 percent in the same period of the previous year. During the first six months of 2012/13, total reserve increased by 2.6 percent to Rs. 450.80 billion. Nepalese rupee appreciated against US dollar on an average by 2.3 percent in mid-January 2013 from the level in mid-September 2012

8. Monetary Policy for 2012/13 has been formulated with the objectives of maintaining price stability, external and financial sector stability, promoting financial access to the general public and facilitating high and sustainable economic growth. Considering improved liquidity situation and rapid growth of money supply, the Monetary Policy of 2012/13 revised the cash reserve ratio (CRR) to be maintained by BFIs at 6 percent for "A" class financial institutions, 5.5 percent for "B" class financial institutions and 5 percent for "C" class financial institutions from existing 5 percent applicable to all categories. Broad money supply (M2) increased by 4.8 percent during the first six months of 2012/13 along with 6.1 percent increase in domestic credit.

Financial Institutions

9. The financial system of Nepal comprises of bank and financial institutions (commercial banks, development banks, finance companies and micro finance institutions), co-operatives, contractual saving institutions (Employee Provident Fund and Citizen Investment Trust), insurance companies and postal saving banks. As of mid-January, 2013 the total number of financial institutions stood at 292 comprising 214 banks and financial institutions of A, B and C categories, 50 financial intermediaries permitted by NRB for limited banking activities, 25 insurance companies and one each of Employees Provident Fund, Citizen Investment Trust and Postal Saving Bank. Out of total numbers of banks and financial institutions, there were 32 licensed commercial banks (A Class institutions), 90 development banks (B Class institutions), 67 finance companies (C Class institutions), 25 micro finance financial institutions and 50 other financial institutions including NRB permitted cooperatives and NGOs as of mid-January 2013. Though a significant number of financial institutions performing their banking and non-banking business in Nepalese financial system, the financial services delivered by those banks and financial institutions have not yet been reached to the poor section of the people particularly in the geographically remote areas. Moreover, BFIs have found concentrating their service in the major cities as well as in the emerging areas for business activities.

10. The ratios of asset/liabilities of the banks and financial institutions with GDP show an upward trend over the periods in the Nepalese financial system. However, the performance of other financial intermediaries including the cooperatives for the last few years has raised some concern to the policymakers regarding their significant size of their activities but dismal contribution to the economy. The ratio of total assets/liabilities to GDP of the banking and non bank financial institution reached to 125.8 percent in mid-January 2013. The ratio of total assets/liabilities to GDP of the banks and financial institutions stood at 111.2 percent comprising the largest share of commercial banks (65.2 percent), followed by Nepal Rastra Bank (26.2 percent), Development Banks (10.2 percent), Finance Companies (6.7 percent), Micro Finance Financial Institutions (1.9 percent), Cooperatives (0.7 percent), and NGOs (0.4 percent). Similarly, the ratio for contractual savings institutions stood at 14.6 percent with the ratio for EPE at 7.9 percent CIT at 2.2 percent, Insurance companies at 4.4 percent and of Postal Saving Bank at 0.08 percent.

11. The commercial banks remained the key player in the financial system contributing 51.8 percent of the system's total assets followed by NRB (20.8 percent), Development Banks (8.6 percent), Employees Provident Fund (6.3 percent), Finance Companies (5.3 percent) and Citizens Investment Trust (1.8 percent) as of mid-January 2013. The contributions of Micro Finance Financial Institutions including cooperatives accounts for 2.4 percent, comprising 1.5 percent of micro finance financial institutions, 0.3 percent of micro credit non-government organizations and 0.6 percent of cooperatives.

12. Branch network of BFIs in the unbanked area has been remaining a key issue to support for financial access and inclusion in Nepal. Total number of bank branches as of mid-January 2013, of Class A financial institutions was 1460 (contributing about 60 percent of total number of bank branches) followed by 712 (28 percent) of Class B financial institutions and 297 (12 percent) of Class C financial institutions. Out of total bank branches, 26.8 percent were serving only in the Kathmandu valley (661), 31.2 percent in Hills and Mountain (771), and 42 percent in the Terai (1037). Therefore, the distribution of bank branches, particularly in the hills and mountain regions is uneven compared to Kathmandu Valley as more than 25 percent BFIs branches were concentrated in the Valley.

13. State-owned banks continued to dominate the banking system in Nepal during the review period. Two state-owned commercial banks (Nepal Bank Ltd. and Rastriya Banijya Bank Ltd.) and one development bank (Agriculture Development Bank Ltd.) constituted more than 30 percent of total banking sector's assets. These three large public commercial banks possessed a significant branch network as Nepal Bank Ltd. had 112 branches, Rastriya Banijya Bank Ltd. had 142 branches and Agriculture Development Bank Ltd. had 234 branches throughout the country.

14. The major financial instruments in Nepal are common stocks, debentures, t-bills, bank loan, etc. Common stock and debentures are traded in NEPSE and OTC markets. The NRB issues t-bills on behalf of the government to help liquidity needs of the financial institutions. The transaction of bond and equity instruments is traded through Nepal Stock Exchange Ltd. There was a boom in stock market in Nepal from 2006 to 2007; as a consequence, NEPSE index increased more than double to almost 1175 and market capitalization rose as high as 40 percent of GDP at the end of 2007 from merely 17 percent of GDP at the beginning of 2006. The market capitalization to GDP reverted back to its normal position of 30 percent at present as the share market index has been getting corrected since early 2008.

15. Commercial banks hold dominant share on the major balance sheet components of financial system in Nepal. As of mid-Jan 2013, commercial banks group occupied 78.9 percent of total assets/liabilities followed by Development banks (12.9 percent) and Finance Companies (8.1 percent). Of the components of total liabilities, deposit held at 79.8 percent followed by other liabilities at 9.6 percent, capital fund at 7.8 percent and borrowings at (1.6 percent). Likewise in the assets side, loan and advances accounted for the largest share of 61.0 percent followed by investment of 12.3 percent and liquid fund of 11.0 percent and remaining group of 15.0 percent. The banking system in Nepal has expanded by a wider range over the years on account of deepening indicators and access of financial services.

16. Considering the deepening indicators, the share of total deposit of the banking system to GDP reached 66.1 percent comprising 53 percent share of commercial banks, 8 percent of development banks and around 5 percent of finance companies in mid-January 2013. Likewise, as of mid-January 2013, the total credit to GDP ratio was less than 12 percent for banks and financial institutions (B and C class institutions) excluding commercial banks. Total credit to deposit ratio of Class B financial institution (84 percent) and class C financial institutions (88 percent) were higher than that of Class A financial institution (77.2 percent). BFIs are directed to provide deprived sector loan from their total loan outstanding as stipulated by the NRB. As of mid-January 2013, deprived sector loan out of total loan from all the banks and financial institutions accountd at 3.7 percent

17. The banking system of Nepal is characterized by low volume of turnover, high interest rate on lending, wide interest rate spread, inefficient management, lack of project financing practice, problem of inadequate working fund and unhealthy competition among banks. In order to overcome these problems, financial consolidation policy has been unveiled by the NRB in the recent past. Among the various alternative measures of financial sector consolidation, the NRB has opted for merger as an efficient measure of financial consolidation in the Nepalese financial system.

18. Financial soundness of the existing banks and financial institutions are gauged on the basis of different soundness indicators. The major soundness indicators prevalent in Nepalese financial system consist of capital adequacy, asset quality, profitability and liquidity. Total capital adequacy ratio of banking system stood at 12.3 percent in mid-January 2013. The negative capital adequacy ratios of NBL and RBB were the attributing factors for the drop in the overall capital adequacy

ratio of the commercial banks. The total NPL ratio of A, B and C class institutions declined substantially to 4.4 percent in mid-January 2013, from the level of 6.1 percent as of mid-July 2012. Finance companies recorded the maximum total NPL of 14.1 percent followed by development banks of 5.8 percent and commercial banks of 3.17 percent in mid-January 2013. Looking at the exposure of BFIs in term of sector wise, security wise and product wise credit, wholesalers and retailers sector is the highest receiver of loans and advances (20.72 percent) followed by the production sector (20.08 percent) as of mid-January 2013. With regard to product-wise loan and advances, demand and working capital loan found about around 23 percent followed by overdraft loan, term loan and real estate loan. The real estate loan accounted for 20 percent of the total loan of the BFIs. The profitability situation of BFIs is observed from the financial accounting point of view in Nepal as the focus of BFIs rests on reporting satisfactory financial picture only at the end of fiscal year. In mid-January 2013, total return on assets among A, B and C class institutions increased to 1.07 percent from that of 0.53 percent in mid-January 2012. At present, BFIs have been experiencing comfortable liquidity situation as against a severe liquidity crisis in 2010/11. The liquid asset to deposit and credit to deposit ratios stood at 30.09 percent and 78.87 percent respectively in mid-January 2013.

19. Stress testing as a forward looking risk management tool has been initiated by the NRB for the risk assessment of financial institutions applicable for the first time to "A" class financial institutions. The stress testing results of commercial banks as of mid-January 2013, revealed that a standard credit shock would push the capital adequacy ratio of 28 out of 32 commercial banks below the regulatory minimum benchmark of 10 percent. Though the liquid assets to deposit ratio of the Nepalese banking system shows an improving situation over the period, in terms of stress testing result two third of the commercial banks found to be turned into a vulnerable situation in case 10 percent or more deposit is asked for withdrawal. The CARs of all the commercial banks excluding two state owned banks are found above the regulatory requirement when calibrating through interest rate, exchange rate and equity price shocks.

20. Out of 90 development banks operated in the financial system in Nepal, 19 are national-level banks while remaining banks are regional and district-level development banks. During the review period, one finance company merged with a national-level development bank and two district-level development banks obtained

license and came into operation. Likewise, 25 new branches were opened up in the review period totaling 712 development bank branches operating in the system. In the review period, three development banks were penalized for not maintaining the minimum CRR ratio of 5.5 percent and two were penalized for shortfall in deprived sector lending. As stated in the Monetary Policy for 2012/13, the task of daily liquidity monitoring of all the development banks and stress testing of those banks mobilizing deposits exceeding two million rupees have also been initiated in Development Bank Supervision Department (DBSD) at NRB. By the end of mid-January 2013, diagnostic review of two developments banks has been completed. Three development banks were declared problematic, out of which, one is under the last stage of liquidation process, one is in the correspondence process to the district court for liquidation and one is under the management takeover process by the NRB.

21. The capital fund of development banks stood at Rs. 24. 40 billion in mid January, 2013. The capital adequacy ratio was 17.99 percent in the review period. Total assets of development banks increased by 8.95 percent to Rs. 186 billion in mid-January 2013. While loan and advances increased by 14.54 percent to Rs. 115 billion in the review period. The share of loans and advances to total assets was 61.90 percent in mid-January 2013. Net profit of development banks increased by 10 percent (y-o-y) and recorded Rs. 903.65 million in mid-January, 2013. Liquid assets of development banks declined by 6.65 percent in the review period. Deposits were the major source of fund for the development banks sharing 73.55 percent of total liabilities in mid-January 2013. About 70 percent of lending of development bank has been concentrated on five economic sectors comprising wholesaler and retailer (20.83 percent), others (18.43 percent), construction (11.64 percent), finance, insurance and real estate (9.40 percent) and transport, communication and public utilities (8.96 per cent).

22. The number of finance companies decreased to 65 in mid-March 2013 from. The reasons for such decrease over the recent past was that some of them merged with commercial banks, development banks and other finance companies. Separate resolution desk has also been established in order to monitor the progress of problematic finance companies and to expedite the task of deposit repayment of the public depositors. Out of the four finance companies selected for diagnostic review during that fiscal year, the reviewing task was completed for two finance companies during the review period. Until the end of June 2013, seven finance

companies were declared as problematic. The major problem appeared in those companies was the practice of insider lending to the member of the board of directors and top management.

23. As of mid-January 2013, altogether there were 24 MFFIs operating under "D" class financial institutions. Out of total number of MFFIs, there were five Grameen Bikas Banks-GBB (considered as rural development banks), 16 private sector micro finance financial institutions replicating the Grameen Banking practices and three wholesale lending micro finance financial institutions. The number of branches of MFFIs reached 577 providing 3245 employment opportunities as of mid-January 2013. During the review period, the capital fund of MFFIs increased by 15.8 percent to Rs. 3.30 billion. The GBBs have capital fund amounting to Rs. 142.7 as of mid-January 2013, forming 4.3 percent of total capital of the MFFIs. Four MFFIs registered negative retained earnings with one had negative capital fund as of mid-January 2013.

24. Total assets/liabilities of Micro Finance Financial Institutions (MFFIs) in the review period grew by 19.5 percent to Rs. 31.74 billion. The share of assets/liabilities for the GBBs was 17.1 percent as of mid-Janyar 2013. Total deposit mobilization of these institutions rose by 35.2 percent to Rs. 5.97 billion in the review period. The GBBs mobilized deposit of Rs. 970.9 million forming 16.3 percent of total deposit of MFFIs. The total amount of overdue loan and interest of these banks rose significantly by 63.5 percent to Rs. 1.08 billion compared to the same period last year. Regarding the asset quality, the overall ratio of performing loan of these institutions remained 97.4 percent during the review period compared to 97.6 percent a year ago.

25. As of mid-January 2013, the number of cooperatives licensed for doing limited-banking activities remained 16. The total assets/liabilities of cooperatives institutions increased by 40.7 percent to Rs.12.47 billion during the review period. Total capital fund of these institutions increased by 37.5 percent to Rs. 1.39 billion during the period. Likewise, their loans and advances increased by 36.3 percent to Rs. 7.91 billion. Out of their total loan disbursement, commercial loan occupied 16 percent with 5 percent as agriculture loan and 75 percent as unspecified 'other loans'.

26. As of January 2013, there were altogether 33 financial NGOs operating with 385 branches throughout the country. Total members in those organizations reached to

5,41,408 in mid- January 2013 from the level of 3,42,092 members last year. The lending of these organization increased by 55.0 percent to Rs. 5.81 billion and total deposit by 72.9 percent to Rs. 2.96 billion during the review period.

27. The Rural Self-Reliance Fund (RSRF) has been established with the objective to work on gradual poverty reduction by providing wholesale credit to those cooperatives and the NGOs that involve in lending needs of poor section of the people at subsidized rate of interest. The seed capital of this fund amounts to Rs. 443.4 million of which the government of Nepal's contribution figured at Rs.190 million with remaining amount contributed by the NRB. The loan limit per borrower has been set at Rs. 60,000 for the loans disbursed through the cooperatives/NGOs. As of mid-January 2013, total loan of Rs. 1062.80 million was disbursed to 720 institutions operating in 62 districts having benefitted around 37 thousands households. The recovery rate improved to 93.5 percent in mid-January 2013 from 90.6 percent a year ago.

28. As of mid-January 2013, there were altogether 26,704 cooperatives operating in Nepal out of which 11,901 were in the category of Saving and Credit Cooperative (SACCOs). The total deposits of all the cooperatives, as of mid-January 2013, stood at Rs. 143.23 billion, of which SACCOs' share was 80.5 percent. Similarly, total loan and advances of the cooperatives amounted to Rs.124.6 billion comprising 86.9 percent share of SACCOs as of mid-January 2013. Saving and Credit Cooperatives (SACCOs) in principal are supposed to operate in specific community or geographical region for the mutual benefits of their members or collect saving from or lend to the members only. However, they are heavily concentrated in the urban areas, particularly, in Kathmandu Valley doing similar activities as banks. The development of cooperatives as a whole and, particularly, the SACCOs has not contributed expected outcomes. Some of the credit and savings cooperatives have command over a wide range of depositors and credit-users in different communities as their turnover is supposed to exceed that of C class financial institutions. A study conducted last year by Department of Cooperatives (DOC) revealed that many cooperatives are still run as family business, with family members working as directors and audit committee member. The cooperatives are found transferring fixed assets like land, buildings and shares as collaterals in the name of board members or other companies they have promoted. The DOC has already issued a regulation relating to capping realty sector lending to 25 percent, but most of SACCOs might have higher investment in

the sector. Therefore, their role has created potential threat in the country's financial sector stability.

29. As of mid-January 2013, there were altogether 25 insurance companies established under Insurance Act, 1992, among them eight offer life insurance services, 16 perform non-life insurance services and one company renders both life as well as non-life insurance services. According to Insurance Board of Nepal, only 6 percent of Nepalese are insured and around 1.6 million people are involved in various insurance activities.. The insurance policies for both life and non-life insurance are progressively increasing over the period. Similarly, the premium collection and its contribution to GDP are also showing increasing trend. The total assets/liabilities of these companies increased by 9.8 percent to Rs. 81.1 billion in mid-March 2013, of which life insurance and non-life insurance account for Rs. 64.8 billion and 16.3 billion respectively. Total premium collection of the insurance companies has been gradually increasing over the years contributing about 60 percent of total premium collection through life insurance. The total investment reached to Rs. 55.9 billion comprising Rs. 45.9 billion from life and Rs. 9.9 billion from non-life insurance. Insurance companies in Nepal are criticized having not complying with the prudent rules and regulations as issued and directed by Insurance Board of Nepal.

30. The increasing trend of sources and uses of Employees Provident Fund (EPF) has turned stagnant since 2010. Total assets/liabilities of the EPF increased by 7.9 percent to Rs. 135.74 billion in mid-January 2013 from the level of Rs. 125.7 billion as of mid-July 2012. The fund collected by the EPF remained at Rs.130.9 billion (an increase of 7.8 percent) in mid-January 2013 from the level of Rs.121.4 billion as at mid-July 2012. The investment of EPF has not been so encouraging as it is less than 5 percent since 2010 with negative growth of 2.6 percent in 2012 but turned to positive growth at 5.6 percent in mid-January 2013. The EPF extended more than 86 percent of its total loan and advances to EPF contributors (including the EPF employees) while the remaining loan extended in different institutions as of mid January 2013. Similarly, it has been investing more than 60 percent of its total investment in the fixed deposit of different banks and financial institutions, less than 35 percent in government securities and the remaining in shares investment. EPF has invested more than 26.0 billion in long term national importance projects, including hydropower as of mid-March 2013. It has also been providing loan to the other public enterprises including Nepal Oil Corporation (Rs. 8.0 billion) for the smooth supply of petroleum products in the economy.

31. The Citizen Investment Trust (CIT) is involved in mobilizing the private and institutional savings, extending loans and advances in different activities and working as an issue manager of securities in Nepal. Total assets/liabilities of the CIT increased by 33.81 percent to Rs. 38.03 billion in mid-January 2013 from Rs. 28.51 billion as of mid-January 2012. Total investment increased by 14.3 percent to Rs. 23.5 billion in mid-January from Rs. 20.4 billion as at mid-January 2012. Similarly, loan and advances increased by 84.2 percent to Rs. 11.3 billion in mid-January 2013 from 6.2 billion of mid-January 2012. The fund collection, the major component in the liabilities side, increased by 14.7 percent to Rs. 35.9 billion in mid-January 2013. On the assets side, loan/advances reached Rs. 11.3 billion in mid-January 2013 from Rs. 9.6 billion as of mid-July 2012.

32. With the objective to encouraging saving habits of the people and use the saved money in the national development process, Postal Savings Banks (PSBs) are involved in limited banking activities in Nepalese financial system. Out of total 117 postal saving offices permitted for banking activities by the mid-January 2013, 68 offices are found mobilizing deposits. Total deposit collected by these offices reached Rs. 1.38 billion in mid-January 2013 from the level of Rs. 1.29 billion in mid-July 2012. The share of assets/liabilities stood at 0.08 percent in mid-January 2013. The number of accounts in PSBs reached 58,558 in mid-January 2013 from 54,796 in mid-July 2012.

33. The financial structure of Nepal has been characterized by dualistic nature, that is, formal (organized) financial structure exists side by side with informal (unorganized) financial structures. Such dualistic phenomenon has been prevailing in Nepalese financial system since a long time. The impact of the informal sector on macroeconomic policies has not been clearly quantifiable to the policy makers due to the unavailability of information, so that the informal sector is considered as a 'black box' in Nepalese economy. A study conducted by NRB revealed that the informal credit market is charging relatively high interest rates on loans provided to poor individuals. The NLSS report (2010/11) shows that only 20 percent of lending in Nepal is obtained from formal financial institutions. Extensive rural credit programs were initiated by the NRB over the last decade to weaken the informal lenders that anticipated monopoly power in the rural credit markets.

Financial Institutions

9. The financial system of Nepal comprises of bank and financial institutions (commercial banks, development banks, finance companies and micro finance institutions), co-operatives, contractual saving institutions (Employee Provident Fund and Citizen Investment Trust), insurance companies and postal saving banks. As of mid-January, 2013 the total number of financial institutions stood at 292 comprising 214 banks and financial institutions of A, B and C categories, 50 financial intermediaries permitted by NRB for limited banking activities, 25 insurance companies and one each of Employees Provident Fund, Citizen Investment Trust and Postal Saving Bank. Out of total numbers of banks and financial institutions, there were 32 licensed commercial banks (A Class institutions), 90 development banks (B Class institutions), 67 finance companies (C Class institutions), 25 micro finance financial institutions and 50 other financial institutions including NRB permitted cooperatives and NGOs as of mid-January 2013. Though a significant number of financial institutions performing their banking and non-banking business in Nepalese financial system, the financial services delivered by those banks and financial institutions have not yet been reached to the poor section of the people particularly in the geographically remote areas. Moreover, BFIs have found concentrating their service in the major cities as well as in the emerging areas for business activities.

10. The ratios of asset/liabilities of the banks and financial institutions with GDP show an upward trend over the periods in the Nepalese financial system. However, the performance of other financial intermediaries including the cooperatives for the last few years has raised some concern to the policymakers regarding their significant size of their activities but dismal contribution to the economy. The ratio of total assets/liabilities to GDP of the banking and non bank financial institution reached to 125.8 percent in mid-January 2013. The ratio of total assets/liabilities to GDP of the banks and financial institutions stood at 111.2 percent comprising the largest share of commercial banks (65.2 percent), followed by Nepal Rastra Bank (26.2 percent), Development Banks (10.2 percent), Finance Companies (6.7 percent), Micro Finance Financial Institutions (1.9 percent), Cooperatives (0.7 percent), and NGOs (0.4 percent). Similarly, the ratio for contractual savings institutions stood at 14.6 percent with the ratio for EPE at 7.9 percent CIT at 2.2 percent, Insurance companies at 4.4 percent and of Postal Saving Bank at 0.08 percent.

cargo and courier and 67 others as of mid-January 2013. The NRB is responsible for maintaining an orderly foreign exchange market through monitoring of foreign currency transaction, issuance of prudential regulations and intervention of domestic foreign exchange market. Nepalese foreign exchange market is characterized with dual exchange rate system, that is, fixed exchange rate system with Indian currency and convertible exchange rate with other foreign currency through open market exchange practice. The commercial banks in Nepal are free to fix the exchange rate of convertible currencies.

38. The gross foreign exchange reserves of the banking system increased marginally by 2.6 percent to Rs. 450.79 billion in mid-January 2013 from a level of Rs. 439.45 billion as at mid-July 2012. As the exchange rate regime with Indian currency is fixed, the exchange rate of Nepalese currency to foreign currency fluctuates as Indian Rupee fluctuate with US dollar. The share of NRB in gross reserves slipped 81.5 percent in mid-January 2013 from a peak of 85.5 percent of mid-July 2012. Growth in the volume of forex holdings for transaction and investment by the BFIs is one of the important factors contributing to a fall in NRB's share in gross reserves during the review period. The increasing demand for INR particularly for import coupled with a large exchange fluctuation loss resulting from a sharp appreciation of Nepalese rupee against US dollar resulted in a fall in reserve.

39. The Nepalese currency appreciated by 1.7 percent to Rs 87.10 per US dollar as at mid-January 2013 from a level of Rs. 88.60 per US dollar as at mid-July 2012. During the review period, NRB purchased US dollar 1.20 billion from banks and financial institutions (BFIs) through forex market intervention compared to purchase of US dollar 1.62 billion in the corresponding period of the last year. The volume of INR purchase grew by 10.33 percent to IRs. 76.28 billion through the sell of US dollar 1.40 billion during the review period. Around IRs.70 billion had been purchased in the corresponding period last year. The widening trade deficit with India emanating from a surge in imports of petroleum products and the additional investment in Indian treasury bills are the factors attributing to such a higher INR purchase over the recent past.

Financial Sector Policies and Infrastructures

40. Sound regulatory policies and robust arrangement for regulating financial system are the fundamental prerequisites for securing financial stability. The NRB is entrusted with the responsibility of regulating, inspecting, supervising and

monitoring banks and financial institutions. It issues various policies, directives, guidelines and circulars for regulation and supervision of the BFIs. NRB's policies, directives and circulars encompass regulations relating to licensing, capital, asset quality, liquidity, corporate governance, risk management, foreign exchange management, access to finance and financial inclusions, among others. The objectives of these regulations are to strengthen the health and soundness of the banks and financial institutions and to enhance public confidence so as to contribute in maintaining stability in the financial system.

41. The NRB revises its existing licensing policy in line with market dynamics, geographical topology and implementation of Basel III both in domestic banking system and in the international financial market. Capital Adequacy Framework, 2007 was issued for the first time in 2007 and been updated in 2012. The new capital adequacy framework, also known as Basel II, includes three pillar approaches: minimum capital requirements, supervisory review and disclosure. The NRB expects banks to operate above the minimum regulatory capital ratios.

42. In order to develop sound, efficient and robust financial institutions with strong capital base, financial consolidation policy has been adopted in the Nepalese financial system. In view of this, the NRB has issued Merger Bylaws, 2011 to implement financial consolidation. A separate desk has been established in Bank and Financial Institution Regulation Department to facilitate the merger process. After NRB's encouraging merger policy been effective, a number of BFIs have shown interest for their financial consolidation**.**

43. The purpose of macroprudential policy is to reduce systemic risk. The latter risk as the risk of development threatens the stability of the financial system as a whole and consequently the on the overall economy. As macroprudential regulation corresponds to financial regulation, its aim is to mitigate the risk (systematic risk) of the financial system as a whole. The macroprudential elements of Basel III consist of the definition of capital, better risk coverage, leverage ratio, and international liquidity framework, etc. As the NRB has the responsibility to ensure financial stability in the country, encouraging banks for self-regulation and making them sensitive toward risks are some keys to macroprudential policy. The main elements of macro-prudential regulation of the NRB consists of capital requirements, risk management guidelines to banks, stress testing guidelines, liquidity monitoring and policies forreal estate market and deposit insurance. Similarly, C-D Ratio, LTV Ratio, Margin Lending, Residential Loan, Single

Borrower Limit and Liquidity Ratio are other macroprudential instruments so far adopted by the NRB since few years ago to stabalize the credit boom.

44. Likewise, the NRB has already formulated and enforced some of the macroprudential regulations relating to strengthening the capital of BFIs, expanding access of general people to financial services, implementing risk based supervision, making necessary arrangement for system audit, establishing coordination among the various regulators of financial sector, enhancing corporate governance in BFIs, and updating the banking rules and regulations in a timely manner, among others. The macroprudential regulations focusing on maintaining difference between bankers and entrepreneurs/ businessmen, strengthening financial intelligence, enhancing financial discipline, formulating financial literacy policy and making necessary arrangement regarding multiple banking practices are some of the important areas underway in the NRB for maintaining the financial stability in Nepal in the future.

45. Policy provision has been introduced allowing BFIs to provide banking services in unbanked areas and rural areas through e-banking and mobile devices to promote financial services, including the access. Likewise, timely revisions are being made in the directives issued to bank and financial institutions bearing microfinance activities so as to strengthen and promote stability of these financial institutions.

46. The NRB has made it mandatory for all commercial banks to make public the base rate at least on a monthly basis. Under this provision, BFIs will have to determine lending rates on the basis of the base rate, a system that makes interest rate on credit transparent and ultimately narrows down the spread. The base rate came into effect from mid-January 2013. It is expected that the base rate system will ensure transparency in the interest rate determination and would ultimately support financial stability.

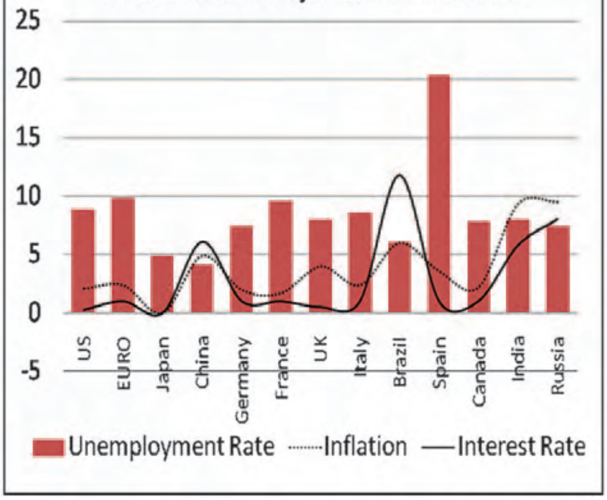
CHAPTER ONE

GLOBAL ECONOMIC DEVELOPMENT AND OUTLOOK

Global Economic Development and Outlook

1.1 Global economic activity is picking up, but the continuing crisis and unemployment in the Euro Area (EA) is delaying a meaningful recovery. The IMF's *World Economic Outlook (WEO),* April 2013 assessment mentioned about three-speed recovery in the world economies[1]. Weak growth and low confidence are expected to complicate efforts to bring down high unemployment rates across much of Europe. The employment is expected to continue to deteriorate in many countries, making it all the more urgent to implement the labour and product market reforms to stimulate growth and create jobs for speeding up the global recovery. Despite some positive signs of improvement in the world's major

Figure 1.1 Unemployment, Inflation and Interest Rate in Major Countries in 2012

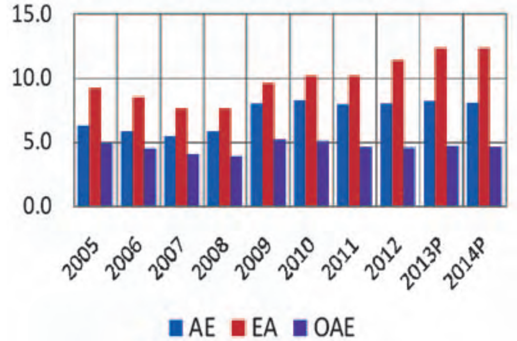


[1] A three-speed global recovery is defined as: 'those countries that are doing well (mainly the emerging markets and developing countries), those that are on the mend (including the United States, Sweden, and Switzerland), and those that still have some distance to travel (such as the Euro Area and Japan)'. The *WEO* has recommended rebuilding policy space and strengthening financial regulation and supervision for emerging markets, investment to meet infrastructure and social needs of low-income countries under first speed group; less but better quality fiscal adjustment at present and much more in future to second speed group, particularly for the United States, Sweden, and Switzerland etc. fixing frayed banking systems and press ahead with banking union in Euro Area and a more ambitious plan to bring down debt, plus structural reforms to shift the economy into higher gear in Japan to third speed group.

economies, the unemployment and inflation rates have been remaining high over the years and continued in 2012.

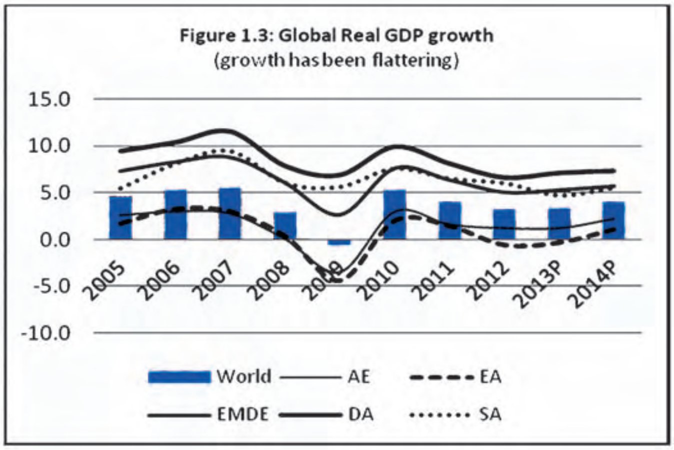
1.2 The unemployment rate further increased in 2012 and is projected to be 12.3 percent in 2013. Advanced economie's unemployment rate had remained high in 2012 and is estimated to stand above 8.0 percent in 2013 and 2014. The *WEO* noted that a possible positive scenario could arise if decisive policy actions are taken to improve business and consumer confidence, and to boost growth and jobs worldwide. Unemployment is set to remain high or even rise further in many countries unless structural measures are used to boost near-term employment growth.

Figure 1.2 Global Unemployment
(Unemployment in Euro Area and Advanced Economies remained stubbornly high)



1.3 Global monetary stimulus is an effective measure to fight against crisis but these needs to be vary across countries. In the United States, the commitment of the Federal Reserve to keep policy rates low until labour market outcomes improve substantially has been well judged, but the need for further exceptional monetary measures is disappearing, while in Japan more aggressive policy action has been suggested to escape deflation and achieve the inflation target. In EA, it has been observed that there is still some scope to ease monetary policy further, given weak demand and inflation well below the ECB's objective, while further action has been recommended to repair the transmission mechanism.

1.4 Global economic growth is expected to improve in 2013 as compared to 2012 but less than 2011, reflecting the setbacks of the global recovery. The revised estimate of the global GDP for 2013 is 3.3 percent while it is projected to grow by 4.0 percent in 2014. In advanced economies, it is estimated to grow by 1.2 percent in 2013 and 2.2 percent in 2014. In contrast, the near-term outlook for the euro area has been estimated to remain at -0.3 percent in 2013 and 1.1 percent in 2014. Financial stress in the euro area has been moderated in response to the policy actions, but still economic activity has been estimated to be in a weak situation, Growth estimated for 2013 have been lowered in EA because of weakness spilled over from the periphery to the core. Likewise, growth in emerging and developing economies is estimated to expand by 5.3 percent in 2013 and 5.7 percent in 2014. Similarly, activities in developing Asia observed improvement in response to the pace of global recovery. The real GDP growth for this region has been estimated to be 7.1 percent in 2013 and 7.3 percent in 2014, higher from 6.6 percent in 2012 but lower than in the earlier two years.



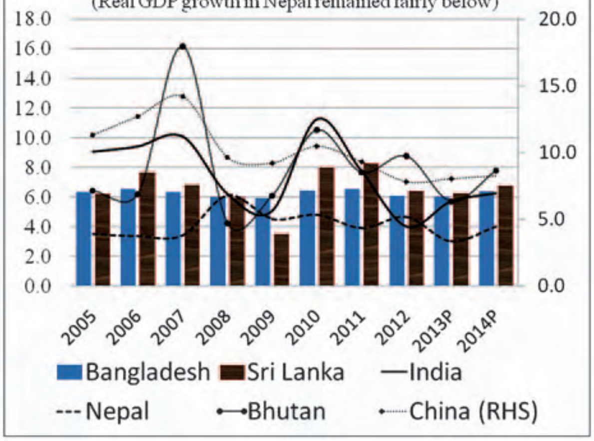
1.5 The EA is expected to remain in recession until early 2013, leading to a mild contraction in GDP before growth picks up in 2014. In the United States, provided the fiscal cliff is avoided, GDP growth is projected at 2 percent in 2013 before rising to 2.8 percent in 2014. In Japan, GDP is expected to expand by 0.7 percent in 2013 and 0.8 percent in 2014.. After softer-than-expected activity during 2012, growth has begun picking up in the emerging-market economies, with increasingly supportive monetary and fiscal policies offsetting the drag exerted by weak external demand. Meanwhile, GDP is also expected to gather steam in 2013 and 2014 in China, Brazil, India, Indonesia, Russia and South Africa.

1.6 The euro area crisis has been observed to be a serious threat to the world economy, despite recent measures that have dampened near-term pressures. Though adjustment of deep-rooted imbalances across EA has been initiated, the region has suggested to implement the plans and programs which can ensure long-term sustainability—structural reform in both deficit and surplus countries. Major risks to global growth is estimated through fiscal weakness and sovereign debt problems in the EA, continued high unemployment in many advanced economies, banking sector default risks and continuance of price hike of energy, food and other commodity prices in different regions.

1.7 Economic growth slowed in Asia in the middle of 2012 following a broad based weakening of exports. Economic performance remain subdued in Asia during 2012 but growth is set to pick up gradually during 2013 on strengthening external demand and continued robust domestic demand. For Asia as a whole, growth is estimated to pick up modestly to about 5.7 percent in 2013, largely as a result of recovering external demand and continued solid domestic demand.

1.8 Growth in the Asia-Pacific region has shown a sign of improvement as extreme risks emanating from advanced economies have receded and domestic demand remains resilient, supported by relatively easy financial conditions and robust labor markets but risks to the outlook from within the region, such as rising financial imbalances and asset prices in some economies, are coming clearer into focus. GDP growth in emerging Asian countries and East Asia is expected to improve as compared to small states and Pacific Island countries but ASEAN growth is projected to be 6 percent in 2013, slightly lower than the growth in 2012, reflecting resilient domestic demand but in Thailand it is expected to return to a more normal pace after a V-shaped recovery mostly driven by reconstruction and investment (particularly, in flood areas) in 2012. South Asia, comprising Bangladesh, India and Sri Lanka is projected to grow by 5.5 percent both in 2013 and 2014, slightly lower as compared with the growth of 5.7 percent in 2012. The fall in private investment over rising policy uncertainty exacerbated supply bottlenecks in India and high inflation as compared with other Asian countries pulled down the real GDP growth estimate for 2013. Similarly, tighter policies in early 2012 to rein in credit and import growth contributed to slowing activity in this region.

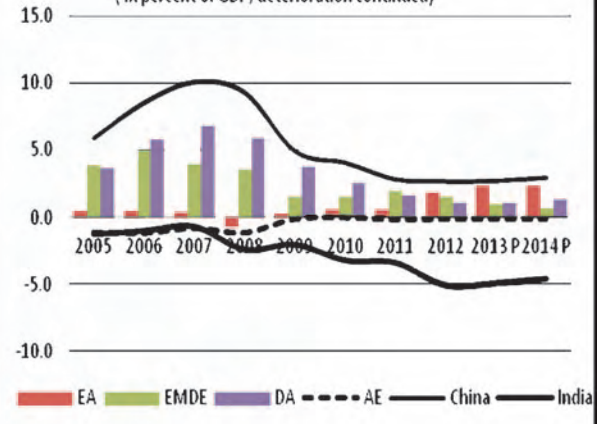
Figure 1.4: Real GDP growth in South Asia and China
(Real GDP growth in Nepal remained fairly below)



1.9 A modest growth recovery in India is projected on a more favorable external demand improvement in current account and fiscal deficit; deep rooted structural challenges are expected to exert a substantial drag on potential growth. South Asia is expected to see a turn around after economic softening, particularly in India if improvement takes place, it is projected to grow by 5.7 percent in 2013 and 6.2

percent in 2014, but the world's second most populous country was struggling to realize its full potential, with structural and policy issues inhibiting investment. GDP growth in China is projected to be about 8.0 percent in 2013 and then strengthen to 8.2 percent in 2014 due as increase in domestic demand. Among the South Asian economies, Bhutan has been found a lead country in achieving highest level of real GDP growth (9.7 percent) in 2012. Real GDP growth in Bangladesh and Sri Lanka is expected to be remain stable averaging above 6 percent but quite weak in Nepal averaging around 4 percent over the years.

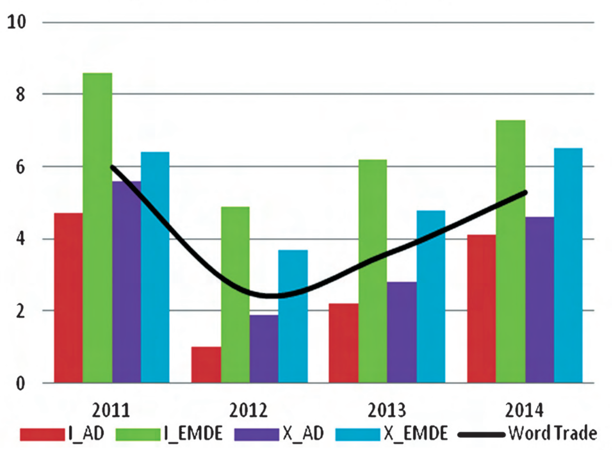
Figure 1.5: Global Current Account Balance
(In percent of GDP, deterioration continued)



1.10 There are no excess demands in the major advanced economies. Current account balances are still falling and deterioration of current account deficit in percent of GDP in advanced economies continued and estimated a further deterioration in 2013 and 2014. Due to the weak external demand and fall in trade volume sharply in 2012, the deficit remained weak both in China and emerging market economies where as the deficit in India also was increased quite high and reached 5.1 percent of GDP due to uncertain external environment and weak investment scenario. The setbacks to the global recovery in 2012 were mirrored in a slowing of world trade growth, which had already cooled in 2011.

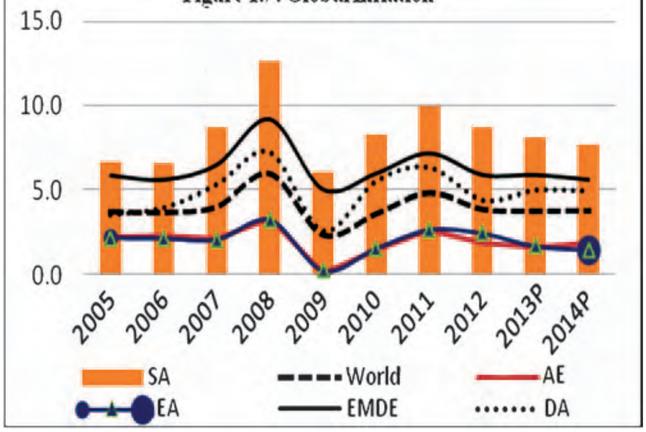
1.11 Fluctuations of global trade volumes are generally more amplified than those of world GDP and, in line with earlier experience, trade volumes decelerated sharply in 2012 but the outlook estimates the situation may turn into a positive scenarios both in 2013 and 2014. Both the export and import in advanced economies declined sharply and stood at 1.0 percent and 1.9 percent respectively in 2012. Both the import and export in emerging and developing countries also declined and stood at 4.9 and 3.7 percent respectively in 2012. On the assumption of the global recovery both on import and export of advanced and emerging economies, the trade volume of the world is estimated to increase by 3.6 and 5.3 percent respectively in 2013 and 2014.

Figure 1.6: World Trade (Percentage change)



1.12 With the pace of growth of the world economy slowing, global inflationary pressures have lessened. Headline rates of inflation have fallen as oil and food price inflation has eased; rates of core inflation have generally moderated, consistent with the significant spare capacity in much of the advanced world. Global inflation has fallen to about 3.9 percent in 2012 from 4.9 percent in 2011, and it is estimated to stay around this level throughout 2014. Food and fuel supply developments will help contain

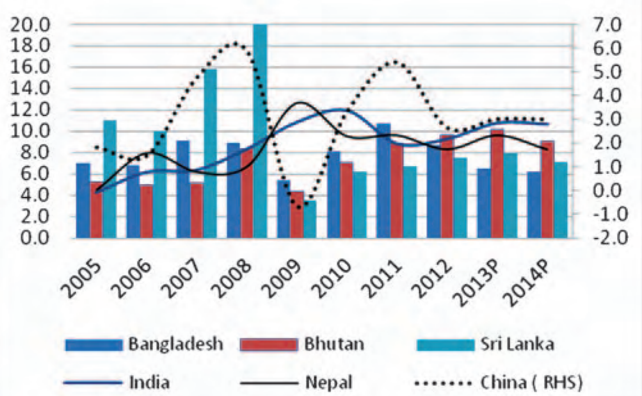
Figure 1.7: Global Inflation



upward pressure on prices of major commodities despite the expected reacceleration in global activity. In the major advanced economies (G7), including the US, inflation will ease from about 2 percent to 1.7 percent and from 2.5 percent to 1.7 percent in the EA in 2013, Inflation pressure is projected to remain contained in the emerging market and developing economies, supported by recent slowdown and lower food and energy prices. Inflation is estimated to slack in emerging Asian economies in 2013 and it is estimated to stand at 5.9 percent in 2013 and then at 5.6 percent in 2014 as compared to 7.2 percent in 2011. Inflation pressure in some economies and regions, spurred by food prices in some cases (India) is projected to remain fairly high, and could be a surprise on the upside.

1.13 Given the persistent inflationary pressures and large fiscal deficits, the scope for policy stimulus in India and other advanced countries has seen limited. China and many East Asian economies, in contrast, possess much greater space for countercyclical policy. Across much of Asia, including China headline inflation slowed markedly through 2012, in many cases by some 2 percentage points; the notable exceptions were India, Indonesia, and, to a lesser extent, Thailand. Inflation in China (RHS) has been stabilized at 3.0 percent in recent years. In South Asia, a drop of private investment over rising policy uncertainty exacerbated supply bottlenecks in India, which contributed to headline inflation that was high compared with that of most other Asian economies, despite a sharp growth slowdown during 2012. Inflation in South Asia is estimated to be 8.1 percent in 2013 and a bit relaxed in 2014. Among the South Asian economies inflation in India and Nepal is estimated to remain in upside where as inflation in Bangladesh and Sri Lanka is epected.

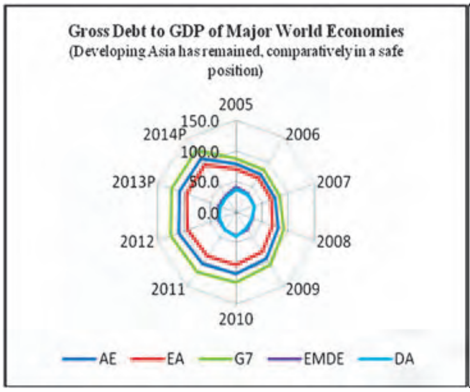
Figure 1.8: Inflation in South Asian Countries and China

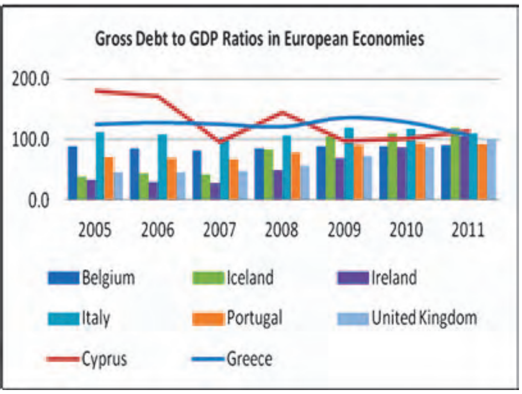


Box 1.1: Global Public Debt and Financial Instability

Public debts in advanced economies have climbed to its highest level and faced debt burdens since the global financial crisis and it has been negatively affecting the global financial stability. In Japan, the United States, and several European countries, it now exceeds 100 percent of GDP. Gross debt to GDP ratio in advanced countries reached to 109.3 percent in 2012 and it is estimated to remain 108.5 percent in 2013 and 2014. The debt further increased in major advanced countries (G7) and it is estimated to reach 124.0 percent in 2013 and 2014. The debt to GDP ratio in emerging market economies and developing Asia has been remaining below 40 percent of GDP throughout the period. Low growth, persistent budget deficits, and high future and contingent liabilities stemming from population-aging-related spending pressure and weak financial sectors have markedly heightened concerns about the sustainability of public finances. These concerns have been reflected in ratings downgrades and higher sovereign borrowing costs, especially for some European countries.

Figure 1.9: Debt to GDP Ratios





The high level of debt seems unsustainable in many countries, with the EA in the eye of the storm. Indeed, throughout 2010, 2011 and even 2012 speculators were betting on defaults by Greece, and possibly Italy, Spain and Portugal. Some countries are in a better position, like France and Germany. However, rating agencies are tweaking with credit ratings and threatening downgrades, bolstering fears that the European Union could collapse under the weight of its members' debt. Correcting fiscal imbalances and reducing public debt have therefore become high priorities. Many countries responded with a wide variety of policy approaches but still again the debt level has not been coming down. Successful debt reduction requires fiscal consolidation and a policy mix that supports growth. Key elements of this policy mix are measures that address structural weaknesses in the economy and supportive monetary policy. Fiscal consolidation must emphasize persistent, structural reforms to public finances over temporary or short-lived fiscal measures. In this respect, fiscal institutions can help lock in any gains but, reducing public debt takes time. To respond to this emergency, governments across Europe have implemented painful austerity measures, which are now causing enormous political dissatisfaction and instability and growing spillover effect across the globe.

Global Financial Stability

1.14 The Global *Financial Stability Report (GFSR),* April 2013 has stated that the risks to financial stability have declined, providing support to the economy and prompting a rally in risk assets. These favorable conditions reflect a combination of deeper policy commitments, renewed monetary stimulus, and continued liquidity support. Together; these actions have reduced tail risks, enhanced confidence, and bolstered the economic outlook. Global financial and market conditions have improved remarkably in the past six months. However, , the improvement in financial conditions can only be sustained through further policy actions that address underlying stability risks and promote continued economic recovery, the *GFSR* has remarked. Continued improvement will require further balance sheet repair in the financial sector and a smooth unwinding of public and private debt overhangs. If progress in addressing these medium-term challenges falters, risks could reappear. The global financial crisis could morph into a more chronic phase, marked by a deterioration of financial conditions and recurring bouts of financial instability.

1.15 Over the medium term, downside risks revolve around the absence of strong fiscal consolidation plans in the advanced countries; high private sector debt, limited policy space, and insufficient institutional progress in the EA, which could lead to a protracted period of low growth; distortions from easy and unconventional monetary policy[2] in many advanced economies; and overinvestment and high assets prices in many emerging market and developing economies. Unless policies address these risks, global financial stability may likely to suffer periodic setbacks,the GFSR stated.

1.16 In the EA, acute near-term stability risks have been reduced significantly. Funding conditions in the markets for sovereign bank, and corporate debt have improved. Despite this notable progress, many banks in the EA periphery remain challenged by elevated funding costs, deteriorating asset quality, and weak profits. Credit transmission remains weak in several economies, as bank balance sheet repair is uneven, while fragmentation between the core and periphery of the EA persists.

[2] Unconventional monetary policy in advanced economies has been providing essential support to aggregate demand. However, a prolonged period of extraordinary monetary accommodation could push portfolio rebalancing and risk appetite to the point of creating significant adverse side effects. On the other hand, the favorable funding conditions for emerging market economies might breed complacency about growing challenges to domestic stability.

1.17 Overshooting was detected in some EA Sovereign Credit Default Swaps (SCDS) markets but little evidence has found that excessive increase in a country's SCDS spreads generally lead to higher sovereign funding costs. As sovereigns and financial institutions are now more interconnected, the risks embedded in SCDS cannot be readily isolated from the risk of the financial system. The policy initiatives underlying the over-the-counter derivatives reforms mandating better disclosure, encouraging central clearing, and requiring the posting of appropriate collateral should help to allay concerns about spillovers and contagion that may arise in these derivative markets.

1.18 As per *GFSR*, banks in advanced economies have taken significant steps to restructure their balance sheets, but progress has been very slow and uneven in some European banks. Although, balance sheet pressures are less acute for other European banks, the process of de-risking and deleveraging is not complete. The main challenges for banks in emerging market economies are to continue supporting growth while safeguarding against rising domestic vulnerabilities. The new regulatory environment is forcing banks globally towards reshaping business models to become smaller, simpler, and more focused on domestic markets.

1.19 The global pace of reform process also reflects difficulties due to concerns about banks facing more structural challenges; while much has been done to improve financial sector regulations, the reform process remains incomplete. Policy makers globally have realized a further work on the too-big-to-fail problem, over-the-counter derivatives reform, accounting convergence, shadow banking regulations and commitments to minimize regulatory uncertainty, arbitrage and financial fragmentation. The recent developments in Cyprus underscore the urgency for completing reforms across the EA in order to reverse financial fragmentations and further strengthen market resilience.

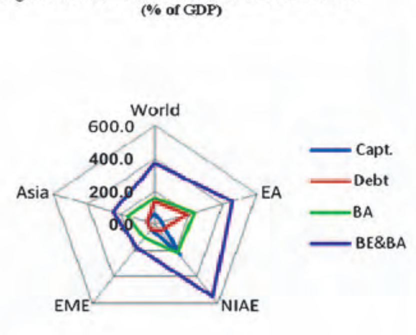
1.20 The prolonged accommodative monetary policies on a global level and an extended period of low rates do not give rise to fresh credit excesses. Financial supervision should be tightened to limit the extent of such excesses; and regulation will need to play a more proactive role in this cycle at both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

1.21 The unconventional policies termed "MP-plus" by the central banks appear to have lessened banking sector vulnerabilities and contributed to financial stability in the short term by improving the bank soundness indicators but reluctance by banks to clean up their balance sheets. Similarly, the intervention in specific assets market has not adversely affected market liquidity. Potential risks raised by MP-plus in the banking system so far appear relatively benign; policymakers have been suggested to be alert to the possibility that risks may be shifting to other parts of the financial system—shadow banks, pension funds, and insurance companies—due in part to increasing regulatory pressures on banks. Implementing macroprudential policies would allow central banks to continue to use MP-plus to support price stability and growth while protecting financial stability.

Global Financial Market

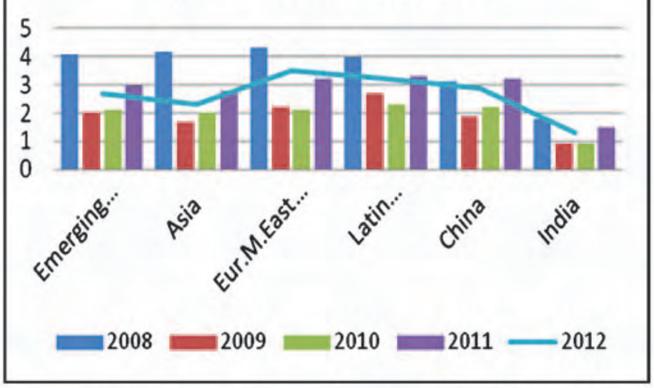
1.22 Global financial market developments of 2012 attributes the important role of financial markets in a modern economy and also the significant responsibility that rests on the market operators, regulators and participants collectively in those markets to promote an efficient and fair market place. The year 2012 has been remembered as a year punctuated by rolling crises in the global markets which posed many challenges in financial market and its participants. Investors were firstly unnerved as the US struggled to increase its debt ceiling, and by the subsequent downgrade of its sovereign debt rating by Standard and Poor’s. This was quickly followed and overtaken by the escalation of the European sovereign debt crisis and, more recently, by the prospect that China’s economic growth could experience a less-than-soft landing. The US and European crises particularly were the drivers of a “risk off ” mindset in the latter half of 2012, and only prompt and coordinated action by central banks and policy makers in early 2013 encouraged investors to re-enter the markets.

Figure 1.10: Global Size of Financial Market in 2012 (% of GDP)



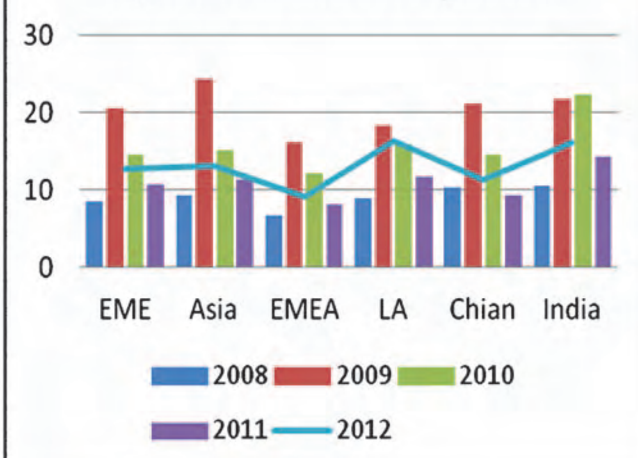
1.23 The global size of market expanded in 2012 and the world's total stock market capitalization reached 67 percent of GDP. Among the world economies, the ratio of Newly Industrialized Asian (NIAE) economies reached 237.5 percent, followed by Asia with 44 percent, Emerging Market Economies (EME) with 38 percent and EA (EA) 35 percent. Similarly the debt securities, banking assets (BA) and bonds, equities and banking assets (BE&BE) as percent of GDP expanded in 2012. The share of debt securities (190 percent of GDP) and banking assets (232 percent of GDP) expanded more in EA, where bonds, equities and banking assets increased by about 550 percent of GDP in the NIAE. In 2012, the global market capitalization recovered with a 15.1 percent growth rate to USD 54,570 million. The best performance in 2012 was observed in the US followed by Asia-Pacific and EAME. In the US, the growth was mainly driven by the US exchanges that increased 19 percent while Canada increased slightly less and contrasted trends were observed in Latin American countries. In Asia-Pacific, the highest growth rates were observed in Thailand (45 percent), Philippine (39 percent), Singapore (28 percent), Hong Kong (25 percent) and India (25 percent) and relatively lower growth rates occurred in mainland China and Japan (respectively 8 percent and 5 percent). The EAME Africa and Middle East region experienced a 20 percent growth rate, and EA increased by 14 percent of growth rate.

Figure 1.11: Dividend Yield Ratio



Note: EM: Emerging Markets and Euro Area, Middle East and Africa

Figure 1.12: : Price Earning Ratios



1.24 In 2012, the dividend yield ratios of all regions stood nearly 3 percent except in Asia. In Europe, UK equity market, as measured by the FTSE Index, rose significantly for the first time that has happened since 1997. The dividend yield in China remained at 2.9 percent but it stood at only 1.3 percent in India. Similarly the price earnings ratios also improved across the regions in 2012 as compared to 2011 and outlooks shows further positive sign of improvement in 2013.

1.25 The risk of a setback remains uneven given the continuing problems in the EA, with the banking crisis in Cyprus being the latest examples. Elsewhere news is better with the US and China showing signs of a strengthening economy.

1.26 Global equity market indices are very attractively valued and *IMF GFSR*, April 2013 is optimistic for better prospects of such indices as the global economy is being normalized. Progress in Europe, the end of China's growth slowdown and continued momentum in the US economy recovery has been expected to support global equities. Longer-term investors must position themselves for a growth-saturated world in which sustainability and innovation will be even more important. Given that the US and China have stabilized and will slowly improve in 2013 while Europe's deterioration decelerates,

Figure 1.13: MSCI Equity Market Indices
(percent change)

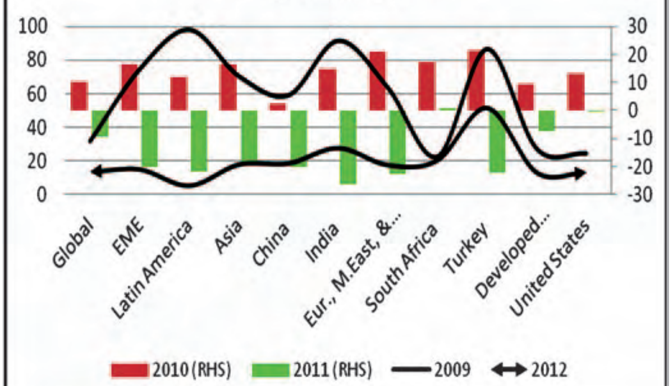
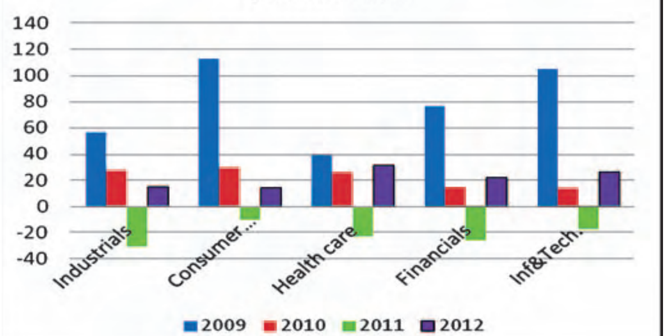


Figure 1.14: MSCI Sectoral Index
(Percent Change)



the scope for global equities to perform in 2013 is quite positive. The *GFSR* doesn't ignore the potential volatility in Europe or the Middle East, but given equity valuations, the appeal of increasing exposure to one's portfolio is said to be strong.

1.27 The MSCI equity market indices observed upsurges significantly in 2012, as marked by 13.4 percent globally, against the negative growth of 9.4 percent in 2011 significantly higher than in 2010 but still below the level of 2009 index. Among the world economies, Asia's index rose by 18.1 percent followed by Europe, Middle East and Africa, EME and developed markets by 17.7 percent, 15.1 percent and 13.2 percent respectively.

1.28 The lowest growth was observed in Latin America among the regions during the year 2012. The US market rose by 13.5 percent, China by 18.1 percent and India's 27.9 percent. Sectors such as health care, information technology and financials witnessed the highest attraction followed by industrial and telecommunications in 2012. Keeping in mind longer-term issues is also essential to position the portfolios adequately for further structural changes as well as betting on companies with superior structural growth, top leadership teams and strong balance sheets.

1.29 As per *The Economist's* house price indicators 2012, the response of property markets—the biggest asset class of all—has varied since the world economy has been stimulated by ultra-loose monetary policy. Whereas the housing boom before the financial crisis was remarkable for its global reach, the recovery after the bust has been irregular. The biggest increase has been in Hong Kong, where house prices rose by 24.5 percent. The biggest fall is in Spain, where prices are down by 7.7 percent. Property markets are generally strong in the developing world. Prices have forged ahead by 11.1 percent in South Africa. They have also been buoyant in two big emerging economies,Brazil, up by 12.8 percent and India by , 10.7 percent. China’s house prices have increased modestly, by 3.3 percent. The recovery in the United States

Figure 1.15: The House Price Indicators

***The Economist* house-price indicators**

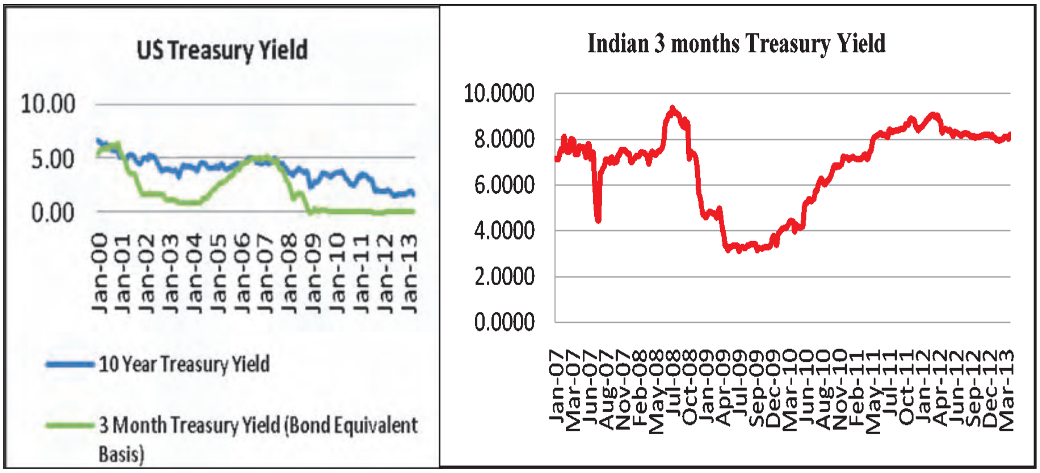
	Latest, % change		Under(-)/over(+) valued, against*:	
	on a year earlier	since Q4 2007	Rents	Income†
Hong Kong	24.5	109.4	81	*na*
Brazil	12.8	*na*	*na*	*na*
South Africa	11.1	18.0	-2	10
India	10.7	88.8	*na*	*na*
United States	9.3	-20.8	-8	-21
Singapore	3.5	24.8	57	*na*
Germany	3.4	9.7	-17	-17
China	3.3	20.4	6	-35
Sweden	3.0	10.0	31	17
Australia	2.6	12.2	44	24
Canada	2.0	18.3	73	32
Britain	0.9	-11.4	19	11
France	-1.7	1.1	39	34
Japan	-2.6	-14.2	-37	-36
Ireland	-3.0	-50.2	-1	-5
Italy	-4.0	-11.3	-2	10
Netherlands	-7.0	-16.5	6	33
Spain	-7.7	-26.5	15	16

*Relative to long-run average †Disposable income per person
Sources: BIS; Haver Analytics; Hong Kong RV; National Housing Bank; Nationwide; OECD; Teranet and National Bank; Thomson Reuters; *The Economist*

stood at 9.3 percent, and previous drop in prices has made homes cheap by historical standards. The recovery has been driven by investors rather than owner-occupiers, but interest on the part of homeowners is increasing. Housing starts are rising sharply. In the crisis-stricken EA the Spanish freefall will continue, judging by still- elevated valuations. Housing markets are depressed throughout southern Europe, notably in Italy. But the agony is no longer confined to the periphery of the EA. The big exception in the EA remains Germany, which avoided the great housing boom before the financial crisis. Property prices continue to rise, though at a stately pace. They remain undervalued judged by both rents and income, which provides scope for more gains.

1.30 The 10-year US treasury yields recorded 1.91 percent in January 2013, after registering the highest yield of 2.17 percent in March 2012. It had hovered around 4.0 per cent in June 2009. It has been in a declining position and below 2 percent

Figure 1.16: US and Indian Treasury Yields

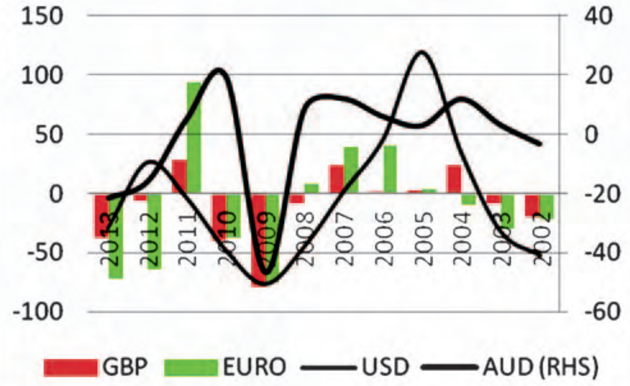


after April 2012. However, 3-month US treasury yield has improved to 0.07 percent after recording the lowest of 0.03 percent in January 2011, but again the yield has not been improved after 2009 and the rate has been remaining below after October 2008 (fall of Lehman Brothers). Similarly, the US Fed Funds daily discount daily rate could not improve since mid 2010 and it has been hovering below 1 percent since then. In case of India, government 3-month Treasury bill rate slightly moderated to 7.9 percent in January 2013 after exhibiting upward trend in

February 2012. The 3-month yield rate which stood at its highest of 9.0 percent up to March 2012 had been decelerating since one year.

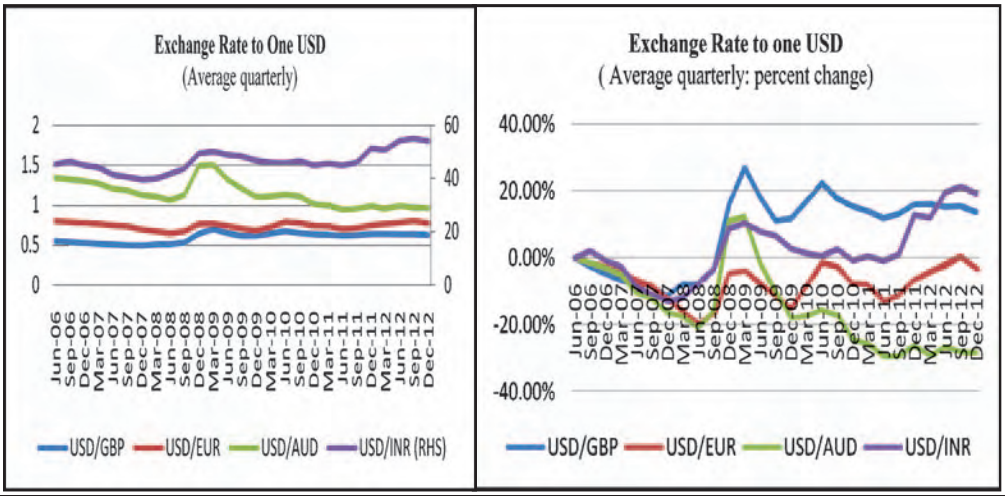
1.31 The LIBOR rate with major internationl currencies (except USD) further declined in 2012 and the trend of decline has continued until January 2013. The LIBOR rate with Euro declined by 64.2 percent in 2012 whereas the rate with AUD and GBP declined by 15.7 and 6.7 percent respectively. But the rate with USD gained by 26.4 percent in 2012. This sort of trend in LIBOR rate with major international currencies, particularly with USD shows that the economic crisis has deteriorated further in EA, and thus the confidence with the USD has been strengthened based on the assumption of recovery in US financial market in the medium term. The 3-months Libor rate in USD showed a bit right upward trend in 2012 but declined significantly recently, whereas 3-month GBP, AUD, and EURO rates declined significantly over the periods. The Libor rate with AUD declined and stood at 3.2 percent in 2013 from 4.1 percent of 2012 whereas the rates with GBP and Euro declined from 0.82 percent and 0.49 percent and stood at 0.51percent and 0.13 percent in January 2013.

Figure 1.17: 3-Month LIBOR Rate
(Percent Change)



1.32 Global central bank's policies have been supporting growth as inflation remains low and contained across advanced economies. European economic weakness is complicated by structural issues and with the limited tool kit to fight with the issues. An aggressive policy stance in Japan has driven the weakeness in JPY reflecting a notable divergence within the Asian region. Low global interest rates are inducing a search for yield, creating fears of bubbles across region particularly both in foreign exchange, housing and equity markets.

Figure 1.18: Exchange Rates



1.33 The policy makers around the world, especially the central bank's and financial market regulators have focused their attention on the relative strength of their currencies. The value of USD against the major international currencies has fluctuated during 2012. The value of one USD to GBP remained stable in 2012, but slightly appreciated in December, whereas the value of USD against the AUD and EUR depreciated during the period. The Indian currency depreciated sharply with USD in 2012 and the value of INR with one USD reached Rs. 54.9 in September from Rs.45.7 of September 2011.The value of USD against the major international currencies has remained more or less stable over the periods.

1.34 The global foreign exchange market outlook noted that the USD will continue to be strengthening for the next few quarters against EUR, GBP and JPY in 2013 as a result of relative growth and central bank's policy dynamics. In India, Reserve Bank of India and Government o India is expected to continue to provide fiscal and monetary stimulus introducing the new measures on a cautious pace—in the coming months in order to invigorate sluggish economic activity via investment.

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CHAPTER TWO

DOMESTIC MACROECONOMIC DEVELOPMENT

Economic Growth

2.1 According to the preliminary estimates of Central Bureau of Statistics (CBS), the real GDP at basic price is expected to grow by 3.6 percent in 2012/13 compared to the growth of 4.5 percent in 2011/12. Lower agricultural production due to weaker monsoon and sluggish performance of the industrial sector arising from continued political uncertainty and energy shortage are some of the responsible factors for such a low growth. The agriculture sector is expected to grow by 1.3 percent in 2012/13 compared to its growth of 5.0 percent in 2011/12. The dismal performance of agriculture sector is mainly attributed to the unfavorable monsoon. Similarly, the industrial sector witnessed a sluggish growth of 1.6 percent in 2012/13 compared to its growth of 3.0 percent in

Figure 2.1: Real GDP Growth

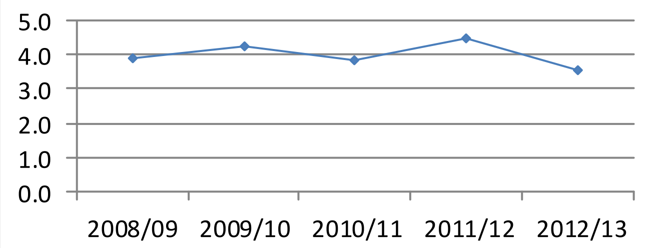
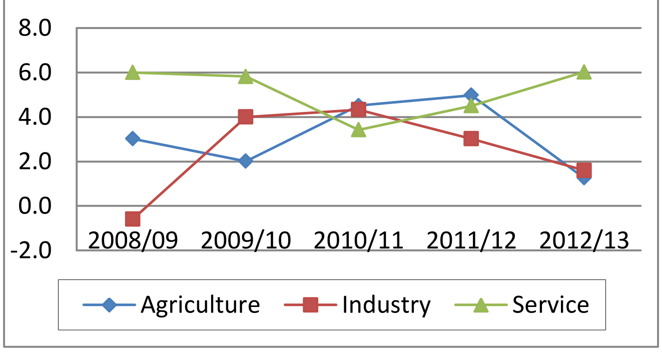


Figure 2.2: Sectoral GDP Growth

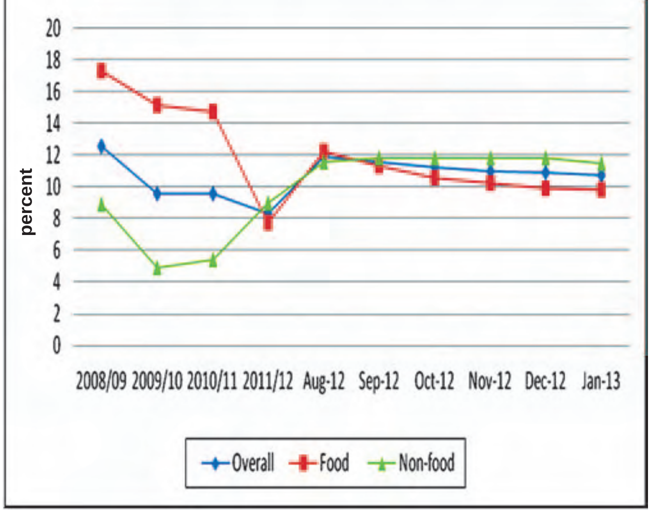


the previous year. The supply side constraints inherent in the Nepalese economy including energy shortage are the main reasons behind the sluggish performance of industrial sector. However, the service sector witnessed a better performance with a growth of 6.0 percent in 2012/13 owing to improvement in the performance of some sub sectors viz. wholesale and retail trade, hotels and restaurants, transport, storage and communication and financial intermediaries. For 2012/13, the ratio of total consumption to GDP is estimated at 90.7 percent compared to 88.5 percent in the previous year. In the review year, the ratio of gross investment to GDP is estimated at 37.8 percent compared to 34.9 percent in the previous year.

Inflation

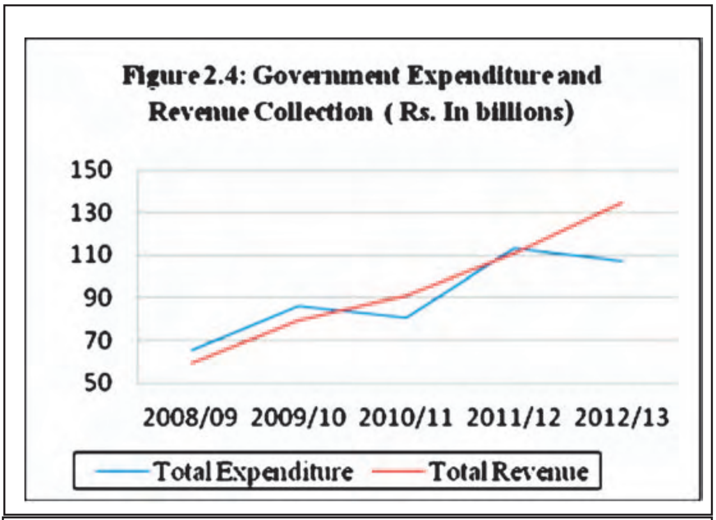
2.2 The year-on-year inflation as measured by the consumer price index (CPI) increased by 9.8 percent in mid-January 2013 compared to 6.8 percent in the corresponding month of the previous year. The average overall consumer price inflation during the review period observed at 10.7 percent comprising at 9.8 percent and 11.5 percent for food and non-food inflation respectively. The growth rate of food price inflation showed declining trend whereas non-food price inflation remained almost constant during the review period. The important factors attributing rise in non-food prices were rise in fuel prices, exchange rate depreciation and rising in wage and salaries. The gradually decreasing trend of overall inflation indicates some possible improvements in price development.

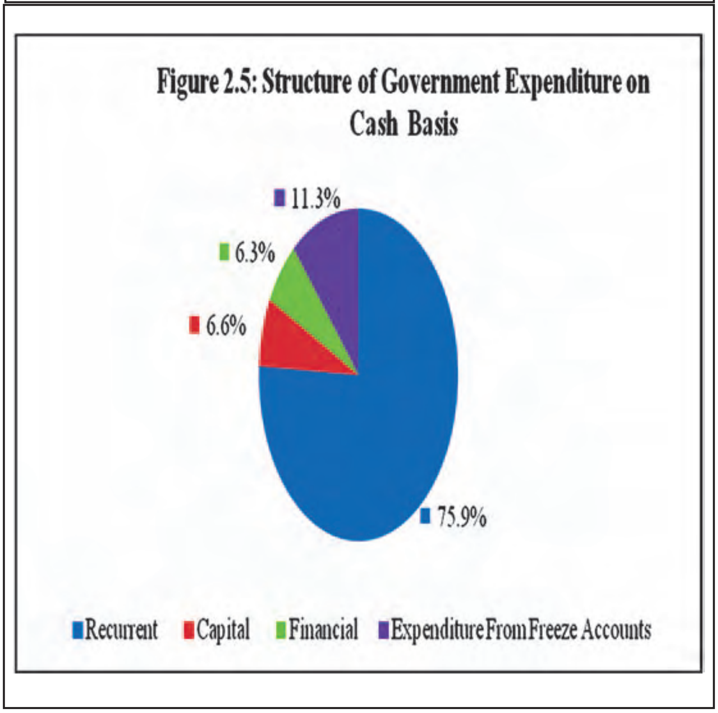
Figure 2.3: Average Consumer Price Inflation



Government Finance

2.3 Government expenditure structure and the size of budget deficit will affect the financial stability of the nation. So, prudent fiscal policy is required for favorable financial sector's development. The fiscal position of the government showed mixed outcomes, as capital expenditure has been discouraging and revenue mobilization has been encouraging. As a result, on a cash basis data, budget surplus has surged to Rs. 40.44 billion during mid-January 2013 from Rs. 24.04 billion in the corresponding period of the previous year. A higher rate of growth in resource mobilization relative to government expenditure led to a rise in the budget surplus during the first six months of 2012/13. Government revenue mobilization has increased by 21.2 percent to Rs. 134.57 billion during the first six months of 2012/13. Such revenue had increased by 21.6 percent in the corresponding period of the previous year. A



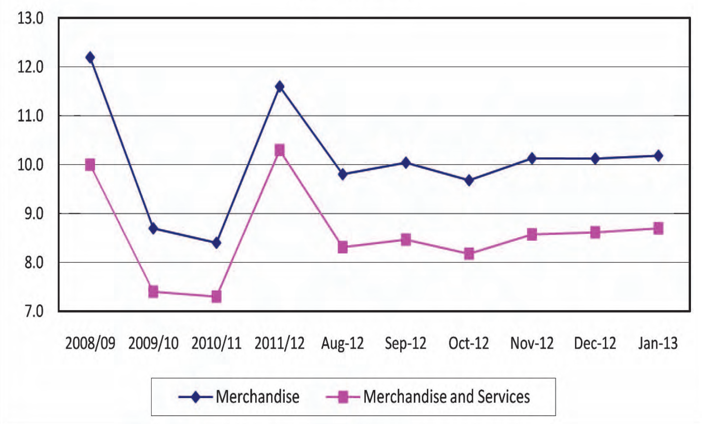


higher growth in imports was responsible for the significant growth of revenue mobilization. During the first six months of 2012/13, total government expenditure has decreased by 5.4 percent to Rs 107.21 billion. The delay in adopting a full year budget for 2012/13 was responsible for the decline in total expenditure during the review period. Of the total government expenditure, the share of recurrent expenditure, capital expenditure, financial expenditure and expenditure from freeze accounts stood at 75.9 percent, 6.6 percent, 6.3 percent and 11.3 percent respectively as of mid-January 2013. Outstanding domestic debt stood at Rs 208.96 billion during the first six months of 2012/13. Such debt had stood at Rs 186.33 billion in the corresponding period of the previous year. Government has paid Rs. 157.60 million of domestic debt during the review period.

External Sector

2.4 Merchandise exports recorded a growth of 15.4 percent to Rs. 74.3 billion in 2011/12 compared to a growth of 5.8 percent in the previous year. Such exports had gone up by 9.3 percent to Rs. 39.3 billion during the first six months of 2012/13 compared to its growth of 11.2 percent during the corresponding period of the previous year. On the other hand, merchandise imports that had increased by 5.8 percent in 2010/11, surged significantly by 16.5 percent to Rs. 461.7 billion in 2011/12. During the first six months of 2012/13, merchandise imports increased by 25.2 percent to Rs. 271.4 billion. Such imports had risen by 16.8 percent during the corresponding period of the previous year. Such an increase in imports was due to a sharp increase in imports from both India and other countries. Total trade deficit went up by 16.7 to Rs. 387.4 billion in 2011/12 compared to a growth of 5.8 percent in the previous year. Such deficit had

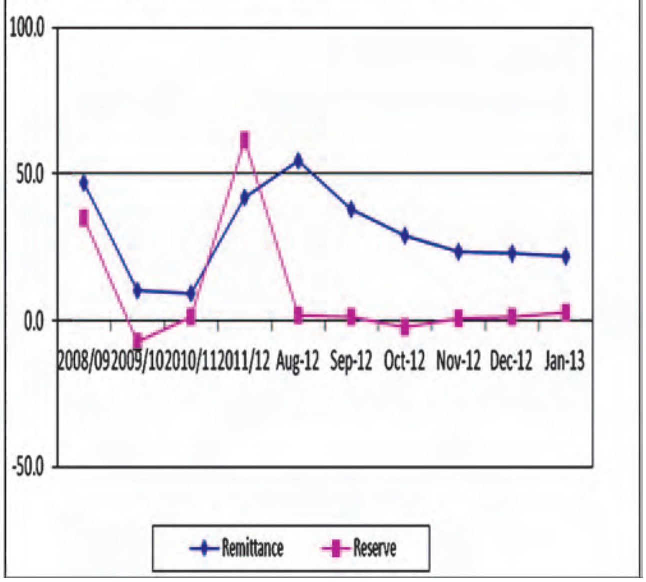
Figure 2.6: Import Capacity of Reserve
(Rs. In Million)



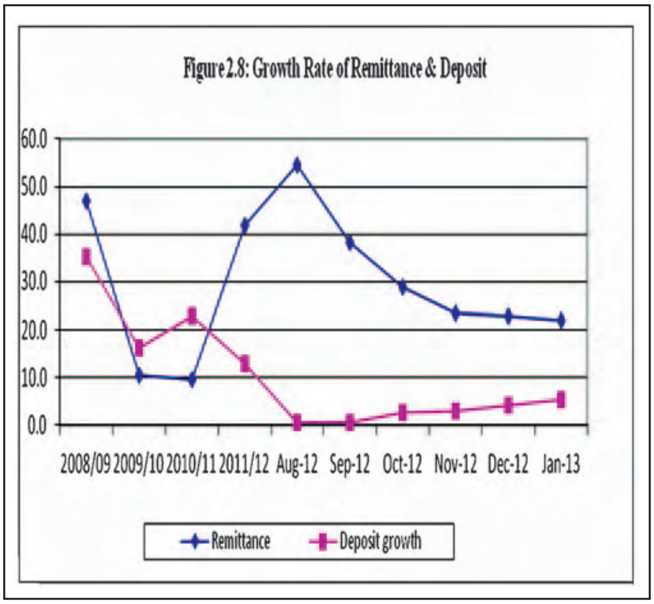
grown by 28.4 percent to Rs. 232.1 billion during the first six months of 2012/13 compared to an increase of 17.9 percent during the same period of the previous year. Due to a high growth of imports, the ratio of export to import declined to 14.5 percent during the first six months of 2012/13 from 16.6 percent in the corresponding period of the previous year. The share of India in total foreign trade stood at 64.6 percent during the first six months of 2012/13.

2.5 The overall balance of payments witnessed a historical surplus of Rs. 131.6 billion in 2011/12 compared to a surplus of just Rs. 4.1 billion in 2010/11. Similarly, current account surplus improved significantly to Rs. 76.0 billion in 2011/12 owing to the elevated level of remittances and service income. However, overall BOP recorded a surplus of just Rs. 6.1 billion during the first six months of 2012/13 compared to a surplus of Rs. 66.7 billion during the same period of the previous year. Consequently, the existing foreign exchange reserve is sufficient for financing merchandise imports of 10.2 months and merchandise and service imports of 8.7 months as at mid-January 2013.

Figure 2.7: Growth Rate of Remittance Inflows & Reserve



2.6 The current account and BOP performance of Nepalese economy largely depends on the volume of merchandise imports and inflow of remittances. Due to the growth in foreign employment and depreciation of Nepalese currency against USD, workers' remittances grew by 41.8 percent to Rs. 359.55 billion in 2011/12 compared to a growth of 9.4 percent in 2010/11.

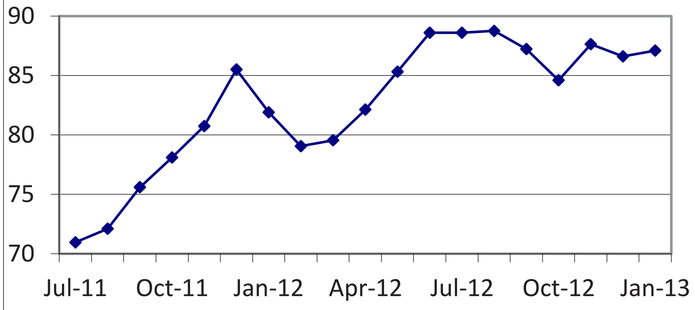


2.7 Remittance inflows accounted for 21.1 percent of GDP in 2011/12. Workers' remittances that had risen by 37.1 percent during the first six months of 2011/12 rose by 21.8 percent to Rs. 197.70 billion during the same period of 2012/13. The foreign exchange reserve of the banking system rose by 61.5 percent to Rs. 439.46 billion in 2011/12 compared to its growth of 1.2 percent in the previous year. During the first six months of 2012/13, total reserve increased by 2.6 percent to Rs. 450.80 billion. Such reserve had grown by 33.1 percent in the corresponding period of the previous year. The growth rate of reserve is closely linked with growth of remittances in Nepal since the last few years. The fluctuation in the growth rate of remittances creates uncertainty in the foreign exchange reserve position, which may create risk to external sector stability. Remittance inflow is also contributing to the expansion of financial sector and deposit mobilization; hence remittance inflow is found to be correlated with the liquidity situation of the banking sector.

Exchange Rate

2.8 Nepalese rupee vis-à-vis the US dollar depreciated sharply by 19.9 percent in 2011/12. It had appreciated by 4.9 percent in the previous year. On the other hand, Nepalese currency appreciated by 1.7 percent during the first six months of 2012/13 against US dollar in contrast to a depreciation by 13.4 percent in the same period of the previous year. The nominal depreciation of Nepalese rupee against US dollar has contributed to improve export competitive-ness, stimulated remittances inflows and helped to narrow down real exchange rate misalignment in 2011/12. However, it has increased net domestic assets and money supply, inflationary pressure and uncertainty in the external sector. It has also inflated the foreign debt liability of the government. But, Nepalese rupee appreciated against US dollar on an average by 2.3 percent since mid-September 2012 to mid-January 2013. This will help to control inflation but there is a risk of losing external sector competitiveness. Nepal is following the fixed exchange rate regime with Indian currency; hence, the exchange rate solely hinges on the movement of INR vis-à-vis US dollar.

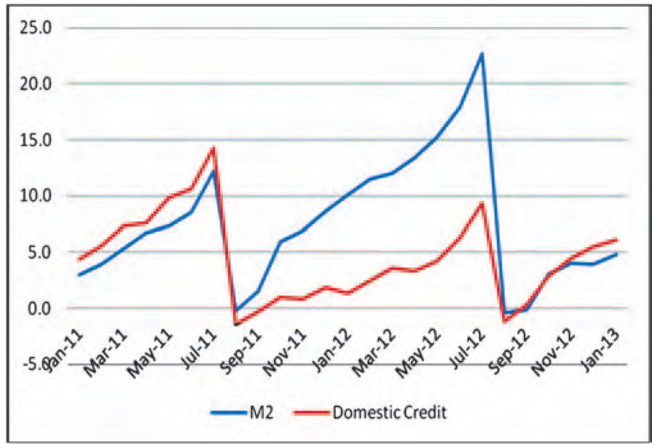
Figure 2.9:Movement of Nominal Exchange Rate (NRs/US$)



Monetary Situation

2.9 Monetary Policy for 2012/13 has been formulated with the objectives of maintaining price stability, external and financial sector stability, promoting financial access to the general public and facilitating high and sustainable economic growth. Broad money supply (M2) increased by 4.8 percent during the first six months of 2012/13 compared to an increase of 10.2 percent in the corresponding period of the previous year. It had increased by 22.7 percent in 2011/12. The decelerating growth of broad money is due to the decrease in NFA led by a significant rise in imports, relatively lower growth in remittance and a fall in capital as well as current transfer. Similarly, narrow money supply (M1) decreased by 0.3 percent during the review period in contrast to a 2.6 percent increase in the corresponding period of the previous year.

Figure 2.10 Money Supply & Credit Growth



2.10 Domestic credit increased by 6.1 percent during the first six months of 2012/13. It had increased by 1.0 percent in the corresponding period of the previous year. A higher growth of domestic credit is due to the accelerated growth in claims on private sector during the review period. During the first six months of 2012/13, claims on private sector increased by 12.3 percent compared to a growth of 4.9 percent in the corresponding period of the previous year.

2.11 Reserve money decreased by 14.6 percent during the first six months of 2012/13 as against an increase of 9.1 percent in the corresponding period of the previous year. A decrease in Nepal Rastra Bank's net claims on government coupled with a decline in net foreign assets caused a decrease in reserve money during the review period.

2.12 Deposit mobilization of banks and financial institutions increased by 5.3 percent (Rs. 54.13 billion) during the first six months of 2012/13. Such deposit mobilization had increased by 10.4 percent (Rs. 85.68 billion) in the corresponding period of the previous year. While the deposit mobilization of commercial banks, development banks and finance companies had increased by 11.4 percent, 11.6 percent and 1.7 percent respectively in the corresponding period of the previous year. In the review period, deposit mobilization of commercial banks, development banks and finance companies increased by 4.6 percent, 7.4 percent and 5.8 percent respectively.

Liquidity Situation

2.13 At the end of 2011/12, there was a pressure on inflation due to excess liquidity accumulated as a result of the high growth of remittances. The NRB mopped up net liquidity equivalent to Rs. 8.50 billion under the open market operation through outright sale auction in the review period. In the corresponding period of the previous year, liquidity of Rs. 8.40 billion was mopped up through outright sale auction while liquidity of Rs. 0.74 billion was injected through repo auction. During the review period, the NRB injected net liquidity of Rs. 103.34 billion through the net purchase of USD 1.19 billion from foreign exchange market (commercial banks). Net liquidity of Rs. 126.47 billion was injected through the purchase of USD 1.62 billion in the corresponding period of the previous year. The NRB purchased Indian currency (INR) equivalent to Rs. 122 billion through the sale of USD 1.40 billion in the Indian money market during the review period. INR equivalent to Rs. 110.62 billion was purchased through the sale of USD 1.42 billion in the corresponding period of the previous year.

2.14 Considering improved liquidity situation and rapid growth of money supply, the mid-term evaluation of Monetary Policy of 2012/13 kept unchanged the cash reserve ratio (CRR) to be maintained by BFIs at 6 percent for “A” class financial institutions, 5.5 percent for “B” class financial institutions and 5 percent for “C” class financial institutions from 5 percent applicable to all categories.

2.15 The statutory liquidity ratio (SLR) provides with an automatic adjustment of liquid asset in assets portfolio along with growth of deposit of BFIs. The provision of SLR which was fixed at15 percent, 11 percent and 10 percent of total deposits for "A", "B" and "C" class institutions in 2011/12 was continued for 2012/13 as well. In addition, there is a provision of maintaining total loan and advance of BFIs not exceeding 80 percent of its deposit and core capital in order to mitigate liquidity risk.

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Chapter Three

FINANCIAL INSTITUTIONS

Structure of the Financial System

3.1 A strong financial system promotes economic growth, mobilizes and allocates resources efficiently, maintains efficient payment system and effective transmission mechanism, makes capital more productive and creates employment opportunities in the economy. It reduces vulnerability to financial crisis and lowers the economic and social costs of financial disruption.

3.2 In Nepal, financial system is at its developing stage. The bank and financial institutions (BFIs) under the regulatory and supervisory purview of NRB have a dominant role in the financial system. Nepalese financial system comprises of other financial institutions like pension fund—Citizen Investment Trust (CIT), and provident fund—Employee Provident Fund (EPF) operating under the regulatory jurisdiction of Ministry of Finance, insurance companies, under the Insurance Board and, Cooperatives, under Department of Cooperatives, Nepal Stock Exchange (NEPSE) under Security Exchange Board. Banking sector in Nepalese financial system incorporates the commercial banks (A class financial institution), development banks (B class financial institution), finance companies (C class financial institution) and micro finance financial institutions (D class financial institution). Few cooperatives and NGOs, performing limited financial activities are also under the regulatory and supervisory jurisdiction of the NRB.

3.3 Despite the existance of significant number of financial institutions performing their banking and non-banking business in Nepalese financial system, the financial services delivered by those banks and financial institutions have not yet been reached to the needy section of the people, particularly in the geographically remote area. The BFIs have been concentrating their service in the major cities and emerging areas of business activities particularly in the urban areas. The Security Exchange Board of Nepal (SEBON), which is the main regulator of capital market in Nepal, regulates the only stock exchange in Nepal. There is also an over the counter (OTC) market under NEPSE, with negligible size in terms of volume of transactions.

3.4 The operation of financial system in Nepal is still not so satisfactory in terms of service delivery with developed infrastructure particularly at the remote areas. Those financial institutions, operating outside of NRB's jurisdictions are found functioning without being properly regulated and supervised. Among them, a number of credit and saving cooperatives, Dhikuties and other several informal financial market intermediaries are doing their business independent of any regulatory and supervisory institutions. The end result would be financial instability as such unregulated insittutions have financial interconnections with that of regulated financial institutions. Generally, many investors and customers who are doing different business activities with so many existing unregulated informal financial institutions without being aware of various misconduct of such institution. Therefore risk for the financial stability cannot be neglected both in the medium and long term.

3.5 The financial system in Nepal comprises of bank and financial institutions (commercial banks, development banks, finance companies and micro finance financial institutions), co-operatives, contractual saving institutions (Employee Provident Fund and Citizen Investment Trust), insurance companies and postal saving banks. As of mid-January, 2013 the total number of financial institutions stood at 292 comprising 214 banks and financial institutions of A, B and C categories, 50 financial intermediaries licensed by NRB, 25 insurance companies and one each of Employees Provident Fund, Citizen Investment Trust and Postal Saving Bank.

Table 3.1: Number of Banks, Financial Institutions and Other Institutions

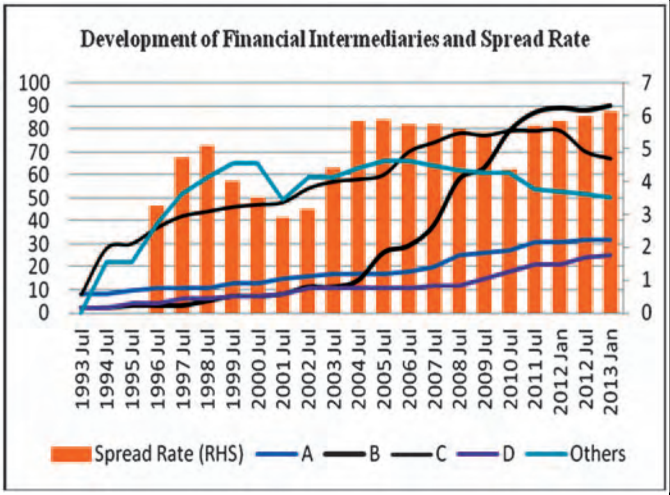
Banks and Financial Institutions	Mid-July 2012	mid-January 2013
Commercial Banks	32	32
Development Banks	88	90
Finance Companies	70	67
Micro Finance Institutions	24	25
NRB permitted Cooperatives (with limited banking activities)	16	16
NRB permitted NGOs (with limited banking activities)	36	34
Insurance Companies	25	25
Employees Provident Fund	1	1
Citizen Investment Trust	1	1
Postal Saving Bank	1	1
Total	**294**	**292**

Source: NRB

3.6 There has been a rapid growth of the banking sector over the last few years. The financial system as of mid-January 2013 included 32 licensed commercial banks (A Class institutions), 90 development banks (B Class institutions), 67 finance companies (C Class institutions), 25 micro finance financial institutions and 50 other financial institutions including NRB permitted cooperatives and NGOs. The banking system has posed the risk of financial stability due to the same nature of banking and financial activities conducted by all the A, B and C class institutions. Though development banks and finance companies have not been permitted to take demand deposits, they undertake limited foreign currency business and hence they are treated as mini commercial banks. Therefore, banking system in Nepal requires restructuring and consolidation with clear demarcation with specific activities for different class of BFIs.

3.7 Along with the liberalization process in Nepal, the establishment of banks and financial institutions gathered momentum without creating sufficient base on prudent legal and operational framework. As a result of that the growth of financial institutions took a rapid tempo untill 2012. During ten years of 2000s financial institutions were established rapidly, enjoying the liberal licensing policy in the financial system in Nepal without strong economic and financial background on its base.During the period, the number of A class financial institutions that obtained license for operating banking and financial activities reached 27 from 13 in year 2000, B class institutions reached 79 from 7 and C class institutions reached 79 from 47. Though there was a rapid expansion in the number of the banks and financial institutions in the economy, the average economic growth remained below 4 percent and other macroeconomic variables including investment remained low implying dismal contribution of such banks and financial institutions to the real economic activities. Increase in the number of financial institutions did not lower the spread rate; rather, it helped to increase such rate, and the credit growth was channelized towards the unproductive sectors, particularly towards the real estate and property markets that lead to real estate market burst in late 2000s. As a consequences, real estate market burst in the late 2010.

Figure 3.1: Development of Financial Institutions and Spread Rate



3.8 The ratio of total assets/liabilities to GDP of the banking and non bank financial institution, on aggregate, reached 125.8 percent in mid-January 2013. Considering banks and financial institutions only, the ratio stood at 111.2 percent during the review period. The ratio for the commercial banks stood at 65.2 percent, a largest share, followed by NRB (26.2 percent), Development Banks (10.1 percent), Finance Companies (6.7 percent), Micro Finance Financial Institutions (1.9

percent), Cooperatives (0.7 percent), and NGOs (0.4 percent). Further, the ratio for contractual saving institutions stood at 14.6 percent comprising 7.9 percent of EPF, 2.2 percent of CIT, 4.4 percent of Insurance Companies and 0.1 of Postal Saving Bank.

Table 3.2: Structure of Nepalese Financial System

(mid-January 2013)

(Rs. in million)

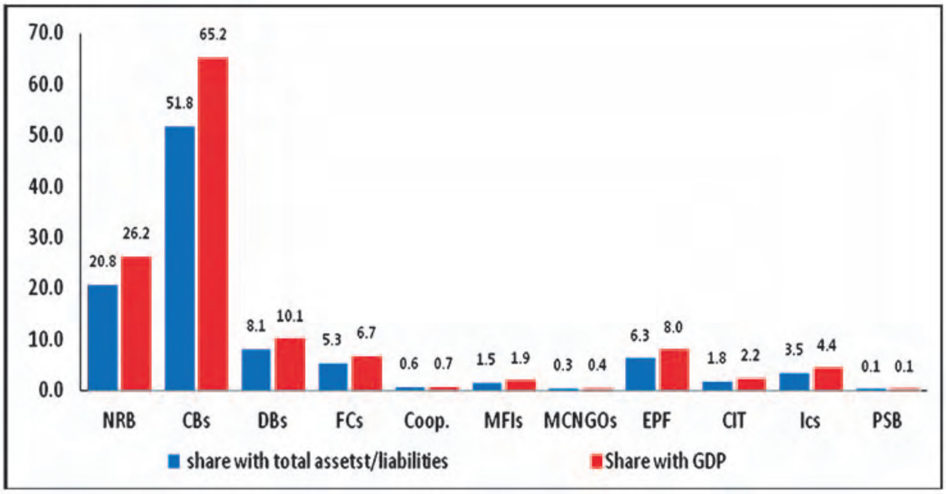
Institutons	Assets/Liabilities	Share (as percent of total)	As percent of GDP
Bank and Financial Institution	1891733.49	88.35	111.20
NRB	445151.3	20.79	26.17
Commercial Banks	1108923.8	51.79	65.19
Development Banks	172578.50	8.06	10.14
Finance Companies	114388.90	5.34	6.72
Cooperatives	12473.55	0.58	0.73
Micro Finance Financial Fnstiutions	31742.2	1.48	1.87
Micro credit non- government Organizations	6475.24	0.30	0.38
Contractual Saving Institutions	248152.41	11.59	14.59
Employees provident Fund	135748.17	6.34	7.98
Citizen Investment trust	38034.84	1.78	2.24
Insurance Companies	74369.4	3.47	4.37
Postal saving Bank	1298.29	0.06	0.08
Total	**2141184.19**	**100**	**125.86**

Source: NRB

3.9 Of the total assets/liabilities of the financial system, the share of BFIs stood at 88.4 percent in mid-January 2013 whereas such ratio was 11.6 percent for the contractual saving institutions. The commercial banks remained the key player in the financial system contributing 51.8 percent of the system's total assets followed by NRB (20.8 percent), Development Banks (8.1 percent), Employees Provident Fund (6.3 percent), Finance Companies (5.3 percent) and Citizens Investment Trust (1.8 percent) as of mid-January 2013. The contributions of micro finance institutions including cooperatives account for 2.4 percent comprising 1.5 percent of Micro finance financial institutions, 0.3 percent of Micro credit Non-Government Organizations and 0.6 percent of Cooperatives.

3.10 In terms of the volume of assets/ liabilities as well as share of assets/liabilities to GDP. Similarly, there are other financial intermediaries including the EPF, Insurance Companies, Cooperatives and small micro finance institutions that are equally important in their contribution to Nepalese financial system. The performance of other financial intermediaries including the cooperatives for the last

Figure 3.2: Structure of Nepalese Financial System

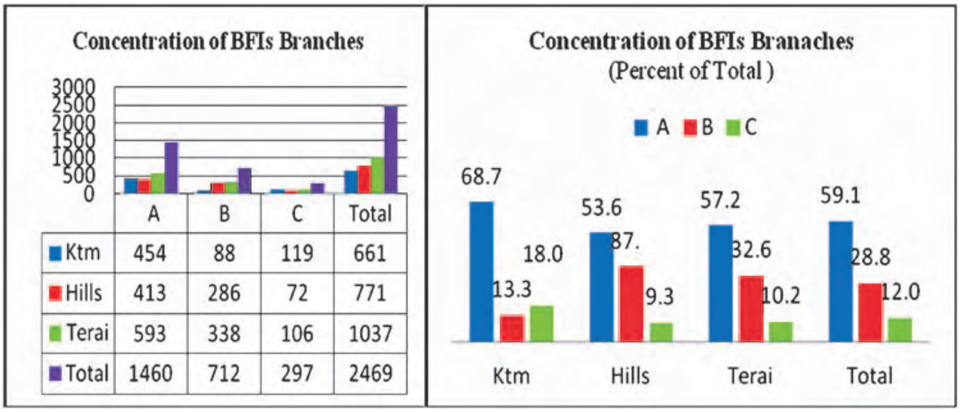


few years has been a matter of policy-concern regarding their significant size of the activities but dismal contribution to the economy. As a consequence of their strong connection with other institutions including the banks the negative shocks arising from the activities of such financial intermediaries including cooperatives (other than NRB's regulatory and supervisory jurisdictions) is likely to spill over to other sound banks and financial institutions leading to leads to systematic risk from the financial stability point of view. Therefore, the financial system of Nepal requires further strengthening by creating strong regulatory infrastructure and provision of supervisory rules and regulations.

3.11 The branch network of the BFIs in the unbanked area has remained a key issue from the point of view to financial access and inclusion in the Nepalese financial system. Total number of bank branches, as of mid-January 2013, of Class A financial institutions stood at 1460 (comprising around 60.0 percent) followed by 712 (28.0 percent) of Class B financial institutions and 297 (12.0 percent) of Class C financial institutions. The numbers were 1356, 650 and 345 respectively for

Class A, B and C class financial institutions as at mid-July, 2012. Among the total bank branches, 26.8 percent were serving only in the Kathmandu valley (661), 31.2 percent in Hills and mountain (771), and 42.0 percent in the Terai (1037) as at mid-

Figure 3.3: Concentration of BFIs Branches



	A	B	C	Total
Ktm	454	88	119	661
Hills	413	286	72	771
Terai	593	338	106	1037
Total	1460	712	297	2469

January 2013. Therefore, the distribution of bank branches, particularly in the Hills and mountain regions is found considerably less, as more than 25.0 percent BFIs branches have been serving only in Kathmandu valley. The districts with highest number of bank branches are Kathmandu, Lalitpur and Rupandehi. On region wise basis, most of the bank branches are located in the Central Development Region followed by the Western and Eastern Development Regions. The Far Western Region has the lowest number of bank branches.

3.12 State-owned banks continued to dominate the banking system. Despite a comprehensive restructuring process of the state-owned banks over the year and the rapid entry of new private banks in the banking system, state-owned commercial banks accounted for more than 30.0 percent of total banking sector assets. The state-owned banks have the largest branch networks also, representing more than half of total bank branches in the country. Among the three large state-owned banks, Nepal Bank Ltd. had 112 branches, Rastriya Banijya Bank has 142 branches and Agriculture Development Bank Limited has 234 branches. Though the performance of state-owned banks is not satisfactory, the continuous reform process therein for the last few years has built a high confidence of those institutions upon the public. Therefore, the reform and restructuring of these institutions should be accorded on top priority for making stronger financial system in Nepal that is capable to counteract the potential shocks and any kind of financial vulnerabilities.

3.13 Major financial instruments used in Nepal are common stocks, debentures, t-bills, bank loan, etc. Common stock and debentures are traded in NEPSE and OTC markets. The NRB issues t-bills on behalf of the government to help liquidity needs of financial institutions. The transaction of bond and equity instruments takes place through Nepal Stock Exchange Ltd. Market capitalization has been increased sharply while a government debt market has still remained underdeveloped. There was a boom in stock market in Nepal between 2006 to 2007, as a consequence share price index increased more than double and market capitalization rose as high as 40.0 percent of GDP at the end of 2007 from merely 17 percent of GDP at the beginning of 2006. The market capitalization to GDP reverted back to its normal position of 30.0 percent at present as the share market index started getting corrected since the early 2008. The size of the government debt market in Nepal has remained small with treasury bills and development bonds accounting for 10.0 percent and 2.0 percent of GDP respectively as at mid-January 2013. Capital market is not found performing well for the last few years as stock prices and NEPSE index are not improving well, despite various efforts were made from the concerned authorities

3.14 There are various regulators of BFIs acting as per the nature of work of different financial intermediaries in the country. The NRB has the mandatory to issue licenses and role of regulator and supervisor for the deposit taking bank and financial institutions in Nepal. The Insurance Board regulates and supervises insurance companies. Similarly, capital market and commodities market are regulated by Securities Board of Nepal. Likewise, EPF and CIT are under the regulatory purview of Ministry of Finance, while Cooperatives fall under the jurisdiction of Department of Cooperatives. In this set up, the financial system of Nepal has been diversified both in terms of financial services available and use of various acts, rules and regulations enforced by different regulating and supervising agencies in the financial system. In terms of the share of total assets/liabilities (out of total) and the contribution of asset/liabilities to GDP, around one third of the financial institutions other than NRB's jurisdictions are still require strong supervision and monitoring to expose their financial status to the public domain on a regular basis. Similarly, in order to identify their connection to one another in the financial market, all the regulatory and supervisory agencies are required to have close coordination and cooperation.

Banking System in Nepal

3.15 As of mid-Jan 2013, commercial banks group occupied 78.9 percent of total assets/liabilities followed by development banks (12.9 percent) and finance companies (8.1 percent). In mid-July 2012, the respective shares were 77.3 percent, 12.4 percent and 8.2 percent. Considering the composition of the total liabilities of commercial bank, the maximum share is held by deposits (79.8 percent) followed by other liabilities (9.6 percent), capital fund (7.8 percent) and borrowings 1.6 percent in mid-January 2013. Likewise in the assets side, loan and advances accounted the largest share of (61.0 percent) followed by investment (12.3 percent), liquid fund (11.0 percent) and remaining group (15.0 percent). In mid-July 2012, the respective shares were 58.5, 12.3, 17.5 and 8.8 percent.

3.16 Commercial banks hold dominant share on the major balance sheet items of financial system. Of the total deposits of Rs. 1125,005 million in mid-January 2013, the commercial banks occupied 79.8 percent. Similarly, development banks hold 12.2 percent and finance companies 7.3 percent. In mid-July 2012, total deposits of financial system was Rs.1076,629 million where the commercial banks had occupied 80.6 percent, development banks 11.8 percent and finance companies 7.1 percent. Likewise, on the loans and advances the share of commercial banks stood at 61 percent, development bank at 13 percent and finance companies at 8.3 percent in mid-January 2013. Commercial banks, development banks and finance companies had loans and advances of 77.1 percent; 12.5 percent, and 8.3 percent respectively in mid-July 2012. Similarly, the share of commercial banks in terms of borrowings, liquid funds and investments constituted 45.1 percent, 66.9 percent and 86.3 percent respectively in mid-July 2012.

Table 3.3: Major Balance Sheet Indicators (Rs. in million)

	Liabilities	Mid-July		Mid-January		Percentage Change	
		2011	2012	2012	2013		
1	Capital fund	103407.53	115162.99	108783.26	127300.41	11.37	17.02
2	Borrowings	34058.68	17805.91	20353.27	21426.30	-47.72	5.27
3	Deposits	869951.43	1071394.11	952724.01	1125005.93	23.16	18.08
4	Liquid funds	147993.99	236056.86	193635.32	194724.40	59.50	0.56
5	Investments	107562.37	137304.43	125857.23	144665.80	27.65	14.94
6	Loan & Advances	698778.98	779560.90	728369.92	879892.38	11.56	20.80

Source: NRB

3.17 The banking system in Nepal has expanded by a wider range over the years on account of deepening indicators and access of financial services. Most of the deepening indicators show an encouraging trend in the overall banking sector development, however, the growth of assets, credit and monetization are not found satisfactory when comparing these indicators with that of emerging Asian and South Asian countries. As of mid-January 2013, the share of total deposit to GDP reached to 66.1 percent comprising 53.0 percent share of commercial banks, 8.0 percent of development banks and around 5.0 percent of finance companies. The dominant share of commercial banks on the total deposit indicates over concentration of such banks in the urban areas with high income people and business communities. Similarly, deposit from rural area and low income people have not yet been captured by other financial institutions as such institutions have negligible share of both total deposit as well as credit to GDP ratio compared to commercial banks. Although the number of D class financial institutions are growing rapidly at present, the share of their deposits and credit to GDP ratio show negligible pattern.

3.18 Lik**e**wise, as of mid-January 2013, the total credit to GDP ratio was less than 12.0 percent for B and C class financial institutions excluding commercial banks. It implied that there is a lack of equal distribution of the access of financial services in the country's financial system. From the financial stability point of view, the dominant share of commercial banks in terms of the ratios of both the deposit and credit to GDP compared to other banks and financial institutions could be one of the main threats, as there is over concentration of financial activities through only one type of financial institutions (i.e. commercial banks) that hampers financial stability in the financial system.

3.19 Total credit to total deposit ratio of Class B (84.0 percent) and Class C (88.0 percent) financial institutions were higher than that of Class A (77.2 percent) financial institution. Though, there is easy access of credit from the development banks and finance companies as against the commercial banks, their negligible share of both the total deposit and credit as percent of GDP compared to commercial banks do not have significant positive impact on economic activities. The NRB as a regulatory and supervisory authority of bank and financial institutions in Nepal, has issued the directive related to maintaining the ratio of credit to deposit and core capital in a phase-wise basis, which, hence is expected to contribute financial stability in Nepal.

3.20 Banks and financial institutions are to provide deprived sector loan as stipulated by the NRB from their total loan outstanding. As of mid-January 2013, such loan from all the banks and financial institutions accounted 3.7 percent of total loan outstanding. The NRB is of the view that the quantum of deprived sector loan should gradually be increased in the future in order to make banks and financial institutions responsible in contributing towards the backward sector of the economy. Bank and financial institutions are in right track in maintaining specified cash and bank balance to total deposit (it is 13.3 percent as at mid-January, 2013) at present, and the NRB is also serious in complying BFIs with such stipulated balance in the days to come.

3.21 Similarly, the total number of branches of the banks and financial institutions in the Nepalese financial system has been increasing over the period. Over concentration of banks and financial institution's branches around the urban area is one of the important concerns for the NRB. The NRB has taken the policy to encourage in expanding as many branches of bank and financial institutions as possible around the country without resorting to issuing new licenses to the banks and financial institutions as the number of banks and financial institutions operating in the economy at present are above the optimal number that has encouraged merger policy in the financial system.

3.22 The number of ATM, Debit Card and Credit Card services provided by different banks and financial institutions have been in an increasing trend over the period and hence encouraged the general public to use modern technology of banking transactions. The NRB is of the opinion that such facilities would significantly contribute to payment and settlement in the country, as NRB's one of the major objectives. The spread of deposit and lending accounts for 7.0 percent as at mid-July 2013. The NRB has adopted several policies to narrow down such spread and maintain an optimal spread over the period. Among such policies, exposure of base rate to the public by the banks and financial institutions within the stipulated time is one of the latest policy formulation and implementation.

Table 3.4: Major Indicators of Banking System in Nepal

(mid-January, in percent)

Financial Ratios	Class "A"		Class "B"		Class "C"		Overall	
	2012	2013	2012	2013	2012	2013	2012	2013
Total Deposit/GDP	56.5	53.2	8.3	8.0	5.0	4.8	69.8	66.1
Total Credit/GDP	40.5	41.1	6.6	6.8	4.3	4.3	51.4	52.2
Total Credit/ Total Deposit	71.7	77.2	79.0	84.2	87.6	88.8	73.7	78.9
Lcy Credit/Lcy Deposit & Core Capital	68.4	74.4	67.0	72.4	72.1	76.7	68.5	74.3
Fixed Deposit/Total Deposit	34.4	32.9	29.4	4.6	47.1	4.3	34.7	41.7
Saving Deposit/Total Deposit	35.1	38.0	47.9	49.3	46.0	46.0	37.4	39.9
Current Deposit/Total Deposit	10.7	9.6	2.1	1.8	0.0	0.0	9.0	7.9
Deprived SectorLoan/Total Loan	3.7	3.9	4.1	3.5	2.5	2.7	3.7	3.7
Cash & Bank Balance/Total Deposit	18.6	12.0	37.2	16.3	35.3	21.6	22.0	13.3
Investment in Gov. Security/Total Deposit	14.7	15.0	2.9	2.3	3.1	2.7	12.4	12.5
Total Deposit/Paid up Capital (times)	12.3	0.0	5.9	0.0	4.4	0.0	9.8	0.0

Source: NRB

Consolidation in Nepalese Banking System

3.23 The banking sector of Nepal has been considered as a fast growing sector, which had been expected to have a positive impact both in economic development as well as outreach of financial services with better health and the soundness of institutions. In the contrary to such expectation, the BFIs in Nepal are found to have a deficiency of sufficient capital base and lack of professionalism in banking business, which have been affecting the health and sustainability of the institutions. Moreover, the banking system of Nepal is characterized by low volume of turnover, high interest rate in lending, high interest rate spread, inefficient management, lack of project financing practice, inadequate working fund and unhealthy competition, among others. As a consequence, financial consolidation policy has been unveiled by the NRB at the recent past. Among the various measures of financial sector consolidation, merger has been one of the important measures. At present, with the objectives like enhancing the confidence of general public upon banking system, protecting the interest of depositors and general investors, promoting healthy and better competition, raising the capital base of financial institutions, and making the financial system disciplined, secured, sound and capable, the NRB has emphasized on consolidation policy through merger of bank and financial institutions. Likewise, in order to avoid the losses of depositors in the case of bank failure, one way to protect such institutions is through increasing the capital base which is an important method for strengthening the consolidation process. The issue of strengthening the consolidation process has been a crucial issue of present discussion among the policy makers in the NRB.

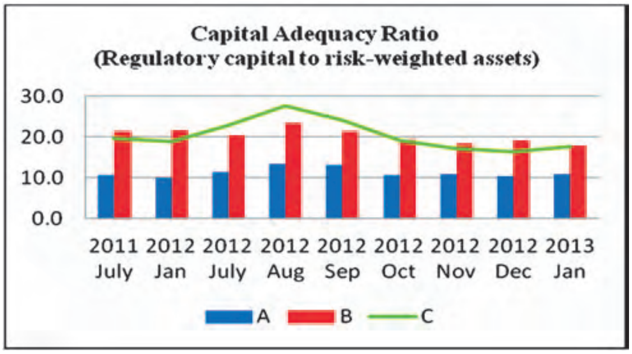
3.24 The NRB issued the Merger Bylaws in 2011 which includes specific process of merger provision of several incentives, regulatory relaxations and an indirect provision of forceful merger. However, some criterion should be fulfilled by the BFIs prior to the implementation of this Bylaws. After the Merger Bylaws came into effect, 30 BFIs have been merged each other forming 14 institutions. Similarly, 32 BFIs (including five RDBs) has obtained the letter of intent (LOI) to create 12 BFIs. In this way, the consolidation process of Nepalese banking system has been actively moving forward and many other BFIs are expected to go for merging with each other in the days to come.

Financial Soundness Indicators (FSI)

Capital Adequacy

3.25 Total capital adequacy ratio of banking system stood at 12.3 percent in mid-January 2013. Commercial banks' capital adequacy ratio declined to 11.0 percent in mid-January 2013 from the level of 11.5 percent in mid-July 2012. The negative capital adequacy ratio of NBL and RBB were the attributing factors that triggered down the overall capital adequacy ratio of the commercial banks. Likewise, the capital adequacy ratios of B and C class institutions have been declining at present. In mid-January 2013, they remained at 17.9 percent and 17.6 percent respectively for B and C class institutions though higher than required minimum capital adequacy ratio. Further, the core capital ratio, as the indicator of high quality capital of financial institutions, stood at 9.6 percent, 17.1 percent and 16.9 percent respectively for A, B and C class institutions implying that Nepalese financial sector is well capitalized.

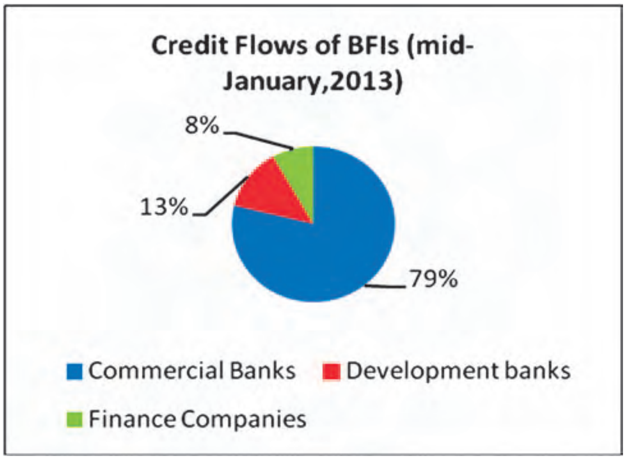
Figure 3.4: Capital Adequacy Ratios



Assets Quality

3.26 The total NPL ratio of A, B and C class institutions declined substantially to 4.4 in mid-January 2013, from the level of 6.1 percent as of mid-July 2012. The total NPL of finance companies posted

Figure 3.5: Credit Flows of BFIs



the maximum of 14.1 percent followed by development banks 5.8 percent and commercial banks 3.2 percent in mid-January 2013. The asset quality of commercial banks has deteriorated slightly in mid-January 2013. The total NPL ratio, as a measure of asset quality, increased to 3.17 percent in mid-January 2013 from the level of 2.6 percent in mid-July 2012. Similarly, the average of total non-performing loan (net of provision) to capital for A, B and C class institutions reached 6.9 percent during the review period comprising 6.91 percent, 8.47 percent and 4.2 percent respectively for A, B and C class institutions.

3.27 Looking at the exposure of BFIs in term of sector wise, security wise and product wise credit, wholesalers and retailers sector was the highest receiver of loans and advances in mid-January 2013 with 20.7 percent followed by the production sector with 20.08 percent. Similarly, finance, insurance and real estate received 9.41 percent of total credit. Though the majority of the people depend on agriculture for their livelihood and contribution of agriculture to GDP is around 35.0 percent, the loan that flowed towards this sector was merely 3.9 percent of GDP. Of the total loan and advances, fixed and current account formed at 86.3 percent out of which 71.3 percent constituted of fixed assets. As more than 70 percent of total loan and advances of BFIs was securitized by fixed assets like land and buildings, the apparent sluggishness in realty sector is expected to have negative repercussion on the value of such securities. As most of the BFIs still do not have strict, fair and periodic revaluation policy and practice, deterioration in the value of such securities adversely affects the quality of credit and hence leads to increase in NPL as well as decrease in profitability, liquidity with end result of financial instability in the medium term.

3.28 With regard to sector wise loan and advances, manufacturing (producing) and wholesaler and retailer loan forms more than 40 percent of total loan of BFIs. Agriculture sector accounted less than 4.0 percent of total loan portfolio with a gradual upward trend in the recent months. Though 'others' sector constitute around 13.0 percent of total loan portfolio. the BFIs paucity of detail reporting of the loans and advances under this heading. Consumption loans increased by around 29 percent in the review period which forms 6.6 percent of total loan portfolio. The high growth of consumption loan of the BFIs accompanied by high inflation and remittance growth in the economy reveals encouraging credit growth, particularly to the unproductive sector despite a number of policy measures brought to control such loans towards such sector.

3.29 Likewise, in the product-wise loan and advances, demand and working capital loan forms around 23.0 percent followed by overdraft loan (18.9 percent), term loan (13.8 percent) and real estate loan (10 percent) as at mid-January 2013. The real estate (including residential personal housing loan) loan accounts for 16.5 percent of the total loan of the BFIs. The major portion of loan provided under overdraft and working capital categories indirectly exposed BFIs to realty sector which gave rise to one big challenge for the stability of financial system originating from the overconcentration of excessive lending particularly on the real estate sector. Over exposure on this sector has further aggravated the situation as there is a decline in real estate prices and slowdown in transaction posing stress to the banking sector. Indirect exposure of BFIs in realty sector through collateral is almost two-thirds of total assets implying very low direct exposure to this sector. However, a significantly damaged balance sheet of the BFIs as a result of decline in real estate prices and slowdown in transaction is not reflected in the reported NPLs of the BFIs.

Table 3.5: Major Credit Distribution from BFIs

(in percent, mid-January 2013)

Categories of Credit	CBs	DBs	FCs
Sector Wise			
Agricultural and Forest Related	79.8	14.8	5.4
Wholesaler & Retailer	80.6	13.1	6.3
Manufacturing (Producing) Related	92.3	4.5	3.2
Construction	73.8	15.3	10.9
Finance, Insurance and Real Estate	77.8	13.0	9.2
Product Wise			
Term Loan	80.0	11.2	8.8
Overdraft	81.2	18.8	0.0
Trust Receipt Loan / Import Loan	100.0	0.0	0.0
Demand & Other Working Capital Loan	83.5	7.0	9.5
Res. Per. H. Loan (Up to Rs. 10 mil.)	70.6	18.4	11.0
Real Estate Loan	74.5	13.9	11.7
Collateral Wise			
Fixed Assets	73.2	16.7	10.2
Current Assets	99.3	0.3	0.3

Source: NRB

Profitability

3.30 The profitability situation of Nepalese BFIs is observed from the financial accounting point of view in Nepal as the focus of BFIs lies on reporting satisfactory financial picture only at the end of fiscal year. Therefore, the measurement and assessment of profitability situation at the mid-year may not give a clear and consistent picture when analyzing the profitability ratios of the BFIs. Though Nepalese economy is characterized by low economic growth and weak investment over the periods, the earning of the BFIs is found ever greening during the periods under review raising some policy concern that how bank's overall profitability could be an increasing trend even there were a decline in demand of credit. Low level of credit growth, huge credit exposure in real estate sector (directly or indirectly), decline in real estate prices and transactions, excess liquidity leading to lower returns, unstable socio-political environment and growing competition among the BIFs leading to the deterioration in interest income are the major threats for the sustainability of earning sources of the BFIs in the medium and long run. The position of profitability has been measured with the help of return on assets (ROA) and return

Figure 3.6: Return on Assets

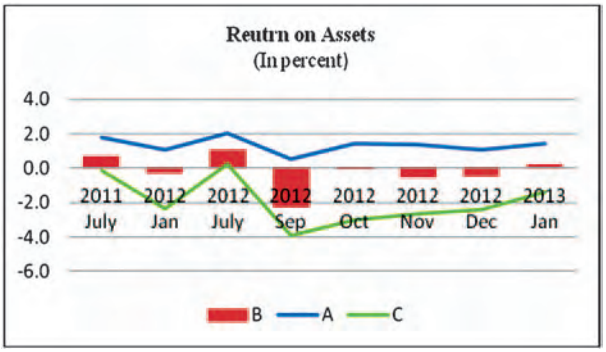
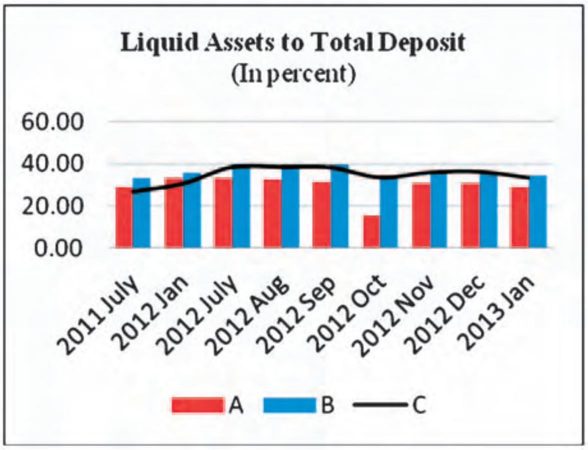


Figure 3.7: Liquid Assets to Total Deposit Ratios



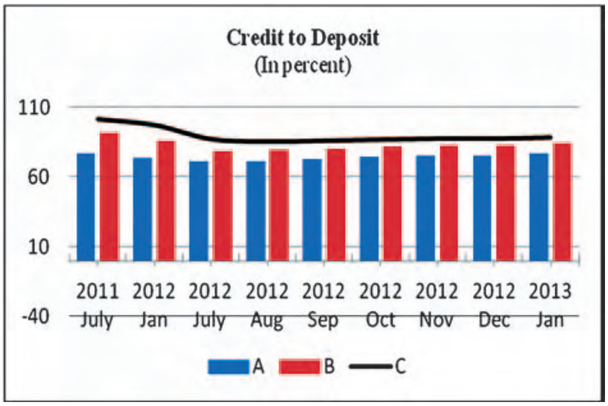
on equity (ROE). ROA is a comprehensive measure of overall bank performance from an accounting perspective.

3.31 In mid-January 2013, total ROA, on an average, for all A, B and C class institutions stood at 1.07 percent compared to 0.53 percent in mid-January 2012, both ROA and ROE improved in the review period. In mid-January 2013, ROA of A, B and C class institutions were recorded at 1.46 percent, 0.23 percent and negative 1.38 percent respectively. Likewise, total return on equity increased to 10.88 percent in mid-January 2013 from the level of 5.62 percent in mid-January 2012. ROE was recorded at 15.94 percent for A class institutions and 1.79 percent and negative 12.14 percent for B and C class institutions respectively. Both the interest margins to gross income and non-interest expenses to gross income stood at 75.18 percent and 46.02 percent respectively in mid-January 2013. The interest margin to gross income ratio of A class institutions has improved since mid-July 2012; however, non-interest expenses to gross income ratio declined in the review period. In contrast, these ratios of B and C class institutions have declined from direction mid-July 2012 to mid-January 2013.

Liquidity

3.32 Nepalese BFIs are experiencing comfortable liquidity situation at present against a severe liquidity crisis in 2010/11. In the review period, the increase in deposit clearly depicts that the overall banking sector liquidity problem have eased down immensely. The inter-bank lending rate remained almost zero again indicating that the banking system, particularly, the commercial banks have excess liquidity with them. The various policy measures initiated by the NRB to resolve the liquidity problems along with the surplus in balance of payment situation, improvement in foreign exchange reserve with the increase in remittances, export earnings and low growth in import, among others. contributed to an increase in

Figure 3.8: Credit to Deposit Ratios



domestic deposits in 2011/12, and hence improved liquidity position. Total liquid asset to deposit ratio of BFIs stood at 30.09 percent in mid-January 2013. The liquid asset to deposit ratio for A, B and C class institutions was recorded at 29.12 percent, 34.61 percent and 33.36 percent respectively, and remained above the regulatory requirement of 20 percent of all of them.

3.33 As at mid-January 2013, the credit to deposit ratio of BFIs stood at 78.8 percent. The credit to deposit ratios respectively for A, B and C class institutions stood at 77.1 percent, 84.1 percent and 88.76 percent respectively. Similarly, total liquid assets to total assets of BFIs stood at 23.5 percent in mid-January 2013 comprising 23.2 percent, 25.4 percent and 23.6 percent respectively for A, B, and C class institutions. Despite the liquidity pressure being moderated at present, liquidity risk is likely to hit banks at any time, as they are subject to operating under growing competition, poor asset/liability management practices, poor corporate governance and high dependence on corporate deposits and remittance as well as huge amount of government balance with NRB since mid-July 2012.

Commercial Banks

3.34 There are 32 commercial banks in operation as of mid-January 2013. The number of branches of commercial banks operating in the country increased to 1460 in mid-January 2013 from 1425 in mid-July 2012. Among the total bank branches, 49.7 percent are concentrated in the Central Region followed by Western Region with 17.7 percent, Eastern Region with 18.3 percent, Mid-Western Region with 8.4 percent and Far-Western Region with 5.8 percent. Although, total deposit and credit of commercial banks are in an increasing trend, a disappointing business sector growth and their poor demand of loan have hampered profitability both in the medium and long run. Likewise, the increased unhealthy competition among banks and financial institutions is a major factor that can hold the growth of financial institutions. Despite the deteriorating economic and political situations in the country, financial institutions, particularly the commercial banks have been able to increase their profit by a good margin. The higher interest being charged for lending and contracting of deposit interest rate may have increased the banks income in the review period. Commercial banks are found aggressive in lending immediately after mid-July 2012 despite deceleration in deposit growth rate.

3.35 The total assets/liabilities of commercial banks grew by 6.3 percent and reached Rs. 1134 billion in mid- January 2013 from the level of Rs. 1067 billion in mid-July 2012. Such asset/liabilities had increased by 7.3 percent in mid-July 2011.The share of loans and advances in total assets stood at 61.6 percent in mid-January 2013. Similarly, share of investment and liquid funds in total assets stood at 5.1 percent and 23.2 percent respectively. Due to excess liquidity position, commercial banks are found focusing on increasing their loan and advances. Consequently, they were successful in raising their loans and advances by more than 24 percent (more than 6-7 percent of deposit growth) from the level of mid-January 2012. However, such loan and advances in the productive sectors is minimal. Considering the growth of both the loan and advances and deposit, old banks are slowly losing their market share, and new banks are moving forward aggressively in terms of deposit collection and mobilization.

Figure 3.9: Assets Composition of CBs

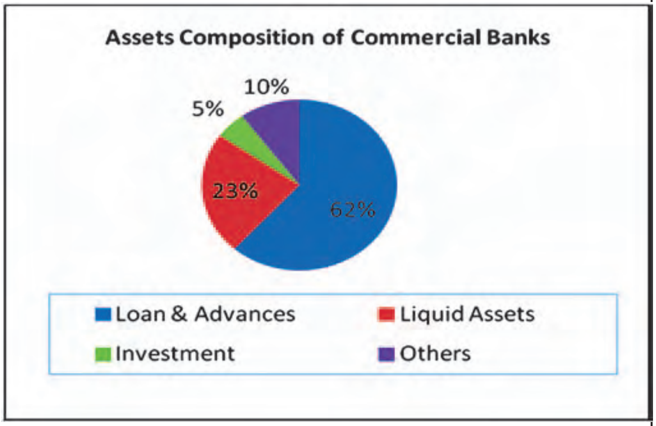


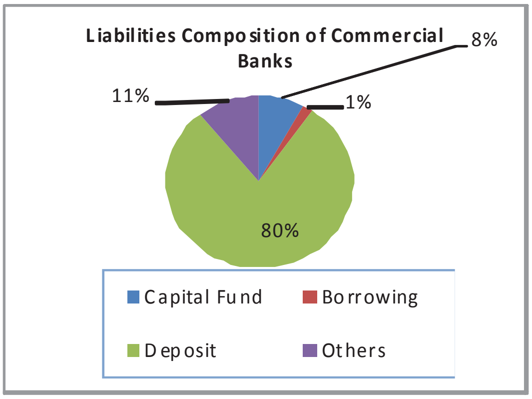
Table 3.6: Composition of Total Assets of CBs

Composition of Total Assets (Rs. In Million)										
Particulars	Mid-Jan 2013	% of Total	Mid-July 2012	% of Total	Mid-Jan 2012	% of Total	Mid-July 2011	% of Total	Mid-Jan 2011	% of Total
Loan & Advances	699066.6	61.6	622575.5	58.3	561719.5	59.6	528023.1	60.1	510144.1	63.1
Liquid Assets	263749.8	23.2	292028.8	27.4	254862.4	27.0	200026.8	22.8	162024.5	20.0
Investment	58159.4	5.1	51029.4	4.8	44310.9	4.7	47602.3	5.4	51545.6	6.4
Others	113856.4	10.0	101463.0	9.5	81880.4	8.7	102712.3	11.7	84598.3	10.5
Total Assets	1134832.2	100.0	1067096.7	100.0	942773.2	100.0	878364.5	100.0	808312.5	100.0

Source: NRB, Statistics Division, BFIRD

3.36 In mid-January 2013, the loans and advances increased by 12.3 percent Rs. 699 billion from the level of Rs. 623 billion in mid-July 2012. Such loans and advances had increased by 6.4 percent in mid-July 2011. In the review period, the total investment including share and other investment of commercial banks increased by 14.0 percent while liquid fund decreased by 9.7 percent. Considering the different components of liabilities, deposit occupied a dominant share of 79.8 percent followed by other liabilities with 10.7 percent, capital fund with 7.8 percent and borrowings with 1.6 percent in mid-January 2013. Total deposits of commercial banks increased by 4.4 percent in mid-January 2013 compared to the level at mid-July 2012. Such deposit had increased by 10.7 percent from the level in mid-July 2011. Saving deposits accounted for 38 percent of total deposits followed by fixed deposits (32.9 percent), call deposits (18.5 percent), current deposits (9.6 percent) and other deposits (1.1 percent).

Figure 3.10: Liabilities Composition of CBs



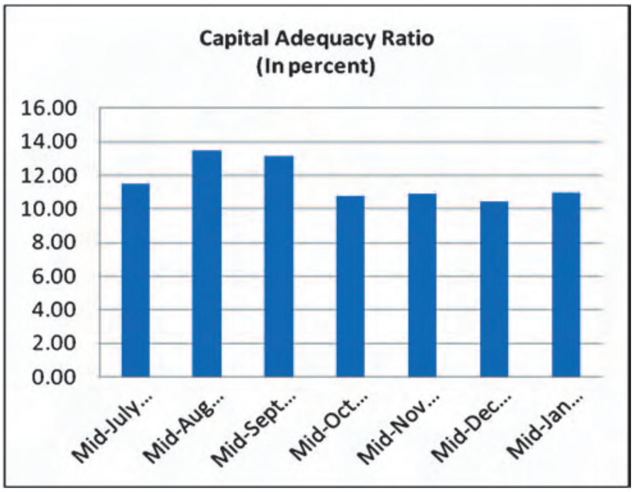
3.37 The effective and efficient utilization of deposit, as the main source of fund available to the banks, towards various profitable ventures determines the magnitude of profits and earnings. The total deposit of commercial banks in mid-January 2013 grew by 19.0 percent from the level in mid-January 2012. The banks in the review period were not in a excess liquidity situation the way they had excess liquidity last year. As a result of an excess liquidity last year, interest rate came down and banks concentrated on aggressive lending rather than mobilizing deposits immediately after mid-July 2012 motivated with earning profitability in the same proportion. Banks had mobilized highest deposit announcing super interest rate in different products in the face of the liquidity crisis in 2011, their focus turned for such lending.

Table 3.7: Composition of Total Liabilities of CBs

Composition of Total Liabilities ((Rs. In Million)										
Particulars	**Mid-Jan 2013**	**% of Total**	**Mid-July 2012**	**% of Total**	**Mid-Jan 2012**	**% of Total**	**Mid-July 2011**	**% of Total**	**Mid-Jan 2011**	**% of Total**
Capital Fund	88909.9	7.8	77142.6	7.2	66636.7	7.1	59064.4	6.7	53649.3	6.6
Borrowing	18360.4	1.6	15507.2	1.5	15940.7	1.7	24852.8	2.8	36378.7	4.5
Deposit	905867.7	79.8	867978.3	81.3	761247.1	80.7	687587.9	78.3	627091.8	77.6
Others	121694.2	10.7	106468.6	10.0	98948.7	10.5	106859.4	12.2	91192.7	11.3
Total Liabilities	1134832.2	100.0	1067096.7	100.0	942773.2	100.0	878364.5	100.0	808312.5	100.0

Source: NRB, Statistics Division, BFIRD

Figure 311: Capital Adequacy of CBs



3.38 In the review period, the borrowings of commercial banks increased by 18.4 percent to Rs. 15.5 billion; the borrowing had decreased by 35.9 percent in the same period of the previous year. In mid-January 2013, the capital fund of commercial banks grew by 15.3 percent to Rs. 88.9 billion from from the level in mid-July 2012. Looking at the provisionings, though the the growth rate of provisioning declined during the review period however the,volume of provisioning recorded a huge amount , which s that on the one hand banks are facing tough time in recovering their loans on time due to the slow recovery of real estate loan from the market and on the other hand clients are realizing an uncomfortable situation for the payment of principal amount and interest. The capital adequacy ratio of commercial banks decreased by 0.5 percentage point and stood at 11.0 percent in the review period compare with 11.5 percent in mid-July 2012. The capital adequacy ratio of two state owned banks are negative and such ratio for other banks remained above the regulatory minimum benchmark of 10.0 percent.

3.39 The asset quality of commercial banks has been in a deteriorating situation in the review period. The NPL ratio reached to 3.2 percent in mid-January 2013 from 2.6 percent in mid-July 2012. Average NPL ratio of three state owned commercial banks was 6.7 percent, whereas such ratio for private commercial banks was 2.4 percent in mid-January 2013. The respective ratios were 6.5 percent and 1.7 percent in mid-July 2012. Similarly, non-performing loan net of provisions to capital stood at 6.9 percent in the review period. When analyzing the real estate exposure of commercial banks (, i.e. above 25.0 percent), none of the 32 banks is found maintaining as high as regulatory limit, but some banks are found to have a very high share of exposure, which need to be reduced in the short run. With the real estate business being in the declining trend and being less attractive sector for the banks now to invest, the banks found diminished their exposure in real estate sector, on an average below 10 percent compared to above 13.0 percent in mid-January 2012. Considering the loan portfolio of the banks, long term loans of the commercial banks showedan increasing trend, which signaled that more loans were flowed to long term projects financing like hydropower sector which hence is expected to contribute in increasing economic growth in the future.

3.40 Commercial banks provided largest share of loans (23.5 percent of total loan) to the sectors such as agricultural, forestry and beverage production in mid-January 2013. Loan to these sectors was followed by the wholesaler and retailer sector with 21.20 percent and finance, insurance and real estate sector with 9.3 percent. Similarly, construction sector received 9.2 percent of total loan. Loan and advances of the commercial banks are backed by the various securities, but deterioration in the value of such securities affects the quality of banks' credit, and thus increases in NPL. With regard to product wise classification of loan, 24.6 percent of the total loan is under the category of demand and other working capital products. Similarly, 19.5 percent and 14.0 percent of loans was extended to overdraft and term loan products respectively. The ratio of the real estate loan (in which housing loan up to Rs. 10 million is excluded) to total loan declined to 9.5 percent in mid-January 2013 from 11.2 percent as in mid-July 2012. The NPA level was found slightly in increasing trend during the review period and the level of NPA reported by the banks has created some doubts in their reporting practice.

3.41 ROA of commercial banks stood at 1.4 percent in mid-January 2013. Such return was 2.04 percent in mid-July 2012. Similarly, ROE of commercial banks stood at 15.9 percent in mid-January 2013 compared to 22.4 percent in mid-July 2012. As a result of reduced interest rate of deposits, the interest expenses of banks decreased during the review period from the level in the previous year. Net profit of commercial banks stood at Rs. 8.3 billion in mid-January 2013. The six months' profit of the previous year was Rs. 4.9 billion. When analyzing the base rate of commercial banks, which they have recently started to publish as per the standard guidelines of the NRB, commercial banks were still working with very high spread in the market, a main reason behind the surge in earning. In this way, the profitability situation of commercial banks increased dramatically and posted a whopping more than 40 percent hike in net profit. Banks profitability was primarly mainly due to the significant growth in credit carried out through the deposit growth during the period. Similarly, decrease in cost of fund and net interest spread might be the strong reasons behind the high growth of net profit of those banks. The cost of fund of commercial banks that stood less than 9.0 percent in mid-January 2012 has come down by more than 27.0 percent which corresponds to slightly higher than 6.0 percent in the review period. The increase in net spread of commercial banks as a result of decline in deposit rate has positively affected the bank's profitability situation rather than encouraging demand for loan to business communities.

3.42 The liquid asset to deposit ratio of commercial banks was recorded at 29.1 percent in mid-January 2013, which is above the regulatory requirement of 20.0 percent. This ratio was 33.30 percent in mid-July 2012. During the review period, the liquid asset to deposit ratio of commercial banks declined by 1.2 percentage point from the level in mid-July 2012. The liquid asset to total asset ratio of commercial banks stood at 23.24 percent in mid-January 2013, whereas such ratio was 27.1 percent in mid-July 2012.The credit to deposit ratio of commercial banks stood at 77.2 percent in the review period compared to 71.7 percent in mid-July 2012. Although the overall ratio is well below the regulatory requirement of 80 percent, some banks are found more aggressive to maintain required ratio during the short span of time, whereas some banks are found to have maintained such ratio fairly below the limit, which indicated that those banks that maintained the ratio fairly below the limit seem unable run with full capacity due to lack of investment demand opportunities in the market.

3.43 The commercial banks in Nepal have a very big role to play in terms of maintaining financial stability as well as growth of the economy. Although the overall financial soundness indicators and stress testing result show the satisfactory situation of commercial banks, which hold more than seventy percent of market share in the banking system of Nepal, the prevailing political situation, weak economic growth, widening trade deficit and weak external sector performance and infrastructure, unfavorable business environment, lack of expediating the implementation process of big projects, and delayed decision-making process, among others have been creating risk on the banking sector and ultimately on the financial stability of the country. The reform measures adopted by the NRB at present particularly through the consolidation process have brought the positive outcome on financial stability situation of country. However, there are various issues that need to be addressed in overall banking industry such as enhancing good corporate governance, analyzing operational risk of banking business, and controlling of ever greening of loans of the banking sector for the achievement of desired objective of financial stability in the economy. Problem bank resolution unit is a recent addition in the Bank Supervision Department (BSD) of the NRB. It is setup with the purpose of designing the framework and resolving the problematic BFIs and implementing the step by step resolution process in case of necessity. This unit identifies additional procedures and best practices regarding problematic bank resolutions and prepares itself to act when situation warrants. Besides, it is working on designing the prompt corrective actions also in case there is liquidity shortfall and excessive NPA of the BFIs.

Stress Testing of Commercial Banks

3.44 The NRB has introduced stress testing system to the banks from 2011/12. It has issued stress testing guidelines consisting of simple methods of popular stress testing process at present. Stress testing as a forward looking risk management tool adopted by the NRB has been applicable for the first time to "A" class financial institutions. The NRB has taken the policy of enforcing stress testing practice gradually for both the "B" and "C" class financial institutions starting from 2012/13. Stress testing practice is used to evaluate the potential impact of specific events on a bank and the impact of such events on a set of financial variables. All the commercial banks have been advised to carry out stress testing on a quarterly basis. The banks need to assess their soundness in the key risk areas such as credit risk, market risk, and liquidity risk. Based on the data as of mid-January 2013, the stress testing results of 32 commercial banks on various shocks have been observed as follows.

Credit Shock

3.45 The stress testing results of commercial banks as of mid-January 2013 revealed that a standard credit shock would push the capital adequacy ratio of 28 out of total 32 commercial banks below the regulatory minimum benchmark of 10 percent. The number of such banks was 22 in mid-July 2012 and 23 in mid-January 2012. Stress testing is conducted based on different scenarios,that is. deterioration of various categories of loan to substandard, doubtful and loss loans, among others. It has been found that in case 25 percent of performing loans of real estate and housing sector is directly downgraded to loss loans, capital adequacy ratio of 13 commercial banks will come below the required level of 10 percent, compared to 8 banks in mid-July 2012 and 16 banks in mid-Jan 2012. Thus, the result explained above signify that banks tension from the exposure to real estate and housing sector during the review period since mid-July 2012 have increased significantly.

3.46 Likewise, if top 2 large exposures (loans) are downgraded from performing to substandard category the capital adequacy ratio of 3 commercial banks would come below the required level. The overall credit shock scenario showed that banks credit quality has not been improved in the review period and banks are likely to have a difficult situation in case of slowdown in recovery, downgrade of loans and increase in provisioning.

Liquidity Shock

3.47 Though the liquid assets to deposit ratio of whole banking system as well as the commercial banks showed an improved situation over the period, the stress test results found that two third of the commercial banks may turn into a vulnerable situation in case of withdrawal of deposits by 10.0 percent or more. Those banks having significant portion of institutional deposits, may turn into liquidity strain in case of withdrawal of their deposits by their top institutional depositors. The number of banks that may turn illiquid after five days of standard withdrawal shock has increased significantly to 19 in mid-January 2013 from 5 in mid-July 2012 and 12 in mid-January 2012. Standard withdrawal shock is the withdrawal of customer deposits by 2.0 percent and 5.0 percent in the first two days and 10 percent each in the following three consecutive days.

3.48 Similarly, if there is a withdrawal of deposit by 5.0 percent, 10.0 percent and 15.0 percent the number of bank's whose liquid assets to deposit ratio below the regulatory minimum of 20.0 percent stood at 7, 20 and 26 in mid-January 2013. The numbers of such banks were 0, 6 and 14 in mid-July 2012 and 2, 9 and 20 in mid-January 2013. With the shock on withdrawal of deposits by top 3 and 5 institutional depositors, liquid assets to deposit ratio of 21 and 25 commercial banks' will be below 20 percent. In mid-July 2012, the number of such banks were 12 and 17. These liquidity shock show that liquidity position of commercial banks may have been deteriorating since mid-July 2012, though the general macroeconomic and financial indictors as well as the inter-bank rate, including the t-bills rate have presented the improved situation of liquidity in the banking system of Nepal.

Market Shock

3.49 The stress testing results revealed that all the commercial banks' (excluding two state owned banks) CAR was above the regulatory requirement when calibrating through interest rate, exchange rate and equity price shocks. Also, they were safe from exchange rate risks as the net open position to foreign currency is lower for a majority of them. Furthermore, since commercial banks are not allowed to make equity investments except in their subsidiaries, the impact of fluctuation in equity price is also lower. When going through market shock, 30 out of 32 commercial banks (excluding two state owned banks) have maintained their capital adequacy ratio above the regulatory requirement of 10.0 percent. The banks do not bear interest rate risks as they pass it directly to their clients, so that they are found to be less affected by interest rate shock.

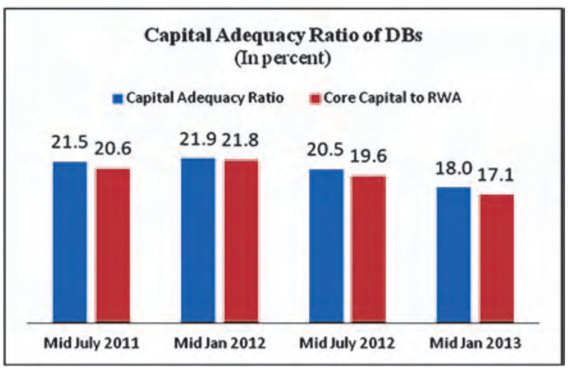
Development Banks

3.50 Total number of development banks stood at 90 in mid-January 2013 which was 88 in mid-July, 2012. Out of 90 development banks, 19 are national-level and rest are regional and district-level development banks. During the review period, a finance company merged with a national-level development bank and became a national-level development bank and two district-level development banks obtained license and came into operation. Likewise, 25 new branches were opened up in the review period aggregating 712 development bank branches operating in the country.

3.51 The offsite unit monitors and reviews CRR positions on weekly basis, capital adequacy and SLR on monthly basis and deprived sector lending, real estate, margin lending (product wise loan), loan classification, single obligor limit, sector wise loan, security wise loan, deposits, structural liquidity and other indicators on a quarterly basis. In the review period, three development banks were penalized for not maintaining the minimum CRR ratio of 5.5 percent and two banks were penalized for shortfall in deprived sector lending. As stated in the Monetary Policy for 2012/13, the task of daily liquidity monitoring of all development banks and stress testing of development banks mobilizing deposit exceeding Rs. 2 million have also been initiated at the Development Bank Supervision Department (DBSD). Similarly, the NRB has been conducting diagnostic review with the objective to reviewing risk management practice, corporate governance, reviewing inter-connectivity and review of real estate loans for 20 BFIs including 6 development banks with the technical assistance of the IMF. By the end of mid January 2013, the diagnostic review of two developments banks has been completed. The diagnostic reviews of all BFIs are scheduled to be completed by the end of mid-July 2013.

3.52 For regular monitoring, follow ups and detail study of problematic development banks, a problem bank resolution unit has been arranged in DBSD recently. The DBSD conducts regular onsite inspection of all development banks once a year as per the approved annual plan of the Department. Besides regular inspection, special follow up and physical infrastructure inspections are also being carried out on need basis. Till mid-January 2013, 48 regular inspection and 20 special inspections of development banks have been completed.

Figure 3.12: Capital Adequacy Ratio of DBs



3.53 The capital fund of development banks stood at Rs. 23.82 billion in mid-January 2013 compared to Rs. 22.70 billion in mid-July 2012. The capital adequacy ratio was 17.9 percent in the review period. It was decreased by 2.5

percent in the review period compared to 20.5 percent in mid-July 2012. The reason behind the fall in capital adequacy ratio was the increase in risky assets. The capital adequacy ratio has been deteriorated since mid-July 2012. Moreover, the core capital to risk weighted assets was 17.1 percent in mid-January 2013 compared to 19.6 percent in mid-July 2012. During the review period, among 90 development banks, only three development banks had not maintained the statutory capital adequacy ratio of 11.0 percent , nine institutions were in buffer capital of 1.0 percent and rest were in buffer capital of two percent or more . Most of the development banks were in comfortable position in terms of capital adequacy, although its growth has been declining.

3.54 Total assets of development banks increased by 8.9 percent to Rs. 186 billion in mid-January 2013 compared to the growth of 12.8 percent in mid-July 2012. Loan and advances of the development banks increased by 14.5 percent to Rs. 115 billion in the review period, compared to the growth of 9.5 percent in mid-July 2012. The share of loans and advances in total assets was 61.9 percent in mid-January 2013, which was 58.8 percent in mid-July 2012. Similarly, share of liquid assets in total assets declined from 27.7 percent to 23.7 percent in the review period. Share of investment in total assets remained very low both in mid-July 2012 and in mid-January 2013. Its contribution was only about 3.0 percent in both the periods.

Table 3.8: Composition of Total Assets of DBs

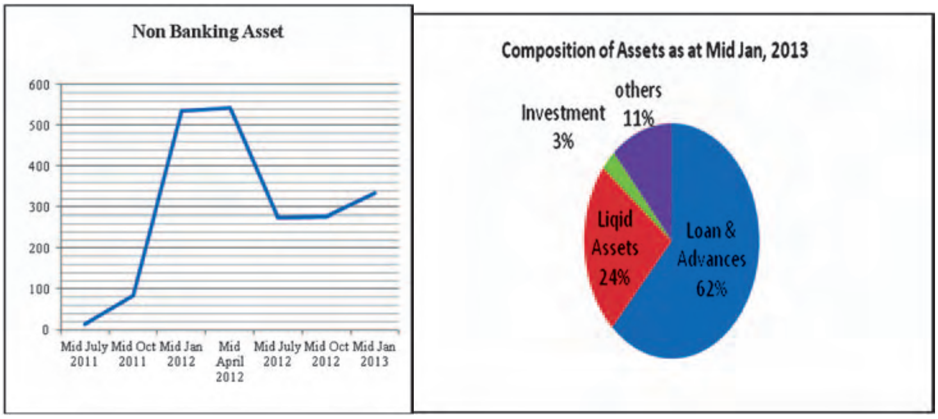
(mid-January 2013)

Composition of Total Assets (Rs. in Million)								
Particulars	**Mid -July 2011**	**% of Total**	**Mid-Jan 2012**	**% of Total**	**Mid-July 2012**	**% of Total**	**Mid-Jan 2013**	**% of Total**
Loan & Advances	88969.0	63.7	91091.0	61.1	100621.8	58.9	115251.0	61.9
Liqid Assets	29411.3	21.0	34247.0	23.0	47387.4	27.7	44233.3	23.8
Investment	5863.2	4.2	5898.0	4.0	5354.2	3.1	5251.8	2.8
others	15492.8	11.1	17786.0	11.9	17530.3	10.3	21446.9	11.5
Total Assets	139736.2	100.0	149022.0	100.0	170893.7	100.0	186183.0	100.0
Source: NRB, Statistics Division, BFIRD								

Note: Loan & Advances include loan & adv and bills purchased. Liquid assets include cash balance, bank balance and money at call. Investment includes investment in securities, share & other investment. Others include fixed assets, other assets, expenses not written off, NBA, and Reconciliation A/C & P/L (Cr. Bal)

3.55 Total amount of non-banking assets of development banks increased sharply by 21.05 percent to Rs. 334 million in mid- January 2013**.** The asset quality of development banks seems to have deteriorated in the review period as the non

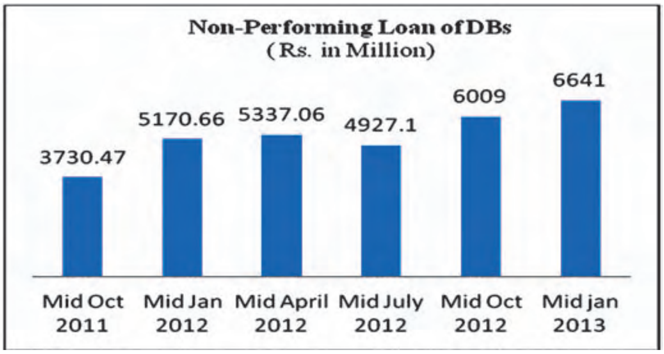
Figure 3.13: Non-banking Assets and Composition of Assets of DBs



performing loan increased by 35.0 percent to Rs. 6640.67 million in mid-January 2013. Further, ratio of non-performing loan to total gross loan stood at 5.7 percent in mid-January, 2013 compared to 4.9 percent in mid-July 2012.

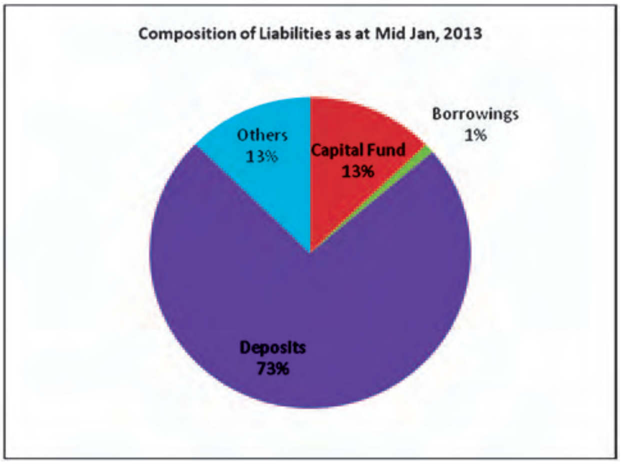
3.56 Net profit of development banks increased by 10.0 percent (y-o-y) and stood at Rs. 903.65 million in mid-January 2013. Interest income and interest expenses grew by the same rate of 10.0 percent both in mid-January 2012 and in mid-January 2013. Interest income, contributed 83.6 percent to the total income (a significant contributor of total income), with remaining income comprised of income from commission, other incomes, exchange income, provision write back, recovery of write-off loans and non-operating income**.** Return on assets of development banks stood at 0.2 percent

Figure 3.14: Non-performing Loan of DBs



as on mid-January 2013 compared to 1.1 percent as on mid-July 2012. Since the major recovery of loan took place at the end of fiscal year, return on asset was higher in mid-July 2012.

Figure 3.15: Composition of Liabilities of DBS



3.57 Liquid assets of development banks declined by 6.6 percent in mid-January 2013 from the level maintained at mid-July 2012. The ratio of liquid assets to total deposits at mid-January 2013 was 32.3 percent, which was 37.2 percent at mid-July 2012. The ratio of liquid assets to total assets in mid-January 2013 was 23.7 percent as compared to 27.7 percent at mid-July 2012. The ratios depicted that the development banks were in comfortable position in terms of liquidity during the review period.

3.58 Deposit is the major source of fund for the development banks comprising 73.5 percent of total liabilities in mid-January 2013, which was 74.5 percent in mid-July 2012. The total deposits increased by 7.7 percent to Rs. 137 billion during the review period compared to a growth of 16.5 percent in mid-July 2012. The second largest source of fund was capital fund, followed by others heading. Capital fund contributed 12.8 percent in mid-January, 2013 compared to 13.3 percent mid-July 2012 whereas such contributions in case of others heading were 12.7 percent and 11.5 percent in the respective periods.

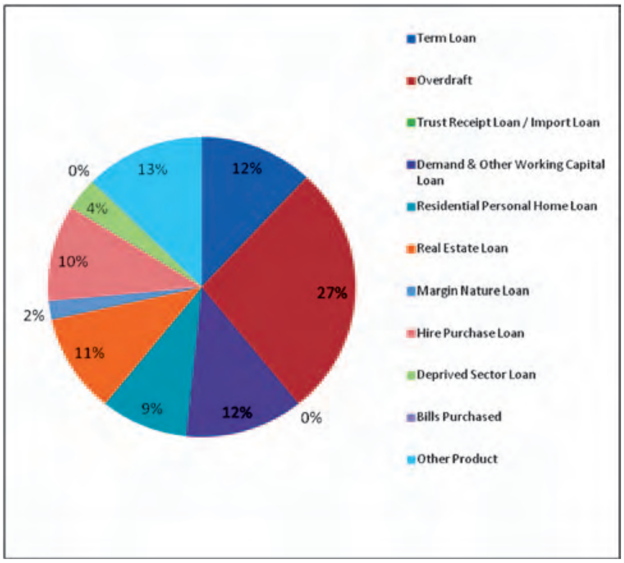
Table 3.9: Composition of Total Liabilities of DBs

Composition of Total Liabilities (Rs. in Million)								
Particulars	Mid-July 2011	% of Total	Mid-Jan 2012	% of Total	Mid-July 2012	% of Total	Mid-Jan 2013	% of Total
Deposits	96886.7	69.3	106276.5	71.3	127300.1	74.5	136930.1	73.5
Capital Fund	22524.6	16.1	22587.1	15.2	22702.2	13.3	23822.1	12.8
Borrowings	4700.0	3.4	2110.6	1.4	1193.0	0.7	1838.1	1.0
Others	15624.9	11.2	18047.7	12.1	19698.5	11.5	23592.7	12.7
Total Liabilities	139736.2	100.0	149022.0	100.0	170893.8	100.0	186183.0	100.0

Source: NRB, Statistics Division, BFIRD

3.59 About 70 percent of lending of the development ba0nk was concentrated in five economic sectors (sector wise) in mid-January 2013. These sectors were wholesaler and retailer (20.8 percent), others (18.4 percent), construction (11.6 percent), finance, insurance and real estate (9.4 percent) and transport, communication and public utilities (8.9 percent). Concentration of lending to few sectors or customers would expose a bank to high credit risk due to a crisis arising in one sector. Nepalese financial sector had experienced liquidity crunch two years back due to crisis in real estate sector and other internal and external reasons. Real estate loan to total loan has been declining gradually after the NRB issued directives regarding total exposure on real estate sector to be reduced. About 39.0 percent of total lending of development banks is of revolving nature i.e. overdraft and demand and other working capital loan. Similarly, 11.0 percent of total loan goes to real estate loan and 2.0 percent in margin loan. Due to high proportion of lending as revolving loan, the actual position of nonperforming loan may not have been reflected correctly. Most of the loans of revolving nature are found ever greening.

Figure 3.16: Product wise Loan of DBS



Finance Companies

3.60 The total number of finance companies stood at 67 in mid-January 2013. The number decreased to 65 as of mid-March 2013. Number of finance companies in decreasing over the period, as some of the finance companies are merged with other finance companies, development banks and commercial banks. Besides no further licenses have been provided for new finance companies for last couple of years. After the separation of Finance Company Supervision Department from Development Bank Supervision Department in the NRB, the former department has been closely monitoring the performance of finance companies with due focus on capital situation, credit quality, profitability, liquidity and financial soundness, among others.

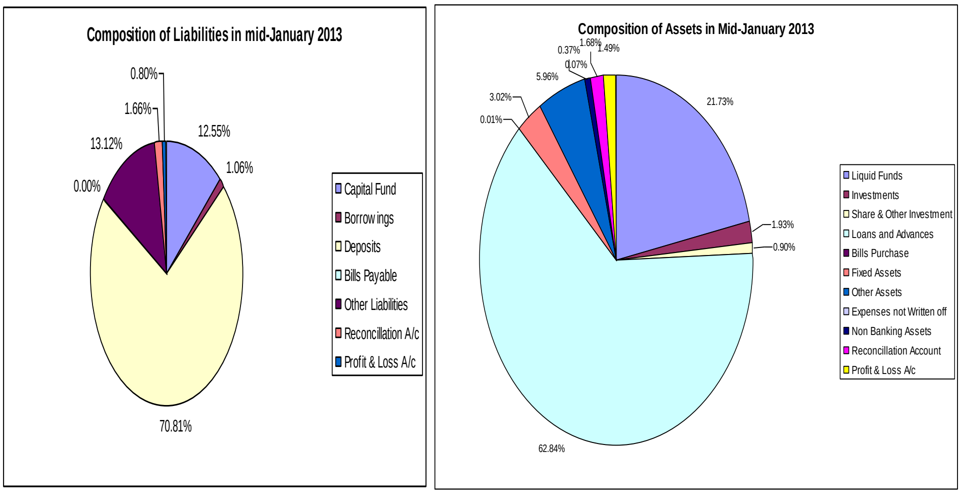
3.61 Compliance as well as risk based supervision is being conducted for monitoring and supervision of finance companies. Separate resolution desk has been established in order to monitor the progress of problematic finance companies and to expedite the repayment of deposit amount to the public depositors. Two finance companies are under review out of six selected finance companies under diagnostic review. Onsite supervision, special inspection and monitoring supervision works have been conducted for 35, 15 and 15 finance companies respectively within the period ranging from mid-July 2012 to mid-March 2013. Based on the report submitted after special inspection and onsite supervision, close monitoring from resolution desk is being conducted on eight existing finance companies out of which seven finance companies are declared as problematic finance companies and prompt corrective action is imposed on one finance company. Besides that two finance companies are already liquidated voluntarily and one finance company is under the process of liquidation. Ten finance companies have been merged with each other or with development banks as on mid-January 2013. One finance company has been upgraded as development bank as of mid-January 2013.

3.62 As at the end of June 2013, seven finance companies were declared as problematic. The major problem in those companies was the practice of insider lending with the personal interest of member of board of directors and top management of the companies. Due to the sluggishness in the realty sector business for the last couple of years, the investment made towards this sector by the finance companies has been turned unproductive. As a result, those investors could not repay the loan timely and non performing loan of finance companies increased. After the declaration of finance companies as problematic, they are not allowed to increase loan and deposit from their existing portfolios. Priority has been given for the recovery of loan and selling of assets in order to return the deposit amount. Since the asset qualities of such companies turned poor, they could not repay the depositors money on time though pressure from depositors has also been increased to return their deposit amounts. Liquidity risk in the problematic companies is very high compared to other existing finance companies. Number of problematic finance companies have been increasing rapidly since mid-July 2012. Though some finance companies were declared problematic over the last two years, a significant progress has not been found despite the undertaking of various problem resolution tasks. Appropriate resolution alternatives are in demand to take further action necessary to these companies.

3.63 In most of these problematic finance companies, the amount of deposits and inter-bank lending is significant. Liquidity risk in the problematic finance companies might create systemic risk when such companies cannot repay their inter-bank borrowing and the deposits of banks and financial institutions. The reason for the arrangement of special resolution desk in addition to existing on-site and off-site supervision of finance companies is to reduce the risk of financial instability arising from problematic finance companies.

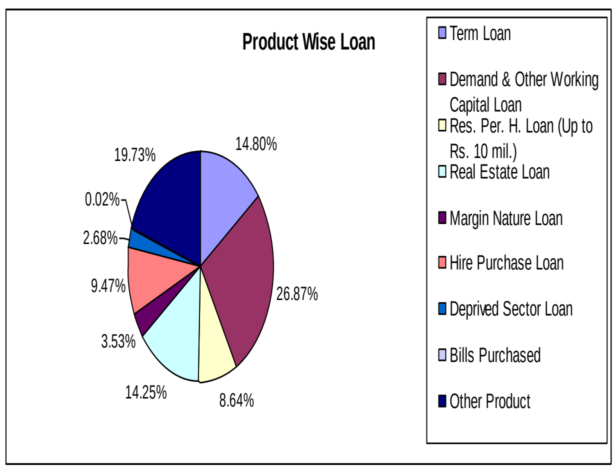
3.64 Finance companies capital fund as of mid-January 2013 was Rs. 14568.42 million whereas it was Rs. 19,559.52 million in mid-January 2012. Such fund stood at Rs. 21818.44 million and Rs. 15318.24 million respectively in mid-July 2011 and mid-July 2012. The capital adequacy ratio of finance companies decreased to 17.5 percent in mid-January 2013 from 18.8 percent in mid-January 2012. The ratio had stood at 23.1 percent in mid-July 2012**.** The level of capital adequacy is higher than the required minimum capital adequacy ratio. Moreover, the core capital ratio of such companies was 16.8 percent in mid-January 2013 compared to 18.1 percent in mid-January 2012. In respect of capital adequacy, finance companies in general have strong capital base.

Figure 3.17: Composition of Assets and Liabilities of FCs



3.65 Of the total liabilities, deposits held in finance companies formed largest proportion (70.81 percent) followed by capital fund (12.55 percent), and borrowings (1.1 percent) in mid-January 2013. Similarly, share of deposit, capital fund and borrowing were 67.35 percent, 15.5 percent and 1.5 percent in mid-January 2012. Out of the total loans and advances the respective share of loan and advances, liquid funds and investments were 62.8 percent, 21.73 percent and 1.9 percent in mid-January 2013. On the asset side, the share of loan and advances held was 65.7 percent followed by liquid funds 18.6 percent, and investments 1.9 percent in mid-January 2012.

Figure 3.18: Product Wise Loan of FCs



3.66 The asset quality of finance companies has been deteriorating for the last couple of years. The ratio of non- performing loan to total gross loan was 14.12 percent in mid-January 2013 compared to 9.9 percent in mid-January 2012. On the other hand, the average non performing loan to net of provision of loan stood at 4.2 percent in mid-January 2013 compared to 4.1 percent in mid-January 2012. With regard to the distribution of loan of finance companies to the different sectors, around 16.0 percent of loan was received by wholesalers and retailers sector (the highest percentage share) followed by 13.1 percent by the construction sector in mid-January 2013. Loans on housing and non-housing construction sector, together with real-estate sector accounted to 16.6 percent during the review period. Non banking assets of finance companies was Rs 188.2 million in mid-January 2012 and Rs 429.50 million in mid-January 2013. Similarly, the investment in the securities heading was Rs 2,509.6 million in mid-January 2012 and Rs 2245.42 million in mid-January 2013. Investment in government securities occupied more than 90.0 percent of total investment in the securities.The share of demand and other working capital loan in total loan remained at 26.8 percent in mid-January 2013. Similarly, term loan in total loan and real estate loan in total loan stood at 14.8 percent and 14.3 percent respectively. The share of margin nature loan in total loan was 3.5 percent during the period under review.

3.67 The liquid asset to deposit ratio of finance companies was 33.46 percent in mid-January 2013 whereas such ratio was 30.5 percent in mid-January 2012. Similarly, this ratio was 38.39 percent and 26.79 percent in mid-July 2012 and mid-July 2011 respectively. As per the regulatory requirement, finance companies need to maintain such ratio above 20 percent. The ratio of liquid asset to total asset of finance companies was 23.6 percent in mid-January 2013 whereas such ratio was 20.57 percent in mid-January 2012. Total credit to deposit ratio remained at 88.7 percent in mid-January 2013 whereas such ratio was at 97.61 percent in mid-January 2012. Such ratios were 87.5 percent and 101.8 percent in mid-July 2012 and mid-July 2011 respectively. As per the regulatory requirement, finance companies need to maintain such ratio up to 80.0 percent.

3.68 ROA of finance companies were negative by 1.4 percent and 2.3 percent in mid-January 2013 and mid-January 2012 respectively. The ROA was positive by 0.2 percent in mid-July 2012 whereas it was negative by 0.1 percent in mid-July 2011. Similarly, ROE of finance companies was negative by 12.1 percent and 18.2 percent in mid-January 2013 and mid-January 2012 respectively. Return on equity was positive by 1.6 percent in mid-July 2012 whereas it was negative by 0.7 percent in mid-July 2011.

Micro Finance Financial Institutions (MFFIs)

3.69 As of mid-January 2013, there were altogether 24 MFFIS operating under "D" class financial institutions. They consisted of five Grameen Bikas Banks (considered as rural development banks), 16 private sector micro finance financial institutions replicating the Grameen Banking Model and three wholesale lending micro finance institutions. The number of branches of MFFIs reached 577, creating employment for 3245 persons in mid-January 2013. Grameen Bikas Banks (GBBs) had 165 branches with 913 employees working in those institutions. Number of members including clients in the GBBs increased by 8.9 percent to 11,29,342 in mid-January 2013. Out of total members, they had 183,269 clients. The total amount of loan disbursed from the MFFIs in the review period rose by 17.1 percent to Rs. 121.59 billion from the level in the previous year. Out of total loan, the GBBs disbursed Rs. 34.01 billion forming 28.0 percent.

3.70 In mid-January 2013, the capital fund of MFFIs increased by 15.8 percent to Rs. 3.30 billion compared to the same period last year. Out of total capital the share of GBBs is 4.3 percent (Rs. 142.7 million). Out of the total capital fund in the MFFIs, paid-up capital registered a growth rate of 18.5 percent to Rs. 1.86 billion. The ratio of paid-up capital to total capital stood at 56.2 percent. In the case of GBBs, their paid-up capital was Rs. 392.1 million a share of 25.0 percent. Four MFFIs registered negative retained earnings while one of them registered negative capital fund. Overall capital adequacy ratio (based on core capital) of the MFFIs, increased to 13.4 percent in mid-January 2013 compared to an increase of 11.9 percent during the same period last year. Likewise, the ratio (based on capital fund) was 14.34 percent in the review period compared to 12.88 percent a year ago. As per the NRB directives, 'D' class FIs are required to maintain at least 4.0 percent of core capital and 8.0 percent of capital fund based on risk-weighted asset.

3.71 Total assets to liabilities of MFFIs in the review period grew by 19.5 percent to Rs. 31.74 billion. The GBBs’ share of assets/ liabilities stood at 17.1 percent. Out of the total assets, loan and advances registered a growth rate of 19.5 percent to Rs. 19.40 billion. GBBs' share in this category was 17.0 percent. The ratio of loan and advances to the total assets stood at 61.1 percent. Out of the total loans and advances, three institutions occupied the share of 27.3 percent, with remaining share related to individual loans. There was a non-banking asset of Rs. 143.6 million in the previous year as against no such asset during the review period. Likewise, investment of these banks during the review period rose by 61.6 percent to Rs. 2.94 billion. In this category, the share of GBBs was 8.3 percent. Out of total investment, the ratio of investment in securities stood at 4.4 percent with 1.2 percent investment in government securities.

3.72 Total saving deposit mobilization of these banks rose by 35.2 percent to Rs. 5.97 billion in the review period. The GBBs mobilized saving deposit of Rs. 970.9 million forming 16.3 percent of total saving deposit by MFFIs. As compared to total liabilities of these institutions, the share of deposit mobilization remained at 18.8 percent. Out of total saving deposit mobilization, the share of compulsory deposit remained at 54.4 percent. Total borrowing of these banks during the review period increased by 18.9 percent to Rs. 17.52 billion. The GBBs borrowed Rs. 3.03 billion contributing 17.3 percent in total borrowing. As compared to total liabilities of these institutions, the share of borrowed amount remained at 55.2 percent. Out of the total borrowings, the share of borrowing from NRB remained at less than 1 percent.

3.73 The total amount of overdue loan and interest of these institutions rose significantly by 63.5 percent to Rs. 1.08 billion compared to the same period last year. GBBs' overdue loan accounts Rs. 736.7 million with a share of 68.1 percent of total overdue of MFFIs. The number of overdue loanee also increased by 66.3 percent to 56,501 persons during the review period. The number of loanee for GBBs was 21022, a share of 37.2 percent. Likewise, the amount of loan loss provision of these institutions also rose by 21.3 percent to Rs. 644 million during the review period. The GBBs had loan loss provision of Rs. 313.5 million with a share of 48.8 percent.

3.74 Regarding the asset quality, the overall ratio of performing loan of these institutions remained 97.4 percent during the review period compared at 97.6 percent a year ago. These indicates that their overall NPL remained within the range of 5 percent. Their earnings/profitability ratio during the review period remained at 3.83 percent. This ratio was 3.22 percent during the same period of the last year. Total liquid fund of these banks increased by 27.4 percent to Rs. 5.76 billion during the review period. The fund for GBBs stood at Rs. 891.0 million forming 15.5 percent of total liquid fund. The total liquid fund formed 18.1 percent of total assets. Of the total liquid fund, money deposited at other BFIs accounted to 55.2 percent and money at call 44.1 percent. The overall liquidity ratio of these institutions remained at 117.9 percent during mid-January 2013 as against 69.1 percent last year.

NRB Permitted Limited Banking Cooperatives and NGOs

3.75 The number of cooperatives permitted for doing limited-banking activities by the NRB was 16 as of mid-January 2013. Out of total number of cooperatives, National Cooperative Development Bank (NCDB) is involved in wholesale lending activities while remaining 15 cooperatives are retail lenders. The total assets to liabilities of these institutions increased by 40.7 percent to Rs.12.47 billion during the review period. Total capital fund of these institutions increased by 37.5 percent to Rs. 1.39 billion during the period. Out of this capital fund, the share capital covers some 67.0 percent. Similarly, total deposit of these institutions also increased by 44.0 percent to Rs. 9.26 billion during the review period. Likewise, their loans and advances increased by 36.3 percent to Rs. 7.91 billion. Out of their total loan disbursement, 16 percent has been disbursed as commercial loan, 5 percent as agriculture loan and 75 percent as unspecified 'other loans'. The total investment of these cooperatives increased significantly by 135.4 percent to Rs. 962.02 million in the review period. Out of this investment, 26 percent was invested on fixed deposits while some 72 percent was invested on other investment.

3.76 As of January 2013, there were altogether 33 financial NGOs with their 385 branches operating throughout the country. The financial NGOs are to be registered under Institutions Registration Act, 1977 and carrying out limited banking transactions in accordance with the provision of the Financial Intermediary Act, 1999. These institutions are permitted by the NRB for doing limited banking transactions. The number of members reached 5,41,408 as of mid-January 2013 from the level of 3,42,092 members last year. The lending of these organization increased by 55.0 percent to Rs. 5.81 billion and total deposits increased by 72.9 percent to Rs. 2.96 billion during the review period.

Rural Self-Reliance Fund (RSRF)

3.77 The Rural Self Reliance Fund (RSRF) was instituted in 1991 with the joint efforts between the NRB and the government of Nepal. The objective of the Fund is to work for gradual poverty reduction by providing wholesale credit to those cooperatives and the NGOs that are involved in providing lending needs of the poor section of the people at subsidized rate of interest. The seed capital of the Fund was Rs. 443.4 million of which the government of Nepal’s contribution is Rs.190 million with remaining amount of Rs.253.4 million contributed by the NRB. The loan limit per borrower has been set at Rs. 60,000 for the loans disbursed through the cooperatives/NGOs. As of mid-January 2013, total loan amounted to Rs. 1062.80 million was disbursed to 720 institutions throughout 62 districts benefitting 37 thousands households from the Fund. The Fund had disbursed loan of Rs. 807.56 million through 548 institutions throughout 57 districts with Fund’s beneficiaries of around 30 thousand households during the same period of the last year. The recovery rate was improved to 93.5 percent in mid-January 2013 as against 90.6 percent of the previous year.

3.78 Though the RSRF is required to be confined to the poor and the disadvantaged households as per the defined directives, its outreach over the last two decades is found not so much satisfactory as expected. Basically, lack of planning of the RSRF program, supply driven approach on the part of the Fund as well as the lending organizations, lack of knowledge about the facility of the Fund's credit among the eligible recipients, coverage of the program not being confined to the poor and ultra-poor in some cases, and lower outreach of the program, particularly in the mountains are some of the major weaknesses of the Fund. These weaknesses can be overcome by the reformulation of appropriate plan for the meaningful operation of RSRF, demand creation through publicity and promotional activities, making easy access to RSRF loans, strict monitoring and evaluation of Fund credit, and unveiling some special schemes to make access to the mountain/remote hills, among others.

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

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

Saving and Credit Cooperatives (SACCOs)

3.81 The development of cooperatives as a whole and, particularly, the Saving and Credit Cooperatives (SACCOs) in Nepal has not generated expected outcomes. Intrinsic weight should be attached to rational mobilization of public money into the productive sector, poverty alleviation and employment rather than

Box 3.1: Recent Status of SACCOs

Number of Cooperatives: 26,704

Number of Saving and Credit Cooperatives: 11,901

Number of Members: 39, 45,214; of *which:* Women Members: 47.5 percent.

Number of employee: 44,677

Share Capital: Rs. 27.4 billion; *of which*: Saving and Credit Cooperatives: 71.6 percent

Total Deposit: Rs. 143.23 billion; *of which*: Saving and Credit Cooperatives: Rs. 115.3 billion (80.5 percent)

Total Loan and Advances: Rs. 124.6 billion; *of which*: Saving into profit-maximizing. Even after conceptualizing the various development models of cooperatives, problems began emerging when cooperatives started attracting deposits through higher rate of interest. The NRB, being the apex body of financial institutions with an objective of developing a secure, healthy, efficient system of payments as well as boosting the public confidence in the country's entire banking and financial system, has been closely watching the operation, particularly the lending connections of SACCOs (regulated and supervised by the Department of Cooperatives (DOC) with a view to ensure financial stability.

3.82 As of mid-January 2013, there were altogether 26,704 cooperatives operating in Nepal out of which 11,901 were in the category of saving and credit cooperative. These saving and credit cooperatives have a deposit base of about Rs.115.30 billion and investment of Rs 87.03 billion.

3.83 With an increasing number of saving and credit cooperatives landing in trouble, a study committee formed by the government recommended for a moratorium on registration of such cooperatives in urban areas. Earlier, the government had imposed a moratorium on registration of SACCOs from 2001 to 2006. Most of the problems seen in the sector are related to SACCOs. A study conducted by DOC last year revealed that many cooperatives are being run as family business, with family members working as directors and audit committee member. The cooperatives are found transferring fixed assets like land, buildings and shares as collaterals in the name of board members or other companies they have promoted. The DOC has already issued a regulation relating to capping realty sector lending 25 percent, but most of SACCOs have higher investment in the sector.

3.84 The DOC statistics shows that cooperatives (all types, including the saving and credit) across the country has deposits worth Rs 143.23 billion as of mid-January 2013. Of the total deposits, SACCOs has a dominant share. The SACCOs hold Rs. 109.94 billion, which is equivalent to 10 percent of the total deposits of A, B and C class banks and financial institutions in Nepal. The cooperatives, in principle are supposed to operate in specific community or geographic region for the mutual benefits of their members or collect saving from or lend to the members only; however they are heavily concentrated in the urban areas, particularly in Kathmandu Valley undertaking transactions similar to banking transactions. From the financial stability point of view, cooperatives should follow the norms or strict cooperative principle.

3.85 Some of the credit and savings cooperatives have command over a wide range of depositors and credit-users in different communities. Their turnover, as reported by them, exceeds that of finance companies ("C" class financial institutions). It reveals the present and potential role as well as threat of such cooperatives in the country's financial sector stability. Growth in number of institutions naturally brings both the opportunities and risks. As a natural law, control and proper regulation should always get stricter, as the number and size of the institutions grow. Hence, there is an imperative need of a control mechanism on the cooperative business. Their almost non-regulation and non-supervision situation at present should be addressed as early as possible with the formulation of sound regulatory and supervisory measure to ensure financial health. Moreover, the DOC lacks technical capabilities and resources in monitoring and supervising the growing number of cooperatives. In the absence of stringent measures, such institutions continue performing shadow banking activities, and hence creating perverse effect on formal banking activities in Nepal.

3.86 A sound regulatory and supervisory authority must be there to control ill-intentioned cooperatives. In the absence of a strong authority, haphazard investment practices, including those in riskier real-estate projects, are reportedly going unabated in the recent years, posing threats to the savings and economy as a whole. The threats are more serious to economically vulnerable depositors associated with the cooperatives.

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

3.88 There is a complaint that lending rates of institutions providing micro finance services are exorbitant, that the margin between the cost of fund and lending rate is too high and that some of the poor borrowers have difficulty to borrow at such a high rate. Though the essence of micro finance institutions is undertaking social business, micro finance institutions are moving towards commercialization at present leading to negative impact on overall stability of the financial system.

Other Financial System Institutions

Insurance Companies

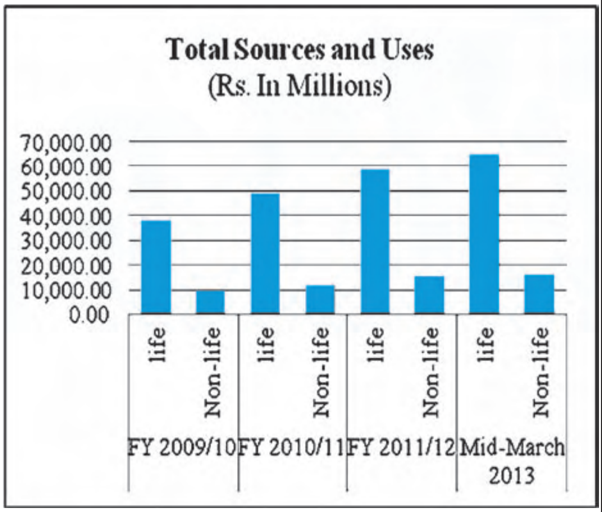
3.89 Insurance plays a significant role in overall financial market of an economy. Due to several reasons, Nepalese insurance market has not been effective and efficient in comparison to foreign insurance market. According to Insurance Board of Nepal, only 6 percent of Nepalese are insured, and around 1.6 million people involve in various insurance activities in Nepal. The insurance policies for both life and non-life insurance are progressively increasing over the period. Similarly, the premium collection and its contribution to GDP are also increasing. Likewise, the investment of both the life and non-life insurance companies is significant. Insurance sector is also one of the emerging sectors in the financial system comprising 3.5 percent share in total asset and liabilities of the financial system. As of mid-January 2013, there were altogether 25 insurance companies established under Insurance Act, 1992. Among them, 8 offer life insurance services, 16 perform non-life insurance services and one renders both the life and non-life insurance services. According to the

Table 3.10

Number of Insurance Companies

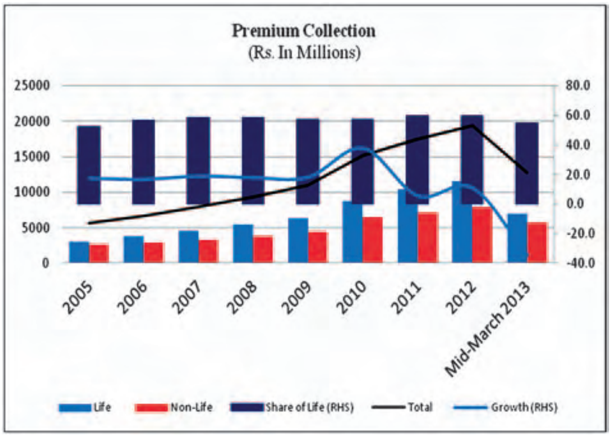
Ownership	Non-Life	Life	General	Total
Government Owned	1	-	1	1
Private Sector	13	5	-	18
Foreign	2	1	-	3
Joint Venture	1	2	-	3
Total	16	8	1	25

Figure 3.19: Source and Uses of Insurance



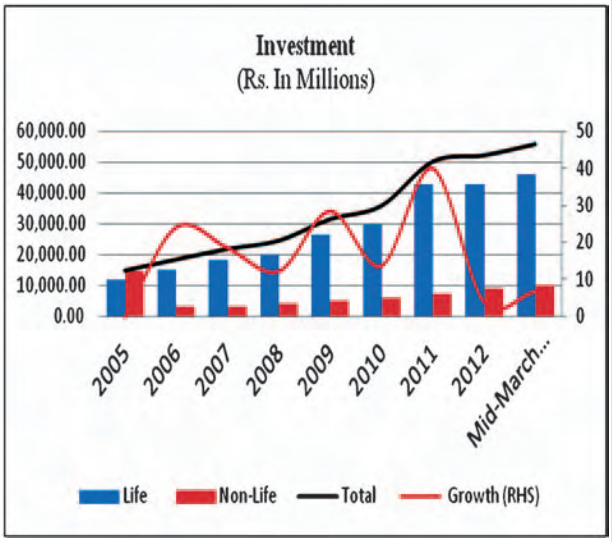
ownership structure, 3 insurance companies are operating under foreign investment and 2 insurance companies are in joint ventures with foreign insurance companies. Likewise, 19 insurance companies belong to the private sector whereas one is under the government ownership.

Figure 3.20: Premium Collection by Insurance



3.90 The total assets/ liabilities of these companies increased by 9.8 percent from mid-July 2012 to Rs. 81.1 billion in mid-March 2013, of which life insurance and non-life insurance account for Rs. 64.8 billion and 16.3 billion respectively.

Figure 3.21: Investment by Insurance Companies



3.91 Total premium collection of the insurance companies has been gradually increasing over the years contributing around 60.0 percent of total premium collection through life insurance. The premium collection was Rs. 5.7 billion in 2005 and increased by about 122 percent to Rs. 12.7 billion as of mid-March 2013 comprising Rs. 7.0 billion premium on life insurance and Rs. 5.7 on non-life insurance. Insurance sector is expected to mobilize almost Rs. 20.0 billion premium up to mid-July 2013. The growth of total premium collection in 2011 did not maintain its speed and stood at

5.7 percent but later in 2012 it stood at 11.2 percent, following upward trend gradually. On the investment side, it was Rs. 14.8 billion in 2005 followed by an increasing trend gradually over the years. The total investment reached to Rs. 55.9 billion as of mid-March 2013 comprising Rs. 45.9 billion and Rs. 9.9 billion from life and non-life insurance respectively. The growth rate of investment up to 2011 was very high and reached its peak of 40.0 percent in 2010, however, it declined afterwards and stood at 4.0 percent in mid-July 2012 and 6.9 percent as in mid-March 2013.

3.92 Considering the development of insurance industry and its connection with the financial system of Nepal, it has been revealed that insurance companies has not been complying with the prudent rules and regulations as issued and directed by Insurance Board of Nepal. Similarly, the huge amount of investment made by the insurance companies in different projects and programs, including the deposits in various banks and financial institutions need to remain safe with sufficient liquidity. Similarly, the insurance companies should maintain further transparency in terms of disclosure, access of information on collection of insurance premium investment in different areas and products as well as the recovery of the investment.

3.93 Total premium collection and total investment of the insurance companies are in increasing trend and they have significant relationship with each other , too. Therefore, the performance of Nepalese insurance industry on aggregate is satisfactory but requires a strong surveillance on their operation and financial indicators to avoid systemic risk. In this context, Nepalese insurance industry needs to be more professional, transparent, competitive, innovative and efficient in order to provide effective services to the public in general and policyholders in particular. Insurance industry must have to go together with the criteria fixed by the IAIS Insurance Core Principles (ICP) and updated insurance accounting standard upon international best practices. Similarly, in the context of growing insurance business, including the companies, a solvency regime is also required to tackle with the problem in insurance companies. Both the prudent regulation and strong supervision are lacking in Nepalese insurance so that the insurance sector is moving forward on a traditional way without considering essential framework in place. Therefore, strengthening the rules and regulations formulated by the insurance board can be instrumental for this sector to counteract possible financial market shocks.

Employees Provident Fund (EPF)

3.94 Employees Provident Fund (EPF), which was established on 16 September 1962 under the EPF Act, 1962, manages the provident fund of government employees, army, police, teachers, government corporations and some private companies. The increasing trend of sources and uses as well as investment of EPF has been found weakening since 2010. The sources/uses of fund before 2010 was increased on an average by 13 percent in contrast to an average increase of 10 percent during the subsequent years. The fund increased by 10.4 percent in 2011 and 10 percent in 2012 January. Total assets to liabilities of the EPF increased by 7.9 percent to Rs. 135.74 billion in mid-January 2013 from Rs. 125.7 billion as of mid-July 2012. The fund collected by the EPF increased by 7.8 percent and stood at Rs.130.9 billion in mid-January 2013 compared to Rs.121.4 billion in mid-July 2012. The investment of EPF shows a slow growth on an average of less than 5 percent after 2010 comprising negative growth of 2.6 percent in 2012 as against positive growth of 5.6 percent in mid-January 2013.

Figure 3.22: EPF Major Indicators

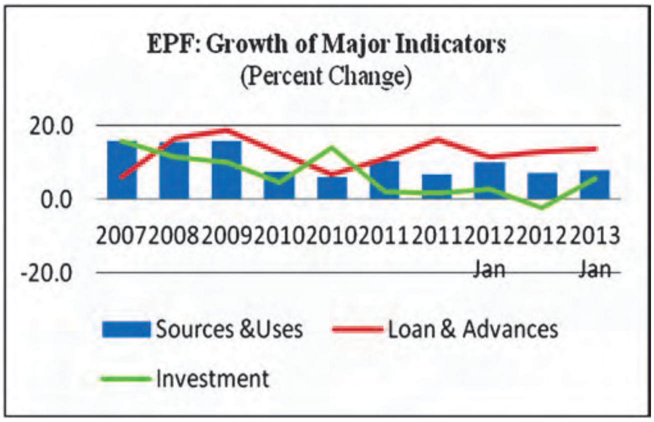
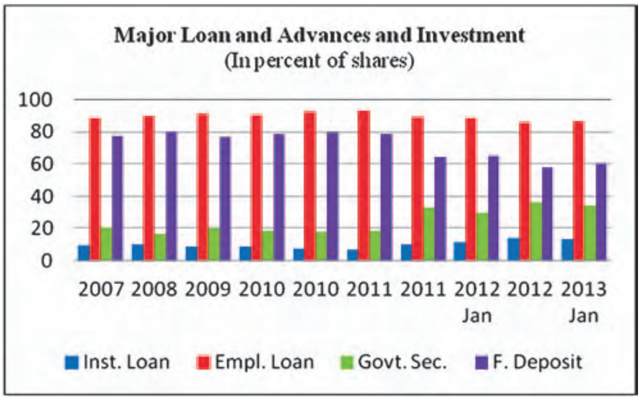


Figure 3.23: EPF Major Loan & Advances



3.95 Although true financial conditions of the EPF's is not available for the public consumption as a result of data unavailability, its financial condition has not been found prudent by analyzing available data and information in the recent years. Thus EPF requires close monitoring and supervision by the concerned authority. However, the EPF has been contributing to the development process in terms of its investment channelized towards different sectors of the economy. It has extended more than 86.0 percent of loan and advances to the EPF contributors (including the EPF employees), and less than 15.0 percent to institutions and others. Similarly, it has been investing more than 60.0 percent of its total investment in the fixed deposit of different banks and financial institutions, less than 35.0 percent to government securities and the remaining to the shares. As the EPF has largest share of total investment on fixed deposit account of banks and financial institutions, it can any at time pose a risk for financial stability domestically as some unhealthy practices of excessive demand of EPF's fund among existing banks and financial institutions were found at the time of liquidity crunch in the financial market earlier.

Table 3.11: Main Financial Indicators of EPF

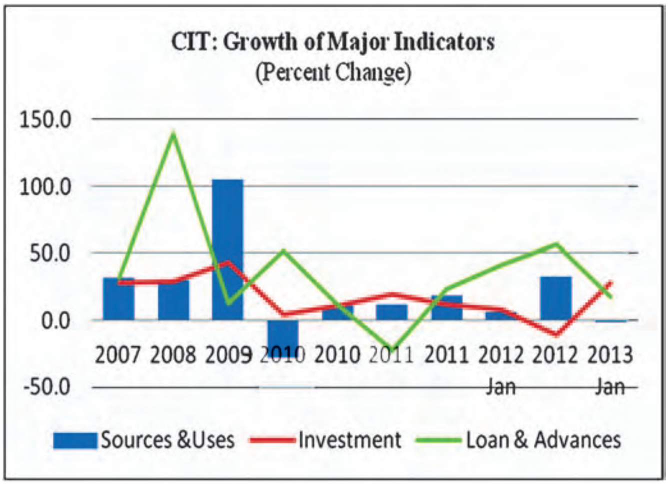
Main Financial Indicators	FY 2010/11	FY 2011/12	mid-Mar. 2013
Liquid Assets/Total Source	3.5	5.0	3.2
Infrastructure Investment /Total Investment	13.2	12.6	20.0
NPL/Total Source	0.4	0.5	0.3
NPL/Total Loan and Investment	0.4	0.5	0.3
Operating Cost/ Operating Income	83.0	88.8	91.5
Credit/Deposit	60.0	63.7	66.1
Total Loan and Advances/ Total Source	96.0	94.4	96.2
Cash and Bank Balance/Total Deposit	2.3	3.9	2.4
Interest Income/Total Loan and Investment	8.9	8.7	5.4
Total Interest Expenses/ Total Deposit	7.1	7.1	4.7
Total Interest Expenses/ Total Interest Income	80.2	83.4	87.4
Total Interest Income/Total Operating Income	97.3	97.2	99.1
Administrative Expenses/ Total Expenses	5.6	6.4	5.1
Operating Expenses/ Total Income	4.6	5.7	4.6

3.96 The EPF has invested more than Rs. 26.0 billion in long term national importance projects like hydropower as of mid-March 2013. Similarly, the EPF, as a contractual saving institution, has investment around Rs. 138.0 billion in different infrastructure and other projects and thus is expected to have a positive impact on economy development through various income and employment generating activities. It has also provided loan to the other public enterprises including Nepal Oil Corporation (Rs. 8.0 billion) for the smooth supply of petroleum products. The EPF has recently been able to recover Rs. 288.2 million from the aggressive effort on recovery from the project financing. As a result of rigorous recovery plan initiated recently, the corporate level NPL declined to 0.3 percent in mid-January 2013 from 5.0 percent a few years ago. Similarly, the NPL from consortium financing has declined to 27.2 percent during the review period from 72.0 percent three years ago. Recently, the liquid asset to total sources of the EPF has been limited to 3.2 percent. Though both the investment and operating cost of the EPF have been in increasing trend at present leading to an increase in credit to deposit ratio, such ratio has been found remaining under the acceptable limit.

3.97 The EPF has a very low share of cash and bank balances out of its total deposit amount. The operating expenses show a satisfactory position as it has been maintained below 5.0 percent, and credit to deposit ratio is also found under acceptable limit. However, the liquidity related indicators as well as the level of NPL may pose risk to the financial stability. From financial stability point of view, EPF should have a sound corporate governance system and should maintain strong self regulatory and supervisory rules in the absence of strong and separate regulatory and supervisory authority. Similarly, under the situation of weak investment and unstable financial market in the country, the EPF has a great challenge to manage its long-term portfolio in the liquid form to fulfill its long-term obligations of EPF's contributors.

Citizen Investment Trust (CIT)

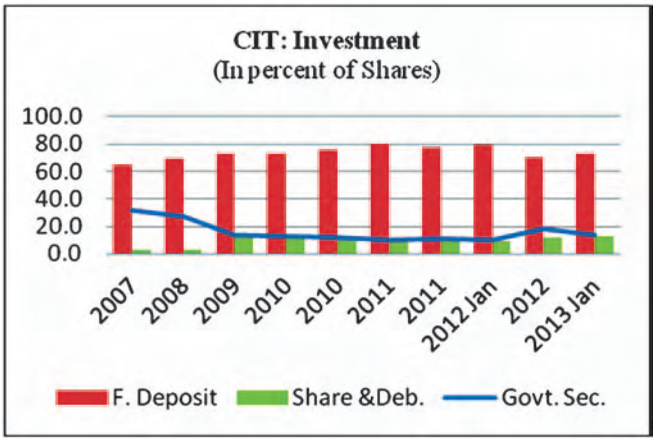
Figure 3.24: CIT Major Indicators



3.98 Citizen Investment Trust (CIT) was established on 18 March 1991 under CIT Act, 1991. The CIT mobilizes the private and institutional savings, extends loans and advances, and also works as an issue manager of securities. The CIT is under the regulator purview of Ministry of Finance. Total assets of the CIT increased by 33.81 percent to Rs. 38.03 billion in mid-January 2013 from Rs. 28.51 billion as of mid-January 2012.

3.99 Total investment increased by 14.3 percent to Rs. 23.5 billion in mid-January 2013 from Rs. 20.4 billion as of mid-January 2012. Similarly, loan and advances increased by 84.2 percent to Rs. 11.3 billion in mid-January 2013 from 6.2 billion of mid-January 2012. Fund collection, the major component of CIT liabilities, increased by 14.7 percent to Rs. 35.9 billion in mid-January 2013. On the assets side, loan/advances of CIT reached Rs. 11.3 billion during the review period compared to Rs. 9.6 billion as of mid-July 2012.

Figure 3.25: CIT Investment



3.100 Though total sources/ uses of CIT shows an increasing trend over the period, it is found to be weak in 2012 followed by an improvement afterwards. On the investment side, as more than 70 percent of total investment has been deposited in the fixed deposit accounts of various BFIs, CIT may face liquidity problems in case the BFIs fail to return their deposit in demand by CIT. The CIT including the EPF have been investing around 70 percent of their total resources in various BFIs; there would sufficient chances of inadequate resources available particularly in the investment of longer term projects and hence deficiency of capital formation in the economy. Therefore, strong resource based institutions like CIT and EPF may create an unstable financial situation in the absence of long term investment and lack of close monitoring and supervision of their financial behavior with the BFIs.

Postal Savings Bank (PSB)

3.101 The Postal Savings Bank was established under GoN's Postal Service Department and came into operation in 1976. Out of total 117 licensed offices as at mid-July 2013, 68 PSBs used to mobilize deposits. Total assets/ liabilities reached Rs. 1.30 billion by mid-January 2013. The share of assets/liabilities reached 0.06 percent and as percent of GDP it stood at 0.08 percent in mid-January 2013. Total deposit collection of these offices reached Rs. 1.38 billion in mid-January 2013 from the level of Rs. 1.29 billion in mid-July 2012. Similarly, the number of total accounts reached to 58,558 in mid-January 2013 from 54,796 in mid-July 2012. The PSB has been established with the objective to encourage people for enhancing their saving habit and using the collected money in the national development process. According to the PSB, the attraction towards the bank is on the rise as one can open an account at minimum balance of Rs. 100. Likewise, the depositors are provided interest ranging 7 to 8 percent and bank provide loan up to Rs. 300,000 charging 10 percent interest rate with collateral to its officials. The PSB provides loan to the postal employee payable in five-year period. The recovery of the loan amount has been almost 100 percent through the active 68 postal saving banking services. The PSD has been offering other various financial services such as money order services, remittance service and insured service, but the later one is slowing down due to the competition and establishment of many more remittance companies in the private sector.

Informal Sectors

3.102 Studies of financial superstructures in Nepal have shown that financial structures are dualistic in nature. On the one hand, there exists a set of institutions comprising the formal financial sector (FFS). This is the legally-regulated part of the financial system, and consists of institutions like the central banks and the banking system, and other financial institutions regulated and supervised by the different regulatory and supervisory agencies such as EPF and CIT by Ministry of Finance, insurance companies by Insurance Board, and cooperatives by Department of Cooperative, to mention a few. On the other hand, there are institutions that are virtually outside the control of the established legal framework. These are the Informal Financial Institutions (IFIs) such as moneylenders, rotating savings and credit associations (ROSCAs), and landlords, neighbours, traders, among others. The basic feature of these institutions is that they participate in the saving-investment process on an informal basis, and are the financial part of what is commonly known as the informal financial sector. The nature, scope, role and technologies of the IFIs appear to differ fundamentally from those of the FFIs. Available evidence shows that the financial structures in Nepal have been remaining dualistic in the sense that formal (organized) financial structures exist side by side with informal (unorganized) financial structures. This duality has been in existence for a very long time, yet there are few studies on the nature of the duality, its causes, and its relationship to other sectors, its stability and sustenance over the long run.

3.103 Hence, the impact of the informal sector on macroeconomic policies focused on the formal sector is not clearly understood by policy makers due to the unavailability of information; the informal sector is, in a way, still a 'black box' in Nepalese economy. That little is known about the informal financial sector in Nepal. Formal banks have access to unlimited funds but are unable to control the use of credit. Informal lenders can prevent non-diligent behavior, but often lack the needed capital. Both the formal and informal credit can be either complements or substitutes. Various informal saving and credit groups, self-help groups, Dhikuties and local money-lenders among others, can be grouped in this category. Since there is no mechanism for registering these sectors/groups, data on their transaction volume and activities of these sectors are not available. However, it is believed that significant volume of transaction are carried out being done by the informal sector. These sectors need to be regularized in order to bring their transactions in the formal channel for maintaining financial stability in the days to come.

3.104 In Nepal, previous studies by the NRB and others had revealed that the informal credit market demonstrate extremely high informal interest rates charged on loans to poor individuals. Extensive rural credit programs by the NRB in the last decades were intended to weaken the informal lenders that anticipated monopoly power in the rural credit markets. Competition was expected to lower the informal interest rates. However, these policies do not seem to have improved the credit terms for the poorest households in rural areas. In order to make policies that can positively affect poor people’s living conditions, it is necessary to understand how informal lenders set the interest rates. There exist competing explanations. One traditional explanation of high interest rates that opposes the monopoly view, that has motivated credit programs in the past, is the risk premium hypothesis. This theory argues that because there is a high share of default on informal loans, lenders charge a risk premium to cover loss due to default. This risk premium can explain the interest rate gaps between formal and informal credit markets.

3.105 Based on these assumptions, credit markets should lie perfectly competitive and expect to observe one equilibrium interest rate reflecting the interception between demand and supply of credit. However, in Nepal the existence of a dual credit market shows a gap between formal and informal interest rates. Despite an increased supply of formal credit, informal lenders are still the most important source of credit among the poor in Nepal. Formal lending institutions often require collateral such as land from borrowers. The poorest households are often landless or have the poor quality of collateral to borrow and have less access (including the approach, too) to formal financial market, and therefore excluded from formal credit channels. The NLSS reports (2010/11) show that only 20 percent of lending in Nepal is obtained from formal institutions.

Issues and Challenges in the Financial Sector

3.106 In the macro economic front, the major challenges include weak industrial growth led by weak private investment and capital expenditure of government. Inflation rate has not come down yet to desired level, while frequent fluctuation in liquidity situation, sometimes with excess and sometimes shortages, poses risk to inflation and put pressure upon financial institutions. A cautious approach is necessary in liquidity management to provide adequate space for credit expansion in productive sectors without additional pressure in inflation. Financial sector stability is influenced directly or indirectly from macroeconomic situation and policies through macro-financial linkages. In the current context of weak investment and its growth implications, NRB gradually should move forward maintaining interest rate at appropriate level and government should come to rebuild the business confidence for stimulating investment in productive sector. In addition, smoothing government capital expenditure throughout the year is beneficial for both growth and financial stability. NRB should provide moral suasion at first to financial institutions to reduce the interest rate of small business and productive sector in the economy. Inflation should be controlled by the central bank (demand side) and by the government (supply side). However, the loan should be properly classified as to whether it is retail or investment oriented. Government should have clear and farsighted policy regarding the realty sector, among others.

3.107 By strengthening the regulatory and supervisory system and improving the implementation of new standards on quality and quantity of capital and liquidity and risk management, the objectives of financial stability can be achieved. There are a number of opportunities that may be created for the banking sector to focus on to the rural areas and, increasing investment particularly, in developing hydro power and tourism sectors, etc. Though there are a lot of challenges in the banking sector, many opportunities and potentials are still yet to be exploited for the benefit Nepalese financial system of Nepal.

3.108 Financial soundness indicators (FSIs) as reported by BFIs are found to have deteriorated moderately at present. However, the FSIs sometimes cannot truly reflect the extent of the problem in the financial system. Multiple banking practices, poor corporate governance, poor risk management practices, poor under writing standards, insider trading, non collateralized and unsecured interbank lending and excessive misuse/siphoning of overdraft loan are among the major challenges to BFIs. To ensure financial soundness, it is necessary to extend PCA triggers in addition to existing capital level. Strengthening supervision in the context of widened and deepened financial sector with modern and complex banking product might be instrumental for a sound and stable financial system. Nepalese financial sector is also integrating with the global financial system day by day which demands for implementation of best practices applied in the international financial market. Therefore, keeping abreast of the developments in global financial market and adopting international best practices is one of the major challenges.

3.109 Strengthening capital base of inadequately capitalized banks, diversification of credit, reducing interest spread and promoting good governance are essential elements to ensure financial stability in the days to come. Considering the size and current state of exposure of BFIs on real estate sector, a gradual adjustment policy should be adopted so that it would not pose unbearable risk to financial stability. Proactive and forward looking regulations for BFIs in line with international best practices are needed to regulate heavily interconnected financial institutions into the system in Nepal**.** To avoid ever greening of loan and under-reporting of NPL by the BFIs, limit on overdraft loan and classification of loans and advances as reported in 'others' heading should be enforced to report in detail for the BFIs. Appropriate exit policy and crisis management framework might be a potential measure for identification of Systematically Important Financial Institutions (SIFIs) and adoption of step by step resolution.

3.110 Regarding the strengthening of NRB's legal power in the areas of regulation, supervision, intervention and resolution, a review of current legal framework is underway. Concerned rules, bylaws and procedures should be formulated to regulate the emergency liquidity facilities, and the supervision of BIFs by the NRB focusing on borrowers should be heightened. Likewise, triggers on PCA by including liquidity, assets quality (NPL), corporate governance, maturity mismatch, quality of internal control and risk management in addition to current capital shortfalls might be an instrumental for financial stability. Prompt resolution framework can also be useful for quick resolution of problem banks. Some provisions of Basel III such as countercyclical buffer, quality of capital, liquidity ratio, leverage, capital for off balance sheet exposure may be better to introduce to reduce the procyclicality of the banking sector.

3.111 Poor corporate good governance in BFIs exacerbates liquidity as well as solvency risk. Insider trading practices is still prevalent in most of the financial institutions as per the supervisor's observation in sites and published BFIs supervision reports which leads to excessive risk taking. Strengthening internal risk management and promoting corporate governance culture in BFIs have been remaining the challenging issues. Weak corporate governance is considered as one of the major factors that lead to financial instability. In this context, review of related provisions of NRB Directives and learning program for board of directors, CEOs of financial institutions on corporate governance, strict code of conduct and effective supervision could be instrumental in improving the current state of corporate governance.

3.112 Likewise, lack of analysis of macroeconomic variable and their potential shocks, lack of credit rating agencies, lack of internal credit rating of borrowers by bank, limited capacity of deposit gurantee, low effectiveness on the aspect of implementatin of the verdicts of Debt Recovery Tribunal, and lack of reliable and scientific data reporting by the banks pose risk to the banking system and therefore, needs to be strengthened for a sound and stable financial system.

3.113 Increasing trend in shadow banking practices has also posed challenge to the Nepalese banking system. Banking like activities of cooperatives could also increase risk in Nepalese banking sector as their deposit mobilization is increasing. Lack of regulatory and supervisory authority for various types of micro finance institutions (MFIs) established and operated under different Acts is also emerging as another challenging issue. Shadow banking activities should be monitored regularly, micro finance credit reporting system should be introduced and an appropriate regulatory body should be established to ensure compliance of cooperatives to minimum financial standards.

3.114 Financial viability is necessary for the long run sustainability of MFIs institutions. MFIs are generally resource deficient. The capital base of most of the MFIs is small compared to other BFIs. Pricing of the financial services of MFIs is higher than BFIs' as MFIs borrow fund from BFIs. At the same time MFIs are being engaged in small sized financial services and normally have higher overhead cost. As a result, interest rate for credit in MFIs is relatively higher. The higher rate of interest in conventional banking has pushed the interest rate of MFIs further up. As a result, many cases of agitation and anger of MFIs clients have been witnessed in our financial system.

3.115 Moreover, major non-compliances are observed in onsite inspections and supervision reports including loan provided exceeding the single obligor limit (SOL) improper loan classification (inadequate loan loss provision), improper utilization of loan amount, loan provided to dummy projects, weak follow-ups regarding monitoring credit utilization, weak corporate governance, lack of internal policies and its weak implementation, poor credit documentation, weak financial analysis of borrower regarding repayment capacity, creation of new loan limit to repay existing loans ,weak implementation of AML/CFT provisions, credit concentration in real estate sector, wrong reporting of loan products, loan provided to promoters group and staff indirectly (insider lending), poor internal control, insufficient collateral backup and poor collateral, less effective internal audit and compliance, weak business and strategic plan, liability concentration in few clients and over valuation of collateral, among others needs to be corrected to avoid the possible vulnerability in BFIs. However, enhancing good corporate governance, promoting self-regulation, controlling multiple banking behavior and avoiding increasing trend of operational risk are the key areas for the stability of the financial system in Nepal.

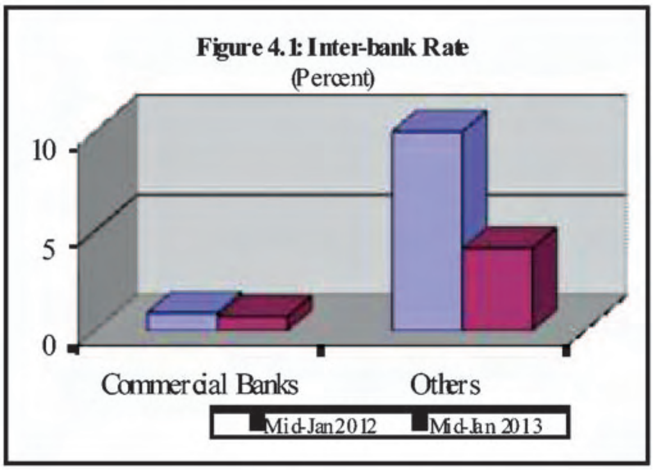
3.116 Legal actions have been taken effeciently on such non-compliances which have created an excellent demonstration effect and set examples in the financial system.

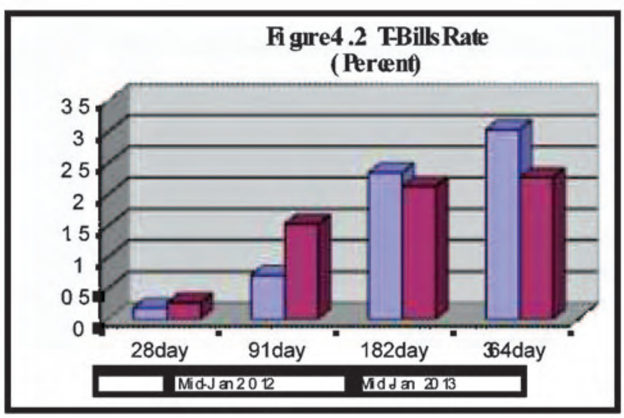
CHAPTER FOUR

FINANCIAL MARKET

Money Market

4.1 The short term and long term interest rates in the market remained at a low level in the first two quarters of 2012/13 because of favorable liquidity condition in market. The weighted average inter-bank transaction rate remained at 0.53 percent for commercial banks and 4.35 percent for other financial institutions (development banks and finance companies) in the first six months of 2012/13. Similarly, the rates remained at 0.71 percent and 4.13 percent in mid-January 2013 compared to 0.90 percent and 9.96 percent in mid-January 2012. Nepalese money market contains a few choices of assets for banks and financial institutions where treasury bills are one of the risk free and highly liquid instruments. As of mid-January 2013, the t-bills outstanding amounted to Rs. 131.62 billion, forming about 80.01 percent of the total internal debt liability of





Nepal Government. Fresh t-bills were not issued in 2012/13, as there was a late announcement of full budget by Government of Nepal. In the secondary transactions, in the first six months of 2012/13 weighted average discount rate of 28-day, 91-day, 182-day and 364-day t-bills remained 0.26 percent, 1.52 percent, 2.12 percent and 2.26 respectively in mid-January 2013 compared to 0.18 percent, 0.70 percent, 2.34 percent and 3.03 respectively in mid-January 2012 respectively.

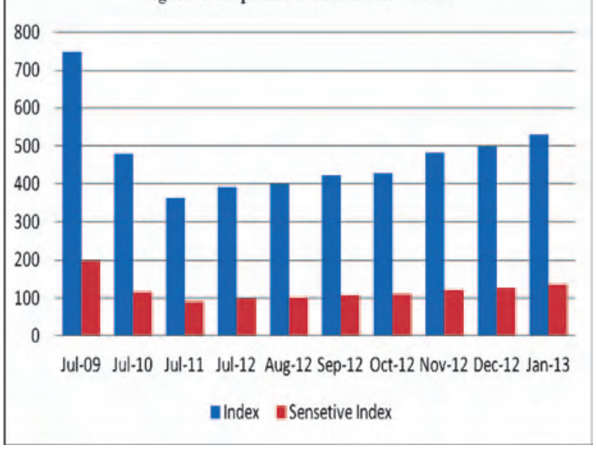
4.2 Government did not issue fresh bonds in the first six months of 2012/13, as full budget was not announced timely because of political chaos and transition phase for changing the government.

4.3 The base rate system introduced through the Monetary Policy of 2012/13 made it mandatory for all commercial banks to publish their base rate on a monthly basis to make the lending rate calculation process transparent and competitive and also to enhance the effectiveness of the transmission mechanism of monetary policy. In the future, the provision for base rate will also be applied to the development banks and finance companies respectively. The average base rate of the commercial banks as at mid-January 2013 remained at 9.38 percent.

Securities Market

4.4 The security market of Nepal, which was experiencing a bearish trend for the last couple of years, showed some signs of improvement from 2011/12. The NEPSE index, on y-o-y basis, increased by 7.4 percent to 389.7 points in mid-July 2012. Similarly, the index increased by 63.7 percent to 529.7 points in mid-January 2013 as against a drop of 19.6 percent to 323.6 points in the corresponding period of the previous year. Likewise, NEPSE sensitive index stood at 134.6 point in mid-January 2013 compared to 80.3 in mid-January 2012. The Nepalese capital market has continued to show a fluctuating trend. The share market has been in bullish trend from August

Figure 4.3: Nepse Index and Sensetive Index



2012, due to the progress in peace process of the country, after a long time invigorating the hopes and aspirations of investors.

4.5 The y-o-y stock market capitalization witnessed a significant surge of 69.9 percent to Rs. 510.43 billion in mid-January 2013. Of the total market capitalization as of mid- January 2013, the share of banks and financial institutions (including insurance companies) stood at 69.8 percent while that of manufacturing and processing companies, hotels, trading, hydropower and other sectors stood at 3.0 percent, 1.6 percent, 0.2 percent, 5.8 percent and 19.5 percent respectively. Total number of companies listed at the NEPSE increased to 221 in mid-January 2013 from 214 in mid-January 2012. Of the total listed companies, the number of BFIs (including insurance companies) stood at 189 followed by production and processing industries (18), hotels (4), trading entities (4), hydropower (4) and other companies (2). Total paid-up capital of the listed companies stood at Rs. 116.64 billion in mid-January 2013, registering an increase of 9.6 percent over mid-January 2012. Additional securities worth Rs. 3.08 billion comprising ordinary share of Rs. 2.51 billion, bonus share of Rs. 0.36 billion and right share of Rs. 0.21 billion were listed at the NEPSE during mid-January 2013.

Foreign Exchange Market

4.6 Nepalese foreign exchange market is the combination of licensed banks, development banks, finance companies, money transfer, money exchange and various other companies such as airlines, hotels, travel and trekking agencies who are involved in foreign currency transactions. The Nepalese forex market is regulated and guided by Foreign Exchange Regulation Act and Rules, Bylaws and, Circulars are issued by the NRB under the said Act in order to regulate the foreign exchange market. The NRB has responsibility to maintain an orderly forex market through monitoring of foreign currency transaction, issues prudential regulations and intervenes in the domestic

Table 4.1: Number of Foreign Currency Transaction

Name of the Foreign Currency Transacting Institutions	Mid-July 2012	Mid-Jan 2013
Commercial Banks	32	32
Development Banks / Financial Institutions	61	61
Money Changer	165	165
Money Transfer	51	47
Hotels	100	100
Travels	1504	1504
Trekking	1281	1281
Airlines (Domestic as well as Foreign)	34	52
GSA/PSA of Foreign Airlines	52	52
Cargo and courier	298	298
Others	67	67

foreign exchange market. Nepal has adopted fixed exchange rate regime with Indian currency and an open market exchange rate regime with other foreign currencies. Commercial banks are free to fix the exchange rate of convertible currencies based on the above mentioned regime. The Commercial banks may perform the transactions of letter of credit, buying and selling of foreign currencies, provide foreign currency under passport facilities as prescribed and are also involved in inward remittance activities. They are allowed to open Nostro account in the foreign banks in concerned countries.

4.7 Financial institutions of "B" and "C" class may issue IC/NC debit and credit card, as sub-agent of licensed banks. The development banks other than national level may also buy foreign currency, but they have to sell it to the commercial banks and or the NRB only. Likewise, BFIs may buy Indian currency from the public by obtaining approval and sell it to the public banks and financial Institutions as well. Money changers are allowed to buy and sell convertible and Indian currency and also to provide foreign currency under passport facility subject to the foreign exchange license. Money Transfers Companies are heavily engaged in inward remittance activities only. Other institutions like hotels, travel and, trekking agencies , hospitals and airlines, among others may accept convertible foreign currencies only in exchange of their services by obtaining prior approval of the NRB. For the smooth operation of the Nepalese foreign exchange market, 32 commercial banks, 61 financial institutions, including "B" and "C" categories, 165 money changers, 47 money transfer companies, 100 hotels, 1504 travel agencies, 1281 trekking agencies, 52 airlines (domestic and foreign), 52 GSP/PSA of foreign airlines, 298 cargoe and courier companies and 67 other service providers did foreign exchange transaction in Nepal during the review period. Altogether, 3659 institutions have been involved in the foreign exchange market in Nepal.

Foreign Exchange Reserve

4.8 The gross foreign exchange reserves of the banking system increased marginally by 2.6 percent to Rs. 450.79 billion in mid-January 2013 from a level of Rs. 439.45 billion as of mid-July 2012. The growth rate of reserves has been moderating during the recent months after a significant increase in reserve before mid-July 2012. As the exchange rate regime with Indian currency is fixed, the exchange rate of Nepalese currency to foreign currency fluctuates as Indian Rupee fluctuates with US dollar. NRB fix and maintains the cross rate to check the inflow and outflow of foreign currency. The apparent high fluctuations of reserves corresponds to downward and upward fluctuations of reserves determined particularly by high/low balance of payment surplus during the review period. Further, the fluctuation in the

Table 4.2.: Total Foreign Exchange Reserve

Gross Foreign Exchange Reserve (Rs. In Million)					
				Percent Change	
	Mid-Jul	Mid-Jul	Mid-Jan	Mid-Jul To Mid-Jan	
Reserve	2011	2012	2013	2011/12	2012/13
Nepal Rastra Bank	**213095.1**	**375524.5**	**367341.9**	**41.3**	**-2.2**
Convertible	165257.5	285682.0	277168.6	34.3	-3.0
Inconvertible	47837.6	89842.5	90173.3	65.4	0.4
Commercial Bank	**59058.0**	**63932.2**	**83454.9**	**3.4**	**30.5**
Convertible	55503.3	57144.0	78137.6	1.6	36.7
Inconvertible	3554.7	6788.2	5317.3	31.3	-21.7
Total Reserve	**272153.1**	**439456.7**	**450796.8**	**33.1**	**2.6**
Convertible	220760.8	342826.0	355306.2	26.1	3.6
Share in total (in percent)	81.1	78.0	78.8	-	-
Inconvertible	51392.3	96630.7	95490.6	63.1	-1.2
Share in total (in percent)	18.9	22.0	21.2	-	-
Import Capacity(Equivalent Months)					
Merchandise	8.4	11.6	10.2	-	-
Merchandise and Services	7.3	10.3	8.7	-	-

Source: Foreign Exchange Department, NRB

reserves could also be determined by a sharp appreciation/depreciation of NPR against major international currencies coupled with surge in remittance inflow vis-à-vis in import. NPR appreciated by 4.86 percent to Rs. 84.49 per US dollar in mid-October and this was the highest level during review period, resulting in exchange fluctuation loss of Rs. 9.76 billion.

4.9 In terms of US dollar, the gross foreign exchange reserves grew by 4.3 percent to US dollar 5.17 billion as at mid-January 2013 compared to a level of US dollar 4.96 billion in mid-July 2012. The level of reserve was US dollar 4.42 billion a year ago. Though the reserves in dollar terms grew moderately over the review period, the month to month trend remained fluctuated. The convertible reserves of the banking system reached Rs. 355.30 billion in mid-January 2013 compared to a level of Rs. 342.82 billion as at mid-July 2012 due mainly to the growth in the volume of reserves held by BFIs. The share of convertible and non-convertible (INR) reserves of the banking system remained at 78.79 percent and 21.21 percent respectively.

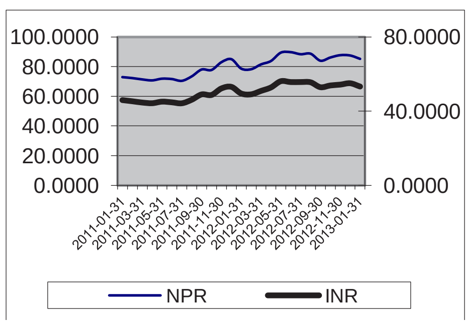
4.10 The share of NRB in gross reserves slipped to its lowest of 81.5 percent in mid-January 2013 from a peak of 85.5 percent in mid-July 2012. Growth in the volume of holdings by BFIs for transaction as well as for investment motives may have led to a fall in NRB's share in gross reserves during the review period. The growth in INR demand for imports from India coupled with a large exchange fluctuation loss resulting from a sharp appreciation of Nepalese rupee against US dollar resulted in a fall in reserves. The import capacity of current reserve slipped marginally, but sufficient to cover 10.2 months of merchandise import and 8.7 months of merchandise and service import. In mid-July 2012 such import capacity was sufficient for 11.6 months and 10.3 months respectively.

4.11 Foreign remittances are playing an increasingly large role in the economies of many developing countries like Nepal, contributing to economic growth and to the livelihoods of less prosperous people. Foreign remittances have become a major source of foreign currency inflow in the nation. BFIs registered remittance inflows of convertible currencies amounting to US dollar 2.16 billion during the review period, a rise of 11.49 percent compared to US dollar 1.93 billion in mid-January 2012. This was mainly on account of depreciation of Nepalese currency during the review period. The monthly convertible remittances averaged US dollar 359 million in the first half of the year compared to US dollar 322 million in the same period of previous year.

Exchange Rate, USD sold and INR Purchase

4.12 The Nepalese currency appreciated by 1.7 percent to Rs 87.10 per US dollar as at mid-January 2013 from a level of Rs. 88.60 per US dollar as at mid-July 2012. NPR had depreciated by 19.9 percent against US dollar during FY 2011/12.

Figure 4.4: Exchange Rate: INR and NPR



4.13 In the first half of FY 2012/13, NRB purchased US dollar 1.20 billion from banks and financial institutions (BFIs) through forex market intervention compared with US dollar 1.62 billion purchased in the ccorresponding period last year. NRB had purchased US dollar 2.42 billion and US dollar 3.19 billion from BFIs during FY

2010/11 and 2011/12 respectively. NRB has been purchasing INR from Indian money market by selling USD since 2001/02 to meet the growing INR demand. The volume of INR purchased grew by 10.33 percent to IRs. 76.28 billion by selling US dollar 1.40 billion during the first six month of 2012/13 compared to that of IRs. 69.14 in the corresponding period last year. In FY 2011/12, NRB had purchased IRs. 133.72 billion by selling USD 2.66 billion in the Indian money market.

4.14 The widening of trade deficit with India emanating from a surge in imports of petroleum products could be attributed to a higher amount of INR purchase in later years. Likewise, the additional investment in Indian treasury bills and a rise in the volume of imports from India were the responsible factors behind the surge in INR purchase. Despite a fall in the volume of US dollar sale to purchase INR, more INR was acquired during the review period due to depreciation of Indian currency against the US dollar. The average selling price per USD remained at IRs. 54.45 during the review period while it was IRs. 48.69 during the corresponding period last year. The US dollar acquired from BFIs was not sufficient to purchase INR. Hence, there was a decline in the holdings of NRB during the review period. The volume of USD purchased from BFIs reached net US dollar 1.20 billion from mid-July 2012 to mid-January 2013, about a quarter less than the figure of the corresponding period of last year.

4.15 NRB had purchased US dollar 1.62 billion during the first half of 2012/13. NRB sold USD amounting to US dollar 11.28 million two times during the review

Figure 4.5: IC Purchase

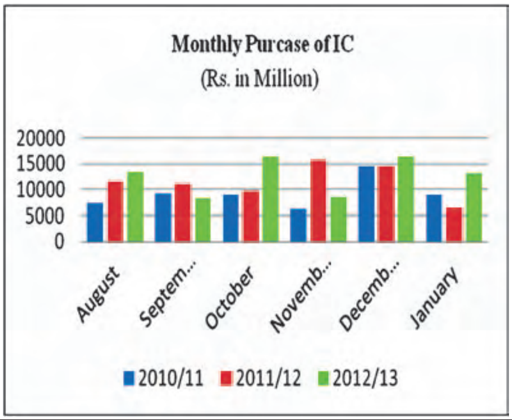
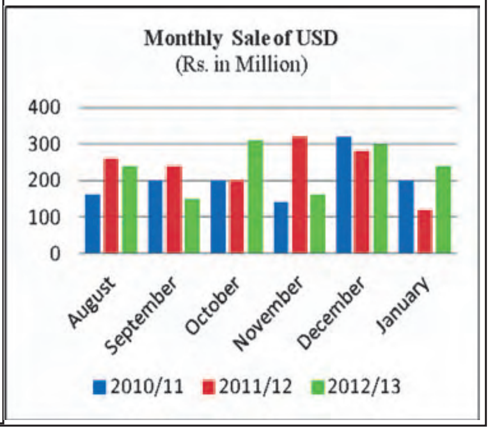


Figure 4.6: Sale of USD



period. Monthly US dollar purchased from BFIs dropped to around 200 million during the review period compared with the monthly average of US dollar 270 million during the corresponding period last year. BFIs' holding of forex reserves grew gradually during the review period as shown by a widening gap between remittance inflows and USD sale to NRB.

Table 4.3: USD sold and INR Purchase (Rs. In million)

Fiscal Year	Sale of USD	Purchase of INR	Equivalent NPR
2007/08	1,730.00	70,602.50	112,964.00
2008/09	1,520.00	73,400.60	117,440.96
2009/10	2,190.00	102,093.23	163,349.16
2010/11	2,740.00	123,845.16	198,152.26
2011/12	2,660.00	133,718.64	213,949.82
2012/13 (First 6 Months)	**1,400.00**	**76,277.61**	**122,044.18**

Source: NRB Foreign Currency Management Dept.

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

Chapter Five

FINANCIAL SECTOR POLICIES AND INFRASTRUCTURES

Financial Sector Policies

5.1 Sound regulatory policies and robust arrangement for regulating financial system are the fundamental requirements in order to ensure financial stability. NRB is entrusted with the responsibility of regulating, inspecting, supervising and monitoring banks and financial institutions. Accordingly, NRB has been issuing various policies, directives, guidelines and circulars. NRB's policies, directives and circulars encompass regulations relating to licensing, capital, asset quality, liquidity, corporate governance, risk management, foreign exchange management, access to finance and financial inclusions, among others. The objectives of these regulations are to strengthen the health and soundness of the banks and financial institutions, enhance public confidence and ultimately contribute in maintaining stability in the financial system. Financial stability also requires very well performance of CAMELS in BFIs. To assure this, inspection and supervision of BFIs are being performed effectively in a regular basis and enforcement actions are taken for non-compliance to ensure the financial health of BFIs.

Licensing Policy

5.2 Rapid growth in number of BFIs during the last decade and comparatively limited market with limited supervision resources lead to unhealthy competition. Considering this fact, a moratorium on licensing of A, B and C class institution has been imposed until another policy provision is announced. However, licensing of D class institutions is still open on selective basis so as to promote establishment of MFFIs aiming to extend access to finance in rural areas. NRB, believes that this will increase financial inclusion and help to reduce poverty in rural areas.

5.3 NRB is considering the revision of existing licencing policy in view of changed context in time, market dynamics, geographical topology and implementation of Basel III both in domesic banking system and in the international financial market.

A working group has been formed for the study of need of the revision as well as and areas needed for the revision.

Capital Adequacy

5.4 With a view to adopting international best practices, Nepal is implementing Basel II framework starting from the simplest form of the available approaches with the vision to move towards the more complex and risk sensitive approaches as the market gradually gains maturity. Capital Adequacy Framework 2007 (updated 2012) issued for the first time in 2007. Implementation of Basel II started after one year of parallel run of Basel I and Basel II (simultaneously) in Commercial Banks. After the parallel run of one-year, "A" class financial institutions were enforced for the compliance in accordance with the new capital adequacy framework. It has been almost five years of successful implementation of Basel II in Nepal. Other institutions are still computing and reporting their capital adequacy according to Basel I framework. The new framework is under parallel run for the national level Development Banks (B class financial institutions) in Nepal.

5.5 The new capital adequacy framework, also known as Basel II, includes the three pillar approach; minimum capital requirements, supervisory review and disclosure. The first pillar includes the risk measurement approaches: Simplified Standardized Approach (SSA) for credit risk, Basic Indicator Approach (BIA) for operational risk and Net Open Position Approach (NOPA) for market risk. These approaches seem to be the simplest approaches for measurement of risks under Basel II. Currently, SSA is used for measuring credit risks and BIA and NOPA are used for measuring operational and market risks respectively. The main objective of this framework is to develop safe and sound financial system by

Table 5.2: Capital Adequacy Requirment in BASEL Criteria

Capital Requirements (% of RWA)	Basel II	Basel III*
• Minimum common equity capital ratio	2.0%	4.5%
• Capital conservation buffer	-	2.5%
Common equity + capital conservation	**2.0%**	**7.0%**
• Minimum Tier I capital ratio	4.0%	6.0%
• Minimum total capital ratio	8.0%	8.0%
Total capital + capital conservation	**8.0%**	**10.5%**
• Leverage ratio (non-risk-based)	-	3.0%
• Countercyclical capital buffer (nat. discretion)	-	0 -2.5%
• SIFI capital buffer	-	Under Discussion

way of sufficient amount of qualitative capital and risk management practices. Based on its risk-weight assets, a licensed financial institution shall have to maintain the following capital adequacy ratio. (Table 5.3)

5.6 After the global financial crisis, there has been significant development and addition in the existing capital framework all over the world. Basel II enhancement, Basel 2.5 and Basel III are some of the recent developments towards capital regulation in banking. Most of the issues included in the new capital regulations were the issues observed during and after the global financial crisis. Additions made in the Basel II framework were especially the efforts to solve the problems emanating from the global financial crisis. NRB expects banks to operate above the minimum regulatory capital ratios. Whenever NRB is not convinced about the risk management practices and control environment, it has the authority to require banks to hold capital in excess of minimum.

Table 5.3: Minimum CAR

Institution	Minimum CAR	
	Core capital	Capital Fund
"A" Class	6.0	10.0
"B" and "C" Class	5.5	11.0
"D" class	4.0	8.0

5.7 Furthermore, as a part of NRB's continuous effort to enhance regulatory framework, homework is being done to adopt BASEL II provisions to B and C class financial institutions and some of the provisions of BASEL III if, required, to all kind of BFIs. According to the New Capital Adequacy Framework 2007, minimum capital requirements for commercial banks are for core capital and total capital is 6 percent and 10 percent of RWE respectively. These ratios are already higher than the global standard for capital adequacy prescribed by Basel II. Under Basel III, minimum Tier I capital should be 6 percent of RWE and there will not be necessity of any change in total capital requirements. There is no specific regulatory requirement for common equity tier 1 capital under SSA of Basel II. But the licensing policy requires the existing banks to have minimum paid up capital (including some components of core capital) of Rs 2 billion.

Financial Consolidation

5.8 In order to develop sound, efficient and robust financial institutions with strong capital base by encouraging financial consolidation, Bank and Financial Institutions

Merger Bylaws, 2011 has been issued. The bylaws include several incentives, regulatory relaxations and an indirect provision of forceful merger as well. A separate desk has been established in Bank and Financial Institution Regulation Department to facilitate the merger process. NRB has taken the policy of encouraging merger and accordingly many BFIs are showing interest for financial consolidation.

Assets Quality

5.9 Entire loans and advances extended by BFIs have to be classified as follows based on expiry of the deadline of repayment of the principal and/or interest of such loans/advances as follows.

(a) Pass: Loans/advances which have not been overdue and which are overdue by a period up to three months.

(b) Sub-standard: Loans/advances which are overdue by a period from three months to a maximum period of six moths.

(c) Doubtful: Loans/advances which are overdue by a period from six-months to a maximum period of one year.

(d) Loss: Loans/advances which are overdue by a period of more than one year.

Based on the above classifications, BFI need to provide for the possible losses on such loans and advances. The provisions required are 1 percent, 25 percent, 50 percent, and 100 percent respectively for each categories of loans and advances. There are other special provisions to cater with additional conditions from which loan and advances may be unrecoverable. Such provisions help to maintain the aqequate level of reserves and capital for the sustainability of BFIs.

Liquidity

5.10 The BFIs of "A", "B" and "C" class shall have to maintain a deposit with NRB of 6 percent, 5.5 percent and 5 percent of total deposit liabilities as CRR respectively as per the announcement in Monetary Policy for 2012/13. Furthermore, with the objective of ensuring sufficient liquidity in the financial system, Statutory Liquidity Ratio (SLR) has been fixed at 15 percent, 11 percent and 10 percent of total deposit for "A", "B" and "C" class institutions respectively. For D class institution collecting public deposits, the SLR requirement is 4 percent. Furthermore, NRB is in the process to introduce a better monitoring system to detect future liquidity problems along with a Prompt Corrective Action (PCA) program with appropriate liquidity triggers, among others. This proposed system aims to ensure that all BFIs maintain an adequate level of high quality liquid assets that can be converted into cash to meet its liquidity needs. Likewise, in order to mitigate liquidity risk there is a provision that the total loan and advance of BFIs should not exceed 80 percent of its deposit and core capital.

Corporate Governance

5.11 Guidelines on services and fees and commission on services charged by BFIs, requirement of establishing information and grievance hearing desk to address grievances of customers, guidelines on compensation packages for chief executive officer of BFIs in order to enhance equitability and transparency in the financial system , a policy provision barring promoters, chief executive officers or managerial level officials of licensed institutions from borrowing any personal loan except education loans, over draft, home loan or home appliances loans from any licensed institutions to avoid systemic risk arising from conflict of interest of banker and entrepreneur, a policy discouraging a single person from being the Chairman and CEO of the financial institution and declarations of loan by promoter and family members from BFIs are some of the major policies for the enhancement of good corporate governance in the financial sector.

Risk Management

5.12 In order to provide guidelines to commercial banks on risk management system, NRB has issued Risk Management Guidelines (RMG). The RMG sets out minimum standards that shall be expected of a risk management framework. Guidelines on stress testing has been issued already to A class instituton and it will be gradually enforced for implementation in to B and C classs instituion in near future to avoid the forward looking risk of the BFIs. Institution-wise Liquidity Monitoring Framework (ILMF) is about to be implemented so as to increase the capacity of forward looking analysis. To increase the effectiveness in Risk Based Supervision, the current supervision mechanism is reanalyzed and modification work is being carried out. Also, to increase the effectiveness on Early Warning System and to prepare the contingency plan, Bank Resolution Framework has been prepared including the stepwise tasks on Crisis Management.

5.13 In order to address risk identified by BASEL II and inherent risk associated with individual banks, guidelines on Internal Capital Adequacy Assessment Process (ICAAP) have been issued for commercial banks. As per the guidelines, banks are required to set policies, methodologies and procedures for assessing its capital adequacy relative to its risk profile

Macroprudential Regulation and Supervision

5.14 Macro prudential policy is the use of prudential tools with the explicit objective of promoting the stability of the financial system as a whole, not necessarily of the individual institutions. The purpose of macroprudential policy is to reduce systemic risk. Systemic risk is understood as the risk of development that threatens the stability of the financial system as a whole, and consequently the broader economy. The term macroprudential regulation characterizes the approach to financial regulation aimed to mitigate the risk (systematic risk) of the financial system as a whole. In the aftermath of the financial crisis, there has been a growing consensus among policymakers and economic researchers about the need to re-orient the regulatory framework towards a macroprudential perspective. The importance of macroprudential regulation and supervision has been enhanced at present as economy's systematic risks were not sufficiently addressed either by monetary policy anchored to price stability objective or by micro prudential regulation through adequacy of capital and liquidity of individual financial institutions.

5.15 Basel III has some micro-prudential elements so that risk is managed in each individual institution and macroprudential elements will take care of issues relating to the systemic risk. The microprudential element of Basel III incorporates definition of capital, better risk coverage, leverage ratio, and international liquidity framework, among others. Similarly, the macroprudential elements of Basel III are leverage ratio, capital conservation buffer, counter cyclical capital buffer, forward looking and dynamic provisioning, addressing systemic risk and interconnectedness, loan to value ratio, debt to income ratio and credit to GDP ratio, and macroeconomic policy reform (including monetary and fiscal reform, institutional and structural reform), among others.

5.16 As NRB has the responsibility to ensure financial stability in the country, encouraging banks for self-regulation and making them sensitive toward risks is one of the key of macroprudential policies. NRB has found, continuously directed its efforts and is making progress in implementing prudential regulations including new capital adequacy norms, strengthening supervisory capacity, making provisions for liquidity support to banks, and introducing Prompt Corrective Actions (PCA), Early Warning Signals (EWS), and Stress Testing of banks. The main elements of macro-prudential regulation of the NRB consists of capital requirements, risk management guidelines to banks, stress testing guidelines, liquidity monitoring, policy in real estate market and deposit insurance. Similarly, C-D Ratio, LTV Ratio, Margin Lending, Residential Loan, Single Borrower Limit and Liquidity Ratio are other macro financial prudential regulations issued by the NRB so far at present.

5.17 NRB has already formulated and enforced some of the macroprudential regulations relating to strengthening the capital of banks and financial institutions (BFIs), and expanding access of general people to financial services, implementing risk based supervision, making necessary arrangement for system audit, establishing coordination among the various regulators of financial sector, enhancing corporate governance in BFIs, updating the banking rules and regulations in timely manner, among others etc. Similarly, maintaining difference between bankers and entrepreneurs/businessmen, strengthening financial intelligence, enhancing financial discipline, formulating financial literacy policy, making necessary arrangement regarding multiple banking for maintaining financial stability in Nepal are underway.

5.18 Regarding real estate policy, the limit of individual residential loan has been increased to Rs 10 million and it has been removed from real estate loan. Similarly, margin lending loan has been made convenient by allowing banks to fix the margin by themselves. Such loan can be renewed also if there is no interest due. To mitigate the risk in realty sector, loan to value ratio (LTR) has been fixed at 60 percent of the market value. Net Liquid Assets /Deposit Ratio have been fixed at 20 percent. Introducing some provisions of Basel III have been under process, liquidity monitoring framework is implemented, and introducing liquidity and NPL based PCA is in the process. Selective and cautious credit policy is the need of Nepal. NRB is careful in adopting policies to release more credit to productive sectors. On the other hand, it will discourage credit to the unproductive sector through various regulatory measures. Though NRB’s directive has been able to control stagnation in the realty business and hence has contributed to mitigate systemic failure in the financial system, the slackness in the real estate business is prevalent. NRB has been carefully watching the trend of real estate business in terms of transaction as well as price. There have been positive movements in realty transactions in certain places of major urban areas/cities; however, the BFI's present focus is on recovery rather than increasing transactions. If the situations propagates, it may take few more time for a complete recovery of the realty sector.

Major Regulatory Pronouncements and Recent Initiatives

5.19 To make the working procedure for AGM clearance and dividend approval with the requirement of 1 percent buffer capital to distribute cash dividend and to make electronic cheque clearing system secured and cost effective, revision has been made on cheque standards and specifications. Similarly, some of the major initiatives in regulation and supervision on which NRB is studying are under consideration, for instance Problem Bank Resolution Framework, PCA for Liquidity Risk, Revision of Inspection and Supervision ByeLaws, Study on remuneration of CEO & Staff of BFI, Investors Survey, Study on Hire Purchase business through Investment companies, and Study to frame Payment & Settlement Byelaws, among others.

Financial Inclusion and Access to Finance

5.20 To enhance financial inclusion and access to finance, a provision of interest free loan up to Rs. 5 million and Rs.10 million has been made for BFIs for opening a branch in district headquarters and outside district headquarter of 17 remote districts for a specified period. Such provision focuses on areas where there is lack of access to finance. Accordingly, a policy provision has been implemented under which BFIs can open branch in Kathmandu valley only after opening one branch in specified remote districts and one in other district. Provision to provide interest free loan up to Rs. 1.5 million for class MFFIs for extending their financial services by opening a new branch in the 9 specified districts with limited financial access are some of the major policies NRB has implemented.

5.21 Policy provision has been introduced allowing BFIs to provide banking services in unbanked areas and rural areas through e-banking and mobile devices to promote financial services, including the access. Similarly, NRB has been promoting branchless banking for the expansion of banking services to the unbanked population instead of focusing on opening more branches. Branchless banking has been recognised as an important tool to increase banking access to the people living in geographically difficult-to-reach places in Nepal.

5.22 The policy of increasing the deprived sector loan by 0.5 percentage point every year up to 3 years by BFIs has been made. Accordingly, for fiscal year 2012/13 commercial banks, development banks and finance companies are required to lend 4 percent, 3.5 percent and 3 percent respectively of their total loans to the deprived sector. As a policy to promote productive sector lending, commercial banks are required to prepare and submit a plan to provide minimum 20 percent loan from their total loan and investment on various productive sectors such as agriculture, energy, tourism, household and small industries within mid-July 2012 and also, minimum 10 percent loan should be provided to agriculture and energy within mid-July 2013.

5.23 An Act regarding Micro Finance Authority has already been drafted and proposed with the provision of establishing a Second-Tier Institution aiming at regulating and supervising the scattered micro finance institutions through out the country. This process is expected to pave the way for intensive and more cautious regulation/supervision of this sector and will further contribute for maintaining the sound financial health. Likewise, a legal framework regarding the establishment of National Micro Finance Fund has also been proposed. It will replace the existing Rural Self Reliance Fund and will act as an autonomous wholesale lending fund that expands the base of microfinance transactions in the days to come.

5.24 With the aim of raising the capital base and enhancing the capacity of poorly performing rural development banks, all of the five rural development banks have been put in the process of merger and to facilitate an effective and efficient supervision of MFFIs, a separate unified directive is being prepared for the micro-finance development banks; a separate inspection directives is being drafted for the FINGOs and a revision is being made on the directives issued to cooperatives licensed by the NRB for limited banking activities.

5.25 Similarly, timely revisions are being made in the directives issued to bank and financial institutions bearing microfinance activities so as to strengthen and promote stability of these financial institutions. A policy has been adopted for the FINGOs that provide them an opportunity to upgrade themselves as a MFFIs. This step will be also helpful for financial stability and corporate governance, in general.

5.26 By examining the current status of financial literacy and their problems, a National Financial Literacy Policy is being worked out and different public awareness programs are being initiated for inclusive financial system, good governance and balanced development in financial sector through increased financial literacy among the general people.

5.27 As the existing Credit Information Centre (CIC) caters services only to commercial banks and financial institutions other than MFIs. The need of a separate credit information agency specialized for micro financing sector is on high priority. Such an endeavor is expected to help promote financial discipline and resolve the problems of multiple banking as well as the over-indebtedness to a large extent.

Other Policies

5.28 As a part of financial safety net mechanism, policy provision has been introduced for guranteeing deposit up to Rs. 200,000 of saving and fixed deposit depostied in the name of natural person of licensed banks and financial institutions with Deposit and Credit Guarantee Corporation (DCGC).

5.29 Since high dependency on institutional deposits may lead to liquidity problems, a limit has been imposed for institutional deposit collection. The A, B and C class licensed institutions are allowed to collect institutional deposits from a single firm, company or any other corporate bodies not exceeding 20 percent of their total deposits.

5.30 A comprehensive Money (Asset) Laundering Prevention Act, 2008 has come into force to combat money laundering and terrorist financing and fulfill the international commitment against money laundering and financing of terrorism. As provisioned by the act, Financial Information Unit (FIU) has been established within NRB to function as a central national agency responsible for receiving, analyzing and disseminating the financial information in order to combat the potential offence of Money Laundering and Financial Terrorism. In order to control financial crimes and fraud, FIU has issued directives to licensed institutions and accordingly it has started receiving a number of Threshold Transaction Reports (TTRs) and Suspicious Transaction Reports (STRs)

Foreign Exchange Policy

5.31 In the context of liberalization, with full convertibility of Nepalese rupee in current account transactions, gradual liberalization of capital account with more liberal foreign exchange rules and regulation to facilitate the Nepalese entrepreneurs for the legimate business purpose and for foreign investment is under consideration and NRB is now studying about the gradual process of capital account convertibility.

5.32 A policy provision has been made allowing Nepalese individuals and organizations to open and operate bank account in foreign countries. Under this provision exporters are allowed to open bank account abroad up to the limit of 5 percent of their export earnings under specified terms and conditions. The policy provision has been introduced such that banks and financial institutions can extend their credit in foreign currency to hydropower projects and in different foreign currency denominated instruments with prior approval of NRB.

5.33 The commercial banks are allowed to invest up to a prescribedt limit of their balance kept in the agency banks in the instruments such as call deposit, certificate of deposit or such other instruments having low risks and the maturity period not exceeding two years.

5.34 Inspection and supervision directive has been prepared and implemented for effective inspection and supervision of companies licensed from this bank for conducting remittance and money changer transactions. Nepalese banks are encouraged to open branches/representative offices in India, South Korea and other countries to channelize remittance inflow through formal channel.

Monetary Policy

5.35 Monetary Policy for 2012/13 incorporated new policies along with policy changes to achieve macroeconomic statbility and for facilitating high and sustainable economic growth in the country. The half yearly review of the policy was released in 20 Feburary 2013. The status of implementation and the revised projection of inflation, BoP and other economic indicators, which need to be implemented for the remaining period of the fiscal year, are also included in this review report.

5.36 The revised projection of economic growth in the half yearly review for 2012/13 is 4.1 percent against the previous projection of 5.5 percent in Monetary Policy of 2012/13. The estimated annual inflation has been revised to 9.5 percent from the projected 7.5 percent. Low domestic production and high inflation in India forced the central bank to make upward revision of inflation. The growth of deposit mobilization of banks and financial institution has been lowered to 13.1 percent from the previously projected 15.1 percent due to decreased government expenditure and the slow growth of foreign resources. Similarly, the growth of gross domestic credit has been lowered to 13.5 percent from the previously projected 16.0 percent, as the claims on government would further decrease**.** CRR, SLR, bank rate, refinance rate and special refinance rate as mentioned in the Monetary Policy of the current fiscal year 2012/13 have been kept unchanged.

5.37 The NRB has made it mandatory for all commercial banks to make public the base rate at least on a monthly basis. Under the provision, BFIs will have to determine lending rates on the basis of the base rate, a system that makes interest rate on credit transparent and ultimately narrow down the spread. The base rate came into effect from mid-January 2013. The base rate gives an idea of the interest rate that banks could charge on lending. In principle, banks cannot extend loans below the base rate and it is expected to make credit pricing more transparent. Banks can add a minimum premium on the base rate depending on the risk inherrited on the loan. In the present context of liberalization of interest rate, the NRB does not intend to intervene into this system, but if the present scenario of higher spread continues further, NRB would take necessary steps to rectify the system. It is expected that the base rate system will ensure transparency in the interest rate determination and would ultimately support financial stability.

Financial Sector Development Strategy

5.38 It is now well-recognized that a competitive, stable, prudentially sound financial system plays a very important role in the development process by ensuring efficient accumulation and effective allocation of financial resources. Therefore, it is increasingly visualized that charting the future direction of financial sector would be very important to ensure a sustainable future of the financial system in Nepal. Despite the regulatory and supervisory provisions of NRB, the financial system has witnessed the risk based lending, concentration in urban areas, and the problems of corporate governance, thus demanding for a long term direction to ensure the financial stability and growth in the country. Majority people of the country are still out of formal banking services. Poverty level exists for around 25 percent of the population, mostly in the rural areas. Geographical dispersion demands for an innovative model of banking services in the rural areas, among others.

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

Financial Infrastructure

Payment and Settlement System

5.40 Payment and Settlement System is a mechanism through which financial transaction are smoothly cleared and timely settled. Safe and efficient payment system creates credibility in the financial system, which is one of the prerequisite for maintaining financial stability. With the rapid development in ICT, method of payment and settling transactions have migrated from conventional paper based payment instruments to electronic payment instruments. Since developing secure, healthy and efficient system is one of the objectives of NRB, NRB is effortful in developing and promoting sound and efficient payment system through introducing Real Time Gross Settlement System (RTGS) and validating E- payment. It is expected that the RTGS will soon be implemented.

5.41 NRB has granted approval to Nepal Clearing House Limited (NCHL) to carry out Electronic Cheque Clearing (ECC) system. The ECC system provides means to electronically transfer cheque images through a secure medium, thus completely replacing the traditional physical routine of moving paper-cheques among the banks and clearing house, which result in significant reduction of traditional and time consuming manual process of cheque clearing, both for the banks and for the customers.

5.42 Nepal Central Depository and Clearing Ltd was established at the initation of NEPSE to provide centralized depository, clearing and settlement services in Nepal. The operation of CDS is expected to bring revolution in the Nepalese capital market. The safety and security of physical holding to electronic medium will eliminate thefts, interceptions and subsequent misuse of certificates while the flow of securities will also be looked due to instant transfers. Hence, the transparency level of trading in this platform is expected to be monitored more secure, clear and easy.

Annex 1

Structure of the Nepalese Financial Sector
(Total Assets/Liabilities)
(mid-January 2013)

(Rs. in million)

Financial Institutions	2008	2009	2010	2011	2012	Mid-Jan 2013
Nepal Rastra Bank	2,12,449.8	2,82,328.4	2,96,625.6	3,22,043.9	4,55,682.5	4,45,151.3
Commercial Banks	5,66,736.0	7,06,036.2	7,63,226.3	8,53,490.7	10,52,450.7	11,08,923.8
Development Banks	39,868.8	68,009.3	1,02,208.9	1,29,617.4	1,60,360.2	1,72,578.5
Micro Finance Financial Instituiotns	12,580.0	15,438.0	17,681.6	20,862.9	29,815.5	31,742.2
Finance Companies	80,383.9	87,430.0	1,09,998.2	1,18,578.2	1,09,687.5	1,14,388.9
Financial Co-operatives	4,360.5	4,965.1	6,975.2	8,076.0	11,358.8	12,473.6
Financial NGOS	2,382.6	2,382.6	2,382.6	4,937.6	4,260.0	6,475.2
Contractual Saving Institutions						
Employees Provident Fund	68,334.1	79,119.7	90,390.3	1,06,584.5	1,27,475.9	1,35,748.2
Citizen Investment Trust	12,371.4	25,379.5	22,647.8	26,905.4	38,068.5	38,034.8
Insurance Companies	31,589.4	37,014.3	47,460.0	61,213.4	70,890.0	74,369.4
Postal Savings Bank	827.0	1,038.4	1,085.9	1,152.4	NA	1,298.3
Total	10,31,883.5	13,09,141.5	14,60,685.0	16,55,673.5	20,60,049.6	21,41,184.2
Market capitalisation	3,66,247.6	5,12,939.0	3,76,871.0	3,23,484.3	3,68,262.1	5,10,427.7
Total (incl. market capitalisation)	13,98,131.1	18,22,080.5	18,37,556.0	19,79,157.8	24,28,311.7	26,51,611.9
Percentage Share						
Financial Institutions	89.0	89.1	88.9	88.0	88.5	88.4
Nepal Rastra Bank	20.6	21.6	20.3	19.5	22.1	20.8
Commercial Banks	54.9	53.9	52.3	51.5	51.1	51.8
Development Banks	3.9	5.2	7.0	7.8	7.8	8.1
Micro Finance Financial Instituiotns	1.2	1.2	1.2	1.3	1.4	1.5
Finance Companies	7.8	6.7	7.5	7.2	5.3	5.3
Financial Co-operatives	0.4	0.4	0.5	0.5	0.6	0.6
Financial NGOS	0.2	0.2	0.2	0.3	0.2	0.3
Contractual Saving Institutions	11.0	10.9	11.1	11.8	11.5	10.9
Employees Provident Fund	6.6	6.0	6.2	6.4	6.2	6.3
Citizen Investment Trust	1.2	1.9	1.6	1.6	1.8	1.8
Insurance Companies	3.1	2.8	3.2	3.7	3.4	2.8
Postal Savings Bank	0.1	0.1	0.1	0.1		
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.00**	**100.00**

Source: *Financial Statistics and NRB staffs' calculation, BFRID, NRB*

Annex 2

Statement of Assets and Liabilities of BFIs (Aggregate)
(mid-January 2013)

(Rs. in million)

	LIABIILTIES	Mid July		Mid-January		Percentage Change	
		2011	2012	2012	2013		
		1	2	3	4	5	6
1	CAPITAL FUND	103407.53	115162.99	108783.26	127300.41	11.37	17.02
	a. Paid-up Capital	98418.17	104303.78	101424.52	111730.86	5.98	10.16
	b. Statutory Reserves	17727.34	22068.14	21139.00	25321.33	24.49	19.78
	c. Retained Earning	-24280.93	-24321.75	-26766.34	-21367.18	0.17	-20.17
	d. Others Reserves	11542.96	13112.82	12986.09	11615.39	13.60	-10.56
2	BORROWINGS	34058.68	17805.91	20353.27	21426.30	-47.72	5.27
	a. NRB	13307.22	4286.68	4355.61	711.79	-67.79	-83.66
	b. "A"Class Licensed Institution	10915.97	3297.01	5788.53	10179.92	-69.80	75.86
	c. Foreign Banks and Fin. Ins.	2232.33	2507.93	2478.84	2189.67	12.35	-11.67
	d. Other Financial Ins.	1453.38	781.08	1630.69	1611.52	-46.26	-1.18
	e. Bonds and Securities	6149.79	6933.22	6099.59	6733.41	12.74	10.39
3	DEPOSITS	869951.43	1071394.11	952724.01	1125005.93	23.16	18.08
	a. Current	80934.33	95993.06	75164.16	89231.49	18.61	18.72
	b. Savings	305589.21	400723.15	344091.46	449158.91	31.13	30.53
	c. Fixed	332726.29	372137.55	363408.62	378134.33	11.84	4.05
	d. Call Deposits	139308.18	187998.54	157072.56	192754.35	34.95	22.72
	e. Others	11393.42	14541.81	12987.22	15726.85	27.63	21.09
4	Bills Payable	964.92	1626.36	783.79	2005.62	68.55	155.89
5	Other Liabilities	106263.83	123660.25	125326.59	141312.73	16.37	12.76
	1. Loan Loss Provision	30215.83	33873.99	38128.44	38742.29	12.11	1.61
	2. Interest Suspense a/c	28130.02	26056.17	31569.09	28951.83	-7.37	-8.29
	3. Others	47917.98	63730.08	55629.06	73618.61	33.00	32.34
6	Reconcillation A/c	9872.98	1537.81	3131.57	9043.85	-84.42	188.80
7	Profit & Loss A/c	20198.37	19776.52	7188.97	11013.75	-2.09	53.20
TOTAL		**1144717.74**	**1350963.95**	**1218291.46**	**1437108.60**	**18.02**	**17.96**

Sources: Financial Statistics and NRB staffs' calculation, BFRID, NRB

LIABIILTIES		Mid July		Mid-January		Percentage Change	
		2011	2012	2012	2013		
		1	2	3	4	5	6
ASSETS							
1	LIQUID FUNDS	147993.99	236056.86	193635.32	194724.40	59.50	0.56
	a. Cash Balance	23950.22	31020.07	23637.80	27712.39	29.52	17.24
	1. Nepalese Notes & Coins	23410.19	30353.28	22819.73	26861.38	29.66	17.71
	2. Foreign Currency	540.03	666.79	818.07	851.01	23.47	4.03
	b. Bank Balance	90221.67	164605.21	139621.07	121372.17	82.45	-13.07
	1. In Nepal Rastra Bank	54649.30	120457.25	95445.32	70321.88	120.42	-26.32
	2. "A"Class Licensed Institution	15881.98	26284.33	17703.19	23658.72	65.50	33.64
	3. Other Financial Ins.	9176.54	7649.81	9154.65	6264.20	-16.64	-31.57
	4. In Foreign banks	10513.86	10213.81	17317.92	21127.38	-2.85	22.00
	c. Money at Call	33822.11	40431.58	30376.44	45639.84	19.54	50.25
2	INVESTMENTS	107562.37	137304.43	125857.23	144665.80	27.65	14.94
	a. Govt.Securities	105115.15	133251.15	124784.09	143841.90	26.77	15.27
	b Others	2447.22	4053.28	1073.15	823.90	65.63	-23.23
3	SHARE & OTHER INVESTMENT	53582.86	52851.08	47680.15	60521.37	-1.37	26.93
4	LOANS & ADVANCES	698778.98	779560.90	728369.92	879892.38	11.56	20.80
	a. Private Sector	675113.87	741145.02	703247.26	850740.77	9.78	20.97
	b. Financial Institutions	17299.98	31389.29	18251.13	20120.78	81.44	10.24
	c. Government Organizations	6365.14	7026.59	6871.53	9030.84	10.39	31.42
5	BILL PURCHED	5149.73	9634.19	7192.18	6938.79	87.08	-3.52
6	LOANS AGT. COLLECTED BILLS	95.96	645.89	416.24	453.66	573.10	8.99
7	FIXED ASSETS	24260.64	27146.40	26009.42	28914.14	11.89	11.17
8	OTHER ASSETS	79138.14	93318.34	92101.96	104736.71	17.92	13.72
	a. Accrued Interests	29689.70	27621.76	33471.84	30666.72	-6.97	-8.38
	b. Others	49448.44	65696.59	58630.13	74070.00	32.86	26.33
9	Expenses not Written off	775.30	586.90	551.95	849.62	-24.30	53.93
10	Non Banking Assets	1549.65	2225.09	2322.85	2566.40	43.59	10.49
11	Reconcillation Account	21980.28	8638.94	-9788.66	9518.19	-60.70	-197.24
12	Profit & Loss A/c	3849.83	2994.86	3943.31	3327.09	-22.21	-15.63
TOTAL		**1144717.74**	**1350963.88**	**1218291.88**	**1437108.56**	**18.02**	**17.96**

Annex 3

Statement of Assets and Liabilities of BFIs
(mid-January 2013)

(Rs. in million)

	Liabilities	Class "A"	Class "B"	Class "C"	Total
1	CAPITAL FUND	88,909.9	23,822.1	14,568.4	1,27,300.4
	a. Paid-up Capital	73,854.6	22,215.5	15,660.7	1,11,730.9
	b. Calls in Advance	3,004.8	223.9	116.3	3,345.0
	c. Proposed Bonus Share	0.0	190.6	32.0	222.5
	d. General Reserves	21,380.2	1,895.3	2,045.8	25,321.3
	e. Share Premium	217.1	38.5	53.4	309.0
	f. Retained Earning	-16,798.3	-1,003.5	-3,565.3	-21,367.2
	g. Others Reserves Fund	7,251.5	261.8	225.5	7,738.9
2	BORROWINGS	18,360.4	1,838.1	1,227.7	21,426.3
	a. NRB	702.5	9.2	0.0	711.8
	b. Interbank Borrowing	7,892.7	1,059.5	1,227.7	10,179.9
	c. Foreign Banks and Fin. Ins.	2,189.7	0.0	0.0	2,189.7
	d. Other Financial Ins.	847.7	763.8	0.0	1,611.5
	e. Bonds and Securities	6,727.8	5.6	0.0	6,733.4
3	DEPOSITS	9,05,867.7	1,36,930.1	82,208.1	11,25,005.9
	a. Current	86,757.5	2,448.3	25.6	89,231.5
	Domestic	73,693.2	2,432.6	25.6	76,151.4
	Foreign	13,064.4	15.7	0.0	13,080.0
	b. Savings	3,43,862.6	67,495.0	37,801.3	4,49,158.9
	Domestic	3,37,364.1	66,941.5	37,733.8	4,42,039.5
	Foreign	6,498.5	553.5	67.5	7,119.5
	c. Fixed	2,97,964.4	41,318.3	38,851.7	3,78,134.3
	Domestic	2,64,562.9	41,244.5	38,798.6	3,44,605.9
	Foreign	33,401.5	73.8	53.1	33,528.4
	d. Call Deposits	1,67,312.8	24,953.6	487.9	1,92,754.3
	Domestic	1,55,500.8	24,727.8	487.9	1,80,716.6
	Foreign	11,811.9	225.8	0.0	12,037.8
	e. Others	9,970.4	714.9	5,041.6	15,726.9
	Domestic	8,773.5	714.9	5,041.6	14,530.0
	Foreign	1,196.9	0.0	0.0	1,196.9
4	Bills Payable	1,972.5	28.4	4.7	2,005.6
5	Other Liabilities	1,09,504.0	16,578.6	15,230.1	1,41,312.7
	1. Sundry Creditors	15,223.5	485.7	520.6	16,229.8
	2. Loan Loss Provision	25,154.9	5,838.5	7,748.9	38,742.3
	3. Interest Suspense a/c	21,943.0	3,346.9	3,661.9	28,951.8
	4. Others	47,182.6	6,907.5	3,298.6	57,388.8
6	Reconcillation A/c	1,530.1	5,584.6	1,929.2	9,043.9
7	Profit & Loss A/c	8,687.6	1,401.1	925.1	11,013.8
TOTAL LIABILITIES		**11,34,832.2**	**1,86,183.0**	**1,16,093.4**	**14,37,108.6**
1	LIQUID FUNDS	1,25,259.6	44,233.3	25,231.5	1,94,724.4
	a. Cash Balance	22,906.2	3,616.9	1,189.3	27,712.4
	Nepalese Notes & Coins	22,102.9	3,569.7	1,188.8	26,861.4
	Foreign Currency	803.3	47.2	0.4	851.0

	Liabilities	Class "A"	Class "B"	Class "C"	Total
	b. Bank Balance	86,072.1	18,749.1	16,551.0	1,21,372.2
	1. In Nepal Rastra Bank	60,241.0	6,271.1	3,809.8	70,321.9
	Domestic Currency	59,331.3	6,243.4	3,809.8	69,384.4
	Foreign Currency	909.7	27.7	0.0	937.5
	2. "A"Class Licensed Institution	4,483.9	9,593.4	9,581.4	23,658.7
	Domestic Currency	4,242.0	9,568.9	9,578.1	23,389.0
	Foreign Currency	241.9	24.5	3.3	269.7
	3. Other Financial Ins.	337.9	2,766.5	3,159.7	6,264.2
	4. In Foreign Banks	21,009.3	118.0	0.0	21,127.4
	c. Money at Call	16,281.3	21,867.3	7,491.3	45,639.8
	Domestic Currency	5,568.8	21,713.8	7,491.3	34,773.8
	Foreign Currency	10,712.5	153.5	0.0	10,866.0
2	INVESTMENT IN SECURITIES	1,39,262.0	3,158.4	2,245.4	1,44,665.8
	a. Govt.Securities	1,38,490.1	3,158.3	2,193.5	1,41,102.3
	b. NRB Bond	0.0	0.0	0.0	0.0
	c. Govt.Non-Fin. Ins.	270.8	0.1	0.0	270.9
	d. Other Non-Fin Ins.	120.0	0.0	51.6	171.6
	e Non Residents	381.1	0.0	0.3	381.4
3	SHARE & OTHER INVESTMENT	57,387.5	2,093.4	1,040.4	60,521.4
	a. Interbank Lending	3,045.5	249.8	16.0	3,311.3
	b. Non Residents	1.9	0.0	45.8	47.7
	c. Others	54,340.2	1,843.6	978.6	57,162.4
4	LOANS & ADVANCES	6,91,698.1	1,15,243.7	72,950.6	8,79,892.4
	a. Private Sector	6,66,073.0	1,12,326.9	72,340.8	8,50,740.8
	b. Financial Institutions	16,698.2	2,828.2	594.4	20,120.8
	c.Government Organizations	8,926.9	88.6	15.3	9,030.8
5	BILL PURCHASED	6,914.8	7.3	16.6	6,938.8
	a. Domestic Bills Purchased	2,265.9	5.7	16.6	2,288.2
	b. Foreign Bills Purchased	1,578.8	1.7	0.0	1,580.5
	c. Import Bills & Imports	3,070.1	0.0	0.0	3,070.1
6	LOANS AGAINST COLLECTED BILLS	453.7	0.0	0.0	453.7
	a. Against Domestic Bills	429.7	0.0	0.0	429.7
	b. Against Foreign Bills	24.0	0.0	0.0	24.0
7	FIXED ASSETS	21,213.6	4,196.2	3,504.3	28,914.1
8	OTHER ASSETS	87,793.8	10,024.6	6,918.3	1,04,736.7
	a. Accrued Interest:	23,486.4	3,465.5	3,714.9	30,666.7
	Financial Institutions	172.9	69.1	39.2	281.3
	Government Enterprises	4,492.2	126.5	199.1	4,817.8
	Private Sector	18,821.3	3,269.9	3,476.5	25,567.7
	b. Staff Loans / Adv.	15,000.2	671.2	327.4	15,998.8
	c. Sundry Debtors	13,151.1	1,269.9	455.9	14,876.8
	d. Cash In Transit	719.2	8.9	7.2	735.3
	e. Others	35,436.9	4,609.1	2,413.0	42,459.0
9	Expenses not Written off	624.2	140.5	84.9	849.6
10	Non Banking Assets	1,802.8	334.1	429.5	2,566.4
11	Reconcillation Account	2,001.8	5,569.0	1,947.4	9,518.2
12	Profit & Loss A/c	420.1	1,182.5	1,724.4	3,327.1
	TOTAL ASSETS	**11,34,832.2**	**1,86,183.0**	**1,16,093.4**	**14,37,108.6**

Sources: Financial Statistics and NRB staffs' calculation, BFRID, NRB

Annex 4

Major Financial Indicators of MFFIs (D Class Institutions)
(mid-January, 2013)

(Rs. in million)

	Liabilities	mid-July		mid-Jan		Percent	
		2011	2012	2012	2013	mid-July	mid-Jan 2013
1	Capital Fund	2408.8	2816.6	2231.0	3318.3	16.9	48.7
2	Borrowings	13037.6	16586.4	10635.7	17521.4	27.2	64.7
3	Deposits	3537.4	5235.2	2676.9	5963.3	48.0	122.8
4	Other Liabilities	1818.6	2502.9	1196.5	2834.1	37.6	136.9
5	Reconcillation A/c	223.2	2236.6	2034.4	1675.1	902.1	-17.7
6	Profit & Loss A/c	470.7	629.8	261.1	414.1	33.8	58.6
Total		**21496.4**	**30007.5**	**19035.5**	**31726.2**	**39.6**	**66.7**
	Assets						
1	Liquid Funds	3272.2	5843.5	3449.1	5737.4	78.6	66.3
2	Investment in Securities Except Shares	164.7	128.7	51.2	128.7	-21.9	151.2
3	Share & Other Investment	1560.5	2040.6	1424.8	2816.5	30.8	97.7
4	Loans & Advances	14649.9	17738.3	11033.7	19402.1	21.1	75.8
5	Fixed Assets	259.3	340.2	243.7	380.5	31.2	56.2
6	Other Assets	1253.2	1594.9	643.6	1541.6	27.3	139.5
7	Expenses not Written off	1.1	0.7	143.6	10.6	-35.1	-92.6
8	Reconcillation Account	253.0	2234.8	2029.2	0.0	783.3	-100.0
9	Profit & Loss A/c	82.5	85.8	15.8	1611.0	4.1	10118.6
Total		**21496.4**	**30007.5**	**19035.51**	**31726.2**	**39.6**	**66.7**

Sources: Financial Statistics and NRB staffs' calculation, BFRID, NRB

Annex 5

Aggregate Statement of Sector wise, Product wise and Security wise Credit (mid-January 2013)

(Rs in million)

	Sector Wise Credit	Class "A"	Class "B"	Class "C"	Total
1	Agricultural and Forest Related	27968.2	5186.1	1906.8	35061.1
2	Fishery Related	1886.6	126.1	22.9	2035.6
3	Mining Related	3830.1	176.5	174.6	4181.2
4	Manufacturing (Producing) Related	164507.9	8048.5	5649.2	178205.7
5	Construction	64817.8	13412.7	9544.5	87775.0
6	Electricity,Gas and Water	16284.5	1687.6	291.3	18263.5
7	Metal Products, Mach. & Ele. Eqp.	9362.8	2001.8	933.4	12298.0
8	Tras., Com. and Public Utilities	24222.2	10326.2	5894.4	40442.8
9	Wholesaler & Retailer	148168.7	23997.9	11652.9	183819.5
10	Finance, Insurance and Real Estate	64966.4	10832.5	7679.8	83478.7
11	Hotel or Restaurant	17774.7	4092.7	2081.2	23948.7
12	Other Services	34518.2	5749.7	3081.4	43349.4
13	Consumption Loans	44762.4	8323.1	5978.4	59063.9
14	Local Government	796.2	31.1	19.4	846.6
15	Others	75199.9	21236.6	18056.9	114493.3
Total sectorwise Loan		**699066.6**	**115229.1**	**72967.2**	**887263.0**
Product Wise Credit					
1	Term Loan	97875.5	13731.3	10801.7	122408.5
2	Overdraft	135996.5	31423.5	0.0	167420.0
3	Trust Receipt Loan / Import Loan	46735.0	0.0	0.0	46735.0
4	Demand & Other Working Capital Loan	172274.8	14362.4	19606.0	206243.2
5	Res. Per. H. Loan (Up to Rs. 10 mil.)	40469.0	10527.4	6306.4	57302.9
6	Real Estate Loan	66388.5	12354.8	10397.5	89140.8
7	Margin Nature Loan	6722.3	2336.9	2575.2	11634.5
8	Hire Purchase Loan	32840.2	11918.7	6913.3	51672.2
9	Deprived Sector Loan	27089.2	4046.4	1952.2	33087.8
10	Bills Purchased	7313.1	7.3	16.6	7337.0
11	Other Product	65362.5	14520.3	14398.3	94281.1
Total Product wise Loan		**699066.6**	**115229.1**	**72967.2**	**887263.0**
Collateral Wise Credit					
1	Gold and Silver	23482.9	2815.7	720.9	27019.5
2	Government Securities	2542.7	25.2	104.7	2672.5
3	Non Governmental Securities	5165.4	1909.0	1324.1	8398.6
4	Fixed Deposit Receipts	6972.7	1481.6	1747.4	10201.8
5	Own	6528.5	1481.6	1729.7	9739.8
6	Other Licences Institutions	444.3	0.0	17.8	462.0
7	Collateral of Properties	595322.1	105803.4	64828.2	765953.7

	Sector Wise Credit	Class "A"	Class "B"	Class "C"	Total
8	Fixed Assets	462745.1	105369.3	64370.1	632484.4
9	Current Assets	132577.0	434.1	458.2	133469.3
10	Against security of Bill	9299.2	13.7	12.9	9325.7
11	Domestic Bills	809.6	5.7	12.9	828.2
12	Foreign Bills	8489.6	8.0	0.0	8497.6
13	Against Guarantee	16603.9	2142.6	893.5	19640.0
14	Government Guarantee	2868.2	97.5	52.4	3018.1
15	Institutional Guarantee	10240.5	827.1	319.8	11387.4
16	Personal Guarantee	631.3	175.8	407.2	1214.2
17	Collective Guarantee	191.7	1020.1	19.1	1230.8
18	Int. Rtd. Foreign Bank's Guarantee	52.9	0.0	0.0	52.9
19	Other Guarantee	2619.3	22.2	95.1	2736.6
20	Credit Card	418.8	0.0	1.5	420.3
21	Others	39258.9	1037.9	3334.0	43630.8
Total Collateral wise Loan		**699066.6**	**115229.1**	**72967.2**	**887263.0**

Sources: Financial Statistics and NRB staffs' calculation, BFRID, NRB

Annex 6

Aggregate Profit & Loss Account of BFIs

(mid-January 2013)

(Rs. in million)

Expenses	Class "A"	Class "B"	Class "C"	Total
1 Interest Expenses	22912.68	5935.46	4087.06	32935.20
1.1 Deposit Liabilities	22685.81	5842.46	4054.85	32583.13
1.1.1 Saving A/c	6881.92	2439.80	1585.09	10906.81
1.1.2 Fixed A/c	12218.48	2559.17	2425.62	17203.26
1.1.2.1 Upto 3 Months Fixed A/c	539.46	31.63	52.20	623.29
1.1.2.2 3 to 6 Months fixed A/c	459.44	95.55	80.83	635.82
1.1.2.3 6 Months to 1 year Fixed A/c	4881.08	1416.40	1280.62	7578.10
1.1.2.4 Above 1 Year	6338.50	1015.58	1011.97	8366.04
1.1.3 Call Deposit	3568.54	843.50	44.06	4456.10
1.1.4 Certificate of Deposits	16.87	0.00	0.09	16.95
1.2 Others	226.87	93.00	32.21	352.08
2 Commission/Fee Expense	178.27	2.41	2.36	183.04
3 Employees Expenses	5570.00	862.61	445.63	6878.24
4 Office Operatiing Expenses	4586.54	1040.13	894.62	6521.29
5 Exchange Fluctuation Loss	30.30	0.61	1.72	32.64
5.1 Due to Change in Exchange Rates	30.05	0.49	0.00	30.55
5.2 Due to Foreign Currency Transactions	0.25	0.12	1.72	2.09
6 Non-Operatiing Expenses	510.76	33.49	3.97	548.22
7. Provision for Risk	4979.71	1983.10	1602.31	8565.13
7.1 Loan loss Provision	4695.60	1914.10	1511.35	8121.05
7.1.1 General Loan loss Provision	1213.07	255.29	595.94	2064.30
7.1.2 Special Loan Loss Provision	3472.55	1622.32	758.90	5853.77
7.1.3 Additional Loan Loss Provision	9.97	36.49	156.51	202.97
7.2. Provision for Non-Banking Assets	280.32	59.36	79.86	419.54
7.3. Provision for Loss on Investment	0.00	0.55	4.84	5.39
7.4. Provision for Loss of Other Assets	3.80	9.09	6.26	19.15
8 Loan Written Off	40.60	0.71	1.97	43.28
9 Provision for Staff Bonus	952.74	96.49	45.24	1094.47
10 Provision for Income Tax	3006.52	278.18	134.51	3419.22
11 Others	96.40	0.13	0.21	96.75
12 Net Profit	8393.44	903.65	785.59	10082.68

Expenses	Class "A"	Class "B"	Class "C"	Total
TOTAL EXPENSES	**51257.98**	**11136.99**	**8005.19**	**70400.16**
Income	Class "A"	Class "B"	Class "C"	Total
1. Interest Income	42189.94	8738.22	5302.74	56230.90
1.1. On Loans and Advance	39488.76	7858.70	4763.68	52111.15
1.2. On Investment	1840.59	67.65	64.19	1972.42
1.2.1 Government Bonds	1622.03	64.80	54.08	1740.91
1.2.2 Foreign Bonds	22.99	0.00	0.00	22.99
1.2.3 NRB Bonds	174.88	2.19	4.02	181.09
1.2.4 Deventure & Bonds	20.69	0.66	6.09	27.44
1.3 Agency Balance	432.00	55.82	66.87	554.69
1.4 On Call Deposit	159.55	598.23	264.24	1022.02
1.5 Others	269.04	157.83	143.76	570.62
2. Comission & Discount	2947.64	310.05	96.22	3353.90
2.1 Bills Purchase & Discount	127.45	1.16	0.00	128.61
2.2 Comission	2273.57	162.21	42.67	2478.44
2.3 Others	546.62	146.68	53.55	746.85
3 Income From Exchange Fluctuation	1551.48	12.17	0.67	1564.32
3.1 Due to Change in Exchange Rate	-193.98	2.01	0.67	-191.30
3.2 Due to Foreign Currency Trans.	1745.46	10.16	0.00	1755.62
4 Other Operating Income	1342.57	457.50	276.97	2077.04
5 Non Operating Income	566.52	73.05	55.10	694.67
6 Provision Written Back	2067.39	799.24	678.66	3545.29
7 Recovery from Written off Loan	313.68	26.63	8.52	348.84
8 Income from Extra Ordinary Expenses	152.46	35.04	1.39	188.89
9 Net Loss	126.31	685.09	1584.92	2396.32
TOTAL INCOME	**51257.99**	**11136.99**	**8005.19**	**70400.16**

Sources: Financial Statistics and NRB staffs' calculation, BFRID, NRB

Annex 7

Financial Soundness Indicators (FSIs) of BFIs Institutions

(mid-January 2013)

(In percent)

	A Class	B Class	C Class	Total
Capital Adequacy Ratios				
Regulatory capital to risk-weighted assets	11.01	17.99	17.58	12.26
Regulatory Tier - 1 capital to risk-weighted assets	9.59	17.12	16.87	10.95
Non-performing loan to total gross loan	3.17	5.76	14.12	4.41
Non-performing loan net of provisions to capital	6.91	8.47	4.23	6.93
Sectoral Distribution of Loans to Total Gross Loan				
Agricultural and Forest Related	4.00	4.50	2.61	3.95
Fishery Related	0.27	0.11	0.03	0.23
Mining Related	0.55	0.15	0.24	0.47
Agricultural, Forestry and beverage Production Related	23.53	6.98	7.74	20.08
Non food Production Related				
Construction	9.27	11.64	13.08	9.89
Electricity, Gas and Water	2.33	1.46	0.40	2.06
Metal Products, Machinery & Electronic Equipment & Assemblage	1.34	1.74	1.28	1.39
Transport, Communication and Public Utilities	3.46	8.96	8.08	4.56
Wholesaler & Retailer	21.20	20.83	15.97	20.72
Finance, Insurance and Real Estate	9.29	9.40	10.53	9.41
Hotel or Restaurant	2.54	3.55	2.85	2.70
Other Services	4.94	4.99	4.22	4.89
Consumption Loans	6.40	7.22	8.19	6.66
Local Government	0.11	0.03	0.03	0.10
Others	10.76	18.43	24.75	12.90
Others				
Returns on Assets	1.46	0.23	-1.38	1.07
Returns on Equity	15.94	1.79	-12.14	10.88
Interest Margin to Gross Income	75.05	76.67	73.92	75.18
Non Interest Expenses to Gross Income	42.72	53.05	81.99	46.02
Liquid Assets to total Assets	23.24	25.45	23.62	23.56
Liquid Assets to total Deposits	29.12	34.61	33.36	30.09
Credit to Deposit Ratio	77.17	84.17	88.76	78.87

Source: Financial Statistics and NRB staffs' calculation, BFRID, NRB

Annex 8

Stress Testing Results for Commercial Banks

	Mid-Jan 2013	Mid-Jul 2012	Mid-Jan 2012
Credit shocks	***No. of banks with CAR < 10%***		
15 Percent of Performing loans deteriorated to substandard, 15 Percent of Substandard loans deteriorated to doubtful loans, 25 Percent of Doubtful loans deteriorated to loss loans., 5 Percent of Performing loans deteriorated to loss loans.	28	22	23
All NPLs under substandard category downgraded to doubtful.	3	2	3
All NPLs under doubtful category downgraded to loss.			
25 Percent of performing loan of Real Estate & Hosing sector loan directly downgraded to substandard category of NPLs.	3	2	6
25 Percent of performing loan of Real Estate & Hosing sector loan directly downgraded to Loss category of NPLs.	13	8	16
Top 2 Large exposures down graded: Performing to Substandard	3	2	7
Liquidity shocks	***No. of banks illiquid after 5 days***		
Withdrawal of customer deposits by 2% 5% 10% 10% and 10% for five consecutive days respectively.	19	5	12
Withdrawal of deposits by 5%	7	0	2
Withdrawal of deposits by 10%	20	6	9
Withdrawal of deposits by 15%	26	14	20
Withdrawal of deposits by top 2 institutional depositors.	17	9	12
Withdrawal of deposits by top 3 institutional depositors.	21	12	18
Withdrawal of deposits by top 5 institutional depositors.	25	17	19
Withdrawal of deposits by top 2 individual depositors.	2	0	0
Withdrawal of deposits by top 3 individual depositors.	2	0	0
Withdrawal of deposits by top 5 individual depositors.	2	0	0

Sources: Financial Statistics and NRB staffs' calculation, BSD and BFRID, NRB

Annex 9

Composition of Financial Stability Oversight Committee

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

Source: NRB

Annex 10

Composition of Financial Stability Sub-Committee

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

Source: NRB