FINANCIAL STABILITY REPORT

Nepal Rastra Bank

Central Office

Baluwatar, Kathmandu

July 2013

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Disclaimer

This third issue of the Financial Stability Report, July 2013, does not warrant the consistency of statistics with other reports. This report is based on provisional data of Bank & Financial Institutions (BFIs) and other financial institutions as of mid-July 2013. Data used in its analysis may thus differ from the most recent statistics or audited final data published by BFIs. The findings, interpretation and conclusions expressed in this report do not necessarily reflect the views of Nepal Rastra Bank or its Board of Directors. The colors, boundaries, denominations or any other signs and symbols used in the report do not imply any metamorphic judgments. This report covers the developments and risks during the fiscal year 2012/13.

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GOVERNOR

FOREWORD

The occurrences of global financial crises have exposed more complex macro-financial linkages in the transmission mechanism of monetary policy. This new development has shifted policy makers' attention towards financial stability. The growing global financial integration, financial innovation and evolution of new financial products along with massive use of electronic technology in financial services have made central bankers' job even more challenging. Deepening and broadening of the financial sector have created more financial risks and vulnerabilities in the Nepalese financial system as well. Moreover, the presence of shadow banking has added further complexities in the financial system. Maintaining financial stability requires an understanding of the key macroeconomic trends, banking system dynamics, and sources of risk in the financial system. Revising monetary policy objectives and instruments, strengthening regulation and supervision and implementing macroprudential measures as a complement to monetary policy are also necessary to maintain stability in the financial sector. Priority has to be given to identify all sources of risk and imbalances that can have systemic implications for the financial stability of our 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 upon the behavior of banks, the performance of financial system and the trend of financial soundness indicators and adopt the warranted policy measures. Thus, preparing financial stability report can be a right way to better understanding of overall performance and resilience of the financial system which would ultimately contribute to maintaining financial stability.

In this context, it has been our regular practice to present the Financial Stability Report to share information and ensure transparency in the functioning of the financial system. For ensuring financial stability, NRB has made some major policy arrangements, amidst slower in economic activities. Some of these measures include macroprudential regulations focused on ensuring stable financial markets and initiation of risk-based supervision. A risk management guideline has been issued in order to make banks identify measures and monitor various risks inherent in the banking sector. Likewise, problem bank resolution framework and toolkits, new supervision Bylaws and manuals, among others are already in place to safeguard the financial system of

Nepal. This report highlights the assessment of risks and threats that could affect the Nepalese financial system and the capacity of the system to withstand potential shocks. It also presents the regulatory and supervisory developments, including the measures undertaken by the NRB to ensure financial stability.

This Report, third in the series of such publication, is prepared by Financial Stability Unit (FSU) and Financial Stability Working Committee (FSWC) 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-July 2013 unless otherwise stated. This report is divided into five main chapters along with an executive summary. Chapter 1 presents global economic and financial development. Chapter 2 deals with the domestic macroeconomic situation. Chapter 3 covers the developments and status of financial institutions and their impact on financial stability. This chapter also presents the financial soundness indicators and stress testing scenarios of commercial banks. Chapter 4 examines the current trend and developments in the financial markets. Finally, the fifth Chapter discusses financial sector policies, including the macro prudential policy measures and payment and settlement system.

This publication has come out with the hard work of our staff and senior officials. In this context, I would like to thank the FSOC, FSWC and the Bank and Financial Institutions Regulation Department of this bank, particularly the FSU for preparing this report. I would like to offer my special thanks to the officials of FSU, notably Executive Director Mr. Bhaskar Mani Gnawali, Director Mr. Purna Bahadur Khatri, Deputy Director Mr. Ramu Paudel, and Assistant Director, Mrs. Mila Devi Barahi in bringing out this report in this form. I would also like to thank Director Dr. Bhubanesh Pant of Research Department and Deputy Director Mr. Krishna Gopal Shrestha of Foreign Exchange Management Department for their valuable contribution to refine this report.

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

Dr. Yuba Raj Khatiwada

ACRONYMS

AE	Advanced Economies
AMC	Asset Management Company
AML	Anti Money Laundering
ATM	Automatic Teller Machine
BAFIA	Bank and Financial Institution Act
BCP	Basel Core Principle
BFIs	Banks and Financial Institutions
BIS	Bank for International Settlement
CAR	Capital Adequacy Ratio
CBs	Commercial Banks
CFT	Combating Financing of Terrorism
CIT	Citizen Investment Trust
DA	Developing Asia
DBs	Development Banks
DBSD	Development Bank Supervision Department
DCGC	Deposit and Credit Guarantee Corporation
DE	Developing Economies
DOC	Department of Cooperative
EA	Euro Area
ECB	European Central Bank
EMDE	Emerging and Developing Economies
EPF	Employee Provident Fund
EU	European Union
FCs	Finance Companies
FFIs	Formal Financial Institutions
FINGO	Financial Intermediary Non-Governmental Organization
FIU	Financial Intelligence Unit
FSIs	Financial Soundness Indicators

GBBs	Grameen Bikas Banks
GEP	Global Economic Prospects
GFSR	Global Financial Stability Report
I_AD	Import in Advance Economies
I_EMDE	Import in Emerging and Developing Economies
ICAAP	Internal Capital Adequacy Assessment Process
ICP	Insurance Core Principles
ICT	Information Communication and Technology
IFIs	Informal Financial Intermediaries
ILMF	Institution-wise Liquidity Monitoring Framework
IMF	International Monetary Fund
INR	Indian Rupees
MFFIs	Micro Finance Financial Institutions
MFIs	Micro Financial Institutions
MP-Plus	Monetary Policy plus
NCHL	Nepal Clearing House Limited
NEPSE	Nepal Stock Exchange
NGOs	Non-Governmental Organizations
OECD	Organization for Economic Cooperation and Development
OTC	Over the Counter Market
PSB	Postal Saving Bank
ROA	Return on Assets
ROE	Return on Equity
ROSCAs	Rotating Savings and Credit Associations
RSRF	Rural Self Refinancing Fund
RTGS	Real Time Gross Settlement
RWA	Risk Weighted Assets
SA	South Asia
SCCs	Saving and Credit Cooperatives
SIFIs	Systematically Important Financial Institutions
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. According to IMF's *World Economic Outlook* (WEO, October 2013), advanced economies have been recovering while growth in emerging economies has witnessed slowdown. Emerging economies are facing dual challenges, slow growth and tight global financial condition. The global economic growth is still sluggish. The *WEO* has revised the estimate of the global GDP growth for 2013 to be 3.1 percent while it is projected to grow by 3.8 percent in 2014. Advanced economies have been estimated to grow by 1.2 percent in 2013 and 2.1 percent in 2014. In contrast, the near-term growth outlook for the euro area has been estimated to remain at -0.6 percent in 2013 and 0.9 percent in 2014. Likewise, growth in emerging market and developing economies has been estimated to expand by 5.0 percent in 2013 and 5.4 percent in 2014. The responsible factors for the slow world economic growth has been the infrastructure bottleneck, capacity constraints, slower external demand, lower commodity prices, financial stability concerns, and in some cases, weaker policy support, among others.

2. The United States economy is estimated to rise by 1.2 percent in 2013 and 2.1 percent in 2014, mainly driven by consumption, net exports, housing recovery and supportive financial settings. Likewise, the GDP growth is estimated at 2.0 percent in Japan whereas in other advanced economies (excluding G7 and other euro areas countries), the GDP growth has been projected to be 2.3 percent in 2013 and 3.1 percent in 2014. Growth in the euro area has been estimated to be held back by the very weak economies in the periphery. Emerging market and developing economies are projected to expand by about 5.0 percent in 2014 on account of neutral fiscal policy and low real interest rate. Growth estimates for the major euro area countries (France, Italy and Spain) is estimated to remain negative in 2013 except for Germany, which is estimated to grow by 0.3 percent.

3. In China, the GDP growth has been estimated to stay at around 7.8 percent both in 2013 and 2014, whereas in India, growth is estimated to be 5.6 percent in 2013 and 6.3 percent in 2014. Among the South Asian economies, Bhutan achieved the highest level of real GDP growth of 6.3 percent. Global inflation is subdued as cost pressures related to commodity price continue to ease and demand factors in advanced economies remain weak. Despite of loose monetary conditions and acceleration of economic activities, global consumer prices rose modestly in recent months. Low-income country inflation has shown the fastest decline whereas in high-income country, inflation remained weak. Unconventional monetary policy helped major high-income economies to avoid disinflation, but Japan is

still caught in disinflationary trap. Monetary policy, is increasingly embracing inflation targeting and loose policy stance in developing countries has seen counterproductive, particularly in countries operating at full capacity.

4. Global inflation is estimated to stay at around 3.8 percent during 2013-14. In the major advanced economies, inflation will ease to 1.5-1.9 percent during 2013-14. Inflation is estimated to stand at 5.5-6.0 percent in emerging market and developing countries during 2013-14. However, inflation pressure in some economies and regions, spurred by food prices in some cases, such as in South Asian countries including India has been projected to remain fairly high. Inflation has moderated in euro area and Central Asia but price pressures are high in large middle income countries. Although, inflation remained sticky in the advanced economies, price pressure moderated across other regions. In South Asia, consumer prices based index remained high but the wholesale prices index-based inflation moderated significantly, especially in India. The momentum of CPI inflation remains strong in Bangladesh and India—although moderating slightly in Bangladesh—suggesting that price pressures continue to remain high in these countries.

5. The *Global Financial Stability Report (GFSR,* October 2013*)* has stated that emerging market and developing countries have been suffering from a large trade deficit, capital flight and depreciating currencies, and their growth rates are slowing. This expectation has increased market volatility. Since 2010, advanced economies' unconventional monetary policies have fuelled unprecedented capital flows into emerging markets and generated unsustainable credit growth, raised asset prices and worsened several recipient countries' vulnerability. Between April to July 2013, Indonesia has lost about 14.0 percent of its foreign exchange reserves and India nearly 10.0 percent. The improvement in financial conditions can only be sustained through further policy actions that address underlying stability risks and promote continued economic recovery. High private sector debt, limited policy space, and insufficient institutional progress in the euro area, can lead to a protracted period of low growth, distortions from easy and unconventional monetary policy in many advanced economies and vulnerabilities in capital flows in many emerging market and developing economies. Unless policies address these risks, global financial stability may likely suffer from periodic setbacks.

6. In the euro area, acute near-term stability risks have been reduced significantly. Funding conditions in the markets for sovereign bank and corporate debt have improved. Credit transmission remained weak in several economies, as bank balance sheet repair is uneven, while fragmentation between the core and periphery of the euro area persists. The main challenges for banks in emerging market economies are to continue supporting growth while safeguarding against rising domestic vulnerabilities. The prolonged accommodative monetary policies on a global level and an extended period of low interest rates do not

give rise to fresh credit excesses. Policy makers must remain alert to the risks stemming from increased cross-broader capital flows and rising domestic financial vulnerabilities to avoid financial instability.

7. Global financial market volatility increased again from May 2013. In advanced economies, longer term interest rate and financial market volatility have risen. The exchange rate and financial market overshooting in the emerging market economies co-exist with weaker economic outlooks, vulnerabilities and severe balance of payment disruptions. Despite the uncertainties, challenges and risks in the financial system; the global financial system is undergoing a series of transitions along the path toward greater financial stability. United States has been expected to move towards less accommodative monetary policies and higher long-term interest rates. Japan is moving towards the new policy regime marked by more vigorous monetary easing, euro area towards more robust and safer financial sector, including a stronger monetary union and the global banking system is phasing in to stronger regulatory standards.

Domestic Economic Development

8. Nepal's real GDP at basic price is expected to grow by 3.6 percent in 2012/13 compared to 4.5 percent in 2011/12. The poor performance of agriculture sector due to weaker monsoon and sluggish performance of the industrial sector arising from continued political uncertainty, and energy shortage and persistent labor problems 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.

9. The annual average consumer price index (CPI) increased by 9.9 percent in 2012/13. The price index of food and beverages group increased by 9.6 percent whereas the index of non-food and services group increased by 10.0 percent in 2012/13. On a cash basis data, government expenditure increased by 8.7 percent to Rs. 347.74 billion in 2012/13 compared to an increase of 15.2 percent to Rs. 319.85 billion in 2011/12. In 2012/13, domestic revenue mobilization exceeded the target of Rs. 289.1 billion. It had increased by 21.1 percent to Rs. 296.01 billion. With regard to foreign trade, merchandise exports rose by 3.6 percent to Rs. 76.92 billion and imports increased by 20.6 percent to Rs. 556.74 billion in 2012/13. Total merchandise imports surged in 2012/13 was a reflection of rapid increase in imports from India. As a result of high growth in imports, total trade deficit surged by 23.9 percent to Rs. 479.82 billion in 2012/13. Nevertheless, overall BOP recorded a surplus of Rs. 68.94 billion in 2012/13, mainly from an increase in worker

remittance and improvement in income and service sector accounts as well as through the contribution from capital account.

10. The total gross foreign exchange reserve increased by 21.4 percent to Rs. 533.3 billion in 2012/13. Nepalese currency depreciated by 6.7 percent in 2012/13 against US Dollar on top of a depreciation of 19.9 percent during the same period of the previous year. From November 2012, there was a continuous depreciation in Nepalese currency against US Dollar. This is expected to have corrected some misalignment in the real exchange rate of the Nepalese currency. Depreciation of Nepalese rupee against US Dollar has contributed to improve export competitiveness and to increase the remittance inflow, but also contributed to the increase in money supply and inflationary pressure.

11. Monetary Policy for 2012/13 was formulated with the major objectives of maintaining stability in the prices and external and financial sectors of economy. Other objectives included, promoting financial access to the general public and facilitating high and sustainable economic growth. Broad money supply (M2) growth rate at 16.4 percent in 2012/13 exceeded the growth rate of 15.9 percent domestic credit expansion. To address the problem of excess liquidity in 2012/13, NRB mopped up net liquidity amounting to Rs. 8.50 billion. The implementation status of Monetary Policy 2012/13 shows that the majority of the objectives and programmes have been achieved or implemented. Assessing the overall performance in 2012/13, it is observed that liquidity position eased, deposit mobilization increased and domestic credit expanded. The 2012/13 growth rate target was scaled down from 5.5 percent to 4.1 percent. Yet, economic growth (3.6 percent) remained below the revised target of 4.1 percent. Similarly, actual inflation hit 9.9 percent in 2012/13 compared to the revised target of 7.5 percent.

Financial Institutions

12. The financial system of Nepal comprises of bank & financial institutions and other financial institutions: commercial banks, development banks, finance companies and micro finance financial institutions, co-operatives, contractual saving institutions, insurance companies and postal saving banks. As of mid-July 2013, the financial system constituted of 31 licensed commercial banks ("A" class institutions), 86 development banks ("B" class institutions), 59 finance companies ("C" class institutions), 31 micro finance financial institutions ("D" class institutions), 18 NRB permitted cooperatives undertaking limited banking transactions, 31 NRB permitted NGOs for limited banking transactions, 25 insurance companies and one each of the Employees Provident Fund, Citizen Investment Trust and Postal Saving Bank. Though there is a significant number of financial institutions performing their banking and non-banking business in the Nepalese financial system, the financial services delivered by these banks and financial institutions are not yet accessible

to the poor section of the people, particularly in the geographically remote areas. Moreover, BFIs have been found concentrating their service in the major cities as well as in the emerging areas for business activities.

13. Branch network of BFIs in the unbanked area has remained a key issue to be addressed in expanding financial access and inclusion in Nepal. Total number of bank branches as of mid-July 2013, of class "A" financial institutions was 1486 (59.6 percent of total number of bank branches), followed by 764 (30.7 percent) of class "B" financial institutions and 242 (9.7 percent) of class "C" financial institutions. Out of total bank branches, 26.7 percent were serving only in the Kathmandu valley (665), 31.3 percent in Hills and Mountain (779), and 42.1 percent in the Terai (1048). Therefore, the distribution of bank branches, particularly in the hills and mountain regions, is uneven compared to Kathmandu.

14. The state-owned banks that had the largest branch networks and have been representing more than half of total bank branches in the country till mid-July 2013, now have shrunk to only 20.3 percent share. These three large public commercial banks possessed a significant branch network as Nepal Bank Ltd. had 115 branches, Rastriya Banijya Bank Ltd. had 151 branches and Agriculture Development Bank Ltd. had 240 branches throughout the country.

15. The rapid growth in the number of financial institutions and stiff competition among the BFIs and their branches failed in lowering interest rate spread in Nepal. The spread rate of deposit and lending of commercial banks stood at 6.8 percent as at mid-July 2013. Such a high interest rate spread is a main reason behind persistent increase in the net profit of commercial banks. It rose by 32.0 percent in 2012/13.

16. During the review period 205 branchless banking stations came into operation throughout the country by 12 BFIs benefiting 30,383 customers. As of mid-July 2013, 1,499 ATM terminals are in operation throughout the country. The numbers of ATM, Debit Card and Credit Card services provided by different BFIs have been increasing over the period.

17. The ratio of total assets & liabilities to GDP of the banks and financial institutions stood at 125.5 percent comprising the largest share of commercial banks (73.1 percent), followed by Nepal Rastra Bank (31.4 percent), development banks (11.8 percent), finance companies (5.9 percent), micro finance financial institutions (2.1 percent), cooperatives (0.9 percent), and NGOs (0.3 percent). Similarly, this ratio for contractual savings institutions stood at 16.1 percent among which the ratio for EPF stood at 8.5 percent, CIT at 2.5 percent, insurance companies at 5.0 percent and postal saving bank at 0.1 percent. Therefore, the ratios of asset and liabilities of the banks and financial institutions with GDP show an upward trend over the periods. However, the performance of other financial

intermediaries and cooperatives since the last few years have raised serious concerns to the financial stability, and ultimately to the overall economy.

18. The commercial banks continue to remain as the key player in the financial system. They contributed 51.6 percent in the system's total assets. It was followed by NRB (22.2 percent), development banks (8.3 percent), EPF (6.0 percent), finance companies (4.2 percent), insurance companies (3.5 percent), PSB (0.1 percent) and CIT (1.8 percent) as of mid-July 2013. The contributions of micro finance financial institutions including cooperatives accounts for 2.4 percent, comprising 1.5 percent of micro finance financial institutions, 0.2 percent of micro credit non-government organizations and 0.6 percent of cooperatives permitted by NRB for the limited banking transactions.

19. Commercial banks hold dominant share in the major balance sheet components of financial system in Nepal. As of mid-July 2013, commercial banks group occupied 79.9 percent of total assets and liabilities followed by development banks (13.3 percent) and finance companies (6.7 percent). During the review period, deposits continued to become a dominant source of bank funding (78.9 percent) followed by other liabilities (8.9 percent), capital fund (8.3 percent) and borrowings (1.7 percent). Likewise, loan and advances accounted for the largest share (59.8 percent) of the system’s total assets. It was followed by investment (13.8 percent), liquid fund (16.4 percent) and others (10.2 percent). The banking system in Nepal has been expanding exponentially over the years, particularly along with the financial liberalization on account of deepening indicators and the expanding access of financial services.

20. The total paid-up capital of the banking system comprising of "A", "B" and "C" class financial institutions increased by 14.6 percent to Rs. 119.51 billion as at mid-July 2013. Moreover, the overall paid-up capital of finance companies noted a decline whereas the paid-up capital of development banks and commercial banks increased by 11.1 percent and 20.0 percent respectively in 2012/13.

21. Considering the deepening indicators, the share of total deposit of the banking system to GDP reached 73.5 percent comprising 60.0 percent share of commercial banks, 9.4 percent of development banks and 4.1 percent of finance companies. Likewise, as of mid-July 2013, the total credit to GDP ratio was 56.2 percent comprising of 7.8 percent and 3.9 percent of "B" and "C" class financial institutions whereas "A" class banks alone stood at 44.5 percent. In mid-July 2013, total credit to deposit ratio of class "B" financial institutions (82.8 percent) and class "C" financial institutions (95.4 percent) were higher than that of class "A" financial institutions (74.2 percent). BFIs are directed to provide deprived sector loan from their total loan outstanding as stipulated by the NRB. As of mid-

July 2013, deprived sector loan out of total loan from all the banks and financial institutions accounted for 4.5 percent.

22. Though the liquidity in the banking system is gradually increasing since the beginning of mid-July 2012, the average base rate of commercial banks that was 9.4 percent as at mid-January 2013 increased to 9.8 percent in mid-July 2013. The base rate, which is now being implemented in commercial banks, is planned to be implemented in other financial institutions as well in order to make lending interest rate transparent and competitive.

23. 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 pushed by NRB in the recent past. Among the various alternative measures of financial sector consolidation, NRB has opted for merger as an efficient measure of financial consolidation.

24. In mid-July 2013, total return on assets of overall banking system increased by 16.2 percent and stood at 1.44 percent comprising 1.65 percent, 0.84 percent and 0.02 percent for "A", "B" and "C" class institutions respectively. Such return of overall banking system was 1.24 percent in mid-July 2012. Similarly, total return on equity stood at 13.85 percent comprising 16.89 percent, 6.44 percent and 0.20 percent for "A", "B" and "C" class financial institutions respectively. 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 32.8 percent and 76.5 percent respectively in mid-July 2013.

25. Looking at the sector-wise credit exposure of BFIs, wholesalers and retailers sector is the largest recipient of loans and advances (20.7 percent). It was followed by the agricultural, forestry and beverage production related sectors (19.9 percent) as of mid-July 2013. With regard to product-wise loan and advances, demand and working capital loan formed about 23.1 percent of total loan followed by overdraft loan (19.3 percent), term loan (14.3 percent), real estate loan (15.9 percent including both housing at 6.9 percent and real estate 9.0 percent), hire purchase loan (5.6 percent), trust receipt & import loan (4.3 percent) and other (11.1 percent) as at mid-July 2013. As far as collateral-wise loan classification is concerned, 84.9 percent of total loans are backed up by properties, 66.0 percent of which are of fixed nature such as land and buildings. Such an over concentration of collaterals into real estate properties together with significant exposure of lending in real estate sector can increase the default risk in case of deterioration in the values of such properties. In the review period, although there has been 21.3 percent

growth in loan and advances in total by the BFIs in different economic sectors, the slower GDP growth rate somewhere indicates that lending extended to productive sectors is still not sufficient to establish a positive relation between credit growth and economic growth.

26. 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 13.2 percent in mid-July 2013. Among two state owned banks with negative capital adequacy—NBL and RBB, the improvement in capital of both banks, which turned into positive figure, contributed in the perfection of capital adequacy ratio of the commercial banking system. The total combined NPL ratio of "A", "B" and "C" class financial institutions increased slightly to 3.8 percent in mid-July 2013, compared to 3.6 percent in mid-July 2012. Finance companies recorded the largest magnitude of NPL at 16.0 percent. It was followed by development banks (4.5 percent) and commercial banks (2.6 percent) in the review period.

27. NRB has made stress-testing, a forward looking risk management tool mandatory to "A" class financial institutions. The stress testing results of commercial banks as of mid-July 2013 revealed that a standard credit shock would push the capital adequacy ratio of 27 out of 31 commercial banks below the regulatory minimum benchmark of 10.0 percent. Though the liquid assets to deposit ratio of the whole banking system as well as the commercial banks improved during the review period, the stress test results found that more than half of the commercial banks may enter into a vulnerable situation in case of withdrawal of deposits by 15.0 percent or more. 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.

28. Out of 86 development banks operating as of mid-July 2013, 20 are national-level and rest are regional and district-level development banks. During the review period, six district level development banks merged to become three regional level development banks. One district level and one national level development bank merged with four finance companies to become two national level development banks. One district level development bank merged with two finance companies and became a national level development bank. One national level development bank merged with a commercial bank.

29. In fiscal year 2012/13, 52 new branches were opened in the review period totaling 764 development bank branches operating in the system. In the review period, development banks have fully complied with regulatory requirement of meeting CRR & SLR. However, one bank experienced a shortfall in meeting deprived sector lending. As per the provision

of Monetary Policy 2012/13, Development Bank Supervision Department (DBSD) of NRB has started the task of monitoring liquidity of all the development banks on a daily basis and stress-testing of those banks that mobilize deposits in excess of two million rupees have been initiated by. By the end of mid-July 2013, diagnostic review of six developments banks has been completed.

30. The capital fund of development banks stood at Rs. 25.09 billion in mid-July, 2013. The capital adequacy ratio was 16.8 percent in the review period. Total assets of development banks increased by 13.6 percent to Rs. 211.51 billion in mid-July 2013, whereas loan and advances increased by 15.2 percent to Rs. 132.73 billion in the review period. The share of loans and advances to total assets was 62.7 percent in mid-July 2013. Net profit of development banks increased by 51.37 percent to Rs. 1735.50 million in mid-July 2013. Liquid assets of development banks increased by 18.2 percent in mid-July 2013. Deposits were the major source of fund for the development banks. As of mid-July 2013, deposits comprised of 75.8 percent of total liabilities. About 70 percent of lending of development bank has been concentrated on five economic sectors comprising wholesaler and retailer (20.4 percent), others (19.4 percent), construction (11.5 percent), finance, insurance and real estate (9.5 percent) and transport, communication and public utilities (8.5 percent).

31. The number of finance companies decreased by 10 to 59 in mid-July 2013 from 69 in mid-July 2012. The reduction in number of finance companies was due to the merger of finance companies with other finance companies and "A" and "B" class financial institutions and also due to moratorium imposed on the licensing of new finance companies. Separate resolution desk has been overseeing the activities of problematic institutions, including repayment of deposit, implementation of the special directives and implementation of action plan presented by these institutions. Out of the four finance companies selected for diagnostic review during the fiscal year, the reviewing task was completed for all four finance companies. So far, 7 finance companies have been declared problematic and 1 is under prompt corrective action. The major problem that appeared in those companies was the practice of insider lending to the member of the board of directors and top management.

32. The number of micro finance financial institutions (MFFIs) operating as "D" class financial institutions has reached 31 including 5 rural development banks, 23 private sector institutions replicating Grameen Banking practices and 3 wholesale lending micro finance institutions. Although rapidly expanding micro finance sector is being widely accepted as an effective tool for enhancing access to finance, reducing poverty, empowering women and uplifting the living standards of the poor and under-privileged groups. The over concentration, mostly in urban and accessible areas and low penetration in hilly and remote areas, multiple financing and duplication in some cases and, comparatively higher

interest rates being charged to the poorest section of the societies, deviation from the social responsibility in many cases and more concentration on the middle class rather than the poor are some of the major weaknesses witnessed in this area.

33. Though the essence of micro finance institutions (MFIs) lies on the social business, these institutions seem to be guided by profit motive. This trend may have negative impact on the overall stability of the financial system. To overcome these weaknesses, there is a need of policy responses to address the issues such as multiple financing, duplication and the issue of high interest rates. Likewise, some kind of codes-of-conduct and good governance are a must for developing professionalism, ensuring healthy competition and thereby good corporate governance in the system. Moreover, a kind of policy incentive is necessary from the government perspective so that these institutions may go to the remote and inaccessible areas and focus on productive sectors as well. All these measures may enhance their activities leading to more productive and effective outcomes in the rural credit sector.

34. The total number of cooperatives registered in DOC and operating throughout the country as of mid-July 2013 reached 29,526. The total deposits of all these cooperatives, as of mid-July 2013, stood at Rs. 158.16 billion, of which saving and credit cooperatives (SCCs)' share was 75.2 percent. The total share capital of SCCs was Rs. 24.78 million. The SCCs has a deposit base of Rs. 118.18 billion and investment of Rs. 133.83 billion. The outstanding loan extended by such cooperatives to various projects and members stood Rs. 100.62 billion as of mid-July 2013.

35. The total number of cooperatives providing financial services especially in urban areas has been increasing and their transaction volume is also found to be increasing in a multiple way. In the absence of stringent measures of supervision, such institutions might not be performing on the right track, which ultimately affects the formal banking activities in a negative way. So, to attract them in enhancing the access to finance and hence in reducing poverty, their activities must be regulated and supervised in a more cautious way. In this context, a legal draft for forming micro finance authority has been proposed for establishing a second tier institution that will be responsible for the regulation and supervision of all kind of micro finance institutions including saving and credit cooperatives.

36. The Rural Self-Reliance Fund (RSRF), instituted jointly by the NRB and the Government, aims to reduce poverty through the provision of wholesale credit to the rural cooperatives and financial intermediaries NGOs at a subsidized rate to on-lend to the poor. However RSRF as defined by its directives is strictly confined to the poor and the disadvantaged households, its outreach during these two decades has not been found to be satisfactory

to the desired extent. Basically, lack of planning of the RSRF program, supply based 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 strictly confined to the poor and ultra-poor, and lower outreach of the program, particularly in the mountains are some of the major weaknesses noticed regarding this Fund. These weaknesses may be addressed by formulating a plan for the operation of RSRF, demand creation through publicity and promotional activities, making access to RSRF loans easy, strict monitoring and evaluation of Fund credit, and unveiling some special schemes to make access to the mountain/remote hills, among others. In the policy front, the drafting of an Act has been already finalized to pave the way to convert the Rural Self Reliance Fund into National Micro Finance Fund so as to act as an independent wholesale lending agency in this field.

37. Legal frameworks regarding the establishment of Micro Finance Authority and National Micro Finance Fund are under-way. The merger process of five rural development banks is ongoing. Separate unified directive for "D" class MFFIs has been put in place and separate supervisory directive for the FINGOs is being considered. Likewise, revision of directives issued to cooperatives licensed by the NRB is also under consideration. The FINGOs have been asked to up-grade into micro finance financial institutions within two years time. Formulation of National Financial Literacy Policy is underway and different public awareness programs, including 'NRB with Students' program, are being carried-out on the financial literacy front. Moreover, priority has been given to establish a separate credit information agency for the micro finance institutions. All these initiatives are expected to promote financial discipline and corporate governance, increase financial soundness and ultimately contribute to financial stability in general.

38. As of mid-July 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 6.0 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 components are progressively reviewed and revised over the period. Similarly, the premium collection and its contribution to GDP have been in an increasing trend. The total assets and liabilities of these companies increased by 14.7 percent to Rs. 84.65 billion in mid-July 2013, of which life insurance and non-life insurance accounted for Rs. 67.8 billion (80.0 percent) and 16.8 billion (20.0 percent) respectively. Total premium collection of the insurance companies has been gradually increasing over the years. Of the total premium collection, premium through life insurance only contributes more than 60.0 percent. The total investment reached Rs. 69.4 billion

comprising Rs. 59.3 billion by life and Rs. 10.1 billion from non-life insurance. Insurance companies in Nepal are accused of not complying with the prudent rules and regulations as issued and directed by the Insurance Board of Nepal.

39. Total assets and liabilities of the EPF increased by 15.5 percent to Rs. 145.28 billion in mid-July 2013 as compared to Rs. 125.7 billion in mid-July 2012. The fund collected by the EPF increased by 15.7 percent to Rs.140.5 billion in mid-July 2013 compared to Rs.121.4 billion as at mid-July 2012. The investment of EPF has not increased as expected. EPF investments have been growing by less than 5.0 percent since 2010. The growth was negative of 2.6 percent in 2012. However such investments increased by 6.7 percent in mid-July 2013. As of mid-July 2013, the EPF extended more than 80 percent of its total loan and advances to EPF contributors (including the EPF employees) while the remaining loan is extended to different institutions. 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 in government securities and the remaining in shares.

40. Total assets and liabilities of the CIT increased by 48.8 percent to Rs. 27.3 billion in mid-July 2013 compared to Rs. 18.3 billion in mid-July 2012. Total investment increased by 48.8 percent to Rs. 27.3 billion in mid-July 2013 compared to Rs. 18.3 billion in mid-July 2012. Similarly, loan and advances increased by 21.6 percent to Rs. 11.7 billion in mid-July 2013 compared to Rs. 9.6 billion of mid-July 2012. Fund collection, the major component of CIT liabilities, increased by 28.5 percent to Rs. 40.3 billion in mid-July 2013. On the assets side, loan and advances reached Rs. 11.7 billion in mid-July 2013 compared to Rs. 9.6 billion in mid-July 2012.

41. As of mid-July 2013, a total of 117 PSBs were involved in limited banking activities. These PSBs intended to encourage saving habits of the people and use the saved money in the national development process of the PSB network, 68 offices are found to be mobilizing deposits. Total deposit collected by these offices reached Rs. 1.39 billion in mid-July 2013 from Rs. 1.29 billion in mid-July 2012. The share of assets and liabilities was 0.1 percent of GDP in mid-July 2013. The number of accounts in PSBs reached 58,558 in mid-July 2013 compared to 54,796 in mid-July 2012.

42. The major financial instruments in Nepal are common stocks, debentures, T-bills, and bank loan, among others. 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 by more than double to almost 1175 and market capitalization rose as high as 40.0 percent of GDP at the end of 2007 from merely 17.0

percent of GDP at the beginning of 2006. The market capitalization to GDP reverted back to its normal position. The NEPSE index has been getting corrected since early 2008 and stood at 518.33 in mid-July 2013 compared to 389.7in mid-July 2012.

43. The financial structure of Nepal is dualistic, that is, formal financial structure exists side by side with informal financial structure (shadow banking). 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. Hence, the informal sector is considered as a 'black box' in Nepalese economy. A recent study conducted by NRB revealed that the informal credit market is charging relatively high interest rates on loans provided to poor individuals. Similarly, the NLSS report (2010/11) shows that only 20 percent of lending in Nepal is obtained from formal financial institutions.

44. Low economic growth, high inflation, weak investment, weak demand for credit, fluctuating liquidity position in the financial institutions has created uncertainty in the financial sector of Nepal. Frauds and forgeries are recurring, taking advantage of weak internal control system. The numbers of problem banks are increasing due to weak corporate governance. Likewise, insufficient capital base in the financial institutions have made financial sector vulnerable to default risk, solvency risk and liquidity risk. Similarly, lack of new sectors to invest and shadow banking practices, in addition, have made tough for identifying the new sectors for deposit mobilizations and investment. Over concentration of branches within the valley has challenged the outreach of financial services to rural areas. Moreover, non-compliances of NRB's directives and prudential norms, less attractive financial soundness indicators, limited access of micro finance financial institutions to poorest section of society, lack of strong regulatory and supervisory authority for all the types of micro finance institutions and informal financial intermediaries, multiple banking practices, lack of analysis of macroeconomic variable and their potential shocks, lack of credit rating agencies, internal credit rating of borrowers by banks, limited capacity of deposit guarantee, low effectiveness on the implementation of the verdicts of Debt Recovery Tribunal, and the lack of reliable and scientific data reporting by the banks, among others are the recent issues and challenges surfacing the Nepalese financial sector.

45. Proactive and forward-looking regulations for BFIs in line with international best practices are needed to regulate heavily interconnected financial institutions within the system**.** Appropriate exit policy and crisis management framework might be a potential measure for identification of Systematically Important Financial Institutions (SIFIs). Likewise, adoption of step by step resolution framework and triggers on PCA by including liquidity, assets quality (NPL), corporate governance, and maturity mismatch, quality of internal

control and risk management, in addition to current capital shortfalls might be instrumentals in insuring financial stability in the medium term crisis management framework. Moreover, prompt resolution framework can also be a useful tool for quick resolution of problem banks. Some provisions of Basel III such as counter cyclical buffer, quality of capital, liquidity ratio, leverage, capital for off-balance sheet exposure might be better to introduce for reducing the procyclicality of the banking sector. Hence, by strengthening the regulatory and supervisory system and improving the implementation of new standards on quality and quantity of capital and, appropriate arrangement for the liquidity and risk management procedures, NRB can attain the objective of financial stability.

Financial Market

46. The short term and long term interest rates in the market remained at low level during the review period in 2012/13 because of the favorable liquidity condition in the market. The weighted average inter-bank transaction rate remained at 0.86 percent for commercial banks and 5.1 percent for other financial institutions (development banks and finance companies). Likewise, the annual weighted average T-bills rate stood at 1.7 percent in mid-July 2013. The Nepalese money market possesses few choices of assets for the transaction for the banks and financial institutions. Treasury bills are considered a risk free and highly liquid instrument in Nepal. As of mid-July 2013, the t-bills outstanding amounted to Rs. 136.46 billion forming 74.5 percent of the total internal debt liability of the Government of Nepal.

47. The concept of base rate has been implemented with the objectives of reducing the spread rate and improving the effectiveness of monetary policy. The average base rate of commercial banks stood at 9.8 percent in mid-July 2013. NRB, through the Monetary Policy of 2012/13, made it mandatory for all commercial banks to publish their base rate on a monthly basis.

48. The NEPSE index increased by 33.7 percent to 518.3 points in mid-July 2013. The stock market capitalization increased by 39.7 percent to Rs. 514.5 billion in mid-July 2013. Of such capitalization, the share of the banks and financial institutions was 71.7 percent. As a result of increase in total market capitalization, the ratio of market capitalization to GDP stood at 30.2 percent in mid-July 2013 compared to 24.0 percent in mid-July 2012.

49. The participants of Nepalese foreign exchange market include licensed banks, development banks, finance companies, money transfer, money exchange and other various companies such as airlines, hotels, travel and trekking agencies which have been involved in foreign exchange transactions in the market. Altogether there were 3840 institutions as participants in the Nepalese foreign exchange market comprising 31

commercial banks, 61 financial institutions (including "B" and "C" categories), 165 money changer, 47 money transfer, 109 hotels, 1578 travels agencies, 1389 trekking agencies, 36 airlines (domestic and foreign), 52 GSP/PSA of foreign airlines, 301 cargo and courier and 71 others as of mid-July 2013. NRB has been maintaining an orderly foreign exchange market through monitoring of foreign currency transaction, issuance of prudential regulations and intervention in domestic foreign exchange market.

50. The gross foreign exchange reserves of the banking system increased considerably by 21.4 percent to Rs. 533.29 billion in mid-July 2013 from the 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 fluctuates with US Dollar. During the review period, NRB's purchased of US Dollar increased marginally by 1.2 percent and reached USD 3.22 billion from BFIs through forex market intervention. The volume of INR purchase grew by 28.3 percent to IRs. 171.52 billion by selling US Dollar 3.12 billion in 2012/13. 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 Infrastructure

51. Sound regulatory policies and robust arrangement for regulating financial system are the fundamental requirements in order to ensure financial stability. NRB's policies, directives and circulars encompass regulations relating to licensing, capital, asset quality, liquidity, corporate governance, risk management, foreign exchange management, and access to finance and financial inclusion, among others. Financial stability also requires very well performance of CAMELS in BFIs. NRB is considering the revision of existing licensing policy in view of changed context in time, market dynamics, geographical topology and implementation of Basel III both in domestic banking system and in the international financial market.

52. Various economic as well as financial factors also affect the bank capital. Capital Adequacy Framework 2007 (updated 2012) was issued for the first time in 2007. The new framework is implemented mandatory for all commercial banks and is under parallel run for the national level development banks ("B" class financial institutions) in Nepal. Basel II enhancement, Basel 2.5 and Basel III are some of the recent developments towards capital regulation in global banking. NRB expects banks to operate above the minimum regulatory capital ratios. BFIs must keep capital adequacy at specific minimum level to avoid risks and bankruptcy. NRB's capital requirements seek to ensure that risk exposures of BFIs are backed by an adequate amount of high quality capital which absorbs the potential risks.

53. Banks have to manage liquidity and a central bank's lender of last resort function, among others, are crucial for liquidity support to banks. Some banks failed during the recent financial crisis, not due to capital shortage but due to funding shortage that brought the banks down. Banks and financial institutions rely to varying degrees on capital markets, including short-term funding markets, for their financing needs. In normal times, NRB provides routine short-term financing to BFIs to support the smooth operation of the payments system, promote well-functioning funding markets and support the monetary policy stance, among others. Furthermore, with the objective of ensuring sufficient liquidity in the financial system, Statutory Liquidity Ratio (SLR) has been fixed at 12.0 percent, 9.0 percent and 8.0 percent of total deposit for "A", "B" and "C" class institutions respectively for 2013/14. For "D" class institution collecting public deposits, the SLR requirement is 4 percent. Likewise, in order to mitigate liquidity risk, there is a provision that the total loan and advance of BFIs should not exceed 80.0 percent of its deposit and core capital.

54. Banks form a crucial link in a country's financial system and their well-being is imperative for the economy. Effective corporate governance in BFIs helps foster financial stability, strengthen risk management and ultimately contribute to a strong financial system. From the viewpoint of BFIs, corporate governance includes maintaining capital adequacy, transparency in the publication of accounts and, management of operational, credit, market and environmental risks, to name a few.

55. In order to provide guidelines to commercial banks on risk management system, NRB has issued Risk Management Guidelines (RMG). 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. Likewise, Problem Bank Resolution Manual and Toolkit that was designed under technical assistance of World Bank with the intention of properly addressing problem banks and financial institutions, has received the final approval.

56. The concept of base rate, implemented in commercial banks, is planned to be implemented in other financial institutions in order to make lending interest rate transparent and competitive. The bank rate was fixed at 8.0 percent and an increment in deprived sector lending requirement was made from 3.5 to 4.0 percent, 3.0 to 3.5 percent and from 2.5 to 3.0 percent for A, B, and "C" class financial institutions respectively for 2013/14.

57. The purpose of macroprudential policies issued by the NRB is to reduce systemic risk. Systemic risk is understood as the risk arising from 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 (systemic risk) of the financial system as a whole. The importance of macroprudential regulation and supervision has increased at present as economy's systemic risks were not sufficiently addressed either by monetary policy anchored to price stability objective or by microprudential regulation through adequacy of capital and liquidity of individual financial institutions. Moreover, macroprudential policy requires an ability to capture the build-up of systemic risk, also in the shadow banking system by developing an enhanced monitoring framework, which NRB is intended to apply for monitoring systemic risk more broadly in BFIs.

58. In fact, macroprudential indicators (MPIs) are related with the health and stability of the financial system. The CAMELS framework which stands for Capital adequacy, Asset quality, Management, Earnings, Liquidity, Sensitivity to market risk has been enhanced while monitoring and supervising BFIs. The financial stability reports also focused on banking sector stability. This is because financial system in Nepal is more banking oriented and macroprudential policy does not seek to replace traditional regulation of financial institutions, such as commercial banks, which are essential to a healthy financial system.

59. To capture aggregate risk in the financial system of Nepal, NRB has been focusing in monitoring overall credit, liquidity, and market risks, as well as any concentrations of those risks in a particular sector, such as housing or consumer credit. The macroprudential element of Basel III incorporates definition of capital, better risk coverage, leverage ratio, and international liquidity framework, among others. 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. 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.

60. NRB has already formulated and enforced some of the macroprudential policies 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 timely manner, among others. Similarly, differentiating 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.

61. 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. As the existing Credit Information Centre (CIC) caters services only to commercial banks and financial institutions other than MFIs and the licensing process for new financial institutions except "D" class financial institutions has been discouraged, the trend of establishment of "D" class institution is increasing now-a-days. As a result, altogether 35 "D" class financial institutions (including five rural development banks) are operating till mid-October 2013.

62. A National Financial Literacy Policy is being worked out by examining the current status of financial literacy and their problems 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. Likewise, financial literacy programs are directed towards financial inclusion and growth in Nepal.

63. The NRB is the driving force in the development of national payment system in Nepal. Likewise, other payment and settlement systems such as Pre-paid Payment Systems, Mobile Banking System and ATMs/Point of Sale (POS) Terminals, and Online Transactions require more expansion and strengthening.

64. By overseeing payment and settlement systems, NRB helps to maintain systemic stability and reduce systemic risk, as well as to maintain public confidence in payment and settlement systems. 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. Currently, formulation of Nepal Payments System Development Strategy and "Payments Oversight in Nepal: Policy Framework", Implementation of the Payments Oversight Function Roadmap is under discussion at NRB.

CHAPTER ONE

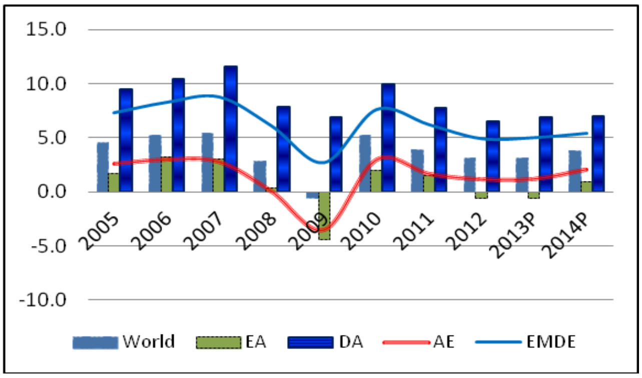
GLOBAL ECONOMIC AND FINANCIAL DEVELOPMENT

Global Economic Development

1.1 According to IMF's *World Economic Outlook (WEO),* October 2013*,* advanced economies have been recovering while growth in emerging economies has seen slowdown. Emerging economies are facing dual challenges, slow growth and tight global financial condition. The global economic growth is still sluggish. Global growth forecasts have been slightly cut down by the *WEO,* October 2013*,* which has highlighted some positive signs of improvement in the world's economic activity that is picking up in some Advanced Economies (AE); however the *WEO* noted that India and Brazil are still soft and there has been growing concerns over the pace of Chinese growth too. Therefore, the global recovery remains still hesitant and uneven across the economies. Likewise, the World Bank's *Global Economic Prospects (GEP)* of June 2013 cut its global economic growth outlook for 2013 citing slower-than-expected expansion in China, India, Brazil, and a stubborn contraction in Europe; however, the world economy will be less volatile in 2014. Large developing economies, which have driven global growth in recent years, will not experience the same boom as they did before the global financial crisis and they should have to focus on structural reforms to keep expanding. The *GEP* also notes that the problem in Euro Area (EA) and fiscal uncertainty in the U.S. should recede as major risks to the global economy can delay the recovery. However, developing economies will have to watch out for side effects from the massive monetary expansion in AE, like United States and Japan.

Figure 1.1: Global Real GDP Growth

(In percent)



1.2 The *WEO* has revised the estimate of the global GDP growth for 2013 to 3.1 percent and its projection for 2014 stands at 3.8 percent. AEs have been estimated to grow by 1.2 percent in 2013 and 2.1 percent in 2014. In contrast, the near-term outlook for the EA has been estimated to remain at -0.6 percent in 2013 and 0.9 percent in 2014. Financial stress in EA has been moderated in response to the policy actions, but still economic activity has been estimated to be in a weak position. The growth estimated for 2013 has been lowered in EA because of weaknesses spilling over from the periphery to the core. Likewise, growth in Emerging Market and Developing Economies (EMDE) has been estimated to expand by 5.0 percent in 2013 and 5.4 percent in 2014. Similarly, activities in Developing Asia (DA) observed some improvement in response to the pace of global recovery. The real GDP growth for this region has been estimated to be 6.9 percent in 2013 and 7.0 percent in 2014.

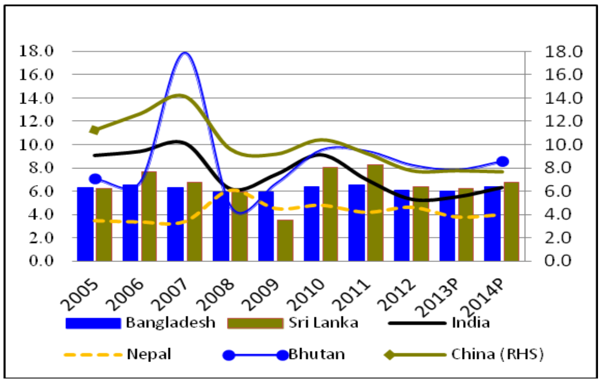
1.3 The main reasons for the revision of lower growth in major world economies include infrastructure bottlenecks, capacity constraints, slower external demand, lower commodity prices, financial stability concerns, and in some cases, weaker policy support. The impact of tight fiscal and financial conditions in various economic regions and expansion of U.S. economy in weaker pace, among others, are also responsible for the reduction in growth forecast. The available indicators have pointed out to uneven growth of economies, particularly the AE, since the EA is still lagging behind the U.S. and Japan.

1.4 The GDP growth in the U.S. has been estimated to rise by 1.2 percent in 2013 and 2.1 percent in 2014, mainly driven by consumption, net exports, housing recovery and supportive financial settings. Likewise, the GDP growth in Japan is estimated at 2.0 percent. In other AE (excluding G7 and other EA countries) the GDP growth has been projected at 2.3 percent in 2013 and 3.1 percent in 2014. Growth forecast for the BRICS countries and many commodity exporting countries has also been lowered due to the fall in commodity prices. However, global economic activity has been expected to strengthen moderately in the medium term. Still, growth in the EA has been estimated to be held back by the very weak economies in the periphery. EMDE and DE are projected to expand by about 5.0 percent in 2014 on account of neutral fiscal policy and low real interest rate. Unemployment has been estimated to remain unacceptably high in many AE as well as in various EME.

1.5 In the EA, recovery is estimated to be delayed despite the role of the ECB as a firewall against financial tensions. Growth estimates for the major EA countries (France, Italy and Spain) is estimated to remain negative in 2013. Germany is estimated to grow by 0.3 percent in 2013. The disordered bailout in Cyprus, the adverse political situation in Italy and in Portugal, the almost shaky situation in Greece and other European Union (EU) countries are the main reasons behind the growth prospects in EA. On the negative side, indicators of the economic situation show a general cyclical weakness that goes beyond the periphery. The bank lending conditions in the region as a whole continue to be tightening while in peripheral countries such as Spain, demand for credit is still falling. The growth analysis by the IMF, OECD, and World Bank all noted that the unexpected delays in policy implementation and the constraints in the EA need to be avoided to expedite the growth swiftly in this region.

1.6 The GDP growth in EMDE, including the DA has been expected to pick up gradually at a moderate pace along with the strengthening of external demand and continued robust domestic demand in these countries. For DA as a whole, growth is estimated to pick up modestly to about 7.0 percent both in 2013 and 2014, largely as a result of recovering external demand and continued solid improvement in domestic demand. The GDP growth in this region has shown a sign of improvement as extreme risks emanating from AE have receded and domestic demand remained resilient, supported by relatively easy financial conditions and robust labor market; however risks to the outlook from within the region, such as rising financial imbalances and asset prices in some economies, are coming clearer into focus. South Asia is expected to see a turn around after economic softening if improvements take place, particularly in India which is struggling to realize its full potential. India is a case where structural and policy issues have been inhibiting investment.

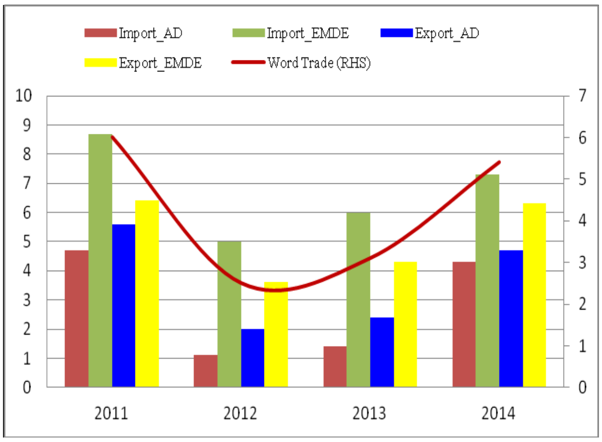
Figure 1.2: Real GDP Growth in South Asia and China
(In percent)



1.7 In China, the GDP growth has been estimated to stay at around 7.8 percent both in 2013 and 2014, where as in India, growth is estimated to be 5.6 percent in 2013 and 6.3 percent in 2014. South Asia is projected to grow by 5.2 percent in 2013 and 6.0 percent in 2014. Among the South Asian economies, Bhutan attained highest rate of real GDP growth of 6.3 percent in 2013 and is projected to grow by 8.6 percent in 2014. The real GDP growth in Bangladesh and Sri Lanka has been expected to remain stable averaging around 6.0 percent.

1.8 The current account balance is weakening due to the weak external demand; fall in trade volume with the uncertain external economic environment and weak investment scenario. Trade deficit further weakened both in the major world economies and in India. The trade volumes decelerated sharply. However, both the IMF *and* World Bank estimate that the situation may turn into positive scenario in the medium term. Based on the assumption of global economic recovery, the world trade volume has been estimated to increase by 3.1 and 5.4 percent respectively in both AE and EMDE in 2014.

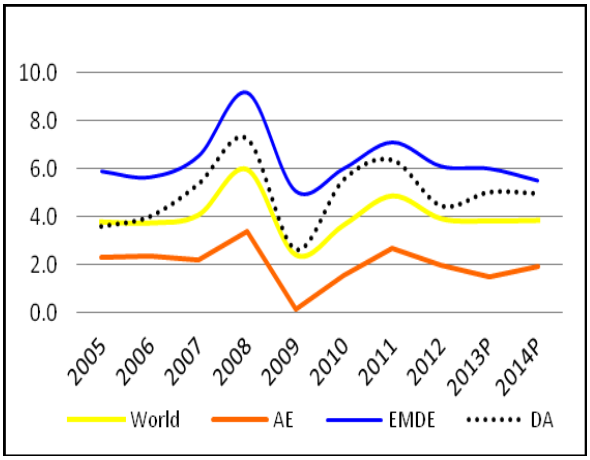
Figure 1.3: World Trade Volume
(In percent)



Global Inflation

1.9 Global inflation is subdued as cost pressures related to commodity price continue to ease and demand factors in AE remain weak. Despite of loose monetary conditions and acceleration of economic activities, global consumer prices increased modestly in recent months. Low income country inflation has shown the fastest decline where as in high income countries inflation remains weak. Unconventional monetary policy helped major high income economies to avoid disinflation but Japan is still caught in disinflationary trap. Monetary policy globally and especially in developing countries is

Figure 1.4: Global Inflation
(In percent)

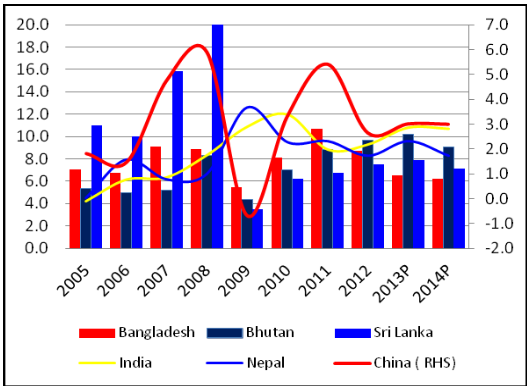


increasingly embracing inflation targeting and loose policy stance. Such stance in developing countries has been counterproductive, particularly in countries operating at full capacity.

1.10 Global inflation is estimated to stay at around 3.8 percent during 2013-14. Food and fuel supply developments will help contain upward pressure on prices of major commodities despite the expected reacceleration in global activity. In the major AE, inflation will ease to 1.5-1.9 percent during 2013-14. Inflation pressure is projected to remain contained in the EMDE as well, supported by recent slowdown and lower food and energy prices. Inflation is estimated to stand at 5.5-6.0 percent in EMDE during 2013-14. However, inflation pressure in some economies and regions, spurred by food prices in some cases, such as in South Asian countries including India has been projected to remain fairly high because of higher food prices.

1.11 Despite overall global inflation being within the target level, the headline inflation in Asia and Pacific region has accelerated in early 2013 as a result of local conditions of rebounding economic activity and accommodative policies. Inflation has moderated in EA and Central Asia, but price pressures are high in large middle income countries. Although inflation remains sticky in the AE, price pressure moderated across other regions such as EA and Central Asia. In contrast, some regions, for instance, the Middle East, have witnessed high prices reflecting both supply disruptions caused by civil and armed strife as well as the measures addressed to adjust large macro-economic imbalances. In South Asia, consumer price based index remained high but the wholesale prices index-based inflation moderated significantly, especially in India. The high inflation pressure in South Asia mainly reflect an upward adjustments to domestic fuel prices implemented time to time over the past few months. Price pressures in South Asia continue to stem from growing demand for food and energy, reflecting raising household incomes combined with supplies related bottlenecks and structural constraints in the production and distribution of food and utilities.

Figure 1.5: Inflation in South Asia and China
(In percent)



1.12 Given the persistent inflationary pressures and large fiscal deficits, the scope for policy stimulus in India and other AE has seen limited. China and many East Asian economies, in contrast, possess much greater space for countercyclical policy. Due to surge in food prices and upward adjustments to regulated fuel price, inflation in SA accelerated at early 2013. However, the quarterly inflation as measured by CPI reflected a sign of moderation, helped in part by easing of international commodity prices. A drop of private investment over rising policy uncertainty exacerbated supply bottlenecks in India, which contributed to headline inflation that was high compared with most other Asian economies. Inflation in South Asia has been estimated to be 8.1 percent in 2013. The high CPI inflation rate in South Asia compared with the average for middle-income developing countries reflect supply-side production constraints, deep-rooted inflationary expectations, and the persistent food inflation in this region. Households' inflation expectations in India remain stubbornly high, partly because of a steady upward trend in inflation over the past 7 years. Food inflation has remained persistently high in this region, as a result of agricultural production constraints and logistics bottlenecks.

Global Financial Stability

1.13 Momentum in the global economy is shifting away from EMDE to AE after years in the doldrums. EMDE has been suffering from large trade deficits, capital flight and depreciating currencies, and their growth rates are slowing.

1.14 Having relied on growth of EMDE to grease the global economy since 2010, a reversal of fortunes has been noted on in 2013, triggered by the improvement in the U.S. economic outlook and expectations of a tightening of its monetary policy. Many EMDE have been affected by capital outflows, rising financing costs and rapid currency depreciations. Those countries and companies in emerging economies that relied on foreign currency borrowing in the good times have been the most vulnerable. Countries with large current account deficit such as India, Brazil and South Africa which relied on inflows of capital, have been affected severely by capital outflows resulting in depreciation of their currencies by more than 10 percent since May 2013.

1.15 The OECD economists have highlighted three specific vulnerabilities to global recovery. First, the EA with its weak banks and high sovereign debt has remained fragile and vulnerable to sharp shifts in sentiment. Second, the worry about further capital flight from troubled EMDE could hit growth even harder, especially given a rise in debt in these countries, raising the vulnerability to financial shocks. And third, U.S. politics might fail to resolve disagreements about the government's debt ceiling, triggering a new rush for the exit in financial market.

1.16 The world has been expecting the U.S. Federal Reserve to start tapering its quantitative easing programme soon. This expectation has increased market volatility. And, as in past episodes of Fed tightening, emerging markets are at the center of the turmoil. But this time, the adjustments taking place are the product of imbalances that originated in the developed world. Since 2010, AE's unconventional monetary policies have fuelled unprecedented capital flows into emerging markets, reaching $1 trillion a year. This generated unsustainable credit growth, raised asset prices and worsened several recipient countries' vulnerability.

1.17 When the Fed signaled the forthcoming end of QE, emerging markets became the focus of financial distress. This has created a challenge for them and policy makers must go beyond temporary measures to defend currencies and stem capital outflows. Exposed countries should move fast to recover their balance, to reassure markets of their long-term stability and to accelerate structural reforms to increase productivity growth.

1.18 Unexpected capital outflows have caused the Indian and Indonesian currencies and stock markets to sink. Countries with the greatest external imbalances have felt the greatest pressure. Since, April 2013, Indonesia has lost about 14 percent of its foreign exchange reserves; India nearly 10 percent. If this stress persists, it is not difficult to envision a full-blown balance of payments crisis. The same holds true for Turkey, Ukraine and South Africa, among others, since May 2013.

1.19 In this scenario, the international community's failure to put in place safeguards against financial dislocations risks is derailing the global recovery. During the 2007-09 crises, liquidity backstops through the IMF and the Federal Reserve prevented further economic deterioration. The *GFSR* of October, 2013 even recommended continued monetary stimulus and that the world must build further lines of defense to reduce global financial risk against a possible emerging markets crisis.

1.20 Measures have been undertaken to escape from a potential depression. However, improvement in unemployment and increase in productivity are still not working as per the plan in global economic adjustment. As always, a central bank's communication strategy is important, as it may mitigate financial volatility, but should not by itself be considered a crucial policy tool. A combination of deeper policy commitments, renewed monetary stimulus, and continued liquidity support can not only reduce tail risks, it can also enhance confidence and bolster the economic outlook and financial stability. The improvement in financial conditions can only be sustained through further policy actions that address underlying stability risks and promote continued economic recovery. Moreover, 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 issues falters, risks could reappear in global financial stability.

1.21 Downside risks revolve around the absence of strong fiscal consolidation plans in the AE. High private sector debt, limited policy space, and insufficient institutional progress in the EA, can lead to a protracted period of low growth, distortions from easy and unconventional monetary policy in many AEs and vulnerabilities in capital flows in many EMDE. Unless policies address these risks, global financial stability may likely suffer periodic setbacks.

1.22 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 have been facing challenges of elevated funding costs, deteriorating asset quality, and weak profit. 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. Similarly, risks continue to flow from the uncompleted business of restoring bank health and credit transmission and from corporate debt overhang in the EA. The large public debts stocks and the absence of medium-term adjustment plans with concrete measures and strong entitlement reforms in key advanced economies combine to keep fiscal risks at a stubbornly high level. Fiscal vulnerabilities are also building up in EMDE and low-income economies to varying degrees.

1.23 As per the *GFSR* analysis, 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.

1.24 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 that there is a need for further works 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.

1.25 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-boarder capital flows and rising domestic financial vulnerabilities to avoid the financial instability.

1.26 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. For example, Japan is scaling up monetary stimulus, aiming to pull the economy out of its deflationary situation. In the EA, reforms have been implemented in domestic economies as well as toward improving the architecture of the monetary union which have helped reduce funding pressures on banks and sovereigns. The WEO, of October 2013, estimates that in some of the economies in EA some banks might need to further increase provisioning to re-address the potential deterioration in asset quality of corporate loan books.

1.27 Despite the efforts by policymakers to revive the weak credit growth, which has been a primary reason behind the slow economic recovery, the *WEO* and *GFSR,* October 2013, analysis noted that policies are most effective if they target the constraints that underline the weakness in credit. But again, these constraints in credit market differ by country and evolve over time, requiring a careful country-by-country assessment. In many cases, demand and supply-oriented policies are complementary, but their relative magnitude and sequencing can be more important. The main risks center on increased credit risk, including a relaxation of underwriting standards and the risks of ever greening existing loans.

1.28 The *GFSR,* of October 2013, analysis found that healthy banks rely more on equity and less on debt, especially short-term wholesale funding that contributed to the global financial crisis and use deposits as their primary funding sources. Careful implementation of the reforms can moderate tensions. For example, the Basel III and over-the-counter derivative reforms should be implemented as planned, but policymakers should monitor the increased demand for collateral and ensure that enough unencumbered assets are available to permit the meaningful bail-in of unsecured senior creditors. The policy makers have shown their determination to keep the global economy away from the precipice. Nonetheless, what is worrisome is that monetary policy in the AE could be stuck at the zero interest bound for many years.

Over the time, very high public debt in all major AE and persistent financial fragmentation in the EA could then trigger a new crisis.

1.29 Global financial market volatility has been increasing again since May 2013. In AE, longer term interest rate and financial market volatility have risen. Likewise, the sovereign spreads in the EA periphery have widened again after a period of sustained declines. The EMDE have generally been hit the hardest, as recent increase in AE interest rates and assets price volatility, combined with weaker domestic activity have led to some capital outflows, equity price declines, rising local yields and depreciation of currencies. The early period of 2013 has been remembered as a year punctuated by rolling crises in the global financial markets which posed many challenges in the economy and in the financial markets. The risk of a setback remains uneven given the continuing problems in the EA and EMDE.

1.30 The *GFSR*, of October 2013, noted that some new downside risks have come to the fore, while old risks remain largely unchanged; for example, the uncertainty about a failure to promptly raise US debt ceiling, leading to a U.S. selective default, could seriously damage the global economy. Beyond the immediate risk, the prospects of reduced monetary accommodation in the U.S may cause additional market adjustments and expose areas of financial excess and systemic vulnerability. The exchange rate and financial market overshooting in the EME can also cope with weaker economic outlooks, vulnerabilities and severe balance of payment disruptions. The advent of new crises requires further policy efforts mainly in the AE and EME which are facing new policy challenges.

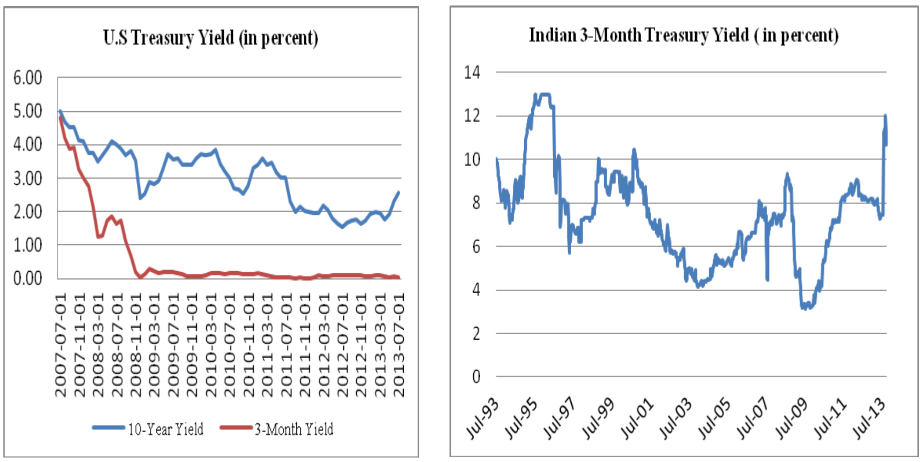
1.31 The appropriate policy mix and the pace of adjustment will differ across economies in view of the differences in output gaps, inflation pressure, central bank credibility and the room for fiscal policy maneuvering and the nature of vulnerabilities. The policies priorities, for example, allowing exchange rates to respond to changing fundamentals, choosing strong nominal anchor to make monetary policy more credible, implementation of macroprudential policy measures to improve financial sector stability, fiscal consolidation and a new round of structural reforms, including investment in public infrastructure, removal of barriers to entry in product and services in markets and replacing growth away from investment toward consumption, might be vital to rebound economic growth and financial sector stability in the future.

1.32 Despite the uncertainties, challenges and risks in the financial system, the global financial system is undergoing a series of transitions along with the path toward greater financial stability. The U.S. is expected to move to less accommodative monetary policies and higher long-term interest rates. The EME, after a prolonged period of strong portfolio inflows, are now facing a transition to more volatile external conditions and macroeconomic vulnerabilities, as they shift to a regime in which financial sector growth is more balanced and sustainable. Japan is moving towards the new policy regime marked by more vigorous monetary easing, EA towards more robust and safer financial sector, including a stronger monetary union and the global banking system is phasing in stronger regulatory standards.

1.33 The core challenges remain in managing the side effects and eventual withdrawal of accommodative monetary policy in the U.S. and the benefits of strong U.S economy should help limit financial stability risks associated with an extended period of low interest rates. The *GFSR* highlights the risk that long-term interest rate could rise more sharply than currently anticipated. Structural reductions in market liquidity and leveraged positions in short-term funding markets and the shadow banking system, for instance in the mortgage real estate investment sector could amplify these rate increases and spill over to the global markets.

1.34 The 10-year US treasury yields stood at 2.30 percent in July 2013, after contracting to the lowest yield of less than 2.0 percent from June 2012 to June 2013. It had hovered around 4.0 percent in June 2009. It has been in a declining position and below 2 percent after April 2012. Likewise, 3-month US treasury yield has declined to 0.05

Figure 1.6: U.S. and Indian Treasury Yields



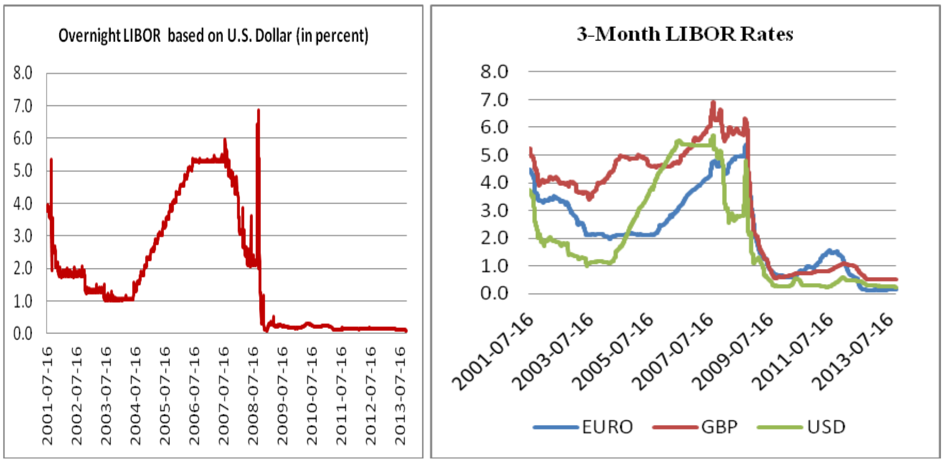
percent after recording the lowest of 0.01 percent in December 2011, but again the yield has not improved and the rate has been remaining persistently too low (below 1.0 percent) after October 2008. Similarly, the U.S. Fed Funds daily discount rate has not improved since mid-August 2010. It has been hovering below 1.0 percent since then. In case of India, government's 3-month T-bill rate has been gradually increasing; it stood 5.4 percent in July 2010, to 8.4 percent in July 2011, and 11.3 percent in July 2013.

1.35 The overnight LIBOR rate for USD further declined to 0.1 percent in July 2013. The rate has not improved after 2008. It is gradually in a declining position, hovering between 0.1 to 0.2 percent since that time.

1.36 The LIBOR rate for major international currencies (except the USD) further declined in 2012 and the trend of decline has also continued in 2013. The LIBOR rate with Euro declined to 0.1 percent in mid-July 2013 from 0.4 percent of mid-July 2012. Likewise,

Figure 1.7: Libor Rates

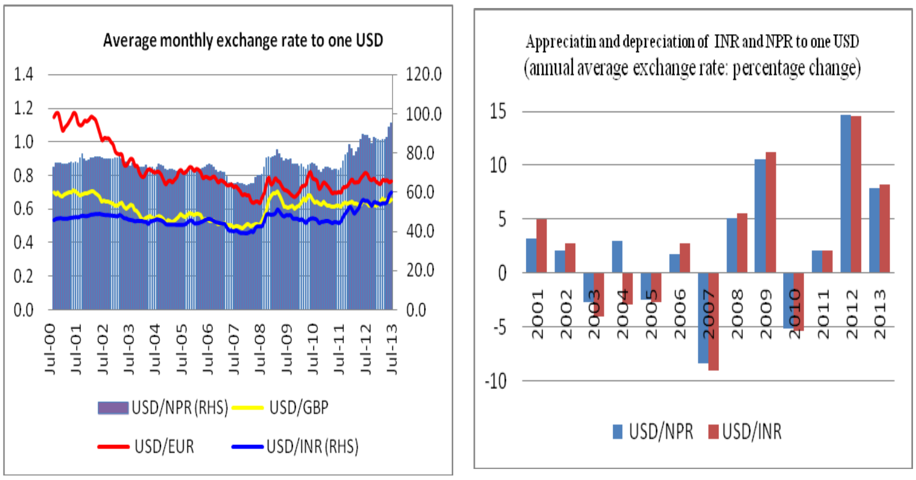
(In percent)



the rate with GBP and USD also declined from 0.8 percent and 0.5 percent of mid-July 2012 to 0.5 and 0.3 percent in mid-July 2013. This sort of trend in LIBOR rate for major international currencies, particularly with USD, shows that the economic crisis might have deteriorated further in some parts of the world. The 3-month Libor rate in USD showed a slightly upward trend in 2012 but declined later significantly. Similarly, 3-month GBP and EURO rates also declined significantly over the period.

1.37 The policy makers around the world, especially the central banks and financial market regulators have focused their attention on the relative strength of their currencies. The exchange rate of major international currencies with one USD has fluctuated during 2012, but sharply depreciated since the beginning of 2013. The average exchange rate of one USD to GBP remained stable in 2012, but depreciated from early 2013. The yearly average rate of INR with USD depreciated sharply in 2012 (14.0 percent) and 2013 (8.0 percent). The average rate of INR with one USD reached Rs. 57.8 in July 2013

Figure 1.8: Exchange Rates



from Rs. 53.4 of July 2012. Since 2001, the INR and NPR had been appreciating and depreciating with one USD moving simultaneously. Such rate of appreciation/deprecation has been slightly different in some years. After appreciation in 2010 by around 5.5 percent, the exchange rate of both currencies with USD has depreciated more steadily in recent years. .

1.38 The global foreign exchange market outlook noted that the USD will continue to be strengthened 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 in order to simulate investment. The Reserve Bank of India (RBI) and Government of India are expected to continue to provide fiscal and monetary stimulus by introducing new measures on a cautious pace in the coming months in order to invigorate sluggish economic. The stabilization of INR correction in the days to come will depend on some correction in Indian macroeconomic indicators such as improvement in growth, current account deficit and large fiscal deficits along with foreign currency inflows in India. Likewise, it is expected that the policy performance and behavior of INR will also depend on the stance and direction to be taken by the Federal Reserve Bank on monetary policy implementation as well as management of sovereign debt related issues in Euro Area and United States in the near term prospect.

CHAPTER TWO

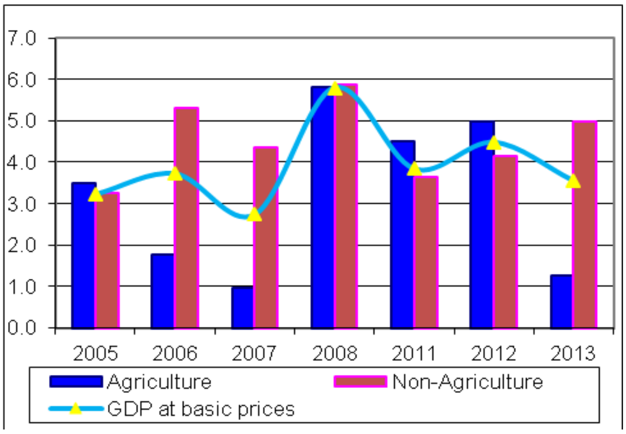
DOMESTIC MACROECONOMIC DEVELOPMENT

Economic Growth

2.1 The preliminary estimates of Central Bureau of Statistics (CBS) has estimated the 2012/13 shows that the real GDP at basic price was expected to grow by 3.6 percent compared to a growth of 4.5 percent in 2011/12. In 2012/13, the agriculture sector and the non-agriculture sector were expected to grow by 1.3 percent and 5.0 percent respectively whereas these sectors had grown by 5.0 percent and 4.2 percent respectively in 2011/12.

Figure 2.1: Real GDP Growth

(In percent)



2.2 Similarly, the industrial sector was estimated to grow marginally by 1.6 percent in 2012/13 compared to a growth of 3.0 percent in 2011/12. The growth performance of service sector has improved due to the improvement in the wholesale and retail trade, hotels and restaurants, transport, storage and communication and financial intermediaries. However, the agriculture and industrial sector witnessed sluggish growth in 2012/13 due to the unfavorable monsoon, energy shortage, poor industrial relation and delay in adopting full-fledged budget. It is expected that growth in the production of agriculture sector will increase in 2013/14 because of favorable monsoon and timely availability of fertilizers.

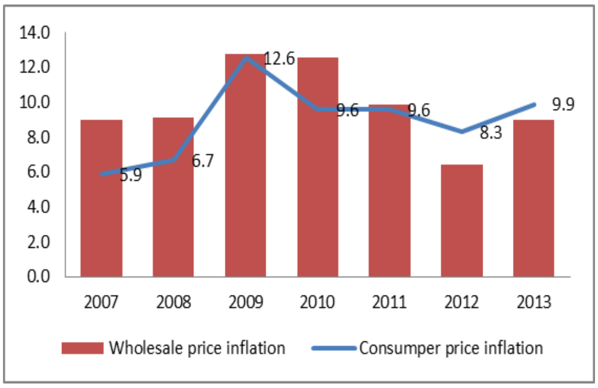
2.3 Total consumption increased to 90.7 percent of GDP, from 88.5 percent in 2011/12. Consequently, the savings ratio dropped from 9.3 percent in 2012/13. In 2012/13, gross investment increased to 31.8 percent of GDP from 34.9 percent in 2011/12.

Inflation

2.4 The annual average consumer price inflation increased by 9.9 percent in 2012/13 compared to an increase of 8.3 percent 2011/12. The price index of food and beverages group increased by 9.6 percent whereas the index of non-food and services group increased by 10.0 percent in 2012/13. The indices of food and beverages and non-food and services had increased by 7.7 percent and 9.0 percent respectively in 2011/12. The major factors that pushed up the index of food prices were meat and fish, sugar and sweets and, ghee and oil. Similarly, the principal factors behind the increase in the price index of non- food and services were furnishing and household equipments, clothing and footwear and, exchange rate depreciation.

Figure 2.2: Annual Average Inflation

(Percent change)

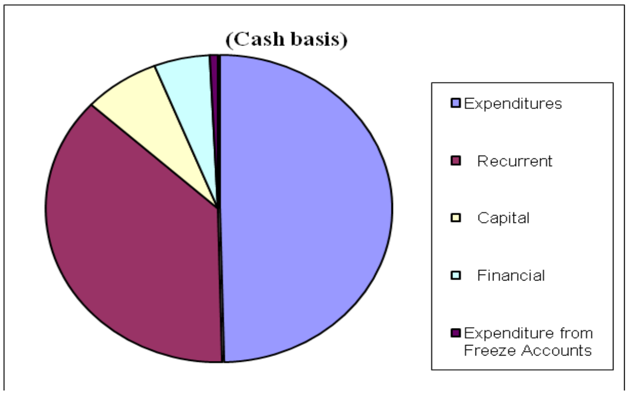


Government Finance

2.5 The performance of the capital expenditure as in past few years remained discouraging. On the contrary, revenue mobilization remained encouraging. . On a basis, total government a decelerated pace of expenditure increased by 8.7 percent to Rs. 347.74 billion, compared to a much higher pace of increase of 15.2 percent in 2011/12. In 2012/13, revenue mobilization of

Figure 2.3: Composition of Government Expenditure

(Rs. in million)



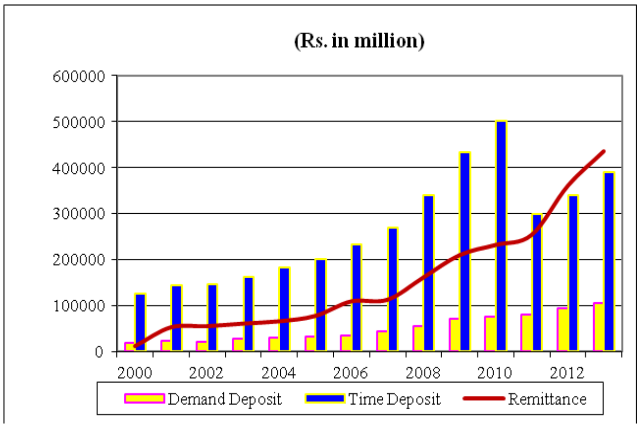
the Government of Nepal (GoN) increased by 21.1 percent to Rs. 296.01 billion, which exceeded the annual budget estimate of Rs. 289.61 billion by 2.2 percent.

2.6 The main contributors to the increase in revenue were increase in imports which resulted in growth of custom revenue, and income tax. The controls of tax leakage as well as overall reforms in tax administration were other factors that had contributed to increased revenue mobilization. Delay in the tender process including other procedural processes due to the prolonged delay in formalized budget was the principle reason behind the slower growth of capital expenditure. The government budget deficit, on cash basis, declined by 18.6 percent to Rs. 18.19 billion in 2012/13 from a much elevated deficit of Rs. 22.34 billion in 2011/12. of the 2012/13 budget deficit was financed by domestic borrowings of Rs. 19.04 billion(equivalent to 1.1 percent of GDP). Outstanding domestic debt of the Government of Nepal stood at Rs. 207.0 billion in 2012/13. After adjusting the government balance of Rs. 13.53 billion, total outstanding domestic debt stood at Rs. 193.48 billion in mid-July 2013. Thus size of domestic debt represents 13.0 percent of the GDP.

External Sector

2.7 Merchandise exports went up by 3.6 percent to Rs. 76.92 billion in 2012/13. Such exports had increased by 15.4 percent to Rs. 74.26 billion in 2011/12. On the other hand, merchandise imports surged by 20.6 percent to Rs. 556.74 billion in 2012/13. Such imports had risen by 16.5 percent to Rs. 461.67 billion in 2011/12. Total merchandise imports surged in 2012/13 primarily owing to the rapid increase in the imports from India. Due to the high growth rate of imports compared to exports, total trade deficit surged by 23.9 percent to Rs. 479.82 billion in 2012/13. Such deficit had expanded by 16.7 percent in the previous year. Trade deficit with India surged by 26.5 percent during 2012/13 compared to a growth of 14.3 percent in 2011/12. The share of India in

Figure 2.4: Movement of Remittance and Deposit



Nepal's total trade increased marginally to 66.0 percent in 2012/13 from 65.1 percent in 2011/12.

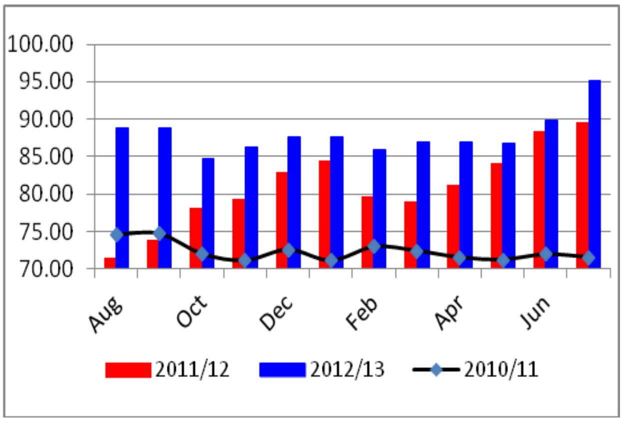
2.8 The overall BoP recorded a surplus of Rs. 68.94 billion in 2012/13 compared to a surplus of Rs. 131.63 billion in 2011/12. The current account posted a surplus of Rs. 57.6 billion in 2012/13 compared to a surplus of Rs. 75.98 billion in the previous year. The current account surplus was lower in 2012/13 due to a substantial rise in imports of services. Workers' remittances rose by 20.9 percent to Rs. 434.58 billion in 2012/13 compared to an increase of 41.8 percent in 2011/12 because of increase in the number of workers going abroad and depreciation of Nepalese currency against USD.

2.9 The gross foreign exchange reserves increased by 21.4 percent to Rs. 533.30 billion in mid-July 2013 from a level of Rs. 439.46 billion in mid-July 2012. The movement of such reserves is highly influenced by the inflows of workers remittance which ultimately affects the liquidity situation of banking system. The existing level of reserves is sufficient for financing merchandise imports of 11.7 months and merchandise and service imports of 10.1 months.

Exchange Rate

2.10 Nepalese currency vis-à-vis the USD depreciated by 6.7 percent in mid-July 2013 from the level of mid-July 2012. It had depreciated by 19.9 percent in the corresponding period of the previous year. The exchange rate of one USD stood at Rs. 95.00 in mid-July 2013 compared to Rs. 88.60 in mid-July 2012. From November 2012, there was a continuous depreciation in the Nepalese currency against the USD. Such decrease in the value of Nepalese currency has corrected the real exchange rate in Nepal. Depreciation of Nepalese rupee against the USD has contributed to the improvement in export competitiveness and to the increase in remittances inflows. On the other hand, net domestic assets, money supply and inflationary pressure are also increasing. Since

Figure 2.5: Exchange Rate of the Nepali Rupee

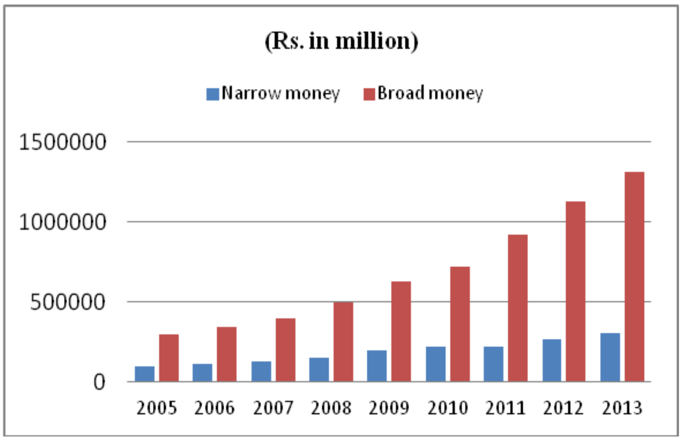


Nepalese currency is pegged with Indian currency, the movement of INR vis-à-vis US Dollar is responsible for the changes in the exchange rate in Nepal.

Monetary Situation

2.11 Broad money supply (M2) growth rate decelerated by 16.4 percent in 2012/13 from 22.7 percent in the previous year. The slower growth of broad money supply was due to the slowdown in the growth rate of net foreign assets of the banking sector. Similarly, narrow money supply (M1) increased by 14.4 percent during 2012/13 compared to a rise of 18.6 percent in the previous year.

Figure 2.6: Money Supply



2.12 Domestic credit expanded by 15.9 percent in 2012/13 compared to a growth of 9.3 percent in the previous year. Such a high growth of domestic credit was due to an accelerated growth in credit flows to the private sector in 2012/13. The claims on the private sector increased considerably by 20.2 percent in 2012/13 compared to a growth of 11.3 percent in the previous year.

2.13 Reserve money growth got compressed to a much much higher 10.9 percent in 2012/13 compared to increase of 36.4 percent in the previous year. A decrease in NRB's net claims on government coupled with a slower growth of net foreign assets resulted in a decelerated growth of reserve money in 2012/13.

2.14 Deposit mobilization of banks and financial institutions (BFIs) increased by 17.4 percent in 2012/13 to Rs. 176.27 billion. Such deposit mobilization had increased by 22.9 percent to Rs. 188.59 billion in the previous year. In 2012/13, deposit mobilization of commercial banks and development banks increased by 17.9 percent and 27.1 percent respectively while deposit mobilization of finance companies decreased by 9.6 percent.

Liquidity Situation

2.15 NRB mopped up net liquidity of Rs. 8.50 billion through outright sale auction in 2012/13. In 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 2012/13, NRB injected net liquidity of Rs. 285.03 billion through the net purchase of USD 3.22 billion from the foreign exchange market. Net liquidity of Rs. 258.28 billion had been injected through the purchase of USD 3.19 billion in the previous year. The NRB purchased Indian currency (INR) equivalent to Rs. 274.44 billion through the sale of USD 3.12 billion in the Indian money market during 2012/13. Indian rupees equivalent to Rs. 213.95 billion had been purchased through the sale of USD 2.66 billion in the previous year. The provision of statutory liquidity ratio (SLR) which was fixed at 15.0 percent, 11.0 percent and 10.0 percent of total deposits for "A", "B" and "C" class institutions for 2012/13 was lowered down to 12.0 percent, 9.0 percent and 8.0 percent respectively for 2013/14. In order to mitigate liquidity risk, there is a provision of maintaining total loan and advance of BFIs not exceeding 80 percent of its deposit and core capital.

CHAPTER THREE

FINANCIAL INSTITUTIONS

Structure of the Financial System

3.1 Modern financial system in Nepal has completed more than 75 years since the establishment of Nepal Bank Limited in 1937 A.D (30th Kartik 1994 B.S.) as Nepal's first commercial bank. With the course of time, the structure of Nepalese financial system has broadened. As of now, it constitutes commercial banks development banks, finance companies and micro finance financial institutions, few cooperatives and NGOs both performing limited banking activities under the regulatory and supervisory jurisdiction of the NRB. Similarly, it also comprises of other financial institutions like pension funds—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, cooperatives under Department of Cooperatives and Nepal Stock Exchange Ltd. (NEPSE) under the regulation of the Security Exchange Board of Nepal (SEBON).

3.2 The Nepalese financial sector has been undergoing significant changes. The banking sector noted an increase in capital base, improvement of efficiency in management and asset mobilization, notable growth in profitability, expansion in deposit mobilization along with increased liquidity cushions, increment in loan disbursed to productive sectors and relaxed liquidity position as positive indicators. Increasing risk weighted assets (RWA), increasing investment in consumption sector, increase in provisioning, and deteriorating asset quality, among others have emerged as challenges for the stability of the financial sector in Nepal.

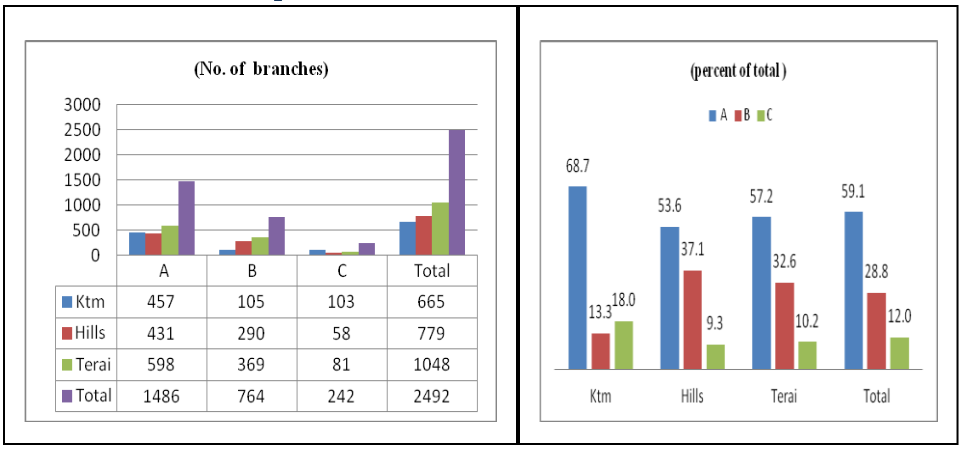
3.3 The rapid growth of BFIs observed in the last couple of years has come to a halt recently. Now, it is passing through the phase of consolidation. As of mid-July 2013, the Nepalese financial sector constituted of 31 licensed commercial banks ("A" class), 86 development banks ("B" class), 59 finance companies ("C" class), 31 micro finance financial institutions ("D" class), 46 other financial institutions including NRB licensed cooperatives and NGOs. As of mid-July 2013, the total number of financial institutions stood at 284 comprising of 176 banks and financial institutions of "A", "B" and "C" categories, 80 financial intermediaries licensed by NRB, 25 insurance companies and one each of EPF, CIT and Postal Saving Bank. Total number of NRB licensed "A", "B", "C" and "D" class financial institutions declined to 207 from 214 in mid-January 2013. The significant decline in number of finance companies by about 12.0 percent and development banks by about 5.0 percent contributed to such decline in total number of BFIs in the review period. However, the number of "D" class MFFIs increased during the same period.

Table 3.1: Number of BFIs and Other Institutions

Banks and Financial Institutions	Mid-July 2012	Mid-Jan. 2013	Mid-July 2013
Commercial Banks	32	32	31
Development Banks	88	90	86
Finance Companies	70	67	59
Micro Finance Institutions	24	25	31
Sub-Total	**214**	**214**	**207**
NRB permitted Cooperatives (with limited banking activities)	16	16	18
NRB permitted NGOs (with limited banking activities)	36	34	31
Insurance Companies	25	25	25
Employees Provident Fund	1	1	1
Citizen Investment Trust	1	1	1
Postal Saving Bank	1	1	1
Total	**294**	**292**	**284**

3.4 Along with the liberalization process in Nepal, the establishment of banks and financial institutions proliferated. Such proliferation was not accompanied with commensurate

Figure 3.1: Concentration of BFIs Branches



developments in the prudent legal and operational framework. Total number of bank branches of BFIs reached 2,492 as of mid-July 2013 from 2,351 a year ago. Of the total number, branches of class "A" financial institutions, class "B" financial institutions and class "C" financial institutions numbered 1486, 784 and 242 respectively as of mid-July 2013. The numbers of such branches were 1356, 650 and 345 a year ago, respectively. Branches of commercial banks and development banks increased by 10.0 percent and 17.5 percent in 2012/13, while the branches of finance companies declined by 9.7 percent. Among the total bank branches of BFIs, 26.7 percent (665) branches were operating in Kathmandu Valley followed by 31.3 percent in Hills and Mountain (779), and 42.1 percent in the Terai (1048) as at mid-July 2013. As a result, 60.0 percent of total deposit and 44.0 percent of total loan of BFIs have been concentrated in Kathmandu Valley only.

3.5 The top three districts with highest number of bank branches are Kathmandu (513), Rupandehi (152) and Kaski (148), In terms of regions, most of the bank branches including the "D" class MFFIs are located in Central Development Region (1409), followed by the Western Development Region (727), Eastern Development Region (568) and Mid-Western Development Region (280). The Far Western Region has the lowest number of bank branches (154). Out of total bank branches of BFIs, about 45.0 percent are situated in the Central Region, while the remaining are serving in other four regions, with the lowest density of less than 5 percent in Far Western Region. NRB has been striving to expand access to finance in the remote and unbanked areas. The NRB has been motivating BFIs for adopting new techniques such as branchless banking and mobile banking for enhancing financial inclusion and access.

Table 3.2: Number of Bank Branches

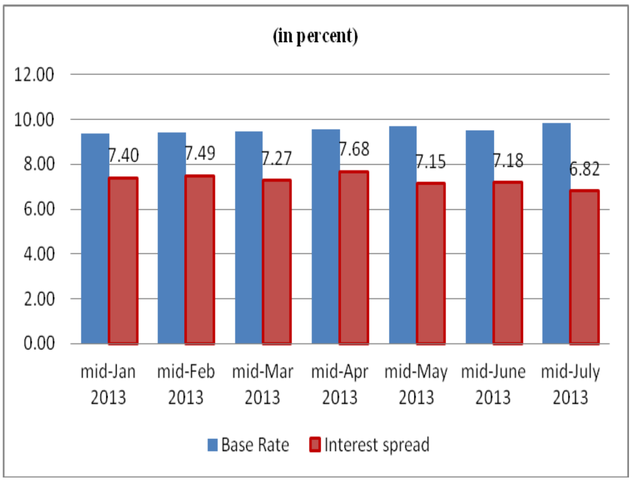
(As of mid-July, 2013)

Bank Branches		Total	Share	In 17 districts	Share
Commercial Banks	State owned	506	20.3	25	53.2
	Other	980	39.3	17	36.2
Development Banks		764	30.6	4	8.5
Finance Companies		242	9.7	1	2.1
Total		2492	100	47	100

3.6 The state-owned banks that had the largest branch networks and had been representing more than half of total bank branches in the country till mid-Jan 2013, now hold only 20.3 percent share whereas other private sector commercial bank hold 39.3 percent of total bank branch network followed by development banks (30.6 percent) and finance companies (9.7 percent). The change in this position is due to the aggressive branch expansion policy adopted by private sector BFIs in the review period. However, 17 districts are still considered far from access to formal financial service. The massive branch expansion by private banking sector has not been able to contribute as expected in financial inclusion and for the needy section of people, particularly in geographically remote areas. The minimal presence of branches of BFIs in 17 districts and almost non-presence of BFIs other than state owned commercial banks in six districts of Nepal, that is Bajhang, Bajura, Dolpa, Jajarkot, Kalikot and Mugu, is a big concern for financial access and inclusion.

3.7 The rapid growth of number of financial institutions and stiff competition among the BFIs and their branches have not played any effective role in lowering interest rate spread in Nepal. With the objective of bringing transparency to loans rates, minimizing lending risks and enabling better assessment of transmission of monetary policy, NRB in its Monetary Policy for 2012/13 has mentioned about introducing base rate system in the Nepalese banking sector. Accordingly, NRB directed "A" class banks to compute and publish their base rate from mid-January 2013 onwards on a monthly basis for which NRB devised a formula for calculating base rate. It was intended to control interest rate spread indirectly by this means. However, the impact of computing base rate is yet to be seen on interest spread.

Figure 3.2: Base Rate and Interest Spread



3.8 The total size of banking and non-banking financial institutions in GDP continued to expand in the review period in comparison to that of mid-July 2012. The ratio of total assets and liabilities of Nepalese financial system reached 141.7 percent of GDP in mid-July 2013. Such a ratio was 125.0 percent if only BFIs including Nepal Rastra Bank are taken into account. Total assets and liabilities of commercial banks remained at 73.1 percent of GDP followed by Nepal Rastra Bank (31.4 percent), development banks (11.8 percent), finance companies (5.9 percent), MFFIs (2.1 percent), cooperatives (0.9 percent), and NGOs (0.3 percent). Further, such ratio for contractual saving institutions stood at 16.1 percent comprising 8.5 percent of EPF, 2.5 percent of CIT, 5.0 percent of insurance companies and 0.1 percent of postal saving bank.

Table 3.3: Structure of Nepalese Financial System

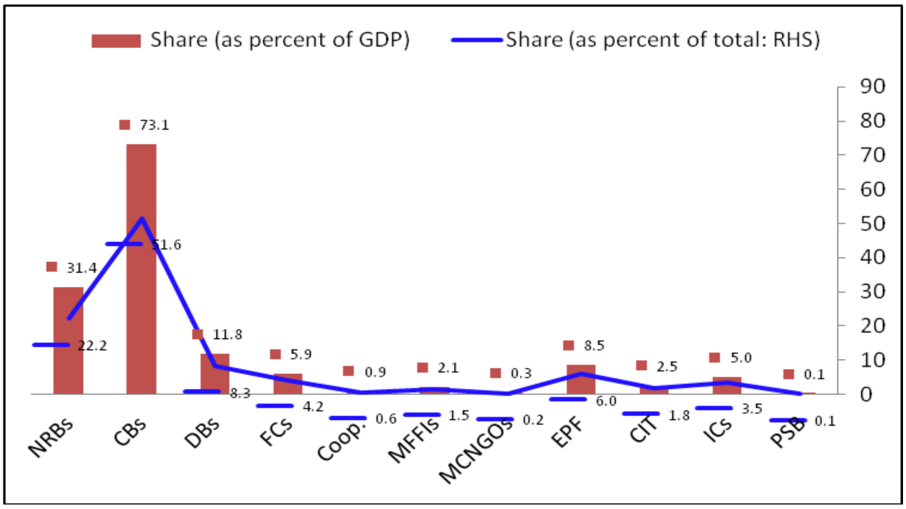
(As of mid-July 2013)

Institutions	Assets/ Liabilities (in million)	Share (percent of total)	Share (percent of GDP)
Bank and Financial Institution	**2135340.7**	**88.6**	**125.5**
NRB	534897.9	22.2	31.4
Commercial Banks	1242881.4	51.6	73.1
Development Banks	199954.8	8.3	11.8
Finance Companies	100856.7	4.2	5.9
Cooperatives	15415.1	0.6	0.9
Micro Finance Financial Institutions	35774.9	1.5	2.1
Micro credit Non-government Organizations	5560	0.2	0.3
Contractual Saving Institutions	**272687.4**	**11.4**	**16.1**
Employees Provident Fund	145283.4	6	8.5
Citizen Investment Trust	42753.6	1.8	2.5
Insurance Companies	84650.4	3.5	5
Postal Saving Bank	**1397.2**	**0.1**	**0.1**
Total	**2410822.5**	**100**	**141.7**

Source: Financial Statistics, NRB and Other Financial Institutions.

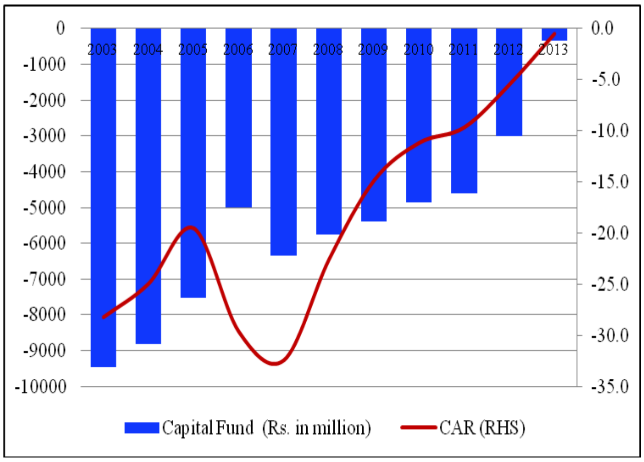
3.9 In terms of total assets and liabilities in mid-July 2013, banks and financial institutions represented 88.6 percent of total financial system of Nepal. Such share was 11.4 percent for the contractual saving institutions. In terms of share in total assets, the commercial banks remained the key player in the financial system occupying 51.6 percent of the system's total assets followed by NRB (22.2 percent), development banks (8.3 percent) and finance companies (4.2 percent). In case of contractual saving institutions, on the same basis, EPF was a dominant institution (6.0 percent), followed by CIT (1.8 percent), insurance companies (3.5 percent) and postal saving banks (0.1 percent) as of mid-July 2013. The share of MFFIS including the saving and credit cooperatives accounted for 2.4 percent including 1.5 percent of MFFIs, 0.2 percent of micro-credit non-government organizations (NGOs) and 0.6 percent of saving and credit cooperatives permitted by NRB undertaking for limited banking transactions.

Figure 3.3: Structure of the Financial System



3.10 The performance of state-owned banks (RBB and NBL) has been gradually improving over the years. The continuous reform process for the last few years has built high public confidence on these institutions. The capital fund as well as the CAR of those two banks reached almost at the prescribed level. However, the reform and restructuring of these institutions should still be accorded top priority for some more time to come so as to make Nepalese financial system capable to counteract the potential shocks and any kind of financial vulnerabilities in future.

Figure 3.4: Capital Fund and CAR of RBB and NBL
(Rs. in million and CAR in percent)



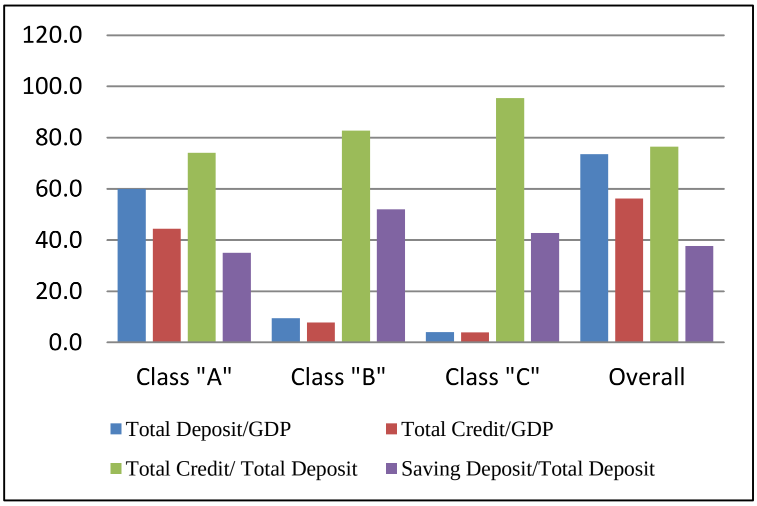
3.11 The major financial instruments used in Nepal are common stocks, debentures, T-bills, and bank loan, among others. Common stock and debentures are traded in NEPSE and OTC markets. NRB issues T-bills on behalf of the government to help liquidity needs of financial institutions. The transaction of bond and equity instruments takes place through Nepal Stock Exchange Ltd. In the current scenario, where market capitalization has been increasing sharply, 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 to as high as 40.0 percent of GDP at the end of 2007 from a mere 17.0 percent of GDP. Market capitalization to GDP reverted to its normal position of about 40.0 percent in mid-July 2013. The size of the government debt market in Nepal has remained small with treasury bills and development bonds (including all types of bond and saving certificates) accounting for 8.1 percent and 4.1 percent of GDP respectively as at mid-July 2013.

Banking System in Nepal

3.12 The banking system in Nepal has expanded over the years because of emergence of new BFIs and expansion of their branches. Most of the financial deepening indicators show an encouraging trend in the overall banking sector development; however, the growth of assets, credit and other indicators are yet to reach a satisfactory position compared to emerging Asian and South Asian countries. As of mid-July 2013, the share of total deposit to GDP reached 73.5 percent comprising 60 percent share of commercial banks, 9.4 percent of development banks and about 4.1 percent of finance companies.

Figure 3.5: Major Banking Sector Indicators

(Share in percent)



3.13 The dominant share of commercial banks on the total deposit indicates over-concentration commercial banks which are mainly urban centric. A scanty share of development banks, finance companies and especially "D" class financial institutions in total deposit to GDP ratio shows the limited outreach to rural area and low income people. Moreover, whatever deposits have been mobilized in rural and underdeveloped area, credit disbursement lags far behind. Although, most of the BFIs have been engaged heavily for the collection of deposit s in rural and semi-urban areas, they have not been extending the credit in the same areas which seems to hamper the economic development and growth of these areas. Such a situation has been of critical concern for the NRB from the perspective of economic growth, employment, creation and optimal use of financial services for development and innovation.

Figure3.6: Total Deposit to Paid-up Capital

(Share in percent)

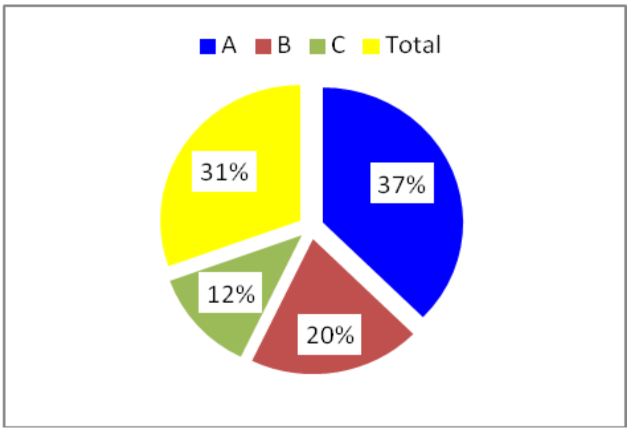
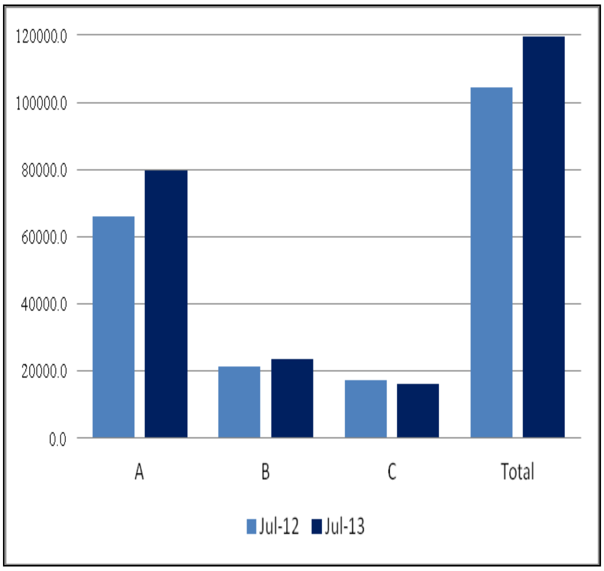


Figure 3.7: Paid-up capital

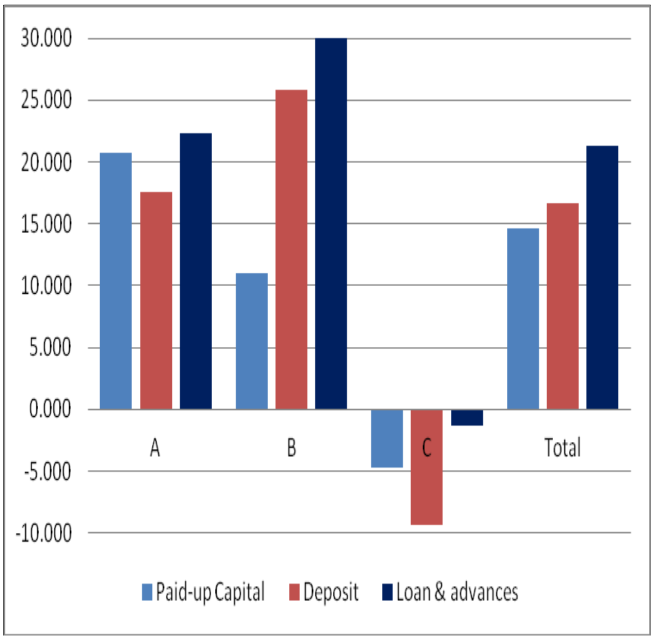
(Rs. in million)



3.14 Similarly, the credit concentration of commercial banks is reflected in total credit to GDP ratio which was just 12.0 percent for "B" and "C" Class financial institutions as of mid-July 2013. From the financial stability point of view, the dominant share of commercial banks in the ratios of both the deposit and credit to GDP compared to other banks and financial institutions could be one of the major threats. There is over concentration of financial activities on commercial banks in Nepal.

3.15 During the review period, deposits continued to become a dominant source of bank funding (78.9 percent) followed by other liabilities (8.9 percent), capital fund (8.3 percent) and borrowings (1.7 percent). This indicates liquidity relaxation in the market on the one hand and a warning on in the other. Likewise in the uses side, loan and advances accounted for the largest share (59.8 percent) followed by investment (13.8 percent), liquid fund (16.4 percent) and others (10.2 percent). In mid-July 2012, such shares were 58.5 percent, 12.3 percent, 17.5 percent and 8.8 percent respectively. As of mid-July 2013, among "A", "B" and "C" class financial institutions, commercial banks occupied 79.9 percent of total assets and liabilities of Nepalese banking system followed by development banks (13.3 percent) and finance companies (6.7 percent). In mid-July 2012, such shares were 77.3 percent, 12.4 percent and 8.2 percent respectively. Of the total deposits of Rs. 1250.06 billion in mid-July 2013, the share of commercial banks was 81.7 percent followed by development banks (12.8 percent) and finance companies (5.5 percent). In mid-July 2012, total deposits of financial system was Rs.1071.39 billion where the share of commercial banks was 81.0 percent, development banks, 11.8 percent and finance

Figure 3.8: Major Balance Sheet Indicators
(Growth in percent)



companies, 7.1 percent. Likewise, on the loans and advances side, the share of commercial banks stood at 79.2 percent, development bank at 13.9 percent and finance companies at about 7.0 percent in mid-July 2013. The share of commercial banks, development banks and finance companies in total loans and advances was 78.5 percent, 12.9 percent, and 8.5 percent respectively in mid-July 2012.

Figure 3.9: Share of BFIs in Deposit Mobilization
(In percent)

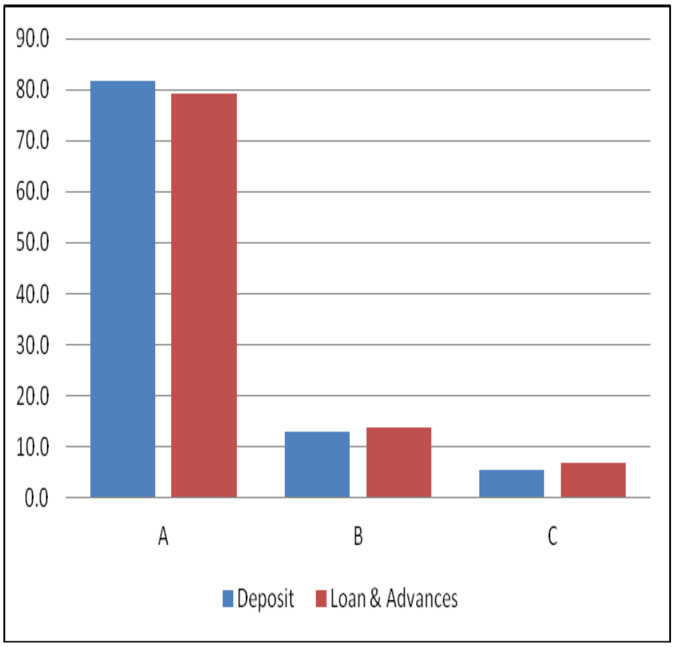
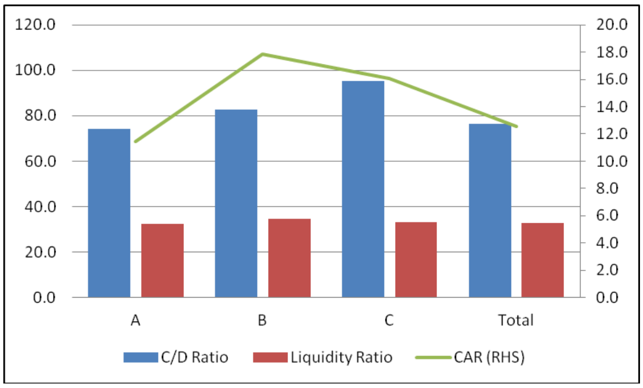


Figure 3.10: Major Regulatory Ratios of BFIs
(In percent)



3.16 The total paid-up capital of the banking system comprising "A", "B" and "C" class financial institutions increased by 14.6 percent to Rs. 119.51 billion as at mid-July 2013 from Rs. 104.3 billion of mid-July 2012. The remarkable growth of paid up capital of "A" class institution by 20.0 percent has made the Nepalese banking system slightly stronger in terms of capital base. Similarly, the merger of financial institutions and increased capital mobilization by banks itself has contributed to the growth in capital base. Moreover, the overall paid up capital of finance companies noted a decline whereas the paid-up capital of development banks increased by 11.1 percent in 2012/13. Deposits and loan and advances of finance companies also declined in the review period. Such a negative performance of finance companies was due to merging of many finance companies into "A" and "B" class financial institutions and weak performance of remaining finance companies owing to decline in public confidence. Increment of capital fund of overall banking sector is the combined effect of the huge increment in capital of commercial banks followed by development banks and declining state of capital of finance companies. Merger could be the strong reason for such increased capital of "A" and "B" class institutions but negative capital growth of "C" class institutions. However, IPOs called by newly established commercial banks and increased capital by them as per their capital plans could be the reason behind actual growth of capital of overall financial sector. Increase in deposits is especially due to increase in saving and fixed deposits of "A" and "B" class BFIs.

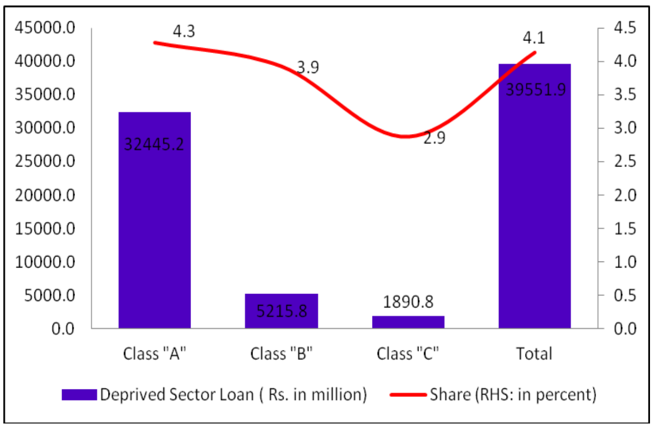
Table 3.4: Major Balance Sheet Indicators

(Rs. in million)

Liabilities	July		January		Percentage change	
	2012	2013	2012	2013	July	Jan
Capital fund	115162.99	131724.33	108783.26	127300.41	14.38	17.02
Borrowings	17805.91	26999.28	20353.27	21426.30	51.63	5.27
Deposits	1071394.11	1250061.98	952724.01	1125005.93	16.68	18.08
Liquid funds	236056.86	259224.93	193635.32	194724.40	9.81	0.56
Investments	137304.43	151339.991	125857.23	144665.80	10.22	14.94
Loan & Advances	779560.9	945698.45	728369.92	879892.38	21.31	20.80

3.17 Total credit to total deposit ratios of Class "B" (82.8 percent) and Class "C" (95.4 percent) financial institutions were higher than that of Class "A" (74.2 percent) financial institutions. NRB has set the limit for 'credit to total deposit ratio' to be at 80.0 percent of

Figure 3.11: Deprived Sector Lending from BFIs

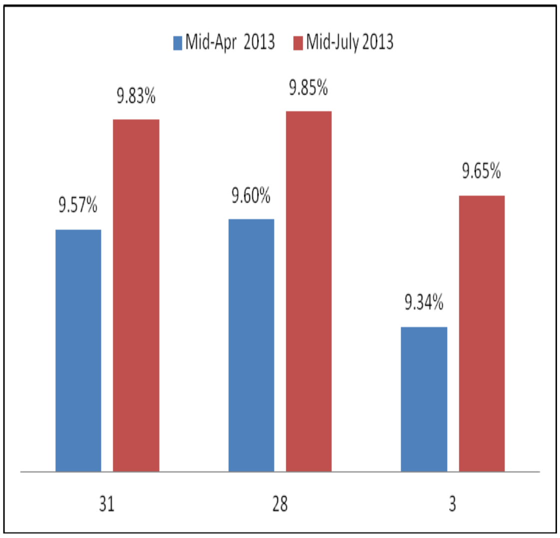


total deposit. Instead of controlling their credit exposure, some finance companies have been aggressively lending which may again create liquidity problem in those institutions. However, as the share of finance companies in both total deposit and credit as percent of GDP is negligible, such a liquidity issues in finance companies do not exert significant impact on the overall economic activities. NRB has been closely monitoring liquidity position of development banks and finance companies. BFIs have also been improving the portion of specified cash and bank balance to total deposit which stood at 16.8 percent as at mid-July 2013.

3.18 BFIs are required to disburse certain percent of their total loan portfolio to the deprived sector as stipulated by the NRB. As of mid-July 2013, such loan from all the BFIs accounted for 4.5 percent of total loan outstanding which remained above the regulatory minimum set by the NRB. With the objective of gradually increasing the size of deprived sector loan in the future for uplifting deprived sectors of the economy, NRB has fixed this rate at 4.5 , 4.0 and 3.5 percent of total loan outstanding for 2013/14 for all "A", "B" and "C class financial institutions.

Figure 3.12: Base Interest Rate of CBs

(In percent)



3.19 The spread rate of deposit and lending stood at 6.8 percent as at mid-July 2013. NRB in the past has implemented various policy measures to narrow down such spread and maintain an optimal spread over the period. Among such policies, publishing of base rate to the general public by the commercial banks within the stipulated time is one of the latest policies. This requirement will gradually be implemented in other BFIs, too since early 2014.

3.20 Though the liquidity in the banking system is gradually increasing since the beginning of mid-July 2012, the base rate of the commercial banks did not fall in mid-July 2013 as expected. It rather increased compared with that in mid-April 2013. The average base rate of commercial banks was 9.4 percent as at mid-January 2013 which increased to 9.8 percent as at mid-July 2013.

3.21 The total number of branches of the BFIs in the Nepalese financial system has been increasing over the period. Over concentration of banks and financial institutions' branches around the urban area is an important concern for NRB. The NRB has pursued the policy to encourage expansion of bank branches of BFIs all across the country. For this, the NRB has suspended without issuing new licenses as the number of banks and financial institutions operating in the economy at present are above the optimal number. To address this problem, NRB has been encouraging merger among the financial institutions.

Figure 3.13: Distribution of BFIs Branches

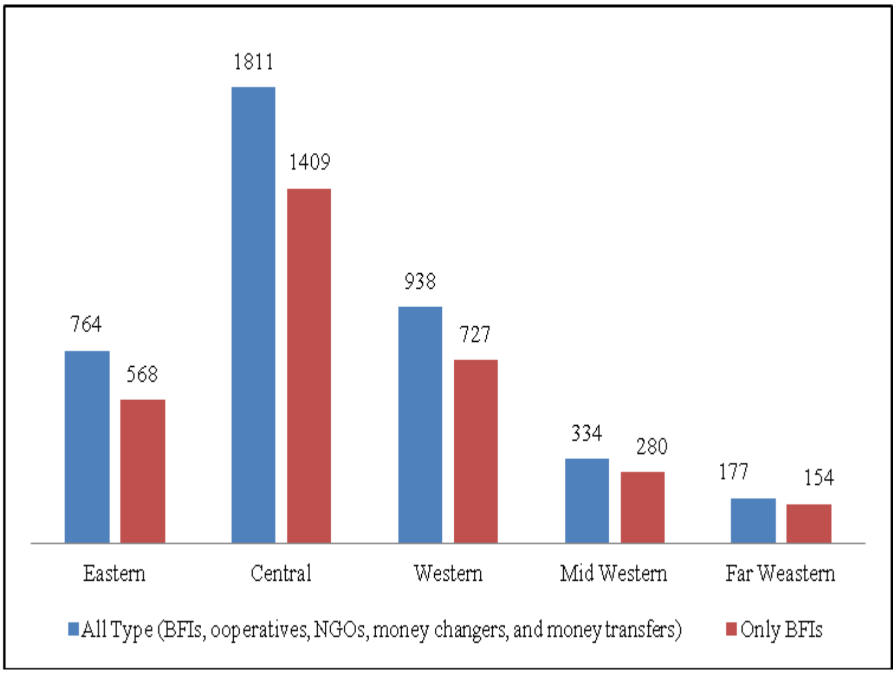
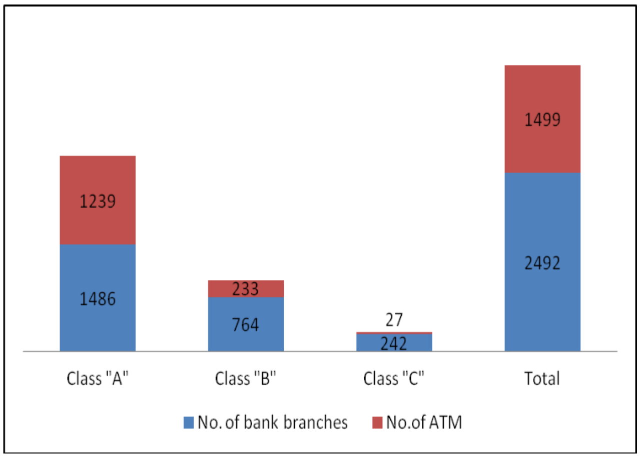


Figure 3.14: No. of Bank Branches and ATM of BFIs

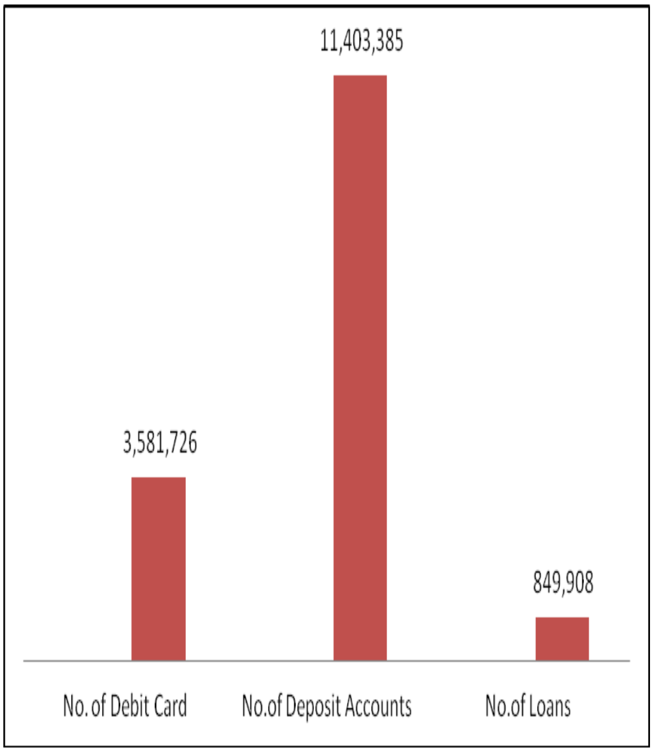


3.22 Branchless banking and mobile banking are the novel innovations introduced in the

Nepalese banking sector with the objective of promoting financial inclusion and easing payment and settlement process. During the review period, 205 branchless banking stations came into operation throughout the country by 12 BFIs benefiting 30,383 customers. The numbers of ATMs, Debit Cards and Credit Cards services provided by different BFIs have been increasing over the years. The NRB, encourages the general public to use modern technology of banking transactions. Total number of ATMs reached 1499 as of mid-July 2013 of which 1239 belonged to “A", 233 to "B" and 27 to" classes of financial intuitions.

3.23 Such terminals of ATMs have significantly contributed to easing payment and settlement process in the country, which is f NRB's one of the major objectives. Similarly, the number of deposits accounts and loans also increased dramatically along with the expansion of financial services in Nepal. As of mid-July 2013, total number of debit card, deposit accounts loan accounts reached 3,581,726 11,403,385 and 849,908 respectively.

Figure 3.15: No. of Deposit Accounts, Loans and Debit Cards



3.24 In mid-July 2013, the major banking sector indicators of BFIs showed an improved situation. The overall share of total deposit to GDP ratio and credit to GDP ratio continued to increase whereas total credit to total deposit ratio slightly declined mainly due from the low growth of credit in the review period. In total deposit, saving deposit contributed a largest share followed by fixed deposit and current deposit. The overall liquidity position of BFIs as measured by shares of cash and bank balances and investment in government securities also remained satisfactory in the review period. These three components supposed around 17.0 percent and 12.0 percent of the total liquidity in the review period respectively.

Table 3.5: Major Indicators of Banking System in Nepal

(In percent)

Financial Ratios	Class "A"		Class "B"		Class "C"		Overall	
	2012	2013	2012	2013	2012	2013	2012	2013
Total Deposit/GDP	55.7	60	8.2	9.4	4.9	4.1	68.8	73.5
Total Credit/GDP	40.0	44.5	6.5	7.8	4.3	3.9	50.7	56.2
Total Credit/ Total Deposit	71.7	74.2	79	82.8	87.6	95.4	73.7	76.5
Cash & Bank Balance/Total Deposit	18.6	16.7	37.2	15.2	35.3	21.4	22	16.8
Investment in Gov. Security/Total Deposit	14.7	14.2	2.9	1.9	3.1	2.5	12.4	12
Total Deposit/Paid up Capital (times)	13.15	12.82	6.00	6.80	4.45	4.24	10.27	10.46

Source: Financial Statistics, BFIRD

Consolidation in Nepalese Banking System

3.25 Although Nepalese banking sector has been growing faster in number, inadequate capital base and lack of professionalism in banking business have been adversely affecting the health and sustainability of the individual institutions and the financial sector as a whole. The merger policy unveiled by NRB at the recent past as an instrument the means of financial sector consolidation is expected to correct the recent troubles such as 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 BFIs.

Table 3.6: No. of Merged, Merging and De-licensed Institutions

BFIs	Merged	Merging	New/ Upgraded/ Renamed	De-licensed
Commercial Banks	3	1	3	1
Development Banks	11	8	13	8
Finance Companies	3	16	2	16
Total	**17**	**25**	**18**	**25**

3.26 The Merger Bylaws, 2011 provides several benefits for the merging financial institutions. As a result, merging process has taken momentum in the Nepalese banking sector. By mid-July 2013, 3 commercial banks, 11 development banks and 3 finance companies have merged. Actual impact of merging process is yet to be felt in the overall banking system in terms of performance and improvement of financial soundness indicators of merged entities. It has been noted that a large number of BFIs have been de-licensed since the merger policy unveiled by the NRB (that is.1 commercial bank, 8 development banks and 16 finance companies.

3.27 NRB believes that merger process will bring substantial benefits to the Nepalese banking system. Merger will create synergy by lowering operating costs, extend the benefits of economies of scope and scale, expansion and diversification of market share. The perceived gains arise out of the belief that a big organization is considered to be efficient in allocating resources—human and capital—to maximize the output gains. Likewise, the empirical studies have illustrated that merger itself could not enhance the success, particularly in terms of access to finance in the rural areas to the targeted groups and communities. Both the merged entity and the regulatory/supervisory authorities require having a close surveillance to enhance and exploit the synergy of the merger.

3.28 Preliminary information shows that after consolidation through merger, BFIs in Nepal have been able to improve their capital base. Merging so far resulted in the lowering of number of 43 BFIs into 18. Further, 19 BFIs (including five RDBs) have obtained the letter of intent (LOI) for merging to create 8 BFIs and 5 BFIs have submitted application for merger into 3 BFIs. Although the merger of BFIs has been moving faster than expected during the review period, the expected outcome in terms of financial soundness and strong institutional capability for the stability of financial system has yet to be realized. Therefore, NRB expects that Nepal's financial system requires an acquisition policy.

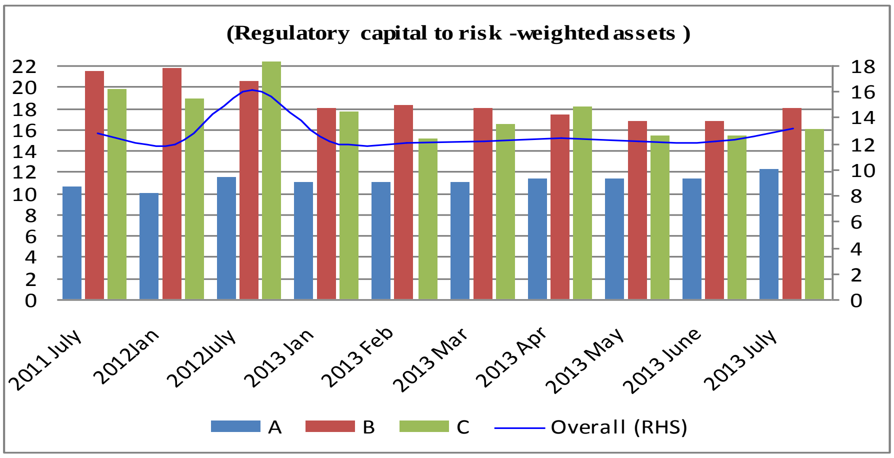
Financial Soundness Indicators (FSI)

Capital Adequacy

3.29 Total capital adequacy ratio (CAR) of the banking system stood at 13.2 percent in mid-July 2013, compared to 11.5 percent a year ago. The improvement was primarily due to progress made by in commercial banks whose capital adequacy ratio rose to 12.3 percent in mid-July 2013 from the level of 11.0 percent in mid-January 2013. It was 11.5 percent in mid-July 2012. Among two state owned banks with negative capital adequacy—NBL and RBB, the improvement in RBB which turned out into positive, attributed in the perfection of capital adequacy ratio of the commercial banks in totality. One of the objectives of NRB since the financial sector reform program in 2002 was the maintenance of financial stability, principally, by improving the capital of these two ailing state owned banks at that time.

Figure 3.16: Capital Adequacy Ratios

(In percent)



3.30 In contrast, the capital adequacy ratios of "B" and "C" class institutions have been eroding recently. In mid-July 2013, the figure remained at 17.8 percent and 16.1 percent respectively for "B" and "C" class institutions though higher than the required minimum capital adequacy ratio. It was 20.5 percent and 23.1 percent respectively in mid-July 2012. The deteriorating capital adequacy ratio for "B" and "C" class institutions was due to negative capital, particularly, of problematic banks and finance companies in the review period. However the overall CAR of "B" and "C" class financial institutions was still above the standard requirements set by NRB which indicates that financial sector is still well capitalized.

3.31 Further, the core capital ratio, as the indicator that reflects the of high quality of capital of financial institutions, stood at 10.7 percent, 17.1 percent and 15.3 percent in mid-July 2013 respectively for "A", "B" and "C" class financial institutions compared to 10.0 percent, 19.6 percent and 22.3 percent respectively in mid-July 2012.

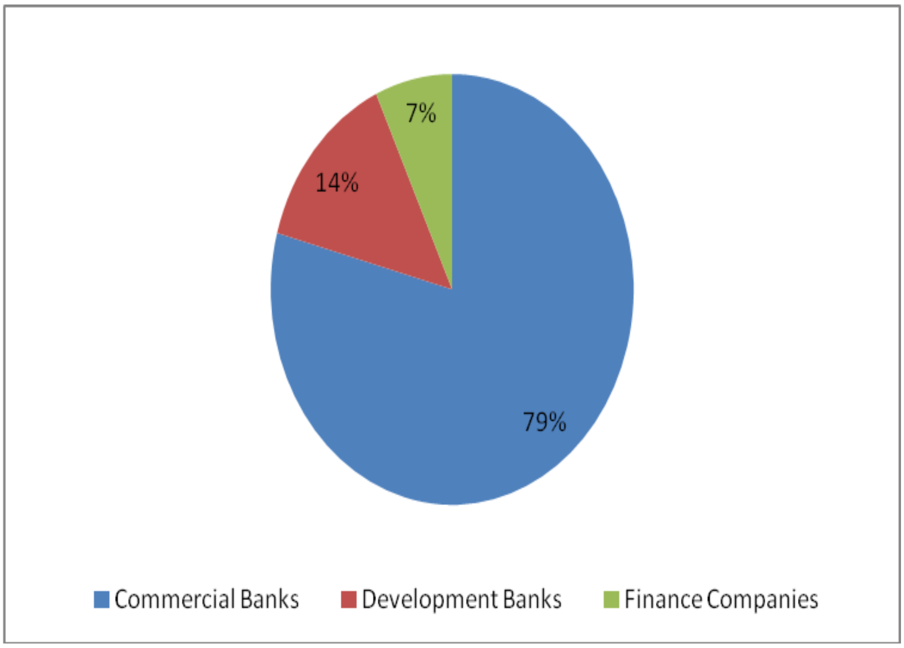
Assets Quality

3.32 The total NPL ratio of BFIs declined substantially to 3.8 percent in mid-July 2013, from the level of 4.4 percent in mid-January 2013 but slightly increased as compared to 3.6 percent in mid-July 2012. The total NPL of finance companies was the highest at 16.0 percent followed by development banks (4.5 percent) and commercial banks (2.6 percent) in mid-July 2013. On the other hand, the average of total non-performing loan (net of provision) to capital for BFIs reached 5.4 percent during the review period comprising 4.1 percent, 5.8 percent and 4.3 percent of "A", "B" and "C" class institutions respectively.

3.33 Regarding the exposure of BFIs in terms of sector wise credit, wholesalers and retailers sectors received the highest volume of loan (20.7 percent) followed by the agricultural, forestry and beverage production related sector (19.9 percent). Finance, insurance and real estate sectors received 8.8 percent of the total credit. Though the majority of the people depend on agriculture for their livelihood and contribution of agriculture to GDP is more than one third, yet this sector formed merely 4.1 percent of total loan in the review period. However, a positive increment of credit in manufacturing sector by about 20.0 percent in mid- July 2013 compared to an increase of 5.9 percent in mid-July 2012, can be considered a favorable development.

Figure 3.17: Credit Flows of BFIs

(Share in percent)

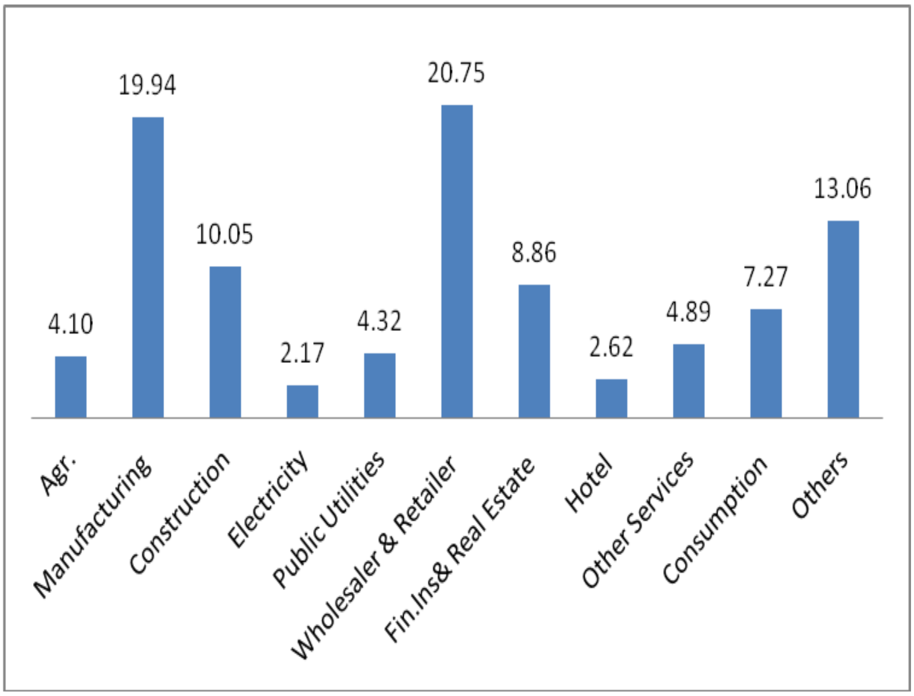


3.34 Despite issues raised by industrialists and manufacturers about the adverse investment friendly climate, a balanced increase in loan disbursement towards manufacturing sector signals positively for the economic growth, income and employment generation as well as demand for further credit to the productive sectors. Consumption loans increased to 7.3 percent of total loan portfolio. This figure was 6.0 percent in mid-July 2012 and 6.7 percent in mid-January 2013. The continuous increase seen in consumption loan of the BFIs supported by remittances indicates that remittance income has been directed to the unproductive sectors. This is resulting in high inflation and deteriorating of trade balance despite of a number of policy measures undertaken to control loans floated towards such sectors. Others sector constituted around 13.0 percent of total loan portfolio. However, the breakdown of details is not available in the reporting format. This might have allowed BFIs a sufficient room for bandaging the loan account tactfully.

3.35 Despite the apparent sluggishness in real sector, loan and advances securitized by current and fixed real assets such as land and building have increased to almost 85.8 percent in mid-July 2013 from 70.0 percent in mid-January 2013, thus increasing default risk in case of adverse repercussion on the value of such securities. As most of the BFIs still do not have strict, fair and periodic revaluation policy and practice,

Figure 3.18: Major Areas of Credit Distribution

(Share in percent)

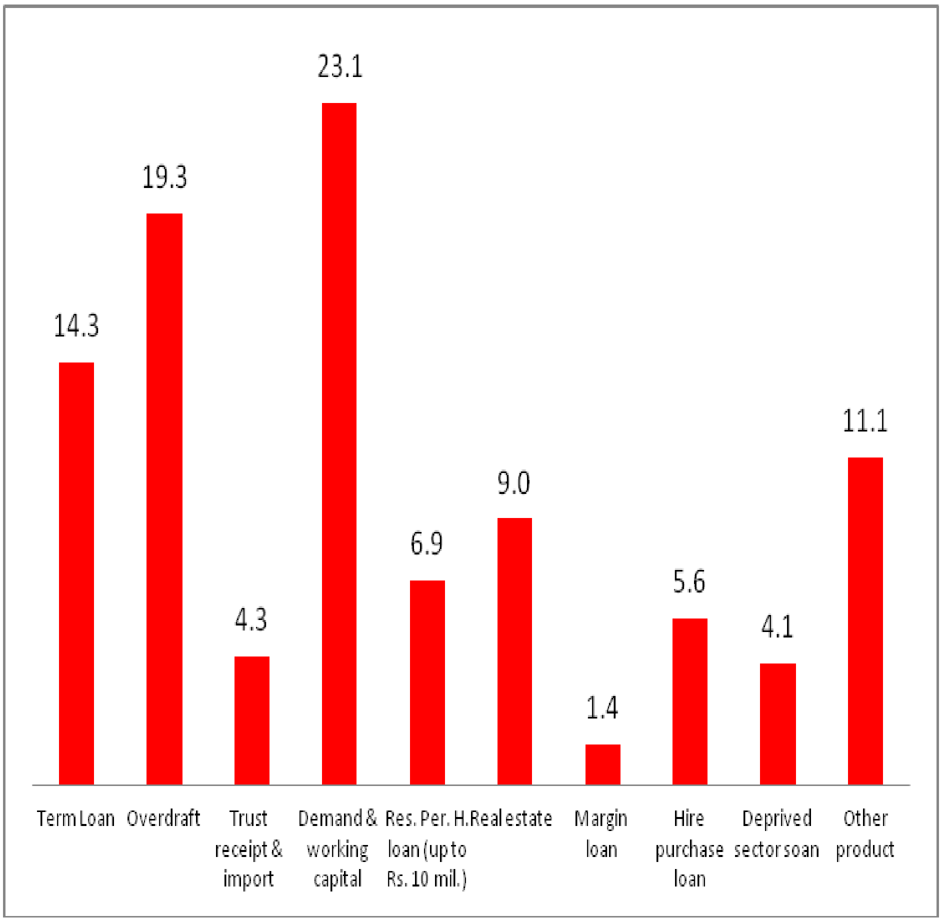


deterioration in the value of such securities may adversely affect the quality of credit and hence lead to increase in NPL as well as decrease in profitability resulting to liquidity shortage, among others.

3.36 Regarding the type of loan product, demand and working capital loan forms around 23.06 percent of total loan and advances followed by overdraft loan (19.3 percent), term loan (14.3 percent), real estate loan (15.9 percent including both the housing with 6.9 percent and real estate with 9.0 percent), hire purchase loan (5.6 percent), trust receipt & import loan (4.3 percent) and other (11.1 percent) as at mid-July 2013. In the

Figure 3.19: Major Product-wise Credit Distribution

(Share in percent)



context, where 85.8 percent of total loan is securitized by current or fixed real assets such as land and buildings which indirectly expose the BFIs to a single sector, such a big portion of direct/indirect exposure to this sector with primary or secondary collateral may create risk for the stability of financial system that originates from the over concentration of excessive credit to such single sectors, particularly as a collateral of land and building.

3.37 Over exposure in a single sector can further aggravate the situation as real estate prices are yet to recover. The slowdown in transactions may pose stress to the banking sector at any time. However, a positive demand for loan from the private sectors despite fragile economic conditions in 2012/2013 can help the banking industries to improve its credit quality and profitability.

Table 3.7: Credit Distribution by Sector, Product and Collateral

(Share in percent, as of mid-July 2013)

Categories of Credit	CBs	DBs	FCs
Sector Wise			
Agricultural and Forest Related	79.27	15.92	4.81
Wholesaler & Retailer	81.48	13.65	4.87
Manufacturing (Producing) Related	92.70	4.82	2.48
Construction	74.65	15.87	9.48
Finance, Insurance and Real Estate	78.10	14.87	7.03
Product Wise			
Term Loan	82.44	11.04	6.52
Overdraft	81.41	18.59	0.00
Trust Receipt Loan / Import Loan	100.00	0.00	0.00
Demand & Other Working Capital Loan	84.12	8.48	7.40
Res. Per. H. Loan (Up to Rs. 10 mil.)	71.37	18.59	10.04
Real Estate Loan	73.25	14.95	11.80
Collateral Wise			
Fixed Assets	66.60	91.53	84.57
Current Assets	18.26	0.30	0.61

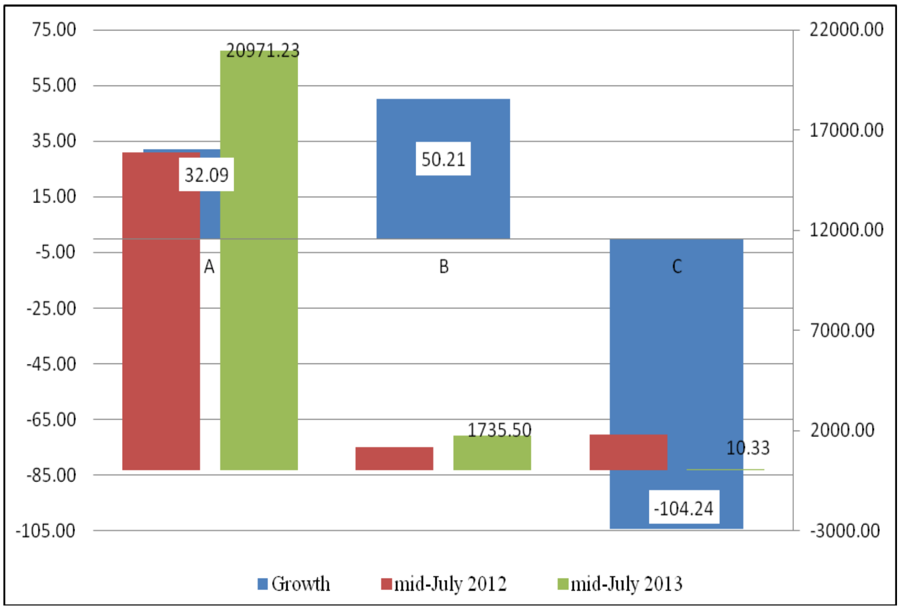
Source: Monthly Financial Statistics, BFIRD, NRB

Profitability

3.38 Despite sluggish economic growth, high inflation and weak investment demand, BFIs have been earning substantial profit during the review period. This situation has raised the concern for sources of profit of BFIs. As shown in figure 3.20, profitability of commercial banks increased by 32.0 percent and that of development banks by 50.2 percent. However, finance companies experienced a decline of profit by 104.2 percent during the review period. Amidst unfavorable situation of low level of credit growth, decline in real estate price and transactions, excess liquidity and growing competition, such a rise in profits of commercial banks and development banks seems to have been generated through high interest rate spread in the review period.

Figure 3.20: Growth in Profitability of BFIs

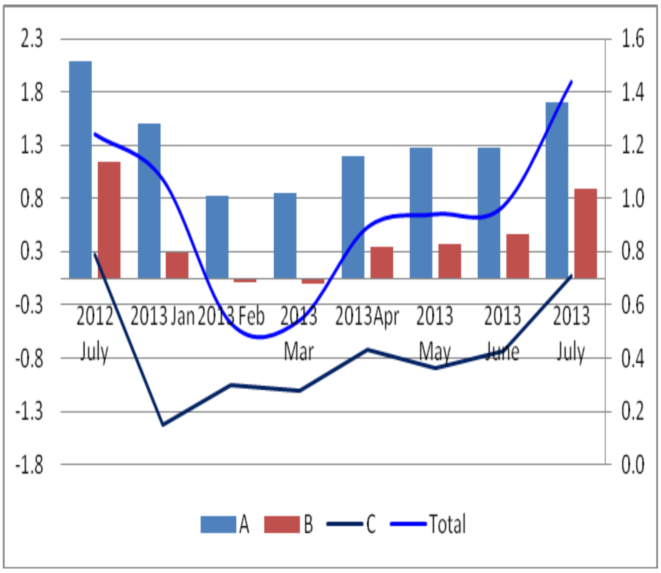
In Rs. in million (RHS) and percent (LHS)



3.39 The position of profitability can also be analyzed through return on assets (ROA) and return on equity (ROE). The ROA is a comprehensive measure of bank's overall performance from an accounting perspective. In mid-July 2013, total ROA, on an average, for all "A", "B" and "C" class institutions stood at 1.44 percent compared to 1.07 percent in mid-Jan 2013 and 1.24 percent in mid-July 2012. Similarly, ROE stood at 13.85 percent in mid-July 2013 compared to 10.88 percent in

Figure 3.21: Return on Assets

(In percent)



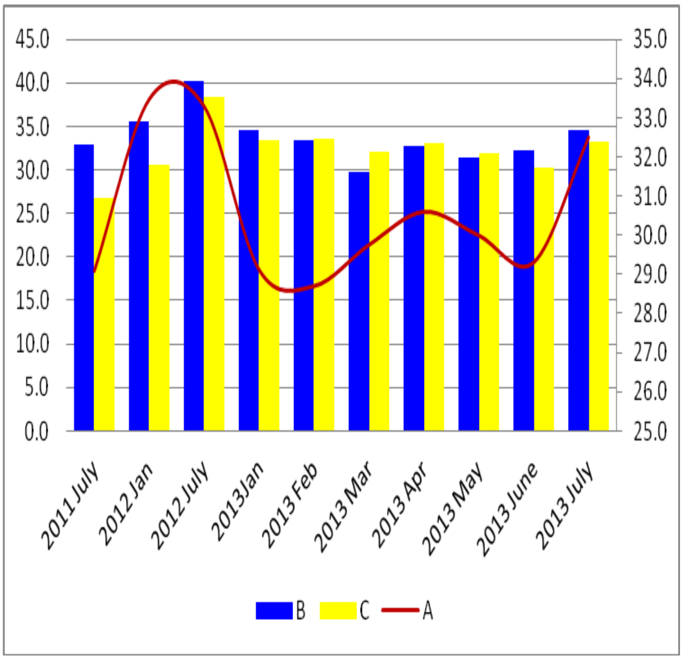
mid-Jan 2013 and 11.35 percent in mid-July 2012. The ROA and ROE that deteriorated throughout the fiscal year has managed to improve, particularly of "C" class institutions in the most recent months of the review period. However, performance of finance companies remained very weak, for example in mid-July 2013, ROA of "A", "B" and "C" class institutions were recorded at 1.65 percent, 0.84 percent and 0.02 percent respectively. Likewise, ROE was recorded at 16.89 percent for "A "class institutions and 6.44 percent and 0.20 percent for "B" and "C" class institutions respectively.

3.40 The interest margins to gross income and non-interest expenses to gross income stood at 76.2 percent and 45.2 percent respectively in mid-July 2013. The interest margin to gross income ratio of total banking sector had been improving over the periods. Among BFIs, the interest margin to gross income ratio and non-interest expenses to gross income ratio of "A" class institutions had improved to 75.9 percent and 44.2 percent respectively as compared to that of mid-July 2012 and mid-January 2013. In contrast, these ratios of "B" and "C" class institutions had fluctuated throughout the period

Liquidity

3.41 In contrast to severe liquidity crisis observed in 2010/11, Nepalese BFIs have been in now comfortable liquidity position. The major policy rates (including the 91 day T-bills rate) and interbank rates remained low during the review period. A number of factors contributed to ease liquidity situation. The various policy measures initiated by the NRB to resolve the liquidity problems along with the surplus in balance of payments situation, improvement in foreign exchange

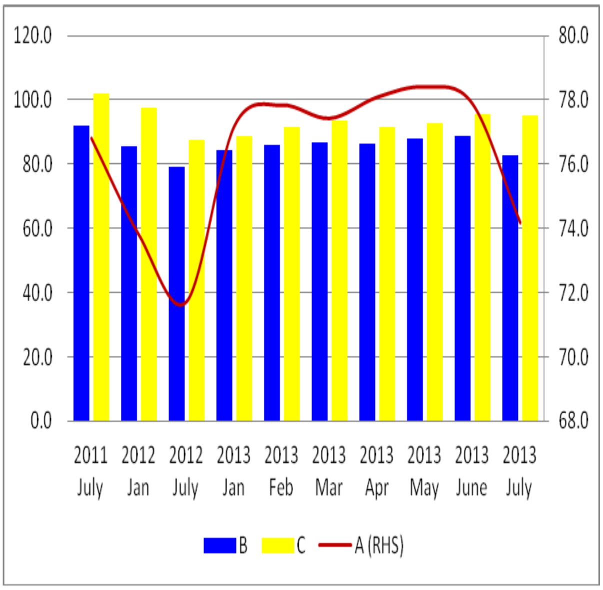
Figure 3.22: Liquid Assets to Total Deposit Ratios
(In percent)



reserves with export earnings and the increase in remittances, depreciation of exchange rate with US Dollar and increased government expenditure, among others contributed to an increase in domestic deposits in 2012/13, and thereby improving the liquidity position. Total liquid asset to deposit ratio of BFIs stood at 32.8 percent in mid-July 2013. The liquid asset to deposit ratio for "A", "B" and "C" class institutions was recorded at 32.5 percent, 34.6 percent and 33.2 percent respectively, all stood above the regulatory requirement.

3.42 As at mid-July 2013, the credit to deposit ratio of BFIs stood at 76.5 percent. The credit to deposit ratios for "A", "B" and "C" class institutions stood at 74.2 percent, 82.8 percent and 95.4 percent respectively. Such ratios were 71.7 percent, 79.0 percent and 87.6 percent for "A", "B" and "C" class "BFIs respectively in mid-July 2012. The increased liquid assets to deposit ratio and decreased credit to deposit ratio of BFIs indicate that BFIs, especially commercial banks have maintained excess liquidity with them. Despite the liquidity pressure being moderated at present, liquidity risk is likely to hit banks at any time, as they are 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.

Figure 3.23: Credit to Deposit Ratios
(In percent)



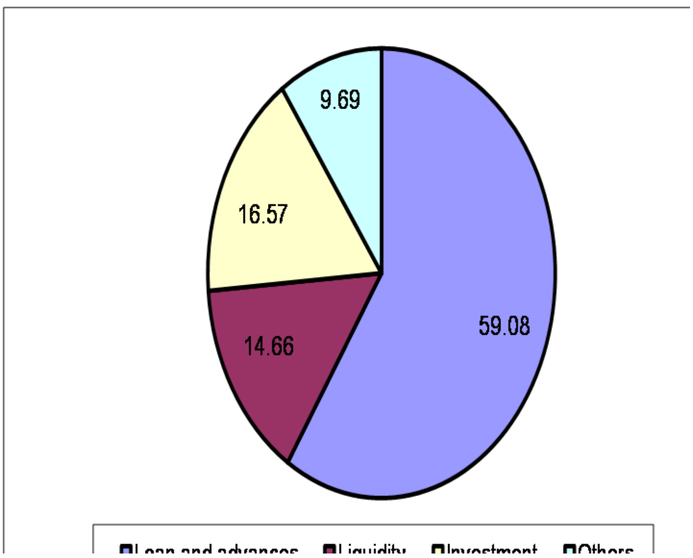
Commercial Banks

3.43 Commercial banks are the key players in Nepalese financial system. Though relatively small in number, compared to "B" and "C" Class "BFIs, they have the widest branch network in the country. They occupy dominant share in total size of banking and non-banking financial institutions and in their major balance sheet items as well. They significantly influence the financial stability index of the country, and hence, are very important section of Nepalese financial sector requiring high level of prudence.

3.44 The commercial banks that numbered 32 till mid-January 2013 declined to 31 after the merger. The total number of commercial bank branches increased to 1486 in mid-July, 2013 from 1425 in mid-July 2012 of this branch network 506 belonged to state owned banks and 980 to the private banks. Out of total commercial banks branches, 457 (30.7 percent) are situated in Kathmandu, of which 53 (10.5 percent of state owned bank branches) branches belonged to state owned banks and 404 (41.2 percent of private commercial bank branches) branches to the private banks. Among the total bank branches, 49.5 percent are concentrated in the Central Development Region followed by Eastern Development Region (18.3 percent), Western Development Region (17.6 percent), Mid-Western Development Region (8.7 percent) and Far-Western Development Region (5.8 percent). The over concentration of bank branches in the Central Development Region especially in Kathmandu Valley indicates, the lopsided access to financial service in favor to the capital city.

Figure 3.24: Assets Composition of CBs

(Share in percent)



3.45 The total assets and liabilities of commercial banks increased by 18.8 percent to Rs. 1267 billion in mid-July 2013 from Rs. 1067 billion in mid-July 2012. It was an increment of 11.7 percent compared to mid-Jan 2013. Last year it had increased by a much higher magnitude of 21.5 percent. Total assets and liabilities of commercial banks occupied about 80.0 percent of total assets and liabilities of BFIs. Loan and advances occupied a big chunk that is of 59.1 percent in total assets amounting to Rs. 748 billion. Similarly, share of liquid funds and investment in total assets stood at 14.7 percent and 16.6

percent respectively in mid-July 2013 compared to 15.2 percent and about 17.0 percent respectively in mid-July 2012. Similarly, the share of commercial banks in financial sector in terms of borrowings, liquid funds and investments constituted 84.4 percent, 71.7 percent and 96.8 percent respectively in mid-July 2013

Table 3.8: Composition of Total Assets of CBs

(Rs. in million and share in percent)

Particular	Mid-Jul 2013		Mid-Jan 2013		Mid-July 2012		Mid-July 2011		Mid-Jul 2010	
	Amount	Share	Amount	Share	Amount	Share	Amount	Share	Amount	Share
Loan and advances	748,753.66	59.08	691,698.12	60.95	612,322.64	57.38	522,853.34	59.53	467,107.25	59.33
Liquidity	185,758.20	14.66	125,259.63	11.04	161,785.49	15.16	98,071.74	11.17	102,748.96	13.05
Investment	209,926.28	16.57	196,649.50	17.33	181,272.66	16.99	149,557.36	17.03	134,041.09	17.03
Others	122,811.05	9.69	121,224.90	10.68	111,715.81	10.47	107,882.08	12.28	83,403.65	10.59
Total Assets	1,267,249.16	100.00	1,134,832.14	100.00	1,067,096.59	100.00	878,364.52	100.00	787,300.95	100.00

3.46 In the review period, the total investment including on shares and other investment of commercial banks increased by 15.8 percent and liquid fund increased by 14.8 percent compared to the respective growth rate of 21.2 percent and 64.9 percent in mid-July 2012. Others component grew by 9.9 percent in the review year in comparison to 10.5 percent growth on previous year. Because of improved liquidity position from mid-July 2012 onwards, commercial banks held excess liquidity and focused on increasing their loans and advances. Consequently, loans and advances grew by 22.3 percent in 2012/13. However, the share of loan and advances in the productive sectors is still minimal.

3.47 In terms of sector wise classification of loans, commercial banks provided largest share of loans (23.3 percent of total loan) to manufacturing (production) related sectors followed by wholesaler and retailer sector (21.3 percent). Similarly, construction sector received 9.5 percent of total loan and finance insurance & real estate sector received 8.73 percent. Loan extended to agricultural, forestry and beverage production sector has remained very disappointing, only 4.1 percent of total loan despite being categorized under priority sector.

3.48 Regarding the product-wise loan classification, short term loans such as demand and working capital loan constituted the highest share 24.5 percent of total loans. Similarly, 19.8 percent and 14.8 percent of loans was extended to overdraft and term loan products respectively. As the real estate business has not yet improved and has been a less attractive sector for the banks now to invest, the banks are found to diminish their exposure in real estate sector. Exposure of commercial banks to real estate sector decreased below 9.0 percent of total gross loans after excluding housing loans up to Rs. 10 million compared to 11.2 percent in mid-July 2012. Such an exposure to real estate sector was far below the limit (25.0 percent of total loans) set by NRB. However, exposure of some banks to real estate sector still remained high.

3.49 With regard to collateral wise loan classification, 84.9 percent of total loans are backed up by properties, 66 percent of which are fixed properties such as land and buildings. Such an over concentration of collaterals into real estate properties together with significant exposure of lending in real estate sector can create the default risk in case of deterioration in values of such properties. Deterioration in the values of real estate affects the quality of banks' credit, and thus may increase the NPL. Considering the loan portfolio of the banks, increasing trend in long term loans and declining position in real estate loans of the commercial banks in recent time appears to signal that more loans have started to flow towards the productive sectors most probably to projects financing such as in hydropower sector. This is what is required for contributing to economic growth in the future.

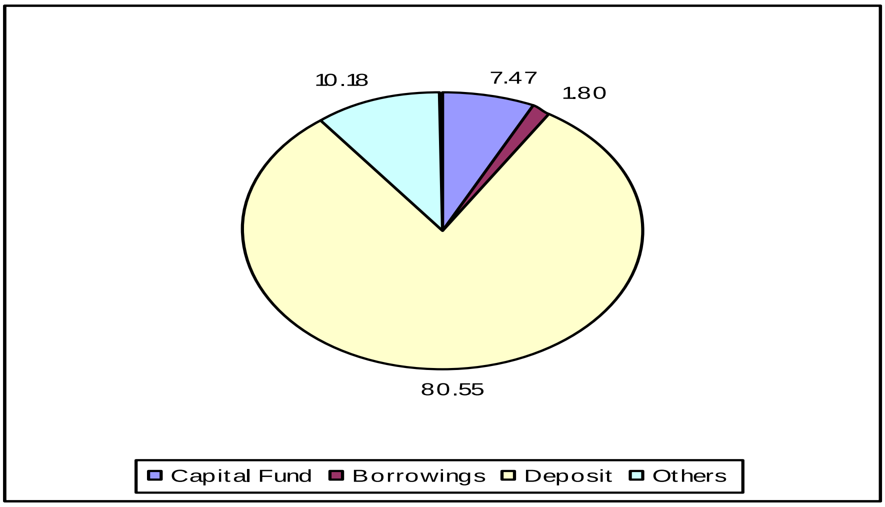
3.50 While there had been 21.3 percent increment in loan and advances by the BFIs in mid-July 2013, the GDP growth rate is in declining state which somewhere indicates that lending is directly or indirectly forwarded to unproductive sectors. A positive relation between credit growth and GDP growth is yet to be established. The higher credit growth in the review period but less than 4.0 percent of GDP growth might have occurred because most of the banks have flowed credit to unproductive sectors. Considering this situation and with an objective to promote lendings to in productive sectors of the economy, NRB has been providing refinancing facility to BFIs under headings such as 'General Refinance' and 'Export Refinance' with the maturity period of six months against the collateral of good loans. In mid-July 2013, the general refinance loan extended to seven "A" class financial institutions increased by 27.4 percent to Rs. 2.74 billion compared to Rs. 2.15 billion in mid-July 2012. Out of total general refinance loan provided to such institutions, Rs. 1.5 billion remained outstanding during the review period. Likewise, export refinance loan of Rs. 7.13 million was provided by the NRB to six "A" class financial institutions in the review period.

3.51 The NPA level of commercial banks had been gradually declining also in the review period considering the growth of both the loan and advances and deposit, it is noted that old banks are gradually losing their market share, and new banks are moving forward aggressively in terms of both deposit mobilization and expansion of credit.

3.52 Regarding the structure of liabilities, deposit occupied a dominant share of 80.5 percent followed by other liabilities (10.2 percent), capital fund (7.5 percent) and borrowings (1.8 percent) in mid-July 2013. Of these components, total deposits of commercial banks increased by 17.6 percent in mid-July 2013 compared to a growth of 26.2

Figure 3.25: Liabilities Composition of CBs

(Share in percent)



percent in mid-July 2012. Saving deposits accounted for 35.1 percent of total deposits followed by fixed deposits (33.8 percent), call deposits (19.2 percent), current deposits (10.6 percent) and other deposits (1.2 percent).

3.53 In the review period, the borrowings of commercial banks increased by 46.9 percent to Rs. 22.79 billion in contrast to a decline by 37.6 percent in the same period of the previous year. Compared to a year ago, in mid-July 2013, the capital fund of commercial banks grew by 22.7 percent to Rs. 94.66 billion. A number of reasons led to such drastic growth. These include significant improvement in capital fund of two state owned banks that is Nepal Bank Limited and Rastriya Banijya Bank, increment in capital by commercial banks as per their capital plan to meet new capital base set by NRB, capital increase after merger of commercial banks with "A" class "B class "and "C class" BFIs and IPOs called by commercial banks. Similarly, debentures and mutual funds issued by some commercial banks further added to tier-2 capital thus contributed in increasing the capital fund of commercial banks in the review period.

Table 3.9: Composition of Total Liabilities of CBs

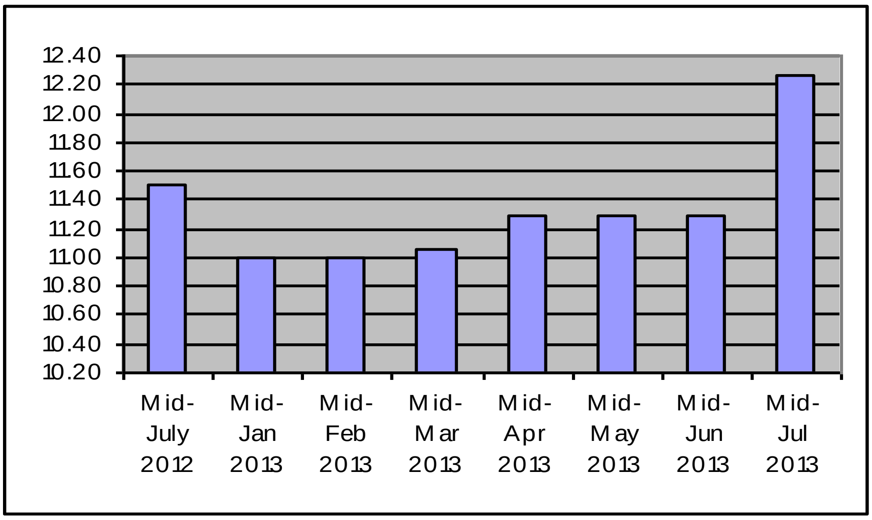
(Rs. in million and share in percent)

Particular	Mid-Jul 2013		Mid-Jan 2013		Mid-July 2012		Mid-July 2011		Mid-Jul 2010	
	Amount	Share %	Amount	Share %	Amount	Share %	Amount	Share %	Amount	Share %
Capital Fund	94660.68	7.47	88909.93	7.83	77142.57	7.23	59064.45	6.72	40719.83	5.17
Borrowings	22792.86	1.80	18360.43	1.62	15507.22	1.45	24852.84	2.83	19783.87	2.51
Deposit	1020830.77	80.55	905867.71	79.82	867978.25	81.34	687587.89	78.28	630880.84	80.13
Others	128,964.83	10.18	121694.10	10.72	106468.57	9.98	106859.34	12.17	95916.41	12.18
Total Assets	1,267,249.13	100.00	1134832.17	100.00	1067096.61	100.00	878364.52	100.00	787300.95	100.00

3.54 The loan loss provisioning increased by 15.8 percent in the review period, reflecting a slow recovery of real estate loans from the market. However, the capital adequacy ratio of commercial banks improved to 12.3 percent compared with 11.5 percent in

Figure 3.26: Capital Adequacy Ratio of CBs

(In percent)



mid-July 2012. The capital adequacy ratio of Rastriya Banijya Bank, one of the two state owned banks with negative ratio, turned positive. For other "A" class and "B" class BFIs, the ratio remained above the regulatory minimum benchmark of 10.0 percent.

3.55 Non-performing loan to total gross loan decreased to 2.6 percent in mid-July 2013. The same ratio was 3.2 percent in mid-January 2013 and 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 4.1 percent in the review period. Such a decline in NPL reflects the improvement in assets quality of commercial banks in the review period.

3.56 ROA of commercial banks stood at 1.65 in mid-July 2013. Such return was 2.04 percent in mid-July 2012 and 1.46 percent in mid-January 2013. Similarly, ROE of commercial banks stood at 16.89 percent in mid-July 2013, compared to 22.44 percent in mid-July 2012 and 15.94 percent in mid-January 2013. As a result of reduced interest rate on deposits (from 6.17 percent in mid-July 2012 to 5.25 percent in mid-July 2013), the interest expenses of banks decreased to Rs. 46.39 billion during the review period while interest income increased to Rs. 90.92 billion in mid-July 2013 from Rs. 85.44 billion in mid-July 2012. Net profit of commercial banks stood at Rs. 20.97 billion in mid-July 2013. The net profit of banks was Rs. 15.88 billion in same period of previous year. Net interest income dominates banks' operating profit. Along with credit growth, a higher interest spread also contributed to increase in net interest income of commercial banks in the review period.

3.57 Commercial banks have started to publish base rate since mid-January 2013 as per the guidelines of the NRB. In addition, they have also started to publish weighted interest rate spread, which shows that they have still high interest rate spread. The weighted interest spread remained at 6.8 percent in mid-July 2013. Such a high interest rate spread was a major factor behind the increase of net profit of commercial banks by 32.0 percent. Such a rise in profit does not match with the growth of economy. On the other hand, banks profitability was also due to the significant growth in credit and decrease in cost of fund and increase in interest income. Besides, increase in commission based income and, decrease in amount of loan written off have also contributed slightly to increase in net profit in the review period.

3.58 The liquid asset to deposit ratio of commercial banks was recorded at 32.5 percent in mid-July 2013, which is for above the regulatory requirement of 20.0 percent. This ratio was 33.3 percent in mid-July 2012. Similarly, the liquid asset to total asset ratio of commercial banks stood at 26.2 percent in mid-July 2013, compared to 27.1 percent in mid-July 2012. The credit to deposit ratio of commercial banks stood at 74.2 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 80.0 percent, some banks are found to have taken steps to maintain required ratio for a very short span of time, whereas some banks are found to have maintained such ratio fairly below the limit. This indicates that those banks that maintained the ratio fairly below the limit, seem unable to run with full capacity due to lack of investment opportunities in the market.

3.59 The commercial banks in Nepal have a very crucial role to play in terms of maintaining financial stability as well as contributing to development and growth. Although the overall financial soundness indicators and stress testing result show the satisfactory situation of commercial banks, which hold almost 80.0 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, slow implementation of big development projects, and delayed decision-making practices, among others, have been piling up risk on the banking sector and ultimately upon the financial stability of the country. The reform measures adopted by the NRB at present particularly focusing on the consolidation process have yielded some positive outcomes on financial stability situation of the 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 the ever greening of loans of the banking sector for the achievement of desired objective of financial stability in Nepal. Likewise, problem bank resolution, a recent initiative, which the NRB is going to implement soon, would help in designing the framework and resolving the problematic BFIs and implementing the step by step resolution process as per necessity. Hence, this process will identify additional procedures and best practices regarding problematic bank resolutions and prepare itself to act whenever situation warrants. Besides, NRB is working on designing the prompt corrective actions linked to liquidity shortfall and excessive NPA of the BFIs.

Stress Testing of Commercial Banks

3.60 The NRB has introduced stress testing system of the banks since 2011/12. It has already issued guidelines consisting of simple methods of stress testing process. Stress testing is a forward looking risk management tool adopted by NRB, which has been applied to "A" class financial institutions for the first time. NRB has taken the policy of extending stress testing practice gradually in both the "B" and "C" class financial institutions. 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. They 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-July 2013, the stress testing results of 31 commercial banks on various shocks are examined below.

Credit Shock

3.61 There is growing credit risk in commercial banks. The stress testing results of commercial banks as of mid-July 2013 revealed that a standard credit shock would push the capital adequacy ratio of 27 out of total 31 commercial banks below the regulatory minimum benchmark of 10.0 percent. The number of such banks was 22 in mid-July 2012 and 28 in mid-January 2013. Stress testing was conducted based on different scenarios such as deterioration of various categories of loan to substandard, doubtful and loss loans, among others. It has been found that in case if 25.0 percent of performing loans of real estate and housing sector is directly downgraded to loss loans, capital adequacy ratio of 11 commercial banks will come below the required level of 10.0 percent, compared to 8 banks in mid-July 2012 and 13 banks in mid-Jan 2013. Thus, the results showed that the risks of exposure to real estate and housing sector were still higher than that in mid-July 2012.

3.62 Likewise, if top 2 large exposures (loans) were downgraded from performing to substandard category, the capital adequacy ratio of 2 commercial banks would fall below the required level. The overall credit shock scenario revealed that banks credit quality has not improved as expected despite the various measures taken during the review period. Furthermore, banks are likely to face a difficult situation in case of slowdown in recovery, downgrade of loans to loss category of NPLs and increase in provisioning.

Liquidity Shock

3.63 Though the liquid assets to deposit ratio of the total banking system as well as the commercial banks improved during the review period, the stress test results found that more than half of the commercial banks may turn into a vulnerable situation in case of withdrawal of deposits by 15.0 percent or more. Those banks having significant portion of institutional deposits may face liquidity strain in case of withdrawal of their deposits by their top institutional depositors. The number of banks that may turn illiquid after withdrawal of deposit by 2.0 and 5.0 percent for first two consecutive days and 10.0 percent for 3 consecutive days has reduced significantly to 5 in mid-July 2013 from 19 in mid-January 2013. Such number was 5 in mid-July 2012. Standard withdrawal shock is the withdrawal of customer deposits by 2.0 percent and 5.0 percent in the first two days and 10.0 percent each in the following three consecutive days. The liquidity situation improved since mid-January 2013, but not significantly compared to mid-July 2012.

3.64 Similarly, if there was a withdrawal of deposit by 5.0 percent, 10.0 percent and 15.0 percent, the number of banks whose liquid asset to deposit ratio would fall below the regulatory minimum of 20.0 percent have stood at 1, 4 and 16 in mid-July 2013. The numbers of such banks were 7, 20 and 26 respectively in mid-January 2013 and 0, 6 and 14 respectively in mid-July 2012. With the shock of withdrawal of deposits by top 3 and 5 institutional depositors, liquid assets to deposit ratio of 14 and 21 commercial banks would be below 20.0 percent in mid-July 2013. In mid-January 2013, the numbers of such banks were 21 and 25 compared to 15 and 21 in mid-July 2012. These findings of liquidity shock show that liquidity position of commercial banks did not improve much as compared to mid-July 2012, though it improved significantly as compared to mid-January 2013 as a result of improvement in the general macroeconomic and financial situation including the position of liquidity in the banking system of Nepal.

Market and Combined Credit and Market Shock

3.65 The stress testing results revealed that all the commercial banks (excluding two state owned banks) have maintained CAR 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 was 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, 29 out of 31 commercial banks (excluding two state owned banks) could maintain their capital adequacy ratio above the regulatory requirement of 10.0 percent. The banks did not bear interest rate risks as they pass it directly to their clients; so, they are found to be less affected by interest rate shock as well.

3.66 The combined credit and market shocks based on a scenario of 25.0 percent of performing loan of real estate and housing sector directly downgraded to substandard category of NPLs and fall of the equity prices by 50.0 percent demonstrated that banks would not be affected. However, if 15.0 percent of performing loans deteriorated to substandard, 15.0 percent of substandard loans deteriorated to doubtful loans, 25.0 percent of doubtful loans deteriorated to loss loans and the equity prices fall by 50.0 percent, the CAR of 4 banks would remain above the regulatory minimum, CAR of 2 banks would remain below zero percent and CAR of 25 banks would lie between 0 and 10.0 percent.

3.67 The resilience of commercial banking system of Nepal towards key stress testing scenario analysis showed an improved, sound and strong financial system through all three kinds of credit, liquidity and market shocks. The overall vulnerability test in aggregate of all 31 commercial banks showed that Nepal's banking system stood in less vulnerable position since the vulnerability test found that no bank in aggregate was in vulnerable situation after these shocks. However, the test showed high chances of vulnerability in public sector banks and moderate chances in private sector banks.

Development Banks

3.68 Total number of development banks stood at 86 in mid-July 2013 compared 88 in mid-July, 2012. Out of 86 development banks, 20 are national-level and rest are regional and district-level development banks. During the review period, six district level development banks merged and became three regional level development banks. One district level and one national level development bank merged with four finance companies and became two national level development banks. One district level development bank merged with two finance companies and became a national level development bank. Likewise, one national level development bank merged with a commercial bank. This shows that the consolidation process of development banks and finance companies has been in increasing trend since the past two years. Similarly, one district-level development bank obtained license and came into operation and 52 new branches were added in the financial market in the review period aggregating 764 branches of development banks operating in the country in mid-July 2013.

3.69 The off-site unit monitors and reviews CRR positions on a weekly basis, capital adequacy and SLR on a 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, development banks were not penalized for not maintaining CRR & SLR and only one bank was penalized for shortfall in deprived sector lending. Liquidity of all development banks are monitored on daily basis, capital adequacy and stress testing of development banks mobilizing deposit exceeding Rs. 2.0 billion have also been monitored on a monthly and a quarterly basis respectively. Similarly, diagnostic review (conducted with the technical assistance of the IMF) of 6 development banks was also completed during 2012/13.

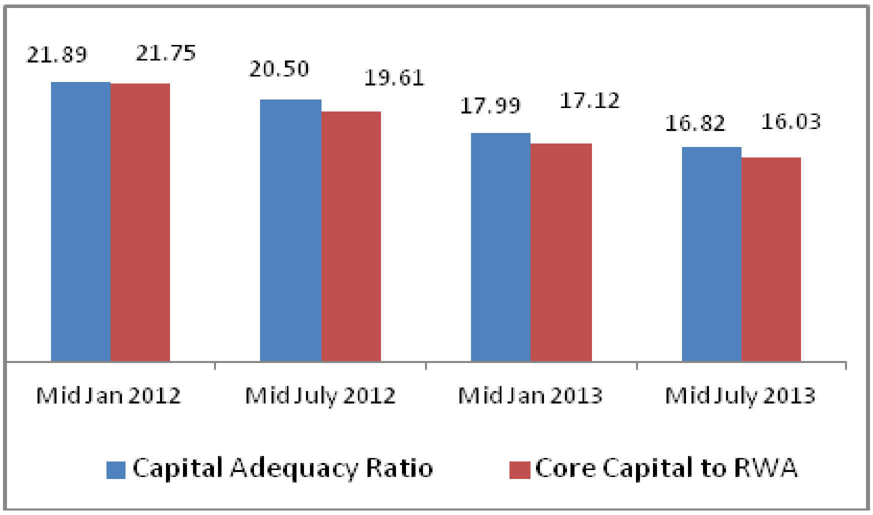
3.70 For regular monitoring, follow-up and detail study of problematic development banks, a problem bank resolution unit has been set up in DBSD. Any issues related to problem bank and its customers are handled by this unit. The DBSD conducts regular onsite inspection of all development banks once a year as per the approved annual plan. Besides regular inspection, special follow up and physical infrastructure inspections are also being carried out on a need basis. By mid-July 2013, 79 regular inspections and 40 special inspections of development banks were completed.

3.71 The capital fund of development banks stood at Rs. 25.09 billion in mid-July 2013 compared to Rs. 23.82 billion in mid-January 2013. The capital adequacy ratio was 16.82 percent in the review period. It decreased by 1.2 percentage point in the review period from 17.2 percent in mid-January 2013. The reason behind the fall in CAR of development banks was the increase in risky assets. The CAR has deteriorated since mid-January 2013. Moreover, the core capital to risk weighted assets was 16.1 percent in mid-July 2013 compared to 17.1 percent in mid-January 2013. During the review period, among the total of 86 development banks, four development banks did not maintain the statutory CAR of 11.0 percent , five institutions were within one percent of capital buffer, six 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 was declining.

3.72 Total assets of development banks increased by 13.6 percent to Rs. 211.51 billion in mid-July 2013 compared to a growth of 8.9 percent in mid-January 2013. Loan and advances of the development banks increased by 15.2 percent to Rs. 132.73 billion in

Figure 3.27: Capital Adequacy Ratio of DBs

(In percent)



the review period compared to a growth of 14.5 percent in mid-January 2013. The share of loans and advances in total assets also increased to 62.7 percent in mid-July 2013 compared to 61.9 percent in mid-January 2013. Similarly, share of liquid assets in total assets increased from 23.7 percent to 24.7 percent in mid-July 2013. Share of investment in total assets remained very low both in mid-January 2012 and in mid-July 2013. Its contribution was only about 3.0 percent in both the periods

Table 3.11: Composition of Total Assets of DBs

(Rs. in million and share in percent)

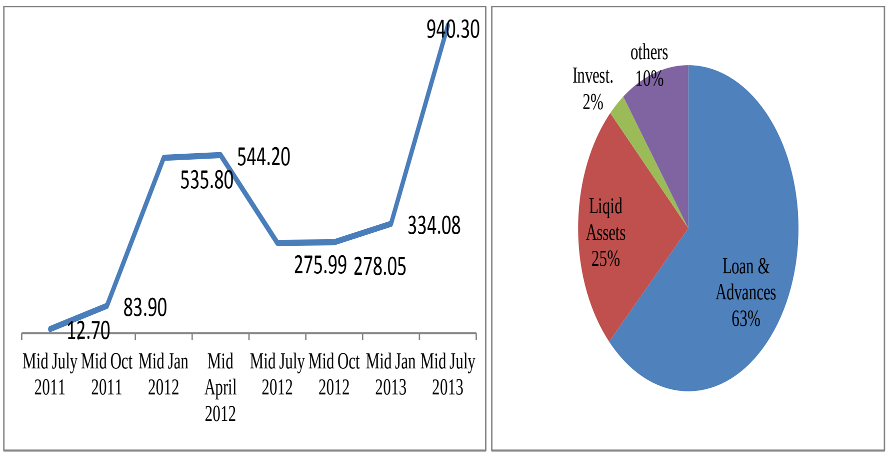
Particulars	Mid -Jan 2012	Share	Mid -July 2012	Share	Mid –Jan 2013	Share	Mid- July 2013	Share
Loan & Advances	91091.00	61.13	100621.80	58.88	115251.00	61.90	132731.20	62.75
Liquid Assets	34247.00	22.98	47387.40	27.73	44233.27	23.76	52289.75	24.72
Investment	5898.00	3.96	5354.22	3.13	5251.82	2.82	5243.10	2.48
others	17786.00	11.94	17530.28	10.26	21446.90	11.52	21245.88	10.04
Total Assets	149022.00	100.00	170893.69	100.00	186182.99	100.00	211509.94	100.00

3.73 Total amount of non-banking assets of development banks increased sharply over 2.8 times to Rs. 940 million in mid- July 2013. However, the asset quality of development banks improved in the review period as the non-performing loan decreased by 9.2 percent to Rs. 6028.65 million in mid-July 2013. Further, ratio of non-performing loan to total gross loan stood at 4.5 percent in mid-July 2013 compared to 5.7 percent in mid-January 2013.

3.74 Net profit of development banks increased by 51.4 percent to Rs. 1735.5 million in mid-July 2013. Among 86 development banks, 71 institutions reported profit in mid-July

Figure 3.28: Non-Banking Assets and Composition of Assets of DBs

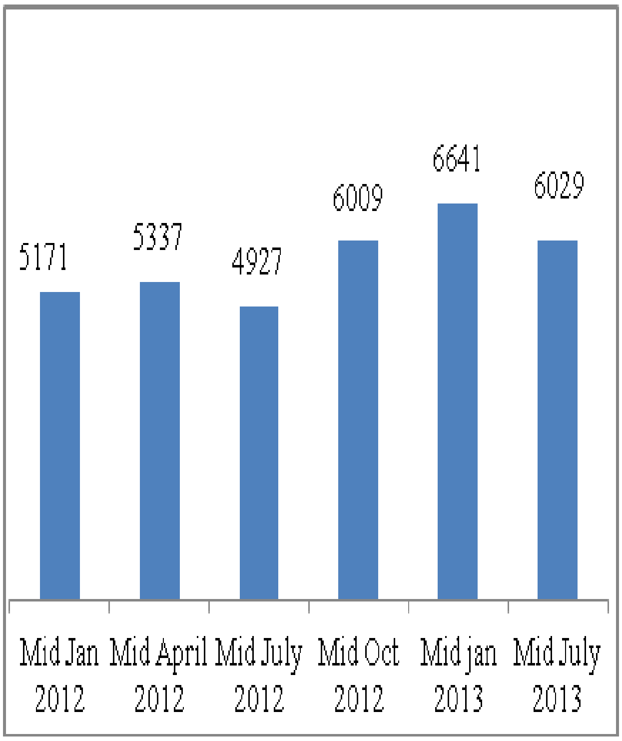
(Rs. in millions and in percent)



2013. In 2012/2013, interest income grew by 18.3 percent whereas interest expenses by 11.7 percent compared to a growth of 10.0 percent in 2011/12. Interest income formed to 82.2 percent of the total income. Other components of income included income from commission, other incomes, exchange income, provision write back, recovery of write-off loans and non-operating income. ROA of development banks dropped to 0.82 percent in mid-July 2013 compared to 1.1 percent in mid-July 2012.

Figure 3.29: Non-Performing Loan of DBs

(Rs. in million)



3.75 Liquid assets of development banks increased by 18.2 percent in mid-July 2013 from the level maintained at mid-January 2013. The ratio of liquid assets to total deposits at mid-July 2013 was 32.6 percent compared to 32.3 percent at mid-January 2013. The ratio of liquid assets to total assets in mid-July 2013 was 24.7 percent compared to 23.7 percent in mid-January 2013. These ratios depict that the development banks were in comfortable position in terms of liquidity management during the review period.

3.76 Deposit is the major source of fund for the development banks comprising 75.8 percent of total liabilities in mid-July 2013. Such share was 73.5 percent in mid-January 2013. The total deposits increased by a much higher rate of 17.0 percent to Rs. 160 billion during the review period compared to a growth of 7.7 percent in mid-January 2013. The second largest source of fund was capital fund, followed by others heading. Capital fund contributed 11.9 percent in mid-July, 2013 compared to 12.8 percent in mid-

January, 2013. Others heading contributed only 8.6 percent in mid-July 2013 compared to 11.1 percent in mid-January, 2013.

Table 3.11: Composition of Total Liabilities of DBs

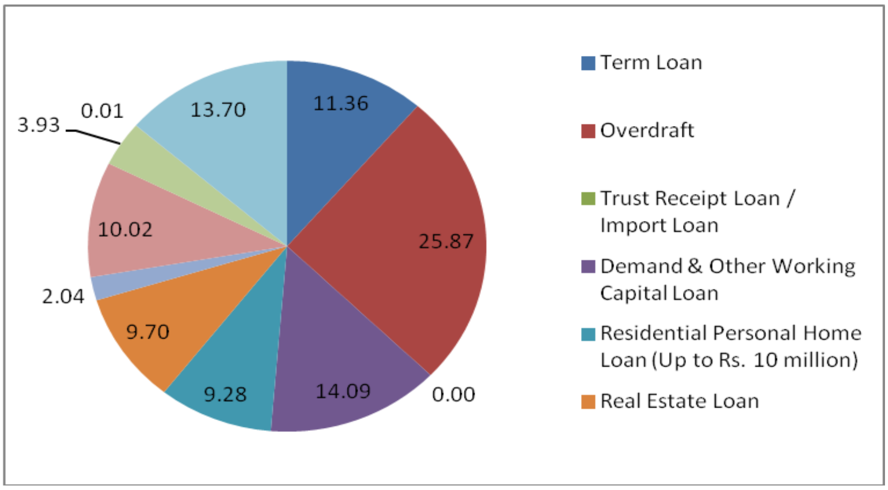
(Rs. in million and share in percent**)**

Particulars	Mid -Jan 2012	Share	Mid -July 2012	Share	Mid -Jan 2013	Share	Mid- July 2013	Share
Deposits	106276.5	71.32	127300.1	74.49	136930.08	73.55	160249.64	75.76
Capital Fund	22587.05	15.16	22702.17	13.28	23822.06	12.79	25094.11	11.86
Borrowings	2110.64	1.42	1193.00	0.70	1838.14	0.99	2753.56	1.30
Others	18047.74	12.11	19698.51	11.53	23592.72	12.67	23412.62	11.07
Total Liabilities	149021.9	100.00	170893.7	100.00	186182.99	100.00	211509.94	100.00

3.77 On a sector-wise basis, about 70.0 percent of lending of the development banks was concentrated in five economic sectors in mid-July 2013. These sectors were wholesaler and retailer (20.4 percent), others (19.4 percent), construction (11.5 percent), finance, insurance and real estate (9.5 percent) and transport, communication and public utilities (8.5 percent). Concentration of lending on few sectors or customers will expose

Figure 3.30: Product-wise Credit of DBs

(Share in percent)



a bank to high credit risk. About 40.0 percent of total lending of development banks was of revolving nature that is overdraft and demand and other working capital loan.

Similarly, only 9.7 percent of total loan was in real estate sector and 2.1 percent in margin loan. Due to high proportion of lending as revolving loan, the actual position of non-performing loan might not have been reflected correctly. Most of the loans of revolving nature were found ever greening

Finance Companies

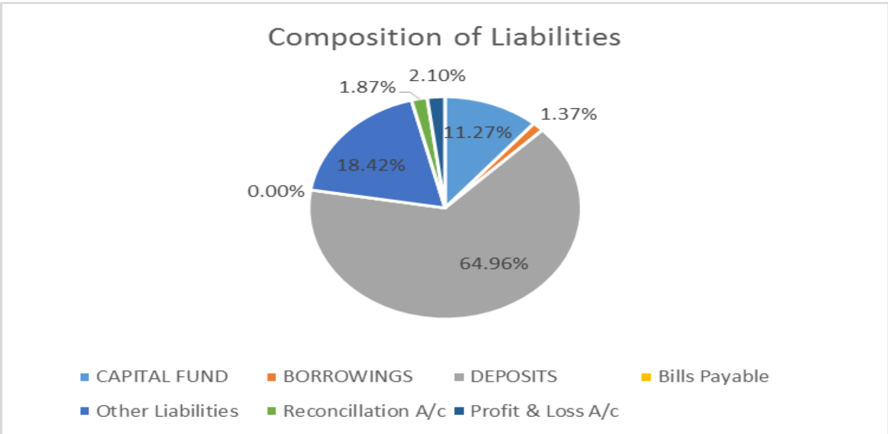
3.78 Total number of finance companies decreased to 59 in mid-July 2013 from 69 in mid-July 2012. Reduction in number of finance companies was due to the merger of finance companies with other finance companies and also with "A" and "B" class financial institutions. Moratorium imposed on the licensing of new finance companies also caused the decrease in the number of finance companies.

3.79 Beside regular on-site and off-site supervision, diagnostic review of 4 finance companies was completed in 2012/13. So far, 7 finance companies have been declared problematic and 1 under prompt corrective action. Resolution desk has been overseeing the activities of problematic institutions, including repayment of deposit, implementation of the special directives and implementation of plan of action presented by these institutions. From mid-July 2012 to mid-July 2013, onsite supervision, special inspection and monitoring supervision has been completed in 58, 25, 19 finance companies respectively. During the review period, 5 finance companies merged with each other to become 2 finance companies and another 5 finance companies merged with development banks to become 3 development banks.

3.80 The aggregate capital adequacy ratio of finance companies decreased to 16.1 percent in mid-July 2013 from 23.1 percent in mid-July 2012. Such ratio was 19.7 percent in mid-

Figure 3.31: Composition of Liabilities of FCs

(Share in percent)



July 2011. However, the level of capital adequacy maintained by the finance companies is higher than the required minimum capital adequacy ratio. Moreover, the core capital ratio of such companies was 15.3 percent in mid-July 2013 compared to 22.3 percent in mid-July 2012 and 18.9 in mid-July 2011. This shows that, finance companies in general have strong capital base. Deposits held in finance companies formed the largest part that is 64.9 percent of total liabilities followed by other liabilities (18.4 percent) and capital fund (11.3 percent) in mid-July 2013. Capital fund amounted to Rs.11.97 billion in mid-July 2013 whereas it was Rs. 15.32 billion in mid-July 2012.

3.81 The asset quality of finance companies had been deteriorating in the last couple of years. The share of non-performing loan to total gross loan worsened to as 14.3 percent in mid-July 2013 compared to 10.7 percent in mid-January 2013 and 5.7 percent in mid-July 2012. On the other hand, the average non-performing loan to net of provision of loan stood at -0.8 percent in mid-July 2013 compared to 5.3 in mid-July 2012.

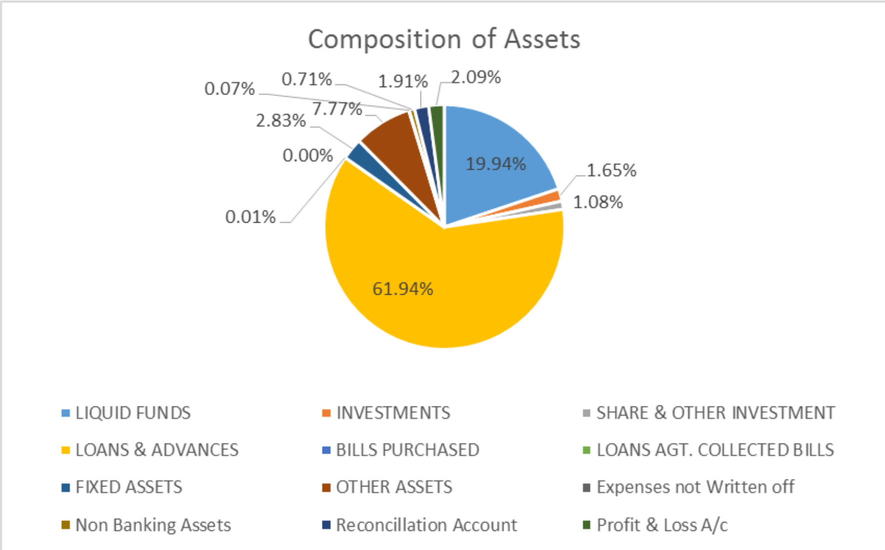
3.82 Regarding the distribution of loan to the different sectors from finance companies, wholesalers and retailers sector received 14.7 percent of total loans and advances in mid-July 2013. It was followed by construction sector (13.8 percent). Non-banking assets of finance companies was Rs. 752.98 million in mid-July 2013 compared to Rs. 310 million in mid-July 2012. The investment was Rs. 1752.16 million in mid-July 2013. Such amount was Rs. 2558 million in mid-July 2012. More than 90.0 percent of such investment was in government securities in the review period.

3.83 Loans & advances, liquid funds and investments were 61.9 percent, 19.9 percent and 2.7 percent of the total assets in mid-July 2013. The average proportion of non-performing loan to total outstanding loan of finance companies increased to Rs. 9996 million in mid - July 2013, up from Rs. 7145 million in mid-July 2012.

3.84 Out of total deposit of Rs. 68.98 billion in mid-July 2013, institutional deposit amounted to Rs. 18.59 billion (27.4 percent of total deposit). Moreover, of the total deposit saving and fixed deposit amounted to Rs. 29.45 billion and, 32.93 billion constituting 42.7 percent and 47.7 percent total deposit respectively. The liquid asset to deposit ratio of finance companies was 21.6 percent in mid-July 2013 compared to 38.39 percent in mid-July 2012. The liquid asset to total asset ratio of finance companies also declined to 21.6 percent in mid-July 2013 whereas from 25.9 percent in mid-July 2012. Total credit to deposit ratio remained at a much elevated level of 95.4 percent in mid-July 2013 whereas such ratio was 87.6 percent in mid-July 2012. As per the regulatory requirement, finance companies are mandated to maintain NRB defined C/D ratio up to 80.0 percent.

Figure 3.32: Composition of Assets of FCs

(Share in percent)



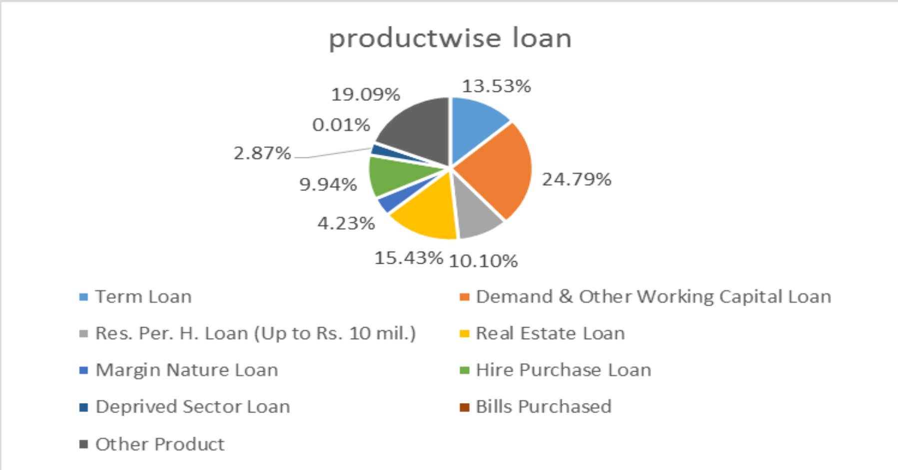
3.85 ROA of finance companies was 0.02 percent in mid-July 2013. Such ROA was 0.22 percent in mid-July 2012 but was negative by 0.11 percent in mid-July 2011. Similarly, ROE of finance companies was 0.08 percent in mid-January 2013, much lower from 1.60 percent in mid-July 2012. It was negative by 0.69 percent in mid-July 2011. Profit of finance companies was Rs. 10.33 million in mid-July 2013 compared to a loss of Rs. 243.84 million in mid-July 2012. Profit of finance companies grew due to decrease in the number of finance companies in mid-July 2013.

3.86 The share of demand and other working capital loans to total loan remained at 24.8 percent in mid-July 2013. Similarly, term loan to total loan and real estate loans to total loans stood at 13.5 percent and 15.4 percent in mid-July 2013 respectively. The share of margin loans to total loans was 4.2 percent in mid-July 2013.

3.87 Capital adequacy and non-compliance of minimum paid up capital requirement have become a major issue in finance companies. NRB has mandated to maintain paid up capital of Rs. 200 million for national level finance companies and 100 million for regional level finance companies. Out of 59 finance companies, 27 have not met the paid up capital requirement. Low level of capital makes these finance companies vulnerable to credit shocks. Even small amount of provisioning leads to large decrease in profitability and shortfall in capital adequacy.

Figure 3.33: Product-wise Credit of FCs

(Share in percent)



3.88 Most of the finance companies lend on the basis of collateral rather than the project. Properties put as collateral are normally valued at a higher rate than government's valuation. Higher loan to value ratio makes these institutions vulnerable to credit risks that arises from decrease in assets price, especially real estate. Most of the finance companies are facing serious problem in assets quality due to unbridled lending on real estate, higher valuation of substandard collateral and concentration of lending to single group of borrowers. Based on the unaudited financial disclosure, non-performing loan of finance companies stood about 16.0 percent of total loan and advances in mid-July 2013; this figure could be much higher if classification of loan and advances was changed as per on-site and off-site inspection. Out of total finance companies, 23 have NPL of more than 5.0 percent of total loan and advances. Some of them have even more than 90.0 percent of total loan and advances.

3.89 The weakest aspect of finance companies is corporate governance. Lack of qualified board members, weak risk management practices, rampant insiders lending practices, poor disclosure, compensation not commensurate to risks, and ineffective committees, among others have made finance companies weak. Most of the finance companies fail to comply with the directives. Non-compliance on provisioning of loans and advances, credit management and cash management issues emerge in all subsequent reports. Such a practice or tendency adds up more risk to finance companies in the future.

3.90 Poor disclosure of financial statement has become a regular occurrence. Data integrity has become a concern regarding growing number of cases of fraud in finance companies. Most of the staff dealing with disclosure lack knowledge and expertise of disclosure and its importance, resulting in frequent revision.

3.91 In the current situation, increasing capital through injection of capital by promoters and shareholders may not be enough. Therefore, merger and acquisition can be the best alternative to increase mandatory capital or to upgrade to higher category of institution. Along with merger, the momentum should be built to make finance companies more resilient to shock emanating from credit and liquidity risk.

3.92 One of the reasons why assets quality has become relatively weaker in finance companies is due to high loan to value ratio. Thus, to decrease the non-performing loan, finance companies should focus on loan to value ratio or income to debt ratio as well as other macroprudential policy measures as applied by other financial institutions in Nepal.

3.93 Although small in size, in terms of capital and assets, risk in finance companies may pass on to other classes of financial institutions through contagion effect. Therefore, robust risk analysis has gained importance than before. Finance companies are not mandated to calculate their risk weighted assets according to simplified approach adopted by commercial banks and national level development banks. But it would be prudent to make finance companies, at least with threshold, to start analyzing their risk weightage assets in the simplified approach. Similarly, like in commercial banks minimum level of liquidity could be determined for finance companies, from the regulatory perspective.

3.94 Increase in cost of fund has caused finance companies to involve in risky investment. Cost of fund has increased due to reliance on institutional depositors and long term deposits such as fixed deposit. A limit on the institutional deposit, recently introduced by NRB, may ease costs of fund burden for finance companies in the future.

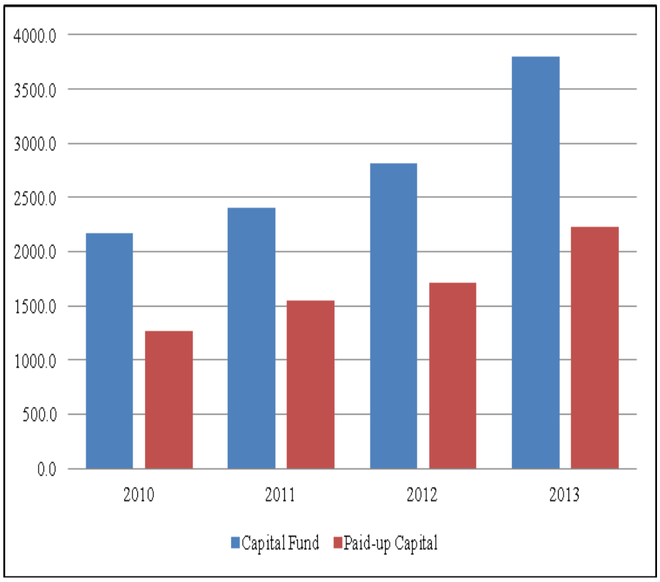
Micro Finance Institutions (MFIs)

Micro Finance Financial Institutions (MFFIs)

3.95 As of mid-July 2013, there were altogether 31 micro finance financial institutions (MFFIs) operating as "D" class financial institutions. They comprised of 5 Grameen Bikas Banks (Rural Development Banks), 23 private sector MFFIs replicating the 'Grameen Banking Model' and 3 wholesale lending MFFIs. The number of branches of MFFIs reached 646, creating employment for 3464 persons by mid-July 2013. Out of these, Grameen Bikas Banks (GBBs) have 161 branches and 911 employees. As compared to the previous year, the total number of members of MFFIs increased by 19.1 percent to 12,52,353 in mid-July 2013. Out of total members, GBBs had 1,86,056 members. The total loan disbursed from the MFFIs as of mid-July 2013 rose by 30.2 percent to Rs. 140.89 billion as compared to the previous year. Out of the total loan, the GBBs disbursed Rs. 36.36 billion which represent an increase of 14.6 percent over the corresponding period in previous year.

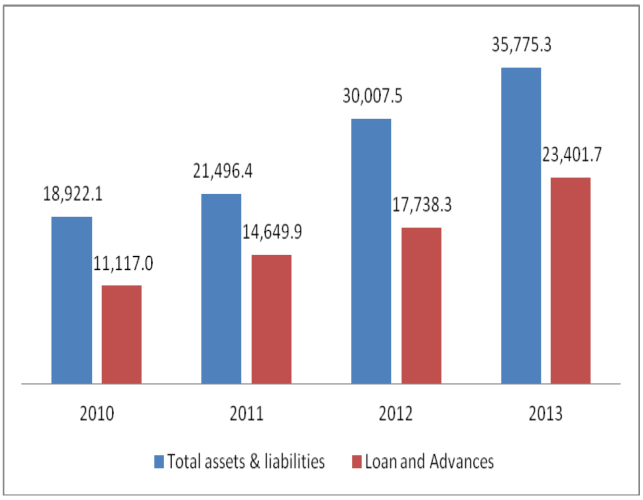
Figure 3.34: Capital Fund and Paid-up Capital of MFFIs

(Rs. in million)



3.96 As of mid-July 2013, the capital fund of MFFIs increased by 35.0 percent to Rs. 3.80 billion compared to the same period last year. Out of total capital fund, the share of GBBs stood at 4.6 percent (Rs. 175.8 million). Out of the total capital fund, paid-up capital rose by 30.1 percent to Rs. 2.23 billion during the corresponding period. The ratio of paid-up capital to total capital stood at 58.8 percent. The paid-up capital of GBBs stood at Rs. 392.1 million, forming 17.5 percent of the total paid-up capital. Out of total MFFIs, 6 of them measured cumulative losses, with one of them having negative capital base. As per NRB directives, "D" class financial institutions are

Figure 3.35: Total Assets & Liabilities and Loan & Advances of MFFIs (Rs. in million)

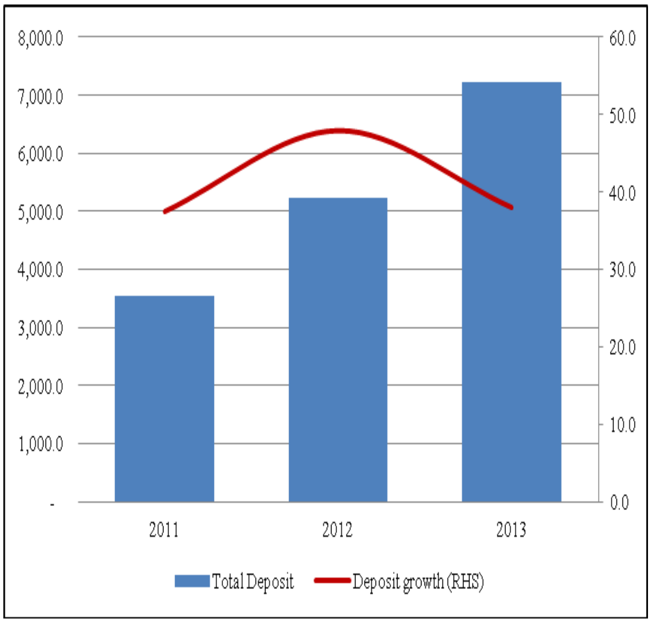


required to maintain at least 4.0 percent of core capital and 8.0 percent of total capital fund based on risk-weighted asset.

3.97 Total assets and liabilities of MFFIs in the review period grew by 19.7 percent to Rs. 35.7 billion. The GBBs' share of assets and liabilities stood at 15.6 percent. Out of the total assets, loan and advances registered a growth of 31.8 percent to Rs. 23.39 billion. GBBs' share in loan and advances category stood at 14.4 percent. The ratio of loan and advances to the total assets stood at 60.5 percent. Out of the total loans and advances, wholesale loan provided by 3 institutions shared 28.8 percent, while individual loans shared remaining part. The MFFIs did not possess any non-banking assets during the review period. Likewise, investment of these banks during the review period rose by 36.3 percent to Rs. 3.1 billion. In this category, the share of GBBs stood at 6.7 percent. Out of total investment, the ratio of investment in government securities stood at 3.8 percent.

Figure 3.36: Total Deposit of MFFIs

(Rs. in million and in percent)



3.98 Total saving deposit mobilization of these MFFIs rose by 39.4 percent to Rs. 7.22 billion in the review period. Out of the total deposits, the GBBs mobilized Rs. 1.0 billion (14.3 percent). As compared to total liabilities of these institutions, the share of deposit mobilization remained at 20.2 percent. Out of total deposits, compulsory deposits constituted 42.5 percent. Total borrowing of these MFFIs banks during the review period increased by 22.4 percent to Rs. 20.21 billion. The GBBs borrowed Rs. 3.07 billion contributing 15.2 percent in total borrowing. As compared to total liabilities of these institutions, the share of borrowed amount remained at 56.5 percent. Out of the total borrowings, the share of borrowing from NRB remained at less than 1 percent.

3.99 The total amount of overdue loans including interest of these institutions rose by 10.2 percent to Rs. 917.06 million compared to the same period last year. GBBs' overdue loan accounted Rs. 721.76 million with a significant share of 78.7 percent of total overdue of MFFIs. The number of overdue loans increased by 68.4 percent to 35,728 persons during the review period. Out of this, the share of GBBs was 59.4 percent. Likewise, the amount of loan loss provision of these institutions also rose by 14.3 percent to Rs. 685.54 million during the review period. The GBBs had loan loss provision of Rs. 310.44 million which is 45.3 percent of total loan loss provision.

3.100 The overall ratio of performing loan of these institutions remained at 97.4 percent during the review period compared to 97.6 percent a year ago. This indicates that their overall NPL remained within the range of 5 percent. Their earnings and profitability ratio during the review period increased to 3.8 percent from 3.2 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 total liquid fund was 18.1 percent of total assets. Of the total liquid fund, money deposited at other BFIs and money at call accounted to 55.2 percent and 44.1 percent respectively. The overall liquidity ratio of these institutions remained at 117.9 percent as on mid-January 2013 compared to 69.1 percent last year.

3.101 As NRB has already submitted the final draft of Microfinance Authority Act and a National Microfinance Development Fund Act to the government, timely enactment of these Acts would promote to access to finance, particularly for the poor and deprived. Provision of a separate supervisory authority would help a lot for the expansion of micro finance services throughout the country. This process would further facilitate the healthy growth and deepening of financial activities in Nepal in the years to come.

Limited Banking Cooperatives and Non-Government Organizations

3.102 The number of cooperatives permitted for conducting limited-banking activities by NRB was 16 as of mid-July 2013. Out of these cooperatives, National Cooperative Development Bank is involved in wholesale lending activities while the other cooperatives are involved in retail business. The total assets and liabilities of these institutions increased by 32.3 percent to Rs.15.42 billion during the review period. Total capital fund of these institutions increased by 38.4 percent to Rs. 1.59 billion during the review period. Out of the total capital fund, the share capital covers about 74.0 percent. Similarly, total deposit of these cooperatives also increased by 30.6 percent to Rs. 11.40 billion during the review period. Likewise, their loans and advances increased by 44.2 percent to Rs. 9.46 billion. Similarly, the total investment of these cooperatives increased by 48.1 percent to Rs. 1.15 billion in the review period.

3.103 As of mid-July 2013, there were altogether 31 financial NGOs with their 260 branches operating throughout the country. The financial NGOs are to be registered under the Institutions Registration Act, 1977 for carrying out limited banking activities in accordance with the provision of the Financial Intermediary Act, 1999. These institutions are permitted by NRB to undertake limited banking transactions. The total number of members of these institutions as of mid-July 2013 stood at 4,27,886. The outstanding loan of these institutions amounted to Rs. 5.26 billion with a total deposit amounting to Rs. 2.82 billion.

Rural Self-Reliance Fund (RSRF)

3.104 The Rural Self Reliance Fund (RSRF) was established in 1991 with the joint efforts of NRB and the Government of Nepal. The objective of the Fund is poverty reduction by providing wholesale credit to those cooperatives and the NGOs which 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 with Rs.190 million contributed by the government and the remaining amount of Rs. 253.4 million contributed by the central bank.

3.105 The loan limit per borrower has been set at a maximum of Rs. 90,000 for loans disbursed through the cooperatives/NGOs. As of mid-July 2013, the Fund disbursed total loans amounting to Rs. 1.30 billion to 720 institutions scattered around 66 districts which benefitted 40 thousand households. During the same period of last year, the Fund had disbursed loans of Rs. 977.85 million through 709 institutions throughout 62 districts benefitting around 32 thousand households. The recovery rate was around 96 percent during the review period.

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

3.107 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 seem to be necessary for developing professionalism, healthy competition and uniform practices in the MFIs. At the time of formulating code-of-conduct and guidelines, some policy incentives are necessary to encourage their business in the productive sector particularly in the remote and inaccessible areas. Besides, legal framework regarding consumer 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

3.108 The development of cooperatives as a whole and, particularly, the saving and Credit Cooperatives in Nepal has not generated expected outcomes. Intrinsic weight should be attached to rational mobilization of public money into the productive sector,

Box 3.1: Current Status of SCCs (As of Mid-July, 2013)

Number of Cooperatives: 29,526

Number of saving and credit cooperatives: 12,916, and Share of SACCOs: 43.74 percent

Number of Members: 43, 25,005; of *which:* Women Members: 44.8 percent.

Number of employee: 52,003

Share Capital: Rs. 33.4 billion; *of which*: Saving and Credit Cooperatives: 74.08 percent and Capital Fund: 4.46 billion

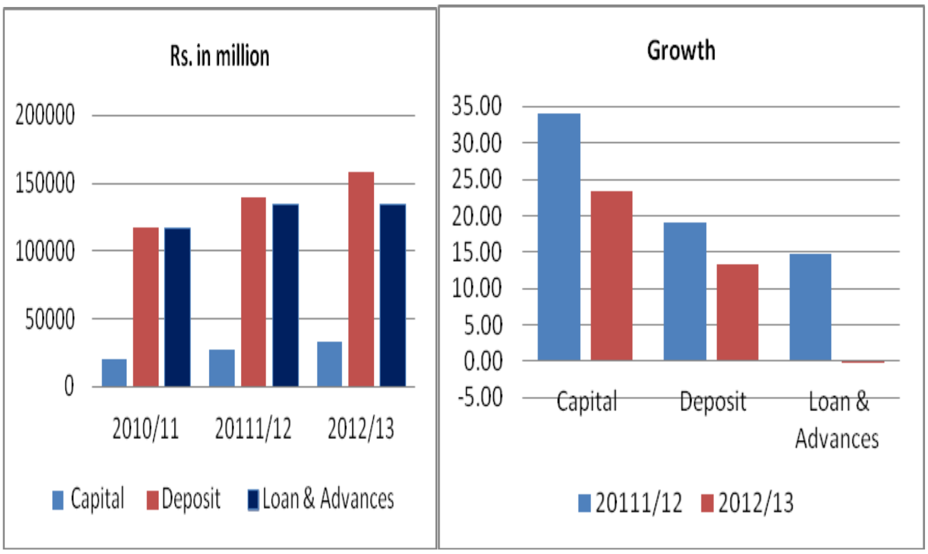
Total Deposit: Rs. 158.16 billion; *of which*: Saving and Credit Cooperatives: Rs. 118.18 billion (75.19 percent)

Total Loan and Advances: Rs. 133.72 billion; *of which*: Saving and Credit Cooperatives: Rs. 100.62 billion (.75.24 percent)

Other Investment: 341.5 million

poverty alleviation and employment rather than into profit-maximizing motive. Even after conceptualizing the various development models of cooperatives, problems began to emerge when cooperatives started attracting deposits by offering higher rate of interest. 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

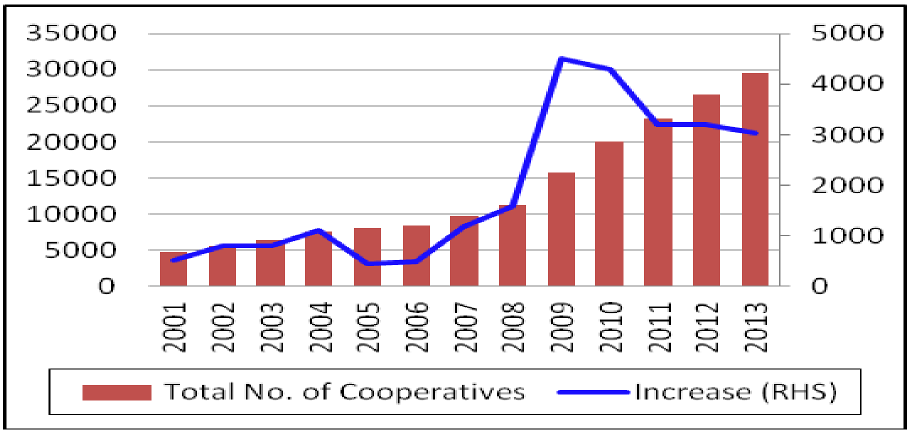
Figure 3.37: Financial Transactions of Cooperatives



watching the operation, particularly the lending connections of Saving and Credit Co-operatives (regulated and supervised by the Department of Cooperatives (DOC) with a view to ensure financial stability.

3.109 As of mid-July 2013, there were altogether 29,526 cooperatives operating in Nepal out of which 43.7 percent (12,916) co-operatives were undertaking saving and credit activities (SCCs), 24 percent were agriculture cooperatives, 13.3 percent multi-purpose cooperatives and the rest were found to be focusing on activities cooperatives such as

Figure 3.38: Total Number of Cooperatives in Nepal



dairy cooperatives , consumer cooperatives and, among others.

3.110 The total memberships of SCCs were 2.31 million, with an average membership of 178 per cooperatives. The males and females employed in these cooperatives stood at 15,062 and 15,294 respectively. The total share capital of SCCs was Rs. 24.78 million with an average share capital of Rs. 1.92 million as of mid-July 2013. These SCCs had a deposit base of about Rs. 118.18 billion and investment of Rs 133.83 billion. The outstanding loan extended to the members for various purposes such as micro enterprises, cereals and cash crops, livestock, dairy services, and poultry, among others as of mid-July 2013 was Rs. 100.62 million. The major sources of loanable fund were deposit, share capital and borrowings from wholesale lending institutions but all the cooperatives do not have access to wholesale loans.

3.111 A recent study conducted independently about the cooperative business in Nepal, 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 collateral in the name of board members or other companies they have promoted. Additionally, member's deposits in such cooperatives (especially working in urban areas, for example, Kathmandu Valley) have been found to be utilized improperly by the board members of such cooperatives or invested in unproductive activities. However, cooperatives working in rural areas have been found to be running smoothly. They are mostly found to be with the involvement in production and employment oriented activities. They have indeed succeeded to fill up the financing gap of beneficiary (members) of rural households.

3.112 The DOC statistics shows that all types of cooperatives (including the saving and credit) across the country has deposits worth Rs 158.16 billion as of mid-July 2013. Of the total deposits, saving and credit cooperatives have dominant share. These cooperatives hold Rs. 118.18 billion, which is equivalent to 13 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 savings 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.

3.113 Some of the credit and savings cooperatives have command over a wide range of depositors and credit-users in different communities. Their turnovers, as reported by them, exceed that of finance companies, which gives an idea about the size of cooperatives. They can play significant role as well as pose threat to the entire financial sector. Growth in number of institutions naturally brings both the opportunities and risks. As a natural law, control and proper regulation should always become stricter as the number and size of the institutions grow. Hence, there is an urgent need of a control mechanism on the cooperative business. So far these cooperatives are not well regulated and not supervised. Considering their growing size and influence, these cooperatives should be strictly monitored and supervised with standard regulatory norms. The issue related to regulatory and supervisory framework for these co-operatives should be addressed as early as possible with the formulation and implementation of sound measures to ensure financial health. In the absence of stringent measures, these cooperatives create adverse effect on formal banking activities in Nepal.

3.114 A sound regulatory and supervisory authority must be there to control malpractices of cooperatives. In the absence of a strong regulatory authority, haphazard investment practices, including those in riskier real-estate projects, are reportedly going unabated in recent years, creating threats to the financial sector and the economy as a whole. These threats are more serious for economically vulnerable depositors associated with the cooperatives.

3.115 Credibility and security are the key factors critical in the context of saving and credit cooperatives in Nepal. 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.

Other Financial System Institutions

Insurance Companies

3.116 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 6.0 percent of Nepalese are insured, and around 1.6 million people are involved in various insurance activities in Nepal. The insurance policies for both life and non-life segments 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.

Table 3.12 : Number of Insurance Companies

Ownership	Non-Life	Life	General	Total
Government Owned	0	0	1	**1**
Private Sector	13	5	0	**18**
Foreign	2	1	0	**3**
Joint Venture	1	2	0	**3**
Total	**16**	**8**	**1**	**25**

Figure 3.39: Source and Uses of Insurance Companies

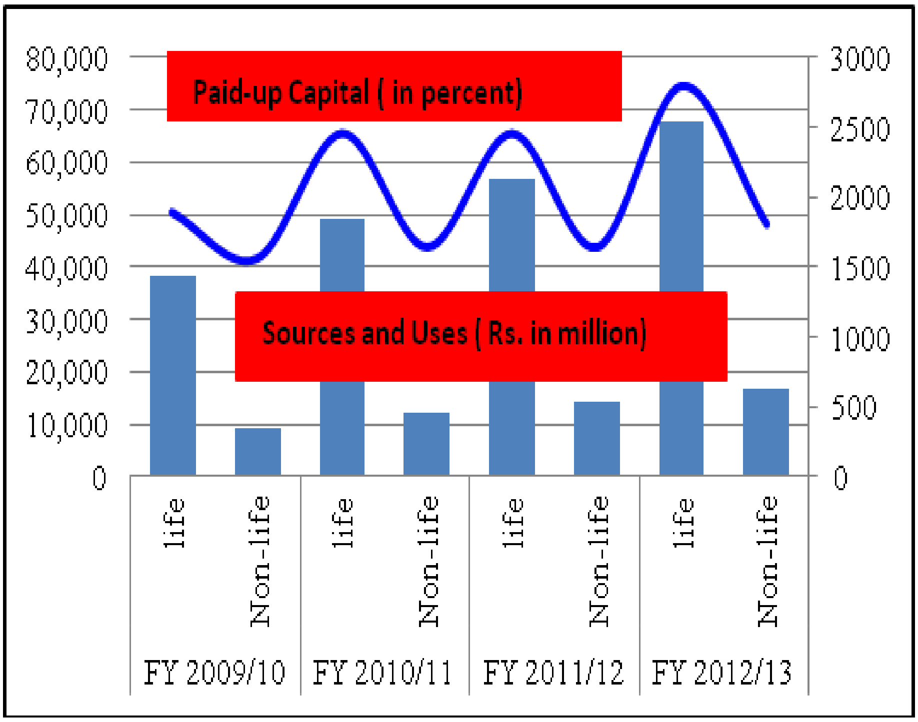


Table No 3.13: Main Indicators of Insurance Companies

(As of mid-July 2013)

Main Indicators	Life	Non-Life	Total
Number of Insurance Companies	9	16	25
Paid-up Capital (Rs. in million)	3345.3	2103.6	5448.9
Investment	47134.4	9261.3	56395.8
Number of office of Insurance Companies	447.0	196.0	643.0
No. of staffs	1540.0	1638.0	3178.0
Gross Insurance Premium (Rs. in million)	21705.8	8668.5	30374.3
No. of premium	128547.0	94766.0	223313.0
No. of Agents	177139.0	4349.0	181488.0
Re-insurance			
Gross Reinsurance Premium (Rs. in million)	431.0	3256.2	3687.2
Reinsurance Commission (Rs. in million)	71.3	794.5	865.7
Gross Claim on Reinsurance (Rs. in million)	209.5	1124.1	1333.6
Claims			
No. of Claims	27555.0	41480.0	69035.0
No. of Claims paid	25240.0	36297.0	61537.0
No. of Claims to be paid	2402.0	14680.0	17082.0
Amount of Claims paid (Rs. in million)	2324.8	3073.0	5397.8

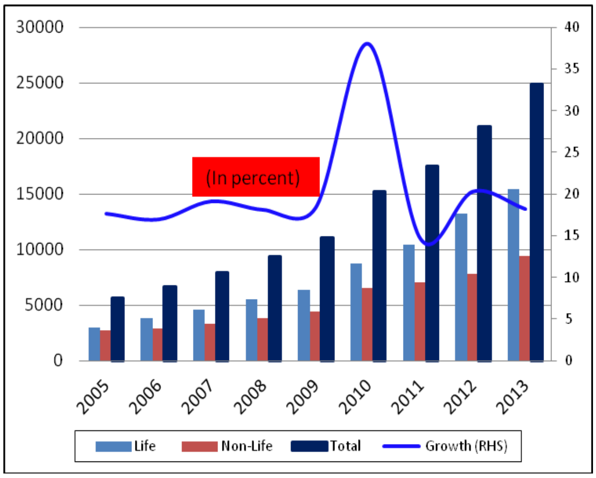
Source: Insurance Board of Nepal

3.117 As of mid-July 2013, there were altogether 25 insurance companies established under Insurance Act, 1992. Among them, 8 insurance companies offer life insurance services, 16 companies offer non-life insurance services and one provides both the life and non-life insurance services. According to the ownership structure, 3 insurance companies are operating under foreign investment and 2 insurance companies are operating as joint venture with foreign insurance companies. Likewise, 19 insurance companies belong to the private sector, whereas one is under the government ownership.

3.118 The total assets/liabilities of these companies increased by 14.7 percent in 2012/13 to Rs. 84.65 billion in mid-July 2013, of which life insurance and non-life insurance account for Rs. 67.8 billion (80.0 percent) and 16.8 billion (20.0 percent) respectively.

3.119 Total premium collection by the insurance companies has been gradually increasing over the years. Premium collected for life insurance contributed more than 60.0 percent of total premium collection. The premium collection was Rs. 5.7 billion in 2005 and increased on an annual average by about 22.2 percent for the next 5 years to Rs. 15.3 billion as of mid-July 2010 comprising of Rs. 8.7 billion from life insurance and Rs.6.5 billion from non-life insurance companies. Insurance sector has been expected to mobilize almost Rs. 24.8 billion premium up to mid-July 2013. The growth of total premium collection in 2012/13 stood at 18.2 percent, compared to 20.3 percent in 2011/12.

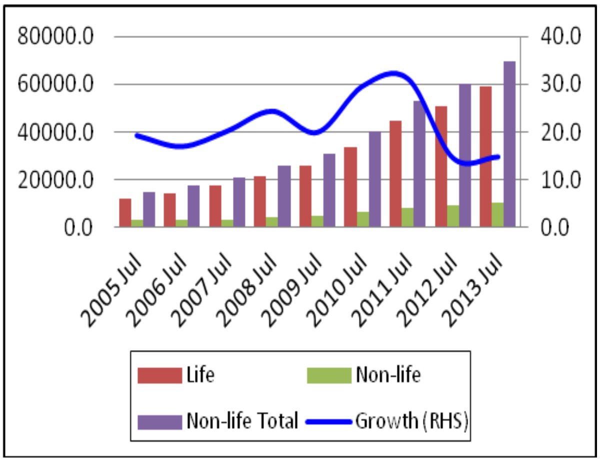
Figure 3.40: Premium Collection by Insurance Companies (Rs. in million)



3.120 On the investment side, it was Rs. 14.8 billion in 2005. It has been observing an increasing trend over the years. The total investment reached Rs. 69.4 billion as of mid-July 2013 comprising of Rs. 59.3 billion and Rs. 10.1 billion from life and non-life insurance respectively. The growth rate of investment up to 2011 was very high. Such growth rate had peaked to 40.0 percent in 2010. After that it declined and stood at 4.0 percent in mid-July 2012 and 6.9 percent in mid-March 2013.

3.121 Considering the development of insurance industry and its connection with the financial system of Nepal, it has been revealed that insurance companies have 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

Figure 3.41: Investment by Insurance Companies (Rs. in million)



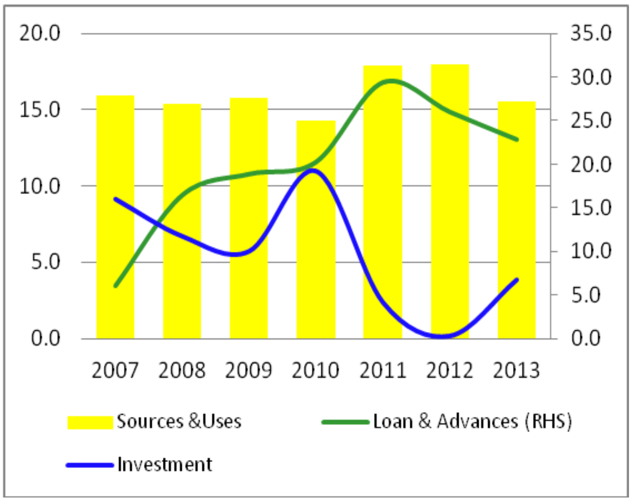
sufficient liquidity. Similarly, the insurance companies should maintain further transparency in terms of disclosure, access to information on collection of insurance premium, investment in different areas and products as well as the recovery of the investment. Likewise, the insurance industry also requires further consolidation by making the individual companies financially strong and offer better service quality.

3.122 Total premium collection and total investment of the insurance companies are in increasing trend The performance of Nepalese insurance industry on aggregate is satisfactory but requires a strong surveillance on their operation 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. Insurance industry should also move towards IAIS Insurance Core Principles (ICP) and update insurance accounting standard following international best practices. Similarly, in the context of growing insurance business, including the companies, a solvency regime is also required to tackle with the problems that surface in insurance companies. Both the prudent regulation and strong supervision are lacking in Nepalese insurance, so the insurance sector is moving forward on a traditional way without having essential framework in place. Therefore, strengthening the rules and regulations formulated by the Insurance Board can be instrumental for this sector to withstand possible financial market shocks.

Employees Provident Fund (EPF)

3.123 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 sources and uses of EPF increased by 16.3 percent on an average in the past

Figure 3.42: Major Indicators of EPF
(In percent)

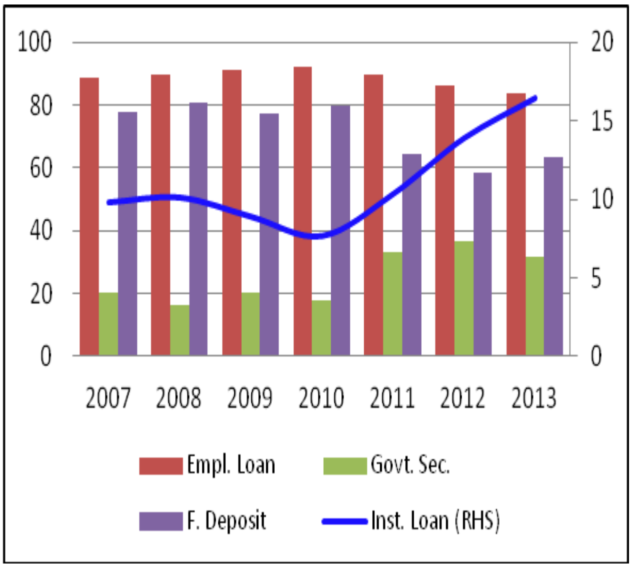


five years. Total assets and liabilities of the EPF increased by 15.5 percent to Rs. 145.28 billion in mid-July 2013 from Rs. 125.7 billion as of mid-July 2012. The fund collected by EPF increased by 15.7 percent and stood at Rs.140.5 billion in mid-July 2013 compared to Rs.121.4 billion in mid-July 2012. The total investment of EPF grew by 6.7 percent in mid-July 2013 compared to the nominal growth of 0.3 percent in 2012.

3.124 True financial condition of the EPF is not available for the public scrutiny because of data unavailability. Its financial conditions are, however, sound. 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 80.0 percent of loan and advances to the EPF contributors (including the EPF employees), and less than 20.0 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 in government securities and the remaining in the shares. The EPF has the largest share of total investment on fixed deposit account of banks and financial institutions. Such a heavy share of EPF can pose risks to BFIs due to high concentration in fixed deposit in few banks and financial institutions.

Figure 3.43: Major Loan & Advances EPF

(Share in percent))



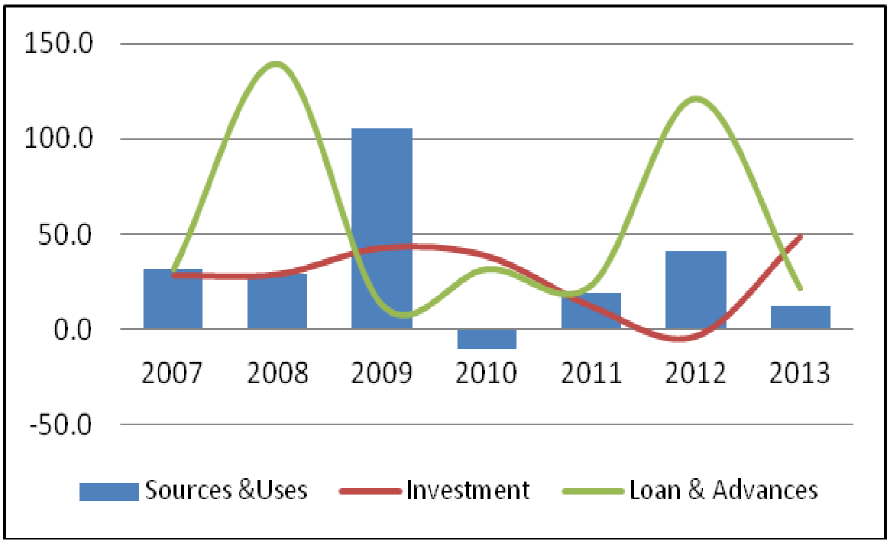
3.125 EPF has a very low share of cash and bank balances out of its total deposit amount. The operating expenses show a satisfactory position as it has been maintained below 5.0 percent, and credit to deposit ratio is also found under acceptable limit. However, the liquidity related indicators as well 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, EPF faces 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)

3.126 Citizen Investment Trust (CIT) was established on 18 March 1991 under CIT Act, 1991. Total assets/liabilities of the CIT increased by 12.3 percent to Rs. 42.75 billion in mid-

Figure 3.44: Major Indicators of CIT

(In percentage change)



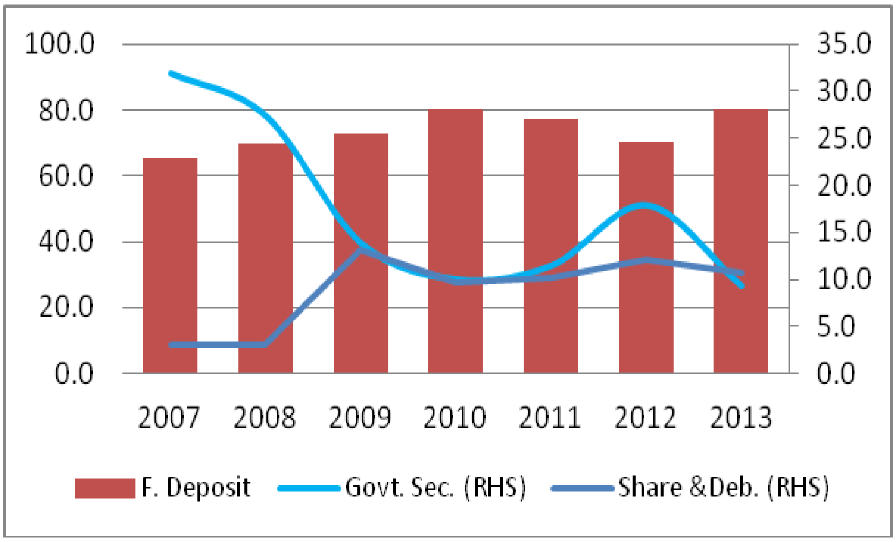
July 2013 compared to Rs. 38.06 billion as of mid-July 2012.

3.127 Total investment increased by 48.8 percent to Rs. 27.3 billion in mid-July 2013 compared to Rs. 18.3 billion as of mid-July 2012. Similarly, loan and advances increased by 21.6 percent to Rs. 11.7 billion in mid-July 2013 compared to 9.6 billion of mid-July 2012. Fund collection, the major component of CIT liabilities, increased by 28.5 percent to Rs. 40.3 billion in mid-July 2013.

3.128 Though total sources/uses of CIT showed an increasing trend over the period, the trend slightly narrowed down in 2012/13. On the investment side, around 80.0 percent of total investment has been deposited in the fixed deposit accounts of various BFIs. As such, CIT may face liquidity problems as well as concentration risk similar to EPF in case

Figure 3.45: Investment by CIT

(In percent)



if the BFIs fail to cash or refund the deposit on demand by CIT. The CIT has been investing around 80.0 percent of its total resources in various BFIs due to the unavailability of opportunities particularly for the investment in longer term projects. Although the capital base of CIT has been strengthening gradually and reached Rs. 300 million, the liquid assets of CIT declined by more than 50.0 percent in mid-July 2013, mainly because of increased total investment.

Postal Savings Bank (PSB)

3.129 The Postal Savings Bank was established under GoN's Postal Service Department and came into operation in 1976. Out of a total 117 licensed offices as at mid-July 2013, 68 PSBs mobilize deposits. Total assets/ liabilities reached Rs. 1.39 billion as at mid-July 2013. The share of assets/liabilities reached 0.1 percent of GDP in mid-July 2013. Total deposit collection of these offices reached Rs. 1.39 billion in mid-July 2013 from the level of Rs. 1.29 billion in mid-July 2012. Similarly, the number of total accounts reached 58,558 in mid-July 2013 from 54,796 in mid-July 2012. The PSB was established with the objective of encouraging people for enhancing their saving habit and utilizing the collected deposit in the national development process. According to the PSB, the attraction towards the bank has been rising as one can open an account at minimum balance of Rs. 100. Likewise, the depositors are provided interest ranging from 7 to 8 percent and PSB provides loan of 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. The PSB has been offering other various financial services such as money order services, remittance service and insurance service, but the later one is slowing down due to the competition and establishment of many more remittance companies in the private sector.

Informal Financial Intermediaries (IFIs)

3.130 Alongside with formal financial institutions, there is also a informal financial structure in Nepal. These informal financial transactions are hard to track because of lack of data on informal financial sector such as money lenders, Rotating Savings and Credit Associations (ROSCAs), and landlords, neighbors, 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 formal financial intermediaries. This duality has been in existence for a very long time, and 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.

3.131 The impact of the informal sector on the economy is hard to estimate because of low availability of data on informal financial sector. Both the formal and informal credit can be either complements or substitutes. Various informal saving and credit groups, self-help groups, Dhukuties 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 their activities are not available. However, it is believed that significant volumes of transaction are being carried out through the informal sector. These sectors need to be regularized in order to bring in their transactions in the formal channel for maintaining financial stability in the days to come.

3.132 In Nepal, previous studies by NRB and others had revealed that extremely high informal interest rates are charged on loans to poor individuals in informal sector. Extensive rural credit programs by NRB in the last decades were intended to weaken the informal lenders that had 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 on high informal 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 probability 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.

3.133 Despite of an increased supply of formal credit, informal lenders are still the most important source of credit among the poorest 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 are therefore excluded from formal credit channels. The NLSS reports (2010/11) show that only 20.0 percent of lending in Nepal is obtained from formal institutions.

3.134 Self-help Groups, Users Groups and Mothers Club, among others, are also involved to some extent with financial activities such as savings and , lending, among others, in rural areas and found to be working in rural communities. One can hardly find their formal attachment with formal financial institutions. How to link such groups in formal financial mainstream and how they could be facilitated further is indeed a daunting task. If such initiatives are supported to attach with formal financial initiatives; then one could expect the dwindling influence of informal sector on saving and credit matter especially in rural economy. SHGs, User Groups, Mother Clubs, among others, could play intermediaries role in financial inclusion of rural economy.

Issues and Challenges in the Financial Sector

3.135 The Nepalese economy has been passing through a transition as a consequence of the ongoing political unsettlements, reduced government expenses and weak private investment, among others. Like other sectors, the financial sector has also been affected by unstable political condition as well as weak investment, low economic growth and high inflation, among others. Despite healthy deposit mobilization, the Nepalese banking sector has been facing weak demand for credit. Inflation rate has not come down yet to the desired level. Liquidity of the financial sector has been fluctuating, which has created uncertainty to the financial sector. This situation demands a cautious approach in liquidity management and requires a review of earlier stance of macroprudential policies such as LTV Ratio and NRB defined CD ratio, among others, to provide adequate space for credit expansion in productive sectors without additional pressure in inflation and to protect the spillover of liquidity to unwanted areas.

3.136 Weak internal control system has always remained a matter of challenge for banking system. Frauds and forgeries either by internal members or by external groups have increased dramatically in recent years. Out of these incidents, maximum frauds go unnoticed and unpunished successful due to poor internal control system in place. ATMs and Internet banking stand as the major targets of frauds. As banking system is in a developing stage, introduction of novel innovations in the banking sector technology require understanding of vulnerabilities. The quick use and development of new technological tools and IT instrument in the banking sector side by side with the inadequate regulatory and monitoring infrastructure has provided space for criminals to web conspiracies. Introduction of innovations, identification of loopholes and continuous monitoring of possible fraudulent activities have become a challenge for the banking sector in Nepal from the regulatory perspective of financial sector.

3.137 Corporate governance is a major challenging issue when examining the systemic risk in the financial system. The financial institutions that faced different types of problem, that went into liquidation and that are declared problematic have mostly been the victims of the weak corporate governance system as manifested in insider lending and lack of transparency in lending, connected banking behaviors, excessive involvement and interference by the high level management of financial institutions in decision making process, among others. Effective and timely supervision ensuring strict obligation of different provisions in directives of NRB and other strict code of conducts is necessary to reduce the risk of breaking down of corporate governance in the financial sector.

3.138 Insufficient capital base has always been a common problem among "B" and "C" class BFIs. This insufficiency makes them vulnerable to default risk, solvency risk and liquidity risk. NRB has adopted the merger policy to deal with such insufficiency, but it is still to see how far this policy will be successful to correct this deficiency. The "A" class financial institutions have maintained minimum required capital so far. However, considering the growing risky situation, they have to maintain sufficient buffer capital under PCA approach based on liquidity and non-performing assets and implement ICAAP (Internal Capital Adequacy Assessment Process) approach based on inherent risks.

3.139 Identifying new sectors for deposit mobilizations and investment have become a hard challenge for BFIs. The bank and branch expansion is much rapid, but the market to invest in productive sector is relatively not attractive to banks. Shut downs of industries are more frequent than the establishment of new ones. Despite having numbers of sectors that are requiring investment such as tourism, hydroelectricity, irrigation, and agriculture, among others, demand for loans in such sectors is suppressed and BFIs, too, hesitate to shift their lending policies from their comfort zone to new projects in these areas. In this context, BFIs do not have options, but to compete in an unhealthy manner for the same market instead of exploiting new opportunities. In addition, shadow-banking practices have snatched some share of credit market, leaving very limited opportunities to BFIs.

3.140 Expanding outreach of financial service to rural areas is still a major challenge in financial sector. Banks and financial institutions do not show much interest in increasing financial access and inclusion until and unless regulatory bodies impose some regulatory pressures. While there is over concentration of banks and their branches within the valley and business hub, rural areas still do not have access to banking services except in their headquarters. It is necessary to address reasons/inconveniences that BFIs are facing in establishing their branches in rural and remote areas.

3.141 Moreover, the major non-compliances observed in onsite inspections and supervision reports are loan provided that exceed the single obligor limit (SOL), improper loan classification (inadequate loan loss provision), improper utilization of loan amount, loan provided to dummy projects, weak follow-up and monitoring on 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 loan, 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. These non-compliances need to be corrected to avoid the possible vulnerability in BFIs. However, enhancing good corporate governance, promoting self-regulation, controlling multiple banking behaviors and avoiding increasing trend of operational risk are the key areas which need attention of policy makers for nurturing the stability of the financial system in Nepal.

3.142 Financial soundness indicators (FSIs) as reported by BFIs were noted satisfactory but not as expected in the review period. However, the BFIs sometimes cannot truly reflect the extent of the problem in the financial system. Replacement of consumption lending by productive sector lending is again a challenge for Nepalese banking sector.

3.143 Financial viability is necessary for the long run sustainability of MFFIs. MFFIs are generally resource deficient. The capital base of most of the MFFIs is small compared to other BFIs. Pricing of the financial services of MFFIs is higher than BFIs' as MFFIs 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 from MFIs clients have been witnessed in Nepal's financial system.

3.144 Activities of cooperatives have been posing risk in the Nepalese banking sector as their deposit mobilization has been increasing. Lack of strong regulatory and supervisory authority for various types of micro finance institutions operating under different Acts is also an emerging and challenging issue. Shadow banking activities should be studied and 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.

3.145 Multiple banking practices, poor risk management practices, poor under writing standards, insider trading, non-collateralized and unsecured interbank lending and excessive misuse/siphoning of overdraft loans to the influential individuals are among the major challenges to BFIs. 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 guarantee, low effectiveness on the implementation of the verdicts of Debt Recovery Tribunal, and lack of reliable and scientific data reporting by the banks may pose risk to the banking system and therefore, needs to be strengthened for a sound and stable financial system.

3.146 Widening interest rate spread, excessive investment in real estate sector, and insecurity of public deposits are some issues that have already been addressed so far, but require some time for the result to come. Liquidity crunch is now relaxed to an extent and investment friendly environment for the BFIs is expected in the future. In the current context of weak investment and its growth implications, NRB gradually should move forward maintaining interest rate targeting at appropriate level and government should come to rebuild the business confidence for stimulating investment in the productive sectors. In addition, smoothing government capital expenditure throughout the year might be beneficial for both growth and financial stability. NRB should also provide moral suasion to BFIs to maintain the interest rate at minimum for small business and productive sector in the economy. Inflation should be controlled by the central bank (demand side) and 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 to reduce the risk of spillover.

3.147 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 possible 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 framework in place.

3.148 Likewise, triggers on PCA by including liquidity, assets quality, corporate governance, maturity mismatch, quality of internal control and risk management in addition to current capital shortfalls might be 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 might be better to introduce for reducing the procyclicality of the banking sector.

3.149 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 BFIs by NRB focusing on borrowers should be heightened. Legal actions have been taken efficiently on such non-compliances which have created an excellent demonstration effect and set examples in the financial system. 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.

Chapter Four

FINANCIAL MARKET

Money Market

4.1 Short term and long term interest rates in the financial market were decreasing in 2012/13. The monthly weighted average 91-day Treasury bill rate increased to 1.19 percent in mid-July 2013 from 1.15 percent a year ago. In mid-July 2013, the weighted average inter-bank rate among commercial banks remained at 0.86 percent, which was the same as of mid-July 2012, whereas the weighted average inter-bank rate among other financial institutions declined to 5.03 percent in mid-July 2013 from to 6.97 percent in mid-July 2012. T-bill is one of the risk free and highly liquid instruments which give an

Figure 4.1: Weighted Average Interest Rate

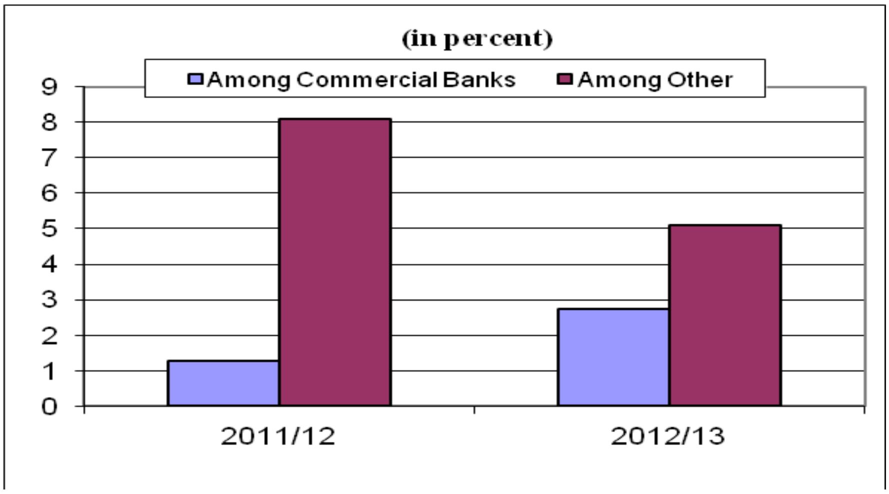
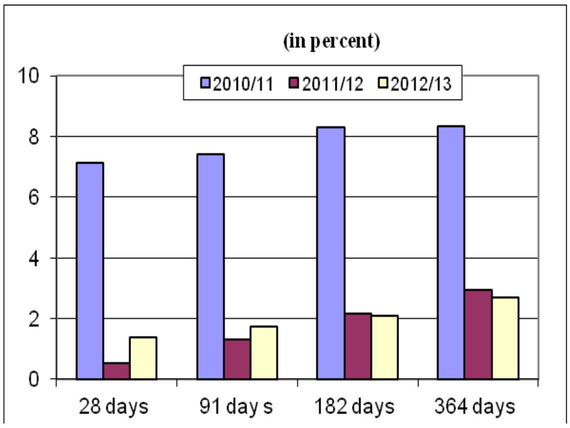


Figure 4.2: Weighted Average T-bills Rate



avenue for banks and financial institutions to maintain their liquidity and short term investment. As of mid-July 2013, the T-bills outstanding amount reached Rs. 136.46 billion, forming about 70.54 percent of the total outstanding domestic debt liability of Nepal Government. In 2012/13, weighted average T-bills rate of 91-days and 364-days remained at 1.74 percent and 2.69 percent respectively whereas such rates were 1.13 percent and 2.94 percent in 2011/12 respectively.

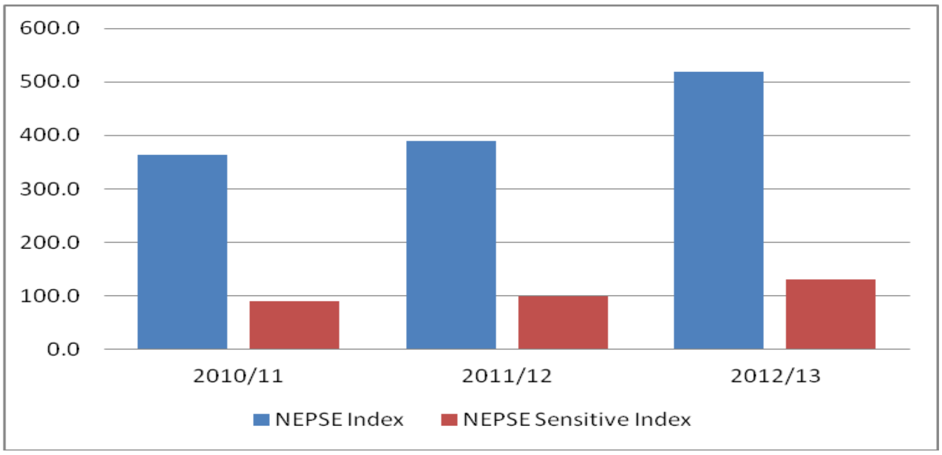
4.2 The concept of base rate has been implemented with the objectives of reducing the spread rate and improving the effectiveness of monetary policy by making lending rate more transparent and competitive. Banks are advised to consider the base rate as minimum rate for lending. In mid-July 2013, the average base rate of commercial banks stood at 9.83 percent, against 9.38 percent in mid-January 2013.

Securities Market

4.3 There was remarkable improvement in NEPSE index and securities transactions in FY 2012/13. The NEPSE index increased by 33 percent to 518.3 points in mid-July 2013 compared to an increase of 7.4 percent to 389.7 points in the previous year. NEPSE sensitive index stood at 130.3 points in mid-July 2013, as against 98.8 points in mid-July 2012. The NEPSE overall index is gradually increasing from 2011/12 to 2012/13 due to the positive hopes and aspirations of investors on the political situation after election to the second Constitution Assembly and on the profitability situation of BFIs in 2012/13.

4.4 The market capitalization increased by 39.7 percent to Rs.514.5 billion in mid July 2013. As a result, the ratio of market capitalization to GDP stood at 30.2 percent in mid-July 2013 as compared to 24.0 percent in mid-July 2012. Of the total market capitalization,

Figure 4.3: Stock Market Indices



the share of banks and financial institutions (including insurance companies) stood at 71.7 percent while that of manufacturing and processing companies, hotels, business entities, hydropower and other sectors stood at 3.0 percent, 1.7 percent, 0.2 percent, 6.0 percent and 17.4 percent respectively. Total number of companies listed at the NEPSE increased from 216 in mid-July 2012 to 230 in mid-July 2013. Of the total listed companies as of mid-July 2013, the number of banks and financial institutions (including insurance companies) stood at 198 followed by production and processing industries (18), hotels (4), business entities (4), hydropower (4) and other companies (2).

4.5 Total paid-up capital of the listed companies stood at Rs. 126.06 billion in mid-July 2013 which represent with an increase of 14.0 percent over mid-July 2012. Paid-up capital of these companies increased. This is a reflection of increase in the number of listing of additional securities at the NEPSE. In 2012/13, additional securities comprising ordinary share worth Rs. 8.25 billion, bonus share worth Rs. 4.02 billion and right share worth Rs. 0.28 billion were listed at the NEPSE. In addition, mutual fund of Rs.0.75 billion and commercial banks' bond of Rs. 120.0 billion were also listed at the NEPSE.

Foreign Exchange Market

4.6 Nepalese foreign exchange market is the combination of licensed banks, development

Table 4.1: Number of Foreign Exchange Transactions Institutions

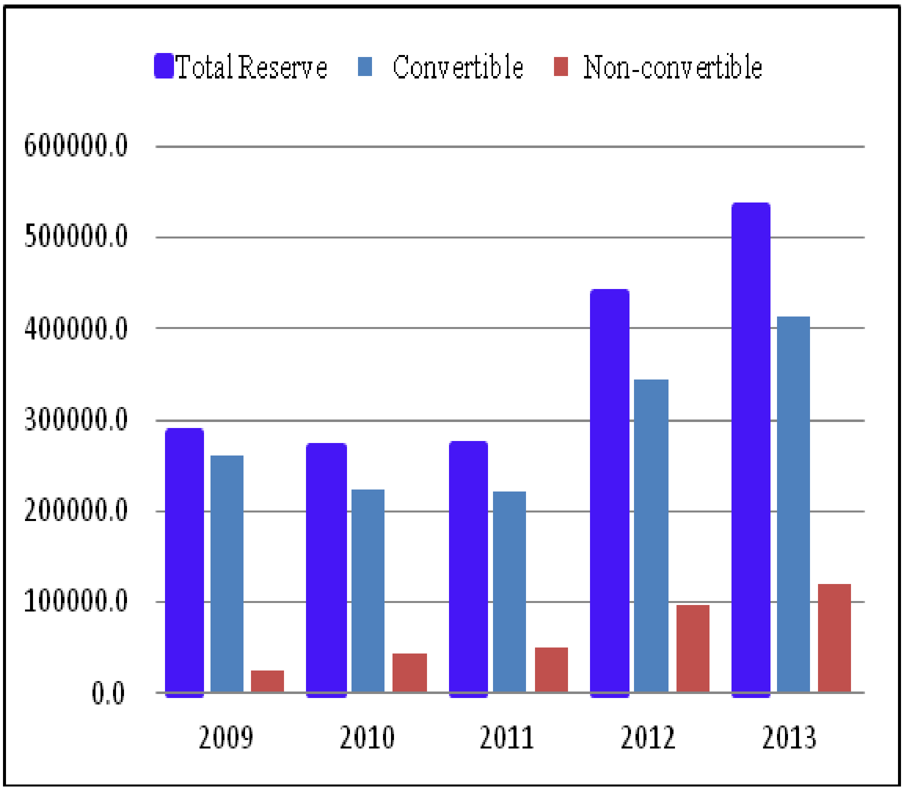
Name of the Institutions	Mid-July, 2012	Mid-July, 2013
Commercial Banks	32	31
Development Banks / Financial Institutions	61	61
Money Changer	165	165
Money Transfer	51	47
Hotels	100	109
Travels	1504	1578
Trekking	1281	1389
Airlines (Domestic as well as Foreign)	34	36
GSA/PSA of Foreign Airlines	52	52
Cargo and courier	298	301
Others	67	71
Total -	**3645**	**3840**

banks, finance companies, money transfer, money exchange and various other companies such as airlines, hotels, travel and trekking agencies that 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 the responsibility to maintain an orderly forex market through monitoring of foreign currency transaction, issuing prudential regulations and intervening in the domestic 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. Commercial banks can 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 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

Figure 4.4: Foreign Exchange Reserve

(Rs. in million)



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, 31 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 cargo 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 considerably by 21.4 percent to Rs. 533.29 billion in mid-July 2013 from a level of Rs. 439.45 billion as of mid-July 2012. The growth rate of reserves has slightly moderated during 2012/13 after a significant increase (61.5 percent) in reserve in 2011/12. 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 the US Dollar. NRB fixes and maintains the cross rate to check the inflow and outflow of foreign currency. The apparent high fluctuation of reserves corresponds to downward and upward fluctuations of reserves determined particularly by high/low balance of payment surplus. Further, the fluctuation in the reserves could also be governed by a sharp appreciation/depreciation of NPR against major international currencies coupled with surge in remittance inflows and in import. In 2012/13 NPR depreciated by 8.6 percent (annual average) to Rs. 87.96 per US Dollar in mid-July, 2013. The monthly average exchange rate reached Rs. 95.22 per US Dollar in mid-July 2013 as compared to Rs. 89.5 and Rs. 71.52 in mid-July 2012 and 2011 respectively. The depreciation of Nepalese currency in the 2012/13 resulted in exchange fluctuation gain of Rs. 15.26 billion.

Table 4.2: Total Foreign Exchange Reserve

(Rs. in million)

Particulars	2009	2010	2011	2012	2013
Total Reserve	286535.5	268888.7	272153.1	439456.7	533297.0
Convertible	260506.3	224196.5	220760.8	342825.9	414019.9
Share in total (in percent)	90.9	83.4	81.1	78.0	77.6
Non-convertible	26029.2	44692.2	51392.3	96630.8	119277.1
Share in total (in percent)	9.1	16.6	18.9	22.0	22.4
Import capacity-goods and services (months)	10.0	7.4	7.3	10.3	10.1
Percentage change					
Total Reserve		-6.2	1.2	61.5	21.4
Convertible		-13.9	-1.5	55.3	20.8
Non-Convertible		71.7	15.0	88.0	23.4

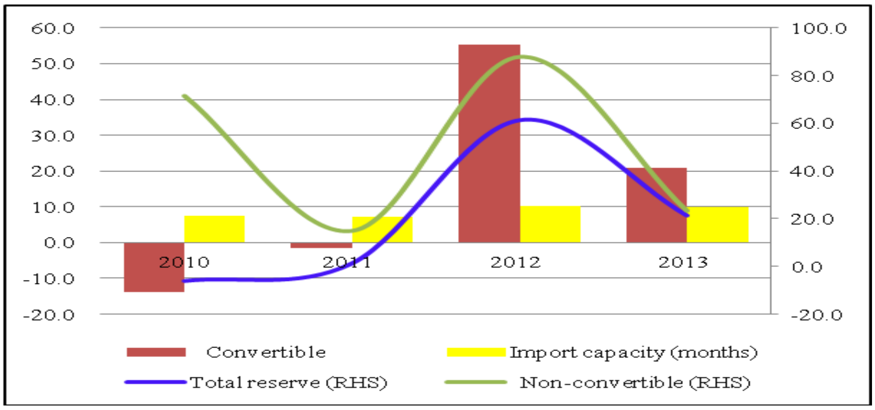
Source: Foreign Exchange Department, NRB

4.9 In terms of US Dollar, the gross foreign exchange reserves grew by 13.2 percent to US Dollar 5.61 billion as at mid-July 2013 compared to a level of US Dollar 4.96 billion in mid-July 2012. The level of reserve in mid-Jul 2011 was US Dollar 3.83 billion and it has been gradually increasing in the recent two years due to the improvement in remittance inflow, tourism receipts and among others. Though the reserves in Dollar terms grew moderately over the review period, the month to month trend remained fluctuating. The convertible reserves of the banking system reached Rs. 414.02 billion in mid-July 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 77.6 percent and 22.4 percent respectively.

4.10 The share of NRB in gross reserves slightly slipped and stood at 84.9 percent in mid-July 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 could be a reason for the decline in NRB share in total reserves. The import capacity of current reserve slipped marginally, but it is still sufficient to cover 10.1 months of merchandise import and 11.7 months of merchandise and service

Figure 4.5: Growth of Reserve

(In percent)



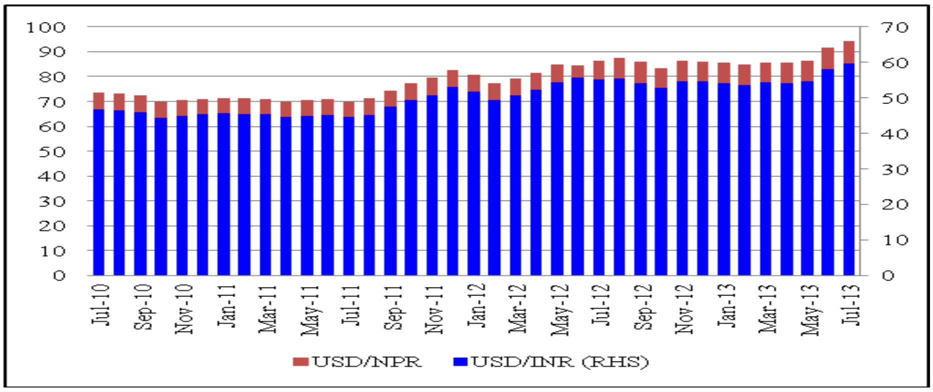
import. In mid-July 2012, such import capacity was sufficient for 11.6 months and 10.3 months respectively.

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 Nepal. 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 2013. In terms of NPR the remittances grew by 20.9 percent in mid-July 2013 and reached Rs. 434.58 billion, from Rs. 359.55 billion in mid-July 2012.

Exchange Rate and NRB's Intervention in Foreign Exchange Market

4.12 The Nepalese currency based on annual average exchange rate depreciated by 8.6 percent to Rs 87.96 per US Dollar as at mid-July 2013 from a level of Rs. 81.02 per US Dollar as at mid-July 2012. NPR had depreciated by 12.1 percent against US Dollar during 2011/12. The average selling price of INR per US Dollar remained at IRs. 55.07 during the review period while it was IRs. 51.33 during the corresponding period last year. Since May 2013 the INR started to depreciate sharply with US Dollar and that resulted in upward pressure in NPR depreciation due to the pegged exchange rate regime with Indian currency. Over the periods, particularly since 2011 both the INR and NPR are fluctuating sharply with the US Dollar. The depreciation of both the currencies occurred faster in early 2013 as compared to 2012.

Figure 4.6: Exchange Rate of INR and NPR to the USD



4.13 In 2012/13, NRB purchase of US Dollar (net) from banks and financial institutions (BFIs) through forex market intervention increased marginally by 1.2 percent to US Dollar 3.22 billion compared with US Dollar 3.19 billion in the corresponding period of last year. Though the financial market in 2012/13 enjoyed sufficient liquidity but the forex market interventions conducted by the NRB did not

Figure 4.7: Appreciation/Depreciation of INR and NPR with USD

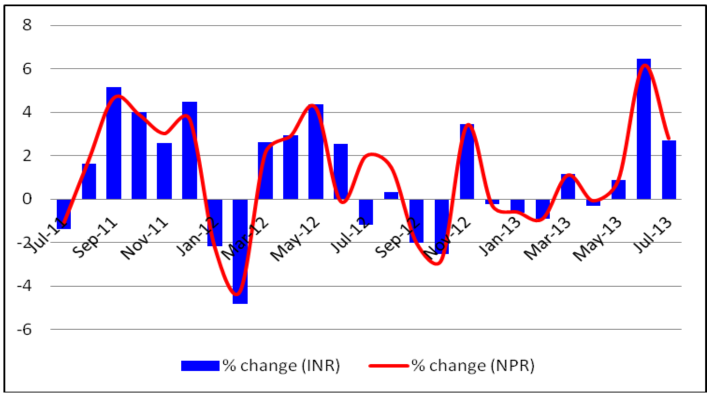
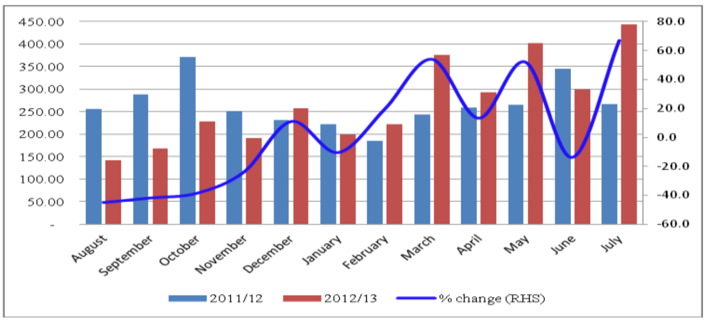


Figure 4.8: NRB's Foreign Exchange Intervention

(Rs. in million)



illustrate the significant growth in foreign exchange inflow in spite of large foreign exchange reserve with BFIs.

Table 4.3: Foreign Exchange Intervention

(Rs. in million USD)

Year	Purchase		Sale		Net Amount	US$ Sold for IC Purchase
	No	Amount	No	Amount		
2008/09	100	1919.0	3	21.4	1897.5	1520.0
2009/10	134	1606.7	1	6.0	1600.7	2190.0
2010/11	134	2419.8	2	9.4	2410.3	2740.0
2011/12	134	3186.1	0	0.0	3186.1	2660.0
2012/13	127	3235.2	2	11.3	3224.0	3120.0

Source: NRB, Foreign Exchange Management Dept.

4.14 NRB has been purchasing INR from Indian money market by selling USD since 2001/02 to meet the mounting INR demand. The volume of INR purchased grew by 28.3 percent to IRs. 171.52 billion by selling US Dollar 3.12 billion during 2012/13 compared to the purchase of IRs.133.72 billion by selling US Dollar 2.67 billion in 2011/12. In 2010/11, NRB had purchased IRs. 123.84 billion by selling US Dollar 2.74 billion in the Indian money market.

Figure 4.9: Purchase of IC by NRB

(Rs. in million)

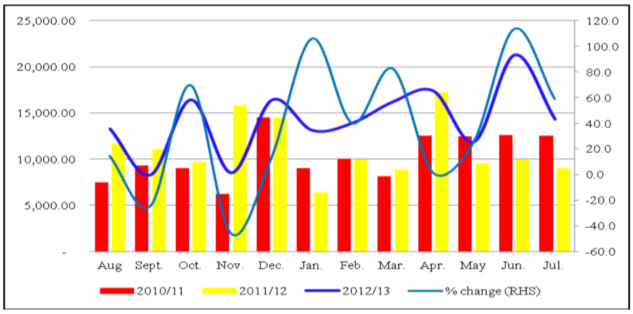
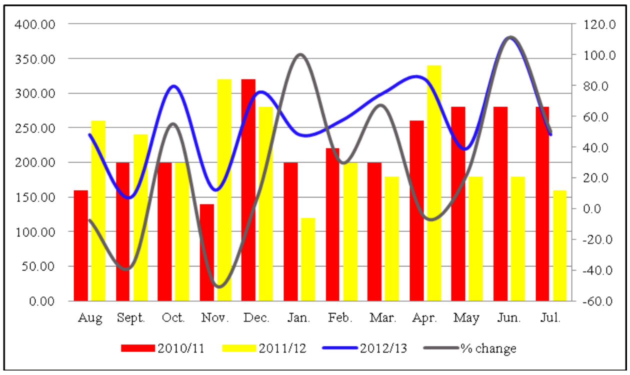


Figure 4.10: Sale of USD by NRB

(Rs. in million)



4.15 The widening of trade deficit with India emanating from a surge in imports of petroleum products and other consumers goods has been attributed to a higher amount of INR purchase in recent 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.

Table 4.4: 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	3120.00	171522.60	274436.16

Source: NRB, Foreign Exchange Management Dept.

4.16 As parallel market transaction of foreign currency is a common phenomenon in developing countries and in countries adopting 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 for ensuring financial stability. NRB is entrusted with the responsibility of regulating, inspecting, supervising and monitoring BFIs. Accordingly, NRB has been issuing various policies, directives, guidelines and circulars. Its 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 inclusion, among others. The objectives of these regulations are to strengthen the health and soundness of the BFIs, 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 on 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. Acknowledging 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 and inclusion in rural areas. NRB believes that this will increase financial inclusion and reduce poverty in rural areas.

5.3 NRB is considering the revision of existing licensing policy in view of changed context in terms of time, market dynamics, geographical topology and implementation of Basel III both in domestic 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 identification of areas that require further revision.

Newly Established/Licensed Bank and Financial Institutions

5.4 Among the applications received in the earlier licensing policy, in the review period Salapa Bikash Bank Limited of "B" class (1 district), Saptakoshi Development Bank Limited (3 districts) and Sajha Bikash Bank Limited (3 districts) received the license from NRB. Likewise, Mahila Sahayatri Micro Finance Financial Institutions Limited, Clean Village Micro Finance Financial institution Limited, Forward Community Micro Finance Financial Institution Limited, Reliable Financial Institution Limited, Mahuli Samudayik Financial Institution Limited, Suryodaya Financial Institution Limited and Mero Micro Finance Financial Institution Limited have received license to operate as "D" class MFFIs. Among these, Mahuli Samudayik Financial Institution Limited and Forward Community Micro Finance Financial Institution Limited were transformed to MFFIs from FINGO.

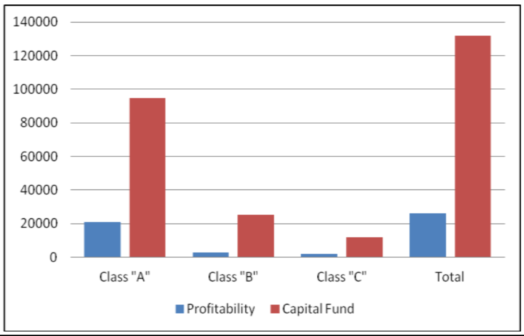
5.5 Among the registered applications, according to the early policy provision in licensing procedure, the proposed MFFIs in review period were Samata Micro Finance Financial Institution, National Micro Finance Financial Institution, Nepal Sewa Micro Finance Financial Institution and Samudayik Micro Finance Financial Institution and in total 3 MFFIs received the letter of intent from the NRB.

Capital Adequacy

5.6 Capital adequacy is a position where the adjusted capital is sufficient to absorb all losses and cover fixed assets of the bank leaving a comfortable surplus for the current operation and future expansion. In fact, adequate capital is regarded as the amount of capital that can effectively protect bank operations from failure by absorbing losses. Moreover, the level of capital must be adjusted at the time when the total operational expenses and withdrawal needs are expected to increase. Adequate capitalization is an important variable in business and it is more so in the business of using other people's money such as banking. Insured banks must have enough capital to provide a cushion for absorbing possible losses or provide funds for its internal needs

Figure 5.1: Profitability and Capital Fund of BFIs

(Rs. in million)



and for expansion, as well as ensure security for depositors and the deposit insurance system. Capital adequacy requirements are also useful in restricting bank size to be small enough to avoid moral hazard problems. Various economic as well as financial factors can also positively and negatively affect the bank capital. For example, the higher the ROA, loan to assets ratio and, dividend payout ratios, among others can positively affect, whereas, deposit assets ratio, size of bank and loan provision ratio can negatively affect the capital of banks. The profitable banks tend to have relatively more equity capital level of BFIs. Hence it is positively correlated with the profit of the bank and accumulation of profits provides a higher level of capital growth. The banking sector in Nepal has been witnessing a notable growth in profitability. The changes in macro-economic variables such as inflation, real exchange rate, money supply and political instability and return on investment might have robust impact on the capital adequacy ratio of BFIs in Nepal. However, political stability and better macroeconomic performance with sound performance indicators certainly might have a positive impact on the bank capital. At present, despite few political problems and comparatively less encouraging macroeconomic indicators, the capital adequacy ratios of BFIs in Nepal have stood quite above the regulatory minimum requirement, which is appreciated from the financial stability point of view.

Table 5.1: Capital Adequacy Requirements 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

5.7 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) was issued for the first time in 2007. Implementation of Basel II started after one year of parallel run of Basel I and Basel II in commercial banks. After the parallel run for 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.

5.8 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 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 capital adequacy ratio as presented in table 5.2 below.

5.9 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.

5.10 Furthermore, as a part of NRB's continuous effort to enhance regulatory framework, initiation has been taken 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 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

Table 5.2 Capital Adequacy

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

total capital requirements. There is no specific regulatory requirement for common equity Tier 1 capital under SSA of Basel II, but the NRB's licensing policy requires the existing banks ("A" class) to have minimum paid up capital (including some components of core capital) of Rs 2 billion.

5.11 NRB's capital requirements seek to ensure that risk exposures of BFIs are backed by an adequate amount of high quality capital which absorbs ongoing concerns. This ensures that BFIs further promote their cushion of assets that can be used to meet claims in liquidation.

Liquidity

5.12 The capital adequacy alone is not enough. Banks have to manage liquidity. A central bank's lender of last resort function, among others, is crucial for liquidity support to banks. Some banks failed during the recent financial crisis, due not to a capital shortage but a funding shortage that brought the banks down. Banks and financial institutions rely to varying degrees on capital markets, including short-term funding markets, for their financing needs. In normal times, NRB provides routine short-term financing to BFIs to support the smooth operation of the payments system, promote well-functioning funding markets and support the monetary policy stance, among others. The provision of liquidity by the NRB during the shortage helped to reduce funding pressures. The provision of NRB's special liquidity window directly improved the funding position of participating institutions by providing funding for a range of assets that had become more difficult to finance in private financial markets in times of stress. It contributed indirectly to improving the liquidity position of the institutions with which these BFIs interact. Overall, this supported the provision of liquidity in markets more broadly.

5.13 At present BFIs of "A", "B" and "C" class shall have to maintain a deposit with NRB of 5 percent, 4.5 percent and 4 percent of total deposit liabilities as CRR respectively. Furthermore, with the objective of ensuring sufficient liquidity in the financial system, Statutory Liquidity Ratio (SLR) has been fixed at 12 percent, 9 percent and 8 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. Likewise, the maximum period of repo and reverse repo for short-term liquidity management under OMOs has been reduced to 21 days and SLF to BFIs is being continued.

Corporate Governance

5.14 Banks form a crucial link in a country's financial system and their well-being is imperative for the economy. The significant transformation of the banking industry in Nepal is clearly evident from the changes that have occurred in the financial markets, institutions and products. While deregulation has opened up new vistas for BFIs to augment revenues, it has entailed greater competition and consequently greater risks. Effective corporate governance in BFIs helps foster financial stability, strengthen risk management and ultimately contribute to a strong financial system. A sustainable growth in the economy is critically dependent on a sound financial system.

5.15 From the viewpoint of BFIs, corporate governance includes maintaining capital adequacy, transparency in the publication of accounts, management of operational, credit, market and environmental risks, to name a few. Now-a-days, there are so many risks that have come through the process of market mechanisms. The Basel II is a good reference of it and NRB has issued directives on good corporate governance. It is a clear indication of NRB's commitment to bring about high level of corporate governance. To be very specific, Directive 6 of the NRB, which has mentioned about the overall corporate governance and the code of ethics of directors and chief executive officers of BFIs, require all the directors regardless of their executive or non-executive status, to sign a declaration which prohibits directors,' involvement in activities against the interest of the company. For the betterment of the overall financial system in the country, it is very important that the regulators, the companies, the directors, employees and the shareholders to gracefully honor the principles of governance. On the other hand, corporate governance is the joint responsibility of all and reforms of BFIs can fully be implemented if and only if prudential regulatory systems of good corporate governance are practiced with strong commitment for success. Nevertheless, an efficient judiciary system is indispensible for effective implementation of good corporate system in Nepal.

5.16 One common factor behind the problems of BFIs in Nepal is poor corporate governance. The common reason behind the financial calamity in BFIs is promotes' and directors' vested financial interests. Over the last few years, many instances of poor governance have appeared. A healthy corporate governance culture is imperative in the banking sector where the retention of public confidence remains of utmost importance. In this regard, the board of directors is the essential fulcrum upon which the mechanism of corporate governance and management rests. Poor corporate governance has been identified as one of the major factors in virtually all known instances of distress in banks. This is taking place against the backdrop of the existence of Code of Corporate Governance of organizations in the bank. Corporate governance has fast emerged as a benchmark for judging corporate excellence in the context of banking business. From guidelines and desirable code of conduct some decade ago, corporate governance is now recognized as paradigm for improving competitiveness and enhancing efficiency, thus improving investors' confidence and accessing capital.

5.17 Guidelines on services and fees and commission on services charged by BFIs, requirement of setting up an information and grievance hearing desk to address grievances of customers, guidelines on compensation packages for Chief Executive Officer of BFIs in order to address pay scale differences and enhance transparency in the financial system are other important functions pertaining to good corporate governance. Likewise, a policy provision barring promoters, CEOs 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 simuleaneously 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 and Supervision Manual

5.18 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 institution and it will be gradually enforced for implementation to "B" and "C" class institution 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 for forward looking analysis. To increase the effectiveness in Risk Based Supervision, the current supervision mechanism is reanalyzed and modification work is being carried out. For implementing risk based supervision approach, Risk based Supervision Manual has also been prepared and presented to NRB Board whereas Offsite Manual is in the phase of preparation.

5.19 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.

5.20 In order to strengthen the monitoring and supervision of both the on-site and off-site inspection of BFIs, an updated and revised Supervision Bylaws 2070 has been approved and it is implemented with the aim of improving existing supervision weakness system.

Problem Bank Resolution Manual, Toolkit and BCP

5.21 In order to effectively implement the Early Warning System and to prepare the contingency plan, Bank Resolution Framework has already been prepared including the stepwise tasks on Crisis Management. Likewise, Problem Bank Resolution Manual and Toolkit that was designed under technical assistance of World Bank with the intention of properly addressing problem banks and financial institutions, has received the final approval. In this concern, necessary correspondence has been conducted with concerned NRB supervisory departments and Human Resource Management Department to develop required institutional structure.

5.22 Similarly, In order to identify the implementation status of main provisions of Basel II in Nepal and to evaluate the issues that need to be rectified in near future, Basel Core Principle Assessment Program (BCAP) has been brought in operation. This will help in understanding the implementation gap of BCP in Nepal. The action plan will be implemented soon by the NRB.

Interest Rate System

5.23 The concept of base rate, under implementation in commercial banks, is planned to be implemented in other financial institutions in order to make lending interest rate transparent and competitive. Moreover, 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 should not 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 inherent on the concerned loan. NRB may further take necessary steps to rectify the interest spread as and when required.

5.24 NRB has issued directives for commercial banks that they should have to publish their base rate calculated by taking into account elements of cost of fund on a monthly basis on their website and quarterly basis on national daily newspapers for information of the general public. While fixing the interest rate for any loan, banks should have to adjust interest rate on the basis of their base rate and normally, the rate should not be lower than the base rate. NRB has clearly stated that it would not be appropriate for banks to lend below their base rate.

Major Regulatory Pronouncements and Recent Initiatives Undertaken in 2012/13

5.25 To clear the working procedure for holding AGM clearance and approving dividend with the requirement of 1 percent buffer capital to distribute cash dividend and to make electronic cheque clearing system secure 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: PCA for liquidity risk, study on remuneration of CEO and staff of BFIs, Investors Survey, study on 'Hire Purchase Business through Investment Companies', and study to frame and issue 'Payment System Development Strategy'.

5.26 Licensed "A", "B" & "C" class BFIs are provided refinance facility by NRB to ease and facilitate extension of loans for agriculture, hydropower and other productive sectors at concessional interest rate.

5.27 A provision is made whereby refinance facility provided by NRB is used by BFIs for loan provided to hydropower projects of up to 25 MW, agriculture sector and other productive sectors, tourism, and infrastructure oriented industries. Refinance rate under this heading is 6 percent whereby BFIS cannot charge more than 9 percent to the clients. Likewise, special refinance rate applicable to credit for export industry, sick industry, small and cottage industry and foreign employment for specified section of people was maintained at 1.5 percent. Under this facility, commercial banks and financial institutions cannot charge more than 4.5 percent to the clients. Similarly, export refinance rate applicable for export oriented firms/companies based on export documents was maintained at 1.5 percent. Under this facility, commercial banks and financial institutions cannot charge more than 4.5 percent interest to the clients. Refinance of up to 300,000 for micro and cottage industries under the ownership of women also made available by the NRB. Refinance rate under this heading is 6 percent where BFIs cannot charge more than 9 percent to the clients.

5.28 The bank rate was fixed at 8.0 percent and the requirement under deprived sector lending was increased from 3.5 to 4.0 percent, 3.0 to 3.5 percent and from 2.5 to 3.0 percent for A, B, and "C" class financial institutions respectively.

5.29 Promoters, CEOs or managerial level officials of licensed institutions are barred from borrowing any personal loan other than education loan, hire purchase loan, home loan or home appliance loan from any licensed institutions. They can borrow for such purposes against the collateral of government securities and credit card.

5.30 The requirement of sending credit information of borrower by licensed BFIs to CIB has been lowered 2.5 million to 1.0 million. Likewise, a policy of providing mobile banking services through agent appointed by BFIs has been made. For undertaking such services a provision has been made where an additional capital charge of 2 to 5 percent of gross income of immediate previous financial year shall be levied for operational risk. Likewise, "B" & 'C" class institutions are required to add 5 percent of their total assets as risk weighted assets as operational risk.

5.31 To operate the branchless banking service with the help of POT machine in rural areas, after analyzing the technical and practical aspects of it, eleven commercial banks were given approval to operate branchless service in 194 spots in 2012/13.

Macro prudential Regulation and Supervision

5.32 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 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 systemic risks were not sufficiently addressed either by monetary policy anchored to price stability objective or by microprudential regulation through adequacy of capital and liquidity of individual financial institutions.

Macroprudential Policy, Assessment and Toolkits

5.33 The global debate in policy circles about the definition of macroprudential policy is ongoing. Macroprudential policy is characterized by reference to three defining elements that is objective to limit systemic risk, its scope to focus on the financial system as a whole, and its instruments and associated governance to use prudential tools calibrated to target the sources of systemic risk. Macroprudential policy also interacts closely with other spheres of public policies. For example, the stance of monetary policy can affect risk taking incentives and fiscal policy and the level of public debt can be an important source of vulnerability for the financial sector. Likewise, macropruential policy interventions, in turn, have macroeconomic effects. For example, raising capital requirements in a credit boom may dampen aggregate demand and hence influence the macroeconomic environment. Given these interlinkages, effective macroprudential framework requires institutional arrangement and governance structures, tailored to Nepal's circumstances that can ensure to limit systemic risk.

5.34 To inform and guide timely policy decisions, systemic risk measures should be able to capture the time and cross-sectional dimensions of systemic risk. Measures should signal the gradual build-up of imbalances and vulnerabilities, likelihood and potential impact of shocks, and flag concentration of risk within the system. Different countries have used a wide range of indicators and models to assess systemic risks as discussed below:

a) *Aggregate indicators of imbalances*: These indicators use macroeconomic data or balance sheet indicators for example bank credit, liquidity, maturity mismatch, currency risk, sectoral and external imbalances to signal the buildup of risk in the financial system and the economy at large. Likewise, leverage in the financial and household and corporate sectors, the gap between credit-to-GDP ratio, credit growth, rapid asset-price growth, among others can be used as an indicator of systemic risk build-up in the banking system, and hence as a guide to set the countercyclical capital buffer for banks.

b) *Indicators of market conditions*: Indictors of risk appetite for example, spreads, risk premia and market liquidity conditions are used on developments in financial markets that may lead to generalized distress.

c) *Metrics of concentration of risk within the system*: This approach includes standard and sophisticated models of assessment of risk. For example, network analyses based on balance sheet cross-exposures, contingent claims analyses, joint probabilities of default and other measures of distress dependence on both equity returns and spread and other market-based indictors of spill-over risks to measure the cross sectional dimension of systemic risk of the whole financial system can be applied. This approach measures the common exposures and interconnectedness among financial institutions, sectors and markets beyond basic measure of size and concentration, among others.

d) *Macro stress testing*: This includes the tools to test stress and the resilience of individual banks as well as financial system as a whole.

5.35 In general, the usefulness of a specific indicator depends on a range of country and context-specific factors in their domestic circumstances and there is no single framework in use. Moreover, because of its system-wide perspective, macroprudential policy requires an ability to capture the build-up of systemic risk, also in the shadow banking system. In developing an enhanced monitoring framework, the central bank need to apply high level principles that are relevant for systemic risk monitoring more broadly. To assess risks in the entire financial system, monitoring should be regular, so that nascent risks can be identified on time. As ready access to the necessary data and information is essential, and so it is important that the relevant unit have the requisite powers to collect information from the market participants and stakeholders of macroprudential policy analysis. Similarly, improving data and information to support macroprudential policy making and analysis is critical for an effective framework and to assess and monitor systemic risk. Improving data for systemic risk analysis will necessitate improvements in data collection frameworks in some cases in Nepal. Moreover, changes in the arrangements for information exchange may also be needed to promote effective data sharing among key agencies, so as to strengthen the assessment of system-wide risks both in house and at the national level.

5.36 In Nepal, developing effective macroprudential policy framework requires identifying and developing a set of policy tools and operational guidelines for their use, including for their calibration. As prudential tools are the key instruments in the framework, where tensions exist between their use from a micro and macroprudential perspective, mechanism need to be in place to assess and ensure their consistency. Although there is no universally agreed theoretical framework of macroprudential tools, it is still too early to provide a definite assessment of the set of macroprudential tools that prove most useful in case of Nepal. However, the commonly used tools can be applied to address threats to financial stability arising from excessive credit expansion and assets price booms.

5.37 Tools to address key amplification mechanisms of systemic risk linked to leverage and maturity mismatches (for example market and funding liquidity tools) and tools to mitigate structural vulnerabilities in the system and limit systemic spillovers in times of stress, such as additional loss absorbing capacity of BFIs, disclosure requirements that target common exposures, common risk factors and interconnectedness and specific requirements for BFIs, in the context of effective resolution framework might be the key supportive instruments in this area. Infrastructure policies (for example, robust payment and settlement systems and trading infrastructures, among others.) and measures to enhance robustness of financial market infrastructure can be helpful in addressing the cross sectional dimension of systemic risk and are considered complementary macroprudential tools.

5.38 In fact, macroprudential indicators (MPIs) are related with the health and stability of financial systems. Various types of MPIs can be found in financial stability reviews (FSRs) published by central banks, supervisory authorities and international organizations. There are two groups of MPIs: aggregated (macroprudential) and individual (microprudential) and macroeconomic variables associated with the soundness of financial system. Aggregated indicators can be divided into groups stemming from the CAMELS framework for assessing individual institutions' soundness. The acronym CAMELS stands for Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. As MPIs should be quantitative, management assessment is usually not included in macroprudential analysis. The set CAELS is often supplemented by market based indicators, such as stock indices etc.

5.39 In 2000 the IMF started a project called "Financial Soundness Indicators" (FSI), which was aimed at assembling a database of MPIs that would allow assessing and comparing the soundness of financial systems in different countries. These MPIs were divided into two subsets: core and encouraged. The core set encompasses 12 indicators measuring the areas of deposit takers' soundness described by the acronym CAELS. NRB has already arranged and calculated such database of core set and started to publish in its FSR from mid-July 2012. The encouraged set comprises 28 indicators: 13 for deposit takers, 2 for other financial corporations, 5 for nonfinancial corporations, 2 for households, 2 for market liquidity and 4 for real estate markets. It is easy to see that the whole set of FSI is dominated by indicators of deposit takers' health. Many FSRs are also focused on banking sector stability. This is due to the fact, that financial systems in most countries are rather banking-oriented than market-oriented. Similarly, an IMF and BIS survey of country experiences revealed that a number of countries have used policy instruments to address aspects of systemic risks for quite some time and highlighted how the choice of toolkit has been clearly influenced by country and context specific factors. These include the type of balance sheet vulnerabilities, the exchange rate regime and the prevailing sources of risk.

5.40 Macroprudential policy does not seek to replace traditional regulation of financial institutions, such as commercial banks, which are essential to a healthy financial system. Instead, it adds to and complements microprudential policy. It can often deploy traditional regulatory tools, and relies on traditional regulators for implementation and enforcement. But it adapts the use of these tools to counter growing risks in the financial system. This evolving approach may require a new type of regulatory setup to monitor the financial system for evidence of growing threats to stability and to enable the regulatory/supervisory agency to take action to counter those threats.

5.41 Macroprudential policies are designed to identify and mitigate risks to systemic stability, in turn reducing the cost to the economy from a disruption in financial services that underpin the workings of financial markets—such as the provision of credit, but also of insurance and payment and settlement services. An example of such a disruption is a credit crunch, in which losses suffered by banks and other lenders cause a curtailment of credit to households and firms that in turn depresses overall economic activity. Such disruptions can arise either from the overall, or aggregate, weakness of the financial sector or from the failure of so-called systemic individual institutions—which are large and have financial relationships with many other institutions.

Table 5.3: Macroprudential Policy Instruments and Potential Indicators

Policy Instruments	Potential Indicators
Capital Based Instruments	
Countercyclical capital buffers	Measure of the aggregate credit cycle
Dynamic Provisions	Bank-specific credit growth and specific provisions
Sectoral capital requirements	• Measures of the price and quantity of credit aggregate on a sectoral basis • Measures of sectoral concentrations • Distribution of borrowing within and across sectors • Real estate prices • Price-to-rent ratios
Liquidity-based Instruments	
Countercyclical liquidity requirements	• Liquid assets to total assets or short-term liabilities • Loans and other long-term assets to long-term funding • Loan-to-depoist ratios • Spread rate
Margin and haircuts in markets	• Margins and haircuts • Bid-ask spreads • Liquidity premia • Shadow banking leverage and valuation • Market depth measures
Asset-side instruments	
LTVs and DTIs	Real estate prices, • Price-to-rent ratios • Mortgage credit growth • Underwriting standards • Indicators related to household vulnerabilities • Indicators of cash-out refinancing

Source: BIS and IMF

5.42 A number of tools are being developed and some have been used recently to address the buildup of aggregate risks over time by the NRB. An important one that is intended to be introduced in the future is the dynamic provisioning as well as the capital buffer related with it. Dynamic provisioning, also called forward looking loss provisioning, is the adjustment of banks provisions for defaults on loans for the effects of the economic cycle, so that provisions will be increased during booms, to leave for the possibility or a downturn, and provisions will be lower during a recession, as there is less room for worsening. Reducing provisions during a downturn also prevents confidence in the stability of banks being undermined by weak balance sheets.

5.43 Financial institutions in Nepal have long been required by the NRB to maintain a certain amount of capital (normally equity and retained profits) to enable them to absorb (or buffer) losses on loans or securities. The dynamic buffer require financial institutions to add to their capital when there are signs of unusually strong credit growth or when there are signs of a credit-driven asset price boom. The buildup of the capital buffer has a two-fold impact. Because lenders must raise more costly equity funds, the cost of credit should rise and its growth should slow down. At the same time, the buffer should increase the resilience of the system, allowing it to better absorb any losses when the boom gives way to bust. That, in turn, reduces the chance of a costly credit crunch.

5.44 Hence, the dynamic, or countercyclical, capital buffer can be used to target specific vulnerabilities. Many of them have already been used in the past in one way or other way round by the NRB to prevent boom-bust credit cycles and include tools to address the interplay between market risks and credit risks—such as maximum loan-to-value ratios for home mortgages and the buildup of liquidity risks as credit grows strongly. Following are the few measures already taken by the NRB.

a) *Variation in sectoral risk weights:* Designed to be less blunt than dynamic capital buffers, these force institutions to add capital to cover new loans in sectors that are building up excessive risks.

b) *Dynamic provisions:* These force banks to set aside money to cover loan losses in good times when credit losses are relatively low so that bank balance sheets are better prepared to absorb losses that build during downturns. This dynamic provisioning regime was introduced in Spain in 2000 and more recently in Chile, Colombia, Peru, and Uruguay.

c) *Loan-to-value ratios:* Maximum loan-to-value ratios are increasingly being applied to reduce systemic risk from boom-bust episodes in real estate markets. By limiting the loan amount to well below the value of the property, loan-to-value ratios help limit household leverage. They are often complemented by debt-to-income ratios (but indirectly by banks along with LTV ratios) that seek to limit the fraction of household income spent on servicing debt.

d) *Liquidity requirements:* When funding is easy to obtain, an increase in required buffers of liquid assets (those that can be easily and quickly converted to cash) provides cash reserves that can be drawn on when funding dries up. Such a time-varying increase in liquidity requirements can also curb credit expansion fueled by short-term and volatile wholesale funding and reduce reliance on such funding.

5.45 Nepal has already in place measures such as liquid assets to deposit ratio and other liquidity requirements, among others. New Zealand and Korea also recently introduced such measures. In Nepal, most tools currently under discussion are designed to reduce the likelihood of failure of institutions that are too important to fail. While the design of institutional foundations for macroprudential policies should take into account country-specific circumstances and differences in institutional starting points, some general goals are likely to be relevant for all countries. The arrangements should foster effective identification of developing risks; provide strong incentives to take timely and effective action to counter those risks; and facilitate coordination across policies that affect systemic risk.

5.46 As an independent central bank, the NRB should play an important role in all regulatory and supervisory roles. Not only does the NRB have expertise in risk assessment, but as lender of last resort to institutions facing liquidity problems, NRB has been motivated to take timely action to reduce the buildup of risks. Moreover, a strong role for bank allows coordination with other policies, which sets the overall conditions that affect the demand for and supply of credit. Participation by the government can be more useful to facilitate legislative changes that may be needed to enable the agency to mitigate systemic risk, such as the creation of regulatory authority over nonbank lenders and other systemic institutions. But because of the political nature of government, a strong role can pose risks because governments have incentives to oppose taking macroprudential measures in good times, when they are often most needed.

5.47 Instead policymakers should move toward employing a set of indicators. This approach recognizes that systemic risk has more than one dimension. More pieces of information also help NRB to identify which tool or combination of tools would be most effective in addressing potential problems. For example, to capture aggregate risk, the NRB must monitor overall credit, liquidity, and market risks, as well as any concentrations of those risks in a particular sector, such as housing or consumer credit. It would then analyze those risks to decide which policy tool is most effective to address them.

5.48 Policymakers should be mindful that macroprudential policy, like any public policy, is not free of costs and that there may be trade-offs between the stability and the efficiency of financial system. For instance, when requiring financial institutions to maintain a high level of capital and liquidity, policymakers may enhance the stability of the system, but they also are employing measures that make credit more expensive and thus may reduce economic growth. Thus, balancing benefits and costs will often require difficult judgments.

5.49 Basel III has some microprudential 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.

5.50 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 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.

5.51 NRB has already formulated and enforced some of the macroprudential regulations relating to strengthening of 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 timely manner, among others etc. Similarly, policies regarding differentiation between bankers and entrepreneurs/businessmen, strengthening financial intelligence, enhancing financial discipline, formulating financial literacy policy, making necessary arrangement against multiple banking practices for maintaining financial stability in Nepal are underway.

5.52 Regarding real estate policy, the limit on individual residential loan has been increased to Rs 10 million and these component 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 loans can also 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. At the same time, the bank 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 still persists. 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 BFIs present focus is on recovery rather than increasing transactions. If the situation propagates in the realty sector it may take some more time for a complete recovery of.

Access to Finance, Reform of MFFIs and Financial Inclusion

Access to Finance

5.53 To enhance financial inclusion and access to finance, a provision of interest free loan has been made for BFIs for opening branch in district headquarters and outside district headquarters 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.

5.54 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 recognized as an important tool to increase banking access to the people living in geographically difficult-to-reach places in Nepal.

Reform of MFFIs

5.55 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 has been issued. Likewise, a separate inspection directive is being drafted for the FINGOs and a revision is being made on the directives issued to cooperatives licensed by the NRB for conducting limited banking activities.

5.56 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 throughout the country. This process is expected to pave the way for intensive and more cautious regulation/supervision of this sector and will further contribute in 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.

5.57 Similarly, timely revisions are being made in the directives issued to BFIs involved in 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 MFFIs. This step will also be helpful for financial stability and corporate governance, in general.

5.58 As the existing Credit Information Centre (CIC) caters services only to commercial banks and financial institutions other than MFIs; the establishment of a separate credit information agency specialized in 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.

5.59 As the licensing process for new financial institutions except "D" class financial institutions has been stopped by NRB, the trend of establishment of "D" class institution is increasing nowadays. Altogether 35 "D" class financial institutions (including five rural development banks) were operating till mid October 2013. NRB regulation allows establishing new micro finance institution as a subsidiary company after investing specific portion of their loan portfolio to deprived sector. This legislation is also encouraging the establishment of new MFFI as the subsidiary company. Four of

"D" class institutions are working as a wholesale lender, 13 of MFFIs are operating at the national level, and rests are operating at the regional level. 29 applications have been received for new license which are under process.

5.60 Public notice has been issued for submitting the working plan to transform NGO's into "D" class financial institutions as per the announcement made in monetary policy of 2013/14. Besides these, those applicants who have submitted the application to get license for "D" class financial Institutions but are now out of contact have already been notified to submit their recent working plan. Likewise, the branch establishment policy has been emphasized to target the unbanked areas and, for this, selected districts have been provided higher priority and privilege to open the branches.

Financial Inclusion

5.61 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 making inclusive financial system inclusive. Other focuses include good governance and balanced development in the financial sector through increased financial literacy among the general people.

5.62 Banks have been encouraged to allocate more credit to agriculture (which provides jobs and livelihood to two-thirds of the households) and energy which is so critical for inclusion. There is a deprived sector lending requirement for BFIs, special refinance facility to cottage and small industries and enterprises run by women and specified community, refinance facility with concessional interest rate to productive sector, and interest free loan to banks to open branches in rural areas. Likewise, financial literacy programs are directed towards financial inclusion and growth in Nepal.

5.63 NRB has made a provision that BFIs need to submit a plan to extend 20 percent of their total credit to productive sector in the next three years. Similarly, to ease availability of credit to productive sectors, BFIs are restricted to extend more than 25 percent of their total credit to real estate sector including housing. Special refinance facility with very low interest rate (1 percent) for loan extended by BFIs to cottage and small industries, enterprises run by women and small enterprises run by people of specified communities is being provided to banks and financial institutions at concessional interest rate against good loans extended to the productive sector. Microcredit facility is being provided to rural people on concessional interest rate from Rural Self Reliance Fund along with interest subsidy to good borrowers and such facility is provided to BFIs for small & medium enterprises' loan up to Rs. 10 million. Project loan of up to Rs. 0.5 million extended by BFIs to enterprise run by women entrepreneurs is counted under deprived sector loan and refinance facility is provided to BFIs against such loan. BFIs are allowed to extend project loan of up to Rs. 10 million in agriculture farming such as coffee, tea, orange, livestock and dairy products on the basis of viability of the projects. Likewise, steps are taken to extend some amount of collateral free loan to small farmers and business enterprises.

Monetary Policy

5.64 The implementation status of Monetary Policy 2012/13 shows that majority of the objectives and programmes have been achieved or implemented. Financial access and inclusion increased with the expansion of network of financial institutions. Liquidity position was relaxed in the financial market. Deposit mobilization increased and so did the credit flow. Credit flows from BFIs to productive sectors has been increasing and simplified refinance facility with cheaper cost has increased the refinance facility to Rs. 2.74 billion as compared to Rs. 0.87 billion in the previous year. BOP surplus grew. Liquidity Monitoring and Forecasting Framework (LMFF) has been expanded to "B" and "C" class financial institutions as well. Despite all these initiatives, economic growth remained at 3.6 against the revised target of 4.1 percent. The annual average inflation rate remained at 9.9 percent against revised projection of 7.5 percent.

Box 5.1: Some Recent Policies Announced in Monetary Policy 2013/14.	
Liquidity Management and Interest Rate Policy	• Bank rate is kept constant at 8 percent. • CRR reduced to 5 percent, 4.5 percent and 4 percent to A, B and "C" class institutions respectively. • SLR revised to 12 percent, 9 percent and 8 percent to A, B and "C" class institutions respectively. • Maximum period of repo and reverse repo auction under OMOs will be reduced to 21 days. • Online bidding system will be introduced in the auction of Treasury bills and development bonds, OMO bylaws will be formed and implemented, and necessary infrastructure will be developed to introduce primary dealer system to make secondary market of government securities more active. • Long-term bonds will be issued. • Concept of base rate will be gradually implemented in other financial institutions. • Provision of Prompt Corrective Action, based on liquidity for commercial banks not maintaining prescribed liquidity ratio, will be made. • Provision of maintaining institutional deposits below 60 percent within a certain period by commercial banks will be introduced. • A provision will be made to bring an average interest spread rate between credit and deposits of A, B and "C" Class "B"FIs to 5 percent within a certain time period. • A provision will be made not to differentiate interest rate above certain percentage on similar types of credit and deposits by BFIs.

Financial Inclusion and Access to Finance	• Licensing will remain open for "D" class financial institutions preferably in those districts with very limited financial access. • Existing provision of providing interest free loans for BFIs to open new branches has been continued. Reopening of displaced branches will be encouraged. • Pension and social security allowance will be made available through branchless banking system of BFIs. • An arrangement will be made to provide loan up to Rs. 2.0 million at zero interest rate for a certain period to "D" class microfinance institutions to open branches in those districts where access to microfinance service is low. • Both punitive as well as motivational actions will be taken to influence "D" class institutions to enhance financial access to rural areas and among needy people. • Guidelines for cross border supervision will be prepared for Home/Host supervision to allow branch openings internationally. • General refinance rate and special refinance rate will be reduced to 5 percent and 1 percent respectively. A provision of lodging complains by customers who do not get such a facility will be introduced. • Deprived sector lending will be increased to 4.5 percent, 4.0 percent and 3.5 percent respectively for A, B and "C" class financial institutions. • In course of implementing action plans of commercial banks to maintain 20.0 percent of total credit to productive sector, commercial banks will have to maintain at least 12.0 percent credit flow to agriculture and energy sector.
Financial Sector Stability	• Merger process will be simplified. • Provisions of BASEL III will be implemented gradually. • The provision will be made for A, B and "C" class institutions to maintain the prescribed minimum paid-up capital compulsorily by mid-July 2014. • Establishment of infrastructure development banks will be encouraged under joint venture to encourage foreign participation in investment in infrastructure and thus to improve capital base. • Financial Sector Development Strategy will be formulated. • Multiple banking will be discouraged. • The Problem Bank Resolution Framework will be implemented gradually. • Necessary arrangement will be undertaken to maintain clear differences between bankers and entrepreneurs by avoiding the probability of board member, chief executive officer or other individuals in management of banks and financial institutions take loan from other BFIs as entrepreneurs for their own company.

5.65 Monetary Policy for 2013/14 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. Interest rate stability is proposed in the policy to ensure necessary and adequate investment in the economy. To contain inflation at 8.0 percent in 2013/14, the monetary policy is cautious enough to rein inflation at targeted level by containing monetary and credit aggregates within the desired limit.

5.66 BOP surplus during 2011/12 and 2012/13 and the resulting accumulation of foreign exchange reserve have helped to maintain external sector stability. It is expected that credit flows to unproductive sectors and imports can put pressure on inflation, pose risk on financial and external sector stability and adversely affect the current account balance. In order to avoid such situation, Monetary Policy 2013/14 has intended to promote credit flows to productive sectors, while containing the expansion of total domestic credit. Adequate attention has been given to consolidate the financial sector by accelerating the merger process.

5.67 Considering the likely increase in aggregate demand stemming from inflation and targeted economic growth, domestic credit in 2013/14 is projected to 17.1 percent in 2013/14. Priority is given to extending financial access to rural and remote areas and financial literacy has also been taken into consideration to enhance access to finance.

Financial Infrastructure

Payment and Settlement System

5.68 Payment and settlement system plays crucial role in effective and efficient circulation of money in the economy by smoothly facilitating trade and business. It is recognized worldwide that an efficient and secure payment system is an enabler of economic activity. It provides the conduit essential for effecting payments and transmission of monetary policy. Role and functionality of payment systems have been changing gradually with advancement in products and technologies. More recently, the proliferation of electronic payment mechanisms, the increase in the number of players in the financial arena and the payment crisis in quite a few countries and regions in the 1990s have focused attention on public policy issues related to the organization and operation of payment systems.

5.69 The NRB is the driving force in the development of national payment system in Nepal. It has been playing this developmental role and has taken several initiatives for safe, secure, sound, efficient, accessible and authorized payment systems in the country. At present, NRB is in the process of adopting many initiatives towards introducing and upgrading safe and efficient modes of payment systems in the country to meet the requirements of the public at large. The dominant features of large geographic spread of the country and the vast network of branches of the banking system require a well-functioning logistics of collection and delivery of paper instruments. These aspects of the banking structure in the country have always been kept in mind while developing the payment systems in Nepal.

5.70 Use of paper-based instruments (such as cheques and drafts, among others) accounts for more than 60.0 percent of the volume of total non-cash transactions in Nepal. Though, share of cash transactions has been steadily decreasing over a period of time and electronic mode has been gaining popularity due to the concerted efforts of NRB, the overall thrust is to reduce the use of paper for transactions, given the fact that it would take some time to completely move to the electronic mode in future. The initiatives taken by NRB in the recent days focused on technology-based solutions for the improvement of the payment and settlement system infrastructure, coupled with the introduction of new payment products by taking advantage of the technological advancements in banks. The continued increase in the volume of cheques added pressure on the existing set-up, thus necessitating a cost-effective alternative system like Electronic Clearing Service, Electronic Funds Transfer (EFT), and Real Time Gross Settlement (RTGS) System. Likewise, other payment and settlement systems such as Pre-paid Payment Systems, Mobile Banking System (already in place) and ATMs / Point of Sale (POS) Terminals / Online Transactions require further expansion and strengthening.

5.71 Oversight of the payment and settlement systems is NRB's major function as mentioned in the NRB Act 2002, whereby the objectives of safety and efficiency are promoted by monitoring existing and planned systems, assessing them against these objectives and, where necessary, inducing change. By overseeing payment and settlement systems, NRB helps to maintain systemic stability and reduce systemic risk, and to maintain public confidence in payment and settlement systems. The payment and settlement systems in Nepal also requires a strong statutory backing to the NRB for undertaking the oversight function over the payment and settlement systems in the country. Therefore, Nepal requires both the strong legal and physical infrastructure for developing and strengthening the payment and settlement system.

5.72 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, it has remained effortful in developing and promoting sound and efficient payment system through introducing Real Time Gross Settlement System (RTGS) and validating E- payment and the RTGS has been implemented since

July 2013. NRB has recently added "Payment and Settlement Desk" in former "Policy and Planning Desk" and new desk is named as "Policy, Planning, Payment and Settlement Desk". Currently, formulation of 'Nepal Payments System Development Strategy', 'Payments Oversight in Nepal: Policy Framework', and implementation of the payments oversight function roadmap is under discussion.

5.73 To carry out activities relating to Electronic Cheque Clearing (ECC) system, Nepal Clearing House Limited (NCHL) has already came into operation. 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. This has resulted in the significant reduction of traditional and time consuming manual process of cheque clearing, both for the banks and the customers.

5.74 Nepal Central Depository and Clearing Ltd was established at the initiation 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 migration from physical holding to electronic medium will eliminate thefts, interceptions and subsequent misuse of certificates. Hence, the transparency level of trading under the new platform will be more secure, clear and easy.

Annex 1

Structure of the Nepalese Financial Sector

(Total Assets/Liabilities)
(2007- 2013)

(Rs. in million)

Financial Institutions	2007	2008	2009	2010	2011	2012	2013
Nepal Rastra Bank	1,74,209.1	2,12,449.8	2,82,328.4	2,96,625.6	3,19,692.6	4,55,826.5	5,34,897.9
Commercial Banks	4,90,638.1	5,66,736.0	7,06,036.2	7,63,226.3	8,53,490.7	10,52,450.7	12,42,881.4
Development Banks	22,658.2	39,868.8	68,009.3	1,02,208.9	1,29,617.4	1,60,360.2	1,99,954.8
Microfinance Development Banks	10,281.4	12,580.0	15,438.0	17,681.6	20,862.9	29,815.5	35,774.9
Finance Companies	53,466.0	80,383.9	87,430.0	1,09,998.2	1,18,578.2	1,09,687.5	1,00,856.7
Financial Co-operatives	3,590.0	4,360.5	4,965.1	6,975.2	8,150.6	11,652.4	15,415.1
Financial NGOS	1,842.2	2,382.6	2,382.6	2,382.6	4,937.6	4,260.0	5,560.0
Contractual Saving Institutions							
Employees Provident Fund	59,225.9	68,334.1	79,119.7	90,390.3	1,06,584.5	1,25,752.8	1,45,283.4
Citizen Investment Trust	9,541.0	12,371.4	25,379.5	22,647.8	26,905.4	38,068.5	42,753.6
Insurance Companies	31,364.0	31,589.4	37,014.3	47,460.0	61,213.4	73,825.0	84,650.4
Postal Savings Bank	700.3	827.0	1,038.4	1,085.9	1,152.4	1,276.4	1,397.2
Total	8,57,516.2	10,31,883.5	13,09,141.5	14,60,682.4	16,51,185.7	20,62,975.5	24,09,425.3
Market capitalisation	1,86,301.3	3,66,247.6	5,12,939.0	3,76,871.0	3,23,484.3	3,68,262.1	5,14,492.1
Total (incl. market capitalisation)	10,43,817.5	13,98,131.1	18,22,080.5	18,37,553.4	19,74,670.0	24,31,237.6	29,23,917.5
Percentage Share							
Nepal Rastra Bank	20.3	20.6	21.6	20.3	19.4	22.1	22.2
Commercial Banks	57.2	54.9	53.9	52.3	51.7	51.0	51.6
Development Banks	2.6	3.9	5.2	7.0	7.8	7.8	8.3
Microfinance Development Banks	1.2	1.2	1.2	1.2	1.3	1.4	1.5
Finance Companies	6.2	7.8	6.7	7.5	7.2	5.3	4.2
Financial Co-operatives	0.4	0.4	0.4	0.5	0.5	0.6	0.6
Financial NGOS	0.2	0.2	0.2	0.2	0.3	0.2	0.2
Employees Provident Fund	6.9	6.6	6.0	6.2	6.5	6.1	6.0
Citizen Investment Trust	1.1	1.2	1.9	1.6	1.6	1.8	1.8
Insurance Companies	3.7	3.1	2.8	3.2	3.7	3.6	3.5
Postal Savings Bank	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.00

Sources: Financial Statistics and NRB staff's Calculation, BFRID, NRB

Annex 2

Aggregated Statement of Assets and Liabilities of BFIs

(2011- 2013)

(Rs. in million)

	LIABIILTIES	mid-July			mid-Jan		Percentage Change		
		2011	2012	2013	2012	2013			
		1	2	3	4	5	2/1	3/2	5/4
1	CAPITAL FUND	103407.5	115163.0	131724.3	108783.3	127300.4	11.4	14.4	17.02
	a. Paid-up Capital	98418.2	104303.8	119506.9	101424.5	111730.9	6.0	14.6	10.16
	b. Statutory Reserves	17727.3	22068.1	26038.2	21139.0	25321.3	24.5	18.0	19.78
	c. Retained Earning	-24280.9	-24321.8	-22344.2	-26766.3	-21367.2	0.2	-8.1	-20.17
	d. Others Reserves	11543.0	13112.8	8523.4	12986.1	11615.4	13.6	-35.0	-10.56
2	BORROWINGS	34058.7	17805.9	26999.3	20353.3	21426.3	-47.7	51.6	5.27
	a. NRB	13307.2	4286.7	2884.3	4355.6	711.8	-67.8	-32.7	-83.66
	b. "A"Class Licensed Institution	10916.0	3297.0	10466.6	5788.5	10179.9	-69.8	217.5	75.86
	c. Foreign Banks and Fin. Ins.	2232.3	2507.9	2954.3	2478.8	2189.7	12.3	17.8	-11.67
	d. Other Financial Ins.	1453.4	781.1	2438.3	1630.7	1611.5	-46.3	212.2	-1.18
	e. Bonds and Securities	6149.8	6933.2	8255.9	6099.6	6733.4	12.7	19.1	10.39
3	DEPOSITS	869951.4	1071394.1	1250062.0	952724.0	1125005.9	23.2	16.7	18.08
	a. Current	80934.3	95993.1	111686.5	75164.2	89231.5	18.6	16.3	18.72
	b. Savings	305589.2	400723.1	471215.4	344091.5	449158.9	31.1	17.6	30.53
	c. Fixed	332726.3	372137.6	423478.4	363408.6	378134.3	11.8	13.8	4.05
	d. Call Deposits	139308.2	187998.5	225704.8	157072.6	192754.3	35.0	20.1	22.72
	e. Others	11393.4	14541.8	17976.8	12987.2	15726.9	27.6	23.6	21.09
4	Bills Payable	964.9	1626.4	1561.6	783.8	2005.6	68.5	-4.0	155.89
5	Other Liabilities	106263.8	123660.2	140770.3	125326.6	141312.7	16.4	13.8	12.76
	1. Loan Loss Provision	30215.8	33874.0	42223.8	38128.4	38742.3	12.1	24.6	1.61
	2. Interest Suspense a/c	28130.0	26056.2	27920.7	31569.1	28951.8	-7.4	7.2	-8.29
	3. Others	47918.0	63730.1	70625.8	55629.1	73618.6	33.0	10.8	32.34
6	Reconcillation A/c	9873.0	1537.8	7290.0	3131.6	9043.9	-84.4	374.1	188.80
7	Profit & Loss A/c	20198.4	19776.5	26544.7	7189.0	11013.8	-2.1	34.2	53.20
TOTAL		1144717.7	1350963.9	1584952.3	1218291.5	1437108.6	18.0	17.3	17.96
ASSETS									
1	LIQUID FUNDS	147994.0	236056.9	259224.9	193635.3	194724.4	59.5	9.8	0.56
	a. Cash Balance	23950.2	31020.1	35728.2	23637.8	27712.4	29.5	15.2	17.24
	Nepalese Notes & Coins	23410.2	30353.3	34876.1	22819.7	26861.4	29.7	14.9	17.71
	Foreign Currency	540.0	666.8	852.1	818.1	851.0	23.5	27.8	4.03
	b. Bank Balance	90221.7	164605.2	173856.7	139621.1	121372.2	82.4	5.6	-13.07
	1. In Nepal Rastra Bank	54649.3	120457.3	130802.8	95445.3	70321.9	120.4	8.6	-26.32
	2. "A"Class Licensed Institution	15882.0	26284.3	23269.1	17703.2	23658.7	65.5	-11.5	33.64
	3.Other Financial Ins.	9176.5	7649.8	5673.4	9154.6	6264.2	-16.6	-25.8	-31.57

	4. In Foreign banks	10513.9	10213.8	14111.4	17317.9	21127.4	-2.9	38.2	22.00
	c. Money at Call	33822.1	40431.6	49640.1	30376.4	45639.8	19.5	22.8	50.25
2	INVESTMENTS	107562.4	137304.4	151340.0	125857.2	144665.8	27.7	10.2	14.94
	a. Govt.Securities	105115.1	133251.1	149700.8	124784.1	143841.9	26.8	12.3	15.27
	b Others	2447.2	4053.3	1639.2	1073.1	823.9	65.6	-59.6	-23.23
3	SHARE & OTHER INVESTMENT	53582.9	52851.1	66725.5	47680.1	60521.4	-1.4	26.3	26.93
4	LOANS & ADVANCES	698779.0	779560.9	945698.4	728369.9	879892.4	11.6	21.3	20.80
	a. Private Sector	675113.9	741145.0	915010.0	703247.3	850740.8	9.8	23.5	20.97
	b. Financial Institutions	17300.0	31389.3	21910.2	18251.1	20120.8	81.4	-30.2	10.24
	c. Govt Organizations	6365.1	7026.6	8778.2	6871.5	9030.8	10.4	24.9	31.42
5	BILL PURCHED	5149.7	9634.2	9007.9	7192.2	6938.8	87.1	-6.5	-3.52
6	LOANS AGT. COLLECTED BILLS	96.0	645.9	1015.5	416.2	453.7	573.1	57.2	8.99
7	FIXED ASSETS	24260.6	27146.4	28916.8	26009.4	28914.1	11.9	6.5	11.17
8	OTHER ASSETS	79138.1	93318.3	104448.2	92102.0	104736.7	17.9	11.9	13.72
	a. Accrued Interests	29689.7	27621.8	30638.6	33471.8	30666.7	-7.0	10.9	-8.38
	b. Others	49448.4	65696.6	73809.6	58630.1	74070.0	32.9	12.3	26.33
9	Expenses not Written off	775.3	586.9	622.0	551.9	849.6	-24.3	6.0	53.93
10	Non-Banking Assets	1549.7	2225.1	3731.3	2322.8	2566.4	43.6	67.7	10.49
11	Reconciliation Account	21980.3	8638.9	10394.1	-9788.7	9518.2	-60.7	20.3	-197.24
12	Profit & Loss A/c	3849.8	2994.9	3827.7	3943.3	3327.1	-22.2	27.8	-15.63
TOTAL		1144717.7	1350963.9	1584952.3	1218291.9	1437108.6	18.0	17.3	17.96

Sources: Financial Statistics and NRB staffs Calculation, BFRID, NRB

Annex 3

Statement of Assets and Liabilities of BFIs

(As of mid-July 2013)

(Rs. in million)

	Liabilities	Class "A"	Class "B"	Class "C"	Total
1	CAPITAL FUND	94,660.7	25,094.1	11,969.5	1,31,724.3
	a. Paid-up Capital	79,652.1	23,568.9	16,285.9	1,19,506.9
	b. Statutory Reserves	21,995.6	2,106.0	1,936.6	26,038.2
	c. Retained Earning	(14,453.0)	(1,106.6)	(6,784.7)	(22,344.2)
	d. Others Reserves	7,465.9	525.8	531.6	8,523.4
2	BORROWINGS	22,792.9	2,753.6	1,452.9	26,999.3
	a. NRB	2,314.3	570.0	-	2,884.3
	b. "A"Class Licensed Institution	7,368.8	1,645.0	1,452.9	10,466.6
	c. Foreign Banks and Fin. Ins.	2,954.3	-	-	2,954.3
	d. Other Financial Ins.	1,905.4	532.8	-	2,438.3
	e. Bonds and Securities	8,250.1	5.7	-	8,255.9
3	DEPOSITS	10,20,830.8	1,60,249.6	68,981.6	12,50,062.0
	a. Current	1,08,656.6	2,944.1	85.8	1,11,686.5
	b. Savings	3,58,546.9	83,215.9	29,452.7	4,71,215.4
	c. Fixed	3,45,412.0	45,134.3	32,932.1	4,23,478.4
	d. Call Deposits	1,96,045.3	28,491.6	1,167.9	2,25,704.8
	e. Others	12,169.9	463.7	5,343.2	17,976.8
4	Bills Payable	1,549.6	8.4	3.6	1,561.6
5	Other Liabilities	1,04,427.1	16,778.1	19,565.2	1,40,770.3
	1. Loan Loss Provision	25,582.3	5,847.7	10,793.7	42,223.8
	2. Interest Suspense a/c	20,629.0	2,594.6	4,697.2	27,920.7
	3. Others	58,215.8	8,335.7	4,074.3	70,625.8
6	Reconcillation A/c	1,927.7	3,374.9	1,987.4	7,290.0
7	Profit & Loss A/c	21,060.4	3,251.3	2,233.0	26,544.7
TOTAL LIABILITIES		12,67,249.1	2,11,509.9	1,06,193.2	15,84,952.3
	Assets	**Class "A"**	**Class "B"**	**Class "C"**	**Total**
1	LIQUID FUNDS	1,85,758.2	52,289.8	21,177.0	2,59,224.9
	a. Cash Balance	29,908.2	4,833.1	986.8	35,728.2
	Nepalese Notes & Coins	29,107.3	4,782.3	986.6	34,876.1
	Foreign Currency	800.9	50.9	0.3	852.1
	b. Bank Balance	1,40,521.9	19,565.4	13,769.4	1,73,856.7
	1. In Nepal Rastra Bank	1,20,642.3	7,458.0	2,702.5	1,30,802.8
	2. "A" Class Licensed Institution	5,753.3	9,507.6	8,008.1	23,269.1
	3. Other Financial Ins.	160.3	2,454.3	3,058.7	5,673.4
	4. In Foreign banks	13,965.9	145.5	-	14,111.4
	c. Money at Call	15,328.1	27,891.2	6,420.7	49,640.1
2	INVESTMENTS	1,46,469.1	3,118.8	1,752.2	1,51,340.0

	a. Govt. Securities	1,44,855.4	3,118.2	1,727.2	1,49,700.8
	b Others	1,613.6	0.5	25.0	1,639.2
3	SHARE & OTHER INVESTMENT	63,457.2	2,124.3	1,144.0	66,725.5
4	LOANS & ADVANCES	7,48,753.7	1,31,169.0	65,775.8	9,45,698.4
	a. Private Sector	7,23,355.1	1,26,319.5	65,335.4	9,15,010.0
	b. Financial Institutions	16,673.9	4,810.0	426.3	21,910.2
	c. Government Organizations	8,724.7	39.5	14.0	8,778.2
5	BILLS PURCHASED	7,438.4	1,562.2	7.2	9,007.9
6	LOANS AGT. COLLECTED BILLS	1,015.5	-	-	1,015.5
7	FIXED ASSETS	21,164.9	4,745.8	3,006.0	28,916.8
8	OTHER ASSETS	85,601.1	10,596.5	8,250.6	1,04,448.2
	a. Accrued Interests	23,015.2	2,815.9	4,807.5	30,638.6
	b. Others	62,585.8	7,780.5	3,443.2	73,809.6
9	Expenses not Written off	475.2	71.6	75.3	622.0
10	Non-Banking Assets	2,038.0	940.3	753.0	3,731.3
11	Reconciliation Account	4,988.8	3,375.9	2,029.4	10,394.1
12	Profit & Loss A/c	89.2	1,515.8	2,222.7	3,827.7
	TOTAL ASSETS	**12,67,249.2**	**2,11,509.9**	**1,06,193.2**	**15,84,952.3**

Sources: Financial Statistics and NRB staffs Calculation, BFRID, NRB

Annex 4

Major Financial Indicators of MFFIs (D Class Financial Institutions)

(As of mid-July, 2013)

(Rs. in million)

	Liabilities	mid-July			mid-Jan		Percent		
		2011	2012	2013	2012	2013			
		1	2	3	4	5	2/1	3/2	5/4
1	CAPITAL FUND	2408.8	2816.6	3801.33	2231.0	3318.3	16.9	35.0	48.7
2	BORROWINGS	13037.6	16586.4	20216.25	10635.7	17521.4	27.2	21.9	64.7
3	DEPOSITS	3537.4	5235.2	7221.62	2676.9	5963.3	48.0	37.9	122.8
4	Other Liabilities	1818.6	2502.9	3009.70	1196.5	2834.1	37.6	20.2	136.9
5	Reconcillation A/c	223.2	2236.6	688.57	2034.4	1675.1	902.1	-69.2	-17.7
6	Profit & Loss A/c	470.7	629.8	837.88	261.1	414.1	33.8	33.0	58.6
	Total	**21496.4**	**30007.5**	**35775.3**	**19035.5**	**31726.2**	**39.6**	**19.2**	**66.7**
	Assets								
1	LIQUID FUNDS	3272.2	5843.5	6322.82	3449.1	5737.4	78.6	8.2	66.3
2	INVESTMENT IN SECURITIES EXCEPT SHARES	164.7	128.7	116.17	51.2	128.7	-21.9	-9.7	151.2
3	SHARE & OTHER INVESTMENT	1560.5	2040.6	2963.62	1424.8	2816.5	30.8	45.2	97.7
4	LOANS & ADVANCES	14649.9	17738.3	23401.73	11033.7	19402.1	21.1	31.9	75.8
5	FIXED ASSETS	259.3	340.2	444.56	243.7	380.5	31.2	30.7	56.2
6	OTHER ASSETS	1253.2	1594.9	1685.83	643.6	1541.6	27.3	5.7	139.5
7	Expenses not Written off	1.1	0.7	9.83	143.6	10.6	-35.1	1301 .7	-92.6
8	Reconcillation Account	253.0	2234.8	699.60	2029.2	0.0	783.3	- 68.7	- 100.0
9	Profit & Loss A/c	82.5	85.8	131.22	15.8	1611.0	4.1	52.9	1011 8.6
	Total	**21496.4**	**30007.5**	**35775.4**	**19035.51**	**31726.2**	**39.6**	**19.2**	**66.7**

Sources: Financial Statistics and NRB staff' Calculation, BFRID, NRB

Annex 5

Aggregated Sector-wise, Product-wise and Security-wise Credit by BFIS

(As of mid-July 2013)

(Rs in million)

		Class "A"	Class "B"	Class "C"	Total
Sector Wise Credit					
1	Agricultural and Forest Related	31031.0	6233.4	1883.5	39147.8
2	Fishery Related	500.3	129.1	28.3	657.8
3	Mining Related	3487.1	267.1	143.0	3897.3
4	Manufacturing (Producing) Related	176661.9	9194.3	4719.0	190575.2
5	Construction	71712.8	15248.5	9106.0	96067.3
6	Electricity,Gas and Water	18386.5	2092.1	215.6	20694.2
7	Metal Products, Mach. & Ele. Eqp.	10044.4	2138.6	867.4	13050.4
8	Tras., Com. and Public Utilities	24431.3	11223.1	5644.4	41298.9
9	Wholesaler & Retailer	161588.2	27070.5	9660.2	198318.9
10	Finance, Insurance and Real Estate	66141.4	12589.4	5952.7	84683.5
11	Hotel or Restaurant	18753.8	4735.0	1598.6	25087.4
12	Other Services	38101.3	6294.9	2322.6	46718.8
13	Consumption Loans	53754.5	9767.0	5915.5	69437.0
14	Local Government	1176.3	31.1	48.1	1255.5
15	Others	81436.7	25717.1	17678.0	124831.8
Total sectorwise Loan		757207.5	132731.2	65783.0	955721.8
Product Wise Credit					
1	Term Loan	112480.4	15064.7	8897.8	136443.0
2	Overdraft	150298.9	34318.0	0.0	184617.0
3	Trust Receipt Loan / Import Loan	41470.3	1.2	0.0	41471.4
4	Demand & Other Working Capital Loan	185398.0	18696.8	16306.4	220401.2
5	Res. Per. H. Loan (Up to Rs. 10 mil.)	47256.3	12309.1	6645.2	66210.5
6	Real Estate Loan	63044.6	12864.3	10153.3	86062.2
7	Margin Nature Loan	7440.6	2709.8	2785.0	12935.4
8	Hire Purchase Loan	34094.0	13297.4	6539.2	53930.7
9	Deprived Sector Loan	32445.2	5215.8	1890.8	39551.9

10	Bills Purchased	7997.6	19.4	7.2	8024.3
11	Other Product	75281.6	18234.6	12558.1	106074.3
Total Product wise Loan		757207.5	132731.2	65783.0	955721.8
Collateral Wise Credit					
1	Gold and Silver	25038.5	3363.9	383.3	28785.8
2	Government Securities	2974.8	21.4	7.9	3004.1
3	Non-Governmental Securities	4925.5	2018.2	1275.2	8219.0
4	Fixed Deposit Receipts	8102.3	1635.3	1933.9	11671.5
	Own	7428.97	1635.28	1931.27	10995.5
	Other Licences Institutions	673.35	0.00	2.60	676.0
5	Collateral of Properties	642528.81	121888.43	56032.38	820449.6
	Fixed Assets	504287.84	121494.56	55633.11	681415.5
	Current Assets	138240.97	393.88	399.27	139034.1
6	Against security of Bill	7675.08	21.13	14.57	7710.8
	Domestic Bills	976.93	19.39	14.57	1010.9
	Foreign Bills	6698.14	1.74	0.00	6699.9
7	Against Guarantee	18424.77	2622.99	699.83	21747.6
	Government Guarantee	3230.85	97.04	66.41	3394.3
	Institutional Guarantee	11547.20	1139.82	322.82	13009.8
	Personal Guarantee	645.28	205.86	108.77	959.9
	Collective Guarantee	204.05	1145.92	14.95	1364.9
	Int. Rtd. Foreign Bank's Guarantee	104.10	11.00	0.00	115.1
	Other Guarantee	2693.29	23.34	186.87	2903.5
8	Credit Card	373.59	0.00	0.00	373.6
9	Others	47164.10	1159.86	5435.98	53759.9
Total Collateral wise Loan		757207.52	132731.23	65783.04	955721.79

Sources: Financial Statistics and NRB staffs Calculation, BFRID, NRB

Annex 6

Aggregated Profit & Loss Account of BFIs (Aggregate)

(As of mid-July 2013)

(Rs. in million)

Expenses	Class "A"	Class "B"	Class "C"	Total
1 Interest Expenses	46387.1	12520.0	6563.2	65470.3
1.1 Deposit Liabilities	45397.0	12284.3	6471.5	64152.7
1.1.1 Saving A/c	13318.1	5614.5	2358.8	21291.4
1.1.2 Fixed A/c	24186.8	5059.3	4017.0	33263.1
• Upto 3 Months Fixed A/c	1329.1	64.8	78.1	1471.9
• 3 to 6 Months fixed A/c	1287.3	172.7	115.7	1575.6
• 6 Months to 1 Year Fixed A/c	10714.1	2916.9	1987.7	15618.7
• Above 1 Year	10856.4	1905.0	1835.6	14596.9
1.1.3 Call Deposit	7846.6	1610.5	95.4	9552.5
1.1.4 Certificate of Deposits	45.5	0.0	0.2	45.7
1.2 Others	990.2	235.7	91.7	1317.6
2 Commission/Fee Expense	377.7	5.0	2.5	385.3
3 Employees Expenses	13238.7	1943.8	787.2	15969.7
4 Office Operating Expenses	10544.5	2714.2	1458.6	14717.4
5 Exchange Fluctuation Loss	30.0	0.5	0.0	30.5
5.1 Due to Change in Exchange Rates	14.4	0.4	0.0	14.8
5.2 Due to Foreign Currency Transactions	15.6	0.1	0.0	15.7
6 Non-Operatiing Expenses	1254.7	52.6	2.5	1309.7
7. Provision for Risk	7952.0	3928.9	2971.5	14852.4
7.1 Loan loss Provision	6870.9	2997.6	2397.6	12266.1
7.1.1 General Loan loss Provision	2080.3	450.3	573.7	3104.3
7.1.2 Special Loan Loss Provision	4584.1	2500.6	1660.2	8744.9
7.1.3 Additional Loan Loss Provision	206.5	46.7	163.7	416.9
7.2. Provision for Non-Banking Assets	824.8	535.2	557.0	1917.0
7.3. Provision for Loss on Investment	93.0	103.2	8.5	204.6
7.4. Provision for Loss of Other Assets	163.4	292.9	8.5	464.8
8 Loan Written Off	525.5	342.0	67.8	935.3
9 Provision for Staff Bonus	2381.6	320.6	164.2	2866.4
10 Provision for Income Tax	7137.1	966.1	489.4	8592.7
11 Others	479.0	0.2	2.7	481.9
12 Net Profit	21060.4	2864.8	2052.5	25977.7
TOTAL EXPENSES	111368.5	25658.8	14562.1	151589.4

Income	Class "A"	Class "B"	Class "C"	Total
1. Interest Income	90919.0	20150.1	9845.4	120914.4
1.1. On Loans and Advance	84817.6	18056.5	8806.4	111680.5
1.2. On Investment	3834.9	152.1	122.8	4109.8
1.2.1 Government Bonds	3459.1	138.3	103.2	3700.5
1.2.2 Foreign Bonds	22.7	0.0	0.0	22.7
1.2.3 NRB Bonds	317.7	4.7	14.2	336.7
1.2.4 Debenture & Bonds	35.4	9.0	5.4	49.8
1.3 Agency Balance	896.9	184.9	102.2	1183.9
1.4 On Call Deposit	585.2	1375.4	587.5	2548.1
1.5 Others	784.4	381.3	226.5	1392.2
2. Commissions & Discount	6347.1	713.8	152.7	7213.6
2.1 Bills Purchase & Discount	210.8	1.4	0.0	212.3
2.2 commission	5028.6	396.3	70.4	5495.3
2.3 Others	1107.7	316.1	82.3	1506.1
3 Income From Exchange Fluctuation	3134.6	89.4	1.6	3225.6
3.1 Due to Change in Exchange Rate	725.0	5.1	1.6	731.7
3.2 Due to Foreign Currency Trans.	2409.6	84.3	0.0	2493.9
4 Other Operating Income	3015.5	1121.6	486.9	4624.0
5 Non-Operating Income	1631.7	489.9	188.1	2309.7
6 Provision Written Back	4665.8	1841.3	1824.7	8331.8
7 Recovery from Written off Loan	1172.2	86.2	16.4	1274.8
8 Income from Extra Ordinary Expenses	393.3	37.3	4.2	434.9
9 Net Loss	89.2	1129.3	2042.2	3260.7
TOTAL INCOME	111368.5	25658.9	14562.1	151589.5

Sources: Financial Statistics and NRB staffs Calculation, BFRID, NRB

Annex 7

Financial Soundness Indicators (FSIs) of A, B and C Class Institutions

(As of mid-July, 2013)

(In percent)

	A Class	B Class	C Class	Total
Capital Adequacy Ratios				
Regulatory capital to risk-weighted assets	12.26	17.84	16.05	13.19
Regulatory Tier - 1 capital to risk-weighted assets	10.66	17.01	15.32	11.75
Non performing loan to total gross loan	2.57	4.54	15.98	3.77
Non performing loan net of provisions to capital	4.11	5.84	4.25	4.41
Sectoral Distribution of Loans to Total Gross Loan				
Agricultural and Forest Related	4.10	4.70	2.86	4.10
Fishery Related	0.07	0.10	0.04	0.07
Mining Related	0.46	0.20	0.22	0.41
Agricultural,Forestry and beverage Production Related	23.33	6.93	7.17	19.94
Non food Production Related				
Construction	9.47	11.49	13.84	10.05
Electricity,Gas and Water	2.43	1.58	0.33	2.17
Metal Products, Machinery & Elecronic Eqipment & Assemblage	1.33	1.61	1.32	1.37
Transport, Communication and Public Utilities	3.23	8.46	8.58	4.32
Wholesaler & Retailer	21.34	20.40	14.68	20.75
Finance, Insurance and Real Estate	8.73	9.48	9.05	8.86
Hotel or Restaurant	2.48	3.57	2.43	2.62
Other Services	5.03	4.74	3.53	4.89
Consumption Loans	7.10	7.36	8.99	7.27
Local Government	0.16	0.02	0.07	0.13
Others	10.75	19.38	26.87	13.06
Others				
Returns on Assets	1.65	0.84	0.02	1.44
Returns on Equity	16.89	6.44	0.20	13.85
Interest Margin to Gross Income	75.91	76.00	79.96	76.16
Non-Interest Expenses to Gross Income	44.19	46.88	54.45	45.15
Liquid Assets to total Assets	26.18	26.20	21.57	25.88
Liquid Assets to total Deposits	32.50	34.58	33.20	32.81
Credit to Deposit Ratio	74.18	82.83	95.36	76.45

Sources: Financial Statistics and NRB staffs Calculation, BFRID, NRB

Annex 8

Stress Testing Results for Commercial Banks

(2012-2013)

	mid-Jul 2013	mid-Jan 2013	mid-Jul 2012	mid-Jan 2012	mid-Jul 2011
Credit Shocks					
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.	27	28	22	23	20
All NPLs under substandard category downgraded to doubtful. All NPLs under doubtful category downgraded to loss.	2	3	2	3	2
25 Percent of performing loan of Real Estate & Hosing sector loan directly downgraded to substandard category of NPLs.	2	3	2	6	4
25 Percent of performing loan of Real Estate & Hosing sector loan directly downgraded to Loss category of NPLs.	5	13	8	16	16
Top 2 Large exposures down graded: Performing to Substandard	2	3	2	7	5
Liquidity Shocks					
Withdrawal of customer deposits by 2% 5% 10% 10% and 10% for five consecutive days respectively.	5	19	5	12	15
Withdrawal of deposits by 5%	1	7	0	2	5
Withdrawal of deposits by 10%	4	20	6	9	13
Withdrawal of deposits by 15%	16	26	14	20	22
Withdrawal of deposits by top 2 institutional depositors.	10	17	9	12	16

	mid-Jul 2013	mid-Jan 2013	mid-Jul 2012	mid-Jan 2012	mid-Jul 2011
Withdrawal of deposits by top 3 institutional depositors.	14	21	12	18	20
Withdrawal of deposits by top 5 institutional depositors.	21	25	17	19	22
Withdrawal of deposits by top 2 individual depositors.	1	2	0	0	1
Withdrawal of deposits by top 3 individual depositors.	1	2	0	0	1
Withdrawal of deposits by top 5 individual depositors.	1	2	0	0	1

Sources: Financial Statistics and NRB staffs Calculation, BFRID, NRB

Annex 9

List of Merged Banks and Financial Institutions

(As of mid-July, 2013)

S.N	Merged and Merging BFIs	Name of BFI (after merger)	Date of operation (after merger)
1	Himchuli Bikash Bank Ltd. (B class) Birgunj Finance Lltd. (C class)	H&B Development Bank Ltd. (B class, National Level)	6/15/2011
2	Business Development Bank Ltd. (B class) Universal Finance Ltd. (C class)	Business Universal Development Bank Ltd. (B class, National Level)	4/3/2012
3	Kasthamandap Development Bank Ltd. (B Class) Shikhar Finance Ltd. (C class)	Kasthamandap Development Bank Ltd. (B Class, National Level)	4/13/2012
4	Machhapuchhre Bank Ltd. Standard Finance Ltd. (C class)	Machhapuchhre Bank Ltd.	7/9/2012
5	Global Bank Ltd. IME Financial Institutions Ltd. (C Class) and Lord Buddha Finance Ltd.(C class)	Global IME bank Ltd.	7/9/2012
6	Infrastructure Development Bank Ltd. (B Class) Swastik Finance Ltd. (C class)	Infrastructure Development Bank Ltd. (B class, National Level)	7/10/2012
7	Annapurna Development Bank Ltd. (B Class) Suryadarshan Finance Ltd. (C Class)	Supreme Development Bank Ltd. (B class, National Level)	7/13/2012
8	Pashupati Development Bank Ltd. (B class) Uddhyam Bikash Bank Ltd. (B Class)	Axis Development Bank Ltd. (B class, National Level)	7/13/2012
9	Vibor bikash Bank Ltd. (B class) Bhajuratna Finance and Savings Company Ltd. (C class)	Vibor Bikash Bank Ltd. (B class, National Level)	9/2/2012
10	Butwal Finance Ltd. (C class) Alpic Everest Finance Ltd. (C class) and CMB Finance Ltd. (C class)	Synergy Finance Ltd. (C class, National level)	12/6/2012
11	Shine Development Bank Ltd. (B class) Resunga Bikash Bank Ltd. (B class)	Shine Resunga Development Bank Ltd. (B class, 10 District Level)	3/17/2012
12	Prudential Finance Coy. Ltd. (C class)	Prudential Finance Comapany Ltd. (C class, National Level)	3/18/2013

S.N	Merged and Merging BFIs	Name of BFI (after merger)	Date of operation (after merger)
	Gorkha Finance Ltd. (C class)		
13	Nepal Industrial and Commercial Bank Ltd. Bank of Asia Ltd.	NIC Asia Ltd.	6/30/2013
14	Diyalo Bikash Bank Ltd. (B class) Professional Bikash Bank Ltd. (B class)	Professional Diyalo Bikash Bank (B class, 10 District Level)	6/30/2013
15	Araniko Development Bank Ltd. (B class) Surya Development Bank Ltd. (B class)	Araniko Development Bank Ltd. (B class, 10 District Level)	7/14/2013
16	Global IME Bank Ltd. Social Development Bank Ltd. (B class) and Gulmi Bikash Bank Ltd. (B class)	Global IME Bank Ltd.	7/14/2013
17	Prabhu Finance Ltd. (C class) Sambridhi Bikash Bank Ltd. (B class) and Baibhav Finance Ltd. (C class)	Prabhu Bikash Bank Ltd. (B class, National Level)	7/14/2013
18	Royal Merchant Banking and Finance Ltd. (C class) Rara Bikash Bank Ltd. (B class) and Api Finance Ltd. (C class)	Apex Development Bank Ltd. (B class, National Level)	7/15/2013
19	Manakamana Development Bank Ltd. (B class) Yeti Finance Ltd. (C class), Valley Finance Ltd. (C Class)	Yeti Development Bank Ltd. (B class, National Level)	7/15/2013

Sources: BFRID, NRB

Annex 10

Method of Calculation of Base Interest Rate

Base Rate = Cost of Fund (%) +Cost of CRR (%) +Cost of SLR (%) +Operating Cost (%) +Return on Assets (%).

1. Cost of fund:

Cost of fund should be calculated as follows:

Cost of fund (%) = Average interest rate of domestic deposit, loans and borrowings.

2. Cost of CRR :

Cost of CRR should be calculated as follows:

$$\text{Cost of CRR (\%)} = \frac{\text{Average amount of CRR X Cost of fund}}{\text{Average amount of Investible fund}}$$

Where, average amount of Investible fund = Average amount of domestic deposits + Average amount of domestic loans and borrowings – Average amount of Statutory Liquidity

3. Cost of SLR :

Cost of SLR is calculated as follows:

$$\text{Cost of SLR (\%)} = \frac{\text{Net SLR amount X (Cost of fund – Weighted Average interest rate of Government securities)}}{\text{Average amount of Investible fund}}$$

Where, net SLR amount = Average amount of SLR – Average amount of CRR.

4. Operating Cost :

Operating cost is calculated as follows:

$$\text{Operating cost (\%)} = \frac{\text{Total operating expenses * x 85*}}{\text{Average amount of Investible fund}}$$

5. Return on Assets:

Return in Assets is fixed by 0.75 percent.

Additional provision on Base rate:

While calculating the Base Rate the financial statements and statistics of the latest period should be taken. The annual expenses which cannot be provided in monthly should be proportionately divided and should be used for calculation.

While calculating the average amount of SLR and CRR the directive issued by NRB should be followed.

In total operating expenses, the staff expenses and other operating expenses should be taken from the financial statements of profit and loss as directed by NRB.

Note:

* Annualized in the basis of latest period.

** Under the operating expenses amount of 15 percent is predicted from non-funded operating expenses and it is fulfilled by the non-funded income.

Annex 11

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. Bishnu Nepal, Executive Director, Development Bank Supervision Department	Member
Mr. Bhaskar Mani Gnawali, Executive Director, Bank and Financial Institutions Regulation	Member
Mr. Manamohan Kumar Shrestha, Executive Director Finance Company Supervision 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 12

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. Laxmi Parsai , Deputy Director, Research Department	Member
Mr. Nischal Adhikari, 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