

# Financial Sector Reform

## 1. Introduction

A well-regulated financial sector of any economy works as a facilitator for achieving sustained economic growth, fostering a robust and vibrant financial market. Financial system is important in the economy to pool and utilize resources, reduce costs and risks, expand and diversify opportunities, increase the allocative efficiency of resources, and promote the productivity and economic growth. While sound and healthy financial system contributes to the growth of the real sector on a sustainable basis, uncertainty and fragility in the financial system adversely affect the objectives of economic development in general and poverty reduction in particular, as evidenced by the financial crises witnessed in different parts of the world over the years. Financial sector reform (FSR) is the strategy aimed at making the financial system sound and supportive to the attainment of the economic development objectives.

The deposit taking financial institutions predominate the financial system of Nepal. Among these institutions, the banking sector's share in the total deposits and lending is not only significantly high but that the problems and stakes in this sector are also accordingly challenging. So, with the view to addressing the huge problems and challenges of this sector, this policy paper focuses more on the banking sector as the overriding component of the overall financial sector reform strategy.

## 2. An Overview of the Nepalese Economy

The Nepalese economy registered an upturn in FY 2002/03 as overall Gross Domestic Product (GDP) grew by 3.0 as against a decline of 0.6 percent in FY 2001/02. The improvement in both agricultural and non-agricultural GDP by 2.4 percent and 2.8 percent, respectively, accounted for the moderate improvement in overall GDP in FY 2002/03. However, the economic growth rate was lower than the targeted growth rate of 4.0 percent owing to the delayed arrival of monsoon in some places and floods and landslides in other places, the global recession which affected Nepal's exports and tourism, and the escalation of insurgency in the country. The CPI-based average inflation rate increased by 4.8 percent in FY 2002/03 as compared to the rise of 2.9 percent in the preceding year. The upsurge in prices of the petroleum products, edible oil and ghee and grains and cereal products contributed to the rise in the overall price level.

The external sector performed better in FY 2002/03. Total exports and imports increased by 6.4 percent and 15.8 percent, respectively, in FY 2002/03 as against a decline of 15.6 percent and 7.2 percent, respectively, in FY 2001/02. Of the total exports, exports to India decreased by 5.5 percent while exports to other countries increased by 23.8 percent. The value addition requirement on Nepalese exports and the quantitative restrictions by India on four Nepalese products (vegetable ghee, copper wire, acrylic yarn and zinc oxide) were responsible for the decline in exports to India.

Of the total imports, imports from India went up by 25.3 percent in FY 2002/03 as against a rise of 3.5 percent in FY 2001/02. Imports from other countries increased by 5.2 percent as compared to a decline of 16.8 percent in the previous year. Owing to the relatively large base of imports, trade deficit increased considerably by 23.1 percent in FY 2002/03 as against an increase of just 0.7 percent in the previous year. While trade deficit with India went up by 55.2 percent, trade deficit with other countries declined by 5.8 percent.

A surplus of Rs. 4.4 billion was recorded in the balance of payments in FY 2002/03 as compared to a deficit of Rs. 3.3 billion in the previous year because of the increase in exports and the continuous rise in remittances. The total remittances increased by 14 percent to Rs. 54.2 billion in FY 2002/03 from Rs. 47.5 billion in FY 2001/02. The foreign exchange holding of the banking system amounted to Rs. 108.2 billion as at mid-July 2003 as compared to Rs. 105.9 billion a year earlier. Total foreign exchange

reserves were sufficient to finance 10.7 months' goods imports and 8.9 months' imports of goods and services.

The nominal exchange rate of the Nepalese rupee with the Indian rupee was stable but appreciated vis-à-vis the US dollar by 4.4 per cent, from Rs. 78 per US dollar (buying rate) in mid-July 2002 to Rs. 74.75 per US dollar on July 16, 2003. The appreciation of the Nepalese rupee vis-à-vis the US dollar was ascribed to the weakening of the US dollar in the international market and the rise in convertible foreign currency reserves in Nepal.

While broad money (M2) increased by a higher rate of 9.8 percent in FY 2002/03 as compared to 4.4 percent rise in the previous year, narrow money (M1) increased by a lower rate of 8.5 percent in FY 2002/03 as compared to 9.3 percent rise in FY 2001/02. The increased accumulation of net foreign assets (NFA) was responsible for the rise in M2. During FY 2002/03, NFA (after adjusting foreign exchange valuation) grew by 4.9 percent to Rs. 91.4 billion as compared to a decline of 3.8 percent in the previous year. The growth in NFA was attributed to the increased inflows from services, net and remittances.

Time deposits increased by 10.4 percent in FY 2002/03 as compared to an increase of 2.1 percent in the preceding year. The rising trend in remittances, the lack of alternative investment opportunities and the slowdown in the securities market contributed to the increase in time deposits.

The monetary sector's claims on the private sector surged by 13.2 percent to Rs. 151.0 billion in FY 2002/03 in comparison to a growth of just 5.2 percent a year earlier. The rise in import credit and the launching of various credit programmes (car loan, housing loan, educational loan, etc) by the commercial banks were responsible for the significant increase in the claims on the private sector.

GDP is estimated to grow by 4.5 percent in FY 2003/04. The agricultural and the non-agricultural GDP are estimated to grow by 3.5 percent and 5.1 percent respectively. Inflation is projected to remain within 5 percent level. M2 and M1 are estimated to increase by 12.6 percent and 9.0 percent respectively. Private sector credit is projected to rise by 14.0 percent. Exports and imports are estimated to go up by 8.6 percent and 13.6 percent, respectively, with balance of payments maintaining a surplus of about Rs. 6.4 billion.

### **3. Monetary Policy Developments**

#### **3.1 Policy Objectives**

The prime objectives of monetary policy have been: (a) attaining domestic price stability, (b) securing a reasonable level of surplus in the balance of payments, and (c) maintaining an adequate level of liquidity to support a high, sustained and broad-based economic growth. The NRB announced for the second time its annual Monetary Policy and Programme for FY 2003/04 on 24 July 2003 taking into consideration the prevailing and prospective domestic economic situation, fiscal operations and emerging external sector developments. The principal focus of the monetary policy stance has been easing monetary conditions further without endangering the overall macroeconomic stability, in an attempt to reduce the costs of funds for encouraging economic activities and investment projects in the backdrop of the prevailing overall stable macro-economic conditions.

#### **3.2 Policy Instruments**

The current framework for monetary policy for FY 2003/04 has been focused at keeping inflation within control and preventing the unnecessary depletion of the country's foreign exchange reserve. Money supply and domestic credit are taken as intermediate targets. Net domestic asset (NDA) of the NRB is being used as the operating target in order to attain the intermediate target of monetary policy.

To achieve the ultimate objectives of monetary policy and also to maintain the growth of monetary aggregates at the desired level, some changes in monetary policy instruments were made. For the attainment of the ultimate targets of monetary policy, open market operations and short-term interest rates are being used as the major

monetary instruments to maintain the NRB's NDA within the desired level. The repurchase agreement (REPO) facility is continued to provide standing liquidity facility for commercial banks.

Effective from FY 2003/04, commercial banks are required to maintain 6 percent of their total domestic deposit liabilities at the NRB as compulsory reserve. The introduction of a single, uniform compulsory ratio has been made to bring about uniformity and simplicity replacing previously varied compulsory ratio on different domestic deposit liabilities. The bank rate has been used as an indication of monetary policy stance as the open market interest rates including the REPOs are determined by the market. The bank rate is currently maintained at 5.5 percent.

With respect to refinancing rates, the prevailing rate of 2 percent for export credit in foreign currency, 4.5 percent for Rural Development Banks and export credits in Nepalese currency, and 5.5 percent for all other types of refinancing remained unchanged. However, the refinance rate against sick industry loans has been brought down to 2 percent from 3 percent in FY 2003/04.

A measure aimed at gradually phasing out the priority sector-lending requirement within a five-year period was undertaken. Initially, a two percentage points cut in the priority sector-lending requirement was effected in FY 2002/03. Though the priority sector-lending requirement will be completely phased out after FY 2006/07, the deprived sector lending arrangements will remain unchanged.

To generate competition among commercial banks for deposit mobilization and credit expansion benefiting both depositors and borrowers with regard to interest rates, the NRB abolished the restrictions on interest rate spread that was fixed at 5.0 percent, for the time being.

With the purpose of boosting the industrial and tourism sectors, a relief package of refinancing facility was introduced through the banks and financial institutions in FY 2001/02. This policy is also being continued for FY 2003/04. Rs. 1.5 billion has been allocated in fiscal year 2003/04 for this purpose.

#### **4. Overview of the Nepalese Financial Sector**

With the economic liberalization initiated in mid-1980s, the Nepalese financial system witnessed significant developments. For instance, the financial system consisted of only two commercial banks and few other financial institutions before liberalization. During the post-liberalized regime spanning almost two decades, the financial system has reasonably developed, diversified, and enriched. As of April 2004, the financial system consisted of 17 commercial banks, 19 development banks, 5 regional rural development banks (RRDBs), 116 postal saving banks, 58 finance companies, 33 saving and credit cooperative societies involved in limited banking activity, 44 non-government micro-credit institutions, one stock exchange with the network of brokers and securities dealers, 18 insurance companies, one employees' provident fund, one credit guarantee and deposit insurance corporation, and one Citizen Investment Trust. Of these institutions, the commercial banks, development banks, RRDBs, finance companies, financial cooperatives and NGOs are under the regulatory framework of Nepal Rastra Bank (NRB). While the insurance board regulates the insurance companies and the securities board regulates the stock exchange, the other institutions are under the overall regulation of the government.

Along with the numerical growth and other institutional developments of the financial sector, the deposits and credits are expanding though the qualitative aspects of the financial system still require much improvement as reflected in the inadequacy of the banks and financial institutions in providing increased benefits to the general public and in contributing adequately to the economic development through raising income level, creating employment opportunities and building internal strength for the growth of the institutions themselves. Though various reform efforts were undertaken in the past, to create a healthy financial sector as a pre-requisite to sustained economic growth by getting rid of the various institutional and structural deficiencies that still characterize the system, further FSR measures need to be continued, initiated and implemented.

## **5. Past Reform Efforts and Outcome**

### **5.1. Reform Measures During 1980s**

Till early-1980s, the banking sector was not opened up for the private sector. Only two commercial banks then in operation were the Rastriya Baniya Bank (RBB) and the Nepal Bank Limited (NBL), with the HMG ownership of a hundred percent at the former and fifty-one percent at the latter, functioning with their network of branches across the country. Three joint-venture commercial banks came into operation during the 1980s. By that time, the government-owned commercial banks had begun to exhibit serious portfolio problems and its severity was deepening. It was not because of their expansionary stages but because of the weak operational performance, mismanagement and imprudent lending decisions that these banks went through during those days. The Commercial Banks Problem Analysis and Strategy Study (CBPASS) was carried out in FY 1989/90 to assess the real financial position of these two banks so as to help these banks to assess their current financial situation, planning for the further course of action and developing operational strategy for making them capable, dynamic and competitive in the context of national need. The study was conducted under the technical collaboration of UNDP. Economic reforms under Stand-by Arrangements and the Structural Adjustment Facility (SAF) of the IMF and the Structural Adjustment Lending (SAL) programs of the World Bank during the latter period of 1980s also incorporated various measures aimed at improving the financial and monetary sector of the country. The reform measures in the financial sector were concentrated on strengthening financial and operational performance, improving the legal and institutional environment, enhancing the capacity of the central bank to supervise the banking system, implementing the improved regulations, and rationalization of branch expansion policies. Accordingly, the following reform activities were completed:

- With a view to strengthening and improving the performance of the two commercial banks, HMG provided Rs. 443 million for re-capitalization and further Rs. 3.12 billion for provisioning and repayments of bad debts.
- HMG made a payment of Rs. 400 million toward government-guaranteed bank loans to public enterprises and second payment of Rs. 260 million.
- Some technical assistance was also provided by the IMF to strengthen the banking supervision and inspection function of the NRB. Consequently, the Inspection Department of NRB was expanded with additional human and other resources.
- Legislative changes were enacted to permit the NRB to supervise NIDC.
- Amendments to the Commercial Bank Act and the NRB Act were made in 1989 and that in the NIDC Act in 1990.
- Credit Information Bureau (CIB) was set up in 1989 to disseminate credit information.

These efforts were in right direction for improving the environment during that period. However, the measures could not improve the system substantially as the reforms lacked comprehensiveness and sustainability and were initiated on a piecemeal basis.

### **5.2. Reform Measures During 1990s**

As the result of the liberal economic policy thrust adopted in the eighties, the financial sector had benefited from several competition-enhancing measures like the new liberal entry policy for banks and non-banks, complete autonomy in determining the interest rates, implementation of prudential regulatory measures, etc. The reform measures were continued during 1990s, initially supported by the IMF's ESAF which, however, could not be fully implemented as only 50 percent of the approved amount (SDR 33.6 million) was drawn. Some of the reform measures introduced could be named as the withdrawal of statutory liquidity ratios, granting of the maintenance of the foreign exchange exposure to commercial banks, and provisions for allowing to open personal foreign currency accounts. Similarly, cash reserve ratio and refinance rates were reduced several times. With a view to introducing private sector culture and

strategic alliance, the shareholding of the government in the NBL was offloaded. Accordingly, some standardization on regulatory norms were also designed on piecemeal basis in order to regulate commercial banks with respect to capital adequacy (1991), re-discounting of treasury bills with NRB (1993), loan classification, provisioning requirements and liquidity norms (1996), definitions of core capital and supplementary capital (1996), increment in the capital (1996) etc. Some other norms were also established on case-by-case basis.

In addition, in order to develop and maintain managerial capabilities, some chairpersons, board of directors, and CEOs were also appointed in the financial institutions from among the professionals of the NRB and HMG. All these attempts and initiatives could not exhibit aspired performance in terms of efficacy and efficiency within the financial system. In the given situation, a "Reconciliation Project" was undertaken by the NRB with the help of the Nepalese auditors to study RBB and to identify the real financial soundness and quality of financial statements in 1999. This study revealed many discrepancies regarding the financial strength and soundness of the bank. The financial indicators of RBB and NBL were exhibiting poor conditions. Thereafter, to verify such findings, study of RBB and NBL was conducted by KPMG, an International Auditor's Group. The two studies portrayed extremely serious position of these banks. The report highlighted that RBB and NBL were having serious shortfalls in all aspects of their governance, management, and operations and were found technically insolvent. The KPMG report also showed that loan assets in those banks were extremely risky and highly overstated. To sum up, the KPMG report highlighted the following aspects of RBB and NBL:

- Severe governance and management shortfalls,
- Dysfunctional lending processes,
- Extremely poor information systems, accounting and record keeping practices,
- Poor strategic planning, business planning and budgeting,
- Low morale of employees and numerous human resource issues,
- A negative net-worth, and
- Technically insolvent.

Hence, it was a matter of grave concern for the country's financial sector as these two banks represented approximately half of the total assets of the banking system with wider branch network in the country. Therefore, without implementing a comprehensive reform program in the financial system, it was apparently impossible to create a sound and healthy economy.

## **6. Logic Behind Initiating Current Comprehensive Reform Program**

The reform measures would be instrumental in improving the soundness of the structure and making positive breakthrough in the competitiveness and effectiveness of the financial system. A sustainable growth cannot be assured in the absence of safe, sound and efficient financial system in the economy. Not only this, without additional reform measures, the efforts we have made to date to improve the efficiency of financial intermediation, the gains of the past reform efforts and the progress we have achieved toward gaining stability can not be continued and justified in the future. In this context, the reform in all the areas of central banking, commercial banking, and non-banking systems has been vital and needs to be properly implemented.

After the promulgation of the NRB Act 2002, the central bank now has the clearly defined responsibility, authority and accountability. The central bank aims at boosting up the contribution of the financial system towards achieving the national goals of macroeconomic stability and financial discipline to a greater extent through increasing efficiency in mobilizing and allocating financial resources, enhancing savings and investment levels, channeling the resources towards productive investments and allocating the available resources to the deficient segments of the economy for enhancing overall competitiveness. But the system still has various structural

deficiencies. The high level of NPA, which is 29 percent in the banking system ( RBB 60.47%, NBL 60.15%), has compelled the banks to bear high profile of risk. The negative net-worth of the two largest commercial banks, which amounted to Rs. 32.22 billion in mid-July 2003, has threatened the stability and sustainability of the system. Weak and poor legislative regime governing financial system has been the bottleneck affecting the faster growth of financial institutions. Quick service delivery to general public and quick recovery from defaulting borrowers have become difficult. The risk profile exhibited through higher default rate has minimized the scope of reducing interest spread between lending and borrowing rates. Adequate institutional strength required to support the financial system is lacking. Due to increment in inefficient banking activities, the intermediation function has been overburdened with non-core activities in the system. The securities market, insurance sector and other contractual saving institutions are also suffering from various legal and structural deficiencies.

On the other hand, the pre-dominance of informal financial sector has stood as a question mark to the policy makers that their efforts are not adequate to make available low price funds to enthusiastic entrepreneurs throughout the country. Concentration of banking institutions in urban areas is pointing out the need for more focused policy interventions for channelizing resources in the rural sector. As monitoring and supervision cost of the banking institutions is high, the practice of retail banking is gradually being reduced and replaced with wholesale ones which has ultimately discouraged the small deposit and lending in the system. The system is lacking banking professionals and skilled managers as well and the gap has created operational inefficiencies, managerial deficiencies, unhealthy competition, and poor banking culture in the system. HMG's involvement in the financial institutions has been significant to date and it will take some time for it to be replaced by the private sector. These institutions are not easily saleable in the market and require restructuring to attract private investors. Therefore, we still have a long way to travel to reform the whole financial system with satisfactorily tangible outcomes.

We should always bear in mind that without healthy and efficient financial system in the economy credit delivery and allocative efficiency of the system will not be improved. Not only this, without healthy financial system, the stable financial growth along with high and sustainable economic growth cannot be achieved. Therefore, efficient, stable and healthy financial sector is needed for promoting economic growth and attaining rapid progress in the poverty reduction.

## **7. Moves Toward Current Comprehensive Reform Program**

Drawing on the inadequacies of the piecemeal attempts of the past reforms, it has been felt necessary to initiate and expedite the process of comprehensive reform and other improvement measures. Hence, the moves toward current comprehensive financial sector reform program reflect the strategic change to get rid of the extremely difficult situation that the financial system of Nepal has undergone.

With the reform initiatives have come the changes in the attitude towards the State-owned commercial banks as more emphasis now been placed on commercial orientation, privatization, managerial culture, greater autonomy and accountability. Therefore, HMG came out with the financial sector reform program by encompassing a wider coverage of issues for their improvement. To accomplish the reform, HMG has obtained financial assistance from IDA, DFID, and ADB so that the financial sector reform program could be launched with a wider coverage, prospective and well-defined set of objectives.

## **8. Areas of Reform in the Financial System**

The clearly identified and addressed agenda of reform in the financial sector strategy statement of HMG are the following:

- (i) Build a strong central bank,
- (ii) Build and maintain strong banking and non-banking sector,
- (iii) Improve existing legal and judicial aspects of financial system,
- (iv) Improve auditing and accounting standards within the banking sector,

- (v) Promote financial discipline through adequate disclosure and competition,
- (vi) Initiate more focused interventions toward the programs for the upliftment of the poor,
- (vii) Re-orient the activities of HMG and NRB from being active participant (Owner) of the financial institutions to a regulatory body.

The strategy paper of HMG has assigned important and enhanced role, responsibility and accountability to the central bank. The government has fully supported the efforts of NRB in strengthening banking supervision and enforcing the regulations. Obviously, NRB has been assigned to focus and handle following reform activities in the financial sector:

- (i) Reforming the financial sector legislations and regulations,
- (ii) Strengthening of bank supervision and inspection,
- (iii) Restructuring and privatization of RBB and NBL,
- (iv) Enhancing competition in the banking sector and streamlining of ownership structure,
- (v) Discouraging multiple banking practices,
- (vi) Reforming the auditing and accounting capabilities,
- (vii) Creation of broad-based banking,
- (viii) Establishment of Bankers' Training Institute, Assets Management Corporation (AMC) and Credit Rating Agency in Nepal,
- (ix) Restructuring of Credit Information Bureau,
- (x) Strengthening of Regional Rural Development Banks,
- (xi) Revamping research and financial monitoring strength of NRB,
- (xii) Meeting sectoral financing requirements and establishment of development banks at the regional level,
- (xiii) Broadening and deepening of financial system in Nepal,
- (xiv) Initiating restructuring program for ADB and NIDC.

## **9. Current Progresses with FSRP**

At the moment, Nepal is passing through the initial stages of the comprehensive financial sector reform program. The FSRP has completed significant homework and implemented some very important activities to build a strong financial architecture. The following are the major developments attempted within a short span of time, i.e., during 2002-2003.

### **9.1. Legislative Reforms**

- ?? The new NRB Act was enacted on January 30, 2002. The new NRB Act has provided more autonomy, authority and accountability to the central bank. As a result of enactment of the new NRB Act, supervisory, oversight, and regulatory functions have been strengthened substantially. NRB has been stricter than in the past in penalizing the banks and financial institutions for non-compliance of NRB's regulations.
- ?? The Debt Recovery Act, which received royal seal in 2002, is another outcome of reform program. HMG has also approved the by-laws of the Act. The Debt Recovery Tribunal was established in 2003. This legislative framework is a new attempt to make loan recovery effective and reduce the burning problem of NPA of the banking system. Now the debt tribunal is receiving the distressed loan

cases and working on it. To hear the appeal on the cases decided by the Tribunal, an Appellate Tribunal has also been recently set up.

?? Similarly, a Bank and Financial Institutions Ordinance has been enacted recently. By this Act, the fragmented legal bases such as Commercial Bank Act, Finance Companies Act, Development Bank Act and other laws governing deposit-taking financial institutions have come under the single legislation. This has also tightened the regulatory rules governing those financial institutions.

?? The major problem faced by the Nepalese banking system is the high level of NPA, which has remained at around 29 percent in 2003. To facilitate the banks to improve their loan recovery, to improve asset portfolio and to reduce the level of NPA, a special type of institution is necessary to be established. For this, efforts are underway to incorporate an AMC in Nepal. A draft of AMC Ordinance is under the consideration of the Cabinet. The establishment of AMC will help manage the bad assets of the banks, and banks will be able to engage in the core banking activities only.

?? Other legislations:

To enhance the legislative regime, Public Debt Act and Foreign Exchange Regulation Act have been amended within last two years to make them up-to-date.

The drafts of the Secured Transactions Ordinance, Insolvency Ordinance and Securities Ordinance have been approved by the Cabinet and are awaiting the royal seal for enactment, and the Company Ordinance is in under the consideration of the Cabinet.

The drafts of the Fiscal Transparency Ordinance and Anti-Moneylaundering Ordinance are also under active consideration of the government.

Thus, the legislative framework is being continuously strengthened and this will significantly improve the financial legislative and regulatory regime of Nepal.

## **9.2. Regulative Reforms**

Similarly, NRB has formulated and issued various prudential regulations for implementation in order to ensure a safe, sound and efficient financial system. These directives meet the international standards and are related to the following areas:

- i. Capital adequacy,
- ii. Loan classification and provisioning,
- iii. Credit concentration and single obligor limits,
- iv. Accounting policies and formats of financial statements,
- v. Management and minimization of risk,
- vi. Good corporate governance,
- vii. Compliance with the directives issued in connection with inspection and supervision,
- viii. Provisions relating to investment in shares and securities,
- ix. Reporting requirements,
- x. Provisions relating to purchase and sale of promoters shares,
- xi. Other relevant provisions such as branch expansion, profitability and dividends.
- xii. Effective from December 17, 2003, NRB has removed the restriction on limitations of interest rates on lending as well as the spread on buying and selling rates for commercial banks on foreign exchange.

The Institute of Chartered Accountants of Nepal has recently prepared Nepalese Accounting and Auditing Standards and these standard are being reviewed in the line of International Banking Practices so that they could be applied in the financial

system. Accordingly, the formation of the Accounting Board and Auditing Board has also helped establish a framework to facilitate the IAS-compliant accounting and auditing practices in the country.

More importantly, the NRB has adopted the proactive strategy. Therefore, other necessary directives will also be issued as per the requirement to bring about the desirable institutional growth, enhance fair competition, make operational improvement, and maintain sound health of institutions within the system.

### **9.3. Capacity Building in Bank Supervision and Inspection**

A series of activities have been launched for strengthening the supervisory capabilities of the NRB.

The first attempt had begun with technical assistance for the preparations of regulatory norms and in preparation of inspection and supervision manual based on international best practices in 2001. For this, NRB had obtained project preparation fund from the World Bank. Under this assistance, on-site inspection manual for banks and non-banks has been prepared and implemented. Apart from this:

- More than 100 supervisors and staff of NRB have been trained in 2002
- Chartered accountants were recruited last year as well as this year to strengthen accounting and audit capabilities in the central bank.
- Risk-based on-site inspection manual and methodology has been designed and implemented in 2002.
- NRB has initiated its re-engineering process under FSRP. NRB concluded agreement with the IOS Partners, USA, on February 6, 2003 to assist in the restructuring program. This team is comprised of one foreign expert on on-site inspection and one for off-site inspection for one-year period. Similarly, to enhance the capability in Human Resource Management, Accounting, Auditing, and Bank Restructuring aspects, other three experts have been selected and employed. This type of technical assistance has been considered to be worthwhile to explore new areas of monitoring, building supervisory capability, and strengthening of the internal strength of the central bank. NRB has launched the Voluntary Retirement Scheme (VRS) to get it in right size. Around 400 staff strength has been reduced through the first phase VRS. New benefit package has been introduced and will be continued for ensuring professionalism. The personnel by-laws are being reviewed to enable the bank to hire and retain the professional staff needed to enhance the capacity of the central bank.
- For the smooth operation and to avoid direct intervention of regulatory body in commercial lending decisions, NRB completely withdrew its representatives from the Board of Directors of commercial banks and development banks in 2003.

### **9.4. Progress on Restructuring of NBL and RBB**

As a component of the financial sector reform program, a Management Team "ICCMT" consisting of international bankers from Bank of Scotland (Ireland) has been appointed in NBL to restructure the NBL. The ICCMT assumed its assignment in NBL on July 22, 2002. The management team has completed the Financial Analysis of the NBL and the preparation of Management Plan and the Budget Plan for the Bank. To-date, the team has come up with clear vision, mission, goals and objectives of the bank. Asset-Liability Management Committee (ALCO), Executive Committee (EXCO), Credit Committee (CC), Relation Management Division (RMD), Credit Administration and Review Division (CARD), Special Asset Group (SAG), and several special Task Forces have been established to create, apply and reinforce internationally accepted norms and modalities in the bank. The norms and modalities are focused toward identifying bank risk and enhance the loan risk rating systems in the bank. New Credit Policy Guide, Guidelines for Credit Decision Process, and Problem Loan Guide have been prepared and implemented from last year. A continuous negotiation and dialogue with big defaulters has been initiated and around Rs. 4.90 billion of loan

categorized as NPA has been recovered in cash and restructured within the one and half year period. Despite the best efforts of the management team, loan recovery of the bank cannot be considered as satisfactory. Hence, the management team needs to make more serious efforts to loan recovery.

On other fronts, new accounting manual and chart of accounts have been introduced in the bank. Around 300 staff in the NBL have received the accounting training. The pending audits of FY 2000/01, and 2001/02 were completed last year and the financial audit of 2002/03 has also been completed this year. A detailed Human Resource Master Plan has been prepared and, accordingly, to get the bank in right size, the first phase of VRS has been able to reduce the staff level by 1,462. The loss position of the bank has been reduced to Rs. 251 million in FY 2002/03 from that of Rs. 3,255 million in FY 2001/02. Interest income to loan and advances ratio increased to 7.52 percent from 5.66 percent. Interest expenses as percent of the total deposits was reduced to 4.58 from 4.97. Despite various efforts, NBL has still 60.47 percent of NPL and negative capital of Rs. 9.75 billion. There are still a lot of areas to be improved in NBL. After solving all the major problems of the bank, the restructuring process is expected to be successful to introduce a new credit culture, sound HR development program, scientific, and modern IT/MIS platform to instill profit-oriented atmosphere, an in-built self-monitoring mechanism and customer service culture within the contract period of ICCMT.

Similarly, despite the breach of contract by the Deloitte Touche Tohmatsu, USA, NRB completed the process of appointing the CEO and other members of the management team for restructuring RBB. Through February 19, 2003, a full team has been placed in the RBB. The new management has prepared and submitted the Management Plan on April 1, 2003 to restructure the bank. The Financial Analysis was completed and the report was submitted to NRB on May 1, 2003. The Management prepared Budget Plan for FY 2002/03 and FY2003/04 and the system of strict monitoring has been initiated. New Chart of Accounts according to international accounting standard has been prepared and implemented. The audit of FY 2001/02 and FY 2002/03 has been completed. Budget Procedure Manual has been prepared and submitted to NRB on May 27, 2003. The Management Team has established seven core teams in order to make adequate efforts toward loan recovery and loan administration. This recovery team comprises 5 recovery units in regional levels, 1 unit for Kathmandu Main Office (KMO) and 1 unit for consortium loans. As in mid-January 2004, within the period of 12 months, the team recovered, through cash repayments and restructuring process, Rs. 2.9 billion categorized under NPA. To right size the bank; branch rationalization and Voluntary Retirement Scheme have been adopted. The first and second phase together had aimed at downsizing the staff strength by 2,322 from the prevailing staff strength of 5,522. This will keep the staff strength within around 3,200. In the first phase of VRS, 1266 employees applied, of which 1,020 applications have already been approved and 246 applications are still in the process awaiting the verdict of departmental action and the action of CIAA on fake certificates. Due to the long-term deposits at high cost, the bank is still suffering from negative net interest. After proper evaluation of loan portfolio, the level of NPA increased to 60.15 percent and the capital fund of the bank has been negative by Rs. 21.99 billion in mid-July 2003. Continuous restructuring efforts are ongoing. To sum up, significant development in the restructuring process has been accomplished and it is expected that, within the project period, the profitability condition in the bank will be restored.

#### **9.5 Capacity Building Program within NRB**

Under the reform program, strengthening of inspection and supervision functions has already been initiated. Prudential regulations have been issued, new inspection manual is in place, and international experts are being hired to uplift the skill among the on-site and off-site supervisors. A human resource expert is being hired to develop and tackle HR issues of the bank. To enhance the auditing and accounting capabilities of the financial system, the process of obtaining technical assistance of foreign experts has almost been completed. IT/MIS is going to be improved shortly. Necessary training and HR development programs are being initiated. Within last two years, all the commercial banks except RBB and NBL were inspected by the NRB at

the corporate level. To implement Basel II by 2007, a group of bank professionals is working on it. All these developments are clearly manifesting positive signs toward capacity building program in the NRB.

#### **9.6 Enhancement of Competition within the Banking System**

To enhance competition in the banking system, many measures have already been undertaken and some are still in the process. To make financial sector attractive to foreign investors, the 50 percent of ceiling on ownership by foreigners has been increased up to two-thirds. To enhance the competitive capabilities among commercial banks and financial institutions, a new bank and non-bank licensing policy has been introduced. NRB has recognized the fact that competitive environment is critical for ensuring the financial intermediation to benefit the borrower, depositors and other users of financial services. The objectives are being achieved through more focused interventions and market-oriented policies.

#### **9.7 New Licensing Policy for Commercial Banks, Development Banks and Finance Companies**

The licensing policy for commercial banks was publicly announced on May 16, 2002, for development banks on May 21, 2002 and finance companies on May 29, 2002 covering the qualification of promoters, required paid-up capital, technical assistance and other requirements. Accordingly, 10 development banks and 10 finance companies have got license for operation. After the enactment of BFI Ordinance, 2004 the new capital requirement for bank and various classes of financial institutions has been announced in April 17, 2004.

#### **9.8. Strengthening of CIB and Information System**

Without building ancillary institution to coordinate in the specialized function in the financial market, the system could not be fertile to grow. Therefore, some preliminary works on the preparation of legal documents to restructure the CIB have been completed. In the meantime, CIB by-laws has been prepared and implemented to regulate the CIB's functions. Shortly, the CIB is going to be established as a company to be operated by the private sector banks.

Under the provision set forth in the NRB Act, NRB credit information Bureau bye-laws have come into effect to strengthen the CIB functions and powers. To strengthen the procedural aspects for CIB, a new directive to banks and non-bank financial institutions has been issued, covering all the systems and procedures of blacklisting by the CIB. This more transparent and strict system has been adopted to restrain the wilful defaulters and compelling them to repay the loan of banks and financial institutions through the application of these new blacklisting procedures. The blacklisting procedures are being reviewed in order to enable and facilitate the system for better performance.

#### **9.9. Programs for Poverty Reduction and Rural Credit Delivery**

For this, more focused interventions have been initiated during this reform program. These include strengthening of "Swabalamban Kosh" (Self-Help Fund) for enhancement of micro-credit facilities through micro-credit institutions and strengthening of RRDBs.

To strengthen the financial soundness of RRDBs, additional capital has been injected. To develop professionalism in the management and also to strengthen the operations, NRB published advertisement on December 30, 2002 for the appointment of CEOs in RRDBs. Accordingly; professional CEOs have been appointed in the RRDBs. Similarly, the privatization process has been initiated by off loading the stake of Western Rural Development Bank held by NRB. Out of 61 percent that was held by Nepal Rastra Bank 51 percent is off loaded. Out of this 51 percent, 37 percent is allocated to the Western Rural Development Bank's group members, 5 percent to employees of the bank and 9 percent to micro finance financial institutions at the price of Rs.107.72. Accordingly, the shares held by NRB in Eastern Rural Development Bank has been decided to offload within this fiscal year. In this process, similar

modality will be applied to dispose 56.75 percent stack of NRB, out of total holding of 66.75 percent.

Accordingly, the ADB-funded Rural Micro-finance Project is being run through the Rural Micro-finance Development Centre (RMDC). The Centre has been effortful in assisting and promoting the rural micro savers and borrowers, though the problems relating to the current conflict situation have stood in its smooth way of operation.

To strengthen and restructure the ADB/N, a diagnostic study has been completed with the technical assistance of the ADB by Price Water House Coopers, an international consulting firm. On the basis of this study, an institutional strengthening plan has been devised and put into implementation in a phasewise manner. Meanwhile, a performance contract has also been concluded recently between the government as well as the management and the board of the bank. With regard to NIDC, the Cabinet has decided for its privatisation with a pre-requisite package of restructuring, stating that failing in achieving this would result in its eventual liquidation.

Phase-out schedule for commercial banks' Priority Sector Lending has been declared on December 23, 2002. However, the deprived sector lending has been continued as usual. Micro-finance institutions and development banks are being encouraged to fill the gap in micro-credit lending activities. Disadvantaged group and poor will be helped through these developed and efficient rural and micro-credit delivery mechanisms.

#### **9.10 Strengthening of Accounting and Audit in the Financial System**

For this purpose, accounting policies, auditing procedures, disclosure requirements and requirements for long form reports (LFR) have been clearly addressed in the new directives issued to banks and financial institutions. To obtain better performance, a list of qualified auditors for banks and financial institutions has been prepared and published on July 31, 2002. For this purpose, 78 qualified auditors under class A and 28 under class B have been categorized. HMG has appointed international auditors to conduct the audit of NRB. Moreover, the government concluded a Country Financial Accountability Assessment report with the donor support to streamline the financial accountability structure of its institutions.

#### **9.11 Improvements in the Financial Statistics**

For monitoring the financial statistics, a new software package has been provided to all the commercial banks to enable them to prepare timely report and submit it to the NRB for the publication of financial information in time.

#### **9.12. Establishment of Monitoring System within FSRP**

A top-level co-ordination committee under the chairmanship of Vice Chairman of National Planning Commission (NPC) has been formed by HMG. The other members are NRB Governor, Secretary from MOF, and a Member from NPC. This committee co-ordinates the program and deals with policy issues. A monitoring and surveillance committee has been formed in NRB to observe the processes and evaluate the performance, make suggestions and implement the policies of FSRP.

A monitoring and surveillance Team (M&ST) has been formed in NRB to monitor and evaluate the progress and report the activities and analyze the issues of RBB and NBL management teams. The bank restructuring advisor from IOS Partners, USA, is building capacity of NRB counterparts on bank restructuring issues and processes. A co-ordination and support team (CST) has been formed in NRB to deal with procurement and financial issues within FSRP. A NRB re-engineering Steering Committee has been formed to monitor the progress and facilitate the activities in the NRB re-engineering process. This committee consists of relevant department chiefs from NRB.

### **10 Developments in the Securities Market**

Financial sector also includes sectors like insurance and capital markets. The insurance business has been encouragingly flourishing over the last few years, as there are already 17 insurance companies in Nepal. They are both in the areas of life and non-life. The Insurance Board regulates the sector with its own statutory authority.

The largely government-controlled Rastriya Beema Sansthan is the oldest corporate entity in this sector. Recently, the recent creation of the Insurance Pool has paved the way for smooth handling of the terrorist incident-related insurance cases.

The Securities Exchange Board (SEBO) is the regulator of capital/securities markets. This is an effective mechanism for raising funds for commercial and productive enterprises. The liberalization process during the 1990s accelerated the development of the securities market. Presently, in the market, the SEBO stands as central regulator and Nepal Stock Exchange Ltd. (NEPSE) as secondary market operator. There are 27 stockbrokers, 2 securities dealers and 9 issue managers providing securities market intermediation services.

As of March, 2004, the SEBO has approved 121 public issues to raise funds equivalent to Rs. 6433.95 million. There are 113 listed companies in the stock exchange with total paid up value of Rs. 12.8 billion and the market capitalization of Rs. 36.6 billion. At the end of FY 2002/03, market capitalization as percent of GDP is 8.2 percent.

#### **10.1. Past Efforts and Outcomes**

Past initiatives and outcomes have had significant impact on the development of capital market in Nepal. After the establishment of Securities Exchange Centre in 1976, the securities market has been developing gradually. The Securities Exchange Act was enacted in 1983 and Securities Exchange Centre started trading of corporate securities through its counter in 1984. A major restructuring of securities market took place in 1993 when Securities Board was established as a regulator after the first amendment to the Securities Exchange Act. The Securities Exchange Centre was converted into Stock Exchange Limited and given the responsibilities of operating secondary trading of securities. At the same time, stockbrokers, issue managers, market makers and securities dealers were also introduced in the market for providing securities market services. The second amendment to the Securities Exchange Act was made in 1997. With the new provision of second amendment to the Securities Exchange Act, the stockbrokers/ dealers and listed companies were required to submit their financial statements to SEBO. In 1990, Citizen Investment Trust was incorporated under Citizen Investment Trust Act, 1990 with a view to expand investment opportunities by encouraging collective savings for investment in the securities market.

#### **10.2. Problems in Securities Market Development**

Existing securities legislation is lacking clear and adequate provisions regarding the securities market regulation. Basically, the major deficiencies of the securities legislation are duality in regulation of public issue of securities, lack of clear demarcation between regulatory functions of SEBO and NEPSE, overlapping regulatory provisions and lack of basis of co-ordination between SEBO and other government regulators, inadequate enforcement provisions, lack of provisions regarding the establishment of market infrastructures, lack of clear entry and exit norms for securities market intermediaries, lack of provisions to regulate market intermediaries' services like share registration, underwriting etc., and lack of regulation for the operation of collective investment scheme, etc.

The SEBO is regulating market with limited resource base. Its sources of capital are the budgetary support from government, charges on public issue approval and renew charges and stock broker/dealer license fees. From these sources, very limited resources are obtained. Due to limited capital resources, the SEBO is unable to recruit skilled and technical manpower as its permanent staff. The SEBO also has not been able to get membership of International Organisation of Securities Commission (IOSCO). Membership of such organization would be necessary to provide exposure to the international market.

The stock exchange is mostly owned by the government and the government-controlled organizations. Its board is governed under the chairmanship of the Ministry of Finance, the line ministry of SEBO. Besides, stock exchange also lacks broader

participation and necessary professionalism. In such a situation, the role of the regulatory authority and its effectiveness has been suffered.

Securities market is dominated by the equity share. Market has not become attractive to risk averter and risk neutral investors due to few corporate bonds and mutual funds in the market. Due to the lack of benchmark interest rate provided by government securities market and lack of trustee mechanism, the corporate bonds issue practice is yet to become popular.

The market has limited infrastructures to improve the market standard and to fasten the securities trading, clearing and settlement systems. Besides, some market intermediary services like share registry underwriting, investment counselling, etc. are lacking.

Due to lack of standard accounting and auditing system, securities market information could not become reliable and consistent, thereby adversely affecting the investor's confidence in the market.

Many corporate bodies, which have entered in the market, have not established credible governance practices including in the area of public reporting. Their audited financial information is not disclosed on time. Most of the companies other than bank and finance sectors are unable to conduct AGM timely. This is gradually eroding the investors' confidence in the market.

### **10.3. Areas of Reform in the Securities Market**

HMG has set its capital market strategies in the tenth plan document and has presented its focus, through the budget speech of the current year, to issue Securities Exchange Ordinance to professionalize securities market intermediaries and to integrate government securities trading in the stock exchange. Implementation of the reforms in the capital market is taking place with HMG, SEBO and NEPSE as the implementing agencies. The Corporate and Financial Governance Project (CPG Project), launched with the loan assistance from Asian Development Bank, intends to develop the market in standard and efficient manner.

To address the securities market issues, the following strategies have been prioritized:

- (i) Strengthening regulatory system and institutional capability of SEBO,
- (ii) Mutualizing/ Privatizing Stock Exchange,
- (iii) Automatizing stock trading system,
- (iv) Establishing central depository system of securities,
- (v) Professionalizing market intermediaries services,
- (vi) Integrating government securities trading to the securities market.

### **10.4. Progress with On-going Reforms in Securities Market**

#### **10.4.1. Legislative Reform**

- SEBO, with the objective of creating effective regulatory system by resolving the anomalies observed in the present Act, drafted new Securities Ordinance and sent it HMG/N. The proposed securities ordinance is expected to be very crucial for securities market reform. In order to implement the upcoming securities ordinance, SEBO is drafting the necessary rules and regulations.
- New Company Ordinance is also in the process of enactment, which is important to bring about harmony with the new Securities Ordinance.

#### **10.4.2. CFG Project**

- The CFG project has two components, namely, strengthening the capacity of judiciary in dealing with financial cases and enhancing the capability of the capital market. The capital market component of the project came into implementation from October 8, 2003. The major objectives of this component of the project are to strengthen institutional capability of SEBO, modernize NEPSE, establish central depository system of securities and build the capacity

of Company Registrar's Office (CRO). The project has three distinct phases; inception, design and implementation. Currently, the inception phase has been completed, though the inception report has yet to be finalized.

#### **10.4.3. Trading of Government Securities in the Stock Exchange**

The Ministry of Finance along with the participation of NRB, SEBO and NEPSE, has initiated the process to integrate government securities market with the stock exchange. Similarly, the move for auctioning and scripless trading of government securities is also underway.

#### **11. Current Issues, Agenda of Reform and Required Assistance**

Despite various economic and non-economic problems facing the country, the progress made on comprehensive financial sector reform seems to be satisfactory. Unless the overall issues of the system are addressed comprehensively, the achievements would not be sustained for a long time. There are still a lot of agenda items in implementing further reform so as to maintain a healthy, competitive and efficient financial system in Nepal. The areas of further reform are provided in the Annex-1. The strategy and medium-term vision on financial sector reform as targeted by the tenth plan (2002-2007) of HMG is provided in Annex-2. The long-term economic, social and development goals as well as those of the financial sector are exhibited in Annex-3. Annex-3 also deals with the matters systematically so as to fill the gaps in the activities, which could be solved by HMG alone, the activities which require to work mutually with development partners and also the activities for which the help of development partners is needed. Some macroeconomic indicators and financial indicators, which are provided in the Annex-4, highlight urgent actions to fill in the gap. Since financial sector reform program is being considered as a vital element of HMG's comprehensive economic reform program in realizing goals of economic growth and poverty reduction, it must be strengthened in the coming days in order to reinforce the private sector-led growth. In this regard, the assistance of the development partners would be a big-push for attaining and achieving the national goal and strategy.

#### **12. Conclusion**

The overarching goal of FSRP is to create well-regulated prudent, market-oriented, competitive and strong financial system in Nepal. It is considered that the FSRP is the most important component of HMG's overall economic reform program. After the completion of FSRP, the financial system would be able to contribute, to the maximum extent, to maintain macroeconomic stability, to lead the private sector for higher economic growth, to reduce poverty, to enhance rural banking, to create employment opportunities, to raise income levels and to maintain the pace of development at the sustainable level. Therefore, it can be expected that, through this consolidated reform initiatives, the people of Nepal can reap the potential benefits of the financial sector in coming days. Accordingly, HMG is looking forward to receiving further support and assistance from bilateral/multilateral donor agencies in this critical area of the economy of Nepal.

## Further Financial Sector Reform Agenda

### 1. Reengineering of NRB

- A. **Capacity Building on Regulation and Supervision Aspects:** (i) strengthening the implementation of on-site and off-site manual and procedures (ii) effective implementation of supervision reports and initiating corrective actions (iii) capacity building to issue pro-active regulatory measures (iii) capacity building in conducting regular study and research on emerging issues of the system (iv) create foundation to implement Basel –II by 2007 (v) formulation of financial legal expert cell (vi) logistic support to Regulation and Supervision Departments.
- B. **Human Resource Development Program:** (i) skill assessment and filling the resource gap (ii) scientific HR planning and implementation (iii) structural restructuring (iv) operational restructuring (v) launching of second phase VRS and competitive remuneration package to retain the professional staff in the bank. (vi) higher education, training and HR development program (v) encourage the development of professionalism within the NRB.
- C. **Capacity Building of Policy-Level Departments:** (i) Research Department (ii) Foreign Exchange Management Department (iii) Public Debt Management Department (iv) Bank and Financial Institutions Regulation Department (v) Bank and Financial Institutions Supervision Department (vi) Corporate Planning Department.
- D. **Capacity Building of Operation-Level Departments:** (i) Financial Management Department (ii) Mint Department (iii) Currency Management Department
- E. **IT and MIS Development:** (i) strengthening of IT Department (ii) computerization of all departments with software (iii) satellite connections (LAN and WAN Networking)
- F. **Revamping of Research and Monitoring Strength of Central Bank:** (i) strengthen the research and analysis wing (ii) strengthening statistical wing (iii) strengthening BOP and Price wing (iv) strengthening central treasury wing.

### 2. Restructuring of RBB and NBL

- (i) Initiate Automation and computerization speedily (ii) launch second phase of VRS (iii) initiate massive recovery from the existing Non Performing Assets (iv) initiate recapitalization for improvement and to meet regulatory compliance on capital adequacy (v) branch rationalization and development (vi) preparation of counterpart staff to replace the Management Team when contract is over (vii) restore the profitability (viii) preparation for privatization.

### 3. Further Legislative Reforms

- (i) Enactment of Assets Management Company Act. (Draft sent to HMG)
- (ii) Enactment of Insolvency Act (Draft sent to HMG)
- (iii) Enactment of Secured Transaction Act (Draft sent to HMG)
- (iv) Amendment in NRB Act, 2002 (Draft sent to HMG)
- (v) Enactment of proposed Securities Exchange Act (Draft prepared)
- (vi) Enactment of New Company Act (Draft prepared)
- (vii) Formulation of Credit Rating Agency Act
- (viii) Formulation of Securitization Act

- (ix) Formulation of Contract and Private Property Act
- (x) Formulation of Trust Act
- (xi) Formulation of Financial Crime and Punishment Act
- (xii) Formulation of Merger and Acquisition Act
- (xiii) Amendments in Financial Intermediary Societies Act and Co-operative Societies Act.
- (xiv) Formulate other necessary financial legal framework.

#### **4. Reforming the Development Banks and Other Institutions**

(i) Reforming ADB/N including separation of commercial banking and development banking (ii) reforming NIDC (iii) reforming Rastiya Beema Sanstan (iv) reforming Employees Provident Fund and strengthening supervisory activities (v) establishing and developing more focused institutions on micro credit and market-oriented measures (vi) NRB shedding its development banking functions (vii) privatization of Rural Development Banks

#### **5. Strengthening and Developing Securities Market**

##### **5.1. Institutional Strengthening of Securities Board**

(i) develop a five years business plan on organizational structure, operational rules and regulations and HRD (ii) Develop regulations on disclosure of listed companies, insider trading , corporate register services, underwriter and portfolio manger, public issue and corporate takeovers, protection of investor's rights (iii) Train SEBO staffs to enforce rules and regulations (iv) Design MIS and train to operate (v) Draft Inspection Manual of NEPSE and other market participants (vi) Operationalise the office of the Chief Accountant (vii) Hold seminars to NEPSE and other market participants on compliance of SEBO's rules and regulations (viii) Make detailed recommendations on establishing the market surveillance system, if required.

##### **5.2. Mutualise/ Privatize NEPSE**

(i) Draft regulations to keep the government regulatory oversight function separate from operation and governance of stock exchange (ii) prepare plans on ownership, operation, funding of NEPSE under private ownership (iii) formulate an action plan and develop rules, procedures and manuals to assist NEPSE to become an SRO (iv) Train NEPSE staffs to ensure self regulation and operate and maintain MIS (v) Develop bye-laws for efficient execution of securities transactions (vi) Develop procedures to conduct investigation (vii) Assist and train in designing investors education programs and develop literature for investors and market participants. (viii) prepare a compliance manual for NEPSE (ix) formulate the plan for the most appropriate level of automation of NEPSE and implement the plan (x) train market participants for conduct of securities and investment business.

##### **5.3. Establish a Central Depository System (CDS)**

(i) Develop a time bound plan to establish CDS as a separate legal entity and a private sector venture under the supervision of SEBO (ii) develop and operationalize a five years business plan for CDS, including ownership and organizational structure, operation and skill requirement, funding sources etc. (iii) draft rule and guide lines to ensure CDS performs all clearing and settlement operations for all NEPSE transactions and government securities as appropriate (iv) detail the operating procedures of CDS ensuring its functions in conformity with G30 standards and implement (v) Prepare operational manuals for CDS staff (vi) Prepare specifications for automation of CDS, install computer hardware and soft ware and provide on the job training to CDS staff to operate and maintain the system .

##### **5.4. Capacity Building of the Company's Registrar Office**

(i) Draft and implement a five year business plan which will cover organizational structure, operational rules and regulations and HRD ( job description, recruitment,

promotion, training etc) (ii) make detail recommendation and plans for linking the CRO system with the income tax system (currently assisted by GTZ) and credit information Bureau. (iii) Define the roles and functions of CRO and make recommendations to increase transparency of companies and business activities (iv) Design and install data base system, update registration of existing companies and provide the on-the – job training to CRO staff to maintain the database (v) prepare and operational manual for CRO staff.

**6. Other Capacity Building Programs for Financial Sector**

(i) building modalities for the operation of co-operatives (ii) improving access to new financial infrastructures by establishment of new Banker's Training Center, Asset Management Company, restructuring Credit Information Bureau, assisting to establish Institute of Financial Journalism, Institute of Finance and Banking Studies (iii) establishment of separate notary public office, (iv) establishment of common platform for IT-based financial products (v) formulation of policies for the establishment of foreign bank branches (vi) formulation of policies for the development of international financial center in Nepal (vii) establishment of more money transfer dealers to develop organized remittance facility (viii) development of deposit insurance mechanism (ix) formulation of policies to conduct audit by international auditing firms (x) enhancement of transparency through disclosure requirements (xi) establishment of second-tier supervisory body for micro-finance activities (xii) prohibition on cross-holding in banks (xiii) introduction of banca assurance.

## Annex-2

### Following Objectives, Strategies and Activities have been Targeted to be Achieved during the Tenth Plan Period (2002-2007)

To ensure sustainable economic growth through financial sector soundness and the attainment of the macroeconomic stability objectives, the following objectives, strategies, activities, intermediate indicators, outcomes and responsible agencies have been specified under the Tenth Plan.

Objectives	Strategies	Activities	Intermediate Indicators	Outcomes	Responsible Agency
1. Maintenance of Monetary Stability	Pursue prudent monetary policy to (i) contain inflation and (ii) attain favorable BOP position	(i) Money Supply (M2) contained to a desired level	(i) money supply (M2) growing at the rate of 14.5 percent	(i) average inflation rate contained at 5% per annum	NRB
		(ii) Limit central bank borrowing as per financial regulation (2003/04)	(ii) Share of private sector credit at 76 percent of the total.	(ii) Favorable Balance of Payments	MoF
		(iii) Limit the growth of bank finance to the government (ongoing)			NRB
		(iv) Widen the instrument of open Market operation (ongoing)			NRB/ MoF
2. Ensure External Sector Stability	(i) diversification of export	(i) promote and divers exportable commodities (commodity wise and countrywise –on going)	(i) current account deficit contained at less than 4 percent of GDP	(i) Balance of payment Favorable	MOICS
	(ii) Promotion of Foreign direct Investment	(ii) Alignment of real exchange rate		(ii) international reserves remains to a comfortable position.	NRB
	(iii) Implementation of prudent foreign exchange rate policy	(iii) Acts, regulations, tariff structure amended/revised and procedural simplification initiated			Ministry Of Industry Commerce Supplies/ MoF

		(iv) Increase remittance (from Nepalese working aboard) by increasing access/ quality of workers into foreign labor markets (ongoing)			DOL/NRB
		(v) Foreign exchange regime Rationalized	Foreign exchange reserve to cover minimum of 6 months of import.		NRB
Strengthen Financial System	Strengthen central bank's regulatory and supervisory capability	Implement re-engineering plan of NRB (2005)	Reduce NPA of the banking system.	Central bank supervisory and regulatory capacity improved.	NRB, MoF
	Reform state owned commercial Banks	Initiate privatization Process of Rastriya Banijya Bank and Nepal Bank Ltd. (2005) Establish asset Reconstruction Company (2003/04)	Improved Capital Adequacy	Confidence in Financial system strengthened	NRB, MOF
	Strengthen Banking and non-banking financial institutions	Strengthen legislative and institutional framework for effective loan recovery (2003/04)	Interest rate spread between deposit and lending narrowed	Efficiency of the financial system service delivery	NRB, MOF
		Enact necessary acts for regulation of local co-operatives (2004)			NRB, MOF
		Complete audit of two main development Banks (ADBN & NIDC) and develop restructuring strategy for them (2004)			NRB, MOF
		Reform Rural Development Banks (2004)			NRB, MOF
		Strengthening rural financing system (on-going)			NRB, MOF
	Widen and deepen the activities of the stock market	Improve the regulatory framework and operational efficiency of the stock market. (On going)	Number of listed companies and transaction volume in the stock exchange increased	Efficiency of the financial system service delivery	MOF, SEBO
Enhanced role of private sector in economic	Continue economic reform in fiscal, monetary and financial sector (on-going)				NRB, MOF

activities					
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**Long-term economic, social and development goals and strategies for poverty alleviation:**

1. Attain high, sustainable and broad based economic growth
2. Development of rural infrastructure and social sector (including human development)
3. Social inclusion and targeted programs
4. Good governance

**To achieve the above-mentioned goals the financial sector has adopted the following Strategy:**

1. Stability in banking and financial system and expansion of services
2. Orientation of financial services towards rural area
3. Formulation of programs and effective implementation

**To achieve those goals financial sector has set the following Agenda, Action and implementation modalities:**

Agenda	Action to fill the gap	Activities	Assistance and coordination and working modality
1. Building strong central bank	Improvements in legal position and in implementation aspects. Continuation to NRB reengineering process	Monitoring and improvements in legal aspects.	Development partners HMG and NRB
		Strengthening of regulatory function	Development partners, HMG and NRB
		Strengthening of supervisory functions	Development partners, HMG and NRB
		Strengthening HRM and development	Development partners and HMG, NRB
		Effectively implementation of monetary policy	Development partners and HMG, NRB
		Strengthening open market operations (OMO) and money market	HMG, NRB
		Strengthening Accounting and auditing of central bank	HMG, NRB
		Liberalizing foreign exchange system and market	Development partners and HMG, NRB

2. Restructuring of NBL & RBB	Restore financial health	(i) Automation and computerization	Development partners, HMG and NRB
		(i) Financial support for second Phase VRS	Development partners
		(ii) Initiation for massive recovery	HMG, NRB
		(iii) Financial support for recapitalization for the improvement and regulatory compliance on capital adequacy	Development partners and HMG
		(iv) Branch rationalization and development	HMG, NRB
		(v) Preparation of counterpart staffs to replace the Management Team when contract is over	HMG, NRB
		(vi) Restore the profitability	HMG, NRB
		(viii) Preparation for privatization	Development partners, HMG and NRB
3. Strengthening Legal financial Environment	Strengthening legal regime and enforcement powers	(i) Formulation of Credit Rating Agency Act	Development partners, HMG and NRB
		(ii) Formulation of Securitisation Act	Development partners, HMG and NRB
		(iii) Formulation of Contract and private property Act	Development partners, HMG and NRB
		(iv) Formulation of Trust Act	Development partners, HMG and NRB
		(v) Formulation of Financial Crime and Punishment Act	Development partners, HMG and NRB
		(vi) Formulation of Merger and Acquisition Act	Development partners, HMG and NRB
		(vii) Formulation of other Necessary Acts to improve legislative regime	Development partners, HMG
4. Strengthening development banking and institutions	Improving weak banks and initiating alternative approaches	(i) Reforming ADB/N	Development partners, HMG and NRB
		(ii) Reforming NIDC	Development partners, HMG and NRB
		(iii) Establishing and developing more focused institutions on micro credit	NRB and HMG

		(iv) Develop focused programs for the development of small and medium size enterprises (SMEs)	Development partners, NRB and HMG
5. Strengthening Capacity of the financial system	Building capacity of financial system and introducing specialized institutions	(i) Building modalities for the operation of co-operatives	Development partners and HMG
		(ii) Improving access to new financial infrastructures by establishment of New Banker's Training Center, Asset Management Company, Credit Information Bureau, Institute of Financial Journalism, Institute of Finance and Banking Studies	Development partners and HMG
		(iii) Establishment of notary public office,	Development partners and HMG
		(iv) Establishment of common platform for IT-based financial products service providers'	Development partners and HMG
		(v) Formulate policies for the establishment of foreign bank branches	HMG, NRB
		(vi) Formulate policies for the development of international financial center in Nepal	HMG, NRB
		(vii) Encourage and establishment of money transfer dealers to develop organized remittance facility	HMG, NRB
		(viii) Develop deposit insurance mechanism	HMG, NRB
		(ix) Formulation of policies to conduct audit by international auditing firms	HMG, NRB
		(x) Clear demarcation of supervisory role of central bank and the government towards co-operative institutions.	HMG, NRB
		(xi) Conduct second series rural credit Survey	HMG, NRB and Development partners
6. Develop the market standards and efficiency in the securities market	(i) legal and operational improvements (ii) more participation of private sector professionals (iii) introduction and listing of new instruments (iv) mutualise/ privatise NEPSE (v) professionalise securities market intermediaries (vi) integrate government securities trading	(Activities as mentioned in annex-1)	HMG, SEBO, NEPSE and Development Partners

	in the stock exchange (viii) effective implementation of Corporate and Financial Governance project (CFG Project) (ix) Institutional strengthening of Securities Board (x) establish a central depository system (CDS) (xii) Capacity building of Company registrar Office		
7.Expanding role and contribution of insurance sector.	(i) Improvements in regulatory and operational frameworks.	(i) Strengthening legal and regulatory functions (ii) enhancing efficiency and scope in the insurance markets (iii) Reforming Rastriya Beema Sansthan.	HMG, Insurance Board and Development partners

## Annex-4

*Gap in Banking Sector Performance*

(some important indicators)

	<b>Performance Indicators</b>	Ninth plan target	Ninth plan achievement	T
1	Capital Fund/ RWA (%)		-5.27	
2	Core Capital/ RWA (%)		-6.51	
3	NPA/ Total Loans (%) (FY 2002/03)		30	
4	Inspection of Banks at Corporate Level (%)		50	
5	Preparation for Implementation of Basel II		5.0	
6	M1 Growth (% p.a.)	13.0	15.7	
7	M2 Growth (% p.a.)	14.8	20.0	
8	Domestic Credit Growth (% p.a.)	16.1	16.6	
9	Private Sector Credit Growth (% p.a.)	20.0	15.9	
10	HMG Credit Growth (% p.a.)	3.2	15.4	
11	Consumer Price Index (% change p.a.)	6.5	5.7	
12	Foreign Exchange Reserve (Equivalent of months of goods and services imports)	5.0	10.5	

Note: RWA = Risk-Weighted Assets

## Annex-5

## Major Financial Indicators of RBB and NBL

		Performance Indicators of Rastriya Banijya Bank		
		1997/98	1998/99	1999/00
1	Net profit/ Total income	(%)	2.28	0
2	Income per share	Rs.	NA	NA
3	Interest income/Loan and advances	(%)	14.26	13.28
4	Staff expenses/ total expenses	(%)	15.71	15.38
5	Interest expenses on total deposit and borrowings	(%)	5.67	7.71
6	Exchange gain/ total income	(%)	2.96	1.41
7	Staff bonus/total staff expenses	(%)	1.28	0.0
8	Net profit/ loan and advances	(%)	0.37	0.0
9	net profit/ total assets	Ratio	0.28	0.0
10	Total credit/ total deposits	(%)	56.2	74.45
11	Total operating expenses/ total assets	(%)	7.08	7.03
12	Capital adequacy on RWA:	(%)		
a.	Primary capital	(%)	-159.07	-177.79
b.	Supplementary capital	(%)	13.32	54.52
c.	Total capital fund	(%)	-16.2	15.63
13	CRR	Ratio		
14	NPA/ Total credit	(%)	20.17	26.64
15	Weighted average interest spread	(%)		
16	Book networth	Per rupee share	-0.55259	-0.56217
17	Total share	In No.	11723000	11723000
18	Total employees	In No.	6018	5982

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		Performance Indicators of Nepal Bank Limited		
		1997/98	1998/99	1999/00
1	Net profit/ Total income	(%)	0.49	-85.15
2	Income per share	Rs.	4.19	-666.54
3	Interest income/Loan and advances (with BP)	(%)	13.55	11.1
4	Staff expenses/ total expenses	(%)	24.04	24.36
5	Interest expenses on total deposit and borrowings	(%)	6.74	6.66
6	Exchange gain/ total income	(%)	8.02	2.11
7	Staff bonus/total staff expenses	(%)	2.63	0.0
8	Net profit/ loan and advances	(%)	0.09	-12.03
9	net profit/ total assets	Ratio	0.05	-6.85
10	Total credit/ total deposits	(%)	66.03	63.5
11	Total operating expenses/ total assets	(%)	7.91	8.46
12	Capital adequacy on RWA	(%)		
a.	Primary capital	(%)	3.81	-5.31
b.	Supplementary capital	(%)	6.25	13.14
c.	Total capital fund	(%)	10.06	7.83
13	CRR	Ratio	23.08	16.32
14	NPA/ Total credit	(%)	27.46	31.99
15	Weighted average interest spread	(%)	4.98	2.67
16	Book net worth	Per share	257.91	-404.38

17	Total share	In No.	3803826	3803826	3803
18	Total employees	In No.	6517	6371	6

Derived from Audited Financial Statements of RBB and NBL.  
NA= Non applicable or not available