

**Policy Paper  
on  
Financial Sector Reform**

**Nepal Development Forum-2002**

**His Majesty's Government of Nepal  
Kathmandu  
February, 2002**

# FINANCIAL SECTOR REFORM: KEY ISSUES AND TASKS AHEAD

## BRIEF OVERVIEW AND KEY ISSUES

Competitive financial markets help 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-raising process. Appropriate policies that increase the role and strength of the financial system and improve the general access to the financial services raise the level of domestic financial saving and improve the resource allocation for development. A policy that encourages an improved, stable and secure financial system and discourages the distortions and defects in the system is vital to ensure a sustained high level of economic growth.

Larger accumulation of financial resources and efficiency in financial intermediation are essential for promoting economic growth and development including attaining rapid progress in the poverty reduction. The Nepalese financial system, however, is still characterized by various institutional and structural deficiencies that have weakened the system's capability to meet such an end. Nepal's development requirements also call for greater proportions of financial resources being available and accessible for which the financial sector reform (FSR) measures become urgently important.

FSR initiatives would help improve the situation plaguing the government-owned and other financial institutions and attain soundness of the entire financial system. FSR would be able to make significantly positive breakthroughs in the structure, competitiveness and effectiveness of the financial sector. It is also crucial to improve efficiency of the financial intermediation, consolidate the gains of the past reform efforts, channelize more investible resources to the financial sector, and ensure stability and sustainability of the financial system. This would help reduce the vulnerabilities to the crisis situations and other uncertainties that could likely be associated with the evolving financial system. A strong and

independent central bank with capability to steer the financial system toward profoundly contributing to the economic development in a well-regulated, dynamic financial sector framework is the logical outcome of the FSR.

**F**SR is expected to contribute immensely toward mobilizing and allocating resources efficiently, developing capital markets for attracting long-term productive investments, improving domestic saving and investment levels, and thus promoting economic growth. The reforms are instrumental to improve the health of the financial system through the strengthened legislative, managerial and corporate governance. Hence, FSR is inevitable for the growth, efficiency, stability and sustainability of the economic and financial systems and supporting poverty reduction goals. It is learnt from the Asian crisis that adverse shocks generated in the financial system can be easily transmitted to the loss of employment and income and thus can worsen poverty situation. This implies that sustainable achievement of poverty reduction goal calls for financial stability as well.

### **Challenges**

**T**he large intermediation cost and inefficiencies in the financial system have remained the major drawbacks of the Nepalese financial structure. The host of challenges and confront this sector could be categorized, among others, the weak financial position of most of the government-owned financial institutions, negative networth and huge accumulated losses of the government-owned commercial banks, higher proportions of non-performing assets (NPA), and large interest rate spread between lending and borrowing rates in the formal financial sector. Besides, there is predominance of the informal financial system with high interest rate differentials between the formal and informal sectors of the economy.

**T**he frontier of the formal financial structure has not expended as desired, with limited financialization of resources. An indicators of weak financial system, the depositors have not received attractive interest rates while the borrowers and investors have suffered from larger cost of capital. While it is reported that small depositors are discouraged from opening their accounts and carrying out transactions in some of the banks that are giving less consideration

to retail banking, the two large domestic banks are plagued by problems like operational inefficiencies, managerial deficiencies, and poor clientele relations.

**H**MG's direct role in the operation of the financial sector is significant. It ranges from ownership of key financial institutions such as Rastriya Banijya Bank (RBB), Agricultural Development Bank (ADB), Nepal Industrial Development Corporation (NIDC), Employees Provident Fund (EPF), Nepal Insurance Corporation (NIC), and two-fifths share ownership in the Nepal Bank Limited (NBL) to effective involvement in the regulation of these and other financial institutions. Not only are RBB and NBL in an unhealthy position financially, a weak accounting and auditing practice has also constrained the timeliness and reliability of financial data. Accounting is also weak in the corporate sector, making the business environment along with the lending decision difficult for the banks. As a result, the positive outcomes expected from a well-developed, soundly-operated and properly regulated financial markets have yet to transmit to the real sector of the economy.

#### **Box 1: RBB and NBL in Nepal's Banking System**

**R**B B and NBL presently account for 49% of the banking system assets, 46% of the total loans and advances, and 43% of the total deposits. Their share in the banking system's investments in the government securities is 56%. Of the total commercial bank branches of 413 as in mid-October 2001, RBB has 162 branches and NBL 156 branches (totalling 318 branches, representing 77% of the total commercial bank branches). The number of rural branches of all the commercial banks as in mid-October 2001 is 313, representing 75.8% of the total branch network. While the RBB has 127 branches and the NBL 122 branches operating in the rural areas (representing 78.4% and 78.2% of their respective total branch network), the other commercial banks combined have 54 branches operating in the rural areas, representing 56.8% of their total branch network. In other words, while 21.8% of the total branches of NBL and 21.6% that of RBB are operating in the urban areas, similar share for other banks stands at 43.2%, as compared with the share of 26.6% of all the branches of the commercial banks in Nepal operating in the urban areas.

A majority of the rural branches of RBB and NBL is involved in extending priority sector lending (the present mandatory rate at not less than 12% of the total outstanding loans and advances) which is an important element for meeting the prioritized development financing needs and also extending the reach of the formal financial structure especially in the rural areas of Nepal. Of a total of 130 branches maintaining the government accounts, 120 branches (70 of RBB and 50 of NBL), or 92% of the total, belong to these banks. Sixty-six branches of these two banks (41 of RBB and 25 of NBL), or 88% of the total, carry out HMG's budgetary expenditure release operations in the same number of districts. These branches make all the receipts and payments on behalf of the government offices and government projects along with preparing the necessary accounts of the transactions.

### **Inadequate Rural Credit Delivery**

The AsDB(Manila)/NRB- conducted Nepal Rural Credit Review Report, 1994 showed that just one-fourth of the rural borrowers managed to have had some access to the formal credit structure. In other words, three-fourths of the rural borrowers had to rely on the informal credit markets like the money-lenders, landlords, merchants, brokers, goldsmiths, pawn brokers, relatives, friends and acquaintances, revolving saving and credit associations (Dhukutis), etc. for financial borrowings. The formal financial structure could not address the needs of the rural borrowers as the formal institutions were overly bureaucratic, collateral-based, and non-responsive to the needs and demands of the rural borrowers. Consequently, the formal structure could not extend into the depths and breadths of the rural community, affecting the resource mobilization and credit delivery mechanisms so essential for enhancing the economic activities, employment promotion and income generation.

The Nepalese financial sector is, therefore, in need of vigorous reforms for addressing the various institutional deficiencies and structural inadequacies that have impacts and implications for the sustained growth of the economy. Nepal's development requirements also call for greater proportions of financial resources being available, for which the reform measures need to be successfully implemented. The financial sector reform measures

introduced so far and also currently contemplated should provide necessary environment to the growth of an orderly, stable and sound financial system.

**Past Efforts in Terms of Policy Changes, Institutional Reform  
and Other Enabling Activities, Status of Implementation and  
Lessons Learnt**

**Outcomes of Past Efforts**

The Nepalese financial system has achieved rapid strides in terms of institutions, products and pricing during the nineties. The institutional network and the volume of operations of the financial system has expanded and diversified, with the number of commercial banks going up from five in 1990 to 15 in 2001. The number of other financial institutions has likewise seen quantum jump. The development banks have increased from two (ADB and NIDC) in 1990 to 15 in 2001. All of the five Regional Rural Development Banks (RRDBs), 49 finance companies, 34 financial cooperatives, and 16 financial NGOs have been the products of the nineties. Altogether 116 postal saving offices are mobilizing postal savings. The number of insurance companies reached 17 in 2001 from two in 1990. Two mutual trust companies (Citizen Investment Trust-CIT- and NIDC Mutual Trust) were also established during the decade. The then Securities Marketing Center was replaced by the Securities Board and the Nepal Stock Exchange in 1993. At the same time, other financial institutions like the EPF, Deposit Insurance and Credit Guarantee Corporation (DICGC), and Nepal Housing Development and Finance Company, established before the nineties, also form part of the formal financial structure.

Accordingly, the quantitative dimensions of the financial operations are also growing. The outstanding deposits of the banking sector as a percentage of GDP rose from 21.1% in 1990 to 40.4% in 2001. Deposits with non-bank financial institutions also grew significantly—it increased from 0.5 per cent of GDP in 1995 to 4.6 per cent in 2001. Similarly, broad money (M2) as a percentage of GDP showed an upward trend, with the ratio reaching 52.2% in 2001

from 30.5% in 1990. Banking sector's outstanding domestic credit as percentage of GDP rose from 28.7% in 1990 to 45.7% in 2001.

**T**here have also been improvements in the levels of quality, delivery, and pricing of the products and services being offered by the financial system. For the year ending mid-July 2001, more than 88% of the transactions that took place in the stock exchange related to the securities of the financial institutions. The role of the financial institutions in the financial operations and economic development process has thus become wider and increasingly significant. HMG has encouraged the growth of institutions like regional rural development Banks (RRDBs), financial cooperatives, and NGOs, with emphasis on realizing the goal of poverty reduction based on the strengths of the micro-credit mechanism. The process of group guarantees, member-based saving mobilization and credit extension process, women-focused financial activities, target group-oriented saving and credit programs, and the waiving of the collateral conditionalities contributed to broaden the extension of saving mobilization and credit delivery services among many rural, poverty-stricken families in Nepal.

**T**he role of the private sector in the financial intermediation and financial market development has become quite significant over the years. Altogether 13 commercial banks, 12 development banks, and all of the 49 finance companies, 16 insurance companies, 34 financial cooperatives and 16 financial NGOs have been operating under private ownership and management. In accordance with the need for involving the private sector in the ownership of the existing government-owned financial institutions, HMG's equity share in NBL was disinvested to the private sector, with HMG's share now reduced to 40.5%. The disinvestment was made with the objective of reducing the interference in the NBL's management and promoting professionalism and corporate governance practices in the functioning of the NBL.

**H**MG's policy of selling its equity to the general public and increasing the private sector representation on its board have, however, failed to bring about positive outcomes as the privatization process could not involve a single strategic partner possessing strong background in commercial banking and adequate international linkages with the global

economy. This has meant that the NBL has not been able to play the dynamic, market leadership role that could be expected from the privatization of such a large bank. This situation has also contributed to the overall inefficiency and weaknesses in the banking system.

### **Box 2: Lessons Learnt from CBPASS**

*The recommendations of the Commercial Banks Problem Analysis and Strategy Study (CBPASS) started to be implemented since 1989, comprising a number of reform agenda including capital injection. The reform measures in the first phase encompassed re-capitalization, loan loss provisioning, and repayment of the government-guaranteed loans extended by the two State-owned commercial banks to the public enterprises. A supplementary budget of Rs. 3.45 billion was announced to implement this program and, accordingly, the proposed capital was injected in these two banks. In the second phase, restructuring of these two banks was envisaged in terms of credit administration, asset and liability management, improvement of management information, office automation, and reduction of excess staff.*

*As the second phase of the reform could not be effectively undertaken, mere capital injection could not improve the position of these two banks. Nor even divestment of government share from one of these banks could improve the situation. The lesson learnt is that reforms do not become successful if implemented in a piecemeal basis. So, reforms need to be implemented in a comprehensive framework with capital injection, institutional restructuring, and strengthening regulatory and supervisory functions carried out concurrently.*

**W**hile the financial sector reform agenda should comprise re-orienting the government's role from being an active participant in the financial system toward being its efficient regulator and supervisor, the financial sector reform strategy should, at the same time, ensure that financial institutions are run in accordance with sound corporate business principles and practices. The capability of the central bank for effective supervision of bank and non-bank financial institutions needs to be enhanced so as to equip it to implement, among others,

comprehensive financial sector reform strategy in a successful way. Similarly, financial discipline based on adequate provisions of disclosure and implementation of internationally-recognized accounting and auditing practices and systems needs to be ensured. Competition-oriented policy regime should be further promoted to enhance financial efficiency. It is important to note that the reforms delayed, inappropriately sequenced or carried out on a piecemeal basis would inherently invite counter-productive outcomes. It is where the consensus of the entire stakeholders assumes vital significance.

**I**n the process of building prudently and efficiently managed bank and non-bank financial network and ensuring strong and capable regulatory body to lead the financial system, broader and deeper reforms are required in the central banking, commercial banking and other areas of the financial system. Reform is vital for strengthening the financial system as well as improving its capability to face the vulnerability to the likely instability and other uncertainties that could affect the evolving financial system. Promoting a stable financial system and also fostering an environment that enhances economic growth, productivity and sustainable development in Nepal is also the expected outcome of the reform process. Given the problems in the financial sector, it could be observed that the economic reform process and the financial liberalization initiatives undertaken over the years have not been quite effective in reforming the financial and economic landscape. This reality has prompted the need for carrying out further reforms in an intensive manner, in a time-bound framework.

### **Current Progress**

**B**uilt on the above developments, Nepal has done significant homework to set up a strong foundation for a healthy financial system. The reform actions envisaged to bring about the expected outcomes in the financial system are the introduction of the new NRB Act and the Debt Recovery Act which has already been done. The NRB Act, 2001 provides more autonomy to the central bank in the spheres of financial sector policy formulation and increase its capability for effective policy implementation. Also, the supervisory and oversight function of the central bank is expected to be strengthened substantially. The Debt

Recovery Act, 2001 should help expedite the recovery process of the pending loans and contribute to reduce the share of the NPA of the banking system. Similarly, the proposal of amendment to the Foreign Exchange Regulation Act, already in the Parliament, would help further liberalize the foreign exchange system. Likewise, the proposal of amendment to the Financial Intermediary Institutions Act that is already in the Parliament should enhance the coverage and effectiveness of such institutions, resulting in greater financial intermediation process in the rural areas of Nepal. Necessary preparations are being carried out for the establishment of the Assets Management Company in Nepal.

**T**he Deposit-Taking Institutions Draft Act, which will encompass the regulation of all the deposit-taking institutions like the commercial banks, development banks and finance companies, is under formulation. Similarly, the proposed legislation on merger and acquisition and bankruptcy and business closure would significantly improve the financial legislative and regulatory regime. The involvement of the foreign insurance companies in the insurance business is expected to make the insurance markets in Nepal wider, more competitive and strong. The operations and capabilities of the Securities Board and Nepal Stock Exchange are being improved through necessary legislative and operational refinements. Likewise, the International Financial Transactions Center Act has been regarded an important beginning to make Nepal as a hub of international financial activities. Also, the current budget of HMG has provided for carrying out reviews on the operations of the ADB and NIDC for their necessary restructuring.

**N**RB has issued a set of nine directives to the commercial banks so as to strengthen the commercial banking institutions, ensure corporate governance, consolidate their financial situation, improve the people's confidence in them, and contribute to the overall health and stability of the financial system. The directives relate to different areas of regulation, as follows: (i) maintenance of minimum capital fund, (ii) loan classification and loan loss provisioning, (iii) limit of credit exposure and facilities to a single borrower, group of related borrowers and single sector of the economy, (iv) accounting policies and formats of financial statements, (v) minimization of risk, (vi) good corporate governance, (vii) time-frame for implementation of regulatory directives issued in connection with inspection and supervision

of bank, (viii) investment in shares and securities, and (ix) statistics reporting by commercial bank to NRB.

**N**RB has also issued 13 directives to the finance companies in order to improve their managerial and operating processes so as to enhance their role in the financial and economic systems of Nepal. The directives cover (i) minimum capital fund, (ii) financial resource mobilization ceiling, (iii) liquid assets, (iv) loan classification and loan loss provisioning, (v) single borrower limit, (vi) corporate governance, (vii) sectoral credit ceiling, (viii) investment requirements, (ix) interest rate, (x) setting-up branch/office, (xi) sale of promoter's share, (xii) audit, and (xiii) net profit and dividend. NRB is shortly issuing similar directives to the development banks and cooperatives with a view to bring about the desirable institutional growth and operational improvements in the non-bank financial structure. Paid-up capital requirement for the commercial banks, development banks, finance companies and cooperatives is being raised in the near future. For the effectiveness of the inspection and supervision of the commercial banks and other financial institutions, inspection manual has been prepared and training programs are implemented. As part of the financial sector reform, in-house central banking modernization activities are proceeding in full swing in NRB. IMF technical assistance has also been utilized for this purpose.

**R**estructuring RBB and NBL for their sound management, better technical capability, and improved financial operations is the other action currently under implementation. Though the country memorandum presented in the NDF meetings in April 2000 envisaged for private sector involvement including handing over 10% share ownership to the employees of the RBB, the current reform process of handing over the managements of RBB and NBL to the management teams, as per the recommendation of the diagnostic studies carried out in the two banks, should not only consolidate the operations and improve the health of these institutions but also contribute to strengthen the overall position and delivery efficiency of the entire commercial banking system. In addition to taking the day-to-day control over the managerial processes and operational activities of the banks, the management teams would also be responsible to stabilize the banks and restore their financial health to an acceptable level, steer the financial control process so as to increase profitability, recover the existing loan portfolio, and develop and strengthen the accounting capacities. The functions of the

management teams include implementing the arrangements required for improving the assets and liabilities structure so as to make the banks financially strong and operationally viable, developing and implementing comprehensive human resource policies, designing and implementing information technology plan, progressively computerizing and automating them, and preparing them for eventual privatization in the hands of safe and sound professional bankers of repute, the ultimate objective of contracting-out the managements of these two banks.

### **Strategies for Reform/Improvement**

**T**he financial institutions owned and controlled by the government still capture a large chunk of commercial and development banking, insurance business, micro-credit and other financial products. With the State-owned financial institutions mostly incurring huge losses and their financial condition deteriorating over the years, restructuring them and their eventual privatization becomes inevitable to ensure a strong and competitive financial structure on the one hand and improving the public sector resource allocative efficiency on the other. So, the government sector financial institutions need to be given utmost priority along the process of expediting the financial sector reform. The reform, appropriately sequenced and effectively implemented under a conducive macroeconomic environment, holds the key to developing a strong, smooth, and efficient financial sector and promotion of productive investments in the economy.

**I**n order to reduce problems inherent in the financial system in general and the government-owned financial institutions in particular, encouraging the competitive markets and the private sector investment, institutional restructuring along with the privatization process are considered to be the most viable alternatives. Reform in the financial sector legislation, strengthening the bank inspection, monitoring and supervision process, restructuring of government-owned commercial and development banks, encouraging more investments in the banking sector, reduction of the directed/subsidized lending and expansion of the capital and insurance markets comprise the important ingredients of the reform agenda in the financial sector.

**F**SR, besides contributing to improve the central banking functions of regulation, supervision, monitoring and inspection of the financial system, would be instrumental for enforcing the implementation of the internationally sound practices in the accounting, auditing and supervisory systems. Making appropriate financial regulatory regime covering the whole gamut and processes of the financial activities is equally important for increasing the competence, competitiveness, transparency, stability, confidence and credibility of the financial system. Such a framework would ensure the qualitative growth of the financial products and services, enhance delivery efficiency, improve, on a sustainable basis, the resource allocative process, and foster an internationally competitive financial environment.

**A**ppropriate environment and mechanisms need to be put into effect for mobilizing external private financial resources so as to meet the large infrastructural and other developmental needs of Nepal. Such resources, especially the foreign direct investments, would be instrumental in tapping the productive potential in the areas of water resource, tourism, manufacturing, transport, finance, education, health, infrastructure, information technology, commercialization of agriculture, and so on. Attracting such investments would be essential in the process of materializing the goal of promoting Nepal as a hub of global financial activities. Foreign bank branches would be established as per Nepal's commitment to WTO membership requirements. The current budget of HMG has allowed two-thirds share ownership of the foreign owners in the commercial banks of Nepal, a significant rise from the existing ceiling of 51%. All these steps would constitute important measures for enhancing the efficiency in financial intermediation and for improving the competitiveness of the Nepalese financial system.

**O**penness in the capital account would result in the availability of larger capital stock supplemental to domestic resources, reduction in the cost of capital, and unrestricted access to international financial markets, thereby producing higher yields for savers, lower interest cost for investors and greater allocative efficiency of the resources. However, the sudden crisis in Asia resulted in cautiousness along this line of thinking. Deliberations on this and other important policy measures are nevertheless significant for making the financial sector sound, competitive and contributory to higher and sustainable growth.

**I**n the context of growing global financial integration, it is necessary to recognize the risks of financial vulnerabilities and accordingly chart out Nepal's future course of action for ensuring efficiency, competitiveness and sustainable development of the economic and financial systems based on adequate macroeconomic and financial infrastructure.

### **Key Sector Objectives and Goals**

**T**he overarching goal of the FSR is to create a well-regulated, sound, market-oriented and stable financial system, which will help form the basis for fiscal consolidation, macroeconomic stability, private sector-led economic growth momentum and significant reduction in poverty on a sustainable basis. The FSR is considered as a vital element of HMG's comprehensive economic reform strategy which aims at realizing the goal of expediting economic growth and making significant gains on poverty reduction. The FSR is important in terms of meeting the financing needs of development, reinforcing the private sector-led economic growth process and ultimately impacting positively upon significant reduction in poverty, through job creation and enhanced resource allocation to potential growth sectors along with releasing/augmenting vital resources required for addressing the specific poverty reduction programs and social development activities.

**T**he realization that the economic reform process and the financial liberalization initiatives undertaken have not been quite instrumental over the years in reforming the financial and the economic landscape of Nepal to the extent visualized has prompted the need for carrying out further reforms in an intensive manner and in a time-bound framework. As the reforms have been initiated to improve the financial health of the institutions and strengthen the various components of the financial system, such reforms are basically of the nature of institutional strengthening through better corporate governance and enhancement of implementation capability through promotion of appropriate legislative and management improvement framework. To pursue further reform measures means to consolidate the gains of the previous reform and realize additional gains from further reforms.

The FSR represents the phase-wise program, focusing on three broad objectives: (i) strengthening and developing the regulatory and supervisory framework and the macroeconomic management capability of the central bank; (ii) reforming the commercial banking sector which is dominated by two large ailing commercial banks - the fully State-owned and controlled RBB and the recently majority-privatized or partly State-owned, NBL; (iii) reforming the development banking and other government-owned financial institutions like ADB, NIDC, NIC, etc.; (iv) strengthening and improving the securities markets; and (v) creating supportive, stable and sound financial system to enhance the growth and building up the capabilities to run the system efficiently. It is anticipated that these actions will be profoundly important in creating a more prudently-operated and commercially viable financial system overseen by the regulatory authorities with sufficient technical capacity to address issues, specifically within the areas of regulations, monitoring and supervision.

#### **Specific Objectives of the FSR**

The objectives of the FSR could be summarized as to: (i) create sound, stable and healthy financial system, (ii) broaden and deepen the financial system in the economy, (iii) enable the policymakers to fully and timely avail sound financial statistics, (iv) canalize adequate resources, on lowest possible cost, to promote sustained, broad-based growth momentum, (v) build the institutional capacity to identify and tackle the problems in the financial system, (vi) increase the autonomy and capability of central bank and other regulatory institutions for making their respective policies, institutions, supervisory and regulatory functions effective, (vii) improve and update the legal and judicial framework for the financial system, and (viii) drastically reduce the NPA, improve the financial intermediation efficiency and build a strong and stable financial system, thereby promoting growth and reducing poverty.

#### **Realigning FSR with Other Ongoing Reform Initiatives of HMG**

Pursuing sound and comprehensive measures aimed at ensuring and improving the macroeconomic fundamentals on a sustainable basis is essential for financial stability and ensuring success of the financial sector improvement measures. Market confidence in the system, policy credibility, prudential macroeconomic and financial regulatory regime, and

continued pursuance of structural improvement measures are the steps and signposts that pave the way for the successful implementation of reforms. Accordingly, the government has given the highest priority to these important measures of macroeconomic and financial improvements.

**U**nder a sound and pragmatic macroeconomic environment and a prudent financial regulatory framework, financial sector reform measures would promote private sector investment in the sector, help reduce the cost of financial activities, promote productive domestic and foreign investments, improve the range and quality of products and delivery of services, and raise the rate of return on resources deployed. Furthermore, such an environment would contribute to provide the private sector a level playing field for the promotion of competitive markets in the financial system. To reap such benefits of the reforms, adequate resources and successful implementation arrangements need to be put in place for concluding the process for the growth, stability and sustainability of the economic and financial systems as the reform outcomes.

### **Financial Reform and Poverty Reduction**

**P**overty in Nepal has remained a complex phenomenon. The socio-economic status of a large segment of the population is dismally low. Underemployment in the rural areas and the traditionally subsistent, monsoon-based agriculture is rampant. The challenge to meet increasing resource requirements in the rural economy needs to be overcome in order to ensure a sound, sustainable, equitable, balanced, and broader-based socio-economic development. Implementing a viable rural credit delivery system for the mobilization of financial resources and supplementation of rural credit needs forms an important strategy toward bridging the resource gap.

**I**n view of the ineffectiveness of the formal financial structure in addressing the fundamental problems of poverty in Nepal, micro-finance is regarded as an effective tool for promoting economic growth, supporting human development, improving the status of women, and reducing poverty. It is also recognized as an important financial service to uplift the level of income of low-income households by ensuring the availability of such services to the

doorsteps of the poor and low-income households. Hence, the potential role of a proper micro-finance system to provide the financial services to the poor and the low-income households on a sustainable and effective basis needs to be strengthened. To make the micro-finance effective for raising the production and the productive capacity, promoting income, generating employment and enhancing the earnings levels of the poor, marginalized, disadvantaged, and the weaker sections of the society, the micro-finance framework needs to be made effective, efficient and sustainable through development of proper policy, legal and regulatory frameworks.

**I**n view of the importance of the micro-finance institutions that extend financial services on the member-based criterion, a number of financial institutions like the cooperatives, RRDBs and NGOs have been promoted that have given a new dynamism and room for mobilizing the greater popular participation in the saving and credit functions. With the growth of these new institutions and their operations, many underemployed rural community members and poverty-entrenched households have now had alternative arrangements to participate in economic activities and generate employment and income, thereby contributing to the improvement of their socio-economic status, though at humble levels.

**A**t the same time, these institutions and their operations are suffering from problems like the inadequacy of resources, inappropriate regulation, loss of confidence of depositors, narrow level and area of operations, excessive overheads, and ineffectiveness of some of their programs and activities. Some of the cooperatives have closed business and also failed to meet the obligations to the depositors. Some others have fled the scene, defrauding the stakeholders in general and the depositors in particular. As a result, negative attitude has been developing against these cooperatives though a large number of them is found doing sound business with respect to enhanced saving mobilization and effective resource utilization.

**T**he RRDBs are suffering from excessive overheads, unionization, limited expansion of activities, negative networth due to large amount of losses, insufficient resources and declining law and order situation. The financial cooperatives and NGOs, being limited in

number and short in operations, have not yet been able to make their presence felt for contributing to the task of poverty reduction.

**T**hese problems need to be corrected through capital injection and professionalization of the activities in the case of the RRDBs, while effective implementation of sound regulatory mechanism is essential to enhance the role and functions of the financial cooperatives and NGOs. Institutional reform, management improvement, and productivity enhancement measures in RRDBs are currently under way. Preliminary steps for the privatization of the Western RRDB have been undertaken. HMG and NRB have already provided the RRDBs Rs.163 million for their recapitalization following which the Rural Micro-Finance Development Center (RMDC) would commence wholesale lending to these banks.

**T**he expansion and growth of the micro-credit institutions is pivotal to attaining the ultimate goal of poverty reduction through the economic activity growth, community participation, social mobilization, employment generation, local resource and skill utilization, and income accretion. Realizing their potential for reducing poverty, the government is effortful to create conducive environment for the healthy, stable and encouraging growth of the cooperatives and other financial institutions as well.

## **PRIORITY AREAS AND KEY ACTIONS OF REFORMS**

**T**he main elements of HMG's financial sector reform strategy are:

- (i) Initiating a strong corporate governance by ensuring that the banks (in particular the two largest commercial banks, RBB and NBL) are owned and managed by "fit and proper" private investors;
- (ii) Enhancing the role of the NRB in the overall financial system of the country by bringing out and implementing a new Act to provide sufficient autonomy in conducting monetary policy, regulation, supervision, and licensing of the bank and non-bank financial institutions;
- (iii) Improving the existing financial legislation and judicial processes for promoting transparency, autonomy and accountability in addition to enforcing financial contracts;
- (iv) Improving auditing and accountancy standards within the banking sector; and

- (v) Promoting financial discipline through ensuring adequate disclosure and promoting competitive environment.

**R**eform priorities are focused on different strategic actions, which include:

- (i) Reforming the Financial Sector Legislation,
- (ii) Strengthening Bank Supervision and Inspection,
- (iii) Restructuring and Ownership Reform of RBB and NBL,
- (iv) Enhancing Competition in the Banking Sector and Promoting Broad-based Banking,
- (v) Reforming the Auditing and Accounting Capabilities,
- (vi) Streamlining Ownership Structure of the Financial Institutions,
- (vii) Establishing Bankers' Training Institute,
- (viii) Establishing Assets Management Company (AMC),
- (ix) Revamping Research and Financial Monitoring Strength of the Central Bank,
- (x) Making Arrangement for Meeting Sectoral Financing Requirements through Improved Institutional and Managerial Capacity,
- (xi) Strengthening the Regional Rural Development Banks and Operating Development Banks at Regional Level,
- (xii) Promoting the Credit Rating Institution and Restructuring Credit Information Institution,
- (xiii) Regulating Other Financial Institutions, and
- (xiv) Broadening and Deepening the Financial System.

<b>KEY OUTCOMES/OUTPUTS/SERVICES</b>
--------------------------------------

**C**onditions like raising the efficiency in financial intermediation, maintenance of competitive and comprehensive interest rate structure, adoption of flexible and market-based exchange rates, promoting autonomy and professionalization in the financial sector transactions so as to encourage sound financial, investment and the related decision-making structures, development of reliable monitoring-inspection-supervision systems, and designing and implementing the market-friendly monetary policy with the core objective of exchange

rate, interest rate and price stability, become inevitable for achieving a deep, broad, healthy and dynamic financial sector environment. Such an environment would promote the large-scale growth of efficient investments along with ensuring a high level of sound, sustained and broad-based economic growth and development process in the country. Reform process would be a sine-qua-non to the realization of such outcomes.

The FSR is expected to deliver many outputs, assisting directly or indirectly many sectors of the economy. The outputs are:

- (i) strengthened capabilities of the central bank to enforce prudential rules and regulations,
- (ii) adequate and up-to-date legal framework for the smooth operation of financial system,
- (iii) increased share of financial system owned and operated by the private sector players,
- (iv) availability of new and innovative financial products and services at competitive prices,
- (v) availability of adequate professionals and financial experts within the nation to run the financial institutions,
- (vi) timely and adequate availability of information on bank and non-bank financial institutions and financial system to regulators, investors, stakeholders and researchers,
- (vii) development of a stable financial system and drastically reduced NPA level,
- (viii) increased financialization of the resources and improved efficiency in the financial intermediation, and
- (ix) improved monetary policy capability of the central bank.

<b>IMPLEMENTATION ARRANGEMENTS/MODALITIES TO ACHIEVE THE STATED GOALS AND TARGETS/RESOURCES REQUIRED</b>
--

<b>Reforming Components</b>
-----------------------------

- 1. Re-engineering NRB's Human Resource Development including Supervisory Capabilities and Legislative Reform.**

- a. **Human Resource Development Program:** (i) HRD Planning and Implementation, (ii) Organizational Development, (iii) Education and Training Program, and (iv) Voluntary Retirement Scheme (VRS) and Benefits Package including Reforming the Remuneration Mechanism.
- b. **Building Supervisory Capabilities and Prudential Norms and Regulations:** (i) Preparation of Manuals and Modalities of Inspection and Supervision for Banks and Non-banks, (ii) Implementation of Supervision Report, (iii) Formulation and Implementation of other Relevant Regulations, (iv) Implementation of Inspection Manuals for Banks and Non-banks, and (v) Logistic Support Program.
- c. **Legislative Reform Program:** (i) Enactment of new NRB Act (already done) (ii) Enactment of Debt Recovery Act (already done), (iii) Formulation of Deposit-Taking Institutions Act, (iv) Formulation of Assets Management Company Act, (v) Formulation of Credit Information Institution Act, (vi) Formulation of Credit Rating Institution Act, (vii) Formulation of Bankruptcy Act, (viii) Formulation of Mergers and Acquisitions Act, and (ix) Formulation of Financial Legal Expert Cell in NRB.
- d. **Capacity Building Program:** (i) Banking Operations Department, (ii) Non-Bank Operations Department, (iii) Foreign Exchange Department, (iv) Banks and Non-banks Inspection and Supervision Departments, (v) Public Debt Department, and (vi) Accounts and Expenditure Department.
- e. **Revamping Research and Monitoring Strength of the Central Bank:** (i) Strengthen Research and Analysis Wing, (ii) Strengthen Statistical Wing, (iii) Strengthen Balance of Payments and Price Wings, and (iv) Strengthen Central Treasury Wings (with the objective of deriving the government cash position, especially the overdraft instantly).

## 2. Restructuring and Ownership Reform of RBB and NBL

- a. **Restructuring and Ownership Reform of RBB:** (i) Management Consultancy Program for RBB, (ii) Establishment of NRB's Evaluation and

Monitoring Cell for RBB, (iii) Logistic Support for Management Consultants in RBB, (iv) Preparation of Manuals, (v) Automation and Computerization of RBB, (vi) Branch Restructuring and Improvement Program, (vii) Preparation for Ownership Reform.

b. Restructuring and Ownership Reform of NBL: (i) Management Consultancy Program for NBL, (ii) Establishment of NRB's Evaluating and Monitoring Cell for NBL, (iii) Logistic Support for Management Consultants in NBL, (iv) Preparation of Manuals, (v) Automation and Computerisation of NBL, (vi) Branch Restructuring and Improvement Program, (vii) Preparation for Ownership Reform.

**3. Reforming the development banking and other government-owned financial institutions like ADB, NIDC, NIC, etc.:** Management Consultancy Program for these institutions, especially through the professionally competent local consultants.

**4. Strengthening and improving the securities markets:** (i) Legal and operational improvements, (ii) Enlisting local private professional management.

**5. Other Financial Sector Reforms**

a. **Reforms in Auditing and Accounting Capabilities:** (i) Preparation of Modalities of Accounting and Auditing Manuals for Commercial Banks and Deposit-Taking Institutions, and (ii) Implementation of Accounting and Auditing Manuals.

b. **Financial Infrastructure Development Program:** (i) Study, Project Preparation and Establishment of a New Banker's Training Institute, (ii) Study, Project Preparation and Establishment of Assets Management Company, (iii) Study, Project Preparation and Restructuring of Credit Information Institution, (iv) Study, Project Preparation and Establishment of Credit Rating Institution, (v) Study and Project Preparation for the Development of Financial Journalism in Nepal, and (vi) Study and Project Preparation for Finance and Banking Studies in the Universities.

**An amount of US\$ 400 million would be required to implement the above components of the reform.**

## **MONITORING AND EVALUATION**

The purpose of assessing and monitoring indicators is to measure the performance relative to the objectives. The FSR activities will be monitored and evaluated as required. The monitoring of the various components under the reform will be carried out by the concerned regulatory bodies like the central bank for the bank and non-bank financial intermediaries, HMG and the central bank for ADB and NIDC, HMG for EPF, CIT and other State-owned financial institutions, insurance board for the insurance companies, and securities board for the securities exchange markets. A system of reporting periodic progress reports to the concerned regulatory bodies and the surveillance teams, if any, constituted by these bodies will be institutionalized as part of the reform process. A continuous review mechanism on a periodic basis against the specified schedules will have to be put into practice so as to assess the implementation progress for ensuring success of the reform activities.

## **CONCLUSION**

The main agenda of the financial sector reform has been carrying out structural improvements in the sector along with addressing the financing needs for enhancing investment, production, productivity, employment, and economic growth in the economy on an efficient, competitive and sustainable basis. There is the need for re-orienting the government's role from being an active participant toward being the strong regulator and supervisor of the system.

The financial sector reform strategy should ensure that financial institutions are run in accordance with sound business principles and practices. Reform in the financial sector legislation, strengthening the bank inspection, monitoring and supervision process, restructuring of government-owned commercial and development banks, encouraging more investments in the financial sector, appropriate targetting of the directed/subsidized lending

and expansion of the capital and insurance markets comprise the important ingredients of the reform agenda in the financial sector. Improvements in prudential regulation and accounting/auditing practices are the related reform actions.

Financial discipline based on adequate provisions of disclosure and implementation of internationally-recognized accounting and auditing practices and systems should be ensured. Competition-oriented policies should be further promoted to enhance financial efficiency. The capability of the central bank for effective supervision and monitoring of bank and non-bank financial institutions should be enhanced so as to implement the financial sector reform strategy in a comprehensive way.

**I**t is a foregone conclusion that the conditions like the efficiency in financial intermediation, competitive interest rate structure, flexible and market-based exchange rates, autonomy and professionalization in the financial sector transactions, and the operation of the market-friendly monetary policy with the core objective of exchange rate, interest rate and price stability become most essential for achieving a healthy and dynamic financial sector environment contributing to the large-scale growth of efficient investments along with ensuring a high, broad-based, and sustained economic growth scenario in the country. Actions envisaged also include improving the operations of the non-bank financial institutions and promoting insurance markets for their enhanced efficiency and wider access.

**I**ncreasing the formalization process of the rural informal credit markets and strengthening micro-credits to improve production and income, social mobilization, and employment growth in the rural areas are the important reform ingredients. Similarly, restructuring the government-owned non-bank financial institutions, creating framework for the establishment of branches of reputed international banks, establishment of credit rating facilities and assets management company, etc. are the other action components. As financial reform is a multi-pronged strategy ranging from liberalization, enhancement of regulatory and supervisory framework, and creation of institutions to capacity building for better financial governance, Nepal Rastra Bank would definitely be in a position to accomplish this task in its re-engineered structure.

Financial Sector Reform Matrix				
Focus	Reform Action	Time Frame	Outcomes Expected	Status
<p>* Financial sector reforms to mobilize and allocate resources efficiently, develop capital markets, promote industrialization, improve saving and investment ratios and create more jobs and promote economic growth.</p> <p>* Broader and deeper reforms to strengthen the financial system as well as improve its capability to face the vulnerability to financial crisis.</p> <p>* Reforms to consolidate the past gains on liberalization, enhance the regulatory capability, attain fiscal prudence and macro-economic stability, build prerequisite to capital openness, and contribute to the poverty alleviation.</p>	<p>* Introduction of new Nepal Rastra Bank Act and Debt Recovery Act, amendment to Foreign Exchange Regulation Act; legislation on Deposit-taking Institutions, merger and acquisition, bankruptcy and business closure to be introduced.</p>	<p>Short to Medium-term</p>	<p>* A strong central bank with capability to steer the financial system that is supportive to the economic development of the country.</p>	<p>* NRB Bill and Debt Recovery Bill enacted. Deposit-Taking Institutions Draft Act formulated.</p>
	<p>* Restructuring of RBB and NBL, with sound management, branch improvement, and strong supervision mechanism.</p>	<p>Short-term</p>	<p>* Drastically reduced NPA level of the banking system.</p>	<p>* Nine NRB directives to commercial banks already under implementation and 13 NRB directives to finance companies.</p>
	<p>* Restructuring of ADB, NIDC and other government-owned financial institutions for professionalizing their managements and improving operations.<sup>1</sup></p>	<p>Medium-term</p>	<p>* A well-developed, competitive and strong financial system that is stable and resilient to crises, and one that contributes to the promotion of a self-sustained, high growth development framework.</p>	<p>* Management teams in RBB and NBL to be shortly placed .</p>
	<p>* Improvements in prudential regulation, accounting, and auditing practices.</p>	<p>Short-term</p>	<p>* Lower spread between the borrowing and lending rates as a manifestation of improved financial intermediation process.</p>	<p>* Joint venture commercial banks up to 50% foreign equity established since 1984, such number now numbering nine. Foreign equity ratio now raised to two-thirds.</p>
	<p>* Strengthening of regulatory and monitoring functions of the central bank.</p>	<p>Short-term</p>	<p>* Financial system devoid of scams and crises.</p>	<p>* Stock Exchange regulatory and operational functions being improved.</p>
	<p>* Establishing credit information and rating institution and the assets management company.</p>	<p>Long-term</p>	<p>* Developed capital markets.</p>	<p>* Directives for the development banks and cooperatives to be shortly issued.</p>
	<p>* Building infrastructure for opening the capital account with adequate caution.</p>	<p>Medium-term</p>	<p>* Financial system's resilience to uncertainty and vulnerability raised.</p>	<p>* Enhancement of paid-up capital requirements in commercial banks, development banks, finance companies and cooperatives to come into operation soon.</p>
	<p>* Improving the operations of the non-bank financial institutions.</p>	<p>Medium-term</p>	<p>* Improved foreign exchange markets.</p>	<p>* Under private initiative are established 13 commercial banks, 13 development banks, 49 finance companies, 16 insurance companies, 34 financial cooperatives and</p>
	<p>* Promoting insurance markets.</p>	<p>Short-term</p>	<p>* Improved operating efficiency and effectiveness in delivery of service through increased competitive environment and promotion of foreign institutional investors with supporting improvements in the legal framework for financial markets.</p>	<p>* Declined poverty ratio through improved macro-credits.</p>
	<p>* Formalizing gradually the rural informal financial markets.</p>	<p>Long-term</p>	<p>* Creation of diverse market instruments and providing service demander's broad accesses to key</p>	<p>* Under private initiative are established 13 commercial banks, 13 development banks, 49 finance companies, 16 insurance companies, 34 financial cooperatives and</p>
	<p>* Strengthening micro credits to improve production and employment opportunities in the rural areas.</p>	<p>Medium-term</p>		
	<p>* Privatization of the</p>	<p>Short-term</p>		

<sup>1</sup> Local professionals would be preferred for the restructuring of these institutions.

	<p>government-owned banks and non-bank financial institutions.</p> <p>* Creating framework for the establishment of branches of reputed international banks.</p>		<p>demanders' broad accesses to key financial services.</p> <p>* Development of efficient domestic debt markets.</p>	<p>financial cooperatives and 16 financial NGOs.</p> <p>* The accumulated loss of RRDBs covered by HMG and NRB. Business plans for increasing productivity and operational soundness in RRDBs soon to be implemented.</p> <p>* Interest rate completely deregulated, SLR scrapped, CRR reduced and instruments of open market operations utilized for making monetary system and financial markets more market based investment friendly and growth promoting.</p>
--	--	--	--	--

Note: Short-term = 6 months; Medium-term = 6-12 months; Long-term = 12-24 months.