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Services Trade in Developing Asia:
A Case Study of the Banking and Insurance Sector in Nepal

By

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Abbreviations

ADBN = Agriculture Development Bank Nepal
ALICO = American Life Insurance Company
COE = Committee of Expert
DOI = Department of Industry
DSCP = Deprived Sector Credit Program
EIA = Environment Impact Assessment
ESAF = Enhance Structural Adjustment Facility
FTAs = Financial Trade Arrangement
GATS = General Agreements on Trade and Service
GDP = Gross Domestic Product
HLC = High Level Commission
IMF = International Monetary Fund
NBL = Nepal Bank Limited
NGOs = Non Governmental Organizations
NIBL = Nepal Investment Bank Limited
NIDC = Nepal Industrial Development Corporation
NIM = Net Interest Margin
NPA = Non Performing Assets
NPLs = Non Performing Loans
NRB = Nepal Rastra Bank
OLS = Ordinary Least Square
PCBs = Private Commercial Banks
PSCP = Priority Sector Credit Programme
RBB = Rastriya Banijaya Bank
SAARC = South Asian Association for Regional Cooperation
SAFTA = South Asian Free Trade Agreement
SAP = Structural Adjustment Programme
SCBNL = Standard Chartered Bank Nepal Limited
WTO = World Trade Organization

Executive Summary

This study reviews the development of the banking and insurance sectors in Nepal and the effect of reforms and commitments linked to these sectors since the 1980s, when financial sector liberalization in Nepal began with deregulation of the interest rate structure and opening of the banking sector to foreign investors. Now, three fourth of foreign equity participation is permissible in the banking sector. The insurance sector is almost fully liberalized with 100 per cent foreign equity participation on a case by case basis. The liberalization of banking and insurance has helped to diversify the banking sector resulting in financial deepening. The contribution of finance and real estate sector to employment reached 11.46 per cent of total employment in 2005, from 9.29 per cent in 1990. A rapid increase in total financial assets of the financial institutions also took place during the period 1990 to 2005.

Despite these positive developments, the financial sector is experiencing serious difficulties. The cost of capital is still high and the financial system relatively inefficient, as the gap between deposit and lending rate indicates. Access to financial services in rural areas also remains a major problem. At the same time, Nepal is in a process of further opening up banking and insurance in meeting WTO obligations.

As a party to the General Agreement on Trade in Services (GATS), in 2004 Nepal committed to opening up of the financial sector. Foreign equity participation in domestic bank has been allowed up to 67 percent. More importantly, Nepal has committed to allow wholesale banking by 2010. The presence of natural persons has been restricted both for market access and national treatment purposes. In the case of insurance, there is no restriction on market access in mode 2 and 3 except for free reinsurance and retrocession. Mode 1 and 2, however, intend that mandatory reinsurance up to USD 25000 by December 2007. Mode 3 is unbound until 31 December 2007 and mode 4 supply is fully unbound. With respect to the limitations on national treatment, Nepal has committed to none for mode 1, 2 and 3. For mode 4, it is unbound. Services, including financial services, are not yet the subject matter of SAFTA and BIMSTEC.

Regression analysis of the linkage between financial deepening and economic growth shows a strong relationship. It also suggests that credit to the private sector is the best measure of financial development or financial intermediation. Despite state owned banks passing through a crisis as a result of non-performing loans, rapid expansion in financial institutions and their lending portfolios promoted growth.

Comparative case studies of three banks, namely RBB, NIBL and SCBNL, suggest that the joint venture banks generally achieve the highest performance, followed by the private domestic banks and the state owned banks. Despite steady expansion in employment in private domestic and joint venture banks, total employment declined sharply after 2002 as a result of drastic cuts by the state owned banks as part of ongoing reforms and restructuring. Estimates of net interest margin, profits before tax, and overhead costs show that a sharp fall in the interest margin to total assets took place in private domestic banks, indicating diversification of bank services. The joint venture banks at the same time have maintained constant but lower margins. The profit before tax to total assets also shows a steadily declining trend in these banks, indicating increased competition. The opposite trend, however, was observed in the government banks.

Nepal's experience shows that structural and institutional reforms should be part and parcel of liberalization policies. Institutional capacity enhancement of the Central Bank and effectiveness in prudential regulations are crucial for making ongoing reform effective and result oriented.

Reforms in ownership and market structures will be particularly important in view of Nepal's commitment to allow foreign wholesale banking and insurance companies in the domestic market. Raising the capital base of the banks and removing government control and interference in the two banks (NBL and RBB) will be necessary.

Nepal's experience with financial liberalization suggests that the multilateral route could be beneficial in pursuing broader trade liberalization policies. By the same token, the speedy introduction of new Acts in fulfilling commitments under WTO may strengthen market institutions.

One of the problems experienced in the course of intensive liberalization is that, despite financial deepening, access to credit by the rural population has not improved. This is also true of small businesses operating in urban areas. In order to overcome this, policy should focus on the growth of micro credit institutions and community - based self-help, saving and credit groups and cooperatives. This will ease pressures on the Government or Central Bank in forcing commercial banks to divert resources to less profitable, more risky ventures. It may also prevent crowding out of funds available to the private sector.

I: Introduction

1.1 Background

Liberalization policies in Nepal were started in the mid-1980s. A severe foreign exchange crisis, emanating from excessive reliance on deficit financing had forced the government to pursue market oriented reforms. However, more intensive and wide-ranging reforms were pursued only after the restoration of democracy in 1990. While augmenting reforms, attempts were also made to remove various distortions impeding growth. The speed and direction of reforms were also affected by the reforms driven in India, given Nepal's open border and special trade relations with that country.

To expedite economic liberalization, a major devaluation of the Nepalese currency was made in 1991. Liberalization and privatization received impetus after the implementation of the Enhanced Structural Adjustment Facility (ESAF) program of the International Monetary Fund (IMF) in 1992. To institutionalize the reform process and develop appropriate market institutions, the Industrial Enterprises Act and the Foreign Investment and Technology Transfer Act were brought into effect in 1992. The Privatization Act was introduced in 1994. License and quota systems were gradually removed. On the trade front, quantitative restrictions on imports through license were completely abolished, and tariffs on imports were drastically slashed. Foreign exchange was also gradually liberalized to ensure its compatibility with the reforms in trade. The Nepalese currency was made fully convertible on the current account with no foreign exchange controls. A more open up policy was pursued in the area of foreign investment by allowing foreign investments up to 100 per cent of issued capital in large and medium industries. This was followed by the removal of entry barriers to foreign investors in the financial sector. In banking, three fourth of foreign equity participation is now permissible. The insurance sector is almost fully liberalized in which up to 100 percent foreign equity participation on a case by case basis is allowed. Following the enforcement of a new Act in 2002, the Nepal Rastra Bank (NRB), the country's central bank, has been granted greater autonomy and full authority to conduct monetary policy. The NRB has also been given full authority and responsibility to play an effective supervisory role. Implementation of more prudential regulatory and supervision systems is a part and parcel of the ongoing financial sector reform. A liberalized trade regime also enabled Nepal to obtain membership of the World Trade Organization (WTO) in 2004, which in turn has obligated Nepal to pursue more trade liberalization policies.

Following financial sector liberalization in Nepal in mid 1980s, financial deepening is taking place at a faster pace. A major diversification in the ownership structure of the financial system is a lsotaking place. Not only is there a steady rise in the contribution of banking and insurance services to the country's value added, but also the banking and insurance services are helping to boost business and industry including international trade. Foreign equity participation is also promoting quality in financial services.

1.2 Definition of the Banking and Insurance Sectors

Financial services usually include banking, insurance, securities, asset management, pension funds, financial advisory, information and other services[1]. These services are commonly associated with the supply of financial instruments[2]. Financial services are divided into banking and non-banking services. Banking institutions provide banking and other financial services to their customers. They render services to the customers in terms of both deposits and lending by performing the role of intermediating for savers and borrowers.

Non-baking financial institutions include insurance and other fund management services. Insurance companies are the most important non-banking financial institutions. An insurance company operates as an insurer[3]. Insurance companies collect premiums and compensate losers. It operates on three principles—the sharing of losses, the participation of large numbers of people, and the quality of risk. Insurance companies not only shift the risks but also collect small scattered capital and invest it in various activities of long-term nature.

1.3 Review of the Literature

The financial system mobilizes financial resources, facilitates risk management, distributes resources to the most efficient sectors and activities, monitors the use of financial resources (exerting corporate governance), and provides a payment system that makes trade among economic participants more efficient (Levine, 1997). Financial development occurs when a financial system is able to improve the performance of these functions. There is a large body of theoretical and empirical work emphasizing that financial development is positively related to economic growth (Hermes and Lensink, 2005).

While there may be several different characterizations of financial liberalization, there is a growing view, shared by these authors, that financial liberalization includes policies that focuses on deregulating credit controls, deregulating interest rate controls, removing entry barriers for foreign financial institutions, privatizing financial institutions, and removing restrictions on foreign financial transactions. Financial liberalization has both a domestic and foreign dimension. Moreover, it focuses on introducing or strengthening the price mechanism in the market, as well as improving the conditions for market competition.

In the literature several arguments in favor of financial sector liberalization have been put forward. Most of these arguments take the neoclassical perspective, which assumes that markets are most efficient in allocating scarce resources. The discussion on liberalizing financial markets more or less started with the seminal publications of McKinnon (1973) and Shaw (1973). They both argued in favor of liberalizing financial markets on the grounds that this would both lead to more efficient allocation of investment which, in turn, would lead to higher economic growth rates. In the 1990s, when the role of financial institutions in economic growth became intensively

[1] For the definition see WTO Document, TN/S/W/43.
[2] See www.fin.gc.ca/hst/hstglo-e.html
[3] See www.alwarrantysolution.com/glossary.htm

discussed in the literature, several authors explicitly modeled the relationship between finance and growth, while others focused on investigating the empirical support for these models.

First, it is claimed that freeing entry and competition in financial markets increases interest rates on deposits, which leads to higher saving rates. This, in turn, increases the amount of resources available for investment (McKinnon 1973). If financial liberalization also opens up the foreign capital account, capital inflows may increase, again raising the availability of funds for investment and growth. Second, competition puts pressure on profit margins, in particular on lending rates. This reduces the cost of capital, leading to a rise in investment and growth. Moreover, financial liberalization contributes to increased possibilities of risk diversification by financial institutions such as banks. This also reduces the cost at which loans are offered. Third, if markets are liberalized, financial intermediaries are stimulated to become more efficient by reducing overhead costs, improving overall bank and risk management, and increasing the supply of new financial instruments and services. Moreover, if financial liberalization means opening up domestic markets to foreign competition, this may lead to the import of bank and risk management techniques, as well as of new financial instruments and services. All these effects will help to improve the efficiency of financial intermediation in a country, contributing to higher returns to investment and thus to higher rates of economic growth.

In parallel, there is also a view that financial liberalization may pose new risks. Stiglitz (2000) and others point out that financial liberalization as such does not solve the problem of asymmetric information. This may prevent financial intermediation from becoming more efficient in a liberalized market. Similarly, Hellmann, Murdock and Stiglitz (1996, 1997, 2000) in a series of articles make the point that liberalization reduces the franchise value of banks, which makes them more prone to financial disruption and stimulates risk taking in order to try to increase profits under the pressure of falling interest rate margins. Reduced margins may also stimulate banks to economize on screening and monitoring efforts, and they may be more willing to opt for a gambling strategy when allocating loans, i.e., putting less emphasis on risk and more on profit.

The impact studies on financial service liberalization (mostly banking and insurance) generally look into three aspects viz., stability of the financial system and growth, competition and efficiency, as well as access to credit and financial services. Laeven (2003) in a recent study finds evidence for the hypothesis that financial liberalization reduces financial constraints of firms. Similarly, positive effects of financial liberalization on reducing financial constraints are found, among others, by Koo and Shin (2004) for Korea, Harris, Schiantarelli and Siregar (1994) for Indonesia, Guncavdi, Bleaney and McKay (1998) for Turkey, and Gelos and Werner (2002) for Mexico. Nazmi (2005) in case of five Latin American countries finds evidence that deregulation of financial markets increases investment and growth. Clarke et al. (2001b) find that the foreign banks tend to be more efficient and profitable than their domestic competitors (Clarke et al. 2001b). Claessens et al. (2001) find econometric evidence that “foreign bank entry can render national banking markets more competitive, and thereby can force domestic banks to start operating more efficiently” (Claessens et al. 2001). In particular, they find that the larger the share of foreign banks in the domestic banking market, the lower the profitability and the lower the operating costs of domestic banks.

Some studies using cross-country panel data to investigate the quality effect of financial liberalization find supportive evidence that financial liberalization spurs productivity growth

(Bonfiglioli, 2005). Levine (2001) focuses on the effects of international financial liberalization on the efficiency of domestic financial markets and growth. Levine finds evidence for the fact that liberalization improves the efficiency of stock markets, since it increases the liquidity of these markets. Moreover, foreign bank entry improves the efficiency of domestic banks. Both these effects in turn help to increase economic growth. The internationalization or liberalization of financial markets matters for financial development as well as for productivity growth. First, the main direct positive effect of foreign banks on the level of financial development is to improve the access to financial services and lower the cost of borrowing, and at same time, it will also improve the quality of banking services. Second, foreign bank entry also has the indirect effect of increasing the competitiveness and efficiency of the domestic banking sector, and providing incentives to improve accounting, auditing, and rating institutions, as well as encouraging learning by doing by local banks (Aghion and Howitt, 1992). Through entry and exit, new banks bring new knowledge, more varieties /products and innovative processes to the market and force-out some inefficient domestic banks. Productivity improves through resources reallocation from inefficient banks to more efficient ones. Consumers and firms in non-financial sectors benefit from more efficient banking services and better products. In an study, Tornell, Westerman and Martinez (2004) present supportive evidence for the idea that financial liberalization in the short term leads to financial fragility, but in the longer term contributes positively to economic growth.

Asian countries, while having experienced rapid financial deepening in the recent years, continue to limit, in varying degrees, the penetration of domestic banking markets by foreign firms. But Claessens and Glaessner (1998) show that net interest margins are lower, overhead costs are lower, and profits are higher in Asian banking systems that are more open to foreign bank participation (Claessens and Glaessner, 1998). The same study concludes that “the limited openness to date has been costly in terms of slower institutional development, greater fragility and higher costs of financial services”.

Studies by Jaramillo, Schiantarelli and Weiss (1996) on Ecuador and Hermes and Lensink (1998) on Chile, however, find much less supportive evidence for the positive effect of financial liberalization on reducing financial constraints. There is also growing evidence that if foreign participation merely substitutes for domestic factors and the sector does not expand, i.e. the degree of competition remains unchanged, then there cannot be a positive growth impact on account of the scale effect. But the net effect is said to depend on the extent of technology transfer. A study by Coe, Helpman, and Hoffmaister (1999) indicates that the impact is linked to factor and productivity impact (Coe, Helpman and Hoffmaister, 1999). In this respect an intensive study by Matto, Rathindran and Subramanian (2001) finds that despite employment effect being ambiguous, the productivity of national factors will unambiguously increase due to liberalization of a service sector that requires local presence. Liberalization will lead, first, to an increase in the aggregate scale of the sector and, secondly, to technology spillovers from the local presence of foreign factors. Both effects will enhance the productivity of the nationally owned factors. Taking the employment and productivity effects together the study concludes that the effect of liberalization on GNP is ambiguous (Mattoo, Rathindran and Subramanian, 2001). A study by Clarke et al. (2001a) concludes that the orientation of foreign banks toward serving larger companies may worsen the access to credit of small and medium-size companies (SMEs). This outcome would be all the more likely if competitive pressure from foreign bank entry were to crowd out smaller domestic banks that are the principal lenders to SMEs in the developing countries (Clarke et al. 2001a).

The major conclusion to be derived based on various studies is that the better outcome and impact critically depends on domestic reforms to underpin the viability and credibility of the financial sector liberalization. If increased entry into financial sectors is not accompanied by adequate prudential supervision, instability may result. And the absence of well-designed universal service requirements may result in new, unsustainable burdens being imposed on vulnerable groups of the society.

Although some studies have attempted to examine the role and impact of financial liberalization in Nepal (Acharya 2003, UNDP 2004, Khanal and Kanel 2005 and Khanal et. al. 2005), they lack rigorous comparative analysis of state owned, private sector owned and joint venture bank and insurance companies. Such a study is important from the standpoint of assessing the strengths and weaknesses of ongoing financial sector liberalization and finding out the suitable course of banking and insurance sector liberalization.

1.4 Research Question(s) and Scope of Study

1.4.1 Research Question

The most important research questions addressed by the study are as follows:

1. How have banking and insurance sector liberalization policies been pursued in Nepal? Are these reforms accompanied by the strengthening of rules, regulations and the regulatory system itself?
2. Has banking and insurance sector liberalization enhanced competition and efficiency to promote business?
3. Is there any adverse employment effect of increased foreign equity participation? Is it adversely affecting the process of gender mainstreaming?
4. What lessons could countries like Nepal learn from the ongoing liberalization of banking and insurance sectors in order to be useful for internal policy reforms as well as international preferential trade negotiations?

1.4.2 Scope of the Study

The scope of the study is as follows:

– Briefly assess the liberalization policies perused in the banking and insurance sector especially since 1990s,

– Examine the strengths and weaknesses of the banking and insurance sector liberalization in the light of their contribution to raising efficiency and competitiveness,

– Make a comparative assessment of the roles of joint venture, private and government owned banks and insurance companies in promoting business and enhancing access to credit with special focus on the gender dimension, and

– Explore the possibility of enhancing the role of banking and insurance services in the Nepalese economy and map out the strategies to be appropriate in preferential trade agreements made by LDC's such as Nepal.

1.5 Methodology and Data

There has been a flourishing body of empirical work aiming at testing the positive relationship between financial development and economic growth.[4] Generally, these studies are based on regression analysis for large cross-sections of countries. The basic equation tested has the following form:

$$y_i = \beta_0 + \beta_1 FD_i + \beta_2 X_i + \varepsilon_i$$

where, y_i is the rate of growth of country i, FD_i is an indicator of financial depth, X_i is a set of control variables, and ε_i is the error term.

Several indicators of financial depth have been proposed in the literature. Initially, the indicators were based on monetary aggregates, such as M1 and M2. However, these may be a poor proxy for financial development, since they are more related to the ability of the financial system to provide transaction services than to the ability to channel funds from savers to borrowers. Indeed, economies with underdeveloped financial systems may have a high ratio of money to GDP, as money is used as a store of value in the absence of other more attractive alternatives. Consequently, researchers have shifted from narrower monetary measures (M1 and M2) to broader definitions, such as M3, which is generally referred to as liquid liabilities of the banking system. Although M3 overcomes some shortcomings associated with M1 and M2, it still contains M2 and therefore may be influenced by factors other than financial depth. More recently, credit to the private sector has been favored as an alternative measure of financial intermediation. The main advantage of this indicator is that, by excluding credit to the public sector, it measures more accurately the role of financial intermediaries in channeling funds to the private sector. Although it may be still a poor indicator where stock and bond markets are well developed, in countries like Nepal this could be a better proxy to represent financial deepening or development.

Some studies also attempt to construct a composite index for use in the cross-country regression analysis. Firstly, indices of openness are constructed. Attention is given to capture the two key elements that contribute to dynamic benefits ofservices liberalization — the degree of competition and the extent of foreign ownership. In view of regulation playing a crucial role in delivering competition, a third element is also included. In the absence of measurement or data problems, some studies include openness to cross-border trade to represent the nature of regulation (Mattoo, Rathindran and Subramanian 2001).

In recent years attempts have also been made to improve the methodology that could help analyse the impact of financial liberalization more robustly. Some alternative methods for assessing the degree of competition and efficiency are suggested in the literature. For this, interest rate spreads and margins are generally used as proxy variables. A number of recent papers have explored the relationship between foreign bank entry, market structure and interest rate spreads and margins (Claessens, Demirguc-Kunt and Huizinga, 2001; Barajas, Steiner and Salazar, 2000; Demirguc-Kunt, Laeven and Levine, 2004) and find a positive relationship between foreign bank entry and intermediation efficiency. Similar approach has been followed by a recent study to

[4] Some of the most important empirical works include King and Levine (1993), Levine (1997 and 2003), Khan and Senhadji (2002), Herms and Lensink (2005) and Bayraktar and Wang 2006).

explore the effect of bank privatization and foreign bank entry on intermediation efficiency (measured by interest margin and spreads) in the Ugandan banking system (Beck and Heiko, 2006). A World Bank study also follows almost the similar approach to examine the competition and efficiency issues in the course of finding relationship between banking sector openness and growth (Bayraktar and Wang, 2006). Some studies also emphasis on the necessity of examining the factor impact in terms of employment and access to credit facilities.

Taking all these into account, this study adopts a three pronged approach. An analytical approach has been followed to examine the features of banking and insurance sector liberalization. In the course of analysis, various indices like financial deepening, spread between lending and deposit rates, rate of return, access to financial services, autonomy of the monetary authority, and extent of prudential regulation have been examined. The restrictions on private investors, including foreign investors, open ing new banks through rules, regulations and other measures has also been examined. Interest margin, profits before tax, and overhead costs of government owned, private domestic and joint venture banks are assessed.

This is followed by regression analysis to examine the relationship between financial deepening and economic growth. During the course of the model estimation, various control variables were also included and tested. Since time series annualized data for the period of 1981 to 2005 were used for the model estimation, unit root tests were also carried out to check for non-stationary characteristic in the series.

Finally, a case study of three banks is undertaken. Net interest margin, non-interest income, overhead costs, non performing loans, credit to the private sector etc., have been examined. One of each institution - government owned, domestically private sector owned, and joint venture - has been randomly selected to make a comparative study. The role of the liberalized banking system in enhancing gender mainstreaming has also been looked into by examining the employment pattern in three banks.

Both secondary and primary data sources have been utilized for the study. Major data sources for the study include Quarterly Economic Bulletin, Banking and Financial Statistics, Annual Monetary Policy Statements and Annual Report of the Central Bank. For detailed Commercial Bank information, annual reports of the concerned banks have been used. Likewise, Economic Surveys of the Ministry of Finance, National Accounts and other statistics of the Central Bureau of Statistics and Annul Reports of the Insurance Board and Insurance Companies have been the sources of data and information. Earlier studies, reports, government policy announcements, government commitment to the WTO, SAFTA and BIMSTEC related documents were also used for the study. For the case study structured questionnaires were developed and concerned authorities were interviewed.

1.6 Structure of the Report

The next chapter briefly reviews the performance of the economy in the pre- and post liberalization period. This is followed by a critical review of the policy reforms carried out in the banking and insurance sectors. In Chapter 4, Nepal's commitments under WTO, SAFTA and BIMSTEC are briefly reviewed. Chapter 5 presents five case studies of three banks. Chapter 6 derives conclusions and policy implications.

II: A Brief Review of the Nepalese Economy

2.1 Growth Performance

There is a marked increase in the rate of growth in the non agricultural sector between the pre-and post liberalization periods. During the second half of 1980s when the structural adjustment program was implemented, GDP grew at a rate of 4.6 per cent on average, comprising of 4.1 per cent in agriculture and 5.0 per cent in non-agricultural sectors. In the first five years of intensive liberalization, the average growth was 4.9 percent despite negative growth in the agriculture sector, the non-agricultural sector recording a high growth rate of 10 per cent (Table 2.1). The growth in electricity and manufacturing was particularly high. A rapid expansion in private sector activities also took place in trade, transport, finance and real estate in the aftermath of market-oriented reforms. However, such a growth momentum could not continue for long due to worsening security situation and triggering of political instability in the country which started from the mid-1990s. The political instability also had some adverse effect on ongoing reforms in banking and other sectors. Studies show that adverse pre-conditions and wrong sequencing also had some negative effect on the performance of various sectors of the economy (Khanal et al. 2005). As a consequence, the growth rate decelerated sharply during the period 2000 to 2005. The adverse effect was particularly severe in the manufacturing and trade sectors. Some deceleration in the growth rate took place in the finance and real estate sectors as well. The fluctuating trend in the growth rate had adverse effects on the speed of structural change in the economy.

Table 2.1

Sectoral Growth Rates, 1980 – 2005 (per cent)

	1985-1990	1990-1995	1995-2000	2000-2005
Agriculture	4.1	-0.2	2.8	2.8
Mining	4.2	7.9	3.4	1.6
Manufacturing	5.4	13.0	5.6	-1.3
Electricity	8.6	23.0	9.0	7.9
Construction	5.4	8.5	4.6	1.8
Trade	4.9	6.6	6.1	-1.4
Transport	3.6	7.5	9.2	4.6
Finance & Real Estate	5.1	5.8	6.4	3.7
Community and Social Services	3.0	7.3	6.1	3.0
Non-Agriculture	5.0	10.0	6.3	2.5
GDP	4.6	4.9	4.5	2.7

Source: Economic Survey (Various Issues), Ministry of Finance, Government of Nepal

During the period 1985 to 1990 only marginal changes in the structure of the economy took place (Table 2.2). The contribution of agriculture in the total GDP fell to 50.6 per cent in 1990 from 51.2 per cent in 1985. Correspondingly, a minor change occurred within the non-agriculture sector. The manufacturing sector's contribution increased to 6 per cent from 5.7 per

cent during the same period. A similar pattern is observed in the trade and construction sectors. During the initial years of the intensive reforms, structural shifts were very rapid. Share of agriculture in total GDP dropped by almost ten percentage point during the period 1990 to 1995. There was a big surge in the contribution of the manufacturing sector as its ratio reached 9.3 percent from 6 percent in 1990. Some increase in the contribution of construction, trade, transport, community and personal services sectors also took place during this period. Better export opportunities enjoyed by the export-oriented industries until the mid-1990s had very positive effect on the structural shift. This momentum could not be maintained for long. After 1995, the shift away from agriculture toward non-agriculture was not only negligible, even the shift within the non-agriculture sector was not as expected. The share of the manufacturing sector continuously dropped, reaching 7.7 per cent in 2005. A similar pattern persisted in the trade sector. The share of finance and real estate reached 11.5 percent in 2005 from about 9 percent in 1985.

Table 2.2
Sectoral Shares in GDP (per cent)

S.N.	**Descriptions**	**1985**	**1990**	**1995**	**2000**	**2005**
1	Agriculture	51.21	50.62	40.75	39.62	38.21
2	Mining	0.43	0.45	0.53	0.49	0.49
3	Manufacturing	5.65	5.97	9.31	9.16	7.72
4	Electric	0.41	0.52	1.36	1.62	2.33
5	Const	8.46	8.96	10.99	10.20	10.40
6	Trade	10.26	10.53	11.58	11.71	9.86
7	Transport	6.02	5.74	6.66	8.01	9.57
8	Finance & Real Estate	8.97	9.29	9.77	10.08	11.46
9	Com Soc Ser	8.55	7.88	9.01	9.08	9.91
10	Non Agriculture GDP	48.78	49.37	59.24	60.37	61.78
11	Agriculture GDP	51.21	50.62	40.75	39.62	38.21
12	Total GDP at factor cost	100.00	100.00	100.00	100.00	100.00

Source: Economic Survey (Various Issues), Ministry of Finance, Government of Nepal

The broad industrial categories give clearer picture on the changing structure of the economy (Table 2.3). The share of services sector was 43.13 percent in 1985. Its share reached 54.06 percent in 2005. Unlike the variability in manufacturing, there has been steady expansion of the services sector.

Table 2.3
Industry Shares in GDP (per cent)

S.N.	Descriptions	1985	1990	1995	2000	2005
1	Agriculture	51.22	50.63	40.75	39.63	38.21
2	Industry (Manufacturing)	5.65	5.97	9.31	9.16	7.72
3	Services	43.13	43.40	49.93	51.21	54.06
4	Total	100.00	100.00	100.00	100.00	100.00

Source: Economic Survey (Various Issues), Ministry of Finance, Government of Nepal

Along with the liberalization of the economy, a big shift in the employment structure took place (Table 2.3). In 1981 as much as 91.1 percent of the active population was engaged in agriculture and related activities. This ratio gradually decreased to 81.2 percent in 1991. Changes in ecomployment structure were phenomenal during the period 1991 to 2001. During this period employment in the agriculture sector went to 65.7 percent. This became possible particularly due to high rates of absorption of the economically active population by the manufacturing and trade sectors. By 1991 employment in these sectors increased by 2.1 and 3.5 percent respectively, and by 2001 they absorbed 9 and 9.9 per cent of the economically active population. A gradual expansion in the level of employment also took place in finance and real estate. In 1981 only 0.1 percent of the economically active population was engaged in this sector. The contribution of this sector to total employment reached 0.8 percent in 2001.

Table 2.4
Employment by Industry

Industrial Group/Year	***1981***	***Share in Total***	***1991***	***Share in Total***	***2001***	***Share in Total***
Total	*6,850,886*	*100.0*	*7339586*	*100.0*	*9900198*	*100.0*
Agriculture.	6,244,289	91.1	5961788	81.2	6504689	65.7
Mining and manufacturing	971	0.0	152418	2.1	888301	9.0
Electricity, gas and water	33029	0.5	11734	0.2	148218	1.5
Construction	3013	0.0	35658	0.5	286418	2.9
Commerce	2022	0.0	256012	3.5	984662	9.9
Transport and communication	109446	1.6	50808	0.7	161638	1.6
Finance and business services	7424	0.1	20847	0.3	76687	0.8
Personal & comm. services	9850	0.1	752019	10.2	663737	6.7
Others	313570	4.6	28004	0.4	163412	1.7
Industry not stated	127272	1.9	70298	1.0	22395	0.2

Source: CBS. Various Population Censuses.

III: Financial Structure and Policy Reforms in the Banking and Insurance Sector

3.1 Structure of the Financial System

Before liberalization, the financial system consisted of only two commercial banks and few other financial institutions. By 2005, NRB licensed bank and non-bank financial institutions totaled 181. Out of them, 17 were commercial banks, 26 were development banks and 60 were finance companies. The remaining 78 were micro credit development banks, saving and credit cooperatives, and NGOs performing limited banking activities (Table 3.1). The other non-deposit taking financial institutions include 21 insurance companies, one Employee Provident Fund, one Citizen Investment Trust, one Deposit Insurance and Credit Guarantee Corporation, one Nepal Stock Exchange Limited, one Credit Information Bureau, 116 postal saving offices and one Rural Self-Reliance Fund. Of these institutions, the commercial banks, development banks, 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 Soard regulates the stock exchange, the other institutions are under the overall regulation of the Government.

Table 3.1
Growth of Financial Institutions

Type of Financial Institutions	**Number of Institutions in mid-July**					
	1980	1985	1990	1995	2000	2005
Commercial Banks	2	3	5	10	13	17
Development Banks	2	2	2	3	7	26
Finance Companies	-	-	-	21	45	60
Micro Credit Development Banks	-	-	-	4	7	11
Saving and Credit Cooperatives	-	-	-	6	19	20
NGOs (Performing limited Banking activities)	-	-	-	-	7	47
Total	4	5	7	44	98	181

Source: Banking and Finance Statistics, NRB, 2005

In terms of ownership structure of the banks, 6 are joint venture banks and 11 are fully domestic owned banks. Out of these, Rastria Banijaya Bank is fully government owned, and Nepal Bank Ltd. is government and private sector owned with 42 percent share still held by the Government (Table 3.2).

Table 3.2
Commercial Banks and Their Ownership Pattern as of Mid-July 2005

Name of Commercial Banks	Paid-up Capital (Rs in million)	Pattern of Ownership	Participating Foreign Bank and Fin. Institutions
Government Owned Banks			
Nepal Bank Ltd	380.4	Government-42% Private-58%	
Rastriya Banijya Bank	1172.3	Government –100%	
Private Owned Banks			
Nepal Investment Bank Ltd.	587.7	Nepalese-100%	
Bank of Kathmandu Ltd.	463.6	Nepalese-100%	
Nepal Credit & Commerce Bank Ltd	693.6	Nepalese-100%	
Nepal Industrial & Commercial Bank Ltd.	500.0	Nepalese-100%	
Lumbani Bank Ltd.	500.0	Nepalese-100%	
Machhapuchere Bank Ltd.	550.0	Nepalese-100%	
Kumari Bank Ltd	500.0	Nepalese-100%	
Laxmi Bank Ltd.	610.0	Nepalese-100%	
Siddratha Bank Ltd.	350.0	Nepalese-100%	
Joint Venture Banks			
Nabil Bank Ltd.	491.7	Nepalese-50% Foreign Joint Venture-50%	NB International, Ireland
Standard Chartered Bank Nepal Ltd	374.6	Nepalese-25% Foreign Joint Venture-75%	Standard chartered Group.
Himalayan Bank Ltd.	643.5	Nepalese-80% Foreign Joint Venture-20%	Habib Bank Ltd, Pakistan
Nepal SBI Bank Ltd	431.9	Nepalese-50% Foreign Joint Venture 50%	State Bank of India, India
Nepal Bangladesh Bank Ltd.	719.9	Nepalese- 75% Foreign Joint Venture-25%	IFIC, Bangladesh
Everest Bank Ltd	455.0	Nepalese-80% Foreign Joint Venture-20%	Punjab National Bank, India
Total	9423.2		

Source: Bank and Financial Institution Department, NRB.

Out of the 21 insurance companies , 14 are in the private sector, 3 are the branches of foreign insurance companies, other 3 are joint venture companies and the remaining one is a government owned company. Sixteen are in general insurance, 3 are in life insurance and 2 are composite insurance companies engaged in both life and non-life insurance business (Table 3.3).

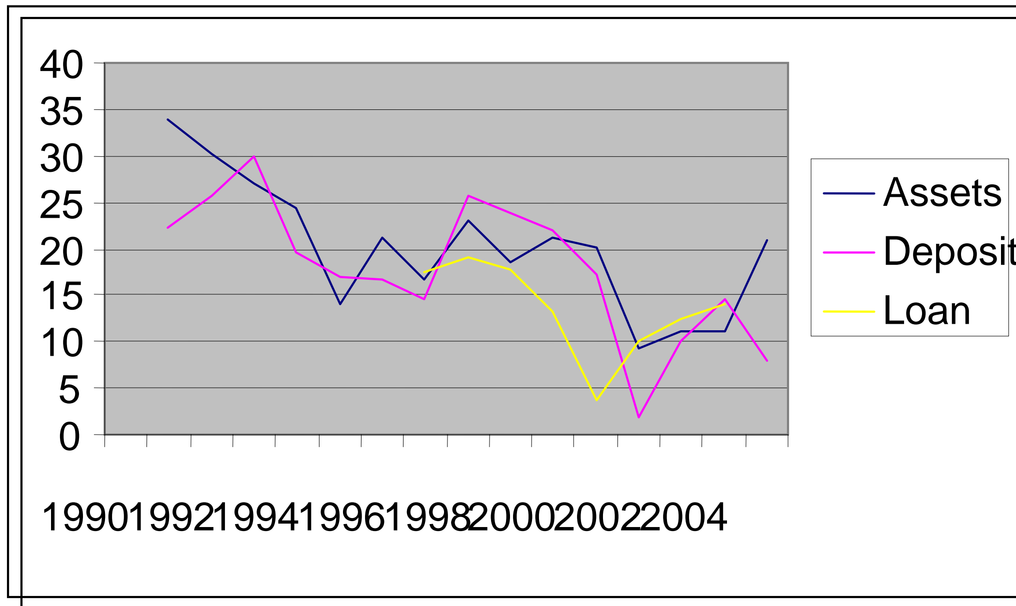
Table 3.3
Ownership Structure of Insurance as of Mid-July 2005

Ownership	Nature of the Companies			Total
	General	Life	Composite	
Government Owned	-	-	1	1
Private Sector	13	1	-	14
Foreign	2	1	-	3
Joint Venture	1	1	1	3
Total	16	3	2	21

Source: News and Views, Nepal Insurance Board, 2006.

The total financial assets of the financial system reached Rs 474325.9 million in Mid July 2005, representing 90 per cent of GDP. The share of financial assets in GDP was only 29 and 32 per cent in 1985 and 1990 respectively. Similarly, the ratio of deposits to GDP went to 47.7 per cent in 2005 from 10 per cent in 1980 and to 32 per cent in 2000. The credit to GDP ratio reached 30.9 percent in 2005 showing somewhat slow growth in comparison.

Figure 1
Growth of Assets, Deposits and Loans (per



Although in terms of market share commercial banks dominate the financial system, a rapid change in share has taken place (Table 3.4). In 2000 the asset share of commercial banks was 92.9 per cent. Their asset share reduced to 86.7 per cent over five years period, the expansion being taken by development banks and finance companies whose share increased to 19.4 per cent in 2005 from just 6.5 per cent in 2000.

Table 3.4
Market Shares of Financial Institutions (Rs million)

	Total Assets		Total Deposit		Total Credit	
	2000	**2005**	**2000**	**2005**	**2000**	**2005**
Commercial Banks	209539.3	411240.56	155027.1	252294.3	96296.4	163689.1
Development Banks	1578.8	23241.96	166	6818.76	748.9	19232.94
Finance Companies	13082.1	30356.85	9793	22445.1	9094.7	21323.48
Micro-credit Development Banks	-	6166.24	-	852.35	-	3344.86
Others (Cooperative and NGOs)	1353.3	3320.2	995.8	1704.69	856	1463.38
Total	225553.5	474325.81	165981.9	284115.2	106996	209053.7
Share in Total						
Commercial Banks	92.90	86.70	93.40	88.80	90.00	78.30
Development Banks	0.70	4.90	0.10	2.40	0.70	9.20
Finance Companies	5.80	6.40	5.90	7.90	8.50	10.20
Micro-credit Development Banks	-	1.30	-	0.30	-	1.60
Others (Cooperative and NGOs)	0.60	0.70	0.60	0.60	0.80	0.70

Source: Annual Banking Statistics, Nepal Rastra Bank, 2006

A big change in market share is also taking place within the banking system. In 2000 the asset share of the two government owned banks was 56.6 percent. It reduced to 38.1 percent in 2005. The decline in the credit share has been sharper, from 56.7 percent in 2000 to 29.4 percent in 2005. On the other hand, the shares of the private domestic banks in assets, deposits and credit has risen to 24.4, 25.4 and 32 per cent, respectively, in 2005, from less than 11 per cent in 2000 (Table 3.5).

Table 3.5
Total Assets, Deposits and Credit in the Banking System (Rs million)

	Total Assets		**Deposit**		**Credit**		**Credit/ Deposit Ratio**	
	2000	**2005**	**2000**	**2005**	**2000**	**2005**	**2000**	**2005**
Government Owned Commercial Bank	103834.20	103867.16	73989.60	78950.22	52004.30	43568.66	0.70	0.55
Private Owned Domestic Banks	15010.00	66433.54	13161.60	57470.28	9583.90	47413.88	0.72	0.82
Joint Venture Banks	64500.60	102357.41	53485.20	89613.75	30146.40	57085.11	0.56	0.63
Total	183344.80	272658.11	140636.40	226034.25	91734.60	148067.65	0.65	0.65
Share (per cent)								
Government Owned Commercial Bank	56.63	38.09	52.61	34.93	56.69	29.42		
Private Owned Domestic Banks	8.19	24.37	9.36	25.43	10.45	32.02		
Joint Venture Banks	35.18	37.54	38.03	39.65	32.86	38.55		
Total	100	100	100	100	100	100		

Source: Bank and Financial Institution Department, NRB.

3.2 Policy Reforms in Banking

3.2.1 General Policy Reforms

Prior to liberalization in the mid 1980s, Nepal's financial system was characterized by interest rate controls, controls on entry and exit, and selective credit policies. Intermediation costs were very high due to lack of competition and inefficiency. There were only two commercial banks, and two specialized financial institutions—the Agricultural Development Bank of Nepal (ADB/N) and the Nepal Industrial Development Corporation (NIDC), all controlled and regulated by the Government.

In 1984, controls on interest rates were gradually lifted. Commercial banks and financial institutions were allowed to fix deposit rates above the floor rate fixed by the Nepal Rastra Bank (NRB). By 1989 decontrolling of interest rate was completed. In 1984, joint venture banks were also allowed to operate. As a result, three joint venture banks came into operation during the period 1984 to 1987. Similarly, the Finance Companies Act was brought into effect in 1985 to meet the rising demand of small borrowers. Removal of the statutory liquidity ratio and introduction of auctioning of Treasury Bills were other reform measures implemented during the 1980s. From 1989, NRB also began to fix capital adequacy ratio. In the same year, NRB also set an upper limit on the amount of loan to be provided to a single borrower or group of borrowers by a bank with the aim of minimizing the risk of over-concentration of loans in few big borrowers. Banks were instructed to provide a maximum of 50 percent of capital fund with respect to funded loan and 100 percent of capital fund with respect to non-fund based loans for a single borrower. Similarly, in 1990 the Central Bank introduced open market operations as one of the tools of monetary policy.

However, these limited reforms were far from adequate in enhancing efficiency, and a more intensive reform was started from early 1990s. The Finance Company Act 1985 was amended allowing promoters to hold 60 percent of the total issued capital. The Development Bank Act 1995 and Financial Intermediary Institutions Act 1998 were introduced to attract private sector and NGOs in establishing financial institutions in the rural areas. In response, a large number of development banks, some of them replicas of Grameen Bank, and financial NGOs and cooperatives came into operation during the post-reform period. Prudential norms were also gradually defined and strengthened. The capital adequacy ratio was increased in 2005 to 12 percent from 9 percent. In 1995 the limit on the amount of loan to a single and group borrower was reduced to 35 percent and 50 percent, respectively. Through the regulation 2001, the loan limits were further revised; 25 percent of core capital in case of fund based loans and 50 percent of core capital in case of non-fund based loans. Along with the changes in the basis from capital fund to core capital, the credit limit also went down drastically over time. The NRB also issued directives to the banks to monitor the sectoral concentration pattern of credit.

The mandatory priority sector lending policy was introduced in Nepal as early as 1974. Paradoxically, in the post-liberalization period this policy was kept intact and the level and forms of priority sector lending were increased. The ratio of priority sector lending was raised to 12 per cent in 1990 from 8 percent in 1985. In 1992, commercial banks were additionally directed to lend a certain percent of priority sector lending toward the small borrowers of deprived sectors. Only in

a recent policy announcement has the Central Bank committed to phase out priority sector lending by 2007.

In the 1990's the Central Bank was ambivalent towards the issued of liberalization. On the one hand it was argued that restriction on entry would lead to oligopolistic practices and suppress competition. On the other it was thought that liberal entry into financial services could generate unhealthy competition (NRB, 1996). Therefore, the regulatory authorities adopted a discouraging and delaying policy mainly through the capital base route.

In 2002 some notable steps were taken to bring institutional reforms in the banking system. Nepal Rastra Bank Act 2002 and Debt Recovery Act 2002 with provisions of Debt Recovery Tribunal were introduced. The Nepal Rastra Bank Act 2002 provides autonomy to the Central Bank. It also gave sufficient authority to NRB to maintain financial discipline and perform its regulatory and supervisory role more effectively.

However, these reforms were ineffective in raising the financial health of the banking system in general and government owned banks in particular. The slow speed or wrong forms of implementation were equally responsible for this (UNDP, 2004 and Khanal et al, 2005). As a result, the financial system entered into crisis. A study conducted by the World Bank (2002) revealed a number of weaknesses in the financial system. Some of the major deficiencies highlighted by the study were: 1) excessive government involvement in the banking system, 2) weak corporate governance and organizational culture, 3) poor lending practices, 4) fragmented legal framework, 5) inadequate disclosure, accounting and auditing standards, 6) high level of non-performing loans and political intervention. A separate study by KPMG found two state owned commercial banks technically insolvent. With the emergence of the new and modern banks, the older state-owned banks with wide rural networks had to compete with banks mostly operating in the urban areas. A phenomenon of 'cream skimming' appeared in the banking services with lucrative and easy business such as export financing and donor transactions appropriated by the new private sector banks (World Bank 2002).

A comprehensive ' Financial Sector Reform Program' with the support of the World Bank and other donors was introduced in 2002. This reform program is now underway. The program aims to create a competitive, market friendly, well diversified and prudently managed system. The major components of the program are three: i) re-engineering of the NRB, ii) restructuring of state owned banks viz., RBB and NBL, and iii) capacity building in the financial sector.

In the beginning the focus of reform was on the improvement in the legislation and prudential norms in the financial sector. The enactment of New NRB Act 2002 and steps to enforce better prudential regulation are outcome of this. As a part of the ongoing reform, two commercial banks were contracted out to the foreigners. Very recently the Banking and Financial Act 2006 (an umbrella Act covering all financial institutions) has been enacted with the aim of bringing more reform to the financial system in a more coordinated way.

3.2.2 Some Specific Policy Measures

General Provisions: Nepal Rastra Bank Act, 2002 has given full authority to the Nepal Rastra Bank regarding regulation, inspection and supervision of the banks and financial institutions. Bank and Financial Institution Act governs the functional aspect of banks and financial institutions. The

NRB classifies the institutions into "A" "B" "C" "D" categories on the basis of minimum paid-up capital and provides a license to the bank or financial institution. The license holder entity must maintain a capital fund according to ratio prescribed by NRB, based on its total risk weighted assets. The license holder entity must contribute a fixed percentage of its profit to general reserve every year until the amount is twice the paid up capital of the entity.

Establishment and Classification: For the establishment of any bank or financial institution in Nepal, each bank should get a license from Nepal Rastra Bank (NRB). For this purpose the NRB has classified the institutions into "A" "B" "C" "D" groups on the basis of the minimum paid-up capital (Table 3.6).

Table 3.6
Minimum Capital Requirement (Rs million)

Category	Minimum Capital Requirement	
	National level	Regional level
A	1000	320
B	320	-
C	150 (for institutions conducting leasing and finance activities) 100 (for the institutions not conducting leasing and finance activities)	-
D	100	10

Source: Licensing Policy for Commercial Banks, 2006, Nepal Rastra Bank

To establish a new commercial bank at national level, the paid up capital of such bank must be at least Rs. 1000 million. Those banks that are in operation or those who have obtained letter of intent before the enforcement of these provisions have to bring up their capital level to Rs 1 billion by 16 July 2009. In order to increase the capital level, profit must be at least 10 percent of the paid up capital.

Rules on Ownership: At least 51 per cent ownership has to be occupied by the promoters for establishing any bank and financial institution. Likewise, a 30 per cent share of total paid up capital has to be allocated to the general public.

Rules on Location: For operating banking all over the country, the paid up capital must be Rs. 1 billion. To operate a bank outside Kathmandu Valley, the paid up capital must be Rs. 320 million.
Legal Provisions for the Establishment of Joint Venture Bank: For establishing a Joint Venture Bank, share capital of the foreign partner bank should be at least 20 per cent. The upper limit has now been raised to 75 per cent of the total paid up capital. In addition, if the ratio of paid up capital of foreign partner is less than 50 per cent, at least 30 per cent shares have to be issued to the general public.

Provisions for Establishing Foreign Bank's Subsidiaries and Branches: A foreign bank or financial institution desiring to open its office within Nepal has to receive permission from the NRB. The NRB may specify necessary terms and conditions while granting transaction license. However, a joint venture bank cannot open another bank or financial institution on a joint venture basis. Additional contacts or representative office may be established with the permission of the Nepal Rastra Bank.

Branching: A new commercial bank with a head office in Kathmandu may initially open a branch in the Valley. Only after some interval is it permitted to open other branches in the Valley and outside. For existing commercial banks, they can open branches anywhere in the country after getting approval from the NRB.

Scope of Business: In order to promote the trust of the public in the overall banking and financial system, protect and promote the rights and interests of depositors and provide quality banking and financial intermediary services through healthy competition, the Bank and Financial Act 2006 has been brought into effect. It aims to promote healthy business and strengthen prudential regulation.

Rules on Employment: There are no specific rules and regulations for domestic banks on employment. Normally, commercial banks prepare their staff by-law covering issues related to personnel management. In case of Joint Venture Banks, they have to make separate Technical Service Agreement on number and responsibilities of expatriates.

Prudential Regulation: The main responsibility of the NRB is to strengthen prudential regulation in the banking system. As a supervisor, the NRB reviews and inspects functioning of financial institutions through, among others, on-site inspections, off-site inspections and special inspections. NRB recently has issued a set of sixteen unified directives for all bank and financial institutions for ensuring corporate governance, consolidating financial situation, improving the people's confidence and enhancing stability of the financial system. The directives related to prudential regulation include: (i) Maintenance of capital adequacy, (ii) Loan classification & loan loss provisioning, (iii) Limit of credit exposure and facilities to 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) Corporate governance, (vii) Time-frame for implementation of regulatory directives issued in connection with inspection & supervision of the banks, (viii) Investment in shares & securities, (ix) Statistical reporting by commercial banks to NRB and (x) Sale and transfer of promoters share (xi) Provision related with Consortium financing (xii) Provision for blacklisting (xiii) Maintenance of Cash reserve ratio (xiv) Provisions for bank branches (xv) Provisions relating interest rate and (xvi) Provisions related with financial resource collection.

3.3 Policy Reforms in Insurance

Nepal is now engaged in amending laws, rules and regulations related to the insurance sector. Free entry to the foreign insurance services providers has required amendments to existing rules for creating a more competitive environment in the domestic market. Changes in the existing rules are also needed to fulfill WTO obligations. Some of the major reforms carried out in various interrelated areas include the following.

Classification Systems: The Insurance Act, 1992 and Insurance Regulation, 1993 govern the insurance business in Nepal. They guarantee equal treatment to national as well as foreign insurance companies.

Establishment: The Insurance Act, 1992 and Insurance Regulation, 1993 provide guidelines for establishing insurance companies in Nepal. The main provisions of the Act and Regulations are:

- No one shall engage in or make arrangement for engaging in insurance business without obtaining a license under the Act,
- No individual or institutions within Nepal shall conduct transaction relating to insurance business with any individual or institutions other than the insurer who have obtained registration certificate under the Act,
- Any national or foreign corporate body desirous to operate Insurance business shall submit an application to the office of the Insurance Board in the prescribed form along with the documents like Memorandum and Articles of association of the corporate body, policies and terms and conditions of the insurance business to be operated, documents displaying calculations of premium in case of life insurance business, documents regarding the methods of utilizing the fund etc., and
- The total liability to be assumed should not be in excess of total assets.

The Act does not restrict the pattern of ownership, location of business inside the country and the legal forms (e.g. subsidiaries vs branches vs joint venture). In case of foreign joint venture, 20 per cent of the share has to be issued to the general public. However, the insurer is not allowed to operate life insurance and non-life insurance business side by side through the same organization. The paid up capital should be at least Rs. 250 million for the life insurance business and Rs. 100 million for the non-life insurance business. There is provision in the Insurance Act, 1992 that the Insurance Board may cancel the registration of an insurance company if the head office of the insurance business of any foreign insurer is situated out side Nepal, and in case it is felt that Nepalese insurer has not obtained equal facilities while operating in the foreign countries as enjoyed by the foreign insurer pursuant to the prevailing law of such a country. The foreign corporate body also has to show evidence that it has adequate assets inside Nepal so as to bear the total liability of his/her insurance business in Nepal.

Operations: The insurer may operate life insurance business under (a) whole life insurance (b) endowment life insurance and (c) term life insurance. Under the non-life insurance business, the insurer may operate (a) fire insurance, (b) motor insurance, (c) marine insurance, (d) engineering and contractors risk insurance, (e) aviation insurance and (f) miscellaneous insurance. The insurer may re-insure the risks which are in excess from the risks assumed by it. There is no specific rule on board membership of insurers regarding the experience and qualification. There is no special law other than the Insurance Act, 1992 and Insurance Regulation 1993 regarding the insurance business in Nepal. The foreign investor making an investment in foreign currency shall be entitled to repatriate share of equity, profit or dividend, and also principal and interest on foreign loan.

Prudential Regulation: Prior to the enactment of Insurance Act 1968, insurance business in Nepal was regulated by the commercial Act and hence there was no system of supervision over insurance companies. Only in 1968 Beema Sammiti (Insurance Board) was established under Insurance Act 1968. In the Insurance Act 1992 and Insurance Regulation 1993 there are number of specific provisions related to prudential regulations. Some of the important provisions include:

- The insurer should maintain separate insurance fund for each category of insurance business and should not utilize it to bear the liabilities relating to other categories of insurance business.
- Every Insurer should maintain a reserve fund which must contain:
  - In case of life insurance business an amount not less than total liability as specified by the actuary on the basis of the insurance policies issued by the insurer within Nepal,

    - An amount not less than 50 per cent of the net non-life insurance premiums,
    - 50 per cent of the profits earned, until the amount equals the insurers paid up capital, and
    - An amount equal to 115 per cent of outstanding claims set for the expiry of each financial year
- The Insurance Board has also set investment norms. The insurance companies are required to invest at least 75 per cent of their total investment in government securities, treasury bills and banks' fixed time deposits. The remaining 25 per cent can be invested in housing schemes, finance companies, and debenture schemes of public limited companies apart from deposits in the commercial banks.
- An insurer may only assume the risk once the premium has been paid by the policy holder.
- Onsite and offsite inspection of companies has to be made by the Insurance Board.
- The insurer shall have to reinsure the risk exceeding their limit in the manner specified by the board.
- Valuation has to be made by an actuary.
- Loan, guarantee and security should not to be provided to the directors.

3.4 Exchange Rate Policy

Prior to the mid 1980s an overvalued fixed exchange rate policy was pursued. This was a part of the inward looking import substitution industrial policy. The aim of such a deliberate policy was to make imports cheaper compared to exports. With severe foreign exchange crisis from the beginning of 1980s, a major devaluation of the Nepalese currency was made in 1985. Exchange rate was further devalued in the early 1990s along with the liberalization drive. The liberalization of the exchange rate gained momentum after India introduced partial convertibility of the current account in 1993. As Nepal could not afford to keep her foreign exchange regime different from that of India due to structural reasons, partial convertibility was introduced immediately after India. In the same year Nepal accepted the Article VIII of the IMF and fully liberalized the current account. Today Nepal's exchange rate with hard currencies is market determined. However, exchange rate with India is still fixed. Nepal is, thus, following two sets of policies regarding the exchange rate - one for the Indian currency and another for the convertible currencies. The major concern of such a dual exchange rate policy is that it becomes extremely difficult to maintain autonomy in the conduct of monetary policy. As an offshoot, the fixed exchange rate regime undermines the prices and balance of payment goals of monetary policy. Although flexible exchange rate system with India may encourage speculation and thereby capital flight in the short run, the misalignment of prices are eroding competitiveness of the Nepalese trade and industry (Khanal and Kanel, 2005). Thus the dual exchange rate system is not compatible with the ongoing reforms in the economy in general, and the financial sector in particular.

IV: Commitments under GATS, SAFTA and BIMSTECS

4.1 Commitments under GATS on Trade in Services

4.1.1 General Commitments

Under WTO, the General Agreement on Trade in Services (GATS) provides a framework within which liberalization commitments in the area of services, including financial services, are to be undertaken and implemented. Part I (Article I) of the Agreement defines the scope and coverage of the GATS. The agreement applies to measures by WTO members, which affects trade in services. Article I sets out a comprehensive definition of trade in services in terms of four different modes of supply: cross-border (i.e., tele-banking), consumption abroad, commercial presence (i.e., a bank or insurance company established with foreign equity in Nepal), and presence of natural persons (i.e., a foreigner works in a financial institution in Nepal). Part II sets out "general obligations and disciplines". These are basic rules which apply to all members and, for the most part, to all services.

Nepal made a number of commitments to liberalize its services sector, including a commitment that supply of services from an existing foreign supplier will not be made more restrictive than they exist at the time of Nepal's accession to WTO. No limitation has been placed in respect to consumption abroad. However, there is a limit of foreign exchange of up to US dollar 2000 for a Nepalese citizen going abroad. Movements of natural person are restricted, except in the categories of sales persons, persons responsible for setting up a commercial presence, and intra-corporate transferees.

In respect to commercial presence, no limitation on national treatment has been placed on foreign investments and reinvestments. But two preconditions have been imposed. The first is that both of these will require approval by the Department of Industry. The second is that any incentives and subsidies provided willl be available wholly to Nepalese owned enterprises. In respect to the presence of natural person, it has been made unbound or restrictive except as specified in the natural person category for market access. The schedule also restricts foreigners from dealing in real estate in Nepal. The present civil code prohibits selling, mortgaging, gifting or endowing or disposing real estate to foreigners. Nonetheless, Nepal is committed to make decisions on the application for investment in Nepal within 30 days, except in the case of project requiring environmental impact assessment (EIA). In this context, it has been clarified that normally such investments will not be withheld except in case of failure to meet environmental standards. This is a wide-ranging commitmen,t and reflects Nepal's commitment to open up Nepalese economy for foreign investment. In case of repatriation of investment in foreign currency, the following facilities have been committed:

- Amount received by the sale, in whole or part, of the investors' share of equity.
- Amount received as profit or dividend as a result of an equity investment,
- Amount received as the payment of the principal of and interest on any foreign loan,
- Amount received under an agreement to transfer technology approved by the DOI or Department of Cottage and Small Industries.

Since these commitments/conditions will apply to all cases, these have been categorized as general commitments.

4.1.2 Specific Commitments in Banking and Finance

Nepal has accepted general conditions in accordance with the GATS and its Annex on financial services. All the commitments are subject to entry requirements, domestic laws, rules and regulations and the terms and conditions of the Nepal Rastra Bank and any other competent authority in Nepal, as the case may be, which are consistent with Article VI of the GATS and paragraph 2 of the Annex on financial services. Financial services in the form of operations identified in the schedule can be carried out in Nepal only through a locally incorporated company. Branches will be allowed for wholesale banking as of 1 January 2010. Only a licensed commercial bank, a licensed specialized bank or a registered finance company may accept deposits, which are repayable upon demand. Only financial institutions with rating of at least 'B' by Credit Rating Agency e.g. MOODI (Standard and Poor) ca n have acommercial presence in Nepal. The total foreign shareholding in any institution providing financial service is limited to 67 percent of the issued share capital. The share held by foreign nationals and foreign financial institutions in their locally incorporated companies are not transferable without the prior written approval of the Nepal Rastra Bank or any other competent authority as the case may be. Representative office may not be engaged in a commercial business. The members of the Board of Directors of a financial services supplier will be in proportion to equity representation of that financial services supplier.

The specified banking and financial services have been restricted for market access purpose except for (k) and (l) (Table 4.1). Commercial presence has been opened up for market access except as indicated in general conditions. For derivative products under sub sector (f) and settlement of and clearing services for financial assets, including securities, derivatives products and other negotiable instruments under (j) have been restricted until Nepal government determines what types of entities can conduct these services, the related laws and regulations are established and such business is authorized by the government or other designated authority. In the issue of national treatment, all three modes of supply, cross-border supply, consumption abroad and commercial presence, no restrictions have been placed except as specified in general conditions and horizontal section. In respect to presence of natural persons, it has been restricted both for market access and national treatment purposes.

Table 4.1
GATs Commitment in Banking and Finance

2. **Banking and Other Financial Services**			
(a) Acceptance of deposits and other repayable funds from the public	(I) Unbound, except for (k) provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services and (l) advisory services on all the activities listed above were none (II) Unbound, except for (k) provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services and (l) advisory services on all the activities listed above were none (III) None, except as indicated in general conditions. For derivative products under sub-sector 'f' and settlement of and clearing services for financial assets, including securities, derivative products, and other negotiable instruments under 'j' unbound until HMG/Nepal determines what types of entities can conduct these services, the related laws and regulations are established and such business is authorised by the government or other designated authority.	(1) None a) None (3) None, except as specified in the general conditions and horizontal section	

(b) Lending of all types, including, inter-alia, consumer credit, mortgage credit, factoring and financing of commercial transactions. (c) Financial leasing (d) All payment and money transmission services (e) Guarantees and commitments (f) Trading for own account or for account of customers, whether on an exchange, an over-the-counter market or otherwise, the following: - money-market instruments (cheques, bills, certificates of deposits, etc.) - foreign exchange - derivative products including, but not limited to, futures and options - exchange rate and interest rate instruments, other than swap. - transferable securities - other negotiable instruments and financial assets, including bullion. (g) Participation in issues of all kinds of securities, including under-writing and placement as agent (whether publicly or privately) and provision of service – related to such issues. (h) Money broking	(4) Unbound, except as specified in the horizontal section.	(4) Unbound, except as indicated in horizontal section.	

(i) Asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial depository and trust services. (j) Settlement of and clearing services for financial assets, including securities, derivative products, and other negotiable instruments (k) Provision and transfer of financial information, and financial data processing and related software by providers of other financial services. (l) Advisory services on all the activities listed above			

4.1.3 Specific Commitments in Insurance

Table 4.2 summarizes Nepal's commitments on insurance services. It is clear from the table that there is no restriction on market access in mode 2 and 3 except for free re-insurance and retrocession. Mode 1 and 2, however, intend that mandatory reinsurance up to USD 25000 must be placed with domestic insurance company until 31, December 2007. Mode 3 is unbound until 31 December 2007 and mode 4 supply is fully unbound. With respect to the limitations on national treatment, Nepal has committed to none for mode 1, 2 and 3. For mode 4, it is unbound. Thus, Nepal has made no restrictions on cross–border (Mode 1) and consumption abroad (Mode 2) modes of supply in life and non life insurance services.

Table 4.2
Commitments under WTO in Insurance and Insurance Related Services

Sector or Sub-sector	Limitations of Market Access	Limitations on National Treatment	Additional Commitments
Direct Insurance			
Life	- None - None - None, except as indicated in general conditions. - Unbound, except as indicated in the horizontal section	- None - None - None, except as indicated in general conditions. - Unbound, except as indicated in the horizontal section	
Non-life	- None - None - None, except as indicated in general conditions. - Unbound, except as indicated in the horizontal section	- None - None - None, except as indicated in general conditions horizontal section. - Unbound, except as indicated in the horizontal section	
Re-insurance and retrocession	(1) and (2) None except, mandatory reinsurance up to USD 25,000 must be placed with domestic insurance	(1) None (2) None (3) None (4) Unbound, except as indicated in the horizontal section	

	company until 31 December 2007. (3) Unbound until 31 December 2007, thereafter none, except as indicated in the general conditions. (4) Unbound, except as indicated in the horizontal section		
Service-Auxiliary Insurance Insurance broking and agency services (CPC 8140)	- None - None - None, except as indicated in general conditions. - Unbound, except as indicated in the horizontal section	- None - None - None - Unbound, except as indicated in the horizontal section	

Source: Nepal Specific Commitment in Services, WTO.

4.2 Regional Commitments

4.2.1 SAFTA

In a major effort to promote regional trade, leaders of the SAARC member countries finalized the agreement on free trade area (SAFTA) at Islamabad SAARC Summit in 2004. Its objectives as stated in the preamble of the agreement are, "to strengthen intra-SAARC economic cooperation to maximize the realization of the region's potential for trade and development for the benefit of their people, in a spirit of mutual accommodation, with full respect for the principles of sovereign equality, independence and territorial integrity of all states." The SAFTA Committee of Experts (COE), set up to resolve outstanding issues, has carried out strenuous negotiations and held 12 meetings to reach the final decision. The 12th meeting of the COE that ended in Kathmandu on 2 December 2005 took the final decision and cleared the way for enactment of SAFTA accord by January 1, 2006.

The SAFTA among others covers tariff rules of origin, safeguards, institutional structures, and dispute settlement issues. It also calls for the necessity of adopting various trade facilitation measures such as harmonization of standards and mutual recognition of test results, harmonization of customs procedures, and cooperation in improving transport infrastructure.

Services, including financial services are not yet the subject matter of SAFTA. However, realizing the importance of services trade, SAARC member countries have recently made a decision to include services within the South Asian Free Trade Agreement (SAFTA) framework. The Ministerial Council Meeting of SAFTA, held in Dhaka in April 2006, has assigned the Committee of Experts (CoE) to explore the possibilities. In a bid to expedite that process, the Ministerial Council has also constituted a study group to look into the possibility of including trade in services within the SAFTA framework.

4.2.2 BIMSTEC

The idea of regional co-operation was first mooted by Bangladesh, India, Sri Lanka and Thailand at a meeting in Bangkok in June 1997. At the Ministerial meeting in February 2004, Nepal also became its new member. This inter-regional grouping is supposed to serve as a bridge between the five SAARC countries (India, Bangladesh, Sri Lanka, Nepal and Bhutan) and two ASEAN countries (Myanmar and Thailand). At the first Ministerial Meeting of the BIMSTEC held in Bangkok on 7 August 1998, it was decided that BIMST-EC would initially begin co-operation in six areas viz. trade and investment, technology, transportation and communication, energy, tourism, and fisheries. Realizing the areas specified very broad, from the standpoint of enhancing efficiency and fulfilling the objectives laid-down in the BIMSTEC, the six sectors have been further divided into various sub-sectors. The financial services are not yet the part of this regional agreement. Nepal's financial services liberalization therefore, will be least affected by the BIMSTEC in the immediate future.

4.3 Actual Implementation Status of WTO Commitments

The commitments under GATS are predominantly related to market access and national treatment in specifically designated sectors. To identify the required changes in rules and policies and to make them compatible with the WTO commitments, Nepal Rastra Bank had established a High Level Committee (HLC) on May 12, 2003 (NRB, 2006). The HLC commissioned a study on foreign bank branches in Nepal. Similarly, Multilateral Trade Integration and Human Development in Nepal, a project jointly initiated by the government of Nepal and United Nations Development Programme, had also commissioned a study to find out the gaps in services sector regulations/rules. Some of the suggestions have already been incorporated in the new Banks and Financial Institutions Act 2006.

Interestingly, Nepal has liberalized banking and insurance sectors beyond the commitments made in the WTO. At present, foreign investors are allowed to invest up to 75 per cent of total equity, in all types of financial institutions, which is more than the commitments of Nepal (67 per cent) at WTO. Similarly, Nepal Rastra Bank has prepared a report outlining the framework to allow foreign banks to open and operate their branches in Nepal, as per the commitments at WTO. In recent monetary policy (NRB 2006), the Central Bank has indicated that it will allow foreign bank branches (wholesale banking) to operate in Nepal by 2010. For this, a process of developing required infrastructure has been initiated by the Nepal Rastra Bank. In order to enhance the competitiveness of the banks, the Central Bank has also fixed a schedule of raising the amount of paid up capital by these banks. The insurance sector has also been liberalized beyond the limits set in the WTO commitments. Apart from allowing branches foreign insurance companies, 100 per cent equity participation is now been allowed.

V: Performance of Banking and Insurance Sectors

In this chapter the performance of the banking sector over the pre and post liberalization periods is examined by reference to key indicators like net profit, ratio of non-performing loans to total loans and interest rate spreads. Competition and efficiency issues are assessed by calculating various performance indices as suggested by Beck and Heiko (2006) and Bayraktar and Wang (2006). The role and importance of banks in augmenting growth, expanding credit and generating employment are also examined using regression and trend analysis of time series data. Insurance sector performance has been assessed separately by examining the pattern of insurance premiums and lending.

5.1 Performance and Efficiency of the Commercial Banks

5.1.1 Net Profit, NPA and Interest Spreads

Table 5.1 shows net profit, the ratio of NPA to total loans, and the interest spread of government owned, private domestic owned and joint venture banks for the years 1990, 1995, 2000 and 2005. By examining the profitability of the three types of banks, it is found that, except in the case of one bank, the profitability of the joint venture banks has substantially increased over time. A similar pattern is observed in the domestic private sector banks. However, in the case of government owned banks non-performing loans in the total loan portfolio (reaching above 60 percent in both banks in 2003), caused a major losses. It was only after contracting out of these banks as a part of overall financial sector reform, could these banks make a net profit. Financial sector liberalization has been associated with continuous reduction in interest rate spreads for all banks and positive net profits. Thus, the Nepalese experience indicates that increased competition backed by institutional and structural reforms are keys to improving performance of the banking system. It is also clear from the Nepalese experience that even in a liberalized environment only severe crises or shocks compel broad based reforms in government banks. Additional indices related to competition and efficiency corroborates this.

Table 5.1
Net Profit, NPA and Interest Spreads of Commercial Banks by Ownership Type

	Net Profit (Rs in million)				NPA/Total Loan (per cent)				Interest Spread (per cent)			
	1990	**1995**	**2000**	**2005**	**1990**	**1995**	**2000**	**2005**	**1990**	**1995**	**2000**	**2005**
Government Owned Banks												
NBL	9.1	78.5	- 2697.80	1730.13	0.88	2.0	48.20	49.64	9.49	6.87	6.1	4.38
RBB	- 37.7	25.4	-1791.5	1322.89	12.2	7.6	38.29	52.99	10.71	5.45	4.2	4.67
Private Domestic Banks												
NIB	53.5	61.4	72.6	232.1	2.09	1.7	8.79	2.69	13.18	9.2	4.78	3.74
BOK		-7.9	70.7	139.53		0	3.3	4.99		1.6	5.7	4.21
NCCB			5.6	-5.16			7.2	8.64			6.85	3.69
LUMB			0.3	-196.77			1.6	15.23			4.6	4.31
NICB			24.2	113.76			1.14	3.78			5.08	3.68
MB				84.87				0.39				3.56
KB				87.88				0.95				3.68
LAXB				26.46				1.63				2.97
SB				70.28				2.58				3.32
Joint Venture Banks												
NABIL	28.2	164.4	329.1	518.64	1.79	0.5	6.3	1.32	9.11	8.2	7	5.36
SCB	37.9	151.1	392.6	539.2	-	1.2	3.71	2.69	5.84	8.9	7.46	4.53
HB		69	199.38	325.22		1.9	1.49	7.44		9.4	7.12	3.53
SBI		7.3	50	57.38		1.5	1.4	6.54		5.9	4.5	3.36
NBB		-5	139.53	-749.54		1.01	1.44	19.04		3.78	6.78	2.76
EB		-3.9	41.3	170.8		0.1	2.99	1.63		11	4.16	4.29

Source: Annual Reports of Banks

5.1.2 Interest Margin, Overhead to Total Assets and Profit before Tax

Net interest margin, profits before tax, and overhead costs have been calculated for three types of banks with different ownership structures. For comparisons purposes, the estimates are made for the years 1990, 1995, 2000 and 2005 (Table 5.2). It is generally expected that as these variables drop, the efficiency of banks increases, indicating a higher level of competition. The net interest margin is defined as the ratio of net interest income to total assets. The net interest margin to total earning assets has also been calculated for comparison of the two ratios more specifically. The interest margin showing the difference between earnings from interest and expenses on interest is an important indicator of competitiveness, since as a banking sector gets more competitive, the lending rate is expected to drop, but the deposit rate is expected to increase. The share of pre=tax profits in total assets is another efficiency indicator. In closed and imperfectly competitive banking sectors, the profit rate has to be higher. In such sectors, banks pay low interest rates for funds, and also charge higher interest rates on loans. They also require high service fees. At the practical level, this is not the case in state run banks where overhead costs due to number of reasons remain high. For this reason, the ratio of overhead costs to total assets is separately reported.

Table 5.2
Net Interest Margin, Overhead to Total Assets and Profit before Tax to Total Assets in the Banking System
(per cent)

Net Interest Margin to Total Assets	**1990**	**1995**	**2000**	**2005**
Government Owned Banks	1.06	2.07	1.00	2.50
Private Owned Domestic Banks	7.04	5.27	2.80	3.32
Joint Venture Banks	2.27	3.72	3.28	3.65
Interest Margin to Total Earning Assets				
Government Owned Banks	1.70	3.58	1.86	5.26
Private Owned Domestic Banks	9.46	8.00	3.49	3.84
Joint Venture Banks	3.76	4.77	3.79	4.09
Overhead to Total Assets Ratio				
Government Owned Banks	2.29	1.82	2.67	3.17
Private Owned Domestic Banks	4.76	3.26	1.83	1.76
Joint Venture Banks	2.80	2.37	1.67	2.07
Profit Before Tax to Total Assets				
Government Owned Bank	-0.13	0.27	-6.74	2.94
Private Owned Bank	7.06	3.57	1.68	1. 60
Joint Venture Commercial Bank	3.32	3.23	2.72	2.76

Source: Annual Report of Various Banks

In the case of government owned banks the margins steadily increased from the low margin in 1990 to reach about 2.1 percent in 1995. After this, the margin reduced considerably up to 2000. With the beginning of reforms in 2002, it again started increasing to reach 2.5 percent in 2005. On the other hand, a sharp fall in the interest margin to total assets is found in private domestic banks. The trend is almost stable in the joint venture banks. The ratio is relatively low through out the period under consideration. When interest margin to total earning assets is analyzed, a slightly a different but expected trend is observed. With the beginning of reforms, interest margin to total earnings increased considerably in the government owned banks. The difference between the two ratios indicates that total assets of these banks still posses high share of non-earning assets. With the increased competition, such a ratio in the private domestic banks fell considerably over time. A

stable trend is observed in the joint venture banks. One interesting phenomenon is that there is a small gap in the two ratios in the private banks indicating efficiency enhancement in these banks. This is further corroborated by the overhead to total assets ratios in the three types of banks under consideration. No reduction in the overhead cost is found in the government banks. However, cost effectiveness is noteworthy in the private domestic banks. In the government owned banks profit before tax has now become positive after very high losses in 2000. In the private banks, the profit before tax to total assets has steadily decreased. Thus, our trend analysis supports the view that bank-specific characteristics play a big role in the performance of the banks. Overall, our findings suggest that both structural impediments and market structures are critically important in driving bank efficiency. In other words, Nepalese experience indicates that government control and regulation is antithetical to improving the performance and enhancing efficiency in the banking system. One implication is that liberalization without simultaneous emphasis on changes in ownership and market structure will be less helpful in improving performance of the overall banking system. The inability of state owned banks to restructure and diversify lending portfolios in the competitive market prevents them] covering the marginal cost of funds plus the intermediation costs. Compulsion to make higher loan loss provisions for non-performing loans with limited earning assets remaining in the portfolio leads to crisis in the state owned banks.

5.2 Financial Deepening and Economic Growth: A Regression Analysis

5.2.1 Estimation Procedures and Time Series Properties of the Variables

There is growing evidence that macroeconomic time series variables are generally non-stationary in nature. As a consequence, the ordinary least squares (OLS) regressions using these data may produce spurious results. In other words, non-stationary time series could produce highly significant nonsense correlation between variables. In order to avoid such problems the integrating properties of the variables should be examined by testing for the existence of unit roots in variables under consideration.

Unit root tests are used to check for non-stationary characteristics in a series. There are several ways of testing for the presence of a unit root. Three most popular tests are Dickey-Fuller (DF), the Augmented Dickey-Fuller (ADF) and the newly formulated Phillips-Perron (PP) tests. Since it is widely believed that both DF and ADF tests do not consider the cases of heteroscedasticity and non-normality frequently revealed in raw data of economic time series variables, the PP test for unit root has been used in the empirical analysis. Moreover, it has an advantage over the ADF test when the concerned time series has serial correlation and there is a structural break. Consequently, the PP test provides robust estimates over the DF and ADF tests and is based on the following form of equation:

$$\Delta Z_t = \varnothing + (\rho-1)Z_{t-1} + \gamma(t-T/2) + \Psi\Delta Z_{t-i} + \varepsilon_{3t}$$

The appropriate critical values of the t-statistic for the null hypothesis of non-stationairty are given by MacKinnon (1991).

The estimation process begins with the testing of variables for unit root to determine whether these can be considered as stationary or non-stationary processes. The results of PP tests on both level form and first difference (with trend) are reported below. The results indicate that the variables considered for the model estimation do not possess serious non-stationarity problem (Annex 1).

5.2.2 Estimated Model and Model Results

For examining the linkage between financial deepening and economic growth, attempts were made to test a neoclassical growth type model. The model was specified and estimated by relating the growth rate of real GDP to financial depth indicator (private sector credit to GDP ratio), investment to GDP ratio, growth rate of population, initial real per capita GDP to capture the level of development, financial sector performance index and total trade to GDP ratio. However, investment to GDP ratio, population growth rate, financial sector performance index[5] and openness variables were found insignificant and dropped. To capture the openness and extent of liberalization, a liberalization dummy[6] was included in the model. Thus, the estimated equation in the log form is as follows:

LOG ((GGDP)) = 89.91108836 + 1.549032249*LOG ((PSC/GDP)) + 0.4146176768*LD
(4.31) (3.55) (1.58)
- 11.30535863*LOG ((PCI (-1)))
- (4.25)

Where,
GGDP=Growth rate of GDP
PSC/GDP = Private Sector Credit to GDP Ratio
LD= Liberalization Dummy (0 before 1991 and 1 for 1991 and onward)
PCI= Per Capita Income

R^2=.58; Adjusted R^2=.51; DW=2.08; F-statistic=8.72

The t-statistics are given in parentheses. The model has a good fit with relatively better explanatory power. DW is at the neighborhood of 2. All the variables except liberalization dummy are highly significant. The liberalization dummy is significant at 13 percent level of significance.

The estimated model provides interesting results in many respects. Our results show a strong link between financial development and economic growth in the Nepalese context. As the results indicate, one percent increase in private sector credit would lead to about 1.5 percent growth in GDP. Similarly, liberalization dummy exerts influence on the growth to some extent. The coefficient on the log of initial income is negative and highly significant suggesting that conditional convergence holds, corroborating the large body of literature[7]. The results also suggest that credit to the private sector is the better measurement of financial development or financial intermediation. Despite financial crisis in the state owned banks due to predominance of non-performing loans, big expansion in banking institutions and their lending portfolios contributed to enhance growth in Nepal.

[5] In view of predominance of two state banks in the assets and other portfolios of the commercial banks during the period under consideration, the index was found to be insignificant. At the same time, the private sector credit variable might have swamped the effect if any.
[6] The equations were estimated without this variable also. But only with the liberalization dummy variable model had good fitness. It partly represents the effect of liberalization as 1 is used for the liberalization period and zero for the period before intensive liberalization. Thus, this partly reflects the effect of shift as well.
[7] Conditional convergence implies that countries that are far from steady equilibrium (which is the case fro developing countries) tend to grow faster than countries that are closer to their steady states (developed countries) See for example Mankiw, Romer and Weil (1992) for a test of the convergence hypothesis and also see Senhadji and Khan (2002).

5.3 Lending Pattern of Commercial Banks and Access to Credit

Due to non-comparability of series, lending status of the commercial banks for the year 1990, 1995 and 2000 and 2003, 2004 and 2005 is separately given (Table 5.3 and 5.4). The level of commercial bank credit shows that there has been phenomenal expansion in credit. In 1990 the level was Rs 11.8 billion. The level reached Rs. 164 billion in 2005 and thus during the fifteen years period there was an almost 14 fold increase in credit. The lending pattern shows that the largest beneficiary of credit expansion has been the industrial sector. Of total commercial bank credit in 1990, the share of the industrial sector was 32.3 percent. Its share went up to 49.2 percent in 2000. The second highest beneficiary of the credit expansion has been the commercial sector. The share of the commercial sector rose to 32 percent from 28.5 percent during the same period. The new classification also shows that after 2000, the major beneficiaries have been production and wholesale and retail trading sectors. Conversely, the major losers have been agriculture and social sectors. The new classification based credit pattern shows even more downward credit flow to the agriculture sector. The lending pattern corroborates the view that the private domestic and joint venture banks concentrate more on lucrative business in urban areas. A mutually inclusive pattern between the commercial bank lending and growth is revealed by the relevant data. As reported in the chapter two, in the liberalized regime, the non-agriculture sector, mainly services, has been the major contributory to the changed economic structure in Nepal.

Table 5.3
Lending Portfolio of the Commercial Banks (1990, 1995 and 2000)
(Rs million)

Year	Agric	Share per cent	Industry	Share per cent	Commerce	Share Per cent	General use/social purpose	Share per cent	service sector	Share Per cent	Total
1990	1531.6	12.9	3817.6	32.3	3371.7	28.5	2785.3	23.6	292.5	2.4	11798.7
1995	4923.8	12.1	15877.6	39.1	13305.7	32.7	4785.5	11.7	1697.7	4.1	40590.3
2000	8863.7	8.9	44885.3	45.1	32753.3	32.9	7237.9	7.2	5713.6	5.7	99453.8

Source: Economic Survey (Various Years), Ministry of Finance.

Table 5.4
Lending Portfolio of the Commercial Banks* (2003. 2004 and 2005)

Year/sector	2003	Share	2004	Share	2005	Share
Agriculture	3734.5	3.1	4901.9	3.6	4415.5	2.7
Mines	399.4	0.3	336.6	0.2	5203	3.2
Production	42910.5	35.5	47181.5	34.4	53744.2	32.8
Construction	2729.2	2.3	4986.7	3.6	8723	5.3
Metal, productions, machinery and electrical tools and fittings	1430.1	1.2	1450.7	1.1	1797.5	1.1
Transportation, equipment, production and fittings	1359.8	1.1	2776.7	2.0	3156.3	1.9
Communication and public services	6523.4	5.4	7963.6	5.8	8997.2	5.5
Wholesalers and retailers	27555.3	22.8	31728.9	23.1	34412.7	21.0
Finance, insurance and fixed assets	4250.3	3.5	4857	3.5	6391	3.9
Service industries	12212.5	10.1	14216.9	10.4	14984.8	9.1
Consumable	3364.6	2.8	4400	3.2	3588	2.2
Local government	1.5	0.0	2.3	0.0	0.1	0.0
Others	14283.5	11.8	12278.1	9.0	18592.6	11.3
Total	120754.6	100.0	137080.9	100.0	164005.9	100.0

Source: Economic Survey (Various Years), Ministry of Finance.
* From 2002/03 new classification has been adopted and hence it is not comparable with previous years.

Realizing that access to credit or financial services among the rural farmers or small borrowers has been increasingly becoming a major problem, priority to establish and operate wholesale banking and micro credit institutions has been given by the Central Bank in recent years. Apart from rural development banks, the Agricultural Development Bank is engaged in providing loans to small and marginal farmers. Despite these efforts, access to credit in the rural areas remains a major problem. After more than a three fold increase in per capita credit of the commercial banks in less than a decade, access of credit to the lower income strata and poor people has not improved commensurately. Living standard surveys of 1995/96 and 2003/04 show that borrowing households (from both the formal and informal financial system) have increased from 61 percent in 1996 to 69 percent in 2004. Of the borrowing households, only 15 per cent borrowed from the banking system in 2004 compared with 16 per cent in 1996 (Table 5.5). This implies that the proportion of households with access to bank credit has risen only marginally from less than 10 per cent in 1996 to just 10.4 percent in 2004. Money lenders and relatives account for more than 80 percent of the borrowing. The poor have to resort to such sources. Only 8.3 per cent of the poorest consumption quintile had access to bank credit in 2004, almost the same as in 1996.

The collateral based lending practice of the banks has been a factor denying access of the poor in bank credit. Although free of collateral based lending has increased considerably overtime from 12 percent in 1996 to 28 percent in 2004, it is yet to encompass most poor and vulnerable group of the society. Besides, the lower the consumption group of households, the higher has been the proportion of borrowing for consumption. In 2004, 58 percent of the borrowing of the poorest consumption quintile went on consumption. This means that these households have to meet their basic consumption needs by incurring debt (CBS, 1996 and 2004). The expansion in consumption through increased indebtedness, however, does not contribute to sustained well-being. Thus, Nepal's experience indicates that there are some serious structural problems persisting in the banking system. From the perspective of agrarian transformation, poverty reduction, and more equitable development, development of a rural - focused banking system as well as specialist credit institutions catering to small businesses would be desirable.

Table 5.5
Household Borrowing and Access to Bank Credit
(per cent)

Year	1995/96	2003/04
Household borrowings	61.3	68.8
Borrowings from banks	16.1	15.1
Borrowings from relatives	40.8	54.5
Borrowings from money lenders	39.7	26
Poorest quintile having access to bank borrowing	8.2	8.3
Richest quintile having access to bank borrowing	21.8	26.8

Source: NLSS I and NLSS II, CBS, 1997 and 2004.

5.4 Employment Pattern in the Commercial Banks

As shown in the table 5.6, a large variation in the employment of three different types of commercial banks is observed. When liberalization was started, two state owned commercial banks were the major employers. In 1990 about fifteen thousand people were employed by these banks. At that time, the banks used to hire a large number of people on an ad-hoc basis on the direction of the Government. The rising overhead cost and huge losses by the banks was a result of this situation.

But with the widening losses, these banks were compelled to streamline their employment policy. Following the contracting out of the banks, a the number of employees was reduced. This resulted into sharp reduction in the level of employment in the banking system. In 2005, the employment number in these two banks fell to six thousand from 14 thousand in 1990.

When the employment pattern of the private domestic and joint venture banks is taken into account, a gradual expansion in bank employment is observed. The increase in the level of employment in the joint venture banks is much more pronounced. Nepalese experience, thus, refutes the notion that with the permission to the joint venture banks, there is a tendency of direct displacement of domestic employees by the foreign workers.

Table 5.6
Number of Employees in Commercial Banks

Name of the banks	1991	1995	2000	2001	2005
Government Owned Banks					
NBL	8444	6989	6272	6030	2912
RBB	6426	6011	5809	5743	3541
Private Domestic Banks					
NIB	48	75	98	107	356
BoK	-	46	154	196	171
NCC Bank	-	-	115	118	262
Lumbini Bank	-	-	71	122	135
NIC Bank	-	-	125	123	140
Machhapuchre Bank	-	-	-	65	75
Kumari Bank	-	-	-	46	141
Laxmi Bank	-	-	-	30	108
Siddhartha Bank	-	-	-	-	56
Joint Venture Banks					
NABIL	267	338	392	331	426
SCB	181	275	264	256	335
Himalayan Bank	-	141	311	359	501
SBI Bank	-	33	133	135	164
NB Bank	-	58	305	362	435
Everest Bank	-	25	158	188	257
Total	**15366**	**13991**	**14207**	**14211**	**10005**

Source: Compiled Based on Information Published by Various Commercial Banks.

5.5 Insurance Sector Performance

With the liberalization of the insurance sector, the role of state has been gradually limited to that of facilitator. Until 2001, the government owned Rastriya Beema Sansthan (National Insurance Corporation) accounted for 78 percent of the total life insurance market. The year 2001 was very important in the history of life insurance business in Nepal. In his year, three specialist life insurance companies were established in the private sector. They were the Nepal Life Insurance Company Ltd set up by local promoters, Life Insurance Corporation (Nepal) Ltd, a joint venture company between life insurance Corporation of India and Nepalese investors, and a branch of American Life Insurance Company (ALICO). The private sector is increasingly occupying a major share in the insurance business as one third of the market now is occupied by the private owned companies. Non-life insurance companies are also gradually expanding their activities.

Along with increased number of insurance companies, the funds available in the form of paid up capital, premium collection and reserve fund has also surged. This has created new opportunities for the insurance companies to deploy funds in various activities. The total paid up capital of all the insurance companies working in Nepal (excluding the paid up capital of branches of foreign insurance companies) stood at Rs 1198.1 million in 2005. Of this, the share of domestic insurance companies is 87.1 per cent. The remaining 12.9 per cent is with joint venture companies (Table 5.7). The total paid up capital (excluding the branches of foreign insurance companies) of all insurance companies was only Rs. 46.0 million in 1990. It went up to Rs 1198.1 million in 2005. Likewise, the total capital investment of foreign insurance companies was only Rs 4.0 million in 1990. It slightly decreased and reached to Rs 1.6 million in 2001. However, after 2001, it jumped and stood at Rs 154.2 million in 2005. This shows the growing importance of foreign insurance companies in Nepal.

Table 5.7
Structure of Paid-up Capital
(Rs million)

Year	**National**	**Foreign***	**Total**	**Per cent Share of Foreign Companies**
1990	42	4.0	46.0	8.7
1995	236.8	6.0	242.8	2.5
2000	486.8	1.4	488.2	0.3
2005	1043.9	154.2	1198.1	12.9

Source: Compiled from Various Publications of Nepal Insurance Board.

*Note: * Includes foreign joint venture share in National Life and General Insurance Company Ltd., Sagarmatha Insurance Company Ltd., and Life Insurance Corporation.*

Similarly, the total premiums collected in 2005 amounted to Rs 5850.0 million, constituting Rs 2850.0 million (48.7 per cent) on account of life insurance and Rs 3000.0 million (51.2 per cent) on account of non-life insurance (Table 5.8). Up to 1994, the total gross annual insurance premium accounted for less than 0.50 per cent of the total non agricultural GDP. However, it continued to increase after1995 and stood at 1.86 per cent of the non-agricultural GDP in 2005. The total collection of premium, which was Rs 243.9 million in 1990 also went up gradually and stood at Rs 5850 million in 2005. Of the total premium income, premium from life insurance accounted for 34.5 per cent, in 1990. However, in 2005, its share went up to 48 per cent and the remaining 52 per cent was generated from non-life sectors.

Table 5.8
Insurance Premium Income
(Rs million)

Year	**Life**	**Per cent Growth Rate**	**Non-life**	**Per cent Growth Rate**	**Total**	**Per cent Growth Rate**
1990	84.1		159.8		243.9	
1995	260.1	29.1	662.1	1001.7	922.2	252.7
2000	494.3	10.0	1337.2	14.7	1831.5	13.4
2005	2850	30.7	3000	16.9	5850	23.2

Source:* *Compiled from Various Publications of Nepal Insurance Board.

Due to the increase in premium collection, the investible reserve fund also surged in recent years. The total investment of insurance sector stood at Rs 14600.0 million in 2005. In 1996 it was just Rs. 3067.5 million. It is noteworthy that of the total investment; more than 80 percent is kept in the form of fixed deposit in commercial banks. This underscores the necessity for diversification of investments of insurance companies (Table 5.9).

Table 5.9
Investment Portfolio of Insurance Business
(Rs million)

	Life				**Non-life**				
	Fixed	**Govt. Security**	**Other**	**Total**	**Fixed**	**Govt. Sector**	**Other**	**Total**	**Grand Total**
1996	1227.6	765.7	39.2	2032.5	469.6	505.5	59.9	1035	3067.5
1997	1461.2	900.5	46.8	2408.5	698.5	602	110.4	1410.9	3819.4
1998	1737	987.1	55.9	2780	820.6	678.6	119.4	1618.6	4398.6
1999	2864.1	783.7	3.7	3651.5	1158.5	691.7	129.5	1979.7	5631.2
2000	3548.7	733.2	3.7	4285.6	1489.7	619.5	182.2	2291.4	6577
2001	5014.1	703.2	3.7	5721	1898.1	530.7	192.9	2621.7	8342.7
2002	6644.7	376.7	56	7077.4	2206.7	455.4	202.7	2864.8	9942.2
2003	6892.7	637.3	355.7	7885.7	1820.2	423.4	212.8	2456.4	10342.1
2004				9779				2676	12455
2005				11700				2900	14600

***Source:** Compiled from Various Publications of Nepal Insurance Board and Economic Survey (Various Issues), Ministry of Finance.*

A quick look at the employment pattern indicates that there has been steady rise in employment too (Table 5.10). In 1990 employment opportunities provided by the insurance industry was 646, and 1350 in 2003.

Table 5.10
Level of Employment

Year	Number
1990	646
1995	663
1997	817
1999	1046
2001	1151
2003	1350

***Source:** Compiled from Annual Report of Insurance Companies (Various Years).*

VI: Banking Sector Performance: Case Studies

Out of the commercial banks the Rastriya Banijya Bank, Nepal Investment Bank Limited and Standard Chartered Bank Nepal Limited were selected for the case study. Among these three, the first is fully government owned. Nepal Investment Bank Ltd. is fully domestic private investor owned. The last is joint venture bank with 75 percent ownership of Standard Chartered Group of Australia and UK.

6.1 Performance

6.1.1 Government Owned Bank: RBB

Rastriya Banijya Bank (RBB) is a fully government owned bank. It is the largest commercial bank in Nepal. RBB was established in January 23, 1966 under the RBB act. It actively undertakes government directed programs including priority sector lending programs to cater to the needs of people living in rural areas. The bank has a large deposit base with more than 1.2 million depositors. It has Nepal's most extensive banking network with over 114 branches. It spreads over all regions. With increased competition, it has also begun to provide modern banking facilities. After the introduction of the financial sector reform program, modernization of its services has been expedited. Since, January, 2003 management of the bank has been given to the foreign consultants. Although considerable improvement in its performance has taken place, it has yet not been able to overcome from crisis. This is evident from many key performance indicators.

Table 6.1 below shows that RBB was incurring high losses up to 2003. After 2003 the net profit margin began to be positive. So far it has not issued any shares as it remains a fully government owned bank. Per share loss has also started decreasing. From Rs 367.9 in 2004, it has reduced to Rs 341 in 2005. The bank has one percent non-redeemable preference share on issue. This has made it possible to provide a one percent dividend to the Government each year. The ratio of interest income to loans and advances is in a declining trend. A similar trend is observed in deposit and lending interest rates. The ratio of non-performing loans to total loans has also reduced to 52.99 per cent in 2005 from 60.15 per cent in 2003. Net worth is still highly negative at Rs 20199 million in 2005. Core capital and capital fund to risk weighted assets still remain highly negative.

Table 6.1
Selected Performance Indicators of Rastriya Banijya Bank Limited

Fiscal Years	**2001**	**2002**	**2003**	**2004**	**2005**
Net Profit/Total Income (%)	-226.22	-332.97	-205.42	27.63	37.69
Earning Per Share (in Rs)	-812.62	-1834.48	-1256.10	267.90	341.30
Market Value Per Share (in Rs)	No public share	No public share	No public share	No public share	No public share
Dividend (Cash & Bonus) on Paid Up Share Capital (%)	1	1	1	1	1

Cash Dividend on Paid Up Share Capital (%)	1	1	1	1	1
Interest Income on Loan & Advance (%)	9.98	6.45	7.56	7.92	7.78
Interest expenses on Deposit & Borrowing (%)	6.3	6	5.35	3.65	2.13
Total Loan/Total Deposit (%)	67.14	69.34	68.83	61.43	62.77
Non Performing Loan/Total Loan (%)	48.16	55.07	60.15	57.64	52.99
Interest Rate Gap (Spread Rate)	1.6	-0.9	0.9	3.39	4.67
Book Net Worth (Rs in million)	-10378.1	-17451.4	-21437.9	-21437.9	-20199.4
Liquidity (Total cash in hand/Total Deposit) (%)	8.2	8.59	9.48	17.18	12.91
Core Capital to Risk Weighted Assets (%)	-20.88	-35.31	-45.51	-43.13	-34.12
Capital Fund to Risk Weighted Assets (%)	-5.49	-28.03	-44.27	-41.98	-33.76

Source: Annual Report of RBB from FY 2000/1 to FY 2004/5

6.1.2 Private Domestic Bank: Nepal Investment Bank LTD

Nepal Investment Bank Limited (NIBL), previously Nepal Indosuez Bank Ltd, was established in 1986 as a joint venture bank. Initially, fifty percent of the capital was owned by Credit Agricole Indosuez, a subsidiary of one of the largest banking group in the world. Bankers, professionals, industrialists and businessmen acquired 50 percent share of NIBL. In 2002 the share of Nepal Indosuez Bank Ltd was purchased by Nepali investors. After this, the bank was registered as a Nepal Investment Bank Ltd. Since 2002 it has widened its services in various parts of the country by opening bank branches. At present, it has twelve branch offices.

Nepal Investment Bank Limited now occupies a competitive position in the Nepalese banking system. Deposits, eBanking, ATM, Loans and advances, Credit card, Safe deposit locker, Easy savings, Premier Banking, NTC mobile bill, Vehicle loans and Debit card are the major services provided by this bank. Recently, NIBL has formed a consortium of banks and financial institutions for issuance and acquiring of Visa products. The scheme allows members banks cardholders to use other banks' ATMs at a very subsidized rate. NIBL has recently launched the 'Premier Banking Cell' that caters to its high net worth clients and renders consultancy services in taxation, legal, insurance and travel tours.

Table 6.2 below shows that the net profit margin of NIBL is increasine. Only in 2004 the ratio slightly declined. The earnings per share are also increasing every year. The earnings decrease in 2005 is mainly due to additional bonus share issue. Dividend per share also showed a somewhat a declining trend in 2004 and 2005. The share of interest earnings to loans and advances has been around 9 per cent in all years except 2003 and 2005. Interest rates on deposits and borrowings are decreasing as a result of growing competition. The ratio of non-performing loans to total loans is equally low. With the exception of 2004, the spread rate is below 5 per cent. Due to higher returns, the net worth of the bank is increasing each year. Despite some fluctuations, liquidity or cash reserve ratio of the bank is also sound. The ratio of both core capital and capital fund to risk weighted assets of the bank is above the regulatory requirement.

Table 6.2
Selected Performance Indicators of Nepal Investment Bank Limited

Fiscal Years	2001	2002	2003	2004	2005
Net Profit/Total Income (%)	13.68	14.54	20.12	16.71	20.26
Earning Per Share (in Rs)	33.18	33.59	39.56	51.7	39.5
Market Value Per Share (in Rs)	1150	760	795	940	800
Dividend (Cash & Bonus) on Paid Up Share Capital (%)	Nil	30	20	15	12.5
Cash Dividend on Paid Up Share Capital (%)	Nil	Nil	20	15	12.5
Interest Income on Loan & Advance (%)	9.43	9.53	7.8	9.03	7.36
Interest expenses on Deposit & Borrowing (%)	3.83	3.05	3	2.74	2.43
Total Loan/Total Deposit (%)	57.07	65	74.74	63.68	73.33
Non Performing Loan/Total Loan (%)	8.29	4.8	1.98	2.47	2.69
Interest Rate Gap (Spread Rate)	4.04	4.24	4.8	5.98	3.74
Book Net Worth (Rs in million)	469.09	523.47	638.54	729.05	1180.17
Liquidity (Total cash in hand/Total Deposit) (%)	9.32	11.16	10.11	9.19	9.78
Core Capital to Risk Weighted Assets (%)	13.1	14.4	7.87	7.22	8.52
Capital Fund to Risk Weighted Assets (%)	14.1	15.9	8.81	11.18	11.58
Interest Income (Rs in million)	229.1	258.6	421.8	663.0	769.2
Interest Expenses (Rs in Million)	167.6	130.4	189.2	326.2	354.5
Margin (Rs in million)	61.5	128.2	232.6	336.8	414.7
Staff Expenses as % of Total Income	12.2	14.4	15.7	15.2	12.2

Source: Annual Report of NIBL from FY 2000/1 to FY 2004/5

6.1.3 Joint Venture Bank: Standard Chartered Bank Nepal LTD

Standard Chartered Bank Nepal Limited has operated in Nepal since 1987. It was registered as a joint-venture bank. The bank today is an integral part of Standard Chartered Group. It has 75 per cent ownership in the bank. The remaining 25 per cent share is owned by the Nepalese public. The Bank enjoys the status of largest international bank currently operating in Nepal. It has 7 branches and 9 ATMs across Nepal. It serves its customers through a modern domestic branch network. With its global network, the bank serves as an international bank in Nepal. It is the first bank in Nepal that has implemented the Anti-Money Laundering policy. It has also applied the 'Know Your Customer' procedure on all customer accounts.

Standard Chartered Bank is one of the best performers among the banks operating in the private sector. As evident from Table 6.3, net profit to total income is increasing. Its market share is also one of the highest among the private banks. Payment of dividend including bonus share (stock dividend) and cash dividend are also increasing every year. Share of interest income to loans and advances is decreasing. From around 10 in 2003, the interest share reduced to 7.43 per cent in 2005. One of the notable trends of SCBNL is that despite increased competition among the banks, its deposit rates decreased over time. This was partly due to excess liquidity and partly due to decline in the interest rate globally. The deregulation of interest rate on both lending and deposits also contributed to this. Lack of investment opportunities in productive sectors also has had effects on the deposit rates. Indicators like NPA ratio, net worth, margins and core capital to risk weighted assets indicate that its financial position is very sound. The net worth of the bank shows a higher return despite more than 100 percent dividend payment. The share of core capital and capital fund to risk weighted assets of the bank has remained above the regulatory requirement throughout the years under review.

Table 6.3
Selected Performance Indicators of Standard Chartered Bank

Fiscal Years	**2001**	**2002**	**2003**	**2004**	**2005**
Net Profit/Total Income (%)	25.92	33.12	33.71	33.95	34.21
Earning Per Share (in Rs)	126.88	141.13	149.3	143.55	143.93
Market Value Per Share (in Rs)	2144	1575	1640	1745	2345
Dividend (Cash & Bonus) on Paid Up Share Capital (%)	100	100	120	110	120
Cash Dividend on Paid Up Share Capital (%)	100	100	110	110	120
Interest Income on Loan & Advance (%)	10.22	10.31	10.11	8.83	7.43
Interest Income on Deposit & Borrowing (%)	2.77	1.82	1.35	1.3	1.31
Total Loan/Total Deposit (%)	36.82	35.97	31.99	31.63	43.55
Non Performing Loan/Total Loan (%)	5.23	4.84	4.13	3.77	2.69
Interest Rate Gap (Spread Rate)	4.65	4.19	4.11	3.76	4.53
Book Net Worth (Rs in million)	1112.02	1235.48	1368.91	1495.74	1582.41
Liquidity (Cash Reserve Ratio)	10.76	9.87	9.07	9.46	8.77
Core Capital to Risk Weighted Assets (%)	11.61	13.92	12.25	13.76	13.81
Capital Fund to Risk Weighted Assets (%)	14	17.3	14.1	15.5	15.8

		8	4	7	5
Interest Income (Rs in million)	558. 10	101 3.60	100 1.30	104 2.10	105 8.60
Interest Expenses (Rs in million)	474. 40	299. 80	255. 10	275. 80	254. 10
Margin (Rs in million)	83.7 0	713. 80	746. 20	766. 30	804. 50
Staff Expenses as % of Total Income	8.68	8.74	8.53	8.50	9.42

Source: Annual Report of SCBNL from FY 2000/1 to FY 2004/5

6.1.4 A Comparative Analysis of Three Banks

A comparative evaluation of all three types of commercial banks based on the same criteria may not be justified. This is because, in the past, public sector banks were driven not only by profit motives but also by many other criteria laid down by the Government. Nonetheless, in view of changed culture in the post liberalization period, that all commercial banks including government owned banks must operate under profit motives, a comparative analysis could help delineate areas of weaknesses and strengths.

As evident from commonly used profitability indicators (Table 6.4), Standard Chartered Bank (joint venture) is a most profitable bank. Both net profit to total income and net profit to total assets ratio are high.
The domestically owned private bank also has a high ratio. On the other hand, the indicators for the state owned bank show the worst performance up to 2003. Only in 2004 and 2005 did some improvement take place in the RBB after greater autonomy and restructuring.

Table 6.4
Profitability Indicators of Selected Commercial Banks
(per cent)

	RBB		**NIBL**		**SCBNL**	
Years	**Net Profit /Total Income**	**Net Profit /Total Assets**	**Net Profit /Total Income**	**Net Profit /Total Assets**	**Net Profit /Total Income**	**Net Profit /Total Assets**
2000	(49.81)	(3.19)	31.63	1.91	41.55	2.29
2001	(223.06)	(9.53)	22.21	1.10	36.61	2.19
2002	(332.93)	(15.72)	19.81	1.11	33.12	2.60
2003	(205.43)	(8.25)	30.05	1.27	33.69	2.42
2004	27.62	1.75	25.97	1.13	33.95	2.27
2005	37.69	1.87	29.34	1.40	34.20	2.46

Source: Annual Report of Commercial Banks (Various Years).

Labor productivity is another measure of efficiency in banking systems. For this purpose, a commonly used loan to staff ratio is calculated (Table 6.5). There is large variation between the banks in this ratio. The NIBL has the highest loans to staff ratio (29.4 per cent in 2005), more than four times that of the state owned RBB (7.3 per cent). Similarly, SCBNL had 25.1 per cent in 2005. In the two private banks the ratio is increasing. Although poor performance of the RBB is partly due to its compulsion to continue with branches in rural areas, over staffing due to political interference is the principal reason. Despite a large number of voluntary retirements the ratio is far from satisfactory. Many non performing loans are also to blame.

Table 6.5
Loans to Staff Ratio

	RBB			NIBL			SCBNL		
	Employment	**Loan (Gross)**	**Loans to Staff Ratio**	**Employment**	**Loan (Gross)**	**Loans to Staff Ratio**	**Employment**	**Loan (Gross)**	**Loans to Staff Ratio**
2000	5809	29140.6	5.0	98	2071.3	21.1	264	4957.5	18.8
2001	5743	28424.7	4.9	107	2431.3	22.7	256	5924.1	23.1
2002	5583	28516.0	5.1	105	2715.7	25.9	243	5787.9	23.8
2003	5402	26608.83	4.9	254	5921.79	23.3	275	6000.16	21.8
2004	3822	25105.68	6.6	325	7338.57	22.5	317	6693.86	21.1
2005	3541	25835.2	7.3	356	10453.16	29.4	335	8420.87	25.1

Source: Annual Report of Commercial Banks (Various Years) and Banking and Financial Statistics, NRB, July 2005.

Another measure of performance is the ratio of fee based income to total income. This ratio is presented in Table 6.6. Like other indicators, a large variation in fee based income to total income is found in these banks. The share of fee based income to total income is going down every year in the SCBNL. Despite some fluctuation, an almost similar trend is also found in the NIBL. However, in the case of RBB not only is the share of fee based income low, it is also constant. Diversification of banking products or services has led private banks to reduce the share of fee based income markedly. No similar efforts are found in the RBB.

Table 6.6

Ratio of Fee Based Income to Total Income

Years	SCBN L*	RBB	NIBL**
2000	88.77	9.59	66.44
2001	91.92	5.05	75.77
2002	29.93	10.13	54.42
2003	31.31	8.96	39.97
2004	34.19	8.23	42.34
2005	32.64	8.21	46.78

Source: Annual Report of Commercial Banks (Various Years) and Banking and Financial Statistics, NRB, July 2005.

Note: * Annual Report and Accounts Various Years, Standard Chartered Bank Nepal Limited.
** Annual Report Nepal Investment Bank Ltd. Various Years.

The respective distribution of loans by RBB, SCBNL and NIBL is presented in Tables 6.7, 6.8 and 6.9. The share of NIBL in the loan portfolio of the commercial banks is increasing rapidly. The growth in credit flow of this bank is higher than that of the SCBNL. Aggressive marketing has made this possible. The composition of credit flow shows that most of the banks have diverted loans towards industrial and commercial activities. The loans allocated to general and social purposes have also increase markedly[8]. On the other hand, credit flow of all these banks to the agriculture sector is very low, more so in the private banks.

The commercial banks have been involved in micro-finance since 1974. Financing to the 'small sector' and priority sector is a mandatory credit requirement of the NRB and the CBs are required to invest a certain percentage of their credit portfolios in this sector. The banks were required to invest at least 5 per cent of the total deposit into the agriculture, cottage industries and services sector which was defined as the 'small sector' effective from 1974. This was later increased to 7 per cent in 1976. This mandatory requirement is still in practice and is known as the Priority Sector Credit Program (PSCP) and Deprived Sector Credit Program (DSCP). The PSCP has been gradually phased out and is presently at 2 percent for the fiscal year 2005/06. The NRB while introducing the DSCP, segregated the priority sector into two segments: 9 per cent for PSCP and 3 per cent for the DSCP. In this program, the banks are required to lend from 0.25 to 3 per cent of their total loan portfolio to the poorest. Despite these mandatory requirements, the banks, however, prefer to pay heavy penalties to the NRB instead of complying with NRB directives. Thus, despite the plethora of micro finance institutions and programs, credit allocations have been urban centered towards consumer lending.

[8] The new Sectoral classification is partly responsible to show big surge in the credit flow to this sector.

Table 6.7
Distribution of Loans by Business Types: RBB

Year	2001	Share	2003	Share	2005	Share
Agricultural Sector	1149.38	4.2	1222.14	4.62	1672.60	6.2
Industrial Sector	9199.48	34.1	9066.22	34.32	7423.30	27.5
Commercial Sector	13293.83	49.1	13058.62	49.42	9621.00	35.6
Services Sector	1591.11	5.9	1648.65	6.24	1908.30	7.1
General use & Social Purpose	1814.85	6.7	1427.24	5.40	6375.70	23.6
Total	27048.65	100	26422.86	100	27000.90	100

Source: Annual Report of Commercial Banks (Various Years) and Banking and Financial Statistics, NRB, July 2005.

Table 6.8
Distribution of Loans by Business Types: SCBNL

Year	2001	Share	2003	Share	2005	Share
Agricultural Sector	7.54	0.2	129.12	2.2	345.24	4.3
Industrial Sector	2,491.62	45.0	2,351.23	40.0	2,283.75	28.2
Commercial Sector	979.85	17.7	676.32	11.5	2,326.27	28.7
Services Sector	627.81	11.3	615.73	10.5	641.79	7.9
General use & Social Purpose	1,430.69	25.8	2,104.79	35.8	2,509.06	30.9
Total	5,537.51	100	5,877.20	100	8,106.10	100

Source: Annual Report of Commercial Banks (Various Years) and Banking and Financial Statistics, NRB, July 2005.

Table 6.9
Distribution of Loans by Business Types: NIB

Year	2001	Share	2003	Share	2005	Share
Agricultural Sector	1.79	0.2	21.92	0.5	59.14	0.7
Industrial Sector	1,675.64	68.9	2,612.96	44.1	4,361.83	41.7
Commercial Sector	445.66	18.3	1,555.46	26.3	2,544.28	24.3
Services Sector	172.28	7.1	828.26	13.9	1,164.85	11.1
General use & Social Purpose	133.66	5.5	903.16	15.2	2,323.07	22.2
Total	2,429.03	100	5,921.77	100	10,453.16	100

Source: Annual Report of Commercial Banks (Various Years) and Banking and Financial Statistics, NRB, July 2005.

Thus, despite some structural problems, the financial liberalization has brought about significant changes in the structure and character of the Nepalese banking sector. The most visible change is the emergence of new private sector banks as well as the entry of several joint venture banks. The increased competition followed by efficiency enhancement in the private sector banks is pushing public sector banks to move towards the same direction. The emergence of the new banks has increased professionalism in the banking sector. Joint venture banks tend to perform better than domestic banks through service diversification and operational efficiency. This has reoriented the whole banking system in the same direction. One problem observed in the private banks, however, is that they generally avoid risky lending. Consequently, their business is concentrated in urban areas and they give low priority to small business.

6.2 Risk Management

The risk management of the commercial banks is at a very primitive stage. Their risk management is mainly based on the compliance of the directives issued by the Nepal Rastra Bank. A few banks like Standard Chartered Bank Nepal Ltd. and Laxmi Bank Ltd have formed risk management committees. But the committees are not functional. Some of the banks have developed a consumer scoring model on their own initiatives. Very few banks have their internal risk based provisioning model. Where such models exist, they are not the major criteria for decisions on loans or for the provisioning of loan losses. Advanced forms of loan grading and credit portfolio management models are not used by the Nepalese commercial banks. In publishing their financial statements, all banks use the criteria prescribed by the Nepal Rastra Bank.

6.3 Employment and Gender Mainstreaming

Table 6.10 shows trends in the employment structure of three different banks. In the case of the government owned bank, almost no change in the ratio of male and female employment is observed for the period under consideration. Out of total employment, the percentage of female employment has never reached 13 per cent. It seems that, in the course of retiring employees with restructuring, of the bank, more females than males were let go, despite their share in total employment already being low. On the other hand, a marked increase in female employment took place in the years 2000 to 2005 in the private banks, more so than in the domestic private bank. However, in terms of distribution, almost 50 percent of positions was occupied by female employees in 2004 in the joint venture bank. Thus, the employment structure shows that financial liberalization coupled with open up policies contributed to strengthen gender mainstreaming processes.

Table 6.10
Employment by Gender

	Govt. Owned RBB			Private Owned NIB			Joint Venture SCB		
Year	**Total**	**Male**	**Female**	**Total**	**Male**	**Female**	**Total**	**Male**	**Female**
2000	5809	5069	740	98	86	12	264	180	84
2001	5743	5017	726	107	90	17	256	179	77
2002	5583	4879	704	105	85	20	243	158	85
2003	5402	4710	692	254	186	68	275	176	99
2004	3996	3485	511	325	223	102	317	162	155
2005	3551	3105	446	353	234	119	335	204	131
Share in Total Employment									
2000	100.00	87.26	12.74	100.00	87.76	12.24	100.00	68.18	31.82
2001	100.00	87.36	12.64	100.00	84.11	15.89	100.00	69.92	30.08
2002	100.00	87.39	12.61	100.00	80.95	19.05	100.00	65.02	34.98
2003	100.00	87.19	12.81	100.00	73.23	26.77	100.00	64.00	36.00
2004	100.00	87.21	12.79	100.00	68.62	31.38	100.00	51.10	48.90
2005	100.00	87.44	12.56	100.00	66.29	33.71	100.00	60.90	39.10

Source: Annual Reports of Banks.

VII: Conclusions and Policy Implications

7.1 Conclusions

- Liberalization and open up policies in Nepal were started in the mid-1980s and intensified from the beginning of the 1990s. Financial sector liberalization has been part and parcel of such a liberalization program. The financial system has rapidly developed and is diversified today. In terms of ownership structure of the banks, 2 are government owned, 9 are domestic private sector owned, and 6 are joint venture banks. Out of the 21 insurance companies, 3 are joint venture companies, 3 are foreign owned, 14 are private domestic owned, and one is government owned.

- The total financial assets of the financial system was about 90 per cent of GDP in 2005. The ratios of deposit and credit to GDP also show growing importance of the financial system. A big change in the market share of the banking system is also taking place in recent years. The asset share of the two government-owned banks reduced to 38.1 per cent in 2005 from 56.6 per cent in 2000. The decline in the credit share has been sharper, from 56.7 per cent to 29.4 per cent over the same period.

- Along with financial deepening and growth in flow of credit to trade and industry, a rapid change in the economic and employment structure is taking place in the economy. In the first five years of intensive liberalization (1990-95), the rate of growth GDP was also high at 4.9 percent. The growth in the non-agricultural sector was very high at 10 percent. A rapid expansion in private sector activities in manufacturing, trade, transport, finance and real estate made this possible. The service sector grew more rapidly during this period. However, the Nepalese experience shows that the initial growth momentum could not continue for long. This had some adverse effect on the rapidly changing structure of the economy. Besides the worsening security and political situation, problems in the policy and institutional fronts occurred. The financial system went into deeper crisis due to the near insolvency of two state owned banks. A review of the policies and a comparative assessment on the performance and efficiency of the government owned, domestic private sector owned and joint venture banks gives some understanding of this state of affairs. Assessment of insurance companies also gives some insights into the functioning of insurance companies. Critical examination of the role and effectiveness of the commercial banks and insurance companies is of utmost importance in view of Nepal's commitments in WTO to pursue more open up and liberalization policies. Nepal's membership in SAFTA and BIMSTEC has further necessitated such a critical assessment.

- A critical review of policy shows that some liberalization policies toward the financial system were initiated in 1984. In this year deregulation of the interest rate structure and opening up of the banking sector to foreigner interests was started. From 1989, NRB also began to fix the capital adequacy ratio. In the same year, an upper limit on the amount of loan to be provided to a single borrower or group of borrowers by a bank was fixed. The Central Bank also introduced open market operations as a tool of monetary policy 1990. However, the slow or very limited reforms were far from adequate either to expand financial institutions or to enhance efficiency in the system.

- A more intensive reform was started from the early 1990s. During the first half of the 1990s, more liberal policies in granting licenses for opening new banks were pursued. The Development Bank Act 1995 and Financial Intermediary Institutions Act 1998 were introduced

to attract the private sector and NGOs to establish financial institutions in rural areas. Prudential norms were also gradually refined and strengthened. However, contrary to liberal policies, the mandatory priority sector lending program started in 1974 was further expanded by raising the lending ratio from 8 percent in 1985 to 12 percent in the liberalization period. Only in a recent policy announcement, has the Central Bank committed to phase out priority sector lending by 2007. All these policies and other interrelated measures, however, were highly inadequate to address growing crises in the two government owned banks. Lack of autonomy, frequent government intervention, and very weak supervisory and regulatory capacity of the Central Bank were some of the principal reasons for this.

- Some notable steps were taken only in 2002 to bring institutional reforms in the banking system. A comprehensive Financial Sector Reform Program, with the support of the World Bank and other donors, was introduced in that year. The enactment of New NRB Act 2002 and some other steps to enforce better prudential regulations are the outcome of this. The Nepal Rastra Bank Act 2002 provides sufficient authority to the Central Bank in maintaining financial discipline and performing regulatory and supervisory role more effectively. As a part of the ongoing reform, these two commercial banks (NBL and RBB) were contracted out to the foreigners in 2003. Very recently the Banking and Financial Act 2006 (an umbrella Act covering all financial institutions) has been enacted with the aim of bringing more reforms to financial institutions in a more co-ordinated way. A number of specific policy measures are being simultaneously pursued either to increase the capital base of the banks or to enhance prudential regulation system. This has been particularly necessary in view of Nepal's commitments to allow foreign wholesale banking by January 2010.

– Performance indicators like net profit, ratio of non-performing loans to total loans, and interest spreads covering the pre and post liberalization period show that the major problem lies in the government-owned banks. A comparative assessment of these ratios reveals that the profitability of the joint venture banks has substantially increased over time. A similar pattern is observed in the domestic private sector banks. However, the case of government-owned banks is entirely different. Along with a surge in non-performing loans in the total loan portfolio (reaching above 60 percent in both banks in 2003), the loss in these banks increased enormously since 1995. Interestingly, only after contracting out of these banks as a part of overall financial sector reform, could they make net profits. One equally important phenomenon is that, along with financial sector liberalization, a continuous reduction in the interest spreads has taken place. This is true in case of government banks also. Despite this, they have also started recording positive net profits. Thus, the Nepalese experience indicates that increased competition backed by institutional and structural reforms are keys to improving performance of the banking system. It is also clear from the Nepalese experience that even in the liberalized environment such a built-in structure is generally lacking in the state-owned banks. In such banks, only severe crises or shocks compel broad based reforms. Additional indices related to competition and efficiency corroborate this.

– Efficiency and competition related indicators like net interest margin, overhead cost to total assets and pre-tax profit to total assets indicate that performance of both domestic private banks and joint venture banks is very satisfactory. With competition they have been able to enhance their efficiency. However, an opposite trend is found in the government-owned banks. Only after the restructuring and reforms were improvements observed in indicators of efficiency. Our findings suggest that both structural impediments and market structures are critically important in driving bank efficiency in countries like Nepal. Therefore, liberalization policies without simultaneous emphasis on changes in ownership and market structure will be less useful in improving the performance of the banking system. The inability of state-owned

banks to restructure and diversify lending portfolios in the competitive market prevents them covering the marginal cost of funds plus intermediation costs. Compulsion to make higher loan loss provisions for non-performing loans amidst limited earning assets remaining in the portfolio tends to generate crisis in the state-owned banks.

- The positive relationship between financial development and growth was analysed in an economic model. The results showed a strong link between financial development and economic growth in the Nepalese context. In view of financial deepening represented by the growth of private sector credit, the results suggest that private sector credit is the better measure of financial deepening or development. Despite financial crisis in state-owned banks, bank credit expansion contributed to growth in Nepal. Had there been improved access of credit to the lower income strata and poor people, the growth would have been broad based. Based on the survey data, it is found that only 8.3 percent of the poorest consumption quintile has access to bank credit.

– Employment patterns also show divergent trends. On the whole, the level of employment has been reduced in the liberalized financial regime. This is, however, due to a policy of reducing the size of the employees in the government banks as a part of their restructuring. In the private banks, the level of employment has gradually increased. The increase in the level of employment in the joint venture banks is much more pronounced. Nepalese experience, thus, refutes the notion that with the permission to the joint venture banks, there is a tendency of direct displacement of domestic employees by foreign workers.

– With the liberalization of the insurance sector, the private sector is increasingly occupying a major share in the insurance business as one-third of the market now is occupied by privately owned companies. Total premium income has increased rapidly, from less than 0.50 percent of the total non-agricultural GDP in 1994 to 1.86 percent in 2005. Correspondingly, the investable reserve fund is also growing. It is noteworthy that, out of the total investment, more than 80 percent is kept in the form of fixed deposit in commercial banks. There is also steady rise in the employment.

– Case studies carried out in three commercial banks, namely Rastriya Banijya Bank (government owned), Nepal Investment Bank Limited (domestic private bank) and Standard Chartered Bank Nepal Limited (joint venture bank), show almost similar patterns as noted above. Performance indicators like net profit to total income, net profit to total assets, loan to staff ratio and fee-based income to total income reveal that joint venture and private banks were the best performers.

– Employment by gender in these banks exhibits an interesting trend. Almost no change in the ratio of female to male employment is observed in government-owned bank. It seems, in the course of restructuring, more female employees were out of the job as the declining ratio of female employees indicates. On the other hand, a marked increase in the female employment took place in the years 2000 to 2005 in the private banks, more so in the domestic private bank. The employment structure shows that financial liberalization coupled with open up policies contributed to strengthen the gender mainstreaming processes.

7.2 Policy Implications

- Nepal's experience shows that structural and institutional reforms should be part and parcel of liberalization policies. Institutional capacity enhancement of the Central Bank and

effectiveness in prudential regulations are crucial for making ongoing reform effective and result oriented.

- Reforms in ownership and market structures will be particularly important in view of Nepal's commitment to allow foreign wholesale banking and insurance companies in the domestic market. Raising the capital base of the banks and removing government control and interference in the two banks (NBL and RBB) will be necessary. The non-performing loans of the state owned banks are a major obstacle to enhance efficiency in these banks. In order to bring about loan recovery from major defaulters and sweeping reforms in these bank such steps are necessary.

- Nepal's experience with financial liberalization suggests that the multilateral route could be beneficial to her in pursuing broader trade liberalization policies. By the same token, the speedy introduction of new Acts in fulfilling commitments under WTO would be necessary to strengthen market institutions. The introduction of legislation prescribing bank rules, banking fraud control laws, asset securitization laws, and trustee laws, are essential.

- One of the problems experienced in the course of intensive liberalization is that, despite financial deepening, access to credit by the rural population has not improved. This is also true of small businesses operating in urban areas. In order to overcome this, policy should focus on the growth of micro credit institutions and community - based self-help, saving and credit groups and cooperatives. This will ease pressures on the Government or Central Bank in forcing commercial banks to divert resources to less profitable, more risky ventures. It may also prevent crowding out of funds available to the private sector.

- For the enhancement of technical or institutional capacity of the baking system including the Central Bank, some support measures through WTO would be desirable for least developed countries like Nepal. In view of small business being adversely affected by ongoing reforms, some safeguard measures for them through WTO would also be desirable.

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Annex 1
Results of the Phillips-Perron Test

S. No.	Variables	With Trends
1	PSC	-3.25
2	ΔPSC	-3.85
3	GGDP	-9.22
4	ΔGGDP	-18.39
5	PCI	-3.50
6	ΔPCI	-7.42
7	POPG	-3.08
8	ΔPOPG	-4.31
9	TGDP	-2.27
10	ΔTGDP	-4.74
11	FL	-3.86
12	ΔFL	-4.81
13	TIGDP	-1.66
14	ΔTIGDP	-5.75
15	M2GDP	-1.05
16	ΔM2GDP	-3.18
	Critical Value	
	Level	First Difference
1 %	-3.37	-4.39
5 %	-3.60	-3.61
10 %	-3.23	-3.24

Source: IPRAD Calculation