

# **CHAPTER - I**

## **INTRODUCTION**

### **1.1 Background of the Study**

As the financial sector works as a facilitator for achieving sustained economic growth, fostering healthy and competitive financial market is highly important. Financial system is important in the economy to pool and utilize resources, reduce costs and risks, expand and diversify opportunities, increase the allocated efficiency of resources, and promote productivity and economic growth.

Financial sector is related with the monetary and capital market. Banks and financial institutions are the major activists of financial market. Such financial institutions play a vital role to perform specific financial activities effectively. Different types of institutions like finance companies, commercial banks, micro financing institutions, provident fund, insurance companies, security market, citizen investment trust, and Credit Security Corporation etc. play their part to develop the national financial strength.

At the international level, financial liberalization process was set in motion in the mid 1970-the southern cone countries of Latin America being the leading ones to embark upon this process, followed by its initiation in the Southern Asian countries in the late 1970s. Nepal being familiar with these reforms as member of the Southeast Asian Central Bank's Organization (SEACEN), was also tempted to adopt financial liberalization measures and the same was initiated in the early 1980s (IIDS, 1999).

The logical background for financial liberalization is provided in the writings of McKinnon (1975), Shaw (1973), Fry (1978) and others. Most of these writers have argued against the monetary and financial policies based on Keynesian thoughts, practiced by many developing countries. Keynesians

believed that instability in the financial market played its part in creating imbalances in the economy. Therefore, they favored administered interest rates, directed credit programs and regulated financial systems. Following this, most of the developing countries tightly regulated their financial system in the 1960s and 1970s to accelerate economic development through a controlled financial market. The controlled financial market was supposed to help (1) finance budget deficit, (2) allocate resources for planned investment programs and (3) accelerate economic growth through import substituting industrialization. Repression of financial system received further attention when James Tobin (1965) developed a model of money and economic growth thorough import substituting industrialization.

Financial repression in most of the developing countries takes the form of control on interest rates, ceiling on bank credit expansion, selective credit policies, and high reserve requirements on the barrier to entry (Alawode 1977). There are, however, serious pitfalls of financial repression. (World Bank, 2002)

The extent of intervention varied among countries. Nearly all governments considered it necessary to intervene in the financial sector in order to channel cheap credit towards the sectors that were to be at the forefronts of development. The financial systems of most developing countries in the 1950s and 1960s could not adequately support a process of industrialization and agricultural modernization. Formal financial systems usually consisted of a few institutions. Often foreign owned, which had branches in major cities only. These provided financing mainly to trading companies, mines and plantations, which were often foreign owners as well. Local businesses had difficulty borrowing from banks; local farmers had no access to them at all. An indigenous informal financial sector made up of moneylenders, traders, and pawnbrokers provided loans to farmers and small businesses. Informal lenders charged high rates however and the scale of lending was small. There were few sources of equity and long-term finance for industries, and what was available

was expensive. In some countries, the banks were owned by industrial groups. This reduced the access of outsiders to finance and concentrated a great deal of wealth and power in the hands of few.

Despite a small and underdeveloped economy, Nepal has a reasonably diversified financial sector with a large number of varied institutions playing active roles. Nepal launched financial reforms at the middle of the 1980s. Most reforms were initiated under the aegis of the Structural Adjustments Facility (SAF). SAF contains economic policy arrangements agreed upon with the International Monetary Fund (IMF) and the Structural Adjustment Program (SAP) concluded with the World Bank.

**Kafle (1990)** has analyzed the process of monetary and financial sector reform in Nepal by dividing the two broad periods : (i) before and (ii) after the implementation of the Structural Adjustment Programme (SAP) in 1987.

Reforms before the implementation of SAP were categorized as:

1. Interest rate reform
2. Exchange rate reform
3. Entry of the joint venture banks and
4. Branches of Agricultural Development Bank allowed for commercial banking activities.

The main objectives of the monetary and financial sector reform under the structural adjustment program were:

1. To increase the mobilization of domestic resources,
2. To improve the utilization of foreign aid, and
3. To promote a more efficient allocation of resources.

A comprehensive set of monetary and financial sector reforms under the SAP in co-ordination with other macro-economic policies were aimed to contribute

on the acceleration of the pace of economic development. Monetary and financial sector reform measures have been implemented to maintain external as well as internal stability of the economy and to correct structural constraints for improving allocative efficiency of the economy.

**Adhikari (1989)** has pointed out three reasons motivating financial deregulations in Nepal. First, financial resources were unevenly distributed among different financial institutions. Some of the financial institutions were abundant of financial resources while the others were facing scarcity. It was due to interest rate rigidity that different financial institutions could not attract resources reflecting their scarce prices. Second, there was a wide interest spread between lending and deposit rates of interest, preventing the development of competitive financial market. And, the third, the introduction of joint venture banks (i.e., foreign investment with domestic participation) obliged the Nepal Rastra Bank to offer competitive financial environment for the activities of commercial banking in Nepal.

“Slow pace of reform and an unstable political environment has impeded economic growth in south Asia in general and Nepal in particular. Economic growth in South Asia can be said faster than world standard; however, the region has not been able to address the needs of the one third of the world’s poor that live in this region. South Asia needs to learn some lessons from the experiences from reforms initiatives of South East Asian countries. Post crisis reform reveals that in East Asia, their future prospect was linked inextricably to their ability in managing financial sector restructuring”(Pyakuryal 2060).

## **1.2 Reform Process of Rastriya Banijya Bank**

In a bid to reform the management and structure of the two largest and oldest commercial banks of the country through contracting out the management to internationally recognized management groups, the management of Rastriya Banijya Bank was handed over to the group led by an American Banker Mr.

Bruce Henderson. Mr. Henderson assumed his responsibility from 16 January 2003. The management team has completed its three years and has already introduced management plan, budget plan and operations manual, accounts head classification and a new credit policy. The contract period was extended up to 15 January 2008. While extending the contract period, management cost has been reduced as per the policy of utilizing financial resources made available by DFID and the World Bank economically.

Overall progress made by this bank under the restructuring program until now can be considered positive. This is based on the fact that the bank has earned net profits from the FY 2003/04, reduced the volume of negative capital fund, prepared and executed various international level manuals, policy and regulations to maintain stability of the bank and formulated and executed internationally acceptable working style. Progress made in recovery of bad debts, however, is not so satisfactory.

### **1.3 Statement of Problem**

As expected, a major outcome of Financial Sector Reform process that began in mid 1980s was the emergence of joint venture commercial banks, which brought modern and efficient banking services to Nepal. The entry of these joint venture banks led to the growth of the financial sector of Nepal in the form of increased deposits and disbursement of credit to various sectors of the economy. However, the financial sector remained largely dominated by the two huge state owned banks Nepal Bank Limited and Rastriya Banijya Bank. High level of Non Performing Assets and negative net worth of these two banks were a threat to Nepal's whole financial sector. The major focus of the reform program launched by the government is improving the condition of these two banks. A major focus of this study is on the impact of financial sector reform program in the performance of one of the huge state owned bank, Rastriya Banijya Bank. To sum up, this study deals with the following issues:

- i. Government-owned banks position is not satisfactory after years of initiation of reform process as
  - a. Banks still have huge negative net worth
  - b. NPA recovery is not satisfactory
- ii. The current financial and operational status of Rastriya Banijya Bank
- iii. Cost of the reform program and its continuation

#### **1.4 Objectives of the Study**

Following are the Objectives of the Study

- i. To assess the effectiveness of Financial Sector Reform Program
- ii. To compare the cost and benefit of the Reform Program in Rastriya Banijya Bank
- iii. To make comparative analysis of performance of Rastriya Banijya Bank after the initiation of Financial Sector Reform Program

#### **1.5 Significance of the Study**

A well functioning financial sector plays a crucial role in the process of economic development by efficiently mobilizing resources and allocating capital for productive investment projects. After introduction of financial sector reforms, the number of banks and other financial institutions with variegated types of financial instrument had emerged up.

As a first step of initiation to liberalize the financial sector since mid-1980s, entry barriers were removed. Three joint venture banks were established in the three subsequent years from 1985. Following it, interest rates were liberalized gradually. Then, especially after the restoration of democracy in 1990, popularly elected government gave a major thrust on economic and financial liberalization in Nepal. The institutional network and volume of operations of the financial system has expanded and diversified, with the number of commercial banks going up from 5 in 1990 to 23 in mid March 2008. The number of other financial institutions has likewise seen a quantum jump.

Realizing the significance of the financial system in the economic development, the government formulated and implemented various policies and processes during the past one and a half decade. They are, permission to establish joint venture banks, autonomy in the determination of the interest rate, scrapping of statutory liquidity ratio, implementation of the prudential guidelines, removal of credit ceilings, and introduction of open market operations and other indirect instruments of monetary policy. This has resulted significant improvements in quantitative as well as qualitative dimensions of the financial system.

Over the past decade, Nepal has made serious efforts to transform itself into a market-based economic system and adopted the policy of financial sector reforms. The financial sector aimed at enhancing savings mobilization and credit allocation to the private sector. However, growth experienced less than expectation, which also affected the performance of its financial sector. Nepal formulated a comprehensive financial sector reform to deregulate the financial markets from decades of government intervention, mainly, by late 1980s and 1990s.

Improvements so far achieved after the introduction of reforms, mainly in the financial sector are not satisfactory. Mainly the performances of public sector banks and financial institutions have been observed to be poor. So, Nepalese financial sector is in the process of broad and comprehensive reforms. Still there are some lacuna and loopholes making reform efforts less effective. It is, therefore, critical to assess the effectiveness of financial sector reforms in Nepal. The success or failure of the reform program can be judged by the improvements in the government owned banks that constitute a huge share of the credit and deposit in the banking sector. In this way the assessment of the performance of the government owned bank after the initiation of the reform program is a significant subject to study.

## **1.6 Limitation of the Study**

The study is carried out with the sole purpose of fulfilling the requirement for the Master's in Business Studies. Therefore, deep analysis into the subject matter is not done due to lack of time and other constraints like availability of data, required resources etc. The limitations of this study are as mentioned under:

- i. All the required information and data may not be available.
- ii. The basic purpose of the study is to fulfill the requirement for the Masters in Business Studies, thus it lacks sufficient time to collect information and analyze them.
- iii. Finally, the study is grandly based on secondary data.

## **1.7 Organization of the Study**

This study has been organized into five chapters. Each chapter covers some facts pertaining to the financial sector reform program in Nepal. The following are the titles of the chapters:

Chapter - I	Introduction
Chapter – II	Review of Literature
Chapter - III	Research Methodology
Chapter - IV	Data Presentation and Analysis
Chapter - V	Summary, Conclusion and Recommendations

### **Chapter- I: Introduction**

The introductory part of the study. This chapter gives an account of the objectives and scope of the study, and also looks over the major issues to be investigated and explained.

### **Chapter –II: Review of Literature**

It is devoted to the theoretical framework that bounds the study, and brief review of relevant literatures. It includes the review of previous writings and

studies relevant to the problem being explored, and within the framework of the theory structure.

**Chapter – III: Research Methodology**

It covers the research methodology employed in the study. This chapter further attempts to explain the nature and sources of data and data collection techniques.

**Chapter- IV: Data Presentation and Analysis**

It elaborates the presentation and analysis of data.

**Chapter- V: Summary, Conclusion and Recommendations**

Finally, summary and conclusions of the study are presented in chapter five. It also focuses on the major findings along with other empirical evidences. Recommendations for further research are also offered in this section.

The exhibits and bibliography are incorporated at the end of the study.

## **CHAPTER- II**

### **REVIEW OF LITERATURE**

#### **2.1 Theoretical Framework**

Financial Sector Reform is defined as a set of actions aimed at reducing or eliminating distortions in financial markets, deepening the financial sector, and strengthening financial institution (World Bank, 1998).

In the process of building prudently and efficiently managed bank and non-bank financial network and ensuring strong and capable regulatory body to lead the financial system, broader and deeper reforms are required in the central banking, commercial banking and other areas of the financial system. Reform is vital for strengthening the financial system as well as improving its capability to face the vulnerability to the likely instability and other uncertainties that could affect the evolving financial system. Likewise, reform is also required for capacity building within the banking system, intend to promote a stable financial system and also foster an environment that enhances economic growth, productivity and sustainable development in Nepal.

With the economic liberalization initiated in mid 1980s, the Nepalese financial system witnessed significant developments in the growth of financial institutions. Along with the numerical growth and other institutional developments of the financial sector, the deposits and credits were expanding. However, due to weak operational management and imprudent lending practices government owned banks Nepal Bank Limited and Rastriya Banijya Bank had begun to exhibit serious portfolio problems as well as operational problems viz, the negative net worth, high level of non performing assets, poor risk management skills, weak governance and poor human resource management.

The government then announced the strategy paper on financial sector reform program. Consequently, Nepal Rastra Bank initiated the first phase of financial sector reform program, funded by World Bank and International Monetary Fund (IMF), in the mid 1980s. In the first step of current comprehensive reform program, management of Nepal Bank Limited was handed over to foreign management team, ICC consulting group of Bank of Scotland. Bruce F Henderson got the management of Rastriya Banijya Bank on a contract basis. The ICC group has completed its term of management contract and currently the bank is under NRB management. On the other hand the contract of CEO in RBB has been renewed for next two years effective from 16 January 2006. Government is expecting a better result from the contracting out, and it is a matter of concern for the financial sector, as the success or failure of these banks will have significant impact on the management of government-owned banks.

## **2.2 Factors Motivating Financial Sector Reforms**

There may be a large number of instances to motivate policy reforms. So long as maintaining the cost of status quo is reasonable in terms of economic stability and growth, policy changes seldom occur. Major factors behind economic policy and financial reforms (Abiad and Mody, 2003: 10) can be described as below:

1. Shocks,
2. Learning and
3. Politico-economic structure

### **1. Shocks**

Nepal suffered a severe balance of payments problem for three continuous years in the early 1980s. A heavy government deficit escalated inflation and a surge in imports. Unsustainable deficit increased the supply of money more than output growth. Therefore, the rise in demand for more goods and services required meeting by more imports. Lack of foreign assistance inflows, and

declining export earnings on one hand and rising imports on the other made the BOP problem terrible. Also, the BOP crisis in the early 1980s provided an opportunity to move towards outward oriented growth policy. Financial sector reform is one among many other economic policies, while far more effective to others.

Macroeconomic shocks of the early 1980s affected Nepalese financial system hard. To get away from such a precarious situation, Nepal adopted the policy of economic reforms with the assistance and expertise of the World Bank and the IMF since 1985 under the Economic Stabilization Program, Structural Adjustment Program in 1987 and Enhanced Structural Adjustment Program (ESAF) in 1992 followed it. The Adjustment program covered a wider range of issues including opening up of the economy, civil service reform, reducing the size of the government, correcting prices and changes in policy measures as well as legal and institutional improvement. External influence was a major determinant of reforms in the Nepalese financial sector. Thus, most of the reforms in Nepalese financial sector have been undertaken by distinct events either due to a new government in power or in the circumstances of changes in global economy. Reforms were generated as a consequence of crises and status quo in good times. Extensive reforms were implemented immediately after the new government took charge after the restoration of democracy in 1990. But required reforms were delayed because reforms are not one stop action like policy announcement, rather it has taken several years to complete the implementation of the reform process.

## **2. Learning**

Reform is multistage process and largely influenced by the experiences of own and to that of successful reforms of the South East Asian countries with a large learning impact for the financial sector reforms in Nepal. However, the experiences of financial trouble in the South-cone countries cautioned Nepalese policy-makers to follow a gradual path of reforms (Khatiwada, 1999; 11). The

global wave of liberalization and spread of democracy in the early 1990s notably encouraged Nepal to adopt market –oriented economic policy in general and financial sector reforms in particular. Further, experiences and expertise of the international financial institutions like the IMF, WB, ADB and academic professionals were quite appreciable in this context. Liberalization process did not only exert distinct impacts on different sectors of the economy but also it helped to bring changes in political, social and cultural aspects. However, slow moment of India towards market-oriented economic policy also had its impact in the pace of reforms of the Nepalese financial sector.

### **3. Politico-economic Structure**

Although market oriented reforms were introduced during 1980s, the then existing party less political system failed to deliver the development benefits, which is generally closely linked with political stability (Thapa, 1992:2). The Nepali Congress government with majority in parliament confidently introduced and accelerated the new economic policy during the first half of the 1990s. However, coalition governments in the succeeding years were timid to implement reforms. As a result, the process of liberalization and reforms were obstructed. Thus, political stability and development of market discipline mechanism were crucial for the success of reforms. Ongoing broader reforms were introduced when for the second time the government was formed with full majority in 1998. Reforms are, thus, motivated, by strong political will and their commitment to implement the policy introduced.

Nepal has introduced a comprehensive set of policy reforms in the financial sector aiming for wider financial intermediation between the savers and borrowers and reduced transaction costs. The objectives of financial sector reforms are to develop a sound financial system; reduce the control over the interest rates, introduce prudential regulation and effective supervision. Similarly, the promotion of capital market and decontrol over the credit flow were some other objectives. The policy changes were directed towards the

promotion of a market oriented financial system, with more private sector participation, efficiency gained through more competition and development of the quality of the financial instruments and services. Thus, political stability and the development of market discipline mechanism were crucial for the success of reforms.

## **2.3 Financial Sector Reform in Nepal**

### **2.3.1 Financial Repression and Liberalization**

In Nepal, financial liberalization began since 1984 by easing entry restrictions and partial decontrol of interest rates in the banking sector. The elimination of interest rate control since 1989 not only affected the market for bank loans and deposit it attracted, but also attracted international capital flows (particularly capital inflow in the form of equity investment). In addition, the stock market began to grow as the extent of credit rationing diminished.

Administered interest rate followed by simultaneous credit control led to widespread financial repression during 1970s and 1980s. Commercial banks were restricted to accept as well as lend foreign currency denominated deposits and loans. Another prevalent characteristic of Nepalese financial system was the existence of dual currency system. Besides, domestic private sector and foreign investors were also restricted from participating in the financial sector. Public sector banks were, thus, insulated from outside competition, poorly regulated and badly supervised. They did not have any external pressure to run efficiently.

Influential growth experiences of many South East Asian countries encouraged Nepal to liberalize domestic financial sector. Liberalization efforts of 1980s focused mainly on policy deregulation and introduction of prudential regulation to improve domestic banking system during 1980s. The efforts during 1990s initiated improving financial health of domestic commercial banks, the development of stock market and further consolidation of liberalization. Thus, both the domestic banking sector and the stock market were jointly

deregulated. A gradual move towards the liberalization of international transaction began since early 1990s. Financial liberalization largely followed by trade liberalization.

## **2.4 Objectives of the Financial Sector Reform Program**

Following are the objectives of the Financial Sector Reform Program:

- i. To create sound, stable and healthy financial system.
- ii. To broaden and deepen the financial system.
- iii. To enable policy makers to fully and timely avail the sound financial statistics.
- iv. To utilize adequate resources, on lowest possible cost, to promote sustained, and broad based growth momentum.
- v. To increase the autonomy and capability of Central Bank for making its monetary policy, supervisory and regulatory functions effective.
- vi. To improve and update the legal and judicial framework for financial system.
- vii. Reduce the level of Non Performing Assets

## **2.5 An Introduction to Rastriya Banijya Bank**

Rastriya Banijya Bank (RBB) is the largest commercial bank in Nepal. It was established in January 23 1966(2022 Magh 10) by an Act of the parliament under the full ownership of the government. At initial stages it had 212 branches in 14 zones and 68 districts. But because of the deteriorating security situation, stiff competition from the joint venture banks and poor performance most of the rural branches were merged with it's nearest branches. Currently 114 branches are providing banking services to the people. The bank has already completed 40 years of operations. The bank is at present serving 62 districts with varieties of services from small loans to financing of various large projects. It has participated in different programs such as cottage and small-scale industries Intensive Banking program, Production Credit for Rural Women (PCRW) and Micro Credit program for Women (MCPW) etc. Banking

with Poor program has been developed and launched by the bank and has gained popularity among the deprived sectors of the country.

## **2.6 Review of Related Studies**

### **2.6.1 International Context**

Financial Sector Reform is one of the main focuses of all the countries in the world. Each concerned government authorities are always curious to improve the sector, which may be in the form of policy reforms or any other media, the target being the same. The central bank of each country annually reviews its financial policies so as to assess the impact on each sector.

World Bank is one of the bodies, which reviews the financial sector of each country of its interest and grants financial aid for various projects. As per the review book of World Bank, 1989 the following were noted:

**Argentina:** The failure of a large private bank sparked the 1980-82. Banking crisis, by 1983, many financing institutions had been liquidated. The restructuring process took very long period.

**Bangladesh:** Four banks that accounted for 70% of total credit had an estimated 20% of non-performing assets in 1987. Loans to two loss-making public enterprises amounted to fourteen times the bank's total capital.

**Bolivia:** In late 1987 the central bank liquidated two of twelve private commercial banks; seven more reported huge losses. In mid 198 reported arrears stood at 92% of commercial banks' net worth.

**Chile:** In 1981 the government liquidated eight insolvent institutions that together held 35% of total financial system assets. In 1983 another eight institutions (45% of system assets) were taken over; three were liquidated, five

restructured and recapitulated. In 1988, central bank's holding of bad commercial bank loans amounted to nearly 19% of GNP.

**Greece:** Non performing loans to ailing industrial companies amounted to several times the capital of the interest of the largest commercial banks, which held more than 80% of total bank assets.

**Guinea:** The government that assumed power in 1984 inherited a virtually defunct banking system; 99% of loans proved irrecoverable. All six state owned banks were liquidated and three new commercial banks were established, each with foreign participation.

**Kuwait:** Because of large losses sustained by speculators in stock and real estate markets, an estimated 40% of bank loans were non-performing by 1986. The government has supported banks by providing highly concessional loans.

**Spain:** Between 1978 and 1983 fifty-one institutions holding nearly a fifth of all deposits were rescued; two were eventually liquidated, and the rest were sold to sound banks (World Bank, 1989).

### **Indonesia and the Sequencing of Reform**

FSR; a Review of World Bank Assistance, 1998 had studied Indonesian financial reform which concluded as follows:

Financial adjustment operations in Indonesia were undertaken within the framework of Bank support for a broader structural adjustment program. Following a drop in oil prices in the early 1980s and their collapse in 1986, Indonesia began a program that included a major depreciation of the rupiah, a reduction in public spending, measures to stimulate exports and encourage foreign investment, improvements to industrial efficiency by opening up the economy, basic financial reform, and a long-term strategy to diversify the

economy away from and over-dependence on oil. This program entailed significant relaxation of the system of close regulation that had characterized the Indonesian economy.

Lending support for adjustment was provided after the fact, endorsing actions that were judged to conform to the Bank's assessment of Indonesia's economic priorities. Initial support in the form of two trade policy loans in 1987-88 was followed by two private sector development loans (PSDLs) in 1989-90, all with financial sector components, and a financial sector development project in 1993. During this period the Bank also approved six Financial Intermediary Loans (FILs). The Bank's operations have supported the evolution of Indonesia's financial system from a state –dominated one, with fixed interest rates and administered credit, to a liberalized, competitive and increasingly privately owned network, with market determined interest rates. This has meant developing an indirect means of monetary control and strengthening the central bank's supervisory framework and enforcement capabilities.

The heart of the government's adjustment effort in the second half of the 1980s was to restore external equilibrium through real depreciation of the exchange rate, bringing public accounts into better balance, opening the economy gradually to increased competition. The liberalization of interest rates introduced under the trade policy adjustment loans, coupled with increased public confidence in the banking system, has led to substantial financial deepening. The measures introduced under the PSDLs-especially permitting the entry of foreign banks –increased competition in the banking sector to some extent. The overall structural adjustment program had been successful in generating high rates of saving and investment, and realizing rapid economic growth: but it did not succeed in reducing substantially the fragility of the banking system, which in 1977 became vulnerable to the effects of the currency crisis.

After oil prices collapsed, Indonesia's immediate need was to depreciate its currency to restore external equilibrium and to cut public spending because of the decline in government revenues and borrowing prospects. But to restore rapid growth from non-oil sources required fundamental structural adjustment. Initiating structural adjustment after implementing the basic measures needed to restore macroeconomic stability was entirely appropriate. The early initiation of FSR was also appropriate. But liberalizing the financial sector without first ensuring that adequate legal, regulatory and supervisory infrastructure was in place led to the proliferation of weak banks and to a number of bank failures, as clearly shown during the currency crisis of 1977.

The audit report for the PSDLs draws a number of important conclusions about the correct sequencing of reforms. First, the legal, regulatory and supervisory environment of the financial sector must be strengthened before or at the same time as entry is liberalized. Second, establishing a strong legal infrastructure for banking activities should have priority from the start, rather than be one item on the continuing agenda. This would have sent a clearer signal to the private sector that the government was irrevocably committed to a fundamental change in relationships. Only in November 1977, did the Bank approve a technical assistance loan to directly strengthen the structure and improve the soundness of the banking system (World Bank, 1998)

### **2.6.2 Nepalese Context**

With the economic liberalization initiated in mid 1980s, the Nepalese financial system witnessed significant development. For instance the financial system consisted of only two commercial banks and few other financial institutions before liberalization. During the post liberalized regime spanning almost two decades, the financial system has reasonably well developed, diversified and enriched. as of mid March 2008, the Nepalese financial system consisted of 23 commercial banks, 58 development banks, 79 finance companies, 11 micro credit development banks, 16 saving and credit cooperatives involved in

limited banking activity, 47 non government micro credit institutions, one stock exchange with the network of brokers and security dealers, 17 insurance companies, one employee provident fund, one credit guarantee and deposit insurance corporation, and one citizen investment trust. Of these institutions, the commercial banks, development banks, rural development banks finance companies, financial cooperatives and NGOs are under the regulatory framework of Nepal Rastra Bank. While the insurance board regulates the insurance companies and the securities board regulates the stock exchange, the other institutions are under the regulations of the government authorities.

Along with the numerical growth and other institutional developments of the Nepalese financial sector, the deposits and credit are expanding though the qualitative aspect of the financial system still require much improvements as reflected in the inadequacy of the banks and financial institutions in providing increased benefits to the general public and in contributing adequately to the economic development through raising income level, creating employment opportunities and building internal strength for the growth of the institution themselves . To create a healthy financial sector as a pre requisite to sustained economic growth by getting rid of the various institutional and structural deficiencies that still characterize the system, various financial sector reform measures need to be further initiated and implemented. Taking into account the above-mentioned facts, Government has initiated financial sector reform in different periods of time.

Reform or liberalization of financial sector is a continuous process. It takes a long prior to complete the process of financial reform. Even in a most developed financial market, innovation in financial products and services take place, which necessitates the changes in rules and regulations in the financial markets. The financial sector reform of Nepal was initiated in mid 1980s and it is still being continued. The financial sector reform process in Nepal has been analyzed in three phases as follows:

## **2.6.2.1 Past Reform Efforts and Outcomes**

### **2.6.2.1.1 Financial Sector Reform in First Phase (1984- 1990)**

The first phase of the financial sector reform was initiated in mid 1980s under the liberal economic policy of HMG/N. Under this policy, HMG/N first opened up the banking sector to foreign investors. In 1984, Nepal Arab Bank Limited was established as the first joint venture commercial bank of the country. The bank was established with 50 percent equity participation of a foreign bank. The establishment of this joint venture bank brought foreign investment in the banking industry and modern banking practices and technical skills. The Nepal Indosuez Bank Limited and Nepal Grindlays Bank Limited were established in 1985 and 1987 respectively as joint venture commercial banks. The banking operations of these three international commercial banks helped the economy to get modern banking services. It enhanced the competitive environment in the banking sector especially in the Kathmandu valley where more than 50 percent of the economic activities of the country take place.

In July 1985, commercial banks were allowed, for the first time, to accept current and fixed deposits on foreign currencies (US dollar and sterling pound). Before May 26, 1986, the interest rates of commercial banks were totally controlled by Nepal Rastra Bank (NRB), the central bank of Nepal. Both deposits and lending rates were being heavily regulated by NRB. On May 26, 1986, NRB deregulated the interest rate regime and authorized commercial banks to fix interest rate at any level above its minimum prescribed levels. These bold steps of NRB had a far reaching impact in the development of the financial sector of the country, which was clearly evidenced in the growth of the assets, and banking activities of commercial banks. Effective from 29 May 1986, the liquidity requirement was also lowered to 9 percent from 25 percent (NRB, 1986).

Under the Structural Adjustment Program of the IMF, the financial sector was further liberalized in 1987. The focus of NRB was placed on indirect monetary

control. The emphasis was laid on increased financial intermediation, deepening of financial markets and increase in the role of market forces in the financial system. The auction mechanism was introduced for the first time to sell treasury bills.

The Agriculture Development Bank of Nepal (ADBN) and the Nepal Industrial development Corporation (NIDC) were allowed to issue debentures to increase their financial resources. ADBN also issued agriculture savings bonds in 1985. These debenture and bond were introduced as new financial instruments to develop the financial markets of the country. HMGN also sold national savings certificates outside the financial system for the first time. The ADBN was also allowed to open commercial banking branches in urban areas. Commercial banks were allowed to determine their lending rates except for exports and productive sector credits. They were granted virtual freedom to fix their interest rates on deposits in July 1989 except for the priority sector credit; The Credit Information Bureau was established in 1989.

NRB strengthened its regulation and supervision of banking and financial institutions. Commercial banks were required to increase their capital adequacy ratio (CAR) gradually. They were required to maintain CAR of 2.5% by mid July 1989 and 3% by mid July 1990. Regulation on single borrower limit was also introduced. There were some new regulations issued on refinance policy and reserve requirements. The Finance Company Act was enacted in 1986 to increase competition in financial markets and especially for the merchant banking and leasing services and to provide loans for hire purchase, term finance and housing construction. But finance companies were not established during the first phase of the financial sector reform.

There was a new development as the capital market opened its floor for corporate share trading in November 1994. The securities exchange center (SEC) also started to provide the some merchant banking services. The trading

in the capital market was limited due to listing of very few company's shares in the SEC.

By that time the government owned commercial banks had begun to exhibit serious portfolio problems and its severity was deepening. It was not because of their expansionary stages but because of the inappropriate operational performance, mismanagement and imprudent lending decisions that these banks made during those days. Therefore, corrective measures were necessary for which, the commercial banks problem analysis and strategy study (CBPASS) was also conducted in 1990 and in this period, reform measures initiated since 1989 under second structural adjustment lending program (SAL-II, 989-91) under the assistance of world bank. The first reform measures were concentrated on strengthening financial and operational performance, improving legal and institutional environment in the financial sector, enhancing the capacity of the central bank to supervise the banking sector, implementing the improved regulations and rationalizations of branch expansion policies. During this period the following reform activities were completed:

- ) With a view to strengthen and improve the performance of the two commercial banks, the government provided Rs 443 million for recapitalization and further Rs 3.12 billion for provisioning and repayment of bad debts.
- ) Separate loan recovery department were established in RBB and NBL
- ) The government vested NRB with the responsibility of implementing specific measures to strengthen these two banks. For this guidelines on a new system of loan classification and accounting policies for interest suspension and provisioning were initiated
- ) Banks were provided freedom to fix interest rates on deposit and credits on their own discretion

- ) The government made a payment of Rs 400 million toward government guaranteed bank loans to public enterprises and second payment of Rs 260 million.
- ) Some technical assistance was also provided by the IMF to strengthen the banking supervision and inspection function of NRB. Consequently the inspection department of NRB was expanded with additional manpower.
- ) Legislative changes were enacted to permit NRB to supervise NIDC
- ) Amendments to the Commercial Bank Act and the NRB act were made in 1989 and that in the NIDC Act in 1990.
- ) Credit Information Bureau (CIB) was set up in 1989 to disseminate credit information
- ) Joint venture banks came into operation since 1984.

These efforts were in right direction for improving the environment during that period. However the measures could not improve the system substantially and could not sustain the improvements for longer period as the reforms were initiated at piecemeal basis.

#### **2.6.2.1.2 Financial Sector Reform in Second Phase (1991- 1998)**

After the restoration of democracy, the democratic governments under its open and liberal economic policy gave more emphasis on the liberalization of the financial sector. As a result, the Nepalese financial sector has grown very rapidly since 1990s. There has been a dramatic rise in the number of banking and non-banking financial institutions. Till mid 1990, there were 5 commercial banks, 2 development banks, 2 insurance companies, and other few financial and quasi-financial institutions. In mid-July 2000 there were 11 commercial banks, 2 development banks, 5 regional rural development banks (RRDB), 44 finance companies, 2 insurance companies, 29 savings and credit cooperatives societies and 30 NGOs licensed by NRB and few other financial and quasi financial institutions (Employee Provident Fund, Deposit Insurance and Credit

Guarantee Corporation, Citizens Investment Trust, Nepal Stock Exchange Limited, Securities Board, Insurance Board, Credit Information Bureau). There has been a tremendous increase in the volume of financial transactions and financial markets during the last decade.

The commitments of the government in the financial sector liberalization gave the needed boost to the confidence of the private sector for the establishment of commercial banks in the private sector. Himalayan Bank Limited and Nepal SBI Bank Limited were established in 1993 and Nepal Bangladesh Bank Limited and Everest Bank Limited in 1994. All of them were established as joint venture commercial banks. Nepal Housing Development Finance Company was established in the public sector as the first finance Company under the Finance Company Act 1986. Soon after the establishment of the first finance company, five other finance companies were established in the private sector in 1993. The rural development banks were established in five development regions to provide micro-finance services to the poor and the ultra-poor women. To provide limited banking services in the un-banked rural areas, saving and credit cooperative societies started to get operating licenses since 1993. Even the NGOs got operating licenses to undertake limited banking transactions. The separate act for development banks was felt necessary and it was enacted in 1996.

The establishment of finance companies not only improved competition in the deposit and credit services, but also helped develop capital market through listing of their shares. Their shares are being traded along with the shares of commercial banks. They have been providing merchant banking services such as underwriters and market makers.

To make the financial sector more liberal, the current account convertibility is very important. Nepal received the article VIII status of the IMF on May 30, 1994. The move towards financial liberalization helped the country receive this

status. Under this status Nepal is obliged to keep the current account convertibility.

NRB further liberalized the restrictive measures for providing banking and non-banking financial institutions and especially development banks and finance companies more freedom in their business operation. The commercial banks were required to increase CAR to 3.5% at Mid July 1991 and 4% at Mid July 1992. The credit ceiling was removed in 1991 except for government and non-financial government enterprise under the policy of indirect monetary control and Nepal entered into the Enhanced Structural Adjustment Facility (ESAF) in October 1992. NRB laid more emphasis on open market operation as main monetary policy instrument.

Under the financial sector reforms 3 joint venture commercial banks were established and they started to provide modern banking services to their customers. They started to compete with Nepal Bank Limited (NBL) and Rastriya Banijya Bank Limited (RBB). They were already ailing even before the establishment of joint venture commercial banks. Because of new development financial, managerial and organizational problems of these banks became more serious. To study these problems and to prescribe necessary recommendations, NRB sought the financial and technical help from UNDP and a study team presented report on Commercial Banking Problem Analysis and Strategy Study (CBPASS)

The CBPASS has recommended the government to address the following critical areas:

1. Full repayment of government guaranteed loans to state-owned enterprises and removal of lending obligations
2. Partial recapitalization of NBL and RBB
3. Establishment of a new Rural Finance Institution to assume priority sector lending of NBL and RBB

To strengthen and improve their performance, the government provided RS 443 million for the recapitalization of NBL and RBB. The government provided Rs 3.12 billion for provisioning and repayment of bad debts and Rs 660 million for the government guaranteed bank loans to public enterprises.

**The CBPASS II** report identified four critical areas where RBB and NBL had to make necessary improvements.

1. Loan recovery,
2. Credit
3. Personnel,
4. Branch operation and MIS

**The CBPASS II** report had revealed that an estimated 5 percent of the assets of NBL and 8 percent of RBB were problem loans and the recovery of these problem loans would significantly improve their liquidity profitability and capital base.

Both NBL and RBB earned a negative spread on all new loans. Their capital and ability to earn profits to meet essential obligations would continue to be at risk until lending practices are improved.

NBL and RBB faced critical human resources issues overstaffing, lack of skills, demoralized staff, ineffective utilization of human resources, and counter productive work culture.

Their own cost sources of funding i.e. current and savings accounts were found eroded and valuable customers were defecting to JV banks. Their cost structure was very high and it was nearly 4 percent of their assets. The reason for this higher administrative cost was overstaffing of 40 to 50 percent in the branches. Critical branch level information was not available and other data unreliable and untimely.

**The CBPASS II** report recommended following new systems for full implementation by the board and top management of NBL and RBB:

- ) Prompt approval of changes
- ) Timely commitment of required financial and human resources
- ) Active support of new systems
- ) Active monitoring of implementation
- ) Adherence to new systems and practices
- ) Removal of key obstacles
- ) Recognition of improved results

They also recommended for 3 years or more of technical assistance required to fully addressing operational weaknesses of NBL and RBB to make them healthy and effective banking institution. They also cautioned concerned authorities to continue the institutional process in the near future to avoid another government sponsored financial restructuring program.

Both the CBPASS reports were implemented half-heartedly by concerned authorities. Both banks were recapitalized but their management and organizational structures could not be improved. They were run as any government enterprises. As a result, their financial health started to deteriorate and the government, NRB and the Top management of NBL and RBB became just silent spectators and waiting for more serious financial, managerial and organizational problems in the future. Until mid July 1998, 15 commercial banks were already in the financial market. The capital market increased due to listing of the shares of commercial banks and finance companies. The insurance activities also increased because of the entry of new insurance companies in the private sector.

#### **2.6.2.1.3 Current Comprehensive Reform Program**

Financial sector reforms introduced in the last one and a half decades made significant improvements in certain sectors such as liberalization of interest

rates, creation of basic regulatory and supervisory frameworks, development of a longer term government securities market, establishment of several types of banking and financial institution, functioning of stock exchange, competitive environment in the insurance services. But serious problems still remained with two largest commercial banks (RBB and NBL) and two largest development banks (ADBN and NIDC). The World Bank, the IMF and the Asian Development Bank (ADB) identified some weaknesses in NRB's regulatory and supervisory capacity. There were Government mandates seriously distorting operation incentives of the banking sector.

Taking into account these serious problems in the financial sector GON adopted the Financial Sector Strategy Statement in December 2000. It has clearly mentioned about the need for the strengthening and autonomy of NRB, so that it can regulate and supervise commercial banks and financial institutions. It has pointed out the need for the enactment of new NRB Act to empower NRB to supervise financial institutions and take over the management of troubled banks and punish those financial institutions that are found engaged in serious irregularities. It has also pointed out the need of having deposit taking institution act, which is an umbrella act of all deposit taking institutions. Some of the main elements of financial sector reform strategy published by the government in December 2000 are as follows:

1. Implementing restructuring plans for the to large commercial banks, RBB and NBL
2. Identifying restructuring strategies for the two development banks, ADBN and NIDC
3. Strengthening banking sector regulation and accounting and auditing standards
4. Strengthening NRB's supervisory capacities and its ability to enforce compliance with prudential regulation.

5. Improving the regulation and supervision on non banking deposit taking institutions
6. Modernizing the legislative framework with a view to reducing legislative overlap and the segmentation and fragmentation
7. Strengthening corporate governance and the framework for loan recovery
8. Phasing out the role of NRB and commercial banks in providing directed credit.

As per the commitment of the government to reform RBB and NBL, the Nepal Banking Reform Project was started with funding assistance of the World Bank and DFID (UK). The KPMG Barents Group, the international expert team associated with the Banking Reform Project, started the reform project since 15 November 1999. They broadly recognized that Nepal's financial sector still faced following systemic problems:

1. Poor bank governance
  - ) Political interference and
  - ) Insider lending
2. Lack of rational banking strategies as well as modern skills and international banking experience to support them
3. Lack of independent, capable supervision
4. Weak legal and accounting practices
5. Difficult and deep seated issue of RBB and NBL to be addressed

The KPMG Barents review of RBB and NBL found that both banks were deeply impaired in virtually all areas of their operations:

1. Overall bank governance and management weak by modern standards
2. Deep flaws in lending process, loan files and loan portfolio

3. Primitive financial accounting with large pockets of " double counting", unsubstantiated assets and major items that should be written off by international standards
4. No business strategies, weak planning and budgeting processes, lack in foundation, follow up, rewards and penalties.
5. Low morale of employees, low pay scales, low skills and counterproductive union oriented activities
6. Primitive management information record keeping and control system.

The governance and management of RBB and NBL took politically driven decisions. They had negative net worth and insufficient capital adequacy. Their human resource management was found extremely weak in all. Their situation seemed clearly worse than in 1992. The KPMG Barents Group recommended following actions to be taken for RBB and NBL.

1. Support Government efforts to create an independent, commercially run banking system and declare banking reform policies fostering sound banking system
2. Upgrade Board, senior management and staff skills, capabilities and processes
3. Design and invest in comprehensive banks restructuring programs
4. Support and assist in implementing long range plans to correct environmental weaknesses
5. Support central bank strengthening and independence and provide full enforcement powers
6. Depoliticize and commercialize the banking system.

The KPMG report concluded that loan assets of RBB and NBL were highly overstated and extremely risky. As a result, both of them were technically insolvent. As of mid 1998, they had losses of around US\$ 450 million, which was equivalent to around 46% of the annual budget of the government or 8.6 percent of GDP. The assessment confirmed that the management of two banks

was basically dysfunctional. It recommended the reduction of the role of the government in the financial sector as a direct owner of bank and financial institutions beginning with RBB and NBL.

As per the recommendation of the KPMG report, NRB removed the NBL Board on March 8, 2002, on account of failure to manage the bank properly and replaced it with an NRB appointed Board. In mid July, the management of NBL was handed over to ICC Bank Ireland, for RBB, an international banking expert has been selected after Deloitte Touché Tohmatsu broke the contract, there are several international and domestic banking and financial experts who have been working in RBB. These banking and financial experts have already completed HRD plan, Credit Policy and Guidelines, Computerization Policy and Programs, Portfolio Review and Loan Recovery and restructuring of RBB and NBL, Both of them have implemented VRS plan and reduced their staff considerably. (Economic Report 2002/03, Nepal Rastra Bank)

#### **2.6.2.1.4 Review of Articles**

Pendleton (2061) in his article "*Nepal's Financial Reform: A Tardy Pace of Deliberate Race*" has tried to explore the need and relevancy of financial reform program in Nepal. In this article he suggests that "GON has way to go for complete financial reform, restore financial soundness to deserving public,, much work is left to do; however, the Government had set "Road Map" to complete this phase and continues to improve the reform process, a process vision to sustain the economy for generations to come. The upcoming World Bank sponsored Phase II of the Financial Sector Reform Program will support this vision. It is important that the citizens of Nepal, particularly the media services, support this effort as well.

Basyal (2059) in his article "*Financial Sector Reform: Need and Strategy*" mentions that "the overarching goal of the F.S.R is to create a well regulated, sound, market oriented and stable financial system, which will help form the

basis for fiscal consolidation, macroeconomic stability, private sector –led economic growth momentum and significant reduction in poverty on a sustainable basis.”

Again the same author presenting the challenges of the Nepalese financial sector opines that “ the host of challenges and complexities that confront this sector could be categorized as the weak financial position of most of the government owned financial institutions, negative net worth and huge accumulated losses of the government owned commercial banks, higher proportions of non performing assets (NPA), predominance of the informal financial system, higher interest rate differentials between the formal and informal sector of the economy , large interest rate spread between lending and borrowing rates in the formal financial sector etc”

Bhatta (2061) in his article, “*Need for Macro Prudential Appraisal of the Financial System Soundness*” has presented the interest of multilateral donor agencies in the financial soundness of the recipient countries. He writes “vulnerabilities in the financial system along with its development have become a common word in the recent years. There have been several efforts in the local, regional and global fronts to mitigate the risk and uncertainties in the financial system. Episodes of turmoil in the international financial markets particularly after mid nineties have underscored the need for better tools to monitor financial risks and vulnerability. Realizing this emerging need, the International Monetary Fund (IMF) initiated to strengthen its assessment of financial system soundness as part of its surveillance work”.

Thapa (2061) in the article “*Financial Sector Stability and Monetary Policy*” mentions “The primary instrument that is generally used for achieving the financial sector stability is the regulation and supervision of banks and financial institutions.”

Ghimire (2062) in his article “*Contract of Rastriya Banijya Bank: Opportunities and Challenges*” opines that “ although the management contract of Rastriya Banijya Bank was quite expensive in cost , when it started ,it is now starting to produce good results. Although there hasn’t been good progress in loan recovery other aspects of management is starting to show progresses”

Gautam (2061) in an article, "*WTO and Challenges of Financial Services Liberalization in Nepal*", has put his opinion in the context of financial service liberalization and financial reform in Nepal. According to him "the process of financial services liberalization in Nepal is very recent phenomenon. It has been gathering pace gradually, the process of liberalization started with the financial sector reform in mid eighties. It surged up after the initiation of Structural Adjustment Program and Enhanced Structural Adjustment Program with respective loan and assistance of the World Bank and International Monetary Fund. Financial sector reform was implemented on a phase wise basis. It was designed to address the institutional deficiencies and closed and controlled financial system. Various macroeconomic policies were modified and adjusted during the period to facilitate the liberalization process. The procedural relaxation on the entry of joint venture banks (with collaboration), determination of interest rate (first, in 1986 with certain limit and then in 1989 without any limit) and operation of various financial transactions are mainly attributable for the reform.

#### **2.6.2.1.5 Review of Previous Thesis**

Ajaya Kumar Nepal (2059) in his thesis “*Financial Sector Reform in Nepal: after Economic Liberalization*” recommends “there is a critical need to reform, revitalize and modernize the financial sector. The government is endeavoring to achieve a privately owned and managed banking system, which provides economic and efficient financial intermediation in the economy. The inefficiency of the banking sector stems mainly because of the problems in the state owned banks viz. Nepal Bank Limited and Rastriya Banijya Bank.

Meanwhile the Agriculture Development Bank and Nepal Industrial Development Corporation are also facing similar type of problem.”

Same author also concludes, “As the biggest commercial bank, Rastriya Banijya Bank has important role to play in the economy. However, political interference, weak management, poor financial information system and ever growing bad loans have extremely impacted on RBB’s financial health. Current auditing work has also exposed a high negative net worth, weak internal control and information system and poor internal financial management”(ibid)

Bibek Pandey (2060) in his thesis “Financial Sector Reform in Nepal: Assessment of Impact on Financial Sector” concludes that the financial reforms initiated by the government had remarkably increased the role of market forces in the financial system. However, reforms could not solve the problem of high liquidity of financial institutions. Similarly, little effect can be seen in the level of non-performing assets of financial sector.

Hiramani Niraula (2063) in his thesis “A study on Loan Classification and Non-Performing Assets Management of Rastriya Banijya Bank” concludes that ineffective credit policy and overvaluation of collateral are the major causes for high non-performing assets in RBB. He further sites that the financial position of RBB has improved since the new management took over in January 2003. However, because of heavy accumulated losses, the bank is in no position to meet the capital fund requirements prescribed by Nepal Rastra Bank.

Khem Raj Bhetuwal (2005) in his thesis “*Assessing the Effectiveness of Financial Sector Reforms in Nepal*” mentions that the comprehensive economic and structural reform of 1990s has achieved a relatively significant success in stabilizing its economy. This has resulted significant improvements in quantitative as well as qualitative dimensions of Nepalese financial system. However, public sector banks were suffering with severe problems making the

system obsolete and unproductive. Public sector banks are found responsible for the deterioration of financial system as they hold a dominant position in terms of deposit, credit lending and asset holding. In these banks, still there are some structural and institutional weaknesses making reform efforts less effective.

## **2.8 Research Gap**

On review of various studies related to financial sector reform, it has been found that they have focused on the financial sector in general terms. None of them have dealt with the performance efficiency of a particular bank after the initiation of financial sector reform program.

This study attempts to look into the cost and benefit aspects of the reform program as a whole. It analyses the comparative performance of Rastriya Banijya Bank, one of the major components of the financial sector reform program. Attempt has been made to look into the financial and operational efficiency of the selected bank.

This study will further strengthen the results and findings of previous related studies and give updated information about the current performance of RBB.

## **CHAPTER- III**

### **RESEARCH METHODOLOGY**

Research Methodology is a systematic way to solve the research problem. It describes the methods and process applied in the entire aspects of study. It refers to the various sequential steps to be adopted by a researcher in studying a problem with certain objectives in view.

#### **3.1 Research Design**

A research design is the agreement of condition for collection and analysis of data in a manner that aims to combine relevance to research purpose with economy in procedure. Research design is the plan, structure and strategy of investigation conceived so as to obtain answer to research questions and to control variances.

This study follows both the analytical and descriptive approaches to assess the effectiveness of reform program and the performance of the sample bank so that logical conclusions could be drawn.

#### **3.2 Population and Sampling**

Overall 23 commercial banks are operating in Nepal. The reform process was mainly felt necessary for 4 publicly owned banks, which are as follows:

1. Rastriya Banijya Bank
2. Nepal Bank Limited
3. Agricultural Development Bank
4. Nepal Industrial Development Corporation

Out of these four public banks, Rastriya Banijya Bank is selected for the purpose of this study. The sample bank constitutes a major portion of the banking sector assets and liabilities. So it is believed that that the sample can represent the requirement of the objective of the study.

### **3.3 Data Source and Collection Technique**

All data used for this study are obtained through secondary sources. Data are collected through related studies, journals, publications of RBB and NRB publications related to the subject matter.

### **3.4 Method of Analysis**

The method used for this study is Ratio Analysis. Ratio analysis is used to compare a firm's financial performance and status to that of the other firms or to it overtime. The following four types of ratios have been used in this study.

#### **3.4.1 Asset Management Ratios**

Asset management ratio measures the proportion of various assets and liabilities in balance sheet. The proper management of assets and liabilities ensures its effective utilization. The banking business converts the liability into assets by way of its lending and investing functions. Asset and liability management ratio measures its efficiency by multiplying various liabilities and performing assets. The following are the various ratios relating to asset and liability management, which are used to determine the efficiency of the bank concerned in managing its assets and efficiency in portfolio management

#### **1. Credit Deposit Ratio**

This ratio measures the ratio between total credit and total deposit. Higher credit deposit ratio in a bank indicates that it has been able to effectively mobilize its deposits. The ratio is calculated by the following formula:-

$$\text{Credit Deposit Ratio} = \frac{\text{Total Credit}}{\text{Total Deposit}}$$

#### **2. Total Credit and Investments to Total Deposit Ratio**

This ratio measures the total credit and investment to total deposit. A higher ratio shows optimum utilization of the bank's deposits. The ratio is calculated by the following formula: -

$$\text{Total Credit and Investments to Total Deposit Ratio} = \frac{\text{Total Credit and Investments}}{\text{Total Deposit}}$$

### **3. Performing Assets to Non Performing Assets Ratio**

This ratio measures the ratio between the performing loans to non-performing loans. A higher ratio shows that the bank has good assets and is in profitable situation. This ratio is calculated by the following formula

$$\text{Performing Assets to Non Performing Assets Ratio} = \frac{\text{Performing Assets}}{\text{Non Performing Assets}}$$

### **4. Non Performing Assets to Total Assets Ratio**

The ratio measures the ratio between the non-performing assets to total assets. A high ratio of non-performing assets is an indicator of a bank's deteriorating financial health. The ratio is calculated by following formula:-

$$\text{Non Performing Assets to Total Assets Ratio} = \frac{\text{Non Performing Assets}}{\text{Total Assets}}$$

#### **3.4.2 Investment Management and Solvency Ratio**

Investment management and solvency measures the performance efficiency of an organization from various angles of its operations. These ratios indicate the efficiency of activity of an enterprise to utilize available funds, particularly short term funds. These ratios are used to determine the efficiency, quality and the contribution of loans and advances in total profitability. The following activity ratios measure the performance efficiency of the bank to utilize its funds.

#### **1. Loan Loss Provision to Total Loans and Advances Ratio**

This ratio measures the total loan and its provision. A high percentage of provision indicates the high portion of problem loans of the bank. Also a higher provision results in lesser profit. The ratio is calculated by following formula:-

$$\text{Loan Loss Provision to Total Loans and Advances Ratio} \\ = \frac{\text{Loan Loss Provision}}{\text{Total Loans and Advances}}$$

## **2. Debt Equity Ratio**

Debt equity ratio is a part of solvency ratio. The standard debt equity ratio is 2:1. The high the ratio the more interests the bank pays. The ratio is calculated by the following formula:-

$$\text{Debt Equity Ratio} = \frac{\text{Total Debt}}{\text{Total Shareholders Equity}}$$

## **3. Debt Ratio**

Debt ratio is solvency ratio. The ratio between total debt and total assets is calculated by this ratio. The ratio is calculated by the following formula:-

$$\text{Debt Ratio} = \frac{\text{Total Debt}}{\text{Total Assets}}$$

### **3.4.3 Profitability Ratios**

Profitability ratios are used to indicate and measure the overall efficiency of a firm in terms of profit and financial performance. For better performance, profitability ratios of firms should be higher.

#### **1. Interest Expenses to Total Expenses Ratio**

A higher ratio between the interest expenses and total expenses indicates that the bank has high interest bearing deposits. This ratio should be low for the profitability of the bank. The ratio is calculated by the following formula:-

$$\text{Interest Expenses to Total Expenses Ratio} = \frac{\text{Total Interest Expenses}}{\text{Total Expenses}}$$

#### **2. Interest Income to Credit and Investment Ratio**

This ratio calculates the relationship between the interest earned through the mobilization of credit and investment. The higher the ratio better is the banks profitability position. The ratio is calculated by the following formula:-

$$\text{Interest Income to Credit and Investment Ratio} = \frac{\text{Total Interest Income}}{\text{Total Credit and Investment}}$$

### **3. Return on Total Assets**

The ratio calculates the relationship between the net profit after tax and total assets. The higher the ratio the better is the banks position in terms of profitability. The ratio is calculated by the following formula:-

$$\text{Return on Total Assets} = \frac{\text{Net Profit after Tax}}{\text{Total Assets}}$$

### **4. Return on Net Loans and Advances**

This ratio calculates the relationship between net profit after tax and loans and advances. A Higher ratio clearly indicates that loans and advances are generating profit. The ratio is calculated by the following formula:-

$$\text{Return on Net Loans and Advances} = \frac{\text{Net Profit After Tax}}{\text{Net Loans And Advances}}$$

### **5. Net Profit on Total Revenue**

This ratio calculates the relationship between net profit after tax and total revenue generated. A higher ratio indicates a better situation of profitability. The ratio is calculated by the following formula:-

$$\text{Net Profit on Total Revenue} = \frac{\text{Net Profit after Tax}}{\text{Total Revenue}}$$

### **6. Earning Per Share**

This ratio shows how much a share is earning at any given point of time. Higher the ratio, better a share earns. The ratio is calculated by the following formula:-

$$\text{Earning Per Share} = \frac{\text{Net Profit after Tax}}{\text{Total number of Shares Outstanding}}$$

## 7. Total Interest Income to Total Revenue Ratio

This ratio measures the relationship between the total interest and total revenue. The higher the ratio the higher the contribution interest income on total revenue. The ratio is calculated by the following formula:-

$$\text{Total Interest Income to Total Revenue Ratio} = \frac{\text{Total Interest Income}}{\text{Total Revenue}}$$

### 3.5 Statistical Tools

Some important tools are used to achieve the objective of this study. In this study statistical tools such as mean, standard deviation, coefficient of variance, and coefficient of correlation have been used

#### 3.5.1 Arithmetic Mean

Arithmetic mean of a given set of observation is their sum divided by the number of observation. In general  $x_1, x_2, \dots, x_n$  are the given number of observation, their arithmetic mean can be derived in this way.

$$\bar{X} = \frac{X_1 + X_2 + X_3 + \dots + X_n}{N}$$

Where,

X= variables

$\bar{X}$  = Arithmetic mean

N= number of observation

The arithmetic mean is a single value of selection, which represents them in average. Out of the various central tendencies a mean is one of the useful tools to find out the average value of the given data. Furthermore it is very much useful with respect of financial analysis and it is also easy to calculate.

#### 3.5.2 Karl Pearson's Coefficient Correlation

Out of several mathematical methods of measuring correlation, the Karl Pearson's coefficient of correlation is widely used to measure the degree of

relationship between two variables. Two variables are said to have correlation when the value of one variable is accompanied by the change in the value of the other. So, it is measured by following formula using two variables (Bajracharya, B.C., 2060: 250).

$$r = \frac{\sum XY}{\sqrt{\sum X^2} \sqrt{\sum Y^2}}$$

r = coefficient of correlation

$\sum XY$  = Sum of product of deviation in two series.

$\sum X^2$  = Sum of squared deviation in X series

$\sum Y^2$  = Sum of squared deviation in Y series

The value of this coefficient can never be more than +1 or less than -1. Thus +1 and -1 are the limit of this coefficient. A correlation coefficient of  $r = +1$  or  $-1$  implies that correlation between variables is positive and vice versa. A zero coefficient denotes that the two variables are not correlated.

## **CHAPTER - IV**

### **DATA PRESENTATION AND ANALYSIS**

#### **Present Situation of Reform**

##### **4.1 Process on Restructuring of RBB and NBL**

The share of RBB and NBL in the assets and liabilities of the banking sector is around 50%. The management contract of NBL with ICC Consulting Group has been concluded since July 21, 2007. The bank is presently being managed by a team comprising of 3 staffs of NRB since 2064 Shrawan 11. Likewise the contract with consultants for RBB concluded on January 15, 2008. However, the period for 4 consultants has been extended upto July 15, 2008.

Both of these banks have been earning profits since the fiscal year 2060/61. Standardised system, procedures and guidelines have been developed and implemented for all sectors of management and operation. NBL has finished computerization of 44 branches, additional 38 branches have been identified for computerization and Any Branch Banking Service (ABBS) has been implemented in 27 branches. The bank has computerized 76% and 88% of total deposits and loans respectively as on 2064 Poush end. Likewise, RBB has computerized 40 branches and 84% and 81% of total deposits and loans respectively as on 2064 Poush end. However, the recovery of NPA has not been satisfactory and the banks have high negative net worth.

A brief glance of the improvements in these two banks can be seen from the table below:

	NBL		RBB	
	060 Asadh end	064 Poush end	060 Asadh end	064 Poush end
Negative Net Worth	9.80 billion	6.06 billion	22.39 billion	16.83 billion
NPA	60.5%	11.10%	60.2%	26.8%
No. of Employees	5,250	2,937	5,402	3,127
Net Profit (Loss)	(25) crores	41.77 crores	(483) crores	161.69 crores

**Table 4.1**

### **Brief Glimpse on Bank's Progress**

(Rs. In Million)

S.N.	Particulars	2060 Asadh end	2064 Asadh end
1	Authorized Capital	1,558	1,558
2	Paid up Capital	1,172	1,172
3	Number of Branches	128	114
4	Regional Offices	-	4
5	Number of Employees	5,402	3,127
6	District Covered	68	68
7	Deposit	39,402	50,464
8	Loans and Advances	26,608	24,775
9	Recovery of Overdue Loan	-	16,830*

\* Only after the new management took over the Bank

### **4.2 Future Strategy and Actions**

The reform of the financial sector is a gigantic task for all stakeholders. Financial Sector Reform is an on going process rather than a program of fixed duration. The Tenth Plan has formulated plans, programs, strategies and activities for the financial sector. The financial sector reform program has outlined its agenda and goal. The success of the FSRP in achieving its agenda and goals will have a far-reaching impact in the whole economy and especially for the macro economic stability. The effectiveness of FSRP in direct and quantitative terms cannot be easily established. However, many areas have seen great improvements since the inception of FSRP. The reengineering of NRB has helped the central bank make its regulatory and supervisory functions more

efficient and effective. All categories of financial institutions are now covered by the Banks and Financial Institutions Act 2063 and a unified directive has been issued. The licensing policy for financial institutions has been changed and made more effective. An onsite and off site supervision manual of international standard has been developed and implemented. To enhance the inspection and supervision capabilities according to international standards Basel II Capital Adequacy Framework has been introduced and made mandatory from fiscal year 2065/66. Likewise Long Form Audit Report (LFAR) has been implemented to make the auditors of banks and financial institutions more responsible.

Various Acts like Secured Transactions Act 2063, Debt Recovery Act 2063, Insolvency Act 2063, and Anti Money Laundering Act 2064 has been passed to strengthen the existing legal framework. The Securities Transactions Act 2064 has been passed and various rules and bye laws relating to functioning of the stock market has been introduced and implemented. Other Acts like Credit Rating Agency Act, Assets Management Company Act, Mergers and Acquisitions Act are under consideration.

Credit Information Bureau Limited (CIBL) has been established for the effective flow of credit information in the financial sector.

The financial sector in Nepal is changing and growing. Nepal is opening its financial sector to foreign investors as a result of its accession to WTO. Foreign banks will be allowed to operate in Nepal since the year 2010 AD. The paid up capital requirement for commercial banks has been increased to Rs 2 billion. In this scenario Nepalese banking sector is likely to see a lot of mergers and acquisitions to face international competition.

There has been new development in the financial markets as well. New money market instruments are being introduced; the activities of inter bank money

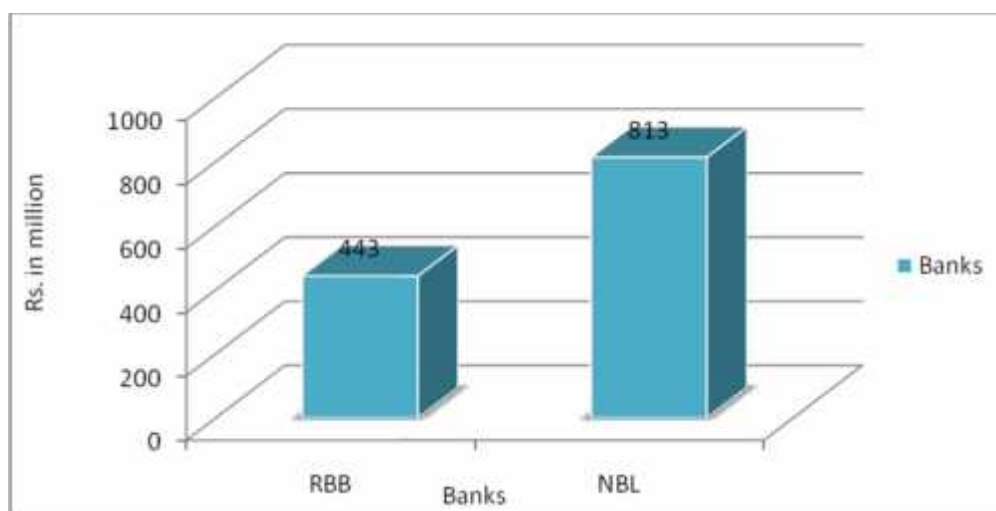
market are increasing. The secondary market for government securities and company shares is being expanded. The repurchase agreements have helped to expand secondary market of government securities. The holders of government securities can turn their securities to liquid assets. The clearing house is going to be automated in the future to a modern payment, clearing and settlement system, which is one of the most important elements of the modern financial system.

### 4.3 Costs and Benefit Analysis

The total project cost of the two phases of the reform program is Nrs 7.55 billion, which comprises the funding of the Government of Nepal and DFID Grant and IDA Credit. Major components of project cost included in the category of goods; management contract/consultant services; training, workshop study tour and VRS payments. The monetary benefit from the project is calculated to be around Rs 28.86 billion (i.e, profits of NBL and RBB Rs 9.81 billion, recovery of NPA Rs 17.58 billion, savings from VRS Rs 1 billion, computerization and installation benefits of SDR 4.764 million).

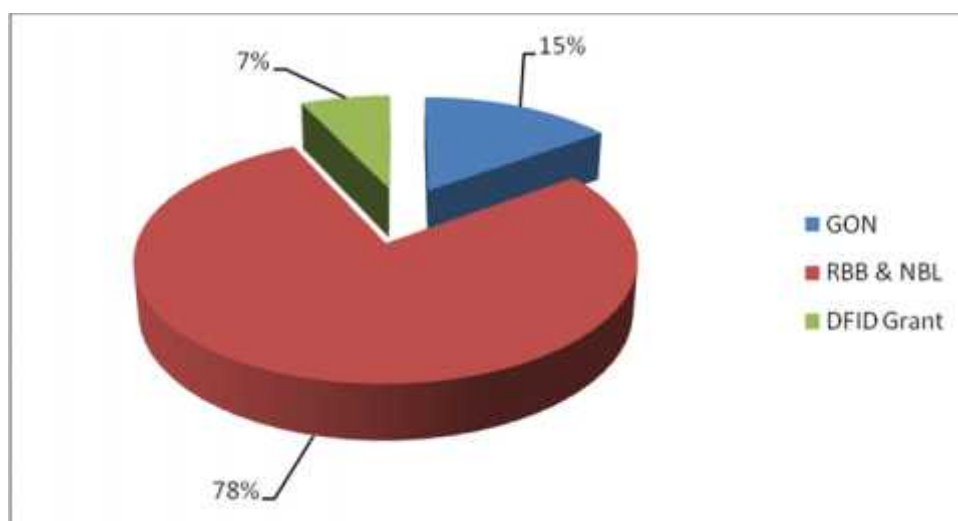
**Figure 4.1**

**Total Management Cost up to July 16, 2007**



**Figure 4.2**

**Funding of the Management Cost**



The management cost has the highest contribution of 78% from the two banks. DFID Grant funds the remaining 15% while the Government of Nepal has taken care of the remaining 7% of the total cost.

#### 4.3.1 NPA Recovery Position

Efforts are going on to recover NPA in cash and restructuring of loans. Around 17 billion NPA has been recovered in cash up to July 2007.

**Table 4.2**  
**NPA Recovery**

(Rs in Billion)

	<b>NPA Recovery</b>	<b>July 2003</b>	<b>July 2004</b>	<b>July 2005</b>	<b>July 2006</b>	<b>July 2007</b>	<b>Total</b>
<b>RBB</b>	Cash	0.98	2.43	3.15	2.78	2.50	<b>11.84</b>
	Restructures	0.25	1.25	0.81	0.24	0.89	<b>3.64</b>
<b>NBL</b>	Cash	2.38	1.23	0.91	1.14	0.78	<b>6.44</b>
	Restructures	1.62	1.04	0.09	0.14	NA	<b>2.89</b>

Table 4.2 shows the NPA recovery position of both Nepal Bank Limited and Rastriya Banijya Bank. Total cash recovery is of Rs 18.28 billion while restructured loss loan amounts to Rs6.53 billion.

Around 10% point of the NPA was written off effect under the mandatory guideline of Nepal Rastra Bank. Similarly, mandatory book write off of Principal Rs 4158million and Interest Rs 8701 million also contributed to a significant effect on the decreased level of NPA. Although this recovery shows positive sign, this effort cannot still be considered satisfactory due to the fact that these banks still have a big amount of negative net worth.

From the above figures the reform program can be considered beneficial in the terms of recovery of loss loan. Besides the monetary aspect, the benefits of the reform program can directly be seen in the qualitative aspects of the operation of these two banks. Hence the reform program can be called a beneficial one.

#### 4.4 Ratio Analysis of Rastriya Banijya Bank

##### 4.4.1 Credit Deposit Ratio

**Table 4.3**  
**Credit Deposit Ratio**

Year	Total Credit (In million Rs )	Total Deposit (In million Rs )	Ratio
<b>Before Initiation of F.S.R</b>			
2056/57	27,699.64	38,575.14	0.72
2057/58	27,375.13	40,773.66	0.67
2058/59	27,037.37	38,993.29	0.69
<b>Mean</b>			<b>0.69</b>
<b>After Initiation of F.S.R</b>			
2059/60	26,608.83	39,402.27	0.68
2060/61	25,105.68	40,866.77	0.61
2061/62	27,000.93	43,016.06	0.63
2062/63	23,246.50	46,195.48	0.46
2063/64	24,775.73	50,464.13	0.49
<b>Mean</b>			<b>0.57</b>

*Source: Appendix*

Table 4.3 presents the credit deposit ratio of Rastriya Banijya Bank before and after the initiation of the Financial Sector Reform Program. The average lending ratio before the reform is 69% whereas this has gone down to 57%

after the reform. The reason behind this is the tight control on credit followed by the new management.

Also the new managements focus was on recovering the non-performing assets than on credit mobilization.

#### 4.4.2 Total Credit and Investment to Total Deposit Ratio

**Table 4.4**

##### **Total Credit and Investment to Total Deposit Ratio**

<b>Year</b>	<b>Total Credit and Investment (In million Rs)</b>	<b>Total Deposit (In million Rs)</b>	<b>Ratio</b>
<b>Before Initiation of F.S.R</b>			
2056/57	32,036.39	38,575.14	0.83
2057/58	33,021.57	40,773.66	0.81
2058/59	31,196.84	38,993.29	0.80
<b>Mean</b>			<b>0.81</b>
<b>After initiation of F.S.R</b>			
2059/60	31,231.96	39,402.27	0.79
2060/61	28,222.70	40,866.77	0.69
2061/62	35,416.81	43,016.06	0.82
2062/63	26,188.90	46,195.48	0.57
2063/64	29,978.93	50,464.13	0.59
<b>Mean</b>			<b>0.69</b>

*Source: Appendix*

Table 4.4 exhibits the credit and investment to total deposit ratio of Rastriya Banijya Bank before and after the Financial Sector Reform program is initiated. The average ratio before the reform is 81%. However after the reform, the credit and investment has accounted to only 69% of total deposit. The total deposit is in increasing trend whereas the credit and investment is not in clear trend. It has declined in the year 2062/63 but again risen in the year 2063/64.

#### 4.4.3 Performing Assets to Non Performing Assets Ratio

Table 4.5

##### Performing Assets to Non Performing Assets Ratio

Year	Performing Assets (In million Rs )	Non-Performing Assets (In million Rs )	Ratio
<b>Before Initiation of F.S.R</b>			
2056/57	18,500.00	9,199.30	2.01
2057/58	14,192.00	13,183.00	1.08
2058/59	12,148.00	14,889.00	0.81
<b>Mean</b>			<b>1.30</b>
<b>After Initiation of F.S.R</b>			
2059/60	10,604.00	16,005.00	0.66
2060/61	10,635.00	14,471.00	0.73
2061/62	13,311.58	13,689.34	0.97
2062/63	14,624.26	8,622.24	1.70
2063/64	17,682.90	7,092.83	2.49
<b>Mean</b>			<b>1.31</b>

Source: Appendix

Table 4.5 shows the ratio of the performing assets to non-performing assets of the bank. The higher the ratio between the performing assets to non-performing assets better the banks efficiency can be. Before the reform the mean ratio is 1.30, which means performing assets is 130% more than the non-performing assets. However, from the fiscal year 2062/63 the performing assets are seen to be increasing. The decrease in non-performing assets shows the recovery of NPA after the reform program.

#### 4.4.4 Non- Performing Assets to Total Assets Ratio

Table 4.6

##### Non-Performing Assets to Total Assets Ratio

Year	Non Performing Assets (In million Rs )	Total Assets (In million Rs)	Ratio
<b>Before Initiation of F.S.R</b>			
2056/57	9,199.30	60,116.22	0.15
2057/58	13,183.00	52,823.71	0.25
2058/59	14,889.00	44,969.22	0.33
<b>Mean</b>			<b>0.24</b>
<b>After Initiation of F.S.R</b>			
2059/60	16,005.00	42,755.16	0.37
2060/61	14,471.00	45,056.32	0.32
2061/62	13,689.34	35,188.95	0.39
2062/63	8,622.24	39,879.62	0.22
2063/64	7,092.83	46,139.65	0.15
<b>Mean</b>			<b>0.29</b>

Source: Appendix

Table 4.6 presents the non- performing assets to total assets ratio of Rastriya Banijya Bank. It can be seen that the non-performing assets amount to 24% of the total assets before the reform. Whereas after the reform this has amounted to 29% of the total assets.

According to Nepal Rastra Bank's directives, non performing assets should be 10% or below the total assets. This means the bank is not being able to maintain the desirable level of non-performing assets. Even after the initiation of the F.S.R.P the ratio is still much higher than the standard though non performing assets have decreased in the years after the initiation of reform program. The higher the non performing assets to total assets ratio the less efficient the banks performance would be.

#### 4.4.5 Interest Expenses to Total Expenses Ratio

Table 4.7

##### Interest Expenses to Total Expenses Ratio

Year	Interest Expenses (In million Rs )	Total Expenses (In million Rs )	Ratio
<b>Before Initiation of F.S.R</b>			
2056/57	2,727.91	4,290.85	0.64
2057/58	2,571.37	4,181.85	0.61
2058/59	2,347.08	3,348.49	0.70
<b>Mean</b>			<b>0.65</b>
<b>After Initiation of F.S.R</b>			
2059/60	2,108.16	5,601.98	0.38
2060/61	1,494.84	2,630.88	0.57
2061/62	1,004.72	2,049.65	0.49
2062/63	850.14	1,883.95	0.45
2063/64	942.75	2,102.48	0.45
<b>Mean</b>			<b>0.47</b>

Source: Appendix

Table 4.7 presents the interest expenses to total expenses ratio. The average ratio is 65% before the reform. After the reform interest expenses have accounted only to 47% of total expenses. Interest expenses are seen in decreasing trend over the years. This could be due to less aggressive effort on deposit mobilization and decrease in interest rates in the market. Decreasing interest expenses are favorable from the profit point of view.

#### 4.4.6 Interest Income to Credit and Investment Ratio

Table 4.8

##### Interest Income to Credit and Investment Ratio

Year	Interest Income (In million Rs)	Credit and Investment (In million Rs)	Ratio
<b>Before Initiation of F.S.R</b>			
2056/57	3,250.43	32,036.39	0.12
2057/58	2,733.89	33,021.57	0.08
2058/59	1,744.74	31,196.84	0.05
<b>Mean</b>			<b>0.08</b>
<b>After Initiation of F.S.R</b>			
2059/60	2,050.68	31,231.96	0.06
2060/61	2,235.88	28,222.70	0.08
2061/62	2,328.82	35,416.81	0.07
2062/63	2,282.83	26,188.90	0.09
2063/64	2,356.94	29,978.93	0.08
<b>Mean</b>			<b>0.08</b>

Source: Appendix

Table 4.8 presents the comparative analysis of interest income to credit and investment. The average ratio is 0.08 in both the periods. This means, the bank is earning interest on an average of 8% from its investment. The higher the ratio the better is the banks profitability position. The interest income was in decreasing trend before the initiation of the program. It is in increasing trend after the reform. While the credit and investment was in fluctuating trend, it is in decreasing trend after the program is initiated. Although the credit and deposit is in decreasing trend, the interest income has increased. This implies that, the bank is being able to recover some due interest or it has reduced the difference between interest suspense and interest receivable.

#### 4.4.7 Total Interest Income to Total Revenue Ratio

Table 4.9

##### Total Interest Income to Total Revenue Ratio

Year	Total Interest Income (In million Rs )	Total Revenue (In million Rs )	Ratio
<b>Before Initiation of F.S.R</b>			
2056/57	3,250.43	3,595.34	0.90
2057/58	2,733.89	3,031.41	0.90
2058/59	1,744.74	2,122.76	0.80
<b>Mean</b>			<b>0.87</b>
<b>After Initiation of F.S.R</b>			
2059/60	2,050.68	2,356.02	0.80
2060/61	2,235.88	3,764.89	0.59
2061/62	2,328.82	3,509.96	0.66
2062/63	2,282.83	2,756.03	0.83
2063/64	2,356.94	2,823.75	0.83
<b>Mean</b>			<b>0.74</b>

Source: Appendix

Table 4.9 presents the total interest income to total revenue ratio. The mean ratio is 0.87 before the reform program which means total interest has 87% of contribution in total revenue of the bank. The average contribution has accounted to 74% after the reform program. Interest income and total revenue is in increasing trend after the initiation of reform program.

#### 4.4.8 Loan Loss Provision to Total Loan Ratio

Table 4.10

##### Loan Loss Provision to Total Loan Ratio

Year	Loan Loss Provision (In million Rs )	Total Loan (In million Rs)	Ratio
<b>Before Initiation of F.S.R</b>			
2056/57	3,979.73	27,699.64	0.14
2057/58	5,891.95	27,375.13	0.21
2058/59	9,693.95	27,037.37	0.36
<b>Mean</b>			<b>0.24</b>
<b>After Initiation of F.S.R</b>			
2059/60	12,217.23	26,608.83	0.46
2060/61	12,784.65	25,105.68	0.51
2061/62	12,730.95	27,000.93	0.47
2062/63	8,612.95	23,246.50	0.37
2063/64	7,446.99	24,775.73	0.30
<b>Mean</b>			<b>0.42</b>

Source: Appendix

Table 4.10 presents the loan loss provision to total loan of Rastriya Banijya Bank for the study period of 2056/57 to 2063/64, before and after the initiation of the Financial Sector Reform program. The average ratio of loan loss provision is 24% before the reform. This ratio has reached to 42% of total loan after the initiation of reform program. Higher ratio of loan loss provision to total loan indicates that the bank has increasing trend in non-performing loans.

Even though the total loan is in the decreasing trend, the loan loss provision has increased in the first three years of the reform. This increase can be subjected to the strict adherence to the Nepal Rastra Banks directives on loan loss provision and increase in additional provision. The bank has reduced the loan and loan loss provision in the years 2062/63 and 2063/64.

#### 4.4.9 Return on Total Assets Ratio

Table 4.11

##### Return on Total Assets Ratio

Year	Net Profit After Tax (In million Rs )	Total Assets (In million Rs )	Ratio
<b>Before Initiation of F.S.R</b>			
2056/57	-1,791.46	60,116.22	-0.03
2057/58	-7,083.25	52,823.71	-0.13
2058/59	-7,068.25	44,969.22	-0.16
<b>Mean</b>			<b>-0.11</b>
<b>After Initiation of F.S.R</b>			
2059/60	-4,839.78	42,755.16	-0.11
2060/61	1,040.10	45,056.32	0.02
2061/62	1,322.89	35,188.95	0.04
2062/63	1,591.48	39,879.62	0.04
2063/64	1,616.91	46,139.65	0.04
<b>Mean</b>			<b>0.01</b>

*Source: Appendix*

Table 4.11 presents the comparative analysis of return on total asset of Rastriya Banijya Bank for the study period of 2056/57 to 2063/64, before and after the initiation of the financial sector reform program. The bank has a very poor performance in terms of profitability. It was in constant loss up to the fiscal year 2059/60. The average ratio of return on total assets for the study period before reform is -0.11 .that means the bank is in loss of 11% on average.

After the initiation of reform, the bank has been able to earn an average of 1% on its total assets which shows the bank is not being able to manage the asset in the efficient way. But since the new management has shown a promising start by earning profit it can be said encouraging. After the initiation of the program total assets and net profit after tax is in increasing trend.

#### 4.4.10 Return on Net Loans and Advances Ratio

Table 4.12

<b>Return on Net Loans and Advances Ratio</b>			
<b>Year</b>	<b>Net Profit After Tax (In million Rs )</b>	<b>Net Loans And Advances (In million Rs )</b>	<b>Ratio</b>
<b>Before Initiation of F.S.R</b>			
2056/57	-1,791.46	23,719.91	-0.08
2057/58	-7,083.25	19,798.28	-0.36
2058/59	-7,068.25	13,689.75	-0.52
<b>Mean</b>			<b>-0.32</b>
<b>After Initiation of F.S.R</b>			
2059/60	-4,839.78	11,679.49	-0.41
2060/61	1,040.10	10,831.08	0.10
2061/62	1,322.89	13,430.93	0.10
2062/63	1,591.48	14,633.55	0.11
2063/64	1,616.91	17,328.73	0.09
<b>Mean</b>			<b>-0.002</b>

Source: Appendix

Table 4.12 presents the comparative analysis of return on net loan and advances of Rastriya Banijya Bank, for the study period of 2056/57 to 2063/64 before and after the initiation of Financial Sector Reform program. The average ratio for the study period before the reform is -0.32. That means the banks return on net loan and advance is negative with 32%. The higher the positive ratio the better is the banks profitability. But the ratios, before the initiation of the F.S.R.P, are negative and, except in the fiscal year 2056/57, higher than the average.

After the initiation of the program the ratio is negative in the fiscal year 2059/60. The bank is being able to generate profit from the fiscal year 2060/61 onwards.

The bank has been able to generate positive return on net loan and advance, after the new management took control of the bank, because of increase in interest income, commission and discount income, increase in the income from the exchange rate fluctuation, and decrease in interest expenses and employee expenses.

#### 4.4.11 Net Profit on Total Revenue Ratio

**Table 4.13**

##### **Net Profit on Total Revenue Ratio**

<b>Year</b>	<b>Net Profit After Tax (In million Rs )</b>	<b>Total Revenue (In million Rs)</b>	<b>Ratio</b>
<b>Before Initiation of F.S.R</b>			
2056/57	-1,791.46	3,595.34	-0.50
2057/58	-7,083.25	3,031.41	-2.33
2058/59	-7,068.25	2,122.76	-3.33
<b>Mean</b>			<b>-2.05</b>
<b>After Initiation of F.S.R</b>			
2059/60	-4,839.78	2,356.02	-2.05
2060/61	1,040.10	3,764.89	0.28
2061/62	1,322.89	3,509.96	0.37
2062/63	1,591.48	2,756.03	0.58
2063/64	1,616.91	2,823.75	0.57
<b>Mean</b>			<b>-0.05</b>

*Source: Appendix*

Table no 4.13 presents the net profit on total revenue of Rastriya Bnija Bank for the study period of 2056/57 to 2063/64, before and after the initiation of Financial Sector Reform program. The net profit after tax is negative from fiscal years 2056/57 to 2059/60. That means the total expenses is higher than the total income in these years. The average ratio of net profit on total revenue is -2.05 in the period before reform. The average ratio has decreased to -0.05 in the period after the reform. Even during the first year after the reform the ratio is negative. This means the bank is in loss till 2059/60. The bank has started

earning profit from the year 2060/61 onwards. This shows that the bank has been able to correct its financial position from the second year of operation under the reform program.

#### 4.4.12 Earning Per Share

**Table 4.14**  
**Earning Per Share**

<b>Year</b>	<b>Net Profit After Tax (In Rs )</b>	<b>Total No. of Shares</b>	<b>Ratio</b>
<b>Before Initiation of F.S.R</b>			
2056/57	-1,791,461,524	3,853,000	-464.95
2057/58	-7,083,249,477	3,853,000	-1838.4
2058/59	-7,068,252,112	3,853,000	-1834.5
<b>Mean</b>			<b>-1379.28</b>
<b>After Initiation of F.S.R</b>			
2059/60	-4,839,783,588	3,853,000	-1256.1
2060/61	1,040,101,227	3,853,000	269.95
2061/62	1,322,893,575	3,853,000	343.34
2062/63	1,591,488,713	3,853,000	413.05
2063/64	1,616,910,912	3,853,000	419.65
<b>Mean</b>			<b>37.98</b>

*Source: Appendix*

Table 4.14 is presented to analyze the trend of earning per share of Rastriya Banijya Bank for the study period of 2056/57 to 2063/64, before and after the initiation of the reform program. The average ratio of earning per share in the period before the reform is -1379.28. That means a price of a share was Rs 1379.28 less than its par value in average in the three years .The earning per share before the initiation of the F.S.R.P is negative in all the three years. After the initiation of the program the earning per share has become positive from the year 2060/61 onwards. But still the average EPS is Rs 37.98 only even with the increase in earnings. The number of shares is constant in each fiscal year. This indicates that the bank has not raised additional capital through the issuance of equity share.

The shares of Rastriya Banijya Bank are not listed in the stock exchange. It would have helped to raise capital from the secondary markets had the banks shares been listed in the stock exchange. Despite that the positive earning per share can be regarded as a good indication of the new management's performance.

#### 4.4.13 Debt Ratio

**Table 4.15**

**Debt Ratio**

<b>Year</b>	<b>Total Debt (In million Rs )</b>	<b>Total Assets (In million Rs )</b>	<b>Ratio</b>
<b>Before Initiation of F.S.R</b>			
2056/57	38,632.42	60,116.22	0.64
2057/58	40,582.76	52,823.71	0.77
2058/59	38,922.37	44,969.22	0.86
<b>Mean</b>			<b>0.76</b>
<b>After Initiation of F.S.R</b>			
2059/60	39,292.66	43,172.43	0.91
2060/61	40,693.65	45,056.32	0.90
2061/62	46,704.90	35,188.95	1.33
2062/63	50,052.20	39,879.62	1.26
2063/64	52,405.70	46,139.65	1.14
<b>Mean</b>			<b>1.11</b>

*Source: Appendix*

Table 4.15 presents the ratio between total debt and total assets of Rastriya Banijya bank for the study period of 2056/57 to 2063/64, before and after the initiation of the financial sector reform program. Earlier total debts comprised on an average 76% of the bank's total assets. This ratio has increased to 111% in the years after the initiation of reform program. Total debt has been in an increasing trend since the year 2059/60 onwards.

#### 4.4.14 Debt Equity Ratio

**Table 4.16**  
**Debt Equity Ratio**

<b>Year</b>	<b>Total Debt (In million Rs )</b>	<b>Total Equity (In million Rs )</b>	<b>Ratio</b>
<b>Before Initiation of F.S.R</b>			
2056/57	38,632.42	1,506.65	25.64
2057/58	40,582.76	1,172.30	34.62
2058/59	38,922.37	1,172.30	33.20
<b>Mean</b>			<b>31.15</b>
<b>After Initiation of F.S.R</b>			
2059/60	39,292.66	1,172.30	33.52
2060/61	40,693.65	1,172.30	34.70
2061/62	46,704.90	1,172.30	39.84
2062/63	50,052.20	1,172.30	42.70
2063/64	52,405.70	1,172.30	44.70
<b>Mean</b>			<b>39.09</b>

*Source: Appendix*

Table 4.16 presents the debt equity ratio of Rastriya Banijya bank for the study period of 2056/57 to 2063/64, before and after the initiation of the Financial Sector Reform program. The average debt ratio of the bank is higher after the initiation of reform program. The equity has remained same since the year 2057/58 while the debt is in increasing trend. The higher the debt equity ratio the more loss bank incurs to pay interests. The reform program has not been able to address the issue of ever increasing debt. The only way out is to increase its share capital.

If bank wants to achieve success it has to issue more equity shares to pay its debt and to recover.

#### 4.4.15 Liquidity – Cash Reserve Ratio

Table 4.17

#### Liquidity – Cash Reserve Ratio

Year	Cash Reserve Ratio (CRR in %)
<b>Before Initiation of F.S.R</b>	
2056/57	9.77
2057/58	8.20
2058/59	8.59
<b>After Initiation of F.S.R</b>	
2059/60	9.48
2060/61	17.18
2061/62	12.91
2062/63	10.97
2063/64	11.11

*Source: Appendix*

Table 4.17 shows the Cash reserve ratios maintained by the bank during the study period. It is mandatory for banks to maintain a reserve ratio of 5% as per the NRB Directives. The bank has been able to maintain the required liquidity in all the years but excess liquidity is also not desirable. Liquidity of the bank has remained at 17.18% in the year 2060/61 which indicates less utilization of available funds. The reform program doesn't seem to be contributing to correct the excess liquidity situation.

## 4.5 Analysis of Correlation Coefficient

### 4.5.1 Correlation between Total Deposit and Investment

**Table 4.18**

#### **Correlation between Total Deposit and Investment**

<b>Fiscal Year</b>	<b>Total Deposit (In million Rs)</b>	<b>Investment (In million Rs)</b>
2056/57	38,480.95	4,336.75
2057/58	40,435.84	5,646.44
2058/59	38,766.2	4,159.47
2059/60	39,212.69	4,623.13
2060/61	40,613.68	3,117.03
2061/62	43,016.06	8,415.88
2062/63	46,195.48	11,555.36
2063/64	50,464.13	12,650.20
<b>Correlation (r)</b>		<b>0.94</b>

Table 4.18 depicts that the coefficient of correlation between total deposit and investment in R.B.B remained 0.94 in the study period. It signifies that a positive relation occurs between the two components. Up to the fiscal year 2059/60 the total deposit and investments are positively correlated with investment increasing and decreasing with the increase or decrease in total deposit. But in the fiscal year 2060/61 the investment decreased while the total deposit has increased. Investment has again increased with the increase in deposit from the year 2061/62 onwards.

#### 4.5.2 Correlation between Net Worth and Net Profit

**Table 4.19**

##### **Correlation between Net Worth and Net Profit**

<b>Fiscal Year</b>	<b>Net Worth (In million Rs)</b>	<b>Net Profit (In million Rs)</b>
2056/57	-2,514.03	-1,791.46
2057/58	-10,378.05	-7,083.25
2058/59	-17,451.35	-7,068.25
2059/60	-22,395.95	-4,839.78
2060/61	-2,1437.9	1,040.10
2061/62	-20,199.43	1,322.89
2062/63	-18,718.58	1,591.48
2063/64	-17,219.50	1,616.91
<b>Correlation (r)</b>		<b>-0.25</b>

Table 4.19 depicts that the coefficient of correlation of net worth and net profit in R.B.B remained -0.25. This implies that there is negative correlation between net worth and net profit. In the fiscal year 2056/57 net worth was (2,514.03) while net profit was (1,791.46) in million Rs. In 2057/58 net profit increased negatively with the increase of negative net worth. But in the fiscal year 2058/59 negative net profit decreased slightly although the negative net worth increased. The trend continued up to the fiscal year 2059/60. The bank has been able to achieve net profit from 2060/61 onwards although it has negative net worth. The negative net worth is in decreasing trend.

### 4.5.3 Correlation between Total Deposit and Loans and Advances

**Table 4.20**

#### **Correlation between Total Deposit and Loans and Advances**

<b>Fiscal Year</b>	<b>Total Deposit (In million Rs)</b>	<b>Loan and Advances (In million Rs)</b>
2056/57	38,480.95	27,699.64
2057/58	40,435.84	27,375.13
2058/59	38,766.20	27,037.37
2059/60	39,212.69	26,608.83
2060/61	40,613.68	25,105.68
2061/62	43,016.06	27,000.93
2062/63	46,195.48	23,246.50
2063/64	50,464.13	24,775.73
<b>Correlation (r)</b>		<b>-0.71</b>

Table 4.20 demonstrates that coefficient of correlation between the total deposit and loans and advances in R.B.B remained -0.71. It implies that the correlation between deposit and loans and advances of the bank is highly negatively correlated. Loans and advances seem to decrease with the rise in the volume of total deposit. While the total deposit has either increased or decreased in each fiscal year the loans and advances is in decreasing trend except for the increase in year 2061/62. The total deposit has increased after the year 2060/61. Whereas total loans and advances have increased in the year 2061/62 and then again declined in the later years.

#### 4.5.4 Correlation between Performing Assets and Net Profit

**Table 4.21**

##### **Correlation between Performing Assets and Net Profit**

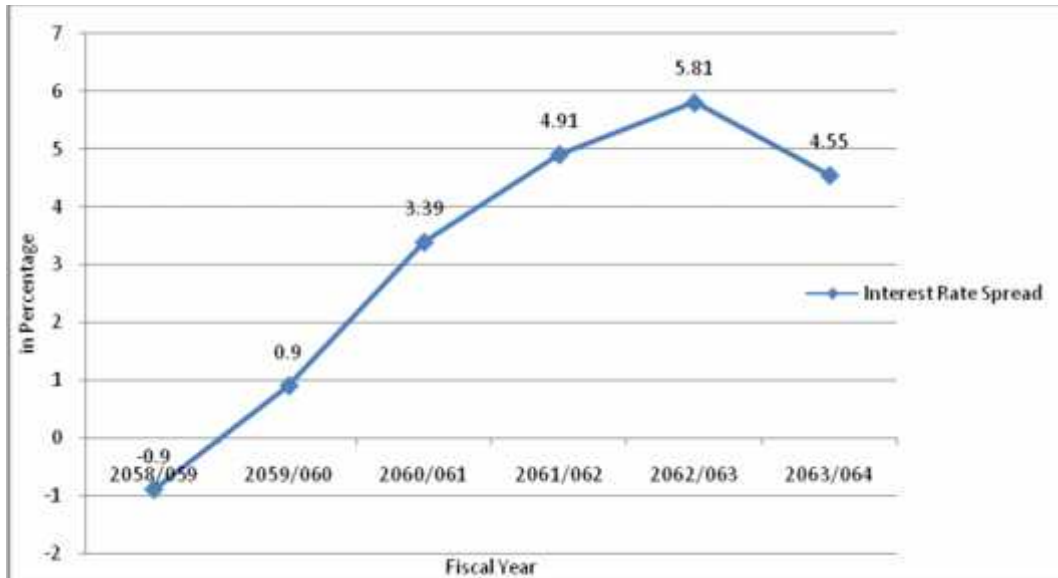
<b>Fiscal Year</b>	<b>Performing Assets (In million Rs)</b>	<b>Net Profit (In million Rs)</b>
2056/57	18,500.00	-1,791.46
2057/58	14,192.00	-7,083.25
2058/59	12,148.00	-7,068.25
2059/60	10,604.00	-4,839.78
2060/61	10,635.00	1,040.10
2061/62	12,145.00	1,322.89
2062/63	14,624.26	1,591.48
2063/64	17,682.90	1,616.91
<b>Correlation (r)</b>		<b>0.22</b>

Table 4.21 depicts the coefficient of correlation between performing assets and net profit in R.B.B remained 0.22. It indicates that the net profit and performing assets of the bank are positively related. Furthermore, the bank can raise its net profit by increasing performing assets. In spite of decreasing performing assets in the fiscal year 2060/61 the bank has been able to register net profit. The final year's data hasn't affected the correlation between them.

#### 4.6 Interest Rate Spread

Interest rate spread is the difference between the interest earned on loans and investments and interest provided on savings and deposits. The more the spread the better it is for a bank, as it shows that the bank is earning more interest from the market than it is spending. The trend of interest rate spread is as under

**Figure 4.3**  
**Interest Rate Spread**

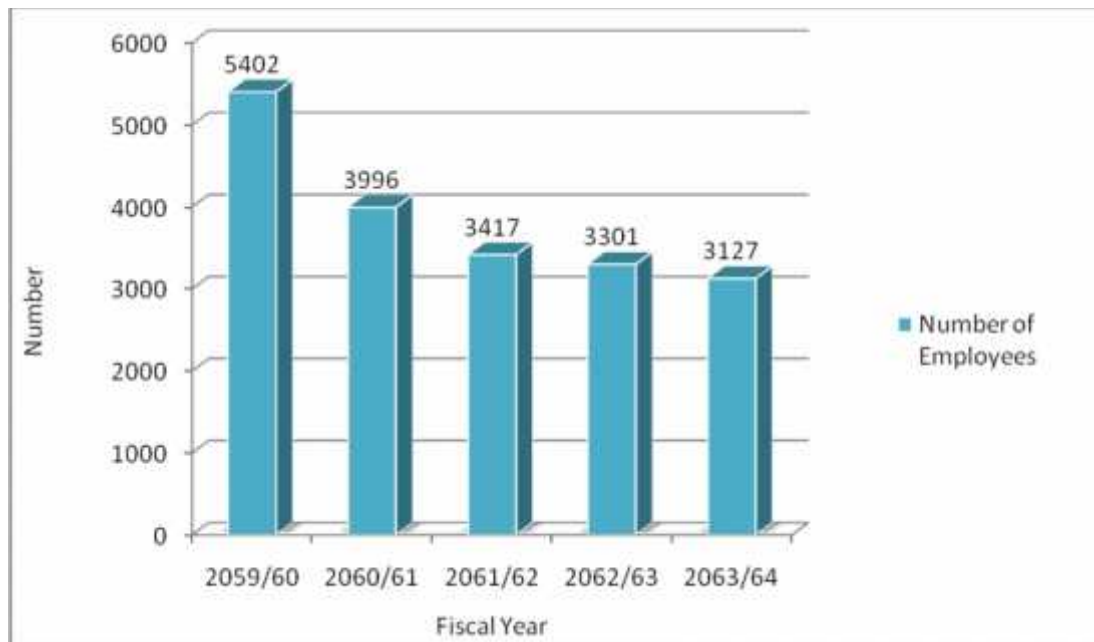


With the negative weighted average interest spread of  $-0.9\%$  in the year 2058/59 the spread has reached a positive mark of  $4.55\%$  in the year 2063/64. This shows that the bank has been gradually earning more interest. The huge difference between interest provided on deposits and interest charged on loans and advances has also accounted for this increasing spread. For instance, the interest rate provided on normal deposits is  $2\%$  while the lowest interest rate on loans is  $7$  to  $9\%$

#### **4.7 Human Resources Development and Management**

To improve efficiency of human resources, Rastriya Banijya Bank has implemented management plan, human resource development plan and skill enhancement plans. New Staff Bye-laws have been prepared. Staff need assessment has been done. Through the voluntary retirement plan employees' number has been decreased up to 3127 from 5402 in the fiscal year 2059/60.

**Figure 4.4**  
**Number of Employees**



Creative trainings have been provided to the employees while facilities of higher education have also been provided. In the fiscal year 2059/60 per employee productivity was 2.162 million Rs, which was 2.84 million in fiscal year 2060/61. Remuneration and other fringe benefits have been increased. As on 2064 Asadh end total staff expenses accounted to 27% of the bank's income. Employees still need to be right sized to achieve reduction in heavy employee related costs.

Human resource management has been made more proactive and strategic with clear line manager's role and sound HRIS System. Management Succession Plan has been developed and implemented. Several new practices like Reward and Punishment Management through New Performance Appraisal System, Performance Based Incentive Plan, Best Performer Reward System and effective departmental action has been initiated.

#### 4.8 Information Technology

To improve the efficiency of the banking activities, computers are provided to the banks branches. Computer trainings have been provided to the employees. Loans are provided to the employees to purchase computer. Banks branches are joined in the computer networks. To provide fast, accessible and reliable banking services to national and international level, SWIFT (society for worldwide international funds transfer) service is in operation. The bank has implemented Integrated Banking Information System (IBIS) in 42 branches. 40 branches of the bank are computerized as of July 16, 2007.

#### 4.9 Capital Adequacy

**Table 4.22**  
**Capital Adequacy**

Fiscal Years	2059/60	2060/61	2061/62	2062/63	2063/64
Capital Adequacy to be Maintained (%)	10	11	11	12	12
Capital Adequacy Maintained by RBB (%)	(44.27)	(41.98)	(33.76)	(55.54)	(43.53)

Table 4.22 shows the Capital Adequacy situation of RBB after the initiation of reform process. NRB has prescribed a certain percentage of capital adequacy to be maintained by commercial banks in each fiscal year. But RBB has not been able to meet these standards even after years of reform. Its Capital Fund is still negative by 43.53%. This does not indicate a sound financial health of the bank.

#### 4.10 Financial Services

RBB has Nepal's most extensive banking network with over 118 branches. Through its branch network, RBB has been contributing to Nepal's economic development by providing banking services throughout the country. RBB has

been trying to make its market position strong by providing all modern day financial services. Some of them are

- ) Internet Banking (e banking)
- ) Sms Banking
- ) ATM
- ) Any Branch Banking Service (ABBS)
- ) 365 Days Banking Service
- ) Visa Debit Cards

RBB is a visa associate member bank. It has launched Debit card services for all the branches within Kathmandu valley and the service has been extended to the other branches out of Kathmandu valley. RBB issues three types of visa debit cards:

- ) Visa Domestic-Valid in Nepal and India
- ) Visa International -Valid Worldwide
- ) Visa Travel Quota -Valid worldwide issued against Travelers Cheque

### **Remittance Service**

Remittance from workers abroad has been a major inflow in the country since last few years. RBB has started online web based remittance system, where by Nepali citizens working at Qatar and UAE can send money to Nepal instantly. Payments can be collected from the sixty branch offices of the Bank. Apart from RBB Remit, RBB provides online foreign remittance through the following international services:

- ) Western Union Money Transfer
- ) Instant Cash Global Money Transfer
- ) Xpress Money Transfer
- ) Eazy Remit

#### 4.11 Current Position

Rastriya Banijya Bank has been providing banking services with its huge network of 114 branches throughout the country. The number of branches over the years has been as under:

**Table 4.23**

**Number of Branches of Rastriya Banijya Bank**

Asadh end	2058	2059	2060	2061	2062	2063	2064
No. of Branches	185	172	128	117	114	114	114

Many branch offices were shut down due to security reasons and many destroyed during the period of Maoist insurgency. At present RBB occupies 16% market share in deposit collection, 15% in credit flow and 3% in remittance business. It has 11,01,531 depositors and 1,23,352 borrowers. With more than 65 international correspondent banks, the bank is making its presence global in the current competitive scenario.

Modern management practices have been introduced in the bank after the new management took control. Guidelines and manuals for every sector of operation have been developed to help smooth and effective functioning. Corporate governance and internal control system have been initiated through effective budgetary practices and structured procedures with the establishment of separate corporate governance unit.

Bank has made a big leap in the area of information technology by computerizing more than 80% of its business and offering its customers all modern banking services like, ABBS, ATM, Visa Debit Card, sms Banking, and Internet Banking etc.

New Accounting System has been developed and implemented and effective budgeting and planning system has been introduced for effective financial

control. Almost all un-reconciled branch accounts have been reconciled and records updated.

The bank has been making every effort in making its good presence felt in the financial sector and is getting successful to some extent. But still the problem lies in recovery of bad loans and recapitalization.

#### **4.12 Major Findings**

Concept of financial reform emerged since 1980s with the economic liberalization. HMG/N and NRB published the economic and monetary policy to support such reform. As a result of these policies, various joint venture banks were established in the private sector. Under the Structural Adjustment Program of the IMF, the financial sector was further liberalized in 1987. The focus of NRB was placed on indirect monetary control. The Agriculture Development Bank of Nepal (ADB) and the Nepal Industrial Development Corporation (NIDC) were allowed to issue debentures to increase their financial resources. NRB strengthened its regulation and supervision of banking and financial institutions and the commercial banks were granted virtual freedom to fix their interest rates on deposits in July 1989 except for the priority sector credit.

The Credit Information Bureau was established in 1989. NRB started to control the financial institutions by strengthening the supervision and monitoring system. There was a new development in the capital market. It opened its floor for corporate share trading in 1994 and the Securities Exchange Center (SEC) also started to provide some merchant banking services. NRB further liberalized the restrictive measures for providing license to banking and non-banking financial institutions and especially development banks and finance companies were given more freedom in their business operation. NRB sought the financial and technical help of UNDP and the study team presented the Commercial Banking Problem Analysis and Strategy study

(CBPASS) report. This report has recommended HMGN to address the different critical areas such as full repayment of government guaranteed loans, partial recapitalization of NBL and RBB etc.

The Government enacted the NRB Act, 2002, the Debt Recovery Act, 2002 and the Banking and Financial Institution Act, 2063, the Secured Transaction Act 2063; the Public Debt Act and Foreign Exchange Regulation Act were amended in 2002, which addressed the weaknesses in the legal enforcement mechanism and judiciary capacity.

Under the comprehensive financial sector reform program the management of the Rastriya Banijya Bank was handed over to the foreign management team. Restructuring of RBB is one of the priority scopes of the program. In light of this program these are the major findings seen after the initiation of the program.

### **1. Utilization of Assets**

Rastriya Banijya Bank has high volume of non-performing assets with respect to the total assets i.e, 29% on an average after the initiation of reform. The non-performing assets have grown from an average of 24% to 29% even after the banks management has been handed over to new management. Similarly, there is positive correlation between performing assets to net profit. This shows that there hasn't been much improvement in the utilization of assets even after the reform program.

### **2. Profitability Position**

There was a situation of continuous negative profit in the bank till the fiscal year 2059/60. It has been able to earn a net profit of 1040.101 million in the fiscal year 2060/61 and the year then onwards. The trend of net profit after tax is increasing. This can be contributed to the new management's effort to improve the bank's position.

### **3. Earning Per Share**

Because of the negative profit, R.B.B has negative earning per share every year up to the fiscal year 2059/60. In the fiscal year 2061/62 the earning per share has reached a positive mark of Rs 343.34. This is due to the turn around in the profitability situation from the year 2061/62 onwards.

### **4. Trend of Deposit Utilization**

Credit and Investment to total deposit ratios is 69% on an average after the reform. Previously it was 81% of the total deposit. Deposit mobilization is thus seen to be decreasing. This may be due to the concentration of the management in the recovery of problem loans than on extending new credit.

### **5. Loan Loss Provision**

The bank has loan loss provision of 42%, on average, of total loan in the years after the initiation of reform program. Earlier this average was only 24% of total loan. The increase in loan loss provision show that the bank's problem loans are increasing. The recovery effort of the new management still seems inadequate.

## **CHAPTER- V**

### **SUMMARY, CONCLUSION AND RECOMMENDATIONS**

#### **5.1 Summary**

Nepal's financial sector has witnessed rapid expansion over the past two and half decades, mainly due to the liberalized policy adopted by the government. In fact, the financial sector has grown faster compared to other sectors in the process of economic liberalization. It has resulted in the increasing role of the private sector. Development of money market, capital market and insurance business has contributed towards increased economic activities. The access to modern financial services has reached to a larger portion of the population. Innovative banking technology, products and services have been introduced in the financial market. The general public has thus been benefited and the confidence of depositors has been enhanced. Financial Sector Reform through different phases has helped the financial sector grow in many ways.

This study was conducted with the objective to assess the effectiveness of the financial sector reform program, compare its costs and benefits and to make comparative analysis of performance of Rastriya Banijya Bank after the initiation of Financial Sector Reform Program.

The reform process was mainly carried out for publicly owned banks. Out of four public owned banks in Nepal, Rastriya Banijya Bank was selected for the study purpose.

Different ratios have been used to compare the performance of the bank before and after the initiation of the reform program. The analysis of financial and operational side of the bank show that various achievements have been made under the reform program. The bank has introduced modern management practices in all sectors of its functioning and its profitability is also increasing. However, the problem still lies in its huge non-performing assets and negative

net worth which can only be addressed by recapitalization of the bank. The bank has also not been able to optimally use its assets and recovery efforts seem inadequate.

## **5.2 Conclusion**

Financial sector reform plays a crucial role in the economic growth of the country. Financial system is regarded as the engine of growth. It works as the lubricator for the economic machinery. As the apex financial institution, Nepal Rastra Bank has a big role to play to support the financial sector reform program. The Insurance Board and Securities Board also have to play their roles to expand security services. The two problematic public banks Rastriya Banijya Bank and Nepal Bank Limited are still under the reform program. Without the improvement in these two banks, reform in the financial system is unthinkable. Financial experts have been invited to sort out existing problems and run them as vibrant and sound banking institution. But their problem is still very acute. They need appropriate diagnosis. Because of the cumulative weakness of the past, they are in serious trouble. The government, NRB and the World Bank are very serious to turn them into sound and efficient banking institution.

The restructuring of Agriculture Development Bank has been initiated very recently under the financial assistance of the Asian Development Bank. The study of the overall performance of the Nepal Industrial Development Corporation (NIDC) has been completed.

While modern management practices have been introduced, branches closed and payroll reduced, the future of both banks is uncertain. Initially, both banks were expected to be privatized, but the shift in the political climate has made this option difficult. While these banks' balance sheets have improved significantly, large, willful defaulters have to a large extent escaped their

responsibilities, and the measures undertaken by the NRB and government-such as seizing passports-have to date yielded only limited results.

The fundamental problems are with the ownership of the banking system. After a decade of reforms, it is increasingly apparent that the banking system needs to be privatized after a thorough cleaning up of the balance sheet and possible capitalization. Until this is done, all the other banking system reforms will remain incomplete.

### **5.3 Recommendations**

The following recommendations are in order for Rastriya Banijya Bank to improve its efficiency: -

1. Growing non-performing assets is a primary reason for the negative net worth of the Rastriya Banijya Bank. So the focus should be given to decrease the non-performing assets. To do this all the non-performing loans should be recovered. The management should show strong will to penalize the willful defaulters. Government should support the bank in its endeavor to recover all bad debts.
2. Excess liquidity is another problem of the bank. Almost 12% of total deposit is in the cash and bank balance. The liquidity should be decreased up to 10% of the total deposit.
3. The interest earning of the bank for the study period is just 8% on average. Where as interest expenses is 47% on average and 45% in 2063/64. Interest expenses still comprise a major portion of expenses. The bank should put efforts to decrease interest bearing deposits and take initiatives to recover interests on credit and investment in time.
4. The earning per share of the bank was negative up to the fiscal year 2059/60. Although the EPS is positive from the fiscal year 2060/61 it is of no use because the shares are not listed on the stock exchange. To

increase the banks presence in the capital market its shares should be listed in the stock exchange.

5. The bank should analyze risk and return before providing loans to the customers. Custom of providing loans on the political pressure should be discouraged. The management should show strong will to penalize the willful defaulters. The question that still arises is whether the bank's ability to appraise credit risk and take prompt corrective action in the case of problem accounts has improved sufficiently. It is difficult to give an affirmative answer to this question
6. The major question that arises in the present situation of reform activities is - "What is the final destination of reform?" Is it privatization or restructuring or making these banks feasible? After five years of reform, it looks like that the vision of reform is still not clear.

What is the desired level for handover? How long will the management contract be in place? These are some of the questions left unanswered.

Similarly another question is "What is the vision now?"

1. If it is bringing operational efficiency and profit then the route to this could be re-capitalization
2. If it is privatization through operational efficiency then a time framework has to be drawn to achieve the set vision.

The government and responsible authorities have to be clear in answering these questions to ensure a sound future of the problematic bank.

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