

**FINANCIAL POSITION OF COMMERCIAL BANKS  
IN NEPAL : PRE & POST REFORMS (FOR FIVE YEARS)-  
A COMPARATIVE STUDY**



**A**

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*submitted to*

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*CERTIFIED THAT SAROJ KUMAR THAKUR HAS CARRIED ON HIS RESEARCH WORK UNDER MY SUPERVISION AND GUIDANCE ON THE TOPIC "FINANCIAL POSITION OF COMMERCIAL BANKS IN NEPAL : PRE & POST REFORMS (FOR FIVE YEARS)-A COMPARATIVE STUDY".*

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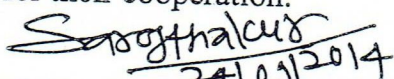
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# **PREFACE**

**T**he commercial banks are currently regarded as key driver of financial institutions of Nepal. Financial services sector had commenced with the establishment of Nepal Bank Limited in 1937. After the liberalization in the mid 1980s, the government permitted the opening of commercial banks in joint venture with foreign banks. Since then, the Nepalese financial system has undergone rapid structural changes, with a large number of financial institutions expose and display of financial products and services.

There are presently 263 financial institutions among them 32 are commercial banks. The market size of both the joint venture and domestic private banks has been increasing at the expense of the public sector banks, which are shrinking over time. The commercial banks are divided into three separate groups based on ownership namely, (i) public sector banks, (ii) joint venture banks, and (iii) domestic private banks.

A decade after the establishment of NRB, Rastriya Banijya Bank (RBB), a commercial bank under the ownership of His Majesty's Government of Nepal (HMG/N) was established. Thereafter, HMG/N adopted open and liberalized policies in the mid 1980s reflected by the structural adjustment process, which included privatization, tariff adjustments, liberalization of industrial licensing, easing of terms of foreign investment and more liberal trade and foreign exchange regime was initiated. With the adoption of liberalization policy, there

has been rapid development of the domestic financial system both in terms of number of financial institutions and as ratio of financial assets to the GDP.

In the context of banking development, the 1980s saw a major structural change in financial sector policies, regulations and institutional developments. HMG/N emphasized the role of the private sector for the investment in the financial sector. The financial sector liberalization, started already in the early eighties with the liberalization of the interest rates, encompassed further deregulation of interest rates, relaxation of entry barriers for domestic and foreign banks, restructuring of public sector commercial banks and withdrawal of central bank control over their portfolio management. These policies opened the doors for foreigners to enter into banking sector under joint venture. Consequently, the third commercial bank in Nepal, or the first foreign joint venture bank, was set up as Nepal Arab Bank Ltd( now called as NABIL Bank Ltd ) in 1984.

There after, two foreign joint venture banks, Nepal Indosuez Bank Ltd. (now called as Nepal Investment Bank) and Nepal Grindlays Bank Ltd (now called as Standard Chartered Bank Nepal Ltd.) was established in 1986 and 1987 respectively. There after, another 12 commercial banks have been established within the period of 12 years. Nepalese banking system has now a wide geographic reach and institutional diversification. Although, Nepalese financial sector is dynamic, a lot of scope for development of this sector exists. This is because the banking and non-banking sectors have not been able to capture all the potentialities of business till this time. It is evident from the Rural Credit Survey Report that the majority of rural credit is supplied by the unorganized sector at a very high cost – perhaps being at two or three time of the formal

sector - suggesting that the financial sector is still in the path of gradual development. Overdue loans and inefficiency of the older and the larger of commercial banks have aggravated and have been made to compete with the new trim banks with no rural operations. Also, the commercial banks, domestic or joint venture have shown little innovation and positive attitude in identifying new areas of saving and investment opportunities.

Banking and Finance sector is one of the important pillar for the economic development of any country. Commercial banks, one of the major components of banking system, have to be efficient as it links the various economic activities such as agriculture, trade, industry, energy and service with the economic development. Banks need to be efficient not only for the greater goal of economic growth but also for survival against its competitors. With the growth in banking activities, the efficiency has been the growing concern of commercial banks in order to remain competitive. Due to the importance of the financial sector and its impact to the whole economy, financial sector development study and efficiency analysis is necessary. The efficiency of financial institutions has been widely and extensively studied in the last few decades. For financial institutions, efficiency implies improved profitability, greater amount of funds channeled in, better prices and services quality for consumers and greater safety in terms of improved capital buffer in absorbing risk. The mostly used measures for evaluating banks in Nepalese context include various financial ratio measures, which provide the tools for managing information in order to analyze the financial condition and performance of a bank. The most commonly used financial ratios, such as Return on Shareholders' Equity (ROE), Return on Assets (ROA), Profit Margin (PM), Net Interest Margin (NIM), Cash Reserve Ratio

(CRR) and Earnings per Share (EPS), are used to characterize the performance of banks.

Though financial ratios analysis compares the financial performance among commercial banks, the same bank had different ranks under the different financial ratios.

High overhead costs, political interventions, poor management and low quality of collateral created continued deterioration in the financial health of the public sector banks. Furthermore, it can be concluded the capital adequacy ratio, interest expenses to total loan and net interest margin were significant but had a negative effect on ROA while non-performing loan and credit to deposit ratio did not have any considerable effect on ROA. The capital adequacy ratio positively influenced the return on equity but the non-performing loan, credit to deposit ratio, interest expenses to total loan and net interest margin had no significant effect on ROE.

Financial development is not only caused by policy changes in the financial sector, but it largely depends on the demand of financial services in the economy. The development of the financial sector is vital for economic development of a country. But it cannot be achieved in isolation with the other sectors of the economy. Simultaneous growth in all the sectors of the economy can raise more demand of financial services and it can stimulate financial development.

Policy changes have no impact indicates that the policy reforms have no impact on financial indicators, such as on banking credit to private sector and liquid liabilities. This implies, the reduction of domestic credit supply could not be reflected in the private sector credit. The presence of some problems in the

banking sector of Nepal is weakening the impact of liberalization. Among them, for instance, during the last two decades, banks suffer from a problem of a high ratio of non-performing loans and it is always discouraging banks from credit allocation. The expansion of commercial banks and their expansion seemed very low in comparison to other bank and non-bank financial institutions, and banks could not capture local savings. Similarly, commercial banks could not capture monetary activities held by the government and other service sectors. This research suggests that the government policy makers should implement policies strictly for financial sector development and to promote growth. Similarly, more investigations to examine the impact of financial development on the economic growth process in Nepal are needed because the presence of a unit root in real GDP, private credit and broad money provides a way of estimating a long run relationship between them.

**(SAROJ KUMAR THAKUR)**

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