IMPACT ASSESSMENT OF FINANCIAL SECTOR REFORM ON COMMERCIAL BANKS AND FINANCE COMAPNIES

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RECOMMENDATION

This is to certify that the Thesis

Submitted by:

NIRDOSH PRASAD SHARMA

Entitled:

IMPACT ASSESSMENT OF FINANCIAL SECTOR REFORM ON COMMERCIAL BANKS AND FINANCE COMAPNIES

has been prepared as approved by this Department in the prescribed format of the Faculty of Management. This thesis is forwarded for examination.

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And found the thesis to be the original work of the student and written according to the prescribed format. We recommend the thesis to be accepted as partial fulfillment of the requirement for

Master Degree of Business Studies (M.B.S.)

Viva-Voce Committee

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DECLARATION

I herby declare that the work reported in this thesis entitled **"IMPACT ASSESSMENT OF FINANCIAL SECTOR REFORM ON COMMERCIAL BANKS AND FINANCE COMPANIES"** submitted to Office of the Dean, Faculty of Management, Tribhuvan University, is my original work done in the form of partial fulfillment of the requirement for the Master's Degree in Business Studies (M.B.S.) under the guidance and supervision of **Shree Bhadra Neupane, Ass. Campus Chief** and **Indra Sharma** of Shanker Dev Campus, Putalisadak, Kathnamdu.

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This study has been done to assess the current status of financial sector reform in Nepal. During the study period, I got the opportunity to interact with different experts and practitioners in the related field which was the main inspiration for me to study more in this area.

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I wish this study will help to all interested candidates in the field of financial sector reform. This work has been completed in short period of time. Hence, there may be shortcomings, lacking and mistaken. I always welcome for the comments from all those well wishers. Needless to say, I am alone responsible for any deficiencies may have remained in this work.

Nirdosh Prasad
Sharma
Researcher

TABLE OF CONTENTS

ABBREVIATIONS

ADB	-	Asian Development Bank
ADB/N	-	Agriculture Development Bank
CAR	-	Capital Adequacy Ratio
CARR	-	Cash Reserve Ratio
CBOs	-	Community Based Organizations
CBs	-	Commercial Banks
CPBASS	-	Commercial Banking Problem Analysis and Strategy Study
DBs	-	Development Banks
DFID	-	Department for International Development
ESAP	-	Enhance Structural Adjustment Program
F/Y	-	Fiscal Year
FCs	-	Finance Companies
FSR	-	Financial Sector Reform
GDP	-	Gross Domestic Product
GoN	-	Government of Nepal
HMG/N	-	His Majesty's Government of Nepal
IIDS	-	Institute for Integrated Development Studies
IMF	-	International Monetary Fund
M2	-	Broad Money
NBL	-	Nepal Bank Limited
NDF	-	Nepal Development Forum
NEPSE	-	Nepal Stock Exchange
NGOs	-	Non- Government Organization
NIDC	-	Nepal Industrial Development Corporation
NPA	-	Non Performing Assets
NRB	-	Nepal Rastra Bank
PRSP	-	Poverty Reduction Strategy Paper
PSC	-	Priority Sector Credit
RBB	-	Rastriya Banijaya Bank
ROA	-	Return on Assets
SAP	-	Structural Adjustment Program
SEC	-	Security Exchange Centre
SLR	-	Statutory Liquidity Ratio
SMC	-	Security Marketing Centre
UK	-	United Kingdom
UNDP	-	United Nation Development Program
USA	-	United States of America
VRS	-	Voluntary Retirement Scheme
WB	-	World Bank
WTO	-	World Trade Organization

CHAPTER - I
INTRODUCTION

1.1 Background of the Study

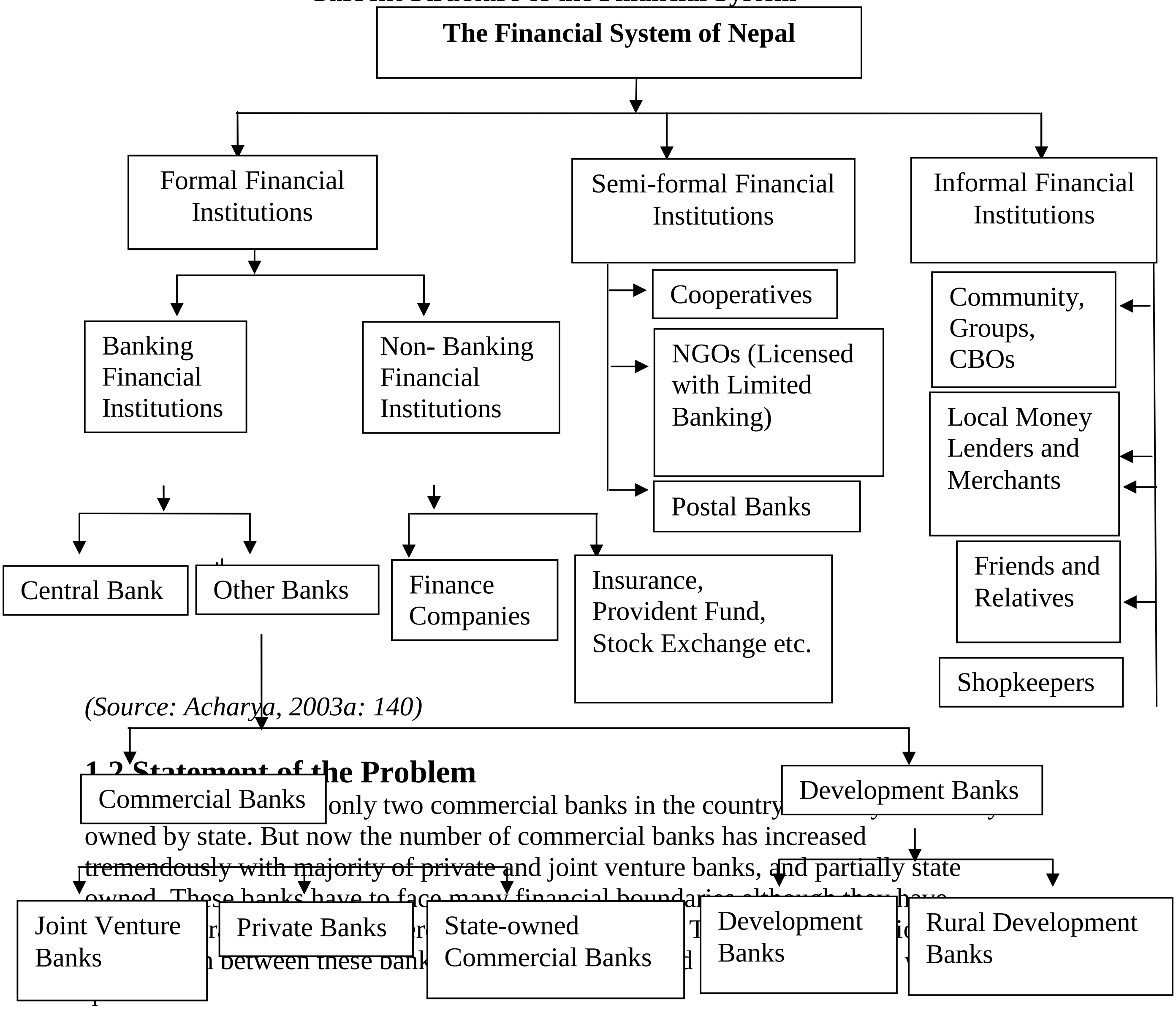
"Financial sector reform means gradual liberalization of financial market and its players and opening of all types of depository and non-depository financial institutions to the private sectors. Depository institutions include Commercial Banks, Development Banks, Finance Companies, Co-operative Banks etc. Other financial institutions include life and non-life insurance companies, mutual funds, credit unions, mortgage banks, money market mutual funds, deposit insurance corporation/company, pension fund/provident fund, unit trust, savings and loan associations and so on. In most developing transition economies, the financial sector is dominated by the banking sectors, which are the largest immobilizers of deposits and providers of credit" *(Shrestha; 2004a: 75).*

The process of financial sector liberalization in Nepal is a very recent phenomenon. The process of liberalization was started with the financial sector reform in mid eighties. It was surged up after the initiation of Structural Adjustment Program (SAP) Enhanced Structural Adjustment Program (ESAP) with respective loan and assistance of the World Bank (WB) and International Monetary Fund (IMF). But in the global context, it was started in the decade of 70s. It was designed to address the institutional deficiencies and closed and controlled financial system.

"Financial sector reform also covers and includes the area of competition, transparency, financial deposits and governance. The process of financial sectors reform begins with deregulation of interest rates on deposits and lending, phasing out of margin rates, statuary reserve requirement and targeted credit programs, opening financial industry to private sector (domestic and foreign), permission to open foreign currency account to commercial banks, current account convertibility and it completes with free entry and exits barriers to foreign investors in banking. Security trading, insurance services and privatization of government owned banking and financial institutions are examples of financial sector liberalization" *(Shrestha; 2004a: 76).* Financial sector plays a vital role in the development of economy and actually works as a lubricator by providing financial resources. "It operates as intermediary between financial surplus units and financial credit units i.e., lenders/savers and barrowers/spenders. The financial markets provide playing field to financial institutions and their customers (depositors, borrowers, investors etc.) with all types of financial instruments such as; deposits, loans and advances securities, insurance polices, share corporate bonds etc. It provides different avenues to savers to invest their saving in financial product and services in accordance with their needs and makes funds available to barrowers/ investors in most competitive prices. So, the financial sector is regarded as the backbone or engine of growth of any economy either developed or developing countries - in transition or emerging" *(Shrestha; 2004a: 76).* It mobilizes and allocates financial resources most productively and efficiently and also induces investment, increases employment opportunity and productivity, maintains growth targets, and attains overall macro economic development.

In Nepalese financial system and financial services, Nepal Bank Limited (NBL) established in 1937 was the first commercial bank in Nepal. The establishment of Nepal Rastra Bank (NRB), the central bank of the country, was in 1956, and it was a major step towards the evolution and generalization of Nepalese Financial System *(Acharya, 2003a: 136).* In July 2008, the financial networks of the country have been widened with the operation of the increased number of commercial banks up to 25, and numbers of its branches are 555. Prior to the financial sector reform, only two commercial banks were established. Even the insurance services sector has developed with the establishment of joint-venture insurance companies. There are all together 21 life and non-life insurance companies in the country. The number of listed companies in the Nepal Stock Exchange (NEPSE) has reached 194. Till July 2008, the number of Development Banks are 58, and the number of Rural Development Banks are 5, number of financial companies are 78, number of co-operative societies (licensed by NRB) are 16, number of Micro-finance Non-governmental organizations (licensed by NRB) are 46 in the country.

Chart: 1.1
Current Structure of the Financial System



(Source: Acharya, 2003a: 140)

1.2 Statement of the Problem

... only two commercial banks in the country ... owned by state. But now the number of commercial banks has increased tremendously with majority of private and joint venture banks, and partially state owned. These banks have to face many financial boundaries although they have ...

In this scenario, to up-lift the quality of services provided and to increase the competition between them, the reform in financial sector was felt as an urgent need. Realizing it, the Commercial Bank Act 2031 was amended in 2041 and the barriers in the entry and exit of banks were set free. In fact, the target of Act amendment was to attract the foreign investors for the establishment of joint-venture banks, expecting to increase flow of foreign capital and technological knowledge in the economy. Besides this, introduction of modern banking efficiency in the conservative national banks and widening the financial sector and financial infrastructure of the country was also expected.

In spite of financial sector liberalization in Nepal, the contribution of financial sector to Gross Domestic Product (GDP) is not far mentionable. Gross Domestic Savings has not shown a steady and constant growth trend. Lack of transparency, Non-Performing Assets (NPA), over-staffing, interest rate spread, weak financial and management information, weak legal and low standard accounting process, low skillful man-power operating with under utilization and deep flows in lending process, loan files and loan portfolios are the major issues of financial sector liberalization in Nepal. After more than two decades of financial liberalization, Nepal's financial sector remains particularly weak and extremely fragile largely benefiting a narrow base of users in the main urban areas and having very little impact upon the mass of Nepalese people. The Financial Sector Reform (FSR) is critical issue, which needs to be addressed not only due to its importance for private sector but also for ensuring macro-economic stability. While addressing the FSR these are the main issues which needs to be addressed or answered:

a. What is the impact of FSR in Nepalese Financial System?
b. What is the impact of FSR in Commercial Banks?
c. What is the impact of FSR in Development Banks?
d. What is the impact of FSR in Finance Companies?
e. What is the impact of FSR in other Financial Institutions?

1.3 Focus of the Study

Although the process of liberalization and opening up of the financial sector started in mid 1980s, the acceleration of financial sector reforms began in early 1990s. For more than two decades of the initiation of reform process, it seems to be relevant to access the impact of reform in the financial sector of Nepal. Since it is difficult to study and access the impact of FSR in overall financial sector of Nepal, this study was focused to assess the impact of financial sector reform only on commercial banks and finance companies. The purpose of this study is to study the recent initiation and commitments in the field of FSR, and to assess the direct or indirect effect of FSR in commercial banks and finance companies.

1.4 Objectives of the Study

The general objective of FSR is to help expanded economic activities. Obviously, an increase in economic activities accelerates the economic growth and it is pertinent to discuss the achievements of the FSR through the help of certain financial indicators. It is also important to note here that it is difficult to isolate the impact of FSR and other related variables on economic growth. This study is targeted at the impact of FSRs on commercial banks and finance companies. The study concentrated on the trend and achievement of FSRs, for which the major variables considered are number of financial institutions, addition of financial services, deposit growth, credit to the private sector, interest rate spread and real interest rate, non-performing assets, cost and benefit of financial sector liberalization and other related variables.

The main objectives of the study are.

a. To assess the impact of FSR program in Nepal;
b. To analyze the impact of FSR program in Commercial Banks;
c. To examine the impact of FSR program in Finance Companies.

1.5 Importance of the Study

Financial sector is the back bone of the country's economy. So, it is directly related to other variables such as, income and employment. The importance of FSR was also learnt from the bitter experience of vulnerable South East Asian Financial Crisis. The healthy and competitive financial system offers timely and competitively priced credit to borrowers. So, it is necessary to know actual condition and direction of financial sector. This study would try to pin point these factors of financial system and give further agenda for reforms and will contribute to a consistent and transparent legal and regularity framework for corporate and financial governance. It would also show the impact of past financial reform on the financial institutions. Thus, this study will try to bridge the gap of research work in this sector. It is hoped that, this study would benefit the reform makers, regulators and other concerned.

1.6 Limitation of the Study

This study is concerned on the trends and impact of the financial sectors reform. Impact analysis is made on the basis of availability of the data. As we have to complete this study within limited time frame, so the limitation of time and budget plays vital role in the final outcome.

Besides the above common limitations these are some important limitations of the study:

a. This study does not cover the fields like manufacturing and non-manufacturing, mutual fund, capital market, postal saving services, insurance companies, employee's provident fund etc.
b. The study mainly covers commercial banks and finance companies in aggregate form.
c. Accuracy of the data used for evaluation in this study is depends up on the accuracy of the source of data.
d. This study does not cover the all component of the FSR. Only major components like NPA, Liquidity, Deposit, Credit etc has considered.
e. Only secondary data are used for the analysis of various component of FSR.

f. It is quite hard to get the required data, review material and studies regarding this topic. So, the major constrain for this study is limited data, review material and studies.
g. Primary data collected as opinion poll and only for percentage analysis.

1.7 Organization of the Study

This study is presented in five chapters. The organization of these chapters and content is as follows:

Chapter-I: Introduction

This chapter deals about the introduction of background of the study, statement of the problem, focus of the study, objectives of study, Importance of the study and limitation of the study.

Chapter-II: Review of Literature

This chapter deals with conceptual part of the FSR and also explores the review of previous literature, and the acts and ordinance relating to Commercial Banks and Finance Companies.

Chapter-III: Research Methodology

This chapter deals about research design, selection of study area, types of data, data collection methods, sources of data, tools for analysis and so on.

Chapter- IV: Data Presentation and Analysis

This chapter covers all the required data and its interpretations. Interpretations of data are solely based on secondary data and it is used to analyze the impact of some independent variable. The gathered data are tabulated and shown in charts, graphs and diagrams whenever relevant.

Chapter- V: Summary, Conclusion and Recommendations

This chapter is the final chapter of the study and consist summary and conclusion of the study. Finally, some recommendations are made according to result of the study.

CHAPTER - II
LITERATURE REVIEW

2.1 Conceptual Review

Financial sector is that part of economy concerned with the transaction of financial institutions. Financial institutions provide many transmission services and loan facilities and influence the working of the real economy by acting as intermediaries in channeling saving and other funds into investment uses. The financial sector together with corporate sector and personal sector constitute the private sector. The private sector, the public (Govt.), sector and foreign sector make up the national economy.

Nepal's financial sector is rather small comprising a small number of financial institutions. The Nepalese financial system comprises the banking and non-banking financial institutions. The banking system consists of Nepal Rastra Bank (NRB) which is the central bank and commercial banks, where non-bank financial institutions includes Employee Provident Fund, Finance Companies, Insurance Companies, Credit Guarantee Corporative, Postal Saving Offices, Credit Guarantee Corporation, Civil Investment Trust, NIDC Capital Markets, Stock Exchange etc.

The Nepalese financial sector is dominated by the banking system, where commercial banks are largest and important constituent. In the sphere of commercial banks two government controlled banks Nepal Bank Limited (majority private owned) and Rastriya Banijya Bank (100% government owned) together control about two-third of the banking business and thus dominate the arena of commercial banks. The status and development of financial system in Nepal, thus largely depends upon the performances of these two governments controlled banks.

An act of liberalization pre-envisages that certain rigidities or fundamental disequilibrium persists in some or certain sectors of the economy. These rigidities be it on financial sector or in pure micro-economic sense, the economy including legal obstacles are shackles which have to be hammered down to free the undaunted task of enforcing market mechanism because economist has already agreed upon that it is intervention which is responsible for any distortion that the economy is burdened with.

Financial Sector Reform is related “to establish a modern financial system capable of acting as the "brain of the economy" and allocating the economy's savings in the most productive way among different potential investments.” *(Willamson; 1999)*

2.1.1 Objective of FSR

The specific objectives of the FSR as highlighted in the policy paper on FSR prepared by His majesty's Nepal during NDF-2002 include:

a. Create sound, stable and healthy financial system,
b. Broaden and deepen the financial system in the economy,
c. Enable and policymaker to fully and timely avail sound financial statistics,
d. Canalize adequate resources on lowest possible cost, to promote sustained, broad- based growth momentum,

e. Build the institutional capacity to identify and tackle the problems in the financial system,
f. Increase the autonomy and capacity of central bank and other regulatory institutions for making their respective policies institutions, supervisory and regulatory functions effective,
g. Improve and update the legal and judicial framework for the financial system, and
h. Drastically reduce the NPA, improve the financial intermediation efficiently and build a strong and stable financial system, there by promoting growth and reducing poverty *(MoF; 2009, and Pyakuryal; 2003: 102).*

The FSR represents the phase-wise program focusing on the three broad objectives:

a. Strengthening and developing, regulatory and supervisory framework and the macro economic management capability of the central bank,
b. Reforming the commercial banking sector which is dominated by two large ailing commercial banks the fully stated-owned and controlled RBB and the recently majority-privatized or party state-owned, NBL
c. Reforming the development banking and other government-owned financial institutions like ADB, NIDC, etc. *(NRB; January 2002).*

In particular, the proximate objective of FSR is to extend, widen and deepen financial markets. The introduction and establishment of financial instruments and financial institutions is not important in absolute terms. What is important here is that, there exists a positive relationship between growth of financial and non-financial sector i.e. the developments of financial market has direct bearing on the growth of the real sector. Hence, the objective of FSR relate to transmitting the impulses of financial sector to the real sector through certain channels. “FSR attempts to strengthen these channels. In essence FSRs envisage attending higher economic growth through (1) allocative efficiency, (2) operational efficiency, and (3) dynamic efficiency.” *(Fischer; 1993: 497)*

Allocative Efficiency: The removal of financial constraints with the deregulation of interest rates helps financial resources to move to high yielding sectors. Interest liberalization helps ration out low yielding investment. This lets to an efficient use of scare resources. Thus, financial reform helps to achieve higher economic growth through improved allocative efficiency of the available resources. “The allocative efficiency increases the return on investment and promotes the growth of the real sector of the economy.” *(Rangarajan; 1997: 1)*

Operational Efficiency*:* The FSR, with the removal of entry and exist barriers, helps foster and enhance competition in the financial market. Improved competition helps lower financial intermediation cost. This also has a direct bearing on economic growth through induced savings and investments. *(Rangarajan; 1997: 1)*

Dynamic Efficiency*:* The FSR helps to improve the quality of financial services making financial market deepen. Both depositors and borrowers in particular and economy in general benefit from the diversified services. Thus, the financial liberalization is expected to support economic growth through increased savings in the financial sector and high quality economic investment.

The ultimate objectives of FSR in Nepal are not different from the theoretical propositions made above. However, when financial liberalization began, Nepal had typical problems with its typical stage of financial system. There were only two commercial banks operating in the government sector. The banks were tightly regulated and there was no competition. The non-performing loans were increasing and the quality of bank services was poor. Nominal interest rates were controlled real deposit rates were often negative. Financial saving mobilization was very low. “There were no non-bank financial institutions other then two specialized financial institutions Agricultural Development Banks (ADB/N) and Nepal Industrial Development Corporation (NIDC), and a few insurance companies and Employee provident Fund.” *(Basyal; 2000: 92)* The financial market was virtually in stage of monopoly. Against this background, the financial sector liberalization process was initiated onwards in the middle of 1980s. “The intermediate objectives of FSR in Nepal are Competition, positive real deposit rate, reduction in interest rate spread, financial deepening, financial widening, promotion of private sector investment, and reduction of non-performing assets.” *(Upadhaya; 2005: 79)*

2.1.1.1 Competition

Financial growth cannot take a desirable path unless financial institutions operate vibrantly. In order to grow the financial institutions vibrantly, new financial products have to be innovated and the quality of their services has to be improved. This can take place only when there is competition among the financial institutions. Financial institutions do not generally operate competitively if they are limited in numbers. Prior to reforms, there were only two state owned commercial banks and other few financial institutions, these institutions did not face any threat or challenge. The banks were enjoying 'duopoly' and thus had a secure market. In this context, Nepal had begun FSR by removing the entry barriers. For this purpose, the Commercial Bank Act 1974 was amended in 1984 and Finance Company Act was introduced in 1985. The objectives of introducing these measures were to open the entry for the private sector and create a competitive environment in the financial system. *(Upadhaya; 2005: 80)*

2.1.1.2 Positive Real Deposit Rates

In a least developed country with a poor economic growth rate and low per capita income, there is a greater need for investment both the public and private sectors. Higher investment can take palace only when savings are mobilized sufficiently, and savings can be more efficiently allocated only if the financial system is advanced. Such savings are highly affected by the ability and the willingness to save, which is determined by the real rate of interest on deposits. That is financial savings can be augmented if real deposits are positive. In the past, when interest rates were controlled, Nepal Rastra Bank attempted to keep the real deposit rates positive by frequent adjustments in the nominal interest rate, along with changes in inflation rate was not successful all the time.

Moreover, it was not possible for the NRB to determine the desire nominal interest rate. It could determine either the quantity of money or its price (interest rate) but not both of them. And money stock being a more competent policy variable, the authorities had abandoned the regulation of interest rates. “Deregulation of the interest rate was supposed to be more reflective of the scarcity of capital. On the whole, the objective of interest rate deregulation was to keep the real deposit rates positive.” *(Basyal; 2002: 172)*

2.1.1.3 Reduction in Interest Rates Spread

“Interest rate spread indicates the cost of financial intermediation. Higher the interest rate spread, the higher is the intermediation cost. Persistent higher interest rate spread causes financial disintermediation and as a result, inhibits financial development. Therefore, liberalization of the interest rate spread is important aspects of FSR” *(Basyal; 2002: 174).*

2.1.1.4 Financial Deepening

Financial deepening is measured as financial assets or border monetary aggregates to GDP ratio, involves the introduction and intensive use of new financial products for economic growth. “Financial deepening would indicate greater financial resource mobilization in the formal sector, an ease in liquidity constraints of banks and enlargement of funds available to finance the projects.” *(Shaw; 1973: 23)* Thus, larger financial deepening provides a possibility for increased resources deployment in the economy. This enhances the change for accelerating economic growth was one of the objectives of financial liberalization in Nepal.

2.1.1.5 Financial Widening

It refers to the greater use of money while exchanging goods and services, thus facilitating financial deepening. Definitely, there had been a greater use of money following the establishment of NRB and two state-owned commercial banks. However, there was still scope for financial widening mainly because of the existence of vast non-monetized activities in rural areas in general and agriculture sector in particular. This prevents commercialization and hence specialization of economic activities and the economy lost its efficiency gain. Although the state-owned commercial banks extended their branches in the rural areas of the country to provide the required banking and financial services but it was not sufficient. Therefore, commercialization of the economic activities financial liberalization was initiated *(Fische;, 1993: 502).*

2.1.1.6 Promotion of Private Sector Investment

One objective of FSR is to promote private sector investment. If the private sector is more efficient than public sector, the public sector can play a supporting role to accelerate economic growth. In a financially repressed economy, private sector investment is crowed out by the public sector investment, so it adversely affect in economic growth. In liberalized financial system, there would be higher level of saving mobilization enhancing deposits and lending that need for efficient financial system. More saving can be mobilized with a wide range of investment and activities and they are readily available for investment at competitive rates of interest. Private investment activities need not suffer from lack of capital.

2.1.1.7 Reduction of Non- Performing Assets

"Non-performing assets implies the bad quality of loans/debts that means the loans is not paid at maturity period and which is responsible to bring banking and financial crisis." *(Dahal; 2004: 82)* Due to the mistake in lending or investment process by the various reasons the two big state-owned banks RBB and NBL have been facing the problem of increasing in NPA during its liberalization. And, not only these two banks, the joint venture banks and financial institutions also have the same problem. According to latest directive issued by Rastra Bank 2058 B.S., the loan of banks and other financial institutions has been classified into four groups;

a. Good loans, if over due period is not exceeded or exceeded by three month
b. Sub-standard loans, if overdue period is exceeded by three to six months
c. Doubtful loans, if overdue period is exceeded from six month to one year
d. Bad loans, if overdue period is exceeded more than one year.

Among these four categories, sub-standard, doubtful and bad loans are taken as non-performing loans. In this contest, the main objective of FSR is to improve the quality of loan portfolios of the financial institutions and thereby reduce their non-performing assets.

2.1.2 Financial Sector Liberalization in Nepal with Reference to WTO

Nepal has become 148th member of WTO from the decision of Cancun Ministerial of September 2003. After accession in WTO, Nepal grasps the opportunities in the global flora, even though there are certain costs and challenges of financial sector liberalization.

2.1.2.1 Benefits of Financial Service Liberalization

"The financial sector reform has many positive impacts such as growing direct foreign investment, easy assess to modern technology, development and growth of various financial institutions and increase in quality and variety of services. These benefits can be classified into three different heading." *(Gautam; 2004: 72)*

To the banking industry: It helps in benefiting as a stronger banking industry in the country performing with the latest technology. It will bear many positive effects on the domestic banks as well. The new banks will introduce various products and services in the market at low costs.

To the customers: The entry of the foreign banks through joint venture brings down the costs of financial intermediation. So, Nepalese customers can enjoy numerous banking and financial services in cheaper prices because they provide new and competitive services.

To government: The strong banking system by the financial sector liberalization will not require any government help and may not accept the intervention as well. There would not be any danger of collapse of the financial industry in the near future. But it determines the direction of the financial industry. So, the government can be benefited by receiving increased tax revenue. Liberalization of financial sector, on one hand, plays a mentionable role in GDP contribution higher percentage of this sector and on the other hand it helps the government reduce unemployment and poverty.

2.1.2.2 The Cost of Financial Services liberalization

The financial sector liberalization is not free from any negative impacts. Nepal as one of the best developed countries paces many problems along with the benefits of liberalization. On the one hand, people of this country are less conscious about financial sector and most of the rural areas are non-monetized and on the other hand, the government and even the central bank are continuously losing the control over banking and financial services. "Joint-venture banks have established most of the banking and financial services in urban center and capture the elite, middle and upper class people. Similarly the government is deprived from the targeted rural banking services through the banking and financial system like productive sector, priority sector, deprived sector and some other directed credit programs. Weak domestic banks and financial institutions like our many loose in competition caused by the financial openness and liberalization." *(Gautam, 2004: 74)*

2.1.2.3 The Commitments in Financial Services Set- Forth in WTO

"Entering into WTO, Nepal has been committed on the provision of WTO's financial and major commitments, which are as mention below:" *(Gautam; 2004: 76)*

- Branches of foreign companies will be allowed insurance services and wholesale banking after January 1, 2010.
- Financial services in the form operations can be carried out inside the country through a locally incorporated company.
- Allowed foreign equity participation (investment) in financial sector up to 67 percent of the issued share capital.
- Composition of Board of Directors of financial institution in proportion of their equity participation.
- Opening financial advisory/consultancy services.
- Assurance of full competition in financial sector.
- Entry in the financial sector is to be regulated by Nepal Rastra Bank and insurance board.
- Status quo has to be maintained and no further restriction can be imposed
- UN bound for the other banking financial/insurance services except specified otherwise in the schedule.

2.1.2.4 WTO and the Challenges of Financial Sector Liberalization

"Financial sector liberalization has started from last 20 years. The membership in the WTO opens many alternatives gates but it has some challenges also. It is a big challenge for the country, like Nepal to explore the potential market for its services and to hold that market in the long run. It is a fact that Nepal is landlocked by India and China; therefore it would be challenge to explore a good access to growing economies of neighboring countries and to get easy access in their huge markets. It is also challenges to explore the space in the competitive market and a sell our services. Besides this, there are some challenges within the country like financial policy and political stability, formulation and implementation of legal framework, future direction and speed of financial sector reform." *(Gautam; 2004: 77)*

2.2 Reviews from Related Studies

The logical background for financial liberalization provided in the writings of McKinnon (1973) and Shaw (1973). McKinnon and Shaw consider the role of government intervention in the financial markets as a major constraint to saving mobilization, investment and growth. Most of these writers have argued against the monetary and financial policies based on Keynesian thought. The government's control of interest rate on deposits and loans even impedes the capital formation and low interest rates lead to capital flight. They opined that an increase in real interest rates increases the inflow of foreign capital for investment and economic growth. "When considering whether to liberalize the financial sector, it is important to compare the potential benefit with the possible cost. A benefit of financial sector liberalization is that it causes more saving to flow through the banking system, producing higher investment when financial repression (e.g. negative real interest rates) is replaced by financial restraint e.g. positive real interest rate below market clearing rates." *(McKinnon; 1973: 45)*

2.2.1 Review of Existing Policies, Acts and Regulations Governing Financial Sector

"During the pre-liberalization period, before mid 1980s Nepalese financial system was developed and controlled by the Nepal Rastra Bank (NRB) and his majesty's government of Nepal. Establishment of Nepal Bank Limited in 1993 was the first step towards institutional development of financial system. There was urgent need of the central bank to mobilize capital and development for banking system. So, Nepal Rastra Bank Act was enacted and it was established in 1956. First five-year plan was started just one year after the NRB established. So, to achieve the goal of plan and lead the nation to the path of economic development, it was felt the need of different financial institutions. As a result, Nepal Industrial Development Corporation (NIDC) was established in 1959, Civil Service Provident Fund was established in 1962, Rastriya Banijya Bank was established in 1966 as fully government owned commercial bank. Likewise, national insurance company and Agriculture Development Bank were established in 1967, and security marketing center was established in 1977 as a joint investment of NIDC and NRB." *(Poudel; 2005: 87)*

The financial sector reform in Nepal was initiated from mid 1980s and it is still being continued. Reform has covered many areas such as:

2.2.1.1 Freedom to Establish Commercial Bank

"Before liberalization there was restriction to establish the commercial bank as private bank or joint venture bank. But Commercial Bank Act 1974 was amended in 1984, which removed the entry barriers for private sector to step into commercial banking trading. As a result, joint venture banks were established in the decade of 80s such as: Nepal Arab Bank Limited, Nepal Indosuez bank Limited and Nepal Grindlays Bank

Limited. So far, 7 joint venture commercial banks are operation in the private sector. In July 1985, commercial banks were allowed for the first time to accept current and fixed deposits on foreign currency in terms of US Dollar and sterling pound."
(Poudel; 2005: 90)

2.2.1.2 Introduction of Financial Company Act

Immediately after the amendment of the Commercial Bank Act, Finance Company Act 1985, was enacted with the objective to widen and deepen the financial market. However, there was no immediate response to this Act; it was only after the political change of 1990 that finance companies started to enter the financial system.

2.2.1.3 Freedom for Limited Banking Services

To provide Limited banking services in the un-banked rural areas, saving and credit co-operative societies started to get operation licenses from NRB since 1993, there were 10 such financial institutions. Even the NGOs got licenses for micro-credit operations in 1994 and within two year's period, 30 NGOs got operating licenses to undertake limited banking transactions.

2.2.1.4 Deregulation of Interest Rate

"Deregulation of interest rates and credit began in 1986 and full deregulation took place in 1989" *(Bhetwal; 2007: 24).*At first, interest rates were partially deregulated. On November 1984, NRB gave a directive to the commercial banks and other deposit taking institutions to permit an increase in deposit rates by up to 1.0 percentage point on the minimum rate of fixed deposit and 1.5 % points on the minimum rate of saving deposit. On May 26, 1986, NRB determined the maximum and minimum level of interest rate for lending and deposit and directive to the commercial banks to act within that level. on July 1989, interest rates were fully deregulated supposing market can determine true cost of capital, keep real deposit rate positive and stimulate saving in competitive environment benefiting both the depositors and borrowers. *(Karki; 2003: 9)*

2.2.1.5 Freedom to Establish Development Bank and to Perform Banking Activities

"Before economic liberalization, there were two development banks, namely NIDC and ADB/N established under NIDC Act 1959, and ADB/N was under ADB/N Act 1967. In 1998, new development act was enacted which gave freedom to establish development bank. At present development banks are also permitted to reform various kinds of banking activities such as long and short term lending, deposit on saving account up to 15 times of core capital." *(Ghimire; 2004: 26)*

2.2.1.6 Provision of Prudential Norms

Without putting prudential norms in place, financial reforms cannot be successful. When Nepal initiated financial reform agenda, emphasis was also given to the establishment of prudential norms in early 80s. These norms are given as follows;

Capital adequacy ratio (CAR): Adequate capital is needed for healthy and sound financial institution and it is also necessary to bear risk and introduce new technology. To make capital base strength in 1975, the NRB had directed NBL and RBB to increase capital fund. The NRB directed to commercial banks to fix their capital adequacy to 2.5 percentages of their total deposits by mid-July 1989 and there after 3.0, 3.5 and 4.0 percentages by mid-July 1990 and 1992 respectively. Likewise, the CAR has improved to 5.8 percent by mid-July 2003, which was only 4.8 percent in mid-July 1998. But in the year 2004 and 2005 the figure had gone to negative i.e. -4.4 percent, and -7.7 percent respectively and now in the mid- July 2008 the figure jump up to positive i.e. 2.4 percent. In July 17, 2001 NRB in the process of financial sector reform, issued directives to commercial banks to maintain their level in international standard saying core capital should 6 percent and capital fund should 12 percent of the risk weighted assets in 2003/04.

Loan Classification and Loan Loss Provision**:** "The loans and advances, and bill purchase of commercial banks were categorized into four classes; good, sub-standard, doubtful and bad. Commercial banks were required to maintain the loan loss provision 1 percent, 25 percent, 50 percent and 100 percent respectively for these types of loans and advances, and bill purchase" *(NRB Annual Report; 2001/02).* Among these four categories sub-standard, doubtful and bad loans are taken as non-performing loans.

Single borrower limit: Single borrower limit has two objectives; the first objective is to lower the risk elements of over-concentration of bank resources and a single borrower. The second objective is to make the bank funds available to many people as possible. In March 1989, this single barrower limit had been fixed in Nepal. NRB has directed the commercial banks to limit their fund based and non-fund based lending. This is gradually liberalized. At present, the single borrower limit is 25 percent of the fund-based loans and 50 percent for non-fund based loans of the core capital.

Reforms in disclosure norms: According to these norms, all financial institutions should follow their common accounting year to the fiscal year of His Majesty's Government. To bring formality in data collection and analysis, financial institutions are directed to adopt mid-July of one year to mid-July of another year as the accounting year. NRB has developed a common pattern for balance sheet, profit and loss account and classification of loans, advances and services and directed financial institutions to follow these patterns.

Liberalization of monetary policy instruments: After the policy reform, NRB has used indirect instruments to control money and capital market rather than direct instruments such as statutory liquidity ration (SLR), and interest rate. Initially, SLR was supposed to provide a captive market for government securities, which were issued at very low interest rate. As banks and individual were reluctant to buy such securities, the provision of SLR, which required as sizeable portion of the deposits to be maintained in liquid form and government securities being defined under such assets, commercial banks were compelled to purchase them. However, such a captive market for government securities was not needed. So the SLR was completely abolished from august 1993. The CRR is easy instrument for central bank if monetary policy instruments are ineffective or unavailable. The banks have to keep certain portion of this resources idle. With deregulation of interest rate and discontinuation of direct monetary control techniques in 1989, the statutory reserve requirement was raised from 9 to12 percent, of which 8 percent would have to be kept in the form of unremunerated rated deposit at the NRB and 4 percent might be kept in cash. *(Bhetwal; 2007)*

2.2.1.7 Establishment of Credit Information Bureau

Credit Information Bureau was established on May 14, 1989 under the agency of Nepal Banker's Association. The objective was to provide information of credit defaulters to the member banks. On the basis of the information, the bureau prepares two list; defaulters' list and black list. The classification is based on the value of the amount involved.

2.2.1.8 Establishment of Credit Information Center (CIC)

"A new Credit Information Centre (CIC) with legal entity in the form of public limited company will be established to cater the credit information needs of all the commercial banks and financial institutions. This Centre will be responsible for procuring and exchanging the credit information of banks and financial institutions, updating the details of the default and insincere borrowers, blacklisting or taking necessary action against those borrowers and reporting to the NRB." ***(Rawal; 2004: 3)***

2.2.1.9 Establishment of Call Money Market

The Call Money Market was introduced as a reform packaged in March 1989. The call money means the resources mobilization among the banks themselves to meet their liquidity requirement. In the absence of such market, commercial banks used to approach the central bank for fund even though there was excess liquidity with other commercial banks. Due to the call money market, liquidity increases in the financial market stopping the banks from central bank approach for overdraft or refinancing.

2.2.1.10 Reforms in Capital Market

The history of security markets is rather new in Nepal. The Securities Marketing Center (SMC) was established in 1977. Initially, this was meant for the creation and development of government securities liquid and there by makes them attractive to the public. "In 1984, the SMC was converted in to the Securities Exchange Center (SEC). The SEC was instituted to deal with government papers and stocks" *(Acharya; 1998).* The reform in stock exchange market was initiated with the amendment of the Security Exchange Act 1983 in 1993. This separated operational and regulatory functions of the securities in 1993. Nepal Stock Exchange (NEPSE) was created in January 1994 to provide the trading floor for government security and corporate security.

2.2.1.11 Reform in Priority Sector Rule

Commercial banks have been involved in rural lending since 1974. Initially, NRB directed two existing CBs to invest 5% of the total deposit in "Small Sector". "This was the first initiative of involving CBs in rural lending directly in Nepal. Later in 1976, the Scope of Small Sector enlarged to cover agriculture, cottage industries and services, and it was renamed as 'Priority Sector'." *(Shrestha and Gyanwaly; 2004:*

231) Before the policy was reformed commercial banks were directed to involve directly on the priority sector program defined by NRB. In FY 1995/96, NRB has reformed priority sector rule. "Reform in priority sector rules in 1995/96 allowed banks to comply through lending on whole sale basis to the rural development banks, Co-operative and NGOs were allowed them to buy share of such institutions." *(Ghimire; 2004: 25)* Minimum requirement of priority sector credit is 7% of total credit for FY 2002/03. In the same way minimum requirement of priority sector credit is 6%, 4%, 2% and 2% of the total credit for FY 2003/04, 2005/06 and 2006/07 respectively. After that, the credit flow to priority sector by CBS is not made compulsory in FY 2007/08.

2.2.1.12 Process of RBB and NBL Management Contract to International Export

Considering the historical background of the two state-owned commercial banks RBB and NBL, they were already ailing even before the establishment of joint venture commercial banks. From that period they had financial, managerial and organizational problems. To study their financial, managerial and organizational problems and to prescribe necessary recommendations, Nepal achieved financial and technical help of the UNDP and the study team presented the Commercial Banking Problem Analysis and Strategy Study (CBPASS) reports in 1992. They provided two reports: CBPASS I and II addressing critical areas of RBB and NBL. The first report (CBASS I) recommended HMG/N to address critical areas. The CBASS II report identified four critical areas: Loan Recovery, Credit, Personnel and Branch Operations, where RBB and NBL had to make necessary improvements even though both reports were implemented to some extent but their management and organizational structures could not be improved.

Taking into account of these serious problems in the financial sector, HMG/N adopted the Financial Sector Strategy Statement in December 2000. It has clearly mentioned about the needs for the strengthening autonomy of NRB so that it can regulate and supervise commercial banks and financial institutions. It has pointed out the needs for the enactment of new NRB Act to increase the independence and authority of NRB to supervise the financial institution and take over the management of troubled banks and severely punish those financial institutions, which are found engaged in serious irregularities. It has also pointed out the need of having the Deposit Taking Institution Act, which is an umbrella act of all deposit taking institutions.

"According to the commitment of HMG/N to reform RBB and NBL, HMG/N and NRB established the Nepal Banking Reform Project and Started to work with funding assistance of World Bank (I DA) and DFID (UK). In this banking reform project, KPMG Barents Group, an international expert team was associated and started the reform project from 15 November1999. They completed their study in FY 1999-2000. They found that both banks RBB and NBL were deeply impaired in all areas of their operations like:" *(KPMG Barent Group; 2000 and Shrestha; 2004a: 84)*

- Overall bank governance and management weak by modern standards.
- Deep flaws in lending process, loan files and loan portfolio
- No business strategies, weak planning and budgeting process, lack in foundation, follow-up rewards and penalties

- Primitive financial accounting with large pockets of "double counting" unsubstantiated assets, and major items that should be written off by international standards
- Low morale of employees, low pay scales, low skills and counter-productive, union-oriented activities
- Primitive management information record keeping and control system

To be free from these impaired conditions of RBB and NBL, the KPMG Barents Group recommended following actions to be taken *(Shrestha; 2004a: 85)*:

- Support government efforts to create on independent commercially run banking system and declared banking reform policies fostering sound banking system
- Upgrade Board, senior management and staffs skills, capabilities and process
- Designed and invest in comprehensive bank restructuring programs
- Support and assist in implementing long-range plans to correct environmental weakness
- Support central bank strengthening and independence and provide full enforcement powers
- De-politicize and commercialize the banking system following the recommendations of KPMG reports, NRB removed the NBL Board on 8 March 2002, and that was replaced by an NRB appointed Board accusing failure to manage the bank property. In July 22, 2002, the management of NBL was handed over ICC bank of Ireland. In the case of RBB, M/S Deloitte Touche Tohmathu of the USA was selected for handing the management of RBB. In the final agreement, Deloitte Touche Tohmathu broke the contract from his side. After that, NRB appointed American citizen Mr. Bruce F Henderson in December 21, 2002 as Chief Executive Officer (CEO) and he have started to work by January 16, 2003.

2.2.1.13 Re-Engineering of Nepal Rastra Bank

“Nepal Rastra Bank Act, 1995 was revised in 2001 and come into law in January 30, 2002 as Nepal Rastra Bank Act 2002. This act has made NRB an autonomous institution. The major difference between the new and old Nepal Rastra Bank Act, 1995 is the fact that the new act has accommodated number of provisions to the NRB's legal structure to establish and preserve the autonomy and accountability of the central bank. It is expected that this act serve the requirement of a modern central bank as part of the government's overall financial sector development and modernization program" *(Pyakuryal; 2003: 107).*

2.2.2 Review from Journals and Articles

"The Asian financial crisis was preceded by a period of financial sector liberalization. By the late 1980s, all countries in the East and Southern Asia had liberalized their domestic financial sectors. Some had opened up their capital accounts as well. Controls on deposits rates, lending rates, credit allocations and capital account transitions were gradually liberalized the capital account in 1970 and interest rate in 1983. It also allowed free entry into banking system in 1988. Thailand liberalized deposit rates in 1990, the capital account in 1991 and lending rate in 1992. By 1995 Indonesia, Hong Kong, China, Korea, Malaysia, Philippines had made "full liberalization" of the domestic financial sector and "partial liberalization" of the capital accounts. The sources of the market reforms depend on the health of the financial system." *(World Bank; 1996: 83)*

The situation is explained by the supply-side conventional economics in terms of inadequate liberalization of the financial sector, particularly the existence of the two public sector banks with huge repayment problems, their widespread loss-making rural branches and priority sector investment requirement.

"Liberalization, however, has completely failed to streamline the commercial banking system in the country as expected. Overdue loan and inefficiency had been aggravated in the 1990s. The older and larger of the commercial banks with their wide rural networks have been made to complete with the new train banks with no rural operations. This has two unwanted consequences. On the one hand, it has allowed the new banks to make huge profits, as their operating costs are much lowers then that of the older banks. On the other, the economic viability banks is eroding faster as all their lucrative business such as the low-cost donor transactions as export financing have been concerned by the private sector banks, while high cost rural operations remains with them. A through overhauling of the older banks and decision to infuse private sectors capital and management in the same, it seems, should have preceded financial-liberalization process the two older banks have a high proportion of non-performing loans which was around 18% of the total loan in 2000." *(IMF; 2001)*

"Macro-economic stability also makes reform of the financial sector more likely to succeed and thus supports the development of capital market that can foster private investment. For this to work, macroeconomic stability and strong supervision of the financial system require the overall review of issues related to accounting, disclosure, and corporate governance. Expectations of high price uncertainty, exchange rate devolution or government borrowing may push real rate too high, increasing the financial deficit and contributing further macroeconomic instability. Excessively high interest rates and inadequate supervision of the banking system may cause defaults and instability in credit markets. Rapid interest rate liberalization under condition of macroeconomic instability and inadequate bank supervision leads to financial crisis that severely damages the economics." *(World Bank; 1991: 124)*

2.2.3 Review from Independent Studies and Reports

Williamson and Mohar (1998) conducted a study on "*A Survey of Financial Liberalization*" where he reveled that financial sector reform is virtually guided by financial liberalization and thus covers the following six different dimensions the elimination of credit controls, the deregulation of interest rate free entry into the banking sector (or, more generally, the financial services industry), bank autonomy (allowing bankers rather then bureaucrats to decided whom to employ, at what wage rate, where to open branches, etc.), and privatization of bank ownerships and liberalization of international capital flows.

The overall objective of adjustment program in Nepal has been alleviation of wide spread poverty, based on sustainable economic growth achieved through all round liberalization including in the financial sector. “Financial sector reform is directly connected with poverty reduction because reform agenda directs to lending priority areas and deprived sectors. *(Khatiwada and Acharya; 2003: 63)* So, progress report on Poverty Reduction and Assessment of the tenth plan (PRSP) implementation has mentioned “financial sector reforms are a critical element of the private sector agenda” *(NPC; 2004)* A sound and sustainable financial system is essential to provide adequate to the private sector at competitive rates for both investment and working capital. In Nepalese case, financial sector reforms is also necessary to ensure the solvency of the financial system itself, and to make efficient, competitive and transparent. However, for a variety of reasons, the implementation of reforms has been slower then expectation.

Since the last five years, renewed reform efforts have focused primarily on the three areas: *(Pendelton; 2004: 98)*
I) Restructuring of the Rastriya Banijya Bank Ltd. (RBB) and Nepal Bank Limited(NBL), Strengthening the autonomy prudential supervision and regularity functions and capacity of the central bank-Nepal Rastra Bank (NRB) and

II) Restructuring two other traditional development financing institutions-Agriculture Development Bank Nepal (ADB/N) and Nepal Industrial Development Corporation (NIDC).

The restructuring and capacity building of NRB has continued with donor support. Some of the achievement so far include: the introduction of 9 Voluntary Retirement Scheme (VRS) scheme, which has resulted in substantial (over 400) staff cuts, strengthening banking supervision and monitoring work. Improvement in human resource management and pay scale helps to enhance the efficiency and initiating the preparation of financial statement and disclosure according to international standard. “To strengthen NRB's supervisory powers, a Banking and Financial Institution Ordinance was promulgated in February 2004. To reduce non-performing loans of banks, blacklisting directives have been strengthened, a Debt Recovery Tribunal has been established, and more recently an Appellate Tribunal has been created. To allow commercial banks more options to resolve non-performing loans, draft legislation is being prepared to set up an Asset Management Company.” *(NPC; 2004)*

On the positive side, after 1990, when the financial sector entry was liberalized completely the number of financial institutions and co-operatives has exploded. The micro-credit programs have also been redesigned to pay equal attention to savings and credit. The finance companies have introduced new instruments of savings and credit.

“The co-operatives ate serving the needs of smaller urban and sub-urban borrowers and savers with their door-to-door schemes and creating to a large section of the educated unemployment. However, all their activities are still concentrated in urban and sub-urban areas and hardly cater to the needs of the poor in urban or rural areas.” *(NRB; 2001)*

“The analysis of FSR indicates that major reform agenda in economic reform in Nepal includes structural improvements in financial sector. Starting from reorienting the government's role as a regulator rather than implementer, the reform initiative has addressed financial sector legislation, prudential regulation and accounting/auditing practices, financial intermediation, market friendly monetary policy, promotion of insurance markets, strengthening of micro-credits restructuring of government-owned commercial banks and non-bank financial institutions and so on in anticipation to run financial institutions efficiently and in sound business principles.” *(Pykuryal; 2003: 113)*

FSR initiative would help improve the situation plaguing the government owned and other financial institutions and attain soundness of the entire financial system. FSR would be able to make significantly positive break through in the structure, competitiveness and effectiveness of financial sector. It is also crucial to improve efficiency of financial intermediation, consolidate the gain of the past reform efforts, canalize more invest able resources to the financial sector, and ensure stability and sustainability of the financial system. This would help reduce the vulnerabilities to the crisis situations and other uncertainties that could likely be associated the evolving financial system. “A strong and independent central bank with capability to steer the financial system towards profoundly contributing to the economic development in a well-regulated, dynamic financial sector framework is the logical outcome of the financial sector reform.” *(Shah; 2003: 25)*

FSR is expected to contribute immensely toward mobilizing and allocation resources efficiently, developing capital market for attracting long-term productive investment, improving domestic saving and investment levels, and thus promoting economic growth. The reforms are instrumental to improve the health of the financial system through the strengthened legislative, managerial and corporate governance. Hence, “FSR is inevitable for the growth, efficiency, stability and sustainability of the economic and financial system and supporting poverty reduction goals. It is learnt from the Asian crisis that adverse shocks generated in the financial system can be transmitted to the loss of employment and income and thus can worsen poverty situation. This implies that sustainable achievement of the poverty reduction goal call for financial stability as well.” *(MOF; 2009)*

After financial sector liberalization, formal financial institutions continue to have an urban bias. Most of the formal credit institutions and resource are concentrated in sub-urban rural areas. The banks and other formal financial institutions have not been in easy access to rural and urban population of the lower income distribution. So, Achary (2003b*)* remarked "despite the branch expansion during 1980s, the financial sector still showed little capacity to observe small urban and rural savings and serve the credit needs of the small borrowers, rural or urban. Hills and Mountains have had few financial facilities for small saving mobilization. In Tarai areas bordering India, savings also flowed to the banks across the border although Nepal offered higher nominal and positive interest rates. The commercial banks limited their operations to large amounts-both in acceptance of deposits and lending. As far as commercial banks are concerned this problem has been aggravated be liberalization of the banking sector".

“Pre-reform period was characterized by the rapid expansion of branches of two commercial banks namely Nepal Bank Ltd. And Rastriya Banijya Bank in the rural areas, directed lending as an instrument to carry government policy of spectral and rural development, interest subsidization and allocation of financial resources at low cost at the desired areas and sectors with the aim of all round development. This understanding has paved the way for reform, which was started in 1984. The allowance of establishment of new commercial banks in the private sector and as joint venture with foreign banks and relaxation of interest rate control etc. were initial measures.” *(Ghimire; 2004: 28)*

The Nepalese financial system, however, is still characterized by various institutional and structural deficiencies. Competitive financial market to utilize resources reduces costs and risks, expend and diversify opportunities, increase the allocative efficiency of the resources, promote the productivity and economic growth-raising process. So appropriate policies is most to increase the role of financial system and the policies encourage improved stable and secure financial system and discourage the distortions and defects in the system is vital to ensure a sustainable higher level of economic growth.

In order to reduce problems inherent in the financial system in general and the government owned financial institution in particular, encouraging the completive markets and the private sector investment, institutional restructuring along with the privatization provable alternatives. “Reform in the financial sector legislation, strengthening the bank inspection, monitoring and supervision process, restructuring of government-owned commercial and development banks, encouraging more investments in the banking sector, reduction of the directed/subsidized and insurance markets comprises the important ingredients of the reform agenda in the financial sector.” *(MOF; 2009)*

A vital element that should be taken into account while opening capital account is the efficiency and soundness of the domestic financial system. An efficient financial system implies that the cost of financial intermediation (the spread between deposit and lending rates) is low. A comparison of the simple spread between deposit and lending rates in Nepal with that of Asian countries, which have already implemented capital account convertibility, shows the spread comparatively high in Nepal. “Although high deposit rates in Nepal are likely to attract foreign savings, the high lending rates are likely to induce domestic or foreign borrowers to opt for borrowing from foreign financial institutions in a situation of capital account convertibility. In such situation, excess liquidity in the domestic financial system cannot be avoided.” *(Poudel; 2004: 82).*

As the policy measure to reduce the spread through interest rates liberalization has not been working, the ultimate solution for the interest rate spread has hampered the restructuring, party and fully, of the government-owned two large commercial banks.

This has impacted the recovery of non-performing loans and prudential regulatory and supervisory system in other areas of financial sector reform.

2.2.4 Review from Related Thesis

Gupta (2004), in the thesis *"Current Financial Structure and Regulation of the Banking Sector: A Comparative Study of Nepal and Thailand"* has the objectives to identify the overall performance of the overall commercial banks of Nepal and Thailand. This study has conducted to find out the recent performance of the Nepalese commercial banking industry and that of the Thailand, by comparing their performance in terms of profitability, non-performing loans (NPL), capital adequacy ratio (CAR), assets quality etc, including the regulations imposed by the central bank of each country.

In this study he has analyzed overall performance of the commercial banks of both countries. The approach made in this study is qualitative in nature based in the findings and the data of some financial institutions.

Khatiwada (2006), in the thesis *"Financial Sector Reform in Nepal an Assessment and Impact"* has the objectives to show the trend of FSR in Nepal and assess the impact of FSR in overall Nepalese financial system.

In his study he has analyzed various secondary data using tools like ratio analysis etc. His major findings are as follows:

a. After FSR implemented the no of financial institutions increased as well as the no of their branches increased significantly.
b. After FSR commercial bank branches in rural area decreased significantly.
c. Deposit growth in banks and finance companies shows positive growth after implementation of FSR.
d. Growth rate of total deposit and total credit shows increasing trend than of GDP.
e. FSR shows positive impact on Agriculture and Industrial credit.
f. NRB adopted effective regulatory role for financial sector of Nepal after FSR.
g. Non performing loan and assets shows decreasing trend after FSR.
h. Interest rate spread not reduced as assumed before the implementation FSR.
i. Percentage share of total financial assets and broad money (M2) in GDP increased significantly after FSR.
j. Credit to GDP ratio increased and shows the importance of credit in economy.

According to these findings he has made some recommendations as follows:

a. NRB should motivate banks and finance companies to open their branches in rural areas more than urban areas.

b. Government should made effort to continue the priority sector credit programme for the up coming fiscal year.
c. NRB should play decisional role in current interest rate structure due to the high interest rate spread.
d. Credit information Bureau and Credit Rating Agency should be more effective to reduce the bad assets.
e. NRB should Strengthened the regulatory and supervisory role towards the financial sector of Nepal.

Adhikari (2007), in the thesis *"Financial Sector Reform in Nepal (A case study of Commercial Bank)"* has the objectives to show the impact of Financial Sector Reform in Commercial Banks.

In his study he has analyzed various secondary data regarding to the commercial banks using tools like capital adequacy ratio and other ratio analysis etc. His major findings were as follows:

a. After FSR, no of Commercial Bank increased significantly as well as their branches and it seen that every district have al least one branches of commercial bank in their district capital.
b. Deposit collection of commercial banks shows rapid growth after few years of FSR implementation.
c. Deposit mobilization by the commercial bank has increased much faster than the GDP growth after FSR.
d. Total credit of commercial bank increased every year due to the high collection of deposit after FSR.
e. Purpose-wise lending portfolio of commercial bank shows significant increase in industry and significant decrease in general use and social credit after FSR.
f. Priority sector credit of commercial bank increased every year over GDP percentage.
g. Interest rate spread was not decreased even after adopting the liberal interest rate policy and even after FSR.
h. Non- performing assets of RBB and NBL shows decreasing trend after implementation of reform in these banks. But it is still higher than the joint venture banks of Nepal.

According to these findings he has made some important recommendations as follows:

a. Role of NRB should be increased to regulate the commercial banks for the maintaining sound liquidity as well as to direct commercial banks to increase the investment in agriculture sector and industrial sector.
b. High interest rate spread is always been a major problem for Nepalese banking sector. So, to reduce the interest rate spread NRB should play a vital role to change the interest rate structure of banking sector of Nepal.
c. Since Nepal has also register as member of WTO few years back but it seems like Nepalese banking sector still not fully prepared for full implementation of WTO norms. So, NRB should develop tools for Nepalese banking sector so that they can cope with the problem involving with the full implementation of WTO norms.

Research Gap

After the two decades of the initiation of FSR program in Nepal there has been few independent studies, and thesis written to asses the impact and progress. Some studies were conducted by the experts and economist, and some studies were conducted by the master's degree students. Since this research topic fall under the economics as well as in management, it seems relevant to review some of the relevant theses prepared by the economics students. As this thesis is prepared for the MBS, only the theses of management students have been taken into consideration.

After reviewing some of similar theses, only three of them are relevant to this topic and these were considered here. The first thesis reviewed was of Gupta (2004), and the second was of Khatiwada (2006), and the third was of Adhikari (2007). The focus and objectives of this study is different from above reviewed theses. Gupta (2004) has focused the study on financial structure and regulation of the banking sector of Nepal and Thailand, and has explored the overall performance of commercial banks of Nepal and Thailand. Likewise, Khatiwada (2006) has focused the study on reform of overall financial sector of Nepal, and explored the impact of FSR in overall Neplease financial system. Similarly, Adhikari (2007) has focused the study on the reform of commercial banks only, and explored the impact of FSR in commercial banks. However, this thesis has focused to access the impact of FSR in commercial banks and finance companies only and it also covers the data till the year 2008.

CHAPTER - III
RESEARCH METHODOLOGY

3.1 Research Design
This study is descriptive cum analytical in nature. It gives the descriptive of FSR and its consequences on the study population. It also analyzes the effect of FSR on the financial sector. Therefore, this study has been designed to assess the impact of the FSR on the commercial banks and finance companies of Nepal.

3.2 Selection of Study Area
Since financial sector reform is a vague topic to deal with only Commercial Banks, Finance Companies and Financial System are considered in this study, but the focus of the study is on Commercial Bank and Finance Companies. Whole population of the banks, finance companies and financial system has been covered as an aggregated form.

3.3 Types of Data
Purely secondary data has been used for this study and actual data are collected from locating appropriate areas that mainly include information on published journals and reports. At least twelve years data have been tabulated. Besides, primary data were used by obtaining data from officials of Commercial Banks and Finance Companies.

3.4 Sources of Data
This study is based on both secondary and primary data. However, this study is purely based on secondary source of data. The major sources of secondary data are from the publication of central bank (NRB) and from its web sight (www.nrb.org.np), which includes publications like Annual Economic Report, Banking and Financial Statistics, Quarterly Economic Bulletin, Monthly Reports, Main Economic Indicator, Nepal Rastra Bank Samachar, Economic Review Prashikshan, Mirmire, Airthik Minansa, other publication and economic survey of HMG/N (now GoN). Definitely some related websites are surfed in the internet.

For collecting primary data interview was made with selected personnel of Commercial Banks and Finance Companies. The main respondents were officials of Commercial Banks and Finance Companies. For interview purpose a structure questionnaire was prepared and administered to the hundred (100) officials who were selected purposively (Appendix- I). Out of them, eighty (80) usable responses were obtained. Hence, the response rate is 80%.

3.5 Data Collection Procedure

Secondary data are collected as per standard guidance *(Panta and Wolf; 1999 and Shrestha; 2004)* locating appropriate areas which mainly include information on published journals, reports and websites. Data were also collected from agencies and bureaus and evaluated for its accuracy. Interview was conducted for obtaining primary data from eighty (80) officers of Commercial Banks and Finance Companies.

3.6 Tools for Analysis

Collected data are comparatively analyzed and the outcome has been interpreted as required. For that, obtained data are presented in various tables, diagrams, charts, graphs and percentage with supporting interpretations. Data have been tabulated according to the nature of data on the basis of fiscal year in different columns and rows.

Most of the data has been analyzed using mathematical tools like ratio analysis etc. These are some of the important tools used for data analysis:

A. Ratio Analysis:

1. Liquidity = $\frac{\text{Total Liquid Assets}}{\text{Total Deposit}}$

   Where, Total Liquid Assets = Total Liquid Fund + Govt. Securities

2. Credit- Total Deposit = $\frac{\text{Credit-Total Deposit Ratio}}{\text{Total Deposit}}$

3. Capital- Total Deposit = $\frac{\text{Total Capital Fund}}{\text{Total Deposit}}$

4. Loan- Loss Provision Ratio = $\frac{\text{Total Loan- Loss}}{\text{Total Credit}}$

B. Profitability:

1. Return on Assets (ROA) = $\frac{\text{Total Profit}}{\text{Total Assets}}$

C. Financial Deepening:

1. Financial Assets Ratio in GDP = $\frac{\text{Total Financial Assets}}{\text{Total GDP}}$

2. Broad Money Ratio in GDP = $\frac{\text{Total Broad Money (M2)}}{\text{Total GDP}}$

CHAPTER - IV

DATA PRESENTATION AND ANALYSIS

4.1 Commercial Banks

Before the establishment of Nepal bank limited there were no any organized institutions to provide credit to support agriculture and other necessities, so, people depended upon unscrupulous money lender who often charged high interest rates and other dues. Even though 'Tejrath Adda' was established in 1876 (1933 B.S.) during the period of the Prime Minister Ranoddip Singh and that was the first step towards the institutional development of banking system in Nepal but that Adda did not provide loans and did not collect deposits from the public. That Adda worked as providing loans only to the limited government employees. In Nepal, History of organized and institutional development of banking sector is around 68 years old and that was started from the establishment of Nepal bank limited in 1937 *(Ghimire, 2003: 15)*.

As per Commercial Bank Act 2031, ''Commercial Bank means a bank which deals in exchange currency, accepting deposits, giving loans and doing commercial transactions" therefore, commercial banks are financial institutions which are engaged in the activities of collection scattered fund from different people and canalized that fund to the other people or investors or organization who need it as loan.

After the establishment of Nepal Rastra bank in 1956, the banking system and financial sector got motion. when NBL as only a commercial bank, that was hesitating to serve unprofitable sectors and poor population of the country to cope this, government set up Rastriya Banijya Bank in 1966, as fully government owned commercial bank. Nepal has started liberalized financial policy from 1984 to make strong financial system and to improve quality and competitive services. As a result, there are twenty three private and joint venture banks and two government owned banks operating in 2008.

4.1.1 Branches of Commercial Bank

With a view to set up at least one bank branch is each of the 34 unbanked by the end of fiscal year 1968/69 the NRB made a plan in 1967 after consulting commercial banks to extend branches in planned way. In fiscal year 1966/67, NRB decided to create a banking development fund to develop and extend banking facilities. By this plan, NRB had provided interest rate free loan and composition of loss facilities. As a result, number of commercial bank branches increased especially in Hills and Terai, and up to the year 1977, all districts had at least one bank branch.

Table: 4.1

Commercial Bank Branches by Areas (1977-1983)

Area	Year						
	1977	1978	1979	1980	1981	1982	1983
Kathmandu valley	35	39	39	40	45	45	45
Hills	78	83	83	67	96	105	136
Terai	103	109	109	114	122	144	144
Total	216	231	231	221	263	294	325

(Source: Data derived from Quarterly Economic Bulletin, NRB 1996 to 2003)

The table no. 4.1 shows the commercial bank branches by area before the intuition of financial sector liberalization. These all branches were related with only two government-controlled Banks NBL and RBB. The year 1983 was the former year of the financial sector reform begun in Nepal in 1977, total commercial bank branches were 216 and which reached 325 in the year 1983. Total increment in commercial bank branches was 50% in year 1983 as compare to the year 1977. At the same way, branches of commercial bank were increased by 28% in Kathmandu valley in year 1983 as compare to the year 1977. The result, mentionable increment in commercial bank branches in Hilly and Terai region implies that banking facilities had been increasing to the poor people providing credit and deposit facility.

Table: 4.2
Commercial Banks Branches by Area (1985-2008)

Year (Mid-July)	Area			
	Kathmandu Valley	**Hills**	**Terai**	**Total**
1985	52	163	166	381
1990	65	192	184	441
1995	65	190	189	444
1996	67	190	191	448
1997	70	194	197	461
1998	75	195	205	475
1999	75	192	214	481
2000	75	164	200	439
2001	83	145	202	430
2002	82	130	188	400
2003	87	125	167	379
2004	89	119	167	375
2005	92	122	161	375
2006	94	126	170	390
2007	135	163	268	566
2008	159	156	243	558

(Source: Data derived from Quarterly Economic Bulletins, NRB 2004 and 2008)

The table 4.2 shows commercial bank branches after financial sector liberalization in 1985, total commercial bank branches were 381, but in 2008 it was 558. Comparing these two periods, branches of commercial bank increased almost twice until the year 2008. But overall branches of commercial bank are increasing trend until the year 1999 and reached 481. After that its shows the decreasing trend until the year 2006 and again it shows highly increasing trend till the end of year 2008, reason for decreasing may be due to the problem of security in Hilly and Terai area and economic liberalization policy that is injecting incentives of profitability for commercial banks, and reason for higher increase after year 2006 is may be due to the increased security situation in the country.

Observing the branches by area, commercial bank branches are increasing at constant rate from the year 1985 to 2006 in Kathmandu Valley but after the year 2006 it shows highly increasing trend, and reached 159 in year 2008 which were only 52 in year

1985, and increment was 205.77%.In Hilly area, total commercial bank branches were 163 and 156 in the year 1985 and 2008 respectively. So, commercial bank branches have been decreased by 4.29% in year 2008 in Hilly areas as compare to the year 1985. Commercial Bank branches are not much difference in Terai area and the total numbers are 166 and 243 in the years 1985 and 2008 respectively. In Terai highest number of commercial bank branches was 268 in year 2007.

After the reform programme, no of commercial bank has increased from 2 to 25 out of which twenty three are private and joint venture. Commercial bank branches were highest in 2007 with 566 branches but it was cut to 558 in year 2008 but it is still higher then 1983 that was only 325.

Table: 4.3

Rural and Urban Distribution of Commercial Bank Branches

Year Mid-July)	Area			
	Rural	Urban	Total	Rural as % of Total
1985	267	116	383	69.7
1990	300	160	460	65.2
1995	310	134	444	69.8
2000	285	193	478	59.6
2005	Na	Na	Na	Na
2008	Na	Na	Na	Na

(Sources: Data derived from Banking and Financial Statistics, NRB 1985 to 2000)

Table no. 4.3 present the commercial bank branches in the rural and urban area. Rural commercial bank branches are decreasing as a percentage of total branches in the course of time. In the year 1985, rural commercial bank branches were 267 and that was 69.7% of total percentage of commercial bank branches. In the year 1990, rural branches of commercial bank were increased and reached 300 but it was only 65.2% of the total percentage of bank branches. That means there is small increment in the rural branches as compare to the urban branches. Urban branches of commercial bank were 160 in year 1990 and it was only 134 in year 1995. Due to this cause, percentage of rural bank branches had increased and reached 69.8% of the total percentage of the bank branches even though total branches of rural were 310 in year 1995. In year 2000, rural commercial bank branches are declining and only 285 and have occupied 59.0% of the total percentage of the bank branches.

Conclusion is that the total numbers of commercial bank branches are increasing but the percentage of rural banks branches are decreasing. That means rural commercial bank branches are decreasing after the financial liberalization in comparison to its urban counterpart. So, the formal financial system of Nepal is becoming urban biased and liberalization has helped to intensity this bias.

4.1.2 Commercial Bank Deposit

Deposit is the main component of liability and it contains current deposit, saving deposit, fixed deposit call deposit and others. It is the main source of commercial banks fund. Higher the volume of deposit means higher volume of lending and investment and which generates higher volume of income through multiple effects. One objective of commercial banks is to increase deposit by providing attractive interest rate, to spread its branches in different area and to attract more customers by providing various facilities in services.

Table: 4.4

Total Deposit of Commercial Bank (1975-1983) **(Rs. in Million)**

Year (Mid-July)	Total Deposit	Annual Growth Rate (%)	% of GDP
1975	1174.0	24.7	NA
1976	1605.2	36.7	NA
1977	2146.8	33.7	12.4
1978	2528.5	17.7	12.8
1979	2920.9	15.5	13.1
1980	3351.6	14.7	14.4
1981	4160.2	24.1	15.2
1982	4935.5	18.6	15.9
1983	6308.4	27.8	18.7
Average		**23.72**	

NA = Not Available

(Source: Data derived from Banking and Financial Statistics, NRB 1978 and 1983)

Before the year 1975, interest rate on deposit was very low, so deposit growth was also low. In the year 1975, NRB increased interest rate on fixed (for one year) and saving deposit. As a result, the growth rate in deposit was mentionable but percentage of deposit growth rate was not constant, it is observed fluctuating. Total percentage growth rate of deposit during the review period (1975 to 1983) before the FSR, was 23.72%. As percentage of GDP, deposit saw a sluggish growth starting from 12.4% in year 1977 to 18.7% in year 1983.

Table: 4.5

Total Deposit of Commercial Bank (1985-2008) **(Rs. in Million)**

Year (Mid-July)	Total Deposit	Annual Growth Rate (%)	% of GDP
1985	8560.1	20.7	19.2
1990	21942.5	15.4	21.2
1995	61193.3	16.9	27.9
1996	71400.5	16.6	28.7
1997	81703.0	14.4	29.1
1998	102598.2	25.6	34.1
1999	127201.7	24.0	37.2
2000	154943.0	21.8	40.8
2001	181767.0	17.3	44.2
2002	185144.7	1.9	43.8
2003	203879.3	10.1	41.4
2004	233811.2	14.7	43.6
2005	252409.8	7.95	42.8
2006	291245.5	9.6	44.5
2007	337497.2	15.9	46.9

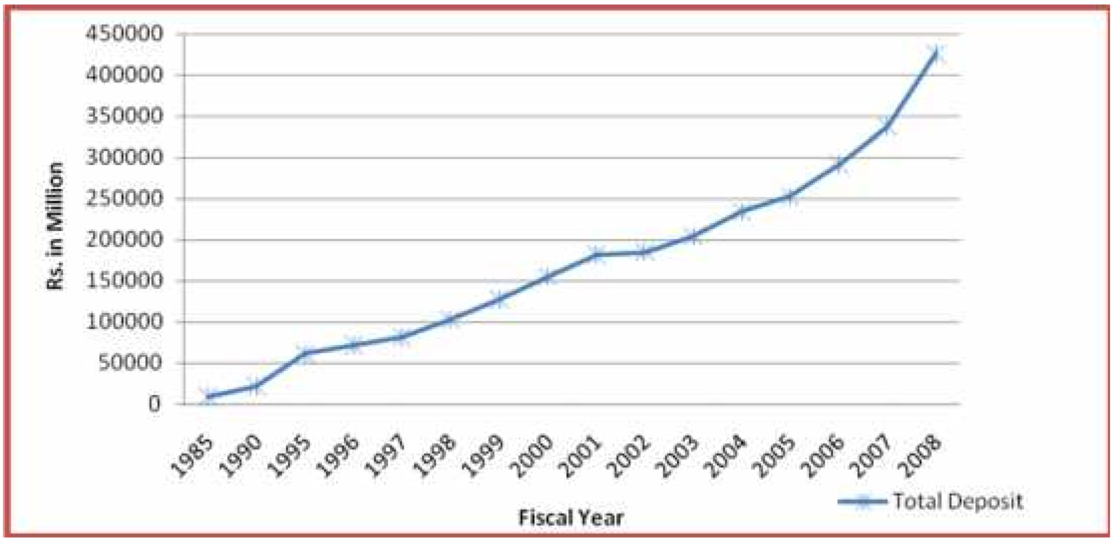
2008	426080.3	26.3	51.9
Average		**16.2**	

(Source: Data derived from Banking and Financial statistics, NRB 1995, 2001 and 2008)

After FSR in Nepal, there is rapid growth in deposit collection by the banks. Total deposit was Rs 8560.1 million in mid-July 1985 and that total deposit had increased by Rs 21942.5 million in 1990 and further increased to Rs 154943.0 million and Rs 426080.3 million in the year 2000 and 2008 respectively. The highest growth rate of total deposit was 25.6% (in the year 1998) till the year 2007, but in the year 2008 it was 26.25% and the lowest growth rate of total deposit was 1.9% in Mid-July 2002 as compare to the former years. After the peak period of Deposit growth rate in 1998, total deposit growth rate is decreasing till the year 2007 but in the year 2008 it went higher than the year 1998. The cause for decreasing deposit growth rate may be due to the NRB directive that was issued in fiscal year 1998/99 and that was about to maintain the interest rate below 5% in between deposits and lending rates. But commercial bank did not reduce only lending rates but also deposit rates, which in turn adversely affected the collection of interest bearing deposits.

As percentage of GDP, the commercial banks, deposit was 19.2% in mid-July 1990, and 34.1%, 43.6%, 51.9% in mid-July 1998, 2004 and 2008 respectively. This indicates that the deposits mobilized by the commercial banks hare increased much faster then the GDP growth after the financial sector liberalization.

Figure: 4.1
Graphical Trend of Total Deposit of CBs



Graphical Trend also shows total deposit is increasing at a decreasing rate till the year 2006 as compared to the beginning years, but in the year 2007 and 2008 it shows even higher growth rate then the begging years . When the impact of FSR is assessed from the viewpoint of deposit growth after and before FSR, average growth rate of total deposit before FSR was 23.7% but after FSR that is 16.2% during the review periods. Even though in between 24 years after FSR, the total amount of deposit has been increased 50 times but nine years period before FSR the increment was only around five times. There is more difference scenario of deposit when it is evaluated in terms of GDP. Total deposit has reached 51.9% of the GDP in 2008, which was only 18.7% in year 1983.

4.1.3 Commercial Bank Credit

Commercial banks collect deposits but increment in deposits is not only the sign of development of the banking system but it depends upon the volume of credit and direction of its mobilization.

Table: 4.6

Total Credit of Commercial Banks (1977-1983) **(Rs. in Million)**

Year (Mid-July)	Total Credit	Annual Growth Rate (%)	As % of GDP
1977	1153.1	-	6.7
1978	1722.5	33.1	8.7
1979	2186.5	21.2	9.8
1980	2773.5	21.2	11.9
1981	3578.7	22.5	13.1
1982	3140.5	-14	10.2
1983	3383.6	7.2	10.0

(Source: Data derived from Banking and Financial Statistics, NRB 1978 and 1983)

Table no. 4.6 shows that, total credit of commercial bank was increased up to the year 1981 and reached Rs 3578.7 million in 1981, but it was decreased in 1982 and become Rs 3140.5 million. After that, at the end of 1983, it becomes Rs 3383.6 million by increasing 7.2% with compare to previous year. Before mid eighties, Total credit to commercial banks increased at average 15.2% and as percentage of GDP, it shared 10% at the end of instructive year 1983.

Table no. 4.7

Total Credit Commercial Bank (1985-2008) **(Rs. in Million)**

Year (Mid-July)	Total Credit	Annual Growth Rate (%)	As % of GDP
1985	6464.4	29.2	13.9
1990	16009.4	12.6	15.5
1995	38779.1	41.8	17.7
1996	50891.0	31.2	20.4
1997	58378.3	14.7	20.8
1998	68618.0	17.5	22.8
1999	81758.7	19.1	23.9
2000	96324.8	17.8	25.4
2001	109121.0	13.3	26.6
2002	113174.6	3.7	26.8
2003	124522.4	10.0	25.3
2004	140031.4	12.5	26.0
2005	163718.8	16.9	27.8
2006	176820.2	3.0	27.03

2007	231829.4	31.1	32.2
2008	306638.0	30.7	36.9

(Source: Data derived from Banking and Financial Statistics, NRB 1990, 2001 and 2008)

Table no. 4.7 shows that, the growth rate of total credit is not increasing systematically, but it is observed as fluctuating. After FSR in 1985, the growth rate of total credit was 29.2% and in 1990 the growth rate was 12.6% as compare to previous year. The growth rate was highest as of 41.8% in the year 1995. In year 2008, the total credit growth rate was 30.7% that is the lower growth rate then 2007. Total credit was Rs 6446.4 million in 1985 but which was Rs. 306638.0 million in 2008. That is, the increment in total credit is more then 47 times in year 2008 as compare to the year 1985.

There are several reasons for gradual rise in total credit, for instance, growing business and other economic activities along with raising national income, attractive interest rate structure for loans and advances, growing interest of different people to promote their respective business, trade, industry and so on.

Table no. 4.7 also shows that the commercial bank credit has increased by more than two folds as percentage of GDP in 2008 as compare to the year 1985. In year 1985, percentage of total credit in GDP was 13.9% and which was 36.9% in 2008. And it is also observed that the growth rate of total credit in GDP is increasing as a constant way. This shows that credit mobilized by the commercial bank has been increased much faster than the GDP growth after the financial sector reform.

Table: 4.8

Purpose-wise Outstanding Loans of the Commercial Bank (Unit in%)

Sector	**Year (Mid-July)**							
	1975	**1980**	**1985**	**1990**	**1995**	**2000**	**2005**	**2008**
Agriculture	0.1	0.9	3.2	13.0	12.1	8.3	2.8	4.2
Industry	5.1	12.0	18.8	32.4	39.1	45.2	57.7	49.9
Commerce	45.1	62.1	44.1	28.6	32.8	32.9	25.6	26.2
General use & social Credit	48.0	20.0	30.0	23.5	11.8	7.3	2.2	3.3
Others	1.4	4.0	3.9	2.5	4.2	5.7	11.7	16.4

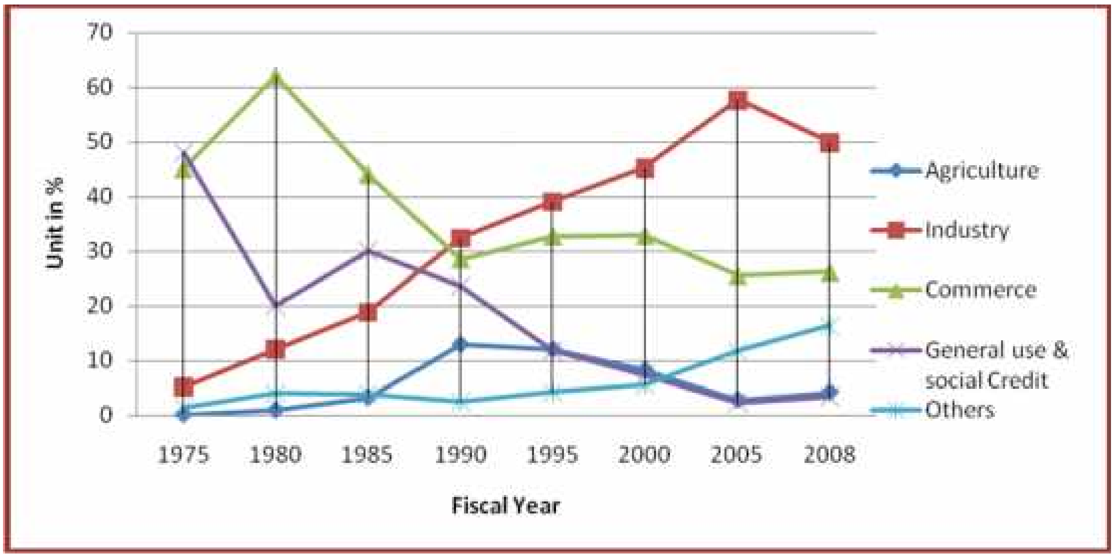
(Source: Data derived from Banking and Financial Statistics, NRB 1980, 1990, 2000 and 2008)

The purpose wise lending portfolio of the commercial bank shows significant change in the pattern of lending in favor of agriculture until the year 1990 and industry till the whole service periods. In 1975, 0.1% of total credit was in agriculture sector and 5.1% in industry. But at the same period, highest credit was 48% in general uses and social credit, and 45.4% in commerce. In 1980, the highest credit was 62% for the purpose of commerce and credit for general uses and social credit had been cut down by more then half and reached 20% of the total credit.

After the financial sector liberalization, credit in agriculture and industry reached 13% and 32.4% respectively in year 1990, but credit to other headings had decreased. After that credit in agriculture sector has started to decline and reached 12.1%, 8.3% and

4.2% in 1995, 2000 and 2008 respectively of the total credit. General used and social credit was only 7.3% in 2000 and that was 48% in 1975. The credit in industrial sector and others were 49.9% and 16.4% of the total credit respectively in year 2008 which were highest credit among all the previous years for others. Similarly credit in general uses and social sector was 3.3% in year 2008, which was second lowest credit among all the previous years.

Figure: 4.2
Purpose-wise Outstanding Loans of the CBs



In chart no. 4.2 share of agriculture credit was increasing at an increasing rate until the year 1990 and after that it has started to decline until the year 2008 but it is higher then before FSR. After the reform program industrial credit has increased by 44.8% point in 2008 as compare to the year 1975. It is also observed that the credit to the commercial and social service is declining after FSR.

4.1.4 Priority Sector Credit

Priority sector credit is related with poor to provide credit facilities and to improve their living condition. So, it is also helpful to reduce poverty and indirectly it creates employment opportunities. Agriculture, cottage industry, services, CSI and deprived sector are included in priority sector are included in priority sector.

Table: 4.9
Priority Sector Credit of Commercial Banks **(Rs. in Million)**

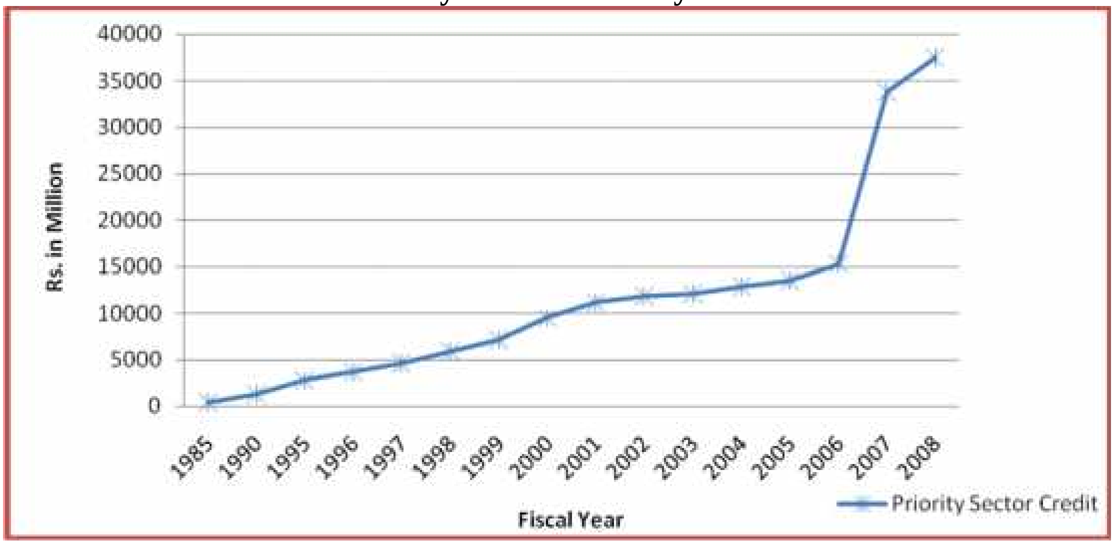
Year (mid-July)	Priority Sector Credit	GDP	As % of GDP	As % of Total Credit
1985	432.8	46587	0.9	6.7
1990	1312.3	103416	1.3	8.2
1995	2797.1	219175	1.3	7.2
1996	3683.2	248913	1.5	7.2
1997	4676.0	280513	1.7	8.0
1998	5893.1	300845	2.0	8.6
1999	7183.1	342036	2.1	8.8
2000	9520.7	379488	2.5	9.9

2001	11177.5	441519	2.5	10.2
2002	11868.4	459443	2.6	10.5
2003	12103.8	492231	2.5	9.7
2004	12912.3	536749	2.4	9.2
2005	13499.2	589412	2.3	8.2
2006	15359.2	654055	2.3	8.7
2007	33799.4	727089	4.6	14.6
2008	37539.6	818401	4.6	12.4

(Source: Data derived from Banking and financial statistics, NRB 1990, 1996, 2001 and 2008)

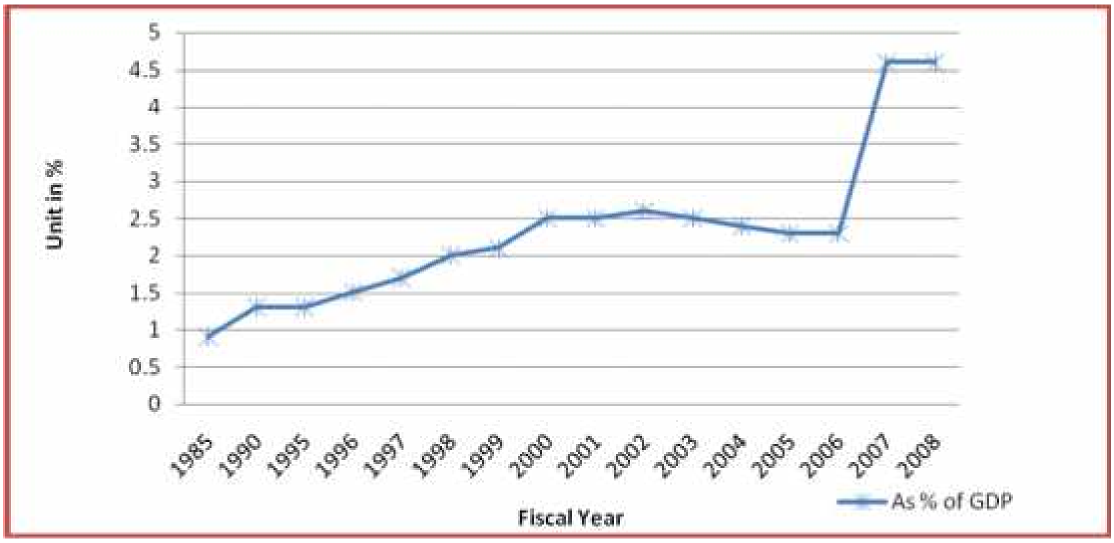
Table 4.9 indicates that absolute amount of priority sector credit is increasing from the year 1985 to 2008. Total priority sector credit was Rs.432.8 million in the year 1985 but that credit was Rs 37539.6 million in the year 2008 and the increment was more then 86 times in 2008 as compare to 1985. But access of credit to the poor should be examined in relative term. Percentage share of priority sector credit is not systematically increasing but it is fluctuating. In the year 1985, percentage share of priority sector credit was 6.7% of the total credit but in 2008 it was 12.4 % of the total credit.

Figure: 4.3
Priority Sector Credit by Year



The slope of this graphical trend observes that the growth rate of priority sector credit is increasing in a slow rate before the year 1995 and after that the growth rate is higher then before. Percentage share of priority sector credit in GDP is fluctuating until the year 1995. Then, share of priority sector credit is increasing until the year 2002 and it starts to decrease after that till 2005 but from year 2006 it shows highly increasing trend. In the year 1985, share of PSC in GDP was 0.9% and that was 2.6% in 2002. But, in the year 2008, it has increased to 4.6%.

Figure: 4.4
The Share of PSC in GDP (%)



Conclusion is that the relative percentage share of priority sector credit in relation to GDP is either stagnating or increasing over the time. It indicates that the positive impact of access of credit to poor people after financial sector reform.

4.1.5 Efficiency Ratio Test

Efficiency Ratio includes Liquidity Ratio, Credit-Deposit Ratio and Capital Total Deposit which are shown in following tables.

Table: 4.10

Some Efficiency Ratio of Commercial Banks (1977-1983) **(Rs. in million)**

Year (Mid-July)	Total Liquidity Assets	Liquidity Ratio	Credit-deposit Ratio	Capital-Total Deposit Ratio
1977	1216.4	57.0	53.7	2.4
1978	1069.7	42.5	68.1	2.3
1979	1225.2	42.2	74.9	2.3
1980	1443.5	34.3	82.8	2.2
1981	1679.3	40.5	86.0	2.0
1982	1935.8	39.4	63.6	1.9
1983	2625.7	41.8	53.6	1.7

(Source: Data derived from Banking and financing statistics, NRB 1980 and 1983)

Liquidity Ratio: Liquidity "is the word that the banker uses to describe his ability to satisfy demands for cash in exchange for deposits" *(Sayers, R. S. 1967)*. Accordingly, a bank's ability to earn profit depends upon its liquidity. So, every banker tries to maintain an appropriate banking liquidity. So, every banker tries to maintain an appropriate banking liquidity ratio that is to say total deposit to total liquid funds.

Liquidity is the bank's ability to pay cash in exchange of deposits. Liquidity is regarded as touchstone of any bank because it is only the banks, in business that requires paying large proportions of cash to the authorized customer that owes deposits in the bank and without question of enquiry. Liquidity is felt need mainly to repay deposit, disburse loans and advances and meet contingent liabilities.

In table no. 4.10, total liquid assets and liquidity position of commercial banks is shown. From table it could be known that before FSRs process begun, banks suffered form high liquidity which was maintained at the cost of profit. High liquidity also reveals a scenario of low investment opportunities. Lowest liquidity in constructive period of commercial banks was in year 1980 which was 34.3% of total deposits against the standard of 30%. Where as, in year 1977, the liquid fund was 57.0% of total deposit which was very high in compare to the end of constructive period 1983. In the year 1983, the liquid fund was 41.8% of total deposit.

Credit-Total Deposit Ratio: Credit in this case includes loans and advances of which the standard generally tried to maintain 75% of total deposits. Credit is extended up to 75% of total deposits to various sectors. From table no. 4.10, it could be known that before FSRs process began, the credit-total deposit ratio was highly increasing from the year 1977 to 1981. In year 1977, it was 53.7% whereas in year 1981, it was increased to 86.0%. But, in year 1982 and 1983, it was decreased to 63.6% and 53.6% respectively.

Capital-Total Deposit Ratio: Capital-Total Deposit ratio is studied to find whether the institutions have enough primary funds to back up the deposit collected. Generally, the standard ratio is 8.1% i.e. 8% of primary capital of total deposit is taken as standard ratio.
From table no. 4.10, it could be known that before FSRs process began, the capital-total deposit ratio was slightly decreasing from the year 1977 to 1983.

In year 1977, it was 2.4% whereas in year 1983, it was 1.7%. This shows that, the total deposit was increasing more in the compare of total capital of the commercial banks before FSRs process began.

Table: 4.11
Some Efficiency Ratio of Commercial Banks (1985-2008) **(Rs. In Million)**

Year (mid-July)	Total Liquid Assets	Liquidity Ratio	Credit-Deposit Ratio	Capital-Total Deposit Ratio
1985	4106.8	48.0	75.5	1.9
1990	9395.1	42.9	73.0	3.0
1997	3595.1	43.5	71.5	4.6
1998	41329.2	40.4	66.9	4.8
1999	50369.3	39.7	64.3	4.8
2000	63337.6	41.0	62.2	4.3
2001	76036.7	42.0	60.0	4.5

2002	76095.7	41.4	61.1	5.5
2003	80799.3	39.9	61.1	5.8
2004	94181.3	40.5	59.9	-4.4
2005	86047.6	37.9	64.9	-7.6
2006	96306.8	34.1	60.7	-6.1
2007	107979.2	33.1	68.7	-1.2
2008	137941.2	32.0	71.1	2.43

(Source: Data derived from Banking and financing statistics, NRB 1990, 2001 and 2008)

Liquidity Ratio: From the presented table, one can easily point out that given the standard liquidity requirement of around 30%, there is considerably excess liquidity in the banking system of Nepal. Liquidity when measured as percentage of total deposits reveals a miserable scenario of commercial banks of Nepal. Since the inception of liberalization and reforms, liquidity position of Commercial Banks of Nepal could not improve. Almost all banks has high liquidity around 40% of total deposits through NRB has no specific directions to maintain such kind of liquidity except CRR which is 10% of total deposits.

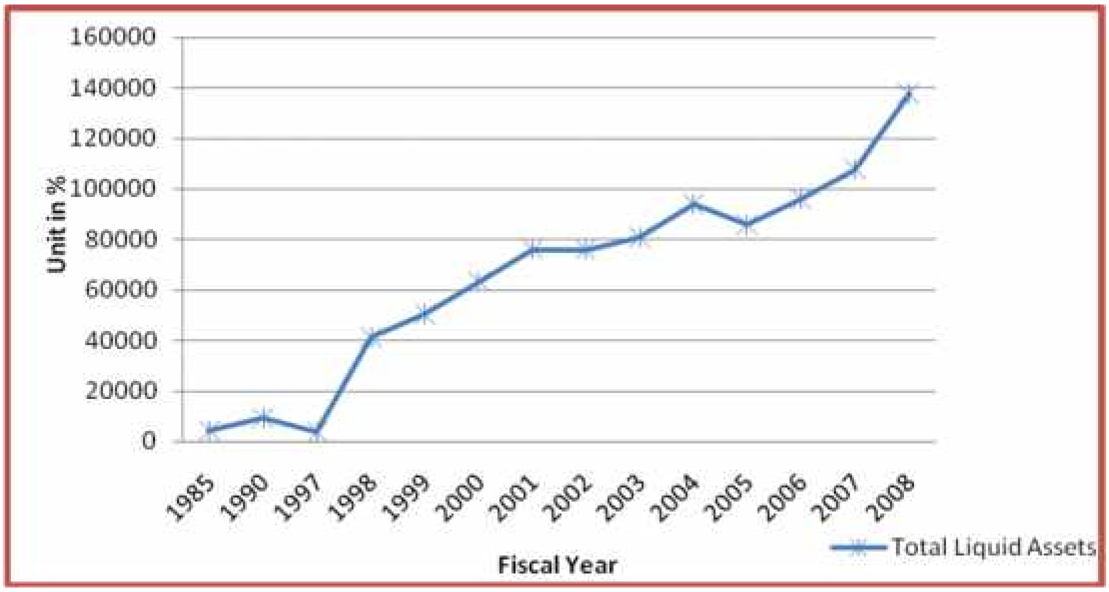
Post of April 1998, the liquidity ratio normally known as Cash Reserve Ratio (CRR) required by the NRB was 12% of the total deposits held which comprised cash in vault and balance with NRB. But lowering down of the CRR could not help improve the liquidity position of Commercial Banks which directly hampered the profit as liquidity is maintained at the cost of profit.

Credit-Deposit Ratio: From table no. 4.11, we could be known that after FSRs process; the credit-deposit ratio was more then 70% before the year 1998. After that, it has been slightly decreasing until the year 2004 and reached 59.9% in the year 2004. But from the year 2005, it has increased and went to 71.1% in the year 2008. After FSRs, the average credit-deposit ratio is being less then the standard ratio i.e. 75%. This shows that, the resources mobilization is lower then the deposit collection due to the less investment on industrial sector. The main reason behind this is the lack of security on investment.

Capital-Total Deposit Ratio: From the table no. 4.11, we could be known that after FSRs process; the capital-total deposit ratio was increasing until the year 2003. In the year 1985, it was 1.9 percent whereas in the year 2003, it was 5.8 percent. This increment was due to the increasing in total capital of newly establishing joint venture commercial banks. But, from the year 2004 to 2007 the figure becomes negative i.e. -4.4 percent, -7.6 percent, -6.1percent and -1.2 percent respectively. This was due to the negative retained earning in such years.

Figure: 4.5

Graphical Trend of Total Liquid Assets of CBs



The trend line shows that Liquid funds grew at a speedy rate. The highest rate of growth on liquid funds was of call deposits which increased to more then 33 fold in year 2008 as compared to 1985. As of total deposit which is the very base of calculating the liquidity ratio, total liquid assets in any reviewed period was not less then 25 percent, actual requirement being 10 percent after 1998 and 12 percent in former periods. This situation of the commercial banks backs up for the stagnating economy and identifies the capital tied up of the commercial banks with low or limited investment alternatives in the financial environment. Liquidity could not be stabilized in spite of reforms initiated.

4.1.6 Interest Rate Spread

The liberal interest rate policy was adopted since 1989 with the exception that it induces competitive environment in commercial banking sector and there bye help to reduce the lending rates and inspire to increase in deposit rates. The assumption was made that it would help to bring down interest rate spread of commercial banks and induce saving and investment.

But, after interest rate deregulation, the banks showed oligopolistic nature using cartel nature in interest rate determination reducing deposit rates and keeping constant in lending rates. To improve this condition in 1993, NRB gave directive to commercial banks to reduce (maintain) interest rate spread within the limit of 6 percent. Finally, as per commitment of the government in the Budget Speech of fiscal year 1998/99, the NRB restored to moral suasion and asked the commercial banks to limit the interest rate spread between lending and deposits within five percent.

Table: 4.12

Interest Rate of Commercial Bank (1975-1988) **(% per annum)**

Year (Mid-July)	Saving/Deposit Interest Rates	Industrial lending Interest Rates	Interest Rate Spread
1975	8.0	12.3	4.3
1977	8.0	12.3	4.3
1982	8.5	13.3	4.8

1986	8.5	16.5	8.0
1988	9.5	15.5	6.25

(Source: Data derived from Quarterly Economy Bulletin, NRB 1980 and 1990)

Interest rate spread is not high in the years 1975, 1977 and 1982 and that was only 4.3 percent, 4.3 percent and 4.8 percent respectively. In the year 1986, interest rate spread was 8 percent, which was the highest interest rate spread before interest rate liberalization. Interest rate in deposit is increasing all the review periods.

Table: 4.13

Interest Rate of Commercial Bank (1990-2008) (% per annum)

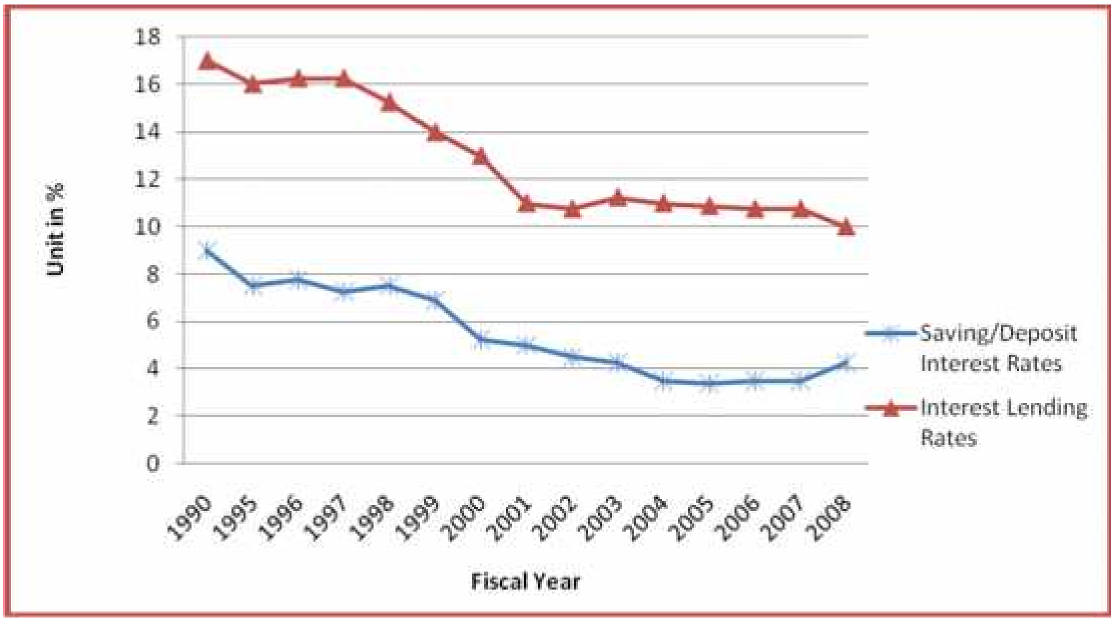
Year (Mid-July)	Saving/Deposit Interest Rates	Industrial lending Interest Rates	Interest Rate Spread
1990	9.0	17.0	8.0
1995	7.5	16.0	8.5
1996	7.75	16.25	8.5
1997	7.25	16.25	8.5
1998	7.5	15.25	7.75
1999	6.87	14.0	7.13
2000	5.25	13.0	7.75
2001	5.0	11.0	6.00
2002	4.5	10.75	6.25
2003	4.25	11.25	7.0
2004	3.5	11.0	7.5
2005	3.38	10.88	7.50
2006	3.5	10.75	7.25
2007	3.5	10.75	7.25
2008	4.25	10.0	5.75

(Source: Data derived from Quarterly Economy Bulletin, NRB 1990, 2001 and 2008)

Table 4.13 shows that, the interest rate spread after the interest rate liberalization. Interest rate of one year saving deposit was 9 percent in the year 1990 and lending rate was 17 percent at the same year and interest rate spread was 8 percent. Interest rate on deposit side is decreasing all the review years. In 2008, interest rate of deposit was 4.25 percent, which is bit higher than the previous year and interest rate spread is 5.75 percent in 2008, which was 7.25 percent in 2007 and 7.5 percent in 2005.

Figure: 4.6

Interest Rate of Commercial Banks



After the interest rate liberalization, it was expected that the interest rate would decrease. This expectation is correct to some extent because interest rate spread is decreasing after the year 1997 with positive real interest rate. But the interest rate spread is high as per government directive to maintain less then five percent interest rate spread. This also implies that the economy is bearing a high financial intermediation cost and it has benefited commercial banks with the high profit margin. So, the entry of new commercial banks and interest rate like realization do not appear as a significant degree of competition on the interest rate structure.

4.1.7 Non-Performing Assets

Earning profit is an objective of commercial banks through loan investment. Whole banking financial management has been influenced by loan investment and its performing. If the portion of non-performing assets is high that affects profit and it is considered as poor financial condition if profit is low. So, quality of assets is the basic thing to measure the health of financial condition. Since, major part of the banks poverty is considered as its investment, those banks whose non-performing loans is maximum and performing loans is maximum are termed as efficient banks and vice-versa. But due to unavailability of adequate and transparent not data of non-performing assets, it is difficult to get actual scenario of commercial banks after the financial sector reform.

Table: 4.14

NPA of Commercial Banks (Unit in %)

Year (Mid- July)	Non-Performing Assets				
	RBB	NBL	RBB+NBL	Joint Venture Banks	Total
1997	NA	NA	17.5	7.5	NA
1998	27.4	20.1	20.5	8.9	NA
1999	NA	NA	25	3.4	NA
2000	31	26	NA	NA	18.3
2001	45.1	50.8	47.5	10.9	28.4
2002	55.1	56.3	55.6	9.9	30.4

2003	60.2	60.5	60.3	7.8	28.8
2004	57.6	53.7	55.3	4.8	22.8
2005	53.0	49.6	NA	5.3	18.9
2006	45.3	25.1	35.2	7.5	13.2
2007	27.6	13.5	20.6	6.2	10.6
2008	21.6	8.95	15.3	4.4	6.1

(Source: Data derived from Economic Report, NRB 2000, 2003 and 2008)
NA= Not Available

NPA of two state owned banks is increasing from the review year 1997 to 2003 but it has started to decrease after the year 2004. In year 1997, NPA was 17.5 percent of the total credit in RBB and NBL. But, after that it is increasing trend and reached 25 percent in year 1998, whereas NPA was only 3.4 percent of the total credit in joint venture banks at the same year. In 2001, NPA of Joint venture bank was 10.9 percent which is the highest percentage in all years. In 2001, increment rate of NPA was high in the banks RBB and NBL and reached 45.1 percent and 50.8 percent respectively, but in 2000, share of NPA to these banks was only 31 percent and 26 percent respectively. Total NPA of all the banks was 28.4 percent in 2001 whereas the share of joint venture banks was 10.9 percent and state-owned banks were 47.5 percent of the total NPA.

It was supposed that NPA would decrease after the management contract of RBB and NBL to the private sector but the result is not as per expectation. Total NPA of commercial banks is 28.8 percent, 22.8 percent, 18.9 percent, 13.2 percent, 10.6 percent and 6.1 percent in the year 2003, 2004, 2005, 2006, 2007 and 2008 respectively. Whereas, NPA is 7.8 percent, 4.8 percent, 5.3 percent, 7.5 percent, 6.2 percent, and 4.4 percent in joint venture banks at the same years. From the year 2004, NPA of RBB and NBL has showed decreasing trend and reached 21.6 percent and 8.9 percent respectively, but in joint venture banks it has started to decline from the year 2002. Thus, NPA might be regarded as a serious problem after the FSR and even the condition of management contract of RBB and NBL to the private sector but after the contract it shows remarkable decrease in those assets. In other words, in the case of these two banks NBL and RBB, FSR could not to raise the quality of assets.

4.2 Finance Companies

As the process of financial sector liberalization, His Majesty's Government of Nepal felt the need of finance companies to accelerate the economic development of the country and supposed that finance companies undertake the task of encouraging the flow of personal saving for productive purpose. So, the role of finance companies has become more important to transform gradually non-monetized sector into monetized sector and channelize the savings for capital formation and economic development. According to financial company act 1985, major functions of finance companies are:

- Granting loans to construct residential houses, construction of offices, ware house, commercial complexes etc,
- Providing term loan to business, transportation, industry and trade,
- Providing installment of hire-purchase loan,
- Make available of lease-financing and leasing of such properties,

- Undertake transaction on government securities, underwrite shares, participate in loan syndication and conduct trading in securities in accordance with rules of securities transaction act,
- Collection and mobilization of deposits within the limits specified by NRB.

Even though, finance company Act was introduced in 1985 and enacted by the same year but the outcome did not come achieve before restoration of democracy. After the restoration of democracy, the finance company act become active and at the same time the 8^{th} plan(1992-1997) stressed, "The vacuum in the present national financial system needs to be filled by intuitionally developed capital market like investment company, finance companies, learning and housing finance in order to create healthy competitive financial sector". As a result, the first finance company, Nepal Housing Development Finance Company Limited was established in 11^{th} Shrawan, 2049 (July 26, 1992) in Kathmandu.

Finance companies are most popular among low-income and middle-income class people to make available hire purchase facility and other loans for the purchase of vehicles, machinery, tools, equipment and loans to individuals, firms companies or institutions in order to promote their economic benefit. But must of the finance companies are operating in Kathmandu valley and same urban areas. In the year 2008, number of finance company has reached 78 out of which 47 companies are operating in Kathmandu valley.

Table: 4.15
Territorially Establishment of Finance Companies in Nepal

Head office	Fiscal Year																	Total
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	
Kathmandu	1	6	1	9	6				1		3	3		3	8	6		47
Lalitpur				1		2					2			1				6
Bhaktapur						1												1
Pokhara		1				1			1			1				2		6
Biratnagar																		-
Birgunj			1	2								1						4
Narayanghat				1														1
Hetauda				1						1								2
Butwal				1			1											2
Janakpur						1												1
Lahan								1										1
Rajbiraj							1											1
Banepa				1														1
Dharan						1												1
Siddhartha Nagar				1								1						2
Kailali															1			1
Dang																1		1
Total	1	7	2	17	6	6	2	1	2	1	5	6	-	4	9	9	-	78

(Source: Data derived from Banking and Financial Statistics, NRB 2008)

From the above table 4.15, it is seen that 60.26 percent finance companies are located in Kathmandu valley and besides this others are concentrated main urban areas outside of the Kathmandu valley. In 1995, establishment of the finance companies were highest in number, which was 17, and the later the pace is not same but decreasing trend. There was not any registration of finance company in the year 2004 and 2008. Conclusion is that the access of the rural people to finance company is far beyond after the financial sector reform program because these companies are concentrated in Kathmandu valley and urban area of the country.

4.2.1 Total Deposit of Finance Companies

Deposit is the main component of the source side of finance companies to run their business. Higher the volume of deposit means higher volume of lending and investment, which generates higher of income through multiplier effect. So, finance companies try to collect higher volume of deposit providing attractive interest rate as possible for saving.

Table: 4.16
Total Deposit of Finance Companies **(Rs. in Million)**

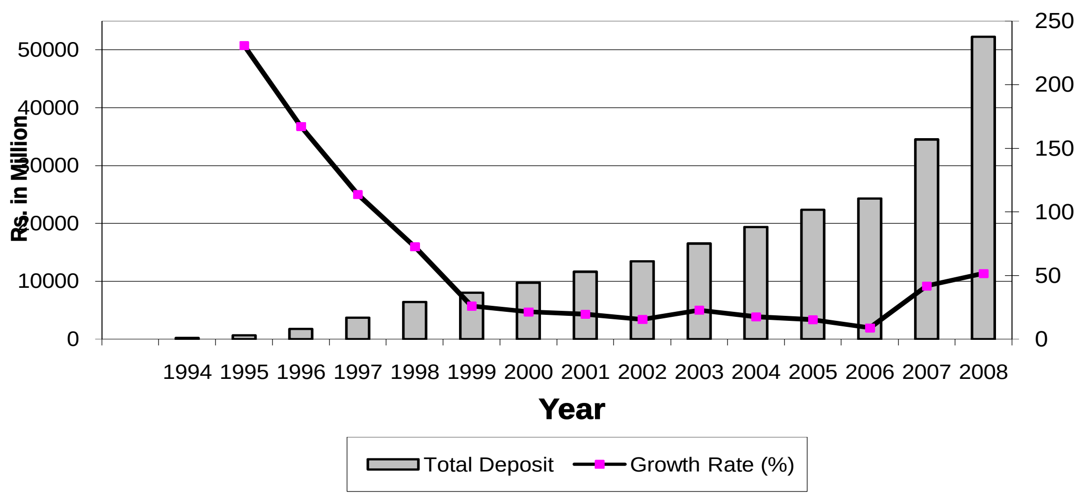
Year (Mid-July)	Total Deposit	Growth Rate (%)	GDP (At Current Price)	As % of GDP
1994	195.8	-	199272	0.1
1995	647.7	230.8	219175	0.3
1996	1730.6	167.2	248913	0.7

1997	3700.4	113.8	280513	1.3
1998	6387.0	72.6	300845	2.1
1999	8036.6	25.9	342036	2.3
2000	9748.6	21.3	379488	2.6
2001	11654.0	19.5	441519	2.7
2002	13453.9	15.4	459443	3.0
2003	16510.3	22.7	492231	3.4
2004	19391.7	17.5	536749	3.6
2005	22341.6	15.2	589412	3.8
2006	24332.5	8.9	654055	3.7
2007	34514.7	41.8	727089	4.7
2008	52282.2	51.5	818401	6.4

(Source: Data derived from Banking and Financial Statistics, NRB 1999, 2003 and 2008, and Economic Survey, Ministry of Finance 1998, 2003 and 2008)

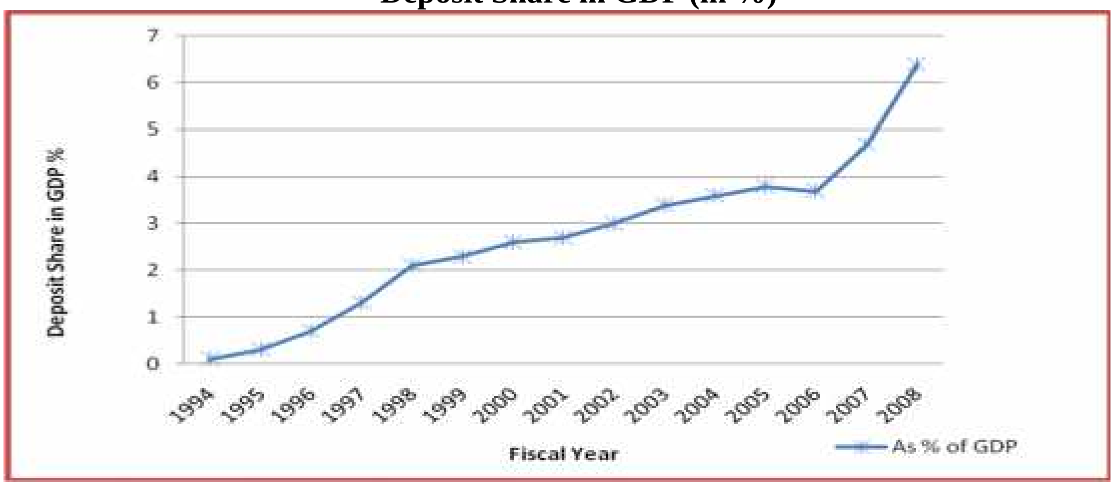
From the above table no. 4.16, total deposit is increasing all the years due to also the increment in number of finance companies. In 1994, total deposit was Rs. 195.8 million which was Rs.52282.2 million in the year 2008; where as number of finance companies were 10 to 78 in the year 1994 and 2008 respectively. Total deposit has increased more then 267 times in 2008 as compare to the year 1994, where numbers of finance companies have increased only by more then 7 times at the same period. The highest growth rate of the total deposit was 230.8 percent in the year 1995 and lowest growth state was just 8.9 percent in 2006. In the year 2007, total deposit growth rate increase drastically and reached to 41.8 percent and on 2008 it was 51.5 percent.

Figure: 4.7
Deposit Growth of Finance Companies



Observing the diagram, total deposit increased in the succeeding year from 1994 to the whole review periods. But, when a trend line of deposit growth of finance companies is drawn against it line and it was steep until the year 1999 then it has stabilized to some extent but in fluctuating way till the year 2005. After year 2006 it has started to rise again in higher rate till year 2008. This indicates slow-down in the growth of deposit of finance companies following the financial sector reform.

Figure: 4.8
Deposit Share in GDP (in %)



In relative term, comparing the total deposit as percent of GDP, it is increasing all the years. Shares of total deposit as percent of GDP, was 0.1 percent in the year 1994, which was 6.4 percent in year 2008. So, graphical trend of deposit share in GDP of finance companies is increasing.

4.2.2 Total Credit of Finance Companies
Nepal Rastra Bank Revised the existing policy and informed new policy measure in the fiscal years 1997/1998 and 2001/02. Single borrower's credit limit of credit disbursement by the finance companies is 25 percent for fund base landing a 50 percent for non-fund based lending but which was 20 percent and 40 percent in respective levels before the fiscal year 1997/98. Term loans, housing loans, hire purchase and leasing are the main fund based services.

Table: 4.17

Total Credit of Finance Companies **(Rs. in Million)**

Year (Mid-July)	Total Credit	Total Assets	As % of Total Assets	As % of GDP
1994	217.3	411.0	52.9	0.11
1995	670.6	1095.5	61.2	0.31
1996	1852.9	2499.9	74.1	0.74
1997	3667.1	5117.4	71.6	1.31
1998	5477.7	8225.9	66.6	1.82
1999	7218.8	10633.0	67.9	2.11
2000	9062.8	13049.7	69.4	2.38
2001	10865.3	15797.2	68.8	2.65
2002	11949.6	18452.7	64.7	2.84
2003	14473.7	22116.4	65.4	3.24
2004	17540.8	27198.7	64.5	5.16
2005	21223.3	30436.7	69.7	5.2
2006	27095.3	38856.2	69.7	5.9
2007	35616.5	53466.3	66.6	7.4
2008	51516.9	80383.9	64.1	9.8

(Source: Data derived from Banking and Finance Statistics, NRB 1996, 2001, 2005 and 2008)

From the table 4.17, total credit of finance companies in average witnessed a significance growth which has reached Rs. 51516.9 million at the end of review year 2008 and that was only Rs. 217.3 million in the year 1994 and the growth is more then 237 times. This increment in the total credit is not only due to the increment in number of finance companies but this is due to wide range of service offered by the financial companies.

Total credit of FCs had occupied 52.9 percent of its total assets in 1994 and which was the lowest as percentage of total assets. This share of total credit grew up to 74.1 percent in the year 1996 and which was the highest percentage of the total assets. At the end of review year 2008, it is also 64.1 percent of the total assets. A percentage of total assets, growth of the total credit is observed in fluctuating condition.

However, when total credit of finance companies is measured with GDP of Nepal, it is found a steady growth that was 0.11 percent in the year 1994 and reached 9.8 percent in the year 2008. There are several reasons for gradual raise in credit side such as growing activities in business trade, industry etc and attractive interest rate for loans. Thus, after the financial sector reform, total credit of finance companies has been growing much faster then total assets and GDP.

4.2.3 Liquid Funds of Finance Companies

Liquid fund is necessary to meet the demand of depositors or investors and to gain the confidence of the depositors to finance company. Liquid funds are for daily transaction including cash in hand, balance with NRB and balance with commercial banks. According to the directive of NRB to finance companies in 2058 B.S., finance companies should keep seven percent as liquid funds of the total deposit liability presence of just needed amount of liquid funds in any financial institution proves a better and good management of resources available. When financial institutions do not find proper and secured fields for investment then resources are not mobilized and liquid fund starts to increase. Therefore, management of liquid fund is the most complicated part of finance companies because low liquid fund is life threatening to the finance companies and high liquidity reduces profit, as liquidity and profit are inter-related.

Table: 4.18

Liquid Fund of Finance Companies **(Rs. in Million)**

Year (Mid-July)	No. of FCs	Liquid Fund	As % of Total Deposit
1994	10	83.8	42.8
1995	27	95.8	14.8
1996	33	124.5	7.2
1997	39	342.5	9.2
1998	41	452.5	7.1
1999	42	1133.6	14.1
2000	44	1728.6	17.7
2001	45	2048.5	17.6
2002	50	2862.4	21.3
2003	56	2674.0	16.2
2004	56	4469.8	23.1
2005	60	3904.9	17.5
2006	69	5386.7	22.1
2007	78	7513.4	21.8
2008	78	17741.7	33.9

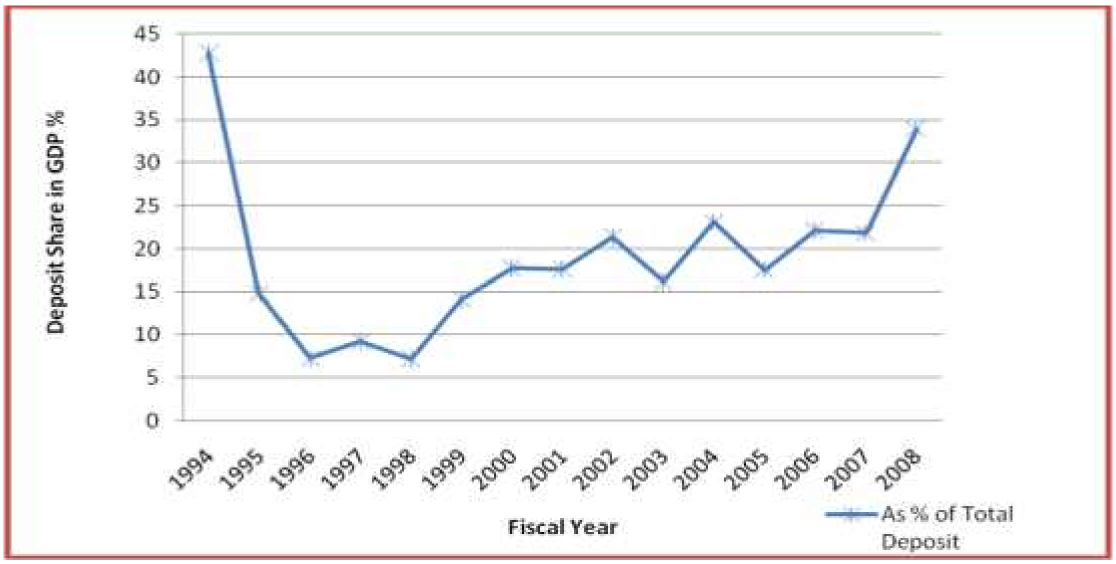
(Source: Data derived from Banking and financial statistics, NRB 1998, 2003 and 2008, and Economic Report, NRB 1997, 2001, 2005 and 2008)

According to table no. 4.18, liquid fund shows a remarkable increment. In the year 1994, the liquid fund was Rs 83.8 million that was Rs 17741.7 million in 2008. Liquid fund is increasing till the fiscal year 2002 and reached Rs. 2862.4 million, but in 2003, the liquid fund is lower by Rs 188.4 million than the year 2002 though the number of finance companies had reached 50 to 56. But in 2004, it was again increased and reached Rs 4469.8 million. Similarly, liquid fund continues to grow till the year 2008, which were Rs. 3904.9 million, Rs. 5386.7 million, and Rs. 7513.4 million in the year 2005, 2006 and

2007 respectively. Main cause of increasing liquid fund is that these finance companies started to face competition among themselves and other commercial banks for credit extension and resource mobilization.

From the prospective of resource mobilization the year 1994 is not good because the liquidity is 42.8 percent of the total deposit. Similarly, second highest liquidity as percent of total deposit is 33.9 percent in the year 2008. The year 1996 and 1998 are considered as better for the purpose of resource mobilization and these years gave net the NRB norms maintaining around 7 percent liquidity of the total deposit liability. In the years 1996 and 1998, liquidity as percent of total deposit was 7.2 percent and 7.1 percent respectively. On the bottom line, following the FSR, liquid funds of finance companies are still more then enough.

Figure: 4.9
Liquid Fund of FCs As Percent of Total Deposit



4.2.4 Loans Loss Provision

Ratio of loan loss provision is calculated as the percentage of total bad loans to the loans. Non-performing loans could be taken as one of the independent variable for determining loan loss provision. And bad loans are generally termed as non performing loan higher the non performing loans, higher would be loan loss provision, increasing loans loss provision ratio indicates that non-performing loans in finance companies is increasing.

Table: 4.19
Loan Loss Provision of Finance Company **(Rs. in Million)**

Year (Mid-July)	Loan Loss	Total Credit	Loan Loss Provision (Ratio in %)
1994	2.3	217.3	1.1
1995	7.9	670.6	1.2
1996	21.0	1852.9	1.1

1997	53.1	3667.1	1.4
1998	116.8	5477.7	2.1
1999	213.2	7218.8	2.9
2000	185.9	9062.8	3.2
2001	395.1	10865.3	3.6
2002	653.6	11949.6	5.5
2003	875.4	14437.7	6.0
2004	992.6	17450.8	5.7
2005	1227.8	21223.3	5.8
2006	1206.0	27095.3	4.5
2007	2163.3	35616.5	6.1
2008	2510.0	51516.9	4.9

(Source: Data derived from Banking and Financial statistics, NRB 1997, 2001, 2005 and 2008)

According to table no. 4.19, it is observed increasing loan loss ratio of finance companies and the increment ratio in later years is greater then the beginning years. In 1994, total loan loss of finance companies was Rs. 2.3 million and which is Rs 2510.0 million in year 2008. As percentage of loan loss ratio was 1.1 percent in the year 1994, and 4.9 percent in 2008. The loan loss ratio has increased by more than 1091 times at the end of the review period 2008 as compare to the year 1994. So, following the FSR, finance companies are facing the increasing loan loss ratio.

4.2.5 Efficiency Ratio Test

Efficiency Ratio Test includes Liquidity Ratio, Credit-Deposit Ratio, Capital-Total Deposit Ratio and Loan-Loss provision.

Table: 4.20

Some Efficiency Ratio of FCs **(Ratio in %)**

Year (Mid-July)	Liquidity Ratio	Credit Deposit Ratio	Capital Total Deposit Ratio	Loan loss Provision
1994	44.3	111.0	49.5	1.1
1995	20.2	103.5	38.0	1.2
1996	12.8	107.1	29.8	1.1
1997	20.4	99.1	19.6	1.4
1998	29.6	85.8	14.1	2.1
1999	25.7	89.8	14.6	3.0
2000	26.4	93.0	15.3	3.2
2001	24.8	93.2	16.6	3.6
2002	29.6	88.8	19.8	5.5
2003	20.5	87.4	19.4	6.0
2004	29.6	90.0	18.8	5.7

2005	20.0	95.0	19.0	5.8
2006	26.1	105.4	17.7	4.5
2007	25.4	103.2	15.6	6.1
2008	35.4	98.5	14.2	4.9

Source: Data derived from Banking and Financial Statistics, NRB 1997, 2001, 2005 and 2008

Liquidity Ratio: Nepal Rastra Bank (NRB) has been indulging in the prohibitive practice of requiring Statuary Liquidity Ratio (SLR), which has been up to 24 percent of total deposits. This was introduced to curtail monetary expansion and limit inflation rates. However it led to reduction in competitiveness of banks. SLR was completely eliminated in 1993 freeing the resources. But NRB has set out direction relating to minimum liquidity ratio (8% of total deposits) in 1998.

Beside these positive reforms initiated, the finance companies could not lower their liquidity to set standard, i.e. 8% of total deposits. It has decreased to 35.4% at the end of 2008 as compared to 1994. It is noted that, lower liquidity includes higher utilization resources. In 1996, the liquidity stood up at 12.8% being a record of lowest liquidity of finance companies. New reforms initiated in 1998 also could not remarkably lower the liquidity then after. Liquidity is maintained at the cost of profit. So, higher liquidity could be one of the causes of low profit of finance companies.

Credit-Total Deposit Ratio: Credit in this case includes loans advances of which the standard generally tried to maintain is 75 percent of total deposits. Credit is extended up to 75 percent of total deposits to various sectors. But it seems ridiculous to absorb that the highest credit deposit ratio beyond the standard of 75 percent pricking to 111.0 percent in 1994 and in the same year liquidity was also highest as compared to other reviewed year. Firstly, this could be taken as an example of problem of transparency of finance companies. Secondly, a quite reasonable one; deposit collection was lower then resources mobilization in the initial operation of the finance companies. Reforms initiated have diverse the case as deposit collection has overtaken the credit extended.

Nevertheless, it should be kept in mind that, in none of the reviewed year, in spite of high liquidity, credit deposit ratio was beyond the standard level of 75 percent. With new reforms initiated in 1998, it has lowered the credit deposit ratio to 85.8 percent, the lower in review year. The higher credit deposit ratio should be checked as this could be the very reason of finance companies going out of business, collapsing and BODs vanishing with the left over funds betraying the depositors. This is often common in Nepal.

Capital-Total Deposit Ratio: Capital deposit ratio is studied of find whether the institutions have enough primary funds to back up the deposit collected. Generally, the standard ratio is 8 percent of primary capital of total deposit is taken as standard ratio. However, in aggregate during the review period, all finance companies had higher capital deposit ratio, 49.5 percent of capital deposit ratio which stands in 1994 was the highest ratio recorded in the review year and the same of 14.1 percent was the lowest recorded in year 1998. In the year of 2008, it was 14.2 percent. As all the finance companies are established with the primary capital base as directed by the NRB, the higher capital deposits ratio indicated the lower deposit collection by finance companies. Interest rate deregulation by the NRB which has provided the finance companies to determine their own interest rate for borrowing(deposit) and lending with the maximum spread of six percent has helped the finance companies to compete with banks. Still, finance companies are not able to look the benefit of collecting deposits from the market.

Loan-Loss Provision: The ratio is calculated as the percentage of total bad loans to the total loans. Bad loans are generally termed as Non-Performing Loans (NPL). Non-Performing Loans could be taken as one of the important independent variable for determining loan loss provision. Higher the Non-Performing Loans, higher would be loan loss provision. Increasing loan provision ratio indicates that Non-Performing Loans in finance companies of Nepal is increasing. Beside various measures taken to secure investment or loan grant, still these companies could not quit with bad loans as result of which loan loss provision has shown increasing trend. Loan loss ratio have increased by more then four folds at the end of review period 2008 which stood at 4.9 percent as compared to the beginning of the review period 1994 which was only 1.1 percent.

4.2.6 Profitability of Finance Companies

With the objective of widening and deepening financial markets of finance companies, Finance Company Act 1985 was enacted. Finance companies actually searched the niche markets that were left over or neglected by commercial banks like providing consumer credit and were expected to meet the consumer credit demand. In fact, finance companies face increasing competition from other financial institutions like commercial banks, development banks and other large and growing number of cooperatives which affect their operations. Although these companies are focusing on areas neglected by the commercial banks and others such as hire-purchase, leasing and housing, the general perception is that, they attract clients that have been rejected by banks. Noticing the insatiable condition of finance companies, NRB has revised the exiting policies and enforced new policy measures like freedom for fixing interest rates, recognition of Interest Income and Expenditure, provision for investment in National Saving Certificates, permission for issuance of Guarantee Letter in 1998.

Table: 4.21
Profit and RoA of FCs **(Rs. in Million)**

Year (Mid-July)	No. of Companies	Profit (Rs)	RoA (%)
1994	10	NA	-
1995	27	NA	-
1996	33	NA	-
1997	39	NA	-
1998	41	193	2.35

1999	42	159	1.49
2000	44	252	1.93
2001	45	334	2.11
2002	50	266	1.44
2003	56	478	2.16
2004	56	615	2.26
2005	60	909	2.99
2006	69	572	2.47
2007	78	1339	2.50
2008	78	2239	2.79

(Source: Data derived from Banking and financial statistics, NRB 1998, 2004 and 2008)

In-spite of these reforms initiated, finance companies could not earn a satisfactory profit. The stiff competition from banks and co-operatives hindered the profit of finance companies. Finance Companies had to provide higher rate on deposits and lower rates on lending. However a majority of finance companies have been able to make profits during the review period. In the year 1998, 41 companies made profit of about Rs 193 million. Total profit of the 78 companies in operation by 2008 was Rs 2239 million which was higher by Rs 2046 million then the year 1998. This scenario indicates that the reform initiated by the NRB has been a boon to finance companies which has helped to increase their profit. Growth of profit in year 1999 and 2002 were negative but positive in other subsequent years showing less growth in year 2001 as compared to the former years 2002.

When profit is viewed as Return on asserts (RoA), it shows a higher return in year 1998 of 2.35 and this rate of return declined to 1.44 on the following year 2002. However, it then took pace and stoop up 2.79 in the final year of review period 2008.

4.3 Financial System

The Nepalese financial system comprises of commercial banks, development banks, finance companies, co-operative societies, non-government organization (permitted to perform limited banking activities), insurance companies, Nepal stock exchange, citizen investment trust, employee's provident fund and postal saving services. However, this topic is only based on aggregate analysis of commercial banks, development banks, finance companies, co-operative and NGOs.

As a consequence of the financial sector liberalization, the numbers of banking and non-banking institutions have increased along with increase in monetization and financial deepening by providing the number and variety of financial institutions, their financial assets and variety of instruments.

Table: 4.22
Number of Banks and Financial Institutions

Year (Mid-July)	Banking and Financial Institutions					
	CBS	DBS	FCs	Co-operatives	NGOs	Total

1983	2	2	-	-	-	4
1994	10	6	10	10	17	53
1999	13	14	42	35	30	134
2000	15	15	44	36	7*	117
2001	15	17	45	34*	15	126
2002	16	21	50	34	25	146
2003	17	21	56	34	36	164
2004	17	25	56	21	44	163
2005	17	26	60	20	47	170
2006	18	28	69	19	47	181
2007	20	38	78	17	47	200
2008	25	58	78	16	46	223

(Source: Data derived from Quarterly Economic Bulletin, NRB 2008)

Due to FSR, both banking and non-banking financial institutions have increased and that was effectively increased from the year 1994. From the table no. 4.22, the number of financial institutions grew from 4 to 223, during mid-July 1983 to 2008. It is also observed that before financial sector reform, two state-owned commercial banks and development banks dominated the whole financial system. So, reform policy brought diversification in financial system.

4.3.1 Financial Deepening

The ratio of all financial assets of broad money (M2) to Gross Domestic Product (GDP) indicates financial depending in the economy. In other words, if the ratio of financial assets or broad money is high in GDP is called financial depending and vice versa. The ratio of broad money (M2) to GDP captures both monetization and efficient of the banking sector in saving mobilization.

Table: 4.23
Total Financial Assets and Financial Deepening

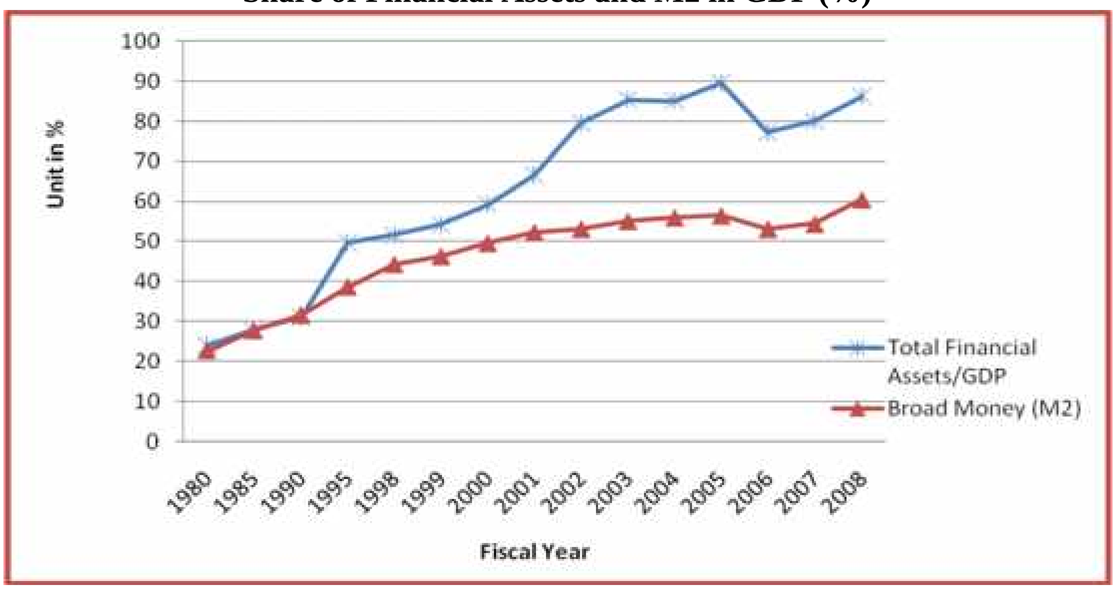
Year (Mid-July)	Total Financial Assets (Rs. Million)	Total Financial Assets/GDP (%)	*Broad Money (M2) GDP (%)
1980	5594.0	24.0	22.6
1985	13611.0	27.9	27.7
1990	32426.0	31.3	31.6
1995	109597.0	49.9	38.6
1998	155111.8	51.7	44.3
1999	185555.9	54.3	46.3
2000	225553.5	59.4	49.6
2001	273946.2	66.8	52.3
2002	335440.6	79.6	53.2
2003	381598.4	85.5	55.1
2004	422233.0	85.2	56.0

2005	474325.9	89.7	56.5
2006	505958.5	77.4	53.1
2007	582477.3	80.1	54.4
2008	706324.0	86.3	60.5

(Source: Data derived from Banking and Financial Statistics, NRB 1985, 1990, 2001 and 2008 and Macro Economic Indicator of Nepal, NRB 1985, 1990, 1996, 2001, 2005 and 2008)
**Khatiwada and Acharya: 2003*

Total assets of the financial sector was Rs. 5594 million (24% of the GDP) during the review period mid-July 1980 and which accounted Rs 13611 million (27.9% of the GDP) during the review period mid-July 1985, the year when the door for foreign participation in banking industry was opened. In the year 2000, 2004 and 2008, growth ratio of financial assets in GDP was higher and reached 66.8 percent, 85.2 percent and 86.3 percent respectively. These figures indicate increasing role of financial sector in the Nepalese economy.

Chart no. 4.10
Share of Financial Assets and M2 in GDP (%)



Share of broad money (M2) in GDP is increasing all the review periods from the beginning. In the year 1980, the share was 22.6 percent and which was 49.6 percent, 56 percent and 60.5 percent in the year 2000, 2004 and 2008 respectively. This means, the economy is monetized and banking sectors are better for saving mobilization. So, in the recent year, financial deepening is catching up fast.

Table: 4.24
Credit and Deposit Situation of Nepalese Financial System
(Including Banking and Other Financial Institutions)

Year (Mid-July)	Deposit	Credit	Credit/Deposit Ratio (in %)

1995	61870.0	41420.0	66.9
1998	109553.7	74875.6	68.3
1999	136107.9	90124.4	66.2
2000	165981.9	106996.0	64.5
2001	197325.6	124048.9	62.9
2002	205135.3	148290.7	72.3
2003	228736.4	165119.1	72.2
2004	258742.3	184389.1	71.3
2005	284115.2	209053.7	73.6
2006	327925.3	230424.7	70.3
2007	391152.6	291605.8	74.6
2008	508905.7	391537.7	76.9

(Source: Data derived from Banking and financial statistics, NRB 2001 and 2008)

After FSR, transaction of financial sector has increased along with increase in number of banking and financial institutions. Here, credit is taken as loans and advances of the financial system. In 1998, total credit was Rs 74875.6 million and share of the commercial banks was 91.6 percent (68586.1 million) and share of other financial institutions was 8.4 percent (Rs 6289.5 million), but in 2008, total credit was Rs 391537.7 and share of commercial banks was 78.3 percent (Rs 306574 million) and the share of other financial institutions was 21.7 percent (Rs 84963.7 million). The increment in financial credit was more then nine times in 2008 as compare to the year 1995. Likewise, total deposit of financial sector was Rs 109553.7 million in 1998 and contribution of commercial banks was 93.7 percent (Rs. 102651.8 million), but in 2008, total deposit was Rs 508905.7 million and contribution of commercial banks was 83.7 percent (Rs. 425954.1 Million). During 11 year period, increment of the total deposit was more then eight times in 2008 as compare to 1995.

From the table 4.24, credit/deposit ratio was 66.9 percent and 68.3 percent in the years 1995 and 1998 respectively. After that it has started to decrease and reached 62.9 percent in the year 2001. In the years 2002 onwards credit/ deposit ratio started to increase again and reached to 76.9 percent on year 2008. Increasing credit/deposit ratio implies financial institutions are able to mobilize increased proportion of private saving and direct them for investment in newer form of activities.

4.3.2 Market Share of Financial System

Before financial sector liberalization, Nepalese financial system was fully dominated by government-owned commercial banks. During 1990s, the number of banks and financial institutions increased along with increase in monetization and financial deepening.

Table: 4.25

Total Assets and Market Share of Financial System **(Rs. in Million)**

Year (Mid-July)	Total Assets	Market Share of Total Assets (in %)			
		CBs	FCs	DBs	Co-operatives
1998	155444.8	93.6	5.3	0.7	0.4
1999	185555.9	92.9	5.7	0.9	0.5
2000	125553.9	92.9	5.7	0.7	0.7
2001	273946.2	91.8	5.8	1.7	0.7
2002	314567.1	87.4	5.9	6.0	0.7
2003	357050.9	85.6	6.2	7.5	0.7
2004	387432.2	87.7	7.0	4.7	0.6
2005	474325.9	86.7	6.4	6.2	0.7
2006	505958.5	84.7	7.7	6.8	0.8
2007	582477.3	84.2	9.2	5.7	0.9
2008	706324.0	80.2	11.4	7.4	1.0

(Source: Data derived from Banking and Financial Statistics, NRB 2001 and 2008)

From the table 4.25, total assets of financial system were Rs 155444.8 million in 1998. Out of the total assets, market share of commercial banks, finance companies, development banks and co-operatives was 93.6 percent, 5.3 percent, 0.7 percent, and 0.4 percent respectively. A rising trend in total financial assets of the financial system has been observed during the period 1998 to 2008. Total financial assets increased by 354.39 percent and reached Rs 706324 million in 2008 as compare to the year 1998. In 2008, total market share of commercial banks, finance companies, development banks and co-operatives were 80.2 percent, 11.4 percent, 7.4 percent and 1 percent respectively. So, in total financial assets, share of commercial banks was decreasing until the year 2003 and reached 85.6 percent but it was increased to 87.7 percent in the year 2004, after that it started to decrease again and reached to 80.2 percent in year 2008. The share of development bank was increasing rapidly until the year 2003 and from the year 2004 it started to fluctuate and finally reached to 7.4 percent in the year 2008. But the share of financial companies and co-operatives was almost constant during the review periods. It means contribution of non-banking financial institution is increasing in total financial assets.

4.4 Analysis of Survey on FSR in Nepal

A survey was conducted to the 80 respondents from Commercial Banks and Finance Companies to collect their opinion regarding the different aspect of FSR programme. A structured questionnaire was prepared within the peripheral of the secondary data analysis. The respondents were asked about the topic stated below. The analysis of the collected data is as follows.

4.4.1 FSR Programme

The FSR programme was always been the subject of debate from its initiation period. Some group voiced that may be it's not so important and some expressed that it is important. Even lots of developed countries of today have adopted the reform programme after the economic crisis caused by Second World War and they got positive result. Similarly, Nepal also adopted this programme to make its financial sector sound and efficient but it looks quite relative to raise the questions and gather some individual views regarding the necessity and impact of FSR programme. The analysis made on the basis of secondary data shows positive changes due to FSR programme in the financial sector of Nepal. Primary data/information analysis was also collected to verify some of the pertinent issues. Interview conducted was primarily based on opinion survey. The respondents were representatives from officials of NBL, RBB and other Commercial Banks and Finance Companies.

4.4.1.1 Necessity of FSR Programme

The respondents were asked to present their views on the necessity of FSR programme. The majority of respondents (82.5%) presented their opinion that the FSR programme was necessary for the overall reform of financial sector of Nepal, 12.5 percent were not in favor of FSR programme and the rest five percent were not aware of the importance of this programme.

4.4.1.2 Performance of Commercial Banks and Finance Companies

Performance of Commercial Banks and Finance Companies depends upon various components like liquidity, deposit, credit etc. The FSR programme helps these components to perform properly which can boost the overall performance. So, to know their observation on this, the respondents were asked if they have observed any changes on the overall performance of CBs and FCs due to FSR programme. The majority of respondents expressed that they have observed the changes. It was found that 46 persons (57.5%) were positive and observed the changes, 34 persons (42.5%) were negative which means they have not observed any changes.

4.4.1.3 Role of different agencies for making FSR Programme successful

There are lots of financial and non-financial institutions, and government and non-government organizations which were involved to make FSR programme successful. As discussed earlier, the respondents were asked to present their views about the role of different agencies. The majority of respondents indicated that the NRB & Government have to play vital role to make FSR programme successful.

Table: 4.26

Role of different agencies for making FSR Programme Successful

Description	No. of Person	Percentage (%)
Financial Institutions	24	30.00%
NRB & Government	34	42.50%
All the Above	22	27.50%

(Source: Field Survey, 2009)

The above table shows the reply of the respondent and its percentage. It was found that 24 persons (30%) of respondents expressed that Financial Institutions have to play vital role, 34 persons (42.5%) indicated that NRB & Government should play vital role and 22 persons (27.5%) stated that both financial institutions and NRB & Government should play vital role.

4.4.2 Interest Rate Spread

High interest rate spread has always been concerned for NRB. As observed in secondary data analysis, interest rate spread was still in the higher side. NRB has deregulated interest rate to reduce the spread but have not worked. In this context, the respondents were asked about the improvement in the interest rate spread after deregulation of interest rate. The reply was mixed in nature but still the high percentage of respondents voiced that the deregulation has not improved the spread. It was seen that 24 persons (30%) were negative and indicated that deregulation has increased the spread, 12 persons (15%) were positive and opined that deregulation has decreased the spread. However, 44 persons (55%) said that deregulation has not helped even for increase or decrease in interest rate spread.

4.4.3 Deposit and Credit Growth

Deposit and Credit is back bone of any financial institutions. In the secondary data analysis deposit and credit shows high growth rate. The cause behind this high growth could be different. In the recent past, the number of Commercial Banks and Finance Companies increased tremendously. In this context, the respondents were asked to present their view on the cause behind the growth of the deposit and credit. The reply was mixed but still high percentage of respondents felt that the increased number of Commercial Banks and Finance Companies and quality of service offered by them was major cause behind this growth.

Table: 4.27
Cause behind the Deposit and Credit Growth

Description	No. of Person	Percentage (%)
Implementation of FSR	26	32.50%
Increased number of CBs and FCs and Quality of Service	32	40.00%
All the Above	22	27.50%

(Source: Field Survey, 2009)

In the above table, 26 persons (32.5%) indicated that the growth was due to the FSR Programme, 32 persons (40%) felt that the growth was due to increased number of CBs and FCs and quality of service provided by them. However, 22 persons (27.5%) expressed that the growth was caused by both reasons.

4.4.4 Liquidity Position

Maintaining appropriate liquidity was always been the challenge for Commercial Banks and Finance Companies. In the secondary data analysis, the liquidity position of CBs and FCs was fluctuating through out the review period. Some time liquidity position was quite high which reduce profit and sometime liquidity position was quite low which restricts the good investment opportunity. The FSR programme was highly focused to help the CBs and FCs to improve its liquidity position and maintain appropriate liquidity. In this context, the respondents were asked to express their views about the improvement in liquidity position of CBs and FCs after FSR programme. The reply was mixed but the high percentage of respondents expressed that the liquidity position of CBs and FCs improved after FSR programme. Analyzing the reply of respondents it was seen that 34 persons (42.5%) were positive and indicated that the liquidity position of CBs and FCs improved, 24 persons (30%) were negative and expressed that liquidity position of CBs and FCs decreased. Similarly, 22 persons (27.5%) were neutral and think that liquidity position remains same.

4.4.5 Growth of Finance Companies

In the last two decade number of Finance Companies grew tremendously. As observed from the secondary data analysis in the year 1992, there was only one Finance Company but now the number has increase to 78. There was lots of direct and indirect cause behind this growth. In this context, the respondents were asked to present their view about the cause for the growth of Finance Companies. The majority of respondents felt that the implementation of FSR programme and lack of Commercial Banks growth is the cause of growth of Finance Companies.

Table No. 4.28
Cause behind the Growth of Finance Companies

Description	No. of Person	Percentage (%)
Implementation of FSR Programme	14	17.50%
Lack of CBs growth	20	25.00%
Both the Above	46	57.50%

(Source: Field Survey, 2009)

As shows in the above table, 14 persons (17.5%) indicated that the implementation of FSR programme was the main cause behind the growth of Finance Companies, 20 persons (25%) stated that lack of Commercial Bank Growth on that period was the major cause behind the Finance Companies growth. However, 46 persons (57.5%) opined both the causes behind the growth of Finance Companies.

4.4.6 Changes in NBL and RBB after management contract to foreign company

NBL and RBB two state owned banks were suffering from serious financial, managerial and organizational problems. As discussed earlier, the main problem of these banks were bad loan and high percentage of NPA. Government decides to take step to reform these banks with the help of NRB and offer its management contract to foreign company. In this context, the respondents expressed their view about the overall change in NBL and RBB after management contract. The reply was mixed but still the high percentage of respondents voiced that the management contract has caused little improvement on these banks. After analyzing the reply, it was seen that 24 persons (30%) were highly positive and stated that the management contract caused more improvement, 30 persons (37.5%) were positive and said that management contract has caused the little improvement.

However, 26 persons (35.5%) were negative and felt that there is no improvement even after management contract.

4.4.7 Competition in financial sector after FSR

After implementation of FSR the door for opening Commercial Bank, Development Bank, Finance Companies and other formal and non-formal financial institutions were opened. Analyzing the past two decades, the growth of CBs, DBs, FCs, Cooperative, and Micro Finance was quite high. The growth of Financial Institutions noted high competition within them. Competition can be healthy and unhealthy and there are some financial institutions which believe in healthy competition but some area against them. In this context, the respondents were asked to share their observation about the competition in financial sector after adopting FSR. Again it was mixed reply but the high percentage of respondent expressed that there is unhealthy competition in the financial sector of Nepal. It was seen that 34 persons (42.5%) were positive and stated that there is healthy competition in financial sector after FSR, 40 persons (50%) were negative and indicated that there is unhealthy competition. However, 6 persons (7.5%) were unaware about it.

4.4.8 Market Share of Commercial Banks

Market share of Commercial Banks was higher before a decade. The secondary data analysis indicated that the market share of Commercial Banks decreasing recently. There could be a lot of cause behind the decrease of market share of CBs. In this context, respondents were asked to present their views relating to the cause of decrease in market share of CBs. Here, respondents were quite even on their option but still a slightly high percentage of respondents stated that it could be due to increase in market share of Development Banks and Finance Companies.

Table: 4.29

Cause of decrease in Market Share of CBs

Description	No. of Person	Percentage (%)
Increase in Market Share of Development Bank	28	35%
Increase in Market Share of Finance Companies	22	27.5%
Both the Above	30	37.5%

(Source: Field Survey, 2009)

In the above table, it was observe that 28 persons (35%) opined the decrease of market share of CBs was due to the increase in market share of Development Banks, 22 persons (27.5%) were voiced that the increase in market share of Finance Companies, and 30 persons (37.5%) said that it could be due to the both reasons.

4.4.9 Re-engineering of NRB

Re-engineering of NRB was a major step taken by government to strengthen the central bank. The main focus of this process was to develop NRB as an autonomous institution and give full autonomy which will increase the accountability as well. In this context, the respondents were asked about the increase of autonomy and accountability of NRB due to re-engineering process. Majority of respondents expressed that the re-engineering process has increased the autonomy and accountability of NRB. While analyzing the reply of respondents, 54 persons (67.5%) were positive and agree about the increase of autonomy and accountability due to re-engineering process, 22 persons (27.5%) were negative and voiced that the re-engineering process would not increase autonomy and accountability of NRB. However, 4 persons (5%) were unaware of re-engineering process.

4.4.10 Role of Private Sector in FSR of Nepal

An open question was asked about the role of private sector in FSR of Nepal. The response varied from all respondents. However, majority of respondents opined that private sector should implement the NRB directive, and government rules and regulations wisely and they should promote healthy competition in the field of financial sector of Nepal. Private sector needs to be informed of achievement of FSR and have to pressurize government for the enforcement of law and regulation related to financial sector of Nepal.

4.5 Major Findings

This study was conducted to study the impact of FSR in the financial sector with the focusing on commercial bank and finance companies.

The result of financial reforms initiated has remarkably increased the number of financial institutions. But hilly and rural commercial bank branches were decreasing after FSR because in 1985, percentage share of rural commercial bank was 69.7 percent in total branches and which was only 59.6 percent in 2000. This indicates FSR in urban biased to some extent.

Impact of deposit growth on commercial banks and finance companies is positive, as deposit of both institutions has remarkably increased during the review periods. And relatively, growth rate of total deposit is grater then the growth rate of GDP and the same case is observed in total credit also. In absolute term, rural credit is increasing but in relative term it has decreased in percentage of total credit to its urban counterpart after FSR.

In purpose-wise credit of commercial banks, it is observed that FSR has brought positive impact to agricultural and industrial credit because these credits are increasing. That means CBs are contributing credit facility to poor for productive and employment generating economic activities. Being the main stay of Nepal, agriculture sector is still neglected and industrial sector owes high portion of credit extended by commercial banks. Finance companies extended much of their resources to unproductive sector like housing loans. Finance companies extended credit beyond the standard ratio as compared to the total deposits which was very risky and no reforms were able to check such activity.

Absolute amount of PSC is increasing all the review periods. The relative percentage share of PSC in relation to other variable like GDP and total credit is either stagnating or increasing but not decreasing. It indicates that positive trend of access of credit to poor after FSR. Commercial banks followed NRB directive to some extent providing around 10% credit to priority sector in 2001.

Reforms initiated could not solve problem of high liquidity in commercial banks and finance companies. Liquid fund of commercial banks further increased in a slow pace after liberalization process began. But the years 1996 and 1998 are considered better for the purpose of resources mobilization and these years have met the NRB norms maintaining around seven percent liquidity of the total deposit liability. However, the reforms initiated had decreased the liquidity of finance companies but was not able to reduce it to desired level.

Non-performing assets of the CBs is increasing trend it indicates the proportion of inferior (bad) assets has risen because of the poor financial system. NPA is around one third of the total assets from 2001 to 2003 and the share in RBB and NBL is more than 60 percent even the management contract of them to foreign expert but after year 2003 total NPA declined to 6.1 percent. So, it shows that FSR did not helped to reduce NPA initially but after 2005 it shows remarkable change. However, profit of finance companies was positively hit by the reforms initiated as most of the finance companies were positively hit by the reforms initiated as most of the finance companies were able to make profit each year but yet not satisfactory.

After the interest rate deregulation, it was expected that the interest rate spread would decrease through competition but the result was not as per expectation. The commercial banks showed oligopolistic nature using cartel nature in interest rate determination, with lending rates and low deposit rates. So, commercial banks did not follow the NRB directive to maintain less than 5% interest rate spread. Nepalese financial system can be divided into two broad categories banking and no-banking institutions. With the adoption of liberal financial policies more than two decades number of financial institutions reached to 223 in mid-July 2008 from 4 in fiscal year 1983. Similarly, percentage share of total financial assets and broad money (M2) in GDP was 24 percent and 22.6 percent respectively in 1980 and the share was 86.3 percent and 60.5 percent in 2008. These indicators reveal an increasing level of financial deepening developing in the economy and which also further shows the role and importance of financial sector.

Increasing credit to GDP ratio, on the one hand, reveals the important role of credit in the economy and on the other, an increasing credit/deposit ratio from 66.9 percent in 1995 and which reached 76.9 percent in 2008, which indicates financial institutions are more efficient to manage investment. Still Nepalese financial system is dominated by banking sector but the domination decreasing after the financial sector reforms.

The landscape of financial system in fact changing with FSRs initiated accompanied with the establishment of new banks, finance companies, insurance companies and stock exchange. A part from the establishment of new banks, there is an increasing demand for reform of two government controlled banks. Reform measures that had to be undertaken in the financial sector in aggregate include policy reform, operational reform and supervisory reform which require commitment, support and coordination of the government, NRB and respective financial institutions.

An opinion survey with the 80 officials of commercial banks and finance companies shows the trend or result observed in secondary data analysis. Necessity of FSR programme was observed in secondary data analysis and in the primary opinion 82.5 percent were agreed on this. Performance of CBs and FCs improved after FSR programme and the majority of (57.5%) respondents also felt the same. The majority (42.5%) of respondents felt that NRB & Government have to play vital role to make FSR programme successful. Interest rate was fully deregulated to reduce the spread but majority of respondents (55%) felt that there is no improvement even after deregulation. The highest percentage (40%) of respondents stated that the high growth in deposit and credit due to increased number of CBs and FCs and quality of service offered by them. Before FSR, the liquidity position was not satisfactory but after FSR it shows improvements and even the highest percentage (42.5%) of respondents agreed on it. The growth of FCs could be due to several reasons but the majority (57.5%) of respondents felt that the growth could be due to the implementation of FSR programme and lack of commercial banks growth during that period. The NBL and RBB show positive changes after management contract and high percentage (37.5%) of respondents felt change and improvement in these banks. High competition was observed in the financial sector after FSR which prompted unhealthy completion, and even the majority (50%) of respondents admits that there is unhealthy competition. The market share of CBs observed to have decreasing trend, and the majority (37.5%) of respondents expressed that it could be due to the increase in market share of DBs and FCs. Re-engineering of NRB helped to increase its autonomy and accountability, and the majority (67.5%) of respondents expressed the same. Most of the respondents stressed on better implementation of NRB directives and Government rules and regulations.

CHAPTER - V
SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

Feeling the urgent need of financial deepening, financial widening, competition and promotion of private sector investment, process of FSR in Nepal took its pace by amending the Commercial Banks Act 1974 in 1984 which removed the entry and exit barriers of commercial bank. Before the year 1984, there were only two state-owned commercial banks namely RBB and NBL. Amended commercial bank act, opened the door for domestic as well as foreign private sector. As a result, 25 commercial banks were operating in 2008.

Immediately after the amendment of the Commercial Bank Act, the Financial Company Act, 1985 was enacted but after the political change of 1990 the finance companies started to inter the financial systems. Development Bank Act was enacted in 1998. Which gave freedom to establish development banks and also pre mitted to perform banking activities; NRB gave permission to NGOs and Co-operatives to perform limited banking activities. As a result, dominant role of commercial banks in the financial system has started to decline.

As a process of financial sector liberalization, interest rate were fully deregulated from July 1989 supposing market can determine true cost of capital, keep real interest rate positive. Call money market was established in the year 1989, and Credit Bureau was also set up at the same year under the aegis of Banker's Association of Nepal. Emphasis was also given to the establishment of the prudential norms are like capital adequacy ratio, loan classification and loan loss provision, single borrower, disclosure norms etc.

After the financial sector liberalization, NRB changed its monetary instruments and used indirect instruments to control money and capital market. Indirect instrument CRR is used instead of direct instruments Statutory Liquidity Ratio (SLR) and interest rate. So, the SLR was completely abolished from August 1993. Another major reform has taken place in the area of capital market. In 1984, Securities Market Center (SMC) 1977 was converted in to the Securities Exchange Center (SEC). Reform in the stock exchange market was initiated with the amendment of the Security Exchange Act, 1983 in 1993. NEPSE was created for trading of securities and stocks. The floor of NEPSE opened for trading in January 1994.

Another reform is taken as the management contracts of two state-owned commercial banks, NBL and RBB because they were ailing from the long time with financial, managerial and organizational problems. To study these problems and prescribe necessary recommendations Nepal achieved financial and technical help of the UNDP and the study team presented the CBPASS (I and II) reports in 1992. These reports were implemented to some extend but the problem could not be improved.

According to the commitment of HMG/N to reform RBB and NBL, Nepal Banking Reform Project was established and in his project, KPMG Barents Group, an international expert team was associated. The reform project started to work from 15 November 1999 and completed the study in FY 1999/2000; the management of NBL was handed over ICC Bank of Ireland. In the case of RBB, M/S Deloitte Touche Tohmathu of the USA broke the contract in final agreement. So, after that NRB appointed American citizen Mr. Bruce F. Henderson in December 21, 2002 as a Chief Executive Officer (CEO) and he have started to work by January 16, 2003.

Till the end of fiscal year 2008, total number of commercial banks operating in Nepal was 25 with 558 branches. Branches of commercial banks were highest in 2007 with 566 branches. In 1983, numbers of commercial bank branches were 325 and it was lower then in the year 2008. In 1983, share of hilly areas commercial bank branches were 41.8 percent of the total commercial bank branches, but, in 2008, the share was only 27.6 percent. In Kathmandu valley, share of commercial bank branches was 13.8 percent in the year 1983 and which is 28.5 percent in 2008.

Rural commercial bank branches were 267 in the year 1985 and which were 285 in year 2000. In absolute term the total number is increased but in relative term percentage share of rural commercial bank branches were 69.7 percent of the total bank branches in the year 1985 and which only 59.6 percent was in 2000. The means rural commercial bank branches are decreasing after the FSR.

After the peak period of deposit growth rate (25.6%) in 1998, the total growth rate is decreasing until the year 2006 and again it started to rise and reached 26.3 percent in year 2008. The cause for decrease in growth rate may be due to the NRB directive, which was issued in FY 1998/99 and that was about to maintain the interest rate below five percent in between lending and deposit rate. The cause for increase in growth rate may be due to the increase in number of commercial bank after year 2006. Commercial bank did not reduce only lending rates but also deposit rates, which in turn adversely affected the collection of interest bearing deposits. When the impact of FSR is assessed from deposit growth after and before FSR, average growth rate of total deposit before FSR was 23.7 percent but after FSR that was 16.2 percent during the review periods. Even though in between 24 years after FSR, the total amount of deposits had been increased 50 times, but nine years period before FSR the increment was only around five times. When total deposit is evaluated from GDP of nation, total deposit has reached 51.9 percent of the GDP in 2008, which was only 18.7 percent in the year 1883. It means growth rate of deposit of commercial banks is much higher then the GDP of the nation.

Total credit of commercial bank is in increasing trend, highest growth rate was 41.8 percent in 1995 and the amount was Rs 38779.1 million and lowest growth rate was 3 percent in 2006. At the end of FY 2008, total credit of commercial bank was Rs 306638.0 million and that was increased by more then 47 times as compare to the year 1985. In 1985, share of total credit in GDP was 13.9 percent and that was 36.9 percent in 2008. This shows commercial banks credit has increased by more then two folds in 2008 as compare to the year 1985.

The purpose-wise lending portfolio of commercial banks shows significant change in the pattern of lending in favor of agriculture and industry to whole review periods. Agriculture credit was 0.1 percent of the total credit in 1975, which was 12.1 percent, 2.8 percent and 4.2 percent in the years 1995, 2005 and 2008 respectively. Industrial credit was 5.1 percent of the total credit in 1975 and which was 39.1 percent and 49.9 percent in the years 1995 and 2008 respectively. But a general use of credit was 48 percent of the total credit in 1975 and which was 3.3 percent in 2008.

Amount of Priority Sector Credit (PSC) is increasing all the review periods but percentage share of PSC on total credit and GDP was fluctuating until the year 1995, then its trend is increasing. In 1985, PSC was Rs 432.8 million which was Rs 37539.6 million in 2008 and the increment was more then 86 times in 2008 as compare to the year 1985. Percentage share of PSC was 0.92 percent in GDP and 6.63 percent in total credit in the year 1985 and which was 4.6 percent in GDP and 12.4 percent in total credit in the year 2008. It indicates that the positive impact to assess to credit to poor people after FSR.

Liquidity is the most criticized part of Commercial Banks as they showed excess liquidity. Before FSRs process begun, banks suffered from high liquidity which was maintained at the cost of profit. Lowest liquidity in constructive period of commercial banks was in the year 1980 which was 34.3 percent of total deposits against the standard of 30 percent, where as in the year 1977, it was 57 percent which was very high in compare to the year 1983. But, after FSRs, the liquidity of commercial banks decreased to 32 percent in the year 2008, where as it was 48 percent in the beginning year of FSRs i.e. in the year 1985. Before FSRs begun, the credit deposit ratio was almost same in the years 1977 and 1983, which was nearly 54 percent in both years. But after FSRs it was increased to 71.1 percent in the years 2008 in compare to the year 1983. Capital-total deposit ratio was slightly decreasing from the year 1977 to 1983 and reached 1.7 percent in the year 1983. But, after FSRs, it was increasing until the year 2003 and reached 5.8 percent. But, from the year 2004 to 2007 the figure becomes negative i.e. -4.4 percent, -7.6 percent, -6.1 percent and -1.2 percent, due to the negative retained earnings.

Aim if interest rate liberalization was to reduce interest rate spread through increasing deposit rates and decreasing lending rates in competitive environment. But, it is observed that before and after the interest rate liberalization, there is no significant change into interest rate spread. Initial period of the interest rate liberalization, interest rate spread had increased. Lowest interest rate spread was 5.75 percent in 2008 and the highest rate was 8.5 percent in year 1995, 1996 and 1997. Former year of the interest rate liberalization, the spread was 7.37 percent. But the interest rate is high as per government directive to maintain less then five percent interest rate spread.

NPA of joint venture bank was highest 10.9 percent in 2001 and then it has started to decline. But reform process could not help to reduce NPA of commercial banks till the year 2003 and after year 2004 NPA started to decrease which means the reform process has shown its effect on NPA. From the year 2001 to 2004, the NPA was around on third of the total assets and the share of state-owned commercial banks was high. In 2004, total

NPA was 22.8 percent and share of RBB and NBL was 55.3 percent. In 2008, NPA of RBB and NBL have decreased significantly to 21.6 percent and 8.95 percent respectively. Likewise total NPA and NPA of joint venture bank also decreased to 4.4 percent and 6.1 percent respectively in same year.

The initiation of financial liberalization policy of NRB, since mid-eighties, under overall economic liberalization policy of HMG/N (HMG/N has now Changed in to Government of Nepal (GoN)) has led to establishment of 78 finance companies until 2008, of which 60.25 percent of them are located in Kathmandu valley. Deposit of finance companies is increasing tremendously. Total deposit was Rs 195.8 million in 1995 and which reached as 52282.2 million in 2008. However, high growth of total deposit could be assigned to some extent to the increased number of finance companies. When total deposit of finance companies is measured with GDP of Nepal, also shows a remarkable growth because in 1994, it was only 0.1 percent in GDP and which reached 6.4 percent in 2008.

The reforms initiated by government viz. NRB have positively affected to the credit of finance companies. In 1994, the total credit was Rs 217.3 million (52.9% of the total asset) which reached Rs 51516.9 million(64.1% of the total asset) in 2008, and the increment in total credit was more then 237 times in 2008 as compared to the year 1994. This is not only due to the increment of finance companies but also due to a wide range of services offered by the finance companies.

To manage just needed amount of liquid fund is complicated part of the finance companies because low liquid fund is life threatening to finance companies and high liquidity reduce profit. The highest liquidity was 42.8 percent of the total deposit in the year 1994 and which was 33.9 percent in 2008. In the years 1996 and 1998, the liquid fund was 7.2 percent and 7.1 percent respectively. So, these years are considered as better for the purpose of resources mobilization and years had met the NRB norms maintaining around seven percent liquidity of the total deposit liability.

Loan loss provision of finance companies is increasing trend, which reveals non-performing loans is also increasing. Loan loss provision was 1.1 percent at the beginning of review period 1994, which was 3.6 percent and 4.9 percent in the years 2001 and 2008 respectively.

Following the reforms, liquidity of finance companies have declined to great extant as 44.3 percent in the year 1994 and was reduced to 35.4 percent in the year 2008, but still it was more than enough. Beside the standard of 75 percent of total credit to total deposit ratio, finance companies were found to be having more credit deposit ratio the maximum being 111 percent in the year 1994 and the least being 85.5 percent in the year 1998. Capital to total deposit ratio of finance companies had shown a decreasing trend till year 1998 which was 49.5 percent in the year 1994 and declined to 14.1 percent in the year 1998, since then it gradually began to increase and stood up to at 14.2 percent in the year 2008. Raising Loan Loss Provision of finance companies reveals the increment of Non-Performing Loans. Loan loss provision at the beginning of review period 1994 was 1.1 percent and increased to 4.9 percent in the year 2008.

Profits of finance companies witnessed increment in their volume which was the due cause of reforms initiated by NRB and HMG/N (now GoN) though few were in loss. ROA of finance companies show a slight increase as it reached to 2.79 percent in the year 2008 where as it was 2.35 percent in the year 1998.

After FSR, number of banking and non-banking financial institutions has increased; particularly it came into motion after the restoration of democracy. The number of financial institutions grew from 4 to 223 between mid-July 1983 and 2008. The trend of financial asset is increasing and total asset was Rs 5594 million (24% of GDP) in the year 1980 which was Rs 706324.0 million (86.3% of GDP) in the year 2008. Share of broad money (M2) in GDP is also increasing and the share was 22.6 percent in 1980, 60.5 percent in 2008. So, role of financial sector is increasing with financial deepening and monetization in Nepalese economy.

After FSR, transaction of financial sector has increased along with increase in number of banking financial institutions. In 1998, total credit of financial system was Rs 74875.6 million and share of commercial bank was 92 percent and other financial institution was eight. In 2008, total credit was Rs 391537.7 million and the share of commercial banks and other financial institutions was 78.3 percent and 21.7 percent respectively. And, the credit was increase more than nine times in 2008 as compare to the year 1995. Like wise, in deposit side, role of commercial banks is dominant and deposit share of commercial banks was 94 percent and 83.7 percent in the total deposit of financial sector in the years 1998 and 2008 respectively. Credit/ deposit ratio of the whole financial system was 66.9 percent in 1995 and that was 76.9 percent in the year 2008. Increasing credit/deposit ratio implies that bank and financial institutions are able to mobilize increase proportion of private saving.

After FSR, in total financial assets, share of commercial banks is decreasing and share or other financial institution in increasing. In 1998, out of total amount market share of commercial banks, finance companies, development banks and co-operative was 94 percent, 5 percent, and 1 percent respectively, and in 2008, the share was 80 percent, 11 percent, 7 percent and 1 percent respectively.

The primary opinion survey shows the result or trend as observed in secondary data analysis. Majority (82.5%) of respondents stressed on the necessity of FSR programme and 57.5 per cent of respondents observed improvement in the performance of CBs and FCs. The highest percentage (42.5%) of respondents opined that the role of NRB & Government was critical to make FSR programme successful. Implementation of FSR programme caused high growth in number of FCs and the majority (57.5%) of respondents felt the same. The increase in the number of CBs and FCs has impacted competition within them, a high percentage (50%) of respondents observed unhealthy competition. Re-engineering process increase autonomy and accountability of NRB and majority (67.5%) of respondents agreed on that. The role of private sector in the reform of was critical and most of the respondents stressed for the better implementation of NRB directives and Government rules and regulations.

5.2 Conclusion

This study was focused to assess the impact of financial sector reform only on commercial banks and finance companies. The purpose of this study is to study the recent initiation and commitments in the field of FSR, and to assess the direct or indirect effect of FSR in commercial banks and finance companies.

During the past few years, a positive impact of FSR programme has been observed in various components of financial sector of Nepal. The number of commercial banks, development banks and finance companies increased in greater extent as well as their branches. High percentage of NPA was always been challenges for the banking sector of Nepal especially to the two state owned banks like, NBL and RBB. The FSR programme helped these banks to reduce their NPA. After FSR, amount of deposit collection has been increased rapidly and total credit of commercial banks also increased significantly. Priority Sector Credit (PSC) also increased in all the review periods but higher liquidity of commercial banks, which was problem before FSR, is now under control. Credit deposit ratio increased after FSR but capital- total deposit ratio was increased initially and became negative due to the negative retained earning. The main aim of interest rate liberalization is to reduce interest rate spread but it is observed that before and after the interest rate liberalization, there is no significant change in interest rate spread.

Similarly, FSR helps to grow finance companies and financial system immensely. Deposit of finance companies is increasing tremendously and the cause behind this growth is the increased number of finance companies. The reform initiated by the government viz. NRB has positive effect to the credit of finance companies. The increment in total credit was more then 237 times, which was not only due to the large number of finance companies but also due to the wide range of service offered. Low liquidity is life threatening to finance companies and high liquidity reduces profit. So, for the past few years, finance companies succeeded to maintain appropriate liquidity according to NRB norms. Loan loss provision and none performing loan is still in increasing trend which is of some concern for finance companies. Capital to total deposit ratio of finance companies had shown a decreasing trend initially but from past few years it is increasing trend. Profit of finance companies witnessed increment in their volume which was the due to the cause of reform initiated by NRB and HMG/N (now GON) though few were in loss.

Likewise, after FSR the number of banking and non-banking financial institutions has increased rapidly. Financial assets are always in increasing trend and share of broad money (M2) in GDP also increasing. Total transaction of financial system has increased and increasing credit deposit ratio implies that bank and financial institutions are able to mobilize increased proportion of private saving.

However, an opinion survey was conducted to the 80 respondents to know their view about the different aspects of FSR. The FSR programme was necessary for the reform of financial sector of Nepal and it shows the positive impact on various aspects (like liquidity, Deposit, Credit, NPA etc) of financial system of Nepal. The role of private sector for the implementation of NRB directives and Government regulation relating to FSR also felt important.

5.3 Recommendations

Following recommendations are made on the basis of the study and analysis of collected data in order to make sound financial institutions;

- As a reform package, NRB should motivate banks and finance companies to open their branches in rural area.
- The credit facility to rural poor is gradually decreasing to its urban counter part and on the other hand priority sector program is going to phase out from 2007/08. But priority sector credit is directly related to poverty alleviation effort. So, government should made effort to continue this.
- NRB should play a decisional role in current interest rate structure because real interest rate in negative and interest rate spread is high. Due to this reason, on one hand, poor people are being exploited and on the other, it has maximum chances to capital flight.
- To reduce bad assets (NPA) of the commercial banks, Credit Information Bureau and Credit Rating Agency should be made strong. The concept of assets Management Company should be implemented effectively.
- Competition oriented policies should be promoted for establishing sound financial sector.
- To strengthen and develop the regulatory, supervisory and inspection management, the framework of NRB should be built as autonomous body without interference of the government in conducting monetary policy, regulation, supervision, (onsite and offside) and licensing of financial institutions.
- NRB should initiate international standard of auditing and accounting, and its transparency.
- Publication of the "Banking and Financial Statistics" should incorporate a detail institution-wise data analysis so that the public can evaluate the current situation of financial system.
- The current restriction of foreign ownership beyond 50% should be eliminated. Removing this restriction altogether may help to attract more banks that could

bring discipline, know-how and transfer of technology to Nepalese financial sector.

- The loan portfolio of the finance companies should be more diversified. The NRB as regulator should strictly follow up the prescribed direction not in the aggregate level but in the institutional level. Such sickness will have positive impact on the behavior of the companies by forcing them to search for new innovations.
- Strong policy should be enacted and implemented to check the priority sector lending of the financial institutions. Also, NRB should create a sound environment for investment in the deprived sector so as to attract investment from banks and finance companies by initiating new financial reforms. New investment opportunities should also be sought by NRB so as to utilize the high liquidity of the markets.
- NRB should develop the tools to make existing financial environment competitive, so they can compete with the international challenges after the full implementation of WTO norms.
- FSR Programme is necessary to improve the performance of Financial Institutions of Nepal. Government & NRB should have to play vital role to make this programme successful.
- Private Sector should implement the NR directives and Government rules & regulation wisely, and they should promote healthy competition in the field of financial sector of Nepal.
- Similar kind of study only on Development Banks of Nepal seems relevant for the future researchers.
- Since the impact of FSR showing positive signs in the different components of CBs and FCs, it looks relevant to conduct similar study after the time span of two or more years to assess the current impact of FSR.

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