INTRODUCTION

Banking sector has undergone tremendous changes and revolution over a period of more than seven decades. The whim of commercial bank started with the establishment of Nepal Bank Limited (NBL) in 1937, first commercial bank of Nepal and Nepal Rastra Bank (NRB), the central bank, nearly after two decades in 1956. The establishment of NBL and NRB is considered to be two major milestones in Nepalese banking sector (Maskay & Subedi, 2009). Third important milestone is the replacement of NRB Act 1955 by current Nepal Rastra Bank Act 2005 (Maskay & Subedi, 2009). A decade after the establishment of NRB, Rastriya Banijya Bank (RBB), a commercial bank under the ownership of the then His Majesty's Government of Nepal (HMG/N) was established. With the adoption of financial sector liberalization, characterized by liberalization and deregulation of the interest rates, relaxation of entry barriers for domestic and foreign banks, restructuring of public sector commercial banks and withdrawal of central bank control over their portfolio management, new commercial banks from private sector entered into the playground. Consequently, the third commercial bank in Nepal, or the first foreign joint venture bank, was set up as Nepal Arab Bank Ltd (now called as NABIL Bank Ltd) in 1984.

Table : 1

First 10 Commercial Banks established in Nepal[1]

Name of Commercial Banks	Date of Operation (A.D.)
Nepal Bank Limited	1937/11/15
Rastriya Banijya Bank	1966/01/23
Nabil Bank Limited	1984/07/16
Nepal Investment Bank Limited	1986/02/27
Standard Chartered Bank Nepal Limited	1987/01/30
Himalayan Bank Limited	1993/01/18
Nepal SBI Bank Limited	1993/07/07
Nepal Bangladesh Bank Limited	1993/06/05
Everest Bank Limited	1994/10/18
Bank of Kathmandu Limited	1995/03/12

Source: Nepal Rastra Bank (2012)

Many prominent authors agree to the fact that banks and financial institutions such as development banks, co-operatives, finance companies, merchant banks, and insurance companies directly and indirectly affect the economic development and are established all over the world to mobilize savings and invest into economy either directly and indirectly for production and generation of income and employment. With liberalization and increasing competition, the banking sector registered impressive achievement in terms of branch expansion, deposits, credit, and investment.

Financial development in many developing economies like Nepal is still faced by a number of obstacles such as macroeconomic instability, the fragility of stock markets, the limitation of capital markets, and the inefficiency of

development and specialized banks. Despite some of these limitations, banking systems in underdeveloped countries remain integral components of the general economic systems and they can be considered as a key element in any development effort.

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

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

Public sector banks:

Public sector banks have substantial shares in the total assets of the industry and have huge branch networks around the country. Rastriya Banijya Bank (RBBL), Nepal Bank Limited (NBL) and Agriculture Development Bank (ADBL) are government owned banks. These banks have significant contribution on improving banking habit among the people at large and encourage entrepreneurship in both the urban as well as rural area. The public sector banks

are still the largest banks in all aspects from deposit and credit mobilization to the number of branches in operation.

Joint venture banks:

The joint venture banks have very few branch networks and are concentrated in urban centers. JVBs started to establish since mid-1980s (Poudel, 2005) and there are seven in Nepal (NRB, 2010) including; Nabil Bank Ltd (NABIL), Standard Charter Bank Ltd (SCBL), Himalayan Bank Ltd (HBL), Nepal SBI Bank Ltd (NSBI), Nepal Bangladesh Bank Ltd (NBBL) and Everest Bank Ltd (EBL). They have foreign equity participation (along with domestic) and management with good name with international reputation, conducting banking business professionally. They are well mechanized and supervised by their respective home country supervisory authorities. The share of total assets of the joint venture banks has been increased to about 50% of total commercial bank assets. The introduction of joint venture banks infused modern banking and financial technology and new financial instrument in the financial system.[2] However, the spillover effect of their efficient management and modern banking skills was less in the domestic banks, as per expectation.

Domestic private banks:

Domestic private banks came in operation by late 1990s and early 2000s. There are seventeen domestic private banks including; Nepal Investment Bank Ltd (NIBL), Bank of Kathmandu Ltd (BOK), Nepal Credit and Commerce Bank Ltd (NCCBL), Lumbini Bank Ltd (LBL), Nepal Industrial and Commercial Bank Ltd (NIC), Machhapuchhre Bank Ltd (MPBL), Kumari Bank Ltd (KBL), Laxmi Bank Ltd (LXBL) and Siddhartha Bank Ltd (SBL).

They are managed and owned by private sector without foreign equity participation. Since they are relatively new banks, they have the opportunity to start as 'fresh banks' without bad loans in their portfolios and with the possibility of adopting recent banking technologies during their inception. Most of them are relatively small in asset size as well as their networks.

A decade after the establishment of NRB, Rastriya Banijya Bank (RBB), a commercial bank under the ownership of His Majesty's Government of Nepal (HMG/N) was established. Thereafter, HMG/N adopted open and liberalized policies in the mid 1980s reflected by the structural adjustment process, which included privatization, tariff adjustments, liberalization of industrial licensing, easing of terms of foreign investment and more liberal trade and foreign exchange regime was initiated. With the adoption of liberalization policy, there has been rapid development of the domestic financial system both in terms of number of financial institutions and as ratio of financial assets to the GDP.[3]

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

venture bank, was set up as Nepal Arab Bank Ltd(now called as NABIL Bank Ltd) in 1984.

There after, two foreign joint venture banks, Nepal Indosuez Bank Ltd. (now called as Nepal Investment Bank) and Nepal Grindlays Bank Ltd (now called as Standard Chartered Bank Nepal Ltd.) was established in 1986 and 1987 respectively. There after, another 12 commercial banks have been established within the period of 12 years. Nepalese banking system has now a wide geographic reach and institutional diversification. Although, Nepalese financial sector is dynamic, a lot of scope for development of this sector exists. This is because the banking and non-banking sectors have not been able to capture all the potentialities of business till this time. It is evident from the Rural Credit Survey Report that the majority of rural credit is supplied by the unorganized sector at a very high cost – perhaps being at two or three time of the formal sector - suggesting that the financial sector is still in the path of gradual development. Overdue loans and inefficiency of the older and the larger of commercial banks have aggravated and have been made to compete with the new trim banks with no rural operations. Also, the commercial banks, domestic or joint venture have shown little innovation and positive attitude in identifying new areas of saving and investment opportunities. Following table reflects the present development of commercial banking institutions in Nepal.

Table : 2

Present Position of Commercial banks in Nepal[4]

NAME	OPERATION DATE	NO. OF BRANCH	Paid Up Capital Rs. in million	Pattern of ownership	Participating foreign Bank
Nepal Bank Ltd	1937	106	380.4	Government-49% Nepalese-51%	
Rastriya Banijya Bank	1996	114	1172.3	Government –100%	

Nabil Bank Ltd.	1984	17	491.7	Nepalese-50% Foreign Joint venture-50%	NB International, Ireland
Nepal Investment Bank Ltd.	1986	12	587.7	Nepalese-100%	
Standard Chartered Bank Nepal	1987	8	374.6	Nepalese-25% Foreign Joint venture-75%	Standard chartered Group
Himalayan Bank Ltd	1991	15	643.5	Nepalese-80% Foreign Joint venture-20%	Habib Bank Ltd, Pakistan
Nepal SBI Bank Ltd	1993	13	431.9	Nepalese-50% Foreign Joint venture 50%	State Bank of India, India
Nepal Bangladesh Bank	1994	17	719.9	Nepalese- 75% Foreign Joint venture-25%	IFIC, Bangladesh
Everest Bank Ltd	1994	16	455	Nepalese-80% Foreign Joint venture-20%	Punjab National Bank, India
Bank of Kathmandu	1995	9	463.6	Nepalese-100%	
Nepal Credit & Commerce Bank	1996	17	693.6	Nepalese-100%	
Nepal Industrial & Commercial Bank	1998	8	500	Nepalese-100%	
Lumbini Bank Ltd.	1998	4	500	Nepalese-100%	
Machhapuchere Bank	2000	9	550	Nepalese-100%	
Kumari Bank Ltd	2001	4	500	Nepalese-100%	
Laxmi Bank Ltd.	2002	3	610	Nepalese-100%	
Siddhartha Bank	2002	3	350	Nepalese-100%	
Global Bank Ltd.	2006	1			

Source: Reports of Commercial Banks, Nepal, 2007

EXISTING SCENARIO OF BANKING SECTOR:

Capital Structure of Banks: The current regulation of NRB prescribes that all the new commercial banks are to be established in Kathmandu at national level should have minimum paid up capital Rs. 1 billion; the existing banks in operation are required to enhance the capital level to Rs. 1 billion by the end of FY 2007-08 BS. For this purpose and objective all the commercial banks have

furnished their plans to enhance the level of capital accordingly. In the mean time, there are separate provisions on capital requirements for the national level banks to be operated outside the Kathmandu. Banks to be established out side the Kathmandu valley are required to have a minimum paid up capital of Rs. 250 million.10 The total paid up capital of 17 banks as at July 2005 has reached at Rs 9.423million. The paid up capital of commercial banks operating in Nepal is on an average of Rs. 554 million

Banks Under Foreign Participation: All together nine banks were established under foreign participation in Nepal but three of these have divested their stake to Nepalese promoters. Six banks still have foreign joint ventures. The banks operating under foreign participation are NABIL Bank Ltd, Standard Chartered Bank Nepal Ltd, Himalayan Bank Limited, Nepal SBI Bank Ltd, Everest Bank Limited and Nepal Bangladesh Bank Ltd. Initially, Bank of Kathmandu, Nepal Credit and Commerce Bank and Nepal Investment Bank were also established under foreign joint venture.

The banking asset with the foreign joint venture banks is gradually increasing. The commercial banks under foreign participation hold 37.54 percent of total banking assets. The deposits and credits are still of greater proportion. Foreign joint venture banks possess 39.65 percent of total deposits and 38.45 percent of total credit of the banking system.

DOMESTIC LEGAL PROVISIONS REGARDING BANKING SECTOR:

Nepal Rastra Bank Act, 2002 has given full authority to the Nepal Rastra Bank regarding regulation, inspection and supervision of the banks and financial institutions. Bank and Financial Institution Ordinance, 2005-06, which is

popularly known as Umbrella Act, has recently been enacted in unified form. Agricultural Development Bank Act, 1967, Commercial Bank Act, 1974, Finance Company Act, 1986, Nepal Industrial Development Corporation Act, 1990 and Development Bank Act 1996 have been repealed with the promulgation of this ordinance. The ordinance governs the functional aspect of banks and financial institutions.[5] Some of the important provisions in the ordinance regarding the banking sector have been analyzed in this chapter as follows:

Any person wishing to incorporate a bank or financial institution to carry on financial transactions should incorporate a bank or financial institution as a registered public limited company under the prevailing law of Nepal with prior approval of NRB by fulfilling the conditions prescribed in section 4 of the ordinance. The individual desiring for the incorporation of such entity is required to submit an application to NRB for prior approval with the prescribed documents. The NRB is required to conduct necessary investigation and grant permission to establish a bank or financial institution with or without terms or conditions if all the criteria are met and information of disapproval with reason is also to be given to the concerned person in case the application is denied. Similarly, any foreign bank or financial institution wishing to establish a bank or financial institution by making joint venture investment with a corporate body incorporated in Nepal or with a Nepali citizen or as a subsidiary company with 100% share is eligible to furnish the application to establish a bank or financial institution. However, the ordinance is silent about the percentage of equity investment in joint venture, such foreign corporate body can invest. It has been regulated by regulation till now as 75%.

The ordinance prohibits anybody to conduct financial transaction except an established bank or financial institution and no bank or financial institution can use the proposed name for the purpose of carrying financial transaction without obtaining license from NRB. The bank or financial institution desiring to conduct financial transaction must submit an application for license to the NRB in the prescribed form including the prescribed fees, documents and description. NRB will grant license if it is satisfied with the basic physical infrastructure of the bank or financial institution; if the issuance of license for operating financial transaction will promote healthy and competitive financial intermediary and protect the interest of the depositors, the applicant is competent to operate financial transaction in accordance with the provision of this ordinance and its regulation, directives, order or provisions of Memorandum and Article of Association and there are sufficient grounds to believe that the entity is competent to operate financial transaction.

The bank or financial institution can be upgraded if the authorized capital is enough for upper class, the institution has been able to make profit for last five years and the non-performing asset is within the prescribed limit. Similarly, the bank or financial institution can be degraded if it fails to meet prescribed capital within the time period, it has been making loss for last five years, it has violated the directives of Rastra Bank time and again and it fails to maintain Risk Management Fund as prescribed by it. The NRB will make necessary investigation and avail opportunity to clarify before taking such decisions.

The NRB is in full power to deny license for financial transaction if the conditions stipulated in ordinance are not met and it is also authorized to impose necessary conditions taking into account the existing financial position of the

bank or financial institution, the interest of depositors and healthy operation of financial transaction. Similarly, it may increase, decrease or modify the terms and conditions time to time. The NRB can suspend the license of the license holder for a specific period of time issued for the purpose of carrying financial activities or it may order the bank or financial institution to close the operation of their office partially or fully if such a license holder acts against the provisions of the Nepal Rastra Bank Act, 2002, or the regulation made there under or fails to act in accordance with the order or directives issued by it or fails to act for the welfare and in the interest of the depositors. The NRB may cancel the license issued under this ordinance to carry on the financial transactions of the license holder under the certain circumstances as stipulated in the ordinance.

A foreign bank or financial institution desiring to open its office within the Kingdom of Nepal must submit an application to NRB in the form as prescribed along with the fees and particulars as prescribed. The NRB may issue a license to foreign bank or financial institution to carry on financial transaction by allowing them to open a office within the Kingdom of Nepal taking into account the situation of competition existing in the banking sector, the contribution that could be rendered in the Nepalese banking sector and the reputation of such foreign bank or financial institution. The NRB may specify necessary terms and conditions in the course of granting transaction license and it shall be the duty of the foreign bank or financial institution to comply with such terms and conditions. The section 34(4) of the ordinance reiterates that the provisions of the ordinance are to be complied by such foreign bank or financial institution. The foreign bank or financial institution, which has been issued license to operate financial transaction by opening its office within the Kingdom

of Nepal, can not open another bank or financial institution in joint venture within the Kingdom of Nepal. However, the provision for the contact or representative office of any foreign bank or financial institution will be as prescribed by NRB. Some of the important issues such as relationship with parent bank in case of liquidation and supervisory role of the different institutions (parent bank and parent bank's supervisory authority) have not been adequately addressed in this ordinance. Provisions relating to capital requirement are also silent in ordinance. However, it can be fixed by regulation.

The section 47 of the ordinance prescribes functions of the bank or financial institutions. The entities functioning under sub-section (1) only can keep their name as bank of class "A" category. The functions of such bank are incorporated in subsection (1) (A) – (AF) which are in very detail. As per Nepal's commitments foreign bank branches are only allowed for wholesale banking functions. So all of the provisions stipulated in subsection (1) will not be relevant to the foreign bank branches. According to the ordinance, NRB has authority to make necessary regulation in this aspect.

FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN NEPAL:

Financial sector is the backbone of economy of a country. It works as a facilitator for achieving sustained economic growth through providing efficient monetary intermediation. A strong financial system promotes investment by financing productive business opportunities, mobilizing savings, efficiently allocating resources and makes easy the trade of goods and services. Several studies have reported that the efficacy of a financial system to reduce information and transaction costs plays an important role in determining the rate of savings,

investment decisions, technological innovations and hence the rate of economic growth.

Banking has become an important feature, which renders service to the people in financial matters, and its magnitude of action is extending day by day. It is a major financial institutional system in Nepal, which accounted for more than 70% (Poudel, 2005) of the total assets of all the financial institutions. A profitable and sound banking sector is at a better point to endure adverse upsets and adds performance in the financial system.

A competitive banking system promotes the efficiency and therefore important for growth, but market power is necessary for stability in the banking system. Commercial bank holds a large share of economic activities of a country. The function of the commercial banks has been enhanced in Nepal to sustain the increasing need of the service sector and the economy in general. Stock market has been dominated by the commercial banks since a decade. Not only the stock market, but the commercial banks have also been major contributors to the revenue of the country. They have been paying a large amount of tax every year.

Performance evaluation is the important approach for enterprises to give incentive and restraint to their operators and it is an important channel for enterprise stakeholders to get the performance information (Sun, 2011). The performance evaluation of a commercial bank is usually related to how well the bank can use its assets, shareholders' equities and liabilities, revenues and expenses. The performance evaluation of banks is important for all parties including depositors, investors, bank managers and regulators. The evaluation of a firm's performance usually employs the financial ratio method, because it provides a simple description about the firm's financial performance in

comparison with previous periods and helps to improve its performance of management. Moreover, the ratio analysis assists in determining the financial position of the bank compared to other banks.

Profitability:

In this study, the position of profitability has been measured with the help of return on assets and return on equity. Return on assets (ROA) is a comprehensive measure of overall bank performance from an accounting perspective.

The average ROAs of all the premeditated banks have been estimated positive demonstrates that in the recent years, the performance of the banking system in Nepal is reasonable in terms of net profit. The average ROA of PSB (2.37%) was found higher than that of JVB (1.77%) and DPB (1.33%) due to having utmost total assets. The earning performance of PSB was satisfactory and no public banks were suffered from net operating loss. Among the public sector banks, the average ROA of RBBL bank was determined 3.34% with positive trend during the study period. The net profit to total assets ratio of RBBL bank to gain profit seemed most attractive due to proper mobilization of available resources than other public banks has appeared better position. The second position was for ADBL bank with average ROA equaled to 1.94%.[6]

Over the study period, there was a positive trend in ROA. The last position was belonged to NBL bank with average ROA equaled to 1.84% but ROA values computed during the study period were found positive. SCBL was maintained first place with ROA equaled to 2.51% among joint venture banks, while the second position was for NABIL bank (2.48%) and the last position was

belonged to NSBI (1.13%). The average ROA of BOK was noted 1.89% and this bank was ranked first position among the domestic private banks. The second position was for LBL bank with ROA equaled to 1.82% and the last position was belonged to NCCBL with ROA equaled to 0.43%. The average ROAs of NCCBL (JVB), MPBL (DPB) and LXBL (DPB) were estimated less than 1 fall in the marginal earning performance (Baral, 2005). As ROAs of the most of the larger banks were estimated greater than those of the smaller banks, it can be concluded that the larger banks were successful in mobilizing their available resources more effectively. Furthermore, availability of limited number of assets restricts the proper utilization of resources and ultimately the earning profit. The situation of PSB was most awful with fluctuating and negative ROE trends. The average ROE ratio was -12.89% for NBL, -12.42% for RBBL and 6.44% for ADBL. This implies that the shareholders receive very low returns in terms of dividend. The ROE of ADBL was only estimated in positive among the three public banks. It seems ADBL was efficiently utilizing its shareholders' funds. The average ROEs for the JVB were noted better than PSB and stood positive over the period 2005 to 2010. In order to rank the JVBs based on this ratio, SCBL was the first one; it has an average ROE of 33.83%.

The second position was for NABIL with ROE equaled to 31.87%, and the last position was belonged to NBBL with ROE equaled to 8.44%. It shows that JVB had satisfactory earning profit and the shareholders earn better return on their investment. The average ROEs of all DPB were going positive except that of LBL. In order to rank the banks based on this ratio, NCCBL was the first one. It had an average ROE of 57.25%. The second position was for BOK with ROE equaled to 24.65%, and the last position was belonging with LBL with ROE

equaled to -3.31%. It shows DPBs were efficiently use their shareholders' funds and earning net profit in satisfactory level.

Capital adequacy:

As stated in the foregoing analysis, banks under study are well capitalized and they are complying with the directive of NRB on capital adequacy ratio. However, their capital base relative to the risk-weighted assets is not so strong. According to the international rating convention, total capital should be greater than 19.5% of the total risk weighted assets of commercial banks in order to be a strong capital base. However, none of the banks under study had the capital fund greater than 19.5% of the total risk weighted capital. As indicated by CAR, on the average, capital adequacy of joint venture banks was fair during the study period. Total capital adequacy ratio less than 15 and equal to 12 indicates that capital adequacy is fair and on the average, this ratio falls within this range. Due to the inherent problems and big chunk of NPA, the public sector banks suffered from massive losses in the past, which had heavy impact on their capital adequacy. Although, the public banks had started to improve their financial condition, it is very different from an acceptable standard.

However, ADBL capital adequacy ratio was seemed to be positive but ADBL was also not achieved the NRB requirement. Most of the joint venture banks have accomplished the capital adequacy ratio as directed by NRB. The banks with non-compliance were NBBL (- 5.58%). In addition, average capital fund ratio of joint venture banks during the study period hang around 14%. This was higher than the minimum ratio specified by NRB. This clearly implies that joint venture banks are complying with the directive of NRB on the requirement of the capital base of commercial banks.

All the selected domestic private banks had complied with the statutory capital adequacy ratio of 10%. The banks with non-compliance were LBL (5.4%) and NCCBL (4.52%). As transactions of the bank increases, the risk weighted assets also increases in the same manner. However, this creates banks difficulty to maintain capital fund as required by the NRB as often capital do not increase and the performance of the bank (that is, earning of profit) has major role to play to comply with the NRB requirements. As such, it is evident that the domestic private bank has been performing well enough to comply with the NRB requirement without failure at any point of time except LBL. It means domestic bank has mobilized capital from the stock market; hence, the bank has been capable to sustain the assurance of shareholders and depositors.

Asset quality:

It is obvious from the theoretical prescription that the performance of commercial banks largely depends on the quality of assets held by them, and quality of the assets relies on the financial health of their borrowers. As stated earlier, many indicators can be used to measure the quality of assets held by commercial banks. Loans are one of the major outputs provided by a bank, but as loan is a risk output, there is always an ex ante risk for a loan to eventually become non-performing.

However, here, only one simple indicator – non- performing loan ratio was used to measure the quality of assets being held by the banks. The increasing trend of these ratios shows the deteriorating quality of commercial bank assets.

The average NPL ratio was 17.27% for NBL, 27.21% for RBBL and 14.69% for ADBL. The ratio of NPL in the public bank was very high when

compared with the joint venture banks and domestic private banks. The share of public sector banks in NPL was extremely high accounting that simply indicates the degradation of quality of loans and concentration as well. Among the JV banks, the average NPL ratio of NBBL and NCCBL were very high. These two banks were not satisfactory level. Other joint venture banks on the average were at reasonable level, but they are far below the aggregate percentage of non-performing assets of the commercial banks. NPL indictors show that joint venture banks were improving the quality of their assets year by year. Average NPL ratio of LBL was superior to other domestic private banks.

Other domestic private banks on the average were at reasonable level. However, the banks NPL ratio was below the aggregate percentage and was in decreasing trend. The declining ratio of NPL had reflected a better quality of their assets year by year.

Management:

The average IETTL of PSB (16.95%) was found lower than that of JVB (28.72%) and DPB (47.83%) because management of the public sector banks was the least efficient among the sampled commercial banks. However, the joint venture and domestic private sector banks were managed the quality of loans and ensured profit.

ADBL (5.31%) management was the least efficient among the sampled public sector banks, whereas EBL (7.39%) management was the most efficient among the joint venture banks, and NCCBL (6.51%) was the efficient among the private sector banks.

Earning:

The net interest margin (NIM) measures how large the spread between interest revenues and interest costs that management has been able to achieve by close control over earning assets and the pursuit of the cheapest sources of funding. NIM has been treated as an extremely important measure to the bank and its minimum value for a healthy bank is considered about 4%. A small change in the interest margin has a huge impact on profitability. Higher NIM is associated with profitable banks by maintaining good asset quality. The public sector banks in Nepal are entirely different from joint-venture banks and private banks. The domestic banks had higher average NIM (26.65%) than that of public banks (12.51%) and joint venture banks (21.30%). It means domestic banks were able to maintain good asset quality.[7]

While comparing the individual banks, the result was very different from the average values. Though ADBL is public sector bank, it was occupied first position with the highest interest margin of 5.61% while SBL, a domestic private bank, was in the last position with lowest interest margin of 1.90%.

The interest margin of EBL, a joint venture bank, was 4.75% and ranked in second position. Among the all commercial banks only ADBL, NABIL, EBL and LBL were maintained minimum level. It seems the profitability of the banks in Nepal was not so satisfactory.

Liquidity:

The credit to deposit ratio (CDR) is a major tool to examine the liquidity of a bank and measures the ratio of fund that a bank has utilized in credit out of the deposit total collected. Higher the CDR more the effectiveness of the bank to

utilize the fund it collected. As per the The CDR of the public banks shows that their liquidity position was lower than the accepted level. However, ADBL was seemed to more efficient to utilize their funds collected as deposit. During the study period, the average CDR of NBL was 39.58% while that of RBBL was 51.14% and ADBL was 111.01%. Although there is no standard for CDR in Nepal, a ratio of 75% can be accepted to be adequate. Among the six joint venture banks, the average CDR of NBBL was higher than other JV banks. In an average, the bank has been able to utilize two-third portion of the depositors fund in the form of credit. The CDR of domestic private banks was in the accepted level. The CDR of domestic private banks was higher than 75% level, which is adequate. In order to rank the banks, SBL was the first one; it has an average CDR of 93.04%. The second position was for LBL bank with CDR equaled to 90.21%, and the last position was belonged to NIBL bank with 76.01%. It seems domestic private banks are efficient to utilize the funds collected as deposit.[8]

Ranking of the commercial banks :

Different commercial banks had different ranking based on each financial ratio related to ROA, ROE, CAR, NPL, IETTL, NIM and CDR. Based on the bank return on assets, the higher rank was for RBBL, which is a public sector bank, SCBL Bank, was the second, which is joint venture bank and the last position, belonged to NCCBL, a domestic private bank. Based on return on equity NCCBL belonged to first position, SCBL was second position and the lowest one was NBL. Based on capital adequacy ratio SCBL was first position, LXBL was second position and last position belonged to RBBL. Based on the NPL ratio, LXBL was first position while KBL was second position and last position belonged to RBBL. Based on interest expenses to total loan, EBL was in

the first position; NCCBL was occupied second position while the last position was for LBL. Based on net interest margin, the first position was for ADBL while EBL was occupied the second position and SBL was in the last position. Based on credit to deposit ratio, ADBL was first position, SBL was second position and last position belonged to NBL.

Though financial ratios analysis compares the financial performance among commercial banks, the same bank had different ranks under the different financial ratios. The ROAs of public sector banks were higher than those of joint venture and domestic public banks due to having utmost total assets but the overall performance of public sector banks was not observed sound because other financial ratios including ROE, CDR, and CAR of most of the joint venture and domestic public banks were found superior.

High overhead costs, political interventions, poor management and low quality of collateral created continued deterioration in the financial health of the public sector banks. The values determined for the financial ratios reveal that joint venture and domestic public banks are also not so strong in Nepal to manage the possible large-scale shocks to their balance sheet. Furthermore, it can be concluded from the multiple regression analysis that the capital adequacy ratio, interest expenses to total loan and net interest margin were significant but had a negative effect on ROA while non-performing loan and credit to deposit ratio did not have any considerable effect on ROA. The capital adequacy ratio positively influenced the return on equity but the non-performing loan, credit to deposit ratio, interest expenses to total loan and net interest margin had no significant effect on ROE.

EFFICIENCY AND PRODUCTIVITY OF COMMERCIAL BANKS IN NEPAL:

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

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

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

REVIEW OF LITERATURE :

The trend of commercial banking is changing rapidly. Competition is getting stiffer and, therefore, banks need to enhance their competitiveness and efficiency by improving performance. Normally, the financial performance of commercial banks and other financial institutions has been measured using a combination of financial ratios analysis, benchmarking, measuring performance against budget or a mix of these methodologies (Avkiran, 1995).

Gopinathan (2009)[9] has presented that the financial ratios analysis can spot better investment options for investors as the ratio analysis measures various aspects of the performance and analyzes fundamentals of a company or an institution. Furthermore, Ho and Zhu (2004) have reported that the evaluation of a company's performance has been focusing the operational effectiveness and efficiency, which might influence the company's survival directly.

Bakar and Tahir (2009)[10] in their paper used multiple linear regression technique and simulated neural network techniques for predicting bank

performance. ROA was used as dependent variable of bank performance and seven variables including liquidity, credit risk, cost to income ratio, size and concentration ratio, were used as independent variables.

They concluded that neural network method outperforms the multiple linear regression method however it need clarification on the factor used and they noted that multiple linear regressions, not withstanding its limitations, can be used as a simple tool to study the linear relationship between the dependent variable and independent variables.

CAMEL stands for capital adequacy, asset quality, management efficiency, earnings performance and liquidity. The capital adequacy ratio is a key measure to determine the health of banks and financial institutions. Capital adequacy refers to the sufficiency of the amount of equity to absorb any shocks that the bank may experience (Kosmidou, 2008)[11].

Nepalese commercial banks need to maintain at least 6% Tier-1 capital and 10% total capital (Tier 1 and Tier 2), that is, core capital and supplementary capital respectively. Tier 1 capital consists of paid-up capital, share premium, non-redeemable preference share, general reserve fund, accumulated profit, capital redemption reserve, capital adjustment fund, and other free reserves. The Tier 2 capital comprises of capital comprises of general loan loss provision, assets revaluation reserve, hybrid capital instruments, subordinated term loan, exchange equalization reserve, excess loan loss provision, and investment adjustment reserve. These minimum capital adequacy requirements are based on the risk-weighted exposures of the banks (NRB, 2010)[12]. Credit risk is one of the factors that affect the health of an individual bank while asset quality analysis involves taking account of the likelihood of borrowers paying back loans. The

extent of the credit risk depends on the quality of assets held by an individual bank.

The quality of assets held by a bank depends on exposure to specific risks, trends in non-performing loans, and the health and profitability of bank borrowers (Baral, 2005)[13]. Poor asset quality and low levels of liquidity are the two major causes of bank failures. Poor asset quality led to many bank failures in Kenya in the early 1980s (Olweny and Shipo, 2011)[14]. NRB uses composition of assets, nonperforming loan to total loan ratio, net nonperforming loan to total loan ratio as the indicators of the quality of assets of the commercial banks (NRB, 2010). The maximum NPL allows for a healthy bank is 5%. Management quality plays a big role in determining the future of the bank. The management has an overview of a bank's operations, manages the quality of loans and has to ensure that the bank is profitable. Rahman et al. (2004) and Elyor (2009) noted that interest expenses divided to total loans can be measured as the bank management quality. Ability to support the present and future operations of a bank depends on the quality of its earnings and profitability profile (Shar et al., 2011)[15]. NRB uses return on total assets as an indicator of profitability of a commercial bank.

In addition, it uses the absolute measures such as interest income, net interest income, non-interest income, net non-interest income, non-operating income, net non- operating income and net profit, to evaluate the profitability of a commercial bank. Liquidity management is one of the most important functions of a bank. If funds tapped are not properly utilized, the Jha and Hui 7603 institution will suffer loss.

Drake (2001)[16] studied efficiency and productivity changes in the main UK banks over the period 1984 to 1995 and suggested that bank scale inefficiencies were a more severe problem than X-efficiencies. Drake's Malmquist productivity indices suggested that, on the whole, UK banks exhibited positive productivity growth over the period. Sathye (2002) also used Malmquist index to analyze productivity changes from 1995-1999 in a panel of 17 Australian banks to assess the effects of deregulation and the reforms introduced by the Wallis report of 1997. Sathye (2002) found a decline of 3.1 per cent in technical efficiency over the period and of 3.5 per cent in the total factor productivity index, although annual productivity grew by 1.3 per cent.

Handful of research has also been devoted to investigate the efficiency of banks in Asian countries. Bhattacharyya et al. (1997)[17] examined the productive efficiency of Indian commercial banks during 1986-1991 and found a marginal increase in overall average performance after 1987 and the average efficiency of publicly owned banks is much higher than in the privately owned or foreign owned banks. Galagedera & Edirisuriya (2005) used data envelopment analysis and Malmquist Index in a sample of Indian commercial banks over the period of 1995-2002 and found no significant growth in productivity during the sample period. He found that there has been no growth in productivity in private sector banks where as the public sector banks appeared to demonstrate a modest positive change through 1995-2002.

Sinha & Chatterjee (2008)[18] tried to make a comparison of fund based operating performance and total factor productivity growth of selected Indian commercial banks for the five year period 2000-01 to 2004-05 using data envelopment analysis and Mamlquist total factor productivity index. The

findings displayed that the mean technical efficiency of the in-sample private and foreign banks is somewhat higher than the in-sample public sector banks. However, in-sample public sector commercial banks exhibited higher Malmquist index than the in-sample private sector banks. Likewise, Rezvanian et al. (2008) also used Malmquist index to examine the effects of the ownership on efficiency, efficiency change, technological progress, and productivity growth of the Indian banking industry over the period of 1998-2003 They found that foreign banks were operating significantly more efficient than privately owned and publicly owned banks.

In Nepalese context, Malmquist index has been used in few sectors such as energy (Jha et al., 2007)[19], and agriculture (Suhariyanto & Thirtle, 2001). With regards to efficiency of banking sector in Nepal, Thagunna & Poudel (2013)[20] used data envelopment analysis to measure and analyze efficiency levels of banks in Nepal during 2007-08 and 2010-11. The study reveals that efficiency level is relatively stable and has increased overall. They found that found that both the ownership type and the asset size of a bank don't affect its efficiency.

Banks have suffered loan losses through relaxed lending standards, unguaranteed credits, the influence of the 1980s culture, and the borrowers' perceptions. It was suggested that bankers should make a fairly accurate personality-morale profile assessment of prospective and current borrowers and guarantors. Besides considering personal interaction, the banker should (i) try to draw some conclusions about staff morale and loyalty, (ii) study the person's personal credit report, (iii) do trade-credit reference checking, (iv) check references from present and former bankers, and (v) determine how the borrower handles stress. In addition, banks can minimize risks by securing the borrower's

guarantee by using government guaranteed loan programs and requiring conservative loan-to-value ratios. Issues of non-performing loans and cost efficiency are related in several important ways. First, a number of researchers have found that failing banks tend to be located far from the best practice frontier. In addition to having high ratios of problem loans, banks approaching failure also tend to have lower cost efficiency. A number of other studies have found negative relationships between efficiency and problem loans even among banks that do not fail (Kwan and Eisenbeis, 1995).

Sergio (1996)[21] in a study of non-performing loans in Italy found evidence that, an increase in the riskiness of loan assets is rooted in a bank's lending policy adducing to relatively unselective and inadequate assessment of sectorial prospects. Interestingly, this study refuted that business cycle could be a primary reason for banks' NPLs. The study emphasized that increase in bad debts as a consequence of recession alone is not empirically demonstrated. It was viewed that the bank-firm relationship will thus prove effective not so much because it overcomes informational asymmetry but because it recoups certain canons of appraisal.

The bank asset quality and operating performance are positively related. If a bank's asset quality is inadequate, the bank will have to increase its bad debt losses as well as spend more resources on the collection of non-performing loans. This increase in non-performing loans in the banking industry can be due to external events, such as adverse situation in economic activities. There is positive relationship between asset quality and cost efficiency and negative relationship between problem loans and cost efficiency (DeYoung, 1997)[22].

On the other hand, Berger and DeYoung (1997)[23] also suggested that efficiency of the banking firms might affect the non-performing loans in the banking industry. The bad management hypothesis was developed to explain this relationship. They argue that bad management of the banking firms will result in banks inefficiency and affects the process of granting loans. The banks' management might not thoroughly evaluate their customers' credit application due to their poor evaluation skills. In addition, the problem of asymmetric information between lenders and borrowers further complicates the matter. Besides that, the management might not be efficient in managing loan portfolios. Consequently, this leads to lower credit ratings for the approved loans and high probability of default resulting in higher non-performing loans. Therefore, banks' inefficiencies might lead to higher non-performing loans. The lending policy of banks could have crucial influence on non-performing loans. Reddy (2004)[24] critically examined various issues pertaining to terms of credit of Indian banks. In this context, it was viewed that the element of power has no bearing on the illegal activity. A default is not entirely an irrational decision. Rather a defaulter takes into account probabilistic assessment of various costs and benefits of his decision'. In a study of institutional finance structure and implications for industrial growth, it has been emphasized on key lending terms of credit, such as maturity and interest-terms of loans to corporate sector. The Indian viewpoint alluding to the concepts of 'credit culture' has an international perspective since several studies in the banking literature agree that banks' lending policy is a major driver of non-performing loans (Bloem and Gorters, 2001)[25]. Jimenez and Saurina (2003)[26] used logit model for analyzing the determinants of the probability of default (PD) of bank loans in terms of variables such as collateral,

type of lender and bank-borrower relationship while controlling for the other explanatory variables such as size of loan, size of borrower, maturity structure of loans and currency composition of loans. Their empirical results suggested that collateralized loans had a higher PD, loans granted by savings banks were riskier and a close bank- borrower relationship had a positive effect on the willingness to take more risk. At the same time, size of bank loan had a negative effect on default while maturity term of loansi.e.short-term loans of less than one year maturity had a significant positive effect on default.

Maskay (2009)[27] analyzed the existence of significant NPA levels prior to the FSRP program pointed to fragility in the domestic financial system. The reduction in NPA levels of NBL and RBB as well as commercial banking sector as a whole can be taken as one of the success measures of FSRP process among others such as formulation of different acts, strengthening regulation and supervision of financial institutions at NRB and movement towards compliance of Basel II accord among others. He examined the development of the Nepalese financial system and concluded that despite significant financial deepening in the context of financial liberalization and integration with the external economy, there is still scope for geographically balanced financial development and finally suggested for the need of formulation of a master plan to strengthen the Nepalese financial system.

Karim, Chan and Hassan (2010)[28] examined the banking efficiency between Malaysian and Singaporean banks as well as the relationship between non-performing loans and bank efficiency. The results indicated that there is no significant differences in the cost efficiency level between commercial banks in Singapore and Malaysia even though the commercial banks in Singapore exhibit

a higher average cost efficiency score than the commercial banks in Malaysia. The research concluded that higher non- performing loan reduces cost efficiency and lower cost efficiency increases non-performing loans. The results supported the hypothesis of poor management in the banking institutions creates bad quality loans and therefore escalate the level of non-performing loans.

PROBLEMS OF THE RESEARCH :

The main problems of the study was to found out the main constrains of Commercial banks in Nepal with special reference to financial performance during pre & post reforms period and also examined the deposit mobilization, management policy and customers services produced by the banks.

To examine the Savings Behaviour of people in Nepal was one of the most important problems of this study. To evaluate Govt. Policy for financial performance development of commercial banks in Nepal was also a critical problems of the study.

Suitable suggestions for the development of financial performance of commercial banks in Nepal was also a problems of this study but some suggestions has been produced for financial performance development of commercial banks in Nepal, it may be helpful for banks, policy makers and Nepalese people.

NEED AND SCOPE OF THE STUDY :

The Commercial Banks account for the major share of banking business in this country. But the Commercial Banks are functioning under pressure from government, regulatory agencies, and the public. The reform process started poses challenges before bankers as never before. After reforms, various new private sector banks and foreign banks have joined the banking industry in

Nepal. It is generally believed that there is a decline in profitability and productivity of the Commercial Banks as a result of reforms.

Banking needs to be looked at from the relevance of the Nepal's economy. Whatever the economy goes through, banks have a significant role to play. The Commercial Banks have strong distribution network all over the country. But the strength of the earlier periods has now become a concern for these banks.

The inefficiencies of Commercial Banks were exposed only when the market was thrown open for competition and new glares started eating up their share. But given their size and strong network, most of these can change their perception. Since the growth of economy is largely dependent on the performance of this banks.

The banking reforms process has increasingly exposed Nepalese industry to international competition and in case of some industries; this has greatly sequenced their margins rendering them in capable of repaying the loans taken by them from banks, with the deficiencies noticed in managing credit risks.

The winds of reforms have opened up new vistas in the banking industry resulting in the generation of intensely competitive environment. The banking areas have been almost completely flooded with new entrants including private banks, foreign banks, non-banking finance companies. So, study on the financial position of commercial banks in Nepal: Pre & Post reforms period is needed.

OBJECTIVES OF THE STUDY:

The main objective of this study is to evaluate the financial position of Banking sector in Nepal. One of the chief constituents of financial and banking sector in Nepal and to point out their weakness. Secondly, various provisions of financial and banking sector reforms will be placed for restricting the commercial banks under financial sector reforms will be analyzed.

Therefore, the objective of the research is to fill the void in Current literature with the application of research methodology and technique.

The purpose of the study is to investigate and highlight the role of banking sector in Nepal which have bearing on the financial performance and that deserve an immediate attention of the policy makers, bank officials and others concerned. More specifically an attempt will be made to study the structure of banking, working capital, credit policy, and above all financial performance.

The broad objectives of this study are based on the following sub-headings :

- To evaluate profitability and productivity of Commercial Banks in Nepal during Pre & Post reforms period.
- To evaluate the financial position of commercial banks in Nepal during Pre & Post reforms period.
- To examine the contribution of various factors towards the Deposit Mobilization of Commercial Banks in Nepal during Pre & Post reforms period.
- To examine the effect of reforms on management policy of commercial banks in Nepal.
- To make suggestions or the improvement of Financial Position of Commercial Banks in Nepal.
- To create platform for future research in this area.

HYPOTHESES OF THE STUDY:

Banking sector in Nepal are a substantial source of income and employment and need rehabilitation. The hypothesis is that the development of banking sector in Nepal are not at the optimum level commensurate to the available man power and resources is tested. Further, it is stressed that with the

financial position of commercial banks in Nepal. The development of commercial banks are the way of prosperity in Nepal economy. It is a common observation that the benefit availed if these are formed according to the situation, so it is imperative to look into the aspects of suitability of system and policies implemented by the Govt. Development requires improvement in prevailing condition as well as in policies and implementing strategy of policies.

Keeping in mind survey of literature and objectives of the study, the following hypotheses emerge:

- The productivity and profitability of Commercial Banks has suffered in Nepal.
- There has been a change in the nature of the factors affecting the productivity and profitability of Commercial Banks in Nepal.
- Commercial Banks have started various innovative schemes, for Deposit Mobilization in Nepal.
- Financial Position of Commercial Banks in Nepal is not favourable and suitable for Nepal's Economy and People.

RESEARCH METHODOLOGY:

The study has been conducted on the basis of primary as well as secondary data. But the secondary data has formed the major source of study. The secondary data has been compiled from statistical tables relating to banks, and other published resources. The collected data have been processed on computer. To reach certain relevant results, the data collected from all resources have been tabulated, analyzed and interpreted with the help of appropriate statistical techniques. The performance of a bank can be measured by number of

indicators. Deposit Mobilization is the most important indicator because it gives an insight into the broad indication of the capability of a bank to increase its earnings.

LIMITATION OF THE STUDY:

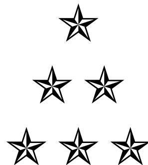
The research project like this one has its own problems and limitations. The problem is aggravated when we do not get any aid from any institution and has to work at my own with very limited resources. Insufficient inter action between the university and the business establishment, lack of library facilities, non-compliance of information data from the part of management, difficulty of timely availability of published data from government and other agencies all pose problems before us. Sometimes the data differ with the change in the Annual Reports and with the result difficulties arise in comparison and so the result lacks perfection. However, all most care has been taken to avoid such conflicting data, wherever possible.

REFERENCES:

1. Nepal Rastra Bank (2012) , p.28-32
2. Nepal Rastra Bank (2003). *Nepal Rastra Bank Samachar, 48th Anniversary Issue, April 2003*. Kathmandu, Governor's Office. p.23-27
3. Ibid
4. Reports of Commercial Banks, Nepal, 2007, p.91-97
5. Pyakuryal, Bishwambher (2002). "Financial Sector Reform in Nepal: Needs and Challenges", *SEACEN Workshop on Macroeconomic Management*, Pokhara, Nepal. p.33-36
6. Shrestha, Min B., Financial Liberalisation in Nepal, Ph.D. Thesis, School of Economics, University of Wollongong, 2005. p.41-45

7. Shrestha, Min B. and Khorshed Chowdhury (2007). "The Impact of Financial Liberalisation on Welfare: Evidence from Nepal," *Applied Econometrics and International Development , p.18-22*
8. Ibid
9. Gopinathan T (2009). Financial ratio analysis for performance check. http://suite101.com/ p.56-58
10. Bakar N, Tahir IM (2009). Applying multiple linear regression and neural network to predict bank performance. p.176-183.
11. Koasmidou K (2008). The determinants of banks' profits in Greece during the period of EU financial integration. Manag. Financ., p. 146-159.
12. NRB (2010). Banking supervision annual report, Bank Supervision Department, Nepal Rastra Bank, Central Bank of Nepal. p.63-66
13. Baral JK (2005). Health check-up of commercial banks in the framework of CAMEL: A case study of joint venture banks in Nepal, J. Nepalese Bus. Stud., p. 41-55
14. Olweny T, Shipho TM (2011). Effects of banking sectrol factors on the profitability of commercial banks in Kenya. Econ. Financ. Rev., p. 1-30.
15. Shar AH, Shah MA, Jamali H (2011). Performance evaluation of pre- and postnationalization of the banking sector in Pakistan: An application of CAMEL model. Afr. J. Bus. Manag., p. 8141-8149.
16. Drake, L. (2001). Efficiency and productivity change in UK banking. *Applied Financial Economics*, *p.* 557-571.
17. Bhattachar, Y A, C A K Lovell and P Sahay (1997): "The Impact of Liberalisation on the Productive Efficiency of Indian Commercial Banks",*European Journal of Operational Research*, p.112-114.
18. Sinha, R. P., & Chatterjee, B. (2008). Fund-Based Activity of Commercial Banks: A Malmquist Approach. *Indian Economic Review*, *XXXXIII*(1), p.83-102.
19. Jha, D. K., Yorino, N., & Zoka, Y. (2007). *Benchmarking results of electricity generating plants in Nepal using Modified DEA models.* Osaka, Japan. p.83-85

20. Thagunna, K. S., & Poudel, S. (2013). Measuring bank performance of Nepali banks: A Data Envelopment Analysis (DEA) perspective. *International Journal of Economics and Financial Issues*, *p.* 54-65.
21. Sergio, M. (1996).Non-performing bank loans: Cyclical patterns and sectoral risk. *Review of Economic Conditions in Italy*. Rome: Jan-Jun 1996. , Issue. 1. p.73-75
22. **DeYoung, R.** (1997), "X-Efficiency and Management Quality in National Banks." *Journal of Financial Services Research*, Vol. 15, No. 2. p.81-82
23. **Berger, A. N., DeYoung, R.** (1997). "Problem Loans and Cost Efficiency in Commercial Banks." *Journal of Banking and Finance*, Vol. 21, pp. 849-870.
24. Reddy, Y.V. (2004).Credit Policy, Systems, and Culture.Reserve Bank of India Bulletin. p.46-48
25. Bloem, M. A. and Cornelis N. G. (2001). The Treatment of Non-performing Loans in Macroeconomic Statistics. IMF Working Paper, WP/01/209: p. 1-28.
26. Jimenez, G. and SaurinaJ. (2003). Collateral, Type of Lender and Relationship Banking as Determinants of Credit Risk.Bank of Spain. p.42-43
27. Maskay, N. M.and Subedi S. R. (2009). Development of Nepalese Financial System: Need for the Formulation of a Master Plan. Economic Review, p. 31-51.
28. Karim, M. Z. A., Chan S. G. and Hassan S. (2010). Bank Efficiency and Non-performing Loans: Evidence from Malaysia and Singapore. Prague Economic Papers, p. 118-131.



FINANCIAL POSITION OF COMMERCIAL BANKS IN NEPAL : PRE & POST REFORMS

There is no doubt that the banking sector is important for both developed and developing economies. Developed economies already have a highly sophisticated financial market in place where as developing economies have no or only rudimentary institutions in place.

Financial markets play a key role in the development of a country. They are the intermediary link in facilitating the flow of fund from domestic savings into productive investment which ultimately help to lower the cost of capital to investors and accelerate economic growth of the country. Financial intermediation between borrowers and savers is done by commercial banks and other non bank entities. Now a day, the crucial importance of financial intermediation in economic development has come under the increasing scrutiny by both economists and policy makers in developing countries. However, financial development in many developing economies is still faced by a number of obstacles such as macroeconomic instability, the fragility of stock markets, the limitation of capital markets, and the inefficiency of development and specialized banks. Despite some of these limitations, banking systems in underdeveloped countries remain integral components of the general economic systems. And they can be seen as a key element in any development effort.

Though Nepalese financial sector is reasonably diversified with financial institutions having institutional arrangement of varied nature, commercial banks are the major player in this system and they occupy substantial share in the structure of financial sector. The commercial banks are supervised by the bank supervision department of NRB while the rest of these institutions are supervised by Financial Institution Supervision. Safe and sound banking is of crucial importance to the financial stability and sustainable development of the country. The first conventional bank in Nepal was the Nepal Bank Limited, established in 1937 followed by Rastriya Banijya Bank in 1966. These banks have the largest networks and they have their operations even in the remote areas of the country. Rastriya Banijya bank is fully owned by the government while the government has controlling stake in Nepal Bank Limited. As the financial market was barred for private investor up until the mid 1980s these two banks were the only players in the banking industry.

It is easy to find out there is a significant growth in the number of commercial banks authorized by NRB in Nepal in the last two decades. At the beginning of the 1980s when the financial sector was not liberalized, there were only two commercial banks. After the liberalization and especially in the 1990s, financial sector has grown both in terms of the number of banks and financial institutions and their branches. This definitely has made a positive impact on the economic development of Nepal.

The role of financial institution in economic growth:

The financial institutions play a key role in development of a national economy because it functions as a medium of collecting and mobilizing resources to finance a business and development project that are essential for

economic development. A country without good financial system can be a major problem for the economy to function properly, to mediate sustainable private investment and promote entrepreneurship.

Financial institutions ease market friction and influence the allocation of resources over different sectors of the country. The author introduces five key functions of financial system that are essential to economic growth.

- Produce information about possible investment and allocation capital
- Monitor investments and provide expert corporate governance
- Facilitate the trading, diversification and management of risk
- Mobilize and pool saving
- Ease the exchange of goods and services

Financial intermediaries help to reduce the transaction cost of obtaining information about company, manager, market situation which are essential to make investment decision. They also help to identify the best investment opportunities. Besides this, they also monitor the fund they lent to the business organization or other types of borrowers which ensure the effective utilization of fund which in turn makes savers more willing to invest. As a result the business sector of a country tends to move in positive direction making progress possible. Thus the effectiveness of a financial corporation directly influences firm's performance which in turn impacts on aggregate growth rate.

Economic growth for developing countries has important indications for poverty elimination and world economic development. This has been the goals of world financial institutions such as World Bank and IMF. To study economic development of Nepal can provide a real world example of a politically

complicated and poverty stricken country's development process, the importance of economic freedom of the country to its development and indications to the future path of the development.

Developing countries have welcomed the multinational banking in order to attract more foreign investments and facilitate the industrial development. There are a number of countries which changed their economic status after the multinational banking intervention such as Korea, Thailand, and Mexico etc. All of these countries opened the door for the foreign investment through MNBs when they were in deep financial trouble. Now MNBs' banking concept is adopted by all countries as a tool to meet the need of capital and funding needs to boost the industrial sector. Over the past few years, service sector has been growing rapidly and accounted for about 20 percent of total international trade. The rate of increase of the service sector is higher than the goods sector. The main importer and exporter of commercial services are developing countries. The Asian economy has grown tremendously because of the increment in the trade of commercial services, construction services, computer software, data processing and tourism. Thus the role of commercial banks is remarkably enhanced in all the countries to support the increasing need of the service sector and the economy in general.

As Bhaskar Sharma (2000) in Business Age pointed out "one of the most important achievements as a result of the growth in the number of commercial banks in the post liberalization period is in the area of domestic banking savings." "Deposit-GDP ratio, one of the most important economic parameters is widely employed to analyze the efficiency of the banking system. More savings

from the economy would make more funds available for investment." This has become our motivation of the study.[1]

Nepal is one of the poorest countries in the world. It is landlocked and covered by mountains as well as hills. The main profession of Nepalese people is agriculture. More than 70 percent of the people are found to be engaged in agriculture sector and rest is employed in service and industry. Unemployment is approximately 40 percent and country severely lacks skilled manpower. However, the productivity of agriculture is falling down and the population of the country is at an increasing trend. Therefore, the traditional occupation is not enough to meet the growing needs of Nepalese people. Now Nepalese people have started to think about the alternative sources of income where financial institutions have been regarded to be the core alternative ways to solve this problem. Press trust of India reported on economic data released by Nepal Central Bureau of Statistics on July 9, 2008 that Nepal's economic is in recovery path with 5.56 percent growth in current fiscal year, most impressive performance in last 7 years, per capita income now stands $470, increase of 11 percent growth shown by number become less obvious when the steep rise inflation rate is considered. Nepal inflation rate now stands at 9 percent so gains made by 11 percent rise in per capita income will not make much difference in the common man's daily life.[2]

Nepal is also the least developed country in the world in terms of GDP per capita. About one third of the total population is living below the poverty line. The contribution of agriculture sector to the GDP constitutes 38 percent. The GDP rate is slowly accelerating. The GDP increased 2.7 percent in the year 2009.

Industrial activities in the country involve processing of agricultural products including jute, sugarcane, tobacco, and grain. The Maoist war has led to the decrease of tourism which is the key source of foreign exchange income. Nepal has good prospects of expanding tourism and hydropower for the economic development. Low economic growth and persistent deficits in financial and trade balances in recent years have left Nepal with very limited resources for development funds needed for nation building. At present the major part of development expenditure comes from other countries as loans and donations. Nepal has adopted mixed economic policy. Many financial institutions were established within the country to achieve social economic development of the country. The Nepalese monarch ended the century old system in 1951. Reforms in 1990 established a multiparty democracy with constitutional monarchy in the country. Nepal communist party Maoist started insurgency in 1996. The Nepal Communist Party Maoist had previously started civil war which they termed `` people's war`` with an aim of establishing a ``People's republic of Nepal``. A comprehensive peace agreement signed in November 2006 had ended the decade long armed conflict in which thousand of civilians, Maoist guerrilla fighters and the then royal Nepalese army personnel were killed and displaced. This insurgency adversely affected the economic development of the country in the study period. Ten members of the royal family, including the King Birendra Bir Bickram Saha Dev and Queen Aishwarya Rajya Laxmi Devi Saha were killed in 2001 allegedly by the then crown prince Dipendra. After the royal massacre, Gyanendra Shah (Gyanendra's brother, Birendra) succeeded to the throne upon the death of his nephew Dipendra who was King for only three days while in a coma. In February 2005, the new king Gyanendra dismissed the prime minister

and his cabinet after they dissolved the parliament. The king declared a state of emergency, imprisoned party leaders, and assumed power and took complete control of the government. The king allowed parliament to reconvene due to mass protests organized by the seven parties and the Maoists in 2006. The election of constitutional assembly is held in 2008 and the nation is declared as republic by the first meeting of constituent assembly. Due to such political instability the country failed to achieve satisfactory level of social and economic development and growth.

Nepal has a reasonably diversified financial sector as evidenced by the number and variety of institutions that play an active role in the society, relative to Nepal's small and underdeveloped economic base over the past 20 years, Nepal's financial sector has become deeper, and the number and type of financial intermediation has grown rapidly with in this period. The Nepalese financial sector has grown significantly both in terms of business volume and size of assets and market capitalization.

The financial sector was not opened up for private sector until the early 1980s in Nepal. At the beginning of the 1980s when financial sector was not liberalized there were only two governments controlled commercial banks; Rastriya Banajya Bank and Nepal Bank Limited and two development banks performing banking activities in Nepal. The economic reforms initiated by the government more than one and half decade ago have changed the landscape of several sectors of the Nepalese economy. As a result of this policy, large number of banks and financial institutions mushroomed across the country. The Nepalese financial market is comprised of regulated and non regulated sector. The Nepalese organized financial sector is composed of banking and non banking

sector. Besides commercial bank, micro credit institution, cooperatives and NGOs; there are other institutions that perform near bank services like postal saving, employee provident fund, mutual fund and citizen investment trust, insurance companies and Nepal stock exchange etc. Similarly brokers, security dealers, market makers and money exchangers are other players of financial market. However, Nepal Rastra Bank's regulatory and supervisory regime is limited to the commercial bank, development banks, finance companies, micro credit development banks, saving and credit cooperatives and non government organizations of which license for operation is provided by Nepal Rastra Bank .

Nepal Rastra Bank has been given various rights and powers including rights of granting license to banks and financial institutions, their monitoring, inspection and supervision and also taking over the management if it appears that transactions of the bank are detrimental to the interest of the depositors. It has authority even to cancel license in case of material non-compliance of various prudential norms and relevant laws and regulations.

FINANCIAL LIBERALIZATION IN NEPAL:

The financial liberalisation process in Nepal started in 1984. Since then, various liberalisation measures have been implemented in order to widen and deepen the financial system. Some policy instruments were aimed at increasing the competition and efficiency in the financial market, which included removal of entry barriers to commercial banks, finance companies and development banks, and restructuring of two state-owned banks. In order to improve the efficiency of money and capital markets, measures such as auctioning of Treasury Bills and floor trading of securities were introduced. The policy instruments such as interest rate deregulation, reduction in reserve requirement

and change in the monetary policy stance from direct to indirect were implemented. Similarly, introduction of prudential norms, establishment of Credit Information Bureau, revision of Nepal Rastra Bank Act, and enactment of Debt Recovery Act were aimed at ensuring the integrity of banks and maintenance of the stability of the financial system of Nepal. All of these policy instruments were expected to complement each other in achieving the overall objectives of competition and efficiency, smooth functioning of money and capital markets, and attainment of stability in the financial sector of Nepal.[3]

Removal of Entry Barriers (1984):

Financial liberalisation in Nepal started evidently with the removal of entry barriers in the banking system. Until 1984, only two government-owned commercial banks were operating in the market. With the objective of promoting healthy competition among banks, the Commercial Bank Act 1974 was amended in 1984, which removed the entry barriers to the private sector in the commercial banking industry. This was done mainly to attract private joint venture banks with foreign collaboration with the hope that such banks would bring in much needed foreign capital and technical know-how, infuse modern banking skills to the domestic banks, and, widen as well as deepen the national financial structure (Acharya *et al.* 1998). Following the amendment of the Act, joint venture banks started to enter the financial system. In 1985, the Finance Companies Act was enacted in order to allow finance companies to enter the financial system. This was done with the objective of serving small borrowers and meeting the demand for consumer credit. The Act was amended in 1992. Following this amendment, there has been a very fast growth in the establishment of finance companies.

Deregulation of Interest Rate (1984):

Interest rate deregulation started in November 1984 with partial freedom provided to the commercial banks to fix the interest rates from 1.0 percentage points to 1.5 percentage points above the minimum administered rates for different types of term deposits. In May 1986, this range was eliminated, allowing the banks to offer higher interest rates to any level above the fixed minimum level. In August 1989, the interest rate was completely deregulated. Since then, commercials banks and financial institutions are free to set both the deposits and loans rates. The objective of interest rate deregulation was to let the market decide the true cost of capital, keep real deposit rates positive, thereby, stimulating savings and creating a competitive environment in the financial system so as to benefit both the depositors and borrowers (Khatiwada 1999).

Reforms in Treasury Bills Issuance (1988):

Treasury bills carried a coupon rate, which used to be generally low. Commercial banks were not interested in investing in such low yielding bills. As a result, Nepal Rastra Bank used to hold a large chunk of treasury bills, exacerbating the excess liquidity in the economy (Khatiwada 1999). To rectify this anomaly, NRB commenced auctioning of treasury bills since November 1988. Initially, the auctioning was done on a monthly basis. As the market matured, auctioning frequency was increased to every fortnight, and then to weekly from December 1991 (Acharya *et al.* 1998). After the introduction of auctioning, commercial banks began to hold increasing shares of such bills.

Introduction of Prudential Norms (1988):

With the objective of helping in the sustainable development of the financial sector through creating a healthy banking environment, a set of

prudential norms was introduced in 1988. Such norms put in place by NRB included capital adequacy requirement, loan classification, loan loss provisioning, interest income recognition, single borrower limit, and account disclosure norms. Most of these norms were revised in 1991. The requirements, ratios, limits, types, and formats set in these norms have been changed from time to time. Commercial banks initially were directed to classify their loans into four categories namely pass, substandard, doubtful, and loss. After the re-categorization of loans in 1991, the banks were required to classify their loans into six categories based on the overdue period. Since 2002, the loans are categorised again into four categories, *viz,* pass, substandard, doubtful, and loss. Along with the introduction of loan classification norms, commercial and development banks were directed to set aside certain funds as loan loss provisioning. With the objective of avoiding the over-concentration of the bank resources in the hands of a few people as well as lowering the risk elements, single borrower limit was introduced in 1989. Since FY 2003, the single borrower limit is 25 percent of the capital base for fund based lending and 50 percent for non-fund based lending. Such limits are the same for both the commercial and development banks (Nepal Rastra Bank 2005a; 2005b). Before the introduction of the norms related to interest income recognition, the banks used to show accrued interests as their income. On the basis of profits based on such accounting, dividends and bonuses were paid. As a consequence, the financial health of the banks started to deteriorate. To check this trend, a new prudential norm was introduced in 1989, which redefined the interest income on the actual basis instead of accrual basis. According to this norm, interest income is recognized only when it is received in cash. Another norm introduced in 1989

was related to disclosure of the financial information of financial institutions. To maintain a common accounting year in line with the fiscal year of the Government of Nepal, financial institutions were directed to adopt the fiscal year starting on the 1st of the Nepali calendar month Shrawan (16 July) and ending on the 31 of Ashadh (15 July). Similarly, NRB developed common formats for financial institutions to prepare their balance sheet, profit and loss account, and classification of loans, advances and reserves.[4]

Establishment of Credit Information Bureau (1989):

With a view to check the possible fraud and irregularities in banking transactions, the Credit Information Bureau was established in 1989. Every commercial bank has to supply necessary credit information to the Bureau and the Bureau in turn supplies credit information to all other banks. On the basis of credit information received from the banks, the Bureau prepares a defaulters list and a black list. Prior to the establishment of the Bureau, a defaulter of one bank could obtain a loan from another bank. With the help of the credit information supplied by the Bureau, it has become easier for the banks to avoid the risky lending.

Shift in Monetary Policy Stance (1989):

The way monetary policy is conducted has a direct impact on the financial sector. After the full liberalisation of the interest rate and elimination of credit ceilings, the monetary policy stance has been changed from direct to indirect. Under the indirect monetary policy stance, there is no direct control on the price or interest as well as on the volume of loans of commercial banks. Market

behaviour is aligned through the use of indirect monetary policy instruments such as bank rate, cash reserve requirement, and open market operations.

Strengthening of Government Owned Commercial Banks (1991):

To evaluate the financial positions of the two state-owned commercial banks – Rastriya Banijya Bank and Nepal Bank Limited, a study was conducted with the financial support of the UNDP in 1989. The study recommended a series of corrective and preventive measures to improve their financial performance. To implement the recommendation of the study, the government provisioned a supplementary budget of Rs.3.45 billion in 1991. The fund was used for the recapitalisation of two banks and to repay the government guaranteed overdue loans (Acharya *et al.* 1998).[5]

Reform in the Capital Market (1992):

The Securities Marketing Centre was established in 1977 with the objective of developing markets for the government securities. The centre carried out both regulatory and operational functions. In 1984, it was converted into the Security Exchange Centre, but the functions carried by it remained almost the same. The reform in capital market started with the amendment in the Security Exchange Act in 1992. Operational and regulatory functions were separated in 1993. The Security Exchange Board was established to look after the regulatory functions and at the same time the Nepal Stock Exchange Centre was created to carry out the trading of the securities (Khatiwada 1999).

Reduction in the Reserve Requirement (1993):

The banks were required to meet the high reserve requirement in the form of the cash reserve ratio (CRR) introduced in 1966 and statutory liquidity ratio

(SLR) introduced in 1974. CRR was imposed for monetary control and prudential norms, whereas SLR was imposed to provide a captive market for government securities. The SLR was completely abolished in August 1993. After the complete liberalisation of the interest rate in 1989, the CRR however, was revised upward from 9 per cent to 12 per cent of the domestic deposits. Since April 1998, the CRR has been gradually revised downward. As of November 2003, the average CRR to be maintained by the commercial banks is 7.75 per cent of their domestic deposits (Nepal Rastra Bank 2003).

Introduction of Floor Trading of Securities (1994):

In January 1994, floor trading of the stocks was introduced under the Nepal Stock Exchange Centre. Due to this new arrangement, trading in stocks started to boom, and the number of listed companies as well as the market capitalization increased gradually. The number of companies listed in the Centre stood at 114 in July 2004.

Enactment of Development Bank Act (1996):

Nepal Industrial Development Corporation, established in 1959, and the Agricultural Development Bank established in 1968 were the two developments banks operating in the market to meet the long- term credits. To allow new development banks in the market, the Development Bank Act was enacted in 1996. The number of development banks including Nepal Industrial Development Corporation and Agricultural Development Bank has reached 25 in July 2004 (Nepal Rastra Bank 2004). This includes five regional development banks that are carrying micro credit operations in rural villages.

Revision of Nepal Rastra Bank Act (2001):

The Nepal Rastra Bank Act 1955 was revised in 2001. This Act has made NRB an autonomous institution. As in other developing countries, central bank of Nepal – Nepal Rastra Bank previously had to work under government control. As a result, the bank could not implement monetary policies as well as financial sector policies independently. It is expected that the revised Act will serve the requirements of a modern central bank as part of the government's overall financial sector development and modernization program (Pyakuryal 2002).

Restructuring of Government Owned Commercial Banks (2002):

The financial health of Rastriya Banijya Bank and Nepal Bank Limited was reported to be gradually deteriorating for quite some time. A diagnostic study carried out by KPMG-Barents Group in 1998 reported that these two banks would need between Rs. 25 billion to 30 billion for recapitalisation. To improve the financial health of these two banks, the restructuring process started with the technical and financial assistance of the World Bank. In this process, NRB has handed over the management of Nepal Bank Limited to the ICC Consulting Group of Bank of Scotland in July 2002. Another professional group - Deloitte Touche Tohmatsu was selected for managing Rastriya Banijya Bank. But since this Group breached the contract, Nepal Rastra Bank hired Mr. Bruce F. Henderson, an American bank Professional, as the Chief Executive Officer of Rastriya Banijya Bank in December 2002. Under the new management, restructuring activities are being carried out in these banks (Nepal Rastra Bank 2003).

Enactment of Debt Recovery Act (2002):

RBB and NBL gradually accumulated a huge proportion of non-performing assets (NPA). Such assets of Rastriya Banijya Bank stood at 52 per

cent and in the case of Nepal Bank Limited; it reached 62 per cent of the total loans in 2003. The increasing NPA in the banking sector was attributed to the lack of strong legal measures for the recovery of loans. To address this issue, the Debt Recovery Act was enacted in 2002. This Act is expected to reduce the increasing pressures of bad loans in banks and financial institutions.

A necessary prerequisite for successful reform is the adoption of prudent macroeconomic policies that would result in positive real interest rates. Second, reforms tend to expand banks' gross lending margins that can be corrected by a strengthening of bank supervision, by further reducing the reserve requirements, and by a rapid implementation of competition-enhancing measures.

"The credit expansion that continues for a long period after reform could threaten macroeconomic stability through putting pressure on price levels and the external accounts imbalance. This would occur if real interest rates were negative in the post-reform period, as this would encourage a more rapid growth of credit and slower growth of deposits. While negative real interest rates are common in pre-reform periods, their impact on credit tends to be limited by application of direct credit controls.

In contrast, if positive real interest rates were maintained, the growth of credit would slow down compared to the initial post-reform period. This would be emphasized by a rise in the growth rate of deposits that would also react favorably to the development of financial instruments and institutions, and to banks becoming more efficient deposit users following the reduction in the central bank role as liquidity provider".[6]

"Financial liberalization tends to affect the cost of funds in complicated ways. First, the removal of interest rate controls allows banks to price credits and risks more appropriately and this may cause an increase in interest rate margins since controlled lending rates were usually set too low in the prereform period. Second, risk premiums tend to rise in the post-reform period as banks significantly expand their loan portfolio to new borrowers with unconventional risks. Thirdly, upward pressure is placed on the gross interest margin since competition in credit markets increases only slowly relative to that in the deposit markets. Against those factors, financial liberalization also tends to put downward pressure on the cost of funds. First, reserve requirements are normally lowered as part of the reform package that reduces the cost differences between deposit and lending rates. Second, competition is increased through the reduction of barriers to entry".

Monetary and Credit Directions:

"Financial reform is usually associated with increases in the ratios of money, financial assets and credit to the private sector, to GDP, while the ratio of currency to deposits falls following the reforms. Thus, the effect of financial liberalization on the behavior of the key monetary and credit aggregates needs to be taken into account in setting monetary targets in the post-reform period. Financial liberalization also tends to be followed by a period in which credit growth exceeds the growth of deposits with financial institutions. This phenomenon can be explained as follows. In the pre-reform period, both deposits and credit tend to fall. The decline in the former reflects a voluntary portfolio response to financial repression. In the post-reform-period there is a gradual portfolio adjustment by depositors to the new liberal financial situation. In

contrast, credit growth in the pre-reform period is constrained by direct controls with an excess demand for credit. Once the direct controls are removed, financial institutions respond by meeting the excess demand for credit and credit expands rapidly. This has the impact of increasing imbalances, and putting pressure on prices and the country's external accounts. The credit boom can pose a threat to economic stability; its appropriate management is a crucial element of successful financial liberalization".

Monetary Policy:

"Financial liberalization requires the ability to manage interest rates and liquidity and credit aggregates through market-oriented instruments of monetary policy, i.e., indirect instruments, rather than through direct administrative fixing of various interest rates. However, in the immediate postreform period, there is a space for using direct controls which would line up credit growth with the otherwise lagging growth of bank deposits. While there is a need for an early implementation of indirect monetary instruments, credit ceilings may be used on a temporary basis, and so long as they are supported by positive real interest rates. Money markets require an active involvement of the central bank in order to ensure the existence of a reciprocal market in bank reserves. In doing so, the central bank should switch gradually from being the principal market maker to creating and supporting the financial deepening of the market. In this capacity, the central bank should withdraw (or inject) reserves at own initiative in anticipation of surpluses (and deficits) emerging in the market while leaving market participants to make their own decisions. Thus, indirect momentary instruments are essential for the development of money markets and the deepening of financial markets".

Prudential Supervision Measures:

"The soundness of the banking system has implications on how to manage the reform process. This is because a system that is burdened with rolling over of loans of weak firms or large nonperforming loans cannot easily change lending priorities to new venues and investments. In addition, higher interest rates on deposits will compound the cash flow problems, and higher lending rates only deteriorate the bad debt problem. Weak institutions tend to also become a greater source of pressure on central bank resources thereby affecting monetary policy. More importantly, financial reforms themselves may weaken the banking sector. For instance, the removal of credit restrictions before proper credit approval processes are put in place may result in an increase in lending to more risky projects and to new activities. This is particularly critical if, as in the developing countries, (implicit or explicit) deposit guarantees exist which leave investors largely indifferent as to where they place their deposits. Thus, financial liberalization in some developing countries implementing financial reforms was followed by a financial crisis. It should therefore be emphasized that financial sector and monetary authorities face difficult constraints and may lose their effectiveness if a significant part of financial institutions have sizeable non-performing loans and face constant cash flow problems. Therefore, measures to deal with banking sector problems would need to be put in place before financial reform starts. In addition, banks need to be encouraged to improve their internal credit assessment, risk appraisal systems and strengthen their accounting and disclosure practices".[7]

Status of Competition:

"The banking systems in countries embarking upon financial reform are usually characterized by oligopoly market structures. As a result, the speed of adjustment of deposit and lending rates to changes in monetary policy conduct is

often slow, and the margin between deposit and lending rates also tends to adjust slowly. While enhancing competition and interest rate liberalization have a positive impact on financial competition, the impact tends to happen with a lag".

The Role of Stock Markets:

"A key question that always arises during the financial reform process concerns what sequence to pursue when developing non-banking financial markets. The international experience appears to suggest that money markets and the markets for short-term instruments such as treasury bills and bankers' acceptances should be developed prior to long-term markets. This is because the development of well-capitalized dealers in securities is easier in short-term instruments than in longterm instruments such as shares and other stocks. The capital markets sophistication and exchange skills developed through short-term instruments can then be translated into long-term instruments over time. The development of capital markets, within a sound regulatory framework, requires a number of structural reforms including; an effective privatization plan; a macroeconomic environment that is conducive to increasing the private sector share in the economy; and the strengthening of market forces through improving information flows, accounting standards, property rights, pricing efficiency, and tax reform. Finally, political stability is vital for the development of sound capital markets".

FINANCIAL SECTOR REFORM NEEDS & AGENDA:

Nepal Rastra Bank (NRB) is a central bank established in 1955 under the special Charter. The Charter designates NRB as a principal regulator of financial sector in Nepal. Still outside its jurisdiction are Postal Savings Bank (which is managed by the government), Employees Provident Fund and The Citizen

Investment Trust, saving and credit cooperatives or community based organisations, (mostly not licensed by the NRB), and of course the informal financial sector. NRB has the sole responsibility to build a sound and healthy financial system in the economy. It involves creating an enabling environment, regulatory services in the like of policy and directives, inspection and supervision, interventions in respect of safeguarding depositors and shareholders, performance monitoring of system and dissemination of financial sector information. NRB's role and performance was poor in the past limited due to the lack of autonomy, an inadequate and outdated legal framework, the poorly trained and unproductive staff (with poor incentive mechanisms, a severely compressed salary structure, and inadequate training opportunities), and an inappropriate structure as well. Besides, NRB's direct representation on bank boards and ownership of development banks contributed to diffuse responsibilities, created conflicts of interest, and undermined its credibility.

Until 2001, two third of the Basel Core Principles for Effective Banking Supervision out of 25 were not implemented in the financial system. A study by the World Bank (2002) pinpointed weaknesses on the part of NRB to carryout the regulatory functions effectively. At the outset, the governing act of the NRB imposed limitations as it was designed in 1955 for a central bank operating in a government controlled economy, and supervising government-owned banks. The central bank had limited authority for effectively managing monetary policy, improving the financial infrastructure, strengthening and improving financial markets and their supervision, and facilitating the growth of the financial sector. Therefore, NRB was failing to comply fully with Basel Core Principles while the preconditions required by the Basel Committee hardly existed in Nepal. The system was lacking adequate legal framework for the banking operation and banking sector related judicial procedures, sound accounting principles and

auditing practices, a market-based banking business, exit and crisis management policies, and deposit insurance and safety net schemes.[8]

The systemic weaknesses made it difficult for the NRB from taking action against problem banks. Therefore, at the first stage to strengthen the regulative regime, seven new banking regulations were issued in March-April 2001 to address weaknesses of the banking system. But, unless fully enforced the regulations would not have a positive effect on the financial sector. Despite the authority to regulate and supervise banks and financial institutions, the system was deficient to provide supervisors with adequate legal protection or with the operational independence and resources they needed to perform their jobs. The supervisors were thus handicapped to enforce the corrective measures needed to prevent and resolve banking problems. Further, NRB's structure to carry out supervisory functions comprised four units, under two different deputy governors, with few staffs. Consequently, surveillance of financial institutions did hardly exist as a specific function and reporting of information was neither timely nor comprehensive enough. The effective supervision requires a matching capacity to do so in terms of prudential norms, appropriate structure and staff capacity. Thus a reengineering of the central bank was put as one of the three thrust areas of the financial sector reform programme.

The key specifications of the reform programme comprised the following:

General:

- Remove direct participation by NRB- and the Government - from the financial sector.
- Shed the development banking functions by NRB

- Undertake a human resource reengineering exercise within NRB - including the implementation of a VRS, complete revision of existing HR policies, and a de-compression of the salary structure
- Develop a tiered regulation system in line with international best practices.

Banking Supervision:

- Implement and enforce the new regulations (minimum capital requirements, provisioning policy, etc) on the same basis for all banks.
- Utilize the support of experienced external consultants in the enforcement of the new regulations.
- Define a programme to include an annual review of RBB and NBL and biennial review of all the other banks.
- Make inspection reports available one month after the on-site visit
- Stop rotation of banking supervision staff.
- Apply stricter criteria in approving banking licenses.
- Make human resource policy changes to enable improved systems for staff selection and career advancement, and greater knowledge sharing.

Restructuring of Departments:

- *Human Resources Department.* Computerize the HR function, develop new HR policies, design a VRS, and implement a decompressed salary system Consultancy and hardware support were the main components of this support.

- *Bank Operation and Bank Inspection & Supervision Departments*. Support the establishment and implementation of an appropriate system of supervision and regulation of banks and nonbanks - both on-site supervision and off-site supervision. Consultancy and hardware support included in respect of enhanced technical and physical support for the work of the department in the form of additional desk top computers, lap top computers for on-site examiners, international experts to assist with on-the-job training (for the complete two year examination cycle of all the commercial banks), and classroom training as related to bank supervision, computing, and English (report writing).
- *Supervision of the Management Teams*. Recruit a bank restructuring expert to work closely with the Banking Operations Department of the NRB, over a two-year period, to supervise the management teams in RBB and NBL on a day-to-day basis.
- *Accounting and Auditing Department.* Recruitment of accountants who will strengthen the accounting and auditing capacities of NRB and gradually move them to internationally accepted accounting standards. Revision of the Accounting Manual to reflect Internal accounting standards and the external audit by a well recognized international accountancy firm to be initiated.
- *Research Department*. The programme aimed at supporting a training programme involving both formal higher degree training as well as capacity building through attendance at seminars and conferences. Support the further development of the NRB library as an important research facility for the staff of the NRB (and others), as well as the

further computerization of the department. Support the development and dissemination of more economic research papers from the Central Bank through Quarterly Bulletins and the Annual Report.

- *Information Technology Support*. Support the development of a holistic IT strategy and IT infrastructure within the NRB, through technical assistance and some limited hardware and software support. Serious investment in up-dated IT systems, including the purchase of a computerized General Ledger system for the institution
- *Additional Support*. Support to other NRB departments:
  - Legal Department. Technical and financial support to engage consultants and legal experts to review the legislative framework in the financial sector and assist GoN in the implementation of this component.
  - Internal Audit. Support to be provided to boost the capacities of this important activity. (Preparing audit manuals, etc.)
  - Training Support. Training to NRB staff, but within the context of a Comprehensive Training Plan based on a review of existing skills, required skills, and a properly undertaken gap analysis.
  - Other Departments. Small amounts of additional funding to be provided to meet needs for consultancies and studies as and when they arise.

Operative Regime of the Financial System:

The financing business is done by several categories of financial operators in Nepal which are found active in formal and informal sectors. Government put

an effort to provide formal financial services throughout the country with such measures as directed lending programme or banks network extension into interiors or establishing specialized institutions. Rural credit and credit in the prioritized area were targeted to be provided through focused institutions. However, various studies indicate that the role of informal sector is still significant in the rural and urban areas. Not only that, the informal sector prevails right within the Kathmandu valley and the overseas remittances have contributed further to enhance the existence of informal markets. At the start of first ever-financial sector reform in 1984 the financial sector was represented by the state-owned commercial banks, 2 development banks and 1 postal savings bank. Besides, stock exchange, insurance company, and provident fund were established by the government. The reform opened the door for the private sector participation in commercial banking although the state still continued to be the predominant player. As such, the financial system has grown to include development banks, microfinance development banks, finance companies, non-government microcredit institutions, and non-government cooperative societies involved in limited banking activities.

NBL established in 1937 with 51% government ownership and a second one RBB which was promoted in 1966 under 100% government ownership are the premier commercial banks. Two development banks were promoted by the government one for supporting industrial sector in 1959, i.e. Nepal Industrial Development Corporation (NIDC), and the next for supporting agricultural sector in 1965, i.e. Agricultural Development Bank (ADB/N). After the economic liberalisation more commercial banks under different modalities (government, private and foreign joint venture, or private and foreign joint venture or private

only) followed. New development banks on the other hand sprang up totally in the private sector. But the quality of service and financial soundness along with legislative regime could not improve.[9]

A study by the World Bank (2002) pinpointed weaknesses of the banking sector in general and two large commercial banks: Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB) in particular.

These were noted to be as follows:

Weak and Fragmented Legal Framework: The report stated about the critical gaps in the legal framework which has plenty of sub-sectoral and institution specific laws and regulations. These have created a fragmented legal environment and, as a result, a fragmented financial system, thereby stifling competition. There was a need for strengthening or amending associated legal framework such as Financial Intermediary Act (1998), Company Act 1997), and Insolvency and Liquidation Laws. Without strengthened laws and proper enforcement, any intervention in the financial sector was unlikely to have a meaningful and long-lasting impact.

Weak Corporate Governance. The government's and the central bank's involvement in the sector as owner and operator inevitably had lead to conflicts of interest. And within the institution, the corporate governance was extremely weak for no clear rules of engagement between a company's management, its board, its shareholders, and other stakeholders. The situation was aggravated by weak systems, poor procedures, and information asymmetry. Accounting and auditing practices were highly deficient and could not provide financial statements at times - even though banks and finance companies were required to

be audited annually by external auditors selected by the shareholders annual general meeting.

Lack of Competition. Despite the rapid growth of the financial system over the past decade, the competitive environment critical for ensuring the benefits to borrowers, depositors, other users of financial services, and shareholders was largely absent. The lack of competition reflected both the fragmentation of the system and the dominance of the two large (but inefficient) government dominated commercial banks. The government authorities were of view that the efforts to enhance competitive pressure should rely on market-oriented approaches rather than mandates such as those for interest rate spreads and priority sector lending which had increased distortions in the market and further burdened the financial institutions.

Poor Banking Culture. The elements of a good banking culture were almost nonexistent in Nepal, whether among banks or among their customers. Firm level data were largely unreliable, and banks were forced to reconstruct firm accounts from client estimates. On the other hand, banks often extend credit on the basis of collateral rather than creditworthiness which had seriously handicapped effective enforcement of the prudential regulations. Only a small number of banks had put in place satisfactory internal guidelines. The Credit Information Bureau, which maintained records of the blacklisted customers to whom banks couldn't extend credit, was hindered in its operations by the lack of cooperation from the banks.

Information Asymmetry and Lack of Financial Sophistication. At that time the public had limited knowledge of the financial position of banks, and had little access to financial information. When financial institutions' accounts and

annual statements were disclosed, they were neither timely nor reliable - even if audited as the accounting and auditing practices were often below the international standards.

Corruption. Fraud, self-dealing, insider dealing, and improper evaluation of collateral had been among the reported abuses. This could be only checked by putting in place transparent systems, checks and balances at every level, and a system of continuous monitoring within and between financial institutions.

Inadequate Banking Services for the Poor. The emphases on the social dimensions of banking had not helped in the past. Most of the policies aimed at benefiting the poor (directed credit, branch opening policies) were too broad, and they created considerable operating disincentives within the financial system while achieving a minimal or even negative impact on their intended target audience. The health of the development banks in the financial sector was not good as well before the initiation of FSRP. The government owned development banks ADB/N and NIDC were facing similar problems. ADB/N and NIDC were studied at length over eleven aspects/issues by Price Water and Cooper (PWC) Thailand over a period of two years and completed in July 2003. They were found in serious trouble with 95% non-performing assets of NIDC and over 50% of ADB/N.

In view of these weaknesses, it was recommended to replace the existing legislations, restructure the ailing banks and improve their capacity to operate and sustain.

ESTABLISHMENT OF ASSETS MANAGEMENT CORPORATION (AMC):

Continuous Management Team support prior to privatization

Joint Venture Commercial Banks:

- Eliminate the current restrictions on foreign ownership beyond 66 percent to attract "good name" banks that could bring discipline, know-how, and technological benefits to the Nepali financial sector.
- Move away from direct participation in banks by the government and NRB, should withdraw from direct participation in the boards of commercial banks
- Replace the current mandated lending requirements on commercial banks with better directed policies that result in less operating disincentives.
- Review and remove the current policy that requires the establishment of rural branches whenever urban branches are established.
- Prohibit cross holding in banks.

ADB/N and NIDC:

- Carryout reforms in ADB/N: (The restructuring plan was endorsed by ADB/N Board and the Cabinet approved it in February 2004). The plan included bringing ADB/N under Banking and Financial Institutions Ordinance (BAFIO), reconstitution of the Board, financial and organisational restructuring, and institutional strengthening components.
- Wind up NIDC: (as it was found to be not having revival potential with more than 95% nonperforming assets). A disengagement plan was proposed to be prepared within two years and get disengaged. However,

the Cabinet on February 2004 decided to restructure it for possible privatization failing which it would be liquidated. The preparatory time frame was extended up to mid-July 2005. If privatization option does not stand chance by then liquidation would be followed.

Capacity Building of the Financial Sector:

Apart from the reform focused at the central bank and ailing commercial and development banks, financial sector reform has targeted the financial sector in entirety through legislative improvement and installing professionalised services. The weaknesses in the legislations was to be corrected with respect to regulatory body, financial intermediaries and related field in financial governance and business organisations. Accordingly, these were targeted under the financial sector reform programme to be prepared and implemented:

- Amend NRB Act, 1955
- Enact Banks and financial institutions ordinance/act (BAFIO/BAFIA)
- Enact Secured transactions ordinance/act
- Enact Insolvency ordinance/act
- Amend Company ordinance/act
- Enact Asset Management Company Act

The financial intermediaries needed support out of regulatory oversight and internal operations as well, purely from a professional services perspective. In this regard, the following reforms were proposed:

(a) Bankers' Training Center. Strengthening the role of this institution through:

- development of a strategic plan, design of appropriate course work, modem and enhanced teaching methodologies and equipment (including computers),

- support for enhanced training capabilities. Capacity to establish twining arrangements with a good foreign Banker's Training Institute to be explored.

(b) Credit Information Bureau (CIB). Strengthening the credit information process as an important building block within the overall financial sector reform effort. The targets were:

- Incorporation as a company to exercise legal power and to be operated by the active participation of private sector banks.
- IT upgradation and reengineering the processes

(c) Financial Journalism. Improving the general public's awareness for a more effective check and balance on bad banking behavior:

- Develop the capacity of local journalists to better convey financial sector issues to a relatively unsophisticated banking public.
- Provide some regional training, attachments, as well as bringing financial journalists from India to interact with Nepali journalists

The financial sector reform programme had thus considered broadly three weaker dimensions of financial sector for the improvement, and the financial sector technical assistance support and fund were sought for implementation of the following components:

Re-engineering of Nepal Rastra Bank:

Re-engineering of NRB consists of legal reforms making new act providing the central bank more autonomy and responsibility, improving regulatory and supervisory capability, improving other policy matters and

strengthening IT platform as well as other related departments and functions. The specific agenda, functional improvements are provided under various topics below.

Restructuring of NBL and RBB:

This comprise the placement of professional management team for restructuring of the bank, building system and procedures, improving HRM, IT, ALM, Risk management, Accounting and auditing. The necessity of reform, specific agenda and progress has been elaborated below under different topics.

Capacity Building in the Financial Sector:

The capacity building programme deals with the developing legal and regulatory regime for the financial system, institutional reforms, introducing of new institutions such as BTC, CRA, AMC, Strengthening of CIB, Developing financial journalism, privatizing rural development banks, establishing more focused institutions for micro credit delivery, and promoting governance and financial discipline in the system, etc.

In this way, NRB Act, 2002 has been promulgated. It has provided clear authority, responsibility and accountability for NRB. The Act has provided NRB the power to address the problem bank resolution aspects. This Act has also incorporated provision for annual monetary policy announcement and implementation. After enactment of the new Act and launching of the comprehensive financial sector reform, major policy changes were announced through the strategy paper of the financial sector reform programme that included the development of system and rules in the NRB as well. As alluded above, NRB objectives are focused for internal and external stability as well as

maintaining a sound and efficient financial system. Within the reform programme, NRB has undergone significant internal restructuring and reengineering to transform it into a professional central banking institution, which would ensure prudent banking practices and help develop healthy financial intermediation that can support the growth of the economy. The progress made with regards to the implementation of reform plan underscores the following achievements:

Direct participation in the financial sector -remove NRB withdraw the appointments of directors in banks & financial institutions begin to divest the ownership from banks and financial institutions including insurance sector.

Development banking functions-shed NRB withdraw the lending requirements in the priority sector in the phase-wise manner. Facilitated the entry policy for micro finance institutions by increasing the ownership ceiling for banks and financial institutions up to 25% from 15%. Lowered the level of capital for development banks operating in rural areas. More focus to establish development Banks. Human resource reengineering Implementation of a VRS, complete revision of existing HR policies, and a de-compression of the salary structure Tiered regulation system in line with international best practices – develop Set of new directives (17), Guidelines (2) Various circulars and new licensing policy prepared and implemented.

On the general front of reforms, the government is yet to withdraw from the ownership of financial institutions including NBL and RBB. Though NRB is pulling out of ownership, the government and government owned institutions still hold the stake in many bank and financial institutions.

On creating appropriate environment for the financial sector, NRB Act has been replaced and all financial institutions have been brought under one umbrella: Banking and Financial Institutions Ordinance which now has been enacted by the Parliament.

Banking Supervision/Regulation

Implement and enforce the new regulations The gap analysis undertaken by foreign consultant and as per recommendation a new set of directives issued and implemented.

Annual review of RBB and NBL and biennial review of all the other banks Review of all commercial bank on on-site basis once a year. Quarterly monitoring of progress of NBL and RBB.

This is currently the practice Stop rotation of banking supervision staff. A clear policy has been announced and implemented Apply stricter criteria in approving banking licenses - A new licensing policy has been announced in 2007, underwhich all the qualifications are tested before providing licenses.

Human resource policy changes to enable improved systems for staff New staff by-law prepared and implemented long term & midterm HR policy prepared and incorporated in strategic plan.

On banking supervision and regulation fronts the following improvements have been made:

In order to strengthen the regulatory and supervisory functions, NRB hired a banking consultant to address the weaker parts of the regulations and shortcomings. As per the consultant's advice, NRB at the first instance issued seven directives, which were extended to 16 by 2006. These are now called

unified regulations and by September 2007 it has reached to 17. Moreover, 2 guidelines: Know your customer (KYC) and Credit policy were issued. Apart from that NRB has issued various circulars.

Control over weak banks and resolution:

With the introduction of NRB Act, 2002 and BAFIA, 2006, NRB has been able to intervene on time the problem banks and financial institutions. Within last 5 years, NRB has taken control over three commercial banks and initiated restructuring to make them sound and healthy. These banks are NBL, Lumbini Bank Limited and Nepal Bangladesh Bank Limited. Among these three, NBL is getting direct support under FSR and two others are still under restructuring programme of NRB in other forms.[10]

Proactive-strategy regulating and strengthening financial system. In this regard Credit Risk Management Mechanism has been introduced through:

- Standard credit policy manuals
- Loan recovery guidelines,
- Write-off policy

Loan files and loans portfolio have been continuously reviewed, measured and managed by the banks themselves. Risk monitoring, assessment and management system and asset/liability management guidelines are in place in all the commercial banks.

Restructuring:

Human Resources Department VRS 3 times, organizational setup completed incentives enhanced. Plan and policies prepared, Bank Operation and

Bank Inspection Departments Set of rules, regulations, policies prepared and implemented. Risk based on-site and off site manual prepared and implemented Supervision of the Management Teams Monitoring and reporting on quarterly basis Accounting and Auditing Department Manuals prepared and implemented. Research Department Capacity enhanced. Information Technology Support Is continuing. Significant improvement not happend to date.

The reform contemplated a lean and efficient and professional central bank. The reform spanned two fronts: institutional capacity building and supervisory/regulatory actions. The first was addressed through restructuring of the organization, right sizing, development and career advancement of human resource, and IT infrastructure in place in full scale with topical policies and operational rules/bye-laws. The second was addressed through a replacement of the charter providing needed autonomy and authority to the central bank. The actions that follow thru consisted of putting in place desired regulations and enforcement of the same over the banking and financial institutions on the one hand and extending supervision of the management teams placed at NBL and RBB and at times in other weak banks.

Broadly the system seems to be in place now. What has not happened yet effectively is timely inspections of non-banks and taking recourse to prompt actions for all banks and financial institutions. NRB withdrew its senior staffs from the board of directors of the banking and financial institutions but yet divestment of its shares remains to be completed in same institutions. Besides, with respect to its own governance NRB is behind in research, critical reviews in dealing with future issues on the one hand and devolution of the authority to the respective departments and development of professional core within the departments on the other. The state of reengineering of NRB is still incomplete.

As envisaged by Phase II, the IT up gradation and training programmes for building the capacity of the regulators and supervisors are yet to be completed. No doubt NRB is capacitated in terms of authority, prudential norms and regulations and the efficiency and effectiveness in banks supervision and regulation has improved and could be at the aggressive level with Phase III.

In order to strengthen the supervisory capability of the central bank, on-site and off-site manual have been prepared and implemented. On-site manual was implemented from 2002. The staff level has been reduced to acceptable level by launching the VRS and CRS programmes. In order to improve the IT system, consultant has been hired and study has been completed, but the procurement aspect has not yet been completed.

For an organisation to remain successful, reengineering is a continuous process as such NRB has to evolve on the same front. The turnover and transfer of the staff could make the Bank Supervision Department and, Bank & Financial Institution Regulation Department extremely vulnerable in terms of staff capacity as well as institutional memory. Therefore, the new practice adopted - not to make frequent transfer should be implemented strongly.

Commercial & Development Banks:

a) Reform at the organization level:

The professional management teams were placed in NBL and RBB in July 22, 2002 and January 16, 2003 respectively for two years. The contract was extended first time for one year and second time for two years with contract cost reduced in the extended periods.

Stabilize the operational and financial positions of the banks	Various operational manuals prepared and implemented, Banks turned to gain profitability.
Human resource programme	Training- Regularly conducted (more than 9000 employees)

	Right sizing- From 11 thousand to 6 thousand.
Branch restructuring and improvement programme	Branch rationalized and reduced from 400 to 221.
NPAs, Debt Recovery Procedures, and Blacklisting	Strengthened
Accounts/Audit - five months from the report date	Completed up to 2006. 2007 July figures are being audited.
Information Technology selection and implementation	Completed. 80 percent of transaction covered by IT system.
Preparation for ownership reform	Not yet completed due to political turmoil.

To be specific, the professional management teams did the following in the respective bank:

- Reorganisation

- Standardized System and procedures put to place
- Management Plan and Strategic plan, Branch operation manual prepared and implemented
- Organizational structures re-organized
- Bank branches rationalized (NBL: brought down to 107 from over 200; RBB: brought down to 114 from over 200) and staffs right sized through VRS and other modes
- Audit manuals prepared and sound audit culture established

- Information Technology (IT)

- IT Plan prepared and implemented
- RBB: RBBSYS in 24 branches and Pumori Plus in 40 branches out of 114 branches,

Integrated Banking Information System (IBIS) pilot testing in 4 branches; NBL: NEWTON in 44 branches out of 107 branches

- KASTLE Software introduced for Treasury operations and Human resource.

- Account and Finance

- Capital Plan of the banks (NBL and RBB) prepared and submitted
- Statutory audits of last several years completed and made up-to-date up to 2005/06.
- New Accounting Manual, New Audit Manual, Budget Manual, charts of accounts prepared and implemented
- Quarterly financial statements are being published on regular basis
- Branch rating system introduced in RBB in terms of ability to attract deposits and loan recovery
- Pending reconciliation items have decreased and are updated from 2002.

- Human resource

- Long term HR plan and Skill enhancement plan prepared and implemented (around 6139 NBL staff and 2923 RBB staff imparted training)
- Monetary benefits hiked for employees by on an average 40% from the beginning of FY 2004/05 at NBL and 45% at RBB.
- Staff level downsized through VRS schemes from 11235 in 2002 to 6261 in 2006: RBB from 5583 to 3301 (1632 off in three phases) + 163 off from CRS; NBL from 5652 to 2960 (2369 off in three phases)

- New Staff Bye-laws prepared and enforced
- Reward and punishment system initiated.

- Credit and banking services

- Standard credit manuals, loan recovery guidelines, problem loan guidelines, loan write-off policies, inspection manual prepared and implemented.
- Loan files and loan portfolio reviewed, risk element measured on regular basis.
- Risk monitoring, assessment and management system are in place.
- New consumer loans (auto, home, margin, education, and personal) introduced and international banking connections and services expanded
- • Cases filed to DRT for recovery NPA: around 1500 cases have been filed (RBB: 547 cases amounting Rs.10031 million by mid July 2006; NBL: 958 cases totaling a principal and interest amount of NRs 13726 million).
- Non performing debt recovered - RBB: Principle NRs. 6018 million and interest NRs.3876 million total NRs 9894 million by mid-July 2006; NBL: NRs 5062 million principal and NRs 2428 million interest total NRs. 7490 million by mid July 2006
- Book write off of NPA - RBB: around NRs. 4000 million & NBL around NRs. 4000 million. (Principal excluding interest)

- Deposits

- Restructured deposit interest rate and reduced interest rates

- Computerized banking services begun
- ABBS (NBL 21 branches), RBB 18 Branches
- SMS balance information (RBB)

b) Reform at selected branches:

The study team visited four branches each of NBL and RBB (two within and two outside Kathmandu valley). The specific findings are noted as follows:

Branch setting:

- Layout improved,
- Documents processing improved.
- System procedure compliance maintained, and any exception required for the faithful customer is forwarded to the central office for decision.

Customers services-deposits:

- Computerized services
- SMS banking for balance information (RBB)
- Customers complaints minimal,
- ABBS introduced
- ATM not yet started (NBL), Services from ATM started in RBB
- Deposits on rising trends

Customers services-loan:

- Customers will first approach the relationship officer (not yet positioned in RBB, NBL Chabahil) and loan committee makes decision.

- The processing time reduced with loan processed within 3 days for complete documents but those requiring HO approval would take 7 days. New business loan might take 15 days. Earlier it was taking more than month.
- Document completion by the customers might take 21-30 days.
- 50% margin on collateral, good customer might get 60-70% on HO approval.
- Mostly consumer loans (house, education, auto, margin) by numbers (not yet in RBB Dhading), business loans based on financial statements but extended to the tune of 30% of sales, 70% of stock with collaterals for the ongoing concerns.
- Credit extension somewhat low but credit quality enhanced
- Credit limit per case authorised to the branch stands at NRs 10 million for RBB main branch, NRs 5 million for NBL main branch, and it varies in other depending on the locations: NRs 0.7 and 0.2 millions for NBL other branches at main and interior locations respectively and NRs 2 and 0.3 million for RBB other branches at main and interior locations respectively

Overall business:

- Branch on profit (Branch profitability study on annual basis)
- NPA down
- Business growth observed

Issues that remain:

- Staff motivation: Behavioral change towards customers but age and habit might be the limiting factor. Old habits die hard.
- Lending (staff size and capacity/skill, Market/credit appraisal)
- Consumer loan centralised (NBL)

Other Banks:

Following the implementation of the reform programme, there have been a number of changes affecting the entire banking system. The government has enhanced the level of foreign ownership from 67 percent to 75 percent, but the government and NRB holdings in the banks remain to be disposed off. The banks are also directed not to maintain cross holdings in other banks and financial institutions licensed by the NRB. Accordingly, NBL and RBB have disposed off the shares of other banking and financial institutions. But it remains to be fully complied with.

The compulsory priority sector lending to the tune of 12% of total credit has also been done away with. The mandatory opening of rural branches to open up urban branch has also been withdrawn. Interest rate determination for credit lending is left at the sole discretion of the banks and financial institutions. The specific reforms targeted for Agricultural Development Bank is going on since July 2004 with the restructuring plan. The Bank has been converted into a limited company and brought under umbrella act. Newly reincarnated Agricultural Development Bank Limited (ADBL) has been graduated into full fledged commercial bank. The bank is undergoing restructuring and strengthening of the rural finance sector. Technical areas that are being strengthened include a) risk

management, b) credit appraisal, c) training, d) corporate plan, e) accounts and internal audit, and f) management information system. Recapitalization and portfolio management constitute other fronts. The non-performing loans have been reduced from 36% in 2002 to 25.6% by April 2007. Government is injecting capital to strengthen its capital base and adequacy ratios.

But, the intended reform of Nepal Industrial Development Corporation (NIDC) has not gone satisfactory ahead. Though its liquidation was proposed, it is now incorporated under development bank and confining to limited operations. If privatization is considered in place of liquidation it is converted into a limited company and brought under umbrella act. There is a need of further evaluation of whether its business stands saleable or not? NIDC regional offices at Biratnagar, and Nepalgunj have been closed upon completion of property valuation reports. Pokhara, and Dhangadhi offices remain to be closed. A total of 118 staff took VRS. Property in Butwal has been disposed off. A report on privatisation process was prepared by a team of MoICs, MoF and CEO of NIDC, but yet no final decision is in place.[11]

Microfinance:

Microfinance is another window of the financial sector which comprises of formal and informal actors. At the formal level and under the regulation of the central bank there are micro-credit development banks (Grameen and local category), financial cooperatives and financial NGOs. There were 11 micro-credit development banks in 2002 and the same number continues; there were 39 cooperatives which has come down to 19 in 2006 (as NRB is not accrediting new ones and those accredited are being delicensed due to non-compliance to regulations); there were 25 NGOs which has gone up to 47 in 2006. The share of

informal actors continues to be large whether community unions or individual schemes operating in localised areas.

Micro-credit institutions, in particular the Grameen Bikas banks are not in good shape and also there are confusions with respect to regulation of cooperatives. Some Grameen Bikas banks are still suffering from political interference in terms of appointment of the board and the senior management and at times even in staff recruitment. The Grameen model of micro-credit delivery has differential operative bases in the Terai and the hills requiring a differential approach failing which the micro financing institutions will face increasing recovery and sustainability problems. Often the employee unions come in the way against restructuring and rightsizing these banks. Financial sector reform programme therefore envisages developing an improved system of microfinance. The programme specifics comprise of:

- Restructuring and privatization of the Grameen Bikas Banks
- Consider ways of ultimately providing sustainable micro-finance services through private sector institutions NRB is divesting shares from Grameen Bikas Banks but it is still not complete. On establishing improved system for micro-finance the Grameen Bikas Banks are yet to be fully restructured as well.

This apart, the private sector is quite active in this front through NGOs and saving and credit cooperatives. The monitoring of their operation and their regulatory jurisdictions has remained an issue in the financial system. These institutions are by nature different than other banking institutions and should have different modality of self regulation and different procedures to monitor the

performance. Not much reform has outreached this category of financial operators. So far as the performances are concerned, these are highlighted below for the regulated microfinance sector. As per Access to Financial Services Survey 2006, microfinance development banks accounted for 37% of the total loan portfolio of the regulated institutions and 23% of deposits; financial NGOs represented 22% of the loan portfolios and 53% of deposits and financial cooperatives had a share of 6% of the loan portfolio and 1% of deposits at 2005.

At the start of the reform in 2002 both NBL and RBB were failed institutions with poor systems, operating losses and huge negative net-worth. As these banks stand now, they have started making profits from FY 2003/04, but, on the question of correcting negative networth the banks management hold the view that to earn the way back to a capital base in compliance with NRB regulations is not possible in a realistic time frame from their own earnings. Government needs to inject the required level of capital from its own budget to comply with the NRB's regulation. The turnaround has happened for improved governance on a system plank with lean but trained staff, reorganized structure and defined procedures, and competitive technology on the one hand and moves to correct the loan services and corner the defaulters on the other.

A significant change in the lending procedures and objective has been observed in recent days. The banks at the central and branches claim that collateral based practices are gradually replaced by objective lending. In the past, the loans were distributed, as customers wanting to milk bank were extended loans by order, these days customers first see the Relationship Officer who looks at the project, the customer and the collateral, and compiles and places the file before loan committee after assessing the risk associated with the loan. Of the

total loans 10% are a new and 90% are renewals, customers at large remain to be attracted as the excess liquidity continues. The banks management had have some problems with the unionism in the banks though it opens up the opportunity as well. It is a problem when the unions overstep their role interfering with management actions and decisions. It is an opportunity when management is able to sell the idea and engage them in a way productive to the bank. The managements have made efforts to make the unions productive segments in the banking environment, but by nature they usually overstep management functions with occasional work stoppages.

As to the succession plan, professional management team at NBL recommended transferring of management team member as permanent staff members within the bank but that did not happen. The middle level managers by and large are professionally sound though are not ready to take over as they are in middle stages of development. RBB as well has developed a succession plan identifying key managerial positions to be replaced and the potential candidates.

IMPACTS OF FINANCIAL SECTOR REFORM:

The study aimed at assessing the results of the financial sector reform process in respect of a) the health of the financial system through improved order and functioning of legal and regulatory oversight, and operations and profitability of the publicly owned financial intermediaries in particular and the Nepali banking sector in general, and b) ease of doing business with the banks for the customers. This meant successes built on the achievement on the part of FSSS by way of legal reforms, system improvement, and capacity building of the regulatory body (NRB), and the banks particularly (RBB and NBL). This also meant replicability to other banks and capacity building to face the foreign banks

after 2010 AD when these will be allowed to operate in Nepal under WTO obligations.

FSSS specified five strategic fronts to generate a more competitive (well regulated, sound, market oriented and stable) financial system to contribute to fiscal consolidation, macro-economic stability, private sector led economic growth, and poverty reduction on a sustainable basis. The strategies comprised initiating strong corporate governance, enhancing the authority and capacity of NRB, improving legal and judicial processes, improving accounting and auditing standards, and promoting financial discipline through disclosure and competition.

As of now, with the reform, the qualitative and quantitative performance levels of the regulated financial institutions are improving. The legislative regime and regulatory order have improved. The internal management system, risk analysis practices, and governance levels within the banks and financial institutions have improved. The institutional infrastructures of supporting institutions such as Credit Information Bureau Limited (CIBL), DRT have been established. The financial system as a whole has begun to restore profitability ensuring a certain degree of stability and sustainability in the financial system.

***RBB*:**

Deposits are rising (by about NRs 7 billion in four years) despite low key promotional efforts and low interest levels. The growth is higher than average growth of the banking sector. It has contributed to excess liquidity as credit front continues to be lacklusture, fluctuating between NRs 28.6 billion and NRs 26.9 billion. The principal credit products are: a) consumer loan (housing, auto, education), b) business loan (mostly trading/working capital/LC based) not much

project establishment/term loans, (education, food processing are major thrust areas) c) lending against shares and government bonds, and d) remittance.

Rationalization of the branch (down to 114), computerization of the branch (up to 65), trimmed down staff level (down to 3301 in July 2006) and enhanced staff efficiency with training, improved layout and initiation of one window system of services backed by operating manuals on accounts, audit, and credit operations have been the key reform fronts. These together with induction of performance incentive ranging 0-14% have contributed towards stabilizing RBB's business.[12]

The bank has been able to bring down the level of non performing loans/assets from above 60% to 35% in July 2006. Negative networth has come down slightly from NRs 22392 million as of July 2003 to NRs 18590 million as of July 2006. While the banner 'government owned' has contributed to upsurge in deposits and that the management team has been effective in controlling the credit operations, much remains to be done in reducing the non-performing loans and correcting the negative networth. The bank has prepared the capitalization plan but remains to be implemented, seemingly for reasons of lack of adequate resources with the government. The bank has prepared the succession plan but remains to be implemented.

NBL:

Deposits have maintained almost at status quo situation despite somewhat upward trend fluctuating in between NRs 36 and 34 billion. Credit is constantly falling from NRs 20.0 billion to NRs 12.0 billion contributing to the excess liquidity. Though there has been checking on easy loans to susceptible

borrowers, efforts made to improve the credit flows through introduction of new consumer loans have not helped to lift the credit extension. Alike RBB, rationalization of the branch (down to 107), computerisation of the branch (up to 44), trimmed down staff (down to 3301) and enhanced efficiency through various measures such as training, improved layout and one window system of services backed by operating manuals on accounts, audit, credit operations, assets and liability management (ALM) have been the key reform fronts of NBL. The bank has been able to bring down the level of non performing loans/assets substantially as it changed from above 60% to 18.18%. Negative net worth has come down from NRs 10 billion to NRs 6 billion in July 2006.

As with RBB, NBL is currently facing a dual challenge of managing excess liquidity and correcting the negative networth, which would require substantial new capital injection on the other. This apart the immediate issues for its sustainable business are in getting strategic investor and management succession.

b) Banks outside direct support

What do the bankers outside the mainstream of direct reform process feel about the financial sector reform? An interaction with Nepal Bankers Association has brought to light some significant remarks. First, it was observed that the banking community has not been well informed about the objectives, programme components and progresses made towards it. Effective communication is lacking apart from occasional media briefings and discussion with bilateral and multilateral agencies. Many bankers opined not knowing much about FSR and what is meant for them as their knowledge is peripheral. Something is being done at NBL and RBB about negative net worth and excessive nonperforming assets.

These two failed because they were doing social service (having bank branches to run government accounts but without business customers). The treatment to these banks showed regulatory forbearance by the government and the central bank vis-a-vis other private sector banks. They are operating with negative capital and non-compliance in most of the critical areas (e.g. capital, SOL, periodical reporting) of the central bank regulations. Second, the bankers also hold the view that their requirements are different from the requirements of the two banks under reform. They feel that they are doing exactly the same what they would be doing in absence of FSR. The bankers feel that they face and live with competition while the government allowed these ailing banks to survive.

Third, the intervention came albeit late for two private sector banks that failed (Lumbini Bank and NB Bank) irrespective of the fact whether that was part of FSR or not. The frauds have not been brought to book; even statutory auditors who failed to notice have been spared. The bankers feel that severe punishment needs to be meted out to fraudulent activities and legal provision be made accordingly.

Fourth, the banks consider BAFIO/BAFIA as a good move, NRB's inspection have become good. Public trust with NRB has enhanced. In addition, they hold the view that the banking sector has been able to partially meet the demand of the emerging financial market in Nepal in that it has helped the growth of the credit uptake and assisted the industries to plan their future credit requirements. The financial sector reform has definitely done some good, but a lot more needs to be done in that the very basic foundation of credit appraisal methodologies not only for projects but also for simple working capital requirements should be put in place. It will assist the central bank in

implementing a unified acceptable approach towards credit evaluation of units and prevent over-financing the units, a factor contributing to very high NPA level. A Secured Transactions Act needs to be implemented with utmost urgency so that priority of charges on collaterals could be registered and in the event of invocation, the Act could be properly used with the help of an efficient judiciary system. NRB could come out with a comprehensive post disbursal monitoring in tandem with the international policies.

Business Sector:

Financial sector is contributory to the basics of business operation that is business needs money and on top of self-funds, it is provided by the financial intermediaries. Banks in the past have been security oriented as they primarily looked upon the collateral but did not look at the project viability or the business prospects and the process of getting bank loans was tiresome. With financial sector reform, naturally, the business sector would expect that doing business with the banks would be hassle free and that the banks would be proactive to the fund requests and would be a business partner sharing equal risk, i.e. every one would loose if a business fails.

a) Loan customers of selected branches:

Altogether 64 loan customers in 8 branches of NBL and RBB were surveyed; seven of them dealing with the bank for the last one year and ten of them doing business with the bank for more than 20 years. Majority of the loans comprised of home loans (14), followed by overdraft (12) and others. 35 customers were provided loan on the basis of project hypothecation with collateral while 24 were provided purely against collateral and only 4 against

hypothecation (in case of auto loans). Property (house and land) outside the business holding were put as collateral against most of these loans (48) while the rest comprised of business owned property.

In responding to loan requests, majority (39) said that the bank communicates only verbally without formal letters regarding the documentation to be complied with by the customers, and 14 said that first time it provides a copy of appraisal report, a letter at times of renewal and only verbally later.

Regarding supervision of the loan performance by the bank 11 customers said that it takes stock list and transaction information and equal number (11) said that there has been never any comment. Others in limited numbers said about positive comments from the banks. 11 customers reported no supervision or not applicable, 15 indicated of quarterly visits, and others reported of monthly (4), half yearly (5) and annual (9) visits. Some others reported of sudden visit or when the staff is changed or at time of release of installment.

With the reform 21 customers felt that it was now comfortable to deal with the bank, while 19 considered that the comfort was only a little bit, and 13 said that they want more ease in dealing with the bank. As to the changes in the behavior of the bank staff 21 customers reported that the negative attitude was down, while 17 said that it was only a little bit and not enough; 9 were of the opinion that it was more active and helpful than in the past and 5 stated that they have not changed their behavior yet as old mentality continues.

On the question regarding any differences in variety in services and service delivery 10 customers held the view that there was newness in bank setup and services approach while 8 did not see comparable change vis-a-vis the

private banks. 6 customers reported of fast service delivery and 5 saw newness in services.

Only 8 customers had no transaction with other banks. As to the question why they transacted with other banks 10 of 30 reporting transactions said that there were lots of facilities and attractive schemes, others provided varying reasons such as evening counter, less complexity, and etc. Stating that the bank services should be as good as others on service delivery and market oriented, the customers have specified sorts of changes there should be in general in the banks.

b) Comments from businessmen:

Officials and members of Federation of Nepal Chamber of Commerce and Industry (FNCCI) are critical of the way the banks are *behaving* or have been asked to behave under the directives of NRB. Who are the customers of the bank? Whom you are targeting? Whether the economy would move on the fronts of consumers loan and remittances. Why genuine business customers are treated alike as fraudulent customers. What FSR would achieve if business/industrial sector remains sick? Business community is of view that one of the worst outcomes of FSR is the black listing (note: the blacklisting procedure was initiated decades ago but the implementation aspect strengthened within FSRP). The way blacklisting is done should not be the way to do it. This harasses investment sentiment as it intends to criminalize the business people who have faced difficulties out of market failure while genuinely pursuing the business. It does not distinguish the one doing fraudulent activity out of bank finances secured through political favors. Lot of loans was provided on political pressure (what constitute a political pressure and favour is hard to define and challenged) and cannot be recovered as it has been misused. The business that suffered out of

market failures can not be put to the same basket. As such business community seems to feel blacklisting is a humiliation to all business people. They opt that the banks should differentiate fraudulent cases from market failure cases. NRB should consult to business people to define fraudulent activity. Banks while trying to be the policeman are paying less to the depositors and have excess liquidity nowhere to invest. Yet they are in profit for heavy spreads they are allowed to enjoy. Business sector on the other is forced to move away from the bank to outer sources. Banks instead of pursuing dialogues and adjustments are akin to police action and auction. It does not help the business and also contributes loss to the economy.[13]

Business community sees a need for improvement in the Insolvency Act. The bank restructuring needed to go hand in hand with economy restructuring. Bank is an integral part of the business and financial system. But the environment is not business friendly. They never had the policy and never tried to promote Asset management company/Reconstruction bank as done in some of the neighboring countries. Businesses are working for the banks, but banks are not as they do not play a role for financial discipline and injecting money whenever the business needs. Government must be forthcoming to provide to the business sector the kind of support and investment guarantee meted to the financial sector.

Business community feels that there is no difference in the banking despite FSR. Banks do not have faith on the project financing they are after collaterals. They do not have capacity and audacity to bear risk. Their project appraisal capacity has not improved. And FSR has infact lowered their capacity to take risk. Collaterals apart, FSR or not, the business sector was and is at ease

in dealing with the private sector banks and despite the reform at RBB/NBL the attraction is still not there. With the remittance income consumer credit has become a new threshold of banking business, but, the everlasting support to the economy comes out of business expansion which can happen in hydroelectricity, tourism and knowledge based business which currently is facing lack of business environment as well as unpreparedness of bank to move from risk avoiding to risk taking stage. The single obligor limit seems to be inadequate to finance the large projects to the private sector due to low level of capital base of the banks and financial institutions. Though there are consortium approaches to meet the fund requirements it is quite a long process and time consuming. While appreciating improvement in NRB, the business community has pointed out that its compliance and monitoring of the banking and financial services is still weak. Business community contends that while depositors be insured, the banks should be allowed to fail. With or without FSR the incompetent management/board/promoters have been protected and rewarded. It is they who benefit at the end of turnaround or capital injection.

Business community say it strongly that the FSR alone without trying to improve the investment climate is not good. Improvement in investment climate means at least three things: a) labour reform (protect employment but not the employees), b) improvement in government service delivery (in relation to administrative compliance, tax and other matters), and c) development of infrastructure. The business community has also demanded that there has to be flexibility in allowing investments outside the country. The investments have not stopped but the legality would provide value addition to the economy.

The financial sector in general and banks in particular were operating on a fragmented legal platform. The reform has addressed the legal shortfall; still some associated regulations have not taken off the ground (cross border issues, and home/host supervisory co-ordinations, and documented prompt correction action rules for identified early warning signals systemic risk management modalities etc.). The legislative order is now much improved but still awaits the reform in respect of insolvency, co70 sharing of the same logic between the legislations, and swiftness of judiciary practices. NRB as a central bank was not fully autonomous, did not have full authority to regulate the financial sector and was grossly incapacitated to carry out the supervisory function. The reform has helped NRB to be on the driving seat with capacity to do so; still some elements of capacity remain to be developed (especially in enhancing the supervisory capabilities & IT systems). NRB now is in better situation to make the regulatory oversight but the capacity building is prone to staff transfers and practices.

The reform has enabled the failed banks back to the profit, but continuing negative net worth, succession and government withdrawal remains to be addressed. That the government has not moved fast enough to pull out of the shareholding, it could derail the improvements made in RBB and NBL. It seems nobody is on the charge for locating and involving strategic investor for the RBB and NBL and there is still confusion with regards to taking strategic steps for NIDC and bringing EPF and CIT under regulatory oversight of NRB.

The FSSS targeted improvement in the financial system and FSR has shown that it could be improved. Five outcome indicators were set for FSRP. Laying the basis for a modern legal framework has been completed but co-sharing of the same logic between the legislations remains to be complied with.

NRB's supervisory function - in particular, its ability to enforce prudential regulations and relevant banking legislation - based on internationally accepted norms has been strengthened but remains to be seen in respect of quick responses as the issues crop up. An increase in the range and sophistication of financial instruments and their availability at competitive prices was something expected but has not happened barring a change in focuses. Enhancement of accounting and auditing standards within the banking sector was attained. Finally, the expectation was of a more prudently operated financial sector with better-trained staff, a better-informed general public, and an enhanced system of credit information. The banks now have the better-trained staff, but no headway has been made on the information fronts.

Despite hard times on Nepali economy resulting from insurgencies and then owing to prolonged political instability, the financial sector is on the leaps and bounds in contrast to other sectors of business economy that witnessed downturn. In a sense this is a dichotomy if we listen to the business sector. Basically, medium and large business experienced a tight situation in sustaining the operations while cottage and small business seem to operate on a limited threshold. As such the banks turned to the consumers who could spend as the country was receiving foreign remittances, though the consumer loan was the domain of finance companies. But a rise in the consumer loan had only a limited effect in lowering the liquidity of the banks.

At the core of FSR was rescuing of the largest two banks RBB and NBL. The reform has brought about system improvement in these banks in terms of operating policy and procedures defined and refined, rationalisation and capacity building of branches and staff. RBB was able to increase deposits and maintain

the credit level while NBL maintained the deposit level but had a fall in credits. FSR gave them the efficiency but could not stop their share in total banking business falling from almost half to quarter of the total banking sector operations.

Issues at stake are correcting negative capital base as foremost. Injecting capital and management succession and ultimately doing away with government ownership are major challenges ahead. The private banks on their part expect that they be meted with equal treatments vis-à-vis government owned banks. They are however appreciative of BAFIO/BAFIA, improvement in NRB's regulatory oversight and supervision system improvements and some restrictions lifted on foreign ownership, and mandatory credits. Borrowers of the banks feel that, with the reform, responses to customers demand are getting better though collateral oriented approach predominantly still occupy their mindset. There has not been change on the time taken by the banks following the first response, but majority are satisfied as it is much more comfortable to deal with the bank now. They however want change for an easier loan as they feel the banks could have done better in respect of competitive services with flexibility and business based approaches.

Business community at large are critical of the way FSR wanted to handle the defaulters through blacklisting and auctioning without segmenting the market failure case from fraudulent ones, and without considering what should make the business get going in a proactive manner. Banks are acting for their own interest in total disregard for a partnership approach. The community feels that apart from improvement seen in the layout and streamlining of their own wrongdoings, there is virtually no difference in dealing with the banks. There are ample scopes

of promoting business ventures but the question of proactive and business friendly and risk daring financial sector remains unanswered.

NON-PERFORMING LOANS :

The existence of banks and non-bank financial institutions in a formal and organized way is collectively known as the financial system. The banking system is made up of commercial banks and investment banks. Commercial banks are primarily in the business of accepting deposits and extending credits. The non-banking financial institutions comprise of development banks, finance companies, saving and credit unions, building societies, discount houses, leasing companies, mortgaged companies, insurance companies, pension funds, and provident funds. Banks are among the most important financial institutions in the economy.

At the beginning of the 1980s when financial sector was not liberalized, there were only two commercial banks namely Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB) and two development banks namely Agricultural Development Bank (ADB) and Nepal Industrial Development Corporation (NIDC) performing banking activities. There were no micro-credit development banks, finance companies, cooperatives, and NGOs with limited banking transactions. Finance company was established only in 1992 AD whereas micro-credit development bank was established in 1993 AD in Nepal. Similarly, NRB licensed cooperative and NGOs were established in 1994 AD. There are 32 commercial banks, 87 development banks, 79 finance companies and 21 micro-finance development banks till April 2012. There has been a rapid growth of financial institutions in Nepal over the last two and half decades.[14]

Non-performing loan is taken as a default or close to being in default. Many loans become non- performing after being in default for three months but this can depend on the contract terms. A loan is non-performing when payments of interest and principal are past due by 90 days or more. Loans become non-performing when it cannot be recovered within certain stipulated time that is governed by respective laws.

The non-performing loans (NPL) of financial institutions are considered as a significant issue in the context of Nepal for last few decades. The immediate consequence of large amount of NPLs in the banking system is bank failure. Many researches on the cause of bank failures find that asset quality is a statistically significant predictor of insolvency and that failing banking institutions always have high level of non-performing loans prior to failure.

There is no standard form to define non-performing loans globally. Variation may exist in terms of the classification system, the scope, and contents as per country. As a regulatory financial institution of Nepal, the central bank i.e. Nepal Rastra Bank has classified the loan basically into the pass loan, sub-standard loan, doubtful loan and loss or bad loan. Pass loan is that type of loan whose interest or principal payments are less than three months in arrears. Sub-standard loans whose interest or principal payments are longer than three months in arrears of lending conditions are eased. Doubtfulis liquidation of outstanding debts appears doubtful and the accounts suggest that there will be a loss, the exact amount of which cannot be determined. Loss loansare regarded as not collectable, usually loans to firms which applied for legal resolution and protection under bankruptcy laws. Pass loans are under the category of

performing loans whereas sub-standard loan, doubtful loan and loss loan are under the non- performing loans.

The Status of NPL of Commercial Banks:

The average proportion of non-performing loan to total outstanding loan of commercial banks reached to 3.20 percent in mid-July 2011 from 2.39 percent in mid-July 2010. Out of three major public banks in Nepal, Rastriya Banijjya Bank (RBB) has higher average NPL as compared to Nepal Bank Limited (NBL) and Agriculture Development Bank (ADB). But the standard deviation of NBL is higher that reflect greater degree of risks factors. Similarly, NBL has greater range of non-performing loans that shows the higher variability. The ADB has low level of NPL that indicates sound banking efficiency among the major public banks in Nepal.

Table : 3

Non-performing Loans of Three Major Public Banks[15]

	NBL (%)	ADB(%)	RBB (%)
Mean	27.42	12.65	34.58
Std. Deviation	24.31	5.34	19.82
Range	58.19	12.37	49.23
Minimum	2.28	8.22	10.92
Maximum	60.47	20.59	60.15

Source: Banking and Financial Statistics, Various Issues of NRB and authors' calculation.

The commercial banks have very huge percentage of NPL in 2002 that reflects the very serious problem in the banking sector. This situation has been

occurred due to greater degree of NPL of two major public banks i.e. NBL and RBB. It is obvious from the figure that the level of NPL has been decreased in each year till 2010. But the NPL have been increased by 0.81% in 2011. However, NPL of commercial banks has been below 5% level during the last three years. The reason behind the substantial reduction of NPL in the commercial banking sector is due to the implementation of financial sector reform program (FSRP).

The non-performing loans of each commercial bank have been analyzed. RBB has the highest percentage of average NPL(34.58%) whereas NBL(27.42%) ranks in the second position. NBBL(19.94%), NCC(16.11%), ADB(12.65%), LBL(12.34%) and HBL(5.65%) have more than 5% average NPL. Out of them, public banks have very serious condition of average NPL and few private banks have also high degree of average NPL. Rest of the commercial banks have lower level of average NPL that shows better status of NPL as well as the efficiency of commercial banks.

Table : 4

Non-performing Loans of Commercial Banks in Nepal[16]

	Mean (%)	Std. Deviation (%)	Range (%)	Minimum (%)	Maximum (%)
NBL	27.42	24.31	58.19	2.28	60.47
RBB	34.58	19.82	49.23	10.92	60.15
NABIL	2.33	2.29	6.96	0.14	7.10
NIBL	1.94	1.30	4.34	0.46	4.80
SCBNL	2.21	1.58	4.26	0.54	4.80
HBL	5.65	2.94	7.92	2.16	10.08
NSBIBL	4.70	2.57	7.77	1.13	8.90
NBBL	19.94	11.06	37.99	1.77	39.76
EBL	1.02	0.67	2.04	0.16	2.20
BOK	3.97	2.90	7.49	1.18	8.67
NCC	16.11	12.63	37.39	2.71	40.10
NICB	4.03	5.72	18.74	0.56	19.30

LBL	12.34	8.62	30.03	0.96	30.99
MBL	2.54	3.06	10.22	0.28	10.50
KBL	0.97	0.41	1.30	0.40	1.70
LXBL	0.40	0.54	1.63	0.00	1.63
SBL	0.83	0.79	2.58	0.00	2.58
ADB	12.65	5.34	12.37	8.22	20.59
GBL	0.64	1.08	2.52	0.00	2.52
CBIL	0.30	0.58	1.17	0.00	1.17
PCBL	0.17	0.23	0.48	0.00	0.48
BOA	0.19	0.31	0.65	0.00	0.65
SUBL	1.24	1.59	3.44	0.00	3.44
DCBL	1.65	0.40	0.97	1.19	2.16
NMB	0.75	0.54	1.25	0.27	1.52
KIBL	0.39	0.52	0.99	0.00	0.99
JBL	0.00	0.00	0.00	0.00	0.00
MBNL	0.00	0.00	0.00	0.00	0.00
CTBNL	0.00	0.00	0.00	0.00	0.00
CBL	0.00	0.00	0.00	0.00	0.00
CCBL	0.00	0.00	0.00	0.00	0.00

Source: Banking and Financial Statistics, Various Issues of NRB and authors' calculation.

The production sector seems to be the highest credit priority of commercial banks because it has the maximum amount of credit outstanding as compared to the other sectors. The wholesalers and retailers, other sectors and Construction are under the second, third and fourth position in terms of greater amount of credit outstanding. The commercial bank has provided the lower average credit outstanding to the local government sectors.

Table : 5

Sector wise Credit Outstanding of Commercial Banks (Rs. Millions)[17]

Sectors	Minimum	Maximum	Mean	Std. Deviation
Agriculture	3734.50	15784.30	10939.69	4993.14
Mines	336.60	2204.80	1215.33	782.02
Production	42910.50	115186.00	70981.36	24136.38
Construction	2729.20	51590.80	25368.07	19604.66
MPMETF*	1430.10	6534.60	3676.58	2261.88
TEPF**	1359.80	12013.80	5230.31	3774.69
TCPS***	6523.40	22276.00	13884.39	5587.59
Wholesalers & Retailers	27555.30	109211.50	55802.74	27989.10

FIFA****	4250.30	57934.20	23918.17	21339.44
Service Industries	12212.50	36504.90	20508.44	8146.74
Consumable	3364.60	22694.90	10503.24	7676.86
Local Government	0.00	3087.70	685.68	1141.19
Others	12371.50	77695.60	40842.58	27292.84

*Metal, Productions, Machinery & Electrical Tools & Fittings
**Transportation, Equipment Production and Fittings
***Transportation, Communication and Public Services
****Finance, Insurance and Fixed Assets
Source: Banking and Financial Statistics, Various Issues of NRB and authors' calculation

The correlation of commercial banks with different indicators has been presented. The correlation between total gross loans and non-performing loans is significant at the 0.01 level. There is inverse relationship between TGL and NPL of commercial banks during the study period. As the size of TGL has been increased, the level of NPL has been decreased.

Table : 6

Correlations of Commercial Banks with Different Indicators[18]

	Total Gross Loans	Non-performing Loans	Net Profit
Total Gross Loans	1	-.879**	0.753
Non-performing Loans	-.879**	1	-0.576
Net Profit	0.753	-0.576	1

**Correlation is significant at the 0.01 level (2-tailed).
Source: Banking and Financial Statistics, Various Issues of NRB and authors' calculation

The Status of NPL of Development Banks:

The average proportion of non-performing loan to total outstanding loan of development banks reached to 4.25 percent in mid July 2011 from 1.5 percent in mid July 2010. Total amount of NPL at the end of mid July 2011 is Rs. 37,771 million. The Nepal Industrial Development Corporation (NIDC) has very worst situation of NPL i.e. 71.81%. Similarly, GorkhaBikas Bank Limited (GBBL) is

another problematic development bank that has 50.69% NPL. United Development Bank Limited (UDBL), Public Development Bank Limited (PDBL) and ViborBikas Bank Limited (VBBL) have 12.98%, 9.07% and 6.46% NPL respectively. Remaining all development banks has less than 5% NPL.

The correlation between total gross loan (TGL) and NPL of development bank is significant at 0.01 level of confidence. The TGL and NPL are highly positively correlated with each other. As the size of total gross loan is increased, the NPL has been also increased. There is positive relationship between TGL and NPL of development banks.

Table : 7

Correlation of Development Banks with Different Indicators[19]

	TGL	NPL
TGL	1	.995**
NPL	.995**	1

**Correlation is significant at the 0.01 level (2-tailed).

Source: Banking and Financial Statistics, Various Issues of NRB and authors' calculation

The Status of NPL of Finance Companies:

The average proportion of non-performing loan to total outstanding loan of finance companies reached to 5.43 percent in mid-July 2011 from 1.54 percent in mid-July 2010. Total amount of NPL at the end of mid July 2011 is Rs. 47,285.95 million. Nepal Share Markets and Finance Ltd. hasthe highest degree of NPL i.e53.30%. Similarly, Peoples Finance Ltd. (36.29%), Investa Finance Ltd. (28.47%), Hama Merchant and Finance Ltd. (24.29%) and CMB Finance Ltd. (21.11%) have higher NPL that reflects poor efficiency of the financial institution. The Multipurpose Finance Co. Ltd (10.23%), World Merchant

Banking & Finance Ltd. (8.16%), Lalitpur Finance Co. Ltd. (7.79%), Mercentile Finance Co. Ltd. (7.34%), Janaki Finance Ltd. (6.51%) and Gorkha Finance Ltd. (5.18%) have more than 5% NPL. Other remaining finance companies have less than 5% NPL.

The correlation between TGL and NPL is significant at the 0.01 level. There is perfectly positive correlation between TGL and NPL of finance companies.

Position of Major Financial Institutions:

Commercial banks' share has reached to 78.7 percent in deposit while lending has reached 73.5percent of the total banking activities by July 2011. The development banks are ranked in second position in the sense of market share of total deposit and total lending. It means that the development banks have 11.1% market shares of total deposit where as it has 12.4% market shares of total lending. But finance companies have been ranked in third position that occupy 9.8% market share of total deposit and 12.1% market share of total lending in mid July 2011. Micro-finance development banks and other institutions occupy 0.4% of market share of total deposit and 2% market share of total lending.

Table : 8

Non-performing Loans of Major Financial Institutions[20]

	Range (%)	Minimum (%)	Maximum (%)	Mean (%)	Std. Deviation (%)
Commercial Banks	28.01	2.39	30.40	13.96	10.65
Development Banks	3.78	1.51	5.29	3.55	1.51
Finance Companies	6.88	1.54	8.42	5.03	2.66

Source: Banking and Financial Statistics, Various Issues of NRB and authors' calculation.

The average non-performing loan of commercial bank is very high as compared to development banks and finance companies. It shows that the regulatory body should give proper emphasis over the commercial banks for the reduction of high level of NPL. There is still scope of reduction of NPL of commercial banks because the trend of NPL has been decreased in each year. It is suggested to the regulatory institutions to maintain the NPL below the international level of 5%.

Concluding Remarks:

The lending policies of banks and financial institutions have crucial influence on non-performing loans. Poor management and competency of financial institutions creates bad quality loans and therefore escalates the level of non-performing loans. There was significant level of NPL of major financial institutions till 2008. The trend of NPL has been decreasing each year up to 2010 but started again to increase from 2011.The recent scenario of NPL of overall financial institutions is around 5% and able to maintain the international standard, so the NPL and efficiency of Nepalese financial institutions can be taken as satisfactory. There is still scope of reduction of NPL if the financial institutions adopted sound lending policies and optimum portfolio management as directed by the regulatory authority.

Non-performing loans have been considered as a major hindrance of efficiency and growth of financial institutions. The regulatory body should develop an effective monitoring and regulation mechanism to reinforce financial institutions in Nepal.

The commercial banks in Nepal have increased tremendously in terms of number and total assets, deposit, investment and capital after the adoption of the liberal policy in 1980 towards the private sector, which lead to the effect of increased privatization, liberalization and globalization.

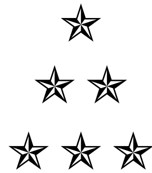
The Number of commercial banks were two before 1980s, which are now twenty (until the study period), and are 439 branch banks. It indicates that commercial banking is increasing rapidly in Nepal. The increase in size and number are limited only in the urban areas. Banking services are not easily accessible to the general public in Nepal and the people staying rural part of the country. The ratio of Deposit to GDP is found to be significant at 6,5% level to the growth rate of the GDP per capita, the parameter value is 0,74. The correlation analysis shows that these two variables are highly correlated with the coefficient equals to 0.49. This has proved our beliefs that the savings rate in a country is crucial to the economic development (GDP per capita), especially for developing countries.

The financial liberalisation index for Nepal has been constructed by including eight different policy measures implemented during the liberalization process. The liberalization index is based on principal component method and also takes into account the partial liberalisation policy measures. Previous studies failed to properly include this part. Most of the past studies either treated the partial financial liberalisation as the full liberalisation, or excluded it by taking only the full liberalisation date. This is misleading, especially during the impact evaluation. The financial liberalization index for Nepal shows that the decade of 1984 – 1994 was the period during which most of the financial liberalisation measures were implementation in Nepal.

REFERENCES :

1. Baltagi, B.H., Demetrides, P.O. and Law, S.H. (2009). Financial Development and Openness: Evidence from Panel Data. *Journal of Development Economics, p.65-68*
2. Ibid
3. Bhetuwal, K.R. (2007). Financial Liberalization &Financial Development in Nepal. *Economic Review*, 19, Nepal Rastra Bank, Kathmandu, Nepal, p.32-34
4. Ibid
5. Acharya, M. (2003). Development of the Financial System and Its Impact on Poverty Alleviation in Nepal Economic Review, Occassional Paper, Nepal Rastra Bank 15. p.112-114
6. Ibid
7. Baral JK (2005). Health check-up of commercial banks in the framework of CAMEL: A case study of joint venture banks in Nepal, J. Nepalese Bus. Stud. p.86-88
8. Adhikary, Ganesh P. 1989. "Deregulation in the Financial System in the SEACEN Countries." South East Asian Central Banks Research and Training Centre. Kuala Lumpur, Malaysia. p.75-76
9. Ibid
10. Ibid
11. Bhetuwal, K.R. (2007). Financial Liberalization &Financial Development in Nepal. *Economic Review*, 19, Nepal Rastra Bank, Kathmandu, Nepal. p.81-85
12. Ibid
13. Bloem, M. A. and Cornelis N. G. (2001). The Treatment of Non-performing Loans in Macroeconomic Statistics. IMF Working Paper, WP/01/209, p.64-67

14. Chowdhury and Shrestha (2007). "The Impact of Financial Liberalization on Welfare: Evidence from Nepal," Applied Econometrics and International Development. p.96-98
15. Banking and Financial Statistics, 1985 & 1990, NRB. p.45-54 & p.68-83
16. Ibid
17. Ibid
18. Ibid
19. Ibid
20. Ibid



ORGANISATION AND MANAGEMENT POLICY OF COMMERCIAL BANKS IN NEPAL

The General Body consisting of the representatives of the Nepal Rastra Bank, 32 commercial banks, five Regional Grameen Bikas Banks (GBBs), the Deposit and Credit Guarantee Corporation and the Nirdhan Utthan Bank Ltd is the supreme authority of the RMDC. Through Annual General Meeting, the General Body gives the overall policy guidelines and directions to the Board of Directors and the management for the smooth functioning of the Centre. It is responsible for approving audited financial statements, appointment of the auditor and fixing audit fee, selection of the Board of Directors, amendment required in the Memorandum of Association and Article of Association and other higher level policy decision of the Centre.

Board of Directors : The Board of Directors (BoDs) of RMDC is represented by seven non- executive directors - one representative from the Nepal Rastra Bank (NRB), the five other representatives of the commercial banks and one independent professional. The Chairman of the Board is elected from among the members of the BoDs which has four year term. The Board has collective responsibility to provide leadership to the Centre. It makes all policy decisions to pursue and implement the objectives of the organization. It is basically involved in making decisions with regard to business plan, approving

annual budget, financial and operational plan, large amount loan, regular monitoring of the performance, overseeing statutory and regulatory compliance and matters related to capital structure.

Audit Committee : The Audit Committee comprises of three non-executive directors. Normally, the Committee meets on quarterly basis and reviews internal audit reports, external audit reports, NRB Inspection reports, etc. The internal auditor submits the internal audit report directly to the audit committee. It also reviews the financial performance report of the Centre. The Committee provides necessary guidance to the management and suggestions to the Board of Directors for policy improvements.

ORGANIZATION STRUCTURE

Board of Directors

Audit Committe

Chief Executive Officer

Internal Audit Department

Microfinance Service Department

Supervision Department

Financial Management Department

Human Resource Management Department

Institutional & Social Development Department

Management Team : The Management team is responsible to carry out day-to-day activities of the Centre. The team is led by a Chief Executive Officer. He has responsibility for the overall performance and acts in accordance with the

authorities delegated by the Board. The Chief Executive Officer is supported by experienced and professional staff to carry out departmental functions. Including the CEO, RMDC has a total of 23 staffs -16 professional staffs and 7 support staffs; RMDC has maintained thin staffing from the very beginning of its operation and has maintained efficiency and cost effectiveness in its operation.

CORPORATE GOVERNANCE IN COMMERCIAL BANKS OF NEPAL :

Corporate governance is a combination of corporate policies and best practices adopted by the corporate bodies to achieve its objectives in relation to their stakeholders. It is also the field of economics, which studies the many issues arising from the separation from ownership and control. The fundamental objective of corporate governance reforms is to enhance transparency and transparency enhances accountability. It is widely recognized that transparency enhances trust among the major players within the governance framework. Various definitions and principles have been introduced to stabilize the corporate governance among corporate entities.[1]

Corporate governance is a set of process a entity's culture, policies, laws and institutional value that affect the way a corporation is directed, administrated or controlled. It is a combination of corporate policies and best practices adopted by corporate bodies in achieving its objectives in relation to their stakeholders. It aims to protect shareholder’s rights, to enhance disclosure and transparency, to facilitate effective functioning of the board and to provide an efficient legal and regulatory enforcement framework. It addresses the principal/agency problem through a mix of company law, stock exchange rules and sub regulatory codes. It arises from high profile corporate scandals, globalization and increased investor activism.

Corporate governance is equally significance to all types of corporate institution. Furthermore it is very crucial and essential element for the banking system because bank and financial institutions depends on the Other Peoples Money (OPM). There may be a gap among major stakeholder like owners, depositors and management. Very limited people have a right to access in resources and decision. Due to the lack of transparency and adequate control mechanism, there may be the chance of vested interest and moral hazard problems. It is a universal fact that the higher degree of transparency contributes towards the maximizing shareholders value and ensuring the fairness to rest of the shareholders. Corporate governance also enhances performance of the corporation by motivating manager to maximize returns on investment, raising operational efficiencies and ensuring long- term productive growth.

BIS (Bank for International Settlement) OECD (Organization of Economic Co-operation and Development) and other different financial institutions has developed and presented the various guidelines on enhancing corporate governance in banking sector but they do not diverge from each other, OECD focus on the following critical elements of desirable corporate Governance for the banks.

- Board members should be qualified for their positions, have a clear understanding of their role in corporate governance and be able to exercise sound judgment about the affairs of the bank.
- The board of directors should approve and oversee the bank's strategic objectives and corporate values that are communicated throughout the banking organization.

- The board of directors should set and enforce clear lines of responsibility throughout the organization.
- The board should ensure that there is appropriate oversight by senior management consistent with board policy
- The board and senior management should effectively utilize the work conducted by the internal audit function, external auditors, and internal control functions.
- The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, long-term objectives and strategy, and control environment
- The bank should be governed in a transparent manner.
- The board and senior management should understand the bank's operational structure, including where the bank operates in jurisdictions, or through structures, that impede transparency ("know-your structure")

Existing Laws and Regulation :

Banking system of Nepal is gearing up for different business and economic environment. Nepal Government and central bank are working to develop transparent, competitive and strong financial sector. Till date, there have been several efforts towards building regulatory mechanism for corporate governance. Among those several efforts following are the acts and regulations, which provide necessary guidelines to maintain corporate governance in the banks.

- Banks and Financial Institutions Act 2063
- Directive 6 issued by the NRB
- Companies Act 2063

Banks and Financial Institutions Act 2063 (BAFIA 2063)

(i) Conflict of Interest and Transparency

- Section 48-Restriction to give loans to promoter, director, executive officer etc
- Restriction on dealing with shares by the directors, Officers of the Bank(s.11)
- Disclosure requirement for directors regarding conflict in appointment of auditors, shareholding by family members, transactions between bank and family members (s.22)
- Directors not to take personal benefit (s.24)
- Disqualification of auditors and duty of the auditors (s.61 and s.63)
- Remuneration of directors to be as provided in the articles of association (s.21)

(ii) Competent Key Personnel

- *Qualification of directors and chief executive officers (s.18,s.26)*
- *Requirement to appoint professional director(s.13)*

Code of Conduct for Directors

- Directors should not interfere in day-to-day operation of the financial institution.
- If there is a conflict, director needs to inform the board before assuming office.
- Directors should not involve in any activity which is against the interest of the company (conflict of interest)
- Chief executive should work fulltime.
- Directors of one deposit taking institution cannot act as director of other FI.

- Director Can not act as custodian or trustee of any of the customer
- Director shall not misuse its position and should deal fairly
- Director should keep up to date and accurate record of accounts and reports
- Director should not use or misuse information received from clients for person benefit
- Outlines the duties and responsibilities of the directors
- Provides additional disqualification for the appointment of chief executive directors
- Provides for code of conduct to be followed by the chief executive and other employees.

Audit Committee

- ➢ Headed non executive director
- ➢ Outlines responsibilities of the audit committee

(i) Conflict of Interest and Transparency

- ➢ Requirement to give beneficial interest on the shares(s.47)
- ➢ Information required to be given on becoming substantial shareholder (s.50)
- ➢ Shareholders having conflict are not qualified to vote in general meetings(s.70)
- ➢ Director required to give information about transaction between company and him/her or close relatives (s. 92)

- Approval of general meeting required to enter transaction between company and director/its close relatives (s.93)
- Restriction on power of board to enter certain transaction (s. 105)
- Restriction to give loans to directors and officers (s.101)
- Financial disclosures to the shareholders (s.109)

(ii) Directors

- Directors are made personally liable for any breach of the Act
- Directors have fiduciary duty to act in the best interest of the company (s.99)
- Directors are specific duty not to exceed their powers (s.103)
- Requirement to appoint independent directors by public companies (s. 86)
- Directors who breach reporting requirement under the Act are disqualified to become director (s.89)

(iii) Audit

- Listed companies having paid up capital of more than Rs. 3 crores need to have audit committee
- An auditor is disqualified to be appointed for three consecutive years.(111)
- A person working full time, or his/her partners are disqualified to be appointed as auditor (112)

(iv) Shareholders' Protection.

- Shareholder have right to inspect books of the company

- Shareholders can sue on behalf of the company.(s.140)
- Shareholders can request to appoint investigation officer (s.121)
- Can prevent directors from exceeding their powers.(s.138)

Before discussing the corporate governance of the Nepalese Banking system, it is necessary to consider the adverse political situation of past two decades. Adverse conflict system of the past hindered to develop transparency and system efficiency in government as well as private sectors. Frequently changed government and different political unrest keep different anomalies (problem) in governance issues. But, now, the Nepalese economy is rapidly integrated with global economy with its outward oriented policies followed by membership of WTO, SAFTA and BIMSTEC. Besides this banking system of Nepal is gearing up for different business and economic environment with second phase of financial sector reform program. Nepal Government and central bank are working to develop a transparent, competitive and strong financial sector.[2]

In conclusion corporate Governance is very crucial for each and every organization. Corporate Governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company and the shareholders. Good corporate Governance should provide proper incentives for the board and management to pursue objectives in the interest of the company and shareholders and should facilitate effective monitoring. The responsibility for good governance lies within the bank's and FIs' senior management. Regulators can only facilitate but not ensure improved governance.

EXISTING RULES AND REGULATIONS RELATING TO THE BANKING SECTOR

Followings are the requirements for establishing a new commercial bank in Nepal :

- To establish a new commercial bank of national level, the paid up capital of such bank must be at Rs. 1000 million.
- To have an office in Kathmandu, the bank is required to have either joint venture with foreign banks and financial institutions or a technical service agreement (TSA) at least for three years with such institutions.
- In general, the share capital of commercial banks will be available for the promoters up to 70 percent and 30 percent to general public. The foreign banks and financial institutions could have a maximum of 75 percent share investment on the commercial banks of national level. In order to provide adequate opportunity for investment to Nepali promoters in National level banks, only 20 percent of total share capital will be made available to general public on the condition that the foreign bank and financial institution are going to acquire 50 percent of total share.
- Banks that are already in operation and those who have already obtained letter of intent before the enforcement of these provisions have to bring their capital level within seven years, i.e., by 16 July 2009 as per this recently declared provision. In order to increase in the capital such increase should be at a rate of 10 percent per annum at the minimum.
- Banks to be established with foreign promoters' participation have also to be registered fulfilling all the legal processes prescribed by the prevalent Nepal laws.

- To establish the commercial banks in all the places in the kingdom other than in the Kathmandu valley, the paid up capital must be Rs. 250 million. In this case, the commercial banks to be established outside Kathmandu Valley, share investment of promoters and general public should stand at 70 percent and 30 percent respectively.
- Banks to be established outside Kathmandu Valley could be allowed to operate throughout the kingdom including Kathmandu Valley only on the condition that they have operated satisfactorily at least for a period of three years and they have brought their paid up capital level up to Rs. 1000 million and also fulfilled other prescribed conditions. Unless and until such banks do not get licence to operate throughout the kingdom, they will not be allowed to open any office in Kathmandu Valley.
- Of the total committed share capital, the promoters has to deposit in NRB an amount equal to 20 percent along with the application and another 30 percent at the time of receiving the letter of intent on the interest free basis. The bank should put into operation within one year of receiving the letter of intent. The promoters have to pay fully the remaining balance of committed total share capital before the banks comes into operation. Normally, within 4 months from the date of filing of the application, NRB should give its decision on the establishment of the bank whether it is in favor or against it. If it declines to issue license, it has to inform in writing with reasons to the concern body.

Regarding Promoters Qualification:

- Action on the promoters' application will not be initiated by the Nepal Rasta Bank if it is proved that their collateral has been put on auction by

the bank and financial institution as a result of non-payment of loans in the past, who have not cleared such loans or those in the black list of the Credit Information Bureau and five years have not elapsed from the date of removal of their name from such list. The application will be deemed automatically cancelled irrespective of it being on any stage of process of license issuance if the above events are proved.

- Of the total promoters, one-third should be its Chartered accountants or at least a graduate of Tribhuvan University or recognized institutions with major in economics or accountancy, finance, law, banking or statistics. Likewise, at least 25 percent of promoters group should have the work experience of the bank or financial institution or similar professional experience.
- An individual, who is already serving as a director in one of the bank and financial institutions licensed by Nepal Rastra Bank, cannot be considered eligible to become the director in other banks or financial institutions.
- Stockbrokers, market makers, or any individual/institution - involved as an auditor of the bank and institution carrying on financial transactions - cannot be a director.

Regarding the Sale of Promoters' Share:

- Promoter group's share can be disposed or transferred only on the condition that the bank has been brought in operation, the share allotted to the general public has been floated in the market and after completion of three year from the date it has been registered in the Stock Exchange.

Prior to the disposal of such shares, it is mandatory to get approval from the Nepal Rastra Bank.

- The share allotted to the general public has to be issued and sold within three years from the date the bank has come into operation. Failing to fulfill such provisions, the bank cannot issue bonus share or declare and distribute dividends.
- Shareholders of the promoters group and their family members cannot have access to loans or facilities from the same institution. For this purpose, the meaning of the family members will comprise of husband, wife, son, daughter, adopted-son, adopted-daughter, father, mother, step-mother and depended brother and sister.

Regarding Branch Expansion Policy:

The Commercial banks established with a head office in Kathmandu will initially be authorized to open a main branch office in the Valley and thereafter, they will be authorised to open one more branch in Kathmandu Valley only after they have opened two branches outside Kathmandu Valley.

Existing Supervision relating to the Banking Sector:

Promotion of financial stability, development of safe and efficient payment systems, regulation and supervision of banking and financial system and the promotion of healthy and competitive financial system are some of the objectives of functioning of Nepal Rastra Bank.

Currently the Bank Supervision Department in Nepal Rastra Bank carries out the function of supervision of all commercial banks in Nepal. Since foreign banks have their presence only in the form of Joint Venture establishments – that

is in collaboration with the local entrepreneurs – Nepal Rastra Bank supervises foreign establishes in the same manner as it supervises other local banks. For the purpose of supervision, the department is required to prepare annual supervision plan for onsite examinations as well off site surveillance of the commercial banks. The same is to be approved by the Governor of the Bank.[3]

The Bank Supervision Department carries out both onsite examinations as well as off site surveillance of the commercial banks as per its annual supervision plan.

HUMAN RESOURCE MANAGEMENT IN NEPAL COMMERCIAL BANK:

Every year, the Bank determines the number of cadres on the basis of work load and future plans. The Bank has also recently prepared a Mid-Term HR Plan which is in the final stage of completion. This plan will forecast the need/demand and supply of human resources for the coming five years.

Recruitment and Placement:

The Bank has the policy of filling vacant positions either internally, externally and promotions based on performance. The percentage of recruitment from outside (open competition), internal competition and promotions are determined by the Staff By-Laws of the Bank. The Bank would make an open call for applications for external recruitment, conduct competency examinations and interviews to select the best candidate. For the internal recruitment, the Bank would also conduct examinations and interviews.

The Bank has a generalised recruitment policy, except for technical/ specialised departments and positions such as information technology, legal, and

other technical grades such as electrician, plumber etc. These general staff can be deployed or placed at any department.

Transfer/ Rotation:

Transfers or rotations are done on a needs based approach. Usually staff are transferred every 2-5 years or so, depending on the nature of the job. Likewise, the Bank seconds its staff for various assignments within the Bank as well as for other government bodies and international bodies such as the Ministry of Finance, Planning Commission.[4]

Performance Appraisal:

Every staff is evaluated biannually. Staff By-Laws have prescribed criteria for the appraisal. The Supervisor rates her/his subordinates on those criteria which will be reviewed by a committee and after approval, the ratings are kept confidential.

Promotion:

The Bank has set two paths for promotion - one is via internal competition and other is performance appraisal based promotion. Once a staff has completed a minimum period of service he/she becomes eligible for the competition. On the other hand, performance based promotion takes into consideration appraisal results, seniority, regional experiences (experience at branch offices) and academic qualification. The weightage of these factors are determined by the Staff By-Laws of Bank.

Training and Development:

Periodically, the Bank conducts a survey for training needs-assessment. On the basis of the needs-assessment and the invitations from international

organisations, staff are nominated to attend learning events. The Bank currently sends its staff mainly to the IMF, The SEACEN Centre, Asian Institute of Technology (AIT), SAARCFinance, etc for the overseas training. Meanwhile, the BTC conducts a survey for training demand annually to formulate its training calendar.

Remuneration and Benefits:

The Bank has a fixed schedule of remuneration which applies to all staff. There are also fixed benefit schemes for staffs such as housing loans, medical allowance, lunch allowance, various leaves, annual grades etc.

In the Bank's Organisation Structure (Annex 1), HRMD is in the Support Service Group, illustrating that HR initiatives in the Bank are mainly to ensure the availability of suitable manpower at right time in the core departments. Each department of the Bank has formulated their own strategies and action plan and based on these, departments have forecasted their HR needs in terms of numbers and qualification, which is further compiled and analysed as a whole in the HR Plan. The HR Plan also recommends the necesary future actions to meet the needs of the departments and provides information on issues such as the recruitment of the type of manpower, categories of HR which are overstaffed, necessary righsizing and so on.

Performance Management:

Performance management requires three things to be done: define, facilitate and encourage performance. It requires the constant willingness and commitment to focus on improving performance at the level of the individual or

team. Performance appraisal is a necessary, but not sufficient, part of the performance management process.

So far, the NCB is practicing a Performance Appraisal or Evaluation System whereby a superior officer rates her/his subordinates biannually, based on various indicators. This report with the individual's score is sent to the relevant department heads and ultimately to HRMD. The scores are kept confidential by the Recruitment Division of HRMD and are used when necessary for decisions on promotions.

The superior officers do not assign a set of goals for the subordinates in advance at the start of the year and they also do not agree officially on the goals. Usually, duties are assigned by the supervisors to the subordinates as and when they need to be accomplished. In such circumstances, supervisors rate the subordinates using indicators such as knowledge possessed by the individual, punctuality, diligence, loyalty, etc.

Therefore, while the Bank has a system which evaluates the individual, the performance of the staff is not managed. As the Bank lacks a performance management system, the indicators that are used to rate an individual are not the right Key Performance Indicators (KPI). Indicators such as knowledge, punctuality, diligence, loyalty, attitude toward work, discipline, honesty, etc., are mainly personal attributes that do not measure the output aspect or goal attainment. In addition, due to the lack of a proper performance management system, the Bank lacks a proper performance based reward system, career management and suitable motivational system. This appraisal system which is anachronistic and not very effective, needs to replaced by a proper Performance Management System. [5]

Competency Based HR:

As a public institution, NCB's HR policies are highly influenced by the government's civil service policies. The Bank's HR practices are more general than competency based. The Bank currently, has a generalised recruitment and selection process; a single salary scheme applicable to all; fixed benefit packages; and blanket policies of transfers and promotions, all of which are traditional practices. The Bank therefore needs to update its HR practices to be more competency-based and a model of talent management also need to be adopted. It is obvious that to achieve the strategic objectives, the Bank needs to first identify the required competencies and then recruit HR to fill those competencies and manage them accordingly.

NCB's HR practices are guided by the philosophy of skill development as the major tool for enhancing productivity. The performance of any organisaiton depends on the performance of the individuals in the organisation. There are more than 1500 staff in NCB and their performance will govern the achievement of strategic objectives of the Bank. In light of this, proper HR management is imperative.

Risk Management Guidelines:

Banks are always faced with different types of risks that may have a potentially negative effect on their business. Risk-taking is an inherent element of banking and, indeed, profits are in part the reward for successful risk taking in business. On the other hand, excessive and poorly managed risk can lead to losses and thus endanger the safety of a bank's depositors. Risks are considered warranted when they are understandable, measurable, controllable and within a

bank's capacity to readily withstand adverse results. Sound risk management systems enable managers of banks to take risks knowingly, reduce risks where appropriate and strive to prepare for a future, which by its nature cannot be predicted.[6]

Nepal Rastra Bank laid significant emphasis on the adequacy of a bank's management of risk. Nepal Rastra Bank puts forward this document for the purpose of providing guidelines to all commercial banks on risk management systems that are expected to be in place. This document sets out minimum standards that shall be expected of a risk management framework. Overall risk management is of utmost importance to Banks, and as such, policies and procedures should be endorsed and strictly enforced by the senior management and the board of the Bank.

Risk Management Process:

For the purpose of these guidelines, risk refers to the possibility that the outcome of an action or event could bring adverse impacts on the bank's capital, earnings or its viability. Such outcomes could either result in direct loss of earnings and erosion of capital or may result in imposition of constraints on a bank's ability to meet its business objectives. These constraints could hinder a bank's capability to conduct its business or to take advantage of opportunities that would enhance its business. As such, managements of banks are expected to ensure that the risks a bank is taking are warranted.

Risk Management is a discipline at the core of every bank and encompasses all activities that affect its risk profile. It involves identification, measurement, monitoring and controlling risks to ensure that:

- The individuals who take or manage risks clearly understand it.

- The organization's Risk exposure is within the limits established by Board of Directors.
- Risk taking Decisions are in line with the business strategy and objectives set by BOD.
- The expected payoffs compensate for the risks taken.
- Risk taking decisions are explicit and clear.
- Sufficient capital as a buffer is available to take risk.

Each situation is unique, in terms of roles and capabilities of individuals and the structure, activities and objectives of the bank. Risk management practices considered suitable for one bank may be unsatisfactory for another. Because of the vast diversity in risk that banks take, there is no single prescribed risk management system that works for all. Moreover, in the context of a particular bank, the definition of a sound or adequate risk management system is ever changing, as new technology accommodates innovation and better information and as market efficiency grows. Each bank should tailor its risk management program to its needs and circumstances. To remain competitive, banks must adapt and constantly improve their process. A sound risk management system should have the following elements:

- Active board and senior management oversight
- Adequate policies, procedures and limits
- Adequate risk measurement, monitoring and management information system; and
- Comprehensive internal controls.

It should not be understood that risk management is only limited to the individual(s), who are responsible for overall risk management function. Business lines are equally responsible for the risks they are taking. Because the line personnel can understand the risks of their activities and any lack of accountability on their part may hinder the sound and effective risk management.

Risk Assessments and Measurement.:

Until and unless risks are not assessed and measured, it will not be possible to manage them. Further a true assessment of risk gives management a clear view of bank's standing and helps in deciding future action plan. To adequately capture banks' risk exposure, risk measurement should represent aggregate exposure of bank to both risk type and business line and encompass short run as well as long run impact on bank. To the maximum possible extent banks should establish systems/models that quantify their risk profile; however, in some risk categories such as operational risk, quantification is quite difficult and complex. Wherever it is not possible to quantify risks, qualitative measures should be adopted to capture those risks. The importance of staff having relevant knowledge and expertise cannot be undermined. Any risk measurement framework, especially those which employ quantitative techniques/model, is only as good as its underlying assumptions, the rigor and robustness of its analytical methodologies, the controls surrounding data inputs and its appropriate application.[7]

Risk Management Framework:

In any bank, support for crucial programs must come from the top. Each entity's senior management and governing board must set the bank's risk

appetite by establishing appropriate policies, limits and standards and ensuring that they are followed and enforced. Risks must be measured, monitored and reported to key decision-makers. Banks should institute a setup that supervises overall risk management at the bank. Such a setup could be in form of a risk manager, committee or department depending on the size and complexity of the bank. Ideally, overall risk management function should be independent from those who take or accept risk on behalf of the bank.

The complexity and formality may vary widely among banks; but they should have clear procedures for assessing risk and evaluating performance regularly. There must also be adequate accountability, clear lines of authority and separation of duties between business functions and those involved in risk management and internal control. Where individuals responsible for overall risk management function are involved in day-to-day operations, then sufficient checks and balances should be established to ensure that risk management is not compromised. Overall risk management function provides an oversight of the management of risks inherent in the bank’s activities. The functions are;

- Identifying current and emerging risks;
- Developing risk assessment and measurement systems;
- Establishing policies, practices and other control mechanisms to manage risks;
- Developing risk tolerance limits for Senior Management and Board approval;
- Monitoring positions against approved risk tolerance limits; and
- Reporting results of risk monitoring to Senior Management and the Board.

An effective risk management framework includes:

- Clearly defined risk management policies and procedures covering risk identification, acceptance, measurement, monitoring, reporting and control.
- A well constituted organizational structure defining clearly roles and responsibilities of individuals involved in risk taking as well as managing it.
- Banks, in addition to risk management functions for various risk categories may institute a setup that supervises overall risk management at the bank.
- Such a setup could be in the form of a separate department or bank's Risk Management Committee (RMC) could perform such function.
- There should be an effective management information system that ensures flow of information from operational level to top management and a system to address any exceptions observed. There should be an explicit procedure regarding measures to be taken to address such deviations.
- The framework should have a mechanism to ensure an ongoing review of systems, policies and procedures for risk management and procedure to adopt changes.

Each bank should develop a mechanism for assessing and reviewing its risk management policies, processes and procedures for individual risk elements, at a regular interval, based on the main findings of the monitoring reports and the results of analysis of developments arising from external market changes and other environmental factors. The results of such review should be properly

documented and reported to the Board for consideration and approval. Banks should carry out a self-assessment of its risk management framework for each risk element and assign appropriate rating as regards the quality of its systems and procedures.

Risk Management Guideline (RMG) :

The guideline at hand does not replace, rather supplements the existing regulations and guidelines. The guideline will become a focal point of reference for all requirements of the Nepal Rastra Bank for overall risk policy formulation and management. The guideline applies to the commercial banks in Nepal. It is not intended to be so comprehensive that it covers each and every aspect of risk management activity. This guideline provides minimum standard for the risk management practice to be exercised in the banks. A bank may establish a more comprehensive and sophisticated framework than that outlined in the guideline. This is entirely acceptable as long as all essential elements of the guideline are fully taken into account. The guideline is in line with internationally accepted risk management principles and the best practices. It is also aligned with the revised version of Core Principles for Effective Banking Supervision, which the Basel Committee published in October 2006. Core Principle on 'Risk Management Processes' mentions that "*banks and banking groups must have comprehensive risk management processes (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the bank".* Other relevant Core Principles (CP) includes credit risk (CP8), market risk (CP13) liquidity risk (CP14), operational risk (CP15) and

interest rate risk (CP16). Moreover, principles set for the specific risk categories (Credit, Market, Operational, and Liquidity).[8]

The types and degree of risks an organization may be exposed to depend upon a number of factors such as its size, complexity, business activities, volume etc. This guideline covers the most common risks of Nepalese commercial banks; mainly Credit Risk, Market Risk, Operational Risk and Liquidity Risk. Depending on the nature and size of business, banks can introduce several stringent measures for the efficient risk management.

There are several risks like; strategic risk, reputation risk, legal risk etc. which can be measured in terms of qualitative criteria. Banks risk management process should incorporate all the risks associated with its business activities. This guideline presents the broader principles and concepts for the risk management in banking business. It provides minimum standard as well as general guidelines to encourage banks for directing their efforts towards stringent measures for risk management. Only objective of the RMG is to contribute towards maintaining and improving financial safety and soundness through better risk management practices in the banks.

Managing Credit Risk :

Credit risk is the likelihood that a debtor or financial instrument issuer is unwilling or unable to pay interest or repay the principal according to the terms specified in a credit agreement resulting in economic loss to the bank. Credit risk also refers the risk of negative effects on the financial result and capital of the bank caused by borrower’s default on its obligations to the bank.

Credit risk is the major risk that banks are exposed during the normal course of lending and credit underwriting. Credit risk arises from non-performance by a borrower. For most banks, loans are the largest and most obvious source of credit risk; however, credit risk could stem from activities both on and off balance sheet. It may arise from either an inability or an unwillingness to perform in the pre-committed contracted manner. In a bank's portfolio, losses arise from outright default due to inability or unwillingness of a customer or counter party to meet commitments in relation to lending, trading, settlement and other financial transactions. Alternatively losses may result from reduction in portfolio value due to actual or perceived deterioration in credit quality.

Credit risk comes from a bank's dealing with individuals, corporate, banks and financial institutions or a sovereign. Credit risk does not necessarily occur in isolation. The same source that endangers credit risk for the bank may also expose it to other risk. For instance a bad portfolio may attract liquidity problem.

This section presents fundamental credit risk management policies and practices that are recommended for adoption by the banks. The guideline outlines general principles that are designed to govern the implementation of more detailed lending procedures and practices within the banks. A typical Credit risk management framework in a bank may be broadly categorized into following main components;

- Board and senior Management's Oversight
- Organizational structure
- Systems and procedures for identification, acceptance, measurement
- Monitoring and control risks.

Managing Market Risk:

Market risk refers to the risk to a bank resulting from movements in market prices, in particular, changes in interest rates, foreign exchange rates, and equity and commodity prices. Market risk is defined as the risk of losses in on and off-balance sheet positions arising from movements in market prices. The risks subject to this requirement are:

- the risks pertaining to *interest rate related instruments* and *equities* in the trading book;
- *foreign exchange risk* and *commodities risk* throughout the bank.

Market risk exposure may be explicit in portfolios of securities/equities and instruments that are actively traded. On the other hand, it may be implicit such as interest rate risk due to mismatch of loans and deposits. Besides, market risk may also arise from activities categorized as off-balance sheet item. Therefore market risk is potential for loss resulting from adverse movement in market risk factors such as interest rates, foreign exchange rates, and equity and commodity prices.

Managing Liquidity Risk:

Liquidity risk is the potential for loss to a bank arising from either its inability to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable cost or losses.

Liquidity is the ability of an institution to transform its assets into cash or its equivalent in a timely manner at a reasonable price to meet its commitments as they fall due. Liquidity risk is considered a major risk for banks. It arises when the cushion provided by the liquid assets are not sufficient enough to meet its

obligation. In such a situation banks often meet their liquidity requirements from market. Funding through market depends upon liquidity in the market and borrowing bank's liquidity.

Liquidity risk can best be described as the risk of a funding crisis. Plan for growth and unexpected expansion of credit can be the main sources of such funding crisis. Banks with large off-balance sheet exposures or the banks, which rely heavily on large corporate deposit, have relatively high level of liquidity risk. Further the banks experiencing a rapid growth in assets should have major concern for liquidity.[9]

Managing Operational Risk:

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and system or from external events.

Rapid development in the pace of financial innovation is making the activities of bank and their risk profiles (i.e. the level of risk across an institution's activities and/or risk categories) more complex. A clear understanding of operational risk is critical to the effective management and control of this risk category.

Operational risk is the risk of negative effects on the financial result and capital of the bank caused by omissions in the work of employees, inadequate internal procedures and processes, inadequate management of information and other systems, and unforeseeable external events. Operational risk event types having the potential to result in substantial losses include:

- Internal fraud; for example, intentional misreporting of positions, employee theft, and insider trading on an employee's own account.

- External fraud; for example, robbery, forgery, cheque kiting, and damage from computer hacking.
- Employment practices and workplace safety; for example, workers compensation claims, violation of employee health and safety rules, organized labor activities, discrimination claims, and general liability.
- Clients, products and business practices; for example, fiduciary breaches, misuse of confidential customer information, improper trading activities on the bank's account, money laundering, and sale of unauthorized products.
- Damage to physical assets; for example, terrorism, vandalism, earthquakes, fires and floods.
- Business disruption and system failures; for example, hardware and software failures, telecommunication problems, and utility outages.
- Execution, delivery and process management; for example; data entry errors, collateral management failures, incomplete legal documentation, unapproved access given to client accounts, non-client counter party undue performance, and vendor disputes.

Operational risk is associated with the problems of accurately processing, settling, and taking or making delivery on trades in exchange for cash. It also arises in record keeping, processing system failures and compliance with various regulations. It is associated with human error, system failures and inadequate procedures and controls. It is the risk of loss arising from the potential that inadequate information system; technology failures, breaches in internal controls, fraud, unforeseen catastrophes, or other operational problems may result in

unexpected losses or reputation problems. Operational risk exists in all products and business activities.

CREDIT RISK MANAGEMENT AND FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN NEPAL:

The health of the financial system has important role in the country as its failure can disrupt economic development of the country. Financial performance is company's ability to generate new resources, from day-to-day operation over a given period of time and it is gauged by net income and cash from operation. The financial performance measure can be divided into traditional measures and market based measures. During the 1980's and 1990's when the financial and banking crises became worldwide, new risk management banking techniques emerged. To be able to manage the different types of risk one has to define them before on can manage them. The risks that are most applicable to banks risk are: credit risk, interest rate risk, liquidity risk, market risk, foreign exchange risk and solvency risk. Risk management is the human activity which integrates recognition of risk, risk assessment, developing strategies to manage it, and mitigation of risk using managerial resources whereas credit risk is the risk of loss due to debtor's non-payment of a loan or other line of credit. Default rate is the possibility that a borrower will default, by failing to repay principal and interest in a timely manner. A bank is a commercial or state institution that provides financial services, including issuing money in various forms, receiving deposits of money, lending money and processing transactions and the creating of credit. Credit risk management is very important to banks as it is an integral part of the loan process. It maximizes bank risk, adjusted risk rate of return by maintaining credit risk exposure with view to shielding the bank from the

adverse effects of credit risk. Bank is investing a lot of funds in credit risk management modeling. There is need to investigate whether this investment in credit risk management is viable to the banks.[10]

Credit risk management is crucial on the bank performance since it have a significant relationship with bank performance and contributes up to 22.6% of the bank performance. Among the risk management indicators, default rate management is the single most important predictor of the bank performance whereas cost per loan assets is not significant predictors of bank performance. Since risk management in general has very significant contribution to bank performance, the banks are advised to put more emphasis on risk management. In order to reduce risk on loans and achieve maximum performance the banks need to allocate more funds to default rate management and try to maintain just optimum level of capital adequacy.

IN NEPAL, DURING 1990S AND later many organizations faced major changes in competitive business environment. Before 1990s organizations such as those operating in the airlines, utilities, and financial sectors were either government owned monopolies or operated in a highly regulated and non-competitive environment. These organizations were not subject to any great pressure to improve the quality and efficiency of their operations or by eliminating services that were making losses. Some public enterprises were getting direct subsidies from government for equalizing their operational losses.

Privatization of some of the government owned enterprises and deregulation in early 1990s changed the competitive environment in Nepalese business environment. Large number of joint venture commercial banks and development banks were established and the process is being continued.

Commercial banks play significant role in the economic development in the nation. In Nepal 32 commercial banks are in operation and providing services to the business and industries through long-term and short-term loans and facilitating business for foreign ex- change and remittance via national and international network. The development of banking system in Nepal was emerged after the liberalization and free market concept. In the beginning of 1980s, private commercial banks came into operation in collaboration with foreign banks. It took pace after 1990s and number of financial institutions has been increased. All the newly established commercial banks tired to operate efficiently and effectively resulting high competition in Nepalese banking industry.

In order to keep activities of the organization in track a management control system is essential. Control in the broad sense of the term relates both organizational structure (Chandler 1962) and informal process (Cyert and March 1963). Management control system a logical integration of techniques to gather and use information to make planning and control decision, to motivate employees behavior, and to evaluate performance. It is the process by which managers assure that resources are used effectively and efficiently in the accomplishment of the organization's objectives' - in other words control using both financial and non-financial objectives. It is specifically concerned with the process by which managers influence other members of the organization to implement the organizational strategies.

A control system is a set of formal and informal systems that designed to asset man- agement in steering the organization towards the achievement of its purpose by bringing unity out of the diverse efforts of subunits and individuals.

The formal system and informal system are independent but they are highly interrelated, indistinguishable, subdivision of control system. Formal system makes possible the delegation of authority. Formal documentation of structure, policies, and procedures assist members of the organization in performing their duties. An effective set of formal control includes three major mechanism-operational plans, performance measurement systems, and feedback mechanism.

Banking industry is high-risk business but not necessarily high profit industry. It is quite difficult to manage risk and return in banking industry. The internal management system in some of the commercial banks of Nepal is inebriated from traditional management system of government. The pyramid shape organizational structure of some banks caused adverse effect in their business development. Modern economy entered into information age. Competitive business environment in banking industry also caused lateral movement of human resources. The traditional management theory could not completely fit the operational environment in banking business in Nepal.

Competitive Environment in Nepalese Commercial Banking Sector: The degree of competition in Nepalese commercial banking sector is very high. The majority (76.9 percent) managers of the branches of the commercial banks of Nepal feel intense competition. The commercial banks of Nepal are competing mainly on service followed by the cost and other factors respectively.

Generic Strategy of Nepalese Commercial Banks: The generic strategy of Nepalese commercial banks has been divided for two main areas of business: deposit and lending. The different branches of the same commercial banks at the different geographical location are adapting different strategy. Around fifty two percent branches of commercial banks are concentrating on differentiation

strategy and 47.4 percent are following focus strategy to attract the depositors. In case of lending, majority of branches (52.6 percent) of such banks are adapting differentiation strategy followed by focus (42.1 percent) and cost leadership (5.3 percent).

Services Offered by Nepalese Commercial Banks: Nepalese commercial banks have been offering number of services to their customers. The services are ranging from 3 to more than 25. The majority of such branches of commercial banks (42.3 percent) are offering more than 21 products. Similarly, 15.4 percent and 30.8 percent of such braches of commercial banks are offering 16-20 and 5-10 services respectively. Only few (11.5 percent) are offering 1-5 services to their customers. In order to compete in highly competitive environment, these banks are continuously introducing new services through their branches established at different places in the country. Majority (76.9 percent) of such commercial banks are introducing 3-4 services every year, and only 11.5 percent of such braches of the commercial banks are offering 5-6 and 6-7 services every year.[11]

Marketing of New Services: Twenty-three percent branches of the commercial banks of Nepal promote their products/service very aggressively. Similarly, 30.8 percent and 46.2 percent branches promote/advertise their new services aggressively and normally respectively. The majority of the commercial banks branches are concentrating in maintaining (retaining) customers and only 28 percent of such branches are competing for customer acquisition.

Target Setting Practice: All the commercial banks of Nepal set target for their branches for the purpose of planning and controlling the activities. In majority (96.2 percent) of the branches the target is fixed in terms of number of

clients, amount of deposit, and the amount of lending. Only in few (3.8 percent) braches the target is fixed in other terms. Concerning to individual level, 83.3% employees responded their banks set target for them and only 16.7% responded they don't get any target for their performance. Out of the individuals who think their bank set target for them, 95.4% feel the target is clearly communicated to them and only 4.6% feel that the target is not clearly communicated to them.

Performance Measurement: All commercial banks compare actual performance with predetermined target of their braches frequently. Coming to the individual level, 65.4 percent respondents feel their actual performance is compared with predetermined target and remaining do not know whether their actual performance is compared with standard or not. The managers of different commercial banks still desire to evaluate the performance of their banks and branches on the basis of net profit margin. After net profit margin they tend to support ROE, ROI, EVA and others (including the degree of NPA) respectively.

Reward System: Employees in any organization work for reward, and most important reward is money, but individual expect more than wages or salary from their employees. In Nepalese commercial banking sector, salary/benefit/pro- motion is mostly determined by performance followed by education, experience, relationship, and other factors respectively.

Regarding additional benefit for better performance (performance higher than the standard), 53.8 percent responded they get additional benefit for better performance. Seventeen percent respondents say they don't get any additional benefit for better performance and 28.2 percent did not provide any comment on this dimension. Majority of commercial banks are providing bonus to their employees out of profit. The amount of bonus is based on the amount of salary

the employees are getting. It indicates that the bonus is not based on the outstanding performance of an employee or a group of employees.

KNOWLEDGE MANAGEMENT IN BANKING INDUSTRY :

The growth of banking sector in Nepal is much better compare to other sectors in the country. The economic reforms initiated by the government more than one and half decade ago have changed the landscape of several sectors of the Nepalese economy including the banking industries. The banking industry is vigorously increasing in the country since the introduction of liberalization in the beginning of 1980s and its reform policy in 1990s. Over the past 20 years, Nepal's banking industries have grown rapidly. Interms of both business volume and assets as well as market. But due to the absence of proper knowledge management practices and reducing number of banking professionals, there may arise complex situation and it is because of liberalization and reforming finance sectors.[12]

It is really a challenging job since new banks enter each day and WTO rules will soon inject stiff competition. Thus, a bank must be sure of its position in the competitive market and of its business strategies for defending and gaining current market share under complex situation. So to be the best and to sustain in the market, human resource through Knowledge Management Strategy effective application with upgrading capability is required.

- Nepalese banks use computer as the major mode of knowledge transfer and have intranet facilities but they are not very effective for the organizations to use them to give remarkable output. The employees are encouraged to attend trainings, seminars, and conferences in Nepalese banking Industry. It is also found that there is a culture of encouraging

interactions among employees in Nepal banking sector. Also, it does have reward system to encourage such employees for knowledge transfer among workers.

- Nepalese banking organizations have mission statement and written corporate strategy and focus on low-cost strategy to meet the particular customer needs. Also Nepalese banks have technological facilities but they should of still give more attention to bring technological change and developments the organizations to satisfy their customer's needs and sustain in competitive market place.
- In case of differentiation strategy, Nepalese banks put out innovated products or services frequently and their customers compose only a small portion of the broad clients/customers. Nepalese banks are hardly able to cover whole national market and give more attention on market information, knowledge transformation process, learning and sharing culture, training and development programs in Nepalese banking organizations.
- There is significant difference between corporate cost leadership strategy in private banks and public banks in Nepal. The private banks give more focus on technological leads than public banks, which helps private banks to satisfy customer needs through goods and services in low cost.
- In case of differentiation strategy, we have got significant difference between corporate differentiation strategy in Nepalese private and public banks. This is because the government of Nepal time and again tries to reform the policies in public banks and impose them in practices. So that,

the public banks may focus on getting more funding facilities for research and development programs, a wider range of market both in city and rural areas, and a variety of marketing policies to compete with adopted private banks.

This research work has mainly used two basic competitive strategies to explain the relationship between KM strategy and business strategy in Nepalese banking industries. The results may be different if additional business strategies and HR strategies are examined. Applying this to the measurement model could give further insights.

The Nepalese commercial banking sector is very competitive. The commercial banks are competing mainly in service in order to put in competitive position, majority of the branches of commercial banks have been adapting differentiation strategy. The response shows that different branches of the similar bank have adapted different strategy and few of the banks have followed more than one strategy at the same time. Majority of commercial banks are offering more than 21 services to their customers through different branches established at different geographical location. Most of the commercial banks (76.9 percent) are introducing 3-4 services in a year. When new services are offered 53.8 percent of them promote aggressively. The priority of the majority of Nepalese commercial banks is to retain customers whereas 28 percent of them are concentrating on customer acquisition.

All the commercial banks are applying the concept of management control system by setting target for their branch and at individual and comparing it with actual performance. The target for a branch is fixed in terms of number of clients,

amount of deposit and lending. Target is also fixed for the majority of the individuals.

All the managers of different branches of different commercial banks encourage employees to participate in decision-making process. But, according to employees, it is not clearly communicated to them. Commercial banks of Nepal are encouraging employees to upgrade their knowledge and skill as the benefit is based on educational qualification and training after performance, they provide paid leave to participate in training and for further education.

The working environment in Nepalese commercial banks is very congenial as the majority of the respondents (75 percent) felt that they get very much cooperation from their coworkers. The existence of informal organization and informal communication system are there in some of the commercial banks.

The effect of age, structure as a dummy variable for foreign joint venture, loan to assets ratio, non performing loans and log of assets is found to be insignificant for the efficiency. As expected, capital fund to risk weighted assets is found to be positively related with efficiency as banks are able to withstand any shocks in their balance sheet. The relationship between efficiency and profitability is positive which suggests that profitable banks are somewhat efficient. The coefficient of leverage as a ratio of debt to equity is positive and significant. Lower capital ratios in banking implies higher leverage and risk, hence, the results show that better capitalized banks exhibit better efficiency and productivity. Thus, profitable bank with high low leverage and higher risk weighted are found to be more efficient in Nepalese banking sector and bank loans seem to be more highly valued than alternative bank outputs i.e., investment and securities.

The empirical findings from this study suggest that the Nepalese commercial banks are not able to catch up to the frontier because of inefficient management practices and deterioration from the optimal size. Therefore, commercial banks need to focus more on management efficiency. Likewise, decline in scale efficiency suggests that banks could have been too small to reap the benefits of economies of scale. Therefore, from the policy making perspective, mergers, particularly among the small banking groups should be encouraged. This could entail the small banking groups to reap the benefits of economies of scale.

REFERENCES :

1. NRB (2010). Banking supervision annual report, Bank Supervision Department, Nepal Rastra Bank, Central Bank of Nepal. p.63-66
2. Ibid
3. Ibid
4. DeYoung, R. (1997), "X-Efficiency and Management Quality in National Banks." Journal of Financial Services Research, Vol. 15, No. 2, p.56-58
5. Ibid
6. Gajurel, D. "Market structure of Nepalese banking industry," Synergy: A Journal of Management (Faculty of Management, Tribhuvan University). p.41-44
7. Gajurel, D. "Cost efficiency of Nepalese commercial banks," Nepalese Management Review (Central Department of Management, Tribhuvan University). p.112-117
8. Ibid
9. Khatiwada, Y.R. (1994). *Some Aspects of Monetary Policy in Nepal*, South Asian Publishers Pvt. Ltd. New Delhi, India. p.86-93
10. Ibid

11. Karim, M. Z. A., Chan S. G. and Hassan S. (2010). Bank Efficiency and Non-performing Loans: Evidence from Malaysia and Singapore. Prague Economic Papers, p. 118-131.
12. Maskay, N. M.and Subedi S. R. (2009). Development of Nepalese Financial System: Need for the Formulation of a Master Plan. Economic Review, p. 31-51.

THE DEPOSIT MOBILISATION AND COMMERCIAL BANKS IN NEPAL

The first commercial bank [Nepal Bank Ltd.) was established in 1937 followed by the second (Rastriya **Bani**jya Bank) in 1966. In 1984, Nepal Arab Bank Ltd. came into existence in collaboration wi th a foreign bank and **,** at later dates , Nepal lndo-Suez Bank and Nepal Grindlays Bank were established on similar pattern. As on mid-July 1987 **,** there were 409 commercial bank branches operating in the country. In addition, there were 34 branches of the Agricultural Development Bank performing commercial ban king business.

The average population per bank branch was 43,000 , and if the Agricultural Development Bank branches performing commercial banking business were also taken into account, the figure would be 39 .000. The target is 30 .000 population per commercial bank branch by mid-July 1990. The numbers of branches of Nepal Bank Ltd. and Rastriya Banijya Bank form the bulk, viz. 213 and 190, respectively. Therefore, reforms in the activities of these institutions are all the more urgent.

The present study is confined to the following areas of commercial banking activities:

Deposit Aspect :

- Reforms in the deposit procedures
- Reforms in the system of depositing amounts and making payments, and
- Suggestions regarding introduction of new deposit instruments.

Credit Aspect:

- Reforms in gold and silver loans
- Reforms in pledge loans
- Reforms in hypothecation loans
- Reforms in documentary credit
- Reforms in large and medi um-si zed project loans , and
- Reforms in priority sector loans.

Miscellaneous Aspect:

- Reforms in government transaction activities
- Introduction of management information system
- Reforms in personnel administration
- Improvements in physical facilities
- Introduction of planning
- Reforms in reporting system
- Reforms in fund management. and
- Reforms in reconci1iation system.

Z- DEPOSIT ASPECT:

The total deposits with the commercial banks as at mid-July 1986 stood at Rs 10,315. 4 million. The total deposits with the banks on mid—July 1957 were just Rs 34.6 mill ion. Unification of the currency system, higher rates of interest , increased tendency on the part of the people to keep their assets in the financial

form and the increased number of bank branches have been the more important factors responsible for the upsurge in bank deposits . The growth rate of deposits has outpaced the increase of consumer prices. While the consumer price index increased from 100 to 361 during the period 1972/73 - 1985/86, the index of deposits went up from 100 to 1238.8 during the corresponding period. The ratio of current deposits to total deposits has come down 'From 67.1 per cent on mid—July 1957 to just 20.7 per cent on mid-July 1986. The ratio of current deposits to total deposits started to piummet more steeply after the hike in time deposit rates in April 1975. From one viewpoint, it is advantageous if the ratio of current deposits to total deposits remained high. But the commercial banks can not p1an their credit operations on a reasonable basis if they were to depend heavily on current deposits. So, another viewpoint is that commercial banks can p1an their credit operations with reasonable self-assurance if they were to rely more on time deposits. Commercial banks should strive to strike a balance between the cheaper deposits in the form of current deposits and cost deposit in that of time deposits. The ratio of current to total deposits is far higher in the newly-established commercial banks than in the other commercial banks. As no interest is payable on current deposits , the choice of bank on the part of current account-holders is mainly determined by the quality of customer service.[1]

The ratio of deposits to gross domestic product is an indicator of banking development. In 1974/75, the ratio of total deposits to gross domestic product stood at 7.08 per cent and that of time deposits to gross domestic product at 4.16 per cent. The ratio of total deposits to gross domestic product stood at 20.68 per cent and that of time deposits to gross domestic product at 15.87 per cent in 1985/86. The trend of higher growth of time deposits in comparison with current

deposits can be cited as an example of contribution of the banking system towards the mobilization of savings. Banks can do a lot more in this regard.

In September 1985, deposits per bank employee amounted to Rs 649 thousand. There is thus strong need-for introduction of modern work practices and on— going reforms in order to improve the per employee deposit figure to a satisfactory level .

Commercial banks are the repositories of the confidence of numerous depositors. A commercial bank that invites even the slightest doubt of the depositors invites troubles for itself. Therefore . improvement on measures to mobilize deposits by inspiring confidence in the new and existing customers of Commercial banks should be a continuous process. Accordingly, the higher management of a commercial bank should inspire confidence in the mind of depositors.

The capital -deposit ratio is an important indicator to determine the position of a bank. It was time when in the USA capital -deposit ratio of 10 per cent was regarded as necessary. The overall capital-deposit ratio in Nepal is 2.9 per cent. This ratio is high in respect of newly—opened banks , but low in that of other banks. Individual banks with inadequate capital -deposit ratio should stop distributing dividends until the ratio goes up to respectable levels. They should also take recourse to general capital increase by augmenting share capital.

It was found that 20 per cent of the fixed deposits in two main Kathmandu branches of Nepal Bank Ltd. and Rastriya Banijya Bank was accounted for by deposits amounting upto Rs 50.000. Similarly, deposits upto Rs 40,000 accounted for 7. 13 per cent of the total deposits in the main {Kantipath} branch

of Nepal Arab Bank Ltd . , Nepal Indo-Suez Bank and Nepal Grindlays Bank. Considering these factors, it is suggested that Rs 40,000 - 50.000 be fixed as the cut' off point for deposit. In some countries such as India, central banks have opened subsidiaries to insure deposits. In other countries such as the United States , independent institutions have been established to perform this function. In Nepal , there is an organization called the Credit Guarantee Corporation. Its capital base should be strengthened if the business of deposit were to be assigned to this institution. However, it is better if Nepal Rastra Bank and commercial banks acted in unison and established a separate deposit. The premia on deposit should be paid by deposit-accepting banks as is the practice all over the world. The premia should be assessed at a rate of 0.04 per cent of the total deposits (including uninsured deposits) as is the practice in India.[2]

There is now at least one commercial bank branch in each of the 75 districts of the country. But the spread of bank branches is sparse in mountainous areas of the country. Similarly, rural areas are less endowed with bank branches. In such areas . banks themselves should try to reach the people. Mobile bank units should be established in those rural areas where there is availability of transport facilities. Such mobile units can perform deposit acceptance function. In those rural areas where there is no transport facility, banks can hire commission agents who would be paid on the basis of deposit accounts opened by the public on account of their efforts. These agents should be appointed by branch managers on the basis of guidelines issued by central offices of the banks.

People are quite cautious and particular about money matters. They prefer, banks that maintain secrecy to banks that are lax in such matters. There is a legal provision for secret accounts in Nepal also. There is a possibility of deposit

inflow from abroad if bank secrecy is strictly maintained. Rate of interest is an effective measure for mobilization of resource in the form of bank deposits. There was a considerable increase in deposits in respect of savings and fixed accounts following the hike in interest rates. The deposit rate at one time was upto 16 per cent in respect of two year deposits. However, there was a downward revision in interest rates in 1977 and the rate of interest on such deposits was lowered to 13 per cent. In 1985, this rate was slightly raised and placed at 13.5 per cent. Frequent changes in interest rates in devel0ping countries such as Nepal are undesirable and should be avoided. Customer service is also an important factor in the mobilization of deposits. It takes much time to deposit money in the banks. It takes still more time to withdraw funds from them. Besides, banks established in collaboration with foreign banks have to make further effort in attracting interest-bearing deposits. However, the Agricultural Development Bank is showing aggressiveness in respect of deposit mobilization. This bank has been offering more interest on savings deposits than what is being offered by other banks. Advertisement is also an effective measure for deposit mobilization. Promotional measures have a bearing on time deposit mobilization. In urban areas, all means of communications can be utilised for deposit mobilization. Personal contact by bank employees in general and branch managers in particular can be more effective than any other means of communication in the rural areas. The higher management of a bank should create conditions that would enable branch managers to participate in the promotional activities for deposit mobilization. Another means of deposit mobilization is tax exemption on interest from bank deposits. Presently, interest earnings upto Rs 5,000 are exempt from taxation. If the exemption limit is raised further up it will boost deposits.

Deposit Procedures:

Since May 1989, Nepal Rastra Bank granted some autonomy to commercial banks in regard to deposit rates and other conditions of deposits. Nepal Rastra Bank has prescribed the minimum rate of interest on savings act at 8.5 per cent, and commercial banks are free to offer interest above this rate. But only the Agricultural Development Bank has offered interest above this minimum rate. In the case of fixed deposits, Nepal Rastra Bank has prescribed that the rate of interest on three-month, six-month and nine-month deposits should not be less than 8.5 per cent, the rate of interest on one-year deposit should not be less than 12.5 per cent and the rates of interest on deposits with more than two- years' maturities should not be less than interest payable on one-year deposits. Accordingly, commercial banks have fixed interest on three—month, six-month and nine—month deposits at 8.5 per cent and more, interest on one-year deposits at 12.5 per cent and interest On two-year deposits at 13.5 per cent. The highest rate of interest on deposits is 14 per cent which is applicable to five-year maturity deposits. Agricultural Development Bank offers interest on fixed deposits at the same rates as offered by commercial banks but it does not accept deposits for more than two—years . There are also variations among the banks regarding the amounts of permissible daily and weekly withdrawal s from the savings accounts and the maximum amount on which interest is payable on savings accounts. There are also variations in regard to minimum sums required to open fixed deposit accounts . These variations between the banks regarding terms and conditions of deposits could be narrowed down and the rates of interest on deposits with more than two years' maturities could be higher than at present so that depositors are provided with further incentives to place their

deposits in accounts with longer maturities. The agricultural Development Bank may also accept deposits with longer than two -year maturities . The Bankers Association is also in a position to suggest harmonization of terms and conditions of deposits among the member banks.[3]

The existing rules of the banks do not allow for free transfer of deposits from savings to fixed deposit accounts . Because of the existing rules , savings account holders have to wait for specified periods only after which they can withdraw from their savings accounts and transfer the sums into fixed deposit accounts. Otherwise , they have to forego interest on account of such transfers. Banks should allow free transfer of deposits from savings to fixed accounts .

The Commercial Banking Act, 1974 has prescribed that particulars of accounts that have remained inoperative for ten years or more should be sent to Nepal Rastra Bank. To implement this provision of the Act, every depositor should be intimated about his account at an interval of six months. If accounts remain inoperative despite such intimations the particulars of such accounts should be sent to Nepal Rastra Bank after which such accounts should be treated at closed.

The number of depositors in banks established with foreign collaboration is not large. Nepal Arab Bank Ltd. has been able to attract depositors in its two and a half years' operation . The clients of banks opened with foreign collaboration are confined to richer and more educated strata of the society. Recognizing this constraint, they should try to refurbish their image by adapting themselves to the Nepalese environment through modifications in their deposit procedures (primarily, requirement of higher sums for opening of amounts) and removal of language barrier (primarily. transaction of business in English).

Cleanliness and attractiveness of the premises of the partly foreign-owned banks should not be allowed to act as a barrier, through stepped up public relations .

The average amount per deposit account is Rs 9,000 for all the commercial banks taken together. But the amount is less in ful1y domestic—owned banks and conversely, it is higher in respect of partly foreign owned banks. Banks in the former category have been able to cover wider sections of the people and this has been the reason for the average deposit with them to be smaller in size. But in respect of partly foreign—owned banks, the reason for larger average size of deposit is the result of their deliberate policy of keeping the smaller depositors out of their reach.

Banking Operations:

The operation of making deposit to, and withdrawing from, the accounts is particularly long in fully domestic—owned banks and relatively quick in partly foreign—owned banks because the latter have installed micro-computers for banking operations. To quicken deposit and withdrawal operations, all the major branches of the banks should be provided with computer facilities and the rest of the branches should undergo major reforms in their operations even without resorting to computerization.

Nepal Bank Ltd. had tried for some time a system of making immediate payment of cheques upto the amount of Rs 200 in its principal Kathmandu branch. Similarly, Rastriya Banijya Bank had introduced a new system of payments which was popularly known as "teller system“ in all the urban branches of the bank. But both of these banks discarded these innovations and returned to the traditional system of banking operation. Regarding

computerization, two branches of the Agricultural Development Bank, one branch of Nepal Bank Ltd. and all branches of partly foreign—owned banks have computer facilities.

There is no computer facility in Rastriya Banijya Bank-According to the prevalent practices, a customer desirous of depositing money in a bank account has to wait all along the time his deposit slip passes through assistant to the cashier, cash assistant, posting assistant. checker and ultimately to the depositor in the form of counterfoil . Because of long wait involved in depositing sums, smaller depositors are not interested in depositing money in banks. More employees have to be employed by the banks because of complicated procedures. In this way, the present system of depositing money in banks is neither advantageous to the customers nor to the banks. The procedures of cheque payments are equally cumbersome. The cheques presented by payees pass through counter assistant, ledger assistant, checker, signature verifier, payment authorization officer and finally to the cash department where cash assistants make payments to the payees. It takes days to get payment of cheques drawn on other bank offices. For this reason , people generally decline to accept cheques and insist on cash in settlement of dues. The existing system of banking operations has been made complicated owing to more than due concern shown for security. Modern banking operations demand efficient , service oriented and economical banking services along with security safeguards. Fully domestic—owned banks are particularly beset with banking operation problems and it is in their case that reforms in banking operations are urgently called for.

Commercial bank branches should be classified on the basis of transactions , and reforms in the banking operations should be introduced

gradually from the higher to the lower order of branches. As a first step, branches with more than Rs 2000 million credits and deposits taken together should be selected for full fledged computerization. In the second step, bank branches with out- standing credits and deposits exceeding Rs 200 mill ion should be selected for the introduction of micro-computers. Finally, by the end of 2000 A.0. . almost all bank branches should be provided with computers and the system of ma king payments from different branches on the basis of deposit account opened in one branch should be introduced gradually. Pending computerization, some changes in the procedures of existing banking operations should be effected for meeting the needs of customers and economy in bank expenditures. Presently, the system of depositing money is complicated mainly because cash and general departments are separated and placed in different rooms. To overcome this difficulty , one of the two alternatives suggested here should be considered. One way of improvement is to give a copy of the deposit slip after duly signing it immediately after accepting deposit along with the 51 i p in duplicate at the counter. One of the two copies of the slip which would be retained in the bank can be sent to different sections in due course of time. Alternatively, cash counter can be set up in the general department itself. In this case , slip in triplicate can be used and one of the copies be provided to the customer immediately after receiving deposit at the counter“ 0f the rest two copies of the slip, one will be sent to the general department for posting in the control chart or long-book. If additional step is deemed necessary from the viewpoint of security, signature of an authorized person in the general department can be added before a copy of the deposit slip is duly presented to the customer.[4]

In respect of payments to the customers , persons of the cash department should be placed in the general department itself. Once a cheque is received in the counter and a token given to the payee, the cheque should pass through a peon to the **balance** verifier, signature verifier, payment authorizer, posting personnel and finally to the cash assistant at the counter who wil1 effect payment of cash to the payee in return of the token issued earlier. Then the cheque can be sent to control chart for posting. When the transaction of the day is over, the ledger can be checked and verified at ease. Still quicker payment can **be** effected if the payee is paid immediately after verifying signature and balance in the account. In order to accept deposits and effect payments as quickly as possible in 'the above—described manner, some pre-requisites such as suitable accommodation, _ improved sitting arrangements. trained personnel , modern gadgets for signature verification, cash insurance or special allowance for risk undertaking , legal protection in case of fraud and provision of personnel in keeping with work load should be fulfilled.

Savings Instruments:

The level of savings depends on income and the desire to save for the future. Banks should strive for bringing even the smallest of the small savers into the savings net by offering suitable savings instruments tailored to the needs of various categories of prospective depositors. Banks have offered to the public only current, savings and fixed deposit accounts. Domestic savings accounts and recurring deposit accounts were neglected later to the extent of stagnation in the case of the former and altogether termination in that of the latter. Frequency of interest payments also affects the saving mobilization efforts. Interest payment at an interval of three months instead of six months has exerted a positive impact on

increasing the fixed deposits with Rastriya Banijya Bank. The Agricultural Development Bank has been mobilizing deposits with considerable success through measures such as daily interest calculation on savings deposit accounts, monthly interest payment on fixed deposit accounts, higher rate of interest on savings deposit accounts and lottery in respect of savings and current accounts. Similarly, the Bank has been offering Agricultural Savings Certificates which carry 10 per cent interest and are free of income tax. According to the Agricultural Credit Review Survey concluded in 1930/81 , the demand for agricultural credit was assessed at Rs 5906.0 mill ion. Because of changed circumstances, the present requirement of credit for agriculture alone can be estimated at Rs 15,000 mill ion in the minimum. As at October 1986. commercial banks had had outstanding deposits to the tune of Rs 10,420.0 million Obviously, there is need for further mobilization of deposits for satisfying the growing **demand** of credit for agriculture and other sectors of the economy. Bank: should therefore come **forward** with newer instruments of deposits. Recently, one of the business companies was able to raise deposits from the public by offering 18 per cent interest. Banks should also not lag behind in innovations in deposit mobilization. They should offer various instruments of savings tailored to the varying needs of diverse categories **of** prospective depositors. In this connection **,** suggestion can be made to revitalize the domestic saving accounts **,** revive recurring deposit accounts and introduce small savings schemes **.** deposit reinvestment certificates **,** fixed income deposit schemes and long—term savings schemes. These instruments of deposits will cater to the needs of various categories of prospective depositors.[5]

REAL INTEREST RATE AND SAVING BEHAVIOR IN NEPAL:

In the business of borrowing and lending money, the lender charges and the borrower agrees to pay an amount in excess of the amount lend and borrowed. The excess amount is called interest, in common language. In economic terminology, like rent and wages, interest is a factor payment. It is paid for the use of capital as a factor of production. In other words, interest rate is the cost of capital per unit of time.

Interest is paid for the sacrifice made by the income holder by deferring consumption for the time being and imparting with liquidity, and to reward the income holder for their savings (Khatiwada, 2005). Interest rates are indeed very important economic variables. There are many uses of interest rate data. First, they indicate the conditions in the financial market. Second, they are indicators of expectations about inflation. If the long term interest rates are lower than that of short term, it can be inferred that the market participants have lower inflation expectations. Third, interest rates are indicators of the result of monetary policy actions. Therefore, interest rate data can be used to analyze the ex-post monetary policy stance. Fourth, interest rates can be used as monetary policy targets. Many central banks, in recent years, have moved towards interest rate targeting from monetary targeting. Fifth, interest rate data can be used to analyze exchange rate movements. The last but not the least, the interest rate data can be used to macroeconomic analysis of consumption, saving, and investment. In this context, it must be noted that interest rates play a key role in monetary analysis, as they are a key element in the transmission process of monetary policy (Thapa, 2005).

The "real interest rate" is approximately the nominal interest rate minus the inflation rate (Fisher, 1911). It is the rate of interest an investor expects to

receive after subtracting inflation. This is not a single number, as different investors have different expectations of future inflation. Since the inflation rate over the course of a loan is not known initially, volatility in inflation represents a risk to both the ender and the borrower.

To achieve a higher economic growth, there has to be an increased investment both from the public and the private sector. Increased investment can take place only when savings are mobilized sufficiently. Savings can be increased if real interest rates are positive. In this respect, NRB had adopted interest rate policy for the (i) mobilization of higher level of savings in the form of bank deposits, (ii) prevention of capital flight to India, (iii) allocation of resources to productive sectors of the economy, and (iv) promotion of economic activities particularly industry and trade. For those purposes, interest rates were regulated since 196T to 1989 (Maskey and Pandit, 2010). In the past, when interest rates were controlled, NRB attempted to keep real interest rates positive by making frequent revisions in nominal rates whenever inflation rates were changing. But NRB was unable to appropriately monitor the movements and the real interest rate was moving up and down over time.

Theories of Interest Rate Determination:

The term capital is used in two senses; (1) money capital, i.e. stock of money that could be loaned out, and (2) physical assets e.g. land, building, plant, machinery etc. Money capital in the form of bank deposit, share and debenture yields different forms of incomes - interest and dividend. Investment in physical capital yields income called return on capital. Money capital finally takes the form of physical capital and interest paid on money capital takes in the form of

cost of capital. Because of this reason, the monetary theory of interest is given more importance than that of real theory of interest.

The common peculiarity of monetary theories of interest is that the interest is a monetary phenomenon. And monetary theorists believed that interest rate varies inversely with supply of money and positively with the purchasing power (value) of money. The defenders of the monetary theories of interest argued that when supply of money increases, purchasing power (value) of money falls and, hence the rate of interest also come down. Economists agree that the real interest rate is determined in the market for investment and savings and thus by the forces of productivity and thrift. Hence, the real interest rate adMusts to equilibrate desired savings (providing the net supply of funds) with desired investment (generating the net demand for funds). In an increasingly integrated world economy with internationally mobile capital, the real rate of interest is determined largely by global forces of saving and investment. For relatively small open economies, the world real rate of interest is somewhat independent of domestic circumstances, especially over the medium to long term.

There are various theories, which explain the determination of interest rates. Classical theory posits that interest rate is a real phenomenon and hence real factors determine the level of interest rate. The real factors are the supply and demand for capital. It is argued that the supply of capital comes from savings (thrifts) and the demand for capital comes from the productivity of capital. Interaction of supply of and demand for capital gives us the equilibrium level of interest rate. Therefore, if there is recession in the economy, the return from investment will be low. This will bring down the overall demand for capital.

Given the level of savings (the supply of capital), the lower level of demand for capital will bring down the level of interest rates.

The Neoclassical or loanable fund theory includes both real and monetary factors as the determinants of interest rate. This is an acknowledgment of the fact that monetary factors also influence the level of interest rates. According to Keynes Liquidity Preference Theory, interest rates are purely monetary phenomena. On the basis of these theories, a number of factors, which influence the level of interest rate, can be discussed. Among the factors influencing the level of interest rates, the size of government borrowing is very important. The higher the size of the budget deficit, the higher is the level of interest rate and vice-versa. This fact has been one of the factors affecting the level of interest rate in Nepal (Thapa, 2005). It is to be noted that both the government and the private sector borrow from the domestic market. Obviously, funds that can be borrowed from the domestic financial market are given. With the given funds, when the government domestic borrowing increases, it puts pressure on domestic interest rates. With the rise in domestic interest rates, the government borrowing crowds out the private sector investment. The second factor relates to business conditions. When economic recovery takes place, economic activities increase, putting an upward pressure on interest rates and vice-versa. The third factor relates to the role of lobbies and pressure groups. In the society, the different interest groups play their roles in raising or lowering interest rates. Retirees will like to see deposit rates going up. Likewise, households will also prefer higher interest rate on their deposits. On the other hand, industrialists and business community will put pressure for lower interest rates. In the Nepalese context,

industrialists and business seems to be found exerting pressure on monetary authority and the political authorities for a lower level of interest rate.[6]

Whether market determined or determined by the monetary authority, there are two aspects of interest rates. The first is the level of interest rate and the second aspect relates to the structure of interest rates. In an interest rate deregulated economy, market forces determine the level and the structure of interest rates. With respect to the former, one of the questions that are very often asked is about the appropriate level of interest rate. For that matter, one can ask: what is an optimal rate of interest for an economy? Nonetheless, there could be a number of ways of Mudging the appropriate level of interest rate. First, real rate of interest, which should be positive to encourage saving. It discourages low yielding investment and thus has positive impact on growth. Again the question remains unanswered, what should be the optimum level of real interest rate. If some inferences can be drawn from the Taylor′s monetary policy decision rule, the level of real interest rate should be 2.0% (Woodford, 2001). Once we agree to this and add the inflation rate to the 2.0% desired real interest rate, optimal nominal interest rate can easily be calculated. Second, interest rates abroad should also be taken into account while Mudging the optimum level of domestic interest rate. It is important to attract foreign capital to accelerate the economic growth of the country. In this case, the domestic interest rate must be higher than international interest rates.

Third, returns on investment are also important factors to Mudge the appropriate levels of interest rates. Fourth, in a developing country like Nepal, interest rates in unorganized markets can also be used to Mudge the appropriate level of interest rate.

Interest Rate and Saving-Investment:

The impact of interest rates on consumption, savings and investment is well established in the literature. Classical and Neoclassical economists took a position that higher interest rates resulted in high savings and lower level of consumption. Keynes, on the other hand, argued that low interest rates increased investment and income, and thereby generating higher savings. Keynes put forward his ideas on interest rates in his famous book, µGeneral Theory of Employment, Interest and Money′ in 1936. He strongly established a negative relationship between the level of investment and interest rate. In order to boost investment, he suggested a lower nominal interest rate. He argued that given marginal efficiency of investment, a lower interest rate would encourage investment, which in turn, would increase output. This phenomenon, in economic literature, is known as Keynes effect. In case, nominal interest rate could not be lowered, he suggested for expansion in money supply leading to a rise in inflation. A rise in inflation would lower real interest rate.

Following Keynes, Tobin also developed a model of money and economic growth and argued that households would maintain their portfolios between money and productive capital assets. He argued that if the return on capital exceed the return on money, the demand for capital in relation to money would increase, resulting in an increased capital to labor ratio. This would enhance labor productivity and per capita income would go up. This analysis suggests for keeping nominal interest rates lower. In case, nominal interest rates could not be maintained at low level administratively, a case was made for an expansion in the money supply. This would generate inflation, driving down real interest rates.

Financial Development and Interest Rate Phase in Nepal Prior to 1955, the domestic financial system was under-developed; it was dominated by unorganized informal financial system generally driven by private individuals, Shahus (merchants) and landlords (Pant, 1964). To provide financial services, Nepal Bank Limited (NBL) which is the first commercial bank in the country, was established in 193T, and reflects the start of the formal financial system.

The establishment of NRB in 1956 coincided with the period of planning (the first development plan from 1956±1960). At the initial stage, the financial system was still rudimentary and described as "predominantly a cash economy" (NRB, 1965); however the further effort by GON of formalizing the financial system was reflected in the establishment of i) Nepal Industrial Development Corporation (NIDC) in 19593; ii) Rastriya Banijya Bank (RBB) 19664; and iii) Agriculture Development Bank in 19684; these institutions facilitated the elimination of the dual currency system in 196T, which predominated in Nepal (NRB, 1996). In that year, NRB also adopted a controlled interest rate regime, where the Bank used to fix deposit and lending rates of the commercial banks.

Administered Interest Rate Phase (1966 -1983) As the market based monetary policy instruments were not developed, determination of interest rate was one of the few options left for the NRB at that time. Likewise, there was a lack of competition in the domestic financial system due to the limited number of banks and financial institutions (BFIs) in the country. Although NRB began to control deposit interest rates in 1966, lending interest rates were untouched. With a reviewing the existing interest rate structure, NRB constituted a high level committee under the chairmanship of a Deputy Governor of NRB in 1969. Deposit rates were increased to 5-8.5% from 4.5% and lending rates were

increased to 13% from 12%. With this, NRB began to administer both deposit rates and lending rates. After that, NRB used the interest rate policy to accelerate the domestic saving mobilization and divert bank credit to the productive sectors of the economy.

First, it began to change the nominal interest rate from time to time so as to influence domestic saving mobilization. Second, NRB commenced the differential interest rate policy for different types of bank credit, discriminating one type against the other. In order to extend the flow of bank credit to the preferred sectors of the economy, lower rates of lending were fixed and in order to discourage the bank credit to some other sectors, higher rates were fixed. To support the differential interest rate policy, NRB introduced an intensive banking program in 1981 (NRB, 1985).

Partiall\ Deregulated Interest Rate Phase (1984 - 1989) In early 1980s, Nepal experienced a series of BOP problem. To control the deteriorating international reserve Nepal adopted the International Monetary Fund (IMF) supported economic stabilization program in 1985, and subsequently entered into IMF's Structural AdMustment Facility; this presaged gradual reform measures in the financial sector (Thornton, 198T). In this regard, on November 16, 1984 NRB initiated a limited flexibility to commercial banks to fix the interest rates. Commercial banks were then allowed to offer interest rate on savings and time deposits to the extent of 1.5 and 1.0% point above the minimum level fixed by NRB. This form of partial deregulation on interest rate helped the BFIs to be more competitive. In this liberalizing environment, three Moint venture commercial banks were established during 1984-198T. Effective from May 29, 1986, interest rates for deposit and lending were further liberalized except for the

priority sector lending, in which banks were not allowed to charge interest rate more than 15%.[7]

Liberalized Interest Rate Phase (1990 to present):

The work of McKinnon and Shaw in early 19T0s provided the theoretical background of interest rate deregulation in developing countries. McKinnon (19T3) and Shaw (19T3) argued that controlled interest rates retarded economic growth. They contended that the deregulation of interest rates was important because it discouraged domestic investment in those areas, which were not yielding adequate rate of return in the long run. Ceteris paribus, higher real interest rates increase domestic as well as foreign savings and total savings. It also increases the flow of savings through financial intermediaries so that the overall efficiency of savings- investment process is enhanced.

In the light of this theoretical background, controlled interest rate regime in Nepal was completely abolished on August 31, 1989. BFIs are now given full autonomy to determine their interest rates on deposits and lending. This coincided with the period of economic liberalization, which saw a huge spurt in the number of banks and financial institutions. Although the BFIs are free to determine the interest rate, the NRB has been forced to occasionally issue directives in regard to anomalies in the interest rate determination indicated by a high interest rate spread between deposit and lending rates (NRB, 2010). Therefore, the objective of interest rate deregulation to lower the financial intermediation cost is yet to meet. Although, the NRB Act – 2002 attempted to develop the country′s financial system, the continuing high level of interest rate spread suggested greater financial sector development had not brought efficiency

in the financial system. To address this, NRB attempted to maintain the interest rate spread of BFIs at a desired level through using moral suasion.

To begin with, in 1991 the real interest rate in Nepal again went to negative territory and reached as low as negative 15.6 percent in 1992. As a result, the growth rate of bank deposit also fell down from more than 25 percent in 1989 to around 15 percent in 1991. But the bank deposit increased by an annual rate of 30 percent in 1993 while the real interest rate was still negative at around 10 percent. This indicates that real interest rate has little effect, if any, on the deposit growth. Besides, this might be due to some structural changes or due to external shocks. Actually that was the time when number of BFIs was increasing rapidly inside or outside Kathmandu valley because of the liberal economic policy adopted by the first elected government after the restoration of democracy in 1990. There was some improvement in real interest rate during 1992-1994, but again real interest rate started to fall since 1994, the growth of bank deposit also failed simultaneously.

The main Objective of the imposition of rigid interest rate spread was to increase financial deepening by forcing BFIs to lower their financial intermediation cost. NRB, in the mean time, adopted a number of measures aimed at helping in maintaining the positive real interest rate. Cash Reserve Requirement (CRR), an indirect instrument of monetary policy and tax on financial intermediation, has direct impact on cost of capital of BFIs and in turn on real interest rate. In the light of this fact, the level of CRR was reduced from 12% to 10% in 1998. It was further reduced to 9% in December 2001 and 8% in 2002. CRR was cut further to 6.0% in 2003 and on July 19, 2004 to 5.0%. It was raised to 5.5% in 2009 and again reduced to 5% in 2011.

Likewise, the bank rate, policy rate on which BFIs used to borrow from central bank by pledging their securities, was gradually lowered. Because the rate has direct impact on the cost of capital of the BFIs, which may increase the cost of production an ultimately general price level. Thus with an aim at helping to contain the inflation and to keep real interest rate positive, the bank rate was gradually reduced from 11% in 199T to 5.5% in 2002. But, the bank rate was gradually raised to cope with the inflationary pressure in the economy and ultimately reached in 2010. Likewise, refinance rates were also lowered from 1.5 to 3.25% between 1998 and 2010. As a result of the policy measures adopted by NRB, the real interest rate remained positive in 11 years during 1996 to 2010. The trend may also show that due to increased number of BFIs and increased competition BFIs are putting up competitive interest rate to survive in the business. Thus, relative to the first phase where government owned bank dominated the scenario, this phase showed positive movement in interest rate although various other factors hampered positive development in the real interest rate movement.[8]

During the period of 1996-2010, an average real interest rate of Nepal was Must 1.19% while such rate was 6.52% in India. However, the SD of 5.08 is lower than 8.43 in the first phase as well as C9 of 425.T5 is also lower than 592.24 of the first phase. This showed that there are lots of improvements in the interest rate movements and it is less volatile and is fluctuating less. The stability in interest rate also helps economic development and hence this phase could be considered better, in this regard. The Nepalese banking system is dominated by the public BFIs in terms of deposit mobilization and loan portfolio and the public BFIs hold larger share of total deposit of the banking system. At the mean time,

the interest rate offered by that government owned BFIs in deposits are relatively lower than that of other BFIs. Because of this reason, the weighted industry average rate of one year time deposit tends to be lower. Apart from that, the rising inflation resulted from economic as well as non-economic reasons is the maMor factor influencing the real interest rate in Nepal. Despite the fact that, the real interest rate in Nepal was lower during second phase, total bank deposit was increased by an annual average rate of 1.03%. This is due to structural changes of Nepalese economy and due to the effort of financial sector reform program implemented by the government. Likewise, the gross national saving and gross domestic saving ratios for that period have registered an annual average value of 24.64 and 11.25 respectively. The growing inflow of money remitted by Nepalese people working abroad, especially in the Middle East and gulf countries has played significant role to maintain the gross national domestic saving ratios in comfortable levels for that period.

DEVELOPMENT OF THE FINANCIAL SYSTEM IN NEPAL:

Nepal started to implement structural adjustment reforms from mid-eighties. The process was disrupted by Nepal-India trade and transit impasse and the subsequent political upheavals. It was accelerated significantly since 1991. Various authors have assessed the impact of such reforms on the economy. An emerging consensus is that the macroeconomic indicators such as balance of payments, fiscal deficit and financial indicators did improve. But the growth rate has remained sluggish and income poverty has hardly declined. Domestic saving rate has improved only marginally.

The reform in the financial sector is an important part of the package designed to accelerate growth through redistribution of credit to the "more

productive sector" and hence increase employment and income of the poor automatically. But the fact that the financial liberalization in the past has not led to redistribution of credit to more employment generation, rural sectors have neither been analyzed nor effective counteracting measures thought out.

The history of financial developments in Nepal may be divided in three phases, 1937-1956, 1956-1985 and post-1985. Nepal Bank Limited, the first commercial bank in the country, was established as a joint venture between the government (51 percent share) and the private sector (49 percent share) in 1937. That was the only bank and financial institution in the country until 1956. Before the establishment of the Nepal Bank Ltd, Nepalese nationals had to keep their savings either in cash or in the Indian banks. All external transactions were effected through Indian banks. Nepal had no central bank until 1956, when the Nepal Rastra Bank (NRB) was established. The central banking functions were shared between Reserve Bank of India and Revenue and Minting Department in the Ministry of Finance in Nepal.

NRB was established in 1956, and then on, the development of the financial system gained momentum. Within a decade, a number of institutions were established in the public sector. These included Nepal Industrial Development Corporation (NIDC), Agriculture Development Bank (ADB\N) and the Employees Provident Fund Corporation, Rastriya Banijya Bank, the Credit Guarantee Corporation, Nepal Insurance Corporation and the Securities Marketing Centre. Besides setting up new institutions, NRB partially subsidised branch expansion of the commercial banks between 1970 and 1989, because commercial banks tended to concentrate in urban areas to avoid higher cost of rural operations. The banking habit expanded, banks were able to mobilise

increased proportion of private savings and direct them for investment in newer forms of activities. Between 1975 and 1990, both deposits with the banking system and total credit expanded rapidly.

Table :9

Selected Indicators of Banking and Monetary Developments (1960-2000)[9]

Mid- July	Outstanding Rs. in Million				Percent Credit/ Deposit	Inflation Adjusted % Interim Period Annual Growth Rate	
	Deposit1	Credit2	Money-M1	Broad Money-M2		Deposit	Credit
1975	1,166	1,222	1,338	2,064	104.8	12.3	20.3
1980	2,330	2,798	2,830	5,285	120.1	9.2	12.2
1985	8,536	5,489	5,480	12,297	64.3	18.3	4.4
1990	21,885	15,335	14,223	31,552	70.1	8.2	10.1

- Excludes inter-bank deposits and government deposits
- Excludes investment in Government securities and includes foreign bills purchased and discounted.

Source: Acharya and Khatiwada, 2003.

NRB started its intervention in the credit market for the first time in 1966. In early years, interest rates were used primarily as instrument for mobilisation of financial resources and directing credit to specific activities. In 1975, the interest rates were drastically revised upwards with the objective of monetary management. The changes in interest rates led to significant increase in the collection of savings and fixed deposits and slowed down expansion of credit to a negative growth in real terms in subsequent two years. But the effect of interest rate rise was one short affair lasting only up to 1976/77.

In the next year, credit expansion rate galloped to nearly 28 percent in real terms while deposit collection decelerated to about 6 percent. By the end of 1979/80, credit/deposit ratio was up to 120.0 percent. The pressure on foreign exchange reserves, particularly Indian Rupee reserves, was turning acute.

Deposit rates were revised upwards once again in 1982 to mop up the liquidity in the system for correcting the emerging balance of payment gap. A comprehensive rationalization of the interest rate structure with substantial upward revision in the priority lending rates was also effected. However, the balance of payment situation did not improve until the end of 1985 and the Nepalese Rupee was devaluated drastically in November 1985.

The financial system remained small, with limited penetration in the economy. It remained inefficient with high cost of financial intermediation, weak management, obsolete financing modalities, poor service delivery, dualism with the domination of informal financial market and low level of financial intermediation as indicated by relatively low proportion of M2 to GDP. While M1/GDP ratio indicates monetization of the economy, M2/GDP captures both monetization and penetration of the banking sector in savings mobilizations. Nepal lagged behind most of the Asian countries in fixed and savings deposit mobilisation and had a much lower ratio of M2 to GDP.

The financial system reforms started in this background. Liberalisation of interest rates started in 1984 when commercial banks were given autonomy to fix interest rates over and above the NRB rates by 1.5 percentage points on saving and 1 percentage point on term deposits. The interest rates were completely liberalised in 1989 leaving them to the market forces.

Foreign capital was accepted in the banking business for the first time in 1984, with the establishment of the Nepal Arab Bank Limited, as a joint venture with foreign and local capital participation. The Commercial Bank Act (1974) had already set out regulations for licensing and supervision of the commercial

banks in the private sector. The domestic private sector, it seems, was too weak to venture into banking on its own.

However, all these liberalisation measures and freeing of interest rates from NRB control did not result in reducing the lending rates or extending the banking facilities to new areas or to emergence of new kind of services. The commercial banks colluded to lower the term and fixed deposit rates without changing the lending rates. Banks remained with excess liquidity but did not make efforts to expand their operations by providing cheaper credit. This clearly was a move towards oligopoly in credit pricing, to exploit market imperfections for increasing the interest spread between loan and deposit rates.

On the other hand, a dearth of financial instrument was felt in the market. As a consequence, traditional informal financial activities such as *Dhikuri, Dhukuti* and other systems, characteristic to the rural economy, emerged in the urban areas as well. Initially such credit groups were small in nature and limited to special groups of family and friends. Once they started to capture the imagination of the larger number of people, and expand beyond family and friends, the risk of fraud emerged on a wide scale. The emergence of informal financial flows on a large scale became a matter of concern to the Government and the Central Bank. Measures were formulated to bring such flows within the policy net. Further initiatives taken to promote financial development included establishment of the Housing Development Finance Company (1992) and five Grameen Bank clones, the Regional Rural Development Banks (RRDBs) and permission to co-operatives and the non-government organisations (NGOs) to undertake limited banking transactions. Such authorisations were issued by the NRB to Credit Co-operative Societies, registered under the new Co- operative

Act of 1992 and the NGOs, registered under the Social Service Registration Act of 1978, starting 1993. The main objectives intended to provide banking services and credit to the poor.

As a consequence of all these liberalization measures, the number and variety of financial institutions, their financial assets and variety of instruments have grown significantly. The number of financial institutions grew from 6 to 136 between 1980/81 to 2000. These 136 financial institutions, registered with NRB, have more than 1060 branches, but mostly concentrated in urban areas.

Commercial banks lend for short term trading, for meeting working capital needs of industries and business, and for consumption and social functions against sufficient collateral. They are directed by the NRB to provide credit to priority and deprived sectors. The Nepal Bank Limited and the Rastriya Banijya Bank dominate the banking system. These two older banks have branches in all the districts, but located mostly in the urban and town areas, or near the highways.

Commercial bank clients generally from upper and middle class are conscious about the credit availability. Further, the joint venture banks concentrate on export business and foreign transactions. They are dealing with the big business houses, elite population, and institutions in education, health, consulting services, etc. and do not get directly involved in the priority lending.

The number of finance companies has grown from none to 48 within ten years. They accept fixed-term deposits, usually at higher rates of interest, attracting the shallow fund in the informal market. They offer new and more flexible investment options and have developed various instruments. They lend

for longer terms than the banks on hire purchase, housing and transport vehicles like trucks, cars, scooters, etc. They are associated with a cluster of family or business "houses" and banks as well. Most of the finance companies also are located and operate in urban areas. Including one Deposit Insurance and Credit Guarantee Corporation, which guarantees priority sector lending of the commercial banks, there were 13 Insurance Companies as of mid-July 2000. Eleven privately-owned insurance companies have been established and have grown rapidly. The only institution dealing with the provident fund, the Provident Fund Corporation, has captive funds collected from government and corporate employees.

Among the semi-formal financial institutions, Savings and Credit Co-operative Societies have most prominent role. As per NRB Report (2000), they numbered 1574, of which, 34 were authorised by the NRB for limited banking transactions. Others operate among their own members without NRB permit, which are allowed under the Co-operatives Act. There are about 25,000 NGOs promoting savings and credit groups. They lend limited amounts to such groups. Among the NGOs, only 25 were licensed by NRB as of July 2000, to operate banking transactions. There are 116 Postal Savings Bank outlets for collection of deposits.

Financial Deepening:

The ratio of all financial assets to gross domestic product indicates financial deepening in the economy. Total financial assets as of mid-July 2000 is estimated at more than Rs 277 billion, which accounted for nearly 76 percent of GDP. The ratio was 32 percent in 1990 and 29 percent in 1985, the year when the door for foreign participation in banking industry was opened. These figures

indicate increasing role of financial sector in the Nepalese economy. The commercial bank deposit and credit ratios to GDP measure the importance of the banking system in the economic activities of the country. The deposit/GDP ratio surged up to 42 percent as of mid-July 2000, which was only 10 percent in 1980 and 22 percent in 1990. The growth in credit/GDP ratio has been slower. This ratio reached 32 percent in 2000 from 12 percent in 1980 and 15 percent in 1990. Comparing the growth during the eighties and nineties, it is clearly seen that, while the deposit/GDP ratio grew much faster during the eighties, the growth of credit/GDP ratio was much faster during the nineties. Increasing credit to GDP ratio indicates that the role of credit is expanding fast as a source of funding for economic activities in the country. This is quite in consonance with the increasing role of non-agricultural sector in the economy, which depends more on bank credit than agriculture in developing countries.

Table : 10

Selected Indicators of Financial Sector Growth[10]

Description	**1975**	**1980**	**1985**	**1990**
Population (in million)	12.9	14.6	16.3	18.1
Overall Financial Sector:				
Total Financial Assets (Rs. million).	2322	5594	13011	32426
Total Financial Assets/ GDP (%)	14.0	24.0	29.3	32.5
Commercial Banking:				
Total Bank Branches(no.)	216	241	380	442
Popn. per Com. Bank Branch (in thousand)	59.58	60.58	42.89	40.95
Bank Assets (Rs. million)	2006	4542	10535	26854
Bank Assets/GDP (%)	12.1	19.5	23.7	26.9
Deposit/GDP (%)	7.0	10.0	19.2	22.0
Credit/GDP (%)	7.4	12.0	12.4	15.4
Credit/ Deposit (%)	104.8	120.1	64.3	70.1
Pvt. Sec. Credit/Total Credit (%)	64.1	68.5	73.5	76.2

Financial Deepening:				
Money(M1)/GDP (%)	8.1	12.1	12.3	14.3
Broad Money(M2)/GDP (%)	12.4	22.6	27.7	31.6

* Including ADB/N.
# Includes Com. Banks, NIDC, ADB, EPF, Finance Com, Co-operatives and RRDBs.
Source: Acharya and Khatiwada, 2003.

Liberalisation, however, has completely failed to streamline the commercial banking system in the country as expected. Overdue loans and inefficiency had been aggravated in the 1990s. The older and the larger of the commercial banks with their wide rural networks have been made to compete with the new trim 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 lower than that of the older banks. On the other, the economic viability of older banks is eroding faster as all their lucrative business such as the low-cost donor transactions and export financing have been cornered by the private sector banks, while high cost rural operations remain with them. Financial liberalisation process, it seems, should have been preceded by a thorough overhauling of the older banks and a decision to infuse private sector capital and management in the same. The two older banks have a high proportion of non-performing loans, which was around 18 percent of the total loan in 2000. As a consequence, the government has contracted out their management to foreign private sector parties. But recent evidences are indicating that the newer banks also have window-dressed their balance sheets to show higher performance than warranted by reality. Overdue has been reduced to a substantial extent by rescheduling. Moreover, the commercial banks, domestic or joint venture, have shown little innovation and positive attitude in identifying new areas of saving and investment opportunities. They have rather preferred to

cater to the traditional larger urban savers and invest in safe and gilt-edged government securities and treasury bills. This kind of investment involves no additional administrative cost and is easily convertible into ready cash in the secondary window operated by NRB.

On the positive side, after 1990 when the financial sector entry was liberalised completely, the number of financial institutions and co-operatives has exploded. The micro-credit programs also have been redesigned to pay equal attention to savings and credit. The finance companies have introduced new instruments of savings and credit in the economy. The co-operatives are serving the needs of smaller urban and sub-urban borrowers and savers with their door-to door schemes and catering to a large section of the educated unemployed. 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. Number of failures of co- operatives in recent months has also shown a severe lack of supervision and control of such micro-financing institutions.

Rural Banking:

Since the majority of the poor live and work in rural areas, the flow of credit to rural areas may be taken as one of the indicators of financial sector role in poverty alleviation. Until about the establishment of ADB/N and RBB, with direct incentive from NRB for commercial branch expansion, the commercial bank branches were concentrated in large cities and trading centers in the Terai. Their rural branch expansion gained speed after NRB introduced the incentive system for this purpose. Between 1980-1990, the commercial bank branches increased by 219. Of these, 146 branches were established in rural areas. The proportion of commercial bank's rural branches in total seems to have increased

during 1980- 1985, in spite of the discontinuation of subsidy from NRB and the financial liberalisation.

Table :11

Rural / Urban Distribution of Commercial Bank Branches[11]

Years	Total	Rural	Urban	Rural as % of Total
1977	216	141	75	65.3
1980	241	154	87	63.9
1985	383	267	116	69.7

* Includes ADB/N's Commercial Banking Branches.
Source: NRB, 1985

The declining trend in the proportion of rural in the overall deposit and lending portfolio of the commercial banks is already visible.

Table : 12

Rural /Urban Credit Operations of The Commercial Banks*[12]

(In million Rs.)

Mid-July	Deposits				Credit & Investment			
	Rural	Urban	Total	Rural %	Rural	Urban	Total	Rural %
1977	341.2	1727.8	2069.0	16.5	217.4	1423.9	1641.3	13.2
1980	634.3	2627.2	3261.5	19.4	491.6	2689.6	3181.2	15.4
1985	1474.2	6617.3	8091.5	18.2	1534.0	4930.4	6464.4	23.7

* Includes ADB/N's Commercial Banking Activities.
Source: NRB, 1985

Despite the branch expansion during 1980s, the financial sector still showed little capacity to absorb small urban or rural savings and serve the credit needs of the small borrowers, rural or urban. Hills and mountains have had few financial facilities for small savings mobilisation. In Terai 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 by liberalisation of the banking sector.

The minimum balance requirements in banks make them unapproachable even to the middle class families. Bulk savers also have ability to negotiate on interest rates, which small savers lack. More evidences are available that average households in rural areas can save smaller amounts. But the commercial banks have shown little interest in this kind of savings. Given the oligopolistic cartelling, they are over liquid and have no need to innovate for deposit mobilisation. The supervisory and regulatory capacity of the NRB lacks required strength in order to regulate the commercial banks and finance companies properly.

Thus, the formal financial system continues to have an urban bias. Its liberalisation has helped to intensify this bias. Most of the formal credit institutions are concentrated in the urban or sub-urban areas because majority of modern sector activities take place in the urban areas and resources are concentrated there. Lack of infrastructure has further impeded financial sector activities in rural areas. The banks and other formal financial institutions have not been in easy access to the rural or urban population at lower echelons of income distribution. Liquidity position of the banking sector has remained above 40 percent throughout the nineties. The flow of credit from the finance companies has been meeting the consumption needs of the urban population.

Likewise, the gross national saving and gross domestic saving ratios for that period have registered an annual average value of 24.64 and 11.25 respectively. However, despite lower values it is to be noted here that the volatility of real interest rate is relatively stable in this period and hence

comfortable for the public than that in controlled regime. Due to relatively stable and less fluctuating interest rates, thus, the market-led economy could be considered better.

Next, the trend lines of real interest rate and growth of bank deposit show that there is a long-run positive relationship between these variables. Apart from that, the correlation analysis has been performed to measure the degree and direction of relationship between real interest rate and saving in the country. It is found that the real interest rate has weak connection with growth of bank deposit indicated by the low and statistically insignificant correlation coefficient. Likewise, the real interest rate has statistically insignificant negative effect on gross national savings. This may be due the high influence of remittance inflow in the gross national saving. At the same time, real interest rate has high correlation on gross domestic saving as indicated by statistically significant result. The real interest rate affects the growth of bank deposit positively but negligibly. This result suggests that trying to influence the bank deposits by manipulating interest rates is not likely to be a practical policy option in Nepal. However, the government should attempt to maintain competitive positive real interest rate relative to that of other neighboring countries in order to increase the gross domestic savings.

Earlier financial development in Nepal was an induced phenomenon as in other developing countries. The central bank (NRB) came into being only in 1956. Government established several financial institutions in the government sector or as subsidiary of these institutions, as the domestic private sector was too weak to do so. In the early years, NRB intervention in the financial market was directed primarily to resource mobilization and directing credit to specific

priority sectors. Only since 1975, monetary management became a major concern. However, financial growth was slow until about mid-eighties. Only after the liberalization process accelerated since early nineties, financial development has been remarkable.

The total financial asset in the economy has increased to an amazing 76 percent of GDP from a paltry minimum of 24 percent in 1980 percent; the broad money (M2), which includes money in circulation and savings and fixed deposits with the commercial banks, has reached 51 percent of GDP. But none of the expectations of liberalization, such as extension of the organized credit market to more rural areas, increasing access for smaller borrower or more efficient and productive use of financial resources seem to have been achieved. The sector is experiencing chaos. The institutional network has expanded to meet some consumption needs of the urban middle class but diversion of resources from the agricultural sector has been substantial as illustrated by the decreased flow of bank resources to agriculture. None of the non-bank financial institutions cater for the rural population. As a source of rural credit, the role of the organized institutional sector has declined in the last decade. While the financial sector with their international connections and quick money-transfer abilities are overflowing with public funds, the productive sectors are starving for credit.

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 requirements. Nevertheless, the financial sector has grown fast during the nineties in spite of these inefficiencies. What this line of argument seems to

ignore is the specific geopolitical situation of the country, which limits its macro-economic policy options severely. Nepalese economy has been and is largely open to India. This puts severe limits to monetary, exchange rate, as also pricing and taxation policy options in Nepal. Conventional economic logic also ignores the huge opportunity for graft the privatization process provides to the political elite, given the inadequate institutional framework to control the fraud. It is becoming increasingly clear that inefficiencies of the commercial banks are attributable more to the political intervention and the oligopolistic tendencies in the financial sector, rather than the priority sector or the rural branches. The joint venture banks with practically no rural operations are also suffering from bad quality of their investment and credit. It is becoming public that their balance sheets are widely window-dressed. On the other hand, the nexus between the political elite and the international financial capital might be getting tighter. Nepal is slowly being drawn into what Mander and Goldsmith (1996) call the "casino economy" controlled by the international financial giants with no evident benefit to the people around the world. Nepal seems to be no exception in this case. Jeffrey Sachs (2002) also notes how today's short-term financial markets are estranged from the economic fundamentals and primarily guided by a gambling mass psychology.

REFERENCES :

1. Bandiera, G, Gerald Caprio, Patrick Honohan and Fabio Schiantarelli (2000). "Does Financial Reform Raise or Reduce Saving?" *Review of Economics and Statistics, p.88-94*
2. Berger, A. N., DeYoung, R. (1997). "Problem Loans and Cost Efficiency in Commercial Banks." *Journal of Banking and Finance*, Vol. 21, p.128-132

3. DeYoung, R. (1997), "X-Efficiency and Management Quality in National Banks." Journal of Financial Services Research, Vol. 15, No. 2, p.36-42
4. Drake, L. (2001). Efficiency and productivity change in UK banking. *Applied Financial Economics* , p.51-54
5. Gajurel, D. "Cost efficiency of Nepalese commercial banks," Nepalese Management Review (Central Department of Management, Tribhuvan University), p.68-73
6. Ibid
7. Gande, A. (2008). Commercial Banks in Investment Banking. In V. T. Anjan & W. A. B. Arnoud (Eds.), Handbook of Financial Intermediation and Banking , p.112-118
8. Ibid
9. Acharya, Meena and Khatiwada, Y.R. WITH Aryal, S. (2003), Structural Adjustment Policies and Poverty Alleviation, IIDS. p.68-73
10. Ibid
11. NRB, 1985, p.81-114
12. Ibid

CUSTOMER SERVICE AND CARE IN COMMERCIAL BANKS

Commercial bank occupies quite an important place in the framework of every economy. It provides capital for the development of industry, trade & business investing the saving collected as deposit. All the economic activities of every country is greatly influenced by the commercial banking business of that country. Commercial banks, by playing active roles, have changed the economic structure of the world. Integrated & speedy development of the country is possible only when competitive banking services reach nooks & corners of the country. In recent years, Banking sector of Nepal has been transformed from a sluggish and government-dominated sector to a much more agile, competitive and profitable industry. Different foreign banks have emerged recently which have increased the competition among commercial banks. In order to get competitive edge and to attract more and more customers, banks are focusing on providing better services to the customers. Banks in Nepal were not established everywhere in same period. It has passed many years upgrading this status and wide sector business. In 1985 Nepal also adopted liberal free economic policy and allowed to establish other joint venture banks under collaboration with foreign banks as well as under private sectors. At Present there are 32 commercial banks with many branches currently operating in Nepal. Customer satisfaction is a long-term strategy. Just as it is difficult to

radically alter perceptions of product quality over a short time horizon, so it is difficult to quickly cultivate a reputation for superior customer service. Consequently customer satisfaction is as competitive advantage that is sustainable over the long term. In the last few years, subject of satisfaction and dissatisfaction has received a great deal of attention from academic researchers.

The liberalization, privatization and globalization has ushered the customer relationship management in banks. The process of globalization and our move towards global standards changed the perception of customer service and the banking endeavor to serve the customer to build customer relationship banking. But to deliver on improved and in depth understanding of customer needs and fully integrated customer management system is required along with complete transparency. In the emerging market scenario, for survival and growth, it is critical for a bank to align its vision, mission, goals and objectives of customer satisfaction.[1]

Customer satisfaction is generally described as the full meeting of one's expectations (Oliver, 1980). Customer satisfaction is the feeling or attitude of a customer towards a product or service after it has been used. This study enhances the relationship between customer satisfaction and service quality. If the customer is fully satisfied then he will be loyal with the bank otherwise he will switch off to that bank which provides the better services. Gremler and W.Brown describes that business are not concerned only with attracting and satisfying customers but also to maintain a long-term relationship with the customers. The service management literature argues that customer satisfaction is the result of a customer's perception of the value received in a transaction or relationship – where value equals perceived service quality relative to price and customer

acquisition costs– relative to the value expected from transactions or relationships with competing vendors. Jamal and Naser(2002) and Beerli et al (2004) found the bank service quality as an important antecedent of customer satisfaction which leads towards customer loyalty. Jamal and Naser(2002) looked into the impact of service quality dimensions and customer expertise on satisfaction.

Commercial bank occupies an important place in the framework of every economy. Commercial banks by playing active roles have changed the economic structure of the world. For the commercial banks sustain the customer acts as the king. Therefore, customer satisfaction is the major topic to be dealt with for the bank. Recently banking sector of Nepal has been transformed to more agile, competitive and profitable industry. Different foreign banks have emerged recently which have increased the competition among commercial banks. In order to get competitive edge and to attract more and more customers, banks are focusing on providing better services to the customers. Customer satisfaction is a long term strategy. To get better response from customers about their satisfaction level, responses were taken from respondents who had frequent transaction with the banks.

Service quality has a significant impact on a bank's success and performance. Service quality is particularly essential in the banking services context because it provides a high level of customer satisfaction, and hence it becomes a key to competitive advantage.

Parasuraman, Zeithaml and Berry (1988) defined service quality as a difference between customer expectation of service and customers' perceptions of the actual service. Kasper, Helsdingen and Vries (1999) defined service

quality as the degree to which the service offered can satisfy the expectations of the user. According to these definitions, customers are the sole judges of service quality. If they perceived good service, they became satisfied with the service quality by comparing their expectations with perception.[2]

Today, the quality of products and services consumed has a great importance in the business world. According to Aga and Safakli (2007), it is widely accepted that surviving in difficult and competitive conditions of a market economy requires good quality production as well as services. To understand and assess the results of efforts realized, quality of production should be measurable. While the quality of goods can easily be measured by taking into account of certain physical properties, the measurement for services is rather difficult because the quality in this case depends on large number of factors.

Defining service quality is difficult as compared to product quality due to some features unique to services including intangibility, inseparability, heterogeneity and pershability (Chang & Yeh, 2002). In presence of these limitations, Parasuraman come up with a comprehensive way of defining service quality. Banks operating in Ethiopia is consequently put into lot of pressures due towards increase in competition. Various strategies are formulated to retain the customer and the key of it is to increase the service quality level. Service quality is particularly essential in the banking services context because it provides high level of customer satisfaction, and hence it becomes a key to competitive advantage. In addition, service quality has a significant impact on a bank's success and performance.

Nowadays, service quality has received much attention because of its obvious relationship with costs, financial performance, customer satisfaction, and

customer retention. Service quality has been defined in different ways by researchers. Gronroos (1978) suggests that service quality is made of two components – technical quality and functional quality. Technical quality refers to what the service provider delivers during the service provision while functional quality is how the service employee provides the service.

'Teller' System of Payment:

Some years back, Rastriya Banij'ya Bank had introduced 'teller' system of payment in its urban branches. This system of payment had considerably reduced the time required for making cheque payments at the counters. However, this system was discontinued and the same traditional system as it. existed before was allowed to relapse. The failure of the ‘teller' system is attributed to inadequate rewards for taking extra risks . unsuitable bank premises for proper counter installation , personnel problems **,** uncooperative attitude of the payees and discontinuity in the system of daily verification of control charts . The 'teller' system of payment can be a useful device for improving cheque payments if some pre-requisites are fulfilled. Cash insurance Or an allowance of 15 to 25 per cent **of** salary to the employees involved in such transactions , placement of payment counter at general department, provision of adequate number of personnel in accordance with work load , trained personnel and daily verification of accounts on the basis of maintenance of control chart are some of important pre—requisites for the success **of** the 'teller' system. But these problems can be obviated if each teller is provided with a computer so that each teller will be in a position to pay a specified amount (say upto Rs 1000} with signature and balance verifications at the counter itself. [3]

CREDIT ASPECT:

Credit operation is a major function of commercial banks. Credit-deposit ratio is one of the important indicators in the operation of commercial banking functions. The ratio as at mid-July 1989 was 67 per cent. If investment is also included in the calculation of this ratio, the figure comes to 85 per cent. The outstanding credit as at mid—July 1989 stood at Rs 5974. 2 million. Of the total outstanding credit of Rs 59?4.2 mil1ion as on mid-July 1986, 39.1 per cent was accounted for by trade, 29. 1 per cent by industry and 25.4 per cent by consumption and social purposes . These three major purposes preempted 93.6 per cent of the total credit. ' The credit per employee is one of the indications of efficiency in the banking system. The credit per employee in Nepal amounted to Rs 511 thousand. As compared to this, the credit per employee in New Bank of India came to Rs 1 million. This means that the banking system in Nepal should be more efficient in respect of credit operation too. There are 563 thousand credit accounts in Nepal. There is the system of limit sanctions prior to actual credit disbursements in respect of pledge and hypothecation loans. The practice of commitment charge is an important device for credit planning . This practice first started in 1978 as a compensation for the loss sustained by commercial banks following interest tax imposed on them by His Majesty‘s Government. Al1 loans other than staff loans. loans against fixed deposit receipts, priority sector credit and loans against gold and silver are subject to commitment charge at the rate of 0.15 per cent per annum. Credit should be provided on the basis of creditworthiness of borrowers. Credit information can be an useful guide for credit managers. At present , there is no system of regular exchange of credit information among the banks. But such a system is necessary and should be

introduced on the basis of under~ standing among the banks; if not, by providing specific provision in the Commercial Banking Act. This system can be introduced also by establishing a separate institution for the purpose by Nepal Rastra Bank in collaboration with the commercial banks. Such an institution should obtain information from all the commercial banks and store it with a view to disseminating it to the requesting commercial banks. Pending the establishment of such an institution, banks should obtain credit information through the interview of prospective customers, financial analysis, scrutiny of own records pertaining to customers and other sources, including other banks.

There is the system of sanctioning credit by different authorities. Bigger loans are sanctioned at the level of boards of directors of the concerned banks. In many countries, prior authorization of central banks is needed in cases of very large loans. The cut—off point in this respect is Rs 100.8 mil1ion (Indian Rs 60 million) in India. In Nepal , the system of prior credit authorization from Nepal Rastra Bank should be introduced and the amount of credit above which a reference to Nepal Rastra Bank has to be made should be decided by Nepal Rastra Bank in consultation with the commercial banks. The operation of credit authorization scheme can be performed in Nepal Rastra Bank by its Banking Operations Department.[4]

Except in Nepal Arab Bank Ltd. , there is no system of classification of debtors into one obliged group. But it is necessary that credit should be sanctioned to the customers taking into account the relationships among the different borrowing individuals and firms . A limit should be fixed beyond which no credit should be advanced to a related group of individuals and firms. Such a limit is fixed at 10 per cent of capital funds in the U. K. and 15 per cent of the

capital funds in the United States. In Nepal, as banks are under- capitalized, a bank should be empowered to extend credit to one obliger group upto the amount equivalent to capital funds of the concerned bank. If any group of individuals or firms needed more than this 1imit of credit. it should approach a consortium of banks for its loan requirement.

Commercial banks should establish separate divisions within their loans and advances departments in order to fully concentrate on the recovery or writing off of overdue loans.

Gold and Silver Loans:

Bank loans for consumption and social purpose ranged between 16.3 per cent and 34.7 per cent of the total loans during the 1974-1986 period. Loans against gold and silver were an important constituent of consumption and social purpose loans. Loans against this purpose ranged between 8.08 per cent and 24.93 per cent during the 1965-1986 period. Gold and silver loans in a way are an innovation of the Nepalese banking system, meeting the social and economic needs of the common people. Despite the prominent position occupied by gold and silver in the banking system. bankers and monetary authorities have not attached importance that is due to gold and silver loans. In the large majority of branches of commercial banks, priority sector and gold and silver are almost the exclusive avenues of credit, and the commercial banks are fulfilling the felt need of the people by extending gold and silver loans. Despite this reality, Agricultural Development Bank and partly foreign-owned commercial banks are not providing loans against gold and si1ver which, for many people, could be the only asset to offer as security against loans. The role of gold tester is pivotal in the scheme of gold and silver loans. Despite this fact. gold—testers are placed on

a level at par with the lowest 'level of assistants . But, in view of the importance of the function performed by gold testers, they should be placed at a level immediately below the cashiers or in a position at par with Senior assistants, whichever is applicable.[5]

There is a system of dual rate of interest in respect of gold and silver loans - 17 per cent for loans upto Rs 10,000 and 18 per cent for loans above this limit. In the urban areas , this dichotomy could be obviated by splitting the loans by approaching more than one bank branch to get loans at 1? per cent. There is no variation in the rate of interest according to variation in loan amount in respect of other loans. There is therefore no justification for resorting to this kind of progressivism in regard to the gold and silver loans alone.

Gold and silver loans are provided for a year. But banks usually wait for two years after which the assets pledged as security are disposed of through auction. As there is no worthwhile market for gold and silver in the majority of rural bank centres, gold and silver from such centres should be brought to the nearest market centres and disposed of at comparatively higher prices.

Pledge Loans:

Pledging of goods in order to obtain credit is as old a practice as the history of the Nepalese banking system. On perusal of mid-July 1979 to mid-July 1989 figures , it was found that the ratio of pledge loans to total credit varied between 21. 2 per cent and 31.1 per cent. It is therefore natural that the concentration of attention is prominently centred on this category of credit to the almost exclusion of other loans . The end-use of pl edge loans can ' t be ascertained and , for this reason, banks should not encourage such loans more than that is necessary for the smooth conduct of trade. Commercial banks opened

in foreign collaboration do not provide such loans . But they should not boycott this category of loans. All the commercial banks should try to reform it in order to remove its defects . The main problems associated with pledge loans are connected with over- valuation of pledged goods , inferior quality of pledged goods , retention of godown keys by the debtors , mis-arrangement in the storage of goods , unsuitability of godowns , storage of goods pertaining to more than one loan in a single godown and, sometimes , claims of more than one bank on the same set of goods stored in a godown , total reliance on lowly-paid godown keepers , etc- To obviate these problems , the following measures should be undertaken: All the commercial banks should join together and float a godown company which would operate godowns in the urban areas and they should provide loans against goods on the strength of receipts issued by this company. Pending the operation of the proposed godown company, the responsibility of storage of goods in the godowns should be entrusted to the higher officials in the banks. Processes and procedures described as essential in credit manual s or guidelines should be strictly followed. Official s entrusted with godown responsibilities should be rotated periodically so that defects , if any, would come to the notice of branch management for rectification in time. Commercial banks should be cautious about businessmen , who are overambitious and who have started business for the first time. Businessmen involved in particular business for long should be given priority in providing pledge loans. Both creditworthiness and security should be considered in advancing pledge loans as in any other type of loans. (Commercial banks should be careful of those businessmen who want to borrow from bank branches away from the areas of their business. Provision of loans in excess of credit limits is one of the main problems besetting the fully domestic—owned commercial banks. These banks should be strict in such a matter and stringent punishment should be meted out to those who indulge in such acts of indiscipline. Commercial banks should insist

on cash memoes from the customers to ascertain the true price of the goods to be pledged in the banks and it should also be insured that no goods bought on credit are pledged with the banks. Pledge loans should be classified into standard, sub-standard, doubtful and bad loans and separate strategies should be adopted in respect of each of these categories of loans. Commodities to be pledged at the banks should be specified at the very time of credit 1imit sanction so that the higher management is in the know regarding the goods that would be pledged by the customers, at the time of disbursements of loans which actually take place at the branch level.[6]

Hypothecation Loans:

Hypothecation loans came into existence in Nepal in 1984 when the newly-opened Nepal Arab Bank Ltd. started to provide such loans. Later in the year, the Commercial Banking Act, 1974 was amended to enable the commercial banks to provide such loans. According to the system of this credit, commercial banks take goods as security, but the goods 'in question are al lowed to be in possession of debtors. Regular inspection and replenishment of goods or repayment of loans in case of shortage of goods are the essential part of this system of credit. Hypothecation loan was the need of industrial establishments. but there is the possibility of misuse of this loan by industry and trade. The following measures should be taken to make this loan practical for the clients and secure for the banks:

- Hypothecation of goods without offering extra security in the form of real property upto Rs 100 thousand should be allowed by fully domestic-owned banks as against the limit of Rs 25 th0usand (Nepal Bank Ltd. } at present.

- Industrial enterprises Which have mortgaged their fixed assets to long-term financial institutions should be allowed to offer those assets as second mortgage as additional security for hypothecation loans. The second mortgage as security against hypothecation loan can be acceptable only if the property has a value over and above the mortgaged value.
- As hypothecation loans are almost insecure loans , credit information should be obtained prior to sanctioning of loans , and post-loan supervision should be maintained. Nepal Rastra Bank should periodically review this system of credit and introduce changes ., if necessary.

All the industrial enterprises should be allowed this loan facility. Hypothecation loans should be provided by the commercial bank branches within their command areas. They should not provide loans outside such areas.

Documentary Credit:

Documentary credit is a safer credit system as the customs and practices of such credits are determined by the provisions of the Uniform Customs and Practices of Documentary Credit prepared by International Chambers of Commerce .

Priority Sector Credit:

Commercial banks started to extend priority sector credit since 1974. But this type of activity of the commercial banks took a concrete and effective shape since 1981 when the Intensive Banking Program was launched at the initiative of Nepal Rastra Bank. Since 1982, Cottage and Small Industry Project has been launched in nine districts with financial assistance of the World Bank. Commercial banks are the participating institutions in respect of the Intensive

Banking Prograrnme. In the case of Cottage and Small Industry Project , Nepal Bank Ltd., Rastriya Banijya Bank and Agricultural Development Bank are the participating institutions.

During mid—November 1981 to mid-January 1986 , people have been provided with priority sector loans to the tune of Rs 323.2 million under the Intensive Banking Programme, generating employment for about 100 thousand people. Because of over-emphasis on security, group loans to the poor people have amounted to only about Rs 10 million so far. About 80 per cent of the loans have been utilized on intended purposes and more than ?‘0 per cent of the loans have been recovered in time. As the rate of interest on priority sector loans have been favourable to banks, they should not hesitate to provide adequate amounts to the priority sector.[7]

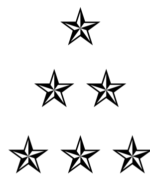
This study clearly showed that customers are satisfied with the commercial banks in Nepal. To be more specific, customers were found satisfied with those banks which are located at feasible location with wide network, having wide and instant ATM service, and polite and courteous employee behavior. Customers of Nepal was found sensitive toward the program offered by the banks to satisfy their customers. The customer perceived that their bankers are neither neglecting them nor are they conducting some outstanding customer satisfaction program. So most so the customer fall under slightly satisfied level of satisfaction. They are neither highly satisfied nor highly dissatisfied. The findings shows that customers are satisfied with their commercial banks and all the commercial banks in Nepal is providing same level of satisfaction to their customers. Though NMB bank has ranked first in every criteria except ATM service, because of lack of ATM machine which becomes disadvantage to itself.

Nepal SBI Bank stands on the top level of ATM service. The difference on result analyzed by satisfaction criteria and overall satisfaction differs because this study is limited only to depositor type of customers. Findings reveal that customers of commercial banks in Nepal is satisfied for convenient location and layout, politeness of staff and responsiveness to their needs and are dissatisfied with bank interest rate policies and fee charged. They are more likely to remain with the bank having convenient location with adequate parking facility and wide ATM networks. Banks should be careful and focus more to the customers. It is the customers who would make the banks in running state. Banks customers are satisfied in overall perspective but at some places they are dissatisfied. Therefore, to make more and more customer attracted to render the service bank can have improvement in many areas.

The study has considered commercial banks and with primary data. The study includes only three independent variables. From the results, it is concluded that the related dimensional service quality and tangible dimensional service quality have no significant impact on customer satisfaction. But, core service quality has a significant impact on customer satisfaction. The study concludes that the related dimensional service quality and the tangible dimensional service quality have a very low relationship with customer's satisfaction in the Nepalese commercial banking sector; it is not desirable. So, Nepalese commercial banks should improve their service quality on the related dimension and tangible dimension to make the banks perform more effectively.

REFERENCES :

1. Ravichandran, K. (2010). Influence of service quality on customer satisfaction, application of SERVQUAL Model. *International Journal of Business Management, p.* 117-124.
2. Sulieman. (2011). Banking service quality provided by commercial banks and customer satisfaction. *American Journal of Scientific Research*, p. 68-83.
3. Ibid
4. Ibid
5. DeYoung, R. (1997), "X-Efficiency and Management Quality in National Banks." Journal of Financial Services Research, Vol. 15, No. 2, p.56-61
6. Shrestha, Min B., Financial Liberalisation in Nepal, Ph.D. Thesis, School of Economics, University of Wollongong, 2005. p.41-45
7. Shrestha, Min B. and Khorshed Chowdhury (2007). "The Impact of Financial Liberalisation on Welfare: Evidence from Nepal," *Applied Econometrics and International Development , p.18-22*



GOVT. POLICY FOR THE DEVELOPMENT OF FINANCIAL CAPACITY OF COMMERCIAL BANKS

Talking about the history of bank, an institutional banking system came into existence in Nepal only in the 19th century. Nepal Bank Limited was the first financial institutional of Nepal established on the 30th of Kartik 1994. Being a commercial bank, it focuses on income generating and profit maximization. As it was only one commercial bank, it has to look the economic condition of country. Only one Nepal Bank Limited was not sufficient to look all the sector of country. So in 2013 B.S. another bank named "Nepal Rastra Bank" was established as the central bank. Similarly the 2nd commercial bank Rastriya Banijya Bank was established as the second commercial bank of Nepal in Magh 10, 2022 B.S., under Rastriya Banijya Bank Act 2021. This act is now revised as Commercial Bank Act 2031. B.S. "Accepting deposits, granting loan and performing commercial banking functions are the main motto of commercial bank" (Commercial Bank Act, 2031). For the development of industry, commerce and trade, Nepal Industrial Development Corporation was established under Industrial Development Corporation Act 2016. For the development of agricultural section, Agricultural Development Bank was established on Magh 7th 2024 B.S., under the Agricultural Bank Act 2024 B.S. The government of Nepal observed the necessities of rapid development of the country for which it has adopted "liberalized economic policy, laissez fair economy and encouraged

foreign investment". "The government formed Foreign Investment & Technology Act 1981 A.D. which was later revised as Act 1992 A.D. by new elected democratic government"(Foreign Investment and Technology Act, 1992). The joint venture bank was introduced in Nepal in 2041 B.S. with the establishment of "Nepal Arab Bank Limited". It was established with joint venture of U.A.E bank, financial institution of Nepal. The second joint venture bank, Nepal Indosuez Bank Limited was established in 6th Magh 2042 B.S. Similarly, others joint venture banks like, Nepal Grindlays Bank Limited on 16th Marg 2043, Himalayan Bank Limited on 2049 B.S., Nepal State Bank of India Limited on 2050 B.S., Nepal Bangladesh Bank Limited on 2051 B.S., Everest Bank Limited on 2051 B.S., Bank of Kathmandu on 2052 B.S. and Nepal Bank of Celon Limited on 2052 B.S. have been established. Till now other commercial banks have been also established. Among them majority of banks are established in joint venture banks. "A joint venture is the joining of forces between two or more enterprises for the purpose of carrying out a specific operation industrial or commercial investment, production or trade". Joint venture banks play an important role for economic development of nation. They have been adopted new banking technique, management like hypothecation, syndication lending policies, tale banking credit card, master card from international banking technique. They render various services to their customers in order to facilitate their economic and social life. Joint venture banks are operating in Nepal in an act as commercial banks are operating and performing their work under the direction and supervision of Nepal Rastra Bank. Nowadays, there are many joint venture banks and other financial institutions, but there are little opportunities to make fair investment. Meanwhile, the banks and financial institutions are offering

competitive deposit and credit interest rate. So to survive in the spirited banking market, one should follow the fundamental principles of sound investment policy with minimum risk and maximum profit. At present, about a dozen of the commercial banks are operating in Nepal and are playing important role in the economic development of the country.[1]

WORKING CAPITAL MANAGEMENT POLICY :

Background of the Study As a developing country, Nepal is striving to develop and modernize economy rapidly on rational and socially desired footings but the structure of the economy is largely dominated by agriculture with very small industry base, so to divert and modify agro-based economy, Nepal adopted mixed economic model with implicit objective to help the state and private sector economy that complement each other in the development process from very inception of economic planning process back in 1956. The primary goal of the developing country like Nepal is to develop economy rapidly and to promote the welfare of the people and nation. So, very recently, Nepal has adopted the path of economic liberalization for the sake of the economic growth of the nation. After the restoration of the democracy, the concept of liberalization policies has been incorporated as directive principal and state policies. Development of trade, commerce and industry are the prime requisite for the attainment of the economic, political and social goals. To fulfill the purpose of planning, financial functions more often dominates the other functions. There is always lack of finance in underdevelopment economy because natural resource are either underutilized or unutilized in productive sectors or even other purposes i.e.; social welfare and so on. Likewise, underdeveloped countries are not deficient in land, water, mineral, forest or power resources, thought they may be untapped;

constituting only potential resources. And in the underdevelopment countries like Nepal there is always lack of financial resources not only because of its real absence but because of the available resource are not properly mobilized and are not fully utilized for the productive purpose.[2]

So, for the rapid economic development in the underdevelopment countries like Nepal there should be proper utilization of resources. Due to various difficulties or even ignorance of the people, such resources have not been properly utilized. Financial institutions pay a vital role of encourages thrift and discourage hoardings by mobilizing the resources and removing the habits of hoarding. They pursue rapid economic growth, development the banking habit among the people, collecting the small-scattered resources in one bulk and utilizing them in further productive purposes and rendering other valuable services to the country. Thus, this gives the individuals an opportunity to borrow funds against future income, which may improve the economic well begin of the borrower. In this course the banks play the most important role in modern economic organization. Their business mainly consists of receiving deposits, giving loans and financing the trade of a country. They provide short-terms credit i.e. lend money for short periods. Bank is the main financial institution, which plays an important role in the economic development of the nation. It is the backbone as well as the foundation for the development of the country. Its principal operations are concerned with the accumulation on the temporary idle money of the public for advancing others for expenditures. In other words, Bank is an institution that deals in money and its substitutes and provides other financial services. Banks accept deposit and make loans and derive a profit from the difference in the interest rates paid and charged, respectively. Depositors may

be either individual or institutions. These deposits may be current, saving or fixed and the tenure depends upon the mutual agreements between the bank may be either an individual or institutions. The tenure of the loan may vary as per the demand, criteria and the usefulness of the loan. Some banks also have the power to create money. The principal types of banking in the modern industrial world are commercial banking and central banking. A commercial banker is a dealer in money and in substitutes for money, such as checks or bills of exchange. The banker also provides a variety of other financial services. The basis of the banking business is borrowing from individuals, firms, and occasionally i.e., receiving "deposits" from them. With these resources and also with the bank's own capital, the banker makes loans or extends credit and also invests in securities. The banker makes profile by borrowing at one rate of interest and lending at a higher rate and by charging commissions for services rendered. Commercial banks are the major financial institutions that occupy quite an important place in the framework in the economy development sectors as well as in saving and investment sectors. Commercial banks are suppliers of finance for trade and industry and play a vital role in the economic and financial life of the country. They also provide an opportunity in the development of individual industries, trade and business organization by investing savings and collected deposits. By investing the saving and collected deposits in the productive sectors, they help in the formation of capital. Besides they also render numerous services to its customers in a view of providing facilities to theirs economic and social life in the community. A bank must always have cash balances on hand order to pay its depositors upon demand or when the amounts credited to them due. It must also keep a proportion of its assets in forms that can readily be converted into

cash. Only in this way the confidence in the banking system can be maintained. Working Capital is the lifeblood of the organization. To sustain the belief of the people & customer, the organization should always get ready to meet the obligations. Working capital management is the crucial aspect of the financial management. It is the Life-blood and controlling nerve center for any types or business organization because without the proper control upon it no business can run smoothly. The management of current assets and current liabilities is necessary for daily operations of any organizations. Thus, it plays the vital role in the success and failure of the organizations as it deal with the part of assets, which are transformed from one form to another form during the course of manufacturing cycle. Therefore, the role of working capital management is more significant for every business organization irrespective to their nature.

Working Capital Management refers to the administration of all aspects of current assets, namely cash, marketable securities, stock and current liabilities. It is the functional area of finance that covers all the current accounts of the firm. It is concerned with the adequacy of current assets as well as the level of risk posed by current liabilities. It is a discipline that seeks proper policies for managing current assets liabilities and practical for maximizing the benefits from managing working capital.

Working capital management has been regarded as one of the conditioning factor in the decision-making issues. The management of working capital is synonymous to the management of short-term liquidity. Working capital is regarded as the lifeblood and nerve of a business concern and is essential to accommodate the smooth operations of any organization. Under and over allocation of working of working capital is harmful to an enterprise to

achieve its primary objectives. Therefore, maintaining optimal level of working capital is the crux of the problem as it is strongly related to the tradeoff between risk and return. However, if it is difficult to point out as to how much working capital need by a particular business organization. An organization, which is not willing to take more financial risks, can go for more short-term liquidity. The more of short-term liquidity means more of current liabilities imply less short-term financing heading. So it is very essential to analyze and find out problems and its solutions to make efficient use of funds for minimizing the risk of loss to attain profit objective. Inadequate investment in working capital threatens the solvency of enterprise as well as affects its growth. On the other hand, excessive investment in working capital yields nothing. Therefore, working capital should be determined in such a way that total cost i.e. cost of liquidity and cost of non-liquidity is minimum. Hence, the goal of working capital management is to manage the firm's current assets and current liabilities in such a way that it should maintain satisfactory level. Working capital management of banks is more difficult than that of manufacturing and nonmanufacturing business organizations. Commercial banks are great monetary institutions, which are playing important role to general welfare of the economy. The responsibility of commercial banks is more than any other financial institutions. They must be ready to pay on demand without warning or notice, a good share of their liabilities. Banks collected funds from different types of deposits for providing loan and advance to different sector. To get higher return, banks must try to increase funds from deposits as well as their investment. The first motive of banking business is to borrow public saving and lend to needy people. But commercial banks always face the problem for utilizing more deposits as

investment of loans increase the cash balance on bank, which require paying its large among of liabilities on its depositors demand without notice. But large amount of idle cash balance also decrease profitability of banks.[3]

Working capital is regarded as the lifeblood and nerve of a business concern and is essential to accommodate the smooth operations of any organizations. Under and over allocation of working capital is harmful to an enterprise to achieve its primary objectives. Inadequate investment in working capital threatens the solvency of enterprise as well as affects its growth. On the other hand, excessive investment in working capital yields nothing. Nepalese commercial banks are operating in the competitive environment. In this situation, banks have to adopt suitable strategies for their existence. They should balance and coordinate the different functional areas of business concern. The success or failure of any organization depends on its strategy, which is affected by working capital management. Working capital management is the crux of problem to prepare the proper strategy on its favors.

FINANCIAL STRUCTURE AND POLICY :

Before liberalization, the financial system consisted of only two commercial banks and few other financial institutions. By 2005, NRB licensed bank and non-bank financial institutions totaled 181. Out of them, 17 were commercial banks, 26 were development banks and 60 were finance companies. The remaining 78 were micro credit development banks, saving and credit cooperatives, and NGOs performing limited banking activities. The other non-deposit taking financial institutions include 21 insurance companies, one Employee Provident Fund, one Citizen Investment Trust, one Deposit Insurance and Credit Guarantee Corporation, one Nepal Stock Exchange Limited, one

Credit Information Bureau, 116 postal saving offices and one Rural Self-Reliance Fund. Of these institutions, the commercial banks, development banks, finance companies, financial cooperatives and NGOs are under the regulatory framework of Nepal Rastra Bank (NRB). While the Insurance Board regulates the insurance companies and the Securities Soard regulates the stock exchange, the other institutions are under the overall regulation of the Government.

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

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

big borrowers. Banks were instructed to provide a maximum of 50 percent of capital fund with respect to funded loan and 100 percent of capital fund with respect to non-fund based loans for a single borrower. Similarly, in 1990 the Central Bank introduced open market operations as one of the tools of monetary policy.[4]

However, these limited reforms were far from adequate in enhancing efficiency, and a more intensive reform was started from early 1990s. The Finance Company Act 1985 was amended allowing promoters to hold 60 percent of the total issued capital. The Development Bank Act 1995 and Financial Intermediary Institutions Act 1998 were introduced to attract private sector and NGOs in establishing financial institutions in the rural areas. In response, a large number of development banks, some of them replicas of Grameen Bank, and financial NGOs and cooperatives came into operation during the post-reform period. Prudential norms were also gradually defined and strengthened. The capital adequacy ratio was increased in 2005 to 12 percent from 9 percent. In 1995 the limit on the amount of loan to a single and group borrower was reduced to 35 percent and 50 percent, respectively. Through the regulation 2001, the loan limits were further revised; 25 percent of core capital in case of fund based loans and 50 percent of core capital in case of non-fund based loans. Along with the changes in the basis from capital fund to core capital, the credit limit also went down drastically over time. The NRB also issued directives to the banks to monitor the sectoral concentration pattern of credit. The mandatory priority sector lending policy was introduced in Nepal as early as 1974. Paradoxically, in the post-liberalization period this policy was kept intact and the level and forms of priority sector lending were increased. The ratio of priority sector lending was

raised to 12 per cent in 1990 from 8 percent in 1985. In 1992, commercial banks were additionally directed to lend a certain percent of priority sector lending toward the small borrowers of deprived sectors.

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

However, these reforms were ineffective in raising the financial health of the banking system in general and government owned banks in particular. The slow speed or wrong forms of implementation were equally responsible for this. As a result, the financial system entered into crisis. A study conducted by the World Bank (2002) revealed a number of weaknesses in the financial system. Some of the major deficiencies highlighted by the study were:

- Excessive government involvement in the banking system,
- Weak corporate governance and organizational culture,
- Poor lending practices,
- Fragmented legal framework,
- Inadequate disclosure, accounting and auditing standards,
- High level of non-performing loans and political intervention.

A separate study by KPMG found two state owned commercial banks technically insolvent. With the emergence of the new and modern banks, the

older state-owned banks with wide rural networks had to compete with banks mostly operating in the urban areas. A phenomenon of 'cream skimming' appeared in the banking services with lucrative and easy business such as export financing and donor transactions appropriated by the new private sector banks. A comprehensive ' Financial Sector Reform Program' with the support of the World Bank and other donors was introduced in 2002. The program aims to create a competitive, market friendly, well diversified and prudently managed system. The major components of the program are three: i) re-engineering of the NRB, ii) restructuring of state owned banks viz., RBB and NBL, and iii) capacity building in the financial sector. In the beginning the focus of reform was on the improvement in the legislation and prudential norms in the financial sector.

Nepal began to eliminate regulatory policies present in the financial and economic system and started to liberalize different sectors (such as financial, foreign trade and public enterprises) of the economy from the mid of 1980s (Shrestha and Chowdhury, 2006). The primary objective of liberalization was to minimize the role of government in the economy by increasing the private sector’s role in stimulating economic growth. Some important financial indicators, such as liquid liabilities, and credit supplied by banks to the private sector have increased tremendously since liberalization. In addition, institutional development is also very much noteworthy. Also, the central bank of Nepal has implemented various reform policies to develop the financial system, especially, from 1980s. The main targets of implementing the policy reforms are to develop the financial system and promote economic growth. Therefore, it is necessary to investigate the impact of those policy implementations on financial development and macroeconomic variables.

Policy reforms implementation for financial sector development:

Nepal has gradually experienced a series of economic reform measures since the mid 1980s. The reform measures have resulted in a widening and deepening of the financial system both in terms of the volume and the nature of financial business (Poudyal, 2005). Policies were introduced to reduce the high extent of government participation in the economy with private sector investment only after 1984. In addition, this decade is important for financial development because the government implemented several policies to ease private sector participation in the economy.

During the 1980s, Nepal needed to increase financial sector activities for economic growth and development. The existing situation prevailed in a highly controlled financial system through some direct policy measures by the central bank with the suggestion of government that the resisted private sector in order to take part in development activities. The entire financial sector was comprised of two government owned commercial banks, two development banks and some insurance companies (Nepal Rastra Bank; NRB hereafter, 2010). Hence, opening up the financial sector to private sector investment and decontrolling of the system seemed essential. The central bank and government started to liberalize the system through the adoption of free entry policy for banks and financial institutions. Then, first joint venture commercial bank Nabil Bank Ltd. was established in 1984. And, this bank played an important role to modernize banking services through technology transfers and to introduce managerial skills (Pant, 2009).[5]

The central bank took steps to deregulate the financial system which constrained the banking sector to function freely in the market. In the first step of

deregulation, the monetary authority removed existing entry barriers of banks and other financial institutions that could ease private sector to enter into the market. Opening up of a joint venture bank called Nabil Bank in the same year of policy reforms implementation was a result of liberalization. With the objective of promoting healthy competition among banks, the Commercial Bank Act-1974 was amended in 1984. Removal of entry barriers aimed at attracting private sector's investment in the commercial banking industry as well as attracting private joint venture banks with foreign collaboration. And, the entry of such types of joint venture banks was expected to bring more foreign capital and technical know-how, modern banking skills to domestic banks, and, widen and deepen the national financial structure (Acharya *et al.*, 1998). Following the amendment of the Act, joint venture banks started to enter into the financial system. In 1985, the Finance Companies Act was enacted in order to allow finance companies to work in the financial system with the objective of serving small borrowers and meeting the demand for consumer credit. This Act was amended in 1992. After the 1992 Act many financial companies came in the market and by 2009 the number of financial companies grew to 78 (NRB, 2010).

During the mid 1980s, macroeconomic imbalance reached to peak due to the unstable fuelling of inflation, due to adoption of expansionary monetary and fiscal policies, BOP imbalances on current account and trade imbalances. This led Nepal to adopt a stabilization program in 1985 that was followed by the Structural Adjustment Programs (SAPs) in 1987 (Osmani and Bajracharya, 2008). Then SAPs sped up liberalization activities with the help of the IMF. This program emphasized to increase the role of market activities in the financial system. One action of it was to introduce regular auction of treasury bills. The

purpose of initiating treasury bills was not only to attract commercial banks to invest in bills but also was to bring flexibility in interest rate structures. Similarly, in 1988 a study called Commercial Bank Problems Analysis and Strategy Study (CBPASS) was held with the guidance of the IMF under SAPs to improve the financial conditions and organizational structure of two state owned commercial banks, NBL and RBB. Nepal entered to Enhanced Structural Adjustment Programs (ESAPs) in 1992 because SAP improved the activities of market forces (Pant, 2009). In the changing financial environment, the central bank realized the need of development banks for development activities. For this, Agriculture Development Bank was allowed to carry out commercial bank activities since 1984 (Khatiwada, 1994). Consequently, such activities played an active role in mobilizing urban resource to lend in the undeveloped agricultural sector. The liberalized system mainly emphasized to mobilize the savings in investment activities. One of the actions relating to it was the establishment of Citizen Investment Trust (1991). Currently this trust is working to mobilize contractual savings. Similarly, the existence of non-monetization and lack of credit availability in the rural sectors were the problems noticed by the central bank and the government at that time. In the meantime, the concept of the Gramin Bikash Bank became popular to mobilize credit in rural areas. Therefore, these two factors have brought the idea of establishing the Regional Rural Development Banks (1993) to ultimately enhance accessibility of formal credit to rural people. Now, these banks are working under Development Bank Act -1996.

The credit control measures imposed before liberalization were gradually removed after liberalization, and commercial banks were left freer to allocate credit. For instance, the central bank removed the provision of Statutory

Liquidity Ratio (SLR) in 1997, which stipulated until that time commercial banks had to maintain at a certain percentage of assets in the form of government securities and cash reserve ratio. It was rendering the lending capacity of commercial banks. The NRB Act 2002 made NRB more independent to execute its policy to ensure an efficient and healthy financial system through its prudential regulatory and supervisory mechanism. The central bank with the guidance of government imposed lending requirements to the private sector commercial banks.

Therefore, the importance of implementing financial liberalization policies cannot be disregarded, and testing the impact of these policy measures in the macroeconomic variables is also an important concern. More importantly this study tries to bridge the gap of non-availability of quantitative research on the impact of policy reforms on financial development and economic growth in Nepal.

Shrestha and Chowdhury (2006) constructed financial liberalization index for Nepal based on principal component methods. This index represents eight major financial liberalization components2 and it examined the extent of financial liberalization during 1984 to 2005 and the degree of liberalization in Nepal was highest during 1984-19994.

Bhetuwal (2007) followed a way of testing the causality between financial development and economic growth of Nepal. He constructed a financial liberalization index to capture the policies implemented for liberalization and found a unidirectional causality from financial liberalization to financial development at 5 percent level of significance and bidirectional relationship at 10 percent level of significance. He argues that financial development is caused by

policy changes in the financial sector and largely dependent on the demand for financial services. Therefore, the simultaneous growth of all sectors can raise more demand of financial services that stimulate financial development. There are very few studies related to the impact of financial liberalization policy and its implication in the Nepalese economy.

Khatiwada and Sharma (2002) focused on the impacts of these policies in relation with factor productivity growth during 1981 to 2000, in which they found the policy dummy is insignificant with the growth variable. This study still falls some sorts of limitations. First, the study period is limited to only 20 observations which are not sufficient to see the policy impact. Secondly, this study focuses on testing the impact on the level shift but does not test the impact on the growth of the variables. Finally, policies were implemented from the mid of 1980s not only from 1990s, setting the dummy for 1990 through 2000. Assuming the policy implementation year 1990 also contradicts itself because Shrestha and Chowdhury (2006) found that the extent of policy implementations were higher during 1984 to 1994.

The monetary and credit variables did not experience a significant structural break when GDP showed a break and it was a cause of implementing policy reforms in the economy. Domestic credit provided by the banking sector has also experienced impacts from the policy changes. However, policy changes have no impact indicates that the policy reforms have no impact on financial indicators, such as on banking credit to private sector and liquid liabilities. This implies, the reduction of domestic credit supply could not be reflected in the private sector credit. The presence of some problems in the banking sector of Nepal is weakening the impact of liberalization. Among them, for instance,

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

The primary goal of the developing country like Nepal is to develop economy rapidly and to promote the welfare of the people and nation. So, very recently, Nepal has adopted the path of economic liberalization for the sake of the economic growth of the nation. The development process of a country involves the proper mobilization and deployment of available resources. Financial institutions assist in the economic development of the country and are considered as the catalyst. Commercial banks are the major financial institutions that occupy quite an important place in the framework in the economy development sectors as well as in saving and investment sectors. Commercial banks are the suppliers of finance for trade and industry and play a vital role in the economic and financial life of the country. After the implementation of the open market policy, joint venture commercial banks are opened as private banks. The liberal trade and investment policies have facilitated joint venture banks to invest in Nepal. Joint venture bank has been helpful in transferring foreign

investment and advanced technology from one country to another. The establishment of joint venture banks gave a new horizon to the financial sector of the country. Commercial bank is income oriented, thus proper financial decision-making is more important in banking transaction for its efficiency and profitability. Most of the financial decisions of a bank are concerned with current assets and current liabilities. Working capital management is concerned with current assets and current liabilities. Generally, working capital refers to the difference between current assets and current liabilities. Thus, working capital management has been regarded as one of the conditioning factor in the decision-making issues of commercial banks. The term working capital management closely relates with short-term financing; it is concerned with collection and allocation of resources. Working capital management relates to problems that arise in attempting to manage the current assets, the current liabilities and interrelationships that exist between them. The major ratio analysis consists of the composition of working capital position, liquidity position, turnover position, capital structure position and profitability position.[6]

Further, the bank should be risk taker and should adopt the aggressive policy for the sustainability of the bank in long run, since the working On thecapital has crucial impact on the profitability and risk. basis of questionnaire survey, it can be concluded that the role of working capital is crucial for smooth operation of the bank. And astoundingly, it can be concluded that the liquidity position of the banks are not satisfactory, and the banks should review the liquidity management to ameliorate the liquidity. Similarly, the negative working capital represents the poor financial management. In case of concerned Banks, positive working capital is found during the study period. This bank should be maintained optimum size of current assets and liabilities. The banks should

follow moderate policy, to minimize the risk. They should use equity capital as well in the same level of debt capital. The banks should use the long term debt capital instead of large The banks should amount of short term debt capital to reduce the risk. The observed banks should promote fixed deposit to lessen the risk immediate requirement of cash and thus having sound working capital Considering the cash and bank balance, the bank should management increase the portion of cash and bank balance in total assets. Similarly, the observed banks should effectively mobilize their total assets, shareholders' equity and total deposit to maximize its profit and sustain in long run. Also, these bank needs to reduce its cost of the bank needs to adopt the best services to maximize their profit capital structure that will best suit its interest and thus maximizes. Finally, the banks profitability and liquidity and minimizes cost need to have highly positive relationship between loan and advances with total deposit and loan and advances with net profit.

REFERENCES :

1. Khatiwada, Y.R. (1994). *Some Aspects of Monetary Policy in Nepal*, South Asian Publishers Pvt. Ltd. New Delhi, India.
2. Ibid
3. Bhetuwal, K.R. (2007). Financial Liberalization &Financial Development in Nepal. *Economic Review*, 19, Nepal Rastra Bank, Kathmandu, Nepal, p.32-34
4. Acharya, M. (2003). Development of the Financial System and Its Impact on Poverty Alleviation in Nepal Economic Review, Occassional Paper, Nepal Rastra Bank 15. p.112-114
5. Baral JK (2005). Health check-up of commercial banks in the framework of CAMEL: A case study of joint venture banks in Nepal, J. Nepalese Bus. Stud. p.86-88
6. Ibid

FINDINGS AND SUGGESTIONS

Nepalese banking industry has undergone significant changes over the past three decade. Nepal Rastra Bank (NRB) as a central bank undertook major changes in policy measures including interest rate deregulation; indirect methods of monetary control and use of open market operations as the main policy tool; abolishment of the statutory provision of liquidity ratio; market based forex system; flexible licensing policy; and prudential legal framework. These changes resulted into entry of foreign- joint venture banks and domestic private banks into the market and widened the scale and scope of activities undertaken by the banks. Some previous studies reported that there was decreasing market concentration (i.e. increasing market competition), and low and even negative factor productivity with significant level of cost inefficiency in Nepalese banking industry over the period of 2001 to 2009. However, the nature of relationship between market concentration, efficiency and performance in the industry remains unexplored.

There are two basic and competing theoretical approaches in industrial organization literature explaining the relationship between market structure, efficiency and performance: market power paradigm and efficiency structure paradigm. The market power paradigm emphasizes on impact of market structure, say concentration on firm's behaviors and performance whereas

efficiency structure paradigm emphasize on impact of individual firm's efficiency on market share and profitability. Within market power paradigm there are two hypotheses: traditional structure-conduct performance (SCP) hypothesis and relative market power (RMP) hypothesis. In a classical fashion, SCP hypothesis states that the banks in concentrated market may have higher performance because the banks in concentrated market may involve in collusive behavior and may charge higher prices for products and services they offer. Hence, higher market concentration impairs the competition but increases the performance. In a slightly different way, RMP hypothesis states that the banks with relatively larger market share and a range of differentiated product lines are better able to exercise their market power to gain superior profit. Therefore, SCP emphasize more and/or abnormal profit deriving from higher concentration whereas RMP emphasize excess profit deriving from larger banks' individual market share but not necessarily from collusive behaviors.

The bank with higher operational (cost and/or technical) efficiency may have some competitive advantages which help to increase bank's market share. Therefore, bank's higher profit is derived from operational efficiency, not from the collusive behaviors as predicted by market power paradigm. The scale efficiency hypothesis, however, emphasize more on the level of scale economies. The banks operating at scale efficient level have lower cost per unit which helps to increase profitability.

Besides these explanations, the quiet life hypothesis states that monopoly power allows managers a quit life free from competition which results into higher market concentration and higher inefficiencies of individual banks. Increased market competition reduces the rents and costs which increases the

welfare and the efficiency. Therefore, the competitive banking market promotes the higher level of efficiency.

As these approaches have distinct policy implications, there has been an extensive research effort to test these hypotheses in banking industry of different economies around the world. This study aims at testing structure- performance hypotheses in the context of Nepalese banking industry by using Berger and Hannan empirical framework. It is first of its type to report the evidences from Nepalese perspective.

AN OVERVIEW OF BANKING INDUSTRIES IN NEPAL :

Nepal has a short history of the modern banking practices that starts from the establishment of Nepal Bank Limited as a first commercial bank in 1937. The establishment of Nepal Rastra Bank in 1956 as a central bank gave new dimension to Nepalese financial system. Nepal adopted financial sector liberalization process during 1980s. As a result, many joint- venture and private banks entered into the market. By the end of mid-July 2009, 26 commercial banks were in operation in Nepal. Of the 26 commercial banks, 3 were state-owned and 23 were privately owned (17 domestic and 6 foreign joint-ventures).

The group share of state, private and foreign owned commercial banks in total assets of the banking sector indicates decrease in the dominance of large state-owned banks as a consequence of financial sector liberalization and reformation. The relatively high value for the ratio of total banking sector assets to real GDP signifies the importance of banking system in Nepalese economy. Banks are the major lenders to private sectors because Nepalese capital market is

at the initial state of development and bank financing is important source of financing for firms.

In contrast, the lending is very nominal to government sectors because government sector receives budget, loan or credit from government or other government owned financial institutions like Employment Provident Fund, Nepal Industrial Development Corporation, etc. The cumulative lending to private and government institutions is lower than deposits to GDP ratios, so reflects comparatively low level of credit to the household and firms. The low level of branch network/extension reflects lack of wider access to banking and higher geographic concentration of banks. Most of the banks' head office is located in Kathmandu and their branches are clustered around major cities of the country.

Nepalese banking industry, for long, is characterized by the dominance of few large and State-owned banks. However, increase in the number of new banks in the market and increasing competitive business environment in recently years have reduced the degree of dominance of State-owned banks. The concentration ratio of "Three-banks" (CR3) mostly represents the market share of State-owned banks, particular since 2005. Still, State-owned banks possess about twenty five percent market share of the industry and five largest banks possess about forty percent.

Therefore, larger Nepalese banks do not necessarily earn higher profits. This evidence might be the reflective of State-owned banks which are the largest but least profitable banks. Regarding the coefficient of cost efficiency, it is positive and statistically significant. The positive and significant influence of cost efficiency on bank profitability does not interfere with the traditional structure-conduct performance hypothesis. The cost efficiency exerts a direct and

autonomous influence on profitability. Hence, cost efficient banks are more profitable. However, referring to the equation two both cost efficiency and scale efficiency have negative coefficients, that means, cost and scale efficient banks help to decrease the market concentration. These results suggest that competitive market condition can be achieved through enhancing cost and scale efficiency. Therefore, policy makers should focus on the policies to enhance the efficiency of banks. The coefficients of efficiency measures are negative and statistically significant in equation three. The negative coefficients may indicate that efficient banks are clustered in niche markets and penetrate the small market segments for higher profitability.

Regarding control variables, bank size, and GDP growth rate have positive influence on banks' profitability. The evidences suggest that increase in assets base of bank provides advantages to grab the additional profit, and the favorable macroeconomic growth helps banks to realize higher profits. Furthermore, macroeconomic growth makes banking market more competitive (less concentrated). The sign and significance of coefficient of GDP growth rate in equation two suggests it.

FINANCIAL POLICY REFORMS AND FINANCIAL DEVELOPMENT :

Nepal began to eliminate regulatory policies present in the financial and economic system and started to liberalize different sectors (such as financial, foreign trade and public enterprises) of the economy from the mid of 1980s. The primary objective of liberalization was to minimize the role of government in the economy by increasing the private sector's role in stimulating economic growth. Some important financial indicators, such as liquid liabilities, and credit supplied by banks to the private sector have increased tremendously since liberalization.

In addition, institutional development is also very much noteworthy. Also, the central bank of Nepal has implemented various reform policies to develop the financial system, especially, from 1980s. The main targets of implementing the policy reforms are to develop the financial system and promote economic growth.

Nepal has gradually experienced a series of economic reform measures since the mid 1980s. The reform measures have resulted in a widening and deepening of the financial system both in terms of the volume and the nature of financial business. Policies were introduced to reduce the high extent of government participation in the economy with private sector investment only after 1984. In addition, this decade is important for financial development because the government implemented several policies to ease private sector participation in the economy.

During the 1980s, Nepal needed to increase financial sector activities for economic growth and development. The existing situation prevailed in a highly controlled financial system through some direct policy measures by the central bank with the suggestion of government that the resisted private sector in order to take part in development activities. The entire financial sector was comprised of two government owned commercial banks, two development banks and some insurance companies. Hence, opening up the financial sector to private sector investment and decontrolling of the system seemed essential. The central bank and government started to liberalize the system through the adoption of free entry policy for banks and financial institutions. Then, first joint venture commercial bank Nabil Bank Ltd. was established in 1984. And, this bank played an

important role to modernize banking services through technology transfers and to introduce managerial skills (Pant, 2009).

The central bank took steps to deregulate the financial system which constrained the banking sector to function freely in the market. In the first step of deregulation, the monetary authority removed existing entry barriers of banks and other financial institutions that could ease private sector to enter into the market. Opening up of a joint venture bank called Nabil Bank in the same year of policy reforms implementation was a result of liberalization. With the objective of promoting healthy competition among banks, the Commercial Bank Act-1974 was amended in 1984. Removal of entry barriers aimed at attracting private sector's investment in the commercial banking industry as well as attracting private joint venture banks with foreign collaboration. And, the entry of such types of joint venture banks was expected to bring more foreign capital and technical know-how, modern banking skills to domestic banks, and, widen and deepen the national financial structure. Following the amendment of the Act, joint venture banks started to enter into the financial system. In 1985, the Finance Companies Act was enacted in order to allow finance companies to work in the financial system with the objective of serving small borrowers and meeting the demand for consumer credit.

This Act was amended in 1992. After the 1992 Act many financial companies came in the market and by 2009 the number of financial companies grew to 78. During the mid 1980s, macroeconomic imbalance reached to peak due to the unstable fuelling of inflation, due to adoption of expansionary monetary and fiscal policies, BOP imbalances on current account and trade imbalances. This led Nepal to adopt a stabilization program in 1985 that was

followed by the Structural Adjustment Programs (SAPs) in 1987. Then SAPs sped up liberalization activities with the help of the IMF. This program emphasized to increase the role of market activities in the financial system. One action of it was to introduce regular auction of treasury bills. The purpose of initiating treasury bills was not only to attract commercial banks to invest in bills but also was to bring flexibility in interest rate structures. Similarly, in 1988 a study called Commercial Bank Problems Analysis and Strategy Study (CBPASS) was held with the guidance of the IMF under SAPs to improve the financial conditions and organizational structure of two state owned commercial banks, NBL and RBB. Nepal entered to Enhanced Structural Adjustment Programs (ESAPs) in 1992 because SAP improved the activities of market forces.

In the changing financial environment, the central bank realized the need of development banks for development activities. For this, Agriculture Development Bank was allowed to carry out commercial bank activities since 1984. Consequently, such activities played an active role in mobilizing urban resource to lend in the undeveloped agricultural sector. The liberalized system mainly emphasized to mobilize the savings in investment activities. One of the actions relating to it was the establishment of Citizen Investment Trust (1991). Currently this trust is working to mobilize contractual savings. Similarly, the existence of non-monetization and lack of credit availability in the rural sectors were the problems noticed by the central bank and the government at that time. In the meantime, the concept of the Gramin Bikash Bank became popular to mobilize credit in rural areas. Therefore, these two factors have brought the idea of establishing the Regional Rural Development Banks (1993) to ultimately

enhance accessibility of formal credit to rural people. Now, these banks are working under Development Bank Act -1996.

The credit control measures imposed before liberalization were gradually removed after liberalization, and commercial banks were left freer to allocate credit. For instance, the central bank removed the provision of Statutory Liquidity Ratio (SLR) in 1997, which stipulated until that time commercial banks had to maintain at a certain percentage of assets in the form of government securities and cash reserve ratio. It was rendering the lending capacity of commercial banks. The NRB Act 2002 made NRB more independent to execute its policy to ensure an efficient and healthy financial system through its prudential regulatory and supervisory mechanism. The central bank with the guidance of government imposed lending requirements to the private sector commercial banks.

Therefore, the importance of implementing financial liberalization policies cannot be disregarded, and testing the impact of these policy measures in the macroeconomic variables is also an important concern. More importantly this study tries to bridge the gap of non-availability of quantitative research on the impact of policy reforms on financial development and economic growth in Nepal.

Financial development consists of the development of financial intermediary, its expansion and reforms. And it is mainly proxied by credit supplied by financial intermediaries, liquid liabilities, their institutional expansion, and so forth in the finance growth literatures. Therefore, these proxy variables for the financial development are used as growth determinants in the growth literatures. In addition, recent literature assumes that financial

liberalization is also an important factor of financial development because it magnifies the level of financial development and contributes to the economic growth. Hence, financial liberalization can also be a promoter of financial development.

The process of liberalization also has a key role in financial development and the economic growth. This process reduces the short run convergence speeds, implying that open economy should spread out significantly with less output volatility, but also longer transitions. Interest rate deregulation is a main characteristic of liberalization policy. Therefore, the liberalization policy lets the market determine the rate of interest freely.

When financial intermediaries determine their rates under free competition it helps to raise the level of domestic savings. An increase in savings implies the increase in the level of investment and disposable income of the economy. Ultimately, it promotes economic growth. In addition, the rate of interest affects the real sector of the economy because financial liberalization allows foreign aid inflows which could have an important role to mitigate the crowding out effects of interest rate deregulation without declining the level of government investment.

Following to Perron (1989), an exogenous one break test is employed assuming that there is a break in 1983. There are some reasons to believe the Nepalese economy experienced a shock in the 1980s. In the early 1980s, macroeconomic imbalances were created due to high budget deficit caused by higher investment in public enterprises. Similarly, the economy faced the problem of low revenue collection and high balance of payment deficit. Then economy faced a series of macroeconomic crises which resulted in low level of

GDP growth. In 1983 the agricultural value added declined to -1.08 percent from 4.6 percent that of 1982. Similarly, the current account deficit increased to 5.9 percent from 3.6 percent in 1982. As a result there was a high drop in economic growth in 1983. In this year, aggregate GDP growth dropped to -2.9 percent from 3.8 percent in 19823. To stabilize the economic system government took the efforts and actions by starting to implement reform policies in the economy. Therefore, reform policy implementation was the first step for liberalization. The major objective of this step was to achieve high economic growth through encouraging the private sector, reducing the role of government. It was also realized that the private sector could be involved through liberalizing the different sectors of the economy. Therefore, financial policy reforms were introduced after the crash in the economy i.e., after 1983.

The government implemented a number of policy reforms in the different sectors of the economy (such as the financial sector, foreign trade sector, public enterprises and so on) to increase private sector participation. Similarly, to include the private sector in the economy some deregulations were essential. Therefore, the government removed entry barriers of banks and other financial institutions in 1984 and interest rate partially deregulated from the same year. Especially the year 1984 is well known for the year of initiating financial policy liberalization in Nepal.

Structural change in the macroeconomic variables is an important issue in the time series analysis because the presence of shocks due to economic crises, policy changes, political changes, international shocks and so on can change the nature of data. Diagnosis of such shocks associates with the unit root test. Since the presence of structural change may be biased for the non rejection of non-

stationarity, if some specifications are not followed (Perron, 1989). The financial policy implementations from 1980s as described in section two can suggest that there may be the possibility of presence of structural break in economic growth, banking and monetary variables.

This estimation provides mixed results on the impact of policy changes on financial development and economic growth. Financial development variables are not strongly influenced by policy reforms whereas economic growth has been influenced. Liberalization helped to spread the financial system from urban to rural areas. After liberalization, the market was highly defined by new non bank financial institutions, new banks, branches of new and old commercial banks, development banks and so on.

At the same time, the financial market has been dominated by non-bank financial institutions, such as co- operatives and NGOs, finance companies and microcredit development banks rather than by banking institutions because non-bank financial institutions could be established easily at low cost, with low capital and less legal barriers. As the rate of monetization increased, the rate of establishing these non-bank institutions also increased at a rapid rate (see figure 2). However, banking institutions and their branches expanded at a very low rate in comparison to the non-bank financial institutions. At the same time, banking sector could not capture the market activities held through cash real estate activities, government and private educational institutions, monetary activities of government offices. This situation evolved due to various reasons. First, the central monetary authority initiated the open and liberal policies in the financial system but in the meantime it could not consider the effective policies to capture such types of activities. Secondly, the banking institutions and expansion of their

branches could not grow at the appropriate level in rural areas and in the areas where the financial sector was still absent because the establishment of banks and their branches is constrained by high establishment cost, high capital requirement and lengthy legal process. So, people were unable to access the banking services and products, and the location of banks was easily captured by other small non-bank financial institutions. In a very short period, these institutions occupied a large sector of the financial market and the availability of these institutions was very high, so this could easily overcome the rate of non-monetization. Thirdly, the government and the central bank could not direct policies for banks to earn profit from productive investment in the economy rather than allowing earning activities without productive investment. This led banks to suffer from non-performing loans and it discouraged the private credit supply, in one hand. On the other hand, the intention of liberalization was to minimize the role of government replacing the public sector with the private sector, but the latter was found unable to capture this place.

Similarly, liberalization created an appropriate environment to grow non-bank financial institutions to collect small deposits and mobilize at the local level. Local level savings were absorbed totally by these institutions. Therefore, it is a reason that time to time banking sector suffered from liquidity constraint that prevented banks to supply credit at the required level. Therefore, openness has contributed to monetization of the country through the rapid development of non-bank financial institutions rather than the development of banking institutions. Although the central bank continued reform activities in the financial sector it could not leave a positive impact on the banking sector. One of the reasons may be non performing loans (NPLs) of commercial banks. Some

figures of commercial banks such as capital adequacy ratio in 2005 remained at -6.3 percent and the accumulated loss of two state owned commercial banks born non-performing loans (NPLs) to 19 percent.

Similarly, it is also obvious to raise the question, of why policy reforms have an impact on economic growth in a country but no impact on financial development. Macroeconomic theories state that economic growth is an accumulation process of several factors such as investment, foreign trade, human capital, public expenditure and so on and not only financial development. When the government introduced liberalization policies, the reform was not only in the financial sector but also in other sectors such as in the foreign trade sector, in public enterprises as a privatization policy and opening up the economy for foreign investment. Therefore, policy reforms are a package that has a cumulative impact on economic growth. Policy reforms in only one sector (i.e., reforms only on financial sector) may not have a direct impact on economic growth but the networking of policy works in the economy and liberalizing one sector needs to open another sector. For instance, when the government needs to open the foreign trade sector it needs to open the financial sector also.

Similarly, if the government implements privatization policies, it should open up to foreign trade that can ease the system for private investor and foreign investors. This networking of liberalization has a cumulative impact on the economy however, policy reforms of a system may not have a distinct impact for single sector and reforms on one sector may ease the other system which is essential for the economy.

A deep and efficient financial system can contribute robustly to sustained economic growth and lower poverty. An efficient and effective provision of

financial services requires that financial policies and financial system structures be adjusted in response to financial innovations and shifts in the broader macroeconomic and institutional environment. Thus, the financial system acts as the brain of modern economy. Well developed financial systems ease the exchange of goods and services by providing payment services; help mobilize and pool savings from a large number of investors; acquire and process information about enterprises and possible investment projects, thus allocating society's savings to their most productive use; monitor investments and exert corporate governance; and help diversify and reduce liquidity and intertemporal risk. The proponents of liberalization argue that the allocation of capital is more efficient in a competitive financial system and that higher real interest rates stimulate saving, thereby raising the funds available to finance investment. According to Shaw's (1973) Debt Intermediation View (DIV), high real interest rates are essential in order to attract more savings. Thus, the McKinnon – Shaw framework of financial liberalization asserts that high interest rates can avail more financing by sufficiently mobilizing scarce savings. Financial interventionism in the 1960s and 1970s directed cheap credit to favoured sectors (industry, exports, small enterprises, and agriculture), which deemed productive, but discouraged consumption and trade as unproductive. In doing so, credit ceilings and high reserve requirements were imposed and interest rate administered in order to contain inflationary pressure due to cheap credit policy. However, financial interventionism could benefit neither industry and exports nor the agricultural sector. Such credits at low rates tended to be characterized by poor lending decisions, weak repayment discipline, and corruption in the government, since those granted access to capital (usually at low rates) may buy

influence to protect their favored positions. Rather, it distorted financial development and economic growth.

However, financial crisis is more prone to financial liberalization. Financial fragility aggravates unpleasant economic development, inappropriate economic policies and balance of payment problems. Institutional development with effective legal enforcement, prudential regulation in place, efficient bureaucracy and low level of corruption minimize the reverse impacts of financial liberalization.

Legal environment (including enactment and enforcement of laws) has important influence on financial liberalization and financial development of a country. Reforms including advancing investor protection are likely to promote financial development. Imperfect financial markets make external finance costly and reduce investment. Financial development and banking sector liberalization help to reduce financing constraint and raise investment.

Financial liberalization helps to improve the functioning of financial system by increasing the availability of funds and allowing risk diversification and increased investment. Moreover, financial liberalization helps to discipline policymakers enticed to a captive financial market. Financial liberalization triggers financial development, which facilitates economic growth. The process of reforms or liberalization varies across countries and is dependent upon the prevailing politico-economic features. In some of the developing countries financial sector reforms started with interest rate liberalization, whereas in Nepal the easing of entry barriers was followed by the liberalization of interest rates on deposits and loans so as to foster competition. The statutory liquidity requirement (SLR) was lifted in 1989 as part of financial reforms, but re-imposed in 1991 for

two more years. Deregulation of interest rates and credit control began in 1986 and full deregulation took place only in 1989. Regarding international financial transactions, current account convertibility was undertaken in 1993, whereas move towards capital account convertibility has been cautious.

Different dimensions of financial liberalization and financial development are highly correlated. It is obvious that correlation does not imply causation, but it is likely to be an outcome of causality. The principal component analysis reduces a number of correlated variables into a smaller set of uncorrelated principal components. It sufficiently deals with the problems of multi collinearity. It expresses different dimensions of financial liberalization and financial development in terms of two indices of financial liberalization and financial development respectively. The new proxies of financial liberalization and financial development are able to capture most of the information from the original series.

The index of financial development consists of the ratios of liquid liabilities of the financial system to GDP, credit to private sector to GDP, domestic assets of commercial banks to the sum of domestic assets of Nepal Rastra Bank and commercial banks, and private sector credit to total loans and advances of commercial banks. The subject matter of financial liberalization is broader and it requires subjective judgment while constructing the index of financial liberalization. The grading is also subjective. However, some guiding principles have been adopted to reduce subjectivity. Interest rates control, for example, was graded as fully repressed when it was determined by the central bank and partially repressed when the interest rates were subject to a ceiling or floor or allowed to vary within a band. It was largely liberalized when some of

the interest rates were allowed to be completely market driven and finally fully liberalized when all the restrictions were removed completely.

Statistical examination of liberalization has two major challenges. Firstly, the policy changes tend to be periodic and triggers for these events need to be identified. The events move both ways, towards liberalization as well as reversals in the long-run process. Secondly, identification of dynamic process also leads to cumulative transformations. Since financial sector reform is an ingredient of overall economic reforms, it is difficult to extricate its effects from the reforms in other sector of the economy. Further, the task of reforms is not straightforward but with numerous pitfalls. Generally, it seems clear that financial liberalization has contributed to mobilize resources through the formal financial system and improved efficiency of allocation.

The reform process has been stretching for more than a decade. Although the process of reforms began in the mid-1980s, the major reforms took place in the late 1980s and comprehensive reforms undertaken after the restoration of democracy in 1990. This index, thus, jointly evaluates the liberalization of the domestic financial sector, the stock market and international financial transaction. The level of financial development was less than average of the overall period before 1993. Among the different variables, LBANK increased more than the others prior to 1981. It was mainly due to the increase in bank lending to the public enterprises and the government. It declined after the initiation of economic stabilization programme in the early 1980s. After liberalization, total domestic assets of commercial banks increased more than that of the central bank. LPRIVATE has an increasing trend but the pace is rather slow over time. LPRIVY has a declining trend before 1980. However, it

improved gradually after the initiation of reforms with a smooth growth path until 1994. The emergence of new banks and financial institutions in private sector after 1994 contributed to the growth of the ratio of private credit to GDP since 1994. Further, its growth is affected due to poor investment environment after 1998. The declining trend in 1980s improved gradually in the late years of the decade. However, it moved down in the year 1992 due to the adoption of contractionary monetary policy during 1991.

FINDINGS :

Poverty alleviation is the top priority of the government of Nepal. Government policy came vividly to fight against poverty vigoursly after the restoration of democracy. Realizing to uplift the poor family's socio-economic status Microfinance Banks, institutions & cooperatives are opened. It was Nepal Rastra Bank (NRB) initiated and led to setup Microfinance Banks regionally with the share capital of Govt , NRB & commercial Banks as Grameeen bikas banks & directed & systemized to commercial Banks to provide deprived sector loan three percent of their transaction I,e, loan to microfinance banks & institutions in simple interest rather than other business loan. And then many Mf Banks & institutions came into exist. Again the direction of deprived sector loan is 2 percent to Dev Banks & 1.5 to finance companies. Apart from this NRB provides a little loan to MF Banks & institutions from RSRF. Thus mf banks operated in rural area providing micro credit & saving mobilization, informal education, first aid health services training on skill development

With the pace and expansion of microfinance in the villages & rural areas the program gain popularity because of office stationed in village, contact to the poor family, select women in the group member, access of micro credit without

collateral & other development activities. Agriculture, livestock development, small irrigation, products marketing, & renewal energy are the main products in credit component as well as saving mobilization of the members and group center's meetings informal education which learned to plan their activities. Despite these activities Microfinance Banks are facing some issues & problems as follows.

Issues on microfinance is that it has not reached the ultra poor, remote areas, hills and not inclusive. But basically microfinance is based on the poor, inclusive and villages & slowly reaching the hills & inner side of terai It is surveyed & selected women from poor family, begins credit providing from 10/20 thousands without collateral. Offices are stationed in village level & objective is to uplift socio-economic status of the poor. Priority of the program is women, janjati & other backwards families. But the program is costly , lacking of infrastructure scattered house & risk is comparatively high. Therefore the Program is seeking & waiting the address & help from Gov & NRB.

Microfinance Banks are moving ahead facing the problems as follows :

Resource (fund) constraint: According to the direction of NRB, Commercial banks, dev banks & finance companies has to provide deprived sector loan 3 pc, 2 pc & 1.5 pc of their transaction to mfis but credit on micro hydro, hospital, youth for employment & small housing is countable in microfinance which is almost half of the resource altered for mfis from last year. MF Banks are expanding areas in villages & unreached districts but resources are going to be limited. NRB & Government should deeply initiate to the fact that 3 pc deprived sector loan must be available to mfis.

High interest on deprived loan : Micro finance program is one of the major tools of poverty alleviation, analyzing the fact NRB set the deprive sector policy to provide resources for the MFIs. Every commercial Banks, Development Bank and Financial companies has to provides 3, 2 and 1.5 percentage of their transactions in low interest rate (3-5%) But now these Bank revised their deprive sector lending rate (6-9%) which is the very higher rate for the MFIs. Due to high interest rate cost of funds has increased that poverty alleviation program has directly affected and has been difficulties to MF Banks to sustain. So NRB should take effective steps to reduce deprive sector lending rate to strengthening of MF Banks so that these banks could reach further remote areas.

High tax rate : All financial institutions are divided in to four categories by NRB. MFIs are lies in category "Gha" In these categories there is different types of rules for their establishment, maintain CRR and other aspects. But the corporate tax is equal to other commercial banks.

The profit of MF Bank's is lower than other banks, in this profit Nepal Government charged 30-% corporate tax which is maximum higher rate for MFIs. If Nepal government exempted corporate tax for MFIs, the rebate amount of tax would be used to have expansion service on poor family, institutional strengthening and capacity building of its staffs as well as client too.

Capacity building : Study, research & information are weak in micro finance banks. without these progressive phenomena banks are in difficulties to achieve the objective of poverty alleviation, the top priority program of the Govt. That is why Capacity building is one of the burning issues of MFIs To provide microfinance services to the rural poor in long-term, micro finance institutions should be strong and sustainable. When MFIS are being strong, they would be

able to provide new products and services to the rural poor. For that NRB, Nepal Government and other related agencies should be committed to enhance the capacity building of Micro Finance Banks vertically & horizontally that is intuitional capacities, staffs capacities and as well as client's skill development.

Public deposit: Bank & financial institution act 2oo6 has provision that Micro finance Banks can accept public deposit with the approval of NRB. It has been essential that public deposit be opened to maintain the fund scarcity. However NRB is positive. Now it is collected some deposit from the members which is small amount & is to learn the banking transaction to the poor. In other South Asian countries like Bangladesh have been permitted continuously & successfully activating public deposit.

Voice not heard : Policy level has not heard the voice of micro finance. There are problems and prospects in this program as development phenomena. Current problems and constraints in this program has been presented to the Government for years but Government has not taken it seriously and studying the trend and prospects. Big and Government owned bank's loan were written off more than 6 billion at the rate of 30 thousand loan and interest and also the interest up to 100 thousand. It affected to the micro finance banks directly but not a single pie and any sympathy was prevail to MFIs.

Sustainability and viability: Due to all the surroundings & policies microfinance banks are in cross-road. Tax is equal to commercial bank, Interest on Deprived sector loan is increasing highly day to day, lack of infrastructure, scattered houses reaching, motivation & service provide to poor in center/group level (ward/block) is costly and atmosphere is not supporting to MF banks. Knowing the fact that microfinance is the significant tool to reduce poverty

micro finance development Banks/institutions should sustain & viable that is why GOvt. & NRB should decide to exempt tax and resource availability soon. So that poor family will understand that the policy level is for poor.

SUGGESTIONS :

- Some of them find it difficult to pay the interest of the loan they have taken so they want low interest rate.
- Awareness program on different issues need to be organized so that small farmers will be aware of it.
- Approach for taking loan need to be removed so that easy access to loan can be guaranteed.
- Along with the saving and credit facility should also be introduced by the bank for the development of economic activities.

CONCLUDING REMARKS :

Nepal is the poorest country in the world and South Asia region. Its poverty reduction rate is low. The main reasons for low poverty reduction rate are: (i) low per capital income, (ii) concentrated urban growth, (iii) high population growth rate and (iv) hard geographical situation (v) and low level of education. About 38% populations are in below the poverty line. Most of the poor people are living in rural areas and have little opportunity to make self-reliant by them self. Micro-finance could help poor people who have no collateral, but a willingness to work and a desire to do some business activities from which he/she will acquire employment as well as income.

Although Nepal has adapted market-based economy, it still needs to enhance and develop rural sustained micro financial system with the coordination of government and private sector. Today's micro finance could turn into the

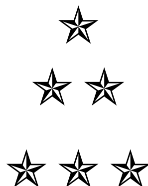
future market for the bank and financial institutions. Situation with appropriate market development intermediary might change in near future, if the time bound poverty addressed specialized micro financial policy environment is formulated and strictly implemented the provision of the policy towards the upliftment of the poor, and rural areas.

The analysis of several financial sector policies with the help of a single index of financial liberalization states that financial sector reforms is a process rather than a single moment event. It is clear that after the introduction of financial sector reforms in 1980s, the Nepalese financial sector has widened. The elimination of direct administration of the prices of financial products and private sector participation has contributed to this expansion. Financial liberalization is a process of removing restrictions taking several years to complete. Further, it is also characterized by reintroduction of restrictions at times, but only temporarily. Institutional reforms do not predate liberalization but they are vital for the success of financial sector reforms. It covers information on the quality of institutions as well as laws governing the functioning of the financial system. Improved quality of institutions is likely to reduce financial instability. This analysis shows that the process of financial reforms in Nepal is rather slow. Reforms are concentrated mainly on improving the financial health of large state-owned banks as well as capacity enhancement of central bank and other institutional improvement. The reorganization and reforming the Nepal Stock Exchange has raised the scope of financial market in Nepalese financial system. Global revolution in information technology and the country's integration with the rest of the world requires the financial sector to be more competitive and updated with recent financial products.

Financial development is not only caused by policy changes in the financial sector, but it largely depends on the demand of financial services in the

economy. The development of the financial sector is vital for economic development of a country. But it cannot be achieved in isolation with the other sectors of the economy. Simultaneous growth in all the sectors of the economy can raise more demand of financial services and it can stimulate financial development.

Policy changes have no impact indicates that the policy reforms have no impact on financial indicators, such as on banking credit to private sector and liquid liabilities. This implies, the reduction of domestic credit supply could not be reflected in the private sector credit. The presence of some problems in the banking sector of Nepal is weakening the impact of liberalization. Among them, for instance, during the last two decades, banks suffer from a problem of a high ratio of non-performing loans and it is always discouraging banks from credit allocation. The expansion of commercial banks and their expansion seemed very low in comparison to other bank and non-bank financial institutions, and banks could not capture local savings. Similarly, commercial banks could not capture monetary activities held by the government and other service sectors. This research suggests that the government policy makers should implement policies strictly for financial sector development and to promote growth. Similarly, more investigations to examine the impact of financial development on the economic growth process in Nepal are needed because the presence of a unit root in real GDP, private credit and broad money provides a way of estimating a long run relationship between them.



BIBLIOGRAPHY

1. Acharya, Keshab Prasad, Nar Bahadur Thapa and Shiva Sharma (1998). Economic Liberalization in Nepal: Sequence and Process. Kathmandu, National Labor Academy and Oxfam GB-Nepal.
2. Acharya, Meena and Khatiwada, Y.R. WITH Aryal, S. (2003), Structural Adjustment Policies and Poverty Alleviation, IIDS
3. Acharya, M. (2003). Development of the Financial System and Its Impact on Poverty Alleviation in Nepal Economic Review, Occassional Paper, Nepal Rastra Bank 15.
4. Bhetuwal, K.R. (2007). Financial Liberalization &Financial Development in Nepal. *Economic Review*, 19, Nepal Rastra Bank, Kathmandu, Nepal.
5. Berger, A. and T. Hannan, (1993) “Using Efficiency Measures to Distinguish Among Alternative Explanations of the Structure Performance Relationship,” Federal Reserve Board, Washington DC Working Paper,
6. Baltagi, B.H., Demetrides, P.O. and Law, S.H. (2009). Financial Development and Openness: Evidence from Panel Data. *Journal of Development Economics*
7. Bandiera, G, Gerald Caprio, Patrick Honohan and Fabio Schiantarelli (2000). "Does Financial Reform Raise or Reduce Saving?" *Review of Economics and Statistics*
8. Bhattachar, Y A, C A K Lovell and P Sahay (1997): “The Impact of Liberalisation on the Productive Efficiency of Indian Commercial Banks",*European Journal of Operational Research*
9. Baral JK (2005). Health check-up of commercial banks in the framework of CAMEL: A case study of joint venture banks in Nepal, J. Nepalese Bus. Stud.

10. Bakar N, Tahir IM (2009). Applying multiple linear regression and neural network to predict bank performance.
11. Berger, A. N., DeYoung, R. (1997). "Problem Loans and Cost Efficiency in Commercial Banks." *Journal of Banking and Finance*, Vol. 21
12. Bloem, M. A. and Cornelis N. G. (2001). The Treatment of Non-performing Loans in Macroeconomic Statistics. IMF Working Paper, WP/01/209
13. Chowdhury and Shrestha (2007). "The Impact of Financial Liberalization on Welfare: Evidence from Nepal," Applied Econometrics and International Development.
14. DeYoung, R. (1997), "X-Efficiency and Management Quality in National Banks." Journal of Financial Services Research, Vol. 15, No. 2
15. Drake, L. (2001). Efficiency and productivity change in UK banking. *Applied Financial Economics*
16. Dahal, Navin and Bhaskar Sharma (2004) ; *WTO membership: opportunity and challenges for small and medium enterprises (SMEs) in Nepal*
17. Demetriades, P., & Luintel, K. (1996). Banking sector policies and financial development in Nepal. Oxford Bulletin of Economics and Statistics
18. Eicher, T. & Hull, L. (2004). Financial Liberalization, Openness, and Convergence. *Journal of International Trade and Economic Development*,
19. Ferrai, A., Jaffrin, G. & Shrestha, S.R. (2007). Access to Financial Services in Nepal. The International Bank for Reconstruction and Development/ The World Bank, Washington, D.C.
20. Gopinathan T (2009). Financial ratio analysis for performance check. http://suite101.com/
21. Goldsmith, R. (1969). *Financial Structure and Development*. New Haven: Yale University Press.
22. Gupta, K.L. & Lensink, R. (1996). *Financial Liberalization and Investment*, Routledge, London and New York.
23. Ghimire, Bhumika, (2008) Nepal Faces Woes: the new republic facing rising inflation and high fuel cost, June 9

24. Gajurel, D. “Market structure of Nepalese banking industry,” Synergy: A Journal of Management (Faculty of Management, Tribhuvan University),
25. Gajurel, D. “Cost efficiency of Nepalese commercial banks,” Nepalese Management Review (Central Department of Management, Tribhuvan University),
26. Gande, A. (2008). Commercial Banks in Investment Banking. In V. T. Anjan & W. A. B. Arnoud (Eds.), Handbook of Financial Intermediation and Banking
27. Jha, D. K., Yorino, N., & Zoka, Y. (2007). *Benchmarking results of electricity generating plants in Nepal using Modified DEA models.* Osaka, Japan
28. Jimenez, G. and SaurinaJ. (2003). Collateral, Type of Lender and Relationship Banking as Determinants of Credit Risk.Bank of Spain.
29. Khatiwada, Yuba Raj (1999). "An Overview of Financial Liberalization and Agenda for Further Reforms", *Do We Need Economic Reforms Phase II*, Kathmandu, Institute for Integrated Development Studies.
30. Khatiwada, Y.R. (1994). *Some Aspects of Monetary Policy in Nepal*, South Asian Publishers Pvt. Ltd. New Delhi, India.
31. Khatiwada, Y.R. & Sharma, S.K. (2002). Nepal: Country Study Report, South Asia Network of Economic Research Institute (SANEI).
32. Kim, B.H, Kim, H.K. & Oh, K.Y. (2009). The Purchasing Power Parity of Southeast Asian Currencies: A Time- varying Coefficient Approach, *Economic Modelling*
33. King, R.G. & Levine, R. (1993). Finance and Growth: Schumpeter might be Right. *Quarterly Journal of Economics*,
34. Karim, M. Z. A., Chan S. G. and Hassan S. (2010). Bank Efficiency and Non-performing Loans: Evidence from Malaysia and Singapore. Prague Economic Papers
35. Koasmidou K (2008). The determinants of banks’ profits in Greece during the period of EU financial integration. Manag. Financ.

36. Maskay, N. M.and Subedi S. R. (2009). Development of Nepalese Financial System: Need for the Formulation of a Master Plan. Economic Review,
37. Mander, Jerry and Edward Golsmith (1996), *The Case Against the Global Economy.* Sierra Club Book, Sanfranciscio.
38. Pyakuryal, Bishwambher (2002). "Financial Sector Reform in Nepal: Needs and Challenges", *SEACEN Workshop on Macroeconomic Management*, Pokhara, Nepal
39. Pant, B. (2009). *Nepalese Financial System: Growth and Challenges*, Nepal Rastra Bank, Kathmandu.
40. Poudyal, N.P. (2005). *Financial System and Economic Development; 50 years of NRB*, Nepal Rastra Bank, Nepal.
41. Rajan, R.G. & Zingales, L. (2003). The Great Reversals: the Politics of Financial Development in the Twentieth Century. *Journal of Financial Development*
42. Romero-Avila, D. (2009). Multiple Breaks, Terms of Trade Shocks and the Unit Root Hypothesis for African Per Capita Real GDP. *World Development*
43. Ravichandran, K. (2010). Influence of service quality on customer satisfaction, application of SERVQUAL Model. *International Journal of Business Management*
44. Reynoso, J., & Moore, B. (1995). Towards the measurement of internal service quality. *International Journal of Service Industry Management*
45. Sahney, S., Banwet, D.K., & Karunes, S. (2004). A SERVQUAL and QFD approach to total quality education: A student perspective. *International Journal of Productivity and Performance Management*
46. Sulieman. (2011). Banking service quality provided by commercial banks and customer satisfaction. *American Journal of Scientific Research*
47. Sergio, M. (1996).Non-performing bank loans: Cyclical patterns and sectoral risk. *Review of Economic Conditions in Italy.* Rome: Jan-Jun 1996. , Issue

48. Shar AH, Shah MA, Jamali H (2011). Performance evaluation of pre- and postnationalization of the banking sector in Pakistan: An application of CAMEL model. Afr. J. Bus. Manag
49. Shrestha, Min B. (2005), Financial Liberalisation in Nepal, Ph.D. Thesis, School of Economics, University of Wollongong
50. Shrestha, Min B. and Khorshed Chowdhury (2007). "The Impact of Financial Liberalisation on Welfare: Evidence from Nepal," *Applied Econometrics and International Development*
51. Shrestha, M.B. & Chowdhury, K. (2006). Financial Liberalization Index for Nepal. *International Journal of Applied Econometrics and Quantitative Studies*
52. Sharma, Bhaskar,(2000) Banking The Future on Competition, *Business Age,* vol.2, No.12, November
53. Song, H., Witt, S.F. & Jensen, T.C. (2003). Tourism Forecasting: Accuracy of Alternative Econometric Models. *International Journal of Forecasting*,
54. Thagunna, K. S., & Poudel, S. (2013). Measuring bank performance of Nepali banks: A Data Envelopment Analysis (DEA) perspective. *International Journal of Economics and Financial Issues*,
55. Olweny T, Shipho TM (2011). Effects of banking sectrol factors on the profitability of commercial banks in Kenya. Econ. Financ. Rev.
56. World Bank, World Development Indicators Online Data Base (2010). Retrieved on December 2010, from data.worldbank.org/data-catalog

REPORTS AND JOURNAL :

57. CFA Institute (2012). CFA Economics. Basic Concepts and Principles. CFA Institute Pearson
58. Annual Report of Nepal Rastra Bank , 1980, 1985, 1990, 1995, 2000 & 2010
59. Nepal Rastra Bank (2003). Nepal Rastra Bank Samachar, 48th Anniversary Issue, April 2003. Kathmandu, Governor's Office

60. Nepal Rastra Bank (2004). Macroeconomic Indicators of Nepal, October 2004.

61. Nepal Rastra Bank (2005a). Commercial Bank Directives, www.nrb.com.np.

62. Nepal Rastra Bank (2005b). Development Bank Regulation, www.nrb.org.np.

63. NRB (2010). Banking supervision annual report, Bank Supervision Department, Nepal Rastra Bank, Central Bank of Nepal.

64. Nepal Development Forum, The role of private sector in Nepal's Development update and outlook on financial sector reform, paper prepared by Donner community in Nepal for the purpose of NDF, April 17-19, 2000 (Paris).

65. Nepal Rastra Bank. 1996. 40 Years of the Nepal Rastra Bank. Kathmandu: Nepal Rastra Bank.

66. Nepal Rastra Bank. 1996. Nepal Rastra Bank in 50 Years. Kathmandu: Nepal Rastra Bank.

67. Reports of Commercial Banks, Nepal, 2007