CHAPTER- I

INTRODUCTION

1.1 Background of the Study

Nepal is a beautiful country full of natural resources. The natural resources are being under utilized; the outcome is that the national economy is not developed enough. The economy development of the nation largely depend upon it financial market development and financial market development is backed by the role of central bank, Nepal Rastra Bank. Adverse trade balance has become the regular phenomenon of Nepal since long time and its magnitude is rising at an alarming pace. Poor performance of export and increasing tendency of imports (development, essential, luxury goods and raw essentials) are the basic ingredients to raise the import bill. Per capita income is increasing; however it is still quite low compared to neighboring countries. The low per capita income reflects low standard of living of the people and absolute poverty of the masses. Industrial activity mainly involves the processing of agricultural produce including jute, sugarcane, tobacco, and grain. Security concerns relating to the Maoist conflict had led to a decrease in tourism, a key source of foreign exchange. Nepal has considerable scope for exploiting its potential in hydropower and tourism, areas of recent foreign investment interest. Prospects for foreign trade or investment in other sectors will remain poor, however, because of the small size of the economy, its technological backwardness, its remoteness, its landlocked geographic location, its civil strife, and its susceptibility to natural disaster (The CIA World fact Book).

After the beginning of planned development in Nepal, various sectors are become developed gradually, being a foreign aid dependent country, she has to depend on foreign aid for the development of agriculture, education, communication, transportation, electricity, health etc. There is still large flow of foreign aid but it has contributed little in improving the quality of life of masses. The majority of people are still living in absolute poverty. Nepal is receiving continuous support for development endeavor from member of Nepal aid group, bilateral as well as multilateral agencies. In 2007/08, the Nepalese economy displayed a satisfactory performance in terms of economic growth. The robust performance of agriculture sector together with the satisfactory expansion of services sector placed the overall growth to a peak of four year high. The industrial performance however remained lackluster. Strikes, roadblocks, paucity of petroleum products, load shedding and turmoil in Terai region continued to drag down the pace of industrial growth in 2007/08. Overall, the real GDP at producers' prices grew by 4.7 percent in 2007/08 compared to a growth of 3.2 percent in the previous year.

The financial market which occupy quite an important place in the economy because through the financial instruments they collect, they provide much needed capital for the development of industry, trade and business and other deficit sectors, there by contributing to the economic growth of the nation. Both neighbor giant economies enjoy higher rate of economic growth around 7.3 percent by India and 9.0 percent by china in 2008. (Economy Report 2007/08, Nepal Rastra Bank).

National development of any country largely depends upon the economic development and economic development is possible only through sophisticated financial system. The prime responsibility of the financial sector is transmitting savings into productive investment. A well functioning financial system allocates savings to the best possible productive investment. This crucial role establishes the financial system as the ‘brain of the economy’. In the last century, the financial sector has been grown dramatically and emerged as one of the most important as well as one of the most dynamic sectors of the world economy (New Business Age, August 2006). Both in developed and developing countries, it is empirically proven that the growth and stability of economy largely depends on the capacity and efficiency of her financial system, the capacity and efficiency of financial system largely depends on role played by central bank in development and growth of financial market. The NRB Act, 2001 provides more autonomy to the central bank in the spheres of financial sector policy formulation and increases its capability for effective policy implementation. Also, the supervisory and oversight function of the central bank is expected to be strengthened substantially. The Debt Recovery Act, 2001 should help expedite the recovery process of the pending loans and contribute to reduce the share of the NPA of the banking system (NRB Newsletter 2006). There are 25 commercial banks, 59 development banks, 78 finance companies and 5 rural development banks, 12 micro credit development banks, 16 co-operatives and 45 NGOs (NRB licensed) are established during mid January 2009.

1.2 Focus of the Study

This study examines the role of NRB in development of financial market and relationship between the economic growth and financial market development in Nepal. This study also analyzes the gradual development of financial market in Nepal and role of NRB in it. This study mostly uses the statistical tools for analysis of role of NRB in financial market development and for analysis of present situation of financial market in Nepal and to show the relationship between economic growth and financial market development. This also analyses the control system implemented by NRB and present controlling system. Lastly, it is not only the cornerstone for the future research but also the detailed analysis of role of NRB in development of financial market in Nepal and it analyzed both present existing situation of financial market and relationship between financial market and economic growth and recommends some useful facts to the concerned parties.

1.3 Introduction to Financial Market

Financial market is the place where the financial instruments are traded; financial instruments included shares, bonds, debentures etc. It is a means to transfer funds from savers to those in need of funds. The failure of the financial market obstructs the progress of the whole economy. Financial markets can be defined as the centers or arrangements, which provide facilities for buying and selling of financial claims and services. More specifically, financial market chiefly refers to money market and capital market. It facilitates the transfer of funds from savers to those who with to invest in capital goods. Money Market can be defined as short-term financial market, which facilitates liquidity and marketability of securities. It is the market for short-term marketable instruments having less than one-year maturity period. Money markets are sometimes defined as organized and unorganized money markets. The organized or formal money markets provide an institutional mechanism for the transactions of short-term securities and commercial banks, finance companies and other saving/credit unions are the players in the money market. Local merchants, indigenous bankers and relatives come under the informal or the unorganized sector.

The development of efficient market requires the development of institutions, instruments and operating procedure that aids widening and deepening of the market and allocation of short-term resources with minimum transactions costs and delays. Capital Markets also play a vital role in the national economy. Capital market facilitates the allocation of longer-term funds between the savers and borrowers. This allocation will be optimum if the capital market has efficient pricing mechanism. If the capital market is efficient, the current share price of the company fully reflects the available information and there will be no question of the share price being over or under priced. Capital market is concerned with the long-term finance. The funds collected in the market are raised and traded by long-term financial instruments such as equities and bonds. Stock Exchange is a market for long-term capital where both new capitals can be raised by companies and where existing shares can also be bought and sold. By providing a second hand market for investors to sell their shares, it facilitates the raising of new capital on the new issues market. The stock exchange also provides a market for government loans and securities, and increasingly involved in the buying and selling of securities in the overseas companies. On the market, the main operators are the market makers who trade in a group of share, and the stock brokers who act as agents for their clients, who are the investors who are actually buying and selling shares. New York Stock Exchange (NYSE), London Stock Exchange, Tokyo Stock Exchange, Paris Stock Exchange, Frankfort Exchange, Toronto Stock Exchanges and Mumbai Stock Exchange are the biggest stock Exchanges of the world. Nepal Stock Exchange (NEPSE) is the only organized stock exchange of Nepal. In the financial system, financial market largely governed by central bank either directly or indirectly.

1.3.1 Strategic Planning of NRB in Financial Development

Nepal Rastra Bank (NRB), the Central Bank of Nepal, was established in 1956 to discharge the central banking responsibilities including guiding the development of the embryonic domestic financial sector. Since then, there has been a huge growth in both the number and the activities of the domestic financial institutions. To reflect this dynamic environment, the functions and objectives of the Bank have been recast by the new NRB Act of 2002,the preamble of which lays down the primary functions of the Bank as: to formulate necessary monetary and foreign exchange policies to maintain the stability in price and consolidate the balance of payments for sustainable development of the economy of Nepal; to develop a secure, healthy and efficient system of payments; to make appropriate supervision of the banking and financial system in order to maintain its stability and foster its healthy development; and to further enhance the public confidence in Nepal's entire banking and financial system.

The Bank is eminently aware that, for the achievement of the above objectives in the present dynamic environment, sustained progress and continued reform of the financial sector is of utmost importance. Continuously aware of this great responsibility, NRB is seriously pursuing various policies, strategies and actions, all of which are conveyed in the annual report on monetary policy which provides a comprehensive review and evaluation of the previous monetary policy and justification and the analysis of the following year's monetary policy. The re-engineering of the NRB itself is one of the critical components of the reform agenda. To improve the financial sector legislative framework, some new Acts, namely Bank and Financial Institution Act, 2006; Nepal Rastra Bank (First Amendment) Act, 2006; Insolvency Act, 2006; Secured Transaction Act, 2006; Company Act, 2006; Money Laundering Prevention Act, 2008 and Banking offence & Punishment Act 2008 have recently been enacted. Likewise The NRB has been adopting 25-point supervisory guidelines of the BASEL as the basis of regulation, inspection and supervision of banks and financial institutions. As per the recommendation of Accord Implementation Group formed to implement BASEL II in Nepal, the directives related to capital adequacy as per the BASEL II has been implemented for the financial institutions of category "A" from 2008/09 and later it will be implemented in other financial institutions also to strengthening the financial sector through building on its healthy development and improved stability.

These activities convey the commitment of the NRB for addressing the present and future challenges of the financial system more competently. This dynamic and proactive approach to the financial system, especially with its increasing openness and competitive process in the context of growing global financial environment, should ensure a sustained progress and stability of the financial system under NRB's guidance and leadership, for contributing substantially to the sustained development of the economy of Nepal.

The Nepalese economy is observing a structural change due to internal and external economic shocks. In the context of rapid economic globalization, financial liberalization and integration, and advancement in information and communication technology, NRB has to address the new issues and challenges emanating from changes in global economic environment in general and financial markets in particular. The new Nepal Rastra Bank Act, 2002, has provided it more autonomy in its policy and operations. It has already initiated the restructuring and reengineering process to meet the challenges of the twenty-first century central bank. As per the legal mandate, it has to formulate and implement monetary, foreign exchange and financial sector policies, regulate and supervise banks and financial institutions, manage foreign exchange reserve, promote develop modern payments and settlement systems and build the confidence of the general public in the financial system of the country. It has to follow these best central banking practices to make its objectives clearer, activities more transparent and operations more credible and accountable.

In this context, the Strategic Plan has been formulated by specifying the Bank’s core values and strategic objectives, reordering priorities, formulating strategies, determining annual action plans and performance indicators and optimizing resource use. The Plan has envisaged a new corporate culture and corporate administration that strongly believes in corporate governance and builds credibility to the public through transparency and accountability. It has been prepared with wider consultations and participations of the bank management and other stakeholders. As it is based on the dynamic and flexible concept, it can be implemented as a rolling plan-that can be modified and changed as per the changed circumstances. The plan will help the Bank to accomplish its institutional vision, mission, core values, and strategic objective and meet the burgeoning policy and management challenges for the coming five years. Nepal Rastra Bank has done significant homework to set up a strong foundation for a healthy financial system. The reform actions envisaged to bring about the expected outcomes in the financial system are the introduction of the new NRB Act and the Debt Recovery Act, which has already been done.

The NRB Act, 2002 provides more autonomy to the central bank in the spheres of financial sector policy formulation and increases its capability for effective policy implementation. Also, the supervisory and oversight function of the central bank is expected to be strengthened substantially. The financial institutions owned and controlled by the government still capture a large chunk of commercial and development banking, insurance business, micro-credit and other financial products. With the State-owned financial institutions mostly incurring huge losses and their financial condition deteriorating over the years, restructuring them and their eventual privatization becomes inevitable to ensure a strong and competitive financial structure on the one hand and improving the public sector resource allocative efficiency on the other. So, the government sector financial institutions need to be given utmost priority along the process of expediting the financial sector reform. The reform, appropriately sequenced and effectively implemented under a conductive macroeconomic environment, holds the key to developing a strong, smooth, and efficient financial sector and promotion of productive investments in the Economy.

In order to reduce problems inherent in the financial system in general and the government owned financial institutions in particular, encouraging the competitive markets and the private sector investment, institutional restructuring along with the privatization process are considered to be the most viable alternatives. Reform in the financial sector legislation, strengthening the bank inspection, monitoring and supervision process, restructuring of government-owned commercial and development banks, encouraging more investments in the banking sector, reduction of the directed/subsidized lending and expansion of the capital and insurance markets comprise the important ingredients of the reform agenda in the financial sector. NRB has issued a set of nine directives to the commercial banks so as to strengthen the commercial banking institutions, ensure corporate governance, consolidate their financial situation, improve the people's confidence in them, and contribute to the overall health and stability of the financial system. The directives relate to different areas of regulation, as follows: (i) maintenance of minimum capital fund, (ii) loan classification and loan loss provisioning, (iii) limit of credit exposure and facilities to a single borrower, group of related borrowers and single sector of the economy, (iv) accounting policies and formats of financial statements, (v) minimization of risk, (vi) good corporate governance, (vii) time-frame for implementation of regulatory directives issued in connection with inspection and supervision of bank, (viii) investment in shares and securities, and (ix) statistics reporting by commercial bank to NRB.

NRB has also issued 13 directives to the finance companies in order to improve their managerial and operating processes so as to enhance their role in the financial and economic systems of Nepal. The directives cover (i) minimum capital fund, (ii) financial resource mobilization ceiling, (iii) liquid assets, (iv) loan classification and loan loss provisioning, (v) single borrower limit, (vi) corporate governance, (vii) sectoral credit ceiling, (viii) investment requirements, (ix) interest rate, (x) setting-up branch/office, (xi) sale of promoter's share, (xii) audit, and (xiii) net profit and dividend. NRB is shortly issuing similar directives to the development banks and cooperatives with a view to bring about the desirable institutional growth and operational improvements in the non-bank financial structure. Paid-up capital requirement for the commercial banks, development banks, finance companies and cooperatives is being raised in the near future. For the effectiveness of the inspection and supervision of the commercial banks and other financial institutions, inspection manual has been prepared and training programs are implemented. As part of the financial sector reform, in-house central banking modernization activities are proceeding in full swing in NRB. IMF technical assistance has also been utilized for this purpose.

1.3.2 Development of Financial Institution in Nepal

The development of financial sector in Nepal is relatively new. The establishment of "Tejarath Adda" during the year 1877 A.D. was the first step in institutional development of banking sector in Nepal. Tejarath Adda did not collect deposit from public but granted loans to public against the collateral of bullions. Consequently the major parts of the country remain untouched from these limited-banking activities. The development of trade with India and other countries increase the necessity of the institutional banker, which can act more widely to enhance the trade and commerce and to touch the remote non-banking sector in the economy. Considering this situation, the "Udyog Parishad" was constituted in 1936 A.D. One year after its establishment, it formulated the "Company Act" and "Nepal Bank Act" in 1937 A.D. Nepal Bank limited was established under Nepal Bank Act in 1937 A.D. as a first commercial bank of Nepal with authorized capital of Rs. 10 million.

Modern banking practices emerged with the establishment of Nepal Bank Limited in 1934 A.D. However the stand of Nepal Bank limited alone in total monetary and financial sector was not sufficient and satisfactory. Thus Nepal Rastra Bank was set up on 1956 A.D.(2013.01.14) as a Central Bank under Nepal Rastra Bank Act 1956 A.D. (2012 B.S.). Similarly, on 1966 A.D. (2022.10.10) Rastriya Banijaya Bank (RBB) was established as a fully government owned commercial bank. With the emergence of RBB, banking service spread to both the urban and rural areas but customers failed to have taste of quality and competitive service because of excessive political and bureaucratic interference. For industrial development, Industrial Development Center was set up in 1956 A.D. (2013 B.S.) which was converted to Nepal Industrial Development Corporation (NIDC) in 1959 A.D. (2016 B.S.). Similarly, Agriculture Development Bank (ADB/N) was established in 1976 AD (2024.10.07) with an objective to provide agricultural products so that agricultural productivity could be enhanced through introduction of modern agricultural techniques. As the country moved towards economic liberalization in 1980 A.D., foreign Banks were invited to operate in Nepal. The financial scenario has changed with the introduction of joint venture banks in 1984.The number of commercial banks has been increasing. Since then, various financial institution like, Joint

Venture Banks, Domestic Commercial Banks, Development Banks, Finance Companies, Micro Finance Companies, Credit Guarantee Corporation, Employee Provident Funds, Citizen Investment Trust, National Insurance Corporation, Nepal stock Exchange have come into existence to cater the financial needs of the country thereby assisting financial development of the country.

In 1990 A.D. after the restoration of democracy in Nepal, the government highlights the agenda of economic liberalization and emphasized to invite Foreign Direct Investment (FDI) in the banking sector of Nepal. Taking an overview of financial institutions providing banking facility in Nepal, there are 25 Commercial Banks, 59 Development Banks, 78 finance companies, 12 micro credit development banks, 5 Rural Development Banks, 16 Co- operative Societies and 45 NGOs (licensed by NRB for limited transaction).

In Nepal, Commercial banks play a vital role in the economic growth. Its investments range from small-scale cottage industries to all types of social and commercial loans and large industries. Generally the investment of the commercial banks include the investment on Government securities like Treasury bills, development bonds, national savings bonds, foreign government securities, shares of government owned companies and non- government companies and investment on debentures. Similarly the Commercial Banks use their major chunk of funds in loan and advances. The branch-opening scenario of Nepalese commercial banks since last nine years can be regarded as follows;

Table 1.1
Branch Opening Scenario of Nepalese Commercial Banks
* Branches opening includes up to mid April 2008.

Region\ Year Starting	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008*	District
Kathmandu Valley	75	75	83	82	87	89	92	94	135	139	3
Hills and Mountains	192	164	145	130	125	119	122	126	163	168	52
Terai	214	200	202	188	167	167	161	170	268	289	20
Total	**481**	**439**	**430**	**400**	**379**	**375**	**375**	**390**	**566**	**596**	**75**

Extended branches include both government owned & private sector commercial banks. Most often it is said that due to security problem branches are retrenched from different area to the more secured cities. The structure of Nepalese financial system is presented in Annexure 7.

1.4 Statement of the Problem

Financial market plays catalytic role in the economic development of each an every country. Efficient financial market paved the way to economic development. It is possible only after proper circulation of financial instruments and development of financial intermediaries in qualitative and quantitative manner. Central bank plays holistic role in development of financial market. In Nepal, the financial sector contributes over 10 percents of the GDP but the sector contributes only 0.2 percent of Nepal's commercial services exports in year 2003 (New Business Age, August 2006) So by the study, it is going to explore: does Nepal Rastra Bank plays significant role in development of Nepalese financial market? Or what is the actual condition of the Nepalese financial market place? If the condition of the financial market is not at satisfactory level, what are the barriers and how it can be removed or mitigated? Focusing on the Nepalese context, the structure of the economy has still remained primarily agriculture with very small manufacturing base, so it is essential to divert and modify agro based economy. Nepal has adopted mixed and liberal economic policy with the implicit objective to help the state and the private sector on the ground of open and liberal eco- system. Nepal is exporting raw materials instead of producing goods and services from this. If the efficient financial market is established many factories can be established to reap benefits from utilization of resources, which would increase the employment, living standard and status of economy.

1.5 Objectives of the Study

The main objective of this study is to analyze role of Nepal Rastra Bank in development of financial market in Nepal. This study will also provide the appropriate suggestion to make efficient financial market or it will provide concrete recommendation on how NRB can play more crucial and accountable role in development of sound financial market in Nepal. This study aims at fulfilling the following objectives;

1. To analyze the relationship between financial system and economy development.
2. To explore current situation of financial market in Nepal.
3. To analyze the role of Nepal Rastra Bank in development of financial market.
4. To provide appropriate suggestion and recommend the general conclusion for the development of Nepalese financial system.

1.6 Significance of the Study

As a study of role of NRB in development of financial market in Nepal, this study basically analyzes the present situation of development of financial market and role played by NRB in it. The effectiveness of existing role will be evaluated and the possibilities of implementing financial principles will be examined. This study assists NRB and other financial intermediaries to face the problems outlined in the statement of the problem. This study is significant because it relates to the overall role of NRB in Nepalese financial market growth and its existence today. This is also proved by research gap felt in the literature review chapter. The recommendations given at the end of this study are more practicable and useful for the further improvement in role of NRB to make financial market more sophisticated.

Principally, role of central bank is prudent for financial market development. But in true practice, the aforementioned theory may not come true especially for developing countries like Nepal because most of the theories of financial market are determined by studies which had been conducted on developed countries like USA, Great Britain and so on. So it is quite necessary to conduct a fair research study and develop facts about role of central bank in development of financial market in developing countries like Nepal.

1.7 Limitations of the Study

Like every research study this study has some limitations. This study is simply a partial study for the fulfillment of MBS degree, which has to be finished within limited period.

Hence, this study is not far from several limitations of its own kind, which weaken the scope of the study to some extent.

Some of such limitations are as follows.

a) This study is only concentrates with those factors, which are related with contribution of NRB in development of financial market in Nepal.
b) The truthfulness of result is based on the data available from the different organizations and employees.
c) This study is based on sampling technique for simplicity out of total population.
d) Resource including monetary and non- monetary available to the researcher are also felt significant.
e) Role of external factors (PEST) are ignored in development in financial market and only the role of NRB is focused.

1.8 Organization of the study

The proposal study is organized into five different chapters that are as follows:

- Introduction
- Review of Literature
- Research Methodology
- Data Analysis and Presentation
- Summary, Conclusion and Recommendation

1.8.1 Introduction

First is introduction chapter, which deals with general background, brief introduction about financial market, its roles and functions and details introduction about Nepal Rastra Bank, statement of the problem, and objectives of the study, significant of the problem, limitations of the study and organization of the study.

1.8.2 Review of Literature

This chapter deals with review of available literatures in the field of the study being conducted. This includes review of the theories of the concerned topic, review of books and review of various empirical studies.

1.8.3 Research Methodology

This chapter explains the research methodology employed to conduct the study and tools and techniques used in analysis of the data as well. This chapter includes research design, source of data, population and samples, methods of data analysis and various financial and statistical tools.

1.8.4 Data Analysis and Presentation

Fourth chapter is devoted to the presentation, analysis and interpretation of the study through definite course of research methodology. This chapter also contain major finding of the study.

1.8.5 Summary Conclusion and Recommendation

Fifth and the last chapter is conclusive and suggestive chapter. It includes summary of the study, conclusion of the main finding and recommendation for further improvement.

Besides these, bibliography and appendices are also presented at the end of the thesis. Similarly acknowledgment, table of contents, list of tables, list of diagrams, acronyms used are included in the front of the thesis report.

CHAPTER- II

REVIEW OF LITERATURE

2.1 Theoretical Concept

Before getting in to the core concept of role of NRB in financial market development, it is logical to be familiar with some technical terms, financial market, types of financial market, functions of financial market, role of NRB etc. which are essential to know when analyzing role of central bank in financial market development. Financial market is the place where the financial instruments are traded; financial instruments included shares, bonds, debentures etc. It is a means to transfer funds from savers to those in need of funds. The failure of the financial market obstructs the progress of the whole economy. Financial markets can be defined as the centers or arrangements, which provide facilities for buying and selling of financial claims and services. More specifically, financial market chiefly refers to money market and capital market. It facilitates the transfer of funds from savers to those who with to invest in capital goods. Money Market can be defined as short-term financial market, which facilitates liquidity and marketability of securities. It is the market for short-term marketable instruments having less than one-year maturity period. Money markets are sometimes defined as organized and unorganized money markets. The organized or formal money markets provide an institutional mechanism for the transactions of short-term securities and commercial banks, finance companies and other saving/credit unions are the players in the money market. Local merchants, indigenous bankers and relatives come under the informal or the unorganized sector.

2.1.1 Types of Financial Market

It is not easy to classify the financial market in to various types and categories. In fact, there is no any hard and fast rule to classify the financial market. Even then for the purpose of simplification and make it understandable, financial market is classified in the following order.

i. Open vs. Negotiated Market

The distinction between markets in the financial system that is often useful focus on open markets vs. negotiated markets for some corporate bonds are sold in open market to the highest bidder and bought and sold only number of times before they mature and are paid off. In constraints, in the negotiated market for corporate bonds securities generally sold to one or few buyers under private contract. An individual who goes to his/her local bankers to secure a loan for a new car enters the negotiated market for auto loans. In the market for corporate stocks there are major stock exchanges which represent the open markets. Operating at sometimes, however, is the negotiated market for stock in which is corporation may sell its entire stock issue to one or handful to buyers.

ii. Primary vs. Secondary Market

The primary market is for the trading of new securities never before issued. Its principal function is raising financial capital to support new investment in building, equipment and inventories. You engage in a primary market transaction when you purchase share of stock just issued by a company or borrow money through a new mortgage to purchase a home. In contrast, the secondary market deals in securities previously issued. Its chief function is to provide liquidity to security investor i.e. to provide an avenue for converting financial instruments in t ready cash. If you sell stocks or bonds you have been holding for some time to a friend or call a broker to place an order for shares currently being traded on the Nepal Stock Exchange or in the other Stock Exchanges you are participating in the secondary market transaction.

iii. Spot vs. Future, Forward, Option Market

A spot market is one which securities or financial securities or financial services are traded for immediate delivery (Usually with in one or two business day). If you pick up a telephone instruct your broker to purchase Telecom Corporation’s share at today’s price this is spot market transaction. You expect you acquire ownership of Telecom share with n matter of minutes or hours. A future or forward market, on the other hand is designed to trade contract calling for future delivery of financial instruments. For example, you may call your broker and ask to purchase a contract from another investor calling for delivery to you of Rs. One Million in T-bonds for Six months from today. The purpose of such contract would e to reduce risk by arranging on a price today rather than waiting Six months when T-bonds prices might have risen. Option market also offers investors in the money and capital market on opportunity to reduce risk these markets make possible the trading of option on selected stocks and bonds which are agreements that given an investor the right to either by from or sell designated securities to the writer of the option at guaranteed price at any time during the life of the contract.

iv. Money vs. Capital Market

On the basis of life span financial market can be divided in to money market and capital market. In the money market financial instrument with the maturity of typically one year or less than one year are traded. The primary function of money market is to provide liquidity to an economy unit. These functions are providing short-term loan to the business, government and individuals. The deficit business unit kike government and business fulfill their short term needs by issuing money market instruments like government T- Bills, commercial papers etc. These instruments are purchased by surplus generating economic unit to supply their saving in needed areas. Generally, house holds, commercial banks and some non-financial business co- operation with temporary surplus is the provider of surplus funds to the money market. Examples of money market instruments: T- Bill, Negotiable Certificate of Deposits, Bankers' Acceptance and Commercial Paper, Federal Funds, Euro Currencies.

Capital market is a market in which financial assets with maturity period of more than one year are traded. The long-term financial instruments like Stocks; Bonds etc. are traded in the capital market. All the house hold, business and government are the borrower of funds in capital market families and individuals need long term funds for residential purpose, government requires such types of funds to make expenditure on policy related facilities like construction of schools, hospitals, roads etc. The business firms rely on capital market for funds to purchase equipment and other constructions. The financial institutions like insurance companies pension funds etc. are the primary suppliers of long-term fund on the capital market. Examples of capital market instruments are Corporate Stocks, Corporate Notes, Bonds, Mortgage Loans, Tax Exempt Bonds, Consumer Loans, Euro Bonds and Euro Notes etc.

2.1.2 Functions of Financial Market

No one can deny the crucial functions of financial market in the economy because financial market channelise the saving to those individuals and institutions needing more funds for spending than are provided by their current incomes. So, the financial market is the heart of the global system attracting and allocating savings and setting interest rate and the prices of financial assets. The basic functions of financial markets are presented in different category. They are as follows;

i. Saving Function

Financial system performs the saving function by providing public saving toward productive uses. This is possible through purchase of financial assets like bond and stock sold on money and capital market. These saving flows through financial market into investment and such investment are used for producing more goods and services which increases the living standard and contrast of society.

ii. Liquidity Function

Financial system performs the liquidity function by providing a means of raising funds by converting securities and other financial assets in to the spend able cash balances whenever the saver need money.

iii. Credit Function

Credit is the loan amount supplied by lender to the user. In return, borrower promises to make future payments. Financial system performs the credit function and credit is needed by various units in the economy to support consumption and investment.

iv. Payment function

The financial system provides a mechanism for making payment for goods and services, basically the cheque account serve as the medium of exchange of making payment.

v. Risk Function

The financial market provides the means to protect business firm, consumers, and government against risk to life, health, property and income. Such function is performed by selling the various types of insurance policies through the financial market. It also reduces the risk by contract the future and forward contract.

vi. Policy Function

The financial market is the medium for implementing government policy with a view to achieve stability economic growth to generate more employment opportunities. The borrowing and lending plans of property are affected by availability of credit and interest rate that influence the creation of job and production.

vii. Wealth Function

The term wealth is the sums of values of all assets hold by individuals, business firm or government units. Any economic unit in the financial system can store their wealth either in financial instruments or in things like real assets. When the funds are not needed for spending but choosing to store wealth in real estate, subjects more risk of losses and depreciation. There fore the financial market provide o excellent way to store wealth in financial market provide on excellent way to store wealth in financial instruments because these assets do not wear out over time.

2.1.3 Role of Central Bank in the Financial System

Central bank appear to influence the spending, saving and borrowing decision of millions of individuals and businesses through at least five interrelated channels- the cost and availability of credit, the volume and rate of growth of the money supply, the market value of assets held by the public, the relative price of world currencies and the public's expectations regarding domestic and international economic conditions. Beyond these the main roles performs by central bank as an autonomous body are cited below.

1. Control of Money Supply

The first and most important function of central bank is the control of money supply because changes in the money supply appear to be closely linked to changes in economic activity. A number of studies in recent years have found a statistically significant relationship between current and lagged changes in the money supply and changes in nominal gross domestic product. Central bank is the principal source of currency and coin because it has monopoly right assigned by government to issue notes and coins. So, if the central bank can control the rate of growth of money it can influence the nominal growth rate of the economy as a whole.

2. Stabilizing the Money and Capital Market

Another vital function of central banking is stabilization of the money and capital markets. The financial system must transmit savings to those who requires funds for investment so the economy can grow. If the system of money and capital market is to work efficiently, however, the public must have confidence in financial institutions and be willing to commit its saving to them. If the financial markets are unruly, with volatile fluctuations in interest and security prices, or if financial institutions are prone to frequent collapse, public confidence in the financial system might well be lost. The flow of investment capital would dry up, resulting in a drastic slowing in the rate of economic growth and a rise in unemployment.

All central bank play a vital role in fostering the mature development of financial markets and in ensuring a stable flow of funds through those markets. Pursuing this objective, a central bank may, from time to time, provide funds to major securities dealers or depository institutions when they have difficulty financing their portfolios or providing an adequate supply of credit so that buyers and sellers may easily acquire or sell securities and borrowers interested in making investment can find adequate funding. When the money supply and interest rates rise or fall more rapidly than seems consistent with economic goal and the desired volume of saving and investment in the economy, a central bank may again intervene in the financial market place.

3. Lender of Last Resort

Another essential function of many central banks is to serve as a lender of last resort. This means providing liquid funds to those financial institutions in need, especially when alternative source of funds have dried up. The central bank can supply large amounts of emergency funds very quickly, as occurred.

4. Maintaining and Improving the Payment Mechanism

Finally, central banks have a role to play in maintaining and improving the payment mechanism. This may involve the central bank helping to clear checks, providing an adequate supply of currency and coin, wiring funds, and preserving confidence in the value of the fundamental monetary unit. A smoothly functioning and efficient payments mechanism is vital for business and commerce. If checks or electronic payments cannot be cleared in timely fashion or if the public cannot get the currency and coin it needs to carry out transaction, business activity will be severely curtailed. The result might well be large-scale unemployment and a decline in the nation's rate of economic growth.

2.1.4 Objectives of NRB

Nepal Rastra Bank Act 2002 replaced Nepal Rastra Bank Act 1955. NRB shall have powers to regulate the functions and activities of commercial banks and financial institutions and it may inspect and supervise them. In the new enacted law, objectives of the NRB are clearly incorporated which are as follows:

a) To formulate necessary monetary and foreign exchange policies to maintain the stability in price and consolidate the balance of payments for sustainable development of the economy of Nepal.
b) To promote stability and liquidity required in banking and financial sector;
c) To develop a secure, healthy and efficient system of payment;
d) To make appropriate supervision of the banking and financial system in order to maintain its stability and foster its healthy development; and
e) To further enhance the public confidence in Nepal's entire banking and financial system.

NRB has paid full attention to be accountable and to fulfill these objectives by standing incorporated principles. Nepal Rastra Bank Act 2002 has clearly defined the core principles of NRB which are cited as below;

a) It is an autonomous body;
b) It safeguards public interest and contributes to economic development; and
c) It ensures economic stability by introducing monetary policy in consonance with the fiscal policy of the government.

2.1.5 Financial Instruments Prevailing in Nepalese Market

Everybody put consent on the fact that is Nepalese financial market growing at a tortoise speed. Number of financial intermediaries is a bit little and types of financial instruments traded in the market are also low. Financial instruments include both money market instruments and capital market instruments. In the Nepalese context, not all the globally accepted instruments are practiced that’s why some financial instruments practiced in Nepalese market are described below.

1. Money Market Instruments: Money market instruments are those instruments which have maturity of one or less than one year. It is for short-term credit, it is used to help corporation or government to pay wages and salary for their workers, make repair, purchase inventories, pay dividend and taxes and satisfy other short-term obligations. Money market also provides channel for exchange of financial assets for money to meet purely short-term needs. This is the mechanism through which "holders of temporary cash deficits". We must remember money is one of the most perishable of all commodities, holding idle surpluses is expensive to all due to its opportunity cost that's why money market instruments are emerged. Money market instruments frequently practiced all over the global and also traded in the Nepalese market are as follows.

A) Treasury Bills

Treasury bills are an obligation issued by government, sold at a discount from the face value. T-bills are the most marketable of all money market instruments. It represents the simplest form of borrowing to the government. T-bills are extremely liquid, short-term notes that mature in 13, 26 or 52 weeks from the date of issue. Treasury bills are sold using 'auction' technique. Regular bill issue is announced on Tuesday by NRB. The minimum value of T-bills in Nepal is Rs. 25,000/-.

B) Banker's Acceptances

Generally, importers to secure trade credit for exporters use it. The accepting bank guarantees payment by the importer. In general, an acceptance is a promise to pay. The promise is made by the person or entity that will actually make the payment- the promissory – to the person or entity who will receive the payment- the payee or beneficiary. The promise to pay document is called a draft. Payment of the draft will be made on a specified future date, so the draft is called a time draft. To seal the promise, the promissory signs the draft and stamps or writes the word "Accepted" above his signature and adds the date on which the amount is written. The formally accepted draft becomes a legal obligation to the parties. If the acceptor is the bank, the acceptance is called a Banker's Acceptance. The promissory then becomes obligated to pay the bank the amount financed in full with interest on or before the maturity date, and the bank becomes the primary entity obligated to pay the amount due to the payee. Banker's Acceptances are used in the foreign trade by commercial banks frequently.

2. Capital Market Instruments

Capital market instruments are those instruments which have maturity of more than one year. It if for long term capital needs like enhancement of land, building, installation of plant, development of human resource etc. that's why capital market instruments provide capital to meet purely long term capital requirements. Among all some instruments practiced in Nepal are described below:

A) Common Stock

The common stock represents equity, or an ownership position in a corporation. It is a residual claim, in the sense that creditors and preferred stockholders can receive any payments (Sharpe, Alexander & Bailey, 2000:322). Common stocks have one important investment characteristics and one important speculative characteristic. Their investment value and average market price increase regularly but persistently over the decades as their network builds through the reinvestment of undistributed earnings. … However, most of the time common stocks are subject to irrational and excessive price fluctuation in both directions, as the consequence of the ingrained tendency of most people to speculate or gamble i.e. to give way to hope, fear and greed (P. Chand, The Investment Game, 1995:45). The common stock investment comes from either of the two sources – the periodic receipt of dividends and capital gains. Common stockholders enjoy a number of rights such as are dividend rights, assets rights, preemptive right and voting rights etc. Common stock is a popular investment alternative in Nepal. Only the common stocks of listed companies are traded in Nepal Stock Exchange.

B) Preferred Stock

Preferred stock, also known as preference share is a hybrid form of capital market instrument with combined features of both common stock and long-term debentures. The investor receives preference dividend which is discretionary. Failure to pay such dividend will not result in a default of a company's obligation or insolvency of the company. The market of preferred stock in Nepal is very lean. Just a very few companies have issued only redeemable preferred stocks. Preferred stocks are traded in NEPSE.

C) Long term Government Securities

Government securities are the fixed income securities issued by governments. These securities are among the safest of all investments, as the government is unlikely to default on interest or on principal repayments. They are of three types, treasury notes, treasury bonds, saving bonds. NRB issues long-term government securities. Development bonds national saving bonds and citizen savings bonds are the long-term government securities issued by NRB on behalf of the government. Long-term government bonds are listed in NEPSE.

D) Corporate Bonds

A corporate bond is a long-term promissory note issued by a corporation. A corporate bond has more risk and return than that of government bonds. Bondholders receive a fixed return and the principal amount at the maturity date and have priority before common stock and preferred stock in the event of liquidation. It is traded in organized stock exchanges like NEPSE and in the over the counter markets. The debentures issued by Everest Bank have been listed on 2062/04/25 B.S.

Besides this, there are two mutual funds are availed in Nepal. One of them Nepal Capital Market (NCM) mutual fund is traded in NEPSE. These all limited number of financial instruments and their limited number reflect the childhood of financial market in Nepal.

2.2 Review of Roles Played by Foreign Central Banks

Every central bank must have prudent role in financial market development in respective country so, since history most of the central banks have been bearing such responsibility successfully. Let us, review development and some important roles played by some selected Asian central banks. Those banks include Reserve Bank of India, Bank of Korea, Bank Negara Malaysia and State Bank of Pakistan.

A) Central Bank of India

The Reserve Bank of India is entrusted with the supervision of India’s banking system under the provisions of the Banking Regulation Act, 1949 and the RBI Act 1934. In order to provide focused supervision of financial entities, the board for financial supervision was constituted in November 1994, as a committee of the central board of directors of the reserve bank with the objective of supervising commercial banks, select financial institutions, non banking financial companies, cooperative banks and primary dealers (http://www.wss.rbi.org.in). A major element of financial sector reforms has been a set of prudential measures aimed at imparting strength to the banking systems as well as ensuring safety and soundness through greater transparency, accountability and public credibility (Unpublished Article of Department of Economic Analysis and Policy of RBI).

Consolidated accounting for banks has been introduced along with a system of Risk-Based Supervision (RBS) for intensified monitoring of vulnerabilities. The Reserve Bank, in close and continuous consultation with the Government, has played a major role in institution building since independence (www.rbi.org.in/). Efforts in this direction encompass Reserve Bank’s contribution in the form of development of commercial banking, development finance institutions for different segments of the economy, and specialized institutions for development of financial markets. Since the onset of economic reforms in the early 1990s, the role of Reserve Bank in the area of developing the various financial markets have come to the fore. Furthermore, in a global environment, with increasing integration of the international economy, the Reserve Bank’s role as the regulator and supervisor of commercial banks and financial institutions has assumed a central place in promoting transparency and credibility of institutions and monetary and financial policies (http://www.reservebank.com/).

B) Central Bank of Korea

The Bank of Korea was established on June 12, 1950 under the Bank of Korea Act, as the country's central bank. For more than 50 years since its establishment, the Bank has gone through many adjustments in respect of its independence and functions, in accordance with changes in the financial and economic environment and government economic policies. At the time of its foundation, the Korean economy was in turmoil suffering severe and chronic inflation with adequate monetary and financial systems not in place. This situation of the times could explain the fact that the primary purposes of the Bank of Korea included, besides securing price stability as the central bank's traditional objective, preserving the soundness of the banking and credit systems and managing the country's foreign reserves. The bank of Korea was empowered to perform not only the orthodox functions of a central bank, but also given the exclusive authority to carry out banking supervision and formulate foreign exchange policy. In order to ensure the independence of the Bank of Korea, its policy- making body (Monetary Board) was to be made up of experts with ample experience and extensive knowledge concerning finance, economy and industry (http://www.bok.or.kr/).

The newly installed Government set out growth-oriented policies. Accordingly, it strengthened its influence over the central bank to support the government's economic program. During the 30 years after this transition, there were no significant changes in the Bank's institutional aspects. There were technical improvements including the supplementing of monetary and credit policy instruments (1968), an increase in the number of officers in charge of banking supervision (1977) and abolition of the government's prior approval for the Bank's budget (1982). During this period, there were several legislative attempts to enhance the independence of the Bank, but they failed to be passed. The Bank of Korea underwent significant institutional change and financial reform initiated following the financial crisis at the end of 1997. With the amendment of the Bank of Korea Act in late 1997, on the one hand the Bank was granted more autonomy in its monetary policy; on the other hand the authority for banking supervision was stripped from the Bank and assigned to a new integrated financial supervisory body. There were substantial changes in the functions of the Bank of Korea (http://www.bok.or.kr/). The transfer of its banking supervision authority to the integrated financial supervisory body was partially balanced by the maintenance of its right to request information from financial institutions for monetary policy implementation, to require the financial supervisory body to examine banking institutions and to participate on a joint basis in the examination of banking institutions. In addition, the Bank took on a new responsibility for the oversight of the payment and settlement systems, an area which has recently attracted greater attention globally. Meanwhile, the Bank's accountability was also heightened, as it now has to report on its conduct of monetary policy implementation to the National Assembly at least twice a year (Unpublished Article Office of the Governor, The Bank of Korea).

C) Financial sector development in Malaysia

In addition to the traditional role of central banks in promoting monetary and financial stability, a key objective of Bank Negara Malaysia (the Central Bank of Malaysia) has been to influence the credit situation to the advantage of the nation. A well functioning and efficient financial system is vital to achieve these objectives. Indeed, the development of an effective and efficient financial system that is sound and resilient is an essential pre- requisite to achieve balanced economic growth and social development. Bank Negara Malaysia has consciously and systematically sought to develop a modern and sophisticated financial system. During this period the financial system has had an important role in effectively mobilizing and Bank Negara Malaysia allocating resources for productive use to contribute towards the rapid economic transformation and changing financing requirements of the Malaysian economy. During the formative years a key priority of the Central Bank was the creation of the basic financial infrastructure, including the development of domestic banks to complement the already strong foreign banking presence in the economy (http://www.economywatch.com/banks/central-banks/bank-negara-malaysia.html). The creation of the basic infrastructure of the financial system, notably the development of a wide network of domestic banks, was considered an important pre-requisite for ensuring access to banking services for all segments of society, regions and economic activities, thus the financing requirements for economic diversification. During 1980s, the Bank’s attention was focused on further strengthening the regulatory and supervisory framework for the banking system to reduce the economy's vulnerability to external shocks. This involved a process of prudential re-regulation and significant structural changes to strengthen the banking system. These measures were instrumental in maintaining the soundness and resilience of the Malaysian banking system in weathering the difficulties which arose when Asian financial unfolded in 1997 (Unpublished Article Office of the Governor, Bank Negara Malaysia).

The over-riding objective of the Financial Sector Master Plan was to develop a more competitive, resilient and dynamic financial system, benchmarked against international best practices and standards, which was able to meet the increasingly sophisticated and demanding requirements of the domestic economy. It was also envisaged that the system would be able to adapt and adjust to the technological advances and financial innovations. Central to this process, was the development of a core of strong and forward looking domestic financial institutions that were more technology-driven and able to face the challenges of globalization and liberalization. The central bank launched financial sector master plan in March 2001. The initiatives that had been implemented thus far had resulted in a financial sector that was stronger, more resilient and better placed to face greater competition. The ability of the domestic financial institutions to continue to register strong financial results despite the increasingly competitive environment reflects their enhanced strength and capabilities. At the same time, the regulatory framework had also been further strengthened commensurate with the challenges of the increasingly complex financial markets. Financial institutions had adopted better risk management practices in their business operations, which accorded them greater flexibility and capacity to respond to the increasing consumer demands and expectations. The creation of robust financial institutions that were able to withstand any potential shocks, and that possessed the agility and adaptability to embrace future challenges were keys in ensuring their long-term sustainability in a more competitive environment, as well as in preserving financial stability (Unpublished Article Office of the Governor, Bank Negara Malaysia).

D) Central Bank of Pakistan

The State Bank of Pakistan (SBP) is the central bank of Pakistan. The main objectives of SBP are defined in the strategic direction it set for itself in the year 2000 include ensuring the soundness of the Financial Sector, maintaining price stability with growth, prudent management of the Exchange Rate and strengthening of the Payment System. In addition to these primary functions, the SBP is also engaged in various non-traditional or promotional roles, which include development of financial framework, provision of training facilities to bankers, and provision of credit to priority sectors. The SBP has also been playing an active part in the process of Islamization of the banking system. Liberalization of the financial sector has been the major policy agenda of all Governments since the late 1980s (http://www.sbp.org.pk/). Since then, various reforms have been undertaken to enhance efficiency of the financial system to keep pace with global developments. These reforms were aimed at reducing segmentation of financial markets, introducing competition in the financial sector, encouraging product development and innovation, and switching over to indirect, market-based and relatively more efficient monetary and credit policy (http://www.sbp.org.pk/).

Financial sector has made significant progress in the last five years by transforming itself into a market oriented, predominantly privately owned sector performing efficient intermediation. The reforms implemented in the banking sector consists various components like privatization of nationalized commercial banks, corporate governance and enhanced discloser, capital strengthening, improvement of assets quality, strengthened supervision and regulatory capacity and liberalization of foreign exchange regime etc. thorough reducing market segmentation financial markets, introducing competition in the financial sector, encouraging product development and innovation and switching over to indirect market based and relatively more efficient monetary and credit policy. The banking supervision and regulatory capacity of the Central Bank has been strengthened through merit – based recruitment, competency – enhancing training, performance –linked promotion, technology – driven process, induction of skilled human resources and greater emphasis on values such as integrity, trust, team work have brought about a structural transformation in the character of the institution (http://www.sbp.org.pk/). The international inter-linkages of capital flows have meant that financial shocks are spread both quickly and widely worldwide. Central banks must remain vigilant and stand ready to deal with these situations swiftly and decisively.

2.3 Review of Previous Studies

There are very limited study relating to the role of NRB and development of financial market in Nepal. Neither there is any material about this topic in the library as dissertation nor any article or books etc. About development of financial market in Nepal there is no clear-cut definition and indication in terms of figure that's why it lies under shadow. Due to various limitations in this study some studies and reports finagling relating to the financial market and role played by central banks are reviewed below.

2.3.1 Thesis / Research Study Review:

Tandukar,(2004) has conducted the research on the topic of "Role of Nepal Rastra Bank in Deposit Mobilization of Commercial Bank" and concluded that being the central bank of Nepal NRB should provide the direction to the commercial banks and commercial banks should have the optimum policy to collect the deposit in various accounts. He added that deposit is the major organ of the commercial bank to live in the industry. Higher the deposit higher will be the chance of the mobilization of working capital fund and profit thereto. Further he concluded that NRB should play the supervisory role to collect the deposit of Commercial Banks. In overall, the researcher insists that role of Nepal Rastra Bank in Deposit Mobilization of Commercial Banks has both positive and negative impacts.

Adhikari (2004) has conducted the research on the topic of "Role of Nepal Rastra Bank for Development of Commercial Bank in Nepal" and focused that in developing country like Nepal central bank (NRB) should play both the traditional as well as development function. Joint adoption of monetary and fiscal policy is needed to mobilize passive resource, to divert saving from speculative and unproductive activities to productive uses, to enhance the effectiveness of public resource management, to accelerate economic reform program, to alleviate poverty etc. The researcher added that for the balance development of the country NRB has directed to the commercial banks for the compulsory investment of their fund in the deprived, priority & productive sector, which is regarded hindrance to the development of the bank by commercial banks.

Further, he mentioned NRB has initiated international standard of accounting of form so as to have accurate financial statements, insuring adequate disclosure and competitive environment by enhancing transparency. Nepal has stated financial liberalization process and that has been implicating by NRB. In the absence of perfect money and capital market NRB has followed the refinance scheme, controls the commercial banks by implicating the bank rate policy for credit operating and encourage them more for credit to priority and productive sectors. Due to refinancing facilities to the commercial banks, NRB succeeded to divert their resources in more desirous lines. NRB has established BTC to develop the skilled manpower in financial sector through the means of training. But BTC training is not sufficient for the need of competitive market. So the contribution of NRB to develop commercial banks through training program is negligible.

NRB has made the policy for commercial banks to open at least one branch in rural areas before opening their branches in urban areas, which helped some what extend to expand the branches of commercial Banks in rural areas.

The reform of interest rate deregulation by NRB was not found to be effective. The interest rate spread did not fall to desired level instead of it has increased. Reform initiated could not solve the problem of high liquidity in commercial banks.

In overall Mr. Adhikari summarized "NRB is trying to develop commercial banks. It has even initiated but the actual succession has not been achieved."

Paudel (2005) has studied on “Financial System and Economic Development” of Nepal and the researcher critically analyzed the current status of Nepalese financial system and economic development in this way. In maintaining the overall stability of the financial system, the role of the NRB as a regulator and supervisor needs to be further strengthened. Broader and deeper reforms are required in the central bank to ensure strong regulatory and supervisory body capable of leading the financial system. Only an effective and prudent regulatory and supervisory system can tackle the vulnerabilities to the likely instability and other uncertainties affecting the evolving financial system. In a liberalized economy, the role of regulating and supervising agencies is supposed to be more vital in maintaining financial stability and thereby facilitating the pace of economic development. Though the Nepalese financial system has grown rapidly over the period, it still lacks competitive environment. The lack of competition is reflected in high interest rate spread of commercial banks. At present, all the banks and financial institutions licensed by the NRB are free to fix their interest rates. The un-weighted interest rate spread of commercial banks has remained in the range of 8.75 to 9.0 percent over the last few years.

Mr. Paudel concluded and recommended that an efficient, sound and healthy financial system is essential for ensuring high and sustainable economic growth in the country. Weaknesses in the financial system create obstacles in achieving the objective of macroeconomic policy. Globalization and liberalization of financial markets have further broadened the nature and the effects of emerging issues. Financial liberalization, if managed properly, can produce desired results in developing the financial system. The nature of issues may be country-specific and strategies or policies to address them must be adapted to fit into the country’s circumstances. In order to stabilize the financial system and to restore public confidence, the central authority is, sometimes, required to adopt some forceful measures. Financial system soundness has become crucial for restoring macroeconomic stability and most of the IMF- supported programs on financial sector policies are directed towards reestablishing efficient financial system through implementing broad reform measures.

The IMF focuses on this area as part of its surveillance, technical assistance and policy development work. The broad-based corrective actions should include setting up appropriate institutional frameworks, removing non-viable financial institutions from the system, strengthening viable institutions, dealing with value impaired assets, improving prudential regulations and supervisions and promoting transparency in financial market operations. In a bank-dominated financial system, the banking sector has to play a vital role in the economic development process of the country through mobilizing and allocating limited resources. The banking system must be prudent with commercial orientation. The organization and financial health of the two state-owned banks have been deteriorating and for the efficacy and efficiency of the banking sector, these two state-owned banks must be restructured as a first step in dealing with the issues of the Nepalese financial system. The financial system still lacks competitive environment and the non- banking sector is yet to grow in terms of size, structure and the volume of business. Lack of competent, qualified and experienced managerial team has remained as one of the serious concerns in the system. The role of central bank as a regulatory and supervisory body needs to be further strengthened. The banking services targeted to the poor and deprived sector people are not adequate.

Looking from these perspectives, these issues can be broadly classified into three categories. The first set of issues is microeconomic in nature and includes poor banking practices such as inadequate capital, failure of loan policy, inadequate assessment of credit, insufficiently diversified loan portfolio, lending to connected borrowers and excessive maturity. Overstaffing and the existence of trade unions have also been chronic problems, particularly in state- owned commercial banks and financial institutions. The second set of issues includes the degree of volatility due to the movements in assets prices and the exchange rates. The third category is system related, indicating that the environment is not conducive to the development of an efficient financial system. System related issues in the financial system include lack of competition, excessive government intervention, inadequate legal framework, under- developed securities market and inadequate regulatory and supervisory mechanism. The corrective actions and policy options should, therefore, address these issues and challenges. The broad thrusts of policy options should aim at the following: creating a sound, stable and healthy financial system, broadening and deepening the financial system, adequate information disclosure, efficiently mobilizing financial resources to promote sustained and broad-based growth momentum, building the institutional capacity to tackle the problems in the financial system by improving the legal and judicial frameworks and increasing the autonomy and capability of the central bank’s regulatory and supervisory roles. To sum up, the corrective actions and policy options should cover the following major issues.

- Improve the organizational and financial health of the state-owned banks and financial institutions.
- Facilitate the new entry of financial institutions in the private sector.
- Make the debt recovery system effective and improve the quality of assets.
- Strengthen the rural credit delivery mechanism.
- Build up the capacity of the financial sector by improving legal, judicial and institutional base.
- Enhance the regulatory and supervisory capacity of the central bank.
- Make the financial system competitive, broad- based and growth- induced.

Ms. Manandhar (2063) has conducted a research study in the title of "Problem and Prospects of Banking Sector in Nepal". This study critically analyzed the prevailed situation and problems in development of banking sector in Nepal. This study concluded that the interest rate of deposit is decreasing every year because of lack of investment opportunity; however, deposit collection is increasing which makes commercial banks more strong. Moreover consumer believed to government owned bank rather than non-government banks. Commercial banks have to face many problems in micro financing. Such as, low income, higher risk, higher transaction costs etc. even though it is seen that commercial banks are successful to flow credit in priority sector credit as NRB rules. In gist, there are many problems in commercial banking sector, however, it has also prospect to growth in Nepal. Mainly semi-government banks have higher prospect to growth as consumer prefer this bank to other.

Ms. Manandhar has recommended to NRB to make compulsory provision to those commercial banks in order to open one urban branch need to open one semi urban and rural branch compulsorily.

Shrestha (2007) has conducted the studied on report "Emerging Issues on the Strategic Planning" and concluded that: as the Nepalese economy is getting rapidly integrated with the global economy, the country needs institutional restructuring and good governance. The policies and operations of the NRB are critical in creating conducive environment for sustainable macroeconomic development. However, being the central bank of one of the least developed countries with vast poverty, high income inequality, vulnerability to external shock and weak financial system, its roles and responsibilities go beyond the central bank of a matured economy is supposed to deliver. Close integration with the Indian economy and fixed exchange rate regime with Indian currency has added challenges to autonomous operation of its central banking functions. The management of NRB should address these issues while implementing strategic planning. The proper implementation of strategic planning could be the panacea for overcoming probable banking and financial crisis. Hence, during implementation of the plan, the progress and status of the implementation should be reviewed at least on a quarterly basis by the board and should be amended as required.

2.3.2 Review of Journals and News Papers

Timilsina (2007) opines on the query about the role of NRB in financial sector reform "It is found that NRB has endeavored but it has not been able to achieve as envisaged. In my opinion it is due to poor progress in real sector. Without congenial investment climate in real sector, it becomes difficult to bring effective reforms in financial sector". He also clarified about the role of NRB in the present context that NRB in the present context has to play promoting as well as regulatory role. The real sector needs to be supported by financial sector. Spatial dimension in banking sector development is to be focused to meet the needs of the region and area to create market or demand centers. Mapping of banking and financial institution is to be done to develop new areas. With the availability of fund the investment opportunities are created in the real sector. Domestic and external sources of fund need to be matched in the growing context of remittances inflow. More inflow of money from other countries can come with the help of non-resident Nepali. Real sector development is possible in human resources by matching with the needs of international market. The market for the type of human resources in the developed market economies can be assessed by NRB in cooperation with the diplomatic mission of Nepal and the business organizations operated by the Nepalese entrepreneurs. This can also be matched with the marketing of our tourist products in such economies.

Karunasena (2007) is rating the supervisory role of NRB in the present context in this way "my understanding is very limited. Financial sector problems are not limited to Nepal only. It is common for LDCs and we have also sought bank failures the past. What is important is whether the political leadership and central banks are moving in the right direction or not. The speed may be different and sequence could be different. Speed and sequence has to be decided based on the situation in the country concerned. Change in the legal system is a long process. So it takes time. We should not decelerate this process".

Dr. Karunasena added about the growth of financial sector in Nepal that when we compare with other countries, that depends upon two factors one is the number of institutions and other is the deepening of the financial sector. Expansion and development of the financial sector is higher or lower depending on which factor we are considering. Some have more but catering to different segments. The question comes if relative size is large or not. Rationalizing the number of financial institutions is important but it does not mean that the sector has overgrown. The financial assets to GDP ratio provide simple intra-country comparison of financial deepening. We take M2 (broad money) is 56 percent to GDP. It is the competition that determines if we can sustain the number of financial institutions and provide quality services. Dr. Karunasena also said that about the autonomy of NRB in working and need of FDI that autonomy is not something that is given but it has to be taken. Autonomy has to show in actions not limiting it to paper only. So, I wish NRB would be able to enjoy functional autonomy in monetary as well as financial management. In case of Nepal, domestic and national saving may be 30 to 40 percent of GDP. This is sufficient to get desirable growth. All are looking for a long-term growth of 6 to 8 percent; to get that level of growth rate we may need at least 30 to 35 percent. It depends upon capital output ratio. Domestic saving may increase the output but it takes time, if we can get foreign direct investment (FDI), we can quickly start that and automatically generate more domestic saving. The FDI not only comes with the capital but also with technology. They also bring management skills. But we have to be careful selecting the areas for FDI and for giving facilities and subsidies.

2.6 Research Gap

The purpose of this research study is quite different and relevant from those studies made by above researchers (related to Nepal Rastra Bank and Nepalese financial market). Though the researcher has conducted the study about the role of Nepal Rastra Bank in development of Commercial Banks in Nepal the issues raised by the researcher are irrelevant at present context. Further, the studies are concentrated only the role of Nepal Rastra Bank in development of Commercial Bank not the financial market. Likewise, the researchers mentioned above focus the study about either the overall role of Nepal Rastra Bank or only financial development of Nepal. But the above mentioned studies are silent about the relationship between the financial market development and economic development. The method of analysis is quite different because all those studies are completed using only secondary data for analysis purpose and limited number of sample size has been taken. This helps in analyzing the present condition and problem faced by Nepalese financial market. This study has tries to explore the actual position of Nepalese financial market and role of NRB in its development.

CHAPTER- III

RESEARCH METHODOLOGY

3.1 Introduction

Research methodology is a systematic way to solve the research problem. In other words, research methodology describes the methods and process applied in the entire aspect of the study. Research methodology refers to the various sequential steps (along with a rational of each steps) to be adopted by a researcher in studying a problem with certain objectives in view (Kothari, 1994:9). Thus the overall approach to the research is presented in this chapter. This chapter consists of research hypothesis, research design, sample size and selection process, data collection procedure and data processing techniques and tools.

3.2 Research Hypothesis

Testing of hypothesis is one of the most important aspects of the research study. It is the quantitative statement about the population parameter. In other words, it is an assumption that is made about the population parameter and then its validity is tested. By testing the hypothesis we can find out whether it deserves the acceptance or rejection of the hypothesis. The acceptance of hypothesis means there is no any sufficient evidence provided by the sample to reject it and does not necessarily imply that it is true. The main goal of testing of hypothesis is to test the characteristics of hypothesized population parameter based on sample information whether the difference between the population parameter and sample statistic is significant or not (Sharma & Chaudhary, 2000:229).

The hypotheses formulated for this study are as follows:

First Hypothesis:

Null hypothesis H_o: $\rho = 0$. That is, population correlation coefficient is zero. In other words, the variables (role of NRB and development of financial market) are uncorrelated in Nepalese context.

Alternative hypothesis H_1: $\rho \neq 0$. That is population correlation coefficient is not equal to zero. In other words, the variables (role of NRB and development of financial market) are correlated.

Second Hypothesis:

Null hypothesis H_0: $\rho = 0$. That is, population correlation coefficient is zero. In other words, the variables (economic growth and financial market growth) are not correlated in Nepalese context.

Alternative hypothesis H_1: $\rho \neq 0$. That is population correlation coefficient is not equal to zero. In other words, the economic growth and the financial market growth are correlated.

3.3 Research Design

A research design is the specification of methods and procedures for acquiring the information needed. It is the overall operational pattern of framework for the project that stipulates what information is to be collected, form which sources and by what procedures. Thus a research design is a plan for the collection an analysis of data. For research there exits different types of research design like; Historical research, Descriptive research, Case study research, Field study research, analytical research, True experimental research and so on. This study is an examination and evaluation of the development of financial market in Nepal and role of NRB in it. This study not only analyses the gradual development of financial market in Nepal but also explore the role of financial market in economic development. It evaluates the development pace of financial market in Nepal, its contribution in economic development and role of NRB in its development. Finally, it also recommends some useful recommendations to the concerned parties. That's why, this study mainly concerned with historical research. If applicable, sometime descriptive and analytical approach may also be used.

3.4 Population and Sample

The term "population" or universe for research means the universe of research study in which the research is based (Wolf & Pant, 2000:75). The population for the study comprises 25 commercial banks, 59 development banks, 78 finance companies and 5 rural development banks, 12 micro credit development banks, 16 co-operatives and 45 NGOs (NRB licensed), 25 Insurance Companies, One Employee Provident Fund, One Citizen Investment Trust, One Postal Saving Bank (117 branches) and One Stock Exchange Limited are established during mid July 208. Among the total population only some selected institutions are taken as sample on stratified sampling basis. For selecting the samples, stratified sampling method is used here among different methods. Among above specified population, only ten institutions are chosen as sample under stratified sampling method. Among ten, including single government owned commercial bank, only five commercial banks, two finance companies, two development banks and one insurance company are chosen.

3.4.1 Basis of Selecting Sample

Stratified sampling method is used when we have to select samples from a heterogeneous population (Wolff and Pant, 2005:173). In this research study stratified sampling method is used due to selecting samples from a heterogeneous population. To represent different types of financial institutions i.e. banks, development banks, financial institutions and insurance company stratified sampling method seems appropriate and used. In this sampling method, entire population is divided into subgroups or strata and a sample random are taken from each such sub-group. All the representative of financial market divided into banks, development banks, finance companies and insurance company for primary data collection. From each stratum the units are picked up together constitute a stratified sample. Among 25 private sector commercial banks only 4, among 2 government owned commercial banks only single commercial banks are chosen in sample under random sampling method from each sub-group. Among 78 finance companies only 2, among 59 development banks only 2 and among 25 insurance companies only one insurance company is chosen under random sampling method. From all there are 10 institutions as representative of entire population. Organizations under study are as follows;

1. Commercial Banks

A) Kumari Bank Limited

B) Siddhartha Bank Limited

C) Himalayan Bank Limited

D) Nepal Bank Limited

E) Global Bank Limited

2. Finance Companies

A) Annapurna Finance Company Limited

B) Prabhu Finance Company Limited

3. Development Banks

A) Sanima Bikas Bank Limited

B) Shangri-la Development Bank Limited

4. Insurance Company

A) Sagarmatha Insurance Company Limited

3.5 Sources of Data and Collection Procedures

Data are crucial for every research work. The sources of data used in this study are as follows:

I) Primary Sources:

Primary data are those, which are collected for the first time, and thus happen to be original in character. In primary sources, consultation with personnel directly related to the role of NRB in development of financial market in Nepal, and the officers of NRB Pokhara branch, structured questionnaire to the officers of sample organizations and frequent visit and contact to the central bank head office and Pokhara branch are made for the study purpose. The entire set of structured questionnaire is presented at the end of this report at Appendix 1.

II) Secondary Sources:

The secondary data are those, which have already been collected and passed through the statistical process. For this study, secondary data are also used. These secondary data are collected mainly from published sources like annual report, prospectus, balance sheet, newspaper, journal, Internet and other sources. Secondary data published on annual reports of concerning organizations are also taken in consideration and like development pace of organization, interest rate as well as amount and their organizational profiles are collected through personal visit of respective organization as well as from their websites. Some secondary data like capital, investment contribution in economic development of respective organization are collected from different sources of respective organization, comparative study and from publication of Nepal Rastra Bank.

3.6 Data Processing and Presentation

The information or data obtained from the different sources are in raw form. From that information, direct presentation is not possible. So it is necessary to process data and converts it into required form. After then only, the data are presented for this study. This process is called data processing. For this study, only required data are taken from the secondary source (organization's publication) and presented in this study. For presentation, different tables are used. Similarly, in some case graphical presentation is also made. So far as the computation is concerned, it has been done with the help of scientific calculator and computer software program as well.

3.7 Methods and Tools of Analysis

In order to get the concrete results from this research, data are analyzed by using different types of tools. The data colleted from different sources are processed and presented in tables and graphs in a simple and proper way. Analysis is done as per the requirement of study. As per topic requirements, emphasis is given on statistical tools rather than financial tools. So for this study following statistical tools are going to use.

I) Arithmetic Mean:

It is the sum of all the observations divided by the number of observations. In such a case all the items are equally important (Pant & Chaudhary, 1999:91). As arithmetic mean is most common and popular tools for data analysis, here in this study also, arithmetic mean is used. It is computed by using following formula:

Mean ($\overline{X}$) = $\frac{\sum X}{n}$ Where $\overline{X}$ = Mean

$\sum$ X = Sum of all the Variable X

n = Variables involved

II) Standard Deviation:

The standard deviation is the best tools to study fluctuation in any data. It is usually denoted by the letter sigma (δ). Karl Pearson suggested it as a widely used measure of dispersion and is defined as the positive square root of their arithmetic mean of squares of the deviation of the given observations from their arithmetic mean of a set of value (Gupta, S.P, 1995: E 8.18). It can be computed by using following formula.

$$S.D(\delta) = \sqrt{\frac{1}{n}\sum\left(X - \overline{X}\right)^2}$$

Greater the magnitude of standard deviation, higher will be the fluctuation and vice versa.

III) Correlation and Regression:

By this statistical tool, the degree of relationship between to variables is identified. In other words, this tool is used to describe the degree to which one variable is linearly related to other variables. Two or more variables are said to be correlated if change in the value of one variable appears to be linked with the change in the other variables. The correlation analysis refers the closeness of the relationship between the variables (Sharma, & Chaudhary, 2000:420).Correlation may be positive or negative and ranges from -1 to +1. Simple correlation between financial market development and economic development is computed for this study. For example, let's say that the correlation between financial market growth and economic development is positive. It indicates that when financial market growth increases, economic growth also increases in same direction and vice versa. For our study following reference is used (Pant& Chaudhary, 2053: 306).

- Correlation may be positive or negative and ranges from -1 to +1. When r = +1, there is positive perfect correlation; when r = -1, there is perfect negative correlation; when r = 0, there is no correlation and when r < 0.5 then there is low degree of correlation.

- When ‘r’ lies between 0.7 to 0.999 (or -0.7 to -0.999), there is high degree of positive (or negative) correlation.
- When ‘r’ lies between 0.5 to 0.699, there is a moderate degree of correlation.

The simple correlation coefficient, r, is calculated by using following formula:

Simple Correlation Coefficient (r) = $\frac{n\Sigma X_1 X_2 - (\Sigma X_1)(\Sigma X_2)}{\sqrt{n\Sigma X_1{}^2 - (\Sigma X_1)^2}\sqrt{n\Sigma X_2{}^2 - (\Sigma X_2)^2}}$

Alternately,

$$r = \frac{Cov(X_1 X_2)}{VarX_1, VarX_2}$$

Where,

Covariance (X_1, X_2) = $\frac{1}{n}\sum (X_1 - \overline{X}_1)(X_2 - \overline{X}_2)$

n = Total number of observations.

X_1 and X2 = two variables, correlation between them are calculated.

IV) Time Series Analysis

A time series consists of statistical data, which are collected, recorded or observed over successive increments. The analysis of time series is more important in all sectors due to following reasons; it helps in planning future operations, it helps in evaluating current accomplishment and it facilitates comparison.

V) T- test

By this statistical tool, the authenticate degree of formulated hypothesis is identified. Hypothesis testing refers to the process of selecting and using sample statistic to draw inference about a population parameter based on a subset of it- the sample drawn from the population. A hypothesis is a supposition made as a basis for reasoning (Gupta, S. P., 1995: A 3.3). The main goal of testing hypothesis is to test the characteristics of hypothesized population parameter based in sample information whether the difference between the population parameter and sample statistic is significant or not. Under certain procedures of testing hypothesis alternatives are already set in the first chapter. At the time of dealing with small samples the main interest is not to estimate the population values as is true in large samples, so, T- test is selected under setting a test criterion.

Small samples means when sample size is less than 30 ($n \leq 30$) deal for testing of hypothesis concerning population means, difference between two population means and an observed sample correlation coefficient, new technique and tests of significance known as exact sample tests. The main assumptions of T-distribution are – the parent populations from which the samples are drawn are normally distributed and the samples are random and independent of each other. The properties of T-distribution are as follows (Sharma & Chaudhary, 2058:279);

- T-distribution is a continuous distribution having symmetrical and bell-shaped. The value of t ranges from minus infinity to plus infinity.
- The t- distribution is flatter than the normal distribution and there is a different t-distribution for every possible sample size.
- A t-distribution is lower at the mean and higher at the tails than a normal distribution.
- The t-distribution can be used even in case of large sample but the sample theory can not be used for small sample.

T-distribution can be defined as;

$$t = \frac{\overline{X} - \text{«}}{\sqrt{\frac{S^2}{n}}}$$

Where, $\overline{X} = \frac{\sum X}{n}$ i.e. sample mean, n refers the size of sample and variance of sample (S^2) is computed as;

$$S^2 = \frac{1}{n-1}\sum\left(X - \overline{X}\right)^2$$

VI) Diagram and Graphical Presentation

The analyzed data are presented in the suitable diagrammatic format and graphs as per the requirements. Simple bar diagram are used. Trends are presented in the graphs also.

CHAPTER- IV

DATA PRESENTATION AND ANALYSIS

4.1 Introduction

This chapter consists of various calculation made for the analysis of role of NRB in development of financial market in Nepal, the relationship between financial market development and economic growth. To make our study effective and precise as well as easily understandable, this chapter is categorized in three parts; presentation, analysis and interpretation. The analysis is fully based on both primary as well as secondary data available. In presentation section data are presented in terms of table, graph chart of figures, according to need. The presented data are then analyzed using different statistical tools mentioned in chapter three. At last the results of analysis are interpreted. Though there is no distinct line of demarcation for each section (like presentation section, analysis section & interpretation section) but the arrangement of writing is made by aforementioned way. Similarly it is also noted that both primary and secondary sources of data are used frequently for the analysis purpose.

For our simplicity, in this thesis, presentation analysis and interpretation of data are made according to the nature. In other words, at first current situation of financial market in Nepal is explored. After then, relationship of financial market with economic growth is presented. Lastly, role of NRB in development of financial market in Nepal is analyzed. While analyzing, different statistical tools like arithmetic mean, standard deviation, correlation coefficient, t-statistics for significance test are employed.

4.2 Historical Scenario of Banks and Financial Institutions in Nepal

The banking system in Nepal is gearing up for another round of competition with second phase of financial sector reform and international standard oriented reform underway. Nepal Government and Nepal Rastra Bank are working to develop transparent, competitive and strong financial sector on the one hand and on the other hand want government dominated banking system to survive and run smoothly. The Nepalese economy is rapidly integrated with the global economy with its outward oriented policies followed by membership of WTO, SAFTA and BIMSTEC. The country is in process of institutional restructuring of financial sector. The face of banking has changed tremendously after the adoption of financial liberalization policy since 1980s. Hence Nepal is in process to make banking system more transparent and international delivery standard. We can observe that progressive liberalization of the banking system has brought out, among others, a sea change in the banking and financial activities.

The Nepalese economy is getting rapidly integrated with the global economy due to the adoption of liberal economic policies and the accession to the international and regional trading agreements. The country needs institutional restructuring in the spectrum of fiscal, financial, and external sectors to enhance competitiveness of the economy, promote policy credibility for attracting long-term foreign investment and maintain macro-economic and financial stability to sustain the economic development.

Policies and activities of the Nepal Rastra Bank (NRB) that practices modern central banking and strategic management principles are critical in creating sound economic environment that fosters sustainable economic growth of the economy in general and financial industry in particular.

During the last two and half decades the Nepalese financial system has grown significantly. At the beginning of 1980s there were only two commercial bank and two development banks. After the adoption of economic liberalization policy, particularly the financial sector liberalization that paved the way for establishment of new banks and non-bank financial institutions into the country. The gradual development of banks and financial institutions is presented below.

Table 4.1

Growth of Financial institution in Nepal (Mid Jan 2009)

Year	Commercial Banks	Development Banks	Finance Companies	Micro Credit Dev. Bank	Co-Operatives	NGOs *	**Total**
1980	2	2	-	-	-	-	**4**
1985	3	2	-	-	-	-	**5**
1990	5	2	-	-		-	**7**
1995	10	3	21	4	6	-	**44**
2000	13	7	45	7	19	7	**98**
2005	17	26	60	11	20	47	**181**
2006	18	28	70	11	19	47	**193**
2007	20	38	74	12	17	47	**208**
2008	**25**	**59**	**78**	**12**	**16**	**45**	**235**

** With limited banking activities.*

(Source: www.nrb.org.np)

As shown by the above table, by the end of mid July 2008, altogether 235 banks and non-bank financial institutions licensed by NRB are in operation. Out of them, 25 are "A" class commercial banks, 59 "B" class development banks, 78 "C" class finance companies, 12 "D" class micro-credit development banks, 16 saving and credit co-operatives, and 45 NGOs as shown in table below. The opening trend of financial institutions seems increasingly increasing in till 2005, the number increased year by year but the ratio decreased in the last two years. In the context of Nepal being 147th member of WTO it is necessary to enhance quality rather than number.

Table 4.2

Soundness Indicators of Commercial Banking System in Nepal

Indicators	Mid - July							
	2002	2003	2004	2005	2005	2006	2007	2008
Profitability (Rs. in million)	-7843	-9428	-3317	3707	5205	7983.51	8797.9	11911.7
NPL as Percentage of Total Loan	29.3	30.4	28.8	22.8	18.94	14.22	9.65	6.08
Total Capital Fund as Percentage of RWA	-5.49	-9.88	-12.04	-9.07	-6.33	-5.30	-1.71	4.04

(Source: www.nrb.org.np)

The consolidated capital adequacy of commercial banks improved remarkably and turned to positive of 4.04 percent in the mid July 2008 as against the continued negative figures in the proceeding years. The non-performing loan of commercial banks declined significantly to 6.08 percent in mid July 2008 from 9.65 percent in the last year. The total amount of NPA remained to Rs.18648.5 million from Rs.24215.85 million in the last year. Based on the indicators tabulated in the above table, it seems that the financial system of Nepal is improving gradually, the behind reason is that, NRB has been playing effective role to establish the sound banking system in Nepal. However, with the increment of number of financial institutions, NRB should expand its role as a regulator body to establish the sound and healthy banking system in Nepal.

4.3 Current Structure of Financial Market in Nepal

With the vast network of bank branches spread across the length and breadth of the country, the scope for bank and financial institutions growth is beyond imagination. This arises from the fact that banks especially those with government dominated are still one of the most trusted institutions in the country. Recently the overall financial system in Nepal is presented in the tabular form as follows;

Table 4.3

Structure of Financial System of Nepal (Mid July 2008)

Regulator		Participants	Numbers
Nepal Rastra Bank	1.	Commercial Banks	25
	2.	Development Banks	78
	3.	Finance Companies	59
	4.	Micro-finance Development Banks	12
	5.	Financial Co-operatives	16
	6.	Non Governmental Organizations	45
	Non-banks Financial Institutions like Credit Guarantee and Deposit Insurance Corporations with equity participation.		
Nepal Government	1.	Postal Saving Banks (Branches- 117)	1
	2.	Employee Provident Fund	1
	3.	Citizen Investment Trust.	1
Securities Exchange Board	Nepal Stock Exchange Limited		
Insurance Board	Insurance Companies		25
TOTAL			**263**

(Source: Nepal Rastra Bank Publications.)

There are 25 commercial banks doing business in the Nepalese financial market out of them six are with foreign joint venture and remaining nineteen are fully domestic banks. Other banking institution includes 59 development banks, 78 finance companies, 12 micro finance development banks, 16 financial co-operatives and 45 non government financial organizations. Likewise, other financial institutions include 1 postal saving bank which has 117 branch offices in different part of the country, single Nepal Stock Exchange for organized stock transaction and 25 insurance companies. There is only one employee provident fund and single citizen investment trust. NRB categorized all the institutions in four groups ‘A’, ‘B’, ‘C’, and ‘D’ for their institutional development based on their capital, investment and limited banking business.

4.3.1 Ownership Structure of Nepalese Commercial Banks

On the ownership front as well, Nepalese banking system has witnessed a sea change after the financial reform introduced in the country. While the government owned commercial banks were holding almost 90 percent of the total assets of the commercial banks in 1990, their share has significantly come down to 34.84 percent in Mid July 2008. In this process, share of the joint venture banks and private banks is increasing over the years. While joint venture banks were holding around 13 percent of the total assets of commercial banks in 1990, it has reached around 31 percent in Mid July 2008. It is more interesting for private banks. While these banks were non-existent in 1990, their share in total assets reached around 24 percent in 2006 and reached around 35 percent in Mid July 2008. In overall the trend seems that the share of government owned commercial bank in total assets is in decreasing trend and the share of private sector commercial bank is in increasing trend. Increasing share of the joint venture, and private sector banks in the total assets is an encouraging indication for the financial development of the country. This sort of diversification helps to foster competition and maintain financial discipline, if managed properly. The ownership structure of Nepalese financial system is presented in the table below:

Table 4.4

Ownership Structure of Commercial Banks

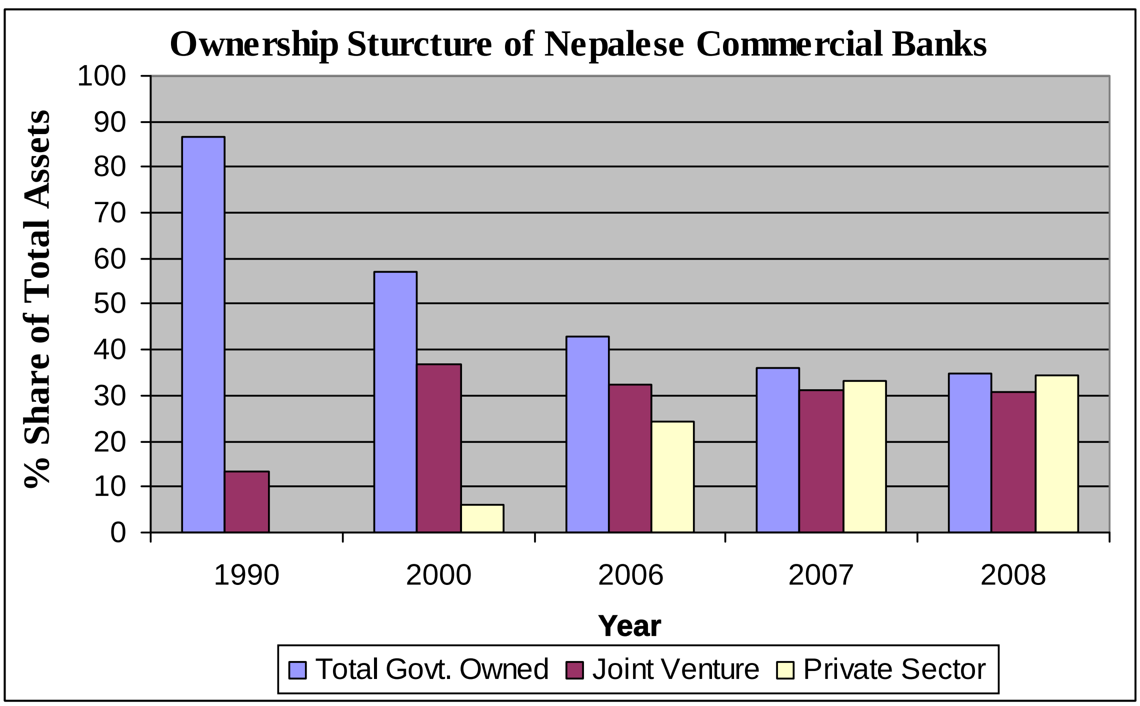
(Rupees in Million)

Name	Type	1990		2000		2006		2007		2008	
		Assets (Rupees)	% Share in Total Assets	Assets (Rupees)	% Share in Total Assets	Assets (Rupees)	% Share in Total Assets	Assets (Rupees)	% Share in Total Assets	Assets (Rupees)	% Share in Total Assets
Nepal Bank Limited	Public	12502.6	50.01%	46120	23.72%	54133	13.63%	47707.1	9.92%	56966.3	10.12%
Rastriya Banijya Bank	Public	9188.7	36.76%	65049	33.45%	83481	21.02%	72041.3	14.98%	84686.2	15.04%
Agricultural Dev Bank	Public					33602.1	8.46%	53496.9	11.13%	54496.1	9.68%
Total Govt. Owned		**21691**	**86.77%**	**111169**	**57.17%**	**171216**	**43.11%**	**173245**	**36.03%**	**196149**	**34.84%**
Standard Chartered Bank Nepal Ltd.	Joint Venture	1232.7	4.93%	18356	9.44%	26798	6.75%	29937.4	6.23%	34312.9	6.09%
Himalayan Bank Ltd	J. V.			16781	8.63%	31065	7.82%	34645.5	7.21%	37526.8	6.66%
Nepal SBI Bank Ltd	J. V.			5191	2.67%	13736	3.46%	15397.2	3.20%	18594	3.30%
NB Bank Ltd	J. V.			7465	3.84%	16722	4.21%	14282.3	2.97%	15584.2	2.77%
Everest Bank Ltd	J.V.			3412	1.75%	16715	4.21%	23335.3	4.85%	28565.9	5.07%
NABIL	JV/Pri.	1314	5.26%	15902	8.18%	24135	6.08%	29660.4	6.17%	38478.6	6.83%
Nepal Investment Bank Ltd	J.V./ Private	759.8	3.04%	4180	2.15%						
Total Joint Venture		**3306.5**	**13.23%**	**71286**	**36.66%**	**129171**	**32.52%**	**147258**	**30.63%**	**173062**	**30.74%**
Nepal Investment Bank Ltd	J.V./ Private					22007	5.54%	28572.8	5.94%	40205.5	7.14%
Bank of Kathmandu	Private			4481	2.30%	12661	3.19%	14997.5	3.12%	18159.1	3.23%
NCC Bank Ltd	Private			3540	1.82%	8641	2.18%	8816.7	1.83%	10175.9	1.81%
Lumbini Bank Ltd	Private			1325	0.68%	6735	1.70%	7134.9	1.48%	7379.8	1.31%
NIC Bank Ltd	Private			2670	1.37%	10383	2.61%	58991.2	12.27%	15451.39	2.74%
Machhapuchre Bank	Private					9256	2.33%	11197.1	2.33%	13142.3	2.33%
Kumari Bank Ltd	Private					9391	2.36%	12324.4	2.56%	15619	2.77%
Laxmi Bank Ltd	Private					5509	1.39%	8800.5	1.83%	13027.6	2.31%
Siddartha Bank Ltd	Private					4901	1.23%	9441.8	1.96%	12142.3	2.16%
Global Bank Ltd	Private					3588.9	0.90%			8332.6	1.48%
Citizen Bank Ltd	Private					3720.3	0.94%			7355.4	1.31%
Prime Bank Ltd	Private									6457.9	1.15%
Sunrise Bank Ltd	Private									7709.8	1.37%
Bank of Asia Ltd	Private									4324.7	0.77%
DCBL Bank Ltd	Private									5334.3	0.95%
NMB Bank Ltd	Private									9037.1	1.60%
Total Private Sector				**12015**	**6.18%**	**96793.2**	**24.37%**	**160277**	**33.34%**	**193855**	**34.43%**
Grand Total		**24998**	**100.00%**	**194470**	**100.00%**	**397180**	**100.00%**	**480780**	**100.00%**	**563066**	**100.00%**

(Sources: www.nrb.org.np)

This above table clearly shows that in year 1990, government owned commercial banks had 86.77 percent share in total assets and remaining 13.23 percent for other commercial banks. Similarly, in year 2000 the government owned commercial banks had significantly decreased to 57.17 percent and on the other hand the share of private sector commercial banks had increased to 42.83 percent, where the share of Joint venture commercial bank was 36.66 percent and share of private commercial bank was 6.18 percent. In year 2006, the participation of commercial banks in the market increased day by day, that why total asset ratio of government owned commercial banks decreased to 43.11 percent and share of private sector commercial banks increased to 56.89 percent, where the share of Joint venture commercial bank was 32.52 percent and share of private commercial bank was 24.37 percent, which indicates that the presence of private sector commercial bank is in increasing trend. Likewise, at the end of Mid July 2008, the presence of Government owned commercial bank is around 35 percent in total assets, whereas the presence of joint venture commercial bank is around 31% and presence of private bank is around 34 percent. These figures clearly advise that participation of private commercial banks increased rather than government owned, it paved the way to perfect competition market. This glimpse is presented in the graph as below;

Figure: 4.1



This figure clearly specifies that the government owned commercial banks hold excessive amount in year 1990 and this amount decreased to 57.17 percent in year 2000 at the same time joint venture commercial banks covered 36.66 percent and private sector commercial banks emerged to 6.0 percent. At the end of Mid July 2008 the deviation among three sectors has been mitigated, the composition comes as the share of Government owned commercial bank is around 35 percent, the share of Joint venture commercial bank is around 31 percent and the share of Private sector commercial bank is around 34 percent.

4.3.2 Structure of Nepalese Financial System

The macro economic indicator, Gross Domestic Product (GDP) can be taken as one of the most powerful tool of disclosing economic situation. Developing countries like Nepal suffers deficit trade balance and formulate deficit budget to invest in physical infrastructure. Money circulation in the economy largely depends on sound financial system. Investment in development of financial system and their growth determines the economic development. That’s why, the ratio of total assets/ liabilities of financial sector to GDP helps to evaluate the contribution of financial market to economic growth. As of mid-July 2008, commercial banks’ share is 66.5 percent followed by a 28.8 percent share of Nepal Rastra Bank. The share of other financial institutions is low. However, contractual savings institutions have a remarkable share of 12 percent. As shown in the table, a total asset of the financial system is almost 124 percent of GDP and if the market capitalization to GDP is included, it stands exactly 168.94 percent of GDP in mid-July 2008. In tabular form the structure of Nepalese financial system is presented below.

Table 4.5

Structure of Nepalese Financial System

(Rupees in Million)

Date	Mid July 2007			Mid July 2008		
Name	Total Assets/ Liabilities	Percent Share in Total	Ratio of Total Assets to Normal GDP (%)	Total Assets/ Liabilities	Percent Share in Total	Ratio of Total Assets to Normal GDP (%)
Financial Institution	**703564.7**	**87.5**	**96.8**	**898375.3**	**88.1**	**105.6**
Nepal Rastra Bank	174209.0	21.7	24.0	212449.8	20.8	28.8
Commercial Banks	439735.0	54.7	60.5	549090.2	53.8	66.5
Finance Companies	53466.4	6.7	7.4	80383.3	7.9	6.7
Development Bank*	22658.2	2.8	3.1	39868.8	3.9	1.8
Cooperatives	3590.0	0.4	0.5	4360.5	0.4	0.5
Micro Credit Fin. Ins.	9906.1	1.2	1.4	12582.7	1.2	1.4
Micro Credit Non Financial Institution.	1842.2	0.2	0.3	2382.7	0.2	1.4
Contractual Saving Institutions	**100131.2**	**12.5**	**13.8**	**121685.8**	**11.9**	**14.8**
Employee Provident Fund	59225.9	7.4	8.1	67940.3	6.7	8.3
Citizen Investment Trust	9541.2	1.2	1.3	13675.5	1.3	1.7
Insurance Companies	31364.0	3.9	4.3	40070.0	3.9	4.9
Postal Saving Banks	700.0	0.1	0.1	827.0	0.1	0.1
Total	**803695.9**	**100.0**	**110.5**	**1020421.1**	**100.0**	**124.3**
Nominal GDP (Rs. million)	727088			820815		
Market Capitalization of Stock Exchange (Rs.million)	186301.28			366247.56		
Ratio of Stock Market Capitalization to GDP (in Percent)	25.8			44.6		

(Source: Nepal Rastra Bank Publications.)

4.4 Foreign Bank and Challenges to Emerging Market Supervisors

During the course of negotiating for accession to WTO, Nepal made commitments for bank branches. However, three aspects are worth mentioning. First, there is a transition period where foreign bank branches are only allowed as of January 1, 2010. Second, entries of financial institutions are limited to a rating of at least “B” by Credit Rating Agency e.g. MOODI, Standard & Poor etc. Lastly, establishment of foreign bank branches are subject to the domestic laws, rules and regulations and terms and conditions of the Nepal Rastra Bank.

The increased presence of foreign banks in a country’s domestic banking system necessitates the development of effective cross-border prudential supervision where the consolidated supervision is the essential element. It is said that the presence of foreign-owned banks grows, the complexity of the tasks facing supervisory authorities increases. The challenges for emerging market supervisors include: (i) choosing of licensing policy and fitness and propriety test for management and owners of a complex holding company or investment funds; (ii) effectively monitoring the local establishment of large international banks or complex financial institutions; (iii) upgrading their supervisory capacity to oversee complicated financial products of foreign banks; (iv) dealing with the issue of the parent bank support in case of difficulties of a branch or subsidiary in normal as well as systemic crisis situations; (v) handling consolidated supervision in the event the market is heavily dependent on foreign banks; (vi) more effective exchange of information with the home supervisors in the case of bank holding companies or other complex financial institutions; (vii) dealing with increasing concentration in the banking system by foreign banks; and (viii) improving the governance structure of complex international banking groups while, among other things enhancing the integrity standards in the financial markets. These challenges should be resolved through more enhanced cooperation between home-and host-country supervisory authorities, as well as development of additional international best practices.

4.5 Analysis of Nepalese Monetary Policy and Financial Stability

Financial stability refers the stable situation of financial system. A financial crisis is a disruption to financial market. There are many factors that can trigger financial instability in the economy such as: decline in asset price (used for collateral), heavy inflow of short-term capital, unanticipated depreciation or appreciation of exchange rate, pegged exchange rate system, increase in interest rate, stock market crash, liquidity mismatch, currency mismatch, heavy lending to real estate business, explicit and implicit government guarantee on loan flow, weak supervisory and regulatory measures.

Financial stability has emerged as one of the objectives of monetary policy recently after the various financial crises observed in many countries, for example, Mexico 1994-1997, East Asia 1997, Russia 1998-1999 and Argentina 1995. Monetary policy and financial stability are interlinked to each other. However, there is still no clear consensus on how one affects the other i.e. trade off or synergies between them. The main job of the financial system is to channel funds from surplus units or savers to investors (deficit units), i.e. intermediation function, there by facilitating economic growth. However, it is the financial market where asymmetric information leads to two basic problems: adverse selection and moral hazard. Hence it is more prone to crisis due to imperfectness of this market. Monetary policy has nexus with financial system through different channels. First, monetary policy of the central bank regulated money stock in the economy, while the financial sector performs intermediary function by doing business in money. Second, central bank has authority of formulating and implementing monetary policy. This has the implications in monetary policy operation. Third, since monetary policy transmitted through financial system, there should be sound financial sector for the effective transmission of monetary policy. Fourth, if monetary policy is too lax, inflation may increase and become more volatile. It redistributes real wealth from lenders to borrowers. And on the other hand, very tight monetary policy leads to very low inflation level. Fifth, financial instability can lead to in-efficient resources allocation, as well as major economic and social disruption in the economy.

Monetary policy, by credibly maintaining price stability, can provide the economy with an environment of predictable interest rate. This would lower the interest rate risk in the economy and helpful to attain financial stability. There can be financial instability even in case of price stability like in Japan in the 1990s. So, the monetary policy needs to be cautious enough about the development in financial system even in case of price stability in the economy. Another way of maintaining financial stability by monetary policy is by lowering intermediation cost. A high intermediation cost would deteriorate the balance sheet of financial institutions. In case of high intermediation cost due to high cash reserve ratio or statutory reserve ratio, interest rate on lending would be high which aggravates the adverse selection problem. At a higher interest rate, only riskier investors would come to borrow fund. Then, the probability of repayment would be lower. Hence, a higher interest rate leads to even greater adverse selection, increasing the likelihood of default. Third way through which monetary policy can maintain financial stability is through timely and appropriate management of liquidity in the banking system.

It is the liquidity that the financial system trades in the economy. Both excess and shortage of liquidity are inimical to financial health of financial sector. Monetary policy, by using open market operations (OMO), manages the liquidity in the financial system. Such a management of liquidity smoothes the payment system in the economy on the one hand and lowers the cost of excess liquidity holding in the financial system on the other hand.

As in the previous years, as envisaged by the NRB Act 2002, the monetary policy of 2008/09 had objectives of supporting high and sustainable economic growth through maintaining price stability, external sector stability and financial sector stability. As per NRB Act, 2002, monetary policy in Nepal has been conducted with a view of attaining price stability and a reasonable BOP surplus for the sustainable development of economy. At the same time, monetary policy has been helping maintain financial stability in the economy as well. Hence, Nepal has not experienced the financial crisis as observed in other countries as far, although maintaining financial stability is now challenging to the NRB in the context of growing financial institutions and due to become 147^{th} member of WTO in the global village. As of mid- July 2008, there are almost 263 financial institutions all together in Nepal. In the last one and a half decade, monetary policy in Nepal has lowered the cash reserve ratio (CRR) from 12 percent in 1990 to 5.5 percent (in 2008). In order to correct the situation of the macroeconomic imbalances likely to merge from inflation, high pressure on the different asset prices and expansion in budget deficit, the CRR on domestic deposits has been increased from 5 percent to 5.5 percent effective from 17 October 2008 as a signal of monetary tightening. The lender of the last resort facility can be provided for a maximum period of one year to commercial banks and financial institution in critical situation upon the request of the GON. According to the Act, the terms and conditions for such facility will be determined by the NRB. The lender of the last resort facility for the maximum period of six months will be provided to the banks and financial institutions maintaining their accounts with the NRB in case the liquidity adjustment through inter bank market, OMOs and SLF remains inadequate. This facility will be provided against the collateral of cash balances held at the NRB for the purpose of CRR, treasury bills of the GON and good loans. The beneficiary of this facility should strictly follow the terms and conditions set by the NRB for maintaining the required liquidity position within six months. With a view to circumvent the misuse of this facility and as a signal of tightening monetary policy stance, the existing bank rate of 6.25 has been increased marginally to 6.5 percent.

In the context of the weakening Nepalese export sector and with a view to enhance the competitiveness of this sector, the refinance rate on exports in Nepalese currency has been reduced to 2 percent from the existing rate of 2.5 percent. The commercial banks using such facility are not allowed to charge more than 5 percent interest rate while extending such loans to respective borrowers. The NRB will encourage the existing banks and financial institutions for merger and acquisition to increase expanding the capital base in order to finance the infrastructure sector which requires a huge amount of financial resources. The bank feels elated with the willingness shown by some banks and financial institutions for merger and acquisition. Before this, HICEF Finance Company merged with Laxmi Bank Limited on July 26, 2004 followed by the merger of Nepal Bangladesh Leasing and Finance Ltd with Nepal Bangladesh Bank Ltd on Sep 18, 2007.

The management of the credit required for the development of infrastructure has remained a challenging task. The mobilization of short-term financial resources by commercial banks and the small capital-base of development banks have posed challenges for mobilizing the long-term credit required for the development of infrastructure. In order to address this challenge to some extent, the single obligor limit of 25 percent was revised upward to 50 percent in 2007/08 in an attempt to ease commercial banks and financial institutions' investment in hydro projects, which will be continued in 2008/09 as well. The credit flow of commercial banks and financial institutions to the micro hydro projects will be counted as loans under the deprived sector. This provision will encourage banks and financial institutions to increase investment in hydro projects.

With a view to address the issue of financial inclusiveness and expand the micro credit, the deprived sector credit requirement for development banks has been increased to 1.5 percent from 1 percent of their total credit. From now onwards, finance companies are also required to provide 1 percent of their total credit to the deprived sector. The deprived sector credit requirement of 3 percent for commercial banks has been continued. The range of the counterparties for the conduct of monetary policy has been broadened to include development banks and finance companies from 2008/09. Earlier, the counter party is limited to commercial banks only. The two special facilities provided to banks and financial institutions as the counterparties of the monetary policy operations will be continued. First, the NRB will conduct its secondary market operations with commercial banks, development banks and finance companies as the counterparties. Second, the short-term standing liquidity facility (SLF) against the collateral of GON treasury bills and development bonds will be provided only to commercial banks, development banks and finance companies. These facilities are entitled only to commercial banks, development banks and finance companies with a view to achieve their cooperation and accountability in the conduct of monetary policy as the counterparties. Previously, these facilities (secondary open market operations and SLF) were provided exclusively to the commercial banks. In order to get these facilities, the counterparties should regularly submit their financial statements in formats stipulated in the NRB directives on a regular basis. This new provision is expected to enhance the effectiveness of the implementation of monetary policy in the days ahead.

4.6 Financial Sector Growth in Nepal

An efficient financial system facilitates economic growth through mobilization and efficient allocation of resources. The status of financial sector can be evaluated in terms of M2 /GDP ratio, currency/ M2 ratio, deposit/M2 ratio, money multiplier, shares in total banking assets, etc.

Table 4.6

Selected Indicators of Financial Sector Growth

Ratio & Share in %				Period Average		
	1975-79	**1980-84**	**1985-89**	**1990-94**	**1995-99**	**2000-05**
M2/GDP Ratio	17.7	26.1	27.7	32.3	39.6	52.9
Currency/M2 ratio	45.3	34.5	30.3	29.6	28.8	24.0
Money multiplier	2.1	2.4	2.5	2.5	2.6	3.0
Share in total banking assets	100.00	100.00	100.00	100.00	100.00	100.00
NRB	51.6	45.4	45.9	44.6	37.0	30.9
Commercial Banks	48.4	54.6	54.1	55.4	63.0	69.1

(Source: Golden Jubilee Publication-2005.)

M2/GDP Ratio

This ratio is the major indicator of financial deepening. A higher ratio indicates greater financial sector development. It implies that people prefer to hold monetary assets, if they feel more confident and convenient to hold such assets keeping in mind the sense of liquidity, risk, return, etc. Looking at the growth trend of M2/GDP ratio, one can easily observe that the growth pattern is in favor of increasing financial deepening. It is however, over the time, the GDP growth rate itself was not so much encouraging compared to money supply growth, which ultimately helped maintain a higher ratio. Nonetheless, the level of M2/GDP ratio (52.9 percent) in Nepal is more or less at the same level with the average ratio of low income countries. TheM2/GDP ratios during late 1990s were tentatively 58.0 percent in low income countries, 65.0 percent in middle income countries and 88.0 percent in high income countries. (Golden Jubilee publication)

Currency/M2 Ratio

Currency ratio and deposit ratio explain the similar point but in opposite way. In other words, deposit ratio equals to 100 minus (-) currency ratio. Currency in circulation to M2 ratio is an indicator reflecting the financial deepening and intermediation. A low currency ratio shows an active role of financial intermediaries on mobilization of financial resources in terms of time (saving and fixed) and demand deposits. As such, the currency ratio has significantly declined to 24.0 percent during period of 2000-05 from that of 45.3 percent in the period 1975-79 which showed some improvements.

Money Multiplier

It is an important indicator showing the strength of the central bank. The money multiplier reflects the responsiveness of money supply to the reserve money/monetary base. A smaller money multiplier indicates a less powerful central bank in terms of independence in conducting the monetary policy and vice-versa. A smaller money multiplier implies that a central bank is unable to bring a large change in money supply with a small change in the balance sheet of central bank known as reserve money. However, the money multiplier has slightly been improved during the referred period from 2.1 to 3.0. Such money multiplier on average was 4.0 in low income countries, 7.0 in middle income countries and 14.0 for high income countries during late 1990s.

Assets Structure

With respect to the question of productivity and profitability, it is but natural that central bank is not a profit making entity. The central bank's profit is something like the profit of a liquor store. In other words, if there are more weaknesses in the financial sector, the central bank could retain a higher profit, though it is not a healthy tradition. This is because, among others, if the government cannot reduce deficit financing depending on the internal banking sector borrowing and if the other banking sector than the central bank are declined to participate, it is easy for the central bank to make profit. However, such profit is a sign of weak financial system. Fortunately, NRB Act, 2002 has fixed the limit on the overdraft facility as well as the holdings of government securities. Similarly, the financial deepening is reflected by the share of central bank and other banks and financial institutions assets over the total financial sector assets. In the initial phase of financial sector development, NRB had a dominating share of central bank assets over the total banking assets. Looking at the share of the NRB and commercial banks (excluding the other banks and financial institutions), there is a good indication that the share of the NRB has been declining and the share of commercial banks has been increasing over the time. Obviously, it is a signal towards a healthy development of banking sector as well as financial deepening.

4.6.1 Regional Distribution of Bank Branches in Nepal

Despite the financial reform measures introduced in the country, the level of financial development indicates that it is still beyond the access of the people of the backward regions. Regions they are far behind in a number of dimensions of economic development are under-banked. The indicators explaining the level of financial access are showing that there are relatively under banked regions in the country. The expansion of commercial banks branches in rural areas has been rapid after the initiation of peace process in the country following the People's Movement II in April 2006. The NRB has also issued new directives relating to the opening up branches by commercial banks, which helped expand bank branches from a number of 452 in mid- July 2007 to 555 in mid-July 2008, excluding one hundred bank branches of Agriculture Development Bank/Nepal (ADB/N) involved in non-banking transactions.

The expansion of bank branches by commercial banks is concentrated in the urban areas. For example, the number of bank branches in Kathmandu Valley increased by 24.6 percent from the total branches of 126 as at mid-July 2007 to 157 as at mid-July 2008 followed by the expansion in the *Terai* region by 22.8 percent from 197 branches as at mid-July 2007 to 242 branches as at mid-July 2008 (Table 4.7). Realizing the concentration of banking activities in the urban areas, the newly issued directives required commercial banks to open a bank branch outside the Kathmandu Valley for opening a branch within the valley.

Table 4.7

Regional Distribution of Financial Institutions

Region	2007	2008	Distribution % (2008)	Growth Rate % (2007- 2008)
Eastern	90	111	20	23.33
Central	220	265	47.75	20.45
Western	88	107	19.28	21.60
Mid-Western	32	46	8.29	43.75
Far-Western	22	26	4.68	18.18
Total	**452**	**555**	**100.00**	**22.78**
Kathmandu Valley	126	157	28.29	24.60
Terai	197	242	43.60	22.84
Hills	129	156	28.11	20.93
Total	**452**	**555**	**100.00**	**22.78**
Population (In Million)	26.44	27.03		
Population per bank branches (In Thousand)	58.49	48.70		

(Source: NRB Publications)

The distribution of bank branches shows that financial services provided by "A" class institutions licensed by the NRB are largely urban centric as Kathmandu valley alone has 157 bank branches (28.29 percent) compared to a meager number of 46 and 26 bank branches operating in the Mid-Western and Far Western Development Regions respectively. The Central Development Region has the highest number of bank branches. Out of the total of 555 bank branches, 265 bank branches (47.75 percent) are operating in the Central Development Region as at mid-July 2008 followed by 111 bank branches in the Eastern Development Region. On the basis of the ecological regions, the hilly regions with 52 districts have 156 bank branches whereas the *Terai* zones with 20 districts have 242 bank branches.

Financial access to poor and backward regions is a challenge for the Nepalese financial system that is expanding over the years. This is also highlighted by the recent World Bank study (Access to Financial Services in Nepal: 2007). The study mentions access to financial services remains limited for many people in many parts of Nepal and in recent years has been declining. Despite government efforts, access to formal financial services is declining. While the banks serve mainly the urban areas and the wealthiest, rural area and poor section of the society largely depends upon informal sources of financing.

4.7 Overview of Nepalese Economy

In 2007/08, the Nepalese economy displayed a satisfactory performance in terms of economic growth. The robust performance of agriculture sector together with the satisfactory expansion of services sector placed the overall growth to a peak of four year high. The industrial performance however remained lackluster. Strikes, roadblocks, paucity of petroleum products, load shedding and turmoil in Terai region continued to drag down the pace of industrial growth in 2007/08. Overall, the real GDP at producers' prices grew by 4.7 percent in 2007/08 compared to a growth of 3.2 percent in the previous year.

By observing the table (4.8) we can say that all economy indicators are moving in the same direction. Per capita GDP is in increasing trend and increased to $ 470 in FY 2007/08. Likewise, Gross Domestic Saving and Gross National Saving are also in increasing trend and increased to 11.47 percent and 32 percent respectively. The ratio of total export is decreased to 12.04 percent whereas the ratio of total import has increased to 32.56 percent. However the ratio between total exports to total import has decreased to 37 percent in FY 2007/08 from the previous year ratio of 42 percent. The total consumption has decreased 88.53 percent in FY 2007/08 from the pervious year ratio of 90.26 percent whereas the ratio of investment is in increasing trend has increased to 27.2 percent in fiscal year 2007/08. Some of the important economic indicators are presented in this table No. 4.8.

Despite the political turmoil and transition phase of the economy, fiscal situation remained broadly stable in 2007/08. Fiscal deficit stood at 2 percent of GDP as against the estimate of 2.7 percent in the budget of 2007/08. Such a prudent fiscal situation was made possible primarily due to the impressive revenue mobilization and foreign grants. A host of reforms in tax administration, growing imports and consumption induced by the rise in remittances, the increasing imports of high tax yielding vehicles and spare parts and increase in non tax revenue were among the responsible factors for the encouraging growth of revenue mobilization. Some of the important economic indicators are presented in this table No. 4.8.

Table No: 4.8

Some Important Macro Economic Indicators

SN	Description	2003/04	2004/05	2005/06	2006/07	2007/08
1.	Per capita GDP (NRs) at producers price	21694	23300	25289	27497	30361
2.	Per capita GNP (NRs) at producers price	21626	23365	25481	27778	30738
3	Per capita GDP at constant price	19476	19683	20042	20289	20816
4.	Per capita GNP at constant price	19406	19738	20193	20497	21074
5.	Annual Change in nominal per capita GDP (%)	6.66	7.41	8.54	8.73	10.42
6.	Annual change in real per capita GDP(%)	2.51	1.11	1.82	1.24	2.59
7.	Per capita GDP (USD)	293	328	350	390	470
8.	Per capita GNP in (USD)	292	329	352	394	476
9.	Total consumption / GDP (%)	88.25	88.44	91.02	90.26	88.53
10.	Total Investment / GDP (%)	24.5	26.5	26.0	25.3	27.2
11.	Gross domestic saving / GDP (%)	11.75	11.56	8.98	9.74	11.47
12.	Gross national saving / GDP (%)	27.25	28.41	29.02	28.5	32
13.	Exports / GDP (%)	16.68	14.58	13.45	13.06	12.04
14.	Imports / GDP (%)	29.46	29.48	31.32	31.35	32.56
15.	Exports / Imports	0.57	0.49	0.43	0.42	0.37
16.	Resource Gap as percentage of GDP (+/-)	2.72	1.96	2.17	0.48	0.01
17.	Gross Fixed Capital Formation / GDP (%)	20.34	19.94	20.72	20.41	21.05
18.	Exchange rate(USD: NRs)	73.97	71.05	72.32	70.49	64.64
19.	Population (in millions)	24.74	25.3	25.86	26.44	27.03

(Source: Central Bureau of Statistics.)

In 2007/08, trade deficit continued to widen as in the previous years. However, there was a surplus in the current account primarily owing to large remittance inflows. The balance of payments also posted a surplus. Ratio of exports to imports declined to 37 percent in 2007/08 from 42 percent in the preceding year, demonstrating the declining import financing capacity of exports. The average annual consumer inflation moderated to 7.7 percent in 2007/08 from the level of 6.4 percent in 2006/07. This was attributed primarily to the upsurge in the price of food articles and petroleum products.

Overall, in terms of the macroeconomic performance, the Nepalese economy displayed a mixed performance in 2007/08. While real GDP posted a higher growth compared to the previous year, the annual average inflation remained high. Although the trade deficit expanded, the current account and the balance of payments remained in surplus primarily due to the significant remittance inflows.

4.8 Relationship between Financial Development and Economic Growth

In examining the level of financial development in Nepal, one needs to rely on monetary survey (monetary authorities and commercial banks). Lack of access to complete set of time series data has forced this study to focus on banking system indicators only.

DEPTH, the first measure, equals broad money (M_2) divided by GDP and it measures the size of financial intermediaries. Broad money (M_1 plus time deposit of the banking system) represents the liquid liabilities in the financial system. Broad money to GDP ratio, a typical measure of financial depth, captures both monetization and penetration of the banking system in mobilizing savings. Over the period 1975- 2004, broad money as a percentage of GDP increased from 12.4 percent to 56.4 percent, indicating that the overall size of the financial intermediary as well as well as monetization of the economy is deepening. However, this may not accurately reflect the provision of financial services in the economy.

BANK measures the degree to which commercial banks versus central bank are allocating credit in the economy. During the sample period, BANK increased from 57.1 percent in 1975 to 92.6 percent in 2004. The increasing trend of this ratio implies that commercial banks are more likely to provide financial functions of saving mobilization, resources allocation, exerting corporate control, managing risk and facilitating the trading to goods and services than the central bank. However, this ratio has some weaknesses because commercial banks may not be the only financial intermediaries in providing efficient financial functions in the system and they may also lend to the government or government owned enterprises.

PRIVATE measures more accurately the role of financial intermediaries in channeling funds to the private sector and, therefore, it is favored as a preferred measure of financial development. PRIVATE showed an upward trend, with the ratio reaching 68.3 percent in 2004 from 40.3 percent in 1975.

PRIVY, the fourth measure, partially accommodates concerns about the allocation of credit to private sector. During the period, credit to private sector as a percentage of GDP rose from 4.7 percent in 1975 to 32.1 percent in 2004. These four indicators of financial development were widely recognized. Some early researches also focused on using narrow money (M_1) to GDP ratio as an indicator of financial development. M_1 /GDP ratio increased from 8.1 percent in 1975 to 19.1 percent in 2004. This ratio indicates the degree of monetization. The indicators based on monetary aggregates advocates the ability of the financial system to provide transaction services.

In a country like Nepal where the economy is not fully monetized, broad money to GDP ratio does matter in measuring the level of financial development. Among all these measures, credit issued to private sector is considered to be the most important indicator of financial development from economic development perspective. Increased credit to private sector leads to promote economic activities. Productive firms and enterprises used to access bank credits only when they have profitable investment opportunities in hand. Private sector can make the best use of credits it obtains from banks and financial intermediaries. A high ratio of private sector credit to total credit indicates that banks are able to channel their loan able funds in more productive ways. Over the period covering 1975 through 2004, commercial banks' credit to private sector as a percentage of total credit increased from 57.6 percent to 72.7 percent. This indicates that the major portion of commercial banks' credit portfolio is being utilized in extending credit to private sector. The indicators DEPTH and PRIVY are averaged to yield an index called FINDEX, which measures the significance of the banking sector in our sample period. This indicator has been used in studying the effect of the financial sector on the growth of the economy (Kunt and Maksimovic, 1996: 351).

Table 4.9
Indicators of Financial Intermediary Development in Nepal, 1975-2004

Mid July	DEPTH	BANK	PRIVATE	PRIVY	M_1/GDP	Pvt./Total	FINDEX
1975	12.40%	57.10%	40.30%	4.60%	8.10%	57.60%	8.50%
1976	14.50%	63.90%	35.30%	4.10%	8.40%	52.90%	9.30%
1977	18.70%	69.10%	36.10%	5.00%	10.70%	48.80%	11.80%
1978	19.10%	61.30%	33.30%	5.40%	10.40%	50.00%	12.30%
1979	17.30%	62.50%	33.60%	5.10%	9.60%	50.30%	11.20%
1980	22.60%	63.90%	40.80%	8.20%	12.10%	58.90%	15.40%
1981	24.70%	66.10%	45.60%	9.80%	12.60%	62.10%	17.20%
1982	24.10%	66.20%	42.30%	8.50%	11.70%	61.00%	16.30%
1983	27.30%	58.60%	30.90%	8.00%	12.90%	51.10%	17.60%
1984	26.60%	56.40%	31.50%	8.10%	12.60%	53.40%	17.30%
1985	26.40%	56.30%	31.20%	8.70%	11.80%	51.60%	17.50%
1986	27.20%	55.30%	32.80%	9.30%	12.60%	56.10%	18.20%
1987	27.40%	57.10%	34.30%	9.80%	12.70%	57.00%	18.60%
1988	27.90%	62.60%	39.10%	10.80%	12.50%	58.70%	19.30%
1989	29.80%	63.30%	38.20%	11.60%	13.20%	58.40%	20.70%
1990	30.50%	62.00%	38.40%	11.30%	13.80%	60.90%	20.90%
1991	31.30%	68.50%	39.60%	11.70%	13.50%	55.50%	21.50%
1992	30.60%	73.70%	41.60%	12.10%	13.00%	54.80%	21.30%
1993	34.00%	71.00%	42.00%	12.60%	13.90%	57.60%	23.30%
1994	35.00%	73.40%	50.10%	15.20%	14.30%	67.00%	25.10%
1995	36.90%	74.90%	57.40%	19.60%	15.00%	75.40%	28.30%
1996	37.20%	75.10%	60.70%	22.30%	14.70%	79.10%	29.80%
1997	37.00%	75.90%	62.50%	23.10%	13.70%	80.50%	30.00%
1998	42.00%	79.10%	64.80%	25.50%	15.00%	80.60%	33.80%
1999	44.70%	81.40%	66.00%	26.50%	14.90%	79.90%	35.60%
2000	49.00%	84.80%	68.20%	28.80%	16.10%	78.80%	38.90%
2001	52.20%	84.80%	66.80%	30.90%	17.20%	76.70%	41.50%
2002	53.00%	82.70%	63.90%	31.60%	18.30%	75.10%	42.30%
2003	54.10%	87.40%	65.60%	33.20%	18.40%	73.40%	43.60%
2004	56.40%	92.60%	68.30%	32.10%	19.10%	72.70%	44.30%

(Calculated on the basis appendix 3 & 4)

Where,

FINDEX- averages the ratio of broad money to GDP (DEPTH) and the ratio of commercial banks credit to private sector to GDP (PRIVY).
DEPTH- Liquid Liabilities to GDP (M_2/ GDP)
BANK- Bank credit divided by bank credit plus central bank domestic credit.
PRIVATE- Credit allocated to private sector to total domestic credit (excluding credit to banks)
PRIVY- Commercial banks' credit to private sector divided by GDP.
Pvt. /Total- The ratio of private sector credit to total credit issued by commercial banks.

A flourishing body of empirical work aiming at testing the positive relationship between financial development and economic growth find that financial development indicators explain a significant portion of economic development. Different models suggest that financial intermediation has a positive effect on growth. The models are based on regression analysis. The basic model proposed by Khan and Senhadji (2000) has the following form:

$$Y_1ß_0 + ß_1FD_i + ß_2X_i + e_i$$

Where Y_i is the rate of growth of country i, FD_i is an indicator of financial depth, X_i is a set of control variables and e_i is the error term. A similar model described by Levine et al. (1999) takes the following form:

$$GROWTH_i = a + ß\ FINANCE_i + Y\ \text{‘}[CONDITIONING\ SET]_i + e_i$$

Where the dependent variable, GROWTH, equals real per capita GDP growth, FINANCE equals indicators of financial intermediary development, CONDITIONING SET represents a vector of conditioning information that controls for other factors associated with economic growth and e_i is the error term.

The case of developed countries is quite different and this indicator (FINDEX) appears to be above 100 percent. In many developing countries banks are the significant financial intermediaries and this situation equally prevails in the context of Nepal. Over the sample period 1975 to 2004, the trend of FINDEX is increasing and it goes up from 8.5 percent in 1975 to 44.3 percent in 2004. With these few observations it can be revealed that the direction of financial development in the Nepalese context shows the right and positive track. However, the level of financial development is much more below as against that of other developed economies. In the following sections, we will try to explore the effect of financial development on economic growth based on some of the models previously applied by different authors in their respective studies.

The effect of financial development indicators on economic growth in Nepal is examined through the estimation of the ordinary least square (OLS). The sample range of the estimated equation is 1975-2004 and most of the data in this study are taken from the publications of the NRB and government of Nepal. The regression equation is specified as:

$$Y = a + ßFD+ u$$

Where, Y is the economic growth indicator (dependent variable),

FD is the financial development indicator and

u is the error term.

However, this linear function has the chance of non-stationary of the variables. Hence, the equation is converted into the log-linear form so that the slope coefficients indicate the constant percentage changes in dependent variable as a result of a one percent changes in independent variable. We obtain the following log linear equation assuming that the error term, u, tends to zero.

$$\ln Y = a + ß \ln FD$$

Real GDP (RGDP), nominal GDP (NGDP), per capital real GDP and per capita nominal GDP have been used as the economic development indicators or the dependent variables in the model. The financial development indicators or the independent variables includes narrow money (M_1), broad money (M_2), commercial banks' total credit and commercial banks' credit to private sector. A priori or the theoretical expectation is that the level of economic development as measured by different growth indicators is explained by financial development indicators. The statistical results of the regression equations are summarized in the table 4.10 below;

Table 4.10
Complicated Regression Result

Eqn	Independent Variable	Constant	Slope	r	r^2	Adjusted r^2
Dependent Variable: ln RGDP						
1	ln M_1	9.3137	0.2855	0.9960	0.9921	0.9918
		(203.5859)	59.3012*			
2	ln M_2	9.4265	0.2513	0.9958	0.9916	0.9913
		(208.8026)	(57.6196)*			
3	ln (Total credit of commercial banks)	9.7026	0.2340	0.9967	0.9933	0.9931
		(269.2898)	(64.5054)*			
4	ln (Credit to private sector commercial Banks)	9.9934	0.2151	0.9963	0.9926	0.9924
		(300.8745)	(61.4832)*			
Dependent Variable: NGDP						
5	ln M_1	3.3565	0.8589	0.9977	0.9954	0.9952
		(31.8650)	(77.4832)*			
6	ln M_2	3.7018	0.7555	0.9967	0.9934	0.9931
		(30.6555)	(64.7575)*			
7	ln (Total credit of commercial banks)	4.5464	0.7030	0.9970	0.9939	0.9937
		(44.0242)	(67.6411)*			
8	ln (Credit to private sector commercial Banks)	5.4160	0.6455	0.9955	0.9911	0.9908
		(49.3057)	(55.7953)			
Dependent Variable: ln (Per capita RGDP)						
9	ln M_1	5.8253	0.1416	0.9823	0.9650	0.9637
		(49.1334)	(27.7774)*			
10	ln M_2	6.1188	0.1245	0.9810	0.9623	0.9609
		(54.5162)	(26.7324)*			
11	ln (Total credit of commercial banks)	6.3732	0.1160	0.9828	0.9658	0.9646
		(65.2509)	(28.1195)*			
12	ln (Credit to private sector commercial Banks)	6.6405	0.1068	0.9843	0.9689	0.9678
		(79.0891)	(29.5369)*			
Dependent Variable: ln (Per capita NGDP)						
13	ln M_1	-8.0535	0.7150	0.9959	0.9918	0.9915
		(-28.1891)	(58.2164)*			
14	ln M_2	-6.5716	0.6287	0.9945	0.9891	0.9887
		(-21.8225)	(50.3184)*			
15	ln (Total credit of commercial banks)	-5.2664	0.5850	0.9949	0.9898	0.9894
		(-19.7845)	(52.0328)*			
16	ln (Credit to private sector commercial Banks)	-3.8830	0.5372	0.9936	0.9873	0.9868
		(-14.5107)	(46.6024)*			

(Calculated on the basis appendix 4 & 5)

* Indicates statistical significance at 0.1 percent.
Figures in parentheses are t- values
Number of observations are 30. Calculated from annexure 3 and 4 as per annexure 5.

In establishing the relationship between per capita real GDP, the third indicator of economic development, and other financial development indicators it has been found that the slope coefficients are in the range of 0.11 to 0.14. Hence, a one percent increase in these financial development indicators will cause real per capita GDP to grow by 0.11 to 0.14 percent. M_1 appears to have the largest slope coefficient of 0.14 as compared to that of other financial development indicators. In the regression model, the fourth indicator of economic development is per capital nominal GDP. M_1, the first indicator of financial development, has an estimated slope coefficient of 0.72. Hence, a one percent increase in M_1 will cause per capita nominal GDP to increase by 0.72 percent. The slope coefficient of 0.63 associated with M_2 implies that per capita nominal GDP will go up by 0.63 if M_2 increases by one percent. Similarly, total credit and credit to private sector issued by commercial banks have estimated slope coefficients of 0.59 and 0.53, implying that a one percent increase in commercial banks' credit causes per capita nominal GDP to increase by more than a half percent.

Both the coefficient of determination (r^2) and the unbiased coefficient of determination (Adjusted r^2) re reasonably high and remain in the range of 0.95 to 0.99. The coefficient of determination measures he overall goodness of fit of the estimated regression model. It shows that more than 95 percent of the variation in economic development indicators dependent variables) has been explained by financial development indicators (independent variables). Though, r^2 or adjusted r^2 is a meaningful measure of the extent to which the variation in one variable determines the variation in the other, this criterion should not be overemphasized. In explaining the parameters we cannot attach any economic meaning o the intercept. However, the signs of the slope coefficients are in accordance with the theoretical or priori expectation.

The slope coefficients measure the percentage change in dependent variable with respect to given change in independent variable. Examining the results we observe that the slope coefficient in each of the equations is positive. One interesting thing to be examined here is whether the slope coefficients on independent variable are zero. Do the results conclude that there is relationship between financial development indicators and economic development indicators? A one-tailed test can be carried out to test the significance of the slope coefficients. The null hypothesis can be postulated that financial development indicators provide no information on economic development ($H_0 = 0$). The alternative hypothesis is that financial development indicators provide information on economic development ($H_1 > 0$). Applying t-test, the calculated t-values are found to be more than the tabulated value of t-statistic at 0.1 percent level of significance ($t_{0.001}$ =

3.408 for 28 d.f.). Therefore, the t-statistics for the slope coefficients are statistically significant. We may reject the null hypothesis in favor of the alternative hypothesis and it can be said that independent variables add significantly to the predictive power of the model.

From these results it is seen that the slope coefficients are positive, implying that for a constant percentage increase in the financial development indicators, the economic development indicators increase by some positive values. Real GDP has been chosen as the first indicator of economic development. M_1, the independent variable, has an estimated slope coefficient of 0.29, which indicates that a one percent increase in M_1 is associated with 0.29 percent increase in real GDP. Similarly M_2 has a coefficient of 0.25, indicating that with a one percent increase in M_2, real GDP, on the average, increases by 0.25 percent. Total credit and credit to private sector issued by commercial banks have beta values of 0.23 and 0.21 respectively. If the total credit and private sector credit issued by commercial banks increase by, say one percent, real GDP will increase by 0.23 percent and 0.21 percent respectively. Nominal GDP has been introduced as the second indicator of economic development. Nominal GDP will increase by about 0.86 percent if M_1 increases by 1 percent. M_2 has an estimated coefficient of 0.76 percent. Compared to that of the slope coefficients of monetary aggregates, total credit and private sector credit issued by commercial banks have relatively smaller slope coefficients of 0.70 and 0.65 respectively.

4.9 Critical Review of Regulatory Role of NRB

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, 2060, which is popularly known as Umbrella Act, has 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 NRB has been continuing the financial sector reform program for the purpose of improving, stabilizing and strengthening the financial sector and relevant changes have been timely incorporated in the regulatory and supervisory process of the banks and financial institutions. Among the three components of the financial sector reform program, the restructuring programs of Nepal Bank Ltd. (NBL) and Rastriya Banijya Bank (RBB) have remained important. After the arrangement of foreign management, improvement has been witnessed in the operational procedures in these banks and both of them are able to earn operating profit. However, due to a less-than-expected recovery of bad loans of these banks, total negative net worth of these two banks has remained at Rs 23.0 billion. The second component of financial sector reform program or the reengineering of the NRB comprising improvement of human resource management, strengthening of the regulatory and supervisory functions, improvement in public relations and programs in information technology will be given continuity in 2008/09, too. The third component of the financial sector reform program relates to the capacity building of the overall financial sector. The functions such as strengthening the debt recovery tribunal (DRT) and credit information bureau (CIB), establishment of national level bankers' training center and development of financial journalism will be continued in 2008/09 as well. It has been noticed that the financial institutions are resorting more to borrowing rather than to deposit mobilization for financial resource mobilization. With a view to mitigate risks arising from such practice, more emphasis laid on deposit collection as a source for financial resource mobilization and generate the improvement in liquidity management, the provision will be made whereby the financial resource mobilization from borrowings will be no more than one-third of the deposits. However, financial institutions of "D" category are exempted to abide by such provision. If loan is provided based on the credit rating of the borrowers, banks and financial institution would be benefited in credit management including determination of credit conditions there by reducing the NPL ratio. This will bring the competition among the lenders and borrowers to obtain the certificate of higher credit rating, which will help institutional development of the private sector and enhance transparency in their transactions. Therefore, the NRB will encourage the private sector to establish the credit rating agency. As banks are themselves rated, this provision will help monitor the market strength of the banks and help the depositors to choose the sound and healthy banks. Under the "Asset (Money) Laundering Prevention Act, 2008", Financial Intelligence Unit (FIU) has been formed in the NRB for the purpose of collection, analysis and investigation of the financial information. The GON is in the process of establishing the "Asset (Money) Laundering Prevention Investigation Department" for investigation and settlement of the crimes under the Act.

A Grievance Hearing Cell (GHC), established on April 24, 2005 under the chairmanship of Deputy Governor of the NRB to settle the grievances resulting from misunderstanding and disputes between customers and financial institutions was continued in 2007/08. Following the decision made by the Council of Ministers on December 15, 2006, the GHC formed at central level under the leadership of the Deputy Governor was revised and extended on January 4, 2007 by including representatives from Ministry of Finance and Nepal Bankers' Association as members and representative from the FNCCI as an observer. The GHC settled 289 cases till mid-July 2008 out of 364 cases filed and circular has been issued to concerned banks and financial institution to look into the remaining 75 cases. The NRB and the GON have done their best to recover the bad loans from the bank defaulters. Accordingly, various stringent actions have been taken against them. As per the decision of the Council of Ministers taken on September 25, 2007, the actions taken against the bank defaulters as well as other persons related to the loan of more than Rs. 50.0 million include the following: a) seize the passport as well as prevent to issue new ones; b) prevent from becoming a member of a board of directors in any company or a company in a process to be registered as per the Company Act; c) prevent the sale of movable as well as fixed property except for settling the debt; d) prevent the sale and purchase of shares except for settling debt, e) seize the holding of government securities and use such securities for the settlement of debt, f) prevent the withdrawal of deposits (domestic as well as foreign) except for the settlement of debt, and g) prevent the use of property in locker by defaulters and other persons related to the loan. Banks and financial institutions while providing margin lending to the concerned borrowers on the security of shares of the listed companies in Nepal Stock Exchange Limited are required to follow certain provisions. In the first place, the amount of margin lending to be provided on the security of shares is limited to the fifty percent of the average price of closing price of last 180 working days or fifty percent of the current market price, whichever is lower. The amount of margin lending once accepted to the borrower cannot be further extended through revaluation of the shares under securities. If the amount of the margin lending exceeds the stipulated limit of 50 percent, the lending should be regulated to the limit of 50 percent by mid-July 2008 or the maturity period whichever is the earlier. Secondly, the maturity period of the margin lending should not be more than a year and such lending is not allowed for renewal, rescheduling and restructuring. Thirdly, banks and financial institutions cannot accept the margin lending to the shares of banks and financial institutions, which have a level of capital less than that fixed by the NRB, have negative net worth, are delisted by Nepal Stock Exchange Ltd, and are unable to complete annual audit even after one year from the end of the fiscal year. Banks and financial institutions are not allowed to provide loans against the receipt of application submitted for the purchase of shares through initial public offering (IPO). If any banks and financial institutions have provided loans of such nature prior to this provision, such loans are to be recovered within a month since this provision has been made effective. Otherwise, loans are to be rescheduled with enough securities and in case the loans are not fully backed up by the securities, banks and financial institutions are required to make provisions for such loans by the full amount of the loan.

The NRB has been adopting 25-point supervisory guidelines of the BASEL as the basis of regulation, inspection and supervision of banks and financial institutions. As per the recommendation of Accord Implementation Group formed to implement BASEL II in Nepal, the directives related to capital adequacy as per the BASEL II has been implemented for the financial institutions of category "A" from 2008/09. It is believed that such capital adequacy will be based on the real risk of the banks. The NRB is of the view that this new provision will induce banks to be more careful in managing their risk. In the current situation of significant expansion in the number of banks and financial institutions, maintaining financial stability has been a great challenge. The bank has taken effective regulation, inspection and supervision as the main measures for maintaining financial stability. In order to address the supervisory challenges brought about by the increasing number of banks and financial institutions, the bank has been preparing for the implementation of new supervisory instruments, given the fact that the traditional supervisory mechanism may not be effective with the existing manpower. For the banks and financial institutions unable to maintain the minimum capital adequacy ratio as per BASEL II, prompt corrective action (PCA) will be strictly implemented from 2008/09. In order to minimize the weaknesses observed in banks and financial institutions in time and following the international practice of taking prompt actions by classifying them in compatible with the level of weaknesses, the bank has prepared a prompt corrective action bylaw and decided to implement it from October 17, 2008. The critical review of regulation, inspection and supervision roles of NRB has been analyzed as follows:

4.9.1 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. To attain the above objectives Section 84 of the Nepal, Rastra Bank Act 2002 has entrusted Nepal Rastra Bank with the necessary powers to perform inspection and examination of any commercial banks or obtain necessary information for the purpose of supervision of the commercial banks. 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. 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.

I. On Site Examination

The Bank Supervision Department can carry out onsite examination of commercial banks in Nepal by sending examination team to the commercial banks. Onsite examination can be corporate level inspection covering all aspects of functioning of commercial banks or can be targeted branch level inspection. The Department also performs follow up of the earlier examination reports by visiting the branches to ensure necessary compliance of the NRB instructions. If information as to functioning of commercial banks against the interest of depositors' or some serious irregularity is received, the Department can perform special on site examination in such cases. The Bank Supervision Department is required to carry out corporate level examination of all commercial banks at least once in a year as per its annual plan but the gap between two inspections at any time should not exceed two years. As per current policy of the Department, corporate examination of all commercial banks is carried out once in a year. For the guidance of the onsite examination, an "On site inspection manual" is in force. On completion of the onsite examination examiners perform CAMELS rating of the bank which is exclusively used for the supervisory purpose and is not revealed to general public.

II. Off Site Supervision

Off site supervision is a supplement to the onsite examination and is designed to act as an early warning system to identify banks with potential problems so that appropriate policies and action can be determined. Off site division of the Bank Supervision Department is carried out in a quarterly frequency as well as annual off site review based on the reports and returns submitted by the commercial banks Quarterly offsite review. Off site division reviews performance of all commercial banks on quarterly basis which is submitted to the Governor of Nepal Rastra Bank. Such review involves assessment of the financial information as well as compliance of applicable rules regulations and legal provisions including NRB directives. Based on the review internal rating which is called CAMELS Offsite Rating (COR) is also assigned to the banks.

III. Quarterly off Site Review

Off site division reviews performance of all commercial banks on quarterly basis which is submitted to the Governor of Nepal Rastra Bank. Such review involves assessment of the financial information as well as compliance of applicable rules regulations and legal provisions including NRB directives. Based on the review internal rating which is called CAELS Offsite Rating (COR) is also assigned to the banks.

IV. Annual Balance Sheet Review

The Department's off site division reviews the balance sheet of the commercial banks at the end of each financial year and issues necessary instructions based on such review; this is then published in their annual report. In the course of such review the auditor's report, audited financial statements, long form audit report preliminary, audit report and banks reply thereon are studied. For the guidance of the offsite surveillance off site supervision manual is in force. Till now there is no difference in the supervision methods used for the banks with foreign investment and other commercial banks.

4.9.2 Domestic Legal Provisions Regarding Banking Sector

Bank and Financial Institution Ordinance, 2060, governs the functional aspect of banks and financial institutions. 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 NRB will classify the institutions into "A" "B" "C" "D" groups on the basis of the minimum paid-up capital and provide the suitable license to the bank or financial institution. The authorized, issued and paid up capital of a license holder institution will be as prescribed by NRB from time to time. The NRB can issue directives to the license holder entity to increase its authorized, issued and paid-up capital if it deems necessary.

Similarly, the license holder entity must maintain a capital fund according to ratio prescribed by NRB based on the basis of its total asset or risk weighted assets, and other transactions. At the same time, the license holder entity must maintain a risk fund according to ratio prescribed by NRB based on the basis of liability relating to its total asset and the other risk to be borne from off balance sheet transaction. The license holder entity must maintain general reserve fund regularly every year till the amount becomes double of the paid up capital of such entity. 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. Provision for upgrading or degrading the class of licensed institution:

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,
- The non-performing asset is within the prescribed limit.

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
- It failed to maintain Risk Management Fund as prescribed by the NRB.

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 following circumstances, if:

- The license holder itself submits an application for the cancellation of its license.
- Fails to conduct the business of financial transaction even after 6 months of issuance of license.
- If it stops financial transaction for more than one month continuously,
- Operates financial transaction against the welfare and interest of the depositors.
- Acts in contravention of NRB Act 2002 or the regulation or byelaws made there under.
- Violates the terms and conditions prescribed by the NRB.
- Fails to act in accordance with the order or directives issued by the NRB.
- Has been declared insolvent.
- The applicant Bank or Financial institution is found to have obtained license by providing false particulars.
- If a bank or financial institution is merged with the other Bank or Financial institution.
- Application is submitted by Bank or Financial institution to Rastra Bank for the cancellation of its license, the NRB must decide on such application within 45 days of receiving the application.

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 as follows:

- To accept deposit with or without interest and make payment of such deposit amount
- To provide loan as prescribed by NRB only
- To operate transactions in foreign exchange, subject to prevailing laws of Nepal
- To operate loan for hire purchase, hypothecation, leasing, housing and service oriented business.
- Subject to the directives of Nepal Rastra Bank, to carry on Merchant Banking Transaction
- To provide loans on the basis of co-financing according to the agreement concluded among the license holding entity so as to divide the collateral on paripassu.

- To issue Bank guarantees on behalf of its customers, have such customers execute necessary bonds in consideration thereof, obtain security, and acquire their movable or immovable assets as collateral or on mortgage, or the assets of third individuals as collateral
- To provide loans against the guarantee provided by any local or foreign bank or financial institution
- To issue, accept, redeem, endorse discount, purchase or deal in letter of credit, bill of exchange, promissory notes, cheques, drafts, traveler's cheques or any other financial instrument.
- Subject to the directives of NRB, to accept, make payment or transfer deposit through telephone, telex, fax, computer or magnetic tape or any other types of electronic devices or instrument.
- Subject to the directives of NRB, to issue and accept credit card, debit card, charge card including other financial instruments and to appoint an agent to perform such activities
- To accept, make payment or provide loan by using automated teller machine or cash dispensing machine.
- To grant overdraft to the person trusted by it
- To provide a fresh loan in the lump sum or in installments against the security of the same movable or immovable assets which have already been pledged with itself or other license holding entity, to the extent of the total value of such security.
- Subject to condition specified by NRB, to work as an agent of the NRB to perform government transaction and similar other transactions on behalf of Government of Nepal.
- To remit or transmit amount to different places within or outside of the Kingdom of Nepal through bill of exchange, cheques, or hundis through other electronic device or arrange for the sale or purchase of bullion, shares, debenture and bond etc. and

collect dividends accruing on the shares and interest on promissory notes, debentures, bonds etc.

- To accept and arrange for the sale or purchase of shares, debentures, securities and collect interest, dividends of securities of limited company in the capacity of a commission agent on behalf of customers, and remit or transmit such interests, dividends to places within or outside of the Kingdom of Nepal
- To purchase, sale or accept the securities issued by the Government of Nepal or Nepal Rastra bank.
- To arrange for safe deposit vaults
- To undertake off balance sheet operations subject to the conditions specified by the NRB
- To provide loans not exceeding the amount specified by the NRB to low-income families, poor class, and natural disaster-affected people with the provision of individual or collective responsibilities.
- To exchange between the NRB and license holding entity the particulars, information or notices regarding debtors or customers who have obtained loans or any other facilities from the license holding entity.
- To provide bank guarantee for loans to be made available by other license holding entity to its clients.
- Subject to the limitation set by NRB, to mobilize capital through shares, debentures, loan bond, saving bond or any other financial instrument.
- To obtain refinance loans from NRB, or supply loan to other license holding entity or obtain loan from them, according to need.
- To conduct or make arrangements for conducting studies, research, and surveys in respect to the establishment, operation and evaluation of projects, and provide training or consultancy service and other information.
- To distribute in the form of loans, fund received from the Government of Nepal or any other domestic or international agency for the purpose of promoting project.

- To prescribe conditions and conclude agreement according to need so as to protect its interest while conducting transaction with or advancing loans to any entity or transacting with any individual
- To obtain loans against the security of its movable or immovable assets
- Subject to bylaws made by the committee, to underwrite the loan
- To make proper arrangements of its assets or to sell them.
- To perform any other functions as prescribed by NRB.

In this ordinance functions which license holding entity can not perform are also incorporated as below. No License Holding Entity shall perform any of the following functions:

- To purchase or sell goods with commercial motives or make investment in immovable property unless required holding for such property for its own use. However, license holding entity of class "B" and "C" may purchase or sell immovable asset or managing such property for the purpose of performing their business.
- To provide loans against the security of its own shares.
- To provide loans of facilities of any kind to the Promoter, Director, person holding more than 1 percent of shares, Executive chief or any member of undivided family of such person or any firm, company or corporate body which is entitled to nominate Director.
- To provide loans of facilities of any kind to any firm, company or corporate body in which the Promoter, Director or any member of his undivided family or the Executive Chief functioning as Director or Managing Agent, or person holding more than 1 percent of shares or in which any such person or form, company, corporate body or individual who is entitled to nominate Director, has financial interest.

- To provide loan, guarantee or facilities for an amount exceeding the percentage of its capital fund specified by the Rastra Bank to a single customer, company or companies belongs to one group, partnership firm except as permitted by the Rastra Bank.
- To provide loan against the personal guarantee of promoter, director or chief executive officer.
- To invest against the security of shares of any entity who has obtained license from Rastra Bank to perform financial transaction.
- To invest money on the share of other license holding entity exceeding the limit imposed by Rastra Bank.
- To carry on those functions in collaboration among or between the license holding entities for the purpose of creating their monopoly and business under their control.
- To engage in manipulative devices or practices to create artificial paucity in the competitive environment of financial sector for unfair advantage for them.
- To work against the business prohibited by the NRB.
- To work anyway for saving or in favor of the person/institution earning money illegally so that he could be saved from punishment or blame.

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.

In course of analyzing the data, here is not only analyzed the secondary data. To make this research work more effective and accurate, the researcher has also collected some valuable primary data through the means of questionnaire by the help of company's employee having different corporate post i.e., branch manager, operation in charge, loan officer etc. This primary data are taken as the supplementary source of data to proven the effectiveness of this research work.

4.10 Analysis of Primary Data

The primary data are collected through structured questionnaire the entire presentation of respondent answers is cited below;

Table 4.11

Analysis of Respondent Answers:

Question Number	Number of respondents				
	Option of answers				
	Yes	No	A	B	C
1			6	4	0
2			4	5	1
3	10				
4			2	6	2
5			3	4	3
6			3	5	2
7			3	5	2
8			4	3	3
9			6	4	0
10	7	3			
11	8	2			
12			3	2	5
13			3	5	2
14	7	3			
15			4	3	3

(Source: Details of questionnaires see Annex 6)

Except some exception, there seems to be homogeneity in answer for the questionnaire. All the answers of respondents are categorized in different groups for analysis purpose as below:

A) Awareness of Respondent: Set of questionnaires is distributed for officer staffs of sample organizations. According to answer of total ten respondents sixty percent are highly aware, forty percent are well known and none is unknown about financial market in Nepal. The authentication of data can be verified by the answer of highly aware respondent.

B) Current Situation of Financial Market in Nepal: There is mixed answer about the situation of financial market in Nepal and its cause as well. Forty percent respondent argued Nepalese financial market is highly developed; fifty percent argued its moderate situation and only ten percent said Nepalese financial market is under developed. About the cause of being current situation of financial market in Nepal, Thirty percent in favor of civil war, forty percent in favor of Nepalese agro based economy and thirty percent in favor of low literacy in Nepal. Almost one third of them thought that Nepalese financial system is victimized by civil war, Forty percent thought that Nepalese financial system could not develop due to agro-based economy and only remaining respondent thought that it is due to low literacy in Nepal.

C) Relationship between Financial Market and Economic Development: All the respondent put consent on sound financial system contributes in economic development. About the role of financial market in economic development, twenty percent argued that there is fundamental role; sixty percent argued that there is important role and only twenty percent argued that there is not important role of financial market in economic development. Thirty percent respondent gave first priority in production, fifty percent gave first priority in investment and twenty percent gave first priority in employment for the economic development.

D) Financial Improvement: To develop financial market in Nepal sixty percent of respondent focused on make people aware and forty percent focus on enhancement of investment. After 2010, in the context of Nepal being WTO member, foreign banks will enter in Nepalese financial market, seventy percent argued that it is beneficial for Nepalese financial market development and thirty percent argued that it is not beneficial. In the same context, after 2010, about the strategy of national commercial banks to compete with international banks, thirty percent argued that there should be consolidation among national commercial banks; twenty percent argued that there should co-operative strategy with other international commercial banks and rest fifty percent argued that there should be enhancement of internal competencies of national commercial banks. NRB has circulated a directive that commercial banks should increased paid up capital by double, eighty percent of the respondent argued that it is necessary but the twenty percent think that it is not necessary. Among all, seventy percent of the respondent has accepted the concept of global village as opportunity and rest thirty percent has taken the concept of global village as threat for the Nepalese financial market.

E) **Role of NRB in Development of Financial Market in Nepal:** Respondent gave mixed answer about the role played by NRB in financial market development; thirty percent said that NRB is playing effective role in financial market development; fifty percent said that NRB is playing satisfactory role and twenty percent said that NRB is playing unsatisfactory role in financial market development in Nepal. Out of the total respondent (NRB is not playing effective role in Nepalese financial market development) forty percent respondents argued that there is leakage in planning, thirty argued that there is leakage in implementation and thirty argued that there is leakage in control system of NRB. To decentralize the banking and financial services from urban to rural area, NRB has circulated a directives for that thirty percent respondent said that this directive highly decentralize the banking service, fifty percent said satisfactory and twenty percent said that this directive decentralize the banking service low. For the further improvement of role of NRB in development of financial market in Nepal forty percent suggest that NRB should focus on planning, thirty percent in implementation and last thirty percent said that NRB should focus on control for further development of financial market in Nepal now.

4.11 Major Findings

This study is conducted to identify the role of NRB in development of financial market in Nepal. With this motive, this study is mainly focused on three objectives. First one is to analyze how sound financial system helps in economic development. Similarly, next objective is to explore current situation of financial market in Nepal. And lastly, the next objective is to evaluate how successfully NRB is playing role in development of financial market in Nepal.

Based on the analysis of both primary and secondary data in this chapter, different facts are found, they are as follows;

Findings from Secondary Data

- Nepalese banking system has changed tremendously by adopting liberalization policy since 1980s. On the other hand, Nepalese economy is rapidly integrated with the global economy.
- Numbers of financial institutions are growing day by day in different territories. It adds central bank's more responsibility and accountability to improve and operate financial sector well.
- The ratio of stock market capitalization to GDP is increasing to 44.6% in year 2008 from 25.8% in year 2007. It proven that role of Nepalese financial system in economic development is increasing significantly.
- After being a member of WTO, Nepal has made different commitments to welcome foreign bank branches. In this context, Nepalese economy got more opportunities and threats and role of NRB seems more vital for smooth operation of financial intuitions and economic development.
- Monetary policy has been helping maintain financial stability that's why Nepal has not experienced the financial crisis. But after year 2010 it seems more complicated when foreign bank branches will establish.

Monetary policy in Nepal manages money supply on the basis of monetary aggregate targeting framework in line with the economic stability in the economy so far.

The consolidated capital adequacy of commercial banks improved remarkably and turned to positive of 4.04 percent in the mid July 2008 as against the continued negative figures in the proceeding years.

The non-performing loan of commercial banks declined significantly to 6.08 percent in mid July 2008 from 9.65 percent in the last year.

Since 1980s, banks deposit and credit ratio increased, its increasing trends clarify the importance of banking system in deposit collection and mobilization.

Some of the key macro-indicators, though improving slowly, have shown inefficient financial sector in Nepal reflecting a less effective and less independent central bank compared to developing countries in conducting monetary policy. The evidences are low M2/GDP ratio, high currency/ money (M2) ratio, low money multiplier, and high share of central bank assets over the total banking assets in comparison to the similarly placed economic group.

Over the total banking assets the share of commercial banks is in increasing trend and share of NRB is in decreasing trend which indicates that Nepalese financial sector is improving gradually.

The expansion of bank branches by commercial banks is concentrated in the urban areas and the financial access to poor and backward regions is a challenge for the Nepalese financial system. Out of the total bank branches around 29 percent are operated within Kathmandu valley.

Ratio of consumption to GDP is very high (88.53%) in FY 2007/08, it shows saving (11.47%) and investment is very low 27.2% in FY 2007/08. Import exceeds exports. Moreover, per capita income is increasing in small growth rate.

Over the period of 1975 to 2004, commercial banks credit to private sector as a percentage of total credit increased from 56.70% to 72.70% so, the major portion of commercial banks credit portfolio is being utilized in extending credit to private sector.

Slope of coefficient between financial indicator and economic growth indicators are positive. It implies that there is proportional relationship between financial development and economic growth.

NRB bank supervision department has carried out corporate level on site examination of all commercial banks at least once a year as per its annual plan. Likewise, special on site supervision has been conducting. Off site supervision carried out quarterly basis on reports of commercial banks.

Finding from Primary Data

Nepalese financial system is moderately developed now; Agro-based economy is the main barrier in Nepalese financial market development, and then civil war.

Everyone put consent on sound financial system clearly contributes in economic development.

Financial sector has important role in economic development. Sixty percent of respondent argued financial development and economic development has positive relation.

Enhance in investment is crucial in economic development first, then in production and lastly, in employment.

Financial market can developed after making people aware first then by enhancing investment in the economy.

Concept of global village is opportunity, concern parties should try to reap benefits by reducing threats.

It is beneficial to enter foreign bank branches in Nepal; it brings more opportunities. Strategy of Nepalese commercial banks should enhance their internal competencies first to compete with foreign banks, then consolidation between/ among national banks lastly may be co-operative strategy between foreign and national banks.

To circulate financial development in rural areas NRB directives is very necessary and more important; banks should focus their attention toward rural areas. To strengthen Nepalese financial institutions it is necessary to increase paid up capital gradually.

NRB has been playing satisfactory role in development of financial market in Nepal and should try to be effective. There is leakage in planning that makes NRB inefficient that's why NRB should focus on planning first then in implementation and control system.

CHAPTER- V

SUMMARY, CONCLUSION AND RECOMMENDATIONS

This chapter is the important chapter for the research because this chapter is the extracts of all the previously discussed chapters. This chapter consists of mainly three parts: Summary, conclusion and recommendation. In summary part, revision or summary of all four chapters is made. In conclusion part, the result from the research is summed up and in recommendation part, suggestion and recommendation is made based on the result and experience of thesis. Recommendation is made for improving the present situation to the concerned parties as well as for further research.

5.1 Summary

Nepal is orienting towards the development. Natural resources of the country remain unused and unutilized due to the lack of financing and technical know-how. In order to mobilize the limited capital, the government of Nepal adopted the liberalization policy. The financial system is a mechanism that transfers funds from the surplus to deficit units. It consists of institutional and legal structure, financial instruments and individuals. As result up to now 25 commercial banks, 59 development banks, 78 finance companies, one employee provident fund, 25 insurance companies and other 16 co operative societies licensed by NRB for limited transaction are established within the financial system of Nepal. Financial system is hoped to develop the economy and help to raise the living standard of the people. Financial intermediaries mobilize the fund by collecting the scattered resources from the savers and provide the collected funds to the users. The intermediaries of financial systems sustain by lending the fund on higher interest rate and paying the deposit holder a little interest.

NRB is an agency of government of Nepal that does not ordinarily deal directly with the public. It has prime responsibility of developing a secure, healthy, efficient financial system in Nepal. NRB has already initiated the restructuring and re-engineering process to meet upcoming challenges. Banks are supervised in order to achieve both long-term financial stability and sectoral efficiency. A weak regulatory framework and poor supervision provide backgrounds for inefficient and unsafe banking practices, which increase the risk of bank failure. Preventing systemic risk, protecting small depositors, and containing financial crimes are concrete steps in attaining these objectives. They require the supervisors enforce fundamental discipline in the banking system with the well-crafted laws and regulations and the presence of strong in-house supervisory expertise. The commitment to implement all the supervisory prejudice towards any particular side in practice on the part of NRB, the only Monitory Authority of the country, is of paramount importance on the one hand and on the other, the full-hearted support from government of Nepal as well as the judiciary system of the country are also very necessary so as to strengthen NRB's supervisory effectiveness and enhance financial discipline and good corporate governance in the financial system of the country.

In a bank dominated financial system, the banking sector has to play a vital role in the economic development process of the country through mobilizing and allocating limited resources. The banking system must be prudent with commercial orientation. The financial system still lacks competitive environment and the non banking sector is yet to grow in terms of size, structure and volume of business. Lack of competent, qualified and experienced managerial teams has remained as one of the serious concern in the system. The role of central bank as regulatory and supervisory body needs to be further strengthened. The banking services targeted to the poor and deprived sector people are not adequate. Looking from these perspectives, these issues can be broadly classified in to three categories. The first set of issues is micro economic in nature and includes poor banking practices such as inadequate capital, failure of loan policy, inadequate assessment of credit, insufficiently diversified loan portfolio, lending to connected borrowers and excessive maturity, over staffing and existence of trade unions have also been chronic problems, particularly in state owned commercial banks and financial institutions. The second set of issues includes the degree of volatility due to the movement in the assets price and the exchange rate. The category is system related, indicating that the environment is not conductive to the development of an efficient financial system. System related issues in the financial system include lack of competition, excessive government intervention, inadequate legal framework, underdeveloped securities market and inadequate regulatory and supervisory mechanism. The corrective action and policy options should therefore, address these issues and challenges.

This study set the objective of analyzing the role of NRB in development of financial market in Nepal and provides necessary suggestion to concern parties. It also explores the current situation of financial market in Nepal and the relationship between financial growth and the economic development although it has not practiced to use different tools in evaluation. This study is based on both primary as well as secondary data which clearly able to analyze the predetermined objectives. This study segregated in five different chapters. The first chapter deals about introduction subject matters, objective of study, significance of study as well as chapter plan of the study. The second chapter presents the theoretical framework of role of central bank in financial market development and review of previous studies relating to role of central banks, financial markets and economic developments. Third chapter presents the methodology for the study. This chapter deals about the research design, population and samples, data collection procedure and tools and techniques applied in the study. The fourth chapter analyzes the variable and data of the study. It applies the financial and statistical tools in analyzing the data. The major findings are also presented. The fifth chapter presents the summary, conclusion and recommendations strictly based on the study.

Although this study, draws some conclusion based on the analysis done in the fourth part of this study it becomes immature to conclude that the study about role of NRB in development of financial market in Nepal is enough by applying financial and statistical aspects in achieving the target. It is the starting point for analyzing the principles and roles of central banks in financial market development. For further study purpose, the recommendations are presented in the last of this study may become useful and can assist in finding the direction of study. This study may be useful for Nepal Rastra Bank to improve role in development of financial market in Nepal.

5.2 Conclusion

From the above study some major facts are found these findings are cited as follows;

⇒ There is positive relationship between financial development indicators and economic development indicators i.e. $\beta_1 = 0.29$ when M_1 keeping independent which refers that one percent increase in M_1 refers to 0.29% increase in RGDP, on the same way, $\beta_2 = 0.25$ which shows when M2 increase by one percent the RGDP will increase by 0.25%. By analyzing primary data it can also be concluded that financial market development helps in economic growth. There is positive correlation between them. Economic development is only possible through sound financial market operation. First priority should give to investment in financial market for economic development.

⇒ NRB has categorized all the financial institutions in four groups for institutional development. There are 25 commercial banks (6 joint venture and 19 domestic banks) 59 development banks, 78 finance companies, 12 micro finance development banks, 16 financial cooperatives, 45 non government financial organizations, 117 postal saving banks, one stock exchange, 25 insurance companies, one employee provident fund and one citizen investment trust. Regional distribution of financial institutions seems more deviation, they are urban oriented, that's why financial institutions should improve their service quality and decentralize to the rural area.

⇒ Investment of private sector in financial reform seems increasing. There was only 6% share of private sector in year 2000 and increased to 34.43% in year 2008. However the position of joint venture bank has decreased to 30.74% from 36.66% from the year 2000 to Mid July 2008, the behind reason is that the number of private sector banks are increasing.. It results the government investment in financial sector decreased to 34.84% from 57.17% in respective period. It reflects the synergic effects of privatization and consciousness of private sector in financial development. By analyzing primary data it is found that enhance in investment is the major key of economic development.

⇒ Over the total banking assets the share of NRB was around 51.6 percent and that of commercial bank was around 48.4 percent during the period of 1975-79. However, at the end of 2005 the share of commercial bank has increased to 69.1 percent and share of NRB has decreased to 30.9 percent. This indicates that with increment of number of financial institution the financial health is also improving.

⇒ The consolidated capital adequacy of commercial banks improved remarkably and turned to positive of 4.04 percent in the mid July 2008 as against the continued negative figures in the proceeding years. Likewise the non-performing loan of commercial banks declined significantly to 6.08 percent in mid July 2008 from 9.65 percent in the last year i.e. 2007. Which conclude the financial system of Nepal is being improved gradually.

⇒ NRB has been formulating proper monetary policy that’s why Nepal has not experienced any economic crisis yet. Institutional development has been growing but it should give attention toward deprived and remote area. Lastly announced monetary policy focused on tight monitory policy for maintaining fiscal stability. Now onward, commercial banks are required to extend three percent of their total loan investment for deprived sector.

⇒ Supervisory rules and guidelines of NRB are satisfactory but the implementation system is loose which results NRB’s inefficiencies. Regulation and supervision of international banks is challenging job, that’s why NRB should deploy taskforce in planning and making clear vision that can create opportunities and brings more FDI for deprived sector.

⇒ NRB has been playing satisfactory role in development of financial market in Nepal till now, rules, regulations and guidelines need to edit time to time for further improvement.

5.3 Recommendations

Based on the analysis, interpretation & conclusions, certain recommendation can be made here so that the concerned authorities, future researchers, academicians, bankers can get some insights on the present conditions on above topics. It is considered that this research will fruitful for them to improve the present condition as well as for further research.

The NRB directives should aim at the following; creating a sound, stable and healthy financial system, broadening the financial system, adequate information disclosure, efficiently mobilizing financial resources to promote sustained and broad based growth momentum, building the institutional capacity to tackle the problems in the financial system by improving the legal and judicial frameworks and increasing the autonomy credibility and capability of central bank's regulatory and supervisory roles. The organization and financial health of the two state owned banks have been deteriorating and for the efficacy and efficiency of the banking sector, these two state owned banks should be restructured as a first step in the dealing with the issue of the Nepalese financial system.

To sum up;

- ⇒ NRB should focus on institutional development of finance in the deprived sector.
- ⇒ Make the debt recovery system effective and improve the quality of assets.
- ⇒ Strengthen the rural credit delivery mechanism.
- ⇒ Build up the capacity of the financial sector by improving legal, judicial and institutional base.
- ⇒ NRB should focus on proper implementation and control along with the formation of the new policies and guidelines.
- ⇒ Enhance the regulatory and supervisory capacity of the central bank to think globally and operate locally.
- ⇒ Make the financial system competitive, broad-based and growth induced.
- ⇒ NRB should persuade in practice of new financial instruments' transaction that can make Nepalese financial market broad based.