

# **ECONOMIC POLICY NETWORK**

**Policy Paper 12**

## **EFFECTIVE & EFFICIENT UTILIZATION OF CONTRACTUAL SAVINGS**

**(Employees Provident Fund and Citizen Investment Trust)**

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May 2006

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This report has been prepared by Dr. Tilak Rawal, Macroeconomic Specialist, under the guidance of the Nepal Economic Association (NEA).

Inputs from various stakeholders during interactions at NEA, and the Advisory Committee meeting have been incorporated in the report.

## Foreword

Economic Policy Network (EPN) is an undertaking of the Government of Nepal since August 2004 with the support of an Asian Development Bank (ADB) technical assistance (TA) to develop and institutionalize an open, responsive and result oriented economic policy formulation process based on sound economic analysis and dialogues with the partnership of public and private sector, academia, and independent professionals, to support and consolidate the Government's economic policy reforms on poverty reduction strategy. The initial focus has been in the areas of macroeconomic management, trade, investment, employment, infrastructure, tourism, agriculture, and regional development through four thematic advisory committees chaired by the secretaries of the respective implementing ministries, and guided by a high-level steering committee. The present study is an outcome of the initiative under the Advisory Committee for Macroeconomic Management chaired by the Secretary of the Ministry of Finance.

The study reviews the current status and practices in managing the Employees Provident Fund (EPF) and Citizen Investment Trust (CIT) and makes recommendations to improve their management. The recommendations are the outcome of consensus reached among major stakeholders through various consultations and the EPN workshop. I hope the findings and recommendations will be helpful for policy makers for future reforms.

I would like to thank the Nepal Economic Association (NEA) for leading the study and Dr. Tilak Rawal for carrying out the study on their behalf. I also thank all those who have provided inputs for the report during the interactions at NEA, the advisory committee meetings, and the EPN workshop. The work of the Advisory Committee for Macroeconomic Management is to be commended for selecting the issue and for following through with the study. I would also like to appreciate the entire EPN team for their hard work. I also thank the former Steering Committee chairperson (former Member of National Planning Commission) Dr. Champak Prasad Pokharel, for his guidance during his tenure. Last but not least, I would like to thank the ADB for supporting this initiative.



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# Executive Summary

## **EPF**

Sainik Drabya Kosh was created in 1934 for the army personnel. Ten years later, this was extended to cover civil servants in the Valey. Nijamati Provident Fund extended to all civil servants in Nepal 1984. EPF Department was created in 1959 under MOF. HMG enacted Karmachari Sanchaya Kosh Ac in 1962 to creat EPF. The sixth amendment to the EPF Act requires ass contributors to contribute at least 10 percent of their salary to PF account and a matching contribution by the employer. EPF currently manages PF of government, public and private sector employees. Current membership of EPF stands at 380,000 which was only 40,000 in 19629 (page 3).

## **Trend of Deposits**

Deposits at EPF have increased significantly at an annual rate of 17 percent reaching Rs 37401 million in 2003/04 (page 4).

## **Sources of Funds**

Capital structure is dividied in to i) provident fund consisting of member contribution, and ii) reserve fund which consists of different reserved {page 6} of which contingency reserve {CRF} is the only free fund which is a cushion for risk taken by EPF. CRF as a proportion of EPF investment decrease to 1.36 percentages in 2003/04 from 2.12 percent in 1999/00. In view of growing investment of EPF, it would be wise to increase the amount of free reserve for risk mitigation purpose.

## **Investment Portfolio**

EPF is empowered to make judicious\prudential use of resources at its disposal {page 7} EPF deposits its resources with different financial institutions in the form of time deposits, which has registered a decline over the years, from 71 percentage in 1962/63 to 41 percent in 2003/04. Low rates on deposits could explain this decline {page 9}. Interest earning from time deposits have drastically gone down. It has also invested sizable sum in land and building under fixed assets. {Page 10}. Interest income from time deposits has constituted a major portion of both total income and interest income. Dividend income from investment in the equity of different companies has fluctuated over the years {page 11}.

## **Schemes**

EPF has launched several security schemes such as funeral grant scheme, home loan, etc (page 13).

## **Citizen Investment Trust (CIT)**

CIT was established in 2047 to provide financial intermediation services and to enhance investment activities for the growth of a dynamic capital market in Nepal. CIT's financial intermediation service is carried out through the operation of different saving schemes. CIT's contribution to capital market growth is shown by its involvement in operating the only unit investment trust in Nepal. CIT has limited its activities to capital market sector.

It provides services in new issue management, underwriting, bridge financing and consortium financing to the corporate sector. As an active member of the stock exchange, it participates in the sales and purchase of securities issued by HMG and corporates. CIT collects funds

through various savings and investment trust schemes and mobilizes the same in available capital market instruments.

### **Structure of Capital**

Authorized capital is Rs. 80 million and issued and paid up capital is Rs. 40 million. HMG, NRB, Nepal Stock Exchange and 4 banks and financial institutions are institutional shareholders and 4200 public shareholders are there. Government and its institutions possess the majority stake.

### **Income and Dividend**

CIT's net worth amounted to Rs. 70.56 million in mid-July 2004, consisting of capital contribution by the shareholders and reserve and surplus: at least 20 percent of the net income must be appropriated by CIT as reserve and surplus (page 17).

Net profit of CIT was Rs. 7.53 million in 2002/03 and increased to Rs. 15.02 million in 2003/04. Net income is growing by 45.33 percent each year. Common stakeholders got 15 percent return on their investment. Return on equity is also growing (page 18).

### **Capital Adequacy**

It is below the normally accepted level: was 4.40 percent in 2002/2003 and declined to 3.07 percent in 2003/2004. CIT is grossly undercapitalized (page 18).

### **Saving Scheme**

Size of CIT managed fund in July 2004 increased to Rs. 4923.4 million from Rs. 3294.5 million mobilized in 2002/2003 (page 20). This growth suggests that CIT's saving schemes are well responded to which is because of the rates which are higher than deposit rates and the yield on government securities. Total funds come from different schemes (page 20, 21).

### **Investment Portfolio**

Adequate avenues allowing reasonable trade off between risk and return are lacking in the market. More than 50 percent of investment assets of CIT is highly liquid. CIT has begun to diversify its investment portfolio: a reduction in the portion of fixed deposits and loans and investment in equity securities has gone up transforming its assets from low return to high return ones (page 24).

### **Earning analysis**

CIT's total income was Rs. 52.91 million in 2003/04 which was only Rs. 21.21 million in 2002/2003. Sources of earnings are – investment on government securities and fixed deposits, service fees and commissions, dividend and miscellaneous income. Share of service fee and commission income has increased from 36 percent of total income in 1999/2000 to 47 percent in 2003/04 indicating that its activities are moving towards capital market services (page 25).

### **Issues**

CIT has to widen its net for fund collection and readjust its investment portfolio.

CIT does not have a regulatory body (page 28). No disclosure requirement. No provision of investment and no provision in case of government guaranteed loans.

CIT treats income and expensed on accrual basis and there is no policy for interest suspension in case of interest not being realized within specified time period.

EPF is facing growing competition. Declining income from funds parked with commercial banks is worrisome. EPF has provided Rs. 2000 million, inclusive of capitalized interest, to 31 projects under consortium lending arrangements. It has to recover Rs. 1660 million as principle and Rs. 613 million in interest (page 33). In view of its huge resources and growing volume of business, the following could be considered.

- Involvement in hydro power projects
- Infrastructure financing.
- Housing Scheme
- Evolving into a full fledged finance company with the participation of CIT and Postal Saving Bank.
- Regulatory body for these agencies (NRB advice could be taken).
- Revisit overall investment portfolio which would require gradual withdrawal from financial institutions of low yielding time deposits.
- Investing only in moderation in government papers.
- A careful study of return and the level of inflation before investing on the proposed power bond



# **Employees Provident Fund (EPF)**

## **Background**

There cannot be any disagreement on the important contribution to the economy of a healthy financial sector. Financial institutions have the responsibility of mobilizing savings and providing capital to the needy area keeping the cost of financial intermediation at a reasonable level. Prior to 1937 A.D., Nepal had no financial institution to mobilize resources and provide the same to raise the economic standard of general public.

The establishment of Nepal Bank Limited (NBL) in 1937 marked the beginning of banking sector development in Nepal. Along with trade financing activities, it had to perform some of the functions of central bank, as Nepal did not have a central bank then. Nepal Rastra Bank (NRB) was established in 1956, which was followed by the creation of Nepal Industrial Development Corporation (NIDC) in 1959, Employee Provident Fund (EPF) in 1962, Rastriya Banijya Bank (RBB) in 1966, National Insurance Corporation (NIC) in 1967, Agricultural Development Bank (AND/N) in 1968 and Citizen Investment Trust (CIT) in 1990.

Till mid 1980's the financial sector of Nepal was occupied by the above institutions of which His Majesty's Government (HMG/N) was a major shareholder. Nepal opened the door of its relatively small government-owned financial industry in 1984 when liberalization of the economy and that of the financial sector started. The initiation made in the 1980s and its vigorous actualization starting from 1990 have helped the financial industry to grow rapidly. Currently, there are 17 commercial banks, 24 development banks (development finance companies), 5 regional rural development banks, 59 finance companies, 47 non-governmental organization, 20 cooperative societies authorized to undertake limited banking activities, 117 postal banks, 19 insurance companies, 1 insurance board, 1 Employee Provident Fund, 1 Citizen Investment Trust, 1 Deposit Insurance and Credit Guarantee Corporation, 1 Security Board and 1 Nepal Stock Exchange Limited. Of these, EPF and CIT are contractual savings organization.

The liberalization of the financial sector was successful in the sense that a significant jump was witnessed in the number of players in the industry operating in a competitive environment. Commercial banks expanded their network and a steady rise in deposit mobilization and loan portfolio is seen. In recent years, however, banks have adopted a contractionary approach in regard to coverage owing basically to deteriorating security situation in the country.

All was, however, not well in the financial industry. Negative capital and astounding NPA levels (above 50 percent) of the two state owned banks – NBL and RBB- has drawn serious attention of HMG and NRB. Some serious discrepancies have been noticed in case of private banks, too. Gross violations of banking norms were noticed and NRB had to initiate strong measures against the management of some institutions. NPA level of some private banks were reported as high as 29 percent.

Liberalization of the economy brings opportunities as well as challenges. With Nepal's joining of WTO, the financial industry will be further opened to outside banks, which will be allowed to open their full-fledged branches in Nepal. Financial institutions in Nepal have the difficult but very essential task of enhancing their capital base as required by NRB and also adhering to the world class prudential norms given by the monetary authority. Financial institution have to restructure themselves otherwise they will not be able to meet their obligations in a situation where some agencies are using fairly advanced technology to serve their clients. The challenge before the financial institution today is to use the mobilized

resources in a manner that would ensure reasonable productivity of capital and the resultant debt servicing. This report focuses on the relatively cash – rich agencies – EPF and CIT.

### **Employees Provident Fund: An Introduction**

Provident fund schemes are designed basically to provide financial security to contributors after retirement from service and also in between the service period as per the need. In Nepal, operation of such a scheme dates back to the year 1934 when Sainik Drabya Kosh was established for the army personnel. This was done with the object of providing some relief to those working in the armed force who often faced financial hardship after retirement. Under this scheme, the army had to deposit a fixed percentage of their salary every month to their provident fund (PF) account. A decade after the initiation of this scheme, it was extended to cover civil servants working in the Kathmandu Valley. The institution established for this purpose in 1944 was named Nijamati Provident Fund, which in 1948 extended its coverage to all civil servants working in Nepal. In 1959, Employees Provident Fund Department was created under the jurisdiction of the Ministry of Finance, to manage the affairs of both Sainik Drabya Kosh and Nijamati Provident Fund. Later on, the scheme provided coverage to police personnel as well. In view of the extended coverage and growing volume of business and the need to carry on fund management business more professionally, HMG enacted Karmachari Sanchaya Kosh Act in 1962 and created Karmachari Sanchaya Kosh (EPF) in the same year. After the establishment of this autonomous organization, the two agencies including the department in the Ministry of Finance ceased to operate as they were merged with the newly created agency. Since its creation in 1962, EPF has expanded its coverage and volume of business, which is effected through network expansion and hiring of professional staff.

The Sixth amendment to the EPF Act in 1991 requires all contributors to contribute at least 10 percent of their salary to their PF account and the employers required to contribute equivalent amount. EPF is currently managing the provident fund of government, public and private sector employees. In addition to providing funds on retirement, EPF has also promulgated over time different schemes to provide other benefits to its members.

### ***Objectives of EPF***

As a social security organization, the object of EPF is to manage the provident fund of government, public and private sector employees and to help them financially on retirement or separation of job. Some other specific objectives include:-

- Updating records of PF contributions of all members mobilizing funds in various field of investment
- Refunding PF deposits along with interest to members as required.
- Providing different kinds of loan facilities to members during their service period.
- Undertaking activities to provide social security to members.
- Conducting research activities.

### **Contributors to EPF**

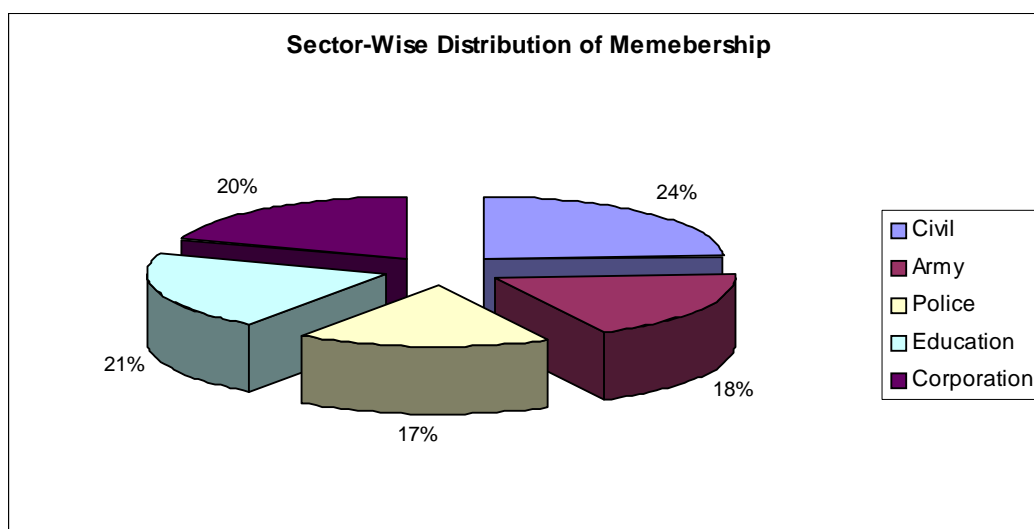
The sixth amendment to the EPF Act broadened the coverage to encompass employees of private enterprises including private schools, universities, diplomatic missions

and non-governmental organization provided the enterprise has at least 10 permanent employees on its staff.

Currently, the total membership of EPF stands at 380,000 which was only 40,000 in 1962, the number of contributing offices currently being 27806. Civil service explains about 24 percent of the membership followed by education (21 percent), corporation (20 percent) army (18 percent) and police (17 percent) (Table 1.1).

**Table 1.1: Sector-wise Distribution of Membership**

Sector	Members	Percentage
Civil	92,000	24.21
Army	70,000	18.42
Police	65,000	17.11
Education	78,000	20.53
Corporation	75,000	19.73
Total	380,000	100.00



Prior to the third amendment to EPF Act in 1971, contribution by employee's differed as per their level and so was the case with contribution from the employer. The rate was fixed at 10 percent in 1971 both for employees and the employer. The sixth amendment in 1991 fixed the contribution by employee at a minimum of 10 percent and the employer to supplement it by an equivalent amount (Table 1.2).

**Table 1.2: Contribution by Members.**

F.Y. year	Employee's contribution	Employer's contribution
1962/63	NR 2 to NR 475 depending on salary scale	10 percent of employee's contribution.
1967/68	10 percent of employee's	50 percent of contribution in case of non-

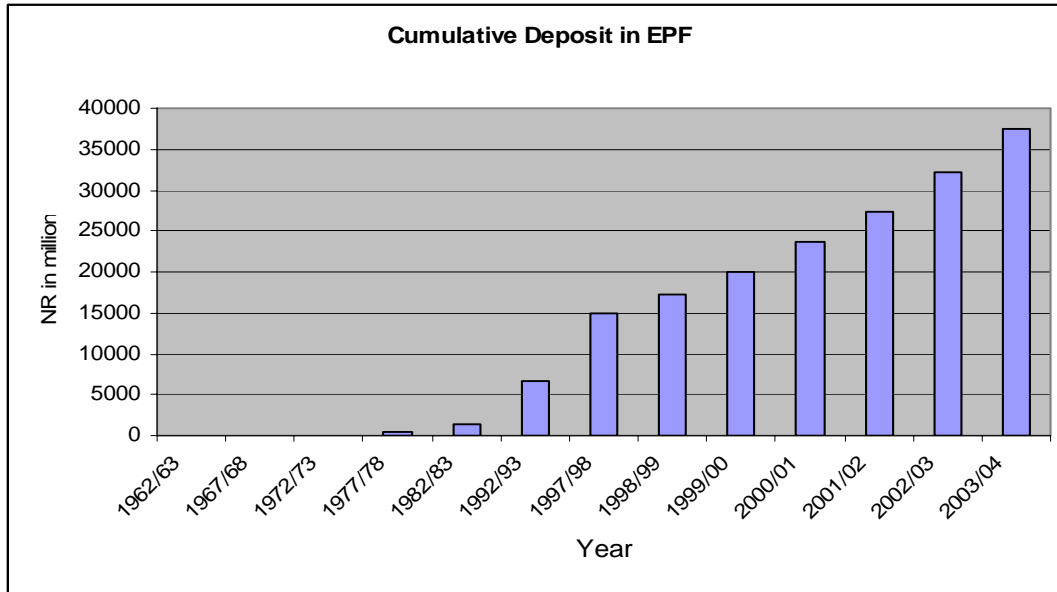
	salary.	officers and 25 percent in case of officers.
1971/72	10 percent of employee's salary.	Matching contribution
1991/92	At least 10 percent of employee's salary	Matching contribution

### **Trend of Deposit**

Along with the increase in membership, deposits at EPF have increased significantly. Periodic increase in salary scale of employees and capitalization of the interest earned on deposits have been the contributing factors. During the period 1995/96 to 2003/04, deposits have grown at an annual rate of 17 percent. Total deposits in 1962/63 amounted to NR 10.99 million and continued to increase over the years to reach NR 37401.99 million in 2003/04 (Table 1.3).

**Table 1.3: Cumulative Deposits in EPF**

NR In million		
S.N.	Year	Amount
1	1962/63	10.99
2	1967/68	38.68
3	1972/73	113.60
4	1977/78	416.83
5	1982/83	1303.72
6	1992/93	6719.76
7	1997/98	14842.86
8	1998/99	17301.00
9	1999/00	20036.00
10	2000/01	23709.64
11	2001/02	27348.69
12	2002/03	32283.11
13	2003/04	37401.99

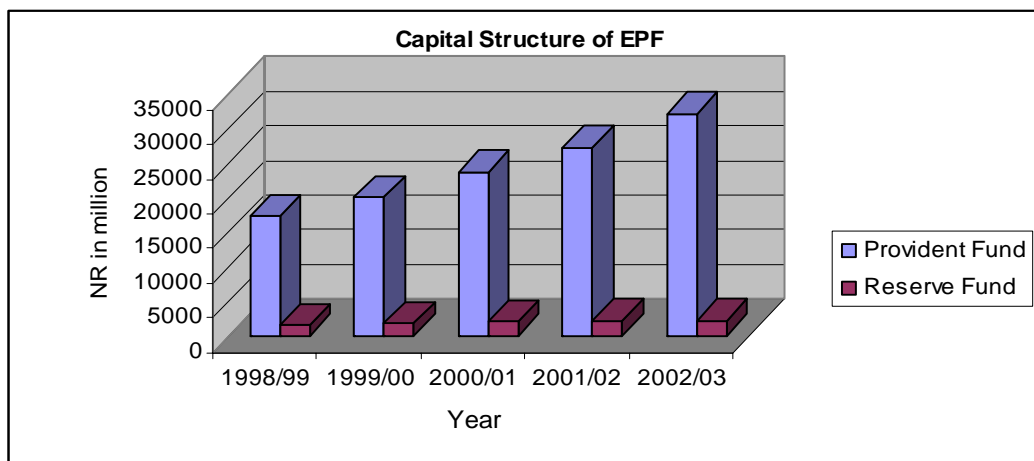


### Source Of Funds

The capital structure of EPF can be divided into two heads – a) provident fund; and b) reserve fund. Provident fund consisting of contributions from members has increased sharply from NR 173,01.6 million in 1998/99 to NR 322,83.1 million in 2002/03. Likewise, reserve funds have also increased encouragingly over time (Table 1.4).

**Table 1.4: Capital Structure of EPF**

Year	NR In million					
	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Provident Fund	173,01.61	200,18.72	237,09.64	273,48.55	322,83.12	37402.00
Reserve Fund	15,17.70	18,05.84	20,70.87	22,71.95	22,77.89	2481.15
<b>Total</b>	188,19.31	218,24.56	257,80.51	296,20.50	345,61.01	39883.15

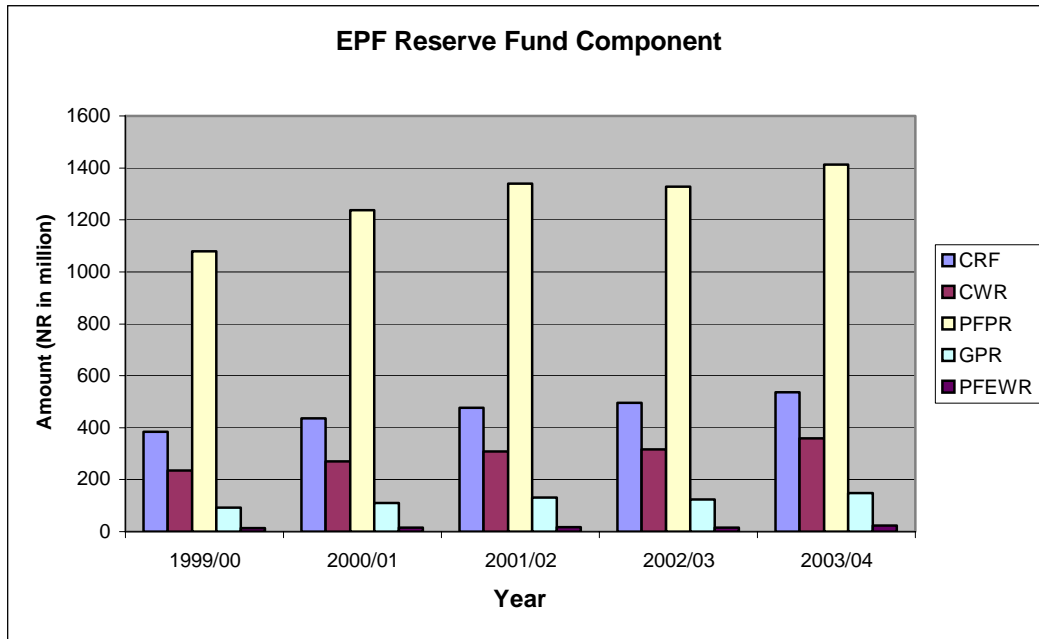


Reserve fund is composed of contingency reserve fund (CRF), contributor's welfare reserve (CWR), provident fund pension reserve (PFPR), gratuity and pension reserve (GPR); and PF employees' welfare reserve (PFEWR). The composition of the reserve fund shows that there is only one free reserve i.e. CRF and the rest are long-term liabilities. There is no capital contribution by HMG. Thus, all the sources of funds are long-term liabilities of the EPF inclusive of provident fund contribution by members. The contingency reserve can be taken as cushion for risk taken by the institution, though it was 21.24 percent of total reserve fund (1.75 percent of the total fund) in 1999/00 became 21.60 percent of total reserve fund (1.34 percent of total fund) in 2003/04. On the other hand, the contingency reserve was 2.12 percent of the total investment of EPF in 1999/00 which further decreased to 1.36 percent in 2003/04. Considering the heavy involvement of EPF in consortium loans and other riskier investments, the primary capital is insignificant to cover the associated risk when looked at from the standpoint of world standards. This requires a clear guideline to EPF to maintain its free reserve for risk mitigation purpose (Table 1.5).

**Table 1.5: Reserve Fund of EPF**

NR in Million

Year	1999/00	2000/01	2001/02	2002/03	2003/04
CRF	383.68	436.81	476.49	495.55	535.97
CWR	236.25	270.46	308.58	316.78	359.57
PFPR	1078.64	1237.09	1339.62	1327.52	1412.51
GPR	93.09	110.35	130.34	123.48	149.33
PFEWR	14.15	16.14	16.92	14.55	23.75



### **Investment Portfolio**

EPF is empowered to make judicious /prudential use of resources at its disposal. EPF can undertake the following as far as use of its resources is concerned.

- a) Investment and/or trading in government securities.
- b) Investment in time deposits and cash certificates of appropriate finance companies within the country against bank guarantee.
- c) Investment in time deposits and cash certificates of bank within the country.
- d) Granting loans to corporate bodies and industrial enterprises against government guarantee on collateral securities with the approval of government or against guarantee of financial institutions.
- e) Investment in the share of banks and finance companies not exceeding 25 percent of the company's issued capital.
- f) Investment in appropriate sectors under consortium finances.
- g) Investment in the debenture of companies established under prevailing act not exceeding 25 percent of the total debenture issued by the company.
- h) Undertaking housing projects independently or jointly with other institutions and sale or lease of housing units to members.
- i) Establishment and operation of company either to sale or distribute houses or housing plots or for the operation of housing projects.
- j) Undertaking such other activities that would promote welfare of the members with the approval of government.

EPF mostly deposited its resources with commercial banks in the form of time deposits. Over the years, however, it has declined. For example, investment in time deposits with commercial banks constituted 71 percent of its portfolio in 1962/63 and this came down to 41 percent in 2003/04: latest information shows a further reduction to 35 percent. Of the

total deposit with different financial institutions, ADB\N tops the list with 31 percent followed by RBB (19percent). Currently, 17 financial institutions have taken EPF's deposits. Notwithstanding the absence of a steady linear trend showing the decrease over time in investment of EPF funds in time deposits of commercial banks, on the whole it is on decline (Table 1.7).

With the intentions of mobilizing its funds effectively, EPF has formulated its own investment policy. Investment sectors, portfolio and priorities are fixed in the policy document. The document spells out the following targeted investment portfolio of EPF (Table 1.6):

**Table 1.6: Target Investment Portfolio of EPF**

S.N.	Investment Sector	Percent of Investable Amount
1	Credit to Contributors	60.00
2	Government Securities	30.00
3	Fixed Deposits (Commercial banks)	50.00
4	Land Development and Housing	25.00
5	Project Financing	25.00
6	Share and Debentures	25.00

**Table 1.7: Sector-Wise Investment**

Fiscal year	Investment (NR in million)	Time deposit (%)	Government Bond (%)	Project Financing (%)	Employees Loan (%)	Equity Share (%)
1962/63	8.51	70.98	27.73	0.00	1.29	-
1967/68	33.34	35.63	27.73	37.28	8.07	-
1972/73	134.59	58.36	19.02	13.16	19.73	-
1977/78	437.07	70.62	9.76	3.44	22.55	-
1982/83	1294.12	72.52	3.39	2.53	24.48	-
1987/88	3532.73	46.83	0.47	1.12	33.74	-
1992/93	6712.48	70.95	18.31	1.34	3.14	0.39
1997/98	15414.74	59.40	24.17	8.14	9.45	0.38
1998/99	18187.40	62.60	22.63	10.12	8.90	0.38
1999/00	20948.79	65.00	18.00	10.35	11.42	0.32
2000/01	24697.84	60.29	11.94	11.67	15.56	0.57
2001/02	28387.34	52.55	12.11	9.39	21.80	0.83
2002/03	33498.88	45.56	11.68	10.81	31.26	0.69
2003/04	39204.06	41.05	13.26	8.57	36.46	0.65

Prevailing interest rate of commercial banks could probably explain these aberrations. There could be a positive relationship between the size of EPF's deposits with the commercial banks and their interest rates on deposits. A sizable increase in loans to corporate sector (37 percent of the total portfolio) could be a major factor explaining a sharp decline

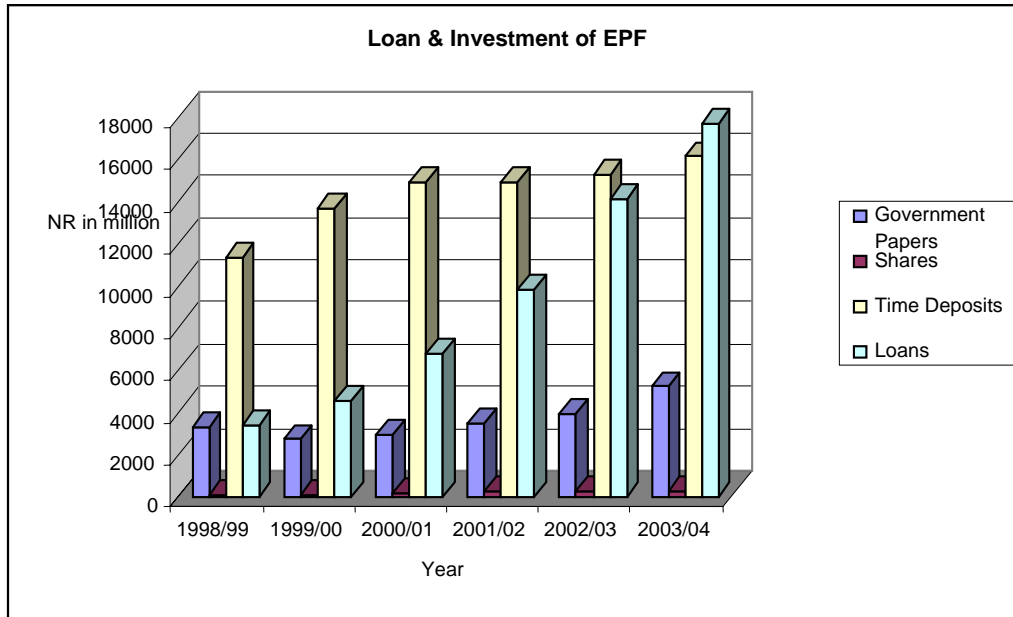
(36 percent) in EPF's deposits with commercial bank. EPF's investment in government bonds remained at 28 percent in 1962/63 and declined to 13.26 percent in 2003/04. In 1977/78, when time deposits again staged a come back to explain about 70 percent of EPF's annual portfolio, investment in government bonds and loans to corporate sector stood at 9.76 and 3.44 percent respectively. EPF has been liberal in granting relatively concessional loans to its employees which is adequately manifested by its increasing share over time from 1.29 percent in 1962/63 to 36.46 percent in 2003/04. Loans to EPF's employees stood at NR 186 million in 1998/99 and increased over time to reach NR 342 million in 2003/04. Time deposits with commercial banks also increased remarkably from NR 11 billion to NR 16 billion during the same time period. The most remarkable jump of 13 times is seen in case of loans to contributors which increased from NR 1300 million in 1998/99 to NR 13900 million in 2003/04. There has been an increase in all the areas under the loan and investment head to reach a total of NR 39200 million in 2003/04 from NR 18000 million in 1998/99. Interest earnings from time deposits have been very disappointing in that NR 11 billion time deposit in 1998/99 generated an interest income of NR 1130 million, while NR 16000 million in 2003/04 fetched only 1 billion (Table 1.8). It is disappointing to note that interest earning from time deposits have decreased in absolute terms, too, despite a remarkable increase in EPF's funds parked with the commercial banks. Drastic reduction on the rates offered on deposits by commercial banks explains this.

**Table 1.8: Loan and Investment of EPF**

NR In million

Years Particulars	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Government Papers	3307 (415)	2704 (335)	2949 (308)	3439 (308)	3914 (308)	5198 (332)
Shares	59 (17)	67 (19)	130 (20)	231 (7)	231 (21)	255 (13)
Time Deposits	11310 (1131)	13616 (1226)	14880 (1271)	14916 (1235)	15256 (1058)	16096 (1002)
Corporate & Other loans	1871 (169)	2169 (292)	2881 (246)	3605 (309)	3622 (361)	3361 (344)
Loans to Depositors	1302 (153)	2186 (178)	3578 (289)	5914 (431)	10202 (713)	13939 (1008)
Pokhara Residential Project			10 (3)	5 (2)	0.7 (1)	11 (1)
Loans to Employees	186 (2)	210 (1)	268 (5)	274 (4)	270 (4)	342 (5)
<b>Total Loans and Investment</b>	<b>18037</b> <b>-1889</b>	<b>20954</b> <b>-2055</b>	<b>24697</b> <b>-2144</b>	<b>28387</b> <b>-2299</b>	<b>33498</b> <b>-2468</b>	<b>39204</b> <b>-2709</b>

Figures in brackets represent the corresponding interest and dividend earning.



EPF has also invested sizable sum in land and building under fixed assets. In 2003/04, EPF's net investment in building stood at NR 208 million, which was NR 211 million in 2002/03. An additional sum of NR 190 million has been spent in building construction up to 2003/04 (Table 1.9).

**Table 1.9: Investment in Land and Building**

Particular	NR In million	
	2002/03	2003/04
Land	12	30
Building (completed)	208	211
Building (under construction)	129	190

Possession of land plots at commercially important points in Kathmandu such as Thamel, Pulchowk and Sundhara (under construction) has encouraged EPF to construct commercial complexes for office use and shops, ensuring itself a sizable amount in the form of rental income. For example, EPF earned NR 36 and 40 million respectively in the year 2002/03 and 2003/04. Rental income has constantly increased over the years reaching 40 million in 2003/04 from NR 15.9 million in 1998/99. The most significant increment was noticed in 2000/01 when the rental income reached NR 28.9 million from NR 16.6 million in 1999/00. With the nearing completion of the huge complex at Sundhara a similar jump in rental income is expected in the year 2006/07.

Interest income from time deposits with commercial banks has constituted a major portion of the interest income of EPF in 2003/04 and also that of its total income. In 2003/04, when the total interest income stood at NR 2696 million, earnings from time deposits stood at NR 1002 million and in 1998/99 when total interest income was NR 1873 million, interest

income from time deposits stood at NR 1131 million, explaining 37 and 60 percent respectively in those years.

Notwithstanding a continuous increase in the stake of EPF in the share capital of different institutions, mainly financial institutions, dividend income declined drastically to NR 12.9 million in 2001/02 from NR 33.23 million in 2000/01, recovered in 2002/03 (NR 36.38 million) and went down again to NR 13.6 million in 2003/04 (Table 1.10 and 1.11). Latest information available shows EPF's investment in 11 different institutions at Rs.310million.

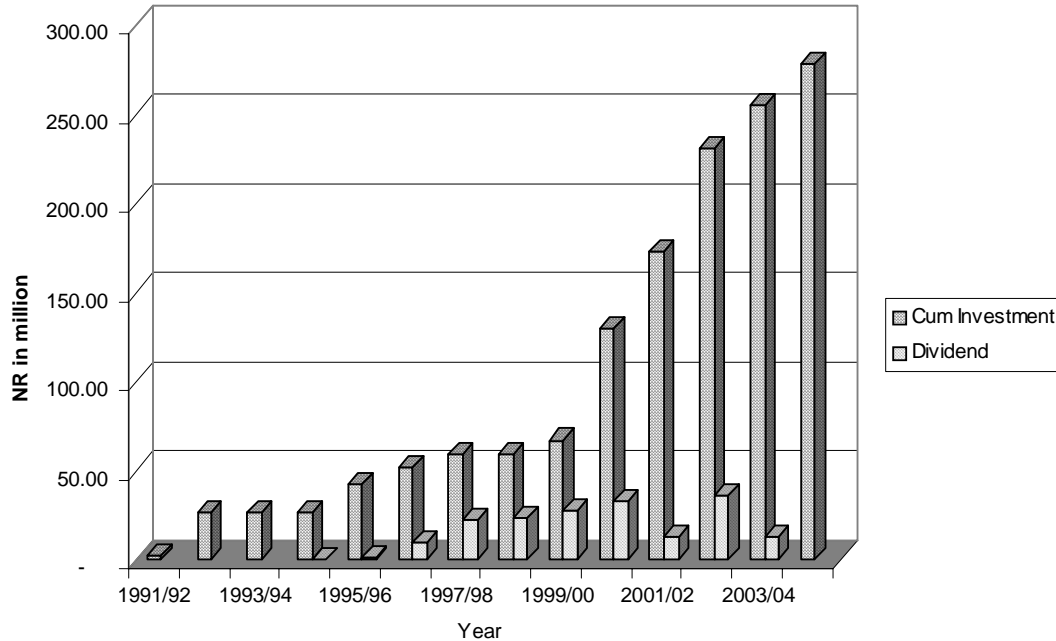
**Table 1.10: Equity Investment of EPF**

S.N.	Name of the Institution	Amount (NR in million)
1	Himalayan Bank Limited	16.80
2	Nepal SBI Bank Limited	61.20
3	Nepal Merchant Banking and Finance Ltd	13.90
4	NIDC Capital Market	0.03
5	Alliance Insurance Company Limited	7.50
6	Lumbini Bank Limited	70.00
7	Nepal Development Bank Limited	8.00
8	Everest Bank Limited (Preference Share)	57.60
9	Nepal CSID Bank Limited	24.00
10	CEID Bank Limited	9.60
11	DEP Financial Institution Limited	9.60

**Table 1.11: Total Share Investment and Return**

Inv Year	Inv Amount	Cum Inv Amt	Dividend	Return %
1991/92	2.10	2.10		-
1992/93	24.31	26.41		-
1993/94		26.41		-
1994/95		26.41	0.84	3
1995/96	15.90	42.31	1.68	4
1996/97	10.00	52.31	10.32	20
1997/98	7.00	59.31	22.53	38
1998/99		59.31	23.73	40
1999/00	8.00	67.31	27.72	41
2000/01	63.00	130.31	33.23	26
2001/02	43.22	173.53	12.90	7
2002/03	57.61	231.14	36.38	16
2003/04	24.00	255.14	13.16	5
2004/05	23.11	278.26		-

### Cumulative Investment & Dividend



### *Savings Mobilization*

EPF is the largest non-bank financial institution in the country and had until recently monopolistic position in mobilizing and managing the contributions of staff of different institutions in the organized sector. Of late, however, many agencies have extended their wings to manage the contribution of not only their own staff but also of employees on the staff of other agencies. Mostly financial institutions have come up with attractive offer e.g. pension scheme and other benefit packages on easy terms and conditions. An environment of competition exists in the financial industry and EPF has also been exposed to a greater level of competition in recent years.

In view of competition and the need to retain the existing contributors and also to get into its net additional contributors, EPF has devised several benefit packages to its members. The contributors in addition to the lump-sum amount on their retirement are entitled to several benefits.

Initially, there was no provision for partial withdrawal of the contributor's deposit. The entire sum accumulated in a contributor's account would be refunded on termination of their job. The provision of partial withdrawal facility, up to 90 percent of PF deposits was introduced in February 1991. The extent of withdrawal allowed, however, depended upon the age of the contributor. This was revised downward to 60 percent in April 1992. A contributor with a minimum of 5 years contributing period would be entitled to withdraw every two years. After the enactment of the Income Tax Act 2058, in February of 2001, which treated EPF as an approved retirement fund, partial withdrawal facility has been stopped. Some of the social security schemes launched by EPF with the object of providing additional benefits to its members are briefly discussed below.

### **Additional Benefit Scheme**

This scheme was introduced in July of 2004 under which retired contributors are entitled to have 0.75 percent of total PF deposit each year as additional benefit at the time of withdrawal of PF deposit. The additional benefit amount could be 15 percent of total PF deposit or NR 300,000 whichever is less. This scheme replaced the periodic pension scheme under which periodic pension at the rate of 5 percent of the PF deposit would be paid to the contributor or the nominee for a maximum period of nine years.

### **Accident Indemnity Scheme**

This scheme was introduced in 1995 to provide a lump sum amount of NR 55 thousand to the member or the nominated beneficiary in the event of death or permanent disability of the contributor due to accident.

### **Funeral Grant Scheme**

This was introduced in January 1990 to provide a sum of NR 5000 as funeral grant to the legal beneficiary of the member who passes away during the service period.

### **Employees Welfare Scheme**

This scheme introduced by HMG/N in 1979 is being implemented by EPF. Present level of benefit payable is NR 40,000 in case of peon or equivalent, NR 75,000 for officer level and the non-officer getting NR 50,000.

EPF is also providing different loan facilities as discussed below.

### **Special Loan**

This was introduced by EPF in the year 2000. Members with 3 years of regular contribution are eligible to borrow at 7 percent to 90 percent of the accumulated contributions every 2 years. Some 155,000 contributors have availed this facility so far.

### **Home Loan**

EPF introduced the “House Loan Scheme 2057” in December 2000 to help its members build and /or buy a residential home. EPF provides house loan at 9 percent for a period of 20 years or remaining tenure of service of member whichever is less with land and the constructed residence as collateral. Members with two years of contribution and having completed 2 years in office are eligible to borrow a sum equivalent to their 10 years basic salary. Currently, this scheme is confined to Kathmandu and Pokhara and is likely to be extended to other areas. About 5000 members have so far been benefited.

### **Education Loan**

“Education Loan Scheme 2057” was introduced in November 2001 to help member or spouse or children to pursue higher studies. Loan is provided for a period of 15 years or remaining tenure of member whichever is less against the collateral of land/building within certain areas fixed by EPF or the PF deposit. Under the scheme, member who have completed 5 years of service and have contributed regularly for 5 years can borrow at 8 percent NR 900,000 for studies abroad and NR 600,000 for studies within the country.

### **Low Cost Housing**

The EPF Act allows mobilization of fund in housing undertaking such activities independently or in cooperation with other institutions. Of late, housing has become the most secured and profitable form of investments. Houses (112) constructed on 1.5 hectare of land in Pokhara for EPF members were sold in no time. Further, it has constructed 5 offices cum

shopping complexes in Kathmandu and 3 in Pokhara. EPF is contemplating constructing 1100 residential house outside the ring road in Kathmandu and 500 in other districts for distribution to EPF's lower and middle level income members on easy terms and conditions.

## **II Citizen Investment Trust**

### **Introduction**

CIT was established under the Citizen Investment Trust Act, 2047 with the primary objective of providing financial intermediation service and to enhance the investment activities for the growth of a dynamic capital market in Nepal. Financial intermediation service of CIT is carried out through the operation of various savings schemes. CIT's contribution to capital market growth is evidenced from its involvement in operating the only unit investment trust in Nepal. CIT is the only institution that has limited its activities to capital market sectors, thus, differentiating it from banks and finance companies. It started its operation with Employees savings and Growth Schemes (ESGS) that requires mandatory contribution from employees of public and private sector agencies. The primary activities of CIT are to mobilize savings, invest in securities and make corporate loans. It also underwrites and manages public offerings and provides trustee, escrow agent, and custodian services. It is explicitly stated in the Act that the CIT may invest in overseas securities with the approval of the Nepal Rastra Bank (NRB).

### **Ownership and Capital Structure of CIT**

#### **Corporate Objectives:**

The basic objective of the CIT is to mobilize the scattered savings of the people for medium and long-term period. Pension and retirement schemes have contributed to the social security system in the country. Similarly, the Trust aims to provide services in new issue management, underwriting, bridge financing and consortium financing to the corporate sector. As an active member of the stock exchange, CIT is participating in the purchase and sale of securities issued by His majesty's Government of Nepal (HMG/N) and corporates. Thus, CIT's overall activities revolve around collection of funds through operating various savings and investment trust schemes and mobilization of the same in available capital market instruments. A part of the benefit, thus generated, is transferred to the contributors.

#### **Structure of Capital:**

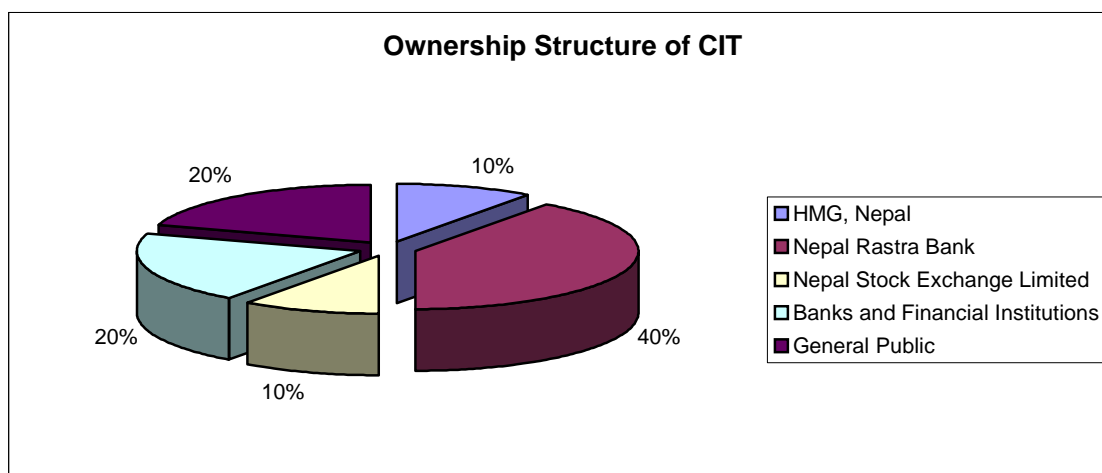
The authorized capital of CIT is NR 80 million. The issued and paid-up capital is NR 40 million. The ownership structure of CIT is composed of 4207 shareholders consisting of HMG, NRB, Nepal Stock Exchange Limited and four banks and financial institutions as institutional investors and 4200 public shareholders. CIT is listed in the Nepal Stock Exchange Limited and has issued capital of NR 40 million, with 10 percent direct ownership of HMG and a further 40 percent by Nepal Rastra Bank and 10 percent by Stock Exchange. Banks, insurance companies and other financial institutions (including those controlled by government) own 20 percent and 20 percent is held by the general public (Table 2.1). Of the 9 members of the CIT board, 5 (including the CIT executive director) are directly nominated by government, and NRB and Stock Exchange also appoint one director each.

**Table 2.1: Structure of Ownership**

S.N.	Shareholder	No.	Amount (NR in Million)	Ownership%
1	HMG, Nepal	1	4.00	10
2	Nepal Rastra Bank	1	16.00	40
3	Nepal Stock Exchange Limited	1	4.00	10
4	Banks and Financial Institutions	4	8.00	20
5	General Public	4200	8.00	20
	<b>Total</b>	<b>4207</b>	<b>40.00</b>	<b>100</b>

The ownership structure shows that majority stake is possessed by government and government owned institutions. This increases the chance of government intervention in its operation. The overwhelming dominance of government in financial institutions is not desirable and there is growing pressure on HMG to off-load its stake which it has done, of late, in certain cases. Currently, it owns the largest commercial bank (RBB), is the biggest shareholder in the second largest one (NBL), and holds somewhat indirectly significant shares in virtually all the joint-venture banks (all joint venture banks are 50 percent Nepali owned with shares generally being held by NRB, NBL, RBB or the EPF). In addition, the government owns the two largest development banks: the Agricultural Development Bank of Nepal; and Nepal Industrial Development Corporation.

Government ownership often leads to poor internal governance, weak management, fragile financial health, and an unhealthy politicization of the state-owned institutions. Government may wish to divest its ownership of CIT in favor of private parties.



### Shareholder's Fund, Net income and Dividend

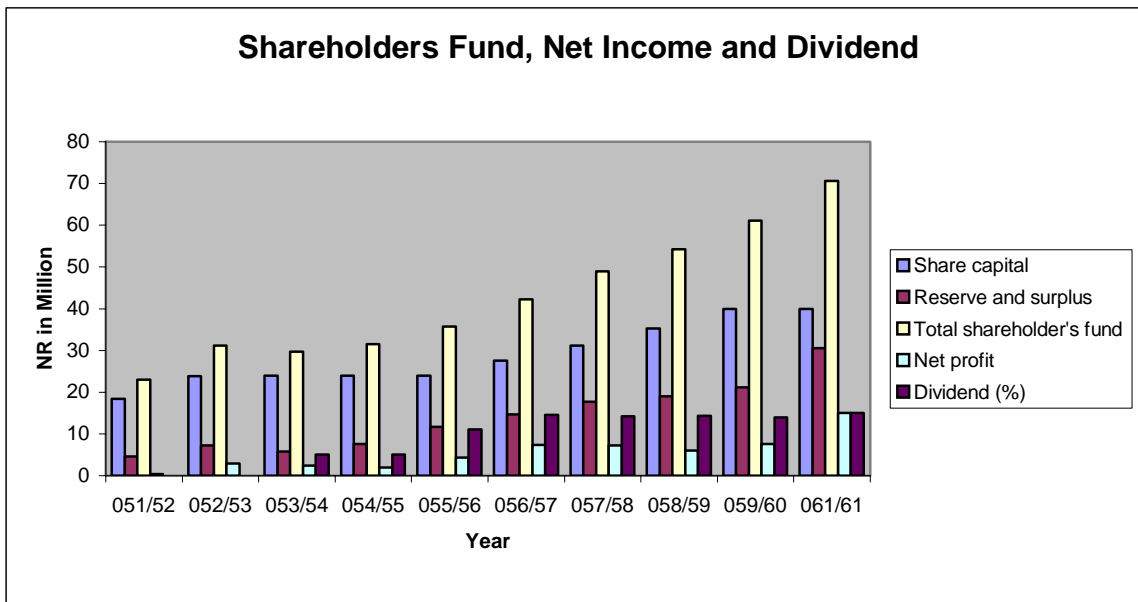
CIT's net worth as of mid-July, 2004 amounted to NR.70.56 million. It consists of capital contributed by the shareholders (NR 39.99 million) and reserve and surplus (NR 30.57 million). As required by the law, minimum 20 percent of the net income must be appropriated by CIT as reserve and surplus. The share capital is now fully subscribed. The shareholder's

fund, net income after taxes and dividend of the Trust in the last 10 years are exhibited in table 2.2.

**Table 2.2: Shareholder's Fund, Net Income and Dividend**

NR in million

Particular	051/52	052/53	053/54	054/55	055/56	056/57	057/58	058/59	059/60	061/61
Share capital	18.44	23.86	23.97	23.97	24.00	27.58	31.20	35.20	39.99	39.99
Reserve & surplus	4.56	7.27	5.77	7.59	11.67	14.65	17.73	19.04	21.14	30.57
Total shareholder's fund	22.99	31.13	29.74	31.57	35.67	42.23	48.93	54.24	61.13	70.56
Net profit	0.36	2.87	2.43	1.93	4.3	7.35	7.24	6.03	7.53	15.02
Dividend (%)	0	0	5.00	5.00	11.12	14.55	14.25	14.35	14.00	15.00
ROE (%)	1.60	9.20	8.20	6.10	120	17.40	14.80	11.10	12.30	21.30



On average, shareholder's fund of the CIT is growing by 11.86% per year. The net profit of CIT was NR 15.02 million in the year 2003-04. This amount is about double (99.46%) the previous year's net income of NR 7.53 million. On average, the net income is growing by 45.22 percent each year. The dividend trends of the CIT also indicate that it is able to provide a fair return to its common stockholders in recent years. Common stockholders got a 15 percent return on their investment in 2003/04. The return on equity is also growing as evidenced by the table. ROE is 21.3 percent in 2003/04 as against 12.3% ROE in the year 2002/03. It is increasing by 11.27% annually.

## Adequacy of Capital Fund

There is no standard, in case of CIT, to measure the adequacy of capital (shareholder's) fund. Capital for any organization is a cushion to absorb the risk for unidentified losses. In case of bank and financial institutions, there is a minimum requirement of capital funds. NRB has issued directive to commercial banks and financial institutions to maintain minimum capital fund at 12 percent of their risk weighted assets for commercial banks, development banks and finance companies and 8 percent for licensed cooperatives. On the basis of practices applied in the financial institutions all over the world, CIT's capital fund adequacy has been measured and found below the normally acceptable level. It was 4.04 percent in 2002/03 which further declined to 3.07 percent in 2003/04. CIT is thus grossly undercapitalized and does not meet the international capital adequacy standards (Table 2.3).

**Table 2.3: Adequacy of the Shareholder's Fund**

NR in million

Assets	Risk Weight	Amount		Risk Weighted Assets	
		FY 2002/03	FY 2003/04	FY 2002/03	FY 2003/04
Differed Assets	100%	0.55	0.37	0.55	0.37
Fixed Assets	100%	2.53	2.42	2.53	2.42
Investments:		<b>1534.29</b>	<b>2303.66</b>	<b>1511.91</b>	<b>2295.82</b>
Government Securities	0%	6.54	0	0	0
Fixed Deposits	20%	19.80	9.8	3.96	1.96
Citizen Unit Scheme	100%	5.00	5	5	5
Loans	100%	31.30	31.3	31.3	31.3
Investment in Shares	100%	10.45	15.81	10.45	15.81
ESGS	100%	1458.12	2238.96	1458.12	2238.96
Total Capital Fund		61.13	70.56		
Capital Fund Ratio				<b>4.04</b>	<b>3.07</b>

## Mobilization of Savings

Savings mobilization is key to effective and efficient financial system in the country. Lack of savings mobilization facilities creates problems at three levels: (i) individual; (ii) institution; and (iii) national economy.

At the level of the individual, lack of appropriate institutional savings facilities forces individuals to rely upon in-kind savings such as savings in the form of gold, animals or raw materials or upon informal financial intermediaries such as Rotating Savings and Credit Associations (ROSCA) or money-keepers. These informal savings options, however, do not offer advantages of security of funds, ready access or liquidity, positive real return and convenience in order to meet various needs of a particular saver.

At the institutional level, contractual savings organizations have small savers and borrowers with an average savings balance or loan amount below the average per capita annual income in the respective countries. Those institutions lacking effective savings

mobilization strategies are unable to increase their outreach to a significant number of clients on a regional or national scale. This tendency encourages these institutions to depend on the external sources of funds as they lack full financial self-sufficiency.

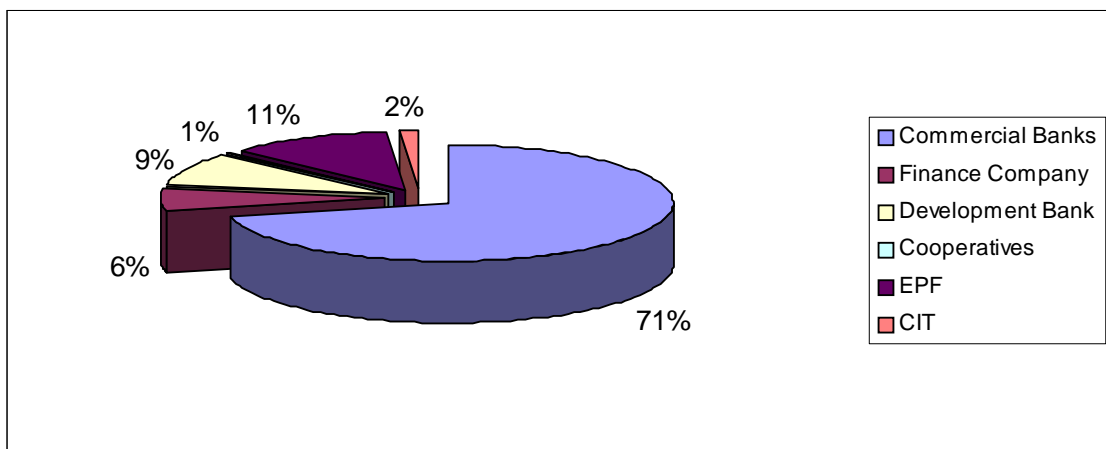
At the level of national economy, high level of savings increases the amount of national reserves and decreases the need to resort to foreign indebtedness in order to meet domestic investment and consumption demand. Countries with low internal savings rates must borrow from abroad, which results in a debt service burden. Savings mobilizations need to be encouraged to foster economic growth and to stop a nation from sliding into a debt trap.

**Table 2.4: Aggregate Deposits of Banks and Financial Institutions, EPF and CIT**  
(Mid-July, 2004)

NR in Million			
S.N.	Particular	Amount	Percent
1	Commercial Banks	233707.79	71.4
2	Finance Company	19380.65	5.9
3	Development Bank	30211.00	9.3
4	Cooperatives	1710.06	0.5
5	EPF	37402.00	11.4
6	CIT	4923.4	1.5
	<b>Total</b>	<b>327334.9</b>	<b>100</b>

**Citizen Investment Trust in the Financial Industry:**

Savings mobilized by different agencies in the financial industry is furnished below:



The total funds collected by the banks and financial institutions together with EPF and CIT is NR 327,324.9 million. Commercial banks have the highest share accounting for 71.4 percent of total funds and CIT has mobilized only NR 4923.4 million (only 1.5 percent)

through various savings schemes. This amount is 1.72 percent of the total funds collected by banks and financial institution together and 10.2 percent of the funds mobilized by the EPF.

### Savings Schemes

The size of the fund managed by CIT as of Mid-July 2004 increased to NR 4923.4 million registering about 50 percent growth over NR 3294.5 million mobilized in FY 2002/03. Average growth rate of the total fund mobilized by CIT is 66.7 percent in the last 10 years. This growth rate indicates that saving schemes of the Trust are overwhelmingly responded to by the investors in recent years. The reason behind this response may be the return on the investment that CIT is committed to, which is above the rates on deposit and the yield on government securities.

The total fund (NR 4923.4 million) consists of employee's savings growth scheme (ESGS), citizen unit scheme (CUS), investment account scheme (IAS) and gratuity fund scheme (GFS). The contribution of ESGS is 51 percent: the other half of the contribution coming from CUS (20Percent), GFS (21 percent) and IAS (8 percent).

The chargeable administrative expense of the Citizen Unit and the Investment Account schemes is capped by law at 3.5 percent per annum and 10 percent of income, and the management fee at 1.5 percent. CIT accepts investments into its schemes through 120 collection centers nationwide at offices of the NRB, RBB and NBL. The status of the scheme and their returns are presented in table 2.5.

**Table 2.5:CIT's Savings Mobilization Schemes**

Particular	NR in Million									
	051/52	052/53	053/54	054/55	055/56	056/57	057/58	058/59	059/60	060/61
ESGS	29.6	22.9	61.2	118.8	200.8	353.1	673.4	1186.6	1523.5	2501.3
Unit 52	-	6.40	7.96	15.40	42.50	143.30	336.80	645.30	837.40	1003.9
Gratuty Fund	-	-	-	-	20.4	33.5	53.9	118.2	656.3	1053.7
Investor's account scheme	-	-	-	-	-	54.0	81.6	143.1	277.3	364.5
Total	29.6	29.3	69.2	134.2	263.7	583.9	1145.7	2093.2	3294.5	4923.4
Return on unit holders (%)	-	11.50	11.50	11.00	11.00	11.00	9.00	8.00	8.00	7.00
Return on ESGS (%)	15	10	10	10	10	9	8	8	7	6
Return on GFS (%)	-	-	-	-	7.50	7.50	7.50	7.00	6.00	4.75
Return on IAS (%)	-	-	-	-	-	7.5	7.5	7.0	6.0	5.0

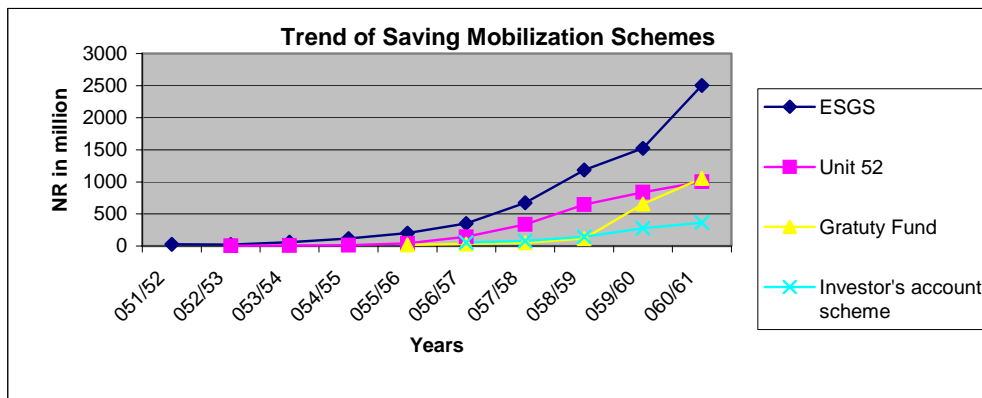
ESGS was introduced in 1991 as a mandatory scheme requiring all employees in the public and private sectors to contribute 5 percent of their salary. The scheme was successfully contested in the court, however, after only 3 months of operation. The scheme was then converted into a voluntary program, allowing workers to contribute either 5 or 10 percent of their monthly salary by direct debit for a period of 5 years. This 5-year plan was then rolled over in 1996. Participants can join the program at any point, but the rollover years are set. In 1998 a new scheme was announced with a 10-year duration. The intention is to ultimately move to a plan that pays only at retirement. ESGS sends annual statements of accounts to its members.

ESGS invests only in fixed income securities (including loans). The management and service charge is only 0.5 percent. Interest earned within the scheme is retained and paid out with principal at the end of the program period. Participants may not withdraw their investments prior to the end of 5-year period (or lose all accrued interest), but they may stop making contributions without penalty. Participants may borrow against their fund assets for the sole purpose of investing in securities issues promoted by CIT. The rate of return was 6 percent in 2004.

The Citizens Unit Scheme was established, by statute, in 1995. Units are continually offered and can be purchased by companies or individuals. Investments of up to Rs.10,000 are tax exempt. The scheme is limited to people with salaries below NR 100,000 per annum. CIT purchases and sells units on a daily basis. The units are always priced at par and the income is distributed periodically. Since inception, the Unit Scheme has provided a rate of return of around 11 percent. However, the return has been reduced to 7 percent in the year 2003-2004 due to the substantial reduction in the market interest rate. Less than 25 percent of the portfolio is invested in equities, though the scheme has substantial unrecognized equity gains.

The Investor Account was established in 1999 as a retirement scheme receiving voluntary contributions from individuals. It is not tax exempt, but it does not pay withholding tax. Participants cannot withdraw funds prior to retirement at which point they receive a lump sum. The participants choose the investments for their own account, and the current rate of return is around 5 percent. At present, the CIT does not charge an administrative fee for this scheme.

The gratuity fund scheme is also a voluntary retirement scheme but is targeted at companies. It was established in 2000. Participating companies use the fund to provide a defined benefit pension to their employees. The company takes all the risk of meeting the defined benefit liability. The current rate of return is 6 percent.



## Return on Funds and Market Interest Rates

The returns on the funds mobilized by the CIT are compared with the similar maturity commercial bank interest rate and interest rate on government savings bonds for the last 5 years. The government bonds known as National Savings Certificates (NSC) yielded 8.5 percent to 13.25 percent depending upon their maturity in the year 1999 which is slid down to 6.5 percent to 13.0 percent in 2004. The interest rates on government securities are regarded as the benchmark rate. In 2004, the average return on the fund is 5.68 percent indicating that the return is below the 8.5 percent interest rate on NSB. The interest rates on deposits of the commercial bank are show a declining trend in the last 5 years. The trend of interest is an indicator of the performance of the economy. The declining trend of interest rate indicates that funds are not properly utilized in the economy in a productive manner. Further, deteriorating law and order situation of the country is impeding the mobilization of funds. CIT's return on savings scheme may be considered fair compared with the commercial banks interest on fixed deposit which ranged between 2.25 percent to 5.0 percent in 2004 (Table 2.6).

**Table 2.6: Interest Rate Structure of Government Securities and Commercial Bank and Return on CIT's Funds**

Particulars	T-Bill Rate (91-day) %	NSC (%)	CB Savings deposit (%)	CB 1-year time deposit (%)	Return on ESGS (%)	Return on GFS (%)	Return on IAS(%)	Return on unit' 52 (%)
1999	3.30	8.5-13.25	5.75-8.0	7.25-9.5	10	7.50	-	11
2000	5.30	8.5-13.25	4.0-6.50	6.0-7.75	9	7.50	7.5	11
2001	4.94	8.5-13.25	3.5-6.50	4.5-7.75	8	7.50	7.5	9
2002	3.55	8.0-13.25	2.5-6.25	3.5-7.0	8	7.00	7.0	8
2003	3.95	7.0-13.00	2.5-6.0	3.0-7.0	7	6.00	6.0	8
2004	1.47	6.5-13.00	2.25-5.0	2.75-5.75	6	4.75	5.0	7

Funds are to be utilized to generate sufficient income to cover cost, provide fair return to the contributors and shareholder's of CIT. This would enhance contributors' confidence in CIT's scheme.

### CIT's Investment Portfolio

Major sources of the funds of CIT are the amounts collected through various savings schemes. Earlier, these schemes were normally operated to refund within a short span of time with fair return. The guiding principles then were safety, liquidity and low risk. There were and still are not adequate avenues in the market that allow reasonable trade off between risk and return in Nepalese capital market.

The earnings assets of CIT are government securities, fixed deposit citizen unit scheme, loans and investment in equity securities. Amount invested was NR 61.9 million in Mid-July 2004: 15.3 percent lower than NR 73.1 million in Mid-July 2003 (Table 2.7).

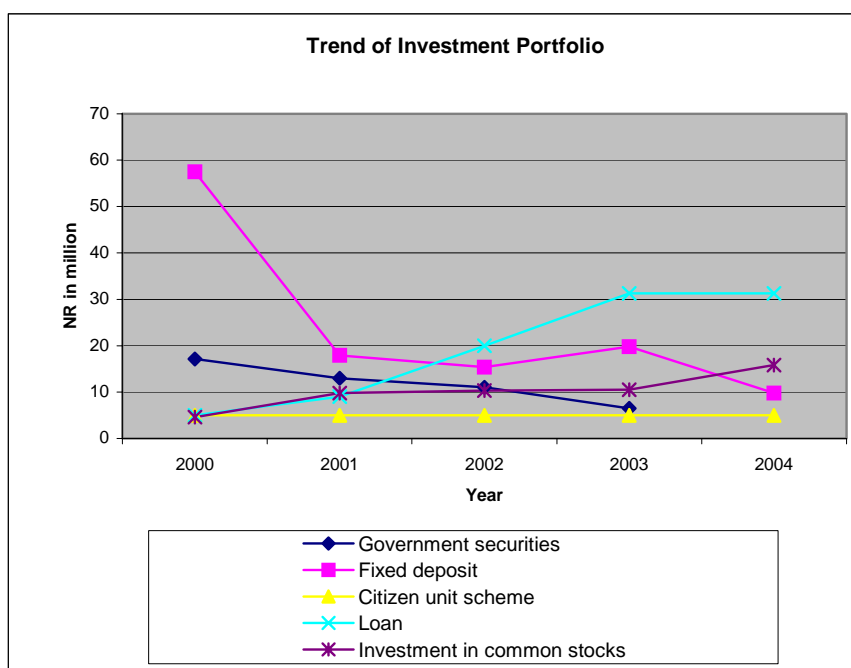
**Table 2.7: Investment Portfolio of CIT(Central Account)**

NR in millions

Particulars	Government securities	Fixed deposit	Citizen unit scheme	Loan	Investment in common stocks	Total
2000	17.1	57.5	5.0	5.0	4.6	89.2
2001	13.0	17.9	5.0	9.0	9.8	54.7
2002	11.0	15.4	5.0	20.0	10.3	61.7
2003	6.5	19.8	5.0	31.3	10.5	73.1
2004	-	9.8	5.0	31.3	15.8	61.9

Last 5-year's portfolio shows that most of CIT's investment is in the form of fixed deposit (34%) with commercial banks. A substantial portion is invested as loans to corporate (27%) and government securities (17%). More than 50% of investment assets of CIT is highly liquid. Liquid asset means low risk and low return. However, the nature of the business and availability of instruments in Nepalese capital market do not allow the Trust to go further in high risky assets. Share investment is accounted in book value and no provision is made in case of loss in investment. This portfolio does not reflect the true picture of the CIT's investment performance.

Over the last 5-years, CIT has diversified its investment portfolio: a drastic reduction in the portion of fixed deposit; and component of loans and investment in equity securities has gone up showing CIT's ability to transform its assets from low return to high return ones. The structure also highlights the fact that CIT is transforming its resources in a longer-term retirement funds. However, adequate care is to be taken while diverting the funds in riskier assets particularly in the absence of regulatory and supervisory standards. The change in the structure of the investment portfolio, however, is in conformity with the change in the structure of the schemes and adequately takes into account the gap between assets and liabilities of the Trust.



## Overall Investment Portfolio (central account and other schemes included)

CIT has been maintaining two types of accounting on its resource position. The annual report published every year consists of information on investment portfolio of central account and ESGS, while balance sheet and status of other schemes are not made public: provided only to the scheme holders. The total investment portfolio stood at Rs. 5110.9 million in 2061/62, ESGS amounting to Rs. 2900 million and GFS at Rs. 1101 million. Aggregate picture of CIT shows heavy placement of funds with commercial banks and other financial institutions (Rs. 1758 million in 2061/62).

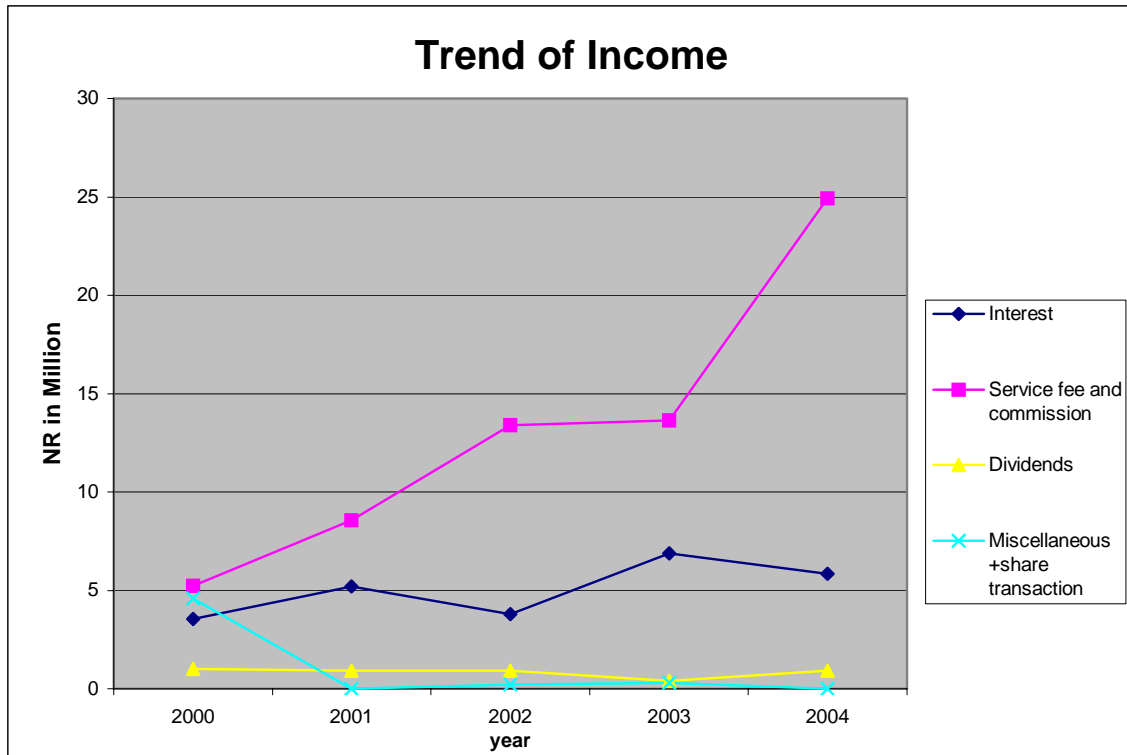
## Earnings Analysis and Capital Market Performance

The total income of CIT was NR 52.91 million in FY 2003/04: 149.45 percent higher than NR 21.21 million income in FY 2002/03. It earned NR 14.40 million in FY 1999/2000 and shows an average growth rate of 29.72 percent over the last 5 years. The major source of earnings of CIT includes interest on investment on government securities and fixed deposits, service fees and commission, dividends and miscellaneous incomes. Service fee and commission income occupied a dominant position in the total income of CIT. In 1999/2000, the ratio of service fee to total income was 36.38% which increased to 47.07 percent in 2003/04, indicating that Trust's activities are moving towards capital market services where CIT provides various services like share issue management, dealers on National savings Certificate, registrar to the issue service, underwriting, escrow agent and trusteeship (Table 2.8).

**Table 2.8: Breakdown of CIT's Earnings**

Particular	NR in Million				
	Interest	Service fee and commission	Dividends	Miscellaneous +share transaction	Total
2000	3.54	5.24	1.02	4.60	14.40
2001	5.20	8.56	0.93	0.00	14.69
2002	3.80	13.39	0.92	0.20	18.31
2003	6.88	13.63	0.40	0.30	21.21
2004	5.84	24.91	0.93	0.00	52.91

Besides operating savings schemes, CIT is an active participant in Nepalese capital market. It is listed in the Nepal Stock Exchange Limited and lies in the finance company group, though it is not licensed as a finance company from Nepal Rastra Bank. Security Board, Nepal (SEBO/N) had permitted CIT to operate the citizen unit scheme in the fiscal year 1994/95. With the objective of collecting capital from the small and medium savers for investment in a professional and efficient way and distribute the returns earned thereon. This is an open-ended scheme with the face value of Rs.100 per unit. CIT itself has been performing the function of selling and purchasing the unit of the scheme.



**Issues and Challenges:**

As a major player in the financial intermediation service industry in Nepal, CIT has to widen its net for collecting funds and readjust its investment portfolio ensuring liquidity, safety and return. It also has to play a key role in expanding the capital market of this small economy. Further, the growing competition, openness and awareness, use of information technology in the investment market, on the one hand, and the shrinkage of activities due to prevailing conflict in the country, on the other, warrant serious steps to minimize risk on the operation of CIT. An attempt has been made to address some of the issues and challenges of CIT in the days to come:

**1. Savings Mobilization:**

Financial intermediation service, especially for contractual savings organizations, activities can be carried out by mobilizing the savings of each sector and segment of the economy. While banks and financial institutions require the funds basically for the short span of time, these institutions rely on the long-term funds. CIT, in this regard, has major four schemes to collect the funds, one of which is the unit scheme. Since CIT's focus is to operate medium and long-term sources, it has converted all of its schemes in such maturity.

Operation of the schemes, particularly in mobilization of longer-term funds, require analyzing the cost and risk of funds. The cost includes return to contributors, management fee and other miscellaneous expenses. The risk is related with the nature of the organization that contributes the fund in the schemes i.e., the sustainability, profitability and continuity of the contributing organization.

It is a serious challenge for CIT to provide reasonable return to the contributor of funds considering the shrinkage in the economic activities in recent years due to growing conflict in the country and sharp decline in market interest rates. It also has to maintain the confidence of the contributors. Moreover, management of the funds requires more expertise, skills and cost and risk reduction devices. Developing, hiring and retaining expert manpower is another big challenge for the CIT.

## **2. Investment Portfolio Management**

In order to provide fair return to the contributors, the funds must be invested in the assets available in the market taking into account safety, liquidity and profitability. However, there is an inverse relationship between safety (and liquidity) and profitability. An asset that is more liquid and safe is less profitable and vice versa. Liquidity and safety is required to maintain the credibility of the institution that ensures the contributor that their investment will be refunded in due time. Profitability, on the other hand, is the crux of the investment mechanism. Return on the investment and cost of the funds mobilized determine the gap (profit) of the institution.

Selecting an asset portfolio that trades-off between return and risk is a key issue in Nepalese investment industry. Firstly, there are few instruments in the market. On the risk-free assets side, HMG securities are available, but there are many obstacles in obtaining these securities for institutional investors like CIT. Further, these securities are not traded in the organized exchanges. Another instrument that is popular in the market is common stock. Nepal Stock Exchange Limited provides liquidity and marketability of the stocks. Except these two instruments, there are insignificant debentures, preferred stocks and money market instruments. Nepalese securities market is not experienced with the derivative instruments yet.

Secondly, it is tough job to access and measure the riskiness of the instruments, particularly in the context of Nepal. Though it requires expert and professional manpower to deal with the financial instruments in well-developed capital market, Nepal's case is far different than other countries. To measure the risk, the prerequisite is to have an efficient capital market where securities prices contain all the available information. Investors must be rational and there should be instantaneous flow of information. There should be an independent rating agency that grades the securities in order to facilitate the investor to identify the default risk inherent in the security. The same problem is faced in granting loans to corporate in the absence of credit rating agencies. Moreover, the deposits in banks and financial institutions, irrespective of whether they are current or fixed, are to be considered risky investments, as these deposits are not yet insured by deposit insurance company.

Thirdly, there are inadequate rules, regulations, and procedural aspects as well as institutional overlapping in securities market. This situation hinders coming into market of new securities. For example, there is no coordination among the Company Registrar's Office, Security Board/Nepal and Nepal Rastra Bank in dealing with the securities issued by the banks and financial institutions. No guiding principles for issuing debentures, bonds and convertible securities are developed. No institutional arrangement has been made for the securities that are not listed in the stock exchanges because of its stringent requirements to make them tradable and liquid. There are no governing rules and regulations to ensure the protection of investors in mutual funds; investment trusts units and the like.

Lastly, the poor governance, inadequate disclosure requirements, less reliance in the audited financials by the institution, fragile management are some other impediments that make assessment of risk more complex. It is reported that several institutions that issue securities and are listed in the Stock Exchange have not audited their statements for several years. Institutions publishing audited report have either inadequate disclosure or take too long a time for public disclosure.

### 3. **Regulatory and Supervisory Status Of CIT**

The Act that established CIT codifies its roles, functions, exemptions and areas of operations. It collects funds from public and invests the same in the securities issued by government; grant loans to corporate houses and deposits with commercial banks and finance companies. Its investment portfolio also shows a significant amount in common stocks and units of the citizen unit scheme.

All the deposits, investments and lending activities involve risk. Since there is no deposit insurance practice in Nepal, the funds collected from the savers are not guaranteed (or insured), nor it is regulated by the central bank. Further, lending and investment activities in capital market instruments require more expertise, control measures, regulatory norms and standards to minimize the risk. These activities are to be closely monitored and supervised so that the interest of the contributors is protected and market is not distorted.

Banks and financial institutions, insurance companies and players in capital markets have their respective regulatory bodies. Nepal Rastra Bank regulates commercial banks and financial institutions like development banks, finance companies and licensed cooperatives and NGOs. Insurance Board regulates and supervises insurance companies and Security Board/Nepal is an apex institution to oversee the primary and secondary market (stock exchanges, brokers, market makers, underwriters, dealers, new issue managers in securities market) in Nepal (Table 1.12). However, institutions like Citizen Investment Trust (CIT), Employees Provident Fund (EPF), Postal Savings Banks (PSBs) and savings and loan cooperatives not licensed by Nepal Rastra Bank do not have a regulatory body. All these institutions deal with public money in one way or the other and failure of the institution is bound to have serious implications on the financial system.

**Table 1.12: Regulatory Bodies**

<b>S.N.</b>	<b>Institution</b>	<b>Regulatory body</b>
1	Commercial Bank	Nepal Rastra Bank
2	Development Banks	Nepal Rastra Bank
3	Finance Companies	Nepal Rastra Bank
4	Micro credit cooperatives	Nepal Rastra Bank
5	NGO's licensed by NRB	Nepal Rastra Bank
6	Insurance Companies	Insurance Board, Nepal
7	Nepal Stock Exchange Limited	Security Board/Nepal
8	Employee Provident Fund	No regulator
9	Citizen Investment Trust	No regulator
10	Postal Savings Banks	No regulator
11	Savings and loan cooperatives	No regulator

The following issues warrant critical attention in case of CIT:

### **Disclosure**

The financial statements of the institutions are the mirror image of the financial health and reflect the true and fair picture about the institution. Accounting of income and expenses, valuation of assets and liabilities and disclosure of the all the relevant financial activities are assumed to be consistent with international practices. However, in CIT's case, there is no disclosure requirement, no accounting policies and inconsistency prevails in structure of financial statements. For example, investments in equities (shares) are valued at par. The international practice is to show at par or market value whichever is lower. Further, Provisioning is required in case of loss in investment. Earlier, the interest on government securities, fixed deposits, T-Bills were disclosed separately (F/Y 2053/54). Now these incomes are disclosed in a single heading of "interest income".

### **Provisioning**

CIT has no written loan classification and provisioning policy. However, annual report 2060/61 has specified that CIT has no policy of providing for loans granted to His Majesty's Government (HMG) as they are guaranteed by the HMG. Provisioning is done only when loan is over due by one year. This is not in conformity with international practices in the classification and provisioning of loans. For banks and financial institutions, the norm is to classify loans in four classes: pass; substandard; doubtful; and bad loans on the basis of overdue of interest and principal and make provisions accordingly.

### **Interest Income and Suspense**

CIT's treats income and expenses on accrual basis which is explicitly disclosed in the annual report. However, no specific policies are devised for interest suspension in case of interest not being realized within specified period of time.

### **Other Policies and Practices**

Clear-cut policies are lacking in case of connected lending, single borrower limit or group of borrower, consortium financing, risk minimization measures and corporate governance practices.

CIT's accounting practices as found in the balance sheet and income statement do not show an adherence to international norms and practices in many areas. This raises a suspicion in the reliability of financial picture drawn by this self-regulated body.

#### **4. Savings Unit Scheme**

CIT is mobilizing the savings of small investors through citizen unit scheme. The scheme, as explained above, is an open-ended scheme and popular among the investors. Despite the bitter experience of NIDC Capital Market in the mutual fund operation, the unit schemes are positively responded to by the investor in the stock market.

Notwithstanding its popularity, there is lack of a separate act to guide the related institutions managing such unit schemes like CIT and NIDC Capital Market. Globally, such schemes are managed by investment companies and unit trusts. The Act that deals with these institutions encompasses the role of the trustee, the investors (unit holders), and the investment company like CIT. The Act specifies the forms of the unit, the organization of managing company, the mechanism of operation, trading, and investing, the fiduciary liabilities and duties of investment company (like CIT), alteration, termination and liquidation of the investment fund, regulatory framework of the investment fund business and legal liabilities.

Small investors, people in the street as they are called, favor such unit schemes rather than directly managing their investment portfolio, because of the three reasons: a) they lack specific knowledge to purchase and sell securities. b) They don't have enough time to administer the security holdings; and c) they don't have enough money to create a well-diversified portfolio. Investment funds are the means to overcome these problems and provide the small investors access to the securities market.

A self-regulated body like CIT, while managing citizen unit scheme and similar other schemes, has to protect the interests of investors managing portfolio in a well-diversified and efficient manner.

### III

#### Conclusions / Recommendations

Latest information available reveals that EPF has so far mobilized NR 40 billion as deposits from 28,000 offices including 400,000 staffs. EPF is not only the largest non-bank financial institution but is also comparable with the two large commercial banks – Rastriya Banijya Bank (fully government owned) and Nepal Bank Limited (partly government owned) in terms of volume of business. RBB's total deposits stand at NR 40313.6 million and that of NBL at NR 36288.5 million. Moreover, RBB still hold sizable sum of EPF as time deposits (20%). Currently, RBB has NR 3040 million and NBL does not have any account of EPF which until few years ago had significant amount with NBL (Table 1.12).

**Table 1.12: Investment in Fixed Deposit**

<b>Name of Bank</b>	<b>Amount (NR in Million)</b>	<b>Portfolio (%)</b>
Nepal Credit and Commerce bank	1110	7.43
Nepal Development Bank Limited	700	4.69
Machhapuchare Bank Limited	690	4.62
Development Credit Bank Limited	230	1.54
Nepal SBI Bank Limited	500	3.35
Everest Bank Limited	345	2.31
Agricultural Development Bank Limited	5115	34.25
Nepal Bangladesh Bank Limited	640	4.29
Rastriya Banijya Bank Limited	3040	20.05
Lumbini Bank Limited	1070	7.16
Nepal Industrial and Commerce Bank Limited	345	2.31
Nepal Investment Bank Limited	400	2.68
Kumari Bank Limited	200	1.34
Laxmi Bank Limited	350	2.34
Siddharth Bank Limited	200	1.34
<b>Total</b>	<b>14935</b>	<b>100.00</b>

In the past these two ailing giant financial institutions faced tough competition from other financial institutions, mainly private sector commercial banks, for funds of EPF. EPF did divert their funds to other institutions, which offered better rates and attractive terms and conditions but always refrained from huge withdrawal of funds from RBB and NBL: a clear manifestation of understanding of problems and extension of cooperation from a public owned agency to two other public entities.

Until recently, EPF was taken as an old – fashioned office of HMG/N not very different from offices of government that are charged with the responsibility of land revenue collection and land registration. Currently, however, housed in a recently constructed building at Pulchowok, the EPF headquarter, also equipped with computers and other accessories and nicely furnished, looks a very modern office.

Headquartered in its newly constructed premises at Pulchowok, EPF is currently operating through its 8 regional offices in different district and a separate office in Kathmandu at Tridevi Marg, Thamel. Offices of EPF are well managed and nicely equipped. Moreover, EPF management is alert about recruiting energetic, qualified manpower. It is also

aware about the need to right size the organization by facilitating ouster from the agency of staff who might have stagnated in terms of productivity or their contribution to EPF. EPF launched VRS twice to oust 13 percent of its staff in the past. Currently it has 510 staff of which the number of CAs and MBAs is 2 and 35, respectively. Organizational reform is a continuous process and EPF should not be left behind in the adoption of modern technology, getting rid of unproductive staff and hiring of skilled manpower e.g. chartered accountant, MBAs and economists. In addition to having skilled manpower from the market, EPF has to substantially hike its budget on training, observation tour, and higher studies for its staff. Only well-trained, better-educated staff of EPF with lots of experience and exposure can better serve its clients and ensure encouraging return on every penny invested by EPF.

Initially, EPF mobilized resources from member contributors and deposited the same with government banks and the interest income thus generated would be used to pay interest to EPF's contributors. With financial sector becoming very open and competitive after the mid-1980's, EPF started experiencing competition from rival institutions. Many institutions started their own provident fund scheme and, of late, some institutions have floated pension scheme and other alternative proposals to net more contributors into their scheme. This is a clear sign of growing competition and should be encouraged as long as it does not turn unhealthy. Competition amongst financial players in a healthy competitive environment enhances efficiency of each agency to better serve the clients as well as fetch better return on their inputs / investment.

The competition in the market for resources and a drastic reduction by commercial banks in their rates on deposits, the only source of income of EPF in the past, prompted EPF to diversify its activities into so many other (non-conventional) areas e.g. house loan, additional benefit scheme, education loan, accident indemnity scheme etc. Attractive as these schemes are, they have helped EPF retain the existing members and also get new ones into its fold. Moreover, EPF has made good money on loan scheme.

The declining income from time deposits, which is solely attributed to drastic fall in rates offered by commercial banks, is disturbing. Compared to the huge profit made by some private sector commercial banks, annual profit of NR 150 million of EPF is not encouraging, especially when huge deposit of NR 40 billion of EPF is taken into account. It may be mentioned that NR 11310 million deposit fetched NR 1131 million in FY 1998/99, while NR 16096 million could fetch NR 1002 million only in FY 2003/04. Interest expenses during the same period have risen from NR 1682.2 million in 1998/99 to NR 2207.5 million in 2003/04. EPF has also participated in the equity of some financial institutions return from which in the form of dividends is satisfactory if not highly encouraging. Management expenses have also gone up from NR 70 million in 1998/99 to NR 120 million in 2003/04, which is a normal increase in view of much needed increase in salary and benefits of staff and the process of office modernization that EPF has embarked upon.

Annual profit (income in excess of expenditure) has, however, not shown an encouraging trend. It was NR 110 million in FY 1998/99, plummeted to NR 5.1 million in 2002/03 and recovered to NR 150 million again in 2003/04.

Consortium lending is relatively a new phenomenon in Nepal. Awash in funds, financial institutions in Nepal joined hands to fund projects of varying nature and size in Nepal. The experience, however, has been that promoters of these projects have defaulted, with the exception of a few, on debt servicing. The on-going situation of conflict has also taken its toll especially in case of hotels the occupancy level of which (5 and 4 star) is said to be below 15 percent. The operators have gotten themselves into a state of distress selling

where a 5 star hotel room is sold for NR 1500 a day. It is unfortunate that coming into operation of some of the hotels coincided with accentuation of problem (conflict) in Nepal.

EPF has provided some NR 2000 million inclusive of capitalized interest to 31 projects. It has to recover NR 1660 million as principal and NR 613 million in interest payment. Out of these 31 projects, 21 were funded in cooperation with other financial institutions and 10 projects were solely funded by EPF. The projects funded range from hotels to sugar mills to research centers. With the exception of a few projects e.g. national hydropower, reliance spinning, Aarati strips, etc. the experience has not been very encouraging and EPF after 2058 does not seem to have agreed to fund any project under consortium lending. Latest information available shows Rs 1500 million disbursed to 34 projects under consortium arrangement and loans provided solely by EPF to different entities was Rs 3681 million, the highest being Rs1401 million to Nepal Oil Corporation. EPF states that its NPA level is less than 5 percent currently. In doing so, it seems they have not taken into account the loan amount disbursed under consortium head. This kind of segregation is not advisable. Indeed, EPF has to make a careful portfolio analysis and get into selective and very prudential lending as suggested hereunder.

### **Hydropower**

Nepal is second only to Brazil in terms of hydropower potentiality (83,000 MW) but very little of this has been harnessed so far (552.201 mw). Huge hydro power projects i.e. The Karnali, (10,000 mw) need collaborative endeavor of a host of outside agencies and nations, mainly that of India which has to buy the power generated, to organize billions of rupees for its implementation. Even a medium scale projects like the Arun III could not be executed, which is partly blamed on the internal misunderstanding amongst major political forces in the country. After this setback and the enormous amount of time that big projects take to get off the ground and also in light of growing power shortage in the country, the government seems to have given priority to the execution of small scale hydropower projects with private sector participation. A number of small hydropower projects have been completed by the private sector using resources provided by financial institutions within Nepal. Generally, Nepal Electricity Authority (NEA) provides market guarantee entering into an agreement with the promoter to purchase the power produced at two different rates for dry season and wet season respectively.

It is learnt that EPF has provided funds to one hydropower project (completed) and is seriously contemplating providing funds to some more. In view of the guaranteed market, it would be the wisest thing to do at the current state of conflict when the real sector of the economy is not performing well and has no genuine demand for credit.

It is stated that NEA has entered into power purchase agreement with a number of projects (some are listed in the table below) awaiting resources to get into execution. Construction work of the following projects (Power Purchase Agreements (PPAs) done) has started: Middle-Modikhola (3.1 MW), Mayelung (5.0 MW), Lower Myagdi (4.5 MW), Khudi (3.4 MW), Mayakada (5.0 MW), Dram Khola (5.0 MW), Bramchi (0.999 MW), Lower Indrawati (4.5 MW), Upper Madikhola (14.0 MW), and Chakukhola (1.5 MW) (Table 1.13).

**Table 1.13: SOME NEA APPROVED SMALL POWER PROJECTS**

S N	Name of Company	Name of project	Location	Installed capacity (KW)
1	Bhagawati Hdropower Demelopment Co. (P) Ltd.	Bijayapur - 1	Kaski	3000
2	Hula Eco Power (P.) Ltd.	Junrimba Khola	Sindhupalchok	995
3	B.P. Power Co. (P.) Ltd.		Sindhupalchok	1500
4	Alliance Power Nepal (P.) Ltd.	Dordikhola	Lamjung	8500
5	Upper Modi-A Hydroelectric Project	Upper Modi-A	Parbat	4200
6	Om Shakti (P.) Ltd.	Bijayapur Small	Kaski	1000
7	Hewa Rover {pwer Development Co. (P.) Ltd.	Hewakhola	Panchthar	5000
8	Swet Bhairab Power Company	Liping Khola	Sindhupalchowk	450
9	Ruru Hodropowe Development Co. (P.) Ltd.	Rurukhola	Gulmi	200
10	Rambeni Hydropower Development Co. (P.) Ltd.	Piluwakhola	Sankhuwasabha	990
11	Mansarobar Powers (P.) Ltd.	Sirsegad	Dadeldhura	990
12	Ridi Hydropower Development Co. (P.) Ltd.	Ridikhola	Gulmi	2400
13	Niltara W&E (P.) Ltd.	Rigdikhola	Chitwan	1500
14	Friendship Hydropower Co. (P.) Ltd.	Belkhukhola	Dhading	2200
15	Rambeni Hydropower Development Co. (P.) Ltd.	Piluwakhola	Sankhuwasabha	480
16	Kolfu Hydropower Co. (P.) Ltd.	Kolfukhola	Dhading	1400
17	Seti Hydropower Development Co. (P.) Ltd.	Upper Seti-1	Kaski	9050
18	Mount Hydropower Co. (P.) Ltd.	Manaharikhola	Makawanpur	5000
19	Mansarowar Powers (P.) Ltd.	Golmagad	Doti	400
20	Syange Bidyut Company	Tatopanikhola	Lamjung	210
21	Task Hydropower Co. (P.) Ltd.	Seti – II	Pokhara	978
22	Kanchan Multipurpose Hydropower (P.) Ltd.	Upperjogmai,	Ilam	435
23	Kankai Hydropower Development (P.) Ltd.	Jogmai	Ilam	999
24	Gopy Binayak Hydropower Project (P.) Ltd.	Gopikhaol	Dolakha	955
25	Welcome Energy Development Co. (P.) Ltd.	Lower Balehpi	Sindhupalchok	4990
26	Gyatri Hydropower (P.) Ltd.	Charanawati	Dolakha	1000
27	Shreerup Hydropower (P.) Ltd.	Setikhola	Chitwan	338
28	Roshi Hydropower Co. (P.) Ltd.	Dapcha	Kavrepalchowk	3200
29	Himalayan Energy Development Co. (P.) Ltd.	Upperjhimruk	Pyuthan	990
30	Kathmandu Small Hydropower System	Salinadi	Kathmandu	232
31	Garjang Upatyaka Hydropower (P.) Ltd.	Chakekhola	Ramechhap	990

S N	Name of Company	Name of project	Location	Installed capacity (KW)
32	Arun Valley Hydropower Development Co. (P.) Ltd.	Upper Puluwa khola	Sankhuwakhola	5000
33	Mankamana Power Co. (P.) Ltd.	Upper roshi –III	Kaverpalchowk	4800
34	Unified Hydropower (P.) Ltd.	Patikhola	Parbat	1000
35	Mansarowar Power (P.) Ltd.	Lipinkhola	Sindhupalchowk	1233
36	Ghumte Hydropower (P.) Ltd.	Daramkhola	Baglung	3000
37	Shivani Hydropower Co. (P.) Ltd.	Phawakhola	Talpeljung	2080
38	Himalaya Energy Development Co. (P.) Ltd.	Dharmawatikhola	Pyuthan	200
39	TMB-Energietechnik	Narayani-Shanker Biomass Powerplant	Rupendehi	500
40	Dolkha Nirman Co. (P.) Ltd.	Maikhola	Ilam	1900

NEA seems to be constrained by resources. Thus, it is unable to materialize its desire of implementing some projects on its own. It has also repeatedly expressed its desire to join hands with private parties to execute small as well as medium scale projects. Available information reveals that about 40 percent of NEA's annual income of NR 12 billion is spent on power procurement from Khimti and Bhote Koshi power projects and the rest is spent on debt servicing, royalty and as operating expenses. NEA is reported to have incurred a huge loss of NR 2 billion last fiscal year. It is definitely in dire need of resources to execute power projects, which is also corroborated by the recent news that NEA will issue with the consent of HMG/N, "power bonds" in the amount of NR 3 billion and will provide a return which could range between 5 to 7 percent.

EPF should work; it is suggested, in close cooperation with NEA and the parties (promoters) concerned to provide the much needed resources for the power sector. In the face of a serious situation of conflict in the country, foreign investment is not likely to flow into Nepal and power sector cannot be an exception. Therefore, the pragmatic approach would be to expedite implementation of small-scale hydropower projects using indigenous resources. It is where EPF's resources can be gainfully utilized. Moreover, EPF should take the initiation of forming a consortium of resourceful non-bank financial institutions such as Citizen Investment Trust, National Insurance Corporation (NIC), and Nepal Telecom (not a financial agency), Postal Savings Bank to seriously start appraising small-scale hydropower projects.

EPF may wish to purchase the reported "power bond" in large sums, if made available both to institutions and individuals because the rates to be offered (5 to 7 percent) is definitely going to be higher than the rates that banks are offering EPF on time deposits. A better option, however, would be to get into direct lending (to power projects) and earn a return which could be anything between 9 to 10 percent.

### **Infrastructure Financing**

EPF could also get into financing of toll highways, tunnel ways and construction of bridges with assured return. In cooperation with private sector, EPF could embark on a program of constructing about 10 kms of toll road to ease the traffic problem that the valley is experiencing these days or starting work in any road of short length and high traffic. EPF

management may wish to participate in the development of following transport infrastructure in Nepal:

Katmmandu -Terai fast track road and railway

Kanti Rajpath (60 KM)

Biirgunj – Jeetpur road (19 KM)

Sitapaila – Dharkhe road (25 KM)

Kathmandu Outer Ringroad (72 KM)

Further, EPF could consider using its funds in the construction of airports, overhead bridges, bus parks, and installation of cableway/ropeway of short length on Develop, Maintain, Manage and Transfer basis or along Develop, Operate and Transfer line. CIT could be made a partner in such endeavors taking full cognizance of the norms prescribed by NRB with regard to lending, loan classification, provisioning and recovery. Since these agencies are not currently under the regulatory jurisdiction of NRB, an adherence to NRB prudential norms is not mandatory in case of these non-bank financial institutions.

### **Housing Scheme**

Although considered unproductive, EPF has already done some exemplary work in this field e.g. one in Pokhara and in extending housing loans to its members. With the completion of the proposed outer ring road for the valley, new areas will be opened up for settlement often leading to the emergence of unplanned dwellings in different pockets. To avoid the recurrence of what happened after the construction of the current ring road. EPF could play a major role in developing settlements in planned way. EPF's intervention would also help check undesired skyrocketing of land prices in newly opened-up areas.

### **Investment in Government Bonds**

EPF has invested in government securities since long. Falling yields on government bonds, however, do not make it an attractive portfolio of investment for EPF. The yield on 10-year bonds has fallen to 5 percent. In the event of inflation level rising above 5 percent which is likely to happen, this yield will become negative. The rate offered by government is not likely to increase because it has not been able to spend the sum allocated under development/capital outlays head in annual budgets. Gross internal borrowing has declined from NR 120 million in 2000/01 to NR 60 million in 2004/05. Further, government has not taken resort to overdraft borrowing after 2001/02 and has maintained huge cash balance with Nepal Rastra Bank. Net internal borrowings as a proportion of GDP have declined over time (Table 1.14). Therefore, with no development projects of sizable nature in pipeline and also the hostile environment impending execution of development projects, HMG/N is not likely to resort to heavy internal borrowing pushing rates high and thereby benefiting agencies like EPF. It will therefore be wise for EPF to invest its resources in government papers only in moderation.

**Table 1.14: Government Borrowing**

NR in Million

<b>Types of Borrowing</b>	<b>2000/01</b>	<b>2001/02</b>	<b>2002/03</b>	<b>2003/04</b>	<b>2004/05</b>
Internal Borrowings	5581.4	7970.8	8736.3	5724.0	9003.0
OD	6546.7	5898.3	-461.7	-753	-270.0
Gross Internal Borrowings	12128.1	13869.1	8274.6	4971.0	6301.0
Repayment	1190.0	1683.6	4063.3	504.0	3465.5
Net Internal Borrowings	10938.1	12185.5	4211.3	-58.0	2835.5
GDP at producers Price	411275	422807	456675	495589	529003
Gross internal borrowings as a % of GDP	2.95	3.25	1.81	1.00	1.19
Net Internal borrowings as a % of GDP	2.66	2.88	0.92	-0.01	0.54

**Development (Finance) Company**

Despite being a powerful agency in term of deposit mobilization, EPF does not have the flexibility of a bank or for that matter even a non-bank financial institution (finance company) in sanctioning loans to worthy clients. Whatever loan schemes it has formulated and implemented are narrow based in the sense that such loan services can be provided only to its members. It may be wise for non-bank financial institutions such as EPF, CIT and Postal Savings Bank to join hands in opening a non-bank financial institution which would, among other things, provide funds for infrastructure development projects, power projects and housing development as recommended earlier.

Participation in such an endeavor, either through equity participation or through special agreement of such agencies of Nepal telecom and NEA would also be highly desirable. Alternatively, EPF could be converted into a specialized development finance agency with the participation of aforesaid agencies in its equity.

**Regulatory Body**

It is suggested that HMG/N while creating a regulatory body for EPF, CIT and Postal Savings Bank as envisaged in the recently made public budget for 2062/63 (2005/06) also give proper attention to the need for evolving EPF into a specialized financial agency, giving it more freedom to widen its operation in terms of serving a wide range of cliental group. As per the envisaged regulatory body for the these non-bank financial institutions, Nepal Rastra Bank can be trusted with this responsibility as it has separate inspection and supervision department for non-bank financial institutions. Further, NRB could also be asked to look into the possibilities of (a) creating a specialized financial institution with the participation of EPF, CIT and Postal Savings Bank, and (b) converting EPF into a development finance agency and having CIT and Postal Savings Bank as stake holders in its new capital structure. Suitable legislative changes could be introduced in the respective acts through ordinance It may also be mentioned that savings and loan cooperatives not licensed by NRB also do not have a regulatory body. Dozens f cases of fund embezzlement have been reported in these

agencies. It would be unwise to have these left unchecked. HMG may also consider creating a separate body for CIT, EPF, and postal savings bank including these cooperatives. It has been stated by the concerned authorities of EPF that work on the amendment of the existing act has begun. It is hoped that necessary changes will be made to provide at least more autonomy to this body even if the suggestion on merger, umbrella act ,etc are not entertained.

### **Revisiting Investment Portfolios**

EPF should aim at maximizing return on contributor's money and be of some help in pushing Nepal's development process pursuing a prudential investment policy. In view of EPF's huge resources (NR 40 billion as deposits) and competition it is facing from employer-based schemes and also from other private financial institutions which have floated very attractive schemes, it cannot afford to remain static. It has embodied changes in recent years both in areas of investment decisions and organizational restructuring. This has to continue keeping in mind different alternatives recommended above.

Total loans and investment of EPF stand at about NR 39 billion, about NR 16 billion being in the form of time deposits from which returns have drastically fallen over time notwithstanding a sharp increase in the money deposited with commercial banks from NR 11 billion in 1998/99 to NR 16 billion in 2003/04. Since banks are reported to be awash in liquid funds, a phased withdrawal program that would draw about 30 percent of NR 16 billion in about two years time would not jeopardize the liquidity position of commercial banks. It may, however, be suggested that EPF management takes into confidence the management of RBB, the largest holder of EPF's time deposit, whenever a decision on withdrawing sizable sum from this bank has to be made. An examination of EPF's investment portfolio clearly suggests that time deposits with the financial institutions should be reduced for investment into new ventures involving minimal risk and providing much higher return on EPF's money. It may be mentioned that EPF has reduced the level of deposits with banks: from 65 percent five years earlier to 35 percent of total investment portfolio in 2002/03.

It has already been stated that EPF should invest in government papers only in moderation and if at all possible should not cross the current investment of NR 510 million because the rates are not attractive and also that EPF would need funds for its own use if it decides to get into broader lending programs under the proposed new set-up. It is likely that NEA will issue "power bonds" with duration of 20 to 30 years to mobilize resources from the market to fund execution of power projects. In making any decision on this front EPF will have to carefully study the yield and level of inflation.

EPF has also invested in the equity of some financial institutions, a total of NR 255 million, returns from which have fluctuated between NR 20 million in 2000/01 to NR 7 million in 2001/02. If EPF decides to become a specialized financial agency with a capital structure that would include stake holders both individual and institutions, then it will have to offload its stake in different financial institutions as required by NRB regulations. Some other portfolios e.g. "loans to depositors" and "loans to employees" could also be revisited in the changed context.

To sum up, EPF is a resourceful agency and its resource base allows it to get into new areas of investment and embark upon any new program, without outside assistance that would further enhance its strength in the gradually evolving competitive environment.

### **Some More About CIT**

CIT is faced with decanting task of providing alternative return to its contributors in the current environment where market rates of interest are on a decline basically due to contraction in economic activities. Selecting an asset portfolio that allows reasonable level of trade-off between risk and return is the issue confronting CIT. Measuring risk in an efficient capital market like ours is a difficult job. Nevertheless, CIT needs to revisit its investment portfolio.

CIT does not have standard accounting policies, no disclosure requirement, and inconsistencies are found in the structure of financial statements. For example, interest on government securities, deposits and T-Bills were reported separately but the current practice has been to show them together under a single heading "interest income". CIT also does not provide for loans granted to HHG and loans are provided for only when they are over due by one year. CIT is getting into aggressive lending therefore it needs to abide by norms prescribed by NRB for financial institutions that it has to regulate and supervise. CIT treats income on accrual basis but no policies are in place for interest suspension in the event of non-realization of interest in the specified time period. Current accounting practices and lack of policies and regulations together cast serious doubt on the reliability of financial statements of CIT. Accounting policies, lending policies, and procedures in conformity with international standard will have to be formulated and practiced. In addition, the following suggestions could be taken into account:

- In order to widen the spectrum of savings mobilization schemes, CIT should introduce new plans to attract units not yet covered by the institution itself and EPF. The scheme may include a pension plan for self-employed persons scattered throughout the country. It may also attract private and partnership firms and private limited companies.
- CIT should set clear and transparent rules for investment of its funds. It also requires the expert manpower to manage the funds, in-house trained or outsourced, in order to make the schemes more popular and investment worthy.
- As a pioneering institution in capital market, it should involve in establishing a separate credit rating agency, deposit insurance and other institutional facilities to create a healthy investment environment.
- The government may wish to review its practice of selling bonds and certificates to targeted institutions as such practices can be distortionary and thus undesirable in the long run.
- The ownership holding of CIT by government and government owned institutions should be diluted to private sector. This could be the opportunity for injection of additional capital to absorb the risk inherent and also making grossly capital short CIT capital adequate in keeping with international norms and practices.

## Policy Action Matrix

### A. Policy

S.N.	Constraints	Policy Improvement	Activities	Indicators	Time Frame	Responsible Agency
1.	Regulatory Body	Review/study by NRB for a regulatory body for EPF and CIT	NRB to do a quick study for establishing a regulatory body	Adherence to prescribed norms	Current F.Y.	NRB and MOF
2.	Investment portfolio	Review investment portfolio with a view to ensuring safe and productive lending	EPF and CIT management to do the review	At least 25% increase in hydropower lending	Current F.Y.	EPF and CIT
3.	Creation of a development finance agency with the participation of EPF, CIT and Postal Saving Bank (PSB).	Commission a study to look into the possibility of creating an agency with the participation of EPF, CIT and PSB.	EPF, CIT and PSB to commission the study for submission to MOF	To have a specialized body.	Next F.Y.	EPF, CIT, PSB and MOF.
4.	Diverting resources of EPF and CIT in infrastructure development projects.	Encouraging investment in infrastructure projects.	EPF and CIT management to do the review	At least 25% increase in infrastructure projects by the end of the current F.Y.	Current F.Y.	EPF and CIT
5.	Withdrawal of time deposits from commercial banks.	Encourage investment in attractive projects.	EPF and CIT management to do the review	25% of time deposits to be withdrawn.	End of current F.Y.	EPF and CIT

S.N.	Constraints	Policy Improvement	Activities	Indicators	Time Frame	Responsible Agency
6.	Adherence to acceptable standards on income accounting, provisioning, loan classification and capital adequacy.	Review current practices of EPF and CIT by a body consisting of representations from NRB	The proposed body to do a quick study (3 months)	Adherence to acceptable standard.	End of Current F. Y.	MOF, NRB and CIT
7.	Divesting government stake in CIT	Divest government stake to ensuring private sector participation in the management of Trust.	HMG/MOF to take the decision.	Government remains a minority partner.	To start by the end of current F.Y.	CIT and MOF

#### B. Bad Debts and its Recovery:

S.N.	Constraints	Policy Improvement	Activities	Indicators	Time Frame	Responsible Agency
8.	Recovery to be carried on a war footing basis	Have proper assessment of bad debt position	EPF and CIT management to work hard to recover bad debts, hitting hard the willful defaulters.	Reduce NPA level by 5% (at least) by the end of the current FY	To continue	EPF and CIT

#### C Institutional

S.N.	Constraints	Policy Improvement	Activities	Indicators	Time Frame	Responsible Agency
9.	Hiring of professional manpower	Review the current manpower position	Introduce VRS, hire CAs and MBAs	Rightsize the institutions and hire professional staff by the end of current FY	End of current F.Y.	EPF and CIT

10.	Equipping EPF and CIT	Offices of EPF and CIT to be equipped	Procurement of computer and other equipments.	Equip the offices at the earliest possible time.	End of current F.Y.	EPF and CIT
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#### D. Legal

S.N.	Constraints	Policy Improvement	Activities	Indicators	Time Frame	Responsible Agency
11.	Legal aspects	Review acts of EPF, CIT and PSB	A team of expert to review the acts in light of the recommendations made	To carry out recommendations	Study to be completed in six months.	EPF, CIT, PSB and MOF
12.	Amendments / Umbrella Act.	Review recommendations of the team	HMG/MOF and Ministry of Law and Justice to review the suggestions.	Changes or formulation of a new act is done and passed by the cabinet before the first half of next FY	First half of next FY	MOF, Ministry of Law and Justice, EPF, CIT and PSB.