

4. Money, Banking and Credit

Policy on Monetary and Financial Sectors

- 4.1 Nepal Rastra Bank (NRB), as per the provision of Nepal Rastra Bank Act, 2002 had announced the Monetary Policy for FY 2004/05 on 19 July, 2004. The main objective of the policy has been maintaining price stability and reasonable Balance of Payments surplus. The level of inflation and balance payment surplus has been expected not to exert pressure on the prevailing exchange rate leading to a reasonable level of real exchange rate. In addition to this, in the context of present monetary and fiscal situation, the stance of monetary policy of FY 2004/05 is to maintain the macroeconomic stability, and make the reasonable level of liquidity necessary for economic activities without disrupting Balance of Payments situation and price stability. Similarly, monetary policy aims at using monetary instruments for the stabilization of financial sector as a vehicle of monetary expansion. The monetary policy of FY 2004/05 has taken accommodative position in the context of low economic growth rate.

Box 4(1)

Monetary Policy and Program for FY 2004/05

- a. While formulating the monetary policy for FY 2004/05, its objective has been clearly specified together with the monetary strategy, instruments and implementation strategy to achieve the said objective, in compatibility with the fiscal policy of HMGN.
- b. The main objective of monetary policy is to maintain price stability and consolidate the BOP with the purpose of helping achieve the targeted economic growth rate. Similarly, special emphasis has been given to the implementation strategy of monetary policy to maintain overall economic stability.
- c. The excess liquidity of commercial banks is taken as the operating target of monetary policy. In order to monitor and forecast short-term liquidity position, the Liquidity Monitoring

and Forecasting Framework (LMFF) has been put into operation with effect from July 15, 2004. To facilitate the same task, an inter-departmental liquidity monitoring working group has already been formed. In addition, a high-level monetary management committee has also been constituted to provide policy guidance in different aspects of monetary management including the operations of LMFF

- d. In order to analyze the monetary situation, a third monetary aggregate, M_3 (M_2 with foreign currency deposits) will be compiled by incorporating foreign currency deposits and it will be taken as a measure of monetary liquidity.
- e. The NRB mops up liquidity through outright sale in the secondary market if commercial banks bid below the rate as shown by the yield curve, whereas it injects liquidity through outright purchase after adding some percentage points (currently 2.0 percentage points) to the yield curve rate. In addition, the NRB has been observing liquidity through the tap sale. The NRB, from now on, will fix the quantities for outright purchase auction, sale auction and repo auction based on LMFF and depending upon the trends of monetary targets by abolishing the existing provisions. The secondary market interest rate will be determined by the market, based on the quantities fixed for such transactions. Earlier, the commercial banks used to take initiative for open market transactions and now NRB is taking initiative on the basis of liquidity position in the market. This new provision will help make the process of deregulated interest rate regime, which was initiated in September 1989, more effective.
- f. Treasury bills with different level of maturities (28-day, 91 days, 182 day, and 364-day) will be open for outright purchase and sale in the secondary market. However, priority will be given to the issue of short-term treasury bills so as to influence the overnight inter-bank rate and make the secondary market operations more effective. In the secondary market outright sale and purchase, the time framework for repayment does not arise because of the changes in ownership but the maturity period of repo under the secondary market auction transaction has been kept unchanged from the existing 1 to 7 days.
- g. The standing liquidity facility (SLF) provided by the NRB to

the commercial banks for 1 to 7 days to meet their short-term liquidity requirement through repo has been abolished. Instead, a new separate permanent SLF has been arranged. The quantity of this new SLF will be determined on the basis of the total securities of HMG under the ownership of commercial banks. The quota of total SLF will be set for each of the commercial banks on the basis of the above-mentioned criterion.

- h. Loan under the SLF will be automatically made available and it will be fully collateralized. The collateral for this type of loan will be treasury bills and development bonds of HMG. Under this provision, the loan will be provided up to 90 percent of the face value of the collateral. As the SLF is the alternative to the secondary market sale of treasury bills and inter-bank (money) market borrowing, the rate on such facility will be a penal rate. Therefore, with a view to controlling the misuse of the facility and preventing adverse effect on secondary market and inter-bank transactions, the open market operations committee will fix the rate on such facility by adding certain percentage point on the last auction rate of 91-day treasury bills. Its maturity period will be only 1 to 5 days.
- i. The auction rate of secondary market outright sale will as a floor rate in short-term money market, whereas the rate determined under the SLF will act as the ceiling rate. These two rates would act as a tunnel corridor within which the inter-bank transaction rate is expected to be remain.
- j. The NRB made public the issue calendar for the mobilization of domestic borrowing by HMG so as to make appropriate management of monetary liquidity. However, some difficulties arose in monetary liquidity management since the domestic loan could not be collected as specified in the issue calendar as the amount of domestic loan as budgeted was not required by HMG during previous year. Various distortions can emerge in the economy if monetary liquidity is not managed properly. As such, NRB will arrange to mobilize total domestic borrowing for FY 2004/05 as per the issue calendar of NRB.
- k. As per the provisions of the NRB Act, 2002, except for monetary management purposes, the government securities under the ownership of the NRB should not exceed 10 percent of the net government revenue of the preceding year. While the

NRB is required to sell the government securities in excess of the amount as prescribed in the Act. However, Non-marketable securities of Rs. 864 million are under the ownership of NRB. NRB will convert such non-marketable securities into marketable ones so as to keep government securities under the statutory limit and to facilitate the task of mopping up of the excess liquidity of the commercial banks.

- l. Currently, HMG does not provide government enterprises guarantee for bank loans. However, some loans used by the government enterprises under government guarantee in the past are yet to be repaid. The interest rate charged on such loans being higher than the current market interest rates has led to the successive increase in the interest obligation of such enterprises over the years. If the total loan including principal and interest under such guarantee is converted into short-term securities and is made marketable, the future loan obligation of the government will be reduced due to the existing low short-term interest rates. The financial position of the banks will also improve when they receive these amounts. The NRB will have extra securities in open market for liquidity and monetary management. Therefore, it is required to issue ad-hoc treasury bills equivalent to the said loan amount.
- m. Development bonds of HMG will be issued in the primary market through a auction process and the secondary market transactions will be allowed through the Nepal Stock Exchange Limited. These development bonds will be issued as coupon bonds and an arrangement will be made to issue these bonds on a uniform price through price auction. Though these bonds will be opened through the Stock Exchange in the secondary market, an arrangement will be made to accept these bonds as collaterals for repo transaction and to provide standing liquidity facility to the commercial banks.
- n. Since FY 2001/02, an arrangement of the refinance amounting to Rs. 2.25 billion was made for commercial banks and Development Banks for the rehabilitation of sick industries. Of this refinance amount, Rs. 635.1 million was sanctioned for industries in FY 2003/04 as of mid-July 2004 including those in the industrial districts. A total of 146 enterprises, 114 hotels and 32 industries, have benefited from this provision in the form of

interest subsidy of Rs. 62.1 million during the past three years. In this context, refinance facility of Rs. 1.0 billion is arranged following the same criteria and procedures for FY 2004/05. The refinance rate for this facility has been revised downwards to 1.5 percent from the existing 2 percent. When the commercial banks utilize such refinancing facility, the interest rate for the borrower would have to be maintained at 4.5 percent.

- o. In order to manage the credit information system of Banks and Financial Institutions, to extend necessary information to the concerned parties, to prepare and update the black-list of credit misuses and to broaden the scope of credit information, the existing Credit Information Bureau (CIB) will be replaced by a new CIB in the form of a company in the current fiscal year.
- p. Arrangement has been made for the regulation, inspection and supervision of the Small Farmers Cooperatives, previously under the supervisory purview of the NRB, through the Small Farmers Development Bank (SFDB). For the remaining cooperatives and non-bank Financial Institutions licensed, and presently inspected and supervised, by the NRB, an arrangement will be made to establish a separate, second-tier institution responsible for the supervision of these institutions. An institutional arrangement will be made for regulation, inspection and supervision for the cooperatives established and operated under the Cooperative Act, 1991.
- q. The expansion of micro-finance services is necessary for reliable and accessible means of credit to deprived people of rural area and also for the institutional development of rural credit. A National Micro-finance Policy will be formulated in FY 2004/05 since the Financial Intermediation Act, 1992 seems to be insufficient. Similarly, as there is an utmost need of providing access to alternative energy in the rural areas, priority will be given to the establishment of rural micro-finance institutions and arrangements will be made to invest in alternative energy through these institutions.
- r. The International Forum for Inspection and Supervision, Basel Committee on Banking Supervision, has made a provision for Minimum Capital Fund (Basel II), effective from 2007. For the effective execution of the New Capital Accord (Basel II) in the context of Nepal, the concept paper prepared by the New

Capital Accord Implementation Preparatory Core Committee will be continuously improved in accordance with the revisions made by the Bank for International Settlements (BIS).

- s. In place of the present NRB practice of directly receiving from the public the soiled notes and exchanging them, this function will henceforth be handed over to the private sector. This new arrangement will involve the private sector in the note exchange function in addition to facilitating this function even in places where NRB offices are not located. Individuals or entities willing to take up this work need to obtain NRB approval and the note exchange work will be carried out only through the approved individuals or entities.
- t. Currently, there is an arrangement of providing exchange facility up to US\$ 500 through commercial banks to individuals and institutions for different purposes. This arrangement helps smoothen the payments system in small amounts and facilitate the general public at large. To make this arrangement easier and more convenient, such limit is to be revised upwards to US\$ 1,000 from FY 2004/05.
- u. The volume of paper-work these days is rapidly increasing due to increase in the number of Nepalese Nationals visiting abroad. As the current monitoring process regarding the repatriation of air tickets seems cumbersome, an arrangement for automatic payment of such repatriation to come into force effective from FY 2004/05.
- v. The existing provision allows repatriation of business class air tickets for only specified officials visiting abroad. In the backdrop of the evolving liberal stance of the foreign exchange management policy, all Nepalese nationals will henceforth be allowed to travel abroad on business class air ticket.
- w. If any amount collected in the foreign agency account of the commercial banks could not be paid for some reason, NRB approval is required for remitting the sum if it amounts to US\$ 2,000 or more under the existing arrangements. From now onwards, arrangement will be made to remove such limit and to remit such sums by the concerned commercial banks themselves.
- x. As per the existing provision, individuals or institutions having

convertible foreign currency deposit accounts in commercial banks are not eligible to make payment in foreign currency in Nepal. From now onwards, this restriction will not be applicable if the recipient is a government body.

- y. Under the existing arrangement, the maximum period that the commercial banks could invest convertible foreign exchange received under the foreign currency deposit accounts of individuals and institutions is one year. From now onwards, this limit is removed.
- z. Of the cash US dollars submitted by the commercial banks to the NRB, 98 percent, after deducting 2 percent, has been deposited in the US dollar account as maintained in the NRB by the respective commercial banks. Effective from this year, the following arrangements will be implemented in the case of convertible currencies other than the US dollar:-
 - (i) The amount of rupee will be counted at the existing buying rate
 - (ii) After deducting 2 percent, 98 percent of such rupee amount will be deposited in the US Dollar account of the commercial banks.
 - (iii) For this purpose, the buying rate of the US dollar shall be used.
 - (iv) As there will be no need for the commercial banks to maintain foreign currency account other the US\$ account, all such other accounts will be closed.
- aa. If an individual has obtained foreign currency credit card under the existing provision, such individual from now onwards could utilize the foreign currency available, under the allowable exchange facility, in the form of credit card/debit card in addition to the cash or the travelers' cheques. Besides, on the conditions of subsequent settlement in foreign currency itself, if the commercial banks so wish, a policy provision of issuing credit card/debit card with an expenditure limit of US\$5000 will be made.
- ab. If a Nepal-based licensed agent/representative of any money transfer company needs bank guarantee for the purpose of receiving advance payment from the principal company, a policy provision of making such facility available within the

specified limits, directly from the commercial banks will be initiated in FY 2004/05. This provision is expected to facilitate the licensed agents in making immediate payments of the remittance to the concerned parties.

- ac. As in other Central Banks, some portion of the gross foreign exchange reserves of the NRB is in the form of the gold. With the recent developments in financial markets, gold can also be placed a interest-earning deposit. NRB will be earning interest in the coming years through deposits of gold lying abroad in its ownership. For investment in the international market, the purity and size of the gold should be that of the international standard. However, most part of such gold stock in Nepal is not as per the international standard. So, the NRB is studying different alternatives of investing the gold and earn interest from it.
- ad. There is no policy provision for Nepalese entities to invest and establish offices abroad for the management of foreign exchange. In the light of the globalization and, especially, as Nepal has become a member of the WTO, in addition to opening the Nepalese market to the foreigners, it is also high time for opening the foreign markets to the Nepalese enterprises. In this context, a policy provision about the alternative arrangements for the Nepalese entities to set up offices/representative offices abroad as well as to invest abroad will be formulated.
- ae. In the context of the facility of inter-bank buying/selling transaction in Indian currency (IC) to the commercial banks, a policy arrangement will be made in FY 2004/05 for the inter-bank lending/borrowing in IC.
- af. Necessary arrangement will be made with respect to the corrections required on the basis of the study on the effects of the spread between the buying and selling rates as maintained by the commercial banks.

Source: Nepal Rastra Bank

Cash Reserve Ratio and Refinance

- 4.2 NRB changed the mandatory cash reserve ratio effective from mid-July 2003, under the flexible monetary policy regime with a view to

reducing the cost of capital of the banks and promoting dynamism in the economic activities. Accordingly, effective from FY 2004/05, the present provision of mandatory cash deposit to be maintained with the NRB of 6.0 percent of the total domestic liability has been reduced to 5.0 percent giving the continuity of the objective of making it as simplified and integrated. This policy will release additional resources of Rs. 2.0 billion, which will help to reduce the financial intermediation cost to some extent. As soon as the existing adverse situation in the country improves, the possible increment in aggregate demand is expected to be supplemented by this provision. The existing provision of taking the bank rate as an indication of monetary policy stance will continue until the completion of financial sector reform program and full-fledged development of secondary open market operations. The bank rate has been kept unchanged at 5.5 percent in the context that some central bank have raised their bank rates, the price situation has not been fully brought under control, and there exist a challenge of managing the liquidity in the economy for the medium term. Regarding the sectoral refinance rate, the refinance rate for rural Development Banks and export credit in domestic currency including agricultural credit, has been revised downwards to 3.0 percent from 4.5 percent. Similarly, the refinance rate for export credit in foreign currency is kept unchanged at 2.0 percent, with a provision that commercial banks charge no more than 4.0 percent to the borrowers of this facility. The refinance facility for sick industries is reduced to 1.5 percent from the existing 2.0 percent since the FY 2004/05. A total of Rs. 1.0 billion has been allocated for the refinance of such industries.

Box 4 (2)			
Changes in the Cash Reserve Ratio (Percentage)			
Item	2059, Shrawan 6 (Dec. 2002)	2060 Shrawan, 8 (July 2003)	2061 Shrawan, 4 (July 2004)

(a) Cash Deposit mandatory for the commercial banks	-	6*	5*
(1) Total domestic current and saving deposit liability	7.0	-	-
(2) Total domestic fixed deposit liability	4.5	-	-
(b) Cash in vault	2.0	-	-

**in aggregate*

Source: NRB

Other Monetary Instruments

4.3 Although in FY 2003/04 the inflation rate was 4.0 percent and a substantial amount of Balance of Payments surplus of Rs. 16 billion, the economic growth rate was only 3.5 percent. In this context, the mandatory cash reserve ratio was reduced by 1 percentage point at the start of FY 2004/05 with the objective of expanding economic activities by increasing investible funds of commercial banks, and helping to reduce the cost of such resources. Such policy was adopted in conformity with the stance of NRB for monetary ease. The weighted average interest rate of 91 days treasury bills was 0.62 percent and 0.63 percent in mid-August and Mid-September 2004 respectively, as a first impact of decrease in mandatory cash reserve ratio and also because of seasonality. After this, the liquidity of commercial bank was absorbed by open market operation and due to which NRB was able to maintain Net Domestic Asset (NDA) within the limit set under PRGF. The interest rate of 91 days treasury bills was gradually increased by the increase in consumption loan flow of all commercial banks and improvement in their liquidity position. As a result, the average interest rate of 91 days treasury bills reached to 3.8 percent in the first week of June 2005.

4.4 In order to monitor and forecast weekly liquidity position and effectively manage the Open Market Operations, the Liquidity Monitoring and Forecasting Framework (LMFF) has been made operational effective from July 15, 2004. On the basis of this structure,

Rs.10.50 billion liquidity was mopped through auction sale and Rs. 1.31 billion worth liquidity was pumped through auction purchase in first week of June 2005. Similarly, Rs.6.36 billion worth liquidity was floated through repo and Rs. 5.27 billion worth liquidity was mopped through reverse repo auction.

Box 4 (3)

Money Demand in Nepal

- a) Theoretically, demand for money is determined by income, interest rate, expectation of inflation, banking development, money substitution, distribution etc. However, only GDP and interest rate are considered as major determinants of money demand.
- b) The money demand function in Nepal is estimated on the basis of real GDP and interest rate of 1-year term fixed account. The sample period for the study was FY 1974-75 to FY 2003/04. The nominal value of M_1/M_2 was converted in real term on the basis of GDP deflator. Following is the result of empirical estimation.

$$\ln(\text{real } M_1) = -6.75 + 1.05 \ln(\text{real GDP}) - 0.04 (\text{Interest rate})$$

(-5.87)* (11.76)* (-4.66)*

Adj. $R^2 = 0.99$, $DW = 2.76$,

F-Statistics = 1441.7

$$\ln(\text{real } M_2) = -11.2 + 1.5 \ln(\text{real GDP}) - 0.03 (\text{Interest rate})$$

(-9.30)* (15.8)* (-3.90)*

Adj $R_2 = 0.99$, $DW = 2.51$, F-Statistics 2401.1

* indicates significance at 1.0 percent level.

The above equation shows that the income elasticity for M_1 is 1.1 and for M_2 it is 1.5.

Source : Nepal Rastra Bank

- 4.5 Since FY 2004/05, the commercial banks will receive the pledgeable but directly available permanent liquidity facility. Under this

arrangement, in order not to have negative impact on the internal payment system, credit up to 50 percent of the face value of collateral government securities was provided. Commercial banks have frequently utilized this permanent liquidity facility and the cumulative credit until the first week of June 2005 has been Rs. 45.84 billion.

Box 4(4)

Inflation Targeting as a Monetary Strategy in the Context of Nepal

- a) Developed and emerging 22 countries had adopted monetary strategy as inflation targeting and are also able to maintain price stability. The initiation of debate regarding whether to adopt or not the strategy is natural, as the main objective of monetary policy is to maintain price stability. The demand for money, especially in developed countries, will be instable in the process of development. As such it was found difficult to execute monetary aggregates as targeted strategy. Similarly emerging states adopted monetary strategy based on targeted inflation as nominal anchor, instead of fixed exchange rate system. In this context the monetary strategy of such type is found as successful.
- b) In the context of Nepal, the demand for money is fixed and the exchange rate of Nepalese currency pegged with Indian currency has helped to create the environment for economic stability. On the other side, some terms and conditions should be fulfilled to adopt inflation targeting monetary policy.
 - First, price stability should be the only one objective of monetary policy under the monetary strategy based on targeted inflation. It will be difficult to take price stability as only one objective of monetary policy, observing the economic structure of the country and the factors affecting the price.
 - Second, Monetary authority will be considered as responsible to maintain the price stability, under the monetary strategy based on targeted inflation. Governor of Central Bank should take the responsibility in case of inability to maintain the targeted inflation set by monetary policy. Interest rate fluctuation, considering the

economic condition of the country, was required to maintain the targeted inflation. Country like Nepal, where the private sector is just in the process of getting established, could not be able to adopt such mechanism.

- Third, under such strategy, monetary instruments should be handled by keenly observing the gap between targeted inflation and projected inflation rates. For this, monetary authority should have the capability to project inflation accurately. The projection of accurate price situation would be difficult in Nepal where the price is highly affected by supply side and the regulation of supply is not fully in the government's hands.
 - Fourth, NRB itself cannot measure the price situation if monetary policy based on targeted inflation is adopted. A separate, capable independent institution, outside NRB, is required for collection of data on price, processing and publication. It will not be easy to make such arrangement immediately and as such, not necessary to change the present strategy.
- c) Exchange rate flexibility will be necessary if capital account is made fully convertible along with the fiscal liberalization. Inflation targeted monetary policy as a nominal anchorage will be appropriate and necessary if flexible exchange rate is adopted.

Source : Nepal Rastra Bank.

- 4.6 With a view to channeling the resources to the rural sector and provide capital for the longer term to the national priority sectors, NRB is contributing 5.00 percent of its profit to Rural Self-reliance Fund (RSF). Accordingly, it has deposited Rs. 78.6 million on the RSF from the profit of FY 2003/04. As of today, NRB has deposited Rs. 253.4 million in this fund. RSF is in the process of being converted into a Financial Institution providing wholesale micro credit.

Priority Sector Lending

- 4.7 Directed program like priority sector lending cannot be said to be compatible to the expansion and development of financial sector and

liberal economic policy. Moreover, with the objective of encouraging commercial banks to manage their businesses in a professional way and use the indirect rather than direct tools of monetary management now is found to be more effective, priority sector lending will be gradually phased out by FY 2007/08. Accordingly, commercial banks are required to lend minimum of 4.0 percent of the total outstanding loan amount to priority sector in FY 2004/05. However, the mandatory loan flow to the deprived sector has been continued with variable ratios of 0.25 percent to 3.0 percent for the new and the old banks.

Box 4 (5)				
<u>Priority Sector Lending</u>				
	Fiscal year			
	2004/05	2005/06	2006/07	2007/08
Percent of total outstanding loan	4	2	2	No longer mandatory

Source: NRB

Financial Sector Reform Program

- 4.8 Although monetary stability has been maintained for the last few years, the financial health of some monetary institutions, as a conduit of monetary policy, has not been satisfactory. Financial Institutions need to be strong and capable of ensuring effective execution of monetary policy and maintaining financial stability, which is one of the major objectives of the policy itself. Financial Sector Reform Program is being implemented for strengthening the financial sector. Bank and Financial Institutions Ordinance 2003, which was introduced as an

umbrella Act by repealing various related Acts, has been amended in 2004 by eliminating weaknesses observed during its implementation, revised and amended accordingly, and brought into operation

- 4.9 A regulatory system of international standard has been formulated by engaging international consultants since last two years in order to improve the regulatory capacity of NRB so as to ensure a healthy and competitive banking system by keeping pace with the technological advancement in this sector. In addition to this, guidelines for the field level inspection and supervision has already been prepared and executed for the enhancement of the regulatory and monitoring capacity of the Bank. Reengineering NRB is under implementation in the first and second phase of financial sector reform program. IOS partners, a consulting company of USA, engaged for this work since March 2003, have already completed the reengineering work as per the contract with the said company.

Box 4(6)

Reengineering of Nepal Rastra Bank

- a) The Consultants imparted on-the-job training to the personnel of NRB for enhancing efficiency and effectiveness in inspection and supervision work.
- b) External auditors received training with the objective of helping them to perform with efficiency.
- c) Charts of accounts as per the International Auditing Standard (IAS) prepared, and necessary reforms in the present accounting manual is in process for making it IAS-compliant.
- d) Job description of NRB staff prepared and facilities of the bank staff reviewed.
- e) NRB to identify the training needs and organize training to enhance efficiency of its staff.
- f) The agreement period of consulting company appointed for the reengineering of NRB under the first phase of financial sector reform program has been completed. The process for the appointment of new consultant for the reengineering of NRB under the second phase of financial sector reform program is underway.

- g) Public relation unit established in NRB with the objective of keeping the general public informed of the Financial Sector Reform Activities of the Bank..
- h) A foreign IT consultant hired to complete the NRB - IT platform by modernizing Bank's IT system.
- i) Work already initiated for the strengthening of Bankers' Training Center of NRB and for strengthening and modernization of credit information center with the assistance of international level expert.
- j) The work of software and hardware installation in Nepal Bank Limited and Rastriya Banijya Bank initiated by an institution selected through a global tender, for the development of MIS technology to conduct the banking activity in more systematic and satisfactory way.
- k) Arrangement to be made for the appointment of international level restructuring advisor to prepare the basic infrastructure for the purpose of privatization of Nepal Bank Limited and Rastriya Banijya Bank, two large national banks of the country.

Source : Nepal Rastra Bank

Commercial Banks

- 4.10 A management contract was signed between the Management Consultants of ICL Consulting of the Bank of Scotland, (Ireland) Ltd. and NRB on 17 July, 2002 for two years for bringing reform in the management of Nepal Bank Ltd under the Financial Sector Reform Program. After the expiry of the contract on 21 July 2004, NRB has given approval for the extension of the contract period for one year starting from July 22, 2004. Similarly, the contract period for the consultant of Rastriya Banijya Bank management group has also been extended up to 15 January 2006. While extending the contract period, the management cost has been reduced as per the policy of utilizing financial resources made available by DFID and the World Bank economically.
- 4.11 Overall progress made by both of these commercial banks under the restructuring program until now can be considered positive. This is based on the fact that these banks have earned net profits from the FY 2003/04, reduced the volume of negative capital fund, prepared and executed various international level manuals, policy and regulations to

maintain stability of the bank and formulated and executed internationally acceptable working style. Progress made in collecting bad debts, however, is not so satisfactory.

Box 4(7)

Reform Process of Nepal Bank Ltd. and Rastriya Banijya Bank

- a) **Profit situation:** Nepal Bank Ltd, which had incurred the losses of billions of Rupees since the year 1999, has brought down its loss to Rs. 250 million in FY 2002/03. It earned a net profit of Rs. 710 million in FY 2003/04. Similarly, the Rastriya Banijya Bank recovered from its losses of Rs. 480 million in 2002/03 and earned a profit of Rs. 1.2 billion in FY 2003/04.
- b) **Capital fund :** The negative capital fund of both of these bank is improving gradually. After the initiation of restructuring of Nepal Bank Ltd. and Rastriya Banijya Bank, the negative capital fund of Nepal Bank Ltd. declined to Rs. 8.09 billion in mid-July 2004 as compared to Rs. 9.08 billion in mid-July 2003. Similarly, the capital fund of Rastriya Banijya Bank was negative by only Rs. 21.03 billion in mid-July 2004 as compared to Rs. 22.39 billion in mid-July 2003.
- c) **Non-performing Loan:** Although the absolute amount of non-performing loan has not declined, its level has started to decline. The share of Non-Performing Assets (NPA) in the total outstanding loan of Nepal Bank Ltd. has declined to 53.1 percent in mid-July 2004 as compared to 60.5 percent in mid-July 2003. The Management group of Nepal Bank Ltd. has collected Rs. 4.01 billion in cash during the last two years from the total NPA. Similarly, the NPA amount of the Rastriya Banijya Bank has decreased to 57.6 percent in mid-July 2004 as compared to 60.2 percent in mid-July 2003. The management group of Rastriya Banijya Bank has collected Rs. 3.03 billion in cash during the last one and half year from the total NPA.
- d) **Auditing :** In the context that accounts of both banks had remained un-audited since last few years, the audit of Nepal Bank Ltd. for the FY 1999/00, 2000/01, 2001/02, 2002/03 and 2003/04 has been complete after the management contract of the bank. The bank has started publishing the quarterly financial reports regularly, and the details of the audit are being updated. Similarly the new management

of Rastriya Banijya Bank has completed its audit for the FY 2001/02, 2002/03 and 2003/04.

- e) **Human Resources:** Both banks have developed Management Plan, Human Resource Development Plan, and Skill Enhancement Plan for the planned development of necessary manpower in order to bring it to the appropriate level. Staff need assessment is also complete. In order to maintain the number of staff at an appropriate level, Nepal Bank Ltd. has reduced its number of staff to 3,818 by mid-July 2004 from its earlier total of 5,322 by implementing Voluntary Retirement Scheme (VRS). Similarly, Rastriya Banijya Bank has reduced its number of staff to 3,994 by mid-July 2004 from the existing 5,422.
- f) **Operating System and Internal Management:** Management group has developed and implemented various types of plans, policies, and guidelines for making the banking system strong and efficient internally. Specially, lending policy and guidelines have been prepared and implemented for the improvement in loan management. Likewise, asset - liability management guidelines have been prepared and implemented towards the management of asset and liabilities. In addition, Asset Liability Committee (ALCO) has been formed. New accounting guidelines, internal audit guidelines, account heading classification guidelines, portfolio status and plan, budget plan, and strategic plan have been prepared and executed.
- g) **Computer Technology:** Information Technology Plan has been prepared for performing fast and systematic banking transaction through the computer system. Accordingly, computer software and hardware have been procured. Pilot Branch Testing Program has been completed in Nepal Bank Ltd., which is being gradually expanded to other branches. Similarly, this work has been initiated in Rastriya Banijya Bank.

Source :Nepal Rastra Bank.

- 4.12 Management of the Lumbini Bank Ltd. was suspended and taken over by NRB and its operation was handed over to the three-member Management Committee in March 2002 under the provisions of Section 86 (1) of NRB Act, 2002. This was done in order to safeguard the

interest of shareholders and depositors by enhancing the credibility of the financial sector.

- 4.13 Realizing the need of management restructuring for the reform of Lumbini Bank Ltd., term of the Management Committee were extended for the first time for a period of one year (March 2002 to March 2003); second time for 8 months (March 2003 to November, 2004); and third time for maximum of five weeks (up to February 2005). These extensions were made in the context of creating an environment for the bank's operation with the representation of the promoter and public shareholders in the Board of Directors, issuing shares allocated for the public, approving audit report by the Board of Directors with public share holders representation; and forming a new Board of Directors.
- 4.14 After the takeover of the management of Lumbini Bank by NRB, Management Committee was successful in improving the financial position of the bank by restructuring. During the restructuring period, different policy and directives were prepared to maintaining financial discipline. Initiation was taken to replace the existing software by installing integrated banking software with modern facilities suitable to the modern banking system. NRB, after selling its non banking assets purchased by itself and timely completion of primary works for the improvement of the bank, withdrew its suspension in December 2004 and handed over the operation of bank to a seven member Board of Directors with public shareholders representation to create the environment of banking operation in a healthy way. NRB also issued necessary directives to the bank for necessary reforms in different aspects for further sustainability and healthy management.

Box 4(8)

Refinement on the Directives Related to Commercial Banks

- a) For the purpose of maintaining clarity and rationality in the flow of credit of commercial banks and Financial Institutions, the directives regarding the arrangement of credit information and blacklist issued in September 2003 were repealed and new directives were issued with timely revision in June 2005.

- b) Consortium loan directives were issued in June 2005 with the objective of making such loan invested by the Financial Institutions licensed by NRB systematic and effective.
- c) Concerning the risk provision related to restructuring or rescheduling of loans, arrangement was made to treat as a good debt with 1.0 percent loan loss provision in case of those loans where the banks and Financial Institutions have rescheduled and restructured their loans upon the recovery of 100 percent interest. This arrangement was made for the FY 2003/04 only. The benefit accrued from such concession, however, is prohibited from distribution as dividend to their shareholders by treating it as a profit.
- d) The minimum capital fund to be maintained by the banks and financial institutions on the basis of risk provision of weighted asset, which was fixed at 11.0 percent for the FY 2003/04 and 12 percent for FY 2004/05, has been retained at 11.0 (5.5 percent for primary capital fund) percent for FY 2004/05 keeping in view of the present uneasy situation.
- e) Banks and Financial Institutions were directed by NRB to sell, by mid-July 2004, all their share investments in other Financial Institutions. Such Banks and Financial Institutions are required to make 100 percent provision for all such investments that could not be sold within FY 2004/05, except in case where the sale of such share investment is prevented by the prevailing law.
- f) Prior permission of NRB was required if bank and Financial Institutions intended to provide services to their customers during the special occasions like Dashain and Tihar, beyond office hours, and on public holidays. Such provision has been repealed and, such transaction can be made now onwards by giving prior notice to NRB.
- g) As the Credit Information Center Ltd., which was previously under the Bankers' Association, is now registered as a Public Limited Company with the Office of the Company Registrar, the provision for credit information and black listing issued on May, 2004 with the objective of directing the credit flow of the banks and Financial Institutions towards a right and appropriate direction has been refined accordingly.

Source: Nepal Ratra Bank

- 4.15 As per the revised policy, a commercial bank with its headquarters outside the Kathmandu Valley will be allowed to operate its office in Kathmandu and in other parts of the country provided that it is functioning satisfactorily for last 3 years; its minimum paid-up capital is 1.0 billion; and it has met other conditions as prescribed. Any

regional level commercial Bank, which is already in operation, will be given permission, on request, to open its offices in the Kathmandu Valley before it completes its 3 years of operation provided that its paid up capital is in the minimum of Rs.1.0 billion and has also entered into a 3-years term Technical Service Agreement (TSA) with a foreign bank. Other conditions to be met by the banks operating outside Kathmandu for 3 years have been clearly laid down in the revised policy. One of such conditions is that the bank should have earned net profit. According to the policy arrangement for determining the satisfactory transaction of the bank, it is required to earn net profit for at least one year and the financial indicators should be directing towards the profit.

Development Banks

4.16 The number of Development Banks is 25, including Nepal Industrial Development Corporation established under the Nepal Industrial Development Corporation Act (2016 B.S.), Agricultural Development Bank established under the Agricultural Development Bank Act (2024 B.S.), and the Development Banks established under the Development Bank Act 1995 (2052 B.S.) and the Bank and Financial Institutions Ordinance 2004. The number of Development Banks engaged in wholesale and micro credit transactions has reached to 11. Such banks include 5 *Grameen Bikash* (Rural Development) Banks in five development regions established with the participation of NRB and HMG/N, 4 Development Banks established under the private sector for the transaction of Micro-credit, Rural Micro-credit Development Center (RMDC), and Small Farmers Development Bank established at the national level. In the present situation of merger and closure of the commercial banks in rural areas due to the internal conflict, the Development Banks and Financial Institutions opened at regional and local level are providing financial services. In this context, priority has been given to those Development Banks and Financial Institutions

willing to be established in remote and hilly areas of the country for the expansion of additional banking and financial services.

- 4.17 All Financial Institutions are required to obtain license under the section (78) of NRB Act. Earlier, NRB had issued directives on January 2001 pertaining to capital fund, liquidity and institutional governance to all the banks excluding banks engaged in micro credit operations, the ADB/N, and NIDC. Such directive was repealed and International Standard-based directive (1 to 13) was issued in January 2003. Development Bank Directives 2003 (with amendment) have been issued with the following directives based on the suggestions received at the discussion with the executive directors of Development Banks as well.

Box 4(9)

Directives Related to Development Bank and 'B' Grade Financial Institutions

- a) **Capital Fund:** Development Banks and 'B' grade Financial Institutions, were required to maintain primary capital and capital fund at 5 and 10 percent, 5.5 percent and 11 percent, and 6 and 12 percent for Fiscal Years, 2002/03, 2003/04 and 2004/05, respectively. Considering the unfavorable situation of the country, the minimum capital fund required to maintain has been reduced to 11 percent for the FY 2004/05 with the requirement to maintain at 12 percent for FY 2005/06.
- b) **Financial Resources:** The Development Banks can collect deposit through fixed, saving, and recurring deposits and provident fund. The 'B' grade Financial Institutions established under the Bank and Financial Institution Ordinance, 2004 can collect non-interest bearing deposits.
- c) **Liquid fund:** Development Bank and Financial Institutions should maintain 1.0 percent of the total deposit liability and provident fund as mandatory cash in hand, and 7.0 percent of the total deposit liability in liquid assets.
- d) **Loan and advances:** Development Banks and Financial Institutions like commercial banks should also classify loan and advances as good, substandard, doubtful and bad, and maintain loan loss provision of 1.0 percent, 25 percent, 50 percent and 100 percent respectively.

- e) **Per customer loan:** Development Banks can advance per customer, credit and loans facility up to 25 percent for fund based and 50 percent for non-fund based advances. Banks should limit their Bank guarantees within three fold of their primary capital.
- f) **Institutional good governance:** The promoters, directors, and employees should be professional, honest, disciplined, and of high moral for the efficiency enhancement of the Development Banks and Financial Institutions.
- g) **Sectoral loan limit:** Of the total lending by Development Banks and Financial Institutions, they can invest in agriculture, industry, service business, land development and residential houses as well as commercial building construction, poor groups, and commercial sector, up to 60.0, 60.0, 70.5, 50.0, 50.0 and 50.0 percent respectively.
- h) **Investment:** Development and Financial Institutions may execute the policy and process for the investment on government bonds, securities, shares and debentures of organized institutions, only after the approved of their Board of Directors.
- i) **Interest rate:** Development Banks can decide their own interest rates on deposits and loans.
- j) **Branch Office:** Development Banks need to take prior approval of NRB to open any type of branch.
- k) **Sale of Promoters' Share:** Prior approval of NRB is required for the sale and transfer of ownership of promoters' share.
- l) **Auditing:** Auditing should be performed by the auditor authorized by NRB. Such auditing report should be submitted to NRB at least 30 days prior to the Annual General Meeting (AGM) and public notice issued within seven days of completion of AGM.
- m) Arrangement has been made for the submission of financial statements in the NRB prescribed format, for making the financial statements of Development Bank and Financial Institutions clear and transparent.

Source : Nepal Rastra Bank.

4.18 *Grameen Bikas* Banks are the sources for capital and managing credits for rural development. Structural reforms of these banks have been imperative for their effective operations. Accordingly, with the objective of gradual privatization of profit making *Grameen* Banks, Western *Grameen* Bikash Bank of Butwal is already privatized. The process for privatization of Eastern *Grameen* Bikash Bank, Biratnagar is underway. In the process, decision has been made on disposing

56.75 percent share out of 66.75 of NRB owned shares, to sell to the group member of this bank, staff, micro-finance institutions and the general public. Accordingly, application is received for 34.29 percent shares and the remaining shares are also in the process of transfer. It is hoped that the privatization of these banks will help to reduce their financial burden, which is piling up every year. It is also hoped that the development of professionalism and the sense of competitiveness will improve their efficiency in service delivery to their clients.

- 4.19 The Micro-finance program has provided substantial help and facility to the ultra poor families. The Micro Finance Institutes (MFI) are providing door-to-door micro credit services to those ultra poor families who have no collateral guarantees to produce, and are not capable of fulfilling the banking requirements for credit eligibility. Such families are able to create their own assets by paying their micro credits in small installments out of their earnings made by engaging themselves in small entrepreneurial activities. Micro finance institutions have been able to expand the size of their credits along with the size of borrowings of such families growing bigger with their gradual economic well being. In addition, these MFIs have been helping these ultra poor families to be self reliant through the process of social mobilization. Even in the present conflict situation whereby the Banks have closes or merged their branches/sub-branches, these MFIs have been constantly delivering door-to-door micro credit services to the ultra poor communities. Credit recovery rate of these MFIs is above 98 percent.

Box 4 (10)

Classification of Banks and Financial Institutions Based on Paid-up Capital and Other Provisions

The following policy provisions have been made in relation to the classification of the licensed institutions according to the Bank and Financial Institutions Ordinance 2004:

Classification of Banks and Financial Institutions

Class	Required minimum Paid-up Capital				
	National level*	Regional*	4-10 districts*	1-3 districts*	1 district*
A	Rs.1.0 billion	Rs250 million	X	X	X
B	Rs.320 million	X	Rs.50 million	Rs.20 million	X
C	Rs150 million+ Rs.50 million	X X	X X	X X	Rs.20 million Rs10 million++
D**	Rs 100 million	Rs 60 million	Rs 20 million	Rs 10 million	X

*Excluding Kathmandu valley, bordering districts (minimum and maximum) included.

**Financial institutions involved in micro-credit finance.

+ Applicable only to the leasing companies.

++ Limited to one district each of Mid-western and Far Western Regions.

The following policy, while fixing the application fee for licensed institutions, has been in place according to the Bank and Financial Ordinance 2004

- A. Pursuant to section 4(1) of the above-mentioned Ordinance, proposal letter for the opening of a bank or Financial Institutions should be accompanied by an amount equivalent to 0.01 percent of the issued capital.
- B. Proposal letter, for the license to carry out financial transaction under the provision of Section 29(2) of the Ordinance, should be accompanied by an amount of 0.02 percent of the issued capital
- C. In case of the finance companies, which have been given provisional approval upon submission of proposal for license; and those already established as per the prevailing law and have applied for license, shall be required to pay the fee as per the B above.

Source: NRB

Finance Companies

- 4.20 By mid-March 2005, finance companies licensed for financial transaction totaled 59. After the merger of HISEF Finance Company in Laxmi Bank in April 2003, the number of finance company is now 57. Prudential Merchant Banking and Finance Company and Investment

and Credit Finance Ltd. received license for financial transactions in June 2004 and in July 2004 respectively. The head office of these both banks are located in Kathmandu and their authorized capital and paid up capital is Rs. 100 million and 50 million respectively. NRB has revised the existing policy and directives for making the Finance Company and Financial Services as suitable to time, well managed, transparent, secured and reliable.

Box : 4(11)

Improvements in Policy / Directives of Finance Companies

- a) **Capital Fund:** The risk weightage provision for the purpose of calculating capital funds of financing companies is revised as follows:
 - 1. The loan against the collateral of Government securities or NRB securities or on the basis of receipt of fixed deposit of the companies concerned 0.0 percent.
 - 2. Loan against the collateral of receipt of fixed deposit of Financial Institutions licensed from NRB 0.2 percent
- b) **Loan Loss Provision:** As per the directives issued to finance companies on credit and loans, and leasehold assets classification, a rebate was granted for FY 2003/04 wherein such credit, loans and leasehold assets was be considered as good credit with 1 percent loan loss provision, in case of companies restructuring or rescheduling such credit, loans and assets by taking cent percent interest collection. However, it was prohibited to distribute dividend to the shareholders from the profit accrued due to such rebate.
- c) **Reduction in Capital Fund:** In view of present unfavorable circumstances, a provision has been made wherein finance companies only require to maintain a minimum capital fund of 11 percent, (Primary fund 5.5 percent) as a risk weighted asset for the FY 2003/04 and FY 2004/05, against the earlier provision of 12 percent (Primary fund 6 percent).
- d) **Share Investment:** Finance companies required to sell their investment on shares except those prohibited by law, by the end of mid-July 2004. All such investment not sold within the above stated period was required to have cent percent provisioning in FY 2004/05.
- e) **Prior Approval not Required:** The existing provision of requiring prior approval from NRB for finance companies to provide services

during special occasion like Dashain, Tihar and on public holiday, was repealed. Now such services can be provided only by giving prior notice to NRB.

- f) **Financial Source:** Finance companies are allowed to accept deposit not exceeding 2.5 times of their primary capital.
- g) **Liquid Asset and Mandatory Cash Reserve:** In case of mandatory cash deposit by finance companies in the ratio of at least 1.0 percent of their total deposit liability and loan fund to be deposited in NRB, they are now given an option of depositing such cash in a separate current account in one of the commercial banks of their choice. As regards to mandatory cash reserve and liquid assets required for finance companies, the existing provision of inclusion of cash deposit in national level development bank as required by NRB has been revised and such cash be deposited in Development Bank except (Micro Finance Development Bank). Finance companies were required to compulsorily submit the description of cash in their vaults certified by chief executive to Bank and Financial Institutions Regulation and Supervision Departments of NRB.
- h) **Credit and Loans:** Prior to the credit and loans, and leasehold assets rescheduling or restructuring, minimum of 25 percent of the interest due on such transactions should have been realized. But, amendments have been made where capitalization of interest arrears into principal arrears and restructuring or rescheduling of credit has been prohibited. Similarly as regards to the loan swapped by the banks and the Financial Institutions, type of loan swapped should be clearly identifiable in the book with certificates of the bank from which the loan was swapped. And the company taking swaps should make loan loss provisioning according to existing regulation on credit loss provisioning.
- i) **Per Customer Loan:** In this regard some provisions were amended considering customers having related to each other as one group.
- j) **Investment in Promoters' Share:** Finance companies are not allowed to invest as promoters of any other bank and Financial Institutions licensed by NRB.
- k) **Financial guarantee:** Following directives are issued for the arrangement of financial guarantee:
 - 1. Bank and Financial Institutions are also required to have a clear policy on offering financial guarantee services with particular mention of limit, security, margin, power of attorney, as well as on information system in place. Such policy should be

- executed after the approval of Board of Directors of respective company. NRB should be notified of such policy.
2. While preparing the policy of financial guarantee by the Board of directors following procedure should be adopted.
 3. It is required to have loan transaction of the customer with guarantee issuer Bank/Financial Institution. The financial guarantee can be issued by the Bank/Financial Institution to their own customer, in case of not being able to provide additional loan exceeding per customer loan limit.
 4. While issuing the financial guarantee, the Bank/Financial Institutions may issue financial guarantee without exceeding the limit per customer for the transaction which does not involve funding .
 - I. After the lapse of guarantee period of all the guarantee issued prior to this direction, it cannot be renewed, such guarantee cannot be issued as per this direction. If renewed against this direction, cent percent credit provisioning is required.
 - II. This provision will not be applicable for the following guarantee.
 5. Guarantee issued against counter guarantee of internationally graded foreign bank.
 6. Bid Bond
 7. Performance Bond
 8. Prior payment guarantee
 9. Guarantees other than financial guarantee.
- 1) **Retirement fund:** Financial companies may manage retirement fund for other corporate bodies as provisioned in the Income Tax Act, 2001. In case of prior approval required from NRB, only the Finance Company fulfilling the following conditions, can request to NRB.
1. Having primary capital of Rs. 100 million
 2. Indexed in Nepal Securities Exchange Market Ltd., after selling its share to general public.
 3. Having net profit since last three years continuously.
 4. Executed all the existing laws and direction of NRB.

Source : Nepal Rastra Bank.

- 4.21 It is required to have information on all the important indicators of the financial companies to shareholders, depositors, customers, and interested general public in a transparent manner. Arrangement regarding accounting policy and format of financial descriptions to be adopted by financial companies and clear provision of financial interest has been implemented for the purpose of maintaining uniformity in accounting policy and financial statements. Financial interest means holding of 10 percent or more of the total paid-up capital of any firm, company or corporate body by any promoter, director, shareholder holding one percent or more of the shares, or the executive director, or any member of his/her family, or any individual firm, company or corporate body empowered to nominate a director, whether singly or taken together.

Box 4(12)

Provision on Non-Banking Asset

Following directives are issued to Commercial Banks, Development Banks and Financial Institutions with regard to the arrangements on loss of non-banking assets.

- a) The loss arrangement should be made in following ways for the non-banking assets, mortgage accepted by banks and Financial Institutions till the end of FY 2002/03 and not being sold within three years (i.e. up to FY 2005/06).

<u>FY</u>	<u>Loss Management</u>
2003/04	33.33 percent
2004/05	66.67 percent
2005/06	100.00 percent

However, if the duration of period for sale specified in the specific law (7 years for commercial banks and 5 years for Finance companies) is less than three years, the loss management should be made in the following ways.

- If the time set by the law/directives is being completed in FY 2004/05, 100 percent loss provision should be made by the end of FY 2003/04 for such non-banking assets.
- If the time set by the law/directives is going to be completed by FY 2005/06, 50 percent and 100 percent loss arrangement should be made

at the end of FY 2003/04 and FY 2004/05 respectively.

- b) In case of non-banking asset accepted by banks and financial institutions in and after FY 2003/04, the loss provisioning of 25 percent is required for the accepted fiscal year. Loss provisioning for additional three fiscal years should be made as follows:

<u>Year</u>	<u>Loss Arrangement</u>
First Year	50.0 percent
Second Year	75.0 percent
Third Year	100.00 percent

- c) In case of sale of non-banking asset, necessary accounting settlement can be made for the loss provision in the profit and loss account of the same year.

Source: Nepal Rastra Ban

- 4.22 Among the other Banking and Financial Institutions established under the different laws before the execution of Bank and Financial Institutions Ordinance 2003, Development Banks, Finance Companies and Micro Finance Institutions are categorized as 'B' 'C' and 'D' groups. Till the mid-April 2005, the number of Finance Companies belonging to 'B' and 'C' group totaled 23 and 59 respectively. Including 5-Development Banks established with the participation of NRB and HMG, the number of Development Banks, which come under 'D' group are 11. In addition to these, there are 20 financial cooperatives, licensed from NRB for limited banking transaction and 47 non government financial institution, which come under the 'D' group are functioning within the preview of regulation of NRB. The number of Financial Institutions for the collection of savings and providing loans, having licensed under the Cooperatives Act is larger than the institutions licensed from NRB. There is a trend of closures and mergers of branches of *Rastriya Banijya Bank*, Agricultural Development Bank and Nepal Bank Ltd in rural areas because of present conflict situation in the country. In this context, the trend of establishment of rural financial institution is increasing due to the shrink in banking and financial services and increase in demand of

financial cooperatives and non-government financial institutions in rural area.

Cooperatives and Non Governmental Organizations

- 4.23 New Directives were issued in July 2002, for saving and credit cooperative societies (except Small Farmers' Cooperatives) licensed by NRB, for limited banking transactions. Some provisions of such directives have been changed in July 2003. The new directives, effective from mid July 2003, requires such cooperatives to maintain mandatory cash deposit of at least 0.5 percent (revised from 1.0 percent) of the total deposit and credit fund with NRB or with a commercial bank in places where NRB is not present. Regulatory, inspection and supervisory services for 11 Small Farmers Cooperatives have been handed over by NRB to Small Farmers Development Bank effective from April 2003. The cooperatives, licensed from NRB for limited banking transactions, not being able to maintain Capital Fund requirement as set by the directives and the Primary Capital Fund turning negative, has been cancelled. The licenses of National Cooperative Society Ltd. of Lalitpur, Nepal Cooperative Society Ltd. of Kathmandu, and Nava Kshitis Cooperative Society Ltd. of Kathmandu have been revoked in April 2003, May 2003 and September 2003 respectively due either being unable to follow directives and/or grossly violating directives during the review period. Now the number of cooperative societies having licensed for limited banking transaction is reduced to 20 after the licenses of 3 co-operatives societies were cancelled. NRB has continued its decision not to issue license for financial transaction to any cooperatives.
- 4.24 The Number of Financial Institutions engaged in Micro Credit operations is increasing after the implementation of Financial Intermediation Institutions Act (first Amendment), 1999. NGO's licensed from NRB to perform as financial intermediaries has reached 47. During the review period, NRB issued license to *Chimek Samaj Sangh Sanstha*, Kathmandu in September 2004, Self Reliance

Development Centre, Kathmandu and Development Projects Services Centre (DEPROSC-Nepal) Kathmandu in November 2005 for financial intermediation. The rules under the said Act, after its Amendment, has also been revised and implemented since April 2003.

Insurance Companies

- 4.25 Insurance Board is functioning to achieve its objectives set by Insurance Act 1992 for the systematic, regular and developed insurance business. In addition to this, it is also functioning for regulation and supervision of insurance business, fixing the priority area of investment in insurance sector, issue license for the insurance entities and individuals, and mediate between insurers on petition, provide necessary direction to insurance companies, protect the right of insurer and any other function related to insurance. After the membership of WTO, Nepalese insurance business is accessible to foreign insurance companies. As such the process for the revision of Insurance Act, 1992, and Insurance Regulation, 1992 has been initiated as per the need of time.

Box 4 (13)

Policy Approach on Insurance Sector.

The following policy is adopted for the development and expansion of insurance industry.

- a) Execute the field level and non-field level inspection and supervision of insurer with primary importance and take necessary action in issues raised during this process.
- b) Mediate the dispute raised between insurer and the insured, and decide petition filed by the insured against insurer as quick as possible.
- c) Conduct training programs on subject matter of insurance as basic level, medium level and higher level for the improvement of efficiency of manpower working in this industry and establish an Insurance Academy for this purpose.
- d) The insurer, performing life and non life insurance business at a place should perform the insurance business as a separate agency as per the Insurance Regulation 1992. Thus, separating life and non life insurance businesses functioning within the country as two separate

insurance entities.

- e) Make insurance business people oriented by making qualitative improvement in the functioning of insurance surveyor and agents by making them follow the code of conduct.
- f) Prepare the substantive and suitable investment policy and fix the priority areas for investment of amount received from insurance.
- g) Make insurance business as trust worthy protecting the investment of life insurer , and
- h) Check capital out flow through insurance business.
- i) **Strategy** : The strategies of insurance sector are (1) To develop as a strong means for the mobilization of financial savings, 2) Strengthen it as a means of economic and social security, 3) Develop and expand it as a competitive and trust worthy sector of investment, and 4) promote long term capital mobilization required for development projects.

Source : Nepal Rastra Bank.

- 4.26 The total number of insurance companies providing life and non-life insurance services is 18, consisting of in 1 the Government sector, 11 in the private sector, and 3 foreign and Joint Venture companies. In terms of business category of insurance companies, there are 13, 3 and 2 in non-life, life, and life and non-life category respectively. Accidental insurance fund is established to help for the establishment of Reinsurance Company in the future. The total number of manpower directly involved in this business is about 17,600 consisting of 16,000 insurance agents, 100 insurance surveyors and 1500 employees working in insurance companies.

Monetary Situation

- 4.27 During the first eight months of FY 2004/05, broad money supply rose by 5.9 percent as compared to 6.7 percent rise during the corresponding period of FY 2003/04. Broad money supply has increased due to considerable increase in net domestic assets, though there was marginal increase in foreign assets during the same period. Narrow money supply rose by 5.5 percent in FY 2004/05 as compared to 2.3 percent rise in FY 2003/04. Narrow money supply in FY 2004/05 rose

considerably in comparison to FY 2003/04 due to significant increase in net non-monetary liabilities. Currency, an integral part of narrow money supply increased by 7.7 percent in FY 2004/05 as compared to the rate of 9.6 percent growth in the review period of FY 2003/04. Demand deposits, another component of narrow money, increased by 1.0 percent in 2004/05 as compared to the decrease by 13.2 percent in FY 2003/04.

- 4.28 Net foreign assets of the monetary sector, one of the contributory factors of expansion in money supply, increased by a marginal rate of 0.7 percent during the first eight months of FY 2004/05. This increase was marginal due to the low rate of increase in the export earnings and remittances and decrease in foreign debt. During the corresponding period of 2003/04, net foreign asset had increased significantly at the rate of 11.6 percent. Gross domestic borrowing, another expansionary factor of money supply, increased considerably by 8.1 percent totaling Rs. 2.7155 billion during the review period of FY 2004/05 as against 3.5 percent increase in the same period of FY 2003/04. During the review period, besides the decrease in the claims on governments, gross domestic credit increased at a considerable rate due to the higher rate of increase on the claims against public enterprises and private sector compared to the previous year.
- 4.29 Of the domestic credit, net credit to HMG from the monetary sector decreased by 3.3 percent in the review period of 2004/05 and came down to Rs. 60.25 billion by mid-March 2005. Favorable cash balance with HMG has caused reduced flow of net credit to the government. Such credit had decreased by a noticeable rate of 11.2 percent rate in the corresponding period of FY 2003/04. Monetary sector's claim against the private sector is another important factor in the gross domestic credit. Such a claim increased, at the rate of 9.2 percent in the review period of FY 2003/04, as compared to significant increase by 12.3 percent in the same period of FY 2004/05 totaling Rs. 193.72 billion by mid-March 2005. This year, claims on private sector

Chart 4 (a) : Determinants of Money Supply

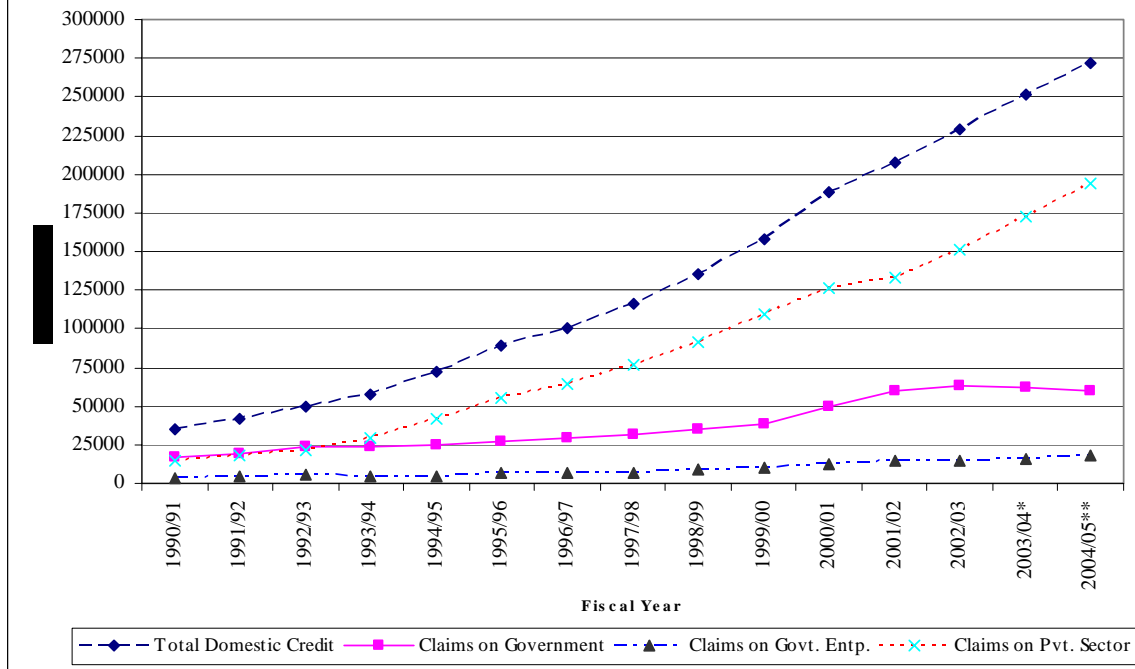
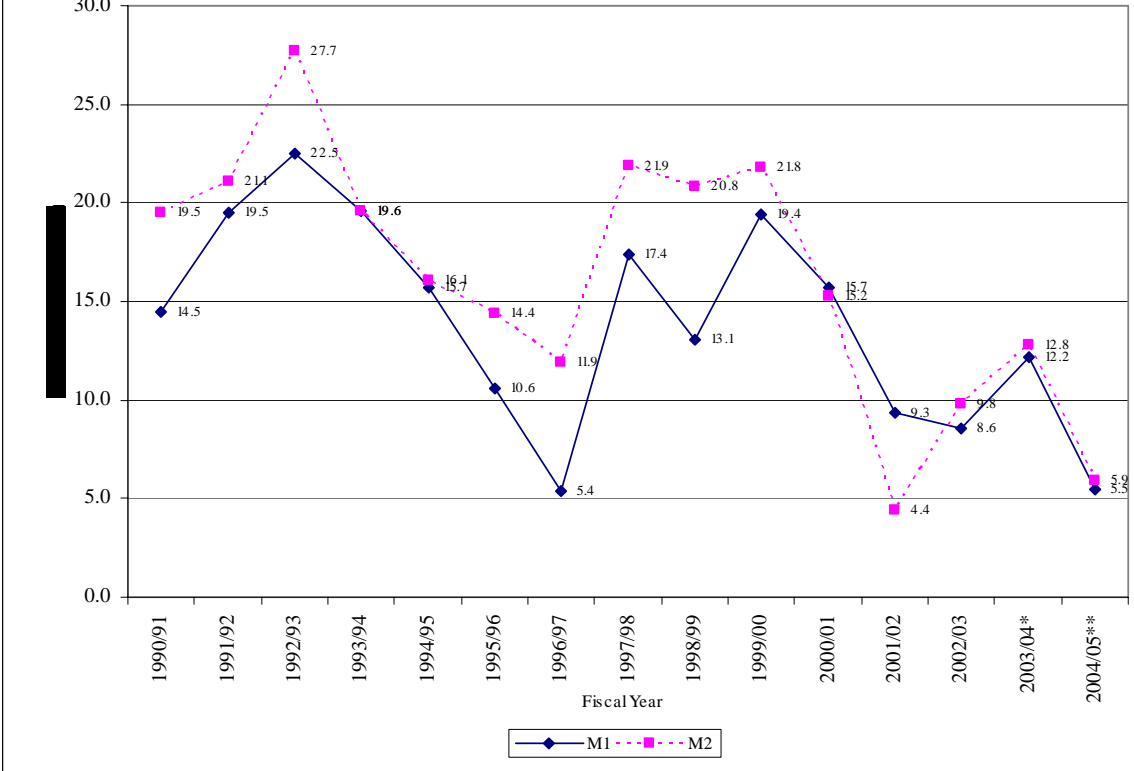


Chart 4 (b) : Growth Rates of Money Supply



increased significantly due to the competitive expansion of consumption credit by commercial banks.

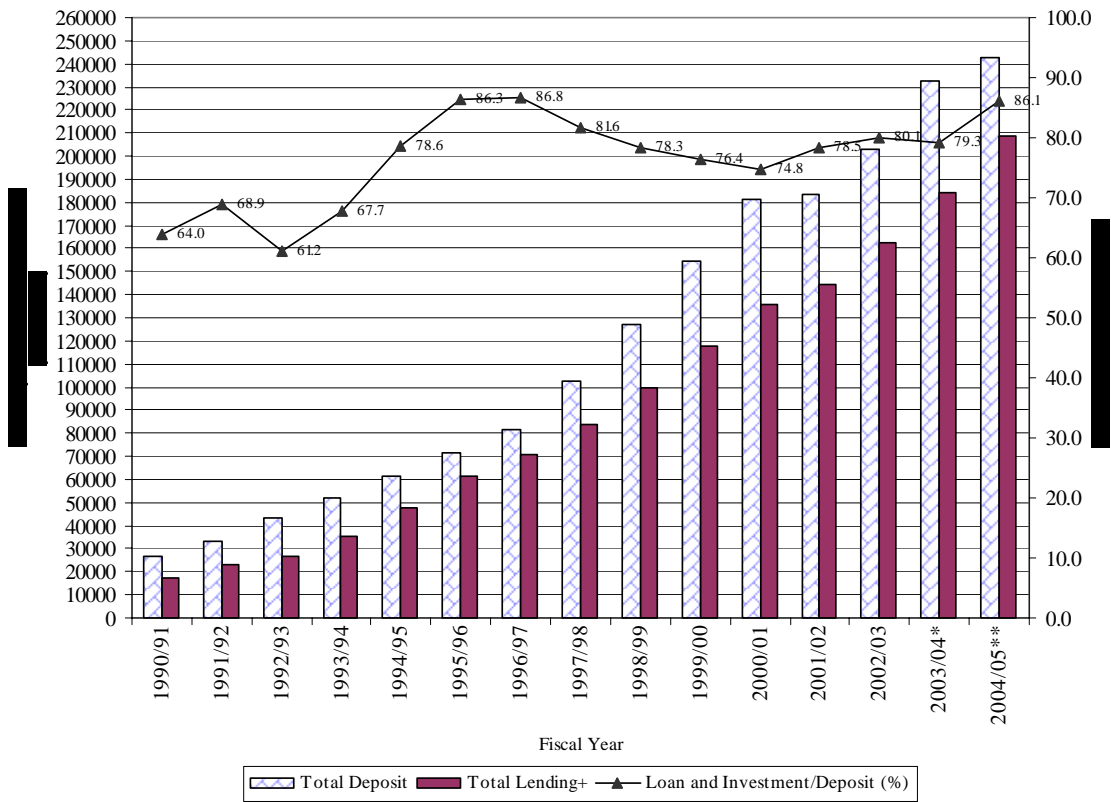
- 4.30 Claims against Public Enterprises increased by 8.1 percent during the first eight months of FY 2004/05, as compared to the increase of 8.7 percent in the corresponding period of FY 2003/04. During the review period claims of the monetary sector against financial corporations decreased due to the payments of some refinance facility drawn from NRB by *Grameen Bikas* Banks and other Development Banks. Despite such decline in the claims of monetary sector against the financial institutions, claims against Public Enterprises increased because of the significant flow of credit to the Royal Nepal Airlines and Nepal Oil Corporation by the Commercial Banks. By mid-March 2003 of FY 2003/04, the gross domestic credit extended to HMG, public enterprises, and the private sector was -32.4 percent, 14.4 percent and 118.0 percent against the 12.8 percent, 4.7 percent and 82.5 percent respectively during the corresponding period of FY 2004/05.
- 4.31 Time deposit, an important part of broad money supply, increased by 6.2 percent totaling Rs. 194.68 billion by the mid-March 2004 (end of the review period). During the corresponding period of FY 2003/04, it increased by 9.0 percent. The lower rate of increase in time deposit in FY 2004/05 compared to the previous fiscal year was due to decrease in remittances at the beginning of the year caused by national and international circumstances.
- 4.32 Net non-monetary liability - a contractionary factor in money supply - increased by 5.8 percent in the first eight months of the FY 2004/05, as compared to the 3.0 percent increase in the same period in FY 2003/04. This increase in non-monetary liability was due to the increase in resource for bad debt by commercial banks and paid up capital. Net domestic assets increased considerably by 9.3 percent in FY 2004/05, which had increased by 3.8 percent in FY 2003/04. As a result of significant increase in both net non-monetary liability and gross

domestic credit, the net domestic asset increased at a higher rate in FY 2004/05.

Status of the Utilization of Resources by Commercial Banks

- 4.33 The resources of commercial banks, during the first eight months of FY 2004/05, increased by 6.6 percent to Rs. 297.60 billion. During the same period of FY 2003/04, it had increased by 8.1 percent. High growth rate of such resources in FY 2004/05 was due to the rise in saving deposits and other net resources despite a decline in current and time deposits. Commercial bank's deposits with NRB decreased due to decline in liquidity with them, which resulted in the decline in liquidity fund as compared to the previous year. Despite the decline in purchase of foreign bills on credit and investment side, total resources utilization during the review period increased due to increase in claims on government, public enterprises and the private sector.
- 4.34 Total deposit liabilities of the commercial banks during the first eight months of FY 2003/04 had increased by 7.0 percent, as against the increase of 4.2 percent in FY 2004/05. Of the total deposits, current deposits in the first eight months of FY 2003/04 and FY 2004/05 declined by 9.5 percent and 0.6 percent respectively. Similarly, saving deposits rose by 9.9 percent during the first eight months of FY 2004/05 compared to 9.4 percent in the same period of FY 2003/04. Saving deposits increased by a higher rate, compared to the previous year, due to the low rate of interest on fixed deposits, which caused depositors to look for alternative investment opportunities, the liberal withdrawal facility without losing the interest on saving deposits. During the first eight months of FY 2004/05, fixed deposits declined by 2.4 percent, whereas its growth rate was 9.7 percent in the same period of the FY 2003/04. Borrowing by commercial banks from NRB, as compared to mid-June, rose to Rs. 610 million with an increase of Rs. 130 million by mid-March 2005. Increase in such borrowing by commercial banks is due to provision of refinancing at a concession rate for rehabilitation of sick industries, and the utilization of permanent liquidity facilities to deal

Chart 4 (c) : Loan & Investment and Deposit of Commercial Banks



with the short-term liquidity crunch of commercial banks. Net other liabilities of commercial banks increased by 20 percent during the first eight months of FY 2004/05, as compared to an increase of 11.9 percent in the same period of FY 2003/04. Net other liabilities increased because of the improvements in the profit of commercial banks.

- 4.35 Gross liquid assets of commercial banks in the review period of FY 2004/05 decreased by 12.6 percent against the increase of 4.9 percent in the same period of FY 2003/04. Of the liquid assets, deposits with NRB declined by 35.5 percent in the review period of 2004.05. Whereas cash deposit, foreign currency reserve and foreign currency deposits with the overseas banks increased by 15.7 percent, 31.2 percent 8.0 percent respectively. During the same period of 2003/04, total amount of liquid assets had increased with a rise in deposit with NRB and deposit in overseas banks by 15.1 percent and 2.5 percent respectively, despite decrease in cash deposit with banks by 17.9 percent and foreign exchange reserves by 16.7 percent.
- 4.36 Total loans and investments during the first eight months of FY 2004/05 increased at a rate of 10.9 percent compared to 8.8 percent increase in the same period of the previous fiscal year. Major reasons of such increase were reduction in the mandatory cash reserve requirement by NRB and increase in consumption credit by commercial banks. Of the total loans and investments, credit to the Government by commercial banks in the review period of FY 2004/05 was up only by 1.5 percent, as compared to 8.1 percent increase in the corresponding period of previous fiscal year. Credit to public enterprises by commercial banks went up by 10.3 percent during the first eight months of FY 2004/05, while it had increased by 9.7 percent in the same period of previous fiscal year. Credit to Public Enterprises increased because of the considerable amount of credit provided to the non-financial institutions like Nepal Oil Corporation and Royal Nepal Airlines Corporation. Of the total loans and investments during the first eight months of FY 2004/05, commercial bank's lending to the private sector increased by 13.5%

mainly due to the rise in consumption credit as compared to 9.1 percent increase in the corresponding period of FY 2003/04. The purchase of foreign bills by commercial banks during the review period of FY 2004/05 and FY 2003/04 decreased by same level of 9.8 percent. In the foreign currency market, NRB intervened 18 times - 17 times to buy excess foreign currency worth Rs. 17.30 billion and one time to bridge the shortfall by selling foreign currency equivalent to Rs. 500 million. Thus net liquidity flow of foreign currency by NRB amounted to Rs. 16.80 billion.

Expansion of Commercial Bank Branches

4.37 Taking into consideration of country's current situation of internal conflict, NRB has been adopting different policies to help commercial banks to improve their financial status and make them competitive. Such policies, include inter alia, opening of new branches based on the financial viability, merger of existing branches in close proximity, putting special efforts to make loss-making branches profitable within a specified period of time, and opening of new branch in city area only after opening a branch in rural area. By mid-April 2005, total number of commercial bank's branches reached 382 from 375 at mid-July 2004. If Agricultural Development Bank's 48 branches licensed for commercial banking activities are included, then total number of commercial bank branches within the Kingdom has reached 430 by mid-April 2005. *Rastriya Banijya* Bank, has the largest number of branches with 117 followed by Nepal Bank Limited with 116 branches. By mid-April 2005, branches of other commercial banks were as follows: Nepal Bangladesh Bank Ltd. - 16, Nepal Arab Bank Ltd. - 16, Nepal Credit and Commerce Bank Ltd. -16, Everest Bank Ltd.-15, Himalayan Bank Ltd. - 14, Nepal S.B.I Bank Ltd. - 12, Nepal Investment Bank Ltd.-12, Bank of Kathmandu Ltd. - 9, Standard Chartered Bank Nepal Ltd. -8, Nepal Industrial and Commercial Bank Ltd-8, Siddhartha Bank Ltd.-8, Machhapuchhre Bank Ltd-5, Lumbini Bank Ltd -4, and 3 each of Kumari Bank Ltd. and Laxmi Bank Ltd.

Other Banks and Financial Institutions

- 4.38 Among the Government owned banks, Agricultural Development Bank is the largest Development Bank on the basis of the number of branches and transactions. Lending of this bank had decreased by 1.9 percent in the first eight months of FY 2003/04, which increased by 16.9 percent and totaled Rs. 6.92 billion during the same period of FY 2004/05. Its loan recovery rate had increased by 7.4 percent in the review period of 2003/04, which further increased by 15.0 percent in FY 2004/05 and totaled Rs. 5.82 billion. As of mid-April 2005, lending by Agricultural Development Bank totaled Rs. 20.81 billion. Outstanding loan increased by 6.2 percent in the first eight months of FY 2003/04, which further increased by 8.9 percent in the same period of FY 2004/05. This bank, operating under the Bank and Financial Institutions Ordinance, 2005 has started to manage necessary losses on loan as per the directives of NRB. In order to develop this bank as 'A' class Financial Institution, HMG has decided to launch reform processes with issued capital of Rs. 1.6 billion and making it Agricultural Development Bank Limited.
- 4.39 Both Credit investments and repayments of Small Farmers Development Project declined during the first eight months of FY 2004/05 as compared to the corresponding period of FY 2003/04. During the review period, credit investments dropped by 17.5 percent from the previous year's Rs. 160 million to Rs. 132 million. Likewise, repayment of principal in the first eight months of FY 2004/05 dropped by 23.9 percent to Rs. 116 million as compared to Rs. 153 million in the corresponding period of last fiscal year. Outstanding credits, which stood at Rs. 674 million at mid-March 2003, fell by 10.8 percent to Rs. 601 million in the corresponding period of 2004.
- 4.40 The number of development banks and class 'B' financial institutions reached to 23 as of mid-April 2005. Agricultural Development Bank, with a majority share from the government, holds the largest portion of

total transactions of Development Banks. Aggregate resources of Development Banks dropped by 18.9 percent to the tune of Rs. 47.47 billion by mid-January 2005 as compared to the corresponding period of FY 2003/04. During the first six months of FY 2004/05, compared to the same period of previous fiscal year, capital fund after adjusting profit and loss declined by 3.8 times and totaled a negative of Rs. 5.13 billion. The amount of deposits and total borrowings increased by 23.3 percent and 1.1 percent and totaled Rs. 5.73 billion and Rs. 5.18 billion respectively during the first six months of FY 2004/05 as compared to the same period of the previous fiscal year. Likewise, other liabilities decreased by 9.1 percent to total Rs. 41.68 billion. Regarding sources of resources, major cause of considerable decline in capital fund is the fall of the capital fund of Agricultural Development Bank. In regards to assets of these banks, investment, credit and loans, and other assets fell noticeably in the first six months of FY 2004/05 as compared to the same period of the previous fiscal year though there was a marginal increase in liquid assets by 6.8 percent reaching a total of Rs. 4.54 billion. Investment, credit and loans, and other assets decreased by 52.4 percent, 18.5 percent and 18.0 percent and totaled Rs. 1.89 billion, Rs. 27.97 billion and Rs. 13.06 billion respectively.

- 4.41 As per the Bank and Financial Institutions Ordinance 2005, the total number of financial companies under class 'C' reached 59 by the mid-April 2005. During the first six months of FY 2004/05, aggregate resources of finance companies rose by 18 percent and reached Rs. 29.25 billion as compared to the increase by 24.7 percent in the same period of the previous fiscal year. Deposit occupies 72.3 percent of the total resources of finance companies. The growth rate of deposit of these companies was 22 percent in the first six months of FY 2003/04, whereas in the same period of FY 2004/05, it increased by 17.9 percent to Rs. 21.15 billion. Capital fund during the same period of 2004/05 increased by 10.6 percent totaling Rs. 3.98 billion, whereas it had increased by 50.4 percent in the corresponding period of 2003/04. Total deposit and capital fund of finance companies reached Rs. 17.95 billion

and Rs. 3.60 billion respectively by mid-January 2005. Same as to the previous year, loan/borrowing of these companies increased remarkably in the first six months of this year. Total loan resources in the first six months of FY 2004/05 rose by 66.8 percent to Rs. 1.33 billion as compared to the steep rise of 2.9 times amounting to Rs. 800 million in the first six months of FY 2003/04. Other liabilities of finance companies increased by 14.2 percent totaling Rs. 2.79 billion in FY 2004/05, as against the decline by 2.7 percent in the same review period of FY 2003/04. Out of total resources, finance companies utilized credit and borrowings by 68.3 percent, liquid assets 12.7 percent, investment 8.7 percent and other assets 10.3 percent. Total credit and borrowings, which occupies major portion of total resource utilization, increased by 22 percent and totaled Rs. 19.96 billion in the first six months of FY 2004/05. Such credit and borrowings had increased by 26.2 percent in the same period of FY 2003/04. Investment of finance companies declined by 1.1 percent and totaling Rs. 2.55 billion at mid-January 2005, whereas such investment had increased by 22.3 percent in the corresponding period of FY 2003/04. Liquid assets of finance companies rose by 33.9 percent totaling Rs. 3.72 billion during the period under review as compared to the increase by 19.7 percent in FY 2003/04. Other assets of finance companies increased by 23.5 percent in the first six months of FY 2003/04, which had declined by 1.4 percent to Rs. 3.02 billion during the same period of FY 2004/05.

- 4.42 Total number of Development Banks dealing in micro finance stood at 11 by mid-January 2005. Five Regional *Grameen Bikash* Banks, having maximum share of HMG and NRB, also belong to these 11 Development Banks. In comparison to the first six months of FY 2003/04, total resources of these banks rose by 18 percent totaling Rs. 5.29 billion during the corresponding period of FY 2004/05. These banks, which provide loans without collateral and accept small saving are assisting in generating income for rural women. Compared to the first six months of FY 2003/04, these bank's total deposit increased by 11.5 percent totaling Rs. 750 million, loan/borrowings increased by 47.8 percent totaling Rs.

3.48 billion and capital fund increased by 18.6 percent totaling Rs. 780 million, and other liabilities decreased by 64 percent to stand Rs. 290 million during the same period of FY 2004/05. On utilization of resources, liquid assets increased by 17 percent totaling Rs. 570 million, investments increased by 13.5 percent totaling Rs. 1.23 billion and loan and borrowings increased by 27.2 percent totaling Rs. 3.15 billion. Whereas other assets declined by 21.7 percent to Rs. 350 million.

- 4.43 Total number of financial cooperatives licensed by Nepal Rastra Bank to conduct banking transactions stood at 20 by mid-April, 2005. The number of such cooperatives did not increase because of the policy adopted by Nepal Rastra Bank not to allow them to conduct financial transactions, even though, there is a large number of cooperatives doing financial transactions established under the cooperatives Act, 1992. Total financial resources of these cooperatives licensed by NRB decreased by 17.9 percent to Rs. 2.35 billion in the first six months of FY 2004/05 in comparison to the corresponding period of FY 2003/04. The number of cooperatives licensed by NRB stood at 33 by the mid-January 2003. The reason for decrease in the number of number of financial cooperatives under the jurisdiction of NRB decreased as regulation, inspection and supervision of Small Farmers Cooperatives is now the responsibility of Small Farmers Development Bank. Thus, capital fund, deposits, loan resources and other liabilities of these cooperatives declined. Likewise, utilization, investment, credit and borrowings and other assets have also decreased. In the first six months of FY 2004/05, capital fund, deposits, loan resources and other liabilities of those cooperatives decreased by 10.5 percent to Rs. 260 million, 18.4 percent to Rs. 1.66 billion, 2.4 percent to Rs. 40 million and 21.3 percent to Rs 390 million, respectively as compared to the same period of FY 2003/04. Likewise in comparison to the first six months of FY 2003/04, investments by these institutions decreased by 39.8 percent to the tune of Rs. 170 million and loans and borrowings decreased by 12.1 percent to Rs. 1.39 billion during the same period of FY 2004/05. But, liquid assets of these institutions increased by 2.4 percent reaching a total of Rs. 380 million. Other

assets declined by 34.4 percent to Rs. 420 million in the first six months of FY 2004/05 as compared to the same period of previous year.

4.44 HMG has contributed a total of Rs. 40 million through the budgetary provisions in FY 1990/91, FY 1991/92 (Rs. 10 million each year) and FY 2004/05 (Rs. 20 million) to the Rural Self-reliance Fund (RSF) established in April 1990 by the decision of the HMG. Nepal Rastra Bank provided Rs. 253.40 million to the RSF including the seed money of Rs. 100 million in FY 2001/02 and the amount deposited under the policy of depositing 5 percent of its profit to the fund. By mid-April 2005, the total amount of RSF totaled Rs. 293.40 million including the contribution of both HMG and NRB. From this fund, financial resources are made available to those government and non-government Financial Institutions working in rural areas and dealing with micro credits and to other institutions which provide wholesale loans to Development Banks and to the Government's priority sectors. As per the Article 7 (2 a) of Nepal Rastra Bank Act 2002, unless otherwise of the provision of the Act, NRB is prevented from forwarding loans, accepting deposits of any kind or to give any charity. As such, NRB now cannot contribute 5 percent of its profit to the Fund. Hence, it is necessary to explore alternative sources of fund to raise the capital for RSF. Attempts have been made to develop Rural Self-reliance Fund as an independent entity to provide wholesale/micro credits.

4.45 *Grameen Bikas* Banks, one each in development regions to function as Rural Bank Replicator Financial Institutions, are operating with the objectives of providing financial resources required for different types of income generating activities by forming groups of deprived women of rural areas. By mid-January 2005, these banks has already formed 35,435 groups through the 4,961 centers of 1,003 VDCs of 43 districts and forwarded micro credits without collaterals to 147,949 members for income generating activities by mobilizing local skills, out of a total of 165,964 female members. As of now, these *Grameen* Banks have provided micro credits totaling Rs. 11.55 billion. Of this, Rs. 10.16

billion has been recovered with Rs. 1.39 billion as outstanding in credits. Total amount of saving deposits by these groups amounted Rs. 471.60 million including collective savings Rs. 416.80 million and individual savings Rs. 54.80 million by mid-January 2005. Total number of employees under these five *Grameen* Banks is 1,032. Similarly there are other four banks working as the Replicator Rural Banks viz, Nirdhan Utthan Bank Ltd., Chimek Bikash Bank. Ltd., Swablamban Bikash Bank Ltd. and DEPROSC Bikash Bank Ltd. Up to mid-January 2005, these banks provided credit totaling of Rs. 4.62 billion to 113,122 members of 24,547 groups through the 4,658 centers of 881 VDCs. During the same period, Rs. 3.89 billion has been recovered while Rs. 737.10 million is outstanding.

4.46 Table 4 (a)

Activities of Rural Development Banks (As of mid-January 2005)

S. No.	Items	Regional Grameen Banks					
		Eastern	Central	Western	Mid-Western	Far Western	Total
1.	No. of VDCs	262	286	272	107	76	1003
2.	No. of centers	1382	1267	1141	560	611	4961
3.	No. of groups	12190	7818	8049	3884	3494	35435
4.	Number of members	50737	37001	39293	19420	19513	165,964
5.	Borrowers	48687	36105	38755	13422	10980	147949
6.	Amount of loans (Rs,000)	4909646	1971616	2759037	1015295	897266	11552860
7.	Recovery of loan (Rs. 000)	4394370	1709907	2402806	878869	774909	10160861
8.	Outstanding loan (Rs. 000)	515276	261709	356231	136426	122357	1391999
9.	Group saving (Rs. 000)	163334	82569	82934	47941	40054	416832
10.	Individual saving (Rs. 000)	37622	7480	4518	3152	1985	54757
11.	Total saving (Rs. 000)	200956	90049	87452	51093	42039	471589
12.	Employees (no.)	311	247	228	133	113	1032

Districts covered in Each Region

Eastern: Jhapa, Morang, Sunsari, Saptari, Siraha, Udayapur, Ilam., Dhankuta and Panchthar (9)

Centrale: Dhanusha, Mahottari, Rautahat, Bara, Persa, Chitwan, Lalitpur, Sarlahi, Makwanpir, Nuwakot, Kabhre, and Dhading (12)
Western: Rupendehi, Nawalparasi, Kapilbastu, Palpa, Syanja, Tanahun, Kaski, Gulmi, Parbat, Baglung, Lamjung, Gorkha, and Arghakanchi (13)
Mid-West: Banke, Bardia, Dang, and Surkhet (4)
Far West: Kailali, Kanchanpur, Dandeldhura, Achham, and Doti (5)
Source : NRB

- 4.46 HMG has been implementing the Micro finance Project with the loan assistance of the Asian Development Bank since the year 2000 with the objective of outreaching the micro credit to the ultra poor communities. Currently, 36 MFIs are providing micro credit and savings services to ultra poor communities of nooks and corners of the country. The volume of credit transactions of the Rural Micro-finance Development Center (RMDC) during the first eight months of FY 2004/05 rose sharply by 177.0 percent totaling Rs. 204.4 million as compared to the corresponding period of the previous fiscal year. The rate of recovery during the same period also increased significantly by 64.0 percent totaling 98 million. The (36) MFIs affiliated with the RMDC have extended their service to 250,000 members of ultra poor communities. RMDC, by mid-May of 2005, has imparted training to 6,407 persons including the officers and other staff of MFIs with the objective of capacity building, expanding their outreach, and their strengthening. The process of bringing improvement in the economic and social status of these MFIs through their capacity development is continued. In this process, a total of 184,482 clients have been provided with the training including observation tours, skill development training, and refresher training.
- 4.47 During the first eight months of FY 2004/05, loan disbursement of Employees Provident Fund has increased remarkably. Loan disbursements which had dropped by 19.7 percent during the first eight months of FY 2003/04, increased sharply by 71.0 percent reaching a total to Rs. 4.45 billion during the same period of FY 2004/05. Principle repayments of the Fund increased only by 8.2 percent and amounted to Rs. 1.10 billion in the first eight months of FY 2004/05, whereas it had increased by 74.9 percent during the same period of FY 2003/04. Because of significant increase in loan disbursements and

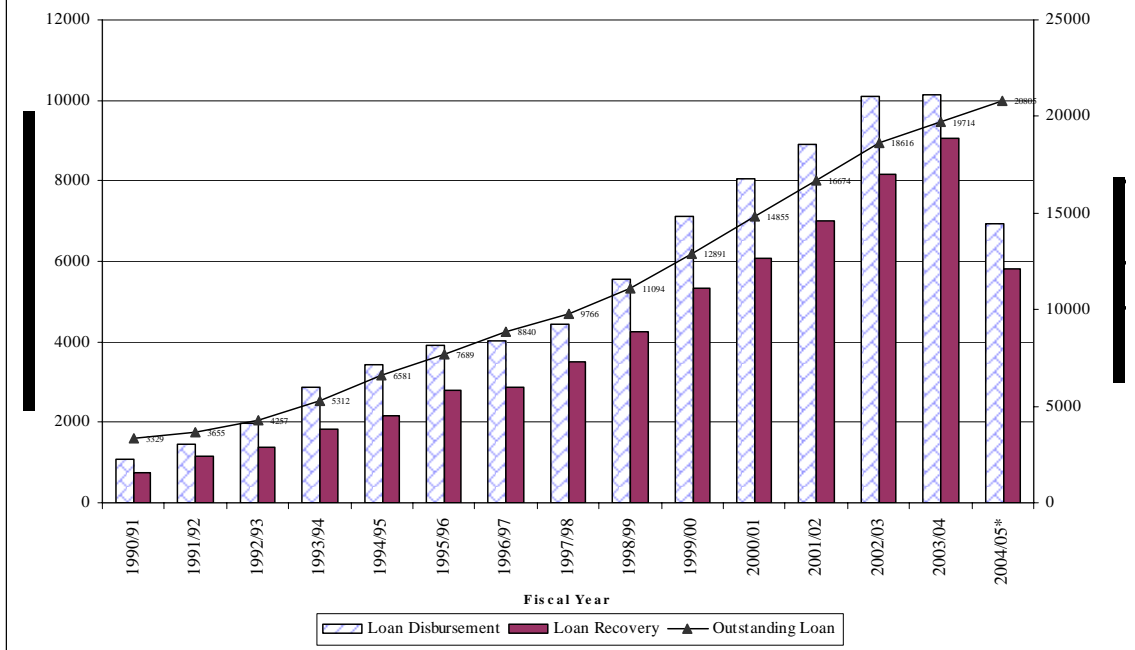
marginal increase in repayments, outstanding loan increased by 33.6 percent totaling Rs. 20.76 billion in the review period of FY 2004/05.

- 4.48 For the last few years, there has been remarkable increase in the transactions in insurance market. The number of insurance companies operating businesses of life insurance, non-life insurance and both life and non-life insurance is 18. The number of such financial institutes engaged in the insurance businesses reached 19 including Deposit Insurance and Credit Guarantee Corporation established in the Government sector for providing insurance in credits on priority areas by mid-April 2005. The contribution of insurance premiums to the GDP of non-agricultural sector had reached to 1.6 percent in FY 2003/04 due to the increase in the insurance premiums from life and non-life insurance businesses. Premium collection from both life and non-life insurance companies had increased noticeably by 26.3 percent in FY 2003/04 and it is estimated to increase again by 22.2 percent totaling Rs. 5.80 billion in FY 2004/05. It is found that insurance companies had invested such collected premiums on government bonds, fixed, deposit and other assets. Investment, on life insurance side, is estimated to increase by 19.6 percent totaling Rs. 11.70 billion in FY 2004/05 as compared to the increase by 22.8 percent in FY 2003/04. Investment on non-life insurance during the same period of FY 2004/05 is estimated to increase by 8.4 percent reaching Rs. 2.9 billion, as compared to the growth of 8.9 percent in the previous fiscal year. Total investment of insurance companies in FY 2004/05 is estimated to increase by 17.2 percent and reach Rs. 14.6 billion as compared to the increase by 19.5 percent in FY 2003/04.

Challenges

- 4.49 Maintaining stability in price, exchange rate, balance of payment and reducing income inequalities through coordinated monetary and fiscal policies, and improving financial sector's efficiency is a challenge together with its development and making domestic payments system more effective. Simultaneous challenge is to formulate and implement appropriate policies in this regard.

Chart 4 (d) : Loan - Agriculture Development Bank



- 4.50 With the adoption of liberal financial policy, establishment of banks and financial institutions has become a lot easier in the country. In this context, problems may arise when economic activities could not pick up commensurate with the increase in number of banks and Financial Institutions. In such a situation, regulations should be in place for liquidation, merger and takeover of institutions to address the economic crisis. Equally important is the establishment of an Asset Management Company to address the problem of Non Performing Assets (NPA), which are also equally challenging.
- 4.51 The volume of loans and advances from Employee Provided Fund and Citizen's Trust Fund is continuously rising. These institutions basically transact the savings received on long-term contracts. However, there is not any proper institution to monitor, regulate and supervise these institutions regarding the classification of loans, provision for loan losses etc. It is essential to have proper arrangements for the regulation and supervision of these institutions.
- 4.52 Many commercial banks and banking/non-banking financial institutions are established as a result of liberal economic policy. Such institutions are collecting a large amount from general public in the form of deposit. Thus it is necessary to establish a specialized deposit insurance company, in private sector for the protection of welfare of the depositors. Establishment of such institution considering the issues like selection of depositors to be insured, issue of moral hazard and its solution, and management of expenses of insurance fee is a challenging task.
- 4.53 There is a tendency of closure and merger of banking offices in rural areas due to existing internal conflict. However, it is necessary to divert the city oriented investment of the banking sector towards the rural sector of the country. Thus it is necessary to develop and execute rural oriented road map for the financial sector and develop a mechanism to reducing rural poverty, which is also a challenge.
- 4.54 Nepal being a member of WTO, its financial sector needs to be more open, liberal, and strengthened. Hence, there is no alternative for the

banks and financial institutions to be more competitive by increasing their own capacities. Strengthening of NRB has become imperative to enable it play an effective role of maintaining a balance between proper regulation and strong supervision on the one hand, and providing freedom of operation and management to the banks and financial institutions on the other.

- 4.55 Maintaining monetary and financial sector stability is the core issue of monetary policy of NRB. For this, NRB as a central bank of the country need to increase the reserve of foreign currency through different external reform programs and also need to maintain dynamism and stability in economic and financial sectors of the country so as to divert the national resources into productive uses, which in itself is a challenge.
- 4.56 Absence of small loans to rural households has impeded their capacity of income generations, raising productivity and access to the market. It is still a challenge to outreach such households to meet their credit requirements.