CHAPTER VI

SUMMARY OF FINDINGS AND SUGGESTIONS

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6.1 SUMMARY OF FINDINGS

Nepal is basically a developing country. Landlocked in between two giant economies of the world, India and China, Nepal has limited agrarian economy, lacks industrialization and possesses few natural resources. Difficult topography, subsistence farming practices, lack of adequate credit facility, lack of irrigation facility etc have negative impact on the poor performance of agricultural sector resulting on a slow growth in overall economy. The widening trade deficit depicts the inferior proportion of export comprising basically semi-finished goods and raw materials. However, import has always been essential for machinery, equipments, medicines and other capital goods. Although trade concentration with India is gradually declining over the years, it is still very high. It has seriously affected both the service sector and production sector.

Over the years, development expenditure has declined sharply. Efforts directed towards revenue mobilization could not come up to offset the mounting regular expenditure. Transfer receipts have significant contribution in reducing current account deficits; however, it may not be sustainable in long run. Similarly, tourism industry has flourished during 1990s it could not keep the pace during recent years. However, it is highly sensitive to the environmental and security issues and thus is vulnerable. Although, inflation has been contained in recent years other macroeconomic indicators do not seem to be encouraging, investors are losing confidence due to poor investment environment and deteriorating law and order situation.

It is recognized that without an active contribution of the financial sector, economy cannot reach to its growth potential and develop at an adequate pace. A well functioning financial system efficiently mobilizes resources and allocates capital for productive investment projects. Voluminous studies have established that financial instruments, markets, and institutions together lessen the effects of information problems on lending and transaction costs. Financial arrangements can offer the incentives and remove constraints of economic agents. Financial system has its influence on saving, investment decisions, technological innovation, and hence on the long-run economic growth process.

Until 1980s bank dominated financial system was shaped to support state-oriented development and industrialization. It had no competition. Controlled interest rates, directed credit, high reserve requirements and other restrictions on financial intermediation had restricted entry of new banks however fostering the oversized branch networks and high overhead costs in public sector banks. As a result, banking system had been inefficient and unproductive.

Nepal has embarked on economic reforms since mid 1980s with far reaching impacts on trade, industry and financial sector. Most of the non-tariff barriers have been eliminated and tariff structure streamlined. Foreign investment policy has been liberalized and exchange rate policy changes have eliminated the discriminatory official exchange rates and parallel market rates are discouraged completely.

Realizing the significance of the financial system in the economic development, various policies and processes were formulated and implemented during the past one and a half decade. They were among others providing permission for the establishment of the joint venture banks, autonomy in the interest rate determination, scrapping of statutory liquidity ratio, implementation of the prudential guidelines, removal of credit ceilings, and introduction of open market operations and other indirect instruments of the monetary policy.

Financial sector reform is an important component of the economic reform program in Nepal. As a first step of initiation to liberalize the financial sector entry barriers were removed. Three joint venture banks were established in the three subsequent years from 1985. Interest rates were liberalized gradually and credit decontrolled. There was a strong commitment of the government towards strengthening the financial system. In fact, popularly elected government gave its major thrust on economic and financial liberalization in Nepal, after the restoration of democracy in 1990. It has created institutions and adopted policies and procedures as part of the financial sector reform so that economic growth could be achieved at a quick pace. Bank-restructuring program has required the existing banks to increase their capital base to a higher standard, improving the soundness and reliability of the banking system, which was crucial for confidence building, and to comply with relevant laws and regulations.

Several legislations related with the financial sector have been enacted and amended to support the reform process. A new central bank act has been promulgated in 2002 providing autonomy to the Nepal Rastra Bank while formulating and implementing monetary and exchange rate policy as well as prudential regulations to banks and other depository institutions. The objectives and status of the central bank are mentioned clearly to achieve price, exchange rate and financial stability. Government intervention in the day-to-day business of the central bank has been reduced and procedure regarding the appointment and removal of the governor from his/her office. Enactment of Debt Recovery Act (2002) and formation of Debt Recovery Tribunal would reduce the problem of non-performing loans in the financial system at a minimum level. The enactment of the Banking and Financial Institution Ordinance (2003) has repealed several laws governing different types of banking and financial institutions. This new law responds to the need to promote a sound financial structure and orderly financial markets by providing appropriate legal framework for the licensing, organization, operation, and supervision of abroad range of financial services companies. All the depository institutions are brought into the regulatory jurisdiction of Nepal Rastra Bank and all of them are monitored and supervised by the central bank by issuing single set of prudential regulation.

Thus the comprehensive economic and structural reform of 1990s has achieved a relatively significant success in stabilizing its economy. This has resulted significant improvements in quantitative as well as qualitative dimensions of Nepalese financial system. A significant number of banks and other financial institutions with variegated types of financial instruments have emerged up. The institutional network and volume of operations of the financial system has expanded and diversified, with the number of commercial banks going up from five in 1990 to 17 in 2003. The number of other financial institutions has likewise seen quantum jump.

Commercial banks are the largest financial institutions dominant in the financial system occupying 68 percent of the total financial assets. Thus, they are considered as the proxy for the financial system. Analysis of various financial, macroeconomic and policy variables have been performed in order to enquire the performance, structure and concentration of financial system and its role in economic growth.

The analysis of the structure, evolution, performance and problems and challenges of financial system has clearly depicted the real picture of Nepalese financial system. Until 1984, Nepalese financial system was suffering from several problems. It was not proliferated until 1984, although there were couples of banks and financial institutions. The initiation of openness and reforms in financial sector and introduction of market oriented economic policies led a rapid expansion of financial institutions and instruments. It has resulted for diversification of financial system during a short span of time. Additionally, the development of new financial instruments and services, introduction of regulatory framework and institutionalization of savings has created new scene for economic growth and development.

Nepalese financial system has been proliferated with a varied number of financial institutions. New financial instruments and services have been introduced thus providing a space for development and growth. The banks in the public sector were suffering with severe problems making the system absolute and unproductive. Public sector banks are found responsible for the deterioration of financial system as they hold a dominant position in terms of deposit taking, credit lending and asset holding.

High Leverage Ratio reflects the financial weaknesses and poor equity position of the public sector banks. The ratio also confirms that such high ratio is a major source of vulnerability in the institution as well as in Nepalese banking system.

The performance of the banking system is not satisfactory in terms of net profit and profitability. The ratio simply indicates that joint venture banks and domestic private banks are strong whereas public sector banks are very unsatisfactory. The Ratio of Net Interest Margin does not indicate the strong position for any banks rather shows fair for joint venture banks, unsatisfactory for domestic private banks and very unsatisfactory position for public sector banks. Liquidity ratio shows that banks in Nepalese financial system are competent enough in terms of liquidity. The liquidity ratios for public sector banks, joint venture banks and domestic private banks clearly indicate strong position. However, non-performing loans has been chronic in Nepalese banking sector and particularly in public sector banks.

The concentration ratio of three banks in the financial system shows a mild picture in recent years. In fact, it is a positive indication for the sound and efficient financial system. The commercial banks have maintained the sectoral portfolio concentration ratio below the level of one percent. Thus, the risk related to lending and deposit has been limited. However, the ratio of NPL to GDP does not seem worse, however, it does neither indicate nor confirm about asset quality and soundness of the banking sector.

The profitability ratios and some other ratios have clearly indicated for an alarming situation. There was no other option except to strengthen the financial health and soundness of the existing financial institution with the introduction of financial sector reforms. Hence, in the beginning restructuring was initiated in these banks following financial sector reforms. It has certainly drawn many positive results in terms of safety and soundness of the system.

The index of financial liberalization depicts that Nepal has implemented various policies on liberalizing its financial sector over a period of time. The estimated index of financial development also shows steady rise and thereby gradual financial development in Nepal. It reveals the bi-directional causality between financial liberalization and financial development indicating financial liberalization leading to financial development and vice versa.

The increase in loans and advances to the private sector is mainly attributed for the surge in import credit and introduction of new debt products (such as, housing loan, educational loan, etc), increased competition between commercial banks and other financial institutions. However, long-term investment could not be encouraged due to an underdeveloped capital market. Increasing regular expenditure has hindered development efforts adversely.

Nepalese financial sector requires a striking balance between conflicting objectives of promoting competition and risk entailed in financial deregulation in the liberalized context. It is universally accepted that banking must be regulated and well supervised, but the banking system also needs to become more competitive.

The assessment of effectiveness of reforms to bring in changes in the financial system essentially focuses on commercial banking system. It has been clear that reform has reduced concentration in the banking industry. However, the banks are still able to coordinate their pricing decisions overtly. High profitability of joint venture and domestic private sector banks appear to have resulted from the banks' uncompetitive pricing rather than their efficiency in the cost of inefficiency of public sector banks. It requires further strengthening of regulation and comprehensive and coordinated efforts in institutional reforms.

Although entry of small-scale depository institutions (like cooperatives and NGOs) is not enough to increase competition, it could be crucial while formalizing informal finance and extending financial services in the rural mass. Due to small size of the economy, limited number of creditworthy borrowers and lack of investment climate, new banks should probably not be expected to alter the market structure.

Therefore, promoting competition requires addressing to both the barriers, entry and mobility. The size of the large banks has exerted a significant negative effect on competition and seems to be the barrier to mobility. Since they hold about 50 percent of total assets of the banking sector, it would be reasonable to break them to reduce concentration and improve mobility in retail banking with a reasonable number of branches. It may facilitate competition among existing banks and improve governance structure and efficiency.

Nepal still lacks the variety and healthy credit institutions. Developing a mortgage market and creating institutions for housing finance could be encouraged to widen and deepen the financial sector and avail better financial services in terms of its quantity and quality. Despite the efforts on financial sector reform, some critics argued about the reforms for the little impact on mobilization of financial savings and for high nominal interest rates on lending (rather than deposit) and continuous devaluation of its currency. The performance so far after the introduction of reforms, mainly in the financial sector, has not been satisfactory. Mainly the performances of public sector banks and financial institutions have been observed poor. Still there are some structural and institutional weaknesses, making reform efforts less effective. However, reforms are continuous process, require sufficient time and budget, conducive environment and continuity in policy. Nepalese financial sector is still in the process of broad and comprehensive reform program.

Rapid development in information and communication has brought about revolution in the financial system. Plastic money has replaced currency. Credit and Debit cards as well as tele-banking have become more popular and extending wide and increased efficiency and reduced cost of services. Financial transactions and settlement may take a minimal of time. Under these circumstances, it would be critically important to regulate e-banking in a timely manner.

Since a strong and well-functioning financial sector can improve on the rudimentary nature of self-financing regime, financial development is important to the speed and direction of economic growth, by mobilizing idle financial resources for productive investment. To link up saving, investment and economic growth, the financial sector development, governance reform and economic activities in the private sector must go simultaneously to underpin the policy of generating growth and reducing mass poverty.

However, political instability, particularly, since mid-1990s has hindered its growth potential and Nepal is not yet able to reap the benefits of economic stability, which is beyond the coverage of present study.

6.2 LIMITATIONS OF THE STUDY

Following are the limitations while going through the study:

1) The study covers the analysis of performance of the activities of commercial banks in Nepal. Analysis of other financial institutions and non-bank financial institutions are excluded due to lack of adequate data series and their lower penetration in the system till early 1990.

2) Some data *viz.* asset classification, non-performing loans were not available over the period due to the earlier practices of disclosure.

6.3 SUGGESTIONS

A sound financial system accompanied with appropriate macroeconomic policies certainly helps achieving financial stability. It has been clear from the global experiences that banking crises inflict high cost and may lead to macroeconomic instability. There are still some prominent issues in the financial system such as restructuring of problematic banks, evaluation of implication and proper resolutions to solve them. Therefore, macroeconomic policies should be directed to minimize the disruptions and systemic problems in the banking sector. In fact, banking sector policies can help mitigating banking sector problems and hence minimize their implications in the overall economy. On the basis of present study, both long term and short term measures are suggested in order to develop a sound financial system and ensure efficiency and stability in the financial system. Long-term suggestions are directed to the development of sound financial system and short-term measures for maintaining stability and efficiency thereon.

Suggestions for Financial Development

Financial development is a long-term process. Creating a modern and efficient financial system is not an easy task. In the long run, the development of a sound and market-based financial system can enhance resource mobilization for sustainable economic growth. It requires simultaneous development of relevant sub-sectors in due course of time. Therefore, following suggestions are made for the sound development of financial system.

1. In order to development a sound banking system, prudential regulation and effective supervision are crucial. Prudential regulations comprising of capital adequacy requirement, corporate governance and market discipline. It can be acquired through improvement in transparency and improved information system. A competitive, integrated, efficient and properly regulated and supervised banking system would mobilize and allocate resources to support the growth of the private sector.

2. Development of a reliable payment system and designing adequate banking safety nets can assure the economic agents and contribute for the smooth expansion of economic activities.

3. Since a large chunk of population is residing in the rural areas, a viable and effective rural finance would be crucial for providing affordable financial services to enhance rural income and reduce poverty.

4. In the context of Nepal's membership with the World Trade Organization, it is crucial in strengthening existing financial institutions and enhance their efficiency in financial intermediation. Increased competitions in the financial system also enhance efficiency in financial intermediation and reduction of cost of funds.

5. The development of insurance sector could protect businesses and individuals from catastrophic events. Similarly, a pension system provides a secure retirement benefits. The development of such non-bank financial sector provides long-term capital for investment in the real sector is also crucial.

6. Diverse non-banking institutions and financial instruments that create more balanced financial structure, increase the depth of financial market, and promote competition are necessary. In addition, leasing business, money market and capital market intermediaries, and development finance institutions can create positive impacts on the financial system.

7. A developed money market enables inter-bank market and provides banks, companies, and individuals with the means for effective liquidity management.

8. An efficient and transparent capital market with a critical mass of issuers can mobilize funds for long-term investment.

9. Improved legal and accounting systems can promote transparency, accountability, and predictability in commercial and financial transactions and support good governance practices.

10. Institutional and legal strengthening of the financial sector also require the development of a reliable financial information system and the introduction of an efficient mechanism to develop capable human resources ready to cope with future challenges in the financial system.

A determined commitments and efforts of all the incumbents, viz., the government, employees and owners of all the financial institutions can materialize the efforts of the financial sector reforms. It equally requires the spirit of the ownership, responsibility and accountability. The government as facilitator and regulator of the financial system can speed up and stabilize the system.

Development of an Efficient Financial System

It is important, in the short run, to maintain stability in the financial system to achieve the long-term goal of developing a sound and strong financial system. In fact, short-term improvements of the financial system can ensure the financial health and improve efficiency and profitability of each individual financial institution as well as of the overall financial system. Therefore, in order to improve the health and soundness of the financial system as well as to enhance market discipline following suggestions appear crucial.

1. Timely adoption of international accounting standards and standard auditing practices.
2. Expansion of the business and professional ethics in the business and particularly in financial community in the light of globalization and international competition.
3. Enhancement of prudential regulation both in the banking and non-bank financial institution.
4. Creation of conducive environment in order to foster competition among financial institutions as well as with other international institution.
5. Opening of domestic financial markets could enhance international competition along with threats and challenges. Thus, it seems necessary to be prepared with proper orientation.
6. Establishment and enabling a proper information system for clients, government agencies, and other stakeholders of financial system is crucial. It provides with information regarding the operation and other activities of financial institutions and fosters transparency.

7. Share capital is, in fact, the strength of financial institutions. The capital base of banks and financial institutions should be raised.
8. Strengthening the Credit Information Bureau and development of information storage systems on financial sector employees and entrepreneurs.
9. Development of the credit union systems as a small saving system with low risks and transaction costs.
10. Introduction of the deposit insurance in the banking system.

The effectiveness of financial sector reforms cannot be assessed in isolation of reforms in real sector of the economy and improvement in legal and institutional environment. They should go simultaneously. Further, political stability and strong political commitment is crucial for the effectiveness of reforms.

It is difficult for a commercial bank to attain social objectives of poverty reduction and operate profitably abiding commercial principles. Financial repression led the public sector banks to rely heavily on central bank for liquidity support. Poor accounting standard, inadequate auditing practices increased volume of non-performing assets, willful defaults, insider lending, weak management and lack of incentive for loan recovery are major causes of financial distress. Lack of transparency in their activities also concealed their poor performance. After the introduction of liberalization and other reform measures, the scale of losses and level of mismanagement were identified. However, piecemeal reforms in the public sector banks could not improve their financial health properly.

Interest rate deregulation, credit decontrol and easing restrictions on foreign exchange transaction are aimed to enable the banks to be profitable. Removing entry barrier and easing branch expansion have increased competition. The three bank concentration ratio shows a declining trend in concentration; however the ratio is still high about 60 percent of total asset of the commercial banks. Regulations like new loan classification and provisioning, capital adequacy requirement, international standard of accounting and auditing practices are important for a sound financial health of banks and financial institutions. Moreover, it is vital even in the financial system to do something right instead of talking too much. Nevertheless, practical transformation is and always remains crucial.