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POLICY DEVELOPMENT FOR NEPALESE FINANCIAL SYSTEM AND ITS CHALLENGES

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ABSTRACT
A sound, efficient and healthy financial system is the preconditions for achieving the faster economic growth. But this situation cannot be built without the presence of sound and healthy banks and financial institutions in the economy. Managing the financial system is, therefore, a subject of crucial importance. The increased number of bank and financial institutions has also resulted in an expansion of deposit collection and lending. This is helpful in promoting financial inclusiveness and deepening in the economy. So, well articulated policies should be in place for the proper management of the financial system. The entry points of Banks and financial institutions are managed and administered through the licensing policy and there should be adequacy of prudential rules, regulations and the supervision system, whereby the sustainability and soundness of the financial institution operation is assured all the time.

KEYWORDS
Nepalese financial system, economic growth.

BACKGROUND
The financial sector includes all the wholesale, retail, formal and informal institutions in an economy offering financial services to consumers, businesses and other financial institutions, every thing from banks, stock exchanges and insurers, to credit unions, microfinance institutions and money lenders. (DFID, 2004). In the theory of economic, it has a long tradition that financial and economic activities are deeply interrelated. The French economist Clement Juglar who was among the first find out the characteristic of business cycles said in 1860 that economic fluctuations begins in the credit system.

To pool and utilized financial resources, decrease costs and risk, expand and diversity opportunities increase the given efficiency of resources and encourage the productivity and help the economic grow a latest financial system is indispensable. On the one hand the development of financial sector on the other hand automatically enables persons, and institutions to channel savings to more productive enterprises offer plays a very significant role in GDP growth. On one hand a strong financial condition promotes and help in the growth of the real sector on a sustainable base on the other hand financial condition badly affect the objectives economic development. It also helps to minimise the poverty. The influence of these already witnessed by the experience of the financial crises of 1990s.

According to central banks, financial sector advancements are different from other services. Financial development affert the long term production and employment. They can affert tools for monitoring and modeling economy patterns. Banking sector changes can influence the mechanism of monetary transmission. Advancement in the financial system can improve transmission of the single monetary policy. An effective financial system can lead to better risk hedging and risk diversification that make economies less vulnerable to disturbances. Some financial development, however, increase speculative behavior, market volatility and deepen financial crises (Gonzalez-Poramo, 2008).

A number of factors are responsible for the efficiency of a financial system, such as level of integration, market competition, development level and capacity to invent. Observation shows that countries that provide more credit to the private sector have stronger economic growth.

A country can develop its financial system in several ways. One of them is to open up to foreign competitions and international capital flows. Many countries fear this approach because they expect foreign shocks. Moreover, many economists claim that the liberalizations cost can be extremely high. A poor financial system may invite bank runs and balance of payments crises irony capitalism and excessive risk-taking by banks. The high cost may overwhelm the benefits from higher growth. But evidence indicates that financial growth with effective regulations can channel savers resources to more productive firms, they results in sustainable long run growth.

It is possible to learn valuable lessons from financial sector policies in developed and emerging market (Beck, 2006). The government needs to play an active role for creating markets by ensuring competitive and contestable banking and capital markets and providing an incentive-compatible financial safety net. It is more important to define a proper role for government.

OBJECTIVES OF THE STUDY
i. To study development policies regarding Nepal's financial system and
ii. To list some challenges of the country's financials system

POLICY DEVELOPMENT AND FINANCIAL SYSTEM OF NEPAL
Because the financial system raises funds for productive investment, successful financial liberalization is an important part of national policy for economic growth. Financial liberalization has many objectives: improving deposit mobilization, enhancing the allocative efficiency of financial intermediation by ending the distortion generated by administrative control, motivating more competition in financial markets and improving monetary control.

In Nepal, financial openness was started in the mid 1980s when the government gave a green signal for the entry of commercial banks is joint venture with foreign banks. To modernize banking through the transfer of technology and managerial skills, Nabil Bank Ltd. was established in 1984 as the first joint-venture bank in Nepal, which was latter fallowed by Nepal Bank Ltd. and Standard Chartered Bank Ltd.

Financial liberalization made progress in 1987/88, when Nepal entered a three year structural Adjustment Programme (SAP) with the IMF. The general purpose of this step was to improve the role of market forces in the financial system. The NRB started regular auctions of treasury bill since 1988/89 in order to begin greater flexibility in the interest rate structure. It also improved its rediscounting rates with form of three windows: basic rate, selective rate, and tender of the last resort rate in 1989.

To reduce the dependence of commercial banks for short term borrowing, a call money market was established during 1988/89. At the same time a comprehensive study under the title of Commercial Bank Problem Analysis and Strategy Study (CBPASS) was carried out to improve the financial and organizational structure of the two state owned commercial banks [Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB)]. A few of the recommendation included in the CBPASS were applied in 1990/91.

Due to positive result Nepal entered into another three-year Enhanced Structural Adjustment Facility (ESAF) with the IMF, in 1992/93. The main focus of financial liberalization was on (a) allowing market forces to play a more active role in the financial system, (b) toughening competition and improving efficiency (c) improving and increasing tools and (d) expanding the capital market.

With the aid of the World Bank and the Department for international Development of the United Kingdom, the Financial Sector Technical Assistance Project has been brought into operation since 1988. The essential elements of the Project are the re-engineering of the NRD, rebuilding of NBL, RBB and capacity improving in the financial sector. Under FSTA Project, the regulatory and supervisory capacities of the NRB have improved. A new licensing policy in 2002 (last revised in 2007) was framed for opening a new commercial bank or financial institution.

A number of reform steps regarding financial sector legislation have been taken, such as enactment of a new Nepal Rastra Bank Act 2002 and Debt Recovery Act 2002. With the enforcement of the Nepal Rastra Bank Act 2002, the central bank of the country has become independent. A Debt Recovery Tribunal (DRT) was established under the Debt Recovery Act 2002 in order to improve the legal and judicial processes of recovery problem loans of bank and financial institution.
The Secured Transaction Act and Insolvency Act were strengthened on Nov 16, 2006 and Nov 20, 2006 respectively to make the legal structure of banks and financial institutions better and more convenient.
For the development of the NRB, the second stage of reform has begun, whose objective is to update the information technology supervisory power and human resource management. In addition, the accounting system of the NRB is modernized to match the international and domestic accounting standards the year 2004 saw the enactment of the bank and Financial Institution ordinance. Besides, in the same year the new legal framework replaced various fragmented legal structure. In view of the promulgation of the Banks and Financial Institutions Act (BFIA), the current prudential rules and instructions, issued at different times, have been revised and incorporated into a unified system and enforced from July 16, 2005.
To lower the risk in the financial sector, a regulation has already been issued. For the supervision of the system, the policy of risk based guidance is being followed. The private sector is being motivated to setup a credit rating agency.
Regarding the construction of suitable base for the enforcement of BASEL ll Accord since 2007, necessary instructions, policies and provisions have been formulated. Moreover, according to BASEL ll Accord, the regulatory provision has been formed to abide by the Simplified Standardized Approach (SSA) for capital base and Basic Indicator Approach (BIA) for operational risk.
The huge quantity of Non-performing Assets (NPA) has posed a main problem for financial sector development and stability. To deal with this problem, the NRB is working with the government in improving the power of Debt Recovery Tribunal and setting up an Asset Management company (AMC).
To reduce the potential fraud and crimes, the Anti-Money Laundering Act 2008 and Banking Crime and Punishment Act 2008 have been implemented on Jan. 28, 2008 and Feb. 5, 2008 respectively. Moreover, the Financial Intelligence Unit has been set up in the NRB and necessary by laws and instructions are being made.
A comprehensive description of all banks and institutions has been posted on the web to offer necessary information to public.
The NRB has been trying to provide a well regulated financial sector. In this directions, the capital sufficiency, single borrower limit, loan loss provision, professionalism of the promoter, standardized capital base, complete deregulation of interest rate, open licensing policy, phasing out the discredit credit have been major improvements.
The NRB has offered sequential financial sector liberalization public financial services, deregulation of micro finance of activities and so on.
The government introduced the National Micro Finance Policy on May 4, 2008 with the objective of increasing the power of micro finance. According to this policy a separate agency would be set up to watch the microfinance. This policy will enhance access of microfinance to undeveloped and poor families. The future plan is to set up National Microfinance Development Fund to mobilize resource, locally as well as internationally.
The NRB has reworked on those requations that are not consistent with market-oriented policies. Interest rate spread has been eradicated and the rule to invest in priority sector has been wiped out. From 2007/08 onwards, priority sector lending will not be in use. In the procedure of the accession to the world Trade Organization (WTO) Nepal had made some allegiance in financial service under the General Agreement on Trade in services (GATS) and the Annex on Financial services. But all the allegiances were conditional upon entry requirement domestic laws, rules and regulation even the terms and conditions of the NRB and Insurance Board. In Nepal, through a domestically incorporated company, the financial services are carried out. For the wholesale banking, the foreign bank's breaches should be encouraged. However, the financial institutions that obtain a rating of at least 'B' from eminent global credit rating agencies will be permitted to do commercial business in the country. On the contrary to this perspective, the foreign banks banking transactions in Nepal and the opening of branches by the Nepalese banks abroad, there is newdraft prepared by the bank. The draft contains special and separate provision for the licensing and the operations of the branches of the foreign bank.
Owing to the various measures initiated by the NRB in the financial sector field of the country and they creating an amiable environment for the entry of new financial institutions where some many financial institutions have been established and competition has been boosted to some extent. As whole, as of mid-July 2013 there were 32 commercial bank ('A' class financial institutions), 89 development banks 'B' class financial institutions and so on licensed by the NRB to undertake certain financial transactions. In addition to these there are other various financial institutions consisting of Employees Provident Fund, Citizen Trust, Postel Saving Bank, Finance Companies and Co-operatives and NGOS licensed to undertake certain banking business full under supervisory jurisdiction of the NRB. Comparatively small and under developed economy base of the country, Nepal has a noticeably diversified financial sector as evidenced by the number and variety of institutions that play a active role in the sector.

TABLE 1: A GLANCE OF NEPAL'S FINANCIAL INSTITUTIONS

	2008	2009	2010	2011	2012	2013
Commercial Banks (A Class)	25	26	27	31	32	32
Development Banks (B class)	58	63	71	88	88	89
Financial companies (C class)	78	77	79	80	70	65
Micro Credit Financial Institutions (D class)	12	15	18	21	24	28
Credit Co-operatives	16	16	15	16	16	16
NRB incensed NGO&	46	45	45	38	36	33
Insurance companies	25	25	25	25	25	25
Employes Provident Fund	1	1	1	1	1	1
Citizens Investment Trust	1	1	1	1	1	1
Postal Savings Bank	117	117	117	117	117	117

Source: Economic survey, 2012/13, Ministry of Finance, Nepal.

After the Development Bank Act 1996 become effective, a number of development banks were established with the aim of helping agriculture industry and commerce through the provision of credit. Before this Act there were only two development banks viz. Agricultural Development Bank and Nepal Industrial Development Corporation, and both of them were under the ownership of the government. Currently a number of development banks are operating under Banks and Financial Institutions Act 2006 with status of 'B' Class.
After the amendment of the Finance companies Act 1992 in 1992, the finance companies were emerged rapidly. Now such companies are operated under Bank and Finance Institution act 2006 as 'C' grade financial institutions on the one hand and on the other co-operatives are operated under Co-operatives Act 1992. Besides, these there are also NRB licensed NGOs to undertake limited banking transactions in accordance with provision of the financial Intermediation Related Institution Act 1999.
The provident fund of army, police teachers, government institutions, and some other private companies is managed under the Employees Provident Fund Act 1962. On the other hand, the private and institutional savings, loans and advances are managed by CIT which is under the Ministry & Finance.
Different areas like capital market and insurance are included in the financial sector. In the capital market, the stock exchange, being the important player of the capital market has a prominent role in the Nepalese Financial Market. To reform capital markets Nepal government converted Securities Exchange Center into Nepal Stock Exchange Limited (NEPSE) in 1993. The NEPSE introduced fully automated screen based trading since August 24, 2007, replacing the preserve system.
When the securities Act 2007 come into effect from Jan. 14, 2007 it has further extended the mandate of the securities Board of Nepal (SEBON) as the operater the securities market. Securities market operation Regulation 2007, Securities Dealers Regulation 2007; Security Board Regulation 2007 etc were introduced by SEBON.

In 1990 the insurance sector was opened to the private sector. Under the insurance Act 1992, there are altogether 25 Insurance companies 17 of these are non life insurance,, seven life insurance and one is both life and non-life insurance. From the vantage point of the ownership, 18 are owned by the private sector three are foreign joint venture, three are foreign branches and one is government owned. The insurance Board operates the insurance sectors.

CHALLENGES

- The financial sector is still docile and there is little approach to financial services for the small business and low income households despite the help of NRB.
- It is more intricate and challenging for the banks and financial institutions to bring changes and reforms after becoming the member of the world trade organization. Nepal's membership to this universal organization represents both opportunities and risks in the process of maintaining overall financial stability so as to speed up the economic growth.
- The new market participants and the emergence of new products has viewed many changes in the past fostered. Moreover, because of the rapid increase in the number of banking and non banking financial institutions with different modes of operations the task of ensuring sufficient monitoring and control by the NRB has been made move challenging.
- As the NEPSE is being run under the government ownership and management, it would be difficult for an autonomous regulatory institution to regulate and observe it. Hence it is needed to review the management and the ownership and enhance it as a modern institution operating as per the international practice.
- To mobilize deposits and allocate credit through informal and community, based banks and microfinance areas where the reach of formal banks is limited close connection between informal and formal financial markets should be developed by inspiring formal financial institutions. To encourage these developments, fiscal policies, regulatory and supervisory structures should be designed.

CONCLUSION

The backbone of an economy is built in many ways by the financial markets. A well operated financial sector takes an efficient transformation of saving and investment, guarneting the resources are well used where they earn the highest return. The major pre-requisites for the financial stability and economic progress are a strong and resilient financial system and the orderly evolution of financial markets.

It is very important to know that success of any financial system, in its resources mobilization and allocation function, depends on its ability to offer the public variety of assets. It is also very much important to formulate appropriate policies to enable financial system.

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