Chapter 34
Financial Market in Nepal:
Challenges of the Financial Sector Development in Nepal

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ABSTRACT

The Nepalese financial sector is attributed of banking sector and non-banking sector. There is exponential growth in the number of financial institutions in Nepal in the last decade. The existing legal framework and institutional setup in Nepal is not conducive to the overall financial sector and private sector development and thus there is an urgent need for reformation in these sectors. The major impediments to private sector involvement in infrastructure development projects include the political and administrative instability; lack of consistent planning; lack of effective institutional support in designing and development of private sector infrastructure projects. Talking about the capital market and capital gains In Nepal, capital gains on securities transactions are taxed as ordinary income to corporations and individual investors while in most of the emerging markets capital gains on investments in stocks and bonds are not taxed, which need to be reformed as per the international practices.

BACKGROUND

The major obstacle to the private sector capital formation and economic development in Nepal is the high cost of capital which is associated with the lack of competition in the financial sector and the poor performance of government owned-banks. In this regard, it can be observed that gap between lending and borrowing rates has widened in recent years while the overall performance of the banking system has showed little improvement despite the growth of private banks in the 1990s. In line with above reference The Nepal Bank Limited (NBL) retrenched its operations, consequently, the market share of private banks doubled more than 37 percent, while the market share of the Rastriya Banijya Bank (RBB) remained unchanged at about 32 percent. Nevertheless, some members of the business community believe that the private joint venture banks have not contributed sufficiently to the economic well-being

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of the nation. Instead, these institutions are sometimes viewed as benefited from the inefficiency in the financial sector (i.e., wide-loan deposit spreads). If this is the case, the Nepalese economy could benefit from the added competition that would be provided from the development of a money-and-bond market for private issues of securities. In Nepal, universal banking is permitted whereby commercial banks and quasi-banks (i.e., deposit-taking finance companies) may perform investment banking services within the same organization. Commercial banks, however, are not actively involved in capital markets. While authorized to act as underwriters they ordinarily do not participate in this line of business as extensively as finance companies. Commercial banks do not act as money managers or instead, sponsor mutual funds. They do not serve as brokers or market-makers on the floor of the stock exchange either. Commercial banks, however, are active participants in the markets for treasury bills and government bonds. Since the secondary market is relatively inactive, their role is largely limited to primary market transactions.

Over the past 20 years Nepal's financial system has become wider and consequently the number and the type of financial intermediaries have grown rapidly. In addition, recent reforms have made banks more stable, yet the access to financial services remains limited for many people in many parts of Nepal and in recent years it has been declining. During the last 40 years, Government of Nepal has tried much to increase access to formal financial services for small business and low-income households.

The government has introduced directed lending programs for small businesses and low-income households and it has required/encouraged banks to open branches outside Kathmandu Valley. Also it has created specialized wholesale and retail institutions, and lowered market entry to foster the development of different types of financial institutions.

The Nepalese financial sector is composed of banking sector and non-banking sector. The banking sector comprises Nepal Rastra Bank (NRB) and commercial banks. The non-banking sector includes development banks, micro-credit development banks, finance companies, cooperatives and non-government organizations (NGOs) that regulate limited banking activities and other financial institutions such as insurance companies, employee's provident fund, citizen investment trust, postal saving offices and Nepal stock exchange.

There is tremendous growth in the number of financial institutions in Nepal in the last decade. In the beginning of the 1980s, when financial sector was not liberalized, there were only two commercial banks, and two development banks performing banking activities. There were no micro-credit development banks, finance companies, cooperatives and NGOs. After the liberalization of the financial sector, it has made a hall-mark of progress both in terms of number of services. After 1984, there was rapid entry of joint venture commercial banks in to the Nepalese financial market. In the first phase, the Nepal Arab Bank (presently known as NABIL) (1984), the Nepal Indo-Suez Bank (1985) and the Nepal Grindlays Bank (1987) entered the market. In the second phase these banks were followed by the Himalayan Bank, the Nepal SBI Bank, the Nepal Bangladesh Bank, the Everest Bank, the Bank of Kathmandu and the Kumari Bank. In the third phase many development banks have emerged in the market.

In Nepal, the banking sector is one of the sectors which have been able to sustain by facing the test of time due to political instability in the country and it has established itself as the most profitable sector. Currently, with the increased rate of various problems in the country, banking sector is able to prosper with less difficulty. But the growth of financial institutions seems to be slowing down due to the entry of new players leading to a harsh competition. One of the signs of such problems has been the credit crunch faced by financial institutions in recent months. As a result, banks are looking for new geographic locations in order to diversify the portfolio of customers.

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