Financial Reforms and Financial Development in Nepal: A Review

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Abstract

Effective financial systems and institutions are foundational to the economic development of any country. Recognizing this, the Government of Nepal and the Nepal Rastra Bank (NRB) have embarked on numerous reforms aimed at bolstering the banking and financial sectors. These efforts are crucial for enhancing the efficiency, accessibility, and stability of financial services, which, in turn, spur economic growth. This study conducts a thorough review of the financial sector reforms initiated primarily by the NRB, detailing their scope and impact. It explores how these reforms have shaped the financial landscape of Nepal, aiming to create a more inclusive and competitive financial environment. Additionally, the research examines the current state of financial development across Nepal's provinces, identifying disparities in financial access and efficiency. This provincial analysis is vital for understanding the uneven distribution of financial services and its implications for regional economic growth. By evaluating the effectiveness of these reforms and the status of financial development, the study provides insights into the challenges and opportunities within Nepal's financial sector. It underscores the importance of continuous reforms, regulatory enhancements, and the promotion of financial literacy to achieve comprehensive financial development. The findings highlight the progress made thus far and the ongoing need for strategic policy interventions to ensure equitable economic development across all regions of Nepal, setting a pathway for future reforms.

Keywords: financial reforms, financial development, financial liberalization, financial access, strategic plans

JEL classification: C22, E31, G10, O47

Introduction

Financial Sector Reform (FSR) plays a pivotal role in shaping the financial landscape of economies, aiming at liberalizing financial markets, enhancing transparency, and promoting healthy competition. Its key objectives include the deregulation of interest rates, encouraging the entry of private and foreign entities into the financial sector, improving corporate governance, and aligning domestic financial practices with international standards. This strategic process entails allowing commercial banks to deal in foreign currency and facilitating foreign investments in local banks to foster a more dynamic and inclusive financial ecosystem (Mohan, 2013).

The financial system, by design, serves as an intermediary, efficiently channeling funds from savers to borrowers while offering a spectrum of investment opportunities. This mechanism is crucial for minimizing transaction costs, ensuring the availability of essential financial services such as ATM access, online banking, and various insurance and pension schemes, thus promoting equitable economic growth (Kumar & Gireesh, 2016).

Opening domestic financial markets to foreign investment is heralded for improving the efficiency and accountability of banking services, thus enhancing transparency and corporate governance. These changes are instrumental in addressing liquidity issues and reducing risks associated with financial transactions, thereby contributing to economic growth by bolstering the liquidity and efficiency of domestic financial markets and intermediaries (Arestis & Demetriades, 1999; Bonfiglioli, 2005; Collier & Mayer, 1989; Levine, 2001).

However, the push for liberalization comes with its share of cautionary tales. Critics argue that without adequate regulatory oversight, such liberalization can lead to boom-bust cycles, increased susceptibility to external shocks, and heightened financial fragility, underscoring the importance of a balanced approach to financial sector reform (Calvo & Mendoza, 2000; Detragiache & Demirgüç-Kunt, 1998; Stiglitz, 1999).

The evolution of the financial system, from the advent of paper money to modern financial instruments, underscores its centrality to capital formation and economic productivity. Financial development, as outlined by Demirguc-Kunt (2008) and Levine (2021), refers to the system's enhanced efficiency in fulfilling key functions such as addressing information asymmetries and managing risks. The measurement of financial development, therefore, focuses on assessing the depth (e.g., liquid liabilities to GDP) and breadth (e.g., bank credit relative to stock market capitalization) of the financial system, shedding light on its structure and impact on the economy (Arestis & Magkonis, 2015).

This study provides an in-depth review of the financial sector reforms in Nepal, analyzing their scope, implementation, and impact. By conducting a descriptive analysis of the current state of financial development in Nepal, it offers insights into the progress made and the challenges that lie ahead, contributing to the broader discourse on financial sector reforms and their implications for economic development.

Literature Review

Financial Sector Reform (FSR) embodies a series of strategic measures aimed at liberalizing financial markets, enhancing market transparency, and stimulating competition within the financial sector. Mohan (2013) underscored the reform's key goals, such as deregulating interest rates, introducing private entities to the financial sector, enhancing corporate governance, and aligning with international financial standards. Such reforms have historically included permitting commercial banks to handle foreign transactions and encouraging foreign stake in domestic banks, pivotal for integrating domestic markets with the global economy.

The liberalization of financial markets, as discussed by Collier and Mayer (1989) and Bonfiglioli (2005), significantly impacts local banking efficiency, promoting transparency and accountability. Levine (2001) posited that financial openness catalyzes economic growth by enhancing domestic financial market efficiency, thereby fostering productivity growth. However, the liberalization process carries inherent risks, including heightened exposure to external financial shocks and increased financial system fragility, as noted by Detragiache and Demirgüç-Kunt (1998).

Critics like Stiglitz (1999) have raised concerns over the potential adverse effects of rapid and unchecked financial sector liberalization, particularly in developing countries. The susceptibility to boom-bust cycles, exacerbated by unregulated capital flows and investor behavioral biases, poses significant risks to economic stability (Calvo & Mendoza, 2000). Historical financial crises in Mexico, East Asia, and the global crisis of 2008 serve as stark reminders of the vulnerabilities introduced by deregulation.

The role of the financial system as a capital intermediary is critical, according to Kumar and Gireesh (2016), who highlighted its function in channeling funds from savers to borrowers and offering a spectrum of investment products. They argue that a robust financial system is integral to reducing transaction costs and providing essential services, thereby facilitating efficient capital allocation across the economy. Equitable access to these financial services is vital for ensuring inclusive economic growth.

Despite these challenges, the financial system's evolution—from the advent of paper money to modern financial instruments—has been a cornerstone of economic development. Demirguc-Kunt (2008) and Levine (2021) outlined the financial system's quintessential functions, emphasizing that financial development entails the system's improved efficiency in fulfilling these roles. The complexity of measuring financial development is acknowledged by Arestis & Magkonis (2015), who suggested various proxies for assessing the financial system's depth and breadth, integral to understanding its structure and impact on the economy.

Although most of these paper focuses on the relationship between financial development, there isn't any attempt to document the reform actions taken by NRB to strengthen the financial sector in Nepal. This literature review provides a foundation for our comprehensive examination of financial sector reforms in Nepal and the descriptive analysis of the country's financial development status. It highlights the multifaceted nature of financial reforms and the critical balance between liberalization and regulation to ensure a stable, efficient, and inclusive financial system that supports sustainable economic growth.

Research Method

This study aims to critically analyze the Financial Sector Reform in Nepal and assess the current state of financial development within the country. Our analysis relies on secondary data collected from reputable sources, including reports and datasets from the NRB, the World Bank, the International Monetary Fund (IMF), and various scholarly articles. A detailed examination of the Financial Sector Reforms undertaken by the Nepal Rastra Bank and the Government of Nepal will be conducted. This includes reviewing policy documents, reform announcements, and related literature to outline the scope, objectives, and implementation phases of these reforms. The time frame for the data spans from the initiation of significant financial reforms in the 1990s to the present day, allowing for an assessment of long-term trends. The study uses descriptive analysis of the status of financial development in Nepal, focusing on key indicators such as number of banking and financial institutions, credit and deposits per capita, etc. This study involves comparative analysis of financial development indicators in different provinces of Nepal. This will help in identifying unique challenges and successes in Nepal’s context and provide insights into the generalizability of Nepal's reform outcomes.

Results

Financial Sector Reforms in Nepal

Nepal's journey towards regulating and supervising its finance sector began in 1956 with the establishment of the Nepal Rastra Bank (NRB), under the Nepal Rastra Bank Act of 1955. This pivotal move aimed at managing credit through directed programs and controlling interest rates. For a long period, up until the mid-1980s, the Nepalese government maintained a stronghold on the finance sector, owning all but a few banking and insurance entities. This era was marked by significant government intervention in financial operations, including stringent interest rate regulation, selective lending policies, and rigorous regulations on the entry and exit of financial institutions.

The landscape began to shifting around late 1970s due to significant political changes and a push towards more open and liberal economic policies. This transformation was partly driven by the necessity to obtain international financial support, leading to the implementation of the Economic Stabilization Program and Structural Adjustment Programs (SAPI and SAP II). These programs aimed to reduce government involvement in the economy and promote market-oriented reforms.

Following these changes, from the late 1980s into the 1990s, Nepal embarked on a liberalization path that significantly increased the role of the private sector in the finance industry. This era of liberalization witnessed a dramatic expansion in the banking sector, as privately-owned commercial banks increased from three to fourteen from 1985 to 2000. The financial landscape also saw a surge in the variety and number of financial institutions, increasing from five to ninety-nine in the same timeframe, marking a period of substantial growth and diversification in Nepal's financial sector.

The era of liberalization and reform in Nepal ushered in a more diverse and competitive financial landscape, significantly improving access to financial services, and propelling economic growth. By transitioning from a primarily state-dominated financial system to one that leverages market forces and encourages private sector participation, these reforms laid a robust groundwork for sustainable economic development. This transformation not only broadened the scope of financial offerings available to individuals and businesses but also introduced a competitive edge that drove innovation and efficiency within the financial sector. As a result, Nepal's financial environment has become more dynamic and resilient, poised to support the nation's economic aspirations in the years to come.

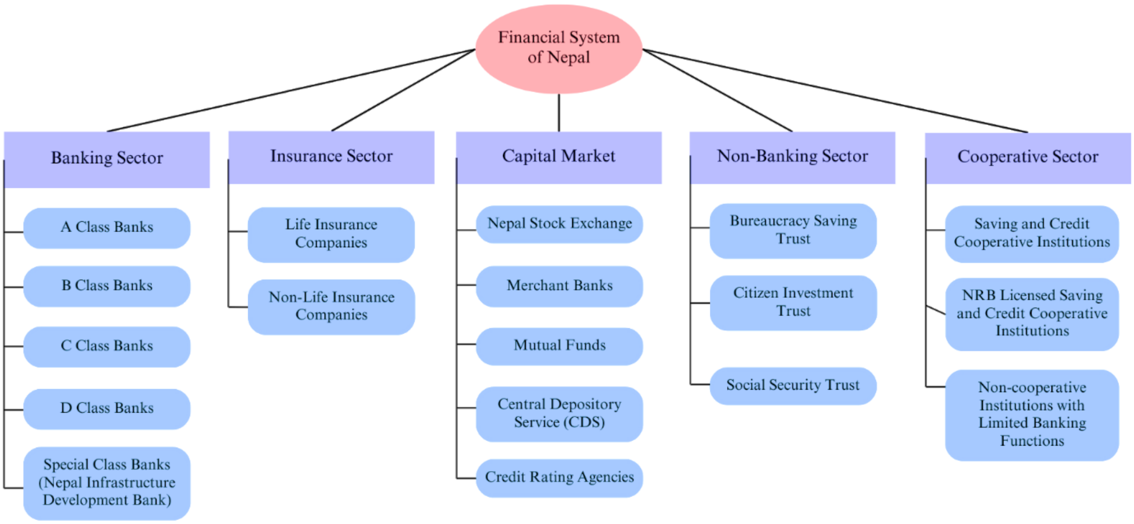
Structure of Financial System in Nepal

The realm of modern banking in Nepal began in 1937 with the establishment of Nepal Bank Limited, signifying the nation's initiation into commercial banking activities. This institution, set up under the Nepal Bank Act, functioned as a semi-private bank and remained the exclusive formal financial entity until the formation of the NRB in 1956, as mandated by the NRB Act of 1955 (Nepal Rastra Bank [NRB], 2005). The foundation of central bank in Nepal, NRB, marked a pivotal advancement in the financial landscape. Following this, a diverse array of financial institutions emerged, broadening the spectrum of financial services available. Since the late 1980s, the financial sector in Nepal has seen considerable growth, with the last twenty-five years witnessing remarkable expansion in both the scale of operations and the market's breadth.

The financial sector in Nepal is broadly categorized into two main segments: the banking and the non-banking financial sectors. Within the banking domain, the ecosystem comprises Commercial Banks, Development Banks, Finance Companies, and Micro Finance Development Banks (all regulated by NRB), along with Saving and Credit Cooperative Societies and Non-Government Organizations that conduct limited banking operations under NRB's authorization. As per the data available until mid-January 2021, there were 27 Commercial Banks, 18 Development Banks, 17 Finance Companies, and 70 Microfinance Institutions. On the non-banking side, the sector includes 19 life and 20 non-life insurance companies, a single re-insurance company, 32 merchant banks, the Employees Provident Fund, Nepal Stock Exchange Limited, various Insurance Companies, Deposit Insurance and Credit Guarantee Corporation, Credit Information Center Limited, and the Citizen Investment Trust (NRB, 2021a;NRB, 2021b). Figure 1 shows the structure of financial system in Nepal.

Figure 1

*Structure of Financial System in Nepal (*NRB, 2021a)



Pre-Financial Reform Phase

The establishment of Nepal Bank Limited as the first bank in the country marked Nepal's beginning of financial sector journey in 1937. However, systematic regulation and supervision kicked off in 1956 with the creation of NRB, aimed at managing credit through specific programs and interest rate guidelines. Until the mid-1980s, the financial landscape remained basic, with the government holding tight control over a small number of banks and insurance companies. This period was characterized by heavy government intervention in various aspects of financial operations, maintaining a protectionist economic stance that hampered export growth and led to structural inefficiencies and economic stagnation. The economic situation was further strained by increasing government expenditure and rising national debt, which, along with regulatory constraints, stifled private sector growth and led to inflationary pressures (NRB, 2005).

The financial sector also saw the establishment of pivotal institutions like the Employee Provident Fund (EPF) in 1962 and the Credit Guarantee Corporation (CGC) in 1964, enhancing the sector's infrastructure. Despite the prevalence of a significant informal money market, these formal institutions played crucial roles in the growing financial landscape. Facing an economic crisis in 1985, Nepal sought international assistance, leading to the adoption of the Economic Stabilization Program with the IMF and a Structural Adjustment Program (SAP) with the World Bank. These programs, aimed at reducing government intervention and promoting market-oriented reforms, marked the beginning of a series of liberalization measures that significantly opened up the financial sector to private participation (NRB, 2005).

Phase I (1984 – 2000)

The first phase of financial reform in Nepal, characterized by the adoption of Structural Adjustment Programs (SAP) with support from the World Bank and the IMF, marked a pivotal shift towards liberalizing the financial sector. A landmark step was the amendment of the Commercial Bank Act in 1984, allowing foreign investment in the banking sector through joint ventures, leading to the establishment of Nepal Arab Bank, Nepal Indosuez Bank Limited, and Nepal Grindlays Bank Limited between 1984 and 1987. The NRB initiated deregulating interest rates for banks and financial institutions, with full deregulation by 1986, and permitted commercial banks to accept foreign currency deposits for the first time in 1985 (NRB, 2005;NRB, 2018a).

The period saw the implementation of prudential regulations to ensure financial stability, including capital adequacy requirements, loan loss provisioning, and liquidity adjustments. The introduction of government securities auctions in 1987 and the allowance for commercial banks to issue bonds and debentures broadened financial resource avenues. Moreover, the establishment of the Credit Information Bureau in 1989 and legislative acts like the Finance Company Act of 1986 aimed to foster competition and transparency within the sector. The democratic restoration in 1990 further accelerated financial liberalization, leading to a significant increase in banking and non-banking financial institutions. The early '90s saw the founding of several commercial banks and the first finance company in the public sector, enhancing the diversity of financial services. Additionally, rural development banks emerged to extend microfinance services to underprivileged women in rural areas, reflecting a commitment to inclusive financial growth (NRB, 2005;NRB, 2018a).

By the year 2000, the number of commercial banks had grown to fourteen, and financial institutions expanded dramatically from five to ninety-nine. This growth phase not only doubled banking credit but also improved access to banking services and saw enhancements in key financial indicators, signaling a healthier financial sector. However, despite these advancements, the performance of government-owned banks lagged, highlighting the need for further reforms. This set the stage for the second significant phase of financial reform, aimed at addressing these shortcomings and continuing Nepal's journey towards a more liberalized and efficient financial system (NRB, 2006).

Phase II (2000-2006)

Financial sector reforms in Nepal have catalyzed a wave of changes, including interest rate liberalization, establishment of regulatory frameworks, development of government securities markets, expansion of banking and financial institutions, and the introduction of competitive dynamics in the financial sector. Despite these strides, challenges persisted, particularly with the major commercial banks (RBB and NBL) and key development banks

(ADB/N and NIDC). Recognizing these issues, international bodies such as the World Bank, IMF, and ADB pointed out deficiencies in the NRB regulatory and supervisory capabilities (NRB, 2005; NRB, 2006).

In response to these challenges, in December 2000, the Government of Nepal (HMG/N) unveiled the Financial Sector Strategy Statement, emphasizing the urgent need to enhance NRB's regulatory authority. This strategy called for the enactment of a new NRB Act to bolster its oversight capabilities, the ability to intervene in the management of failing banks, and to impose stringent penalties for significant irregularities. It also highlighted the importance of the Deposit Taking Institution Act for regulating deposit-taking entities. Key initiatives outlined in the Financial Sector Strategy Statement included reforming financial sector legislation, strengthening NRB supervision, restructuring and privatizing RBB and NBL, establishing a banking training center, enhancing the Credit Information Bureau, and improving the Agricultural Development Bank Limited (ADBL) along with establishing rural development banks (NRB, 2006; NRB, 2018a).

To bolster these reform initiatives, substantial international financial support was secured. In 2003, the World Bank launched a Financial Sector Technical Assistance Project with a $16 million fund, which was followed by a $72 million agreement for the Poverty Reduction and Growth Facility (PRGF) by the IMF in 2004. Furthermore, in 2005, the World Bank allocated $68.5 million in loans and grants for the Financial Sector Restructuring Project (FSRP). In 2007, the Asian Development Bank (ADB) provided a $57 million loan and grant for the Rural Finance Sector Development Cluster Program (RFSDCP). These concerted efforts underscore a comprehensive strategy to reform Nepal's financial sector, aiming to address systemic weaknesses, enhance regulatory frameworks, and promote a more inclusive and robust financial ecosystem (NRB, 2005).

The restructuring of Rastriya Banijya Bank (RBB), initiated in 2059 BS with World Bank support, encompassed comprehensive reforms led by an external management team. These reforms focused on human resource development, supervisory capacity enhancement, legislative updates, capacity building in various departments, and IT automation, including a fully integrated management information system. These efforts, bolstered by consultants and experts across fields, continued until 2008, significantly modernizing RBB's operations (NRB, 2006).

First Strategic Plan (2006-2010)

In 2006, NRB initiated its strategic planning with a series of five-year plans aimed at adapting to financial globalization and technological progress. The first plan (2006-2010) set out to tackle global economic shifts, focusing on essential financial management areas and enhancing capabilities in human resources, research, ICT, and legal affairs to maintain economic stability and meet overarching goals (NRB, 2006).

This foundational plan featured 65 strategies and 204 actions, successfully completing 85% of them. It effectively aligned NRB's resources with its vision and mission, despite some actions being deferred or dropped for technical reasons. This first strategic effort significantly bolstered NRB's operational efficiency and strategic focus, serving as a crucial milestone in its evolution, continuing with further plans (NRB, 2018a).

Second Strategic Plan (2012- 2016)

The Second Strategic Plan of the Nepal Rastra Bank (2012-2016) refined its approach by focusing on specific strategies organized around seven strategic pillars, rather than the broad strategies of the first plan. These pillars included macroeconomic and financial sector stability, foreign exchange management, payment systems, human resource management, infrastructure and corporate governance, customer service, and ICT development, building on the groundwork of the initial plan (NRB, 2012).

With 201 activities distributed across 24 priorities, the plan set out a clear timeline for implementation: 58 activities in 2012, 61 in 2013, and a decreasing number in subsequent years, with some activities ongoing. By December 2016, 78% of the activities were completed, showcasing a solid execution rate and leaving a portion under progress (NRB, 2017). This structured approach further advanced NRB's mission, illustrating progress and continued commitment to Nepal's financial stability and development.

Third Strategic Plan (2017-2021)

The Third Strategic Plan (2017-2021) of the NRB aimed to address global shifts and organizational goals, leveraging insights from previous plans and acknowledging the challenges and opportunities presented by global financial integration and technological advancements. It focused on maintaining macroeconomic stability and enhancing the NRB's infrastructure in physical, technological, and human resources to navigate economic and financial challenges facing Nepal.

Incorporating considerations such as economic difficulties, NRB restructuring, and environmental factors, the plan was structured around four core pillars: macroeconomic stability, financial stability and sector development, external sector stability, and a sound payment system, supported by seven additional pillars (NRB, 2017). Of the 194 tasks outlined, 71% were completed, 5% were dropped, and 24% remained in progress as of mid-July 2021, demonstrating a strategic and focused effort towards improving governance and the financial environment in Nepal.

Challenges in Financial Sector Reform

Since its inception in the late 1980s, Nepal's FSR has marked significant progress under the NRB stewardship, despite facing evolving challenges amidst political changes. Key issues include enhancing financial sector stability, improving productive sector lending, broadening financial access especially in remote areas, and addressing the risks associated with shadow banking. Despite a 68% financial literacy rate, banking services remain urban-centric, leaving rural populations underserved. State-owned banks grapple with inefficiency and productivity issues due to outdated skill sets, while private bank employees face exploitation. Policies like the Interest Rate Corridor have induced interest rate volatility, and cyber security risks have surged with the rise in digital transactions.

The reform agenda calls for a strengthened supervisory role for the NRB, strategic consolidation of banking institutions, tackling of cyber threats, and addressing internal management challenges. Additionally, the pandemic has introduced new hurdles, underscoring the importance of expanding digital banking access nationwide and curbing informal financial activities. A focused and multifaceted approach is vital for addressing these challenges, ensuring the FSR's continued contribution to Nepal's economic resilience and growth.

Financial Development in Nepal

Measuring financial development lacks a universally accepted metric, yet the goal is to evaluate the financial system's efficiency in addressing information asymmetries, reducing transaction costs, mobilizing resources, and risk management. Scholars have adopted various proxies for this purpose. Financial development encompasses two primary dimensions: depth and breadth. Depth refers to the volume of financial services within an economy, indicated by metrics like the total liquid liabilities to GDP, bank credit to GDP, and stock market capitalization to GDP ratios. Breadth, on the other hand, considers the diversity and accessibility of financial services, often assessed through the ratio of bank credit to stock market capitalization. These indicators collectively offer insights into the robustness and inclusivity of the financial system, reflecting its capacity to support economic growth and development.

Figure 1

Economy of Nepal

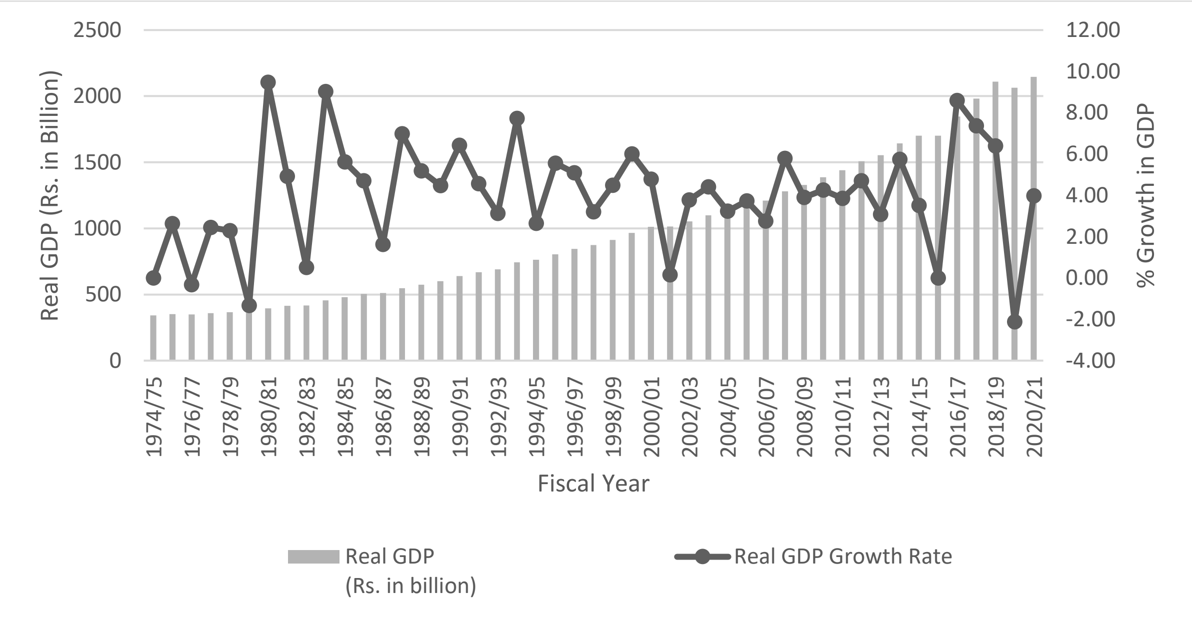


Figure 1 highlights Nepal's Real GDP growth, which, despite being exponential, has experienced slow and sometimes negative growth rates. To gain a clearer understanding of the country's financial development, it's essential to juxtapose financial indicators against GDP trends. Notably, the M2 (broad money supply) to Nominal GDP ratio has seen a significant rise, moving from 12% in 1974/75 to 121% in 2020/21. This surge suggests an increase in economic activities as money circulation has outpaced GDP in recent years, although it remains below the global average of 143.9% in 2020.

Other key financial indicators, including the domestic credit to GDP ratio, private sector credit to GDP ratio, and deposits to GDP ratio, have followed a similar upward trend, especially noticeable since the fiscal year 2010/11 as indicated in Figure 2. This period marked a transition for Nepal, moving beyond the impacts of a decade-long Maoist insurgency towards a more stable business environment. The collective impact of governmental reforms and market dynamics has significantly contributed to the advancement of Nepal's financial system, reflecting meaningful progress in its financial depth and overall economic health.

Figure 2

Financial Indicators Compared to GDP

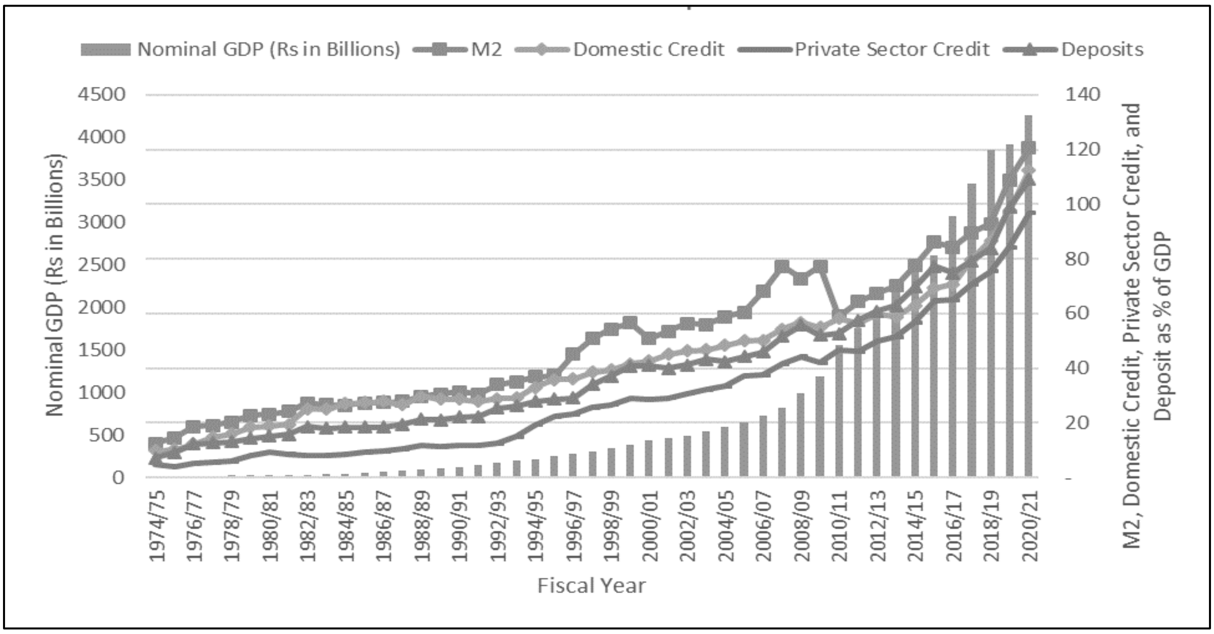
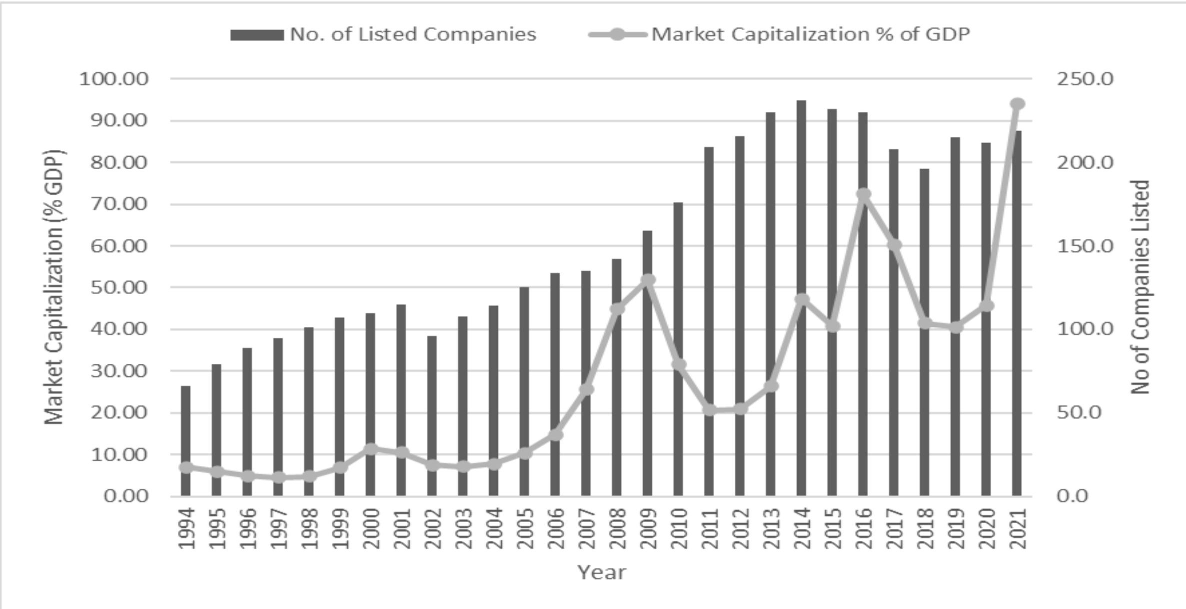


Figure 3

Stock Market Performance



Nepal's financial market, primarily represented by the Nepal Stock Exchange (NEPSE), has shown significant quantitative growth since its inception in 1994. The evolution of NEPSE is marked by an increase in the number of listed companies up to 2014, followed by a slight decline and a modest uptick from 2018 onwards, with 219 securities listed as of 2021 as shown in Figure 3. The consistent increase in the paid-up capital of listed shares highlights the Nepalese economy's escalating use of the financial market for capital formation. Market capitalization has seen fluctuations due to cyclical market trends but has notably surged since 2011, signifying the financial market's crucial role in economic development. Despite these advances, the market requires further enhancements, including the diversification of listed securities to encompass bonds, futures, and options, the introduction of book building in initial public offerings (IPOs), and improvements in brokerage services. These measures are essential for broadening capital raising avenues for businesses, underscoring the potential for further development in Nepal's financial market.

Figure 4

Status of Financial Institutions in Nepal

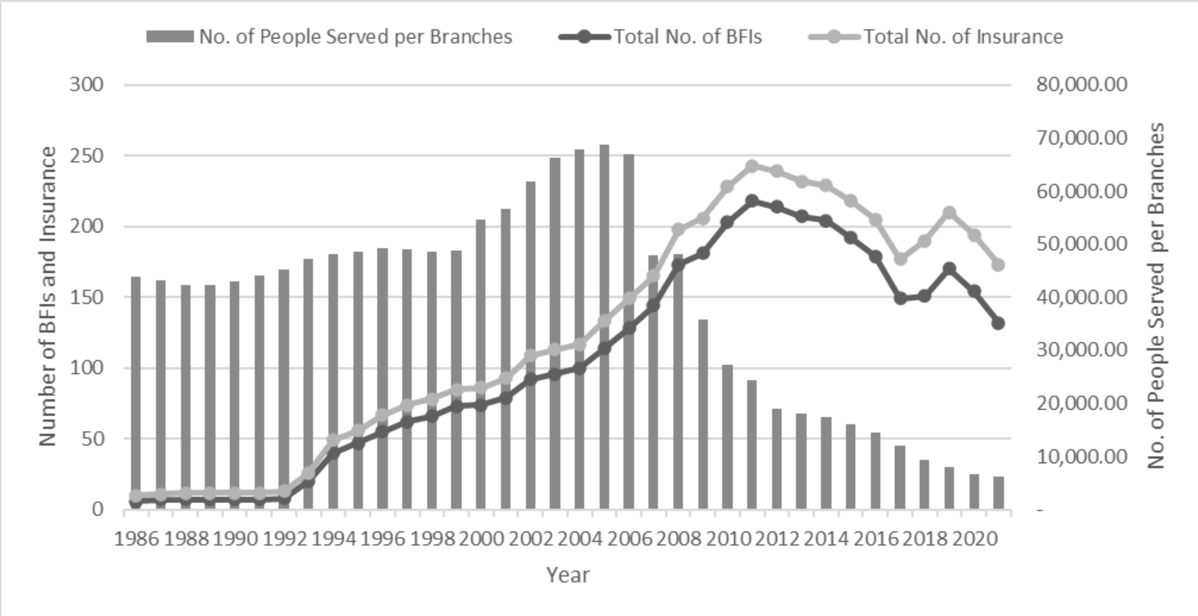


Figure 5

Credit and Deposit per Capita

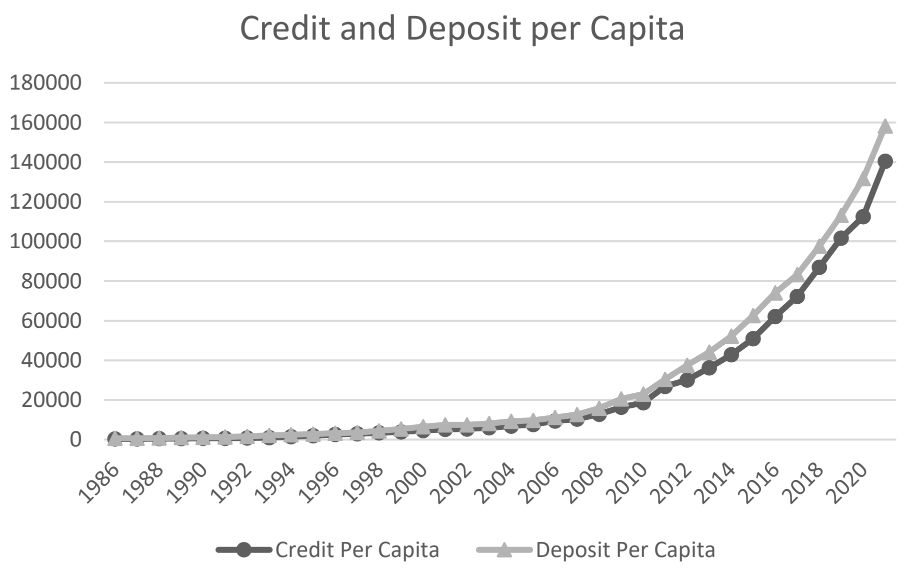


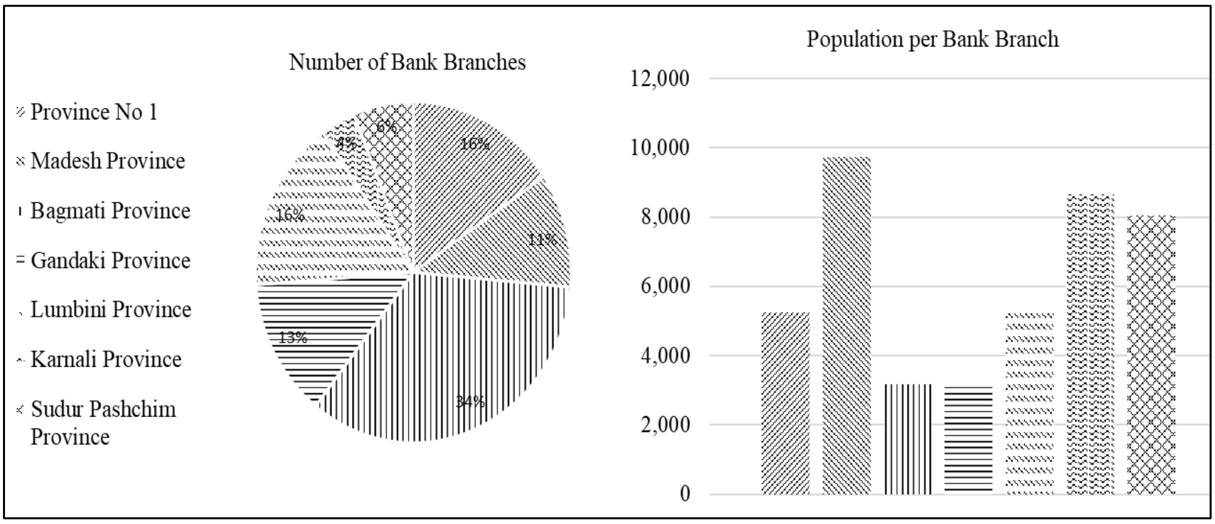
Figure 4 shows that the number of banking and financial institutions as well as insurance companies are increasing with time. The decrease in the number of those financial institutions in recent years is due to the merger and acquisitions in the industry. The number of people served per branch has been decreasing rapidly over the years. Figure 5 shows that the credit and deposit per capita has the same trend and has been increasing over the time exponentially. Strengthening financial institutions and markets plays a crucial role in financial development, but measuring this development goes beyond just quantitative indicators. Financial inclusion, representing the accessibility of affordable financial products and services to all, is a vital qualitative aspect. It's challenging to quantify but essential for comprehensive development. In Nepal, commercial bank branches have expanded to nearly all local levels, significantly reducing the number of people served per branch and increasing per capita deposit and credit, especially after the end of the Maoist insurgency. This expansion highlights the strides Nepal has made towards broader financial inclusion, ensuring more citizens and businesses can access necessary financial services.

Financial Access in Provinces

The 2015 Constitution of Nepal established a federal structure with three tiers of government: federal, seven provinces, and 753 local governments, transitioning Nepal into a federal democratic republic. Given this structure, understanding the financial system and access at every level is crucial. However, analyzing all 753 local governments is impractical due to time constraints and data availability issues. Therefore, this study focuses on the financial landscape at the provincial level using data from different reports of NRB (NRB, 2018b; NRB, 2020a; NRB, 2020b; NRB, 2021c; NRB, 2021d). Bagmati Province has the highest population of 6.44 million, closely followed by Madesh Province at 6.26 million with the smallest area. In contrast, Karnali Province, the largest in area, has the lowest population. These variations offer insights into the diverse financial system and access levels across the provinces.

Figure 6

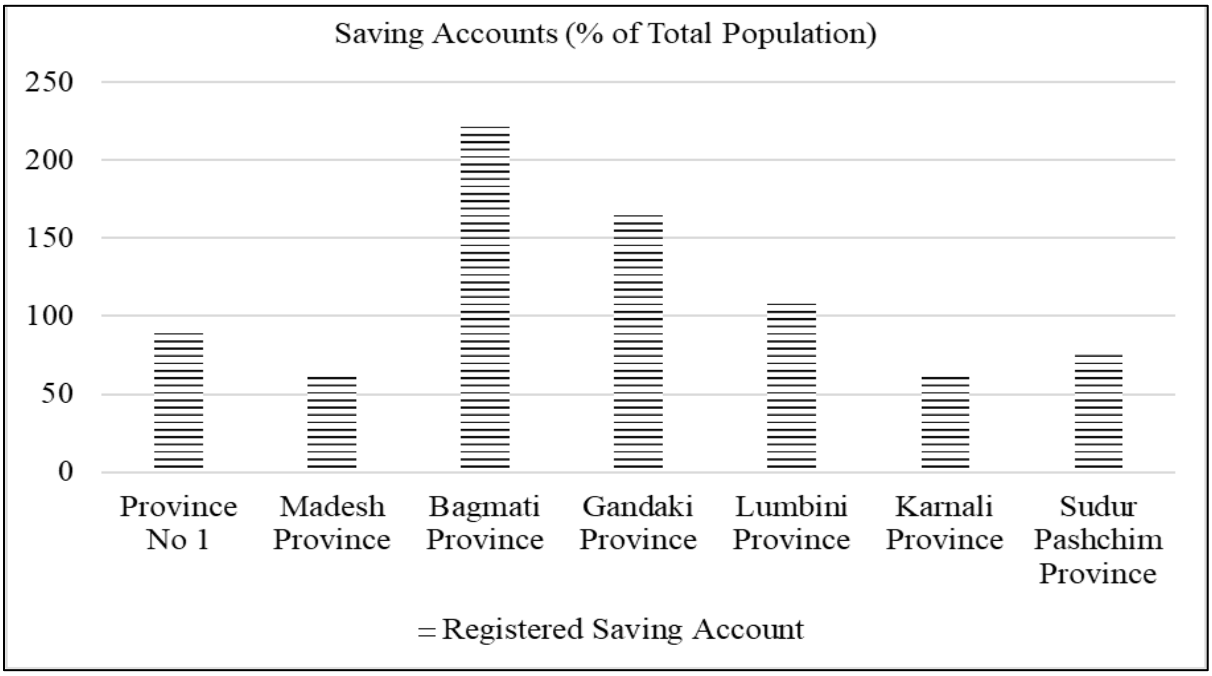
Distribution of Bank Branches



By mid-July 2021, Nepal's bank branches (across categories A, B, and C) increased to 5998 from 5,257 in mid-Sept 2019, covering 750 out of 753 local levels, a significant rise from 296 in mid-July 2017. Despite this growth, disparities in access remain, with Bagmati Province hosting over a third of the total bank branches, contrasting sharply with Karnali and Sudur Pashchim Provinces, which together account for only 10%. Bagmati and Gandaki Provinces enjoy the lowest population per branch, indicating higher access as indicated in Figure 6. In contrast, Madesh Province faces a higher ratio with around 10,000 people per branch, reflecting less financial access. This uneven distribution highlights regional inequalities in banking services, exacerbated by geographical challenges in regions like Karnali and Sudur Pashchim, though such factors do not explain the limited access in Madesh Province.

Figure 7

Distribution of Saving Accounts

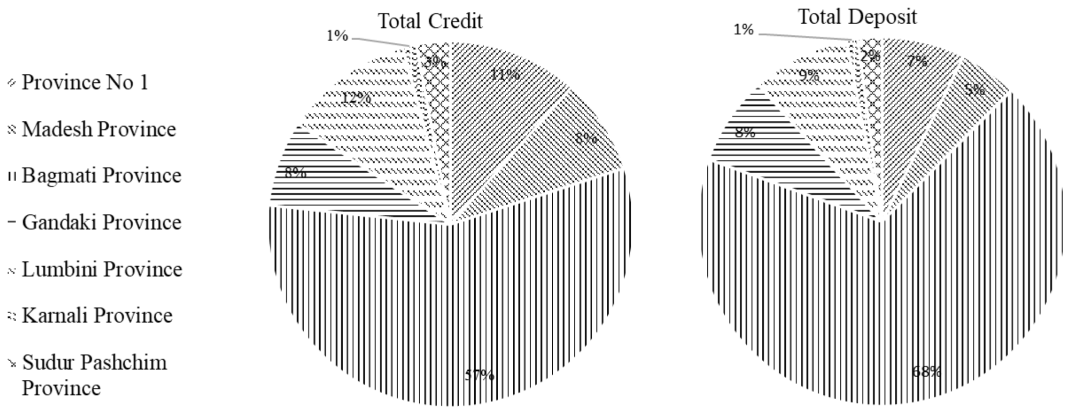


As of mid-July 2021, Nepal has seen a notable increase in financial inclusion, with registered saving accounts in the banking sector exceeding the total population by 137%. Breaking this down by gender, 49% of the total population holds active male saving accounts, while 45% have active female saving accounts. Bagmati Province leads with a remarkable 223% of its population having registered saving accounts. Conversely, Madesh and Karnali Provinces have the lowest saving account with only 64% of total population with registered saving accounts as depicted by Figure 7. Notably, Gandaki Province is the exception where active female saving accounts surpass male ones, indicating diverse financial participation across provinces.

The deposits held in BFIs experienced a significant increase, reaching Rs. 4.28 trillion in mid-July 2021, up from Rs. 3.18 trillion in mid-July 2019 and further increasing from Rs. 3.91 trillion by mid-July 2020. Moreover, the total outstanding loans provided by BFIs were reported at Rs. 3.66 trillion as of mid-January 2021, showing a rise from Rs. 2.74 trillion in July 2019 and Rs. 3.26 trillion by July 2020 (NRB, 2021d). Figure 8 shows that Bagmati Province emerges as the financial powerhouse, commanding over half of the total credit (57%) and deposits (68%). Conversely, Karnali and Sudur Paschim Provinces account for less than 2% in both categories. Madesh Province outperforms these two in resource mobilization, despite a similar banking presence, while Gandaki Province's resource allocation lags its access to financial services. This concentration underscores Bagmati's central role in Nepal's financial landscape.

Figure 8

Distribution of Credit and Deposit



Discussion and Conclusion

Since the mid-1980s, Nepal has embarked on a series of financial sector reforms, significantly influenced by the World Bank and IMF, and guided by the Nepal Rastra Bank's (NRB) strategic plans. These reforms have notably enhanced governance, regulatory frameworks, and the supervisory capacity of the NRB, leading to a more robust financial system characterized by lower non-performing loans (NPLs) and improved financial service quality. However, challenges remain, particularly in regulating shadow banking and ensuring the NRB's autonomy against political pressures, which impacts its decision-making effectiveness.

Despite increased financial access in remote areas due to mandatory policies, more efforts are needed to expand banking services and financial literacy. The performance of government-owned banks suggests a need for greater autonomy coupled with stringent NRB oversight. Moving forward, the reform's primary aim should be to bolster the NRB's capacity and independence, potentially seeking international advice to navigate future challenges and enhance the financial sector's contribution to Nepal's economic development.

Nepal's financial system has seen significant quality enhancements, with notable improvements in its depth and breadth. Depth indicators, such as the ratios of total liquid liabilities to GDP, bank credit to GDP, and stock market capitalization to GDP, have all seen substantial growth, indicating a richer financial environment. Meanwhile, the breadth of the financial system, highlighted by the bank credit to stock market value ratio, reveals a bank-based economy where banks are the primary credit providers to the private sector. This underscores an overall positive trend in financial development.

Despite these advances, there's a critical need for the Nepal Rastra Bank (NRB) to enhance financial literacy and inclusion, especially among rural and marginalized communities. A provincial analysis reveals significant disparities in the distribution of financial institutions and services, with Karnali, Madesh, and Sudur Paschim provinces facing a notable lack of access. The concentration of financial activities, including registered accounts and digital banking services, predominantly in Bagmati and Gandaki provinces, calls for NRB's intervention to ensure equitable financial service distribution across all regions, ensuring comprehensive access to finance for every citizen.

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