Asia-Pacific Research and Training Network on Trade
Working Paper Series, No. 39, July 2007

Services Trade in Developing Asia:
A Case Study of the Banking and Insurance Sector in Nepal

By

Dilli Raj Khanal*

*Dilli.Raj. Khanal is chairman of Institute for Policy Research and Development (IPRAD), Nepal. The views presented in this paper are those of author and do not necessarily reflect the views of IPRAD, ARTNeT members, partners and the United Nations. This study was conducted as part of the Asia-Pacific Research and Training Network on Trade (ARTNeT) initiative, aimed at building regional trade policy and facilitation research capacity in developing countries. This work was carried out with the aid of a grant from the IDRC. The technical support of the United Nations Economic and Social Commission for Asia and the Pacific is gratefully acknowledged. Any remaining errors are the responsibility of the author. The author may be contacted at iprad@ntc.net.np

Table of Contents

Abbreviations

ADBN	= Agriculture Development Bank Nepal
ALICO	= American Life Insurance Company
COE	= Committee of Expert
DOI	= Department of Industry
DSCP	= Deprived Sector Credit Program
EIA	= Environment Impact Assessment
ESAF	= Enhance Structural Adjustment Facility
FTAs	= Financial Trade Arrangement
GATS	= General Agreements on Trade and Service
GDP	= Gross Domestic Product
HLC	= High Level Commission
IMF	= International Monetary Fund
NBL	= Nepal Bank Limited
NGOs	= Non Governmental Organizations
NIBL	= Nepal Investment Bank Limited
NIDC	= Nepal Industrial Development Corporation
NIM	= Net Interest Margin
NPA	= Non Performing Assets
NPLs	= Non Performing Loans
NRB	= Nepal Rastra Bank
OLS	= Ordinary Least Square
PCBs	= Private Commercial Banks
PSCP	= Priority Sector Credit Programme
RBB	= Rastriya Banijaya Bank
SAARC	= South Asian Association for Regional Cooperation
SAFTA	= South Asian Free Trade Agreement
SAP	= Structural Adjustment Programme
SCBNL	= Standard Chartered Bank Nepal Limited
WTO	= World Trade Organization

Executive Summary

This study reviews the development of the banking and insurance sectors in Nepal and the effect of reforms and commitments linked to these sectors since the 1980s, when financial sector liberalization in Nepal began with deregulation of the interest rate structure and opening of the banking sector to foreign investors. Now, three fourth of foreign equity participation is permissible in the banking sector. The insurance sector is almost fully liberalized with 100 per cent foreign equity participation on a case by case basis. The liberalization of banking and insurance has helped to diversify the banking sector resulting in financial deepening. The contribution of finance and real estate sector to employment reached 11.46 per cent of total employment in 2005, from 9.29 per cent in 1990. A rapid increase in total financial assets of the financial institutions also took place during the period 1990 to 2005.

Despite these positive developments, the financial sector is experiencing serious difficulties. The cost of capital is still high and the financial system relatively inefficient, as the gap between deposit and lending rate indicates. Access to financial services in rural areas also remains a major problem. At the same time, Nepal is in a process of further opening up banking and insurance in meeting WTO obligations.

As a party to the General Agreement on Trade in Services (GATS), in 2004 Nepal committed to opening up of the financial sector. Foreign equity participation in domestic bank has been allowed up to 67 percent. More importantly, Nepal has committed to allow wholesale banking by 2010. The presence of natural persons has been restricted both for market access and national treatment purposes. In the case of insurance, there is no restriction on market access in mode 2 and 3 except for free reinsurance and retrocession. Mode 1 and 2, however, intend that mandatory reinsurance up to USD 25000 by December 2007. Mode 3 is unbound until 31 December 2007 and mode 4 supply is fully unbound. With respect to the limitations on national treatment, Nepal has committed to none for mode 1, 2 and 3. For mode 4, it is unbound. Services, including financial services, are not yet the subject matter of SAFTA and BIMSTEC.

Regression analysis of the linkage between financial deepening and economic growth shows a strong relationship. It also suggests that credit to the private sector is the best measure of financial development or financial intermediation. Despite state owned banks passing through a crisis as a result of non-performing loans, rapid expansion in financial institutions and their lending portfolios promoted growth.

Comparative case studies of three banks, namely RBB, NIBL and SCBNL, suggest that the joint venture banks generally achieve the highest performance, followed by the private domestic banks and the state owned banks. Despite steady expansion in employment in private domestic and joint venture banks, total employment declined sharply after 2002 as a result of drastic cuts by the state owned banks as part of ongoing reforms and restructuring. Estimates of net interest margin, profits before tax, and overhead costs show that a sharp fall in the interest margin to total assets took place in private domestic banks, indicating diversification of bank services. The joint venture banks at the same time have maintained constant but lower margins. The profit before tax to total assets also shows a steadily declining trend in these banks, indicating increased competition. The opposite trend, however, was observed in the government banks.

Nepal's experience shows that structural and institutional reforms should be part and parcel of liberalization policies. Institutional capacity enhancement of the Central Bank and effectiveness in prudential regulations are crucial for making ongoing reform effective and result oriented.

Reforms in ownership and market structures will be particularly important in view of Nepal's commitment to allow foreign wholesale banking and insurance companies in the domestic market. Raising the capital base of the banks and removing government control and interference in the two banks (NBL and RBB) will be necessary.

Nepal's experience with financial liberalization suggests that the multilateral route could be beneficial in pursuing broader trade liberalization policies. By the same token, the speedy introduction of new Acts in fulfilling commitments under WTO may strengthen market institutions.

One of the problems experienced in the course of intensive liberalization is that, despite financial deepening, access to credit by the rural population has not improved. This is also true of small businesses operating in urban areas. In order to overcome this, policy should focus on the growth of micro credit institutions and community - based self-help, saving and credit groups and cooperatives. This will ease pressures on the Government or Central Bank in forcing commercial banks to divert resources to less profitable, more risky ventures. It may also prevent crowding out of funds available to the private sector.

I: Introduction

1.1 Background

Liberalization policies in Nepal were started in the mid-1980s. A severe foreign exchange crisis, emanating from excessive reliance on deficit financing had forced the government to pursue market oriented reforms. However, more intensive and wide-ranging reforms were pursued only after the restoration of democracy in 1990. While augmenting reforms, attempts were also made to remove various distortions impeding growth. The speed and direction of reforms were also affected by the reforms driven in India, given Nepal's open border and special trade relations with that country.

To expedite economic liberalization, a major devaluation of the Nepalese currency was made in 1991. Liberalization and privatization received impetus after the implementation of the Enhanced Structural Adjustment Facility (ESAF) program of the International Monetary Fund (IMF) in 1992. To institutionalize the reform process and develop appropriate market institutions, the Industrial Enterprises Act and the Foreign Investment and Technology Transfer Act were brought into effect in 1992. The Privatization Act was introduced in 1994. License and quota systems were gradually removed. On the trade front, quantitative restrictions on imports through license were completely abolished, and tariffs on imports were drastically slashed. Foreign exchange was also gradually liberalized to ensure its compatibility with the reforms in trade. The Nepalese currency was made fully convertible on the current account with no foreign exchange controls. A more open up policy was pursued in the area of foreign investment by allowing foreign investments up to 100 per cent of issued capital in large and medium industries. This was followed by the removal of entry barriers to foreign investors in the financial sector. In banking, three fourth of foreign equity participation is now permissible. The insurance sector is almost fully liberalized in which up to 100 percent foreign equity participation on a case by case basis is allowed. Following the enforcement of a new Act in 2002, the Nepal Rastra Bank (NRB), the country's central bank, has been granted greater autonomy and full authority to conduct monetary policy. The NRB has also been given full authority and responsibility to play an effective supervisory role. Implementation of more prudential regulatory and supervision systems is a part and parcel of the ongoing financial sector reform. A liberalized trade regime also enabled Nepal to obtain membership of the World Trade Organization (WTO) in 2004, which in turn has obligated Nepal to pursue more trade liberalization policies.

Following financial sector liberalization in Nepal in mid 1980s, financial deepening is taking place at a faster pace. A major diversification in the ownership structure of the financial system is a lsotaking place. Not only is there a steady rise in the contribution of banking and insurance services to the country's value added, but also the banking and insurance services are helping to boost business and industry including international trade. Foreign equity participation is also promoting quality in financial services.

1.2 Definition of the Banking and Insurance Sectors

Financial services usually include banking, insurance, securities, asset management, pension funds, financial advisory, information and other services[1]. These services are commonly associated with the supply of financial instruments[2]. Financial services are divided into banking and non-banking services. Banking institutions provide banking and other financial services to their customers. They render services to the customers in terms of both deposits and lending by performing the role of intermediating for savers and borrowers.

Non-baking financial institutions include insurance and other fund management services. Insurance companies are the most important non-banking financial institutions. An insurance company operates as an insurer[3]. Insurance companies collect premiums and compensate losers. It operates on three principles—the sharing of losses, the participation of large numbers of people, and the quality of risk. Insurance companies not only shift the risks but also collect small scattered capital and invest it in various activities of long-term nature.

1.3 Review of the Literature

The financial system mobilizes financial resources, facilitates risk management, distributes resources to the most efficient sectors and activities, monitors the use of financial resources (exerting corporate governance), and provides a payment system that makes trade among economic participants more efficient (Levine, 1997). Financial development occurs when a financial system is able to improve the performance of these functions. There is a large body of theoretical and empirical work emphasizing that financial development is positively related to economic growth (Hermes and Lensink, 2005).

While there may be several different characterizations of financial liberalization, there is a growing view, shared by these authors, that financial liberalization includes policies that focuses on deregulating credit controls, deregulating interest rate controls, removing entry barriers for foreign financial institutions, privatizing financial institutions, and removing restrictions on foreign financial transactions. Financial liberalization has both a domestic and foreign dimension.