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Accessing Impacts of Banks and Financial Institutions Act in the Development of Financial Sector

Ram Sharan Pokharel*

The main objective behind the establishment of Nepal Rastra Bank in 1956, as per the then Nepal Rastra Bank Act, 2012 B.S. (Now Nepal Rastra Bank Act, 1955), was to maintain macro-economic stability, by adopting sound and effective monetary, foreign exchange and financial sector policies. Institutional Development and Legal Development are the main underlying components to achieve the objectives of macro-economic stability along with the development of Regulatory Authority and market mechanism subject to Institutional Development.

Ministry of Finance, Nepal Rastra Bank, Securities Board of Nepal, Insurance Board, etc. form Regulatory Authorities whereas banks and financial institutions, securities brokers, merchant bankers, insurance companies form the Market Mechanism.

This article, does not give much attention to institutional development, aims mainly to emphasize on the impacts of legal input in the development of financial sectors of Nepal, especially, the promotion of Banks and Financial Institutions and its impacts in the financial sector and the impacts of Banks and Financial Institutions Act (BAFIA) in the development of Banks and Financial Institutions, respectively.

The history of modern banking in Nepal is yet to complete 100 years as it is evident from the establishment of Nepal Bank Limited in 1937. Prior to the establishment of Nepal Bank Limited, limited amount of bank transactions used to be done by Tejarath Adda which was established in 1880. Tejarath Adda did not collect deposit but it used to disburse loan. However, it did not provide loan to general people, rather it used to provide loan to government employees and land-lords only. Nevertheless, the government had provided loan to general people through Tejarath Adda to build house after the great earthquake of 1934.


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As of the list published by Nepal Rastra Bank on mid October 2017, there are 28 'A' Class commercial banks, 39 'B' Class development banks, 27 'C' Class finance companies and 54 'D' Class microfinance financial institutions doing banking business in Nepal. That means 148 banks and financial institutions are providing financial services in Nepal at the moment.

While observing the historical development of banks and financial institutions in Nepal, Nepal Rastra Bank Act, 1955 was promulgated only after 18 years of the establishment of Nepal Bank Limited (1937) which was established under Nepal Bank Act, 1937. Thus, Nepal Bank Limited was discharging the role of central bank prior to 2013; but after the establishment of Nepal Rastra Bank in 1956, the role of Nepal Bank Limited was then confined to a commercial bank’s function. Subsequently, Nepal Industrial Development Corporation Act, 1959, Rastriya Banijjya Bank Act, 1966 and Agricultural Development Bank Act, 1968 came into force; and both Nepal Bank Limited and Rastriya Banijjya Bank were brought under the domain of Banijjya Bank Act.

Similarly, banks and financial institutions were to be classified into different classes to meet the objective of establishing bank and financial institutions at different regions with investment of even lesser amount of capital and make them do different types of banking business as per the policy of Nepal Rastra Bank. So, the government enacted and enforced Development Bank Act, 1996 and Finance Company Act, 1985 respectively giving due consideration to the requirement of establishing Development Bank, Finance Company and Micro-Finance Financial Institutions.

In order to address, the requirement of the country and people's will at different time period of historical development of banking business, various types of banks and financial institutions have been gradually established. Different types of Acts were also to be enacted from the Legislative Parliament for the establishment of such types of banks and financial institutions. The concerned authorities faced problems while implementing laws, since the entities established for undertaking same type of business and regulated by the same regulator were to be managed under different laws, enacted at different time span thus, causing confusion among the stakeholders. It had also caused difficulty in implementing law.

To address such problems, a consolidated Act was felt and the Government of Nepal tabled the Banks and Financial Institutions Act and the Legislative Parliament passed it in the year 2006. Thus it came into force as a consolidated Banking law, Banks and Financial Institutions Act, 2006. Banks and Financial Institutions Act, 2006 repealed all Acts related to banking business namely Nepal Industrial Development Corporation Act, Agricultural Development Bank Act, Commercial Bank Act, Development Bank Act and Finance Company Act then it remained in force as a single consolidated banking law for 10 years that means till 2017. Section 31 of Bank and Financial Institutions Act, 2006 classified banks and financial institutions into four classes namely 'A' class banks, 'B' class development banks, 'C' class finance companies
and 'D' class microfinance financial institutions and made provisions relating to
business commencement license to be given based on such classification. Section 47
of the same Act made provisions relating to the transactions that can be executed
by 'A', 'B', 'C' and 'D' Class banks and financial institutions. Banks and Financial
Institutions Act has been discharging very important role in the development of
banking transactions and financial sector; as it is evidently reflected from the number
of banks and financial institutions doing business in Nepal at the moment.

At the moment 148 banks and financial institutions are doing business in Nepal.
Their branches have been opened at every nook and corner of Nepal. Now it will
be the rarest of the rarest case to find out not having any branch of banks and
financial institutions at any part of Nepal. According to the statistics, published
by the Investment Board of Nepal, 'A' class commercial banks alone have provided
employment opportunities to 22,465 people by Mid July 2015. Employment
opportunities provided by 'B' class development banks, 'C' class finance companies
and 'D' class microfinance financial institutions further escalate this number. Further,
148 banks and financial institutions have ensured financial access to ordinary people.
The statistics published by Nepal Rastra Bank in Mid December 2017 show that there
is presence of commercial banks’ branches in 332 local levels among 753 local levels
of Nepal. However, uncontrolled growth of banks and financial institutions also
has created unfair competition too. Several promoters and directors of banks and
financial institutions have reportedly embezzled the deposit of public by creating
fake loans. Banks and financial institutions with very limited paid up capital are
allowed to collect unlimited deposit from the public; and it is identified as the main
reason behind the banks’ failure. As a result, Nepal Rastra Bank adopted the policy
of merger of banks and financial institutions to prevent such unfair competition and
issued the Merger Bylaw, 2011 exercising the power conferred by Section 110 of Nepal
Rastra Bank Act, 2002. Now there is Merger and Acquisition Bylaw 2017 which has
replaced the Merger Bylaw, 2011.

Now the Bank and Financial Institutions Act, 2017 is under operation in Nepal. It
has replaced the Bank and Financial Institutions Act, 2006. The Banks and Financial
Institutions Act, 2017 has tried to address most of the new issues, however, it has also
given continuity to many provisions of the old Act as it was. We have to wait for
some times to see the impacts of the Banks and Financial Institutions Act, 2017 in
the growth and development of the entire financial sector in the days to come, however,
some of the effects may be guessed by conducting analytical study of the provisions
incorporated in the Act.

One may guess that the impact of the Banks and Financial Institutions Act, 2017
in the development, growth and expansion of entire financial sector takes off from
its preamble itself. Preamble is the mirror of any Act. The preamble of any Act
reflects the spirit of the entire Act. It is mentioned in the preamble of the Act that
"to enhance trust of general public on the entire banking and financial system of the
country ..." It means that banks and financial institutions are able to gain the public
trust only when, they conduct their business subject to self-regulation. If the general
public become able to withdraw money deposited in their account on time or they become able to get the principal and interest of their deposit on time of demand, then only they have trust on the banking and financial system. If the banks and financial institutions become problematic, then the general public will also lose their deposits and instead of the protection of right and interest of depositors as envisioned by the preamble of the Act, the entire financial sector will collapse as a chain effect.

Banks and Financial Institutions Act, 2017 has made several provisions of self-regulation in order to protect economic interest of general public and the good will of the banks and financial institutions. These provisions of self-regulation range from the strategy to reduce the operational risk to the compliance of rules relating to good governance.

Section 3 of Chapter 2 of the Act makes provision relating to the incorporation of Banks and Financial Institutions. But now, Nepal Rastra Bank has stopped the issuance of operating license to new banks and financial institutions giving due consideration to the growing numbers of banks and financial institutions in Nepal. Nevertheless, Nepal Rastra Bank has opened license for the establishment of infrastructure development banks as per Section 49(5) of the Act. General public get effective and reliable banking service only when there is fair competition among banks and financial institutions as envisioned by the preamble of the Act. Nepal Rastra Bank has implemented the policy of interest rate corridor in deposit and lending, in order to minimize the unfair competition among banks and financial institutions. Now Nepal Rastra Bank has made legal provision that the 'A' class commercial banks must make their paid up capital Rs. 8 billion and Nepal Rastra Bank has prescribed mid January 2018 as the cutoff date for new capital requirement.

Section 54 of Chapter 7 of the Act has given power to Nepal Rastra Bank as that it can issue directives to the banks and financial institutions. According to this provision, Nepal Rastra Bank may issue directives to banks and financial institutions on the procedures to be adopted while conducting business as per this Chapter and other related activities. The Act has played very effective role in the development of financial sector as it is evident from the role of Nepal Rastra Bank in the implementation of Section 54 of the Act. Section 42 of the Act has made provision relating to capital fund. According to the keynote speech of Governor Dr. Chiranjeevi Nepal of Nepal Rastra Bank on '30th SEANZA Governors' Symposium 2016', there are 1851 branches of commercial banks, 848 branches of development banks, 190 branches of finance companies and 1330 branches of micro finance financial institutions providing financial services at the rate of 6,647 people per branch in Nepal. Now 61% adults have bank account out of them 52% are men and 48% are women. According to the Economic Survey of 2015/016 published by the Ministry of Finance of Nepal in mid-March 2016, the total deposit of the banks and financial institutions was 89.9% of the gross domestic product (GDP) and total lending was 70.4% in the same period. Similarly, according to the news published on 'The Himalayan Times'- Nepal's one
of national daily English newspapers- of August 23, 2017, 'A' class commercial banks alone had generated a profit of Rs. 45.26 billion in the fiscal year 2016/2017. Based on above mentioned statistics, it is evident that the Banks and Financial Institutions Act has played very important role in the expansion of financial sector along with the development of banks and financial institutions. The volume of deposit, lending and the profit of the banks and financial institutions are self-evidently showing very good development of the financial sectors of Nepal.

However, some of the banks and financial institutions have collapsed in past years and several hundreds of people lost their deposits. Giving due consideration to this fact, Nepal Rastra Bank further made stringent rules regarding capital adequacy; and those banks and financial institutions unable to maintain capital adequacy as prescribed by Nepal Rastra Bank have to go in merger. Section 69 of Chapter 10 of the Act makes provision relating to merger or acquisition in order to address the issue relating to merger.

Banks and financial institutions have to submit report relating to capital adequacy every month in Nepal Rastra Bank. According to the report relating to capital adequacy thus submitted, if the capital adequacy of any bank or financial institution is found lesser, Nepal Rastra Bank takes action against such bank or financial institution. Section 60 of the Act makes provision relating to Audit Committee. Audit committee conducts and supervises if the account, budget and internal audit procedures, internal control provision of banks and financial institutions are intact; and if such provisions are intact, whether they have been implementated. The audit committee in any bank or financial institution helps in maintaining and strengthening good governance.

Similarly, ‘Banks and Financial Institutions Act’ has also made provisions relating to the qualification and tenure of office of chief executive officer (CEO) and directors. Section 15 of the Act, arranges that even though the maximum tenure of office of any director is 4 years, s/he can be reappointed again for another term; however, executive chair or managing director may stay in office consecutive two terms only. Section 29 of the Act makes provision that the CEO may remain in office for a maximum period of four years and may be reappointed again for another one term only. This provision is made with the intention of appointing new face with better ideas in the managerial leadership of the banks and financial institutions.

Section 31 (BAFIA, 2017) of the Act makes provision that any other person or institution except licensed banks and financial institutions authorized to do financial transactions as per Section 34 of the Act shall not conduct banking and financial transactions. This provision has banned disbursement of loans by any person other than banks and financial institutions thus discouraging the financial mafias from lending at unreasonably high interest rate. It has also put rein on the trend of providing loan by money lenders and land-lords of village, society, neighborhood to poor farmers and workers at high interest rate and later owning their land and house-thus making them homeless- when such poor farmers and workers become unable to
repay the loan. Now the general people visit banks or financial institutions to meet their financial needs showing evidence; and it shows that the public trust on banks and financial institutions has been augmented day by day. Due to this, majority people have now access to banks and financial institutions thus making contribution in the development and expansion of financial sectors.

The establishment of banks and financial institutions at large scale in Nepal as per the Banks and Financial Institutions Act and the policy of Nepal Rastra Bank have contributed on money multiplier effect at market level. Due to numerous banks and financial institutions operating in the market, Nepal Rastra Bank does not have to make direct intervention regarding money supply in the market, as it has been regulated automatically by the market. The credit deposit ratio of 80:20 prescribed by Nepal Rasta Bank has also contributed indirectly on money multiplier effect and money supply in the market.

Section 53 of the Act makes provision relating to anti-money laundering standards to be implemented by banks and financial institutions, making the role of banks and financial institutions significant in preventing financial crime and recognizing public private partnership in crime control.

Banks and financial institutions have to collect, deposit lend following the rules and regulation prescribed by Nepal Rastra Bank as per the provision of the Act. The Act not only has made the provision relating to the incorporation of banks and financial institutions but also has made the provisions relating to voluntary liquidation in Chapter 11 from Sections 75 to 77, providing easy exit of promoters of bank or financial institution from banking business.

Similarly, those banks and financial institutions unable to discharge their liability shall undergo compulsory liquidation as per Chapter 12 of the Act and Sections 78 to 98 deal compulsory liquidation.

Section 99 of the Act arranges that Nepal Rastra Bank may take regulatory actions against banks or financial institutions. As per this Section, if any bank or financial institution violating Banks and Financial Institutions Act or Nepal Rastra Bank Act or Rules, Bylaws, Directive or Order issued as per Banks and Financial Institutions Act or Nepal Rastra Bank Act, Nepal Rastra Bank may be reprimanded, such bank or financial institution or may be issued written warning as well as Nepal Rastra Bank may also put full or partial ban on deposit collection or lending or even may suspend or revoke license. Nepal Rastra Bank, thus keeping bank or financial institution within a very stringent domain of regulation, has made its best effort to protect public interest and enhance public faith on the entire financial sector which will surely contribute in the development and expansion of the financial sectors in the days to come.

Section 105 makes provision that any bank or financial institution dissatisfied with the action of Nepal Rastra Bank may file appeal against the decision of Nepal Rastra
Bank. This provision has played very important role in establishing the norms of fair hearing thus enhancing democratic norms and values. Section 107 of the Act makes special provision relating to the establishment of infrastructure development bank with the aim of constructing mega projects and structures, bridges, roads, and hydropower station, etc., by mobilizing domestic capital within the country; and it has opened door of nation building. It requires Rs. 50 billion paid up capital for the establishment of an infrastructure development bank.

Section 108 of the Act makes compulsory provision of deposit protection. Now any bank or financial institution has to have the deposit insurance of deposit up to Rs. 3,00,000.00 (three hundred thousand in words) through Deposit and Credit Guarantee Fund. It protects the deposit of general people even though any bank or financial institution becomes problematic. It prevents the financial sectors suffering from greater shock of bank failure. Section 124 protects the employees of any bank or financial institutions from the result of any act done by them in good faith. This provision helps to create the fearless working environment.

Section 131 makes provision that Nepal Rastra Bank may give Order or Direction to any bank or financial institution as required subject to the Banks and Financial Institutions Act or Rules or Bylaws made under this Act. This provision has ensured the full legal power of the regulatory authority namely to Nepal Rastra Bank as envisioned by Basel Core Principles of Banking Supervision for effective supervision, inspection and monitoring of banks and financial institutions.

Finally, thus the Banks and Financial Institutions Act, 2017 has come not only to address the issue of incorporation of banks and financial institutions but also for their safe acquittal too. Both the provision of incorporation and acquittal has played very important role for the growth and development of banks and financial institutions including the expansion and development of financial sector. Further, the Act has clearly outlined the financial transactions to be done by the banks and financial institutions making the clear objectives behind the establishment of the banks and financial institutions. The Act has also promoted the compliance of self-regulation by making provision that the banks and financial institutions should observe the instruction given by Nepal Rastra Bank after identification of non-compliance by inspection and supervision. By prescribing the minimum qualification of promoters, directors and chief executive officers, it has also prevented the entry of people in banking business just based on money and power. These provisions of the Act are sure to make very important contribution in the development and expansion of financial sector reinforcing the public faith by enhancing fair competition in banking and financial sectors.