The Development of Securities Market in Nepal: A Comparative Analysis

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Abstract

This paper analyzes the development of securities market in Nepal from historical and comparative perspectives. It is observed that the financial sector (commercial banks and finance companies) highly dominates the Nepalese securities market in which the corporate equities are the largest market instruments. Measured in terms of market capitalization, total value traded, and turnover ratio in relation to the size of respective economies (seven industrial and six South Asian developing economies), it is found that the Nepalese securities market is very small, highly illiquid, inefficient and underdeveloped compared not only with developed countries but also with most of its South Asian counterparts. The correlation between the major securities market indicators and real GDP growth is consistent with the hypothesis that there exists causal relationship between securities market development and economic growth. The correlation results also reveal the strong complementarity between the growth of banking sector and securities market in Nepal. Moreover, the Gini Coefficient and Herfindahl concentration indices show the highly concentrated market structure implying the lack of competition in the market. Finally, the overall analysis indicates that Nepal has a limited scope of financing choice from bank to market. Due to the inadequate securities market infrastructure and small size of industrial undertakings within a few numbers of public limited companies, the Nepalese financial system is highly dominated by banking sector and is likely to follow the same pattern in the future until the market infrastructures are developed and corporate sector earns sufficient credibility.

Key words: Securities Market, Financial System, Market Capitalization, Turnover, Corporate Governance, Listed Companies

1. INTRODUCTION

The historical evolution shows that the banking sector was the single component of Nepalese financial system until the emergence of securities market in the late 1970s. Although few companies were partially financed by issuing securities in the market, a modern securities market was almost non-existent until the early 1990s. The early phase of financial sector liberalization initiated in the mid-1980s primarily focused on the banking system rather than securities market. The major institutional as well as legal reforms in the securities market were made with the first amendment of Securities Exchange Act, 1983 in 1993 that established Securities Board as an apex regulatory authority to govern and facilitate the securities operations in the country. A systematized market operation began after the conversion of Securities Exchange Center into Nepal Stock Exchange Limited in 1993. In spite of the various reform initiatives, there remains number of structural, legal, as well as institutional deficiencies limiting the scope and efficiency of the market. It is, however, too early to expect a perfect and smoothly functioning securities market in Nepal as it is passing through its infancy. To the date, some significant but few achievements have been made, nevertheless, Nepal still has a long way to go for maintaining efficient, competitive and widely participatory securities market.

This paper presents the historical and comparative analysis of Nepalese securities market, especially the corporate equity market, based on the data obtained from various domestic as well as international sources. The World Bank data are used for comparison of Nepalese securities market with that of six developing South Asian and seven industrial economies, namely Japan, Germany, USA, UK, France, Italy and Canada. The main purpose of this comparison is to examine the current state and the future path of Nepalese securities market in relation to the international trend and experience. The statistics obviously show that Nepal has very small, underdeveloped, illiquid and inefficient securities market compared not only with that of developed economies but also among the low income developing countries of South Asia, except Bhutan and Bangladesh. The data available from the Securities Board and Nepal Stock Exchange Limited are used for historical evolution as well as for current situation of the securities market in the country. Moreover, the banking system data available from the central bank, Nepal Rastra Bank, are used for comparison between the banking sector and securities market in relation to the Gross Domestic Product, GDP. This paper, however, excludes the government securities and mainly focuses on the private corporate equities market.

This study basically employs qualitative technique for data analysis. The study of various securities market indicators are made following the techniques used in the scholarly work by prominent financial experts, Demirguc-Kunt and Ross Levine (2001) and other standard practices for calculating the concentration indices and correlation analysis. The comparative statistics are simply presented by diagrams.

The rest of the chapters are organized as follows. The historical evolution of Nepalese securities market is presented in the second chapter. The third chapter outlines a brief overview of the regulatory framework and corporate governance system. The fourth chapter, as the main outcome of this paper, presents the empirical analysis of the development of Nepalese securities market in relation to some selected developing as well as developed economies. The investigation of different market indicators measured in terms of size, liquidity and efficiency and their international comparison are made employing the various ratio analyses. Moreover, the level of concentration and competition in the market is also explained in this chapter. The fifth chapter simply describes the structure of Nepalese financial system and identifies the major problems and challenges of securities market in Nepal. The sixth chapter summarizes and concludes the overall analysis with some policy implications.

2. HISTORICAL EVOLUTION OF NEPALESE SECURITIES MARKET

2.1. Initial Phase (1976-1993)

The origination of the modern securities market in Nepal may be traced back to 1976 with the establishment of **Securities Exchange Center** (SEC). Although some large domestic public enterprises had floated their shares in the market prior to the establishment of SEC; the securities market was not formally organized. It was in 1937, Biratnagar Jute Mills Limited initiated the public floatation of shares in the market for the first time in Nepal. Until the establishment of the SEC, and even after that period until the early 1990s, an effective and modern securities market was almost non-existent. There were very few domestically operated companies, which floated their share in the market. The share of private sector in the industrial undertakings was very few. Until the late 1980s, the industrial sector was being financed by a few numbers of state owned financial institutions. There were 5 commercial and 2 development banks as the main sources of corporate finance until 1991. In the absence of well-organized securities market, the government itself was the sole issuing authority of national saving certificates and development bonds since the first issuance of 91-day Treasury bill in 1962 and the development bond in 1964. The central bank was the major agent of the government to undertake all transactions related to issuance, transfer, and sale of the securities.

The establishment of Securities Exchange Center in 1976 was the first institutional effort for the development of the securities market in Nepal. It started trading of corporate securities through its counter in 1984. The Center was established with the joint contribution of Nepal Rastra Bank (49 percent) and Nepal Industrial Development Corporation (51 percent) with the aim of promoting and facilitating the securities market development and providing conductive environment for securities business in the country. The early phase of financial system liberalization initiated in the mid-1980s primarily focused on the banking sector reform rather than securities market. The Securities Exchange Center was a good initiation; however, the securities market remained almost stagnant until the end of 1980s. In the year 1984, the first joint venture bank, Nepal Arab Bank Limited (Nabil Bank), was established as a welcoming step to attract foreign investment in the financial sector. After the restoration of multiparty democracy 1990, the process of **economic liberalization** turned more explicit and the **financial liberalization** rapidly took place with the enactment of market friendly acts and regulations to facilitate growth and development of financial system.

There were no institutional arrangements for issuance, sale, and underwriting corporate securities before the establishment of the Securities Exchange Center (SEC). Prior to this, the corporations were to follow the provisions of Companies Act 1964 for the public offerings of their shares and debenture. After the establishment of SEC, the issuing company had to pay necessary commission or fee for managing and selling its share according to the guidelines for new issue and sales management, 1986 (Timilsina, 2001). The issuing corporations were required to list their shares and debentures in the SEC. However, the government bonds issued under the National Debt Act were not necessarily required for listing in SEC. The trading of securities was required to undertake through the recognized Exchange Center or through their licensed broker under Securities Exchange Act 1983. The SEC started secondary trading of the corporate share in 1984. Prior to this, the SEC was restricted to trading of government bonds.

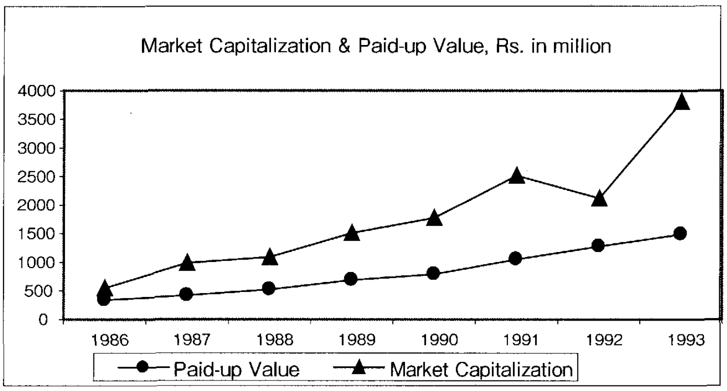
It is obvious from the table (table 1) that until mid-July 1986, there were 16 **listed companies** with paid-up share capital of Rs. 341 million. The **market capitalization** of listed shares and the **annual turnover** for the FY 1985/86 amounted to Rs. 548 and Rs. 10.1 million respectively. In 1990, the number of listed companies reached to 41 with the increased paid up value of the listed shares to Rs. 789 million and the market capitalization (mid-July 1990) at Rs. 1775 million.

Along with the financial liberalization and reforms in the industrial policies, a number of companies, especially banks and non-bank financial companies, emerged and listed in the stock exchange. Until the end of the fiscal year 1993, there were 62 companies listed in the SEC and the total market capitalization reached to Rs. 3806 million accounting for 2.3 % of nominal GDP. The securities market witnessed a steady growth until the end of this phase. The most noteworthy point is that this phase laid the foundation stone of

Table 1. Major Stock Market Indicators (Rs. in million)

Fiscal Year End	No. of listed companies	Paid-up values of listed shares	Market Capitalization	Total annual Turnover
1986	16	341	548	10.1
1987	23	419	988	8.1
1988	27	524	1089	7.7
1989	36	684	1509	30
1990	41	789	1775	25.3
1991	46	1049	2516	27.3
1992	55	1273	2120	36.9
1993	62	1483	3806	79.8

Source: Nepal Stock Exchange Limited (NEPSE)



Source- Nepal Stock Exchange Limited

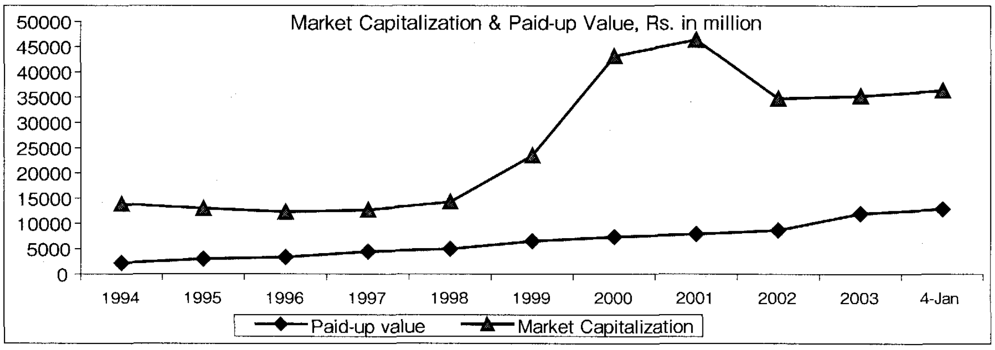
the modern securities market in the country. Some significant institutional and legal reforms governing the operations of securities market were undertaken at the end of this phase.

2.2. Post Reform Phase (1993- Present)

In an attempt to keep pace with the global market, the financial market in Nepal is going through the different stages of liberalization that is gradually increasing its degree of integration with the global practices. With the sweeping economic changes witnessed globally towards more market-oriented economies, the government has embarked upon the radical economic policy measures to revitalize the economy. In the process of reform of the securities market supported by USAID Economic Liberalization Project, the Securities Exchange Center (SEC) was converted into **Nepal Stock Exchange Limited** (NEPSE) in 1993.

The reform allowed the share brokers to trade in shares in the secondary market. NEPSE is a non-profit making organization operating under the Securities Exchange Act, 1983 and is owned by Ministry of Finance (58.67 percent), Nepal Rastra Bank (34.6 percent), Nepal Industrial Development Corporation (6.13 percent), and the stock agents (0.6 percent). In an attempt to protect the interest of investors and to provide necessary policy direction for the systematic and regular exchange of the securities and to develop an efficient and competitive securities market in the country, the Securities Board was established in 1993 with the first amendment of Securities Exchange Act, 1983. The second amendment of the Securities Exchange Act was made in 1997 under which the stockholders/dealers and listed companies were required to submit their financial statements to Securities Board (SEBO). The Securities Board is the major regulatory authority to control, promote and supervise the operations of securities market in the country with the help of Nepal Stock Exchange Limited (NEPSE).

Members of NEPSE are permitted to act as intermediaries in buying and selling of government bonds and listed corporate securities. At present, there are 27 member brokers and 2 market makers, who operate on the trading floor as per the Securities Exchange Act, 1983, rules and by-laws. Besides this, NEPSE has also granted membership to issue and sales manager securities trader (Dealer). Issue and sales manager works as manager to the issue and underwriter for public issue of securities whereas securities trader (Dealer) works as individual portfolio manager. At present there are 11 sales and issue manager and 2 dealers (Nepal Stock Exchange, 2004).



Source-Nepal Stock Exchange Limited (NEPSE)

As mentioned earlier, the second phase of the securities market development in Nepal initiated with the conversion of SEC into Nepal Stock Exchange Limited (NEPSE) in 1993. When NEPSE started its secondary market floor in 13 January 1994; the size of market began to expand as the new listing of the companies increased continuously. The total market capitalization reached to Rs. 46349.4 million in 2001, accounting for about 12 % of GDP. However, the NEPSE index since 1996 until 1998 showed downward trend. It reached to record-high level in 2000 and again started to fall as the economy began to shrink thereafter. By the end of fiscal year 2004, there were 125 companies listed in NEPSE and the total market capitalization reached to Rs. 62568 million representing more than 11% of GDP(estimated).

Table 2. Major Stock Market Indicators (Rs. in million)

Fiscal Year End	No.of listed companies	Paid-up values of listed shares	Market Capitalization	Total annual Turnover	NEPSE Index*
1994**	66	2182.2	13872	431.3	226
1995	79	2961.8	12963	1054	195.5
1996	89	3358.5	12295	210	185.6
1997	95	4476.5	12698	416	176.3
1998	101	4959.8	14289	203	163.4
1999	107	6487.4	23508	1500	216.9
2000	110	7347.4	43123.3	1157.2	360.7
2001	115	7939	46349.4	2344.16	348.4
2002	96	8680.2	34704	1540.63	227.5
2003	108	11898	35240	575.80	204.9
Jan-04	111	12865	36347		201.9

Source- Nepal Stock Exchange, Quarterly Economic Bulletin, Népal Rastra Bank, Jan-2004.
*Base Year 12th February 1994/ ** Six month data.

The number of listed companies increased from 66 in 1994 to 115 in 2001 widening the scope of market as many banks and finance companies emerged and floated their share to the public, however, the manufacturing sector remained weak and could not boost up the market. The so-called 'good time' for the banking and non-bank finance sector gradually came to an end since 2001 as the economy began to fall. Consequently, the de-listing of the companies in the stock exchange took place in 2002. The number of listed companies again increased to 108 in 2003 and 111 until the Mid-January 2004. There are various instruments through which the securities markets channel funds from the surplus to the deficits units. The bond market usually attracts the interest of professional and institutional investors (such as pension funds, insurance companies, banks etc.) than from the general public. On the other hand, equity market attracts more interests of the general public. There are two types of securities markets in Nepal: the government and corporate markets. For its financing requirements, the government uses three instruments, namely, short-term treasury bills, national saving certificates (NSCs) and overdraft financing through Nepal Rastra Bank (NRB), the central bank. Out of these financing instruments, the 91-day Treasury bill accounts for the largest share at which the commercial banks are the primary dealers.

The statistics show that the government securities market is largely confined to the central and commercial banks. The commercial banks holding of Treasury bill increased from 17 percent in 1990 to 64 % in 2003. Similarly, the holding of national certificate by the non-profit organization increased from 19 percent in 1990 to 61 percent in 2003. The participation of individual investors in the government securities is negligible. Thus, a large proportion of government securities are owned mostly by commercial banks, central bank and few other institutional investors. On the corporate market, there are number of privately placed corporate bonds and equities. Most trading takes place in share of financial institutions and few manufacturing companies. The reporting standards and dissemination of information about manufacturing companies are largely inadequate.

One of the relative measures of the efficiency of a stock market is the level of transaction cost. The higher the transaction cost the highly inefficient the market is perceived to be. Transaction cost can either be viewed from the perspective of an investor or that of the companies. From a company's point of view, it includes all expenses incurred in the bid to make public offer of equity or loan stock. For an investor on the other hand, transaction cost comprises all expenses incurred in the purchase of shares or loan stock. In NEPSE, the opening prices cannot be more or less than 10 percent of the previous day's closing price, but once transactions are concluded within this range, the price is permitted to change with a limit of 5 percent on each consecutive transaction. The rate of brokerage on equity transactions ranges from 1.0 to 1.5 percent depending upon the traded amount (the World Bank, 2002).

Table 3. Listing and Annual Fees

Paid-up Capital (Rs. in million)	Listing Fee (Rs. '000)	Annual Fee (Rs. '000)
Up to 10	0.20 % or minimum of 15	15,000
Above 10-50	0.15% or minimum of 45	25,000
Above 50-100	0.10% or minimum of 75	35,000
Above 100	0.075 % or minimum of 100	50,000

Source- Nepal Stock Exchange Limited, 2002.

The table above (table 3) presents the listing fee and the annual fee to be paid by the listed company based on the company's capital base. The NEPSE trades five days a week and operates on an 'Open Cry Out' system under which the securities transactions are undertaken in open auction on the trading floor. Although 111 companies (as of 2004-January) are listed, only 20 to 30 companies' shares are actively traded and the trading information is quoted in the local and national level newspaper on the daily basis.

To sum up, the Nepalese securities market evolved through two different phases. The first phase consisted the period between 1976 and 1993 that laid the foundation for modern securities market. Some significant institutional and legal reforms in the securities market were undertaken at the end of this phase. The major changes took place with the amendment of Securities Exchange Act, 1983 in 1993 in which the private brokers were allowed to trade in shares in the secondary market and mandatory provisions for disclosure and transparency were revised. The second phase began with the conversion of Securities Exchange Center into Nepal Stock Exchange in 1993. The creation of stock index and spread of public information about share business gradually widened the scope of securities market. Consequently, the number of listed companies increased from 16 in 1986, 63 in 1993 to 111 in 2004. Similarly, the market capitalization and annual turnover grew rapidly from Rs. 3,806 million and 79.8 million in 1993 to the record high level at Rs. 46,349.2 million and Rs. 2,344.16 million respectively in 2001. The overall indicators show that the securities market, which was almost stagnant until the late 1980s, witnessed a steady growth until 1993 and then took relatively faster pace to arrive at the current stage of development. However, in relation to its market share in the overall financial system, the Nepalese securities market is passing through its infancy.

3. THE REGULATORY FRAMEWORK AND CORPORATE GOVERNANCE SYSTEM

3.1. Regulatory Framework

There are several Acts and Organizations governing the securities market activities in the country. The development or success of any system depends, among other things, largely on the legal provisions, institutional settings, and enforcement mechanism being pursued on that particular system in relation to the time and existing circumstances. The central bank, Nepal Rastra Bank (NRB), is the supreme authority to regulate the banking and non-banking financial sector while the **Securities Board** (SEBO) established in 1993 under the Securities Exchange Act, 1983 regulates the securities market activities in Nepal. The major objectives of the Board are to develop securities market and formulate necessary policies for the benefit of the investors, and provide necessary policy advice to the government, to make necessary arrangements in order to regularize the securities exchange, to grant permission to corporate bodies to operate securities exchange and, finally, to operate the securities exchange systematically and provide necessary directions.

The SEBO is composed of seven board members representing each from the Ministry of Finance, the Ministry of Law and Justice, the Ministry of Industry, Commerce and Supplies, Nepal Rastra Bank, Federation of Nepal Chamber of Commerce and Industry (FNCCI) and Nepal Chartered Accountants' Association. Among others, the Board is responsible for the supervision of NEPSE, its members, and disclosure requirements for listed companies and licensing of issue managers, underwriters, portfolio managers, market makers, and stockbrokers. It also performs the necessary functions for registration and supervision of investment funds. All securities market intermediaries are required to be registered with the SEBO and submit the report of their financial and trading activities to it. Moreover, the listed companies have to submit their **annual progress reports** along with **financial statements** to SEBO and the NEPSE within four months after the expiry of the fiscal year and semi-annual report within 60 days after the expiry of each six-month period. The market intermediaries are required to be registered with SEBO before doing securities business and to report their financial and trading activities to SEBO. Securities businesspersons such as brokers, issue managers, market makers and securities dealers have to be licensed by SEBO, and to renew their licenses from SEBO before the end of each fiscal year.

Moreover, the Nepal Stock Exchange Limited, NEPSE, the Office of the Company Registrar, Nepal Rastra Bank, are the other major agents to regulate the securities operation in Nepal.

It has often been said that the overlapping regulatory functions of SEBO and NRB has created ambiguity in the securities market. This claim, however, needs further confirmation. The strict implementation of the mandatory requirement of uniform reporting system and standard accounting and auditing practices of listed companies has become the most challenging job for SEBO. Moreover, the issues of poor disclosure and transparency mechanism and weak corporate monitoring and governance system in the corporate sector are other major impediments to the development of securities market in the country.

3.2. The Corporate Governance System

The corporate ownership in Nepal is largely concentrated with few numbers of family or business groups, in which the **majority shareholders** highly dominate the process of corporate decision-making. The **minority shareholders** are largely ignored in the matters of corporate undertakings. 'In the tradition of many South Asian Companies, many firms in Nepal are family-owned and operated. Often inexperienced family members operate as managers, accountants, and hold other management positions' (World Bank, 2002). A few number of stronghold business group possess the ownership in financial sector, such as banks and non-bank finance companies, as well as in the manufacturing, trading and other significant businesses. The **Company Act,**

1997 specifies the number of board members of the company ranging from 3 to 11 depending upon the size and nature of the company. The boards of directors are selected from majority shareholders, from among the promoters by election under the support of majority shareholders, and from among the minority shareholders by election in the Annual General Meeting (**AGM**). The company should publish the notice in the national level newspapers 21 days prior to the date of AGM with detailed agenda for discussion. The AGMs are generally held once a year and in special case upon the request of the shareholders, an extra ordinary general meeting is called.

The AGM is empowered to amend the memorandum of association and articles of association, change the amount of authorized capital of the company taking permission from company' s registrar, appointment of external auditor, distribution of bonus and dividend and other major policy issues of the company. A **proxy voting** is acceptable in the election. Through this provision, the majority shareholder often transfers his votes exceeding the numbers necessary for him to win the election to the person representing the minority shareholder in his favor. This, in practice, shows that the board of the company is highly influenced by the interests of majority shareholders. Among the board members, one is chosen as an executive director of the company who works as a member-secretary in the board meeting (Koirala and Bajracharya, 2004).

The newly established company has to issue ownership shares of 15 percent at the minimum to 25 percent of the paid up capital and sell them through primary market on public notice to the general public. Such issues are 25 at minimum to 30 percent of the total paid up capital to the commercial banks and financial institutions. In order to make the size of shareholders manageable, the Securities Board (SEBO) reviewed the existing allotment limit and amended the 1994 Share Allotment Guidelines, which prescribe the **allotment ceiling**. Before the amendment, the allotment limit was a minimum of 50 shareholders per Rs. 100,000 of issued capital. After the amendment, the limit has been changed to a minimum of 50 shareholders per Rs. 100,000 of issued capital, if the issued capital is up to Rs. 50 million; and a minimum of 20 shareholders per Rs. 100,000 of issued capital, if the issued capital is more than Rs. 50 million.

The big business persons posses enough power to influence the politics and bureaucracy, by supplying election funds to the national parties with the chance of coming in power and to major opposition benches to be able to influence on the

Table 4. Ownership structure of some top listed companies (percent)

Name of Company	Promoters	General Public	Domestic Institutions	Foreigners
Commercial Bank				
Bank of Kathmandu	42	58	-	-
Himalaya Bank Limited	51	15	14	20
Nepal Bangladesh Bank	20	30	-	50
Standard Chartered Bank Nepal Ltd.	-	25	-	75
Nabil Bank	-	30	20	50
Nepal Industrial and Commercial Bank	65	35	-	-
Nepal Credit and Commerce Bank	61	30	9	
Finance Company				
International Leasing and Finance Co.Ltd.	36	25	-	39
Development Bank				
Nepal Development Bank	31	30	29	10
Insurance Company				
Everest Insurance Company Ltd.	60	40	-	-
Nepal Life Insurance Company	80	20	-	-
Manufacturing Company				
Nepal Lever Limited	-	20	-	80

Source- Compiled from the respective companies profiles

governments. Most of the minority shareholders, on the other hand, do not want or cannot be the owner. They want to be the passive investors or short-term investors. The board of directors mainly acts as the superfluous body trying to fulfill formalities rather than seriously attending to corporate governance (Koirala and Bajracharya, 2004). Because of the relationship-based system in Nepal, most boards do not satisfy any of the conditions that accompany the principle of independent oversight. Although there is a clear distinction between full time directors and non-executive board members, there is no legal definition of independence. Moreover, the non-executives are family members or nominees from the government or institutional shareholders. It is common for prominent persons to serve on the boards of several corporations simultaneously (Maskay, 2004).

Finally, despite the various provisions closed to internationally accepted practices in the Company Act and other legal and institutional settings, the real execution of corporate governance practices in Nepal is highly influenced by the majority shareholders and significant business groups thereby ignoring the minority shareholders in the process of corporate decision-making. The major reasons behind these practices are the lack of easy access of information disclosure of the corporations to the public, insufficient legal provisions to protect minority shareholders and weak enforcement of the existing mandatory requirements of the listed companies, and the lack of public knowledge and education about corporate investment and governance system.

3.3. Disclosure and Transparency

The timely disclosure of information is the most significant aspect for the company to acquire the investors' confidence. It is mandatory for all companies to prepare **audited annual accounts** and submit first to the board for approval, then to all shareholders and finally to the Office of the Company Registrar. The listed companies are required to submit their annual financial report to the Securities Board (SEBO) within four months after the expiry of the fiscal year as well as their semi-annual report within 60 days after expiry of each six-month period. In accordance with the provision of Company Act, 1997, the listed companies are expected to prepare their financial statements based on **General Accepted Accounting Practices**. The companies violating the disclosure provision specified by the Company Act are subject to punishment. Nevertheless, many publicly listed companies fail to submit these mandatory requirements.

The statistics clearly show that there is severe lack of **disclosure** and **transparency** in the corporate governance system in Nepal. It is evident from the table above (table

Table 5. Category-wise Disclosure Status of Listed Companies

Category	2001/02			2002/03		
	Total Number	Disclosed	Percent	Total Number	Disclosed	Percent
Banks	12	11	91.7	15	12	80
Non-bank finance Companies	30	28	93.3	35	29	80.3
Insurance Companies	7	5	71.4	13	6	46.2
Hotels	4	2	50	4	4	100
Manufacturing and Processing	28	14	50	29	13	44.9
Trading Companies	8	5	62	8	3	37.5
Others	3	3	100	4	0	0
Total	92*	68	73.9	108	67	62.0

Source- Securities Board

5) that only 73.9 percent of 92 listed companies disclosed their financial information to the SEBO in 2001/02. Only 50 percent of listed hotels and manufacturing companies submitted their annual report and financial account in 2001/02 whereas the number of trading and manufacturing companies furnishing the information to the SEBO sharply declined to 44.9 and 37.5 percent respectively in 2002/03. The number of companies disclosing their status further deteriorated in 2002/03 representing only 62 percent of the total 108 listed companies.

The following table (table 6) shows the disclosure status of the overall companies listed in the stock exchange. The statistics clearly show that despite the gradual increase in the number of listed companies over the years, the disclosure of their financial status has decreased. This fact suggests that the companies fail to meet their optimistic estimates of profits and to pay dividends, fail to publish annual accounts and to hold AGM timely.

Table 6. Disclosure Status of Listed Companies

	1995/96	1996/97	1997/98	1999/00	2000/01
Listed Companies	89	95	101	110	115
Disclosing Companies	65	69	58	68	67
Percentage	73.0	72.6	57.4	61.8	58.3

Source- Securities Board

To sum up, there are several laws and regulations governing the operation of securities market in Nepal. The Securities Board (SEBO), established in 1993 under the Securities Exchange Act, 1983, is the apex regulatory institution to regulate, manage and supervise the securities operations in the country. All securities market intermediaries are required to be registered with the SEBO and submit their annual progress and financial report to SEBO and Nepal Stock Exchange Limited. The corporate ownership in Nepal is largely concentrated with few numbers of family and business groups in which the majority shareholders dominate the process of corporate decision-making. The weak transparency and disclosure mechanism and lack of strict enforcement of existing mandatory provisions have seriously dented the corporate governance system in Nepal. The disclosure status of the listed companies has been further deteriorated in the recent years.

4. COMPARATIVE ANALYSIS OF NEPALESE SECURITIES MARKET

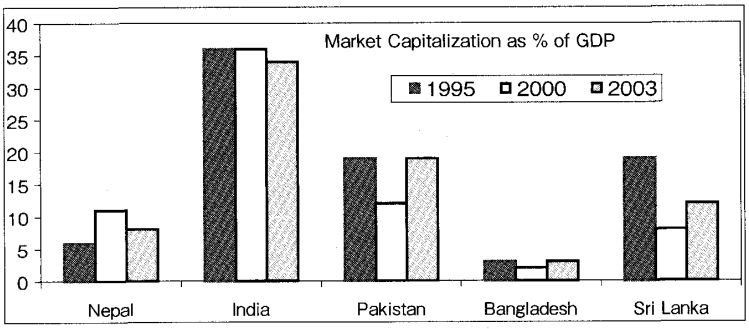
Analysis of securities market development, like economic development, is a complex and multifaceted concept and hence no single measure captures all aspects of its development indices. This section examines the market size, liquidity, efficiency and structure measures of Nepalese stock market in relation to the South Asian countries and also compares those variables with that of industrial (G7) economies. Most of the data for the analysis of Nepalese securities market are obtained from various domestic sources (such as the various publications of Nepal Rastra Bank, Central Bureau of Statistics, Ministry of Finance, Securities Board, Stock Exchange Limited etc.) whereas for international comparisons, we use the World Bank data. The data, in most cases, cover the period between1990-2003. In the most simplistic form, the measurement of size, liquidity, efficiency, and structure are undertaken deflating the various securities market variables by the size of the economy and the market, measured by GDP and the value of stock market capitalization respectively.

4.1. The Market Size

The market capitalization, defined as the total market value of listed shares, divided by the Gross Domestic Product (GDP) measures the size of securities market in relation to the size of the economy. Higher the ratio, the larger the size of stock market and vice versa. This ratio tends to be larger in those countries where the stock market is well developed and the share of bank assets/deposits to GDP is relatively small. This ratio also compares the type of country's financial system. Lower the ratio, more bank-based the country's financial system tends to be.

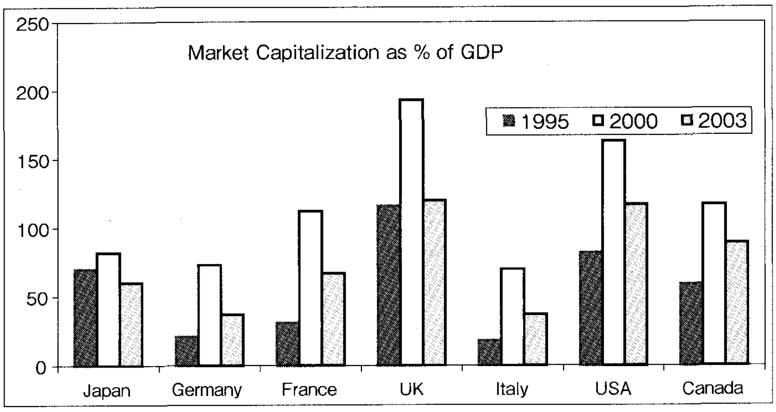
This ratio for Nepal ranges from the **lowest 1.46 percent to the highest 11.78 percent** with an average value of 6 percent over the period 1990-2003, which is far below the range of emerging economies (20-40 percent of GNP). This ratio for India, Pakistan, Sri Lanka and Bangladesh ranges from 10-36, 7-23, 8-23, and 1-7 percent with an average of 28 %, 15 %, 13 % and 3 % respectively over the period 1990-2003. This shows that the overall size of Nepal's securities market measured in terms of market capitalization to GDP ratio is smaller than its South Asian counterparts except

Bangladesh.



Source: World Bank 2004, data for Nepal, Nepal Stock Exchange Limited

The ratio for the most advanced countries tends to be high implying that the securities market plays major role in supplying the external funds for corporate financing. The ratio in the developed countries ranges from 55-110 percent (IFC, 2002). The statistics show that the most advanced countries like Japan, USA, UK, France, Germany, Italy and Canada have relatively higher market capitalization to GDP ratio ranging from 55-121, 58-164, 85-193, 27-112, 18-73, 12-70 and 43-117 percent with an average of 73 %, 106 %, 130 %, 54%, 37 %, 31 % and 76 % respectively over the period 1990-2003.

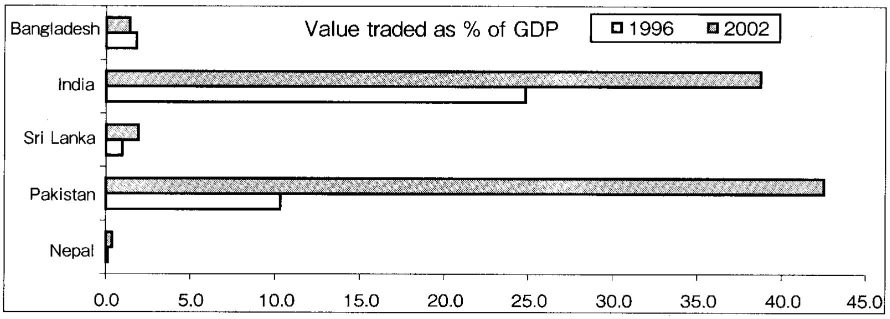


Source-World Bank, 2004

4.2. Market Liquidity

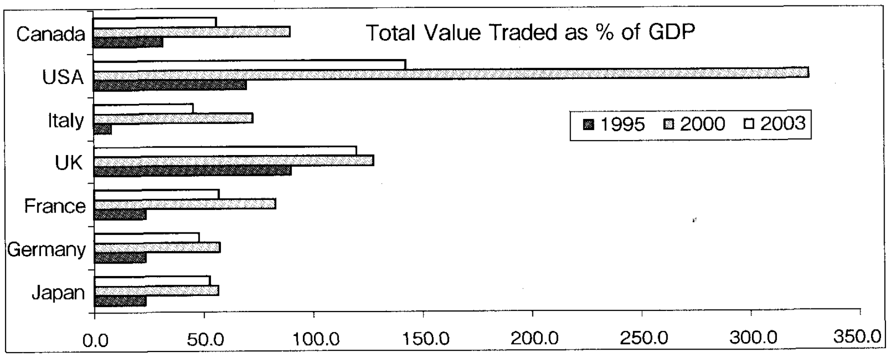
Total value traded as percentage of GDP measures the value of stork transactions relative to the size of economy, a measure of **market liquidity**. This ratio shows the position of market liquidity because it measures trading relative to economic activity (Levine and Zerovs, 1998). The ratio tends to be very low (below 1 percent) implying high liquidity risk in equities market in Nepal.

Due to the very small size of market in Nepal, the ratio of total value traded relative to GDP turns to be very low. There is no doubt that the legal, regulatory, accounting, tax, and supervisory systems influence stock market liquidity. The efficiency of trading systems determines the ease and confidence with which investors can buy and sell their shares. In addition, the macroeconomic and political environments affect market liquidity.



Source- World Bank, 2004

The value traded to GDP ratio for Nepal is extremely low as shown in the figure above. India and Pakistan have high value traded to GDP ratio ranging from 7-110 and 1-96 percent with an average of 32 % and 23 % respectively over the period 1990-2003. This implies that the value of stock trading is relatively high in these countries comparable to that of developed bank-based countries as shown in the figure. The ratio for highly industrialized economies like Japan, Germany, USA, UK, France, Italy and Canada ranges from 17-57, 15-77, 31-327, 28-174, 9-83, 2-72 and 12- 90 percent respectively over the period 1990-2003. The average ratio of total value traded as percentage of GDP stands at 56 % for seven industrialized countries as against 10 percent of six developing South Asian countries. The securities market is more liquid in the developed countries than in developing economies. However, the market tends to be relatively illiquid in those economies where the banking sector plays major role in supplying funds for corporate financing as in Japan and Germany. These countries have higher value traded to GDP ratio than low-income developing countries on average; however, the ratio is sufficiently lower than that of the USA and UK where the market dominates the financial system. This shows that the market is highly liquid in the USA and UK than the countries where the banking system predominates the corporate financing pattern. Based on the statistics, we can conclude that Japan, Germany, Italy, France and Canada have relatively illiquid securities market than that of the USA and UK as shown in the figure below.



Source-World Bank 2004

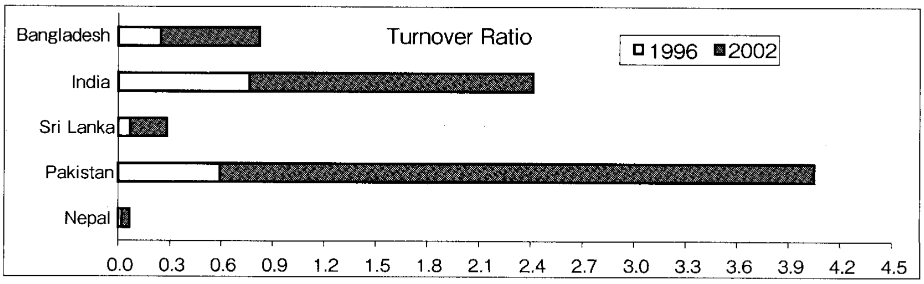
4.3. Turnover Ratio

Turnover ratio, defined as the value of trades of domestic equities on domestic exchanges as a share of value of domestic equities that are traded on domestic exchanges, measures the value of stock transactions relative to the size of the market and it is frequently used as a measure of market liquidity.

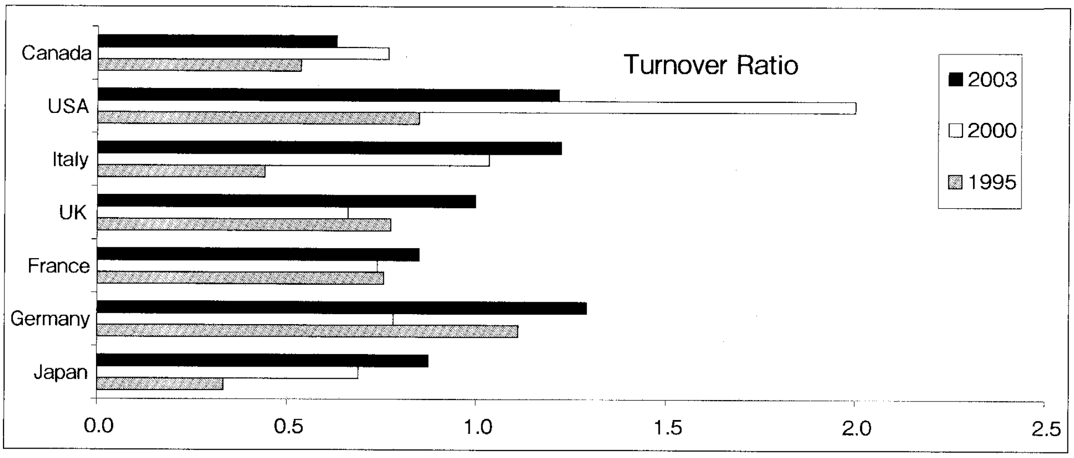
It appears that the vast fractions of stock markets in the world are highly illiquid: there are only 16 countries in the world where annual equity trading volume is above 75 % of equity market capitalization (Shah and Thomas, 2001).

In general, the turnover ratio is used for measuring the efficiency of the securities market. However, this ratio is not a direct measure of efficiency because it does not measure the trading costs. The ratio of total value traded to GDP measures trading relative to size of the economy, whereas the turnover ratio measures trading relative to size of the market. Thus, a small active market may have high turnover and low total value traded to GDP ratio. The turnover ratio for Nepal ranges from 1 to 8 percent over the period 1990-2003 implying that the value of equity trades in Nepal is small relative to the market capitalization and securities market is inefficient. The ratio for other developing economies such as India, Pakistan, Sri Lanka and Bangladesh ranges from 0.17-3.06, 0.09-5.04, 0.06-0.35 and 0.09-5.04 respectively over the period 1990-2003.

The turnover ratio for developed industrial countries such as Japan, Germany, USA, UK, France, Italy and Canada ranges from 0.23-0.87, 1.20-1.29, 0.48-1.21, 0.40-1.0, 0.19-1.21, and 0.33-0.63 respectively over the period 1990-2003.



Source-World Bank, 2004



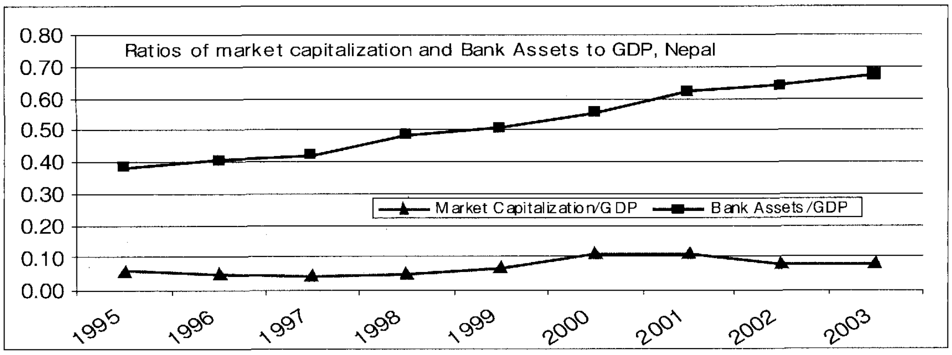
Source- World Bank, 2004

4.4. The Market Structure

The ratio of total bank assets to market capitalization is the measure of country's **financial structure**. This ratio tends be high in those countries where the financial system is dominated by banks and the securities market is relatively small or underdeveloped. Financial system is broadly divided into two types: bank-based and securities market-based. Because the bank financing predominates the market financing in Japan and Germany against the securities market financing in the US and UK, the former is often referred to as the **Japan-German model** and the later **Anglo-US model**.

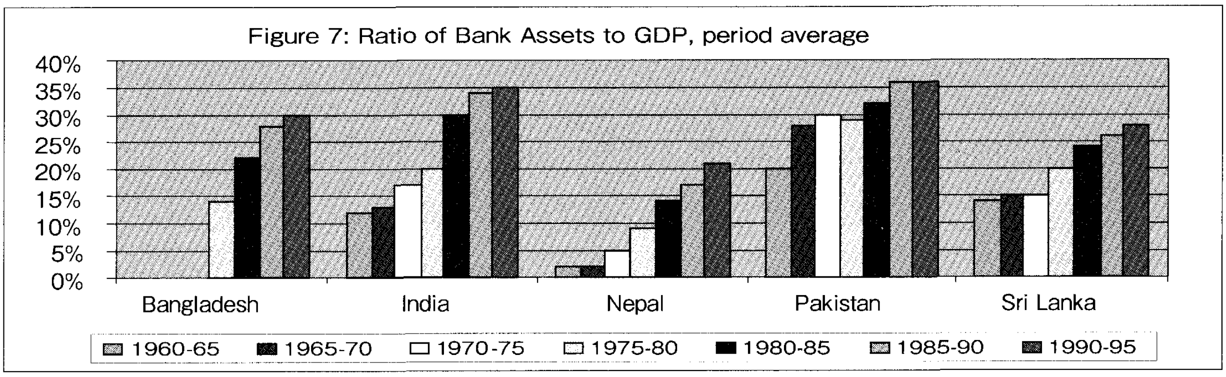
The total bank assets to market capitalization ratio ranges from 4.9 to 21.9 over the period 1990-2003 implying that the Nepalese financial system is highly bank-based with relatively underdeveloped securities market. A careful interpretation is needed to explain this ratio. Because the ratio may be high due to the small size of securities market. This doesn't necessarily mean that the banking system is large, developed and efficient. This is the case in most of the developing countries. However, for comparative analysis, we can simply draw the conclusion that higher the ratio, the more bank-based system that tends to be. Damirguc-Kunt and Levine et al. (2001) finds this ratio for many developed as well as developing countries ranging from 0.4 to 10 (Malaysia-0.41, USA-0.86, UK-1.03, Japan-1.66, Germany-5.01, Pakistan-2.17, Sri Lanka-1.69, Nepal-4.3, Bangladesh-7.76).

The ratio of bank assets to GDP tends to be much higher than the ratio of market capitalization to GDP. This shows that the banking sector is the major constituent of the financial system in Nepal as in the most developing countries and some developed countries like Japan, Germany, Italy, France, etc.



Source- Quarterly Economic Bulletin, Mid-July 2003, Nepal Rastra Bank / Securities Board, Nepal

A comparison of period average of the bank assets to GDP ratio among five South Asian countries for different periods reveals the fact that the financial systems in those countries are dominated by banking sector. In other words, these countries have bank-based financial system.



Source- Nepal Development Forum, Economic Update 2002, World Bank.

4.5. Overall Size of Financial System

The sum of the domestic assets of deposit money banks and the stock market capitalization as percentage of GDP measures the **overall size** of financial system. This ratio increased from 28.5 percent in 1990 to 78 percent in 2003 implying that the overall size of financial system is rapidly increasing over time as a number of banks emerged during 1990s and the market capitalization increased with the increasing number of companies in the stock exchanges.

$$\text{Overall Size} = \frac{\text{Bank Assets} + \text{Market Capitalization}}{\text{GDP}}$$

This ratio tends to be much higher in the developed countries. International comparison shows that Nepal still has very small size of financial system even compared with other developed as well as developing economies. (USA 153 %, Australia 148 %, India 62%, Pakistan 52 %, Bangladesh 35%, Japan 210 %, Sri Lanka 43 %, Singapore 232 % over the period 1990-95- Demirguc-Kunt and Levine, 2001).

4.6. The Linkage with the Real Sector

The empirical results of **correlation analysis** show that there exists positive but weak relationship between economic growth rate and ratio of market capitalization to GDP. Similarly, the relationship between NEPSE and GDP growth is also **positive but weak,** implying that the stock market performs with respect to the change in economic indicators but there exists large presence of non-explanatory factors. It may be due to the very small size and underdeveloped nature of securities market, which is highly affected by other **non-economic factors**.

A positive and strong relationship is observed between bank assets to GDP and market capitalization to GDP. This result reveals strong **complementarity** between

Correlation Matrix (1994-2003)

Particulars	MCAP/Y	Tov/Y	Tov Ratio	NEPSE	GY
MCAP/Y	1				
Tov/Y	0.594349	1			
Tov Ratio	0.1200003	0.8461664	1		
NEPSE	0.9554486	0.5769297	0.1129686	1	
GY	0.0276998	-	-	0.233654834	1

Note : Y- Gross Domestic Product, GDP; MCAP/Y- Market Capitalization to GDP
Tov/Y- Turnover to GDP; Tov Ratio- Turnover Ratio, measured by annual turnover divided by market capitalization; NEPSE- Nepal Stock Exchange Index; GY- Growth Rate of Real GDP

growth of banking sector and securities market in Nepal.

Correlation Matrix (1994-2003)

	GY	MCAP/Y	Bank Assets /Y
GY	1		
MCAP/Y	0.0277	1	
Bank Assets /Y	-	0.636592	1

The NEPSE index, money supply, and GDP growth rate all move in the same direction. However, correlation results show that NEPSE is more strongly associated with M1 than M2 and growth rate of real GDP. The NPESE index reached record-high level in 1999/00 when economy recorded an impressive growth rate of about 6 and 5 percent in the year 1999/00 and 2000/01 respectively. Both the size and trend of market began to shrink along with downward trend of the economy since 2001/02.

4.7. The Market Share and Competition

Though the decade of 1990 remained 'Good Time' for banking and non-banking financial institutions in Nepal, many manufacturing companies and hotels witnessed poor performance mainly due to the overall economic situation severely affected by the ongoing political instability and security problems since the last 7/8 years. This situation further aggravated the stock exchanges of manufacturing companies. However, the so-called 'good time' for banking sector so far has come to an end. The manufacturing companies and the hotels were/are the most loss making enterprises in 2000/01 and 2001/02 as shown in the table below (table 8).

Table 7. Stock index, money supply and GDP growth

Fiscal Year	NEPSE Index	M1	M2	Real GDP
1993/94	226.0	19.6	19.6	8.27
1994/95	195.5	15.6	16.1	2.73
1995/96	185.6	10.7	14.4	5.69
1996/97	176.3	5.4	11.9	5.01
1997/98	163.4	17.4	21.9	3.34
1998/99	216.9	13.1	20.8	4.54
1999/00	360.7	19.4	21.8	6.09
2000/01	348.4	18.3	17.2	4.74
2001/02	227.5	6.1	4.8	-0.32
2002/03	204.9	9.4	7.6	2.74

Source- Quarterly Economic Bulletin, NRB/ Economic Survey, 2002/03, MOF

Table 8. Profit/Loss Situation

Category	2000/01 Total	2000/01 Profit Making	2000/01 Loss Making	2001/02 Total	2001/02 Profit Making	2001/02 Loss Making
Bank	12	10	-	12	11	1
Non-bank Finance	30	28	-	29	26	3
Insurance	11	9	-	6	6	-
Hotel	4	2	-	4		4
Manufacturing	28	7	7	13	9	4
Trading	8	3		3	3	-
Others	3	2	1	-	-	-

Source- Securities Board Nepal, Annual Report, 2002/03

The securities market in Nepal is mainly dominated by the banking sector. The category of top companies listed in the stock market is the bank and non-bank finance companies followed by very few manufacturing companies. Out of total paid up values of the total listed companies of Rs. 12436.78 million, the commercial banking sector alone accounts for 43 percent followed by manufacturing and processing industries accounting for 15 percent in the fiscal year 2003/04. Similarly, the commercial bank group alone accounts for about 40 percent and 69 percent of total traded amount and market capitalization respectively. This fact shows that the commercial banking group plays the dominant role in determining the key indicators in Nepalese securities markets.

The market is highly concentrated to the limited sectors implying the lack of competition. There is high risk of investment in the share of manufacturing and hotel industries due to high uncertainties of profits and poor disclosure and transparency mechanism. The investment in the share of banking industries so far is relatively less risky, however, excessive concentration of the market in banking sector may create the risk of market collapse and invite the systemic crisis in times of financial distress in the banking sector. The statistics for the fiscal year 2003/04 (as shown in the table 9 above) reveals that the commercial banks hold the topmost position in terms of market capitalization, traded shares, outstanding equities and NEPSE Index. In terms of traded amount, manufacturing and processing companies occupy the highest position and rank second in terms of market capitalization as shown in the table above (table 9).

In terms of number of shares traded, Bottlers Nepal Limited holds the top position

Table 9. Company-wise Share in different Market Variables (as % of total), FY 2003/04

Company Category	Listed Number	Paid-up value	Traded amount	Market Capitalization
Commercial Banks	14	43	40	69
Finance Companies	45	15	8	7
Development Banks	4	5	2	2
A. Banking Sector Total	**63**	**63**	**49**	**78**
Insurance Companies	14	9	2	6
Manufacturing and Processing	12	15	48	11
Hotel	4	11	0	3
Trading	3	1	1	1
Others	3	2	0	0
B. Non-banking Sector Total	**37**	**37**	**51**	**22**
Grand Total (A+B)	**100**	**100**	**100**	**100**
Total Amount (Rs. million)	**92**	**12,436.78**	**2,144.27**	**40,454.79**

Source- Nepal Stock Exchange, Annual Report.

followed by banks, finance and insurance companies in the fiscal year 2003/04. The statistics clearly show that the banking and non-banking financial sectors dominate the market in terms of number and volume traded as shown in the tables (10 and 11).

Measured in terms of number of companies in relation to the total listed companies, the finance companies account for the highest share (32.4 %) followed by manufacturing and processing (26.8%) in the fiscal year 2002/03 (table 12).

In terms of paid up value, the commercial banks account for the highest share

Table 10. Top Ten Companies on the Basis of Share Traded (Mid-July 2003-Mid-July 2004)

S.N.	Name of Company	Category	Number of Share Traded (in '000)
1	Bottlers Nepal Ltd. (Balaju)	manufacturing	1914
2	Laxmi Bank Limited	Bank	848
3	Nepal Bangladesh Bank Ltd	Bank	590
4	Bank of Kathmandu Ltd.	Bank	327
5	Machha Puchchhre Bank Ltd.	Bank	318
6	Development Credit Bank Limited	Bank	190
7	Himalayan Bank Ltd	Bank	179
8	International Leas & Finance Co. Ltd.	non-bank finance co.	127
9	Butwal Finance Ltd	non-bank finance co.	122
10	Nepal Life Insurance Co. Ltd.	insurance company	118

Source- Nepal Stock Exchange Limited

Table 11. Top Ten Companies on the Basis of Amount Traded (July 17, 2003- 15 July, 2004)

S.N.	Name of Company	Category	Amount traded (Rs. in million)
1	Bottlers Nepal Ltd. (Balaju)	manufacturing	1025.6
2	Nepal Bangladesh Bank Ltd.	bank	222.79
3	Himalayan Bank Ltd.	bank	152.15
4	Laxmi Bank Limited	bank	108.08
5	Nabil Bank Ltd.	bank	73.96
6	Bank Of Kathmandu Ltd.	bank	70.96
7	Standard Chartered Bank Nepal Ltd.	bank	64.32
8	Everest Bank Ltd.	bank	56.11
9	Nepal Investment Bank Ltd.	bank	41.39
10	Machha Puchchhre Bank Ltd.	bank	34.04

Source- Nepal Stock Exchange Limited

Table 12. Listed Companies by the end of Fiscal Year 2002/03

S.N.	Category.	Number	Percent
1	Commercial Banks	11	10.18
2	Development Banks	4	3.70
3	Finance Companies	35	32.41
4	Insurance Companies	13	12.04
5	Hotel	4	3.70
6	Manufacturing and Processing	29	26.85
7	Trading Companies	8	7.41
8	Others	4	3.70
	Total	108	100.00

Source-Nepal Stock Exchange Limited

followed by the manufacturing companies for the fiscal year 2002/03 (table 13).

Based on the facts mentioned above, we can conclude that the securities market in

Table 13. Paid up Value, end of FY 2002/03 (Rs. in million)

S.N.	Category	Paid up Value	Percent
1	Commercial Banks	4444.92	35.39
2	Development Banks	611.88	4.87
3	Finance Companies	1415.89	11.27
4	Insurance Companies	1047.48	8.34
5	Hotel	1552.88	12.36
6	Manufacturing and Processing	2758.78	21.96
7	Trading Companies	76.64	0.61
8	Others	651.6	5.19
	Total	12560.07	100.00

Source- Securities Board, Annual Report, 2002/03

Nepal is highly dominated by the banking and non-bank financial sector. The share of non-financial sector, i.e. manufacturing, service, trading and others is relatively small measured in terms of any aspects, such as number of listed companies, total value traded, market capitalization, paid up value of listed shares etc.

4.8. Market Concentration Indices

The competition in the market plays substantial role in allocating the resources to their best uses. In order to evaluate the level of competition and market structure, we employ *Gini coefficient* and Herfindahl Index. We use them to examine the market concentration of various securities market variables. The Gini Coefficient is used more often to gauge the income inequality. The same technique is used here to measure the degree of concentration of various securities market variables such as market capitalization, turnover, paid up value and share traded. The following formula is used to calculate *Gini Coefficient*:

$$Gini = \frac{2}{\mu n^2}\sum_{i=1}^{n} i\, X_i - \frac{n+1}{n}$$

Where, μ is the mean of market variable (market capitalization, paid-up value, amount traded, and shares traded), n is number of observations in ascending order and X_i is cumulative share of market variables in descending order. The value of G ranges between 0 and 1 implying that closer the value towards zero, the market structure tends to be less concentrated and vice versa.

The Herfindahl Index is a well-known measure of industry concentration. This index ranges from the lowest of zero, indicating perfect competition, to the highest of 10,000, indicating complete monopoly. Greater values mean greater concentration, less competition, and more market control held by individual firms. The index is defined as the sum of the squared shares of market participants, which is given mathematically as:

$$H = \sum_{i}^{n} \alpha_i^2$$

Where, H is *Herfindahl Index*, α_i is share of various securities market variables mentioned above. The *Herfindahl index* is taken to be better concentration index than Gini coefficient as the former does not take into account the number of companies and focuses on the size only. The calculated index is then compared with the level of concentration as given in the following Herfindahl concentration table:

Concentration Level

Level	Concentration Ratio	Herfindahl Index
High	80 to 100%	1,800 to 10,000
Medium	50 to 80%	1,000 to 1,800
Low	0 to 50 %	0 to 1,000

The empirical results are presented in the following table showing that the market is highly concentrated in terms of traded amount, market capitalization, and share traded.

Concentration Index

	Gini Index	Herfindahl Index
Traded Amount	0.698750041	4000.8000
Market Capitalization	0.687559217	5004.30698
Traded Share	0.626115961	3098.96020
Paid-up Value	0.496977916	2539.97201

Similarly, the concentration index calculated for the top ten companies in terms of amount and number of share traded shows that the market is highly concentrated to the limited industries (here, the banks and finance companies) revealing less competition in the securities market in the country. The Gini Coefficient obtained from the same statistics is consistent with the results from H concentration index showing that the market is highly concentrated even within the top ten companies. The concentration index will give even higher level of concentration, if we include all the listed companies' variables in our sample.

Concentration Index of top ten Companies (FY 2002/03)

Herfindahl Index (Nepal)		
Share traded		2255.107284
Amount traded		3382.71774
Gini Coefficient (Nepal)		
Share traded		0.50988802
Amount traded		0.584423056
Amount traded	**TSE (top 15)**-Tokyo Stock E\exchange	**0.213730206**
	NYSE (top 10)- New York Stock Exchange	**0.096379352**
	NSE (top 15)-National Stock Exchange, India	**0.332877665**

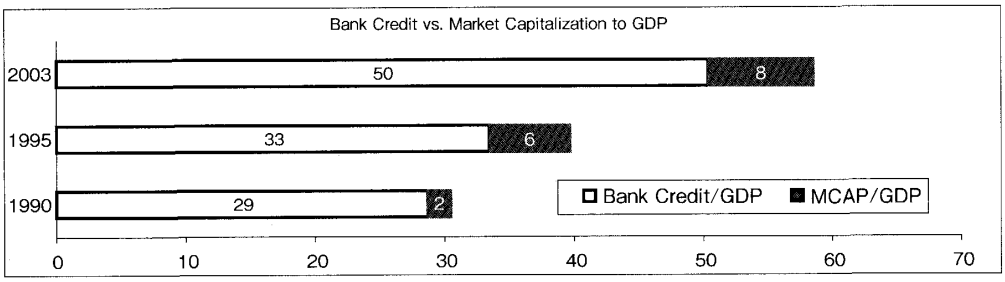
To sum up, a comparative analysis of securities market among the selected developing as well as developed countries by employing various ratio measurement of market size, liquidity and efficiency reveals the fact that Nepalese securities market is very small, more illiquid and inefficient compared not only with developed economies but also with South Asian developing countries except Bhutan and Bangladesh. The overall size and structure measures show that Nepalese financial system is a prototype of bank-centered model, however, it is not meaningfully comparable with many other countries following Japan-German vs. Anglo-US model. The measures of market concentration obtained from Gini Coefficient and Herfindahl index show that Nepalese securities market is highly concentrated implying very low level of competition in the market. The empirical results obtained from correlation analysis are consistent with the hypothesis that there exists positive relationship between securities market development and economic growth. However, the relationship is weak. Moreover, the correlation analysis revealed a strong complementarity between the growth of banking sector and securities market in Nepal. Finally, the securities market; more concisely, the equities market, in Nepal is largely confined to the banking sector. The banks and finance companies are the major industries whose shares are actively traded in the stock exchange. The market share of non-banking sector (such as manufacturing, hotel, trading etc.) is relatively small and the securities investments in these sectors are relatively less profitable and attractive.

5. THE STRUCTURE OF NEPALESE FINANCIAL SYSTEM

Financial system can simply be defined as a mechanism that transfers funds from surplus to deficit units. There may be various means and instruments through which funds are channeled and utilized for generating returns. The system, as a whole, consists of the legal and institutional structure, financial instruments and individuals. It performs the functions of mobilizing savings, allocating resources, exerting corporate control, facilitating risk management and easing trades and contracts. More concisely, banking sector and the securities market are the two major constituents of the financial system. These both components are subject to facilitate the needy ones by providing long as well as short-term funds. The choice between these two methods of financing decision depends, among other things, on the risk and return consideration, level of socio-economic condition and the government policy designation.

Although the securities market is still passing through the infant stage of development, the banking sector in Nepal has relatively longer historical foundation, established institutional settings and better growth and development trend. Measured in terms of the ratio of total bank assets to market capitalization, the Nepalese financial system falls in the category of **bank-based model** led by Japan and Germany, however, a relative measure puts Nepal in the state of underdeveloped financial system. The banking system is composed of 17 commercial banks, 59 finance companies, 34 development banks and many micro-credit banks and NGOs licensed to conduct limited banking activities. Despite the rapid increase in the number of banks and other financial institutions during the last decade, the two public sector banks (Nepal Bank Limited and Rastriya Banijya Bank) still account for a significant proportion of the total commercial banking of assets (49%, as of 2003), deposits (36%), loans (38%) and investment (35%). Due to the politically motivated and imprudent lending practices, poor management and lack of rational banking strategies, these two banks are formerly declared technically insolvent and currently being operated under management contract. Nevertheless, these two banks still hold a significant market share, especially outside the capital city, and are operating with the largest branch network throughout the country. There are 6 private joint venture and 9 domestically operated private banks. Though these banks have relatively small share in the market, most of them are operating with sound financial as well as managerial performance and few of them provide the services and products of international standard.

The financial system liberalization initiated in the mid-1980s resulted into a rapid growth of financial institutions, services and product innovation. The decade of 1990 witnessed 'good time' for banking sector, however, the amount of increasing **non-performing loans** (NPL) and accumulated loss in the public sector banks have nullified the overall performance of banking system. The share of NPL as percentage of total banking sector loans stood at 29 percent in 2003. The public sector banks have considerably higher NPL ratio (60% of total loans) than that of private sector banks (8%, as of 2003). Moreover, the degrading politico-economic condition since last few years has further aggravated the situation that has severely hit the banking sector.

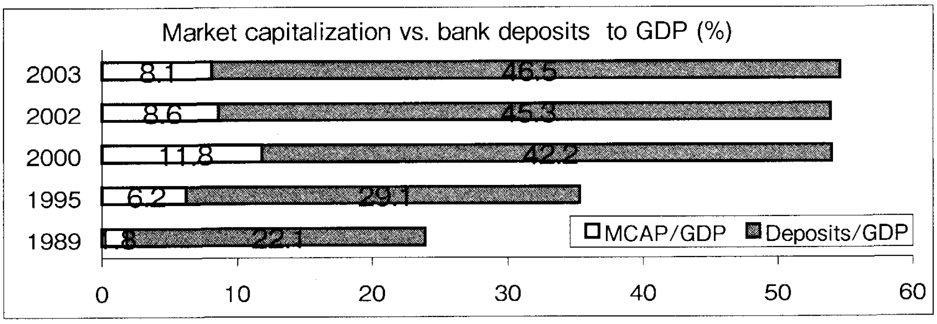


Source- Source-Quarterly Economic Bulletin, mid-July 2004, Nepal Rastra Bank

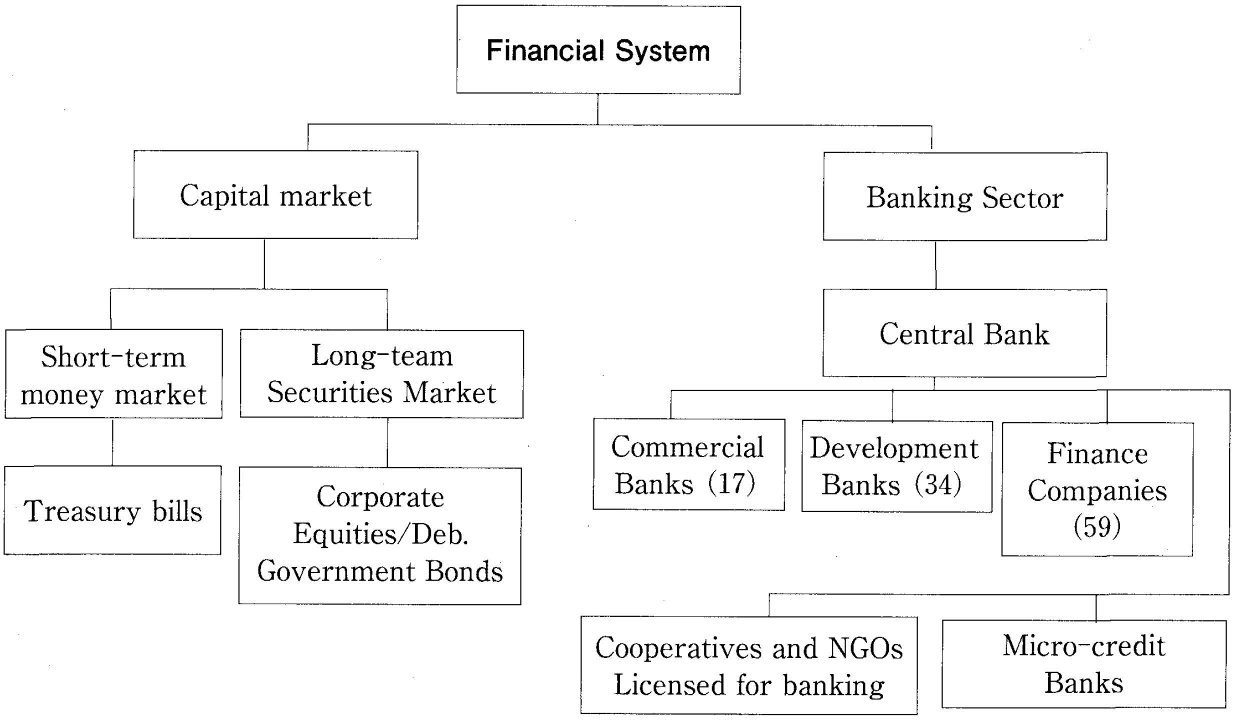
The bank credit is the main source of financing. However, there still exists large presence of **informal sector credit** in Nepal. The rich landlords and merchants provide loans to the small peasants and businessmen against the collateral of precious jewels and real estates at very high rate of interest, especially in the countryside where the banking facilities are not adequately available. The Bank credit as percent of GDP increased from 29 percent in 1990 to 50 percent in 2003 implying the increasing role of banks in providing domestic credit. Similarly, the market capitalization to GDP is also increasing implying that the securities market is growing gradually over time as shown in the figure below. Nevertheless, the share of securities market in the overall financial system is very small and still not remarkably significant.

Bank Deposits as percent of GDP are increasing over the period as shown in the figure below. The bank deposits remained/will remain the largest source of household financial assets in Nepal. The anatomy of Nepalese financial system is shown in the following chart.

The major features of Nepalese financial system can be summarized as follows: Firstly, the Nepalese financial system can be leveled as the bank-centered model, however, international comparison made in the earlier chapter shows that Nepal has



Source-Quarterly Economic Bulletin, mid-July 2004, Nepal Rastra Bank



underdeveloped financial system, which is not meaningfully comparable to the Japan-German vs. Anglo-US models. Secondly, the securities market is in the infant stage of development and hence most of the corporate financing sources are obtained from the bank loans. Followed by the universal banking model, the commercial banks are the major players in the financial system. Thirdly, the securities market, especially, the equities market is largely confined to the banking sector. The manufacturing sector has relatively small share in the market. The major (top ranking) industries listed in the stock exchange are either banks or finance companies with relatively small number of other non-banking sector industries. Fourth, due to the lack of knowledge and sufficient information about securities market, the general people, except few professionals, are often reluctant to invest in the securities market and hold their financial assets in the form of bank deposits. Similarly, due to the lack of relatively less risky market instruments such as, corporate debentures than highly volatile equities investment, the general people are compelled to allocate their hard earning in the form of bank deposits. The risk aversion behavior of the people has also played pivotal role in this context. These factors have limited the scope of securities market in the country. Fifth, the banking system is highly dominated, in all aspects, by the two largest public sector banks (Nepal Bank Limited & Rastriya Banijya Bank) recognized as technically insolvent and currently operating with fragile financial health. Moreover, these banks are highly unequipped, poorly managed and triggered by political interference. The private sector banks, on the other hand, have shown good performance with diversified services and products of international standard. Nevertheless, the overall banking system reveals quite poor indicators due to the large market share of problem-led public sector banks. Moreover, there is high concentration of assets, deposits, loans and investments in the few large banks. Sixth, due to the urban-centered financial system, there exists some informal sector credit in Nepal. Though it is difficult to quantify the amount, it is true that a large fraction of rural people, especially, small and poor farmers and shopkeepers, make use of such loans because of their inability to meet administrative and legal requirements for bank loans and also due to the lack of easy banking access in their locality. Finally, the lack of uniform accounting and reporting system, poor disclosure and transparency mechanism and weak corporate governance system are other salient features of Nepalese financial system.

Under these circumstances, the replacement of banking system by securities market in meeting the corporate financing requirement is almost impossible in the short run. The development of sustained and effective securities market is a long process that depends, among other things, largely on the socio-economic condition and government's financial policy. Nevertheless, the development of securities market is extremely necessary for sustained growth and development of Nepalese financial system. The securities market must be made the major source of financing in the long-run but the banking system should play a complementary role and should grow simultaneously. Until attaining the certain level of economic as well as financial system development, the banking sector will/should be the major supplier of the corporate finance because there exists large information asymmetries and the lack of basic infrastructure for securities market development in Nepal.

Major Problems and Challenges

Despite some significant measures undertaken during the early 1990s, the securities market in Nepal has not remarkably been playing the significant role in financing long-term capital requirements. The individuals are more prone to place their savings in the form of bank deposits and in the fixed interest bearing government securities even at very low rate of interest. Thus, long term saving that should have been invested in the securities market are going to the shot-term markets due to the lack of exact disclosure of financial information, weak governance structure and poor accounting standards of the corporations.

A majority of low income people do not have access to ongoing, formal financial services, and are forced to relay instead on a narrow range of often risky and expensive, informal services. This constraints their ability to participate fully in the markets, to increase their incomes and to contribute to economic growth. The issuance of long-term bond is limited only to the government. At present, it issues National Saving Certificates to the general public at predominated interest rates and offers only short-term securities in the market at market rates. The government needs bond markets to push state-owned enterprises to borrow from the market instead of financing them from the fiscal budget. A bond market would eventually help resolve the bad-loan situation. Nepal does not have an active money market except 91-day Treasury bill market. An effective short-term money market is also a prerequisite for an effective long-term market. There are large number of small scale companies (such as garment and carpet industries) that do not need and could not issue bonds or shares and regulations prohibit insurance companies and pension funds from investing freely in the securities market.

There is not an easy access to the people living outside the capital city to participate the **stock investment** due to the lack of stock operations outside Kathmandu valley. This has also limited the scope of securities market in Nepal. Moreover, most of the people are unknown about the stock market and they are compelled to use their savings in the form of bank deposits yielding low return. Because very few companies are paying their dividends, the trading activity is low. The tradition of family-owned corporate culture has little disclosure and transparency practices. Stock exchange also lacks broader participation and necessary professionalism.

Increasing problems noted with corporate governance, transparency and disclosure have seriously dented the Nepalese securities market (Koirala and Bajracharya, 2004). The frequent changes of government and its interference in the appointment of CEO and other board members who have little or almost no knowledge about corporate undertakings has brought the serious **operational inefficiency** in most of the **state**

owned enterprises in Nepal. The soft budget constraint has become even more serious problem. Moreover, the current mandatory provision for the provident funds to invest only in the capital of bank and finance companies has restricted a large amount of long-term funds going into the securities market.

The corporate equities dominate the securities market in Nepal. The market has not become attractive to **risk averter** and **risk neutral** investors due to few corporate bonds and mutual funds in the market. The market has limited infrastructures to improve the standard and fasten the securities trading, clearing, and settlement systems. The lack of reliable and consistent accounting and auditing practices has adversely affected the investors' confidence in the market. The failure to conduct AGM of most of companies' and disclose the audited financial information to the public have further eroded the investors' confidence in the securities market. Thus, insider trading, lack of credibility, weak accounting standards, poor disclosure and transparency mechanism and lack of public knowledge about securities investment are the main constraints to further development of securities market in Nepal.

As the result of government's policy towards economic liberalization after the restoration of democracy in 1990, 24 public enterprises so far have been privatized through various methods, such as auction and share sale, liquidation, lease contract etc. However, the privatization of these enterprises did not materialize the real outcome as was expected. The securities of privatized enterprises could not attract investors' interests as these enterprises, which were financially troubled in the past continued to shrink their performance even after privatization.

The foundation of an effective government bond market must rest primarily on macroeconomic stability, a clear definition of the government's debt strategy, a transparent and effective legal framework supporting bond issues and their subsequent trading in the secondary markets, the presence of a wide investor base for purchasing the bonds and a stable and liquid money market overseen and managed by the nation's central bank. These foundations are of grave concern in Nepal.

Finally, given these impediments, there are enormous prospects for economic prosperity. As a growing economy, a number of corporations and financial institutions are likely to emerge as profitable and attractive issuers of bonds or equities. The prospects of emerging industries in hydropower, tourism, and agriculture can attract the investors' interest in the days to come. The banks and non-bank finance companies' lending to these industries may be constrained by the credit-risk concern and also insufficient to finance large investment requirements. In such situation, securities market would be very useful tool to raise the funds. The proposed privatization process, if implemented properly, may push the development of securities market. .

To sum up, Nepalese financial system, as that of other developing economies, is highly dominated by the banking sector. The securities market has very small share of corporate finance compared with bank credits. The banking sector is composed of 17 commercial banks, 34 development banks, 59 finance companies and many micro-credit banks and NGOs licensed to conduct limited banking activities. The capital market consists of short-term treasury bills market and long-term securities market. The central bank and the commercial banks are the major owners of the treasury bills whereas the long-term securities market is largely confined to the corporate equities (share) market. The banking system, on the other hand, is highly concentrated to two largest problem-led public sector banks. The market share of these banks is gradually declining as many efficient and well-managed private sector banks with diversified services and products of international standard entered into the market. The financial deregulation created the private-sector-friendly environment that resulted into the significant growth of banks and finance companies during 1990s. Nevertheless, the financial system is still predominated by inefficiently running, and hung NPL and loss making public sector banks. The securities market, on the other hand, is passing through its infancy. Among many others, the lack of disclosure and transparency, weak corporate governance system and poor accounting and reporting standards are the major problems in Nepalese securities market in particular and financial system as a whole.

6. SUMMARY, CONCLUSION, AND POLICY IMPLICATIONS

With the initiation of financial liberalization in mid-1980s, Nepalese financial system witnessed significant development. The early phase of liberalization basically focused on the banking sector rather than securities market. The banking sector remained as a single component of financial system for long time until the emergence of modern securities market in the early 1990s. There are very few information and research works about Nepalese securities market. In this backdrop, this paper attempts to provide a non-technical analysis of the overall structure and general performance of Nepalese securities market from comparative and historical perspectives and makes the following conclusions:

First, the history of securities market in Nepal dates back to 1976 with the establishment of Securities Exchange Center (SEC). The evolution of Nepalese financial market reveals that the emergence of modern securities market is a new phenomenon. Nepal has passed few but some significant steps toward development of modern securities market, but it still has a long way to go. The securities market witnessed a momentous move after the amendments in the Securities Exchange Act, 1983 that brought many legal and institutional reforms and allowed the share brokers to trade in shares in the secondary market. A more systematized market operation began with the conversion of Securities Exchange Center into Nepal Stock Exchange Limited in 1993. As a consequence of continued reform initiatives and increasing public participation in the market, the number of listed companies increased from 16 in 1986, 63 in 1993 to 111 in 2004. Similarly, the market capitalization and annual turnover grew rapidly from Rs. 3,806 million and 79.8 million in 1993 to the record high level at Rs. 46,349.2 million and Rs. 2,344.16 million respectively in 2001. The overall indicators show that the securities market, which was almost stagnant until the late 1980s, witnessed a steady growth until 1993 and then jumped slightly upward to arrive this stage. Nevertheless, in relation to its market share in the overall financial system, the Nepalese securities market is passing through its infancy.

Second, measured in terms of the market capitalization, annual turnover, turnover ratio in relation to the size of economy (GDP) and the market, the Nepalese securities market is very small, illiquid, more inefficient and underdeveloped compared not only with the developed industrial countries but also with the South Asian developing countries except Bhutan and Bangladesh. The size of annual turnover as well as market capitalization in Nepal is very small relative to its GDP. Moreover, the statistics reveal strong complementarity between the growth of banking sector and securities market in Nepal. The empirical evidences are consistent with the fact that there exists causal relationship between economic growth and securities market development. However, there exists positive but weak relationship between the market size and economic growth implying that the market is volatile and highly affected by non-economic factors.

Third, Nepalese securities market is largely confined to the corporate equities market. The presence of other securities instruments in the private sector is negligible in the stock exchange. With respect to trading volume, number of listed companies, share issues, market capitalization and equity transactions; the corporate equity market in Nepal is highly dominated by banking and non-bank financial sector with relatively small share of manufacturing and non-financial sectors. With the initiation of financial liberalization, a number of banks and non-bank finance companies emerged and grew rapidly with sound financial health in the 1990s. Consequently, they were able to win investors' confidence whereas the share of manufacturing and other non-financial companies in the securities market began to shrink as they were severely affected by the economic downturn and unstable political situation for the last few years.

Fourth, the most important aspects associated with the development of securities market are market infrastructure, the system of corporate governance, regulatory frameworks and, transparency and disclosure mechanisms being practiced in that particular country. All of these issues in Nepal are of grave concern and the mere improvements in the documents cannot address the problems until they are implemented practically. A few numbers of business groups and majority shareholders dominate the corporate governance system and there are no explicit provisions, in practice, for the protection of the rights of minority shareholders. Due to the weak enforcement mechanism, the problem of disclosure and transparency has become more serious. In such situation, there is enough room for the investors to worry about adverse selection and agency problems. In order to avoid this, the information about the financial state and future prospects of companies must be made available on a timely basis to give investors confidence to purchase corporate instruments and, on the other hand, the corporations must be governed in a fashion that also gives investors confidence that their future funds will not be wasted.

Finally, the Nepalese securities market is passing through its infancy. Despite some notable but few measures undertaken by the government, the securities market in

Nepal has not yet become a significant contributor in mobilizing the public savings for corporate investment and government deficit financing. There are number of problems and challenges associated with it. Among others, the lack of good corporate governance, weak enforcement of regulatory actions against the non-compliance of mandatory provisions, lack of uniform and standard accounting and reporting practices, and weak disclosure and transparency mechanisms are the most serious problems. There are large informational asymmetries between the managers and small shareholders. Moreover, the shrinking economic growth partly accompanied by deteriorating politico-economic situation in the country has seriously hampered the growth and development of securities market for the last few years. The lack of public knowledge about the securities investment has also limited the public participation in the securities market. Given these impediments, there are ample prospects for healthy, competitive, and efficient securities market if consolidated reform initiatives to tackle the above-mentioned problems are seriously undertaken. As a growing economy, the utilization of its rich natural resources through the emerging industries in hydropower, tourism and agriculture and the prospective industries in the communication and IT related sectors may attract the interest of domestic as well as foreign investors and widen the scope of securities market in the future. A stable politico-economic situation is inevitable to materialize these prospects in the days ahead.

Policy Implications

Based on the analysis of historical evolution, overall structure, and the major performance indicators of Nepal's corporate securities market in relation to that of other economies, this paper prescribes some policy recommendations for addressing the existing problems and enhancing the further growth and development of securities market in the country. As mentioned in the earlier sections, the most serious challenges in the Nepalese securities market are related to corporate governance and regulatory system characterized by the weak disclosure and transparency mechanism, lack of standardized and uniform accounting and reporting system, and the poor implementation of mandatory provisions. Under such situation, the three major players in the market, namely, corporate sector, regulatory authority, and investors, have significant role to play on their own behalf. The corporate sector should strictly follow the uniform reporting and auditing system to ensure the good disclosure and transparency mechanism. Such practices discourage moral hazard and insider problems and ultimately lead to the effective corporate governance system. The regulatory authority is the most important component of this trinity. It should strictly implement the existing mandatory provisions and introduce more market friendly and perpetual reform initiatives including the privatization of Nepal Stock Exchange Limited (NEPSE), creation of Credit Rating Agency, integration of government securities trading into the stock exchange, etc. In order to ease the monitoring mechanism, the regulatory authority can specify the minimum performance thresholds of the listed companies. The non-compliance of the mandatory provisions should be brought under strict regulatory action. On behalf of investors, representation in the company board/ management should be made based on the professional knowledge and experience rather than family or any other business relations. In spite of their weak bargaining power in the decision making process, the minority shareholders should not be completely indifferent to the company affairs. In order to develop the widely participatory securities market, we should start from educating the general people about securities investment and bring a large fraction of their financial assets allocated in the form of saving deposits into the marketable securities. The development of basic market infrastructure along with the creation of the investors' confidence in the market is the most important policy aspect in the first place. Finally, the process of privatization should not be limited only to the sick and incredible state enterprises, which have already lost their significant market value and trustworthiness. The privatization of state enterprises through the sale of shares to the general public will promote the growth of securitized finance and ultimately lead to the development of securities market in the future.

Appendix I

Summary of Key Securities Market Indicators (Nepal)

Particulars	1999/00	2000/01	2001/02	2002/03
Turnover (Rs.in million)	1157	2344.1	1540.6	575.8
Banks %	75.9	82.3	76.3	62.2
Insurance and Finance %	12.4	12.6	12.9	34
Manufacturing and Processing %	6.4	2.9	1.4	0.6
Hotels %	2.3	1.0	9.0	1.1
Trading %	1.1	0.2	0.2	2.3
Others %	2.0	1.1	0.2	0.1
Market Days	240	231	246	238
Average daily turnover (Rs.in million)	32	10.1	6.3	2.42
Number of transactions	29136	46095	42028	69163
Number of companies traded	69	67	69	81
Number of shares traded (000)	7673.7	4989.2	6005	2428
Number of companies listed	110	115	96	108
Number of scrip listed	112	115	NA	NA
Number of listed units of mutual fund	5250	5250	NA	NA
Total amount of listed shares (000)	7347.4	7919.1	NA	NA
Market capitalization (Rs. in million)	43123.3	46349	34703.8	35240.4
Turnover/Paid-up Value (%)	15.7	28.7	15.9	4.5
Turnover/Market Capitalization (%)	2.7	5.1	4.4	1.6
Number of listed securities	114057	124971	134150	159958
Banks %	9.1	8.7	12.5	NA
Insurance and Finance %	30.9	33.9	41.7	NA
Manufacturing and Processing %	33.6	32.2	29.2	NA
Trading %	2.7	2.6	4.2	NA
Others %	23.7	22.6	12.4	NA
NEPSE Index	360.7	348.4	227.5	204.8

Source: Nepal Stock Exchange, Annual Reports

Appendix II
Operational Results of Selected Listed Companies (FY 2002/03)

A. Commercial Banks	Paid-up Capital Rs.in million	Net Profit Rs. in million	Paid value per share (in Rs.)	Market Price of Share (in Rs.)
Standard Chartered Bank Nepal Ltd.	339.55	506.93	100	1640
Nabil Bank Limited	491.65	416.25	100	735
Himalayan Bank Limited	429.00	212.13	100	836
Nepal Investment Bank Limited	295.29	116.82	100	795
Everest Bank Limited	315.00	94.18	100	445
B. Development Banks				
Development Credit Bank Limited	160.00	16.65	100	145
Nepal Development Bank Limited	144.00	1.08	100	140
Nirdhan Utthan Bank Limited	6.70	1.69	100	100
C. Finance Companies				
Nepal Merchant Banking and Finance Limited	100.00	30.24	50	171
Ace Finance Co. Limited	90.00	23.36	100	240
Paschimanchal Finance Co. Limited	40.00	21.27	100	235
Pokhara Finance Limited	20.00	13.56	100	275
Annapurna Finance Co. Limited	20.00	13.43	100	420
D. Insurance Companies				
Everest Insurance Co. Limited	30.00	18.52	100	610
National Life and General Insurance Co. Ltd.	30.00	17.71	100	460
Himalayan General Insurance Co. Ltd.	30.00	11.52	100	190
Sagarmatha Insurance Co. Ltd.	51.00	10.40	100	150
Alliance Insurance Co. Ltd.	49.94	8.08	100	110
E. Hotel				
Yak and Yeti Hotel Limited	225.84	-8.88	100	600 (2001/02)
Soaltee Hotel Limited	86.97	-37.80	10	75
Oriental Hotel Limited	495.2	-120.35	100	49
F. Manufacturing and Processing				
Bottlers Nepal (Balaju) Limited	194.89	19.37	100	700
Bottlers Nepal (Terai) Limited	121.00	25.36	100	480
Nepal Lever Limited	92.07	93.17	100	1130
Sri Raghupati Jute Mills Limited	180.70	4.74	100	16 (1996/97)
Nepal Banaspati Ghee Udyog	20.25	-42.23	100	300 (1997/98)
G. Trading Company				
Bishal Bazar Co. Limited	27.3	22.77	100	1405
Salt Trading Corporation Ltd.	24.78	50.25	100	300 (2001/02)
Nepal Welfare Co. Limited	3.08	-0.35	75	80

Source- Securities Board Nepal, Annual Report 2003/04

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