NEPAL
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FORUM

nefsearch

January 2012 Issue 2

WHERE ARE THE BANKS HEADING?

ANALYSIS OF CATCH 22 SITUATION | EXISTING PUZZLE AND OUTLOOK

NEPAL'S BANKING SCENE

The Nepali Banking and Financial Sector was able to end the 2010/11 fiscal year on a positive note despite a severe liquidity crisis, lower than expected government expenditure, a negative Balance of Payments (BOP) position, bleeding capital markets, plummeting realty sector, political instability and an overall sluggish economy.

The current fiscal year is expected to pose a series of challenges to Banks and Financial Institutions (BFI'S) and could lead to a serious crisis as most of the problems confronted by BFI's have only obtained a short term cure.

This nefsearch looks into the current status of the Nepali banking industry and the challenges it faces through an in-depth situational analysis. It then anticipates possible outcomes and future implications.

Over the years, the Banking Industry has emerged as one of the most lucrative industries to invest in Nepali. Its profitability has enticed a larger number of aspirants to enter the market. At the end of the last fiscal year, 31 commercial banks, 87 development banks, 79 finance companies and 21 micro credit development banks were operating in Nepal. However, according to the Nepal Living Standard Survey (NLSS) 2011 only 39.9% of the population have access to commercial banks (within 30 minutes). According to a World Bank (WB) report, only 26% of households in Nepal have a bank account and 45% of these households prefer to save at home while 53% prefer to borrow from the informal sector.[1]

Figures from the last two decades reveals that the Banking and Financial

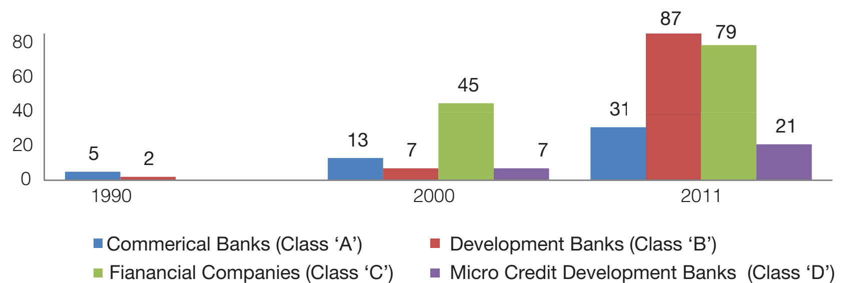
Table 1: Number of Banks and Financial Institutions

Category	1990	2000	2011	CAGR
Commercial Banks (Class 'A')	5	13	31	
Development Banks (Class 'B')	2	7	87	
Finance Companies (Class 'C')		45	79	
Micro Credit Development Banks (Class 'D')		7	21	
Total BFI's	**7**	**72**	**218**	**19%**
Total Deposits (in NPR millions)	21,885.00	154,530.30	873,488.80	20%
Total Credit (in NPR millions)	15,334.70	118,008.01	713,428.80	21%
Average Deposit per Institution (in NPR millions)	3.10	2.10	4.00	1%

Source: NRB

Sector has come a long way from the 7 BFI's in 1990 to 218 in the year 2011. Despite the growth in BFI numbers, the average deposit per financial institution has only seen a Cumulative Average Growth Rate (CAGR) of 1% in the past two decades. The synergy that was expected regarding deposit mobilization and market penetration was defeated in the rat race that saw BFIs busy garnering short term profits for their promoters.

Figure 1: Growth of BFI's in Nepal



BANKING CRISIS

The world seems to be continuously beset by banking crises. According to a WB study, 117 episodes of systematic crises and 51 cases of borderline or non-systematic crises were documented in developed and emerging markets since the late 1970s.[2] The cost of resolving these crises has significantly impacted government budgets. Cross-country estimates suggest that output losses during a banking crisis are large, averaging over 10% of annual GDP.[3] The causes of banking crises can be categorized under several headings - macroeconomic instability, microeconomic polices, banking strategies and operations, fraud, and corruption.[4]

The Nepali Banking and Financial system is currently going through a challenging phase. Besides diminishing profitability, a few BFIs have already indicated their weak financial position, this could possibly trigger a banking crisis in the near future. Till date, Nepal Development Bank and Samjhana Finance are undergoing liquidation, while Gurkha Development Bank and United Bikas Bank have been declared problematic. During 2010/11, a number of BFI's witnessed acute problems starting from Nepal Share Markets and Finance (NSM), Vibor Bikas Bank, CMB Finance, and Peoples Finance. Recently, the Nepal Rastra Bank (NRB) has sought clarification from four finance companies that have failed to maintain their Capital Adequacy Ratio (CAR). The NRB is already taking Prompt Corrective Action (PCA) against Arun Finance as its clarification was not satisfactory.

It is hard to draw specific conclusions on the cause of the banking crisis in Nepal. However, the problems faced by Nepali BFIs are largely due to their poor liquidity management, weak adherence to governance and required compliances, short term strategy (such as concentration of lending to a single sector i.e. real estate), non-compliance with accounting standards, and banking fraud.

PROFITABILITY
Analysis of Commercial Banks

The first quarter result of the current fiscal year demonstrates the challenges the banking and financial sector face. Despite NRB allowing BFIs to adjust their Balance Sheet, their first quarter results (unaudited) are concerning.

The total operating profit of commercial banks declined by almost 15% whereas it's total net profit declined by 23%. Out of 31 commercial banks (of which three were not in operation in the last corresponding quarter), 24 banks saw their operating profit decline, while 22 banks saw their net profits slump, compared to the same quarter last year. Due to the appreciation of the US Dollar (USD) against the Nepali Rupee (NPR), foreign exchange gains have provided a cushion for commercial banks to enhance their earnings, forex gains went up by 110.49% and accounted for almost 28% of net profit in contrast to the 10% for the same period last year.

Table 2: Key indicators of Commercial Banks (In NPR crores)

Indicators	FY 9/10 -1 QTR	FY 10/11 -1QTR	FY 11/12- 1 QTR	% Change
Total Banks	26	29	31	
Operating Profit	354.18	407.13	346.21	-14.96
Net Profit	308.328	346.48	267.26	-22.86
Foreign Exchange Gain	53.58	35.16	74.01	110.49
Provision for possible losses	89.24	101.99	128.68	26.17
Write back provision for possible loss	80.75	96.89	55.25	-42.98

Table 3: Key ratios of Commercial Banks

Indicators	Total Banks	FY 10/11-4 QTR	FY 11/12-1 QTR	Change
NPA (%)	31	2.52	3.01	0.49
Average Yield (%)	28	12.08	11.67	-0.41
Cost of Fund (%)	31	8.28	8.66	0.38
Average Interest Spread (%)	28	3.50	3.10	-0.40

Moreover, the provision for possible losses has increased by 26.17% and write back has declined by 42.98%, therefore, the average Non Performing Assets (NPA) of commercial banks has gone up-to 3.01% from 2.52%. Likewise, the average interest spread has tumbled to 3.10% from 3.50% as the cost of funds has gone up by 0.38 basis points whereas average yield has gone down by 0.41 basis points, which further indicates declining profitability for BFIs in the days ahead.

DEPOSIT & CREDIT SITUATION

The net deposit of commercial banks and of overall BFI's increased by 5.50% and 4.30% whereas their net lending increased by 1.90% and 1.20% respectively. Despite easing liquidity, domestic credit only increased by 1.5% during the first quarter of the current fiscal year which had increased by 3.3% during the same period the last year. The first quarter's outstanding credit decreased, resulting in the pulling back of credit facilities in the market, particularly from the real estate sector. Moreover, credit to the private sector, essential for economic growth, increased by 2.4% only, compared to the 4.1% increase during the corresponding period last year.

The lending capacity of BFIs briefly contracted due to the CCD and Capital Adequacy Ratio (CAR) requirement. Commercial

SITUATIONAL ANALYSIS

LIQUIDITY

After experiencing tight liquidity during the last fiscal year, the Nepali financial market has seen surplus liquidity in recent months, signalled by an increase in deposits, and declining interbank lending rates. The NRB has scrapped all refinancing facilities, except the 'lender of last resort' facility as commercial banks are currently witnessing a NPR 40 billion worth of surplus.

Relaxation on the threshold for income declaration, improved confidence in the banking system, timely government expenditure, and a positive BOP position have contributed to the current liquidity surplus in the banking and financial sector. Stringent regulatory measures such as requiring BFIs to maintain a Credit to Core capital and LCY Deposit (CCD) Ratio of below 80% has also directly contributed to the current liquidity position.

Table 4: Net Liquidity and CCD position of Commercial Banks

Indicators	FY 10/11- 4 QTR	FY 11/12- 1 QTR	Change
Net Liquidity (%)	30.01	33.04	3.03
CCD Ratio	75.57	73.93	-1.64

Source: NRB

At the end of first quarter of the current fiscal year, net liquidity (net liquid assets to total deposits) of commercial banks has increased to 33.04% from 30.01% and the CCD Ratio has come down to 73.93% from 75.57%. Furthermore, broad money (M2) has increased by 6.8% as compared to a growth of 1.1% during the same period last year. Narrow Money (M1) increased by 4.9% and the Balance of Payments (BOP) recorded a surplus of NPR 33.89 billion compared to a deficit of NPR 6.88 billion in the same period last year.

Table 5: Short Term Interest Rates

	Short Term Interest Rates	Rate (%)	Effective Date
1	Weighted Average Treasury Bills		
	28-Days	0.1893	20 Dec, 2011
	91-Days	0.6704	27 Dec, 2011
	182-Days	2.3852	27 Dec, 2011
	364-Days	2.9977	27 Dec, 2011
2	Weighted Average Interbank	0.75	26 Dec, 2011

Source: NRB

The ease in liquidity has meant the yield from short term money market instruments has nose dived, the yield on 28 days treasury bill plummeted to as low as 0.1893% whereas 91 day treasury bills and one year treasury bills dropped to 0.67% and 2.99% respectively.

The decline in short term money market instrument rates is expected to further impact BFI earnings, as they will have to park their excess liquidity, currently over 33%, in lower yielding instruments. Likewise, the weighted average inter-bank rate during the period has dropped to around 1.08% compared to 5.63% during the same period last year. Moreover, citing anomalies and in a bid to maintain financial discipline, NRB has decided to restrict BFIs from opening interest earning deposit accounts amongst themselves by the end of the second quarter of the current fiscal year. However, despite the ease in the liquidity situation, Bankers are still sceptical as to whether this position is permanent or will go back to the tightened position of a few months back.

Table 6: Recent Deposit and Credit Position of BFI's (In NPR billions)

Details	FY 10/11 Mid-July	FY 11/12 Mid-Oct	% change	FY 11/12 Mid-Nov	% change
Deposit					
Commercial Banks	687.58	725.21	5.50	735.71	1.40
BFI's	873.48	910.98	4.30	922.66	1.30
Loans and Advances					
Commercial Banks	522.85	532.64	1.90	531.78	-0.20
BF'Is	713.42	722.33	1.20	719.81	-0.30

Source: NRB

banks need to maintain their CAR above 10%. Currently, the average CAR of commercial banks stands at around 12%. As the gap between the required rate and the current rate isn't very large, BFIs will either have to increase their core capital or limit their lending. At the end of the first quarter of the current fiscal year, most commercial banks managed to bring their CCD ratio below the required 80% level. However, it still remains a big challenge for 'B' & 'C' class financial institutions to achieve the required level as their exposure to the realty sector is considerably high.

REAL ESTATE SITUATION

The Nepali Realty sector is going through a rough patch and is plummeting in value. This is largely due to regulatory incompetency, macro-economic factors, a severe liquidity crisis and decreasing inventor's sentiment. Unsurprisingly, loan recovery has been the biggest challenge for BFIs because of their high exposure to the sector.

Considering the high exposure of BFIs to the realty sector, NRB has time and again directed BFIs to limit their exposure to the sector. It has directed BFIs to bring their realty sector loans below 25% of their total loan portfolio by the end of current fiscal year wherein, real estate loans (not including residential housing loans) should not exceed 10% of total loans.

NRB has carried out various measures to control risky assets, this includes increasing the home loan ceiling, excluding home loans up to NPR 8 million (recently increased to NPR 10 million), relaxation on income disclosure for land and housing purchases, and allowing BFI's to reschedule their realty lending for a year, if the borrower pays all outstanding interests for the current year. Despite all these efforts, the realty sector has not recovered.

According to the latest monthly statistics published by NRB, at the end of mid-November 2011, total realty sector exposure stood at NPR 139.47 billion. Total realty sector loans floated by BFIs stands at 19.57% of the total loans and advances. Residential personal home loan amount to NPR 42.43 billion (5.95%), while real estate loans amount to NPR 97.04 billion (13.61%). Meanwhile, the total exposure of commercial banks to real estate loans stands at 12.71% only.

Figure 2: Real Estate Exposure of commercial banks and BFI's

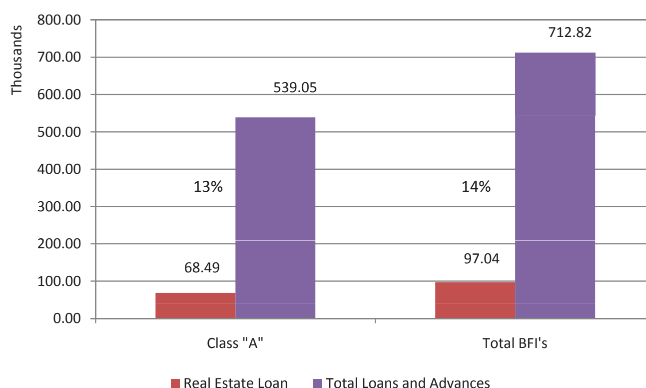


Table 7: Realty Sector Exposure including personal home loan of BFI's (figures in NPR million)

	Description	Class "A"		Class "B"		Class "C"		Total BFI's	
		Amount	Total Loan (%)	Amount	Total Loan (%)	Amount	Total Loan (%)	Amount	Total Loan (%)
1	Residential Personal Home Loan (up to Rs.8 million)	29,573.00	5.49%	6,258.20	6.98%	6,604.60	7.85%	42,435.80	5.95%
2	Real Estate Loan	68,493.20	12.71%	12,553.30	14.01%	15,996.20	19.01%	97,042.70	13.61%
3	Total Realty Sector Loan	98,066.20	18.19%	18,811.50	20.99%	22,600.80	26.85%	139,478.50	19.57%
4	Total Loans and Advances	539,045.10		89,605.50		84,167.60		712,818.20	

Source: NRB

THE PUZZLE & ITS ANALYSIS

Negative Real Interest

At the end of first quarter, official year-on-year inflation as measured by the Consumer Price Index stands at 8.9%. However in actuality, the inflation rate is estimated to be around 18 to 20% on basic necessity goods, moreover, due to the surge of the USD against the NPR, it is estimated that inflationary pressure will increase in the days to come. A decline in the deposit rates coupled with higher inflation has seen the real interest rate which depositors expect to receive after adjusting for inflation will be negative, this can lead to higher consumption, lower savings and the diversion of funds from BFIs to other instruments which in turn can again exert liquidity pressure on the system. Due to the surge in the USD, inward remittance has also seen a leap which has accelerated the current liquidity position of BFIs.

Both bankers and the regulators disagree with the CPI calculations that place inflation rate around 18 to 20%. They cite that inflation has remained flat over the last few months. Additionally, India is currently enjoying one of the lowest food inflation rates in years and two third of Nepali imports come from India. To some extent, this would negate the impact of the devaluation of the INR over the USD.

Higher cost of Fund

Due to the recent liquidity crunch and competition, BFIs were offering interest rates as high as 12.5% to attract deposits. This increased their cost of funds and narrowed their spread. On the other hand, the banking and financial system is under pressure from the government, regulators, borrowers and general stakeholders to decrease the lending rate and extend credit to productive sectors as the system is currently flushed in cash. Bankers are still skeptical about the current liquidity and its sustainability. The high cost of deposits taken up till July 2011 for the next one to two years are yet to mature, thus the cost of funds for BFIs is still on the higher side.

Bankers believe that due to the intense competition among banks to go after good assets, there is a competition on lending as well. Hence, banks have started to decrease interest rates on corporate lending. Moreover, bankers expect that if the current liquidity seen in the system prevails into the third quarter, consumer lending rates will also start declining. This will further lower the spread rate and hit the bank's profitability. Banks claim that the cost of operations continues to rise and will lead to a contraction

in the BFI's profits for the next two years. Promoters should be ready for fewer dividends for the next few years, in some cases, there will be no dividend.

Regulators claim that the bankers are currently experiencing one of the most comfortable liquidity positions in the past three years, and expect changes by the third quarter.

Real Estate Exposure

The default rate is expected to increase in the real estate sector. The biggest question is whether to defer the problem or accept reality and book the losses. Deferring means facing an even larger problem in the future.

In a recent development, the High Level Financial Sector Coordination Committee (HLFCC) convened by the Finance Minister has decided to write to the central bank to make crucial changes which are expected to provide a short term solution to the problem. However, these measures fail to address the crux of the problem. The committee has decided to extend the timeframe for reducing the realty sector lending bar to 25% of the total loan portfolio from the current 30% by a year and raise the personal home loan threshold to NPR 10 million from NPR 0.8 million. Likewise, it has decided to allow housing developers to categorize apartment blocks that are complete or under construction as service apartments, this provision of switching groups will allow BFI's to place these apartments under the heading of services instead of the present real estate category. Moreover, the committee has decided to initiate steps to arrange cheap home loans for civil servants so that they can purchase homes at affordable prices.

Regulators admit that these changes are measures to defer the problem and to address the demand of the market, they believe that the real solution to the problem lies with realty entrepreneurs who should cut property prices and make it affordable to target groups. They also pointed out that increasing the threshold would not solve the problem as it would just make changes in the loan portfolio but will fail to address the crux of the problem. They are working to solve the core problem and are assessing each individual banks.

Regulators are confident that the financial system will not collapse due to the problems in the realty sector. They have assumed that even if 25% of total real estate loans underperform, around 50% of the profit of BFIs can absorb it. This will not trigger a bigger problem for most BFIs and to the system as a whole, but will hurt those BFIs which have not adopted stringent lending policy.

In the long term, if there is a systematic risk, regulators will undertake measures such as easing the current provisioning structure for non performing loans and institute special purpose vehicles like an Asset Management Company (AMC) to handle toxic assets. Moreover, regulators view that the current problem seen in the realty sector has taught a lesson to BFIs and has been beneficial to the system. As a result, none of the banks are ready to lend to unproductive sectors and regulators expect the banking community to behave much more responsibly.

> Bankers strongly believe that unless and until the political environment changes for the better, it will remain an issue.

Bankers do not believe their current predicament is a systemic problem, it arose due to the liberal approach of BFIs in speculative lending and are also partly responsible for it. They also believe that 15% exposure in real estate is not high, even if 25% of it fails, it would only hit the balance sheet and profitability of a few banks. However, in the years ahead, it will create a good opportunity to separate good banks from bad ones. Moreover, they believe that the full extent of the problem will only be seen once BFIs start publishing their annual audited financials for the current fiscal year.

Operational Cash Trapped & Multiplier Effect

The diversion of funds is a common phenomenon in Nepal. Many individuals and businesses have borrowed money for the purpose of operations and have diverted these funds to the realty sector, creating additional risk for the system. Deficiencies on the part of banks in credit appraisal, monitoring and follow-up are also one of the primary reasons for this. People normally have multiple business partners hence, there exists the risk that if one is exposed to real estate and defaults, the other partner may also get affected and may also affect non-exposed BFI's.

Absence of Productive Sector

In the first five months of the current FY alone, banks mobilized over NPR 52 billion, while issuing credit of around NPR 15 billion.[5] Despite an ease in liquidity, banks were unable to enhance their lending against the surge of high cost deposits, largely due to the absence of productive sectors.

Bankers strongly believe that unless and until the political environment changes for the better, it will remain an issue. The lower suppression of credit demand over the last few months, coupled with regulations imposed by the central bank such as capital adequacy, liquidity, and proposed stress testing reduces the capacity of the bank to lend aggressively which will directly affect the profitability of the BFI's.

Low Depositor Confidence

The banking system, especially commercial banks, have been able to regain the confidence of depositors. However, confidence in 'B' and 'C' class financial institutions is still low. In the days ahead, if some banks post losses or the BFIs profitability declines noticeably, there is a higher probability of losing depositors confidence in the banking and financial system.

The role of authorities is also crucial, they need to to ensure that banks are prudently run and the interests of depositors is protected. They need to ensure systematic stability within the financial sector and prevent moral hazards from arising wherein depositors may not bother to discriminate between "good" and "bad" banks, thereby, prolonging the survival of bad ones, only to be magnified during a crisis.

VDIS vs. FATF

The Informal sector is roughly estimated to be around 40 to 50%. At times, measures have been taken such as Voluntary Declaration of Income Sources (VDIS) to allow funds from the informal sector to flow into the formal sector. However, as Nepal is already struggling to comply with guidelines of Financial Action Task Force (FATF) regarding Anti-Money Laundering, it finds itself in a catch-22 situation, thus any sort of declaration scheme to channelize informal money into the formal system would raise the eye brow of watchdogs when most of the compliances are yet to be met.

Compliance Issues

Though most of the blame has been put on the realty sector for the existing situation, there are various compliance issue that need a fine toothed combing. Besides the realty sector loans which are in the limelight, the default rate of loans provided to the 'other' sectors is also noticeably increasing due to the lack of compliance to banking norms and guidelines by most BFIs. In the past few years, adherence to general compliances and governance practices took a back seat, BFIs were busy taking a short term view to garner profits for their promoters. Thus, basic practices of credit risk appraisal was overlooked by providing credit based on the name of the borrower, which is a major defect within BFIs. Further, accounts departments being crucial for ensuring compliances and disclosure practices always lacked qualified resources.

Though compliance would never emerge as a key reason for the existing crises, our analysis shows that its accumulation over a period of time creates an acute problem. This is now hitting the bank and financial sector badly. Further, disclosure requirements of International Financial Reporting Standards that would come into effect by the end of the current year will push BFIs to another limit.

OUTLOOK & IMPLICATIONS

The outlook for the banking and financial sector of Nepal after mid-January 2012 does not look promising. However, this provides for the possibility for dramatically improving the sector overall. The impact of the realty sector, the higher cost of fund, the absence of a productive sector, rising inflation, diversion of operational funds have seriously hit the profitability of the sector. The following is the expected scenario that everybody should be prepared for the next two to three year and the measures to be taken:

- BFI's profitability will be lower due to the burden of higher cost of funds and higher default rates from the real estate sector. Investors should be prepared for low returns or even no return for a few years. Innovation will be a crucial avenue for bankers to emerge from the league.

- Uniformity within the institution will be distorted wherein a few BFI's that are running badly will either die out or will be acquired by good BFI's. Those BFI's that were managed professionally adhering to all banking compliances will survive and will continue to grow successfully.

- Unlike mergers, acquisition of BFIs in distress or their good assets will be the modality that will prevail and regulators should start their homework in preparing the policies/directives that would differentiate mergers from acquisitions. Any restrictive directive for cross-holdings has to be re-visited.

- BFI's with low exposure on the realty sector are likely to feel the impact through funds being diverted from operations to realty. Likewise, credit given to businesses having multiple partners that includes one or more partner exposed in real estate will create a multiple chain of defaults, impacting the profitability of non-exposed BFIs. This will reveal the indirect exposure to the real estate sector, providing an overall picture for regulators to address the issue holistically.

- As a dose of temporary relief, the government has/ should come up with various flexible packages to boost confidence in the sector (financial and realty jointly) these include:

  o Home loans separated from the realty loan

  o Limit for the home loan slab increased from Rs. 8 million to 10 million

  o The cap to bring down the realty loan exposure up to 25% deferred to 2012/13

  o Government is planning to buy housing units and apartments for civil servants

  o Homework is being done for the establishment of an Asset Management Company to take-over assets in distress

  o Policies are being formed for foreigners to buy apartments

  o Directives are being prepared for relaxation of the provisioning of realty loans or allow flexible restructuring policies so that the impact of the provision will be less

The above measures are being used as a deferment strategy for existing problems with the hope that it may revive the realty sector soon and reverse the current scenario. However, a deeper diagnosis of the existing situation will be required to address the following underlying facts:

- Conflict of interest exists where the BFIs promoter/directors are real estate borrowers

- The attitude of the real estate owners trying to make enormous profits without lowering prices to create additional demand is a self destructive act. They are holding on to their assets without offering a discount and are creating a false crisis. They expect that the relaxation or bailout package from the government/regulators will create a favorable scenario in the

future for them to reap their profits.

- The data of real estate exposure is not holistic and indirect exposure to this sector through diverted funds is still unknown. Bankers and regulators conception that the total exposure of BFIs to real estate stands only at 15% is not true.

- The real return from assets does not justify existing prices, thus the argument of a shortage of land, particularly in the Valley, has to be revisited and the real estate owner should be prepared to accept this fundamental reality.

- BFIs will be forced to adhere to higher levels of compliances and provide better transparency with upcoming BASEL II and even BASEL III (in coming years) requirements along with the acceptance of disclosure requirements by adopting the International Financial Reporting Standards (IFRS) from this year onwards for all listed companies, this will include most BFIs. This will prevent any misleading of information to the depositors and investors. Further, the role of Credit Rating will further enhance the situation vis-à-vis the right to full information for the public.

The issues facing the banking and financial sector are obviously complex and are tightly entangled. Unwinding it will require a considerable amount of time, but is possible with clear short, mid and long term policies from the regulators together with the serious commitment of bankers and entrepreneur. Bankers are now prepared for hard times in the days to come and will be tested to prove their skills. Positively, lessons have been/are being learnt by all the stakeholders and together, they can overcome the present crises over a period of time. It is expected that a different scenario will emerge that will be based on innovative financial products, delivery of quality service, high levels of transparency and compliance, and widespread access to finance. This will take the financial sector of Nepal to the Next Level.

This nefsearch is based on the research and analysis carried out by the nefsearch team and also incorporates the proceedings of the neftalk on the topic "where are the banks heading?" a talk program organized by Nepal Economic Forum (NEF) held on 06 January 2012. The keynote speakers were Jitendra Rajbhandary, FCA, Senior Partner J.B. Rajbhandary & DiBins; Maha Prasad Adhikari, Deputy Governor of Nepal Rastra Bank and Sashin Joshi, CEO of NIC Bank Limited.

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Issue 2, January 2012 | Publisher: Nepal Economic Forum | www.nepaleconomicforum.org | P.O.Box 7025, Krishna Galli, Lalitpur - 3, Nepal | Phone: +977 1 554-8400 | email: info@nepaleconomicforum.org | Nefsearch Team: Suman Rayamajhi and Rojesh Bhakta Shrestha | Design: Big Stone Medium, contact@bigstonemedium.com
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