Nepalese Financial System and Investment Environment

Narayan Prasad Paudel

Ratna Pustak Bhandar
Kathmandu, Nepal
# Chapter 1

**Nepalese Financial System 1–62**

<table>
<thead>
<tr>
<th>Financial System and Economic Development</th>
<th>1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nepal's Financial Sector</td>
<td>3</td>
</tr>
<tr>
<td>An Overview of Financial System in Nepal</td>
<td>4</td>
</tr>
<tr>
<td>The Supply of Financial Services in Nepal</td>
<td>5</td>
</tr>
<tr>
<td>Problems of the Financial Sector Development</td>
<td>6</td>
</tr>
<tr>
<td>The Financial Sector Reform</td>
<td>8</td>
</tr>
<tr>
<td>A Framework of Freedom for the Private Sector</td>
<td>8</td>
</tr>
<tr>
<td>Investment Problems and Prospective in the Private Sector</td>
<td>9</td>
</tr>
<tr>
<td>Problems relating to private sector development</td>
<td>9</td>
</tr>
<tr>
<td>Measures for effective development of the private sector in Nepal</td>
<td>9</td>
</tr>
<tr>
<td>Important Acts to be formulated in Nepal</td>
<td>10</td>
</tr>
<tr>
<td>Investment Environment in Nepal</td>
<td>11</td>
</tr>
<tr>
<td>Policy issues for the private sector development</td>
<td>12</td>
</tr>
<tr>
<td>Major constraint on the private sector</td>
<td>13</td>
</tr>
<tr>
<td>Role of Privatization in Capital Market Development: A Global Observation</td>
<td>14</td>
</tr>
<tr>
<td>Tax Policy for Listed Companies, Financial Instruments and Transactions</td>
<td>16</td>
</tr>
<tr>
<td>Privatization Process in Nepal</td>
<td>17</td>
</tr>
<tr>
<td>Private Sector Development and Strategic Opportunities</td>
<td>19</td>
</tr>
<tr>
<td>Development of institutional mechanism in Nepal</td>
<td>21</td>
</tr>
<tr>
<td>Economic reforms</td>
<td>21</td>
</tr>
<tr>
<td>Need of Financial Service Centre in Nepal</td>
<td>22</td>
</tr>
<tr>
<td>Operation of a money and bond market and need of a credit rating agency</td>
<td>22</td>
</tr>
<tr>
<td>Asian experience in establishing credit rating agencies</td>
<td>23</td>
</tr>
<tr>
<td>A move towards establishing a credit rating agency in Nepal</td>
<td>26</td>
</tr>
<tr>
<td>Prospective Investment Environment</td>
<td>28</td>
</tr>
<tr>
<td>Impediments to private sector involvement in infrastructure development</td>
<td>28</td>
</tr>
<tr>
<td>Measures for improvement on private sector development in Nepal</td>
<td>28</td>
</tr>
<tr>
<td>Common problems in the existing legal framework</td>
<td>29</td>
</tr>
<tr>
<td>Measures to Remedy Problems and Overall Private Sector Development</td>
<td>30</td>
</tr>
<tr>
<td>Legislative reform</td>
<td>30</td>
</tr>
<tr>
<td>Institutional development for private sector development</td>
<td>31</td>
</tr>
<tr>
<td>Strengthening the existing institutional mechanism</td>
<td>31</td>
</tr>
<tr>
<td>Strengthening the corporate governance</td>
<td>33</td>
</tr>
<tr>
<td>Banking and Financial System in Nepal</td>
<td>34</td>
</tr>
</tbody>
</table>

---

*vi*
Chapter 2

Corporate Governance, Public Finance and Government Budget 63–83

Corporate governance in Nepal 63
Significance of corporate governance 64
Principles of corporate governance in the banking sector 64
Existing laws and regulation and corporate governance 65
Challenges to ensure good corporate governance 67
An Overview of Performance of Global Economy 69
  Consumer price 69
  Net aggregate domestic demand 69
  Economic growth rates of neighbors 70
  Economic Growth Rates of Nepal and Neighboring (SAARC) Countries 70

An Overview of Sector-wise Domestic Financial Performance 71
  Agriculture sector 71
  Non-agriculture Sector 71
  Manufacturing industry 72
  Construction industry 72
  Wholesale and retail trade 72
  Hotel and restaurant 72
  Transport, communication and warehousing 72
  Financial intermediation 72

Capital Formation 73

Public Finance and Government Budget 73
  An overview on the government budget of fiscal year 2009/10 73
  Review of economic status and budget implementation of the fiscal year 2008/09 73
  An overview of the Government budget for the FY 2008/09 77
  An overview of the focus of the budget 77
  Important Issues and challenges addressed in the budget 78
  Recognition of private sector through public private participation 79
  The salient features of the budget 79
  More focus on sustainable economic development of the country 81
  Some other innovative features of the budget 82

Chapter 3

Development Finance 84–114

Development Finance and Investment 84
The Demand for Financial Services in Nepal 85
Access to Financial Services 86
Constraints on the Increase Access to Financial Services 87
Declining Access to Financial Services in Nepal 87
Improving Access to Financial Services in Nepal 89
Rural Development Banks (RDBs) and Microfinance Activities in Nepal 89
  Outcome and consequences of microfinance 90
  Problems and challenges 90
The Reform Program for Regional Rural Development Banks 90
Microfinance and Services to Low Income Households 91
Increase Access for Small Business and Low Income Households 92
Conceptual Framework of Microfinance 93
Cost of investing in mutual funds 123
Fees and mutual fund returns 123
Financial intermediaries and their role 123
Investment bankers 124
Contractual savings and institutional investors 124
Employees' Provident Fund 126
Insurance companies 126
An Overview on Mutual Fund Study and Investment Performance 127
Measuring Mutual Fund Performance with Characteristic-based Benchmarks 144
Mutual Fund Investors' Fund Selection Ability 144
The Performance of Hedge Funds: Risk, Return and Incentives 145
Computation of net Asset value (NAV) 148
The recipe for success to mutual fund investors 148

Chapter 5
Capital Market and Regulation 150–172
General Background of Financial Market and Environment 150
Regulation of Capital Market and Intermediaries 150
Efficient Capital Market 151
Capital Market in Nepal 152
Capital Market and Nepalese Economy 153
Capital Market and Investment Prospective in Nepal 153
Framework for Capital Market Development 154
Obstructions in Capital Market Development in Nepal 154
Consideration About Capital Market Development in Nepal 156
Role of Non-bank financial Institutions in the Capital Market 160
Information Disclosure Practices in the Nepalese Capital Market 161
Legal framework on Dividend and Share Prices in Nepal 163
Government's Long-term Plan Regarding Capital Market Development 165
Financial Markets and Institutions 167
The Nepal Rastra Bank (NRB) as a capital market regulator 168
The Securities Board Nepal as a regulator of the capital market 168
Financial Institutions in Nepalese Securities Market 169
The Primary Securities Market and Legal Arrangement 170
The Impact of the Changing Capital Market Structure 170
Market Risk and Model Risk for a Financial Institution 171

Chapter 6
Fundamentals of Stock Market 173–200
Recent Economic Development in Nepal 173
Chapter 8

Security Analysis and Portfolio Management 222–320

Investment Policy 222

Security Analysis 222

Definition of risk in CAPM 222

Using security expected returns 225

Relationship between risk and return 225

Measurement of risk 226

Alternative measure of risk 227

Rates of return 227

Risk and risk premiums 228

The risk-return trade-off 228

Empirical Implications of Theories of Corporate Risk Management 228

Development of Portfolio Theory 229

Strategic asset allocation 229

The input to portfolio analysis 230

Portfolio design theory 230
Effective asset allocation 230
Portfolio Optimization 231
Portfolio Management 231
Portfolio Types and Their Needs 232
Portfolio strategy 233
Characteristics of portfolios in general 233
Process and Principles of Portfolio Investment 235
Objectives of portfolio management 235
Timing and selection of individual investment 236
Timing of Portfolio Investment and Performance Evaluation 236
General Background of Portfolio Management 237
Some background assumptions 237
Portfolio objectives 238
Portfolio Analysis: Risk and Return 239
Portfolio Analysis 239
The Formation of Optimal Portfolio 241
Setting the cut-off rate (c) 242
Constructing the optimal portfolio 242
Return Expectations and Portfolio Performance 242
Determining expected returns and standard deviation for portfolios 243
Strategy for portfolio selection 244
Portfolio Implementation 244
Portfolio monitoring 244
Portfolio constraint 245
Portfolio risk and return 245
Portfolio expected return 246
Portfolio risk 246
Determining the rate of return on a portfolio 246
Risk and return analysis 247
Beta coefficient 247
Portfolio risk 247
Beta 249
Estimating beta 249
Accuracy of historical betas 250
Accuracy of adjusted beta 251
Fundamental betas 251
Random error terms 253
Does the "Beta" Measure Risks? 254
The portfolio approach 254
Equilibrium approach 254
Stability of beta 254
Relation between betas and returns 255
Chapter 9

Global Portfolio Management 321–361

Recent Trends in Investment Environment 321
  Globalization 321
  Securitization 322
  Financial engineering 322
Portfolio Diversification into the Emerging Market 322
Foreign Portfolio Investment 322
Stock Market Liberalization and Economic Reform 323
  Economic reforms 323
  Issue posed by foreign portfolio investment 324
Global Portfolio Management 324
  Do emerging stock markets affect economic growth through creation of liquidity? 324
  Corporate investment, cash flow, and financial structure at the turn of the twentieth century 325
Analyzing Overseas Investments 325
Benefit of Foreign Direct Investment (FDI) for Developing Countries 326
Investors in Emerging Markets and Their Motivations 326
Foreign Investment: A Door Half-Open 328
Fiscal Policy and Private Investment in Developing Countries 331
Investors Protection and Compensation Plan 331
  Regulation of the investors compensation plan 332
  Investor awareness program 333
Risk Management Practices in the Gold Mining Industry 333
Foreign Direct Investment in Developing Countries 333
Benefit of International Portfolio Diversification 334
Portfolio Investment in Developing Countries 334
Portfolio Investment Follows to Emerging Markets 335
Asset Pricing and Portfolio Diversification 336
  Evidence from emerging financial markets 336
  Market integration and investment barriers in emerging equity markets 336
Leading Stock Market in the World 337
Emerging vs. Developed Markets 337
World Stock Market Histories 339
Global Investment Choices 340
Investment Companies 344
Informational Efficiency of European Equity Markets 345
Foreign Portfolio Investment 346
Re-emerging Markets 348