Dhungana, B. R. (2011). Overview of finance companies in Nepal. *Journal of Finance and Management Review*, 2(2): 241-251, Kathmandu, Nepal.

Overview of Finance Companies in Nepal

Bharat Ram Dhungana [1]

Abstract

This paper examines the study of macro-economic aspect of finance companies (Non-bank financial institutions) of Nepal over the period of July, 1990 to October, 2010. The finance companies are still unable to expand their services in Mechi, Dhaulagiri, Bheri, Karnali and Mahakali zone. Moreover, almost 70 percent finance companies are concentrated in Bagmati zone especially in Kathmandu valley. The Nepalese finance companies are ranked in second position in the sense of market share of total deposit and total lending. The finance companies are holding 8.5 percent market share of total deposit and 11.3 percent market share of total lending at mid-July, 2010. The overall NPL status of finance companies are 1.98 percent that reflects the satisfactory situation of the lending policy of finance companies. There have been some improvements on the non-performing loans (NPL) of finance companies in the recent years due to the effective regulations and supervision made by the regulatory agency. The NRB needs to be committed in its work of leading the financial sector development with the object of creating a sound, healthy and competitive environment in which the non-bank financial institutions will be able to compete in this globalized market.

Keywords: Finance Company, liberalized economic policy, non-performing loans, regulatory agency

1. Background of Finance Companies in Nepal

The existence of banks and other non-bank financial institutions in a formal and organized way is collectively known as the financial system of a country. Financial system can be grouped into banking and non-banking financial institutions. The banking system is made up of commercial banks and investment banks. Commercial banks are primarily in the business of accepting deposits and extending credits. The non-banking financial institutions comprise of development banks, finance companies, saving and credit unions, building societies, discount houses, leasing companies, mortgaged companies, insurance companies, pension funds and provident funds. Few of these non-bank financial institutions are also engaged in the business of accepting deposits from the general public. However, the central authority can impose certain restrictions on accepting deposits by these institutions. Only commercial banks are authorized to conduct full-fledged banking services.

The other non-bank financial institutions can operate conditional or limited banking services, which may vary from country to country. Some other non-bank financial institutions such as insurance companies, pension and provident funds are, sometimes, categorized as contractual saving institutions and they mobilize savings on contractual basis. Financial institutions, financial instruments and financial markets are the three interrelated aspects of the overall financial system. A wide variety of financial institutions may exist in the financial market. Each market serves a different set of customers or deals with a different type of security. A financial market is a place where all financial securities or instruments and financial services are transacted or exchanged and serviced. Financial institutions help to mobilize savings by issuing liabilities in form of different types of financial instruments (Paudel, 2005).

Finance companies are the non-depository financial institution that does not accept deposit like commercial banks. Generally, they are set up to provide credit to households or firms, usually to finance the purchase of appliances or equipment. They are non-banking financial institutions that provide credit facilities to households and businesses. For households, they originate loans and leases to finance the purchase of consumer goods such as automobiles, furniture, and household appliances. For businesses, they supply short- and intermediate-term credit (including leases) for such purposes as the purchase of equipment and motor vehicles and the financing of inventories (Kohn, 2007).

Finance companies are the financial institution that supplies credit for the purchase of consumer goods and services by purchasing the time-sales contracts of merchants or by granting small loans directly to consumers. Specialized consumer-finance agencies now operate throughout Western Europe, Canada,

[1] Mr. Dhungana is Lecturer, School of Business, Pokhara University.

the United States, Australia, Japan, and some Latin American countries. Although they existed in the early 1900s, their greatest development came after World War II.

Finance is the linchpin of any development strategy. Prior to the mid-eighties, finance markets in Nepal were characterized by barriers to entry. The development in this sector actually took place in the mid-1980s with joint venture banks entering the Nepalese financial market reversing the monopoly of state owned banks. The licensing of non-banking financial institutions (NBFIs) in 1984 marked, with lower capital requirements, the need for more players in the market to avail access of services to the public. However, the actual proliferation of finance companies did not commence until the mid-90s (Aurora, 2007).

Financial institutions of 'B', 'C', and 'D' class are allowed to carry out inward remittances, companies of B and C class can purchase and sell Indian Currency, whereas B class national level financial institutions can accept foreign currency deposits, buy and sell foreign currency, provide exchange facilities against passport & open foreign currency accounts. 'B' and 'C' class financial institutions can act as co-agent of licensed commercial banks to issue debit and credit card in Nepalese and Indian currencies while 'B' class financial institutions (other than national level) are allowed to buy foreign currency and sell it to NRB and/or/ to commercial banks. Development banks and financial institutions can operate automated Teller Machine (ATM) under specified directives. Policy decision is made for 'D' Class financial institutions carrying retail banking transactions, remaining within the given conditions, to mobilize public deposit. Likewise, those national level "C" class finance companies meeting the set criteria can avail safe deposit vault and locker facilities (Economic Survey, 2009/2010).

A healthy financial system is the one that effectively fosters resource mobilization for capital accumulation and determines efficient allocation of resources. It is important to remember that success of any financial system, in its resource mobilization and allocation functions, depends on its ability to offer the public a variety of assets (money as a medium of exchange, earning assets, pension funds, etc.) corresponding to the various needs and preferences of economic agents. A clear understanding and recognition of this fact is very important to formulate appropriate policies to enable the financial system to function properly and efficiently. The test of the strength of a country's financial sector is its capability to make available the appropriate types of institutions and financial instruments that can support economic growth. The NRB’s challenge is to build up a financial system that is supportive of growth, and dynamic enough to change and fulfill the evolving demands of a real economy (Panta, 2009).

Nepalese financial system has witnessed a rapid growth both in terms of quantitative and qualitative aspects. Growing share of total credit, total assets and other measures of financial development indicators can prove this fact. Notwithstanding this fact, there are mixed empirical findings about the role of financial development indicators on economic growth; this study tried to determine the relationship with economic growth of Nepalese economy over the period FY 1975 to FY 2007. For this purpose, the study selected per capita real GDP as a measure of growth and four proxies of financial development indicators (A Joint Study of EAD and FID of Nepal Rastra Bank, 2009).

The history of the finance companies began with the establishment of the Nepal Housing Development Finance Company Limited in 1992. During the period of 1993, seven finance companies were established. There was a rapid growth of finance companies in 1994 & the total number of finance companies became 28. The tendency of establishment of finance companies has been continuously increasing & coming to the mid October, 2010, the total number of finance companies has been 79. These institutions have all commenced operations over the past six years since the Finance Company Act was promulgated. The Act permits these companies to offer installment credit for the purchase of vehicles, equipment, or durable household goods, for purchase or construction of residential buildings, for leasing financing, and for operating industrial, commercial or other enterprises. Majority of the finance companies have their corporate offices in the Kathmandu Valley, and a very few are operating outside the Valley.

It was the Finance Companies Act (2042) that governed the operation and limitations of finance companies. It allowed finance companies to take deposits from the people and institutions and make investment on hire purchase, housing industry, commerce etc. In effect they were allowed to operate as mini banks. Some eight years later the Merchant Banking Act 2050 allowed certain finance companies that met the regulatory requirements to acquire merchant banking license. As of 2007 data there are 8 non-banking financial institutions (NBFI) with merchant banking license. This has been from the beginning till date the only major difference between a commercial bank and finance company in terms of the activities allowed to them. The only areas reserved for the commercial banks are: over drafts, personal loans, foreign exchange except Indian currency, and opening letters of credit (Pandey, 2009).

The finance companies are allowed to transact also in Indian currencies though they are still restricted to transact in other foreign currencies. In order to govern this sector more prudently the Banks and Financial Institutions Act 2061 (also known as the Umbrella Act) replaced all other earlier acts thus making this the single Act that governs all financial sector players from commercial banks and finance companies. The banks and finance companies are divided into various categories fixing the extent of services based on capital. The players with the highest capital base are commercial banks and they were given a class "A" category; development banks a class "B" category, finance companies a class "C" category and micro-financing institutions and cooperatives were given a class "D" category. Products and services were allowed according to the class the institution belonged to. Although this has been in line with the principle of prudential regulation factor and it has enabled the Nepal Rastra Bank to incorporate all the formal players in the financial sector under its regulatory jurisdiction, the purpose of making financial services endemic has not materialized. All it has done is that it has divided up the number of players into capital structured groups. The Umbrella Act along with the prudential regulations of the Nepal (Economic Survey, 2009/2010).

In 1985, the Finance Companies Act was enacted in order to allow finance companies to enter the financial system. This was done with the objective of serving small borrowers and meeting the demand for consumer credit. But this Act could not produce the desired response in the market, as the Act was not clear and transparent. Only one finance company was established under the government sector in 1989. To make the Act clear and transparent, the Finance Company Act 1985 was amended in 1992. Following this amendment, there has been a very fast growth in the establishment of finance companies (Shrestha, 2005).

Financial sector in Nepal has shown better performance relative to other sectors in the economy. The economic reforms initiated by the Government in 1990s have changed the landscape of several sectors of the Nepalese economy. As a result, several banks and financial institutions have been providing financial services in different region of the country. But whatever the commercial banks are established in the nation, they are highly concentrated in Kathmandu valley & other major cities of the Nepal. The central development region has located more than 50% branches of commercial bank where as far western development region has only 5.49%. Moreover, one third of the branches of the commercial banks were located in Kathmandu valley where as 26.09% in the hilly areas & 40.43% in the terai areas till the mid-April, 2010 (Dhungana, 2010).

2. Growth and Position of the Banking and Non-Banking Sector in Nepal

There has been a rapid growth of financial institutions in Nepal over the last two and half decades. At the beginning of the 1980s when financial sector was not liberalized, there were only two commercial banks namely Nepal Bank limited (NBL) and Rastriya Banijya Bank (RBB) and two development banks namely Agricultural Development Bank, Nepal (ADBN) and Nepal Industrial Development Corporation (NIDC) performing banking activities. There were no micro-credit development banks, finance companies, cooperatives and NGOs with limited banking transactions. Finance company was established only from the 1992 AD in Nepal whereas micro-credit development bank was established only from the 1993 AD. Similarly, NRB licensed cooperative & NGOs were established only from 1994 AD in Nepal (Dhungana, 2010).

2.1 Position of Financial Institutions

The number of 'A' class commercial banks reached 29, 'B' class developmental banks 83, 'C' class finance companies 79, and 'D' class micro-credit development bank institutions (MFIs) 19, NRB licensed cooperatives 16 & NRB licensed NGOs 45 by Mid-October, 2010.

Dhungana, B. R. (2011). Overview of finance companies in Nepal. *Journal of Finance and Management Review*, 2(2): 241-251, Kathmandu, Nepal.

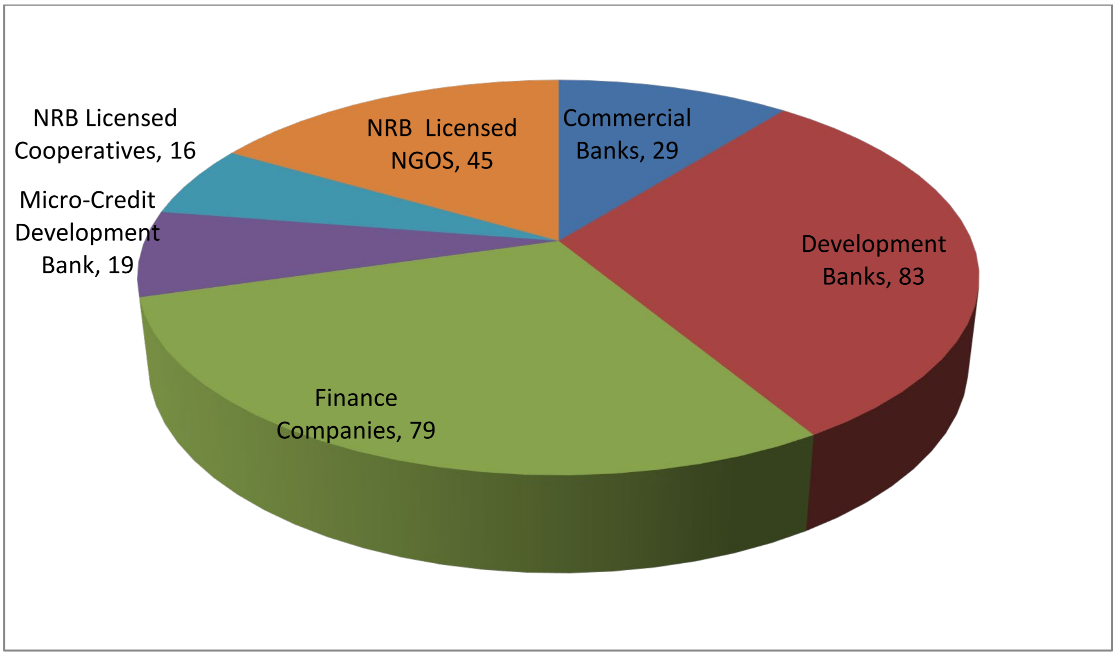

Figure 1: Position of Financial Institutions in Nepal.
Source: *Banking & Financial Statistics, NRB, Mid October, 2010.*

2.2 Geographical Disbursement of Finance Companies

The scenario Nepalese finance companies reflect that the accessibility of finance company in different geographical boundaries as per the zone wise analysis seems to be very unbalanced. During the period of 1995, the services provided by the finance companies were concentrated only in Bagmati, Narayani, Lumbini & Gandaki zone. The finance companies are able to expand their accessibility to the additional five zones till the mid April, 2010.The position of finance companies in mid April, 2010 shows that 70% finance companies are located in Bagmati zone, especially in Kathmandu valley. The finance companies are still unable to expand their services in Mechi, Dhaulagiri, Bheri, Karnali & Mahakali zones.

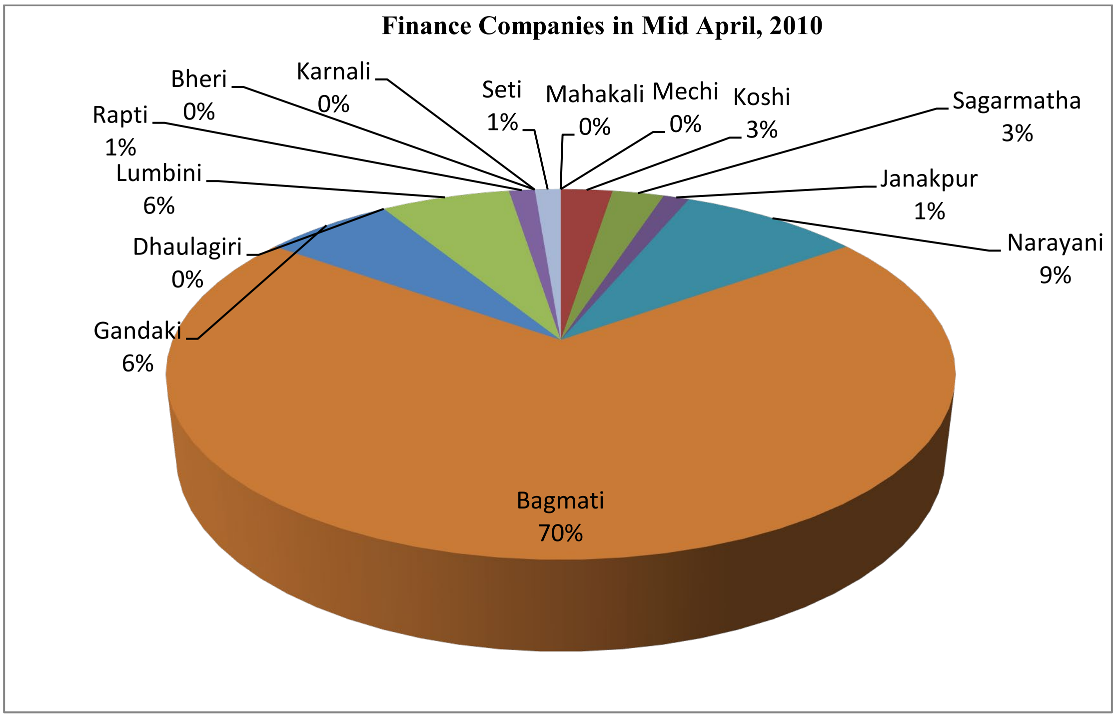

Figure 2: Zone Wise Distribution of Finance Companies in Nepal.
Source: *Quarterly Economic Bulletin of NRB, Mid April, 2010.*

2.3 Sector Wise Outstanding Credit of Finance Companies

Finance companies are set up with the objective of providing credit facilities to the households or firms, usually to finance the purchase of appliances or equipments. Generally, they originate loans and leases to finance the purchase of consumer goods such as automobiles, furniture, and household appliances to the households & they supply short- and intermediate-term credit (including leases) for such purposes as the purchase of equipment and motor vehicles and the financing of inventories.

So far as sector wise outstanding credit of finance companies of Nepal, 32% loan is made for the finance, insurance & fixed assets whereas other sector has occupied 28% loan. The finance companies has maximum invested their funds toward the finance, insurance & fixed assets as a loan & second priority has been seen to the other sectors. Similarly, the flow of loan has been made by the finance companies to the construction sector (i.e.15%) & 8% for the wholesale & retailer business. It is obvious from the figure that the lowest flow of the outstanding credit provided by the finance companies is for the agriculture sector, mines sector & local government which is less than 1%. The investment toward consumable loans, transportation, communication & public services remain the 5%. The production sector has occupies the 3% outstanding credit where as the metal production, machinery & electrical tools & fittings & transportation equipment production & fittings has 1%.

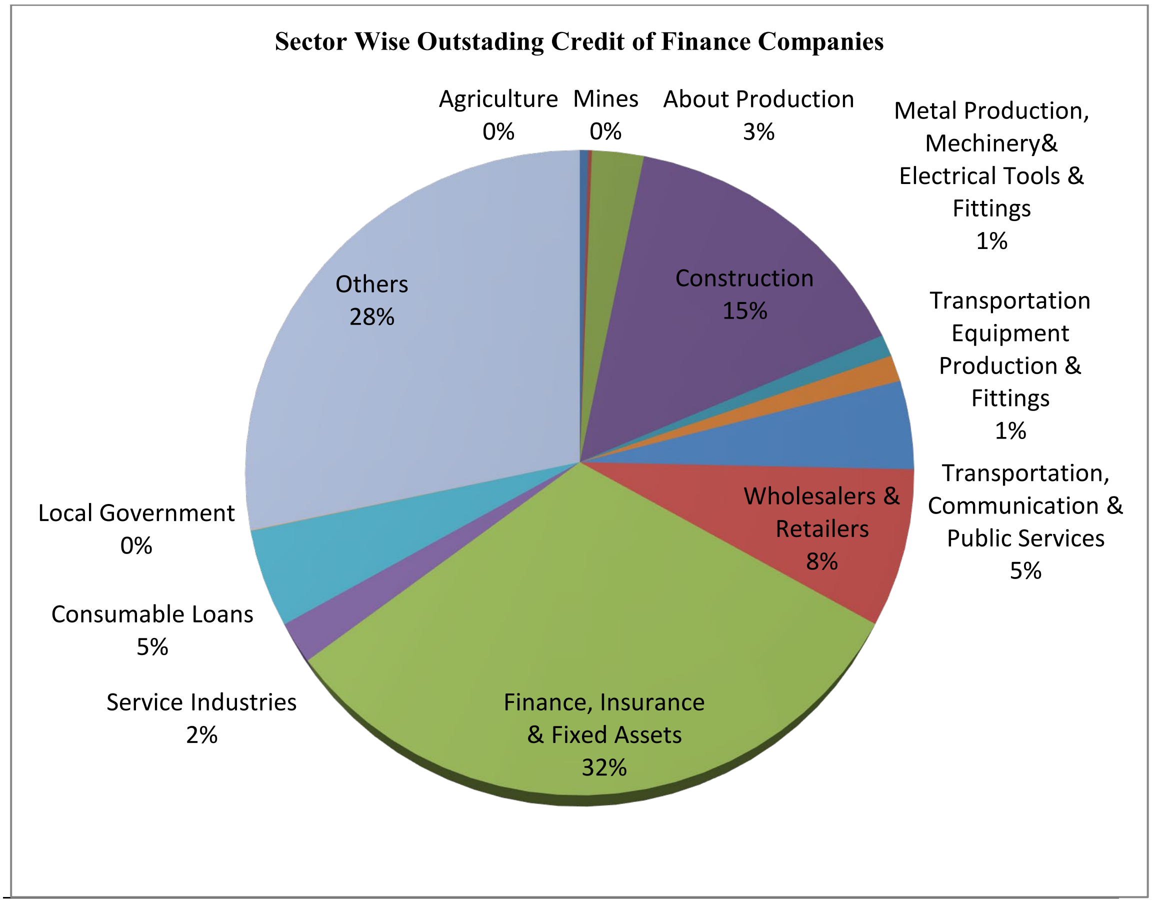

Figure 3: Sector Wise Outstanding Credit of Finance Companies.
Source: Banking & Financial Statistics, NRB, January, 2010.

2.4 Total Deposits & Total Lending of Finance Companies

The deposit and lending of banks and financial institutions have been constantly growing in proportion to GDP. The gradual increase in deposit by 68.0 percent and lending by 51.6 percent by July 2009 shows the deepening of the financial sector (Economic Survey, 2009/2010). Commercial banks' share has reached to 83.5 percent in deposit while lending has reached 77.8 percent of the total banking activities by July 2009. Finance companies have been ranked in second position that occupy 8.5%

market share of total deposit & 11.7% market share of total lending in mid July, 2010. But the development banks are ranked in the third position in the sense of market share of total deposit & total lending. Besides, shares of transactions of development banks conducting micro finance activities, and governmental and non-governmental organizations with limited baking activities are very low.

During the eleven months of 2009/10, the deposit mobilization of the class "C" finance companies increased by 24.8 percent to Rs 71.23 billion compared to Rs 57.8 billion at mid-July 2009. Similarly, loans and advances of the finance companies also increased by 27.4 percent and stood at Rs 76.39 billion at mid-June 2010 compared to Rs 59.94 billion at mid-July 2009. (Monetary Policy, 2010)

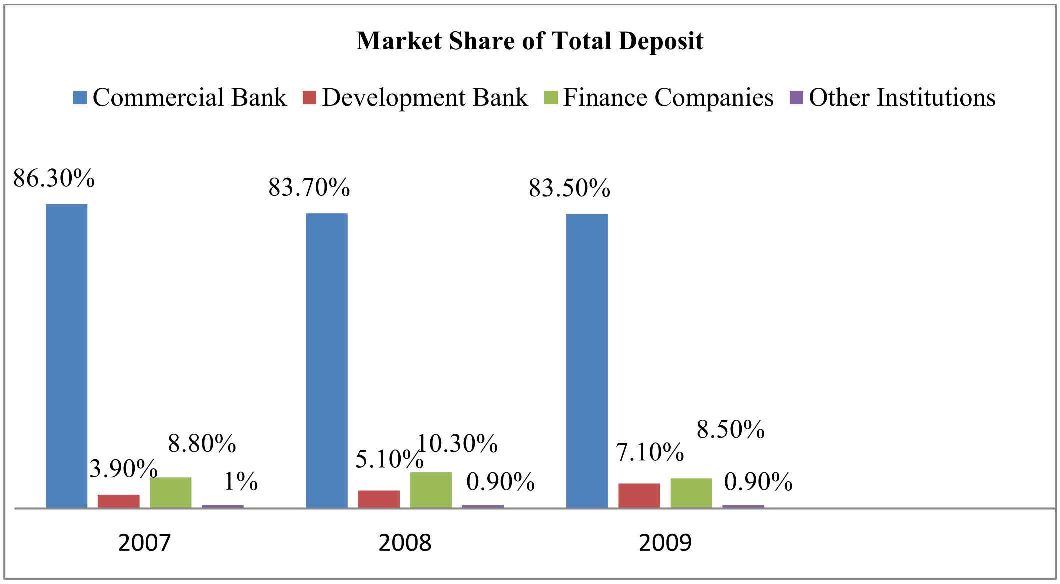

Figure 4: Market Share of Total Deposits.
Source: Economic Survey, 2009/2010

Market Share of Total Lending (%)

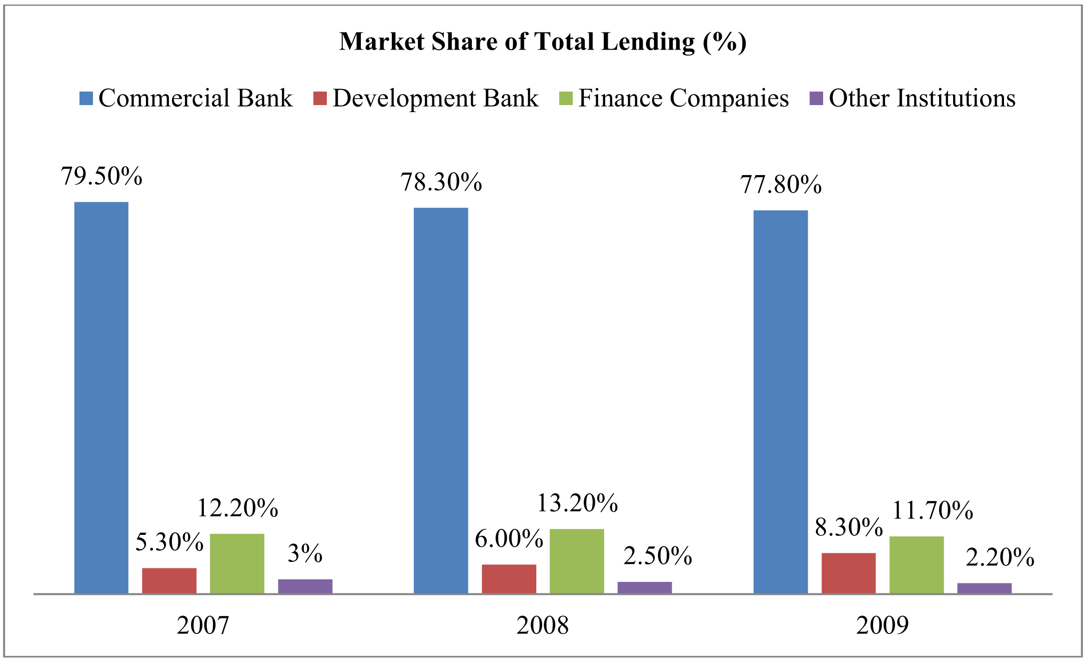

Figure 5: Market Share of Total Lending.

Source: Economic Survey, 2009/2010

2.5 Sources and Uses of Funds of Finance Companies

The aggregate resources of finance companies have reached Rs. 99,380 million with a growth of 13.7 percent as compared to the Rs 87,430 million by July 2009. Deposit as the major source of such finance companies has reached to Rs 66,990 million marking a growth of 17.4 percent during the review period. Similarly, the capital funds for these companies increased by 44.1 percent arriving at Rs 15,180 million while the credit Rs 5,190 million with one 1.0 percent growth. 4.34 On the uses side of the fund, loan and advances of finance companies has increased by 17.9 percent to Rs 70,810 million between mid-July 2009 and mid-January 2010. This sum stood at Rs 60070 million by mid-July of 2009. There has been a higher growth of 74.6 percent worth Rs 5,700 million in investment in the review period. The liquid asset, however, has declined by 13.5 percent and limited to Rs 14,180 million by mid-January 2010 (Economic Survey, 2009/2010).

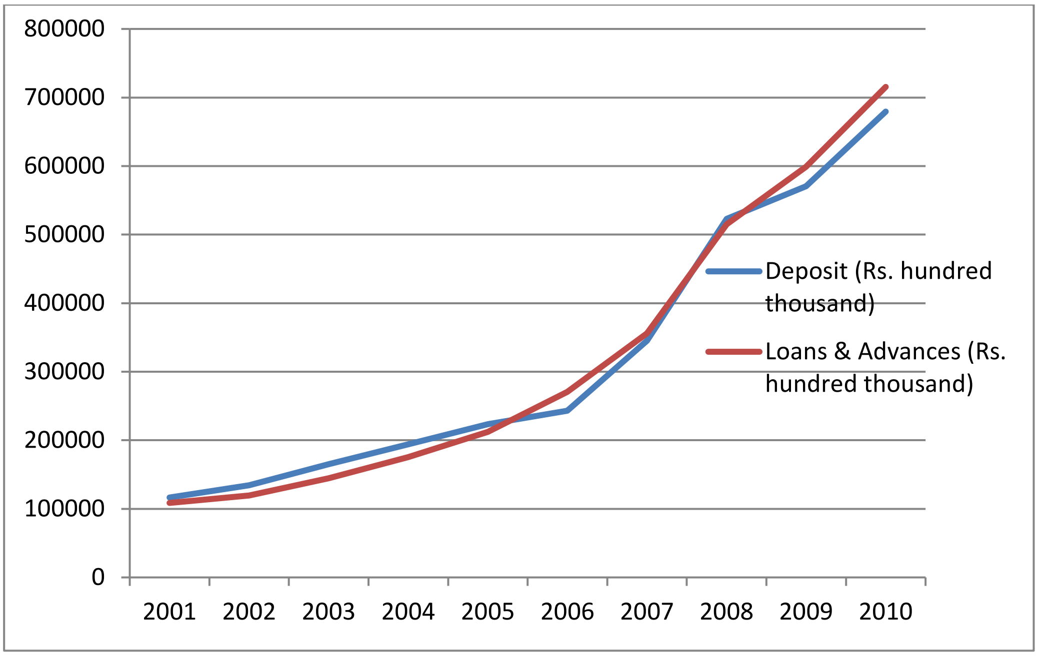

Figure 6: Deposits, Loans and Advance of Finance Companies.
Source: Banking & Financial Statistics, NRB, January, 2010.

2.6 Status of Non-Performing Loan (NPL) of Finance Companies

The Nepal Shreelanka Merchant Banking & Finance Ltd. has the highest percent of NPL i.e.59.84% that reflects the poor performance regarding the loan management. High level of NPL blocks the financial institutions' resources in unprofitable segments because it requires higher loan loss provision that reduces the fund for new lending. Similarly, high level of NPL in the financial sector hinders the economic growth & impairs the economic efficiency of the country itself as it reduces the institutions' capacity in providing fresh fund for new projects. As a result, the higher degree of NPL limits the financial institutions' capacity to honor the depositors claim on demand & if the finance company fails to provide money on demand, the public will lose faith & confidence over the finance company. The regulatory agency should take immediate action over such finance companies regarding to control the status of NPL that helps to win the public confidence.

Another higher NPL status of finance companies is CBM Finance Company having 28.35% NPL. The NPL status of Investa Finance Limited has 17.66% whereas the Arun Finance & Saving Company Limited has 13.33%. The Gorkha Finance Limited, Merchant Finance Company Limited & Janaki Finance Limited have the NPL status having the range of 5 to 10%. The setti Bittiya Sanstha Limited, Manjushree Financial Institutions Limited, Swostik Merchant Finance Company Limited, Jebil's Finance Limited, Reliance Finance Limited & Mercentile Finance Company Limited do not have the availability of NPL status. Remaining finance companies have less than 5% NPL status.

There have been some improvements on the non-performing loans of finance companies in recent times due to effective regulations and improved supervision by NRB, strong actions being taken against the willful defaulters, and finance companies' own willingness to stand themselves as efficient, capable and competitive entities in the current huge competitive environment. The total loan, total NPL & NPL status of finance companies in mid-July 2009 was Rs.7,373,60,23,740, Rs.146,24,35,440 &1.98 percent respectively.

3. Concluding Remarks

The C class financial institutions (Finance Companies) are still unable to expand their services in Mechi, Dhaulagiri, Bheri, Karnali & Mahakali zones till the mid April, 2010. It means that their services have been confined within the nine zones only. Moreover, the position of finance companies in mid April, 2010 shows that 70% finance companies are concentrated in Bagmati zone whereas remaining 30% have been scattered over the eight zones. It can be concluded from the above fact that there is no regional balanced development & expansion of Nepalese finance companies

The Nepalese Finance Companies have occupied the second position out of total financial system in terms of market share of the total deposit as well as total lending. The commercial banks are able to hold first position of market share of the total deposit & lending where as development banks lies in the third rank. The NPL status of the some finance companies (such as Nepal Shreelanka Merchant Banking & Finance Ltd. and CBM Finance Company) has very high that hinders the economic growth & impairs the economic efficiency of the country itself as it reduces the institutions' capacity in providing fresh fund for new projects. The regulatory agency should monitor & inspect the performance of the finance companies periodically & corrective actions should be taken if necessary to safeguard the finance companies from the failure. The finance companies should create public confidence among the people that encourage depositing their savings.

Finance companies are considered as an important non-banking financial institutions that support economic development of the nation through the supplying the funds for the promotion of the sectoral development like agriculture, industrial, mines, transportation, communication, public health & so-on. The agriculture, mines & production sectors have got low priority of the outstanding loan made by the finance companies but finance, insurance & fixes assets, other sectors and construction sector have got highest priority. The finance companies should give proper attention regarding their sector wise investment that how the objectives of finance companies can be fulfilled. Moreover, the government & regulatory agency should encourage the finance companies to make rational investment in the priority sectors that may help to enhance the national economy.

The finance sector has shown maturity in recent years. The positive trend is also due to the strict regulatory guidelines. However, innovation in this sector is lacking. In order to be competitive in this market, finance companies need to collaborate and start thinking and planning mergers to create a larger capital base. The globalization and internationalization of financial market, the complex financial systems within the country and the emerging needs for better and quality service require NRB to be innovative, dynamic and effective. All Institutions in the financial sector should move towards achieving a common goal of making the financial sector sound, prudent, efficient and effective. The NRB needs to be committed in its work of leading the financial sector development with the object of creating a sound, healthy and competitive environment in which the non-bank financial institutions will be able to compete in this globalized market.

Dhungana, B. R. (2011). Overview of finance companies in Nepal. *Journal of Finance and Management Review*, 2(2): 241-251, Kathmandu, Nepal.

References

A Joint Study of Economic Analysis Division (EAD) and Financial Institution Division (FID) of Nepal Rastra Bank (2009). Financial Sector Development and Economic growth in Nepal: FY 1975 - FY 2007. Nepalese Financial System: Growth & Challenges. Nepal Rastra Bank.

Aurora Ferrari et al.(2007). Access to Financial Services in Nepal. The World Bank.

Banuri. (2003). "Financing for Sustainable Development, International Institute for Environment and Development." UK.

Baye M. R. and Dennis W. J. (1996). Money, Banking & Financial Markets: An Economic Approach.USA: Houghton Mifflin Company.

Dhungana, B. R. (2010). Banking Industry of Nepal: Regional Imbalance, Journal of Finance & Management Review, August, 2010.

Dhungana, B. R. (2010). Development Banks of Nepal: Recent Scenario, Journal of Finance & Management Review, October, 2010.

Kohn, Meir (2007). Financial Institutions & Markets. New Delhi: Tata McGraw-Hill Publishing Company Limited.

Ministry of Finance (2002). *Economic* Survey, Various Issues, Kathmandu, Nepal.

Nepal Rastra Bank. Monetary Policy, Various Years, available at www.nrb.org.np

Nepal Rastra Bank (2009). Quarterly Economic Bulletin, Mid October 2009 to Mid January 2010.

Nepal Rastra Bank (2010).Quarterly Economic Bulletin. Volume 46.Mid January 2010 to Mid April 2010.

Nepal Rastra Bank(2009). Banking & Financial Statistics, Various Years, available at www.nrb.org.np.

Nepal Rastra Bank (2009).Financial Sector Development and Economic Growth in Nepal: FY 1975 - FY 2007.

NRB Directives, Issued by Bank and Financial Institutions Regulation Department of NRB:NRB Licensing Policy, 2063 Issued by NRB.

Pandey, S. R. (2009). Development & Challenges of Nepalese Finance Companies. Nepalese Financial System: Growth & Challenges. Nepal Rastra Bank.

Panta, Bhubanesh (2009). Nepalese Financial System: Policy Development and Challenges. Nepalese Financial System: Growth & Challenges, NRB.

Paudel, N. P. (2005). Financial System & Economic Development. Golden Jubilee Publication. Nepal Rastra Bank.

Shrestha, G. K. (2004). Financial Sector Reforms in Nepal. Economic Review. Kathmandu: Nepal Rastra Bank.

Shrestha, M. B. (2005). Financial Liberalization in Nepal. *Ph.D. Dissertation Submitted to University of Wollongon*, Australia.

.

Dhungana, B. R. (2011). Overview of finance companies in Nepal. *Journal of Finance and Management Review*, 2(2): 241-251, Kathmandu, Nepal.