ABSTRACT

Financial sector plays crucial intermediary role that create public trust and confidence among the participants in the financial system. This sector, being considered a highly trusted sector, any lacking in the system or failure in the governance would attract adverse effect in public trust and economic environment of the country. Financial institutions are operated as a trustee and are responsible day to day operations with high level of integrity and professionalism. Nepal being a developing country has its own problems and prospects of banking and financial institutions. The financial institutions are growing in numbers which pressurized the central bank to effective supervision for the protection of rights and interest of depositors, creditors, shareholders and other stakeholders. Most of the failure of financial institutions has resulted from misappropriation of funds, lack of transparency and disclosure that unfavorably affect the public confidence in the reliability of performance of financial institutions. Capital market and corporate sector cannot develop with weak minority shareholders, inadequate disclosures practices, non-compliance of laws and regulations and lack of independent oversight function of management.

Keywords: Corporate Governance; BFIs; Nepal Rastra Bank; BAFIA; Basel Committee; BOD

INTRODUCTION

Corporate governance signifies the corporate decision making process with the involvement of shareholders, directors and management of the company. The governance mechanism tries to reduce or eliminate the problems between the principal and agent. The principal delegates the power to the manager to act in the best interest of the principal. This separation of power between these two parties, assist to align the responsibilities of managers with the shareholders. The modern concept of corporate governance was heavily brought into light after the failure of big corporate houses (Polly Peck, Maxwell) in Britain and set up the Cadbury Committee in 1992 to study the governance system. The Committee reported major causes of failures due to the flaws or lapses in governance system. Further, there has been growing interest in the corporate governance issues since failures of high profile companies in the United States in 2001 and thereafter.

Implications of corporate governance principles are more important for financial sectors due to the special nature of business which is more challenging to operate, survive in long-run and trust by the wide range of stakeholders including public. Corporate governance practice has been a hot issue especially in those institutions which have failed and did not perform well. Majority of the financial institutions failure has resulted from misappropriation of fund and manipulation of financial records by the Board and the executive management. The lack of transparency and disclosure also considered one of the major causes of the corporate scandals and failures that unfavorably affect the public confidence in the reliability of disclosure practices in financial institutions. Multifaceted role of banks and financial institutions in the economic system of the country has attracted much more regulatory
attention to encourage sound corporate governance norms and address the risks faced by banking and financial institutions. If single financial institution is gone to failure, it leads to bust the financial system which will have greater impact in the economic environment of the country.

Corporate governance principles of Basel Committee on Banking Supervision are considered the basic elements in the stability of financial markets and corporate governance practices in financial institutions. Laws, rules and regulations together assimilate the elements of corporate governance framework for Bank and Financial Institutions (BFIs) in Nepal. Despite the enormous growth of financial institutions within a short period, equal number of cases of failure, fraud and malpractices has found important space in news and print media since the past few years in the Nepalese financial sector. The financial sector is passing through a transitional phase that includes number of institutional governance reform such as financial sector reform program, effective application of laws and regulations that expected to enhance the institutionalization of corporate governance.

**OBJECTIVE OF THE STUDY AND RESEARCH QUESTIONS**

Based on the above background, the objectives of the study is to analyze the growth and crises in BFIs, examine legal and regulatory provisions of corporate governance in financial institutions with reference to application of Basel principles of corporate governance in Nepalese Financial Institutions. Descriptive methodology has been adopted to become familiar with the framework of corporate governance which is built on the appropriate application of legal, regulatory and best practices and causes of crises in financial institutions. On this objective, the following research questions have been developed.

**R.Q. 1** What are the factors responsible for corporate governance framework?

**R.Q. 2** How do you examine the impact of these factors in corporate governance practices?

**R.Q. 3** What do you suggest for improvement of effective corporate governance framework?

**LITERATURE REVIEW**

Corporate governance signifies the corporate decision making process among the corporate participants. The ownership of a corporate body is separated from its management and control (Berle & Means, 1932). A corporate governance framework should protect shareholders' right, such as voting right, right to elect board member, right to get relevant information, interact and communicate with the management, equitable treatment of all shareholders (Tricker, 1984). Corporate governance is a set of relationships between a company’s management, its board, its shareholders and other stakeholders (OECD, 1999). Corporate governance issue arises from high profile corporate scandals, globalization and increased investor activism (Thapa, 2008). Corporate governance refers to leadership and control of a firm with long-term sustainability (Adhikari, 2008). Corporate governance is the appropriate management and control structure of the company (Gorkhali, 2010).

Bank, being the responsible corporate citizen understands its commitments towards stakeholders and society at large. The strategies of bank includes to nurture and grow a sustainable business far beyond profit making or being the best and seek to create a value for a variety of stakeholders including shareholders, employees, customers, creditors, communities and the natural environment (CBC, Annual Report, 2010). From the viewpoint of banks and financial institutions, corporate governance includes maintaining capital adequacy, transparency in the publication of accounts, management of operational, credit, market and environmental risks, to name a few (Mundul, 2009). Stiglitz et. al. (2009), observe that, banks have the unique ability to attract funding in the form of deposits that are fully insured up to a limit and thus insensitive to risk. Corporate governance is particularly important in Banking industries in less-developed countries because economic development and growth is dependent to a large extent on well functioning, stable and soundly managed banking system (Islam, et.al, 2009). Banking business is highly regulated businesses, oversight by the government and regulator and is important factor of economic reforms and development of the country (Gorkhali,
Effective corporate governance in banks and financial institutions helps foster financial stability, strengthen risk management and ultimately contribute to a strong financial system (Mundul, 2009).

Poor corporate governance of banks can drive the market to lose confidence in the ability of a bank then it leads to economic crisis in a country and invite systemic risk (García-Marco & Robles-Fernández, 2008). Corporate Governance aims to minimize the chances of corruption, malpractices, financial frauds and misconduct of management (Ubha, 2007). Alexander (2004) believes that best corporate governance practices enable banks to get easy access in the capital market, decrease the cost of capital and protect the rights of minority shareholders.

Arun and Turner (2004), emphasizes that corporate governance of banks in developing economies is important for several reasons. First, banks have dominant position in developing-economy financial systems and are extremely important engines of economic growth. Second, banks in developing economies are typically the most important source of finance for the majority of firms. Third, banks in developing countries are usually the main depository for the economy’s savings. Fourth, many developing economies have recently liberalized their banking systems through privatization/disinvestments and reducing role of economic regulation.

Corporate governance aims to protect shareholder’s rights, to enhance disclosure and transparency, to facilitate effective functioning of the board and to provide an efficient legal and regulatory enforcement framework (Thapa, 2008). Corporate governance of the financial institutions such as banks remains ever crucial that banks will operate in a safe and sound manner and will comply with applicable laws and regulations while protecting the interests of depositors (Wilson, 2006). The implementation of the governance principles should be proportionate to the size complexity, structure, economic significance and risk profile of the bank and the group to which it belongs (Basel, 2006).

**Basel Principles of Corporate Governance**

Basel Committee published a guidance paper which was drawn from OECD principles of corporate governance to assist central banks of the member countries to evaluate and improve corporate governance framework in their jurisdictions. The Committee issued revised set of principles for enhancing sound corporate governance practices in banking organizations in 2010. This was the result of drawing lessons learned from the global financial crisis of 2008-09. The Committee’s document, principles for enhancing corporate governance set out best practices for banking institutions. The key areas related with corporate governance principles include:

1. Approve and oversees the corporate strategies that will direct the ongoing activities of the bank in which they operate.
2. Qualifications of board member and composition of the board. For example, the board member should have adequate knowledge and experience relevant about the activities of the bank and oversight the management functions.
3. Appraisal of independent risk management function and access to the board, monitoring risks on an ongoing firm-wide and individual entity basis.
4. Active oversight of the board regarding compensation system design and operation, including careful alignment of employee compensation with prudent risk-taking.
5. Board and senior management understanding of the bank's operational structure i.e. know your structure.

The on-site and off-site supervision, BASEL provisions for banking supervision, laws and regulatory provisions are linkages with the institutionalisation of corporate governance practices towards the better performance of the banks and financial institutions in Nepal.
Evolution and Growth Pattern of BFIs in Nepal

The initiation of formal banking system in Nepal commenced with the establishment of Nepal Bank Limited (NBL), the first Nepalese commercial bank in 1937. The country’s Central Bank, Nepal Rastra Bank (NRB) was established after nearly two decades of NBL’s existence, in 1956 by an Act of 1955. A decade after the establishment of NRB, Rastriya Banijya Bank (RBB), a commercial bank under the ownership of the Government of Nepal was established. After the financial liberalization in the 1980s, a third commercial bank and the first foreign joint venture bank, Nepal Arab Bank Ltd (now NABIL Bank) was set up in 1984. Following this, two foreign joint venture banks, Nepal Indosuez Bank Ltd (now Nepal Investment Bank) and Nepal Grindlays Bank Ltd (now Standard Chartered Bank) were established in 1986 and 1987 respectively. In 1993 Himalayan Bank Ltd, Nepal SBI Bank Ltd and in 1994 Nepal Bangladesh Bank Ltd and Everest Bank Ltd were established that counts altogether ten commercial banks.

There has been a tremendous growth on the number of BFIs after 1995. By the end of 2005 there were 17 commercial banks, 26 development banks, 60 finance companies and 78 micro-finance institutions came into existence. By overlooking the need for having a limited number of BFIs, the depositor base and financial penetration over the years, NRB let too many BFIs to pop up. It created a BFI bubble within very short period. As on mid-July 2013, altogether 253 banks and non-bank financial institutions licensed by NRB were in operation. Out of them, 31 were commercial banks, 86 were development banks, 59 were finance companies, 31 were micro-credit development banks, 15 were saving and credit co-operatives and 31 were NGOs. Total banks branches were 1,486 with the population of 8,443 per branch (NRB Report, 2013).

As per the size of the economy of Nepal the enormous growth in financial institutions was followed by intense competition not only between commercial banks in the same category but also between other financial institutions in different categories, leading to an informal competition in offering high deposit rates and lending without differentiating markets, products and borrowers’ creditworthiness. Without a proportional increase in customer base and diversification of investment portfolios, the unnatural growth in the number of BFIs led to unhealthy competition in enticing depositors such as institutional and borrowers.

Many financial and economic analysts failed to perceive the rapid changes happening in the banking and financial sector and business journalists failed to even read clues of troubles starting more than a decade ago when the liquidated Nepal Development Bank was put under management review and the number of BFIs increased multifold within a very short period. Nepal has unsustainable number of BFIs at present in term of size of the economy and the regulator, NRB has no answer why such a huge number of licenses were issued to operate BFIs within a period of just a decade. The following table shows growth of BFIs within 4 decades starting from 1980s.

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<td>Development Banks (B)</td>
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<td>Micro Finance Institutions, Saving &amp; Credit Cooperatives, NGOs</td>
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<td>Total BFIs</td>
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<td>7</td>
<td>44</td>
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Source: BFIs Regulation Department Statistics, NRB, July-2013

Further, commercial banks dominate the substantial share of the balance sheet components of the overall financial system with minimal role of non-bank financial institutions and the capital market. Commercial banks stand alone occupied 78.2 percent of total assets/liabilities, 81.2 percent of total deposits and NRs. 94,661 million/ USD 985 million of capital fund (NRB Report, 2013).
Legal and Regulatory Environment in Nepalese Banks

Considering the banking environment in Nepal, it is important to emphasize the banking laws, commercial laws and other regulatory frameworks. These are some of the basic tenets of corporate governance which are in mandatory form but the main responsibility for maintaining good governance lies within the companies themselves. Nepalese banks are operated by the Bank and Financial Institutions Act (BAFIA) 2006, Companies Act 2006 and directives issued by Nepal Rastra Bank. The legal and institutional framework related with the corporate governance practices in Nepal evolved progressively after 2006, where some of the important provisions in terms of governance issues have been incorporated in different laws. Provisions regarding corporate governance were incorporated in Companies Act 2006, BAFIA 2006 and Securities Act 2006. Mainly these provisions consists of composition of the BOD, tenure of BOD, provision of independent/professional director, qualifications of board members, compensation to the board and executives, responsibilities of BOD, Board meetings, disclosure of interest by directors, CEO and executives holding company's shares, composition, powers and reporting of audit committee.

After the operations of the international commercial banks as joint venture bank in Nepal since 1984, they help to modernize the banking business and exercise to establish the good governance practices in Nepalese financial sector. It has to be well understood that the growth in number of listed companies and participation of small investors depends on the governance practices and the ultimate responsibility to govern the capital market rest with the Securities Board of Nepal. Apart from the provisions enshrined in the different laws, Directive No. 6 of Nepal Rastra Bank on good corporate governance, this is clear indication of central bank’s commitment to bring corporate governance at high level. Mundul (2009) agrees that, to be very specific, Directive Number 6 of the central bank is related to the code of ethics to be observed by directors and chief executive officers of banks and financial institutions and these codes require all the directors, regardless of their executive or non-executive status, to sign a declaration which prohibits directors’ involvement in activities against the interest of the company.

Nepal Rastra Bank, the regulator of the bank and financial institutions, has the responsibility to supervise the nature of corporate governance practices in the financial institutions. The Basel Committee corporate governance principles are being adopted by the Nepalese commercial banks in order to safeguard the financial system and stability of the economy. Government of Nepal and NRB has continued the financial sector reform and emphasizes the maintenance of good governance practices in financial sector that create the environment to ensure the flow of foreign investment.

Review the Causes of Crises of Nepalese BFIs

Before analyzing the corporate governance in Nepalese banking and financial system, we also need to consider the unfavorable political situation of more than a decade. Frequently changed government and political unrest also creates different problem and lapses in governance issues. Poudel & Hovey (2013) analyses that Nepal Rastra Bank reported severe lapses in corporate governance in most of the banks, despite issuing directives to strengthen corporate governance in 2005, the results were not improved.

The liquidation of Nepal Development Bank and Samjhana Finance, management take over action of Nepal Rastra Bank to Lumbini Bank, Kumari Bank, Nepal Bangladesh Bank, Bank of Kathmandu, Nepal Bank, Nepal Credit & Commerce Bank, huge amount of fraud cases and crisis-ridden reported in Kist Bank, Gurkha Development Bank, H & B Development Bank, Peoples Finance, Nepal Share Markets Finance, Royal Merchant Banking & Finance, liquidity crises of Vibor Development Bank, United Development Bank are the noteworthy ups and downs in Nepalese financial sector that attracted the eye and minds of corporate bodies, depositors, lenders, regulatory authorities, shareholders and other stakeholders including Government. Now let us review the causes of Nepalese financial sector crises happened during last one decade.
First it was Nepal Development Bank to go into liquidation process and then Samjhana Finance followed suit. It is the second instance since 2009 when the central bank took a bold step to initiate the liquidation process of Nepal Development Bank. Gurkha Development Bank and United Development Bank were declared crisis-ridden. One common factor behind the misfortune of these institutions is bad corporate governance. Gurkha Development Bank fiasco is due to the tussle between promoters (The Kathmandu Post, 2011). Sapkota (2011) strongly argue that, due to the ignorance by the central bank on the unhealthy competition among BFIs, questionable lending to few sectors, governance practices by BFIs, the new BFIs pop up without even evaluating whether the economy needs so many of them and ultimately took damage control measures of late.

With the easy licensing policy in place, the number of BFIs soared to over 200. However, the supervisory capacity of the central bank remained same and the BFIs, one after another, are being found involved in fraudulent activities which has hampered the credibility of the banking sector (The Kathmandu Post, 2011). Pandey (2011) suggests that corporate governance should be given priority, in the wake of financial crisis, and it should be understood that financial indiscretion invites crisis sooner or later. Sapkota (2011) strongly argues that the rescue of Vibor Development Bank, in Nepal’s banking history, is a ‘northern-rock-moment’ the day when the Bank of England extended emergency financial support to the troubled mortgage lender and saved it from collapsing. United Development Bank declared crisis-ridden as its directors were found to have taken loans for themselves (The Kathmandu Post, 2011). According to Pandey, (2011), failures of Nepal Share Markets Finance and Peoples Finance have come as a rude awakening to Nepalese financial sectors and consumers. Ghimire (2013), argue that many times, BOD, CEO and other giant managerial leaders are found involved in the unethical and illegal practices in financial institutions.

Sapkota (2011), analyze that too many BFIs to pop up, created a BFI bubble. This increase follow by intense competition of not only between banks in the same category but also between BFIs in different categories, leading to an informal war in offering high deposit rates and lending without differentiating markets, products, and borrowers’ creditworthiness that reflected bad corporate governance practice. Pandey, (2011) argue that majority of the institutions failure has resulted from misappropriation of bank’s fund by the BOD and the top management. Promoters and executives think that banks are their own property and they are free to do whatever they want (The Kathmandu Post, 2011).

Ghimire (2013) further argue that truth and transparency in every course of action is a demanding concern of today in Nepalese corporate sector. Indeed, companies can’t innovate, respond to the changing needs of the stakeholders and function efficiently unless and until they are honest and transparent for the long run in business. Sapkota (2008) claim that Nepalese financial institutions do not have self-managed codes of conduct to disclosed details of facilities provided to board members and senior executives. Nepalese banking industry, in recent years practicing to disclose the material matters including regulatory requirements; however most of the banks disclosed very few items of accounting standards compliance notes observed in their annual reports.

Sapkota (2011) claim that tendency to seek short term, quick returns against long term viability and sustainability is leading the BFIs in a path of self-destruction. Ghimire (2013) also analyze that most of the business managers involved in short term business practices to gain profit deviated from corporate norms and values that certainly affect the corporate image and customer loyalty in the long run. Sapkota (2011) further argues that without a proportional increase in depositor base and diversification of investment portfolios, the unnatural growth in the number of BFIs led to cutthroat competition in enticing depositors and borrowers. According to Ghimire (2013), globally manager-centered approach in managing organization is out of vogue and has shifted to teamwork that obviously empowers transparency. Team work and participation as cultivating factors of candor are an increasing trend; most of the BOD and top managers make crucial decisions in their own favor or corporate point of view without any satisfaction to its employees. Stiglitz et. al. (2009), observe that unhealthy banks are taken over by regulators instead of having to face bankruptcy in public courts. Decisions by regulators and the Companies Board are regularly appealed, while the average court case
in Nepal take less time than other countries in the region including India and Pakistan and compare favorably in terms of cost and number of procedures, courts lack expertise and the time is taken to resolve a dispute 1-2 years remains substantial (World Bank, 2005).

If just by pulling out a few millions of mature deposits by institutional depositors puts the BFIs in trouble, then there is something wrong with the way they are doing business. It points to bankers’ incompetence and inability to run BFIs (Sapkota, 2011). The high concentration of corporate ownership structure and dominance of family business in corporate affairs have become major constraints in exercising good corporate governance in Nepalese corporate sector (Mundul, 2005). Failure teaches a lot. The system has started to witness outcome of financial indiscipline. Now, time has come to accept the reality and realize that we are in trouble. Timely review and inspection by Nepal Rastra Bank, self management of the risks by the bank management itself are felt desperately (Pandey, 2011).

**Challenges of Corporate Governance Practices In BFIs**

From the review of legal and regulatory framework and banking industry ups and down scenario during last one and half decade, causes of crises from the banking perspectives, it is clear that corporate governance ensures board governance system, transparency, accountability and professionalism in the financial system that enhances the credibility and acceptability to the shareholders, employees, investors, customers, lenders, governments and other stakeholders. This is more relevant in case of banking industry, since bank deals in public money, public confidence is of outmost importance in this industry. Besides this, banking system is gearing up with financial sector reform program to develop a transparent, competitive and strong financial sector (Thapa, 2008). Good governance and good performance reinforce each other and with good governance, good performance comes automatically (Mundul, 2009).

After analysis of the numbers of situations, following challenges are seen in the financial sector in Nepal. First, board governance system, leadership, guidance and oversight to ensure the needs and rights of all parties are not adequately and appropriately managed. Second, issues of compliance of stringent legal and regulatory requirements as well as their proper supervision. Third, bank and financial institutions are continue to consolidate and becoming larger and more complex as they grow in size but managing risk will be challenge to BFIs i.e. challenge to manage the business becoming "big-is-better" rather than “small-is-beautiful”. Fourth, responsibility of board and management to disclose the legal, regulatory and other pertinent informations friendly and transparently seems to be inadequate. Fifth, board and management approach on mitigating the risks associated with the banking industry and potential misconduct and negligence of bank management. Sixth, challenge to innovate the new banking product and able to compete with global networking of the banking environment. Seventh, proper implementation of global regulatory reforms such as compliance of BASEL principles for bank supervision and finally lack of efficient judiciary system i.e. still courts lack adequate expertise in commercial laws and the time is taken to resolve a dispute within couple of years remains substantial.

**CONCLUSION**

The survival and stability of financial sector depends on the quality of its governance system. Effective corporate governance in banking industry helps foster financial stability, strengthen risk management and ultimately contribute to a strong financial system. In spite of several reforms programs put to strengthen this sector, financial institutions are still prone to failure. The loss associated with this failure is enormous on their reputation as well as industrial growth in Nepalese economy. For a healthy financial industry, Nepal needs fewer but stronger BFIs with sound corporate governance system. Financial institutions should have self-managed codes of conduct to disclose board governance system, financial situations, facilities provided to board members and senior executives. Further, there has to enhancement of regulatory and supervisory capabilities of NRB with the increase in number of BFIs. Few but strong BFIs with strong supervision would lead to minimize the operating expenses, healthy
competition, economics of scale and innovation in the banking products. To build public confidence and trust in the financial industry, strong enforcement mechanism of legal and regulatory framework is a must. Efficient judiciary system would also be indispensable factor to enhance and effective implementation of corporate governance in Nepalese financial sector.

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