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The Legal and Judicial Environment For Financial Sector Development A Review

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Finance and Private Sector Development Unit
South Asia Region

World Bank

Nepal

The Legal and Judicial Environment For Financial Sector Development —A Review

March 2005

Finance and Private Sector Development Unit
South Asia Region
The World Bank

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Currency Equivalents

(Exchange Rate Effective February 2005)

Currency unit	=	Rupee (NR)
1 Rupee	=	0.014US$
1 US$	=	72.2 NR

Abbreviations and Acronyms

ADB	Asian Development Bank
AMC	Asset Management Corporation
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BFIO	Banks and Financial Institutions Ordinance 2004
CFG	Corporate and Financial Governance
CIAA	Commission for the Investigation of Abuse of Authority
CIC	Credit Information Centre
CIT	Citizens' Investment Trust
CITPS	Citizens' Investment Trust Pension Scheme
CRO	Company Registrar's Office
DFID	The Department for International Development of the UK
DRT	Debt Recovery Tribunal
EPF	Employees' Provident Fund
ICAN	Institute of Chartered Accountants of Nepal
IFRS	International Financial Reporting Standards
NEPSE	Nepal Stock Exchange
NGO	Nongovernmental organization
NRB	Nepal Rastra Bank
NRB Act	Nepal Rastra Bank Act 2002
ROSC	Report on the Observance of Standards and Codes
SEBO	Securities Bureau of Nepal
STO	Secured Transaction Ordinance
UN	United Nations
USAID	U.S. Agency for International Development

Executive Summary

Legal systems play a pivotal role in the operation of financial markets. They ensure the efficient intermediation of capital flows and domestic savings. Banks and other financial institutions hold claims on borrowers, the value of which is dependent upon the certainty of legal rights and the predictability and speed of their fair and impartial enforcement. A competitive business and corporate sector is built on a solid legal foundation. That foundation includes strong property rights, ease of company formation, and corporate governance. It provides for the availability of flexible collateral mechanisms to support the granting of credit, and reliable insolvency systems to minimize lender risk and encourage the rehabilitation of viable firms in financial difficulty. Laws and legal institutions also underpin fund raising and securities trading through well-regulated securities markets.

The process by which laws and regulations are conceptualized, drafted, enacted, publicized, and enforced is the foundation of a society governed by the rule of law. By consistently enforcing clear rules, an independent and impartial judicial system supports legal reform and promotes economic and social development. An effective judiciary applies and enforces laws and regulations impartially, predictably, and efficiently. It is an accepted fact that economic growth and social development cannot be sustained and promoted in countries where the justice system fails.

OBJECTIVES

Over the past few years, Nepal has received technical assistance and implemented development projects supported by the World Bank and other international financial institutions. The goal of this work has been to improve the legal and judicial framework for financial and private sector growth in Nepal. These endeavors have however been ad hoc, often isolated or components of larger projects.

In 2004, the World Bank's Board of Directors raised concerns about the legal and judicial environment for financial sector reform in Nepal. When the second phase of the Financial Sector Reform Project was submitted for its approval in February of that year, the board wanted a report on past and future reforms required to strengthen the enabling legal environment for financial sector reform. It also wanted to know whether the necessary reforms are being effectively implemented. The board's request resulted in this preliminary assessment of Nepal's legal and judicial environment. The assessment's goal is to understand better the current state of that environment and to identify areas most deserving of reform.

Though the assessment in this report is not exhaustive, it provides a useful snapshot of the legal and judicial environment for financial sector growth and development in Nepal. The report, among other things, looks into future reforms required to strengthen the enabling environment, whether supported by the World Bank or other donors. It examines whether past reforms have been effectively implemented or not. It also provides a review of the effectiveness of Nepal's regulatory legal framework in ensuring a sound financial system.

This review also examines and assesses the corporate legislative framework—laws on corporations, capital markets, corporate governance, and so on—to evaluate its appropriateness in supporting a modern and efficient financial system. It explores creditors' rights and the insolvency regime, in particular the creation, registration, and realization of collateral. It considers the effectiveness of the judicial system, especially in supporting the growth and stability of financial markets and the private sector with respect of property rights, debt recovery, and dispute settlement. The report examines more general laws relating to law enforcement and corruption that have an impact on private sector

growth. Finally, it provides recommendations for reform in the areas of law and justice. While these initiatives have contributed to the improvement of the legal framework of the financial sector, their impact on the overall banking and corporate sector has been modest. There are a number of reasons for this. They include a lack of comprehensiveness with regard to legal reform and an inadequate supporting infrastructure and institutional capacity to implement laws. Shortcomings also include lethargy in enforcement of new rules and a naïve hope that inefficiency and ineffectiveness can simply be legislated away.

THE GENERAL LEGAL FRAMEWORK

The legal system of Nepal is predominately influenced by the common law tradition, together with some elements of the continental law. The Constitution of Nepal, which was enacted in 1990, is the country's supreme law. The constitution supports the Muluki Ain, Nepal's general law for substantive and procedural law on both criminal and civil matters. Commercial laws were first introduced in the 1930s on a common law foundation, although Nepal has not kept up with subsequent common law developments. As a result, the legal framework for commercial laws—even the basic legal mechanism for the functioning of the corporate sector—was not in place until the early 1990s. Realizing the legislative gap, the government, with the help of multilateral organizations and donors, has been introducing new laws and institutions to fill the vacuum since the late 1980s. The process is far from complete and is ongoing.

Several laws, largely affecting the corporate and private sector, have either been drafted, passed by the Cabinet, or are in the final stages of enactment. For instance, a new Banking and Financial Institutions Ordinance was passed in February 2004. The drafts of the Secured Transactions Ordinance, Insolvency Ordinance, Companies Ordinance, and Securities Ordinance have been approved by the Cabinet and are awaiting royal assent. The Asset Management Company Ordinance is under consideration by the Cabinet. The Fiscal Transparency Ordinance, Governance Ordinance, and Anti-Money Laundering Ordinance are currently being drafted. The Public Debt Act and Foreign Exchange Regulation Act were amended two years ago, and the Asia Development Bank is currently assisting in the drafting of a new law to govern the microfinance sector. Thus, the legal and regulatory framework of not only the corporate and financial sector but also the government itself is being continuously improved and strengthened.

Notwithstanding the above, progress toward improving Nepal's legal and regulatory framework suffered a setback when the king dissolved Parliament in 2002. All laws are currently passed by the Cabinet and receive the royal assent to complete the enactment process. These ordinances are valid for six months only, unless renewed by royal assent. Further, the Constitution requires the Parliament to ratify any ordinance passed in its absence in order for the ordinance to become a permanent law. The Parliament in turn has the prerogative to either amend or reject ordinances. As such, the fate of ordinances beyond six months is uncertain. This process is not conducive to certainty in the legal system, especially for the financial and private sector. Nor does it stabilize the legal structure for the regulatory institutions that implement these ordinances. The sacking of the government and the assumption by the King of direct leadership of the Cabinet on February 1, 2005 has further exacerbated the uncertainty.

THE LEGAL FRAMEWORK FOR THE BANKING SECTOR

With the economic liberalization initiated in the mid-1980s, the Nepalese financial system has witnessed significant developments. As of January 2005, the financial system consisted of 237 institutions. These include: 17 commercial banks, 24 development banks, 5 regional rural development banks, 116 postal saving banks, 59 finance companies, 21 saving and credit cooperative societies involved in limited banking activity, 47 non-government microcredit institutions, 1 stock

exchange with a network of brokers and securities dealers, 18 insurance companies, 1 employees' provident fund, 1 credit guarantee and deposit insurance corporation, and 1 citizen investment trust. Of these institutions, the commercial banks, development banks, rural development banks, finance companies, financial cooperatives, and NGOs are regulated by the Nepal Rastra Bank (NRB). While the insurance board regulates the insurance companies and the securities board regulates the stock exchange as independent regulatory agencies, the other institutions are under the direct regulation of the government.

Financial sector reform projects undertaken by the government in the past three years have resulted in significant legal reform in the banking sector. Financial Sector Reform Project Phases I and II are noteworthy. Phase I commenced in 2002 and involved bringing in three management consultant teams to restructure and re-engineer the central bank and reform the two commercial banks (Rastriya Banijya Bank and Nepal Bank Limited). [1] Phase II commenced in April 2004. [2] It seeks to continue the implementation of the government's Financial Sector Strategy to restructure and privatize the state-owned banks, to strengthen the supervisory and regulatory capacity of the NRB, and to strengthen the legislative and institutional framework for the sector. Good leadership and an appropriate incentive structure within the NRB are essential strengthen it and to sustain the foregoing reforms.

The introduction of the Nepal Rastra Bank Act in 2002 was an important step in strengthening the legal framework governing the NRB. It improved the bank's autonomy, governance, and accountability. However, section 86 relating to the NRB powers to deal with troubled banks was grossly inadequate. Hence, in November 2003, with the assistance of IMF and World Bank legal experts, the NRB undertook amendments to section 86. These amendments were passed by the Cabinet and received the royal assent in October 2004. The amendments improve NRB's power to act speedily, cost effectively, flexibly, and consistently with respect to troubled institutions. They also provide a regime that avoids moral hazard and increases transparency in dealing with troubled banks.

Another legal reform initiative was the Bank and Financial Institutions Ordinance 2004, enacted in April 2004, which replaced the 1972 Banking Law. It consolidated various laws governing banks and banking activities. It also repealed the Agricultural Development Bank Act 1967, Finance Company Act 1985, Nepal Industrial Development Corporation Act 1990, and Development Bank Act 1996. Though well-intended, the scope and application of the Bank and Financial Institutions Act do not provide an adequate legal framework for the 25 Basel Core Principles for Effective Banking Supervision. Among other things, the Bank and Financial Institutions Ordinance does not provide a practical classification of institutions. Inadequate transition provisions in the law have removed the legal basis for Nepal Industrial Development Corporation Act and Agricultural Development Bank Act. There is also extensive overlap between the Companies Act and the Bank and Financial Institutions Ordinance. The Bank and Financial Institutions Ordinance has to be reviewed to address this overlap. Accordingly, the NRB is in the process of amending the ordinance.

The NRB issued a new Directive on Credit Information and Blacklisting in 2002 to improve the credit culture in Nepal. Though viewed as draconian, the directive seems to be the only feasible approach to debt collection in Nepal until the banking system is well governed and is in private hands. This is because there is an entrenched default culture and major banks are susceptible to interference from various quarters. Nevertheless, blacklisting has its limitations and its effectiveness

[1] World Bank Project Phase I, Board date December 19, 2002; agreement date April 30, 2003; effectiveness date July 1, 2003. DFID was a co-financier, through a grant of US$10 million.

[2] Development Finance Agreement and Project Agreement date June 10, 2004; effectiveness date July 15, 2004.

may not last long. As such, apart from improving the governance of banks and moving such governance away from the public sector, the NRB's Credit Information Centre (CIC), needs to be transformed into an effective credit information bureau. Either the NRB Act has to be amended or a new law has to be enacted to enable the CIC to incorporate, expand its scope of activities and membership, introduce confidentiality and information access, and transform into an effective credit information bureau.

Committed to combating money laundering and terrorism financing, Nepal is in the process of drafting a new law based on the recommendations of the Financial Action Task Force (FATF). Following the recently-introduced Banking and Financial Institution Ordinance 2004, the NRB has issued directives on suspicious transactions in relation to deposits and remittances. NRB officers are currently being trained in anti-money laundering measures. The NRB is also carrying out a training program for senior officers from the NRB, the Nepalese Police, the Commission on Investigation for Abuse of Authority, and the Revenue Investigation Department. The NRB ought to tap the expertise of foreign banks operating in Nepal for further training in anti-money laundering and terrorism financing.

One of the major problems in the banking system is the high level of non-performing loans. These have remained at around 65.9 percent, 6.4 percent, and 7.5 percent in the public, private and foreign banks, respectively. Most of these loans, especially in Nepal Bank Limited and Rastriya Banijya Bank, are irrecoverable. This is the case because they are unsecured or have no valid documentation. In some cases, the borrowers are willful defaulters who have absconded from the country or died without assets. These loans are not written off because there are no write-off guidelines from the NRB. Also the NRB is fearful of being investigated for abuse of authority should it attempt to write off the loans. As a result, the NRB needs to develop a write-off policy for the banks in consultation with the industry and enter into a clear agreement with the tax authorities on the tax deductibility of write-offs.

In an effort to reduce the non-performing loans of Rastriya Banijya Bank and Nepal Bank Limited, the government is in the process of establishing an asset management corporation (AMC). A draft AMC ordinance is under the consideration of the Cabinet. The draft law provided to the donors has severe structural, administrative, and legal deficiencies that need to be addressed if an AMC is to be effective. As the experience of AMCs globally is mixed, the government ought to assess carefully whether, at this time, an AMC will help with privatization—including pre-privatization and recapitalization of banks—and with asset recovery, given Nepal's current conditions. This is critical since Nepal does not have a deep enough secondary market, or foreign investor interest, for such assets. Also, there is inadequate legal, accounting, auditing, and valuation skills, and inadequate investment banking capacity in Nepal to staff an AMC.

THE INSOLVENCY AND CREDITORS' RIGHTS SYSTEMS

Nepal does not have a law providing for the creation, recognition, and enforcement of security interests in movable property. Nor is there a concept of fixed or floating charge. Moreover, the absence of priority rules results in frequent disputes and litigation. The Secured Transaction Ordinance 2004 is in the process of being enacted to create security over moveable assets and enforcement that security. The law would enable the creation of an electronic registry for movable property. It is evident that Nepal currently lacks the human resources and institutional capacity to implement the Secured Transaction Ordinance effectively. The authorities need to address this shortcoming. As for land mortgages, the registration of a land mortgage is simple, cost effective, and compulsory, but the land registry functions manually and lacks institutional capacity and resources. Collection and dissemination of information at the land registry is unsatisfactory and its improvement is essential for expanding access to credit.

The security enforcement mechanism provided under the Debt Recovery Act 2003, and the Banks and Financial Institutions Ordinance 2004 (BFIO) is a vast improvement over the past situation. The BFIO provides for enforcement of a secured claim without the intervention of a court. However, in practice, the enforcement process suffers from excessive interference by courts in the form of stay orders that render the law ineffective and unpredictable. Frequent stay orders and long, drawn-out litigation are a major stumbling block in dealing with defaulting debtors and non-performing loans in Nepal. There is an urgent need to amend the BFIO to minimize court interference and streamline the enforcement procedures. This can be done by explicitly setting out the grounds for the grant of a stay by a court against an enforcement action, specifying the duration of stay orders, and prohibiting *ex-parte*[3] stay orders.

The Debt Recovery Act provides for a summary procedure for recovery of debt by the Debt Recovery Tribunal. The Debt Recovery Tribunal started operation in October 2003, with one trial court and one appellate court to expedite the debt recovery process. A total of 131 cases have been filed so far. Five cases were settled amicably and 43 judgments have been issued. However, only one case has been fully enforced. The biggest problems the tribunal faces are the service of summons and enforcement. Enforcement takes more than a year from the date of judgment due to the enforcement staff's lack of skills and the sheer challenge of serving the whole of Nepal. It must be noted that the district courts have not fully transferred pending debt recovery cases to the Debt Recovery Tribunal. When that transfer happens, the Debt Recovery Tribunal will be overwhelmed. The Debt Recovery Tribunal Act has to be amended to further simplify the tribunal's procedures and to improve enforcement powers. Sufficient budgetary and human resource support must also be provided to make the Debt Recovery Tribunal effective.

While a law on corporate restructuring is absent, matters dealing with the liquidation of companies with limited liability is governed by the Companies Act 2053 (1997). The liquidation process is highly inefficient, ambiguous, uncertain, and disorganized. Courts do not play any meaningful role in the liquidation process. The Office of Company Registrar, which supervises the liquidation, is not competent enough to discharge this function effectively. Stakeholders are not involved in the process and have no impact on the outcome of the liquidation.

A draft Insolvency Ordinance 2003, sponsored by Ministry of Finance with the ADB's technical assistance is presently under consideration. The Insolvency Ordinance, if enacted in its present form, would create a satisfactory framework for corporate insolvency but will still fall short of the Principles and Guidelines for Effective Insolvency and Creditors' Rights Systems developed jointly by the WB and IMF. Also, there is an urgent need to build the necessary capacity for insolvency professionals and appropriate implementing agencies in Nepal.

There is no legislation or established framework providing for an informal out-of-court restructuring. As such, there are no procedures, guidelines, or standards dealing with corporate financial difficulty in situations of multiple financing. The directives of the NRB are general and do not set a policy for informal workouts. The Mount Everest Brewery case exemplifies this. In the brewery case, a lender with 2 percent of the consortium loan has been capable of holding up the restructuring process. (For details, see chapter 2). Invariably the banks prefer the extreme action of recovery by enforcement of security without exploring or attempting revival of potential businesses. Like the other bank supervisors, the NRB ought to take a lead in developing an out-of-court restructuring mechanism for the banks.[4]

[3] *Ex-parte* stay orders are orders granted by the court on the application of the appellant, without giving the right of hearing to the party that obtained the judgment or execution order that is being stayed.

[4] Malaysia's Corporate Development and Restructuring Committee would be a good example.

THE JUDICIAL SYSTEM

Increasing evidence from around the world suggests that when court performance improves, it can support economic development by facilitating market transactions. In addition to improving the overall macroeconomic climate in a country, judicial reforms, through a better enforcement of legal contracts, are critical to lowering the cost of financial intermediation for households and firms.[5] The judiciary falls short of fulfilling its rightful role with regard to these kinds of development issues.

Nepal's 1990 Constitution guarantees independence of the judiciary and provides three tiers of courts. Judges are appointed by His Majesty the King of Nepal. The Judicial Council and the Judicial Services Commission are presided over by the Chief Justice of the Supreme Court. Several important reforms are in progress. Two examples are efforts to modernize legislation with support from UNDP and the establishment of National Judicial Academy with support from the ADB. In addition, a five year strategic plan for the judiciary is being developed with support from the Danish International Development Agency (DANIDA). This five-year strategic plan emphasizes infrastructures and facilities and identifies 17 areas of strategic intervention. However, it does not indicate concrete problem-solving steps. Priority focus should be on the core business of case handling. Additional analytical work, for instance on legal training, the role of the Bar, and alternative dispute resolution will provide a more in-depth understanding of the legal and judicial framework.

Governance of the entire judicial organization is concentrated in the Supreme Court. This constitutes a potential conflict of interest that may endanger reform. It also endangers the continuity of reform, since Chief Justices of the Supreme Court generally have tenure of less than one year. If the aims of the present strategic plan are to be fulfilled, ownership of reform and continuity of its leadership must be safeguarded. To successfully implement the five-year plan Nepal should conduct a complete legal and judicial assessment of its judicial system. An assessment like this will help to identify strengths and weaknesses in the judicial system, determine the specific measures needed to deal with the weaknesses, and prioritize the measures to be taken to improve the overall system.

Special tribunals have been set up to deal with taxation, debt recovery, and corruption. A specialized bench for commercial disputes is under discussion. Specialized courts or tribunals, however, will not solve problems caused by underperforming ordinary courts. The need for competent, efficient justice in the long run can only be fulfilled by effective, efficient performance of the ordinary courts. Performance of the courts is low and should be a primary concern for reform. Most cases take several years, and disposal rates are very low. If delays are to be reduced, management of civil cases should be made a primary concern in the judiciary's strategic plan. Specialized fast-track units in the courts have been successful in other judicial reform programs. Present library, documentation, and archiving facilities are insufficient and must be brought up-to-date. The rate of computerization is very uneven and extremely low in the lower courts.

The formal legal training of lawyers in Nepal, including judges, consists of no more than initial training leading to a bachelor's degree in law. University legal training meeting the needs of legal practice must be established. To ensure effective and efficient case handling, initial and permanent training of judges and court staff needs to be institutionalized in a permanent training facility. Even in the courts themselves, access to the current laws is a problem and reference material is scarce. These concerns have to be addressed in the reform program.

[5] Luc Laeven and Giovanni Majnoni. 2003. "Does Judicial Efficiency Lower the Cost of Credit?" Policy Research Working Paper 3159, World Bank, Washington, D.C.

The judiciary, as an independent state body, must be capable of generating public trust. Public opinion in Nepal considers corruption in the judiciary a serious problem, one which should be dealt with by the judiciary itself. The strategic plan for the judiciary recognizes the public's perceptions. The plan calls for strengthening the Judicial Council and its secretariat as an anti-corruption agency. The plan also empowers the council to act against all judges, including the members and the Chief Justice of the Supreme Court.

THE LEGAL FRAMEWORK FOR CAPITAL MARKETS AND CORPORATIONS

The capital market in Nepal is facing a crisis of trust. The single greatest problem is the lack of reliable, current information regarding publicly-offered and traded companies. The lack of reliable information has a number of negative results. These include market activity based on rumor and not on current financial data; mismanagement of corporate business; and the perception that the market for public companies is not fair or trustworthy. The result is that investors do not feel that they can invest in the market because they lack sound information regarding the conduct of the market and the companies offered for investment.

The current regulatory and governance structure is insufficient to provide investors with confidence in the securities markets. The applicable laws do not give sufficient authority to the securities commission to regulate the capital markets. The laws establish conflicting regulatory jurisdictions among the securities commission, stock exchange, and registrar of companies. They frequently give regulatory responsibility to the entity least capable of carrying it out. This results in inadequate surveillance of the market, reduced regulation of intermediaries, and the weak enforcement of what rules do exist. In addition, the accounting and auditing standards and disclosure rules must be improved and enforced. The current authority and financial support given to the securities commission and auditing institute are inadequate to properly fulfill this responsibility.

Non-bank financial institutions are not effectively regulated to protect investor interests. There is no independent pension regulator in Nepal to review the collection, investment, and pay-out activities of the pension programs. The pension programs of the Employees Provident Fund (EPF) and the Citizens' Investment Trust (CIT) operate autonomously, without government supervision. Similarly, there is no regulatory structure set out in the securities laws and regulations regarding the establishment and operation of collective investment vehicles, named "unit savings schemes" in the Nepalese law. Even though the laws and the regulations authorize the securities commission to license such schemes, the commission has not even set out guidelines for their regulation.

With respect to insurance, the law establishes an Insurance Board with only limited authority over the insurance industry. Gaps exist in the regulatory structure, such as the lack of qualification requirements in the law or regulations regarding the promoters and managers of insurers. Finally, although finance companies that engage in leasing are regulated under the Banks and Financial Institutions Ordinance 2004, their leasing activity is minimal due to the inability to amortize a lease under current tax laws.

THE LEGAL FRAMEWORK FOR MICROFINANCE INSTITUTIONS

There is no specific law that governs microfinance institutions in Nepal. The Co-operative Act of 1991 can be considered the main law for the registration and regulation of microfinance NGOs. While the act enables a broad range of activities and grants a fair amount of autonomy to the entities registered under it, it is inadequate to ensure proper governance, accountability, and transparency of the micro-credit sector. The Financial Intermediary Societies Act 1998 requires all NGOs engaging in microfinance to be registered with the NRB. Licensing and other prudential requirements, however, have kept many microfinance institutions from registering under this law. Lately, the BFIO

brought microfinance institutions under its purview by requiring them to be licensed as category D institutions. (For details on category D institutions, see chapter 5). It is obvious that there are overlapping laws and regulators in this sector. An adequate and enabling legal framework is required to ensure better development, governance, transparency, and accountability of the sector. The ADB has started this process.

LEGISLATIVE AND ENFORCEMENT ISSUES

The major issues in this area are the lack of deliberation, clear policy decisions in line ministries, and public consultation for new laws. There is a need to make it compulsory for experts in line ministries and independent subject-matter experts to be included in legislative committees, to ensure that a law meets regulatory and legislative intent. The current process for enacting laws has been going through some crisis in the absence of the Parliament. Restoration of the parliamentary process and installation of a more transparent and efficient process for law-making will be essential. In addition, the role of the Ministry of Law and Attorney General's office in the law-making process has to be reviewed in order to keep the office regularly involved in implementation and enforcement issues. The legislative drafting office in the Ministry of Law in particular needs strengthening to ensure consistency and greater clarity in the laws it drafts.

Even the best-crafted laws are only as good as their implementation and enforcement. The failure to implement and enforce laws is still a major problem in Nepal. Politicization of government employees and the lack of clear rules to govern them, as well as the failure to deal with breaches of rules, inefficiency, and dishonesty have badly impaired the implementation and enforcement of the legal system. Corruption and the lack of an effective mechanism for accountability have marred the civil service, including regulators. In addition, regulators suffer from lack of institutional capacity, including budgets and skilled human resources. Lack of skills and knowledge has resulted in the failure to understand the basic provisions laws and procedures. Institutional reform, capacity building, and skills improvement in both the civil service and the regulatory institutions will go along way to improving implementation and enforcement of laws.

The government is committed to curbing corruption. The establishment in 1999 of the Commission for the Investigation of Abuse of Authority (CIAA), pursuant to section 97 of the Constitution, was a significant step forward. In 2002, the government enacted a new Anti-Corruption Act and amended the CIAA Act to strengthen the authority of the CIAA. Consequently, the CIAA has been particularly active. It has filed corruption cases in Special Court against some former ministers and high-ranking officials of the government. According to the CIAA's published monthly report of April 2003, it had received a total of 2,316 complaints as of April and disposed of 1,639 cases, of which 118 were corruption cases. With the number of cases increasing rapidly, CIAA needs to be provided with sufficient budgetary and institutional capacity.

SUMMARY OF RECOMMENDATION

Banking sector

- Amend the Banks and Financial Institutions Ordinance to have a practical categorization of institutions and remove the overlap between the Companies Act and the Ordinance to provide a legal framework for the implementation of Core Principles.
- Introduce a clear write-off policy in consultation with the industry and reach agreement with tax authorities on tax deductibility of write-offs.
- Introduce an appropriate legal framework to make the CIC a corporate body and transform it into a full-fledged credit information bureau to provide for customer and data protection.

Creditors' rights and insolvency system

- Amend the provisions of the BFIO and Debt Recovery Acts for efficient implementation.
- Build capacity in the area of insolvency for insolvency professionals and their regulators.
- Create a suitable formal out-of court restructuring process for banks to restructure borrowers having financial trouble.

Judicial system

- Establish a permanent facility for initial and permanent training for judges and court staff; develop proper library facilities; and university legal training meeting the needs of legal practice.
- Strengthen court capacity for ensuring fair and timely case handling, including specialized units for fast track and other civil cases where appropriate.
- Improve and strengthen the governance and court management structure to support effective and efficient case handling.
- Establish sound and transparent structures and procedures for effectively and accountably preventing and fighting corruption.

Capital market and non-bank financial institutions

- Fully implement accounting standards for public interest entities based on International Financial Reporting Standards and complete the issuance of national accounting standards for small and medium enterprises. A ROSC (Report on the Observance of Standards and Codes) evaluation of the auditing and accounting profession should be conducted to determine what assistance needs to be given to Nepal to achieve this goal.
- Expedite the passing of the Securities Act and ensure that the Securities Exchange Board of Nepal (SEBO) is given full authority over the capital markets and full enforcement authority to investigate and prosecution violations of the securities laws.
- Designate a government ministry to supervise the activities of the EPF to ensure that investor funds are properly used and will be available for the investors at the time of retirement. Private pension schemes should be supervised by an independent supervisory authority.

Legal framework for microfinance

- Establish an adequate and enabling legal framework for microfinance institutions to ensure better development, governance, transparency, and accountability of the sector.

Institutional issues

- Install an appropriate consultative process and sufficient checks and balances for lawmaking.

A detailed matrix of recommendations appears in Annex 1.

1 The Legal System and Framework for Banking

1.1 Overview of the Legal System

Nepal's legal system is predominately influenced by the common law tradition and also has some elements of continental law. The first codified law for a unified Nepal—Muluki Ain (the Country Code) — was introduced in 1853 and was replaced by the existing Muluki Ain in 1963. The Muluki Ain is a general law that contains both substantive and procedural laws covering criminal and civil matters. The Constitution of Nepal, which was enacted in 1990, is the country's supreme law. Commercial laws were first introduced in the 1930s on the basis of common law, although Nepal has not kept up with subsequent developments in common law. As a result, the legal framework for commercial laws and the necessary legal mechanisms for the effective functioning of the corporate sector were not in place until the early 1990s. Realizing the legislative gap, in the mid 1980s the government, with the help of multilateral organizations and donors, began introducing new legislation to fill the vacuum and the process is ongoing.

Several laws, largely affecting the corporate and private sector, have been either drafted, passed by the Cabinet or are in the final stages of enactment. A new Banking and Financial Institutions Ordinance was passed in February 2004. The drafts of the Secured Transactions Ordinance, Insolvency Ordinance, Securities Ordinance, and Companies Ordinance have been approved by the Cabinet and are awaiting royal assent. The Asset Management Company Ordinance is under the consideration of the Cabinet. The drafts of the Fiscal Transparency Ordinance and Anti-Money Laundering Ordinance are also under active consideration by the government. A Public Debt Act and Foreign Exchange Regulation Act have been amended during the last two years to make them up-to-date. The ADB is currently assisting the drafting of a new law to govern the microfinance sector. It is noteworthy that the legal framework for the corporate and private sector is being continuously strengthened. This will significantly improve the legislative and regulatory framework of the financial sector.

Progress in improving the legal and regulatory framework has suffered since the dissolution of the Parliament in 2002. All laws are currently passed by the Cabinet and receive royal assent. These laws are called Ordinances and are only valid for six months, unless renewed by royal assent at intervals of six months. The real fate of these Ordinances is uncertain since the Parliament, once it comes into session, has to ratify them. The Parliament can ratify an ordinance without changes and make it a permanent law or it can reject or amend the ordinance before ratification. As a result, all ordinances are certain and good for six months only. This is not conducive to certainty in the legal system, especially for the corporate sector and regulatory institutions. There is, as a result, an urgent need to restore the Parliament so that it can resume its lawmaking role. Meanwhile, proper consultation with stake holders, private experts, and government ministries would improve the credibility of the ordinances and reduce their chances of being rejected or amended.

1.2 The Legal Framework for Banking

With the economic liberalization initiated in the mid-1980s, the Nepalese financial system experienced significant developments. As of January 2005, the financial system consisted of over 230 institutions. These include: 17 commercial banks, 24 development banks, 5 regional rural development banks, 116 postal saving banks, 59 finance companies, 21 saving and credit cooperative societies involved in limited banking activity, 47 non-government micro-credit institutions, 1 stock exchange with a network of brokers and securities dealers, 18 insurance companies, 1 employees' provident fund, 1 credit guarantee and deposit insurance corporation, and 1 Citizen Investment Trust. Of these institutions, the commercial banks, development banks, rural development banks, finance

companies, financial cooperatives, and NGOs are under the regulatory framework of Nepal Rastra Bank (NRB). While the insurance board regulates the insurance companies and the securities board regulates the stock exchange as independent regulatory agencies, the other institutions are under the direct regulation of the government.

The government has demonstrated a firm commitment to reforming the banking sector. Having brought foreign management teams into Rastriya Banijya Bank and Nepal Bank Limited, the government has taken steps to expedite the reform of these banks, along with the banking system as a whole. It has permitted the aggressive pursuit of non-performing borrowers (including some politically well-connected individuals). It has taken some nonperforming borrowers to the Committee for the Investigation of the Abuse of Authority. The government has established Debt Recovery Tribunals in an effort to expedite the legal procedures associated with recovery from non-performing borrowers. Finally, it has instituted an extremely strong blacklisting law that prohibits any nonperforming borrower from being able to access future borrowings until the borrower has regularized its lending arrangements within the banking system. The government has also committed itself, in a Letter of Financial Sector Policies for Phase II of a World Bank-supported reform project, to ultimately privatizing these banks. This commitment coincides with the government's financial sector strategy, which aims to expedite the process of comprehensive reform in the area of the financial sector.

Reform initiatives undertaken by the government in the past three years, especially the Financial Sector Reform Project Phases I and II, have set the stage for significant legal reform in the banking sector. Phase I project,[6] commenced in 2002, involved bringing in three management consultant teams to restructure and re-engineer the central bank and reform the two commercial banks (Rastriya Banijya Bank and Nepal Bank Limited). Phase II of the project commenced in April 2004[7] and seeks to continue the implementation of the government's financial sector strategy. It will restructure and privatize the state-owned banks. It will also strengthen the supervisory and regulatory capacity of the NRB and the legislative and institutional framework for the sector. By supporting change in the financial sector as part of the Country Assistance Strategy (fiscal 2003-07), this project will bring significant reform to the banking system in Nepal.

1.3 THE NEPAL RASTRA BANK ACT 2002

Nepal has a 45-year-old law that has been amended intermittently over the years. The law was replaced with a new one in January 2002. The previous law was essentially designed for a central bank in a government-controlled economy, with a bank supervisor to supervise government-owned banks. Hence the structure, architecture, and legislative framework of the old NRB Act was ill-suited for a complex and modern central bank and banking system. The new NRB Act has provided more autonomy, authority, and accountability to the central bank. As a result of enactment of the new NRB Act, the supervisory, oversight, and regulatory powers of the NRB have been strengthened.

Among other things, the new NRB Act provides for an autonomous central bank answerable to Parliament. The members of the Bank's board are appointed by the government upon the recommendation of a specially-constituted committee. Removal of board members has to follow due process. The new law also provides for a mechanism for coordination between the government and the central bank. It states clearly the rules on conflict of interest and the powers and duties of the board and governor. The law establishes a management committee and an independent audit committee appointed by the Board and answerable to the Board.

[6] World Bank Project Phase I, Board date December 19, 2002; agreement date April 30, 2003; effectiveness date July 1, 2003. DFID was a co-financier, through a grant of US$10 million.

[7] Development Finance Agreement and Project Agreement (PA) date June 10, 2004; effective date July 15, 2004.

The NRB Act specifies the role of the central bank and of the government foreign exchange policy. It limits lending to government to secured lending of 10 percent and for a duration of 180 days. Chapter 10 of the new law sets out numerous requirements for the NRB. These include a mandate for a proper accounting system, specifically the use of an international accounting system and the auditing of accounts by external auditors in addition to the government auditor. Chapter 10 also requires the submission of an annual report to the government. However, section 81 still empowers the NRB to issue directives to commercial banks and financial institutions to provide credit to sectors prescribed by NRB. This kind of power may not be ideal for a competitive banking sector. NRB authorities need to review this.

One of the main drawbacks of the law is section 86 on the powers of the NRB to deal with troubled banks. The section is highly inadequate. The Core Principles of Effective Banking Supervision issued by the Basel Committee of Bank Supervisors recommends the use of a graduated approach to the enforcement of prudential requirements under the banking laws. The principles require the use of appropriate bank resolution measures in necessary cases, including bank rehabilitation, liquidation, and cancellation of a banking license. However, the NRB Act does not contain all of these measures. Hence, in November 2003, with the assistance of IMF and World Bank legal experts, amendments were proposed to section 86. The provisions also provide a regime that avoids moral hazard and increases transparency in dealing with troubled banks. The amendments were passed by the Cabinet in January 2004 and received royal assent in the first week of October. These amendments should enable the NRB to act speedily, cost efficiently, and with sufficient flexibility and consistency when dealing with troubled banks.

1.4 THE BANKING AND FINANCIAL INSTITUTIONS ORDINANCE 2004

The Banks and Financial Institutions Ordinance of 2004 (BFIO) was enacted in February 2004. This act unified the previously-fragmented legal basis of the Nepalese banking industry. Prior to passage of BFI, the Nepalese banking industry based its legality on four acts. These included the Agricultural Development Bank Act 1967, the Commercial Bank Act 1974, the Finance Company Act 1985, and the Nepal Industrial Development Corporation Act 1990. The BFIO aims to streamline and tighten the regulatory rules for various financial institutions. Another objective is to improve the supervisory powers of the NRB. Though well intended, the scope and provisions of the law have grave shortcomings and do not provide an appropriate legal framework for the 25 Core Principles of Effective Banking Supervision. The ordinance was developed without meaningful consultation with the banking industry, which has widely criticized the law.

One of the major problems with the BFIO is its licensing regime, which blurs the regulatory demarcation of financial institutions and overburdens the NRB with regulatory duties. The new law maintains the status quo for existing institutions and adds non-deposit-taking entities, moneylenders, leasing companies, and so on, into the regulatory ambit of the NRB. Since there are four different categories of institutions with different financial activities, their importance and impact on the general public, as well as their importance for overall financial banking and payment systems, vary. This situation calls for tiered regulation and supervision, which is absent in the law. Banks, including development banks that do banking business, should be subject to comprehensive supervision and regulation in accordance with international best practices. Less significant financial institutions, however, should be subject to less comprehensive supervision and regulation. Non-deposit taking institutions need not fall within BFIO jurisdiction and institutions that only accept deposits from members ought to be exempt as well.

Gate-keeping provisions in the BFIO are not comprehensive. Their lax "fit and proper" test will give rise to weak bank management. The licensing provisions require academic qualifications for directors and mention the university they have to come from, instead of emphasizing the need for

relevant experience. In addition, there is no "fit and proper" test for shareholders. There are no express provisions on the right of the NRB to obtain relevant information from the home-country supervisor for foreign bank licensing. Finally, there are inadequate provisions on capital, ownership, and prudential requirements. For instance, there is no clear definition of capital, no restrictions on acquisition of material interest in banks, and no specific provisions and related procedures on a number of prudential requirements. Such provisions include, for example, approval of a CEO, credit documentation requirements, risk management, right to set rules on provisioning, and single customer limits. They also address large exposure reporting, investments by banks, and rules on non-financial subsidiaries.

The absence of a "Prompt Corrective Action" as a supervisory tool is another major deficiency of the law. The law does not envisage prompt corrective action as a supervisory tool. Some of the normal prompt corrective actions appear as penalties for infractions of the banking law or regulations.

The law also does not provide for gradual and follow-up action after a supervision or inspection. This is a serious lacuna. There is an obvious need for measures that have an impact on shareholders, on directors and managers, and on banks, such as requiring banks to enhance governance, internal controls, and risk management systems. In addition, the provisions on dealing with bad banks are ineffective and inadequate. The current regime in the draft law provides for punishment of a bad bank when it breaches the law, the takeover of its management by a committee, or liquidation. In this way, the draft law does not invoke internationally accepted and practiced methods. The law repeats section 86 of the NRB Act, which is proving inadequate and exasperating in the case of both Rastriya Banijya Bank and Nepal Bank Limited.

Disclosure and governance requirements are weak. There is no requirement for an audit committee and publication of accounts by banks. Banks are given five months after the close of the financial year and another three months with the approval of the NRB to submit their accounts to it. Accounts need not be published and NRB is not expressly empowered to discuss issues with the external auditor of a bank directly. In addition, the management of banks enjoys immunity for acts done in good faith, a situation which is rather unusual. Insolvency and liquidation provisions in the law will prove problematic and ineffective in maximizing recovery or value for depositors. This is because there is no clear definition of insolvency or deposit in the BFI. Also there is no deposit insurance and the law does not provide a preference for household deposits over all other depositors and creditors.

There is overlap and conflict of jurisdiction between the BFIO and the Companies Act 1997. Sections 3-60 of the BFIO deal essentially with matters contained in the Companies Act, without stating which provisions will prevail in the event of conflict or lacuna. Effectively, the provisions pertaining to the law of companies in the BFIO are redundant and may cause conflicts. Even if these provisions are justified, the new Companies Act, which was pending enactment at the time of this writing, may override similar provisions in BFI. What is needed in the BFIO is to list the specific provisions in the Banking Act on governance, accompanied by a clear provision to give precedence to the Banking law provisions.

The absence of provisions on many key issues renders the draft law inadequate for effective supervision. Examples of these missing stipulations include provisions on immunity for supervisors, anti-money laundering and countering financing of terrorism, integrity requirements, electronic banking, and clear power to issue regulations, among others. In some areas, such as licensing, governance, prudential requirements, and rule-making powers, the new law is a step backward. Lack of express provisions and procedural details will make implementation difficult and inconsistent. In addition, they can render decisions taken under the BFIO vulnerable to legal action. Also, the BFIO ought to lay a foundation for the conduct of electronic banking to avoid the necessity of being

amended in the future, when electronic banking becomes more prevalent. Amending the BFIO to address the above-mentioned deficiencies is an urgent priority.

1.5 IMPROVEMENT IN PRUDENTIAL REGULATIONS FOR BANKS

Notwithstanding the above, the NRB's efforts to improve the prudential requirement for banks are commendable. Since 2002, the NRB has been issuing various prudential regulations in the form of directives to improve the safety, soundness, and efficiency of the financial system. These directives have been drawn up with the help of international consultants and meet international standards. They relate, among other things, to capital adequacy, loan classification and provisioning, credit concentration and single obligor limits, and accounting policies and formats of financial statements. The directives also address management and minimization of risk, good corporate governance, compliance with the directives issued in connection with inspection and supervision, and provisions relating to investment in shares and securities. They consider matters such as reporting requirements, provisions relating to purchase and sale of promoters shares, and other relevant provisions such as branch expansion, profitability, and dividends. Licensing policy for commercial banks, development banks, and finance companies was issued in 2002. New capital requirements for banks and various classes of financial institutions were announced on April 17, 2004.

The supervisory capacity of the NRB is being continuously improved through many initiatives, including the use of international consultants and the training of NRB staff. Since 2002, financial sector technical assistance and the World Bank's Financial Sector Restructuring Project have been providing support to strengthen the implementation of on-site and off-site manuals and procedures. Also strengthened through this project are the effective implementation of supervision reports and the initiation of corrective actions and the capacity building to issue pro-active regulatory measures. The project addresses capacity building with regard to conducting regular study and research on emerging issues in the banking system and the creation of a foundation to implement Basel II by 2007. The NRB has also established a financial legal expert cell, as well as logistic support for the Regulation and Supervision Departments.

Despite all these efforts, the industry is of the view that the NRB lacks professionalism and skills. It is too slow to respond and often acts inconsistently. It lacks predictability and does not consult the industry sufficiently when issuing directives and guidelines. There is also a general view that it is high-handed and not transparent in its dealing with the institutions under its authority. It is necessary for the NRB to change this perception and improve its own stature. While the many efforts underway to improve the legislative framework and regulatory capacity of the NRB will help tremendously, good leadership and an appropriate incentive structure within the NRB are also necessary.

1.6 CREDIT REPORTING SYSTEM

There is no broad law regulating information sharing in Nepal. Until recently, the operations of the Credit Information Bureau were governed entirely by the NRB Directive on Blacklisting and Reporting to Credit Information Bureau, issued in 1989. That situation, however, has proven untenable. Legal challenges arose to the functioning of the Credit Information Bureau and the NRB directive. Problems with poor compliance by participating banks and the lack of enforcement made it clear that the regulatory framework had to be strengthened. This was addressed when the new NRB Act was passed in 2002. Article 88 of the new NRB Act authorizes the NRB to establish the Credit Information Center (CIC). Key provisions of article 88 include obligatory participation by financial institutions in the CIC; a requirement to obtain a credit report before extending a loan; and empowerment of the NRB to have oversight and regulatory authority over the operations of CIC.

Subsequently, the NRB issued a new Directive on Credit Information and Black Listing—pursuant to Article 88 of the NRB Act (2002). The new directive, though viewed by some as draconian, seems to be the only feasible approach to debt collection in Nepal until the banking system is well governed and is in private hands. This is because there is entrenched a default culture in Nepal and because major banks are susceptible to interference. The absence of a bankruptcy threat is also a factor in this regard. A common tactic is for borrowers to use the courts to delay recovery while continuing to borrow. This tactic has further deepened the default culture. Now, the blacklisting of borrowers and companies in which borrowers have 15 percent or more shareholder interest has had success in bringing borrowers back to the table to restructure and start repayment of loans. Nevertheless, blacklisting has its limitations and its effectiveness may not last long. As such, apart from improving the governance of banks and moving the governance away from the public sector, the credit culture needs to be improved. Credit information bureaus can bring about such improvement.

The existing legal framework and administrative structure of the CIC needs to be improved to transform it into an effective credit information bureau. Economic research shows that access to credit improves with the availability of credit information and credit records. This in turn results in better credit decisions and a healthier credit culture. In this regard, credit registries that collect information from a wide number of sources, including bank and non-bank financial institutions as well as firms selling goods on credit, tend to be particularly effective. CIC is currently confined to collecting information from banks and non-banks, is owned and operated by NRB and is only partially computerized. The CIC's capacity has to be improved for it to better play its role in blacklisting and the development of credit culture. Constituting CIC as a corporate body with private sector participation and an appropriate business plan, as well as computerizing and improving its administrative capacity, would go a long way to improve it. Since resources would be an issue, the NRB has to consider bringing in a strategic investor for the CIC, to reduce the financial burden on the NRB and the local banks as well as to increase its overall efficiency.

In order to become an effective credit bureau, CIC also has to make sure that attention is paid to data integrity and data and consumer protection. The ability of a borrower to review his own record, challenge the accuracy of his data, and file a complaint with the appropriate authority is a major self-enforcing mechanism that allows improvements in data quality and facilitates complete reporting by creditors. Currently, there are no legal provisions for the foregoing. Among the absent provisions are: rights to have access to a person's own credit record, procedures for correcting incorrect information, the duty of the credit information center to verify information it collects, and the duty of banks or participating institutions to provide accurate information. Either section 88 of the NRB Act needs to be amended to include these concerns or a new law for the CIC, among other things, should provide for this.

1.7 DEALING WITH NON-PERFORMING ASSETS: THE ASSET MANAGEMENT CORPORATION

A major problem in the banking system is the high level of non-performing loans. These have remained at around 65.9 percent, 6.4 percent, and 7.5 percent in the public, private and foreign banks, respectively. Nepal Bank Limited and Rastriya Banijya Bank constitute 40 percent of the banking industry and most of their loans are irrecoverable. The loans are either unsecured, have no valid documentation, or the borrowers are willful defaulters who have absconded from the country or died without assets. These loans are not written off because there are no write-off guidelines from the NRB. Banks fear being investigated by the Commission for Investigation of Abuse of Authority if they attempt to write off loans. The NRB needs to develop a clear write-off policy for the banks in consultation with the industry. There must also be a tax incentive for banks to write off bad debts, so the NRB has to enter into an appropriate agreement with the tax authorities on the tax deductibility of write-offs. This will help to not only reduce the stock but also the flow of non-performing loans in the banking system.

The government is keen to facilitate cleaning up of the books of Nepal Bank Limited and Rastriya Banijya Bank. To that end it is establishing an Asset Management Corporation (AMC). A draft AMC ordinance is under consideration by the Cabinet. The initial draft law, which was commented upon by the World Bank, had structural, administrative, and legal deficiencies. Generally, international experience shows that the establishment of an AMC entails granting "extraordinary and special powers" to the AMC. It also requires changes to various laws governing the banking sector, regulations on accounting standards, tax legislations, bankruptcy laws, security enforcement guidelines, collateral documentation, and regulations relating to ownership and transfer of title. For example, the Malaysian AMC, Danaharta, can enforce the security interest and take over the secured assets of the borrower without any court intervention. This has facilitated an easy acceptance of restructuring packages proposed by Danaharta. Danaharta has also been permitted to appoint a special administrator to take over a company's management and control. Similarly, the central bank regulations on appropriate levels for nonperforming assets caused lenders in Taiwan to transfer their non-performing assets to various AMCs set up for non-performing asset acquisition.

The success rates of AMCs have been mixed. The legal environment, especially the bankruptcy and foreclosure laws, have particularly affected the level of success achieved under different AMC models. The quality of staffing, availability of resources, and autonomy in the management of an AMC has proven to be key prerequisites for the success of AMCs around the world. This is true of Danaharta in Malaysia, for example. Bankruptcy and foreclosure provisions based on the Westminster model, combined with special legal powers available to Danaharta, increased its effectiveness. On the other hand the judiciary has had problems in interpreting laws in Thailand.

Banking industry skills in Nepal are insufficient, in terms of what is needed to successfully restructure the financial sector. This should be considered in reviewing the draft AMC law. It may be advisable to review the current draft to incorporate adequate powers and autonomy, and to provide a clearer mandate to the AMC. Procedural details and the inclusion of objective criteria will help during the inevitable judicial review of the law.

1.8 ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM

Although Nepal has no specific laws to combat money laundering and the financing of terrorism, there are a number of legal provisions scattered in various pieces of legislation that deal with issues related to money laundering. The laws include, for example: The Foreign Exchange (Regulation) Act, 1962; Narcotic Drugs (Control) Act, 1976; Trafficking in Persons (Control) Act, 1987; Commission for the Investigation of Abuse of Authority Act, 1991; Prevention of Corruption Act, 2002; Nepal Rastra Bank Act, 2002; Terrorism Control Act, 2002; and the Bank and Financial Institution Ordinance, 2004. Nepal is a founding member of the Asia Pacific Group on Combating Money Laundering. It is party to the UN Protocol of 1972 and the UN Convention against Illicit Trafficking of Narcotic Drugs and Psychotropic Substances (1988). It is also is a party to the South Asian Association for Regional Cooperation Convention on Narcotic Drugs and Psychotropic Substances, 1990. It became a member of the Asia Pacific Group of Money Laundering in March 2002.

Nepal, which is committed to combating money laundering and anti-terrorism financing, is in the process of drafting a new law based on the forty plus eight recommendations of the Financial Action Task Force. The NRB has also issued directives on suspicious transactions in relation to deposits and remittances under the BFIO. It has taken steps to increase awareness of anti-money laundering and of countering financing of terrorism. These steps include training NRC officers and officers from the Nepalese Police, the Commission on Investigation for Abuse of Authority, and the Revenue Investigation Department. NRB ought to tap the training resources of foreign bank branches in the region to train Nepal's banking industry and also those involved in the implementation of the new

rules. The authorities also need to garner sufficient resources to implement the new anti-money laundering and countering financing of terrorism law, once it is passed.

1.9 PAYMENT INSTRUMENTS AND SYSTEMS

In Nepal the payment system and its legal framework are rudimentary. The ADB is currently in the process of assisting Nepal on this front. The ADB's assistance includes the automation of NRB's clearing house.[8] The team conducting the World Bank's legal and judicial environment review was informed that consultation on the objective, scope, financing plan, and implementation arrangements for the ADB's NPS Project have been carried out in consultation with Nepalese authorities, the banking industry, utilities, and representatives of the business community. It is however unclear when the actual implementation will take place. There is a need to ensure that the legal rules on finality of payment and avoidance of zero hour rules are established. This will avoid interruptions to the payment system when a bank or participant becomes bankrupt.

Compounding the problem, the law dealing with Checks and Bills of Exchange has not been implemented fully. The Negotiable Instrument Act 2034 (1977) came into effect only in 1982 and is seldom used. The act, among other things, defines a bill of exchange and checks and sets out the responsibilities of a banker in accepting checks. Section 107A of the act deals with bad checks, for which the drawer faces fines up to Rs.3,000, imprisonment of three months, or both. In addition, the drawer is liable to pay the amount of the check to the drawee along with interest. Since the act is not fully implemented, bad checks currently go unsanctioned and unpunished. This has discouraged the use of checks, people generally preferring to use cash in their dealings. In this regard, the Credit Information Center ought to keep records and require banks to impose sanctions on customers who issue bad checks repeatedly. This would encourage a better check culture.

The National Debt Act 2059 (2002) governs government debt activities. It authorizes the government to raise loans by issuing various instruments such as bonds, stocks, promissory notes, bearer bonds, and price bonds. The NRB is authorized to manage all government debt instruments on behalf of His Majesty's government. The NRB is authorized to organize the primary and secondary markets for bonds, which are to be regulated through rules prescribed by the government. No rules have been prescribed so far and there is currently no secondary market for government bonds. The NRB has issued licenses to a few finance companies to enable them to purchase bonds at face value but the procedure for transfer requires written application to the NRB. Prescribing rules for secondary trading is going to be necessary. When Nepal moves ahead with automation, dematerialized trading of government debt will require an amendment to the National Debt Act, since the law envisages paper securities and requires manual execution and redemption.

[8] On December 14, 2000, the ADB approved the Corporate and Financial Governance (CFG) Project Loan 1811-NEP and TA Cluster 3580-NEP. One of the technical clusters, for US$400,000, supports the development of Nepal's payment system.

RECOMMENDATION

- Consider adopting a system that incorporates sufficient checks and balances when laws are made and provides for an appropriate consultation process.
- Amend the BFIO to provide clearer delineation between banks and non-banks; remove overlap between the Companies Act and the BFIO; create an appropriate framework for the implementation of the 25 Core principles for Effective Supervision; and ensure that there are sufficient transitional arrangements.
- Amend Section 88 of the NRB Act to incorporate the CIC as a company, expand its ownership and participation, provide for customer and data protection and improve its efficiency.
- Issue a NPL write-off policy and establish a memorandum of understanding with the tax authority on tax deductibility of write-offs.
- Enforce the Bills of Exchange Act to improve credibility of check use.
- Pass and implement the AML/CFT law and provide sufficient training to the banking industry and implementing agencies.
- Amend the draft AMC law to provide, among other things, clear objective and adequate powers to the AMC.

2 the Insolvency and CreditorS' Rights Systems

Nepal does not have a law providing for the creation, recognition, and enforcement of security interests in movable property. There is also no legal concept of fixed or floating charge. Priority of interest in land mortgage is determined by the date of registration of the mortgage. The Muluki Ain provides for the compulsory registration of mortgages. The registration recognizes the charge and determines priority by date in case of multiple registrations. Hence, it is not surprising that real estate is preferred as a security over movable property. Movable property is not preferred because there is no law providing for registration of charges and rules on priority of charges. This results in frequent litigation. Since the situation could be easily addressed with an appropriate law, the current move to introduce the Secured Transactions Ordinance is most welcome.

2.1 CREDITORS' RIGHTS AND ENFORCEMENT PROCEDURES

Though the registration procedure for mortgage deeds is simple and cost-effective, the land registry functions manually and lacks the institutional capacity to discharge its functions efficiently. It suffers from infrastructural and administrative constraints. The registry is not computerized and does not collect and disseminate information on mortgages satisfactorily. The inspection process is disorganized; obtaining certified copies is cumbersome and time consuming. The records are not protected against natural calamities and other hazards. Registration of a deed could take a few hours or it could take a day or more, depending on the deed-holder's relationship with the staff at the registry. Since most of the lending is based on landed securities, it is essential for Nepal to improve the administrative and infrastructural aspects of the land registry.

The Secured Transaction Ordinance 2060 (STO), which is under consideration by the Cabinet, deals with the creation of a security interest in moveable assets and its enforcement. It also provides for the creation of an electronic registry. It supports the right of a security holder to take possession or control of collateral and enforce a security interest without court orders. Since there is inadequate capacity to implement the STO at the moment, necessary measures must be taken to ensure that there are sufficient resources, including human resources and related capacity, to implement this law effectively. In the long run, Nepal needs to consider having a single law with a single registry for the creation, recording, and registration of all kinds of security interests, including land mortgages. The STO, if well implemented, would increase the use of movable property as security and increase access to finance generally.

Although the BFIO 2004 and the Debt Recovery Act 2003 have improved the security enforcement mechanism substantially, there are still problems in debt recovery. The BFIO facilitates enforcement of secured claims without the intervention of a court. Typically, a bank can auction off the mortgaged property when a borrower fails to pay and after the bank has served due notices. Though it sounds relatively easy, in reality the enforcement process is not so simple. The process of auction is frequently stalled due to injunctions and writ petitions against the sale of property. This renders the law unpredictable. While the law empowers the bank to enforce the security, it does not stipulate the procedures and process to be followed by the banks. Also there is no consistent approach among different courts of appeal, or even among the judges of the Supreme Court, on the matter of granting a stay against the security enforcement process. The BFIO needs to be amended to exclude the jurisdiction of civil courts. This will help address the problem of stay orders. (See box 2.1).

Box 2.1 Enforcement of security and debt recovery

The security enforcement mechanism remains unpredictable and inefficient in spite of the self-help remedy provided to the banks and financial institutions under the BFIO 2003. The process suffers from frequent interference and stays of action by courts. Erring debtors exploit lack of co-ordination among courts and judges, inconsistency in decisions, and failures by lower courts to follow the pronouncements of superior courts, for the purpose of obtaining a stay against creditor action. The debtors have been known to seek court intervention on basis of legal issues already settled favorably to creditors by the Supreme Court in other cases.

A classic example is the stay obtained recently by Mt. Everest Brewery Private Limited from the Kathmandu District Court against a consortium of banks without granting opportunity of hearing to the banks. The company challenged a bank action alleging a dispute over debt due and the valuation on which the bank transferred the assets to itself pursuant to an unsuccessful auction. The District Court stayed creditor action in spite of the Supreme Court decision rejecting similar pleas in *Dal Bahadur Budhmagar vs. Nepal Bank Limited* [Nepal Kanoon Patrika, 2048 page 508]. That ruling held that the bank dues could not be disputed and decided by a civil court in such proceedings. *Sher Bahadur Gurung vs. Nepal Bank Ltd.* [Nepal Kanoon Patrika, 2042 page 76] also holds that the valuation of the security determined through the bidding process in public auction cannot challenged in the court. (Sometimes, the lawyers representing parties do not bring the earlier decisions to the court's attention). Once granted, it is difficult to get the stay vacated by the court, since the courts easily adjourn hearings. Able lawyers deploy skills to prolong the proceedings by manipulating the weaknesses in the legal system, frustrating the sale of assets and in turn the recovery.

To an extent, court interference is also attributable to lack of transparent and clear procedures for enforcement. The BFIO grants power to banks to dispose of secured assets "by auction or otherwise" but no effective road map, procedure, or guidelines have evolved to make the process clear, efficient, and accountable. There are no appropriate guidelines on valuation of the asset for sale or transfer to the bank in case of an unsuccessful auction. No time frame or procedure is provided for the bank to dispose of the acquired assets.

Frequent stays and long drawn out litigation are creating a major stumbling block for creditors in exercising their rights to deal with defaulting debtors and non-performing loans. There is an urgent need to streamline the enforcement procedure by plugging the gaps in BFIO and amending it to make it efficient. Specific provisions should be introduced in this law to minimize court interference and to provide clear grounds for the granting of stays by the courts against enforcement actions. The law should specify the time period during which the creditor can operate under a stay granted without hearing and should clarify the grounds for judicial review of enforcement actions.

There are other critical weaknesses in the BFIO that need to be addressed to make the law more effective. One example of this is the valuation of property. In the event no one offers a bid for assets in an auction, the BFIO makes it obligatory for the banks or financial institutions to transfer the ownership of the asset to themselves. A directive issued by Nepal Rastra Bank requires the creditors to value the assets at the price equal to the total outstanding due, including the principal and interest. This is an unrealistic legal requirement as the market reality and the actual value of an asset may not match the amount outstanding. The banks must be given the right to dispose of the property at prevailing market prices and have the ability to sue the borrowers for the remaining debt, if the value of property is less than the amount due.

It is noteworthy that the government is in the process of amending the legislation to clearly specify the grounds on which a challenge can be made in court to a bank action. This would help to rationalize court intervention and confine it to proper grounds. Despite the weaknesses in the law, the general view of the industry is that the courts have become more sensitized to their role in debt recovery as a result of the law. There has also been a reduction in the number of *ex parte* stay orders granted in 2004, compared with 2003. Increased training and specialization of judges would go a long way to improve the debt recovery process in Nepal.

The Debt Recovery Act was set up to expedite recovery of debt by the Debt Recovery Tribunal (DRT). The DRT started operation in October 2003, with one court, together with an appellate court and the hope of expediting the debt recovery process. Loans below 0.5 million rupees fall under the jurisdiction of district courts. A total of 131 cases have been filed to date. Five cases were settled amicably and 43 judgments have been handed down. However, only one case has been fully enforced as of end of 2004. (See Annex 2 for more details). As such, except for the Darbar Hotel Pvt. Ltd. case, no lender bank has yet realized any money out of a judgment of the DRT. While the summary process is a marked improvement over the conventional courts and is helping to dispose of cases in a speedy manner, the enforcement of judgment is still a serious problem. This is particularly so since there is no collateral and a lack of assistance from the police. In addition, the procedures for the service of summons and judgments by the DRT, instead of by the party seeking relief (a legacy of the conventional judicial system), are not helping to expedite cases.

Though the Debt Recovery Act provides for summary procedure and is a big step forward in debt recovery, the law suffers from serious deficiencies. For instance, the DRT cannot entertain claims by debtors who are free to approach a district court for any claim of money or damages against creditors. This has resulted in *ex parte* stays being granted on proceedings and judgments issued by DRT. Another example of the act's deficiencies is that the DRT's awards of are not self-executing. They follow the same lengthy processes conventional courts use in all other matters, despite the summary procedure. A judgment is not enforced immediately upon award. The law permits the losing party to appeal within 35 days and judgment is stayed until the Appellate Tribunal decides on the appeal. Also, a bank has to file a separate application with the DRT to implement the DRT's judgment.

Appeals should not stay enforcement of judgment except in cases where the appellant deposits 50 percent or 75 percent of the judgment in court. Dissipation of property by borrowers is common. Increasing the penalty on borrowers either through hefty fines or imprisonment may help to prevent dissipation of security prior to execution. The DRT needs to be strengthened in the area of execution of judgment as well. Utilizing private parties to execute judgment for a fee may help. The DRT also has to enter into a working arrangement with the police to help in the execution of judgment. The execution officers of the DRT also need to be trained, in addition to being provided sufficient resources to carry out their duties. Amending the law and remedying the foregoing problems will strengthen the DRT and debt collection system of Nepal.

An overall assessment of enforcement of commercial contracts in Nepal supports these findings. The ease or difficulty of enforcing commercial contracts in Nepal is measured in box 2.2, using three indicators—the number of procedures counted from the moment the plaintiff files a lawsuit until actual payment, the associated time, and the cost (in court and attorney fees), expressed as a percentage of debt value. In Nepal, the cost of enforcing contracts is 25.8, compared with the regional average of 38.4 and OECD average of 10.8. Though Nepal rates better than the region as a whole, it has to improve its contract enforcement mechanisms.

Box 2.2 Enforcing contracts (2004)			
Indicator	Nepal	Regional average	OECD average
Number of procedures	28	29	19
Time (days)	350	349	229
Cost (percent of debt)	25.8	38.4	10.8

World Bank, *Doing Business 2005*, http://rru.worldbank.org/DoingBusiness/

2.2 LEGAL AND INSTITUTIONAL FRAMEWORK FOR CORPORATE INSOLVENCY

The matters dealing with liquidation of companies with limited liability is governed by the Companies Act 2053 (1997). This law does not satisfy the minimum requirements of a sound insolvency system. There is no law of rehabilitation. In addition, the provisions relating to liquidation of companies do not comply with the key objectives and policies of a legal framework for corporate insolvency. The law has no synergy with the other laws that establish rights for enforcement of security interests and recovery of dues. Liquidation is a long, drawn-out process, which is highly inefficient, ambiguous, uncertain, and disorganized. Finally, courts do not have any role in the liquidation process.

About 170 companies are reported to have been liquidated by the Company Registrar's Office (CRO), although most of these cases were voluntary liquidations. Stakeholders do not own the liquidation process and prefer to stand aside. The liquidation process set forth in the law does not protect the interests of creditors, who prefer to enforce security interests through the self-help mechanisms. The liquidation process also does not define the claim. No appropriate provisions for determination of priorities exist, although similarly situated foreign and domestic creditors are treated at par. The law does not establish a framework for cross-border insolvencies, with recognition of foreign proceedings. There is no law to recognize foreign judgments and orders.

The CRO supervises liquidations. It is unequipped and not competent enough to discharge this function and provide timely, efficient, and impartial resolution of insolvencies. It lacks a specific working manual for its staff. All records except the records of company names are kept manually. There is frequent turnover in the position of the company registrar, which poses a serious problem. During a period of 18 months, for example, three registrars were appointed and transferred. The CRO's roles in the administration and enforcement of company law are also not free from the general public's complaints. A common complaint is corruption at the lower operational levels.

Box 2.3 summarizes the time and cost required to close a business or resolve bankruptcies in Nepal. Costs in the indicator include court costs as well as fees for insolvency practitioners, lawyers, accountants, and so on. The recovery rate measures the efficiency of foreclosure or bankruptcy procedures, expressed in terms of how many cents on the dollar claimants recover from the insolvent firm. The recovery rate in Nepal is 25.8, compared with the regional average of 21.4 and OECD average of 72.1. Nepal fairs better when compared to other countries in the region simply because of the low average of the region as a whole.

Box 2.3 Closing a business (2004)			
Indicator	Nepal	Regional average	OECD average
Time (years)	5.0	5.2	1.7
Cost (percent of estate)	8	8.3	6.8
Recovery rate (cents on the dollar)	25.8	21.4	72.1

World Bank, *Doing Business 2005*, http://rru.worldbank.org/DoingBusiness/

There is a pressing need to provide an effective and efficient insolvency regime in Nepal. The Ministry of Finance with the Asian Development Bank's technical assistance sponsored a draft Insolvency Ordinance 2003. The ordinance was sent to the Palace for royal assent, but was returned without approval. As a result, it is uncertain that the ordinance will pass in its currently proposed form. The proposed Insolvency Ordinance provides for the liquidation and restructuring of companies. It covers companies with limited liability, banks, financial companies (with prior approval of the NRB) and insurance companies (with prior approval of Beema Samiti—the regulatory authority for insurance companies). The Insolvency Ordinance, if enacted in its present form, would create a satisfactory initial framework for corporate insolvency although a review of the law is required to make it compliant with the insolvency principles developed by the World Bank and IMF. Steps need to be taken also to develop sufficient skills for individuals involved in the insolvency practice in Nepal, as governed by the ordinance.

2.3 INFORMAL WORKOUT MECHANISMS

There is no legislation or established framework providing for an informal out-of-court restructuring. There are no procedures, guidelines, or standards dealing with corporate financial difficulty in instances of multiple financing. The directives of the NRB are general and do not set forth a policy approach on informal workout. The banks adopt the extreme action of recovery by the enforcement of security without exploring alternative possibilities or attempting a revival of potentially-failing businesses. If a borrower requests relief, a bank may grant any one or more concessions. The possible concessions include a simple moratorium for a set period, re-scheduling of installments, equity reconstruction of the company; and/or conversion of the loan into shares. The process becomes complex and time consuming in the case of multiple lenders. There is a need to fill the vacuum in this vital area by framing an appropriate corporate debt-restructuring program such as the Corporate Debt Restructuring Scheme of the Reserve Bank of India or the Malaysian Corporate and Debt Restructuring Committee programs. The NRB is best suited to take the lead in this matter. Instead of in-house professionals at the NRB, Nepal might do well to develop a private profession that could be self-regulated, with government oversight, to complement the out-of-court settlement mechanisms.

2.4 CREDIT RISK MANAGEMENT SYSTEMS

Nepal currently does not have effective tools and techniques for credit risk management and credit information collecting, collating, and sharing. The banks do not employ effective and efficient internal procedures for managing credit defaults, recovery, and resolution. Though the NRB has issued various directives—on capital adequacy, prudential norms, provisioning requirements and risk management methods—banks do not comply with them strictly. Nor does the NRB have the capacity to effectively supervise the observance and implementation of these directives. The banks do not possess adequate skills to evaluate borrowers' loan requests and to assess the collateral requirements to cover risk.

The Credit Information Bureau of Nepal, which Nepalese banks promoted, is used primarily to ascertain the blacklisting status of potential borrowers. The blacklisting of defaulters is considered too harsh a measure, though some banks argue in favor of it. At the same time, in the absence of the mapping of group companies, the blacklisting process remains vulnerable and can be easily circumvented. Nepal does not have sophisticated methods for tracking and monitoring default levels. Nor does it have methods for tracking data and statistics, or for collecting, compiling, and analyzing credit information. Except in a few cases, banks do not maintain a vigil over the client's businesses or follow the usual techniques of managing risk. Such techniques include monitoring project implementation, containing diversion of funds, advising on cost cutting measures and downsizing workforces, disposing of non-core assets or units, and taking additional collateral to secure repayment in case of difficult times or potential problems.

Banks have well-established legal departments, but the staffs do not possess a strong working knowledge of recovery and resolution techniques. Sufficient attention is not paid to managing credit default and there is a tendency to rush to enforce security. The credit recovery departments, if they exist, do not possess the knowledge and skills required for balancing the need to keeping business alive while ensuring timely and adequate recovery. The Nepal Banker's Association lacks the capacity to help the NRB in the development and implementation of its policies.

RECOMMENDATION

The following measures are suggested to address the abovementioned issues

- Improve the administrative and infrastructural aspects of the land registry.
- Ensure sufficient budget and institutional capacity to implement the STO.
- Review and amend the proposed Insolvency Ordinance to make it compliant with the Principles and Guidelines for Effective Insolvency and Creditors Right Systems and build the capacity of insolvency professionals and their regulators.
- Create a suitable framework providing for an informal out-of-court process for restructuring companies in financial trouble. The Corporate Debt Restructuring Scheme of the Reserve Bank of India or the Malaysian Corporate and Debt Restructuring Committee can be referred to.
- Amend the provisions of DRT Act to ensure its efficient implementation and address the anomalies and gaps in the law, particularly those relating to service of parties; complete pecuniary jurisdiction; and extend jurisdiction to categories of creditors beyond those provided in section 3, among others.
- Build capacity for credit risk management and credit information sharing and application.

3 The Judicial System

The 1990 Constitution of Nepal provides the framework for the country's courts. It regulates the ordinary, general civil, and criminal judicial systems. It also provides a basis for special courts and tribunals. The Muluki Ain, the National Law Code, contains the provisions for substantive and procedural civil law. The Administration of Justice Act and the Judges Code of Conduct 2055 (1999) regulate the organization of the judiciary and the profession of judges.[9]

There are three tiers of ordinary courts: 75 district courts, 16 courts of appeal and the Supreme Court. The courts are competent for civil and criminal justice cases. The first instance courts have an executive wing for the enforcement of judgments. There are no specialized units in the ordinary courts. Cases are decided by judges, as there is no jury system. There are 242 judges and justices in the ordinary civil and criminal jurisdiction. The Supreme Court has the right to review the constitutionality of legislation passed by Parliament.

Judges are appointed by His Majesty the King of Nepal. The Judicial Council makes recommendations to the King for the appointment and transfer of, disciplinary actions against, and dismissal of judges, as well as any other matter related to the administration of justice. The King has authorized the Chief Justice to appoint judges to the district courts. Judges must have a bachelor of law degree, and a certain number of years of experience in the judicial service—or equivalent experience—to be appointed or promoted. All judges have life tenure. They are entitled to a pension. There is compulsory rotation, in principle every two years. More than one interviewee pointed out that the judicial career should be managed in a transparent, objective manner, and on merit, not just on seniority. The judges' selection and promotion need to be looked into to ascertain what criteria are applied, and if and how these need to be changed.

The Judicial Council and the Judicial Services Commission are presided over by the Chief Justice of the Supreme Court. The Chief Justice is appointed by the King on the recommendation of the Constitutional Council. Over the past ten years, numerous Chief Justices have headed the judiciary, each for a very short period of time. They are generally appointed late in their careers, and the mandatory retirement age is 65 years. If the institution of Chief Justice is to provide the leadership needed to reform the judiciary, this situation needs to change. Best practice in providing leadership in judicial reform varies widely from country to country. In some cases, the Chief Justice or president of the Supreme Court, as the head of the judiciary, leads the reform. In other instances, there is a governing body called by different names, which governs the judiciary and steers the changes.

The large number of courts in Nepal raises certain problems. The large number of small courts results in an inefficient use of funds and resources. It also increases the risk of corruption since there is very little control in small, outlying courts. Finally, it makes professionalizing services difficult.

3.1 SPECIAL TRIBUNALS

Revenue Tribunal: The four revenue tribunals review decisions by the tax office concerning income tax, value-added tax, and decisions by the customs office. Tribunal decisions can be appealed, after approval of a request for appeal to the Supreme Court. The tribunals have three deciding members.

[9] General information on the judiciary is derived from Web site of the Supreme Court of Nepal, http://www.supremecourt.gov.np/

The caseload is 500-600 pending cases, most of them in the Kathmandu tribunal. Income tax cases constitute the large majority of these cases. Delays are sometimes four years or more.

Debt Recovery Tribunal: Since July 2003, some cases regarding bank loans have been handled by a Debt Recovery Tribunal. Cases are initiated by a petition filed by a bank or other financial institution. There is an appellate tribunal that reviews tribunal decisions. The tribunal has an executive wing, the Debt Recovery Officer. The Debt Recovery Tribunal has a law member who is also the chair, a banking member, and an accounts member. The members are appointed by the government. Their tenure is five years in length and is renewable. The tribunal intends to proclaim its decisions within 150 days of the note of defense. The members of the tribunal earn a salary amounting to that of a district court judge plus 60 percent. The tribunal's Web site, www.drtribunal.gov.np offers information in Nepali as well as in English about its work, including case descriptions and statistics.

Tribunal for Corruption: The Special Court for Corruption and Drug Trafficking Cases handles a variety of cases, including those resulting from investigations by the Commission on the Investigation of Abuse of Authority. Some 190 of its 212 cases resulted from CIAA investigations. Most have been cases of unexplained property and false certificates and diplomas. Cases are judged by a three-judge chamber. A single judge can take a statement from a witness. Summoning defendants can also be done by publication in the press, on shorter notice than is the case in the ordinary courts. The tribunal can warrant police and order witnesses to appear. The tribunal also has the power to employ experts. It can also order the CIAA to produce evidence or conduct investigations. The tribunal has the power to confiscate passports. Ordinary courts have most of these powers as well, but they are less effective since procedures are said to take much longer in the ordinary courts. A reason given for instituting the Tribunal for Corruption was the long delay—up to ten years— in enforcing ordinary court decisions.

Commercial Court: A specialized commercial bench is under discussion. It would meet the very real need for competent, professional handling of commercial disputes. The bench is mentioned in some pending legislation for the financial and private sectors. It is not clear whether this bench will be part of the ordinary judiciary, and if so, how. One option mentioned was to create a specialized section in the Court of Appeal. This preference was motivated by the economic impact of the decisions to be taken by the commercial bench. A commercial bench at the appellate court level will either create a two-tier jurisdiction, depriving the parties in commercial cases of a second instance of decision on the facts, or it would add to the burden of the Supreme Court as an appellate instance.

Instituting specialized tribunals will not solve the problems of delay and lack of expertise in the courts. Special courts, separate from the regular judicial system, are at best a short-term, quick-fix solution to expertise and management problems. It is unlikely they can provide real, sustainable solutions. Appointed by the government, and for a fixed term, tribunal members are not independent. Judicial reform experience has shown that special tribunals risk becoming a tool of special-interest groups. In Nepal, the ordinary courts handle more than 130,000 cases per year; the specialized courts put together handle less than 1,000 cases, so they do not significantly contribute to reducing the backlog. The special tribunals themselves are not immune to the risk of backlog. Experience shows that it takes some years before backlogs start to build up, so for now they would not be evident in the new specialized courts. Backlogs in the revenue tribunal of Katmandu, for example, which has existed for a number of years, are substantial.

In the long run, the need for competent efficient justice can only be fulfilled by improving the performance of the ordinary courts. Case management and management of the ordinary courts need to be improved. Responsibility for that lies with the judiciary itself. The Nepali judiciary is an independent state organ. That means that it is responsible for improving case and court management.

Improving the governance structure of the judicial organization as a whole will help the judiciary carry out this task. Judicial independence is also the reason why most of the recommendations in this report are addressed directly to the judiciary. The judiciary is aware of the need for improvement and has already begun the process of reform.

3.2 PAST, PRESENT AND PLANNED REFORMS

Since 1990, Nepal has been a constitutional monarchy with a parliamentary form of government and a legal system based on Hindu legal concepts and English common law. Under this constitution, the judiciary is an independent organ. Since the 1950s, there have been judicial reform efforts. Reform recommendations have been made in the Court Management Committee Report of 1998 and the Court Strengthening Recommendation Report of 2001. Presently, several important reforms are in progress, supported by a number of donors. Four model courts pilot alternative approaches to case and court management. A National Judicial Academy is being set up with support from the Asian Development Bank. The basic structure of the academy should be put in place in 2005. In addition, the National Code is being rewritten with support of the United Nations Development Programme. This will produce a draft civil procedural code in the very near future.

The Nepali Judiciary developed a five-year Strategic Plan with assistance from the Danish International Development Agency. The plan, a great step forward, emphasizes infrastructures and facilities. It identifies 17 areas of strategic intervention. If implemented as planned and well, it will address most of the issues raised in this chapter of the World Bank review. (Details of the plan are attached in Annex 3.) However, the plan itself does not indicate concrete steps that can be taken to solve the problems faced by the judiciary. Priority focus should be on the core business of case handling, as is explained below. Additional analytical work will be needed to provide a basis for prioritization of reform. The new analyses can look into subjects not covered in any detail in this review or the strategic plan, such as legal training, the role of the Bar and alternative dispute. In addition, it can provide more in depth analysis of the legal and judicial framework.

If the aims of the present strategic plan are to be fulfilled, ownership of reform and continuity of its leadership must be safeguarded. Support will be needed for implementation of the plan. Carrying out strategic judicial reform requires commitment, primarily on the part of the judiciary itself, but also by the Minister of Justice and everyone else involved, over a long period of time. Reformers, therefore, need to address the problem of high turnover in key judicial positions. A Chief Justice with a tenure of less than a year on average, as is currently the case, can not fulfill the leadership role required. If the changes involve a reform of the governance structure as recommended, setting up a special steering body is advisable. Success in reform will also require a management structure that ensures equitable distribution of funds to all courts.

3.3 LEGAL AND JUDICIAL TRAINING

There is a need for judges and units with specific expertise in commercial and financial matters. The formal legal training for lawyers in Nepal, including judges, needs to be professionalized. Current training is limited to the theoretical teaching of contract law and similar subjects. As far as could be ascertained during this review, training for the judges also ends there: there is no training specifically for those who will become a judge or for sitting judges. The National Judicial Academy is being set up with funding from the ADB, but it urgently needs structural funding. The academy is governed by the judiciary itself. The chief educator has been appointed, but the rest of the staff is still on secondment as of January 2005. If knowledge in the judiciary is to be kept up-to-date, the academy must provide state-of-the-art training, not fulfilled by the expertise currently available in the ordinary courts.

Training for judges and judicial officers dealing with commercial disputes needs to be introduced. The judicial academy is undertaking a number of activities in this area, including two commercial law orientation programs (each a week in length) and four additional seminars, on secured transactions registry and other commercial and banking matters (each two to four hours in length). Another four seminars are planned in the next few months. The academy has also developed a more advanced two-week commercial law program, to be held some time in the first half of 2005. The National Judicial Academy's activities—mainly focused on developing a basic curriculum—are presently funded by a variety of donor agencies, notably the Asian Development Bank and the U.S. Agency for International Development (USAID). Since laws change and systems become obsolete or are improved, there is a constant need to acquire new knowledge. Permanent education is essential for a good quality judiciary. Initial and permanent training are the essence for a knowledge-based organization such as the judiciary. So funding for the Academy should be provided on a permanent basis. This will also enable comprehensive and up-to-date resource support. Finally, academy library development and some specialist curricula and related source support, as well as staff development, are needed but are not being supported at present.

3.4 CASE MANAGEMENT

Case management is the core business of courts. There is general agreement that timely decisions by the courts best fulfill the task of the judiciary. In Nepal at this time, all judges generally handle any type of case. There are no specialized units in the courts. Either one of two modalities for case handling is common: (i) A case file is allotted to a judge each time judicial activity is required to move the case forward or (ii) one judge or chamber is in charge of a case from beginning to end. Cases are moved or delayed at the request of the parties; judges tend not to go against these requests.

Most cases take several years, and disposal rates are very low. In the first instance, the district courts, cases filed by a party are distributed by lot. They are then handled by a single judge. In the beginning of fiscal 2001-02 the district courts had 57,666 registered civil cases (out of a total of 132,216 cases for the judiciary as a whole). In that year, 35,805 civil cases or about 73 percent were disposed, leaving arrears of 21,861 civil cases. There were 131 judges in the district courts in fiscal 2001-02. Each judge disposed 273 cases per year on average. In the appeals courts, cases are distributed by the chief judge and handled by a two judge divisional bench. At the beginning of fiscal year 2001-02, the appeals courts had 28,335 cases and writs registered. They disposed 17,007 cases or 60 percent, and were left with 11,328 cases in arrears. The appeals courts had 89 judges in fiscal 2001-02, so cases disposed per judge averaged 191. The Supreme Court, with 16 justices, had 24,216 cases registered at the beginning of fiscal 2001-2002 7,542 or 31 percent were disposed, leaving arrears of 16,674. Cases disposed per judge averaged 471.

As the above discussion indicates, disposal rates vary from 31 percent in the Supreme Court to 70 percent in the district courts. The average for all countries in the World Bank Legal and Judicial Reform Indicators Database is 83 percent. Case handling is balanced when the disposal rate averages 100%. The major difficulty in case disposal mentioned most often to World Bank in the interviews is that notices have to be formally served by court staff to the various parties, parties who are sometimes hard to find. There appears to be very little, if any, use of injunction procedures, summary proceedings, or other forms of short term or fast-track court proceedings. Enforcement of judicial decisions is done by the enforcement department of the court at the request of a party. If enforcement is needed, it may take an estimated two years from the time of request. The appeal rate is over 60 percent. All told, that means that the majority of cases take at least six years from start to enforcement.

If delays are to be reduced, management of civil cases should be made a primary concern in the judiciary's strategic plan. The present clearance rates are very low to extremely low. The number of

cases per judge is highest in the Supreme Court, which is very unusual. It can be explained, at least in part, by the fact that the Supreme Court is the court of first instance for some case categories, and the appeals courts for others. It is also possible that the Supreme Court is addressed regarding problems that might otherwise be the realm of the legislature or the executive. Neither of these state powers has been fully operational lately. Case handling is a very complex matter, with a large number of factors influencing the results and the duration of court procedures. Whether methods of case handling are efficient and effective depends on factors like the number of cases per court, the nature of the dispute, the proportion of uncontested claims, the parties who do not have a lawyer representing them, the quality of lawyers, and the number of judges, court staff and other resources available to the court.

There are numerous lessons to be learned from successful judicial reform around the world. Seven examples are highlighted here.

- Courts are well served by having specialized units for civil cases. The only exception to this rule is very small courts, with only one judge and a few support staff.
- A fast track for summary proceedings is indispensable. It is common practice in most civil law jurisdictions. A number of common law jurisdictions, such as Hong Kong and Singapore, have recently introduced fast track under the influence of the Woolf Commission proposals for civil procedural reform in the United Kingdom.
- An active, preferably proactive attitude on the part of the judges with regard to granting or refusing delays helps to speed cases up. Systematically granting parties' wishes for deference favors defending parties over claimants, whose claims are normally well-founded
- Privatizing notice-serving in civil cases, frequently mentioned in the World Bank interviews, will remove the burden of serving the notices from the already-overburdened court support staff.
- Oral proceedings tend to shorten delays.
- In some instances, delays are reduced when lengthy oral proceedings are replaced with limited exchanges in writing.
- Available statistics are an effective tool to improve performance.

3.5 COURT MANAGEMENT

The primary purpose of court management is to ensure effective, efficient case handling by the court. In all Nepali courts, the officer responsible for court administration is the registrar. The registrars report to the registrar of the Supreme Court. The registrar of the Supreme Court prepares a proposal for the budget of the judiciary as a whole, based on the number of judges, the number of cases, and the special requirements of the courts. This proposal for the budget for the judiciary is then transmitted to the Ministry of Finance by the Supreme Court. The courts each have their own allocation in the budget, which cannot be amended.

If courts are to be run as professional organizations, then library, documentation, and archiving facilities must be brought up-to-date. In the courts the World Bank team visited, no properly-maintained law libraries with up-to-date texts of the law, reference books, or collections of judicial decisions were found. The team was informed that the statutes, published in the Nepal Gazette, and the Supreme Court decisions published in the Nepal Law Reports with summaries in the Supreme Court Bulletin, are sent to all the courts, judges, and second class officers. Legal information sent to the courts is not going to serve its purpose if it is not accessible to the users in the courts. Thus, judges are unable to take recent Supreme Court decisions, legal provisions, or other developments in the legal field into account when deciding cases brought before them. The judges have no

workplaces other than the courtrooms. Archiving of case files is done in large plastic bags. It appears unlikely that case files or documents are accessible or safe when archived in this way.

Computerization is very unevenly distributed over the courts. According to the data in the strategic plan, two out of the 75 district courts have one computer each; none has a fax or a photocopy machine. Four of the 16 appeals courts have one computer each, all appeals courts have a photocopy machine and three have a fax. In the Supreme Court, by contrast, there are 56 computers, five photocopy machines and four faxes. The courts keep their statistics on blackboards in the judges' common rooms. The Supreme Court produces an annual report that includes fairly detailed statistics on all the courts. The strategic plan contains no program for computerization. There was no concrete vision of what computerization might achieve for the courts. Computerization will be viable only after the judiciary develops a vision and a plan for it.

Judging from the number of computers and their distribution throughout the judiciary, it looks as if a disproportionate amount of funding stays in the Supreme Court, even taking into account the equally disproportionate caseload of the Supreme Court. This highlights a conflict of interest in the governance structure of the Nepali judiciary. As indicated above, the budget for the judiciary is proposed to the Ministry of Finance by the registrar of the Supreme Court. In theory, the registrar assesses the courts' budgetary needs on the basis of the number of judges, the caseload, and other related requirements. The Supreme Court, however, besides managing the overall judiciary budget, has its own interest in funding for its own offices. The budget management structure of the judiciary needs to be revised, therefore, in order to ensure equitable distribution of funds.

Moreover, there is a concentration of substantive and administrative control in the Supreme Court, as its chief leads the Judicial Council, which is in charge of judicial career and discipline, and the Judicial Services Commission. This is a conflict of interest between the pressing needs of the Supreme Court, and the duties of its leadership for the judiciary as a whole. These conflicts need to be avoided. Therefore, the governance structure should be clearly separated from the substantive structure of the courts. It may be best to use a phased approach to address this issue.

3.6 PUBLIC TRUST

Nepali public opinion perceives corruption in the judiciary to be a serious problem. The press in Nepal regularly reports on allegations of corruption. The judiciary considers these press reports to be "not always responsible". In order to assess public opinion directly, Transparency International Nepal conducted a household survey on corruption https://tinepal.org/contents/newsroom/Corruption Experience.pdf. Among those interviewed, 42 percent of court users said they had faced corruption when using the court system. They said that the main instigators were court employees and public prosecutors. The main factors those interviewed believed facilitated corruption were lack of accountability, followed by lack of transparency and monopoly of power. The most common example of corruption was the expectation that the parties themselves would pay court staff to have a case put on, or off, the court agenda.

The strategic plan for the judiciary recognizes that the public considers the judiciary corrupt. The plan also recognizes the judiciary itself will have to deal with this by developing a mechanism to study irregularities and address them promptly. This is a concern in particular for the Judicial Council, which is the body responsible for the discipline of judges. The council can dismiss district or appeals court judges. Supreme Court judges can only be removed by impeachment and a two-thirds majority vote in Parliament. This is not viable at the moment, since there is no parliament. As far as can be ascertained, formal disciplinary measures have never been taken by the Council, although a number of judges have resigned voluntarily after allegations of irregularities were made.

To compound matters, judges are exempt from scrutiny by the Commission on Investigations of Abuse of Authority.

If the Nepali judiciary is to generate public trust, the present exemption from CIAA scrutiny should be removed immediately. The judiciary must build institutional safeguards against partiality as well as corruption. Any internal disciplinary mechanism needs to be thoroughly transparent. Such a mechanism is also a tool to build impartial institutional safeguards in the form of instructions, routines, and other procedures. Professional case and court management will also contribute to reducing opportunities for corruption by both judges and court employees. More short-term recommendations include sustaining the Judicial Council as an anti-corruption agency and empowering it to act against all judges, including the members and chief justice of the Supreme Court. To that end, the Judicial Council Secretariat also needs to be strengthened to cope with anti-corruption issues. The Judicial Council should be able to request that the CIAA investigate any judge. Finally, the council's annual report should be made public.

3.7 ACCESS TO JUSTICE AND THE LEGAL SYSTEM

Access to justice is an issue from a number of perspectives. Even in the courts themselves, information about the law is difficult to find. Court staff needs better access to applicable laws and other documentation, for example, for which the courts should develop a professional library function. The judiciary and the courts must also be physically and financially accessible. The courts should be geographically dispersed, not just concentrated in the capital, so that all citizens can avail themselves of court services. Courts must be managed in such a way that taking a case to court is not unnecessarily cumbersome. Cost should not hinder a citizen's access to legal redress. Since most of the cost in a court case is in legal fees, there should be sufficient possibilities for low-cost or free legal advice and assistance for low-income citizens. Currently, the Bar Association provides legal aid in case of need, funded by a Norwegian donor organization. An assessment that focuses on the justice sector can look into the optimum number of courts, court and legal aid fees, and other aspects of access to justice.

RECOMMENDATION

- Legal and judicial assessment: Carry out a complete assessment of the Nepali judicial system to identify strengths and weaknesses and determine the action plan needed to address the weaknesses.
- Training and knowledge: Establish a permanent facility for initial and permanent training for judges and court staff, proper library facilities, and university legal training programs.
- Case management: Strengthen the courts' capacity for ensuring fair and timely case handling; establish specialized units for fast track and other civil cases.
- Governance and court management: Improve and strengthen governance and court management structures to support effective and efficient case handling.
- Public trust and corruption: Establish effective and transparent structures and procedures for accountably preventing and fighting corruption

4 The Legal Framework for the Capital Market and Non-Bank Financial Sector

The securities markets have not been a significant part of economic development in Nepal. The number of companies listed and the ratio of market capitalization to GNP over the last five years clearly shows that the securities market has not been significantly used as a source of capital by companies in Nepal (table 4.1). The market capitalization of the Nepal Stock Exchange (NEPSE) has never been over 12 percent of GDP. The annual turnover on the NEPSE suffered a sharp decline in 2002-03, even as new issues continued increasing, although at a smaller total value. This is probably attributable to the difficult political situation in Nepal. Although considerable criticism was leveled at the securities markets for failing to de-list companies that were not in compliance with regulatory requirements, 2001-2002 shows a remarkable decrease in listed firms due to declining business and violations of reporting requirements.

Table 4.1 NEPSE: Market Statistics and Performance 1998–2003

Major indicators	1998–99	1999–2000	2000–01	2001–02	2002–03
No. of issues approved	5	9	9	16	17
Amount of issues approved (NR millions)	258	630.31	717.20	1,555.11	854.42
Listed companies	107	110	115	96*	108
Traded companies	69	69	67	69	81
Annual turnover (NR millions)	1,499.98	1,157.03	2,344.16	1,540.63	575.80
Gross domestic product (NR millions)	330,018	36,6251	39,3566	40,4482	428,477
Market capitalization (NR millions)	23,508	43,123.33	40,063.33	34,704	35,240.39
Market capitalization ratio	.07	.12	.10	.09	.08

Source: *Securities Board of Nepal Journal* June 2004. * 25 companies were de-listed in fiscal 2001-02.

4.1 PRIOR REFORMS AND ASSISTANCE FROM INTERNATIONAL DONORS

The World Bank has not provided significant assistance with the development of the capital markets in Nepal. Initial assistance came from the USAID Economic Liberalization Project in 1993. The institutions in the securities markets began their modern development at that time. The Securities Center, which had been set up in 1976 to provide a venue for the trading of securities in corporations, was converted to the Nepal Stock Exchange with the help of USAID, while the Securities Board of Nepal (SEBO) was established to regulate the exchange and public securities market. Notwithstanding the assistance, neither entity has fully developed the necessary legal and resource infrastructure to perform its functions.

In 2002, the Asian Development Bank commenced a significant lending activity, the Corporate and Financial Governance (CFG) Project, for the broad development of all aspects of the securities markets. The CFG Project is funded at $13.3 million, with $7.3 million for three loans and $3.6 million in grants. The remainder is for six technical assistance projects for the purpose of evaluating, advising, and developing the project. A sub-loan for corporate governance and capital markets is geared toward capacity building at SEBO, NEPSE, and the Company Registrar's Office (CRO). Some of the anticipated capacity building will be used to create an electronic trading system for

NEPSE and the technical infrastructure for a central depository to handle the clearing and settlement of securities transactions.

So far, this project has made little progress. It bogged down when the ADB's consultants advised that the legal framework needed to be put in place before other technical assistance could be given. As a result, little has been done other than drafting a new securities ordinance and a companies' ordinance, both of which are yet to be enacted. Importantly, a trust law, which is deemed critical for the development of a central depository, has not progressed far in the drafting process.

The draft securities ordinance and companies' ordinance prepared under the CFG Project would significantly improve the legal regulatory structure for the capital markets in Nepal. The changes in the draft securities and companies' ordinances address many of the weaknesses in the current law. The draft ordinances give SEBO authority over the preparation of a public company's prospectus and leave the regulation of private companies to the CRO. The draft securities ordinance gives SEBO the authority to issue rules and directives. It also allows SEBO to approve NEPSE's bylaws with the overall supervision of the Ministry of Finance. In addition, under the draft securities ordinance SEBO would have greatly-expanded enforcement powers and new statutory definitions for market-based violations such as insider trading and market manipulation. SEBO would also have enhanced authority with regard to fraud, such as misrepresentation, in the offer and sale of securities.

4.2 SECURITIES MARKETS

The capital market currently operates under the Securities Exchange Act 2040 (1993), the Securities Exchange Regulation 2050 (1993), and the Company Act 2053 (1997), which governs a large part of the issuance of securities. SEBO has also issued a number of guidelines and directives regarding the operation of the capital markets. The regulatory framework for the capital markets is limited in scope and does not clearly articulate the division of responsibilities among different supervisory, regulatory, and enforcement authorities.

There is currently significant overlap in the responsibilities of the securities markets' three regulatory institutions—SEBO, NEPSE, and CRO. This results in unclear or duplicate jurisdiction over specific areas in the market. As an example, the CRO approves the prospectus for a public issue of securities and then sends it to SEBO for approval. Only one entity, SEBO, should be involved in the review and approval of a prospectus for a public offering of securities. The Ministry of Finance, to cite another example, issues regulations governing provisions to implement the Securities Act, while SEBO can only issue bylaws and directives regarding the activity of market participants.

SEBO is not given comprehensive investigative powers in the Securities Exchange Act and thus is not able to implement an effective compliance program. SEBO does not have adequate inspection, investigation, or surveillance powers. It does not have the specific authority or procedures to question or obtain documents from persons or entities that are not registered with SEBO or NEPSE. In addition, SEBO does not conduct its own surveillance of trading activity, leaving NEPSE to conduct most surveillance of trading on the exchange.

The definitions of market integrity violations are unclear or inadequate. The provisions in articles 16C and 16D of the Securities Exchange Act related to insider trading and market manipulation do not cover all aspects of violations such as trading for the benefit of people not related to the insider in question. In addition, the market manipulation provisions do not cover persons and entities that are not registered with SEBO. The sanctions for violations of the Securities Exchange Act are weak. SEBO is not given the power to levy penalties or fines against violators, nor to demand the return of profits for market violations such as insider trading. Moreover, SEBO has no power to withdraw the

license of intermediaries or individuals but must request that NEPSE take that action based on SEBO's recommendation.

There is currently no system in place to halt the trading of shares that are being exchanged at abnormal price levels. This capacity is critical to prevent the manipulation of the market. In addition to the weakness of the sanctions, there are no procedures for applying the sanctions that do exist, nor apparently is there a will to do so on the part of SEBO, particularly in the circumstance where issuers do not comply with the requirement to file and publish periodic financial reports with NEPSE. Similarly, the sanction of de-listing a security from NEPSE is highly controversial and not regularly used—its use in 2001-02 has been the exception—due to the perception that de-listing harms the interest of shareholders by rendering their shares illiquid.

The Securities Exchange Regulation does not adequately regulate market intermediaries. It sets out the minimum requirements for registration as an intermediary in various categories, including that of broker, primary dealer (for initial public offerings), and secondary dealers, who are market makers. However, the intermediaries register with NEPSE, based on the requirements in the regulation, not with SEBO. Moreover, it is NEPSE that formally withdraws a license, not SEBO. SEBO as the market regulator, should be the entity that registers market participants and withdraws the registration as needed.

The Securities Exchange Regulation only requires a basic paid-in capital of 10 million rupees (Nrs 15 million for multiple licenses) but does not have ongoing capital and other prudential and organizational requirements that reflect and enable companies to manage the risks that they undertake. Moreover, currently the bankruptcy of an intermediary is handled by standard bankruptcy procedures applicable to all corporations. Adequate procedures should be in place for segregation of client assets so that the clients' assets are not part of their broker's bankruptcy estate.

NEPSE's legal and technical infrastructure is outdated. NEPSE is still owned by the government. The Ministry of Finance owns the majority of shares and chairs the board of directors meetings. NEPSE continues to operate on an open outcry system for trading. The audit trail for transactions is paper-based and not as efficient or transparent as an electronic trading system.

There is no clearing and settlement organization at NEPSE and the regulatory oversight of the payment for transactions is minimal. There is no central depository. Trade settlement is done manually on a cash basis. The seller deposits the shares with NEPSE while the buyer deposits the purchase price. The final settlement is complete with the transfer of money and shares at T+3. If the trade fails, the brokerage house is expected to deliver the securities or cash and if the broker does not, then it is suspended from NEPSE for a period of time. This system seems to work for a small exchange with a limited number of issues, but would be unworkable if the exchange begins to increase its volume of activity.

The issue of accurate financial reporting has not been fully addressed in the draft securities ordinance. This is the most important issue for the market at this moment in time. Without accurate and timely financial information regarding public companies, accurate market analysis and transparent trading cannot take place. The law must clearly set out the obligation for periodic reports. Regulations by SEBO must clarify the contents of the reports. Finally, SEBO must be willing to sanction companies for failure to comply with their reporting obligations.

The legal regime for the securities markets could be improved in additional ways such as the development of an arbitration system for the settlement of investment disputes. Numerous emerging markets have found this to be an efficient and fair way of dealing with contested issues, more so than resorting to the court system.

The existing system of exchanging cash for paper securities is workable in the current environment of low trading volumes, but will be increasingly unwieldy as volume increases, requiring the creation of a central depository. The development of such an institution will require the enactment of a trust law that allows for nominee holdings and custodial obligations and rights. This legal framework is also necessary for the development of collective investments, in order to set up the duties of fiduciaries that handle investors' funds. An automated central depository also runs most efficiently when the securities are dematerialized.

The World Bank team recommends the following measures to address the issues raised here.

- Listing requirements at NEPSE should be enhanced and de-listing should be applied for failure to comply with listing rules. The law should give SEBO the authority to require revised listing rules and their enforcement.
- The bond market is still in an undeveloped state and will need a credit rating system and a rating agency in order for it to get off the ground. The legal framework for this has not yet been put in place.
- SEBO needs to be given full authority over the capital markets, authority it can then delegate with oversight to other institutions such as NEPSE. The confusion in jurisdiction among CRO, NEPSE, and SEBO should be clarified and SEBO should be given full authority over all listed companies. SEBO must also be given full enforcement authority to investigate and prosecution violations of the securities laws.

4.3 CORPORATE GOVERNANCE

Corporations are generally regulated by the Company Act 2053 (1997) and the Securities Exchange Act 2040. Specialized corporations, such as banks, insurance companies, and other financial institutions are also governed by the regulatory laws specific to them. The Companies Registrar's Office has the primary responsibility for regulating the activity of corporations. The CRO receives and approves applications for incorporation by business entities by reviewing their memoranda and articles of association and approving their offering prospectuses. It receives all statutorily-required reporting such as annual reports and financial statements. It also has the authority to conduct investigations into corporate misconduct and actions against shareholder rights, including the right to remove a director from the board of directors. The CRO has the authority to withdraw the license of a corporation for violations of the Company Act 2053 (1997), although in practice it has found this to be very difficult to do.

Notwithstanding its extensive responsibilities which it holds over 36,000 companies, the CRO does not have the capacity in terms of personnel, equipment, or infrastructure to establish and enforce the basic rules of operation and governance for either listed and non-listed corporations in Nepal. It does not have sufficient manpower to properly review all of the annual reports submitted by corporations to determine their compliance with the law. It does not conduct a review of any of the financial statements filed and only does a general review of a corporation's filings if there is a change in capital structure or in purpose and objective of business. It does not have the expertise to review and approve the prospectuses of public companies.

The Company Act does not provide secure methods of ownership and conveyance of shares in corporations. The law provides that the share registry giving evidence of ownership of shares in a company is maintained by the company itself. All transfers of ownership are recorded by the registry. The Company Act allows the company to refuse to transfer shares if it does not receive application documents, the share certificates, and fees. Article 27A of the Securities Exchange Regulation 2050 (1993) also allows the company to refuse to transfer the securities if the number of securities exceeds the amount the purchaser can hold in his own name. (The law is not clear on this,

but presumably this limit is set forth in each company's articles of incorporation). These legal provisions do not allow for an automatic and impartial transfer of ownership for shares traded on the NEPSE. A securities transaction remains in doubt until the final decision is made by the share registry to register the new owners.

The Company Act does not regulate the market for corporate control so that it functions in an efficient and transparent manner. There are no provisions in the Company Act related to tender offers for shares or purchases of shares that give a shareholder a significant or controlling interest in a company. Consequently, there is no way to fairly allocate the sales of shares to such a tender offer or to notify shareholders of the tender offer and the premium that may be attached to their shares. In addition, there is no regulation of anti-takeover defenses in order to minimize their negative effect on shareholder value.

The Company Act and Securities Exchange Act do not establish a regime for full, timely, and accurate disclosure of financial results and other information that is material to investors' decisions, including the financial situation, performance, ownership, and governance of public companies. Under Article 24 of the Securities Exchange Act, each listed company must file its annual report, including financials, with NEPSE within four months of the close of the fiscal year. For 2001-02, only 67 out of 96 listed companies filed their reports and, of those, only five were on time. The result is that investors do not have adequate information upon which to base their decisions. The lack of accurate and timely information regarding companies listed on the exchange has led to a market in which trading is based mainly on rumors and false information.

The required content of the disclosure documents is also inadequate. Article 83(3) (c) of the Company Act allows the directors' discussion in the annual report to place excessive emphasis on projected future earnings rather than on past results. The result has been overly optimistic and inflated descriptions of future corporate activity. The law or interpretive rules should be clearer as to the contents and manner of the presentation of projections of future activity. The legal requirement for the general contents of the director's report, which is to be prepared for the annual meeting, is not comprehensive enough. Such requirements should be left up to the Securities Board so that it can treat matters in detail as needed. SEBO does not have authority to review the periodic reporting of listed companies under Article 24 of the Securities Exchange Regulation. Under the current law, the review of disclosure of listed companies is made by the CRO and NEPSE, but not by the regulator of the markets.

The Company Act and Securities Exchange Act do not provide sufficient guidance regarding the procedure and requirements for preparing and disclosing financial information in accordance with high-quality accounting and auditing standards. There is no requirement that the annual and periodic audits of corporations be performed pursuant to any specific accounting or auditing standard. Consequently, auditors do not have guidance as to what standards to apply and analysts of financial statements can not be sure what standards were used in preparing financial statements of listed or private companies.

The Company Act omits important provisions that protect shareholder rights at the annual and extraordinary general meetings. The law requires that many critical issues, such as capital increases, which will impact on shareholder rights, be decided by a "special resolution", one which requires 75 percent majority approval. Nonetheless, the disposition of a significant asset by the corporation is not covered by this provision, even if the disposition is made to a related party. This is a critical omission since in emerging markets the improper sales of corporate assets has been one of the largest problems in the area of investor protection.

The Company Act allows the annual meeting to be held as late as six months after the end of the fiscal year. As a result, the information regarding the company that will be discussed at the annual meeting becomes stale and loses a great deal of its usefulness. Finally, in 2002-03, only 62 of the 108 listed companies held the annual general meeting required for the period 2001-02. It would appear that the requirement for the holding of a general meeting is honored more in theory than in practice. No apparent attempt was made to sanction companies for not holding their annual general meetings within the prescribed time.

The Company Act provisions regarding ethical standards are not sufficiently comprehensive. There is no code of corporate governance in Nepal that governs the behavior of directors and managers of a company. Importantly, the few provisions that exist in the Company Act do not extend to significant and controlling shareholders. As a result, corporate actions can be taken to the unfair advantage of minority shareholders in favor of majority shareholders.

The Company Act does not require the appointment of independent directors. In practice, most corporations in Nepal are family-owned businesses that have directors who are friends and family members and not objective managers of the company. There is no obligation for the board of directors to exercise objective independent judgment on corporate affairs. Public companies should have boards that are independent and have real authority in the governance of the corporation.

The legal system should be strengthened to allow all shareholders to obtain effective redress for violations of their rights. The Company Act permits shareholder derivative actions and actions directly against the directors if the shareholder instituting the action proves that the director acted deliberately or with bad intent in causing the damages to him or the company. A shareholder can also request that the CRO conduct an investigation of the shareholder's company, an action that could result in instructions to the company to take action to rectify the violation. Moreover, a court has the authority to remove a director and order the disgorgement of benefits obtained by him. It is not clear, though, if these remedies are used by shareholders to defend their rights. For example, the CRO has indicated that it does not have sufficient resources to investigate possible violations of shareholder rights. It also does not appear that a securities bar has developed in the legal profession that would help shareholders pursue such cases.

The World Bank team recommends the following to address issues raised in this discussion.

- The CRO must be enhanced in terms of resources and expertise in order for it to properly carry out its functions. After the initial incorporation phase, its responsibilities should be limited to non-listed companies, while SEBO is assigned responsibility for regulating listed ones.
- The law should require that the registry of a listed corporation be held by an independent registrar who does not evaluate a purchase other than to verify that a transaction has taken place on the NEPSE.
- The law should provide for transparent rules for the acquisition of control positions in a public company.
- The law must be modified to provide for full and complete disclosure of a company's financial and business position. The requirement to file annual reports should include a requirement that SEBO set rules for the management discussion and analysis section of the report.
- The law should require that financial statements be prepared according to specified accounting standards. Full disclosure should cover the remuneration of directors and a report on corporate governance during the past year, based upon a compliance audit.

- SEBO should be given the authority to review periodic reports of listed companies and to sanction listed companies for late, incomplete, or inaccurate financial statements and other required sections of periodic reports.
- The law should require that annual general meetings be held within four months of the end of the fiscal year and that companies be sanctioned by CRO or SEBO, as appropriate, for failure to hold such meetings.
- A code of corporate governance should be passed that covers, among other things, conflicts of interest and related party transactions in detail. The law should be amended to require "supermajority" provisions for the disposition of all major corporate assets.
- In order to have more objective management of the company, the law should require independent board directors of whom at least 50 percent are non-executive directors. The appointment of an independent audit committee for the board should also be required.
- An institute of directors should be established to increase professionalism among corporate directors.
- The judicial system should be given the capacity to properly evaluate shareholder disputes.

4.4 ACCOUNTING AND AUDITING

Auditors are regulated by the Nepal Chartered Accountants Act, 1997, which created the Institute of Chartered Accountants of Nepal (ICAN), the Accounting Standards Board, and the Standards on Auditing Board. The obligation for corporations to have annual financial statements audited is set forth in the Company Act 2053 (1997) and the Securities Exchange Act 2040 (1993). The development of the auditing profession over the last 30 years has been uneven with regard to creating a profession of qualified auditors for public interest entities. A large number of licenses were given to individuals from the Auditor General's Office beginning thirty years ago. At that time, applicants had to meet only minimal requirements to obtain a license. The requirements that did exist related mainly to the education of the auditors. In 1974 the Association of Chartered Accountants was created to provide certification for qualified auditors. In 1997 ICAN was created to provide for the oversight of the auditing profession as a whole.

Nepal has approximately 7,300 licensed auditors. The overwhelming majority are licensed but not qualified auditors, most of whom work in small companies and in the government. These individuals were grandfathered into ICAN without being required to update their qualifications or take new examinations. Of the 7,300 there are approximately 300 qualified auditors who have passed examinations and met other certification requirements. All members of ICAN can give an audit opinion, but the auditors who have not been certified can only audit companies that are below a certain size.

ICAN lacks the resources, experience, and legal authority to adequately regulate the audit profession. It is still grappling with the issuance of basic auditing standards. One of its problems is the lack of a significant permanent staff for drafting standards and for consultation with members of International Federation of Accountants. Another issue is the question of which entity should approve the auditors of public companies. SEBO wants this authority, but currently only ICAN can investigate and sanction auditors for violating the auditing rules. However, while ICAN wants to retain the authority to approve auditors for public companies, it does not have adequate staff and resources to conduct periodic examinations and can only act in specific, isolated cases.

The Chartered Accountants Law provides no resources or funding for the Accounting Standards Board and Auditing Standards Board to conduct their business and promulgate new and revised standards. Under the law, the boards are to be housed in ICAN but no provision was made in the law

for additional facilities, staff, computers and other infrastructural needs. As a result, the promulgation of accounting standards in Nepal has been very slow. The boards need to have their own resources, facilities, and legal framework to function properly. To date the Accounting Standards Board has issued six accounting standards and two exposure drafts. The Auditing Standard Setting Board has issued 12 auditing standards, nine more standards that will be effective in January 2005, and five exposure drafts.

There is no entity in the capital markets charged with the responsibility of regulating and enforcing accounting standards. ICAN has the authority to discipline auditors for failure to meet auditing standards, however it is not charged with enforcing accounting standards. As a result, there is no real impetus for companies to prepare their financial statements in conformity with the standards that have been promulgated. The CRO is obligated to review annual filings by corporations but only to see if they conform to statutory requirements. It does not have the duty to see if the annual financial statements conform to Nepalese accounting standards. Even if the CRO had this duty, it would be unable to fulfill it due to the lack of manpower and expertise. NEPSE also lacks the expertise to evaluate the periodic financial statements that are filed with it. SEBO can not enforce accounting standards because it does not have the legal authority to review financial statements.

The law does not clearly stipulate that an external auditor must be independent of the entity audited. It does not set forth the requirements for such independence. The Company Law does not have a requirement preventing auditors from engaging in non-audit activities for a company for which they are the outside auditor. It does require, however, that external auditors be accountable to the shareholders of a company and contains disqualifications preventing individuals from acting as auditors under certain circumstances. These provisions must be clarified to achieve real independence in the auditing function.

Tax accounting is not sufficiently defined and regularized such that companies can accurately engage in tax planning for their activities. It is also out of line with international best practices in evaluating a business entity's financial performance.

The following measures are recommended to address some of the issues raised above. The law should require that only certified ICAN auditors can audit listed companies.

- ICAN needs to increase its capacity to examine and license auditors and carry out examinations of their work.
- The Accounting Standards Board and Board on Auditing Standards should work as rapidly as possible to complete the issuance of accounting and auditing standards.
- Tax accounting should be brought into line with modern best practices.
- SEBO should be given the responsibility of reviewing and enforcing the application of accounting standards by listed companies.
- The Company Act and Securities Exchange Act must be amended to elaborate the requirements for the independence of a company's external auditor.
- An Accounting and Auditing ROSC should be conducted to determine what improvements need to be made to the accounting and auditing environment in Nepal.

4.5 NON-BANK FINANCIAL INSTITUTIONS: COLLECTIVE INVESTMENTS

There is no regulatory structure set out in the Securities Exchange Act 2040 (1993) or the Securities Exchange Regulation (1993) on the establishment and operation of the collective investment scheme known in Nepal as a "unit savings scheme." Even though the act and the regulation authorize SEBO

to license such schemes, SEBO has not even set out guidelines on the procedures for regulating them. Currently, only two such schemes operate in Nepal with only minimal oversight by SEBO.

The two mutual funds currently in operation in Nepal are NCM Mutual Fund, 2059 (NCM) and the Citizen Unit Scheme operated by Citizens' Investment Trust (CIT). NCM initially began prior to the creation of SEBO under the name NCM Mutual Fund 2050. This fund was never properly capitalized by its founders and allegedly engaged in misrepresentation in the sale of its units. It finally terminated at the end of fiscal 2000-01, at which time its participants were offered a refund or participation in NCM. The latter was approved on August 9, 2002. CIT's fund has been operating since 1994-95 and has not been charged with the same irregularities as NCM. Neither of the two funds has been subject to the detailed regulation for mutual funds found in the most developed regulatory jurisdictions for mutual funds, the United States and the European Union.

4.6 PENSIONS

Pension programs in Nepal are governed by the Employees Provident Fund Act, which established the Employees Provident Fund (EPF) and the Citizens' Investment Trust Act. The act in turn established the Citizens' Investment Trust. CIT then set up the Employee Savings Growth Scheme and the Pension Scheme (CIT PS). The EPF is a mandatory program for government employees, while the Employee Savings Growth Scheme is a voluntary program aimed at private individuals and CIT PS is a voluntary pension program aimed at employers. In each case, the policy holder contributes to the fund a set amount from his or her monthly salary. On retirement, the policy holder receives a lump sum payment based on the investment performance of the fund. The employees receive other benefits in the forms of loans, mortgages, and education assistance. As indicated, the pension programs of EPF and CIT operate autonomously without government supervision. There is no independent pension regulator in Nepal to review the collection, investment, and pay-out activities of the pension programs.

There is a severe lack of investment opportunities for the EPF and other collective investment entities in the Nepalese capital market. The result is that the EPF and other collective investment entities are investing in non-liquid investments such as infrastructure projects which are highly risky and possibly inappropriate for the EPF; pension schemes and other collective investment entities that require low risk and a high degree of stability and security.

4.7 INSURANCE AND LEASING

The insurance industry in Nepal is regulated by two acts. The first is the Insurance Act 2049 (1992), as amended by the Insurance Act (First Amendment) 2052 (1996). The second is Insurance Regulation 2049 (1992), as amended by Insurance Regulation 2053 (1996). The law establishes an insurance board with limited authority over the industry. Although called autonomous, the board must obtain approval from the government before issuing licenses for insurers or regulations for the industry. Gaps exist in the regulatory structure in that there are no qualification requirements in the laws or regulations regarding the promoters and managers of insurers. Moreover, the laws and regulations lack any qualification requirements for the promoters, managers, and employees of insurance brokers.

Leasing activity in Nepal is conducted by finance companies that are regulated under the Banks and Financial Institutions Ordinance 2004. There is very little leasing activity in Nepal, however, due to the inability to amortize a lease under current tax laws.

An entire regulatory structure needs to be put in place for collective investments, addressing, among other things, minimum capital requirements, qualifications for managers, sales practice rules, and

fund calculation rules. The new draft law must deal with these issues in a comprehensive manner. In particular, a system must be put in place for an objective oversight of the funds, such as a depositary along the EU model. This would greatly enhance investor protection in the collective investment regulatory structure.

There is currently no supervisory authority that evaluates these programs for the benefit of the investors. A government ministry, for example, should supervise the activities of the EPF to ensure that investor funds are properly used and will be available for the investors at the time of retirement. Private pension schemes should be supervised by an independent supervisory authority.

The Insurance Board should have comprehensive authority to review and approve the qualifications of all participants in the insurance sector. In addition, the board should have the authority to independently approve the issuance of licenses without additional governmental approval.

CONCLUSIONS AND RECOMMENDATION

The capital markets in Nepal are facing a crisis of trust. The current regulatory and governance structure of the capital markets and companies traded on them is insufficient to provide investors with confidence that they can invest in the market based on sound information. The single greatest problem is the lack of reliable, current information regarding publicly offered and traded companies. This is the result of conflicting regulatory jurisdictions, inadequate financial and corporate disclosure rules, and the weak enforcement of such rules as do exist. The lack of reliable information results in market activity based on rumor instead of fact, mismanagement of corporate business, and the perception that the market for public companies is not fair or trustworthy.

The draft securities and corporate laws prepared under the CFG Project go a long way to providing a new regulatory structure, which will encourage investment. These laws should be enacted immediately**.** In addition, the regulatory authorities must develop enhanced disclosure rules and enforce them. Accounting and auditing standards must be upgraded and enforced. Investors must be able to obtain redress for securities violations whether their complaints are handled by the regulatory authority or through private civil lawsuits. The law must give investors the confidence that they can obtain justice for wrongful actions done to them. The government has begun an ambitious plan to improve the capital markets with the help of the ADB. This reform program must be vigorously pursued to become a significant avenue for raising capital for businesses in Nepal.

5 The Legal Framework for Microfinance Institutions

There is no specific law dealing only with the microfinance institutions in Nepal. Instead, one or more acts govern institutions engaged in microfinance activities for which the NRB is the main regulator. For instance, cooperatives established under the Cooperative Act 1959, which engage in deposit taking, are licensed by the NRB, under NRB Act 1955. Non-governmental organizations (NGOs) that engage in deposit taking activities are registered under Society Registration Act 1978 or the Social Welfare Act 1991, and are licensed under NRB Act 1955. The cooperatives and NGOs licensed by NRB are not subject to capital adequacy requirements or liquidity requirements. They are, however, directed by the NRB to limit their loans to less than Nrs100,000 (US$1,440) per individual and are required to build a reserve fund through 10 percent allocation of their operating profit.

The Financial Intermediary Societies Act 1998 also regulates NGOs engaged in microfinance activities. Under this act, all NGOs wanting to engage in microfinance activities have to be licensed with the NRB. The act, among other things, prescribes accounting practices and requires licensed institutions to create a risk-bearing fund as a provision for possible loan losses. The NRB is empowered to prescribe the level of administrative expenses and directives needed to protect the interests of the ultimate borrowers and demand information, data, or other documents that it considers necessary. The act is silent on the issue of deposit taking and savings mobilization from either members or non-members by such societies. The NRB has interpreted this as a ban on deposit taking by societies registered under the act. Thus, the Financial Intermediary Societies Act has deterred NGOs from engaging in microfinance activities and failed as a tool for enabling and expanding the microfinance sector. The law has fallen into disuse.

While the Co-operative Act of 1991 gives a fair measure of autonomy to cooperatives, those licensed by the NRB have to meet a number of prudential requirements. Cooperatives must have a minimum capital requirement for opening branches and, like banks, they must maintain a capital adequacy ratio of 8 percent of risk-weighted average assets. However, licensed cooperatives that carry on finance company activities are not allowed to collect deposits exceeding ten times their share capital. Persons wanting to engage in deposit taking and those who do not want to go through the NRB can do so by registering as savings and credit societies under the Societies Registration Act. This will enable them to collect deposits from both members and non-members. It is evident that there is a substantial regulatory arbitrage at the moment as far as deposit taking activities are concerned. Some rationalization of this situation is called for.

The latest development in the legal framework for microfinance is the enactment of the BFIO, which has attempted to rationalize the regulatory framework through the licensing of Category D institutions. Category D is a wide net that captures almost all institutions dealing in financial transactions, including credit-only microfinance institutions. BFIO also empowers the NRB to regulate donor operations in Nepal and requires institutions licensed under the act to be autonomous and corporate bodies with perpetual succession and limited liability. The institutions are required to be licensed and regulated by NRB despite the NRB's own limited capacity. The law imposes a heavy regulatory burden on small and start-up microfinance institutions and could stunt the growth of the microfinance sector in the long run. The BFIO has to be amended to exempt microfinance institutions unless they are too big or too important to have an impact on financial system stability and the payment system.

Other major legal problems have been highlighted by the ADB's report on Policy and Legal Framework for the Rural and Micro-finance Sector project. Problems include (1) the current legal

framework, which perpetuates weak private sector and co-operative institutions that take advantage of lax licensing requirements; (2) an inappropriate legal infrastructure governing the licensing of institutions that obstructs smaller institutions from developing from credit-only institutions to credit member savings institutions; and (3) an outdated co-operative legislation that provides an easy avenue for the wrong type of players to enter the savings and credit field, building large operations without being subjected to any form of regulation and supervision.

There is a clear need to establish an appropriate legal framework for microfinance activities in Nepal and to confine the NRB's involvement in regulatory activities to big microfinance institutions engaged in taking public deposits, institutions which will have an impact on the stability of the financial system and the payment system. Having a microfinance regulator and an enabling legal framework will help in engendering the orderly growth of the microfinance sector in Nepal.

RECOMMENDATION

- Install an adequate, sound, and enabling legal framework that addresses the needs for the sector and takes into account the special characteristics of microfinance institutions of all types.
- Empower the NRB to exempt institutions accepting demand deposits from the public on the grounds of size or the nature of their business or the origin of their financial funds or resources, under the BFIO.

6 Other Institutional Issues

6.1 LEGISLATIVE PROCESSES

The major issue in this area is the lack of deliberate, clear policy decision-making and public consultation for new laws. Laws are initiated by a line ministry, which forwards its draft law to the Ministry of Law. It is not an established practice for line ministries to carry out a consultative process with the stakeholders affected by the proposed law. The ministry examines the draft law to ensure drafting consistencies and the law's conformity with the Constitution. The Office of Attorney General, however, is not consulted or involved in any part of the drafting process, though he may be called upon from time to time to provide opinions on the law. The main complaint by implementing agencies is that the ministry lacks expertise and is slow in evaluating proposed legislation. Institutionalizing the consultative process for lawmaking, improving capacity at the ministry, and ensuring the involvement of key ministries in the lawmaking process will certainly enhance the quality and implementation of laws in Nepal.

Another complaint is that laws are distorted at the parliamentary committee level. When a law is passed by the Cabinet, it is tabled in Parliament. At that point, parliamentary committees review most of the laws. Members of the committees are lacking in knowledge and competency, however. The committees are supposed to call for expert assistance to make the necessary recommendations on the laws they receive. Anecdotal evidence suggests that this happens infrequently. Most of the time, the committee process is compromised. This dilutes the effect of the law, as the integrity of the provisions gives way to vested interests. There is an urgent need to make it compulsory for experts in line ministries and independent subject matter experts to be included in the committees, to ensure that the laws meet the regulatory and legislative intent.

The institutionalizing of a consultative process and publication of draft laws in a bill form before they are made into law would enhance public awareness of laws and improve compliance. At the moment, there is no system for publishing a bill presented to the Parliament. Technically, in exceptional cases the proposed bill may be published for public comment if a proposal to this effect is approved by Parliament. The World Bank team was given to understand that this has never happened in the parliamentary history of Nepal.

The process for enacting laws has been going through some measure of crisis in the absence of the Parliament. Currently, all draft laws by line ministries are reviewed by a legislative committee that is chaired by the Minister of Finance or the Law Minister. The members of the committee are usually the joint secretaries of the ministries. Sometimes experts from line ministries participate in meetings. Once the Cabinet approves a law, it is sent to the palace for royal assent. Throughout this process there is very little information made available to the public and stakeholders. Apart from the fact that a law is not published as a bill before it is enacted, there is also no formal consultative process. Restoration of the parliamentary process and establishment of an appropriate consultative process would be likely to increase stakeholders' awareness of and compliance with the law in general.

6.2 CORRUPTION — AN IMPEDIMENT TO DEVELOPMENT

Corruption is a major problem and the main cause of political and economic underdevelopment in Nepal. Though it may not be widely reported, corruption exists in all sectors of government administration including the judiciary. It prevails at both the policy-making and operational levels. Since corruption at the operational level affects the life of ordinary people, its impact is directly felt by the general public. Though the impact of corruption at the policy level is more serious in the

overall development of the nation, it takes place discreetly and not in full knowledge of the general public.

The government departments and offices frequented by the general public, like the tax offices, immigration office, Labor Department, land revenue offices, district offices, and the Department of Industries, have high rates of corruption. In a World Bank report published in 2000, 36 percent of respondents identified the government as the biggest obstacle to doing business effectively. This was followed by lack of demand (22 percent) and financial difficulties (14 percent). According to the Transparency International report, within the government, land administration is perceived to be the most corrupt sector followed by the Customs Department. Police and the judiciary were ranked as third and fourth respectively. However, the actual usage profiles, seen from respondents' answers about their own experiences, indicated that the police (42 percent) and judiciary (48 percent) are the most corrupt sectors.[10] See Annex 4 for more details on the Transparency International report.

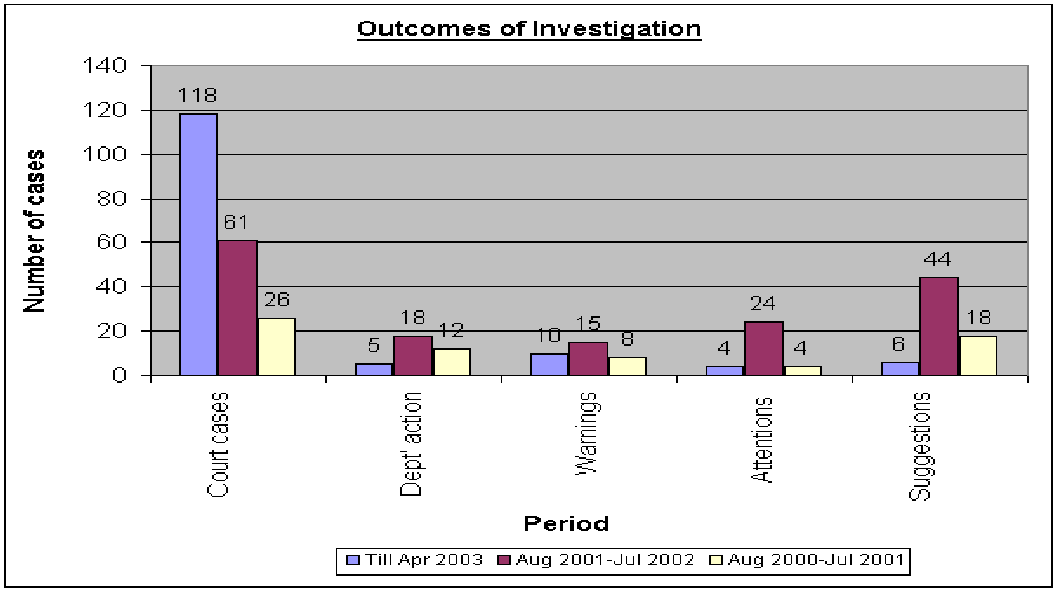
The government is committed to curbing corruption. The establishment of Commission for the Investigation of Abuse of Authority in 1999 has been a significant step forward in this regard. The enactment of the new Anti-Corruption Act and amendments to the CIAA Act in 2002 further strengthen the authority of commission. The Anti-Corruption Act has widened the scope of law to include corruption at the operational level. It confers special powers on the CIAA to seize goods and documents, issue arrest warrants, and detain suspects. It also empowers CIAA to call the police or other government authorities to assist in its investigations. Similarly, the second amendment to the CIAA Act widens and clarifies the commission's authority.

Subsequent to these amendments, the CIAA has activated its operations and filed corruption cases in Special Court, including cases against some former ministers and high-ranking officers in the government. The new team at the CIAA has been able to give a positive message to the people that something is being done to punish those guilty of corruption. However, the CIAA needs to guard itself against a perception in some quarters that it is concentrating more on business decisions that have gone bad than pursuing real corruption cases. There is also a general view that the CIAA's authority needs to be extended to enable it to investigate judges, CIAA commissioners, the Auditor General, members of the Public Service Commission, and members of the armed forces. Steps need to be taken to assess these suggestions and incorporate them in the CIAA Law as necessary.

According to the CIAA's published monthly report in April 2003,[11] it received a total of 2,316 complaints as of that April. It disposed of 1,639 cases as of the same date, of which 118 were corruption cases. Relative to past activity, this is an impressive response. Traditionally, only about 8 percent of total cases were subject to comprehensive investigation. In the past, more than 95 percent of cases filed by the CIAA were unsuccessfully prosecuted, and only 10 of the 31 cases filed in various appellate courts were successful. Reasons for the low success rates include inadequate investigation, non-observance of the legal processes, and ambiguities and uncertainties in applicable laws. More recently, the overall success rate in prosecutions is reported to have improved to about 50 percent. See figure 6.1[12]

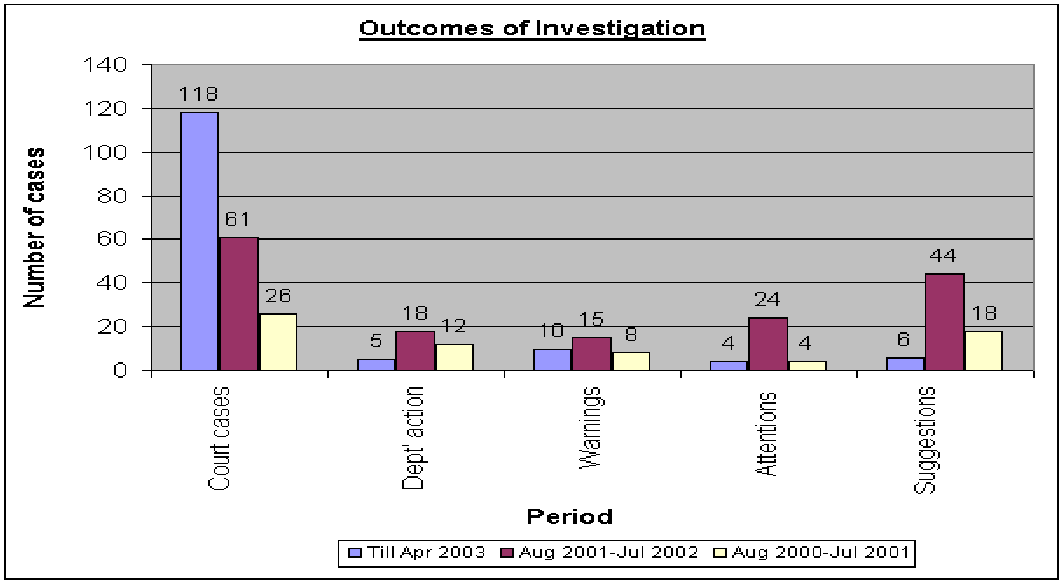
[10] Transparency International, *Corruption in south Asia: Insights and Benchmarks from Citizen Feedback Surveys 2002*.
[11] http://www.akhtiyar.org.np/reports.htm
[12] http://www.akhtiyar.org.np/reports.htm

Figure 6.1 Outcomes of investigations



Not only have the complaints filed and disposed of increased, the outcomes of the investigations also show that the CIAA has greater flexibility and ability to institute measures commensurate with the gravity of the offenses. See figure 6.2[13]

Figure 6.2 Complaints lodged and disposed



The CIAA is currently assisted by international donors, including the ADB, Danish Cooperation Fund, and UNDP. With the increase in the jurisdiction of the CIAA and an increasing number of cases, it is critical for the government to provide the commission with adequate budget and institutional capacity to carry out its duties effectively.

[13] http://www.akhtiyar.org.np/reports.htm

The other important initiative to curb corruption is the enactment of the Special Court Act 2002. The act, among other things, has widened the authority of the Special Court. The act has simplified the process of serving notice to the accused and fixed the time for case disposal by both the Special Court and the Supreme Court. The act has also provided for setting up the National Vigilance Centre under the direct supervision of the Prime Minister, to supervise the working of government offices and to record and report incidences of corrupt practices. The center is effectively dormant, however. Steps must be taken to revitalize its activities.

Corruption is directly tied with the system of governance as a whole. Thus, no initiative to control corruption is possible without improvement in the system of governance. The public's right to information has to be entrenched in the system, as does transparency in the dealings of the public sector. Publishing rules and regulations and making them available widely would help to curb corruption.

There is very little inter-departmental interaction or coordination, a situation that results in delay and duplication of efforts. There is a clear need for change in the process and attitude of all Nepal's civil servants. The Civil Service Act needs to be reviewed to provide more comprehensive and progressive guidelines for the civil service.

6.3 LACK OF IMPLEMENTATION AND ENFORCEMENT

Failure to implement laws is still a major problem in Nepal. Laws are only as good as their implementation and the administrators who oversee them. The politicization of government employees, the lack of clear rules to govern them, and the lack of sanctions to counter their inefficiency and dishonesty have marred the civil service. Generally then, there are two problems with the implementation of laws. The first is corruption. Second, there is no effective mechanism for accountability. Regulators also have human resource problems and suffer from lack of institutional capacity. A lack of skills and knowledge results in a failure to understand a law's basic provisions and its implementation process. There are instances where the civil service continues with its processes, even when they have been declared illegal by the Supreme Court. There have also been cases where civil servants have been reckless and negligent with impunity. Introducing the right skills, providing sufficient training, and inducing professionalism among regulatory authorities would go a long way toward improving the implementation law.

There is also a real need for the regulators of the banks, the insurance industry, the capital markets and other sectors of the economy to strictly apply and enforce the laws. In the absence of proper application and enforcement, laws serve a limited role in the regulation of a market. Hence, transparent and consistent application of the laws and regulations, observance of the procedures laid out in the laws, exercise of discretion within the powers of the law, and vigilant monitoring and enforcement of the laws are important for inculcating a regulatory discipline in the market. This discipline will, in the long run, pave the way toward self-regulation.

As a final observation, given the administrative and institutional difficulties in imposing sanctions and prosecuting serious offenders, the concept of compounding offences—with sufficient procedures and safeguards—might be introduced in the legal system. This alternative method has helped other countries enforce the law and mete out appropriate sanctions for non-compliance expediently and effectively.

RECOMMENDATION

- Improve law-making by instituting a more transparent and consultative process; this ought to include the publication of laws in bill form prior to their debate in Parliament or before royal assent.
- Improve the skills and professionalism of regulatory authorities through capacity building exercises.
- Improve access to information by the public through the publication of laws, regulations, orders, circulars and so on administered by the various regulatory bodies.

Annex 1 Details Reform Matrix

Legal framework for the banking and financial sector

Current reforms	Proposed area of reform	Short term (6 months–1 year)	Medium term (2–3 years)	Long term (3–5 years)
WB Financial sector Restructuring Project—strengthening of legislative framework for financial sector	Banking and Financial Institutions Act	Amend the BFIO to enhance supervisory capacity, remove overlap and streamline procedures in the law Introduce guidelines on write-offs	Complete the issuance of new directives and regulation for the implementation of the amended BFIO	Carry out a review of the NRB act to update it
	Credit bureau	Corporatize and computerize CIC fully Shift focus of CIC from Blacklisting to credit bureau function Start blacklisting bad check issuers	Enact a separate credit bureau law that will allow other operators of credit bureaus Provide for sufficient consumer protection	
	Bills of exchange	Implement and increase use of the Bills of Exchange Act	Amend the law to deal with bad checks more effectively	
ADB—Corporate and Financial Governance—developing Nepal's payment system.	Payment system	Ensure directives on automated check clearing is introduced	Amend the NRB Act to provide for general oversight over payments system and finality of payment	
	Government debt	Issue guidelines on secondary dealing of government debt	Amend the National Debt Act 2202 to enable scriptless securities trading	

The creditors' rights and insolvency system

Current reforms	Proposed area of reform	Short term (6 months–1 year)	Medium term (2–3 years)	Long term (3–5 years)
ADB — Corporate and Financial Governance—new Insolvency Law has been approved by Cabinet and is awaiting Royal Assent	Insolvency system	Ensure sufficient budget is allocated for the implementation of Insolvency Ordinance when passed	Amend Insolvency Ordinance to ensure compliance with Principles and Guidelines for Effective Insolvency and Creditors Right Systems Build capacity for insolvency professionals and their regulators	
		Create a suitable framework providing for informal out-of court process for restructuring of companies in financial trouble	Build capacity for credit risk management, credit information sharing and application	
ADB—Corporate and Financial Governance—Secured Transaction Law has been approved by Cabinet and is awaiting Royal Assent	Creditors' rights	Ensure allocation of necessary budget for the law to be implemented Build necessary capacity to implement the proposed law Train the staff and increase public awareness of the new law	Ensure that the Registry is fully computerized and staff are fully trained	Enact a single legislation for creation, recording, registration, determination of priorities Establish central electronic registry for movable and immovable properties
IMF—DRT was set up in June 2004 and started operation in Oct 2004	Debt recovery	Transfer all cases in District Court to DRT Improve funding of DRT to enable training of judges and enforcement officers Improve implementation structure Amend DRT Law to reduce notice period, change the procedure for service of summons and allow borrowers to file suits	Create more DRTs to serve far away regions if demand is high	

The judicial system

Current reforms	Proposed area of reform	Short term (6 months–1 year)	Medium term (2–3 years)	Long term (3–5 years)
ADB—Corporate and Financial Governance Project—building commercial judiciary and legal capacity. Set up judicial academy	Knowledge and training	Ensure structural funding for National Judicial Academy is available	Curriculum for permanent training be established	Make training mandatory Continue to develop the - National Judicial Academy curriculum and safeguard its existence by structural funding
			Develop recruitment policy based on merit	Implement merit based recruitment and promotion policy
			Introduce plan for and begin professionalizing library function in courts	Modernize legal university education
	Case management	Carry out a comprehensive Legal and Judicial Assessment Make case management a priority in Strategic Plan and Evaluate pilot courts		
		Commission study on case management specific of Nepal situation	Implement recommendations from study including specialized fast track civil units and commercial in larger courts	Continue monitoring and implementing measures to reduce delays
		Develop active attitude towards delays	Develop policy for granting delays	Implement the policy for judicial case management
				Amend relevant legislation to remove unnecessary formalities and other legal obstacles to efficient, effective case management
	Court management and governance	Reduce number of courts	Plan for privatizing notice serving	Implement plan for privatizing notice serving

Current reforms	Proposed area of reform	Short term (6 months–1 year)	Medium term (2–3 years)	Long term (3–5 years)
		Improve and restructure court management	Implement new court administration	Evaluate new structures and procedures, and improve where necessary
		Study improvement of budgeting structure	Implement new budgeting structure	
			Professionalize archiving function	
			Develop vision and plan for computerization	
	Public trust	Give up immunity from CIAA investigations, and use existing structures	Review existing structures for effectiveness, transparency and accountability	Implement improved procedures and structures

The legal framework for corporate sector and capital market

Current reforms	Proposed reform area	Short term (6 months–1 year)	Medium term (2–3 years)	Long term (3–5 years)
ADB - Corporate and Financial Governance — Draft Securities Ordinance approved by Cabinet and awaiting Royal Assent	Securities law	Issue New Securities Ordinance Give SEBO clear jurisdiction over market Improve disclosure requirements Give SEBO authority to review financial statements	Increase SEBO's enforcement capacity. Improve skills at the SEBO	SEBO will be independent and empowered securities market regulator
		Encourage SEBO to bring enforcement actions for failure to file financial statements on time		
			Enact ordinance to establish Arbitration Tribunal for Securities Litigation	
			Pass ordinance to permit government securities to trade on NEPSE. Form credit rating agency	
ADB — Corporate and Financial Governance—draft trust law in preparation		Complete legislation needed for Central Depository and Trust Law	Begin central depository operations	
ADB — Corporate and Financial Governance—draft companies ordinance being considered by Cabinet	Company law	Issue New Companies Ordinance Amend law to allow for independent registrars	Upgrade CRO in resources and expertise	CRO will have modern operations and effective staff.
			Fully develop securities registrar system	
		Formulate code of corporate governance	Implement Institute of Directors	Institute will have broadly improved quality of directors
			Educate judiciary on financial laws and litigation	Fully competent judiciary in financial matters

Current reforms	Proposed reform area	Short term (6 months–1 year)	Medium term (2–3 years)	Long term (3–5 years)
	Accounting and auditing law	Provide Funding for Accounting and Auditing Standards Boards Conduct World Bank Accounting and Auditing ROSC	Have a fully operable standard setting process.	Increase the number of certified auditors that are members of the Institute
	Collective investments	As part of new securities ordinance, issue regulations establishing a regulatory regime	Have a system of fund depositaries fully functional and operating.	Secure depositary system for the entire capital markets.
	Pensions	Pass ordinances creating supervisory structure for EPF and private pensions	Have private fund regulatory installed and fully functioning.	Open and transparent regulation of pension industry.
	Insurance	Amend insurance law to give Board authority to evaluate qualifications of promoters and managers of insurers Amend insurance law to allow Board to evaluate qualifications of promoters, managers and employees of insurance brokers.		

The regulatory framework for microfinance

Current reforms	Proposed area of reform	Short term (6 months–1 year)	Medium term (2–3 years)	Long term (3–5 years)
ADB — Corporate and Financial Governance — regulation and supervision of rural finance institutions. A series of working papers has been completed.	BFI law	Ensure BFIO exempts microfinance institutions accepting demand deposits from the public based size or nature of their business or the origin of their funds	Install an enabling legal framework that take account of special characteristics of microfinance institutions Provide sufficient funding and ensure institutional capacity to implement and enforce the law	

Legislative and institutional issues

Current Reforms	Proposed Area of reform	Short term (6 months–1 year)	Medium term (2–3 years)	Long term (3–5 years)
PRSC (WB) — Governance Act to be passed by April 2005	Law making	Improve consultative process and publicize laws before the are enacted Introduce proper system of dissemination of information on laws, regulations, orders, circulars etc. administered	Improve Parliamentary Committee process	
	Civil service	Publicize information on guidelines and manuals to improve accountability	Amend Civil Service Act to introduce guidelines and operational manuals civil service Introduce more effective recruitment process. Provide sufficient training and continuous performance management system to improve the productivity, accountability and standards of service amidst civil servants and regulators.	

Annex 2 Status of Cases at DRT

Number of cases filed	Total claim in millions	Number of banks	Number of financial institutions	Claims decided	Amount in millions
131	1,080	10	12	46	480

None of the cases went to hearing.
No orders have been issued for essential documents in any cases.
There are no cases in the process of being issued with summons to the defendants.
There are no cases in the process of hearing.

Cases with Debt Recovery Tribunal as at October 12, 2004

Claim amount (NR thousands)

S.N.	Number of cases			Bank	Decided cases	Decided amount	Claim amount
	T	R	Total				
1	2	15	17	Nepal Bank Limited	8	126,222	176,491
2	9	3	12	Himalayan Bank Limited	6	166,594	219,633
3	—	17	17	Bank of Katmandu	5	45,276	171,024
4	3	—	3	Nepal Credit & Commerce Bank	2	7,533	35,468
5	3	—	3	Everest Bank Limited	2	6,880	7,012
6	—	33	33	Rastriya Banijya Bank	3	63,644	314,375
7	1	3	4	Nepal Bangladesh Bank	1	9,084	27,925
8	—	1	1	Lumbini Bank Ltd.			1,610
9	—	1	1	Nepal Industrial Commercial Bank	1	17,525	16,295
10	1	6	7	Nabil Bank Limited			26,256
Subtotal	19	79	98		28	442,758	996,089
Financial Institutions							
1	6	—	6	Sri Lanka Merchant Bank Ltd.	3	7,892	13,124
2	1	1	2	ACE Finance	2	3,985	5,169
3	2	1	3	Gorkha Finance		2,615	3,597
4	3	2	5	HISEF Finance	4	7,300	8,470
5	1	1	2	Union Finance	2	2,724	1,792
6	1	—	1	Nepal Industrial & Dev. Corporation			2449
7	7	—	7	Nepal Share Market	6	5,265	6,834
8	—	1	1	Agricultural Development Bank	1	6,692	6,169
9	—	2	2	National Finance Company			2,365
10	—	1	1	Lumbini Finance Company			12,878
11	—	1	1	Nepal Development Bank			1,674
12	—	2	2	National Finance Limited & Nepal Finance & Saving Company			19,559
Subtotal	21	12	33		18	38,079	84,080
Total	40	91	131		46	480,837	1,080,169

T= Transferred from district courts, R= Registered with DRT

Annex 3 Strategic Plan for the Nepali Judiciary (2004–08)

The 2004 – 2008 Strategic Plan for the Nepali judiciary calls transforming the constitutional responsibility of protecting the rights of people and transforming the concept of the rule of law into a living reality and into action a great challenge. The lack of human and financial resources is a great impediment for introducing reform programs. The annual budgetary outlay for the judiciary is less than 0.58 percent of the national budget. Expeditious case disposal was impeded by a lack of legislation. The judiciary long remained outside of the national planning process. Until recently, the concept of planning was foreign to the judiciary.

Taking stock of the situation, ten key issues are identified as the basis for the situational analysis:

- Human resources and career development;
- reform of law and legislation regarding judicial administration;
- procedures and jurisdiction, court management including research, analysis and planning;
- improvement of efficiency and introduction of new technologies;
- Infrastructure and facilities;
- independence and autonomy regarding financial and administrative autonomy;
- cooperation within the justice sector;
- controlling irregularities and corruption;
- delivery of services and public trust;
- resource constraints including emolument and benefits, and the insurgency and the security situation in the courts.

The mission for the judiciary is "To impart fair and impartial justice in accordance with the provisions of the Constitution, the laws, and the recognized principles of justice". The vision, which is set out as "A system of justice which is independent, competent, inexpensive, speedy, accessible and worthy of public trust, thereby transforming the concept of the rule of law and human rights into a living reality and thus ensuring justice to all". This is the aim of the implementation plan.

The development of the plan of action has been inspired by the following values: commitment to the realization of socio-economic and political justice, independence of the judiciary, responsibility towards society within the purview of law and further collaboration with external actors, increased access to judicial services, improvement of the service delivery capacity of judicial institutions, morality, ethics, integrity, accountability, transparency and honesty in the judicial process in order to enhance public trust, and fair demographic representation.

The adjudication function, the advisory, the supervision and monitoring function and court management are identified as the core functions. Key results indicators are timely disposal of cases, regular courts inspection and professional court management. Cross-cutting key results indicators are access to legal aid, increased user satisfaction, further enhancement of public trust, continuous strengthening of institutional capacity and increased autonomy in management. The vision for action was broken down into the following strategic interventions: streamlining management capacity, increased budget allocation, developing infrastructure and logistical support, streamlining geographical distribution, strengthening execution of decisions, developing a promotion system, reviewing laws and procedures, ensuring judicial autonomy, and strengthening communication.

The plan was prepared between October 2003 and February 2004. Its planning process was directed by a management team consisting of three Supreme Court Justices and two Court of Appeal Justices and the Registrar of the Supreme Court. It was produced by a working group consisting of the Registrar of the Supreme Court, two District Judges and the Joint Registrar of the Supreme Court. Four consultative meetings in Kathmandu and the regions and a consultation meeting for the justice sector actors were part of the process.

The Plan recognizes the need for reform and provides an important and necessary conceptual framework for reform and improvement. The participatory preparation process will contribute to its successful implementation. Most areas of intervention are identified, but no priorities have been set. What is needed for successful implementation is a more in-depth assessment of the judiciary organization which also looks into legal training, the role of the Bar and the potential use of alternative dispute resolution. It will help to set priorities and make choices. Those choices will also involve setting up a decision making and support structure suited to the needs of the reform.

Annex 4 Corruption in South Asia—Extract from report by Transparency International

The following text was extracted from "Corruption in South Asia: Insights and Benchmarks from Citizen Feedback Surveys in Five Countries" (Transparency International, 2002).

"The public service frequented most was education, followed by health, power and land administration. The departments of taxation, police and judiciary had the fewest users, with judiciary being the least used.

"Land administration is perceived to be the most corrupt sector followed by the customs department. Police and judiciary were ranked as third and fourth most corrupt sectors respectively. However, the actual usage profiles, seen from respondents' answers about their own experiences, indicated that the police (42 percent) and judiciary (48 percent) are the most corrupt sectors.

"While 7 percent of the respondents questioned on the education sector complained of irregular admission processes, one in four regular users reported corruption in the day-to-day functioning of educational institutions. The key facilitators of corruption cited in this sector were teachers followed by members of the management committee. Government hospitals were found to be the main institution used for health care in the country. While 8 percent of those who frequented public hospitals reported irregular methods of access, about 18 percent of users reported corruption during regular visits. Paying extra for prescribed medicines and being forced to buy medicines from specific pharmacies were cited as the main forms of corruption. Doctors and hospital staff were named as the major facilitators of corruption in the public health service.

"About a quarter of respondents with access to electricity reported getting connections through irregular means. Interestingly, the percentage reporting corruption in their regular interaction with the power service was quite low at 12 percent. Paying extra for an uninterrupted supply of electricity and bribes to correct over-billing were the most commonly named forms of corruption. Linesmen were cited most often as the main facilitators of corruption, followed by meter readers.

"About 17 percent of those who used the services of the department of land administration during the past year said that they had encountered corruption. The Tehsilder was reported as the main instigator of corruption in this sector, followed by surveyors. Fourteen percent of respondents said they interacted with officials from the tax department during the past year. Service users were concentrated in urban areas and the most common form of service was the payment by users of income tax. A quarter of service users said that they had encountered corruption in this sector. Employees of the department were found to be the main facilitators of corruption. Only seven percent of respondents reported interaction with the police sector during the past year. Almost half of those reporting interaction (48 percent) said that they had encountered corruption in this sector. The police officer was found to be the main instigator of corruption, followed by the department clerk.

"The service used the least was the judiciary, with only 5 percent of respondents reporting that they/their family members had needed the service during the past year. Nearly 42 percent of service users reported encountering corruption in this sector. Court employees and public prosecutors were cited as the main facilitators of corruption.

"Across all sectors, extortion was quite common and a lack of accountability was identified as the major reason for corruption."