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SHADOW BANKING AND NEPAL RASTRA BANK: A POLICY REVIEW

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ABSTRACT

Economic liberalization, financial inclusion and financial innovation have fueled not only the growth of banking institutions but also non-banking financial institutions called shadow banking. Shadow banks are rendering easy access to financial services and credit availability and supporting Nepalese economy. The study uses exploratory and descriptive research design. The study found that nonbanking sector has occupied 12.7 percentages of the total assets and liability structure of the Nepalese financial system in mid-January 2019 which was 11.5 percentages in mid-June 2018. Shadow banking, however, can raise the systemic risk via reinforcing interconnectedness between financial institutions. This study reviews the national and international financial agencies' policies that Nepal Rastra Bank (NRB) can refer to and has already responded through various policies for the regulatory framework. As a central bank of Nepal, NRB is in the avenue of setting up the prudential mechanism for the stronger regulation to prevent excessive leverage, deregulation and maturity mismatch of shadow banking in order to achieve financial stability in Nepal.

I. INTRODUCTION

The term shadow banking was coined by Paul McCulley, from Pacific Investment Management Company-PIMCO, at a Federal Reserve System Annual Symposium in August 2007. In the 2007 economic crisis, many traditional banks conked out owing to the collapse of the real estate market, making room for the shadow banking system to flourish. However, at the epicenter of the financial crisis and after the economic meltdown, it has come under close scrutiny and regulation.

The "shadow banking system" can broadly be described as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system". Some authorities and market participants prefer to use other terms such as "market-based finance" instead of "shadow banking" (FSB, 2017).

The four key aspects of intermediation which are performed by shadow banking as developed by the Financial Stability Board (FSB) are:

1. **maturity transformation:** obtaining short-term liabilities (such as demand deposits) to invest in longer-term assets (such as mortgage loans);
2. **liquidity transformation:** a concept similar to maturity transformation that entails using liquid liabilities (such as cash or digital value) to buy less liquid and harder-to-sell assets (such as loans); -
3. **leverage:** employing any techniques to magnify/multiply the potential gains (or losses) in an investment such as borrowing money to buy fixed assets (or finance lending);
4. **credit risk transfer:** taking the risk of a borrower's default and transferring it from the originator of the loan to another party.-

According to Adrian and Jones (2018), the basic difference between the traditional banking and shadow banking can be explained with the help of following table.

Table 1: A Stylized View of the Structural Characteristics of Credit Intermediation

S/N	*Characteristics*	*Traditional Banking*	*Shadow Banking*
1	Key Risk Transformations	Liquidity, maturity, leverage	Credit enhancement, liquidity, maturity, leverage
2	Institutions Involved in Intermediation	Single entity	Can be many entities, interconnected through collateral chains and credit guarantees
3	Formal Official Backstop	Yes	No, but possibly indirect access
4	Implied Private Sponsor Support	n.a.	Yes, can sometimes be contingent liabilities
5	Key Features of Funding Base	Mix of debt and deposits, wholesale and retail-financed	Highly runnable

Source: International Monetary Fund (IMF).

In contrast, according to Investopedia, the shadow banking system also refers to unregulated activities by regulated institutions. It is a blanket term to describe financial activities that take place among non-bank financial institutions outside the scope of the regulators.

Therefore, the shadow banking is the today's emerging topic to discuss up on and have prudent policies to regulate it and support financial stability. Hence, the section two discusses the review of literature, section three explains the present scenarios of shadow banking in Nepal, section four discusses reasons for the development of shadow banking, section five deals with why does shadow banking need to be regulated?, section six discusses a framework for policy response: international and Government of Nepal, section seven deals with the policy responses by Nepal Rastra Bank, and final section, section eight discusses with the conclusion of the study.

II. REVIEW OF LITERATURE

In global context, banks are the most regulated financial institutions. However, due to the globalization, cut-throat competitions and financial innovations there has been a paradigm shift in the banking, which has encouraged the channeling of investment funds into unregulated or less regulated sectors as well. Such less regulated institutions operate under the shadow of traditional banking system, called shadow banks. Shadow banking comprises a set of activities, markets, contracts, and institutions that operate partially (or fully) outside the traditional commercial banking sector, and, as such, are either lightly regulated or not regulated at all (Ghosh *et al.,* 2012). According to IIF (2012), the benefits from non-bank financial activities can include; (1) efficiency, innovation, and specialization; (2) diversification and mitigation of risk; (3) Greater flexibility and investment opportunities; and (4) Increased liquidity and funding.

Buchak *et al.* (2017) found that the increasing regulatory burden faced by traditional banks and the rise of fintech and non-fintech shadow banks in the residential lending market can account, respectively, for about 55% and 35% of the recent shadow bank growth. Ilesanmi and Tewari (2019) concluded that the shadow banking sector is said to be advantageous in terms of extending banking services and investment opportunities to the unbanked as well as to those who lack knowledge of how to access capital respectively, however, issues about regulations and transparency have not been adequately dealt with.

The shadow banking system represents a special policy challenge for central banks, since its growth is closely linked to the regulation of the banking system. The transmission of monetary policy is also affected by the size and behavior of the shadow banking system. The study found that a monetary contraction aimed at reducing the asset growth of commercial banks would tend to cause a migration of activity beyond the regulatory perimeter to the shadow banking sector (Nelson *et al.,* 2017).

The Finanical Stability Board (FSB) (2011) has taken stock of existing national and international regulatory initiatives and launched five work streams to assess shadow banking risks for further regulatory action:

(i) regulation of banks' interactions with shadow banking entities (indirect regulation)
(ii) regulatory reform of money market funds (MMFs) examined by the International Organization of Securities Commissions (IOSCO)
(iii) regulation of other shadow banking entities (other than MMFs)
(iv) regulation of securitization- examine retention requirements and transparency
(v) regulation of securities lending and repos- examine possible measures on margins and haircuts.

Nabilou and Prum (2019) concluded that international standard-setters should be attentive to the differences: structural, practical and other differences and avoid a one-size-fits-all regulatory approach toward shadow banking. In particular, the international initiatives put forward by the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) should take note of the subtleties in the structure of the shadow banking sector and its regulatory frameworks in different jurisdictions before attempting to shape global regulatory initiatives. Therefore, the study concluded that distinctive features of the EU shadow banking require a differentiated and tailor-made approach to regulating shadow banking than others.

In contrast, Sreelakshmi and Nidhiparpiani (2020) showed no significant influence of shadow banks on the Indian banking system in terms of profitability. Shadow banking products are mainly appreciated by households who are deprived of creditworthiness. So the view that shadow banks as being a threat to the mainstream banks was not justifiable. Therefore, rather than treating shadow banking acts a threat, it should be considered as a complementary element to the formal banking system as it exerts competitive pleasures on the formal banking system.

Therefore, the literatures reviewed above show that there is no any study conducted related to shadow banking in the context of developing economies like; Nepal. Nepal Rastra bank, as a regulatory authority, must discuss and research on the regulation of shadow banking protecting the interest and investment of customers and without necessarily jeopardizing the interest of shadow banking operators.

III. PRESENT SCENARIO OF SHADOW BANKING IN NEPAL

The following table shows the number of banks and financial institutions in the current Nepalese financial system.

Table 2: Number of banks and financial institutions in the Nepalese Financial System

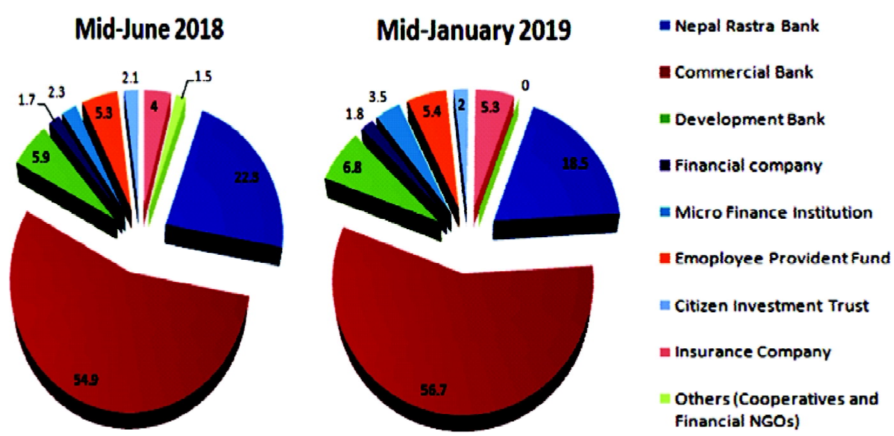
S/N	*Financial Institutions*	*Number (Mid Feb 2020)*	*Branches (Mid Feb 2020)*
1	Commercial Banks - A class	27	4077
2	Development Banks - B class	24	1311
3	Finance Companies - C class	22	233
4	Microfinance Financial Institutions - D class	90	3929
5	Infrastructure Development Bank (IDB)	1	-
6	Employee Provident Fund (EPF)	1	8
7	Citizen Investment Trust (CIT)	1	2
8	Social Security Fund (SSF)	1	-
9	Cooperatives	34,737 (Mid-March 2019)	-

Source: Nepal Rastra Bank, Ministry of Finance, and http://emap.nrb.org.np/

As shown in above table (see Table 2), the total number of BFIs licensed by NRB is 164 in mid-February 2020 and the number of BFIs branches reached 9,550 in mid-February 2020 from 8,686 in mid-July 2019 (NRB, Current Macroeconomic and Financial Situation, Seven Months Data-2020).

The following figure shows the structure of assets and liabilities of the Nepalese financial system.

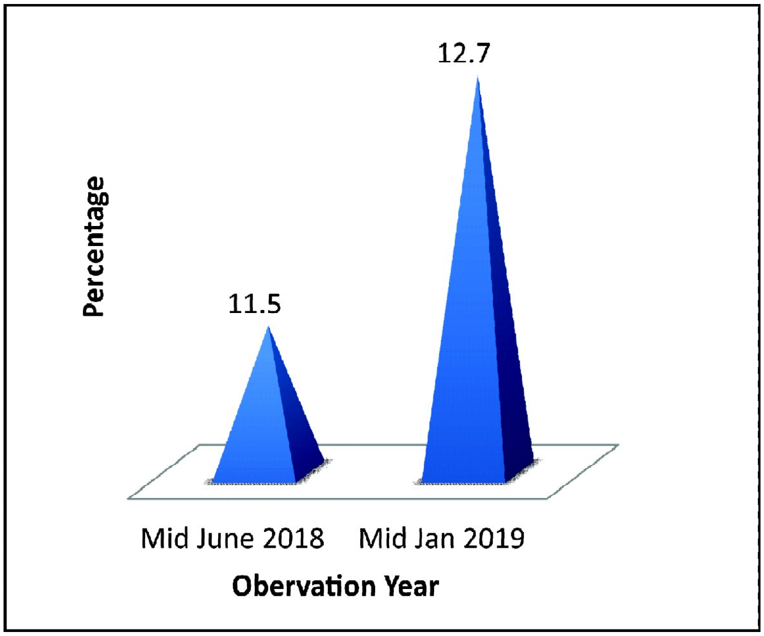
Figure 1: Structure of Assets and Liabilities of the Financial System (In percentage)



Source: Ministry of Finance, Economic Survey 2018/19 and 2017/18.

As shown in above figure, banking sector has occupied significant share in the total assets and liability structure of the financial system.

Figure 2: Nonbanking sector's assets and liabilities structure



By the mid-January 2019, bank and financial institution have occupied the share of 87.3 percent in total assets and financial liabilities of the financial sector which was 88.5 percent in the last mid-June 2018. Total assets and liabilities of banking sector along with all institutions mobilizing contractual savings is 170.1 percent of GDP which was 181 percent in the last mid-June 2018 (Ministry of Finance Economic Survey-2017/18,and 2018/19).

It implies that nonbanking sector has occupied 12.7 percentages of the total assets and liability structure of the financial system in mid-January 2019 which was 11.5 percentages in mid-June 2018. There is a clear 1.20 percentage points rise in share of non-banking financial sector total assets and liability structure of the Nepalese financial system during the observation years (see Figure 2).

A survey was conducted on financial inclusion by the United Nations Capital Development Fund (UNCDF) under UNNATI Access to Finance Project (A2F) of NRB in 2014. As per the survey, 22 percent people claim to belong to cooperatives, of which 11 percent are with cooperatives only. Likewise, 29 percent people claim to belong to saving groups (NRB, Special Publications, 2018).

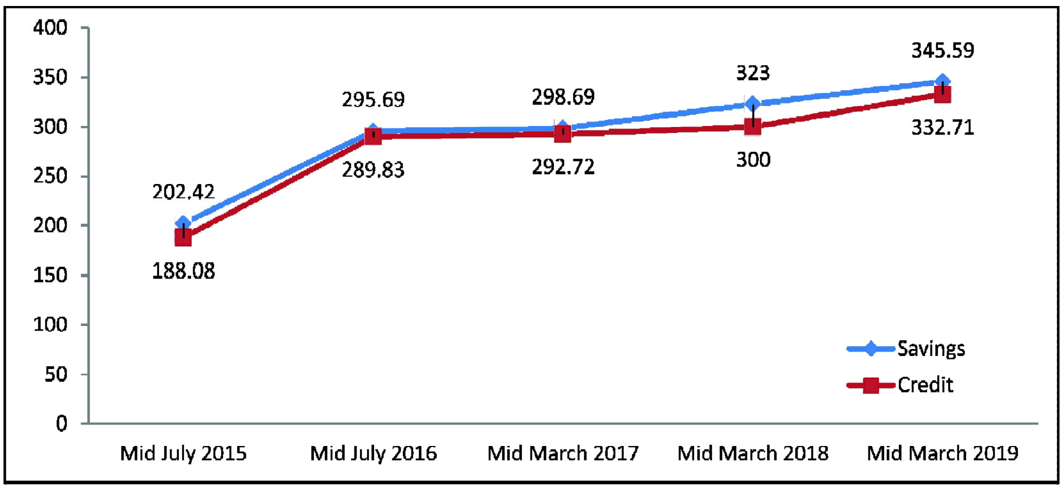
Major Non-Banking Financial Institutions in Nepal

(1) Co-operatives

A cooperative is an autonomous association of persons who voluntarily cooperate for their mutual, social, economic, and cultural benefit. Cooperatives include non-profit community organizations and businesses that are owned and managed by the people who use its services (a consumer cooperative) or by the people who work there (a worker cooperative) or by the people who live there (a housing cooperative). Modern co-operatives began in Nepal in 1953 when a Department of Co-operatives (DOC) was established within the Ministry of Agriculture to promote and assist development of co-operatives. They are guided by the Cooperative Act, 1991 later amended as Cooperative Act 2017 (NEFSCUN, 2020).

Following figure shows the growth in mobilized savings and credit of the cooperatives for the last five fiscal years as per the economic survey report of the respective years.

Figure 3: Trend of mobilized savings and credit by the cooperatives. (Rs. in Billion)



Source: Ministry of Finance, Economic Survey Report (2015/16/17/18/19)

The diagram shows the increasing trend of mobilized savings and credit by the cooperatives. However, license of cooperatives established under Cooperative Act, 1991 with limited permission of banking transaction from Nepal Rastra Bank has been dismissed since mid-August 2018 (Economic Survey Report, 2019).

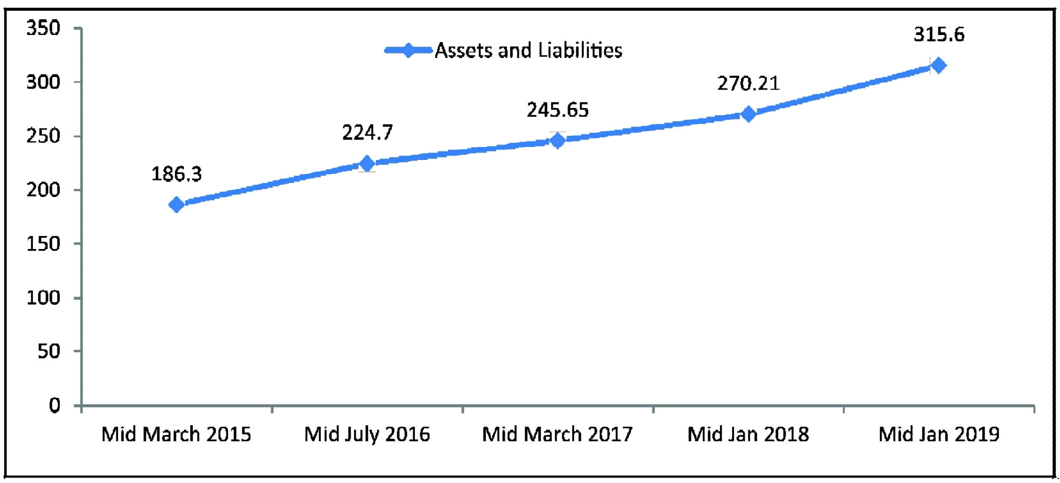
(2) Employees Provident Fund

Employees Provident Fund (EPF), also known as Karmachari Sanachaya Kosh (KSK), was established in 1962, under the "Karmachari Sanchaya Kosh (KSK) Act-1962. It manages

Provident Fund (PF) in Nepal on behalf of the Government of Nepal (GoN) for government, public and private sector employees and come under Ministry of Finance. Around 30,000 offices contribute to KSK and the present membership base is 6,00,000 individuals (July 2018 data). It is an approved retirement fund of GoN, and the provident fund that it manages is supposed to help the contributors financially on retirement or separation from their jobs. Besides managing provident fund of the contributors, it also provides certain social benefits to the contributors.

Following figure shows the growth in assets and liabilities of the Employees Provident Fund for the last five fiscal years as per the economic survey report of the respective years.

Figure 4: Trend of assets and liabilities of the Employees Provident Fund (Rs. in Billion)



Source: Ministry of Finance, Economic Survey Report (2015/16/17/18/19)

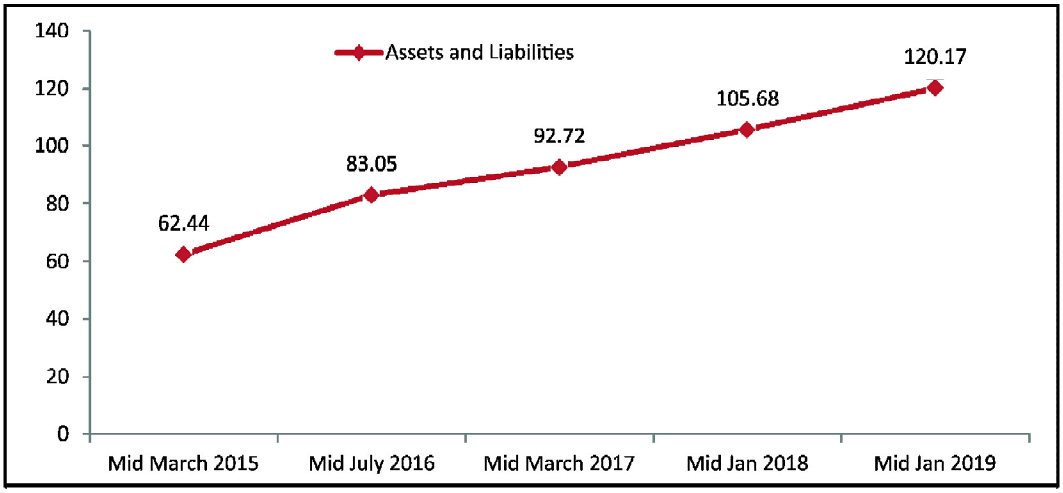
The diagram shows the increasing trend of in assets and liabilities of the Employees Provident Fund.

(3) Citizen Investment Trust

Citizen Investment Trust (CIT) also known as Nagarik Lagani Kosh, a statutory institute under Citizen Investment Trust Act-1991, has ownership of Nepal Government as a public financial organization. It was established on 18th March, 1991, however, it has been operating its activities formally since 15th January, 1992. The major functions of CIT are; saving mobilization, investment/financing, and capital market services. Under investment/financing it invests in corporate shares, debentures and government securities, provides term loan and bridge finances to corporate bodies and provides credit for purchasing shares.

Following figure shows the growth in assets and liabilities of the Citizen Investment Trust for the last five fiscal years as per the economic survey report of the respective years.

Figure 5: Trend of assets and liabilities of the Citizen Investment Trust (Rs. in Billion)



Source: Ministry of Finance, Economic Survey Report (2015/16/17/18/19)

The diagram also shows the increasing trend of in assets and liabilities of the Citizen Investment Trust.

(4) Social Security Fund

Social Security Fund (SSF) was unveiled in November 2018 under The Social Security Act (the Compensation-based Social Security Act-2017 in full) and has been effective from 17 July 2019. The recently passed Labour Act-2017 has also provision for creating a Social Security Fund (Maharjan, 2018). Under the social security fund employer and the Employees are required to contribute certain amount of the employee's basic salary specifically 11 percent by employee and 20 percent by employer totaling to 31 percent of basic salary each month to the Social Security Fund. Therefore, the fund receives contributions made by employers and employees; provident funds; retirement benefits (gratuities and other benefits); bonus deposited to the National Welfare Fund; social security tax; donations and loans provided by the government; donations, loans and grants provided by foreign governments; amounts of interest or profit from the deposits in the fund or from international corporations; and amounts from any other source (Maharjan, 2017).

The fund may also invest the deposits in the lucrative sectors such as hydropower. The fund may also give loans to government entities like Nepal Airlines Corporation and

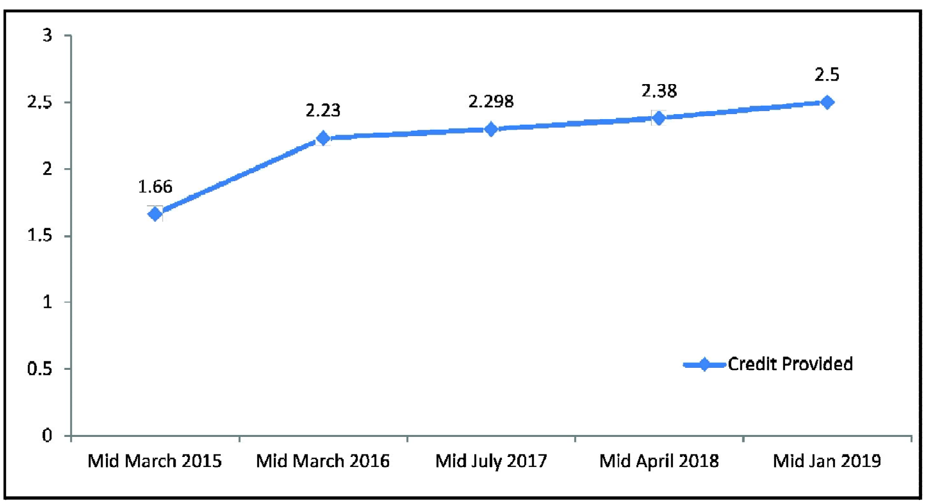
Nepal Oil Corporation under government surety. The total contributed fund is Rs. 870.1 Million with the 12,315 employer and 153,276 employees till the Mid-March 2020.

(5) Rural Self-Reliance Fund

Rural Self Reliance Fund (RSRF) was established by the Government of Nepal in February 1991. It provides institutional wholesale credit to the financial intermediaries, i.e., Saving and Credit Cooperatives (SACCOs) and Financial Non-Government Organizations (FINGOs) (NRB, Special Publication, 2018). It is an NRB operated micro financing project that provides credit on the installment basis based on the performance of the borrowing institutions. It has been providing bulk credits with an objective of improving the socio-economic status of the targeted group through optimum use of local resources and skills.

Following figure shows the growth in credit provided by the Rural Self Reliance Fund for the last five fiscal years as per the economic survey report of the respective years.

Figure 6: Trend of credit provided by the Rural Self Reliance Fund (Rs. in Billion)



Source: Ministry of Finance, Economic Survey Report (2015/16/17/18/19)

The diagram shows the increasing trend of in credit provided by the Rural Self Reliance Fund.

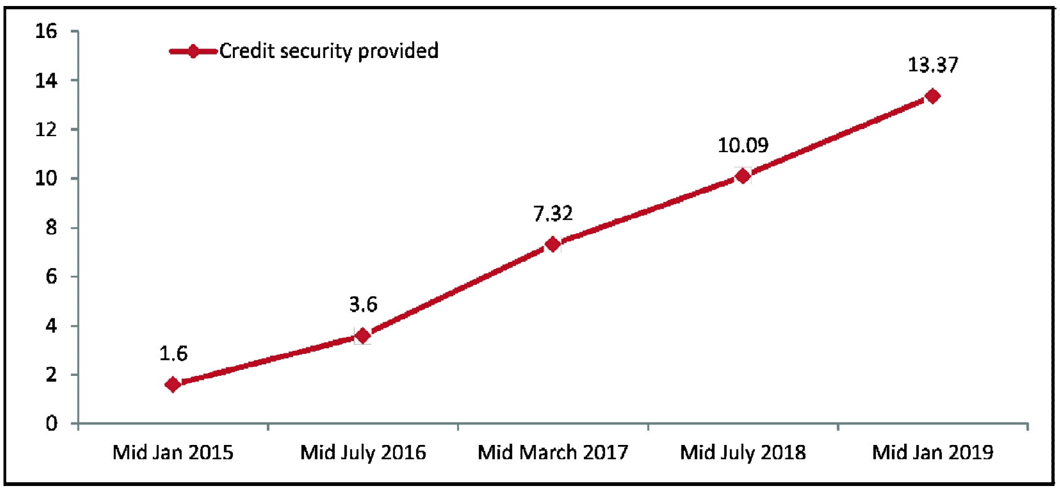
(6) Deposit and Credit Guarantee Fund

As a deposit insurer, Deposit and Credit Guarantee Fund (DCGF) has started the deposit guarantee scheme in Nepal from the year 2010. DCGF has given the statutory responsibility to perform both the deposit guarantee and credit guarantee function through it's own

"Deposit and Credit Guarantee Fund Act, 2073" (DCGF, 2020). DCGF has been providing the deposit security up to amount Rs. 300 thousand deposited in saving and fixed accounts of bank and financial institution in the name of natural person. Likewise, it has also been providing the security to the credit of priority sector including livestock credit, credits to deprived class, credits to small and medium enterprises, agricultural credit etc.

Following figure shows the growth in credit security provided by the Deposit and Credit Guarantee Fund for the last five fiscal years as per the economic survey report of the respective years.

Figure 7: Trend of credit security provided by the DCGF (Rs. in Billion)



Source: Ministry of Finance, Economic Survey Report (2015/16/17/18/19)

The diagram shows the increasing trend of in security provided by the Deposit and Credit Guarantee Fund.

(7) Postal Savings Banks

The Postal Savings Banks are managed under the Postal Service Department, Government of Nepal and came into operation since 1976. Till mid-January of FY 2018/19, the total deposit amount of Postal Savings Bank (PSB) has been Rs.1.39 billion. The total number of saving accounts in this bank has reached to 50,765 (Economic Survey Report, 2019).

IV. REASONS FOR THE DEVELOPMENT OF SHADOW BANKING

The growth of shadow banking especially during the years preceding the financial crisis resulted largely from the increase in the global demand for safe assets. The growth of shadow banking in the US went almost hand-in-hand with the flow of surplus capital from China to the US. Risks were spread also to European banks. One way to increase safety and reduce the risks of shadow banking is to increase the public supply of safe assets (SUERF, 2017).

In one of the study, it is found that the growth of shadow banking is due to technological innovation and regulatory changes in the past several decades. In the shadow banking system, financing is mostly done through securitization techniques and financing guaranteed (secured funding) include Assets Backed Commercial Paper (ABCP), assets backed securities, Collateralized Debt Obligations (CDOs), and repo, that lack transparency and have weak oversight.

According to Constâncio (2015), the recent substantial increase in the size of the shadow banking sector in the Euro area is also due to a more stringent banking regulation in anticipation of the implementation of new capital and liquidity rules under Basel III could have, in itself, induced a shift of lending to the unregulated sector. Likewise, Kim (2016) concluded that the growth of shadow banking, in G20 countries, is accompanied with the growth in traditional banking. The study revealed that one percentage point increase in the size of traditional banking to Gross Domestic Product (GDP) attributes to the growth of shadow banking by 0.51~0.66%p in the long run.

In conceptual terms, one could argue that shadow banking is like any other form of financial intermediation - a response to the unmet needs and preferences of willing borrower and lenders. It can be taken as one of the hidden justifications to the development of shadow banking in the financial system in the world including the developing countries like Nepal. According to Chaulagain (2015), there is a strong stake of saving and credit cooperative societies (SACCOS) in Nepal outside the Nepal Rastra Bank's purview of regulation and supervision, which are doing the similar saving/credit functions as banks and financial institutions licensed by NRB do. Currently, there are more than 30,000 cooperatives, one employee provident fund and one citizen investment fund that provide saving and credit services but do not have any direct regulating and supervisory body.

It is pragmatic and empirical to state that the presence of shadow banking entities becomes the top choice for small business and agribusiness. It is because that the shadow banking entities' micro business loan is very favorable and convenient to them. Shadow banks also prefer such customer because in addition to safety, it yields better profits especially when dealing with the same customers since for small business rate of interest is not an issue.

One of the countries that have rapid growth of shadow banking is China, neighboring country of Nepal. The growth of shadow banking in China is due to banking regulations that are very strict hence the shadow banking practice grows at high interest. It is applicable to the Nepalese context also in a sense that Nepalese customers firstly approach to the informal banking units for the financial needs fulfillment. It is also because that they find bank rules and regulations are not friendly to them and have to pass through time consuming procedural. Therefore, banking regulations has also fueled the informal channels.

Similarly, one of the major reasons for growing informal banking sector in Nepal is that entering the formal channel is met with resistance and there is culture of avoiding formal channels among the customers. The higher costs attached to the documentation requirements and the potential for increased tax scrutiny act as a disincentive to associating with formal providers. Formal channels have specific collateral requirements which the borrower is usually not able to fulfill for instance, assets used as collateral must be insured. It was found that 24% of Nepali adults had been refused loans due to lack of proof of sufficient income, while 19% were unable to provide collateral (UNCDF, 2017). Therefore, customers tend to search for ease in the processes for the financial services which lead them to the informal sectors, ultimately promoting shadow banking.

Nepal Rastra Bank, central bank of Nepal, is also keenly watching the shadow banking prevail in Nepal and trying to gauze the depth of it and implementing prudential policies to regulate.

V. WHY DOES SHADOW BANKING NEED TO BE REGULATED?

Assets of non-bank intermediaries, using a narrow definition, reached $117 trillion in 2017, a 31% share of total global financial assets, up from 26% in 2008. Meanwhile, over the same period, banks' share of total global financial assets declined from 45% to 39% (Das, 2019).

Global economy has accepted the fact that shadow banking has contributed to enhancing the efficiency in the financial markets and improving the credit availability in the real sector. However, the shadow banking system can raise the systemic risk in the financial markets via reinforcing interconnectedness between financial institutions. It is the risk which shows the possibility that an event at the institution level could trigger severe instability or collapse an entire industry or economy which was the major contributor to the financial crisis in 2008. Similarly, according to FSB (2020), non-bank financing may become a source of systemic risk – both directly and through its interconnectedness with other parts of the financial system – if it involves activities that are typically performed by banks, such as maturity/liquidity transformation and the creation of leverage. Therefore, the regulations are the most.

Shadow banks can expand their activities by taking advantage of loose capital requirement or employing evasive behaviors. Between traditional banking and shadow banking there are similarities and differences. Both traditional/regular banks and shadow banks perform credit intermediation. But while in traditional banking intermediation occurs under "the same roof" and in shadow banking intermediation occurs through a chain of entities (Pozsar *et al.,* 2010). Therefore, operations are more complex in the shadow banking system than in the traditional banking system.

According to IMF (2013), the shadow banking entities are characterized by a lack of disclosure and information about the value of their assets (or sometimes even what the assets were); opaque governance and ownership structures between banks and shadow banks; little regulatory or supervisory oversight of the type associated with traditional banks; virtually no loss-absorbing capital or cash for redemptions; and a lack of access to formal liquidity support to help prevent fire sales. Because of all these reasons, there is the urgent need for the regulations in order to mitigate the probable risks due to the involvement of the shadow banks in financial system.

For example, the demise of Lehman Brothers in 2008, victim of the subprime mortgage crisis, is believed due to it's over leveraging, poor long term investments, shaky funding, unwieldy venture and lack of trust. Lehman Brothers, like many other firms were become more and more heavily involved in issuing mortgage backed securities and collateral debt obligations. These activities were beyond the regulatory framework of the central banks and the firm declared $639 billion in assets and $613 billion in debts, making it the largest bankruptcy filing in US history (History, 2018).

Infrastructure Leasing & Financial Services Ltd., which funds projects including roads and tunnels, got into trouble as short-term financing costs jumped, raising questions about other Indian shadow banks that rely on such funding (Luo, 2018). In the context of Nepal, the Ministry of Land Management, Cooperatives and Poverty Alleviation has declared 11 savings and credit cooperatives in the Kathmandu valley problematic after they failed to pay back their depositors' money. The Problematic Cooperatives Asset Management Committee has been working to liquidate their assets to raise cash to pay off creditors, so far (Khanal, 2019).

VI. A FRAMEWORK FOR POLICY RESPONSE: INTERNATIONAL AND GOVERNMENT OF NEPAL

International Monetary Fund, Article IV Consultation Report, (2017) has already recommended for the policy that the central bank, NRB, should continue to roll out the application of risk-based offsite and onsite AML/CFT tools, including decisive and prompt enforcement action and sanctions for non-compliance with AML/CFT requirements. Strengthened implementation of the AML/CFT framework is encouraged, notably by cooperatives, insurance companies and securities firms.

The large number of financial cooperatives accounts for more than 15 percent of financial system assets and have linkages to the banks. However, the absence of meaningful regulation and supervision of the cooperatives sector needs to be remedied, for example through the creation of a designated second-tier institution as well as resolution tools. Similarly, there is increasing debate going on among the cooperative managers and stakeholders that there is urgent need to set-up the second tier institution for the protection of depositors who have their billions of savings in such financial institutions (IMF, Article IV Consultation Report, 2017). Therefore, NRB, as central bank, can take an initiation for designing and formulating the second-tier institution and regulatory framework for the shadow banking system.

Likewise, the Banking Offence and Punishment Act, 2008 following its first amendment in 2016, Section (14ka) has expanded the scope of banking offences to 'Dhukuti' transactions (a practice of unauthorized informal group deposit and lending). Similarly, Section (14kha) has also explained an involvement in illegal banking transactions as banking offense. Particularly, cooperatives, registered under Cooperative Act-2017, and according to this act Section 26 (2), have to obtain prior approval of the Nepal Rastra Bank in order to carry on other banking transactions including acceptance of deposits and disbursement of loans limited only to its members other than the transactions mentioned in Sub-section (1) "An association or society may accept saving deposits from its member and lend loans to its members." Such association or society has to observe the terms and conditions prescribed and directions given by the Nepal Rastra Bank. This also helps the direct regulation of the shadow banking activities in which NRB can focus on.

Cooperative Act-2017, chapter 17 'Inspection and Monitoring', section 95 ' Inspection and Checking of Accounts' sub-section 2 has stated that the Nepal Rastra Bank may at anytime inspect or check or cause to be inspected or checked accounts financial transaction of a cooperative bank or of a cooperative organization which carries out financial transaction of an amount or exceeding a ceiling. This provision allows NRB to regulate the cooperatives and control over the shadow banking to some extent.

Similarly, according to Cooperative Act-2017, entire functions as to registration and regulation of cooperative organizations having their services within the local level may be carried out by the concerned local level i.e. 753 local levels and orderly to 7 provinces and the central with extended services. This allows wide span for the niche regulation of the cooperatives and promotes control over.

The cooperatives ministry is also working to ensure effective implementation of COPOMIS, Cooperative and Poverty related Management Information System, to keep cooperatives in line. The government introduced COPOMIS two years ago and instructed cooperatives to install the software. As per department sources, most cooperatives have installed the programme but only a few of them are using it regularly. The ministry is making all cooperatives enter their data instantly into the system, update the details of cooperatives and make the regulation effective. It is believed that the problems in cooperative businesses would be largely resolved once a monitoring mechanism is developed at the local level.

The Government of Nepal has formally joined the **Better Than Cash Alliance (BTCA)** which is an alliance of governments, private sector and development organizations committed to accelerating the shift from cash to electronic payments. UNCDF supports the Ministry of Finance in Nepal shift from cash to electronic payments (UNCDF, 2017). According mid-term review of Monetary policy-2020/21, total 9 payment system operators and 10 payment service providers non-banking and financial institutions have been provided final licenses to operate with the policy of enhancing electronic payment systems. This allows the people to involve in financial transactions without being the member of non-financial institutions as electronic payments are under the various regulations and transactions are recorded that help to regulate these institutions.

Financial inclusion is one of the pillars to promote the formal banking system in Nepal. Nepal Financial Inclusion Roadmap (2017–2022) is a part of Making Access Possible (MAP) Nepal Initiative which is governed by a Project Executive Board chaired by the Nepal Rastra Bank. It has proposed a policy target of increasing formal financial inclusion in Nepal from 60 percent to 75 percent by 2022, and reducing the excluded proportion from 18 percent to 3 percent. There are six initiatives and priorities proposed in the road map; one of them is to unlock constrained credit and savings markets. It helps formal channels to compete with the informal channels to unlock the correct value proposition for the market. In a way, NRB is developing micro finance institutions, D class, as an alternative to the cooperatives and other financial non-government organizations (FINGOs).

'Open Bank Account' campaign was launched as per the budgetary program of the government for the fiscal year 2018/19 in order to enhance the access of all people into the banking system. The campaign aims at opening bank accounts of every Nepali citizen in commercial banks at zero balance. The banks have also agreed to provide Rs. 100 in each account opened under the campaign as per their corporate social responsibility (CSR). Since, banking is the most transparent and most regulated business sector in the country, government is also focusing on promoting formal banking channel so that informal banking channels do not grow and can be regulated.

According to SUERF (2017), the Chinese authorities are facing a trade-off: the credit growth in the shadow banking sector is importantly supporting economic growth but also causing risks to financial stability. Authorities have required banks to consolidate exposures to shadow banks in stress testing. NRB can also think of implementing stress testing mechanisms in shadow banking system as similar to China.

In October 2017, the Basel Committee on Banking Supervision released the final Guidelines on identification and management of step-in risk. Step-in risk refers to the risk that a bank provides financial support to an entity beyond, or in the absence of, its contractual obligations should the entity experience financial stress. As part of the G20's initiative to strengthen the oversight and regulation of the shadow banking system, the guidelines help mitigate the risk that potential distress faced by shadow banking entities spills over to banks. The guidelines do not prescribe any automatic Pillar 1 liquidity or capital charge, but rather rely on the application of existing prudential measures available to mitigate significant step-in risk (NRB, Bank Supervision Report, 2018). Thus, NRB can implement such BASEL accords and guidelines on identification and management of step-in risk prevail in the Nepalese financial system.

These policy formulation, effective implementation and coordination with the other stakeholders lead NRB to the desired control and regulation over the shadow banking system.

VII. POLICY RESPONSES BY NEPAL RASTRA BANK

Nepal Rastra Bank (NRB), central bank of Nepal, established in 1956 under the Nepal Rastra Bank Act 1955 is the monetary, regulatory and supervisory authority of banks and financial institutions. However, non-banking institutions are also growing in Nepal which is under the regulation of Ministry of Finance, Government of Nepal. The Third Strategic Plan (2017-2021) and its SWOT analysis also has prioritized Informal financial market and shadow banking as one of the emerging threats of Nepal Rastra Bank.

In light of these, NRB is responsible for everything possible to control over the shadow banking so that informal banking does not be the reason for the spillover effect of failures in formal banking. Shadow banking practices, especially those involving larger cooperatives around the urban areas has posed challenges to the financial system (NRB, Financial Stability Report, 2018).

A newly issued regulation requires cooperatives with annual transactions of more than Rs. 500 million to be supervised jointly by Nepal Rastra Bank, the Department of Cooperatives and the central or sub-national government. Therefore, NRB can rigorously participate and cooperate in this regulatory activity. In addition, NRB has also adopted the policy of handing over the cooperatives, which were operating by obtaining license from the bank to the Small Farmers Development Bank (SFDB) and National Cooperative Development Bank for their effective supervision (NRB, 2018).

In order to make Rural Self-Reliance Fund more effective, Rural Self Employment Fund Working Procedure-2019, has been implemented with a decision to mobilize it through Small Farmers Development Micro-finance Financial Institutions limited. Similarly, NRB, Bank and Financial Institutions Regulation Department, has also issued a notice urging banks and financial institutions, of grade 'A', 'B', 'C' and 'D', to mandatorily enlist and manage to get enlisted in the contribution-based social security scheme under Social Security Fund (SSF), on 10 December 2019. SSF is expected to be an umbrella organization for the provident fund management under regulation of Government of Nepal which ultimately facilitates regulation of the shadow banking.

Improvement in oversight and regulation of shadow banking should be given apt priority mostly in emerging economies. The monetary policy is one of the tool through which the central bank or NRB can have control over the monetary system. The recent Monetary Policy, 2019/20 has set the provision of introducing 'Financial Consumer Protection Manual' in order to increase the confidence of general public in financial sector by addressing the grievances of depositors and borrowers. Similarly, a 'Financial Consumer Protection Unit' will be established in NRB in order to protect the interest of financial consumers (NRB, 2019).

As mentioned in the Monetary Policy 2019/20 that a provision will be made for the development banks and finance companies as well to upload their statements directly from their core banking system to the goAML software with a view to enhance the effectiveness of the goAML system in preventing money laundering and combating financing of terrorist activities. As a result, goAML has been in effective for the commercial banks in order to upload the information electronically into FIU since 15 Jan 2020. Similarly, development banks and finance companies are mandated to fully operate this system by the end of mid-July 2020 according Mid-term Review of Monetary policy-2020/21.This is expected to control the informal banking activities which are outside the regulatory framework also.

Nepal Rastra Bank (NRB), via its Banking and Financial Institutions Regulation Department, has upgraded its reporting system with support from United Nations Capital Development Fund (UNCDF) and the Mobile Money for the Poor Programme (MM4P). NRB has created an e-mapping platform based on a geographic information system (GIS) that shows all existing financial points in Nepal and enables efficient compliance control, data analysis and policy formulation. One of the objectives of this platform is to track deposits/loans, including amounts at different levels (UNCDF, 2017). This should be continued for the purpose of updated with the financial inclusion and formal banking.

According to NRB Unified Directives-2020, the cooperative institutions established according to the existing law shall not be allowed to invest in institutional capacity in the shares of promoters or of promoters group of banks and financial institutions licensed by the bank or in the applications to be submitted for new license. This directive is required to be continued so that BFIs and cooperatives do not have mutual ownership and promote shadow banking.

In line with the Merger & Acquisition Policy of Nepal Rastra Bank, a total of 185 BFIs have undergone through the merger/acquisition process as of mid-Jan 2020. Out of these, license of 140 institutions has been revoked thereby forming 45 institutions. Therefore, BFIs are slowly coming in to size of the economy that enables NRB to effectively regulate them and ensure if they are involve in promoting the informal banking as well. According to IMF (2012), one of the views on regulating shadow banking is that these banks should become, or merge into, traditional banks. The usual argument for merging (or expanding the regulatory perimeter) is that putting all activities in commercial banks will ensure supervisory coverage and help prevent regulatory arbitrage. However, it is debatable issue to discuss upon. In addition, it is helpful for the NRB if it can promote the merger and acquisitions of other informal sector for the strong operations.

In the Human Resource Plan (2019/20 and 2021/22) of Nepal Rastra Bank, it has envisioned, created and proposed a separate department called Non-Financial Institution Supervision Department. It will have inspection and supervision unit specifically responsible to supervise the institutions which accept contractual deposits and mobilize the funds like; citizen investment fund and employee provident fund, hire purchase company, money transfer, airlines, cargo company, payment system operators, money changer, hotel/casino and travel agents and so on. By this foresightedness also, it can be concluded that NRB is rigorously working hard to regulate the shadow banking formally.

With the due consideration of recent international practices for controlling the shadow banking and fully exercising and implementing the prevailing rules, guidelines and acts, Nepal Rastra Bank can have regulatory control over the shadow banking system. This ultimately helps NRB to analyze the financial system of Nepal and promulgate policies that support financial soundness and stability leading to achieve higher economic growth.

VIII. CONCLUSION

Shadow banks are institutions that operate outside the regulatory framework of the traditional banking system and because of that, they do not have the same safety net as the traditional banks. Shadow banking offers an access to cheaper and more flexible credit arrangements which encourages business investment and the efficient flow of money, which in turn drive economic growth. While shadow banks are viewed beneficial to the economy because they provide alternative sources of credit within the economy, they can be sources of serious threat to the stability of the financial sector and the economy as a whole. Other regulators and the stakeholders need to formulate the policies that curtail the risky parts of shadow banking.

Being a supreme monetary authority and central bank of Nepal, Nepal Rastra Bank is supposed to figure out the non banking financial intermediations and have prudential regulatory framework to deal with the shadow banking system. The proposed Non-Financial Institution Supervision Department in the Human Resource Plan (2019/20 and 2021/22) also shows the evidence that NRB is in the avenue of regulating the shadow banking system. However, the basic problems that arise in the Nepalese economy are in the effective implementation of the action plans, so does the NRB. Having almost all the supportive rules, bylaws and acts, NRB now has to focus on the effective implementation of the formulated plans. Learning from the international best policies and practices, complying with the domestic rules and regulations and setting up the system that suits particularly the Nepalese financial system, NRB is the only one institution in Nepal that can make appropriate supervision of the banking and financial system in order to maintain its stability and foster its healthy development and to enhance the public confidence in Nepal's entire banking and financial system.

Disclaimer: *The views expressed here are those of the author and do not necessarily reflect those of the Nepal Rastra Bank and any other institutions.*

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