Sound Money and Credit Market Regulations in Nepal

Ashansa Mulmi

1. Introduction

Nepal's monetary policies have fluctuated between easing and tightening over the past decade in response to significant crises such as the 2015 earthquakes and the 2020 pandemic. These events have transformed the country's financial and economic system. According to the International Monetary the post-earthquake period saw an economic boom with a significant rise in productive investments, leading to a demand-driven and investment-oriented credit cycle[1]. The result of COVID-19 was a different scenario—the country experienced a shift toward a supply-driven and consumption-heavy credit cycle. Financial measures and credit regulation relaxation during this period have had lasting repercussions to the present day.

NRB's policies in the wake of COVID were swift, but absent accompanying strategies and regulations to leverage them, the country was left vulnerable to economic stagnation[2]. Before the pandemic, and specifically after the 2015 earthquake, the credit system was exhibiting new growth trends; private sector optimism was high, and credit was substantially being used for capital formation and long-term expansion, such as in hydropower, infrastructure, and manufacturing. The onset of the pandemic triggered a domestic liquidity surge financed by a rapidly expanded credit availability through monetary easing, concessional lending policies, and refinancing schemes. The difference between the post-earthquake reality and the post-pandemic reality was that in the latter, the economy was not set to steer toward long-term productivity-enhancing sectors. The financial system, under discretion from the central bank, expanded the vast resources throughout the nation without a proper needs assessment in response to the pandemic shock. And so, the equal but inequitable flow of this "free money"[3] got channeled into real estate/land speculation, security markets, and consumer loans, all of which limited long-run multiplier effects.

Recent regulatory shifts by Nepal Rastra Bank (NRB) have tightened credit conditions, raising concerns about the timing and the drastic impact on economic recovery. With financial stability as the apex objective, the sudden and simultaneous implementation of stringent measures may discourage new credit, add to banking costs, and diminish private sector confidence.

---

[1] International Monetary Fund, *Nepal: Technical Assistance Report—Financial Sector Stability Review,* (Washington DC: IMF, 2023), https://www.imf.org/en/Publications/CR/Issues/2023/10/03/Nepal-Technical-Assistance-Report-Financial-Sector-Stability-Review-539970.

[2] Anal Bhattarai, *Economic Outlook Feb 2025,* (Kathmandu: Kala Legal, 2025), https://kala-legal.com/navigating-the-financial-horizon-explore-financial-outlook-with-kala-legal/.

[3] As discussed in the stakeholder meeting.

This study builds on the Economic Freedom of the World Index conducted by the Fraser Institute to explore the relationship between Nepal's credit market regulations and their impact on sound money. Current policy tightening risks a reduction in economic activities and may push the nation toward deflationary results. The index notes that monetary authority decisions change the value of money, resulting in sudden inflation or deflation, expropriating property from lenders or from borrowers, and eventually interfering with individuals' ability to make their own economic choices.

Over the past decade, Nepal's mean scores for sound money (6.04) and credit market regulations (8.88) have trended positively toward 10, indicating an economically free environment (See Figure 1). However, these scores do not adequately reflect Nepal's actual financial environment. Despite seemingly strong credit market conditions, private sector credit growth has stagnated, failing to meet target rates in recent years. Private capital formation is slowing while defaults, non-performing loans (NPLs), and blacklisted entities are on the rise.

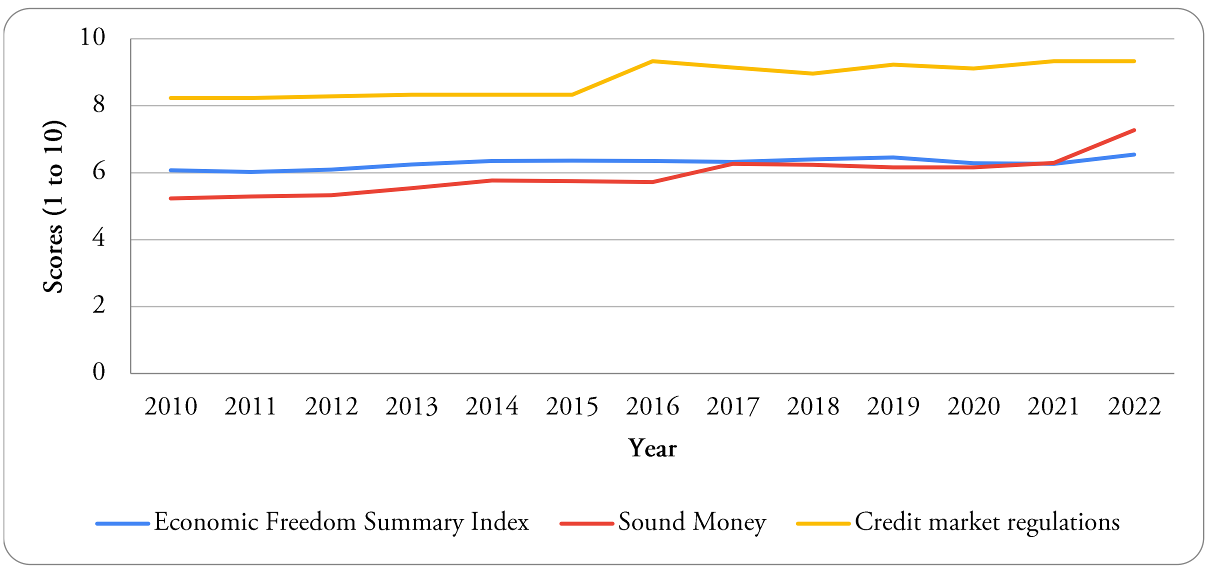

Figure 1: Nepal's (score) performance in - Economic Freedom Index, Sound Money, and Credit market regulations

Source: Fraser Institute

The Economic Freedom's Sound Money Score is calculated through a combination of sub-metrics. These include money growth to measure the five-year annual average growth of money supply in relation to the ten-year Real Gross Domestic Product (RGDP) growth; the standard deviation of inflation, which captures volatility of inflation rates in the past five years, and also the most recent year's inflation rate. This component also checks if citizens of the nation are able to operate foreign currency bank accounts, both domestically and abroad. NRB allows any person or entity with foreign currency income to open a foreign currency account domestically. There are no limits on deposits or withdrawals given the source is documented. However, as per the provisions of the Foreign Exchange (Regulation) Act, 2019, and the Act Restricting Investment Abroad, 2021, Nepali citizens are prohibited from opening a bank account abroad.[4]

The *Credit Market Regulations* component, which falls under the broader Regulations category, relies on four main sub-indicators. These include ownership of banks, which measures the share of deposits held under government and private banks; private sector credit, which assesses the amount of credit flown into the private sector as compared to the government sector; and Interest rate controls or negative interest rates, which evaluates if interest rates are determined by the market or set by authorities to assess the competitiveness of the industry. Both indicators capture a country's relative strength in maintaining the purchasing power of the currency, preventing inflationary distortions, and supporting sustainable economic growth.

On paper, Nepal has adopted sound Monetary principles and even an efficient Credit Market regime. Nepal's score in the Economic freedom Report, suggests that its policy environment is economically free. Between 2019-2023, Nepal's inflation rate had an average standard deviation of 9.27%, with a five-year standard deviation of 1.6%. On a scale from 0 to 10, where higher scores indicate minimal variation in the annual inflation rate, Nepal's inflation stability score is 9.36 (see Annex). The share of deposits held in private banks compared to the share in government-owned banks is higher, private sector credit growth has increased modestly, and private ownership of banks in Nepal is high. All of this should ideally result in modest real GDP growth.

---

[4] There is a provision that allows citizens to open a foreign currency account in a foreign bank and deposit amount they have earned during their stay abroad. However, recent NRB mandates that money in foreign banks should be brought home within 35 days of return to Nepal. If someone wishes to maintain such an account or make investment even after returning to Nepal, they must disclose their name, address, account number, foreign currency, and amount to the NRB within 35 days. Nepal Rastra Bank, Directive: *Under What Circumstances Can Nepali Citizens Living Abroad Open a Bank Account Abroad?,* (Kathmandu: NRB, 2025), https://www.nrb.org.np.

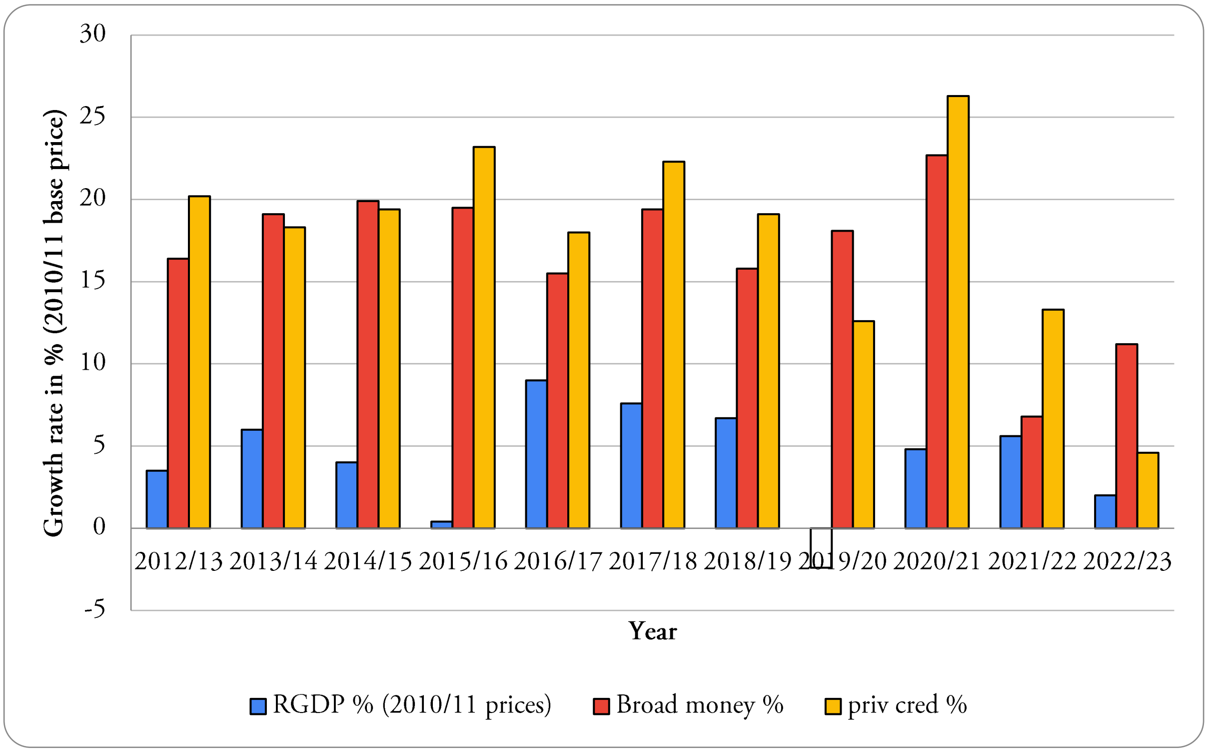

Figure 2: Growth rates of RGDP, Credit to private, and M2
Source: NRB

Broad Money Supply has increased significantly, but Nepal's real GDP growth rate has not increased at the same pace. The average growth of RGDP over the past decade is 4.29% while that of broad money supply (M2[5]) is 16.19%. The average growth rate of money supply in the past 5 years, however, is lower at 14.92%. While private sector credit has grown substantially, the RGDP shows only a modest increase. This suggests that credit extended to the private sector has not fully translated into proportional economic output or real growth. In a sound economy, private sector credit should stimulate productive activities, leading to corresponding increases in RGDP. However, the relatively flat RGDP growth compared to the steep rise in private sector credit indicates diminishing returns on credit expansion.

A perplexing situation currently unfolds in Nepal, where the economy has a rather subdued inflation effect despite the hike in monetary expansion with a significant surge in remittance and deposits. Traditional macroeconomic theories would suggest that rise in liquidity would add onto consumer prices and potentially destabilize the fixed exchange rate peg with India. However, inflation remains contained.

[5] Includes cash, checking deposits, and easily convertible near money

One of the essential factors explaining this is the fixed exchange rate regime with India which is a powerful anchor for inflation. Historically, Nepal's inflation trends have closely followed those of India, and hence, the country indirectly imports price stability. So, even when the central bank expanded liquidity in the past five years, its impact on prices has been moderated mainly through external anchoring.

Adding on to this, much of the liquidity generated from remittances and credit was absorbed into asset markets—particularly into real estate—into bank deposits, or refinancing of existing loans. Much of the increased money supply has also fueled consumption growth but since Nepal relies heavily on imports, liquidity has leaked abroad rather than exerting pressure on domestic prices. In totality, whatever liquidity had increased, it had a much larger impact on asset prices rather than consumer goods inflation; in the end it did not translate into a broader demand-pull inflation domestically.

The central bank's proactive liquidity management has also played a critical role; as per the latest Financial Stability report, NRB has absorbed over NPR 16 trillion in liquidity in the first eight months of 2024/25. These measures have prevented the surplus money from fully translating to inflationary pressures, thereby reinforcing the limit of monetary discretion as implied by the fixed exchange rate regime.

While these structural factors help explain why Nepal maintained a relatively low inflation—despite conditions that superficially appear highly inflationary—it is important to note that there are risks in the long run. If asset price bubbles burst and spill over to broader demand, or if there is sharp inflationary surge in India, Nepal will eventually face inflationary pressures with a lag.

While the country's money supply is regulated, it does not necessarily align with RGDP growth. The sections that follow, therefore, assess the supply-side constraints to credit disbursements. While demand-side factors also play an important role, they are largely impacted by fiscal policies rather than monetary policies. Since supply-side constraints have become a growing factor in the current financial challenges, this paper prioritizes analysing them to better understand the credit availability and their effectiveness on Nepal's economic growth.

2. Structural Weaknesses and Regulatory Overreach

Nepal's regulatory architecture consists of overlapping restrictions, which may be individually justifiable but collectively constrict credit growth. Among the most notable reforms is the introduction of the Expected Credit Loss (ECL) accounting framework in 2024, which mandates BFIs to provision against possible loan defaults based on projected cash flows. While the accounting standard may be necessary, it is important to acknowledge that along with other restrictive mandates the BFIs will have to keep substantial reserves for their entire loan portfolio, further constraining funds for new lending. Beyond ECL, the other concern is the implementation of blanket regulatory requirements—such as the uniform Capital Adequacy ratio (CAR) and Working Capital loan guidelines—without regard to each institution's diversity, or macroeconomic/cash cycle. Again, while these measures aim to maintain financial resilience, they are instead becoming burdensome for banks operating in a stagnating economic environment.

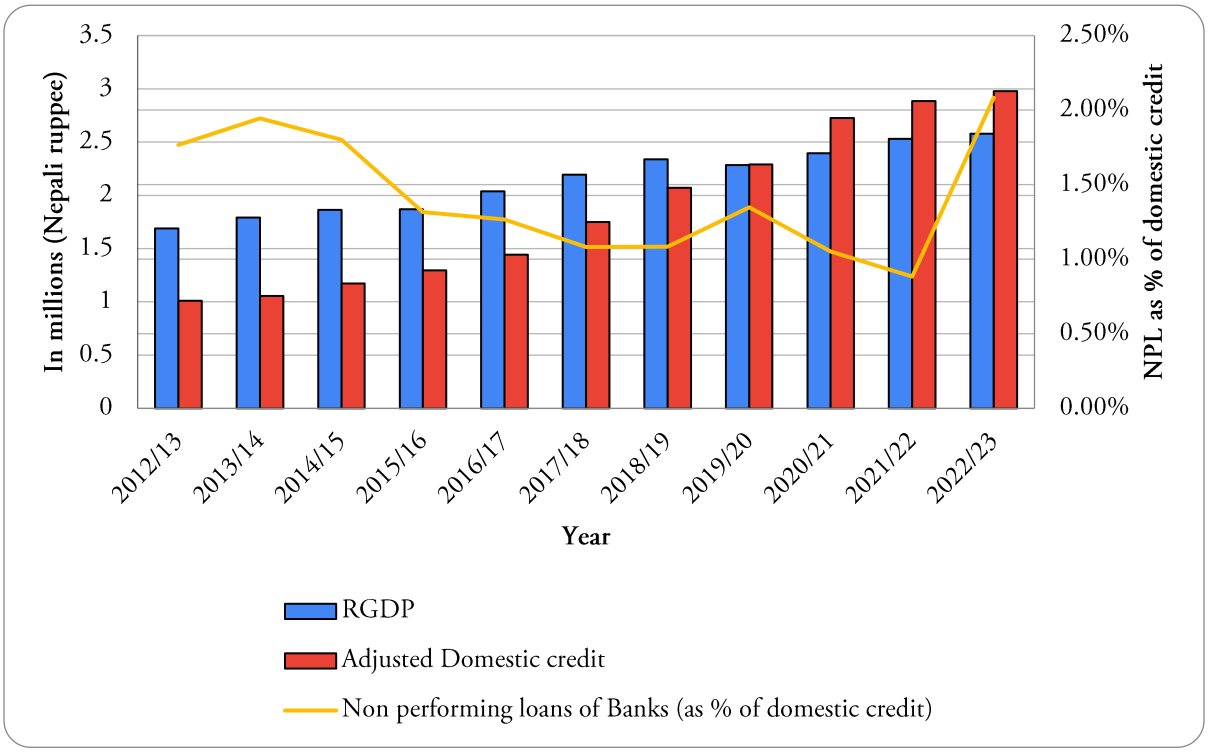

Figure 3: Economic Performance of the country based on RGDP, Adjusted domestic credit, and Non-Performing Loans (NPL) as percentage of adjusted domestic credit

Source: NRB. Base year = 2010/11 (RGDP; domestic credit and NPL has been rebased to 2010/11 for comparability

Recent financial indicators reinforce the severity of the credit market distortions. As per the recent Financial Stability Report[6], private sector credit has grown by 6% in the first eight months of 2024/25

[6] Nepal Rastra Bank, *Financial Stability Report, Fiscal Year 2023/2024,* (Kathmandu: NRB, 2025)

from 4.2% last year, but deposit growth has slowed to 4.3% from 7.6% signaling an emerging funding pressure in the system. As credit in the economy has been increasing, its composition has shifted between government and private borrowing, and has resulted in an inefficient credit allocation because it is not translating to proportional economic productivity.

Interest rates have also decreased, with both deposit and lending rates reduced. The lending rate, which stood at 12.3% in 2022/23, has fallen to 9.93% in 2023/24, while deposit rates have also declined to 5.77% from 7.99%. A narrowing spread indicates shrinking bank profitability, and when combined with stringent regulatory measures, results in an increase in credit expansion to low-risk and short-term deals.

The capital adequacy framework, aligned with global standards such as Basel III, mandates banks to maintain a high level of regulatory capital to enhance stability. However, the current economic situation poses challenges to this. Small and mid-tier banks struggle to maintain the capital buffers in the face of declining profitability and rising credit risks. As provisions rise, retained earnings deplete, which limits internal capital generation. This has led to banks adopting more conservative credit issuance behavior, whereby priority has shifted from supporting economic expansion to preserving balance sheets, resulting in slower credit growth. Suppliers of credit have tightened their resources, not necessarily due to demand weakness but because of the need for capital rationing.

On the other hand, access to working capital financing has become increasingly restricted for businesses, particularly small and medium enterprises (SMEs). In alignment with amendments to the working capital guidelines, banks have tightened their standards for short-term credit products across different sectors, stemming from the rise of NPL concerns, especially among SMEs. The mandate that banks need a 100% loan loss provision and borrower blacklisting for non-compliance disproportionately affects SMEs given their inability to recover completely post pandemic. The immediate consequence of such a blanket policy is a liquidity crunch in the economy. Businesses that rely on short-term credit to manage operating expenses are facing cash flow volatility. The financial stress that this entails is a rise in loan defaults, creating a negative feedback loop in the sectors. Ultimately, the vast number of SMEs across the country face the brunt of this cycle[7].

An illustrative case of regulatory overreach comes from the Indian banking sector. In 2018, the Reserve Bank of India (RBI) introduced a circular that mandated lenders to begin insolvency

---

https://www.nrb.org.np/contents/uploads/2025/04/Financial-Stability-Report.pdf#:~:text=As%20a%20result%2C%20the%20Nepalese,stabilized%20during%20the%20review%20year.

[7] Bhattarai, Anal, *Economic Outlook Feb 2025,* (Kathmandu: Kala Legal, 2025), https://kala-legal.com/navigating-the-financial-horizon-explore-financial-outlook-with-kala-legal/

proceedings under the Insolvency and Bankruptcy Code (IBC), against defaulted loan payments for more than 180 days; within those days if any borrower had a late payment, they would be labelled as defaulters. This policy was intended to expedite bad loan resolution and establish credit discipline, but it was implemented as a blanket policy applicable on all sectors without considering any operational differences.

It is important to note this policy was introduced as a solution after assessing the country's bad loan problem because banks were often involved in loan evergreening to avoid classifying non-performing assets. However, the new circular eventually caused many corporations to challenge its legitimacy; in April 2019 the Supreme Court of India brought an end to it stating the RBI overstepped its authority under the Banking Regulation Act, and that it should direct (not mandate) banks to initiate solvency proceedings only on a case-by-case basis.[8]

This highlights how regulatory changes, even when well-intentioned, can create adverse consequences; without sensitivity to ground realities, they can constrain credit flow and undermine sectoral recovery. When strong regulatory interventions may seem necessary to maintain financial discipline, it is equally important to balance them with a sectoral flexibility and economic outlook in mind.

While total credit has risen over the past decade, its allocation has shifted toward low-risk and short-term lending, often favoring government and consumption-based borrowing. Despite the increase in credit, there isn't a proportional rise in RGDP. While regulatory reforms had aimed to create a more stable financial system, their rapid implementation has stifled economic recovery. This is supported by the fact that the economy has observed a sharp rise in blacklisted entities with the implementation of all these regulations post-pandemic. Over the past three years, there has been a 424.86% rise in blacklisted entities.

[8] Saheli Roy Choudhury, *India's top court voided rules meant to resolve bad debt. That's not good for banks, Moody's says,* CNBC, (India: CNBC, 2019)
https://www.cnbc.com/2019/04/03/india-supreme-court-quashes-rbi-directive-on-bad-debt.html

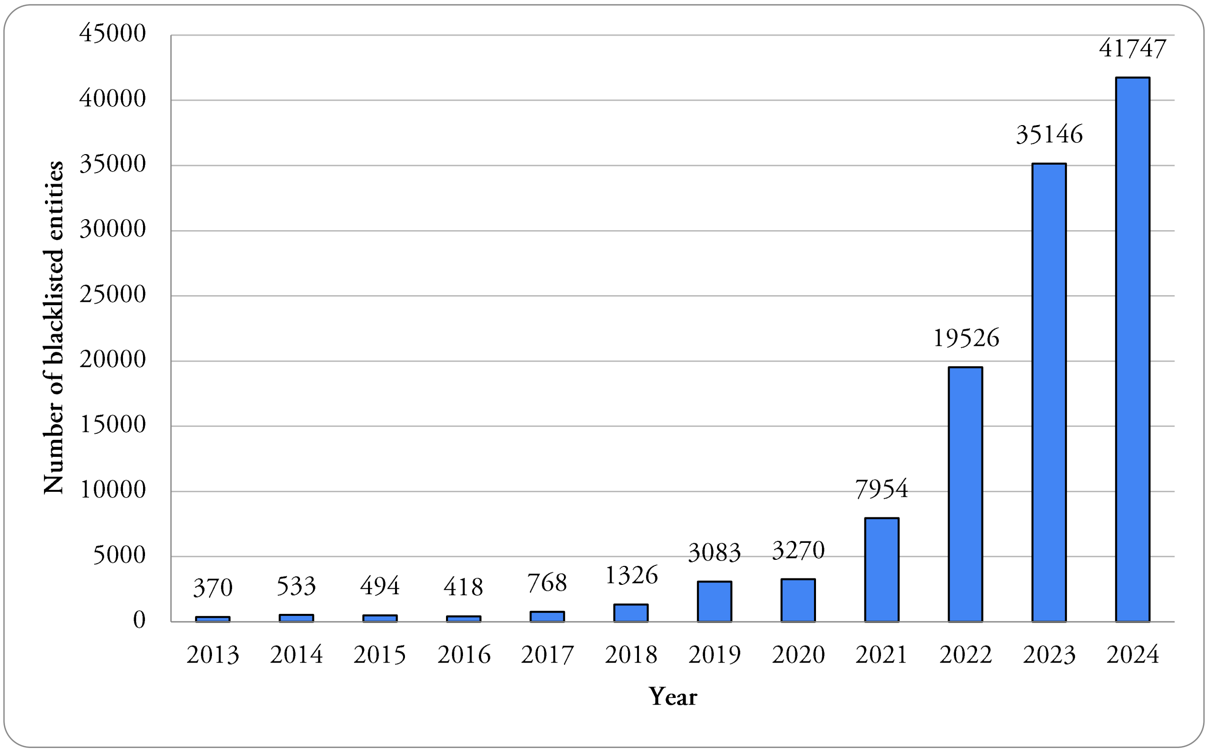

Figure 4: Number of blacklisted entities in the past decade

Source: Credit Investigation Bureau (CIB)

This rise can be attributed to SMEs that benefited from relaxed credit provisions during the pandemic and are now unable to meet stricter repayment criteria. While higher provisioning requirements have been introduced to deter the misuse of loans and the growing non-performing loans, they have also created a negative cycle—higher operating costs and banks' reliance on deposits in NRB have slowed credit expansion. Limited access to credit combined with higher borrowing costs has led to increased loan defaults in the context of economic downturn after COVID, further driving up non-performing loans and prompting even stricter lending criteria. If this cycle continues unchecked the economy risks falling into stagnation.

3. Coordination Failure: Fiscal Delays and Monetary Limits

There are broader systemic issues related to the alignment of fiscal and monetary policy. A telling example of this phenomenon is the construction sector. In August of 2024, the Federation of Contractors' Association of Nepal (FCAN) announced that its members would halt construction activities until the government disbursed the required funds to clear outstanding payments with vendors and banks. Just a month before this, NRB had introduced measures of extension of loan repayment periods and ease of blacklisting process for construction business. Yet, its impact was limited because of underlying fiscal constraints[9]. In December of the same year, the President of FCAN claimed that until the government and NRB coordinated, merely extending payment duration would not help. As a consequence, more than 90% of construction entrepreneurs could risk being bankrupt within a month[10]. It did not help that this was followed by a significant rise in the underperformance of Non-Banking Assets (NBAs) and a rise in defaults.

The government's fiscal policies are ambitious, but absent strong implementation capacity, the NRB often has to step in, something which it is neither designed to do nor able to. The government prepares the budget and plans to drive economic development in sectors including construction, agriculture, and even small businesses, but often falters in execution. This weak fiscal push then leaves monetary policy alone to carry the burden of stabilization. The NRB mandates BFIs to allocate specific portions to their lending portfolios to priority sectors i.e. 12% to agriculture and Micro, Small and Medium Enterprises (MSMEs), 7% to energy, among others. However, it is common to see that many BFIs struggle to meet these thresholds, often citing lack of viable markets and the inability of the targeted sector to absorb the credit effectively.[11] This disconnect has resulted in a credit environment where even mandated sectors struggle to absorb liquidity. NPLs are rising sharply in sectors that are considered priority lending areas; 7.28% of loans in the construction sector are recognized as non-performing, 6.65% in fishery, and 6.22% in agriculture[12]. This result reflects an urgent need to reassess the effectiveness of priority lending. Without the much-needed assessment, simply pushing credit to sector without addressing structural bottlenecks only adds to the gaping financial vulnerabilities.

4. Private Investment Stagnation

Credit has expanded, but economic activity remains stagnant. Private capital formation, a key driver of economic expansion, has remained stagnant in the past decade. Private sector investment as a percentage of the total Gross Fixed Capital Formation (GFCF) has shown no significant improvement, highlighting a lack of private sector confidence. While the post-earthquake period saw increased

---

[9] Fiscal Nepal, *Contractors Halt Construction Work Citing Insufficient Budget Allocation: FCAN Demands Government Action,* (Kathmandu: Fiscal Nepal, 2024), https://www.fiscalnepal.com/2024/08/11/17550/contractors-halt-construction-work-citing-insufficient-budget-allocation-fcan-demands-government-action/.

[10] MyRepublica, *Above 90 Pc Construction Entrepreneurs Will Default on Dec 16: FCAN Prez Singh* (Kathmandu: MyRepublica, 2024), https://myrepublica.nagariknetwork.com/news/above-90-pc-construction-entrepreneurs-will-default-on-dec-16-fcan-prez-singh-675d5be3a2724.html.

[11] Findings from the stakeholder meeting.

[12] Nepal Rastra Bank, *Financial Stability Report, Fiscal Year 2023/2024,* (Kathmandu: NRB, 2025) https://www.nrb.org.np/contents/uploads/2025/04/Financial-Stability-Report.pdf#:~:text=As%20a%20result%2C%20the%20Nepalese,stabilized%20during%20the%20review%20year

private capital formation, the trend is not replicated in the post-pandemic cycle. The drop from 2017/18 to 2023/24 is concerning and highlights low private sector confidence. In comparison to government investment, private capital formation has not kept pace with the overall gross capital formation.

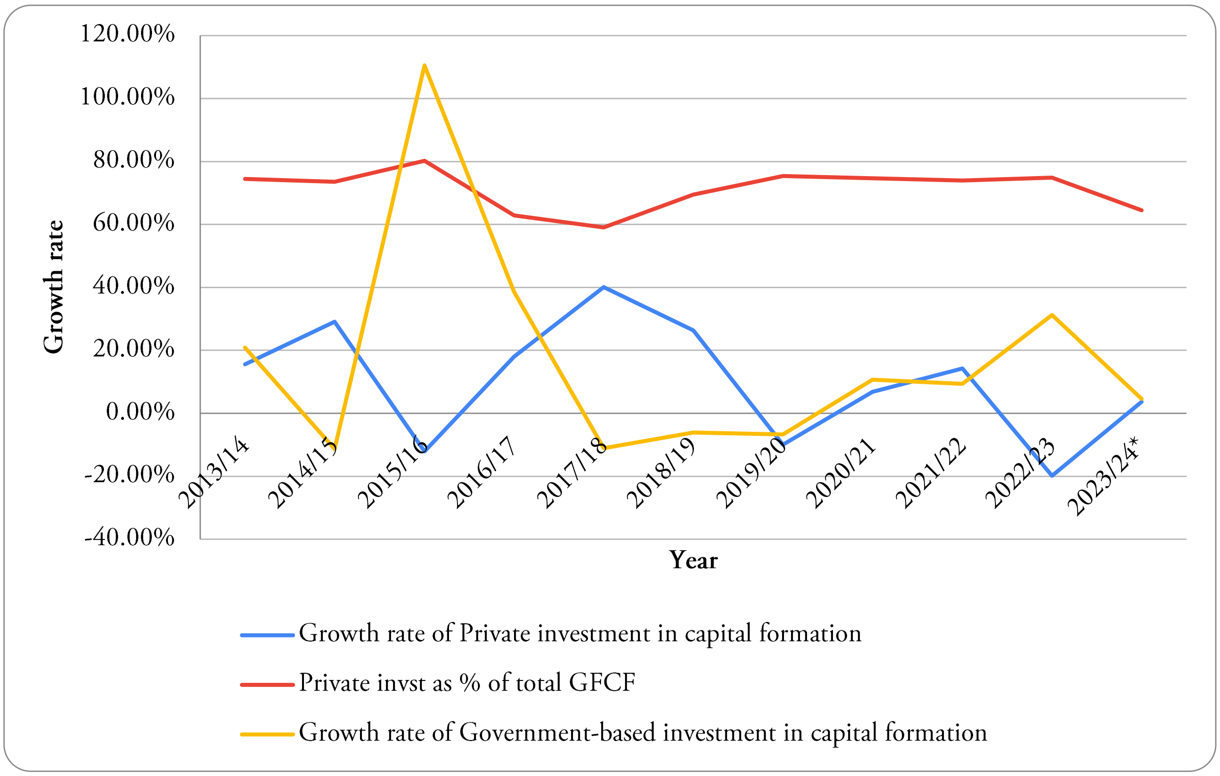

Figure 5: Growth rate of Government and Private investment in Gross Fixed Capital Formation
*Source: NRB, *Estimated*

Over the past decade, both credit (including net claims on government, government enterprises, financial institutions, and on the private sector) and deposits (in BFIs) have increased, with credit exceeding deposits significantly since the pandemic. While this suggests that credit expansion has remained strong, the underlying reality is complex. In 2023/24, NRB had absorbed over NPR 360 billion in liquidity from commercial banks through deposit collection auctions and repo sales[13]. There is at least some lack of confidence to issue new debt, consequently, banks find it much safer to hold funds at the central bank for a very little interest of 3%, in the face of a lack of investment

[13] In the first eight months of 2024/25 the figure has risen to NPR 16 trillion through Standing Deposit Facility (SDF).

opportunities. Yet, NRB has also expanded refinancing facilities, allowing businesses to access funds up to five times their original loan amount[14].

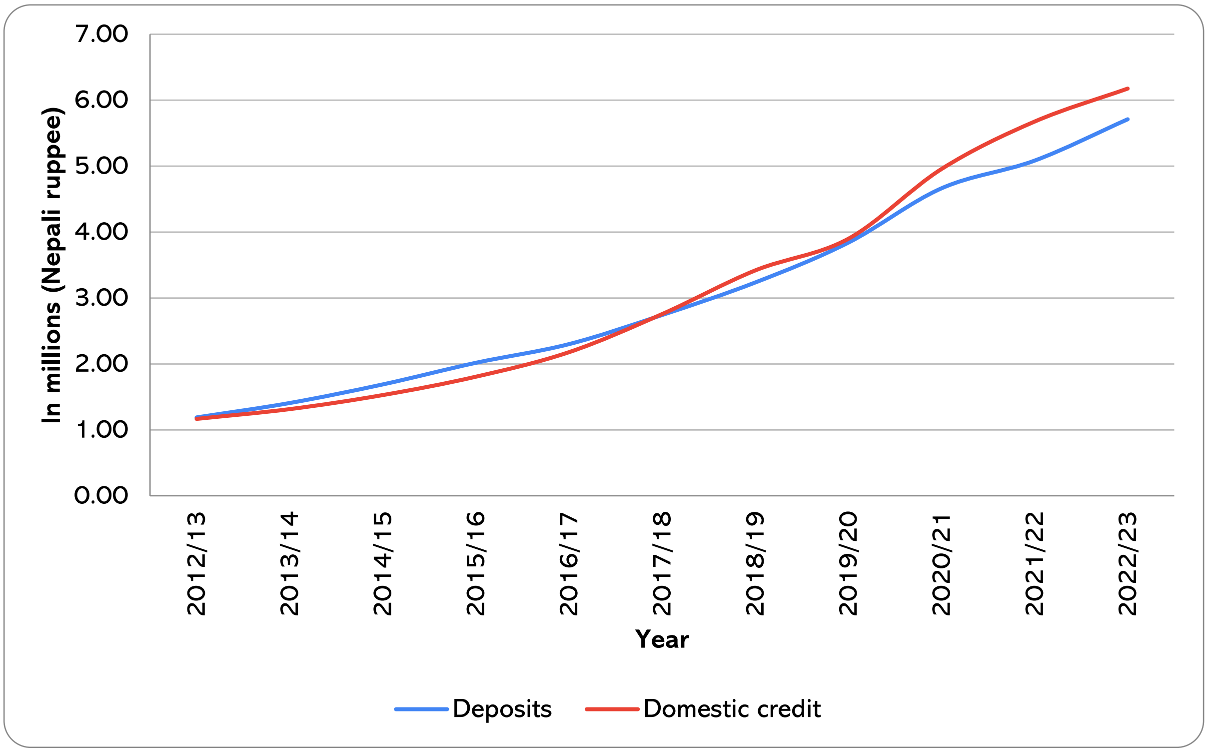

Figure 6: Liquidity situation in BFIs

Source: NRB

The actual use of refinancing is an issue; instead of channeling funds into new investments, much of it is being used to roll over existing loans. BFIs appear reluctant to disburse credit despite available liquidity, instead opting to park funds in NRB deposit facilities. This suggests that either risk perception remains high, or NRB's tightening measures have discouraged new lending altogether. Consequently, while refinancing aims to maintain credit supply, its actual impact on productive investment remains unclear.

Consequently, loan evergreening has increased, whereby banks restructure or roll over the NPLs to avoid officially recognizing defaults. According to NRB's Financial Stability Report of 2022/23,

[14] Fiscal Nepal, *Nepal Rastra Bank Revises Policies amid Dashain, Introduces New Refinancing Rules,* (Kathmandu: Fiscal Nepal, 2024), https://www.fiscalnepal.com/2024/10/09/18294/nepal-rastra-bank-revises-policies-amid-dashain-introduces-new-refinancing-rules/.

the Banking Stability Indicator (BSI) has deteriorated continuously over the years, mainly due to the decline in asset quality of banks, lower profitability, and increased risk exposure. Rising defaults have worsened banks' balance sheets while stricter provisioning requirements have squeezed profitability[15]. This creates a vicious cycle where banks extend loans to struggling borrowers to avoid provisioning costs, further delaying the needed financial corrections.

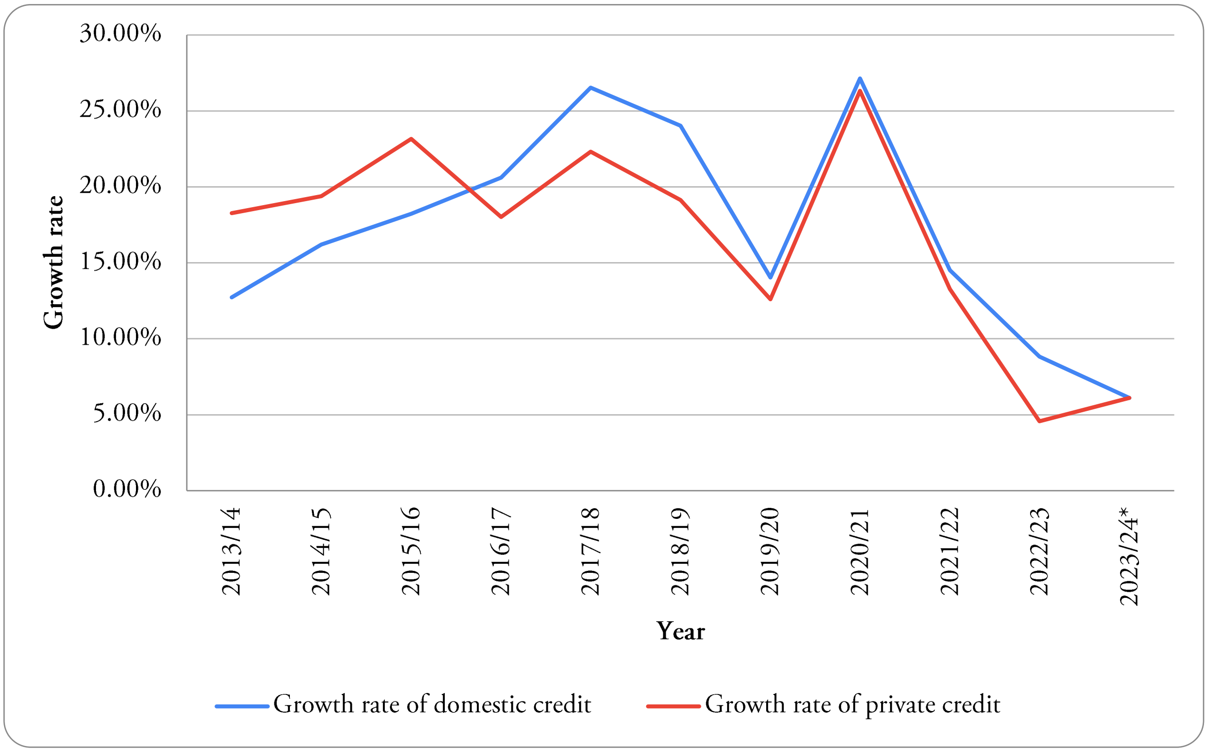

Figure 7: Growth rate of Domestic and Private credit from BFIs

*Source: NRB, *estimated*

At the same time, banks are also increasing loan extensions to the government, rather than to new private borrowers, given lower risks. Despite credit expansion, the growth rate of domestic credit has been declining, signaling a shift in credit demand. Here, domestic credit includes all credit extended to both the public sector (government) and the private sector (businesses and households). While total credit allocated has increased, the composition has changed—government borrowing has risen while private sector credit has slowed down. A simple calculation of credit-to-deposit (CD) ratios for domestic credit (*includes private sector credit*) and solely private sector credit suggest a disproportionate

[15] Nepal Rastra Bank (NRB), *Financial Stability Report Fiscal Year 2022/23,* (Kathmandu: Nepal Rastra Bank, 2024),
https://www.nrb.org.np/contents/uploads/2024/06/FSR-2022_23-2.pdf.

allocation of credit to government and other institutions as the CD ratio of private sector credit has not exceeded 100%. This may suggest the financial system is functioning properly but the sluggish growth of private credit indicates government borrowing is absorbing a greater share of the available liquidity. BFIs seem to be reallocating credit towards safer and low risk borrowers such as the government amidst the tightening regulations. This raises concerns about a potential ***crowding-out effect***, where liquidity that could support business expansion is instead channeled toward financing fiscal deficits. If this trend continues, Nepal's private sector investment may struggle to recover, reinforcing the stagnation in Gross Fixed Capital Formation (as evidenced in Figure 5).

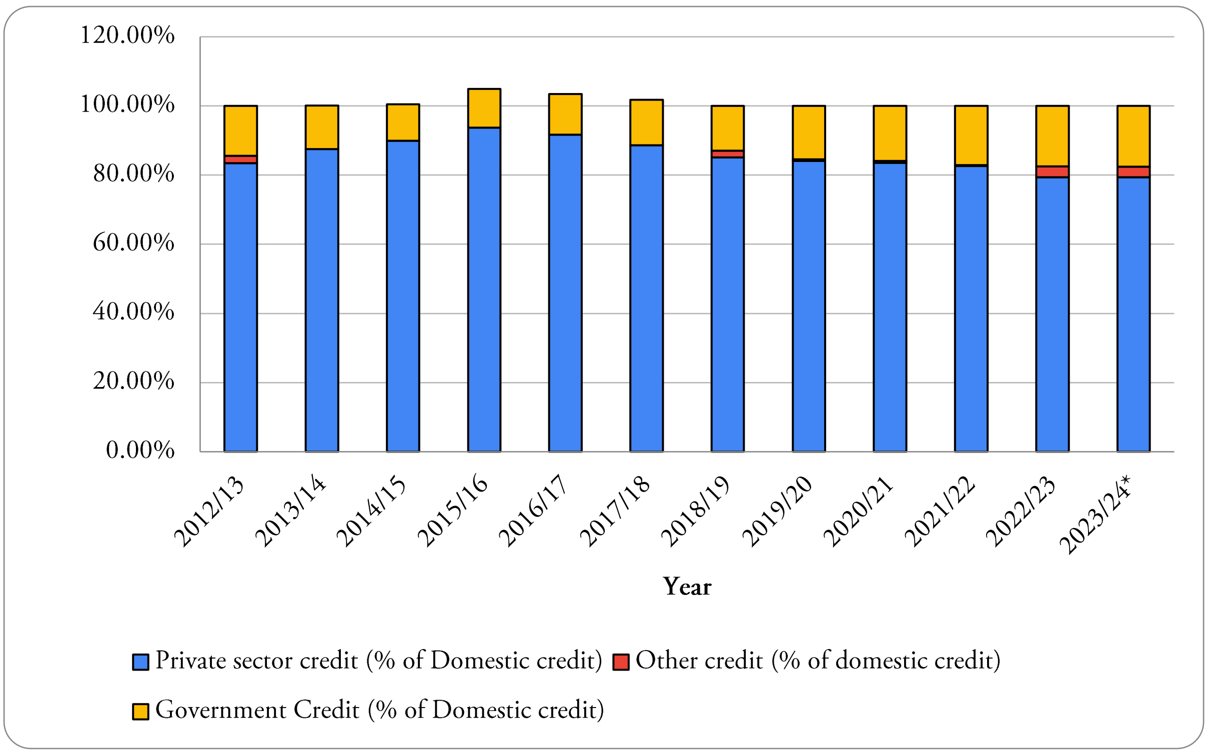

Figure 8: Components of Domestic Credit

*Source: NRB, *estimated*

Table 1: Credit-to-Deposit (CD) ratios for Domestic Credit and Private Credit

Year	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
CD ratio (domestic credit)	98.13%	93.43%	90.44%	89.53%	94.69%	100.50%	105.65%	101.51%	106.28%	111.65%	108.15%

CD ratio (private credit)	81.90%	81.81%	81.35%	83.91%	86.84%	89.08%	89.96%	85.34%	88.78%	92.25%	85.87%

Source: NRB

Despite the adherence to the CD ratio (80%), the composition of private credit raises concerns about its sustainability for economic development. The red flag lies in the distribution of this credit—a 10-year average trend line shows that the credit allocation in non-productive sectors is much higher than productive sectors[16]. A deeper look shows that there has been a significant hike in consumable loans[17] since the post-pandemic period. While credit for consumption is not inherently worrisome, the trend of credit flow to short-term investments indicates a lack of confidence within the economy to invest for long-term returns, especially in productive sectors.

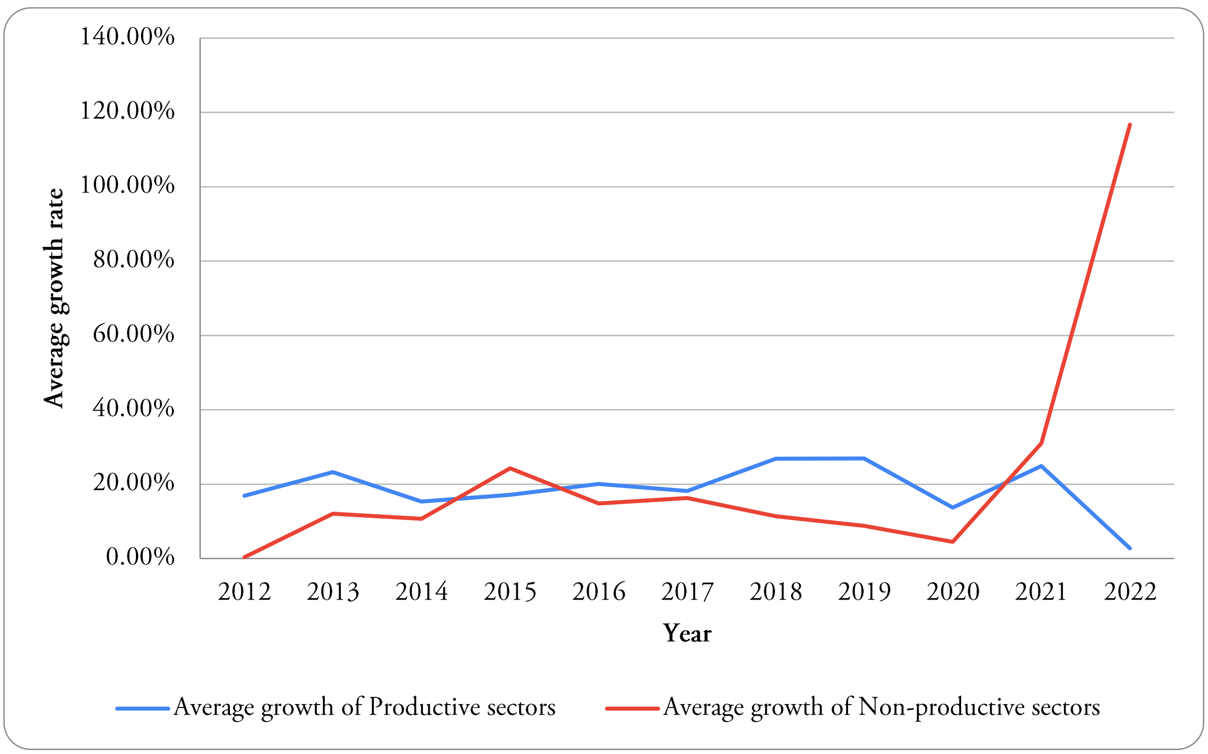

Figure 9: Average growth rate of credit in productive and non-productive sectors

[16] Productive sectors include *"Agriculture", "Mines", "Production", "Construction", "Metal Productions, Machinery & Electrical Tools & Fitting", "Transportation Equipment Production & Fitting", "Transportation, Communication and Public Services", and "Service Industries*".
Non-productive sectors include *"Finance Insurance & Fixed Assets", "Wholesaler & Retailers", "Consumable Loan", and "Local Government"*. The term "non-productive" is used to refer to activities or sectors that generate limited long-term multiplier effects on the economy.
[17] Includes Gold and Silver, Fixed account receipts, guarantee bond, credit card, and others (Hire purchase, education, residential personal home, and personal Loans)

Source: NRB

Recent policies adopted by the NRB further exacerbate sectoral disparities in credit allocation. Hydropower projects that are not operating, stemming from delays due to infrastructure bottlenecks, such as lack of transmission lines, are now ineligible for loan restructuring. This policy disproportionately affects a sector critical for economic expansion and export revenue[18]. Similarly, while NRB has increased working capital limits for the manufacturing sector, other industries such as agriculture, construction, and services do not receive similar preferential treatment. If BFIs begin reallocating credit towards manufacturing while tightening lending to other sectors, this could create long-term imbalances that restrict investment diversity. As can be evidenced from Figure 10, private sector credit targets have not been achieved post-pandemic further indicative of stagnation in credit expansion and capital building.

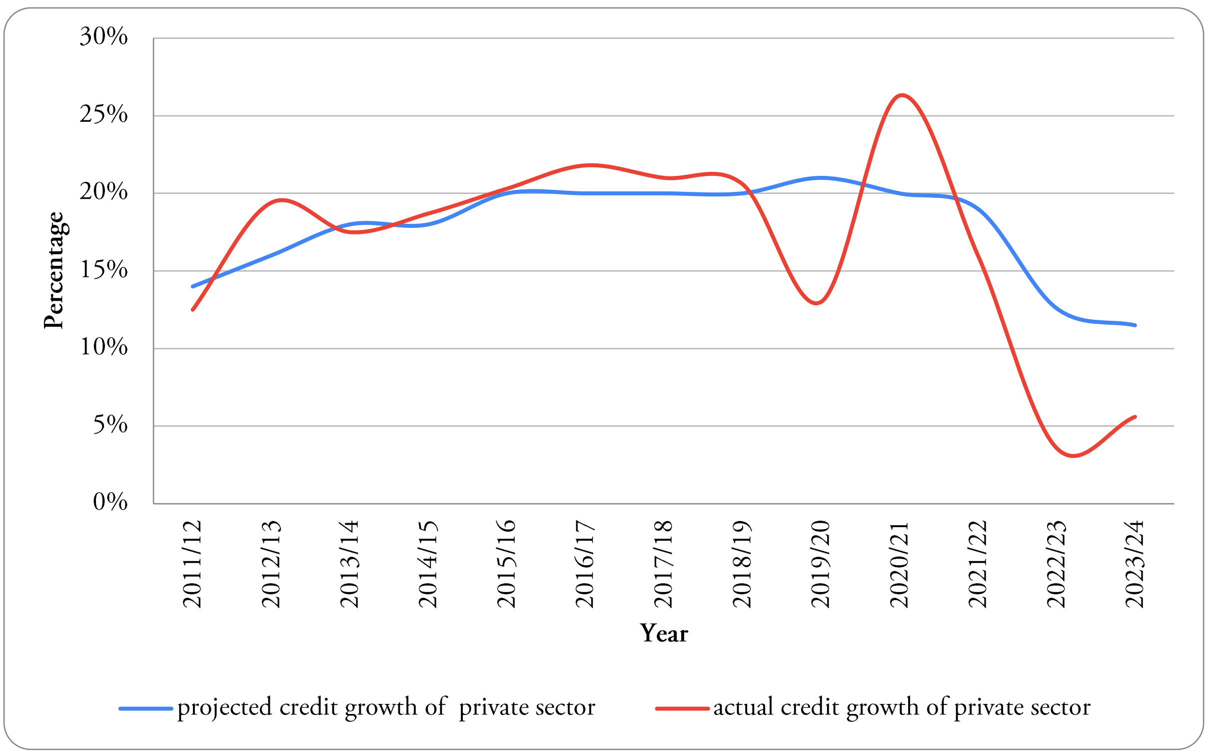

Figure 10: Private credit target and reality
Source: NRB

[18] Fiscal Nepal, *Nepal Rastra Bank Revises Policies amid Dashain, Introduces New Refinancing Rules,* (Kathmandu: Fiscal Nepal, 2024), https://www.fiscalnepal.com/2024/10/09/18294/nepal-rastra-bank-revises-policies-amid-dashain-introduces-new-refinancing-rules/

To understand the disconnect between liquidity and investment in the real sector, it is necessary to consider how credit rationing functions under conditions of imperfect information. In markets with information asymmetry, where lenders are not able to perfectly assess borrowers' risks, interest rates cannot equilibrate the demand and supply of credit. And so, lenders limit the quantity, lending it conservatively to borrowers of well-established profiles—with collateral in case of Nepal. As a result, institutions become disincentivized to provide credit to entities, such as SMEs and startups that lack hard collateral. The issue here is not of a lack of capital in the financial system, but a systemic reluctance to bear risk. Hence, the current method of credit rationing continues to be fueled by asymmetric information and also explains why credit expansion post-COVID has failed to translate to real sector growth.

5. Real Estate Dominance and Collateral Constraints

Consumable loans have surged by close to 470 percent between 2012 and 2022 hinting to a dependence on financing consumption through credit. Such loans are often underwritten using real estate as collateral, and much of the borrowed capital goes back into the same asset class which fuels a speculative cycle of unproductive investment. Real estate is widely seen as a safe and appreciating asset in Nepal, which prompts both the borrowers and lenders to securitize it against loans. Arguably, the current financial crisis stems from such dependence.

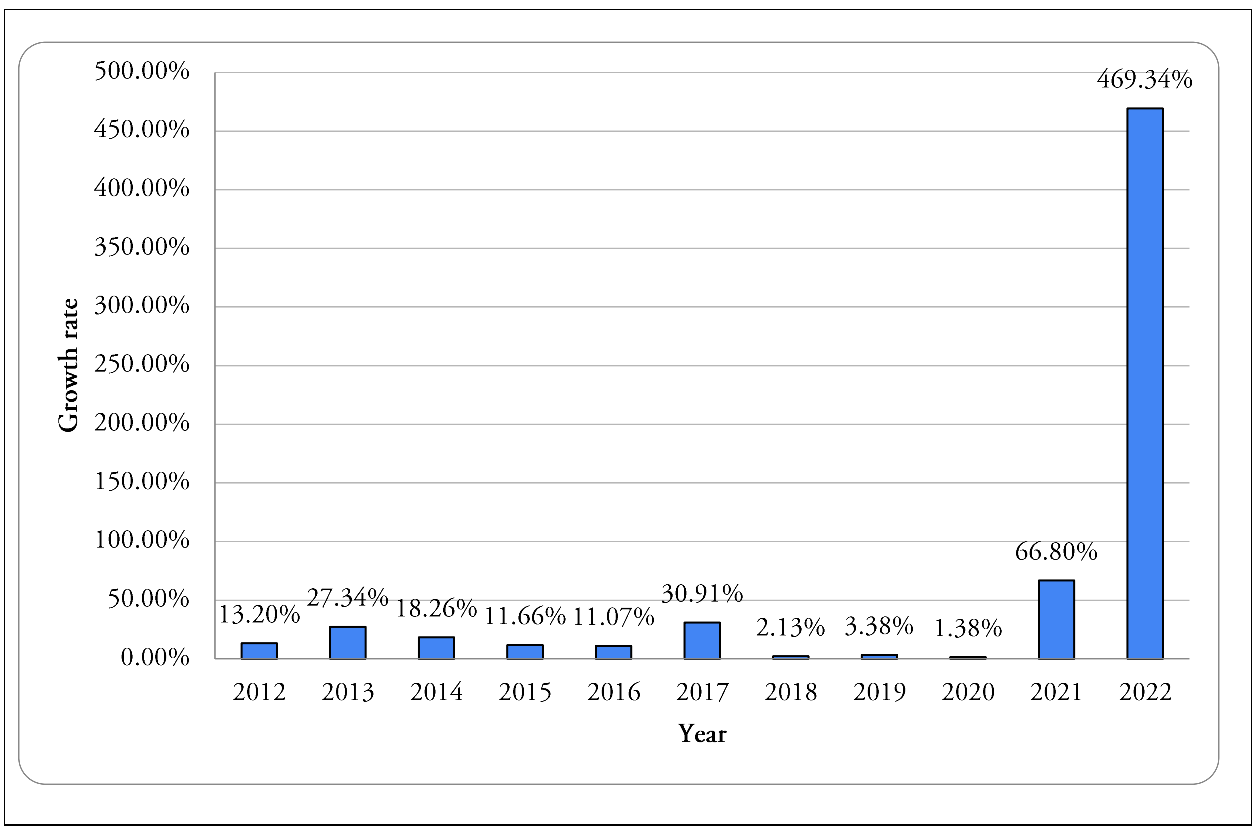

Figure 11: Growth rate of Consumable Loans
Source: NRB

The Secured Transaction Act of 2006 encourages the use of movable and intangible collateral besides land and real estate, but, its implementation has been weak. The financial system of Nepal relies on real estate, limiting access to credit. Furthermore, with no standardized valuation mechanisms for such movable assets, banks remain hesitant to accept such alternatives. The Financial Stability Report 2023/24, notes that lending against fixed assets has continued to dominate the financial system, accounting for ***76.22%*** of all loans. This perpetuates the credit flow into a narrow niche of low-risk and asset-rich borrowers. With rising NPAs, it has become abundantly clear that lending practices in Nepal need to shift from immovable collateral-based to movable securitisation.

While NRB's effort to ease the credit policies during the pandemic were swift, it nonetheless lacked strong foundations. Participants of the consultative meeting undertaken to inform this audit noted that the NRB mandated BFIs to increase credit flow into the economy either through new debt or re-issuance,[19] but adequate criteria for assessing the needs of the borrowers were missing. The central bank also brought in a concessional loan for first-time home buyers, intended to create an indirect impact by stimulating other sectors such as construction. With rising deposits and no targeted criteria to assess borrowers' needs or the productivity of loans, credit disproportionately flowed into speculative areas. The money did not correspond to real sector activity nor to return-generating enterprises. As a result, land prices have become driven more by buyer expectations and investment momentum rather than intrinsic value indicators such as location accessibility or infrastructural facilities.

Despite regulatory efforts to limit this exposure, real estate lending grew by 9.17% in FY 2022/23 reaching over Rs. 217 billion[20]. The consequence of such an approach is now materializing. As NRB tightens its stance to correct the market through stricter Loan-to-value (LTV) ratios, the demand for credit to finance the bubble is decreasing. As of mid-November 2024, the NBAs have risen to Rs. 32.33 billion, which is over 77% increase from Rs. 18.21 billion the previous year. It is suggested that this increase is due to the unsold collateral from loan defaults due to a lack of buyers[21]. The downturn in real estate has also resulted in a significant drop in property value by 40% in rural areas and 20%

[19] Findings from the stakeholder meeting.
[20] Fiscal Nepal, *Nepal's BFIs Increase Investments in Real Estate Loans,* (Kathmandu: Fiscal Nepal, 2023), https://www.fiscalnepal.com/2023/09/03/13640/nepals-bfis-increase-investments-in-real-estate-loans/.
[21] Fiscal Nepal, *Rising Non-Banking Assets: A Growing Challenge for Nepal's Banking Sector*, (Kathmandu: Fiscal Nepal, 2024), https://www.fiscalnepal.com/2024/12/30/18997/rising-non-banking-assets-a-growing-challenge-for-nepals-banking-sector/.

in urban areas[22]. Banks that had aggressively expanded their loans using real estate as collateral now face a mismatch of asset value and loan exposure. Real estate, however, continues to make up a disproportionately large share of loan portfolios indicating both a systemic over-exposure and a lack of viable alternatives. The lack of a proper valuation and legal enforcement for such alternate assets restricts BFIs ability to lend, further discouraging capital formation[23].

Prior to 1997's Asian Financial crisis, South Korea's financial system was heavily dependent on real estate as its collateral against bank credit. Credit risk was concentrated in the property market, exposing the banking sector to severe vulnerabilities. So, when real estate prices collapsed during the crisis, NPLs surged which eroded bank capital and deteriorated the economy. In response, the country brought in legal and institutional reforms that diversified collateral forms to strengthen credit resilience. The recognized movable assets such as inventory, machinery, and receivables, and even intangible ones like intellectual property rights, as collateral against loans. This reform diversified the collateral base making it much easier to flow in credit to SMEs and reduce the systemic risk tied to property price fluctuations.

OECD, 2022 also reports that use of unconventional collateral forms actually broadens the range of leverage for many SMEs. It also identifies that a well-designed collateral registry provides transparency and legal certainty which encourages financial institutions to broaden their collateral acceptance practices. However, the report also highlights the challenges in implementing such frameworks; overcoming informational asymmetries between borrowers and lenders, and developing technical infrastructure should be the utmost priority. Countries that invest in these areas will establish a substantial source of economic growth driven by empowered SMEs, which is important for a SME driven country like Nepal.[24]

[22] Kishor Dahal, *Rising Bad Debts Drive Banks to Sell Assets Cheap, Property Prices Drop by 40 Percent,* Biznessnews, (Kathmandu: Biznessnews, 2025), https://english.biznessnews.com/posts/rising-bad-debts-drive-banks-to-sell-assets-cheap%2C-property-prices-drop-by-40-percent.

[23] Bhattarai, Anal, *Economic Outlook Feb 2025,* (Kathmandu: Kala Legal, 2025), https://kala-legal.com/navigating-the-financial-horizon-explore-financial-outlook-with-kala-legal/

[24] Martin Brassell and Kris Boschmans, *Secured lending for SMEs: Making effective use of registries and intangibles - A case study approach*, OECD (France: OECD, 2022), https://www.oecd.org/content/dam/oecd/en/publications/reports/2022/07/secured-lending-for-smes_fa8fa095/cf451ee7-en.pdf

6. Policy Recommendations

The credit ecosystem in Nepal today reflects a fundamental misalignment of capital and its flow within the economy. The cycle and timing of regulatory tightening, speculative lending, and fiscal incoordination has created a paradox where despite ample liquidity, the dispersed credit lacks long-term and short-term impacts. The policies in place are not simply failure in intent but also a failure in precision and adaptability. Monetary policy, as of today, has become burdened by covering fiscal inefficiencies and so has lost its stabilization function. At the same time, credit regulations have stifled growth by ignoring market readiness and capability. The financial policies in place need to evolve beyond just blanket compliance, and shift toward a framework that encourages capital formation and productive credit expansion. Thus, the present scenario presents a cautionary tale that liquidity abundance despite low interest rates will not guarantee not encourage credit expansion into economic development.

The central bank needs to reconsider the one-size-fits-all approach to preparing and implementing credit regulations. Policies such capital adequacy, provisioning norms, and restructuring need to reflect the varying maturity levels, risk profiles, and capital absorption capacities. For instance, provisioning mandates for cash-flow sensitive industries such as manufacturing sectors should differ from those applied to capital-intensive but delayed-return sectors such as hydropower. By adopting a more dynamic approach, BFIs can be held more accountable for their credit extension decisions, encouraging better judgement in allocation of capital to different sectors. This shift will enhance financial discipline and reduce the unintended consequences of overregulation during economic downturns.

Conducting a comprehensive and evidence-based review of the existing priority sectors should be a priority. The present approach is overly supply-driven with little regard to actual demand or financial viability. This misalignment has resulted in credit expansion slowdown, and forced exposure to underperforming sectors. There is a dire need for a comprehensive and date driven review of existing deprived sectors to evaluate their actual economic contribution and credit absorption capacity. Further, such a review needs to be multi-stakeholder in nature including government agencies, private sector actors, and financial institutions. It is also important to note that the definition or selection of priority sectors should be in step with Nepal's shifting development trajectory in comparison to the rapid global changes. Modern and high-growth sectors such as IT and digital services should be included in this framework to ensure that priority credit mandates are actually long-term oriented and economically justified while being aligned to national competitiveness.

To build a more resilient financial system, NRB and BFIs need to promote the use of alternative collateral of movable properties. Preference for land and real estate as collateral has distorted credit flows and amplified asset bubbles that now threaten system stability. Even though the Secured Transaction Act, 2006, allows for movable asset securitisation, its implementation has been affected by a lack of standardized valuation practices. The central bank, in collaboration with BFIs should develop valuation standards and legal recourse mechanisms for non-traditional collateral. This will not only broaden access to credit but also rebalance the collateral ecosystem.

The central bank should reconsider the current provisioning norms. Currently, the framework distinguishes loans by the duration of late payments without considering if they are backed by collateral or not. However, since secured loans have more recoverable value than unsecured ones, penalizing different credit at the same severity is economically inefficient; this only discourages lending. Additionally, drawing on India's provisions, banks can adopt a differentiated structure. Under this model, banks would keep a 100% provision for unsecured loans after 12 months of being classified as "doubtful loans". In contrast, loans backed by collateral would have varying standards depending on the number of years.

Annex

<table>
<tr><th colspan="8">Table 1: Sound Money Rating of Nepal (2023-24)</th></tr>
<tr><th colspan="2">Money Growth</th><th colspan="2">Standard Deviation of Inflation</th><th colspan="2">Most Recent Inflation</th><th colspan="2">Foreign Currency (FC) Account Permitted</th></tr>
<tr><td>Avg RGDP gr (10 years)</td><td>4.29%</td><td rowspan="2">St Dev inflation (5 years)</td><td rowspan="2">1.6%</td><td rowspan="2">Inflation 2023</td><td rowspan="2">3.57%</td><td rowspan="2">FC acc permitted in Nepal</td><td rowspan="2">Yes</td></tr>
<tr><td>Avg M2 gr (5 years)</td><td>14.92%</td></tr>
<tr><td>Adjusted M2 gr (Vi)</td><td>10.63%</td><td>Vi</td><td>1.6%</td><td>Vi</td><td>3.57%</td><td rowspan="3">FC acc permitted abroad</td><td rowspan="3">Yes, with restrictions.</td></tr>
<tr><td>Vmax</td><td>50%</td><td>Vmax</td><td>25%</td><td>Vmax</td><td>50%</td></tr>
<tr><td>Vmin</td><td>0%</td><td>Vmin</td><td>0%</td><td>Vmin</td><td>0%</td></tr>
<tr><td>Rating*</td><td>7.87</td><td>Rating*</td><td>9.36</td><td>Rating*</td><td>9.28</td><td>Rating</td><td>5.00</td></tr>
<tr><td colspan="4">Aggregate Rating**</td><td colspan="4">7.87</td></tr>
<tr><td colspan="8">*Rating = (Vmax-Vi)/(Vmax-Vmin)*10; where Vmax and Vmin are the maximum and minimum values of score (V), while Vi is the respective score of the component for a country
**Aggregate Rating is measured as the average of ratings of all four components of sound money.</td></tr>
</table>