Capital Market Reform: Initiatives and Assessment

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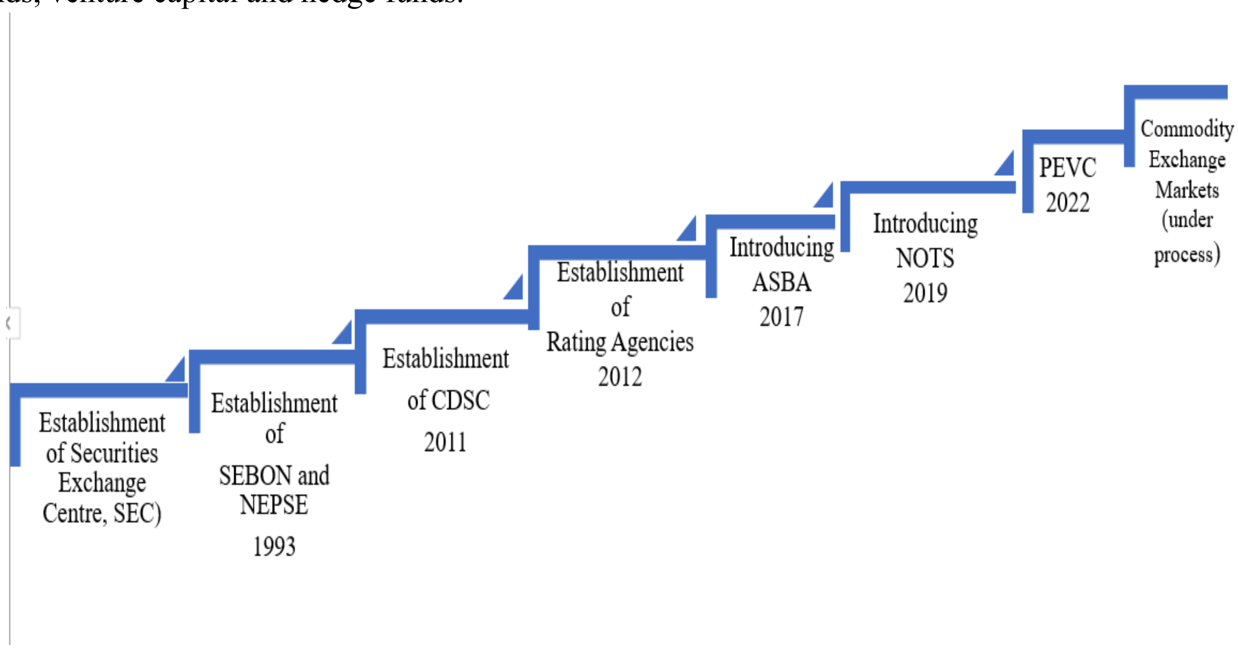
Capital Market in Nepalese Financial System

The Capital Market refers to markets for medium to long term financial assets. It encompasses corporate stocks, public and private debt securities with maturity exceeding one year and shares with no fixed maturity period which are traded in the stock market. In our context, it also comprises commodity derivative markets. The Nepalese financial system consists of banks and financial institutions (BFIs), securities markets, insurance companies, non-banking financial institutions, saving and credit cooperatives, and non- government organizations (NGOs) providing limited banking services.

BFIs are regulated by central bank (Nepal Rastra Bank, NRB) insurance and reinsurance companies are regulated by Insurance Authority, saving and credit cooperatives are regulated by Department of Cooperatives whereas Nepalese capital market comprising securities markets and commodity market in regulated by Securities Board of Nepal (SEBON).

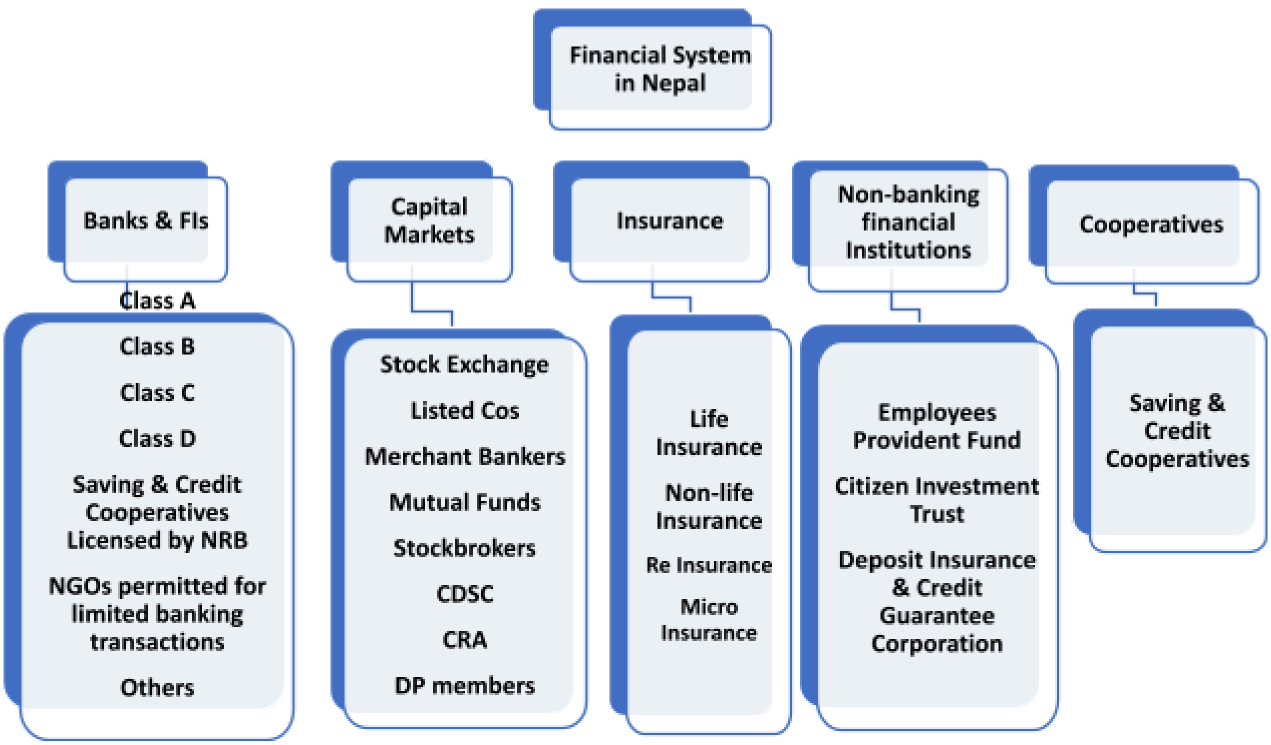
Government of Nepal established Securities Board of Nepal (SEBON) on 7th June, 1993 as an apex regulator of Securities Markets. It has been regulating the markets under the Securities Related Act, 2006 whereby SEBON's mandate is to regulate and manage the activities of the securities markets and persons involved in securities business by regularizing the issue, purchase, sale and exchange of securities. Its primary objectives are to bring fairness, efficiency and protection of investors' interest. SEBON is also mandated to regulate commodity exchange markets after the enactment of Commodity Exchange Market Act, 2017 in 2017. SEBON, with the approval of the Government of Nepal, issued Specialized Investment Fund Regulations, 2019 to regulate and manage private equity funds, venture capital and hedge funds.



The Major milestones of SEBON.

Securities market has crucial role in economic growth and national development through a mechanism for efficient mobilization of scattered savings, liquidity management and risk diversification. Government of Nepal has prioritized the securities markets and has recognized as a gateway for capital mobilization. While the legal framework for regulation of commodity exchange markets is in place, the operational infrastructure is still in the process of development. The capital market development is essential due to the following reasons as well:

- Facilitates Investment
- Encourage Innovations
- Increasing access to financing
- Enhancing Financial Stability



Strategic Planning Practices and Developmental Initiatives Undertaken

As an apex regulator, SEBON has gone through several initiates for overall development of the capital market though it has a very short history of operation. It had formulated strategic plans and master plans in the past. The major steps are: Four- year strategic plan (1998-2002), Five-year capital market development master plan (2011-2016) and Strategic Plan (2021-2024). Besides these capital market development projects prepared by the Aries Group Ltd. The USA with the assistance of the Asian Development Bank in 1993 was focused on the development of fixed income securities markets, equity markets and institutions. Similarly, the Corporate and Financial Governance Project

(CFG) was implemented in 2005 under the ADB assistance to enhance the institutional capacity of SEBON and Company Registrar Office, to modernize the NEPSE trading system and to establish a central securities depository. Securities Data Management System Project (SDMS), implemented in 2008 with the assistance of World Bank under Economic Reform Program of Government of Nepal thereby strengthened the capacity of SEBON by enhancing ICT sophistication, website upgradation and managing capacity building program for officials. Moreover, under the financial and technical assistance of ADB, a capital market and infrastructure capacity support project was implemented to develop the bond market in Nepal as well as to enhance the institutional capacity of SEBON.

The current strategic plan i.e. Strategic Plan (2021-2024) is in implementation phase now and it has set the strategic objectives as below:

1. Strengthening the legal and regulatory framework relating to securities markets and commodity exchange markets.
2. Facilitating development of the markets in terms of instruments, institutions, and infrastructures.
3. Building regulatory capacity.
4. Improving the governance, disclosure and compliance relating to regulator, securities markets and commodity exchange markets.
5. Reducing the systemic risk and other risks of the securities markets and commodity exchange markets.
6. Promoting investor education, public awareness and understanding of securities markets and commodity exchange markets.
7. Enhancing the national and international relation and cooperation to facilitate the development of securities markets and commodity exchange markets.

In accordance with set strategies, priorities, and objectives, the action plan for each strategy and priority for the FY 2020/21–FY2023/24 had been also developed along with performance indicators and responsible authority for their execution. Soon the evaluation phase is coming to ensure that everything we set are well achieved or take some corrective measure in the next planning initiative.

Moreover, the budget for fiscal year BS 2081/82 by the Government of Nepal (GoN) has embraced the plans for institutional reforms aimed at enhancing investment and ensuring investor protection in the capital market. It also outlined initiatives for structural improvements in the Nepal Stock Exchange (NEPSE) and the Securities Board of Nepal (SEBON), emphasizing the enhancement of institutional capacity in the SEBON. Furthermore, the budget addresses the regulation of commodity exchange markets, emphasizing the importance of legal and institutional frameworks for their operation. Additionally, provisions have been made in the budget to mandate companies with capital exceeding a certain threshold to be listed on the secondary market, ensuring greater oversight and transparency in the capital market. Some measures announced by GoN in earlier years' budgetary programs are already implemented like – reservation on IPO for Nepalese workers on foreign employment and easing the licensing of private equity and venture capital (PEVC). Other programs as declared in earlier budgets by the GoN are attracting non-resident Nepalese into the capital market, reform in the secondary market and mandatory provision to companies with certain capital aimed to be listed in secondary securities market as listed companies.

Capital Market Reform under Financial Sector Reform Program in Nepal

Financial sector is regarded as the backbone of economic growth of any nation whether developed or developing or in transition or emerging. It plays a pivotal role in the development of all sectors of the economy and actually works as a lubricator by providing financial resources. The effective mobilization of financial resources is a critical prerequisite for economic growth and an efficient and competitive capital market is an important precondition for the mobilization of financial resources. Capital market is one of the significant sectors of the economy that provides a playing field to financial market intermediary institutions and their customers (investors) with a wide range of financial instruments such as shares, bonds & debentures, mutual fund units, specialized investment units etc. The capital market is the source of funds for corporate governments and provides opportunities to savers to park their long-term savings.

In Nepal, the Financial Sector Reform Program (FSRP) took place in the mid-1980s. The Nepal Government and Central Bank have been implementing a comprehensive Financial Sector Reform Program since 2001. Now, the third phase of the program is in implementation and Nepal Government is strongly committed for the reform of the financial sectors like BFIs, Insurance and cooperative sectors including capital market. The financial sectors sometimes bring crises which may easily transfer to other sectors of the economy. So, we should be cautious of the financial liberalization and reforms of the financial sector.

The first phase of the financial sector reform was initiated in the mid-1980s under the liberal economic policy. Under this policy, the Nepal Government had opened up the banking sector to foreign investors. Structural Adjustment Program of the IMF, the financial sector was further liberalized in 1987. The focus of NRB was placed on indirect monetary control. There was a new development on the capital market as it opened its floor for corporate share trading in 1994. The Securities Exchange Center (SEC) also started to provide some merchant banking services. The trading in the capital market was limited due to listing of very few company's shares in the SEC. There was a limited transaction of government securities.

The second phase: After the restoration of democracy, the democratic governments under its open and liberal economic policy gave more emphasis on the liberalization of the financial sector. As a result, the Nepalese financial sector has grown very rapidly since the 1990s. There has been a rise in the number of banking and non-banking financial institutions. Employee Provident Fund (EPF), Deposit Insurance and Credit Guarantee Corporation, Citizens Investment Trust, Nepal Stock Exchange Limited, Securities Board of Nepal, Insurance Board, Credit Information Bureau were the other big entities established during the phase.

The third phase: the third phase is still continuing since 1999 and by now financial sector reforms has made significant improvements in certain sectors such as liberalization of interest rates, creation of a basic regulatory and supervisory frameworks, development of a long-term government securities market, secondary market of government securities, establishment of several types of banking and financial institutions, smooth functioning of stock exchange, competitive environment in the insurance services with establishment several insurance and reinsurance companies.

The FSRP has primary focus on Reforming the financial sector laws and regulations, Strengthening NRB's regulatory and supervisory functions, Restructuring and privatization of Nepalese Banks, Enhancing competition in the banking sector etc. However, it is realized that special considerations and initiatives on capital market reform should be equally prioritized in such programs with cooperation from regional and international organizations for a real break-through. Such financial sector reform facilitates gradual liberalization of the financial market and its players to the private sector. In most developing and transition economies, the financial sector is dominated by the banking sector, which is a largest mobilizer of deposits and provider of credit. In the case of Nepal, we have different areas of financial domain mainly BFIs, Insurance, Cooperative and Capital market. Financial sector reform also means competition, transparency, financial discipline and governance.

Capital Market Reform Initiatives in Some Asian Economies

Several Asian countries have adopted the Capital Market Development Program (CMDP) through initiatives led by the Asian Development Bank (ADB). Key countries involved in this program include:

Thailand: The CMDP in Thailand focused on enhancing market efficiency, liquidity, transparency, and strengthening market infrastructure and regulatory oversight

Sri Lanka: The CMDP aimed to deepen and broaden the capital market, improve regulatory frameworks, and enhance financial literacy and inclusion.

Bangladesh: Bangladesh has implemented multiple phases of the CMDP, aiming to stabilize and reform the market, improve regulatory measures, and support long-term economic objectives through a robust financial system. Bangladesh is engaged in a third capital development program with support of ADB.

Pakistan: Pakistan's CMDP supports structural reforms to create a competitive capital market and promote private investment. It aligns with the country's Vision 2025 and involves coordination with other international financial institutions like the IMF.

Indonesia: The CMDP in Indonesia focuses on strengthening the capital market infrastructure and regulatory environment to foster investment and economic growth

Moreover, the ASEAN Capital Markets Forum (ACMF), which includes countries such as Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam, focuses on integrating and harmonizing capital market regulations across these nations. Thus, at least these mentioned countries have adopted various forms of the CMDP, contributing to the broader goal of developing robust and competitive capital markets in Asia.

Nepal had also adopted initiatives aligned with the Capital Market Development Program. Specifically, Nepal implemented the "Capital Market and Infrastructure Capacity Support Project" with the assistance of the Asian Development Bank (ADB). This project aimed to enhance the regulatory and institutional framework for the bond market, develop a strategy for government securities issuance, and build the capacity of the Securities Board of Nepal (SEBON).

These initiatives illustrate the widespread commitment in the region to developing and strengthening capital markets as a means of supporting broader economic growth and stability.

Several Asian countries have adopted the Capital Market Development Program (CMDP) through initiatives by the Asian Development Bank (ADB). Notably, countries like Indonesia, Sri Lanka, and Pakistan have implemented these programs aimed at enhancing their financial markets.

The Indian capital market has undergone tremendous changes after the Commencement of Securities & Exchange Board of India (SEBI) in 1992. A number of measures are taken by SEBI, Ministry of Finance, RBI & other regulators to make the Indian stock market a dependable platform for Foreign Institutional Investors (FIIs), High Net worth Individuals (HNIs). Domestic Institutional Investors (DIs), & Retail Investors. Introduction of new products also helped in inviting potential investors (foreign as well as domestic) to the Indian Capital Market. Reforms by SEBI in the primary market include improved disclosure standards, introduction of prudential norms, and simplification of issue procedures. Companies required disclosing all material facts and specific risk factors associated with their projects while making public issues. There was an addition on provision of requirement to listed companies to furnish annual statements to the exchanges showing variations between financial projections and projected utilization of funds in the offer document and actual figures. This is to enable shareholders to make comparisons between performance and promises.

SEBI also introduced a code of advertisement for public issues to ensure fair and truthful disclosures. Furthermore, disclosure norms further strengthened by introducing cash flow statements. Similarly, new issue procedures were introduced—book building for institutional investors. Some other reforms including increment of merchant banking activities, growing mutual fund Industry, growth of derivative transactions, commodity trading, investor's protection etc. have been undertaken.

Needs, Significance and Process of Reform

Capital market reforms refer to regulatory changes and policy initiatives targeted at enhancing the efficiency, transparency and accessibility of financial markets for investors. Capital markets are like engines that help power the global economy. Nonbank financial intermediation has grown to represent almost half of the assets of the global financial system, thereby playing a much bigger role in the global economy. Regulators must better ensure that its vulnerabilities and business models don’t amplify future shocks to markets and financial stability. Sustainability, green financing, blue financing, environmental, social and governance (ESG), cyber resilience, fintech, and climate change are some key emerging issues in the capital market. Trading venues are a focus for cybersecurity, as both supervisors and market participants aim to boost their technological and operational resilience to minimize potential market disruptions. To ensure those issues are genuinely addressed, the capital market should undertake some reform measures. Generally capital market reform comprises the following aspects:

- Regulatory Reform
- Structural Reform
- Legal Reform
- Trading Reform
- Policy Reform
- Governance Reform
- Investors' Protection

Capital market reform becomes a critical issue as it is an essential aspect of government policy that aims to improve the efficiency of regulatory systems while ensuring their effectiveness in achieving public policy objectives. Regulatory reform can take different forms, ranging from the simplification of regulatory processes to the introduction of new regulatory approaches. It is a complex process that requires a careful understanding of the underlying issues and the potential solutions. The process involves the following processes:

- **The Need of Reform:** Regulatory reform is necessary to ensure that regulatory systems remain effective in achieving their intended objectives and cope with new changes in the scenario and innovations.
- **The Benefits of Reform:** Regulatory reform can bring several benefits to society, including improved economic growth, increased innovation, and reduced compliance costs. It can increase the transparency and accountability of regulatory systems, promoting public trust and confidence.
- **The Challenges of Reform:** Despite the potential benefits of regulatory reform, there are also several challenges associated with it. One of the main challenges is the balancing of competing interests, including the need for regulatory effectiveness and the desire for regulatory flexibility. Moreover, it can be a politically sensitive issue, with stakeholders often having different viewpoints on the appropriate level of regulation.
- **Options for Reform:** There are several choices available for regulatory reform, ranging from the simplification of regulatory processes to the introduction of new regulatory approaches. One option is the use of regulatory impact assessments, which can help identify the potential costs and benefits of regulatory proposals.
- **The assessment of Reform:** The effectiveness of regulatory reform depends on the specific context and the underlying issues. The regulatory impact assessments can help identify the potential costs and benefits of regulatory proposals, while the use of regulatory sandboxes can promote innovation and reduce compliance costs thereby promoting economic growth, innovation, and public trust.

Capital market development plays a critical role in the economic growth of a country. It provides a platform for companies and governments to raise funds for investments and expansion. A well-functioning capital market ensures that the capital is allocated efficiently, which leads to economic growth and also leads to the development of other sectors. Capital market development needs reform from time to time ensuring that regulatory systems remain effective in the changing environment and national-international market scenarios with changes in priorities. In general, capital market reform covers the following processes:

- Recognition of structural deficiencies in the capital market.
- Recent efforts to strengthen the regulatory framework.

- Assess the past and current status of capital market reform and its outcomes.
- Identify the remaining gaps in the regulatory and institutional framework.
- Policy recommendations for the reform.

Emerging challenges like new market technology and a broadening of the regulatory perimeter make it important for regulators to have a wider range of expertise and to ensure that their supervisory techniques and technology keep pace. Structural issues, resource capability and autonomy in some jurisdictions are major limitations for operational independence, which limits their ability to effectively supervise and respond to risks. In the context of Nepalese capital market, there are various causes as mentioned below, behind the need of reform program with special focus:

- Nepalese capital market reforms have long been overdue; liberalization, disclosure requirements, improved price discovery mechanisms by introducing book building, and entry of investment from non-resident Nepalese from abroad into Nepalese markets would provide the necessary boost to the economy's overall growth.
- Increment of participation from national and global institutional investors also ensures increased liquidity and market reputation.
- Furthermore, such reforms would have ancillary benefits such as job creation in Nepalese financial domains and exposure to global best practices.
- An active market for non-resident Nepalese people and foreign entities in Nepal is likely to attract investment from a broader range of sources, both domestic and foreign, and will thus benefit domestic companies that are already listed or are in the process of being listed on secondary market.
- Strengthening the regulatory capacity along with implementation of good corporate governance not only into the regulatory regime but also in capital market intermediary entities thereby increasing reliability of functioning.
- Boosting up the investors' confidence by provisioning the Monitoring Agency (MA) for safeguarding and increasing the transparency on utilization of IPO proceeds.

The aforementioned points are just some key areas where we can put efforts into taking the initiatives. Furthermore, it will be more appropriate if a study committee or task force is formed to dig out further details where we can initiate the reform actions in regulation, supervision as well as operational areas.

Financial Sector Assessment: Securities Sector

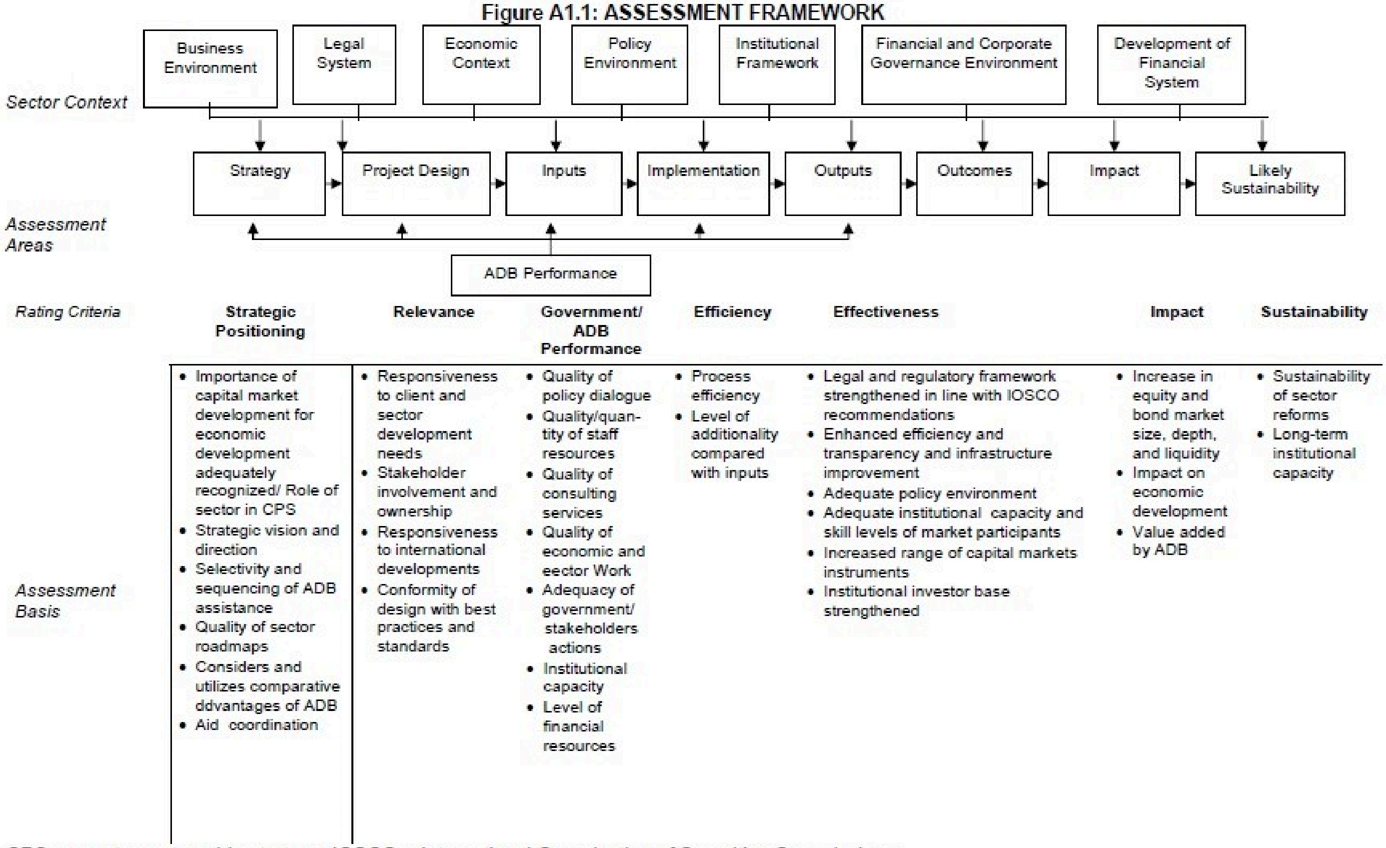
The formulation of policies to foster financial system stability and development has become a great priority among policy makers. Financial policy reflects the financial sector development contributing economic growth whereas the instability and disruptions of the financial policy drags the economic downturns and financial crises-the world has witnessed several crises including 1980s, 1990s, and 2008 as few instances. So, we can find two-way linkages between financial sector soundness and performance,

on the one hand, and macroeconomic and real sector developments, on the other hand, need to be considered when designing macroeconomic and financial policies. Moreover, effective surveillance of national financial systems, along with a harmonization and international convergence of key components of financial policies, will help minimize those types of risks and will promote orderly development of the financial system. Thus, financial stability considerations and financial sector development policies are intrinsically interlinked.

Recognizing the need for stronger policies to foster financial stability and development, several entities around the world, including national authorities, multilateral development agencies, regional development institutions, and various standard-setting bodies are focusing on further developing the tools and methodologies of financial sector analysis and assessments.

The stability and state of development of a financial system depend on a broad range of structural, institutional, and policy factors that operate through two channels. First, they affect the attitude of the private sector toward risk taking, the scope and reach of financial services, and the quality of financial sector governance. Second, they influence the effectiveness of financial policies in fostering sound and well-functioning financial institutions and markets. Those considerations are reflected particularly on the World Bank–IMF experience in conducting the Financial Sector Assessment Program (FSAP). The FSAP has been built on a range of analytical techniques and assessment tools developed by the IMF, World Bank, Asian Development Bank, Bank for International Settlements (BIS), international standard-setting bodies like IOSCO, and national authorities. The agencies are helping country authorities to conduct their own assessments of the soundness, structure, and development needs of the financial system. The assessment framework of ADB for the capital market development program (CMDP) demonstrates the steps involved in the assessment (mentioned in a diagram).

Figure A1.1: ASSESSMENT FRAMEWORK



CPS = country partnership strategy, IOSCO = International Organization of Securities Commissions.

Capital market reform allows capital markets to embrace new ideas and techniques that affect the capital market. Capital market liberalization is one such capital market reform that various countries have implemented in order to strengthen their economies. Though numbers of initiatives from time to time to provided financial and regulatory reforms in the primary and secondary market segments of the capital market, the time has come to assess the overall development of the capital market and effect on investors' confidence. The primary goal of all policies and reforms was obviously to introduce and strengthen the economic system as much as possible.

The sectoral development assessment is to some extent subsumed in International Organization of Securities Commission's (IOSCO's) Objectives and Principles of Securities Regulation. Investor protection, fairness, efficiency, and transparency are among the most important prerequisites for the development of organized securities markets. These important elements of effective securities regulation are also covered in the IOSCO objectives and principles. When investors have confidence, the market tends to grow. IOSCO Objectives and Principles of Security Regulations promote robust and efficient financial markets. Thus, IOSCO principles 14–16 aim to ensure that issuers are transparent and fair, principles 17–20 to ensure that collective investment schemes are equally trustworthy, and principle 28 to ensure that secondary market manipulation is inhibited. IOSCO principle 23 deals with standards for the internal organization and operational conduct of market intermediaries to ensure adequate client protection and risk management.

The legal, institutional, and policy framework are needed to ensure effectiveness of financial sector supervision. It focuses on banking, insurance, and securities markets. Effective supervision, however, depends on a legal and institutional environment that provides the necessary preconditions. Those preconditions include the following:

• The provision and consistent enforcement of business laws—including corporate, bankruptcy, contract, consumer protection, and private property laws—and a mechanism for fair resolution of disputes

• Good corporate governance, including adoption of sound accounting, auditing, and transparency procedures that carry wide international acceptance and that promote market discipline

• Appropriate systemic liquidity arrangements, including secure and efficient payment clearing systems that enable adequate control of risks and efficient management of liquidity

• Adequate ways to minimize systemic risk, including appropriate levels of systemic protection or safety nets and efficient procedures for handling problem institutions.

The preconditions complement the legal and institutional framework governing the specific sectors of the financial system and their supervision

The Assessment of the effectiveness of financial supervision and regulation of banking, insurance, and securities markets is critical for financial system stability and development. The assessments are based on the Basel committee's Core Principles for Effective Banking Supervision (BCP); the International Association of Insurance Supervisors' Insurance Core Principles (ICP) and methodology; and the International Organization of Securities Commissions' Objectives and Principles of Securities Regulations.

The supervisory standards consist of a set of core principles that can be grouped as below:

• Regulatory governance—relating to the objectives, independence, enforcement authority, and decision-making arrangements of the regulator

• Regulatory practices—consisting of practical application of laws, rules, and procedures

• Prudential framework—referring to rules and guidance on internal controls and governance of supervised entities

• Financial integrity and safety net—dealing with policies and instruments to promote fairness and integrity of operations of financial institutions and markets as well as safeguards of depositors, investors, and policy holders in times of stress and crises.

Moreover, the Assessment Committee (AC) has been established to drive IOSCO's key strategic goal of being the recognised standard setter for securities regulation. The AC was established in February 2012 by the Executive Committee as an initiative of IOSCO's Strategic Direction Review. The objective of these programs is to encourage full, effective and consistent implementation of Principles and Standards across IOSCO membership which will - in turn - contribute to:

- Investor protection, fair and efficient markets and reducing systemic risk globally;
- Reducing opportunities for regulatory arbitrage;
- Reducing the costs of conducting business across borders; and improving regulatory capability.

The three main activities of the Assessment Committee are:

1. The conduct of **Thematic Reviews** of particular IOSCO Principles and IOSCO Standards across IOSCO's membership. The aim of these Reviews will be to provide a snapshot of implementation of IOSCO's Principles and Standards. This snapshot will assist in identifying gaps in implementation, differences in approach to implementation, examples of good practice and difficulties and issues experienced in implementation. If appropriate, Reviews will address identified gaps in implementation; and
2. The conduct of **IOSCO Standards Implementation Monitoring (ISIM) Reviews**. The AC developed the ISIM program to complement its ongoing work streams as a useful, less resource intensive, mechanism for monitoring implementation progress for a set of IOSCO Principles across IOSCO members. The aim of ISIM is to provide an overview of implementation, identify gaps, trends and good practices and targeted recommendations.
3. **Maintenance of the IOSCO Principles and Methodology**. This work involves supporting users of the Methodology, updating the Methodology and assessing the need to update the IOSCO Principles. This may also involve programs to make the Methodology more accessible and user-friendly for members.

Conclusion

The stability and state of development of a financial system depend on a broad range of structural, institutional, and policy factors as they affect the attitude of the private sector toward risk taking, the scope and reach of financial services, and the quality of financial sector governance. Moreover, they influence the effectiveness of financial policies in fostering sound and well-functioning financial institutions and markets. Being one of the critical components of the financial system, the capital market plays a vital role in the economic growth and national prosperity through a functioning mechanism for efficient mobilization of scattered savings, liquidity management and risk diversification. As it has been recognized as a gateway for capital mobilization, the Government of Nepal should prioritize the securities and commodity markets as a backbone of the economy. As an apex regulator of the capital market, SEBON with cooperation from regional and international organizations has taken several initiatives from time to time, through formulation and implementation of various strategic programs and developmental Initiatives in the evolution process. In fact, capital market reform also means bringing competition, transparency, financial discipline and governance, however, changing market complexities, new and innovative products, rapidly changing technology, dynamism in investors' demand and recent development in international regulatory aspects have triggered the reform initiatives. Nepalese capital market reforms have long been overdue; though we have more than three decades of history. We can take examples from other Asian nations to compare our progress track when contemporary counterparts and their markets. The sectoral development assessment is to some extent subsumed in International Organization of Securities Commission's (IOSCO's) Objectives and Principles of Securities Regulation. Investor protection, fairness, efficiency, and transparency are among the most important prerequisites for the development of organized securities markets. The legal, institutional, and policy framework are needed to ensure effectiveness of financial sector regulation and supervision.

Capital market development process needs reform from time to time ensuring that regulatory systems remain effective in the changing environment and national-international market scenarios along with shifts in priorities. In light of this background, recognition of structural deficiencies in our capital market is the first step we should take. Thereafter, time has come to review our recent efforts to strengthen the regulatory framework and do the assessment of our current status and outcomes. Most importantly identifying the remaining gaps in the regulatory and institutional framework is crucial, aimed at reforming our capital market by putting policy recommendations into the actions with the help of expert agencies like IOSCO, IMF, ADB etc. for the desired reform.

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