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Exploring Higher Capital Requirements in Nepal Under Basel III: A Qualitative Approach

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ABSTRACT

This paper explored the impact of capital regulation on the banking industry in Nepal and sought to understand the reasons behind the requirements for higher capital in the country compared to global standards set by the Basel Committee on Banking Supervision (BCBS). The paper incorporated semi-structured interviews with experts from banks and the Nepal Rastra Bank (NRB) and employed thematic analysis to analyze the responses. The main factors driving higher capital requirements in Nepal were identified as risk management practices, financial stability, and the cost of financing, including the supervisory review process and the internal control systems of banks. The study found that the banking industry in Nepal lacks strong risk management policies and practices and that the regulator places a greater emphasis on ensuring the stability and resilience of banks rather than minimizing the economic cost of financing. Additionally, the corporate governance and internal control systems of banks in Nepal were found to be suboptimal.

INTRODUCTION

The financial sector plays a crucial role in driving long-term economic growth by facilitating the growth of productive businesses through financing, utilizing savings effectively, and ensuring that resources are used efficiently. In Nepal, commercial banks make up a significant portion of the nation's banking system (Timsina, 2019). The implementation of the Basel accords, international standards for banking regulation, has generated a noteworthy amount of research on the impact of new capital rules (Naceuret al., 2018). Given the vital role that banks play in society, they are heavily regulated and supervised to ensure they operate in a manner that does not pose undue risk to society (Mishkin, 2000; Bank for International Settlements, 2008). Prudential regulation and supervision aim to promote stability so that the financial system can effectively fulfill its societal responsibilities without posing undue risk (Fullenkamp& Sharma, 2012; Mishkin, 2000).

Capital adequacy requirements are considered important for commercial banks Kombo&Njuguna (2017), and the global financial crisis of 2009-2010 highlighted the need for reforms to address flaws in the regulatory framework for banks. It has been argued that undercapitalization contributed to the 2007-2010 financial crises (Bean, 2009). However, increasing minimum capital requirements may have adverse impacts on share prices, bank profitability, and loan supply (Aiyar et al.,2015), but avoiding the severe consequences of banking crises may outweigh these costs.

Nepal Rastra Bank (NRB) capital adequacy framework 2015(Unified-Directives-2077) states that banks should have sufficient capital to match their risk profile and those regulatory capital requirements are important for loss-absorption and creditor protection. The Basel Committee on Banking Supervision (BCBS) developed Basel III reforms with the objective to improve the ability of the banking sector to withstand financial and economic stress and reduce the risk of negative impacts on the real economy. The BCBS recommendations on capital requirements serve as a global guide for regulatory capital requirements in the banking industry, including in Nepal. NRB has implemented capital adequacy requirements based on international practices and adapted them to the domestic market. The goal is to ensure the stability and safety of individual banks and the banking system overall.

According to International Monetary Fund's (IMF) compilation guide for 2019, capital adequacy is a key indicator of the financial soundness of banks. Studies have shown that bank capital requirements can promote financial stability through behavior modification (Bhatta, 2015) and that regulatory capital requirements can improve banks' financial performance and reduce risk-taking (Pham & Daly 2020). A study by Ghulam et al., (2021) examined the nexus between Basel capital requirements, Asian emerging markets profitability, and risk in the banking sector and found that regulatory capital has a positive effect on profitability while risk has a negative effect. Likewise, previous research has primarily focused on the impact of capital sufficiency on bank stability and risk-taking, largely based on the moral hazard theory and agency problem theory (Le et al., 2020). Studies have shown that the Basel II framework of capital adequacy regulations has not effectively curbed risk-taking behavior in the banking industry (Demirguc-Kunt, et al., 2006; Janson, 2009). However, other research suggests moral hazard risk due to capital requirements, although it may negatively impact profitability (Hellmann et al., 2000; Lee & Hsieh, 2013; Pham & Daly, 2020). The main macroeconomic benefit of higher capital requirements is increased resilience in the banking sector and a reduced likelihood of a banking crisis, but there may also be temporary costs related to slower GDP growth due to higher financing costs for banks and the economy as a whole. The net effect of higher capital requirements is the difference between the expected benefits and costs (Banbula et al., 2019).

BCBS sets global banking regulation standards and aims to improve risk management, governance, and transparency in the banking sector. The BCBS comprises 28 central banks and supervisors and released the Basel III framework to strengthen capital and liquidity rules and make the banking sector more resilient. The Basel Committee's reforms aim to improve robustness in the banking sector by increasing regulatory capital and enhancing risk coverage, using a leverage ratio to limit excess leverage and protect against model and measurement error, and addressing systemic risks related to procyclicality and interconnectedness in the financial sector. The global financial crisis of 2007-2010 emphasized the need for strengthened regulations and the importance of maintaining a strong and resilient banking system for economic stability. The Basel III reforms were implemented to address these issues and increase the resilience of individual banks during times of stress. Public sector interventions were necessary during the crisis, but also exposed taxpayers to losses, highlighting the need for a more resilient banking sector that can absorb shocks and protect against systemic risk.

NRB has implemented the Basel III framework in the country to ensure the safety and soundness of the banking system and to promote public confidence. The framework has three pillars: minimum capital requirements, supervisory review of capital adequacy, and market discipline. NRB has adopted international best practices and issued an action plan for implementing the Basel III framework in Nepal, with some simplifications to create a safe and stable financial system through the use of adequate, high-quality capital and effective risk management practices. Banks in Nepal are required to meet additional regulatory capital requirements as specified by the Nepal Rastra Bank's capital adequacy framework beyond those established by the global regulatory framework of the Basel Committee on Banking Supervision (BCBS). The optimal level of capitalization for a business, including banks, is crucial for its long-term viability. Previous research has shown that capital structure can impact bank performance (Siddik et al., 2017), and understanding the impact of capital regulation on the banking industry and the economy as a whole is important. A strong and resilient banking system is essential for sustainable economic growth, as banks play a central role in the credit intermediation process between savers and investors. Capital requirements can affect various aspects of businesses and the economy, and the capital framework prioritized the protection of depositors and creditors. Maintaining a sufficient level of capital that is appropriate for a bank's risk profile and activities is necessary to enhance public confidence in the banking system and foster a safe and sound financial system (NRB Directive 2078, Capital Adequacy Framework 2015).

Capital regulation is a critical aspect of the banking industry as it impacts various factors such as financial performance, risk management, and economic growth. Previous research has examined the impact of capital regulation on these factors in both developed and emerging economies, using different theoretical foundations. Nepalese studies exploring the effects of capital regulations on the banking industry and economy have shown mixed results, with some finding a negative effect on bank performance, growth, GDP, and financial stability, while others found a positive effect. Bhatta (2015) suggests that higher capital requirements can promote financial stability by altering the behavior of banks and borrowers, but Uprety (2014) notes that weaknesses in the banking system of Nepal, such as insider lending and weak internal controls, may be further exacerbated by the implementation of Basel III. Gautam (2018) found a positive relationship between capital adequacy and financial performance in Nepalese commercial banks, but Gautam (2019) found a negative relationship between capital adequacy and profitability. Bhattarai (2019) did not find a significant effect of credit risk on the performance of Nepalese commercial banks. The central bank's motivations for implementing higher capital requirements in Nepal are not explicitly stated. There has been a lack of research specifically examining the reasons for higher capital requirements in Nepal compared to the recommendations of BCBS.

The paper fills the gap by using qualitative research methods to explore the drivers and rationales for higher capital requirements in Nepal. The research compares the capital regulation frameworks in Nepal (Capital Adequacy Framework, 2015) and the global framework (Basel III) issued by the Bank for International Settlements (BIS), through the lens of the public interest theory of regulation. The Nepal Rastra Bank's capital adequacy framework 2015 aligns with the public interest theory by emphasizing the importance of capital to ensure a sound financial system, while also taking into account domestic market conditions. The findings of this study may have implications for policymakers and regulatory systems for banks, as the impact of capital regulation may vary depending on a bank's ability to originate loans and economic context, and may not always be effective or even harmful. Therefore, regulators need to consider the characteristics and actions of individual banks when developing and implementing policies that promote financial stability and support the core function of banks as credit providers (Naceuret al., 2018).

Having a better understanding of capital frameworks and regulations can have various implications for different stakeholders. The central bank enhances risk management and governance practices of banks that in turn promote increased transparency and more thorough disclosure requirements, and policy and lawmakers may develop and implement policies to ensure a sound, safe, and resilient banking and financial system. The public may have increased confidence in the financial system, investors can make informed investment decisions, and bank management can gain a deeper understanding of capital requirements, risk management practices, governance, and disclosure requirements and practices.

Through semi-structured interviews with experts from banks and financial institutions and NRB, this paper explored why Nepal's banking industry requires higher capital than global standards, finding that the main reasons are risk management practices, financial stability, and the cost of financing, and identified weaknesses in the industry's risk management policies, corporate governance, and internal control systems.

METHODS

The research approach of this study involves the analysis and understanding of both global and local capital frameworks, including the identification of qualitative and quantitative capital requirements. The sources for this study include policy documents, circulars, directives, working papers, and consultative documents linked to the implementation of Basel III. The paper includes five participants, three individuals from banks responsible for reporting to the Nepal Rastra Bank (NRB) on Basel III, and two individuals from NRB who have worked on the implementation of Basel III. The study uses purposive sampling to select participants who have expertise in the subject matter and can provide technical information. The participants include 60% bankers involved in the implementation and reporting of Basel III, and 40%

regulators from NRB responsible for regulating, supervising, and monitoring the requirements of Basel III. The inclusion of both bankers and regulators provides a diverse perspective on the subject.

Information is gathered from discussions with and insights from participants. Detailed discussion and semi-structured interview is conducted with the participants. Semi-structured interviews of this study consist of several key questions that help to explore and understand the issue. Semi-structured interviews, which involve preset open-ended questions and are often utilized by researchers for their in-depth and flexible nature, are a type of in-depth interview used to gather information from respondents. It also allows for flexibility in the conversation, allowing both the interviewer and interviewee to explore ideas and responses in more depth, and also enables the discovery of important information that may not have been previously considered by the researcher.

This study gathered information through discussions with participants and insights from them. Detailed semi-structured interviews were conducted with participants using a questionnaire. The interviews were semi-structured, meaning they included preset open-ended questions, allowing for some flexibility to pursue ideas or responses in more detail. The collected information was analyzed using thematic analysis. This allowed for the identification of shared meanings and experiences related to the research topic and question. The analysis provided answers to the research question, even if the specific question only became clear through the analysis process (Braun & Clarke, 2012).

In this study, the quality of the research is ensured through a thorough understanding and analysis of relevant materials and the inclusion of important and pertinent questions for the participants. Ethical considerations, including objectivity, integrity, and respect for intellectual property and privacy, are also taken into account throughout the research process.

RESULTS AND DISCUSSION

This section presents the findings and major themes identified through semi-structured interviews with the participants and analysis of the collected data. The themes that emerged from the discussions and data analysis include Risk Management Policies and Practices; Financial Stability contrasted with Cost of Financing; Supervisory Review Process and Corporate Governance/Internal Control System.

Risk Management Policies and Practices

The main views and ideas coming under risk management policies and practices is the presence of a conventional banking system in Nepal and the use of a simplified approach for the measurement of various risks in the banking industry. The financial crisis that began in 2007 has provided opportunities for reforming insufficient financial risk management in the sector (Janson, 2009; KPMG, 2011). Capital regulation should address the risks posed to the banking system by off-balance sheet transactions by taking steps to mitigate these systemic risks. (Weissman & Donahue, 2009; Johnson & Murphy, 1987). The findings of this paper also revealed there are inadequate risk management practices in the banking industry in Nepal and that the regulator is attempting to address these issues through higher capital requirements. It was noted that there is a limited understanding of risks in Nepal and that risk management is not a priority for banks. The paper also highlighted the lack of a robust risk management framework and the need for improvement in risk management practices and comprehensive risk management policies. It is suggested that higher capital requirements may reduce risk-taking by banks in Nepal and may have been implemented to address the overall stress that could result from risk exposure, both internal and external.

Banker 1: The banking industry operates within a conventional system with primitive products, and uses a simplified approach to measure various risks such as operational, credit, and market risks. This approach does not cover all types of risk and may not be sufficient to effectively manage risk in the industry. The central bank is aware of these limitations and has recognized the need for a more comprehensive risk management framework. To address these weaknesses and manage the risks posed by the growing banking industry, it has been suggested that banks in Nepal should allocate higher capital to cover different types of risk. These risks include investment risk, credit risk, exchange rate risk, interest rate risk, and concentration risk, among others. Higher capital adequacy requirements are seen as a risk management tool to cover both calculated and non-calculated risks and can help banks to better manage unexpected risks to achieve higher returns on investment if better investment opportunities are available. However, Nepal currently lacks the resources and infrastructure to fully implement a comprehensive risk management framework. Instead, the current capital framework is a converged form of international standards, adjusted to take into account the economic factors specific to Nepal.

Banker 2: In Nepal, the banking industry is still in its early stages and has not yet experienced enough credit and economic cycles to fully understand and address the risks it faces. While a simplified approach is currently used to measure risks such as credit, operational, and liquidity risks, the central bank is also aware that banks may face risks that are not adequately captured by these approaches. To better manage these risks, it is recommended that banks in Nepal maintain higher capital levels, which can help to strengthen their financial stability and resilience. Banks should also make adequate disclosures, adhere to international banking norms and practices, and have sufficient reserves to absorb most stresses and risks. Overall, it is important for banks to adequately measure and manage risk to ensure their long-term stability and success.

Banker 3: Basel III has increased risk weights for risky exposures, but it is expected that these changes will have only a minor impact on the risk exposures of Nepalese banks. However, due to a lack of clarity around the impact of complex and risky exposures on the Nepalese economy, the central bank has suggested that banks in Nepal should maintain higher capital levels. Higher capital requirements may have a positive impact on those banks that can use capital efficiently and effectively and have robust risk management frameworks in place, with clear plans and policies to address different risks. However, the lack of in-depth understanding of the banking and financial system, coupled with poor governance, has contributed to the need for higher capital requirements in Nepal.

Regulator 1: In Nepal, weak risk management practices in the banking industry and the use of a simplified standardized approach are the main drivers behind the need for higher capital requirements. Capital regulation, including higher capital requirements, is used by the central bank as a risk management tool at the institutional level. However, the impact on a bank's financial performance depends on how effectively it leverages its capital and its risk management philosophy and practices. Factors such as risk management practices, supervisory review, internal capital adequacy assessment processes, transparency, and others have all contributed to the need for higher capital requirements in Nepal. Overall, risk management in the country is currently inadequate.

Regulator 2: The capital requirements suggested by the BCBS are flexible and depend on the risk exposures of individual banks and the overall risk environment in which they operate. The central bank in Nepal has taken into account several factors when issuing capital-related directives and regulations, including the risk environment and risk practices within the country, as well as various banking indicators such as liquidity pressures, high exposure to risk assets, and pressures from a promoter and public shareholders in the stock market. However, there is still a need for further improvements in the implementation of comprehensive risk management policies and effective management of operational risk in Nepal.

Financial Stability contrasted with Cost of Financing

The major understanding coming under this theme is the significance of financial stability in the economy. Allen and Herring (2001) revealed that regulation leads to financial stability. Financial market regulation and monetary policy can significantly affect intermediary services and a decline in market liquidity can lead to a decrease in bank lending, which ultimately affects GDP growth (BCBS, 2012). It is crucial to strike a balance between the benefits and costs of supervision and regulation, as regulators must consider the potential consequences of both under the regulation which may lead to failures and overregulation which can result in stifling innovation and financial inefficiencies (Walter, 2009; Lamfalussy, 1989). Ensuring the stability and resilience of banks is critical for the overall stability of the economy, and higher capital levels can help to absorb more risk and reduce stress on the economy. Maintaining a stable financial system and building confidence among the public and regulators is an important goal for regulators, who are mindful of the potential negative impact of slower GDP growth but also recognize the importance of preventing financial system failures. Participants in the study noted that the regulator in the country places a greater emphasis on financial stability and appears to be less concerned with growth in terms of capital regulation. From the perspective of regulators, the benefits of financial stability may outweigh the economic costs associated with higher capital requirements, and policymakers and regulators must consider the balance between maintaining a steady and secure financial system and economic growth. Below are the participants' wise views and discussions on financial stability and the cost of financing.

Banker 1: The growth of banks in Nepal is significant in relation to the size of the economy, and the potential failure of a large industry could have serious consequences for the overall economy. As a result, regulators have introduced more stringent capital regulations to increase the resilience of banks to financial downturns and ensure financial stability. Higher capital levels can help to absorb more risk and maintain stability during times of stress. However, higher capital requirements may not always be ideal from the perspective of banks, as they may put additional pressure on measures of profitability such as return on assets and return on equity. The main objectives of the central bank in Nepal include financial stability, the protection of the interests of the general public, and the adoption of international standards, norms, and guidelines. Higher capital requirements can help to build confidence among the public and regulators and facilitate the growth of businesses while maintaining a balance in the economy. The new capital accord introduced by the central bank aims to cover risk profiles that were not addressed by the previous framework and has resulted in changes to the behavior of banks in various areas, including lending and investment. The implementation of the accord has also led to changes in banks' strategies, such as dividend restrictions, and has enforced greater transparency through the use of pillar 3 disclosures. Overall, the central bank's priority is financial stability, which is seen as more important than slower GDP growth resulting from restricted lending. While slower GDP growth can lead to negative consequences such as lower production, unemployment, and reduced spending power, the potential failure of the financial system would have even more severe consequences, including higher country risk, and negative impacts on foreign direct investment, foreign loans, and grants.

Banker 2: Banks play a critical role in the infrastructure of the economic system and any stress experienced by a bank can have cascading effects on other sectors through credit and settlement risks. Maintaining a strong capital base can help to ensure financial stability and allow banks to take on larger positions in bigger projects, while also enabling them to withstand pressures caused by liquidity and market conditions. The global financial crisis of 2008 revealed the importance of strong capital in helping banks to handle write-downs in major asset classes. While operating with higher capital levels may have economic costs, the benefits in terms of financial stability for the economy as a whole are seen as outweighing these costs. In some cases, increasing the strength of depositor insurance may allow for the relaxation of capital requirements, but there is still a risk that banks may transform short-term deposits into longer-term loans. Overall, higher capital adequacy requirements are a risk management tool used to ensure financial stability and can have a positive impact on a bank's financial performance by helping it to recover from stressful situations. The central bank in Nepal recognizes the benefits of higher capital in connection with financial stability, lower costs for the government in the form of bailouts or deposit insurance and the overall cost of financing for banks and the economy.

Banker 3: The central bank in Nepal has suggested higher capital requirements to improve the shock-absorbing capacity of the banking system and minimize negative spillover effects on the real economy. The NRB's strategic plan for 2012-2016 outlined the implementation of Basel III by 2015 to increase capital and liquidity requirements for banks. The introduction of a new capital accord is intended to enhance financial stability, however, risk-taking and competition in the financial sector may be reduced due to higher capital requirements by banks, as well as increased borrowing costs that could lead to higher risk-taking by borrowers. Policymakers face the challenge of balancing the need for financial stability with efficiency, while economists seek to more accurately measure the economic effects of higher capital requirements to determine the optimal level of bank capital. Ultimately, the central bank in Nepal is more comfortable with higher capital requirements to avoid problems in the financial system, even if it means some costs to the economy.

Regulator 1: In accordance with the objective of financial stability set by BIS, the central bank in Nepal has introduced a new capital accord. While higher capital requirements may not always be ideal, they are generally seen as a prudential measure to help ensure financial stability. From the perspective of regulators, the benefits of increased capital in terms of financial stability outweigh the economic costs. The main assumption behind the issuance of capital regulations by the central bank is the importance of financial stability and the need to strengthen the resilience of the banking system in the economy. To maintain financial stability, the benefits of higher capital are seen as being greater than the cost of financing for banks and the economy as a whole.

Regulator 2: Higher capital requirements for banks in Nepal may have been suggested to mitigate the risk exposure faced by banks, both internal and external. The size and nature of the economy in Nepal may also warrant higher capital to support growth potential. The central bank in Nepal has introduced a new capital accord for financial stability, as required by Nepal's commitments to the World Bank and International Monetary Fund. While higher capital requirements may create pressure for banks to maintain return on investment, return on equity, dividend ratios, and earnings per share, which could lead to increased risk-taking behavior, there is a need to balance these considerations with the overall economic and risk environment. The central bank views higher capital adequacy requirements as a risk management tool that can handle stressful situations, but the impact on banks' financial performance has been mixed, with some banks facing mergers or acquisitions and others being upgraded. Ultimately, the central bank sees higher benefits from increased capital in terms of financial stability and the overall cost of financing for banks and the economy.

Supervisory Review Process and Corporate Governance/Internal Control System

One of the main themes in this context is the need for effective supervisory review processes and improvements in the Basel principles of supervision by the central bank, as well as significant improvements in the internal control and corporate governance systems of banks. Governments should prioritize effective supervision over inefficient regulation to maintain the stability and efficiency of the financial system (West, 1983). Good regulation can be achieved through regulators' engagement in an interactive dialogue with the financial industry that can result in proactive supervision and regulation, rather than relying on reactive measures. (Fullenkamp & Sharma, 2012). Previous research has emphasized the importance of effective supervision, regulatory interactions, and a robust supervisory review process in creating good regulation. Participants noted regulators' planning, evaluation, review, and control systems are lacking in robustness and supervisory haircuts are more subjective rather than based on parameters. The corporate governance and internal control of banks are poor and require significant improvement. Transparency and market discipline within the banking sector are also major issues. There is a need for significant improvement in the supervisory review process system, including in-depth risk monitoring by the regulator, to address the challenges facing the financial system, such as poor institutional development, professionalism, and governance issues. Improving the supervisory evaluation system, the Basel principles of supervision, and corporate governance standards is also necessary. The main views and thoughts in this area emphasize the importance of effective supervisory review and regulatory improvements, including the Basel principles of supervision and corporate governance standards, to address these challenges. Below are the participants' wise views and discussions on the supervisory review process and corporate governance/internal control system.

Banker 1: Higher capital should not be seen only solution to address increased risks facing banks. Supervisory review is used to assess the adequacy of a bank's internal control processes and the central bank requires banks to perform internal capital adequacy assessment processes (ICAAP) to ensure compliance with regulatory capital requirements and the soundness of the bank's risk management framework. The central bank also conducts regular supervisory reviews to assess the effectiveness of a bank's risk management and internal control systems. However, the supervisory review process (SREP) in place is not robust or effective, which can impact the assessment of risk management practices and internal controls. The SREP system is more backward-looking than forward-looking, and there is a lack of resources, skilled manpower, and infrastructure to support it. Supervisory haircuts are applied due to inadequate risk management practices and internal controls, which are evaluated through onsite inspections if officers are not satisfied. The parameters for these haircuts are not clearly defined and are based on subjective judgment rather than on objective parameters. Unless banks can address these issues, capital requirements will remain high.

Banker 2: The central bank in Nepal expects banks to have strong governance and risk management practices and maintain adequate disclosures and operate transparently. The supervisory review process, which is a core part of the Basel framework, should ensure that banks adhere to regulatory norms and adequately provide for impairments. However, in Nepal, the supervisory review process is not fully effective and the standards of corporate governance are generally not high. Risk management is not a priority for most banks, and operational risk is not thoroughly monitored, often limited to isolated analyses of smaller risks. These principles are not consistently implemented and followed in the banking industry in Nepal.

Banker 3: In Nepal, the central bank has implemented higher capital requirements to address various issues within the banking industry, such as weak risk management practices, poor governance, and a lack of transparency. These issues have contributed to the need for higher capital to ensure the stability of the financial system. The central bank has also implemented the Basel III framework, which focuses to improve the resilience of banks to financial downturns. However, the effectiveness of the supervisory review process in Nepal needs to be improved to better assess the risks faced by banks and ensure that they are operating in compliance with regulatory norms. Additionally, the Nepalese banking system still has several shortcomings and limitations, such as the lack of credit rating practices and weak corporate governance, which need to be addressed to bring it up to international standards.

Regulator 1: Overall, the higher capital requirement in Nepal's banking system is a result of weak risk management practices, inadequate internal control systems, and low levels of transparency within the industry. The regulator, NRB, has implemented new capital regulations and introduced the Basel III framework to improve financial stability and increase banks' resilience to future financial downturns. However, these measures have also been influenced by the lack of robust supervisory review processes and improvements needed in the principles of supervision, internal control, and corporate governance within the banking system. NRB sees higher benefits from increased capital as compared to the cost of financing for banks and the economy, as it helps to ensure financial stability and prevent potential collapses during times of credit and economic stress. However, the implementation and effectiveness of these measures are still being improved and there is still a long way to go in terms of achieving international standards of risk management and corporate governance within the Nepalese banking industry.

Regulator 2: The regulator is aware of the market discipline, management, and board of financial institutions (BFIs), as well as the poor internal control systems, corporate governance, and inadequate risk management frameworks and practices. These factors contribute to the need for higher capital requirements. During the implementation of the new capital accord, some impact analysis was conducted by the regulator, though the discussion and reporting by banks during this time may have been questionable. The new accord is expected to bring about changes in bank behavior due to public disclosures and the optimization of the portfolio mix due to the higher risk weight for risky and complicated financial instruments. Factors such as poor governance, inadequate internal control systems in banks, and risk management, monitoring, and evaluation systems, as well as the history of the bank, have all played a role in the higher capital requirement. A more effective supervisory review system would lead to a lower capital charge and requirement.

Improving the implementation of the Basel Core Principles for effective Banking Supervision and adhering to high standards of corporate governance will be crucial in addressing these issues.

CONCLUSION

This paper compares capital regulation under local (Capital Adequacy Framework, 2015) and global (Basel III, 2011) frameworks and investigates the reasons for higher capital requirements for banks in Nepal than recommended by BCBS. It discusses the drivers and rationale for these higher capital requirements, including risk management practices, financial stability, the cost of financing, and the supervisory review process and corporate governance/internal control systems of the banks. Previous research has recognized the need for capital regulation to mitigate systematic risks due to inadequate risk management practices in the banking industry. The paper also found that there are insufficient risk management policies and practices in the banking industry in Nepal, and NRB is trying to address through higher capital requirements. However, there is a lack of a sound and robust risk measurement framework and comprehensive risk management policies, and limited understanding of risks by market participants. Improving risk management practices and policies is necessary.

Prior literature has emphasized the importance of financial stability for economic growth, but regulators in Nepal place a higher priority on financial stability and may be less concerned with economic growth when it comes to capital regulation. Higher capital requirements are necessary for maintaining the public's and regulators' confidence, covering stress situations, and improving shock-absorbing capacity. Regulators are aware of slower GDP growth but prioritize preventing financial system failure. The NRB sees more benefits from increased capital than the cost of financing. However, finding the right balance between economic costs and financial stability is important, as inadequate or overregulation can lead to failures or lower innovation and financial inefficiencies, respectively (Walter, 2009; Lamfalussy, 1989). Previous research has also emphasized the importance of effective supervision and regulatory interactions for good regulation.

The current supervisory review process is significant, but there are issues with its planning, evaluation, review, and control, as well as suboptimal corporate governance, transparency, market discipline, and internal control at banks. The supervisory review process system needs significant improvement, and there is a need to improve the supervisory evaluation system, the Basel principles of supervision, and corporate governance standards. Also Effective regulation requires dialogue and interaction between stakeholders, including financial regulators, to facilitate proactive supervision and regulation (Fullenkamp & Sharma, 2012). There are several limitations to this study due to its qualitative nature and the technical subject matter. These include time constraints, a limited number of participants, potential personal biases in observations and conclusions, limited resources and published material, and focus on only "A" class financial institutions in Nepal.

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