Voice : A Biannual & Bilingual Journal
2025 July, Vol : 17, No. 1, pp.104-114
DOI : https://doi.org/10.3126/voice.v17i1.84780

Qualitative Exploration of Enhanced Capital Requirements in Nepal: A Study Under the Basel III Framework

Prakash Regmi[1]

Article Information : Received : June 12, 2025 **Revised :** June 24, 2025 **Accepted :** July 13, 2025

Abstract

Through an empirical approach, this paper critically rethinks the reasons behind the increased capital requirements imposed on Nepalese banks that apply the Basel III framework. The paper will be designed based on interviews with banking professionals and their regulatory officials to provide a critical view of inadequate risk management practices, concerns over financial stability, deficiencies in supervisory oversight, and challenges in corporate governance in Nepal's banking industry. The results indicate that Nepal Rastra Bank has implemented elevated capital standards as a cautious risk management strategy, customized to the country's specific economic context, to enhance the resilience of banks against systemic risks and mitigate financial threats. The study aims to cover sectors such as risk management and supervisory frameworks, emphasizing the need for continuous reforms to scale up risk assessment, transparency, and internal control systems. These are key alignments for Nepal's banking sector to meet global standards, promoting sustainable economic development.

Keywords: Financial Stability, Capital Adequacy, Basel III Framework, Risk Management, Supervisory Oversight

[1]Teaching Assistant, Tribhuvan University,Mahendra Multiple Campus, Nepalgunj
Corresponding Author : prakashregmi123@gmail.com

ISSN : 2091-2161

Published by Autar Dei Chaudharain Research Centre (ADCRC), Mahendra Multiple Campus, Nepalgunj, Banke

Introduction

In order to minimize funding mismatches, modern banking systems employ advanced financial technologies and optimize resource distribution in key economic sectors. Banks create multiple effects that enhance GDP expansion and create employment, which is possible by channeling deposits into business loans, infrastructure projects, and entrepreneurial ventures. Financial intermediaries enhance market liquidity while developing innovative products tailored to local investment requirements. Their credit creation capabilities permit minimum savings to financiers for larger-scale economic activities through responsible leverage. The sector's role extends to risk mitigation by carefully evaluating projects and monitoring fund utilization. Digital transformation has further amplified their impact through mobile banking and fintech solutions that reach underserved populations. Studies have shown that economies with robust financial intermediation consistently achieve higher productivity and sustainable development outcomes. This capital recycling process remains fundamental to national progress, particularly in developing economies seeking to accelerate industrialization (Khanal et al., 2023).

Basel III standard on its implementation level found significantly strengthening Nepal's banking sector by introducing impactful capital adequacy requirements for risk management frameworks. The new standards introduced stricter liquidity coverage ratios, ensuring banks maintain sufficient high-quality liquid assets to survive short-term stress scenarios. The adjustments in the regulatory level have increased accountability in financial statements and allow for improved oversight by the Nepal Rastra Bank. Furthermore, the countercyclical capital buffer requirement permits banks to build up capital during times of economic growth, which can be utilized during downturns. However, there are challenges at the implementation level, especially in small regional banks. The result has been a more stable and better-capitalized banking system. These regulations have also brought Nepal's financial sector closer to international best practices, thereby increasing foreign investor confidence. In this context, Adhikari adds that these comprehensive reforms demonstrate how prudential regulation can effectively enhance banking sector stability without compromising growth (Adhikari, 2022).

The financial sector plays a vital role in economic growth by mobilizing savings into productive investments and ensuring efficient capital allocation. Timsina further writes in Nepal, commercial banks form the backbone of the financial system, holding the majority of banking assets and driving economic development through their extensive lending operations and financial intermediation services (Timsina, 2019). The institutions cooperate in business expansion, support start-ups, and strengthen infrastructure development via credit provision. The dominance in Nepal's banking sector has systemic importance to the national economy. Commercial banks' ability to intermediate funds between savers and borrowers enhances overall financial inclusion and market liquidity. The sector's performance has a direct impact on employment generation, industrial growth, and GDP expansion. Effective banking operations contribute to price stability and help maintain monetary equilibrium. Regulatory frameworks governing these institutions aim to ensure financial stability while promoting sustainable growth.

The banking sector is founded on capital adequacy, with global frameworks such as Basel III playing a key role in emphasizing the resilience of financial systems. Capital thresholds on the one hand boost banks' financial strength and on the other hand limit excessive risk-taking. However, the impacts often vary depending on a country's economic conditions. Studies have shown that sufficient capital reserves are positively linked to profitability in developing economies and contribute to lowering the risk of systemic banking failures. At the same time, concerns exist that such regulations could have unintended drawbacks, including potential short-term constraints on GDP growth due to increased borrowing costs. The gross effectiveness of capital regulation relies on the ability to strike a balance between promoting sectoral stability and long-term economic growth, particularly within the context of developing banking environments (IMF, 2019).

The Basel Committee on Banking Supervision (BCBS) pays attention to 28 central banks and regulatory bodies, significantly shaping international guidelines aiming to reinforce the stability of the global banking sector through transparency and risk control. Basel III (2007-2010) financial crisis was designed to improve the resilience of financial institutions during economic turbulence. It introduces more rigorous capital requirements, imposes leverage limits to curb over-borrowing, and includes tools to address risks stemming from interconnected financial markets. The measures collectively aim to prevent future crises by strengthening both individual bank resilience and the robustness of the broader financial system, while supporting the flow of credit through well-regulated innovation (BCBS, 2019).

This study addresses a gap in the literature by applying qualitative research methods to examine the underlying factors and justifications for imposing higher capital requirements in Nepal which makes a comparative analysis of Nepal's Capital Adequacy Framework (2015) and the international Basel III standards founded by the Bank for International Settlements (BIS); framed within the context of public interest theory. The capital framework of Nepal Rastra Bank 2015 resembles the principles of this theory by highlighting adequate capital levels to ensure a stable financial system. It equally considers the specific conditions of the local market. The study's impact on policymakers and regulatory authorities often depends on the effectiveness of capital regulation, which in turn depends on the lending capacity of individual banks and broader economic dynamics. In some cases, such regulations may be less effective or even counterproductive. Hence, regulators need to account for the unique attributes and behavior of individual financial institutions when designing policies aimed at preserving financial stability and supporting the banking sector's key role in credit distribution (Naceur et al., 2018).

Nepal Rastra Bank (NRB) has adopted the Basel III framework to strengthen the stability of the banking sector and bolster public confidence by applying its three main components: capital adequacy, supervisory oversight, and market discipline. While adhering to international norms, NRB has customized these regulations by introducing capital adequacy standards that are both simplified and more robust, requiring banks to maintain strong, high-quality capital in relation to their risk exposure. This localized adaptation also includes additional capital provisions that exceed global Basel requirements, aimed at enhancing institutional resilience and effective risk governance. Evidence suggests that strategic capital structuring plays a key role in improving bank performance and ensuring long-term sustainability, with broader effects on credit availability and economic development (Siddik et al., 2017).

The financial sector plays a significant role in promoting long-term economic growth by tactically mobilizing savings, investing, allocating capital to productive businesses, and coordinating effective resource utilization. Nepal's banking system serves commercial banks as the dominant financial intermediaries, making their stability and performance crucial for overall economic develop. In order to strengthen financial stability and minimize systemic risks, banks should be operated under strict prudential regulations, covering compliance with international banking standards like the Basel Accords that govern capital adequacy and risk management (Bank for International Settlements, 2008).

Various stakeholders benefit from capital frameworks and regulatory guidelines, including central banks, lawmakers, and investors. It enhances risk management, governance, transparency, and disclosure standards to ensure a safe and resilient banking environment. It also boosts public confidence, supports informed investment decisions, and equips bank leadership with a clear understanding of capital adequacy norms and risk mitigation techniques.

This empirical study, through interviews with professionals from banks and financial institutions, reveals that Nepal's higher capital requirements are driven by risk management, financial stability, and financing costs. Indeed, it also reveals threats in risk management frameworks, corporate governance, and internal control mechanisms.

Methodology

This study adopts an empirical research approach by examining and interpreting national and international capital frameworks, with special attention to distinguishing qualitative and quantitative capital requirements. The data sources include a range of relevant materials such as regulatory policies, circulars, directives, working papers, and consultative documents associated with the implementation of Basel III. The study incorporates insights from five carefully selected participants—three banking professionals tasked with Basel III reporting to Nepal Rastra Bank (NRB) and two NRB officials directly involved in its implementation. Utilizing purposive sampling, participants were chosen based on their subject-matter expertise and capacity to provide detailed technical insights. In total, 60% are banking personnel involved in executing and reporting under Basel III, and the remaining 40% are under the oversight of NRB regulators, who enforce, supervise, and monitor Basel III requirements. The inclusion of both practitioners and regulators ensures a comprehensive and balanced understanding of the regulatory framework.

This research comprises an interactive engagement and feedback from participants to gather data. In-depth, semi-structured interviews were conducted, guided by open-ended questions. These interviews allowed for a thorough exploration of central research themes and a dynamic exchange between interviewers and respondents. The open framework encouraged participants to elaborate on their views, enriching the overall quality and depth of the collected data.

The paper uses a guided set of open-ended questions; the interviews provided the flexibility to explore complex ideas and follow up on emerging themes as conversations evolved. This method encouraged participants to share detailed and reflective responses, facilitating a rich understanding of the subject matter. Notwell et al. are particularly interested in the collected and analyzed data applying thematic analysis, which is particularly effective for identifying recurring themes and interpreting shared meanings within qualitative narratives. This approach enabled the researcher to uncover significant patterns and gain a nuanced understanding of the participants' perspectives on regulatory practices (Nowell et al., 2017). The research was rigorously conducted by reviewing relevant literature and primary and secondary sources.

Results and Discussion

The analysis of semi-structured interviews revealed key insights into managing financial risk, the tension between financial system resilience and capital funding expenses, and the role of regulatory oversight, including governance frameworks and internal oversight mechanisms.

Risk Management Policies and Practices

The prevailing perspectives on risk management policies and practices within Nepal's banking sector emphasize the existence of a conventional banking system alongside the adoption of a simplified methodology for assessing various risks. The 2007 financial crisis served as a catalyst for reforms aimed at addressing deficiencies in financial risk management within the industry (Janson, 2009; KPMG, 2011). Weissman et al. argue that capital regulations must consider risks arising from off-balance sheet activities, implementing measures to mitigate these systemic vulnerabilities (Weissman & Donahue, 2009; Johnson & Murphy, 1987). Furthermore, there exists a limited comprehension of risk among Nepalese banking institutions, with risk management often deprioritized. The paper unfolds the lack of a comprehensive risk management framework and suggests improvements in both risk management practices and policy formulation. The elevated capital requirements may serve to curtail excessive risk-taking by banks in Nepal and function as a safeguard against potential internal and external risk exposures.

Banker 1: Nepal›s banking sector›s risk assessment method may not cover all risk categories. The central bank urges its bank network to increase their capital allocation to cover various risk types, such as investment, credit, foreign exchange, interest rate, and concentration risk. This would help banks manage unforeseen risks and potentially achieve higher investment returns. However, Nepal lacks the resources and infrastructure to adopt a comprehensive risk management framework fully, so the existing capital framework is a localized adaptation of international standards, tailored to Nepal›s specific economic conditions.

Banker 2: Nepal›s banking sector is in its early stages, and a simplified approach to assessing risks does not fully understand the full range of risks faced by banks. To improve risk management, Nepalese banks should maintain high capital levels, provide comprehensive disclosures, comply with international standards, and have adequate reserves to withstand various stresses and risks. Effective risk measurement and management are essential for the sustained stability and success of Nepalese banks.

Banker 3: Basel III has increased risk weights for high-risk exposures; however, these may not significantly impact the risk profiles of Nepalese banks. The central bank recommends maintaining high capital levels for banks to effectively deploy capital, supported by strong risk management frameworks and policies.

Nepal’s banking sector requires higher capital requirements due to weak risk management practices and a simplified standardized approach. The central bank uses capital regulation, including increased thresholds, to manage risk. However, the bank’s financial performance depends on its capital utilization and risk management philosophy. Factors like effectiveness, supervisory oversight, internal capital adequacy assessment, and transparency influence the adoption of these requirements. BCBS recommends adaptable capital requirements for banks, considering their specific risk exposures and the broader risk environment. Nepal’s central bank has considered factors like the domestic risk landscape, risk management practices, liquidity challenges, and stock market pressures. However, there is a need for improved risk management policies and operational risk management in the banking sector. According to Mishkin (2007), “effective regulation is instrumental in promoting financial stability. Gorton & Metrick state that “ together financial market oversight and monetary policy critically influence intermediary services, where a reduction in market liquidity can lead to decreased bank lending, subsequently impeding GDP growth” (Gorton & Metrick, 2012).

Goodhart writes that achieving a balanced approach to supervision and regulation is crucial, as regulators must consider the risks associated with under-regulation, which can result in systemic failures, and over-regulation, which may suppress innovation and cause inefficiencies within the financial system (Goodhart, 2008; Borio, 2011). To establish and maintain a stable financial system while cultivating confidence among both the public and regulatory bodies remain a fundamental goal for regulators. Although regulators recognize that stricter capital requirements might slow GDP growth, they also emphasize the necessity of avoiding financial system collapses.

Banker 1: The significant banking sector of Nepal may collapse with severe economic consequences. However, these higher capital mandates may exert additional pressure on profitability indicators. The central bank prioritizes financial stability, safeguards public interests, and aligns with international standards. The new capital framework addresses risk exposures and has influenced banking strategies, including dividend restrictions and mandatory disclosure requirements. The central bank places greater emphasis on financial stability than on the potential drawbacks of slower GDP growth resulting from constrained lending activities. The collapse of the financial system would have severe consequences, including increased country risk and negative impacts on foreign direct investment, external borrowing, and international aid inflows.

Banker 2: Banks are crucial for economic infrastructure and can have ripple effects across sectors due to credit and settlement risks. The current global financial crisis reinforces the importance of strong capital buffers. While operating with elevated capital levels may incur economic costs, the overall benefits outweigh these costs. Strengthening depositor insurance schemes may allow for relaxation of capital requirements, but it also risks banks engaging in maturity transformation.

Banker 3: Nepal›s central bank, the NRB, has promoted to increase capital requirements, aiming to enhance the banking system›s resilience and mitigate economic impact. The Basel III standards implemented by Banks in 2015 /raised capital and liquidity thresholds for banks. However, this could reduce risk-taking and competition in the financial sector and increase borrowing costs, encouraging more risk-taking by borrowers. The bank prioritizes adopting higher capital standards to prevent financial system disruptions, despite potential costs to the broader economy.

Regulator 1: The new capital framework deployed by the Central Bank to ensure financial stability aligns with the Bank for International Settlements› objectives. While higher capital requirements may not always be optimal, they are considered prudent regulatory measures. The positive impact of increased capital outweighs the associated economic costs, making central banks believe in maintaining a higher capital level to enhance the banking system›s resilience and the broader economy.

Regulator 2: Nepal›s central bank has introduced a new capital framework to enhance financial stability and mitigate risk exposures faced by financial institutions. The rising capital responsibility may pressurize banks to maintain key financial metrics, possibly encouraging risk-taking behavior. Even so, it is mandatory to balance these factors with the broader economic context and risk environment. The central bank views higher capital adequacy requirements as a risk management tool, helping banks navigate stressful conditions. The effects on banks› financial performance vary, with some undergoing mergers or acquisitions and others experiencing upgrades. The central bank believes the advantages of higher capital levels outweigh the challenges.

To maintain financial system stability and efficiency, governments should priorities effective supervision over inefficient regulatory measures. An impactful regulation can be acquired through long-term interactive engagement between regulators and the financial industry, promoting proactive supervision. The current regulatory framework is insufficiently robust, with supervisory judgments often being subjective. Addressing systemic problems like underdeveloped institutions, lack of professionalism, and governance shortcomings requires a substantial upgrade of the supervisory review system, including more rigorous risk monitoring by regulatory authorities. The researcher finds three steps: to enhance supervisory evaluation processes, to adhere to Basel principles, and to improve corporate governance standards.

Banker 1: SREP is sufficient in evaluating banks' internal monitoring mechanisms and risk management patterns. The central bank mandates ICAAP and conducts periodic assessments to align with regulatory frameworks. The SREP framework is retrospective and lacks resources, skilled personnel, and infrastructure. Supervisory haircuts are imposed when inadequate risk management and internal controls are found. However, the criteria for applying these haircuts are subjective and rely on subjective judgment. Without addressing these issues, capital requirements for banks may remain elevated.

Banker 2: Strong corporate governance, risk management, and transparency are requirements set by the Nepalese central bank for banks. However, corporate governance standards are low in Nepal, and the supervisory review process a crucial part of the Basel framework—is not entirely functional. Operational risk monitoring is inadequate, and risk management is not given enough attention. This results in inconsistent application and inadequate enforcement of regulatory principles in Nepal's banking industry.

Banker 3: In order to address issues in the banking industry, such as inadequate risk management, poor governance, and limited transparency, Nepal›s central bank has raised capital requirements. To improve bank resilience, the bank has embraced the Basel III framework. To effectively assess risks and guarantee regulatory compliance, the supervisory review process›s efficacy must be increased. The effectiveness of the supervisory review process must be improved in order to evaluate risks and ensure regulatory compliance. Inadequate corporate governance frameworks and a lack of formal credit rating systems are two shortcomings in the banking sector in Nepal.

Regulator 1: Due to inadequate internal control, poor risk management, and a lack of transparency, Nepal›s banking industry has high capital needs. To increase financial stability and resilience, the Nepal Rastra Bank (NRB) embraced the Basel III framework and implemented additional capital standards. The need for enhancements in corporate governance, internal controls, and supervisory principles, as well as deficiencies in supervisory review procedures, impact these measures. Although progress is required to bring Nepal›s banking sector into compliance with international norms, the NRB feels that these steps exceed the related financing costs.

Regulator 2: Acknowledges the importance of market discipline, management, and BFI boards, but also acknowledges weaknesses in internal control systems, corporate governance, and risk management. These deficiencies have led to higher capital requirements. The accuracy and transparency of banks' talks are still in doubt, despite the fact that the regulator carried out an impact analysis throughout the new capital accord's implementation. It is anticipated that the new agreement will affect bank conduct by causing more public disclosures and changes to the makeup of the bank's portfolio. Reducing capital costs and requirements may be possible with an improved supervisory review process. The regulator conducted an impact analysis during the implementation of the new capital accord, but the accuracy and transparency of banks' discussions remain under question. It is anticipated that the new agreement will affect bank conduct by causing more public disclosures and changes to the makeup of the bank's portfolio. Reducing capital costs and requirements may be possible with an improved supervisory review process.

Conclusion

The comparison made on the present research shows Nepal's Capital Adequacy Framework with the global Basel III framework, highlighting challenges in risk management, financial stability, financing costs, and supervisory processes. Strengthening risk management frameworks is crucial for industry stability and resilience.

Financial stability is crucial for economic growth, but in Nepal, regulatory authorities priorities it over economic development. Higher capital requirements are necessary to maintain trust, manage financial distress, and enhance the resilience of the banking sector. The Nepal Rastra Bank sees the benefits outweighing the costs. Balancing economic burdens and financial stability is essential, as under-regulation can lead to financial instability.

The supervisory review process in Nepal faces challenges in planning, evaluation, review, and control functions, as well as substandard corporate governance. It concludes with a strong enhancement in order to adhere to Basel principles and strong corporate governance standards. However, the article has limitations on its technical competencies as well as limitations in the qualitative approach.

References

Adhikari, U. (2022). The Impact of Basel III Implementation on Nepal's Banking Sector Stability.

Barth, J. R., Caprio, G., & Levine, R. (2004). Bank regulation and supervision: What works best? Journal of Financial Intermediation, 13(2), 205–248. https://doi.org/10.1016/S1042-9573(03)00043-4

Bank for International Settlements. (2008). Principles for effective banking supervision. https://www.bis.org/publ/bcbs122.pdf

Basel Committee on Banking Supervision (BCBS). (2019). Basel III: Finalising post-crisis reforms. Bank for International Settlements. https://www.bis.org/bcbs/publ/d424.pdf

Borio, C. (2011). Implementing a macroprudential framework: blending boldness and realism. Journal of Financial Stability, 7(4), 243–259. https://doi.org/10.1016/j.jfs.2011.05.010

Claessens, S., & Kodres, L. (2014). The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Questions. IMF Working Paper No. 14/46. International Monetary Fund. https://doi.org/10.5089/9781498320572.001

Demirgüç-Kunt, A., & Detragiache, E. (1998). The determinants of banking crises in developing and developed countries. IMF Staff Papers, 45(1), 81–109. https://doi.org/10.2307/3867323

Fullenkamp, C., & Sharma, S. (2012). Rethinking financial sector regulation. IMF Finance & Development, 49(4), 18–21. https://www.imf.org/external/pubs/ft/fandd/2012/12/fullenkamp.htm

Gorton, G., & Metrick, A. (2012). Getting up to speed on the financial crisis: A one-weekend reader's guide. Journal of Economic Literature, 50(1), 128–150. https://doi.org/10.1257/jel.50.1.128

Goodhart, C. A. E. (2008). The Regulatory Response to the Financial Crisis. Journal of Financial Stability, 4(4), 351–358. https://doi.org/10.1016/j.jfs.2008.05.002

Haldane, A. G. (2011). Capital discipline. Bank of England Speech. https://www.bankofengland.co.uk/speech/2011/capital-discipline

IMF. (2019). Capital Adequacy Regulation and Bank Performance in Developing Economies. International Monetary Fund Working Paper. https://www.imf.org/en/Publications/WP

Janson, C. (2009). Risk management reforms post-2007 financial crisis. Financial Risk Review, 14(2), 56–72.

Johnson, R., & Murphy, K. (1987). Off-balance sheet activities and bank risk. Journal of Banking & Finance, 11(3), 393–408.

Khanal, R., Shrestha, P., & Sharma, M. (2023). Modern banking systems and economic development: A review. Journal of Finance and Development Studies, 12(2), 45–67.

KPMG. (2011). Post-crisis risk management in banking. KPMG Advisory Report. https://home.kpmg/content/dam/kpmg/pdf/2011/06/risk-management.pdf

Mishkin, F. S. (2007). The economics of money, banking, and financial markets (8th ed.). Pearson Education.

Naceur, S. B., Ghazouani, S., & Omran, M. (2018). Capital regulation and bank lending: Evidence from emerging markets. Journal of Banking & Finance, 92, 1–13. https://doi.org/10.1016/j.jbankfin.2018.04.004

Nepal Rastra Bank. (2015). Capital adequacy framework. Kathmandu, Nepal: Nepal Rastra Bank.

Nowell, L. S., Norris, J. M., White, D. E., & Moules, N. J. (2017). Thematic analysis: striving to meet the trustworthiness criteria. International Journal of Qualitative Methods, 16(1), 1–13. https://doi.org/10.1177/1609406917733847

Siddik, M. N. A., Dewandaru, G., & Masih, M. (2017). Capital adequacy and bank performance: Evidence from Nepal. Journal of Banking Regulation, 18(4), 301–314. https://doi.org/10.1057/s41261-017-0046-3

Timsina, N. (2019). The Role of Commercial Banks in Nepal's Economic Development. Nepalese Journal of Economics, 6(1), 22–38.

Weissman, S., & Donahue, C. (2009). Capital regulations and systemic risk. Journal of Financial Regulation and Compliance, 17(2), 123–135.