Devkota Journal of

INTERDISCIPLINARY STUDIES

Vol. : 6 | December, 2024

Editorial's Note

With a commitment to encourage faculty members and students for research activities and to publish original and innovative scholarly research articles from research scholars, Research Management Committee has been publishing *Devkota Journal of Interdisciplinary Studies* – a platform for conceptual and empirical papers in the field of management, social sciences and humanities. Through this attempt, RMC observes the development of research based academic environment at the campus and surroundings.

As a further step in this odyssey, RMC has brought forth its fourth volume of the journal. The journal consists of issues from health, literature, linguistics, management and social sciences. With these issues, it has not only tried to negotiate with the contemporary scenario, but also seeks to ask how we are to re-orientate these issues. This journal, we hope, will become a source for all those perspective readers who are interested in upgrading their knowledge in different fields, and for all those creative writers in pursuing their further study.

Research Management Cell owes its existence to all those helping hands that are involved directly and indirectly in publishing this journal. RMC would also like to express its gratitude to the scholars who provided us with their creative and analytical articles. Besides, it welcomes submissions from across various range of scholarship.

Peer Reviewed Journal

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Promoting Sustainable Financial Services through Cashless Transactions: An Empirical Analysis of Small and Medium Enterprises (SMEs) in Nepal

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Abstract

Digital financial technologies are reshaping the economic landscape, enhancing financial inclusion and sustainable development. This study examines the adoption of cashless transactions among Small and Medium Enterprises (SMEs) in Nepal, focusing on factors like privacy, security, and resource availability through the Technology Acceptance Model (TAM). A structured survey was utilized to gather information from 389 SME owners in the Kathmandu Valley as part of a cross-sectional study design. Path analysis and other quantitative techniques were used to investigate the connections between the adoption of cashless transactions and the main adoption drivers, which include perceived usefulness, perceived ease of use, social influence, privacy concerns, and resource availability. Results show a strong link between these factors and adopting electronic payment systems, with privacy and security being the most significant. While perceived ease of use and usefulness drive adoption, challenges like limited digital literacy and infrastructural constraints exist, especially in rural areas. This study highlights how cashless transactions can help SMEs become more resilient and operationally efficient, which aligns with global trends. It offers practical advice on how financial service providers and legislators can remove obstacles, encourage digital inclusion, and build a strong digital ecosystem.

Keywords: *Cashless Economy, Digital Finance, Fintech, SMEs, e-wallet, Nepal*

Introduction

The swift transition to digital financial technologies has completely changed the financial landscape in the modern world, especially in the wake of economic upheavals from major world crises like the COVID-19 pandemic and climate-related issues. To enhance financial inclusion and foster sustainable growth, these technologies have become crucial, especially for small and medium-sized enterprises (SMEs). Research highlights the growing acceptance of fintech solutions among SMEs, driven by factors such as prior experience, brand familiarity, and perceived benefits (Gupta et al., 2022). These innovations have positively influenced financial performance and have become essential in enabling enterprises to adapt to changing market dynamics and consumer preferences (Daud et al., 2022).

The integration of digital financial inclusion has further supported the sustainable development of private and high-tech industries, particularly by alleviating financing constraints and fostering resilience against economic disruptions (Yang & Zhang, 2020). The adoption of electronic payment systems (EPS), including mobile-driven payment platforms and e-wallets, reflects a paradigm shift toward cashless economies, enabling seamless, secure, and efficient transactions. This transformation is particularly relevant in the context of Nepal, where SMEs form a significant portion of the economy but often struggle with limited capital, access to technology, and expertise (Pandey, 2004; NRB, 2021). The reports by ESCAP (2020) and Kharel and Dahal (2020) provide comprehensive insights into the financial challenges and opportunities for SMEs in Nepal, aligning closely with the objective of promoting sustainable financial services through cashless transactions. ESCAP (2020) highlights a $3.6 billion financing gap for Nepalese SMEs, driven by stringent collateral requirements and the absence of targeted financial products for the "missing middle." The study emphasizes the transformative potential of FinTech in bridging this gap, suggesting that cashless transactions could bypass traditional banking barriers, particularly in rural areas. Furthermore, the report underscores the importance of integrating digital payment systems and financial literacy campaigns to foster a sustainable financial ecosystem for SMEs. Similarly, Kharel and Dahal (2020) identify high-interest rates, procedural complexities, and a lack of targeted policies as significant impediments to SME financial inclusion. They advocate for the adoption of digital technologies, noting that cashless systems can enhance efficiency, transparency, and competitiveness. The authors also stress the need for incentives to encourage SME adoption of cashless transactions, which can alleviate dependence on costly credit sources. Both studies converge on the view that cashless transactions, supported by FinTech innovations and policy interventions, could enhance the financial sustainability and resilience of Nepalese SMEs, making them key tools for advancing financial inclusion in the sector.

The potential of fostering public-private partnerships to address youth unemployment, which aligns with the goal of promoting cashless transactions by leveraging digital innovations to enhance the financial inclusion and sustainability of SMEs (UNDP, 2021). The COVID-19

pandemic served as a catalyst for accelerating the adoption of digital payment systems in Nepal, as social distancing measures and declining in-person interactions necessitated alternatives to traditional cash transactions. During this period, platforms like eSewa and IME Pay witnessed substantial growth, with user bases increasing by 35% and 25%, respectively, within months of the pandemic's onset (Shrestha, 2021). This surge underscores the role of digital wallets and other fintech tools in ensuring business continuity and safety during crises. Moreover, the pandemic highlighted the need for businesses to digitize operations, aligning with Nepal's Digital Nepal Framework 2019, which aims to leverage digital solutions to unlock the country's growth potential (Chaudhary, 2020; NRB, 2022). Despite these advancements, challenges persist in rural and semi-urban areas, where low digital literacy, inconsistent internet access, and trust issues hinder widespread adoption of digital financial technologies (Timalsina, 2021).

On a global scale, the push for cashless economies has been associated with enhanced transparency, lower operating costs, and environmental sustainability. However, in Nepal, where SMEs make up a sizable share of the economy, the adoption of cashless transactions is still constrained by a lack of digital infrastructure, low financial literacy, and a reluctance to embrace new technologies. This emphasizes the pressing need to investigate the effective integration of digital financial technologies, including marketing tools, payment systems, and financial services, to assist SMEs in overcoming obstacles and attaining long-term sustainability. In addition to empowering SMEs, resolving this issue is essential for Nepal to align with the UN's 2030 Sustainable Development Goals (SDGs). Thus to address these gaps, targeted interventions are required to build capacity, raise awareness, and ensure equitable access to digital tools across the diverse SMEs. This paper seeks to explore the multifaceted impact of digital financial technologies on SMEs in Nepal by leveraging primary data and analyzing trends through statistical techniques, providing actionable insights for policymakers, businesses, and stakeholders to promote sustainable financial services through the adoption of cashless transactions contributing to Nepal's journey toward a digitally empowered economy.

Review of literature and Hypothesis

Encouraging sustainable financial services in developing nations requires a shift to cashless transactions and digital financial inclusion. Formal financial institutions are still difficult to access, a major problem. However, digital financial services can solve this problem, particularly for small and medium-sized businesses (SMEs) in these countries (Bai et al., 2021). Adopting digital payment systems can promote financial inclusion, improve operational effectiveness, and stimulate economic growth, especially in underserved areas (Shrestha, 2020; Bhattarai et al., 2023).

The theoretical underpinnings of digital wallet adoption are often explained using the Technology Acceptance Model (TAM), the Motivation Model, and the Theory of Planned Behavior. TAM, developed by Davis (1989), highlights perceived usefulness and ease of use's influence on the

behavioral intention to adopt new technologies. Social influence, work relevance, and result demonstrability reinforce perceived usefulness, shaping users' attitudes toward digital payment systems. The Technology Acceptance Model (TAM) underscores the importance of perceived ease of use and perceived usefulness in shaping behavioral intention toward digital payment systems, while trust, privacy, and security remain critical factors influencing adoption (Adhikari, 2022; Iyer, 2018). Furthermore, demand and supply-side constraints, such as inadequate infrastructure, high transaction costs, and lack of financial literacy, underscore the need for tailored strategies to support SMEs (Adhikari, 2022; Bhusal, 2011). Moreover, empirical studies identify additional factors—such as social impact, facilitating conditions, trust, and lifestyle compatibility—as crucial in influencing behavioral intent and adoption (Lieu et al., 2020; Aryal, 2021; Nawi et al., 2022). As lifestyles grow busier and consumer habits evolve, the popularity of e-payment systems has surged significantly (Singh & Srivastava, 2018; Adhikari et al., 2024).

The perceived ease of use of these platforms critically influences their perceived usefulness and likelihood of adoption (Yang et al., 2021). For small and medium enterprises (SMEs), perceived ease of use and usefulness are particularly impactful in the decision to adopt cashless payment systems (Monoarfa et al., 2024; Najib & Fahma, 2020). SMEs often adopt digital payment technologies driven by factors such as prior experience, trust in established brands, and the presence of supportive government policies (Gupta et al., 2022). However, barriers such as perceived risks and high costs can hinder their adoption (Raj et al., 2023). The recently developed Cashless Transaction Adoption Model (CTAM) identifies additional motivators, such as reduced risks of economic offenses and enhanced economic security, which further incentivize the transition to digital payments (Raj et al., 2023).

The growth of electronic payment systems (EPS) has been facilitated by technological advancements, increased access to mobile and telecommunications infrastructure, and a growing population of tech-savvy young users (Marimuthu & Roseline, 2020). These attributes play a pivotal role in shaping individuals' willingness to embrace such payment methods (Karim et al., 2020). Nevertheless, challenges such as lack of awareness, limited knowledge, and concerns about security and privacy remain significant barriers. Customers may lose trust in information system providers if adequate security and privacy safeguards are not implemented, thereby discouraging them from conducting electronic transactions (Gitau et al., 2014). The rapid advancement of technology has heightened privacy and security concerns, leading to user hesitance in sharing financial information online or on e-commerce platforms (Ahmad et al., 2010). To mitigate these concerns, EPS providers must enforce robust security measures, provide clear user guidance, and disseminate relevant information to address potential vulnerabilities and cyber threats (Abdulhamid, 2018).

The widespread adoption of digital payments requires a collaborative effort. Service providers

must focus on designing secure and user-friendly platforms, while governments should implement policies that enhance financial literacy and ensure data protection (Musyaffi, 2024). As Yang et al. (2021) emphasize, intuitive and accessible app designs are crucial for driving user adoption, making usability a key factor in promoting cashless transactions. Social influence has also emerged as a significant driver of behavioral intention toward adopting digital payment systems. Additionally, facilitating conditions—such as the availability of resources and technical support—play a crucial role in encouraging the adoption of e-wallets (Yang et al., 2021; Abdullah et al., 2016).

Expanding on these insights, Raj et al. (2023) introduced the Cashless Transaction Adoption Model (CTAM), which accounts for 84.7% of the variability in behavioral intentions toward cashless transactions. This model integrates innovative factors such as Perceived Economic Offense Reduction (PEOR), Perceived Economic Benefit (PEB), and Perceived Economy Security (PES), all of which positively influence adoption behavior. Furthermore, factors like performance expectancy, trust, and perceived usefulness underscore the multifaceted nature of digital payment adoption (Yang et al., 2021; Abdullah et al., 2016).

These studies highlight the importance of addressing individual and systemic factors to promote the broader acceptance of cashless transactions in SMEs. As Nepal envisions a cashless economy aligned with the United Nations' Sustainable Development Goals 2030, leveraging fintech innovations and addressing barriers to adoption is imperative for fostering sustainable financial services and empowering SMEs. Building on these insights, this study integrates key variables from prior research to examine how these factors influence the adoption of digital wallets among SMEs in Nepal. Therefore, the following hypotheses have been put forward to test these relationships.

H1: There is a significant relationship between perceived ease of use and digital wallet adoption among Nepalese SMEs.

H2: Perceived usefulness has a significant positive effect on digital wallet adoption among Nepalese SMEs.

H3: Privacy and security concerns have a significant positive effect on the adoption of digital wallets among Nepalese SMEs.

H4: The availability of resources significantly influences the adoption of digital wallets in local businesses.

H5: Social influence has a significant positive effect on the adoption of digital wallets in local businesses.

Thus, the following research framework has been developed for the study based on the past literature discussed.

Research Framework
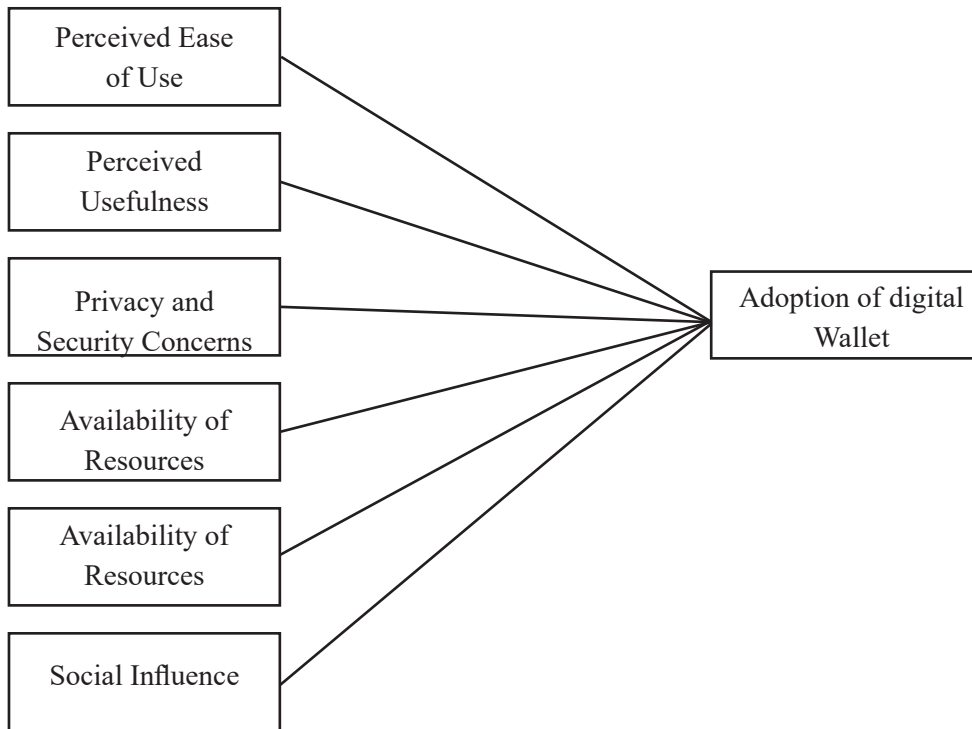
Figure 1: Research framework
Source (Nawi et al., 2022)

Methodology:

This study explores how Nepalese small and medium-sized enterprises (SMEs) promote sustainable financial services through cashless transactions. It employs structural quantitative methods and a cross-sectional survey design. A carefully crafted printed version of the questionnaire was given to 450 SME owners in the Asan, Patan, and Kirtipur regions. Before distribution, a pilot study was carried out in the Patan area with a sample size of 50 respondents. Any discrepancies found during the pilot study were addressed and fixed so that the data collection process would go smoothly and the data interpretation would remain accurate and trustworthy. After correcting for non-responses and missing data, 389 final responses were obtained for analysis, predominantly owners or promoters of small and medium local businesses registered in Department of cottage and small industries, Nepal located in traditional shopping areas of the Kathmandu Valley, including Asan in Kathmandu Metropolitan City, Patan in Lalitpur

Metropolitan City, and Kirtipur in Kirtipur Municipality. The relationship between the variables based on the research hypotheses was tested using a causal research design. The goal was to determine the precise relationship between the variables and to provide a representative model. The two sections of the structured questionnaire were questions based on sociodemographic information and variables. The sociodemographic section gathered data on respondents' age, gender, and level of education in addition to three questions concerning their use of digital wallets and preferred payment methods.

The variable-based part used a five-point Likert scale, where 1 meant "strongly disagree" and 5 meant "strongly agree." Specific Likert statements were used to evaluate each of the variables as privacy and security: eight items (Pavlou, 2003; Iyer, 2018); perceived utility: five items (Davis, 1989); perceived ease of use: four items (Davis, 1989); available resources: six items (Venkatesh et al. (2003); social influences: four items (Venkatesh et al., 2003), and Acceptance of digital wallets: Four items (Venkatesh et al., 2012).

SME owners' perceptions of the adoption of cashless transactions may be examined using the Technology Acceptance Model (TAM) developed by Davis (1989). TAM offers a framework for comprehending the cashless payment methods that SME owners prefer. The model identifies two key determinants of acceptance: perceived usefulness, which captures how SME owners think cashless systems will improve operational effectiveness and expedite business transactions, and perceived ease of use, which captures their conviction that such systems are easy to use and straightforward. These elements influence SME owners' inclination to adopt cashless technologies, affecting how well they incorporate cutting-edge financial solutions into their operations. This study builds on the conceptual framework and previous literature aimed at promoting sustainable financial services through cashless transactions. It uses the fundamental model created by Davis (1989), adding more variables as suggested by (Oney et al., 2017; Roy et al., 2014; Nawi et al., 2022).

The information gathered was analyzed and arranged for data processing using **SPSS** and MS Excel. The questionnaire also contained open-ended questions regarding the sustainability of EPS (Environmental, Psychological, and Social factors) and its implications in order to promote insightful responses and a thorough grasp of the subject. After confirming the normality of the dataset, advanced analyses were conducted using Structural Equation Modeling (SEM) with AMOS to evaluate the hypotheses outlined in the conceptual framework.

Results

Demographic Characteristics

Table 1

Demographic Characteristics

Baseline Characteristics	Frequency	Percentage (%)
Gender		
Female	148	38.04
Male	241	61.96
Age Groups		
20-30 years	145	37.27
31-40 years	185	47.56
41-50 years	54	13.88
51 years and more	5	1.29
Education Distribution		
Up to High School	189	48.58
Undergraduate Degree	132	33.93
Postgraduate Degree and above	68	17.48

Table 1 shows the demographic characteristics of the respondents in this research. Males (61.96%) clearly outnumbered females in the survey (38.04 percent). It reveals that, the local SMEs majority of male owner but 38.04 percent shows that, the female entrepreneur are also growing the involvement in SMEs. The major portion of responders (47.56% were aged 31-40, with 37.27 percent aged 20-30 years, and only 1.29 percent aged more than 51 years. It indicates that, the younger generations aggressively adopting the electronic payment systems. The majority of respondents held up to higher school. Similarly, almost 34% finished the undergraduate degree and only 18 percent respondent's involvement in SMEs after completing Post graduate degree and above.

Table 2

Factor Loadings, AVE and CR

Items	Factor Loadings	Communalities	AVE	CR
PEU1	0.889	0.898		
PEU2	0.883	0.849	0.872	0.608
PEU3	0.843	0.78		
PEU4	0.9	0.921		
PU1	0.923	0.888		
PU2	0.947	0.922		
PU3	0.849	0.779	0.93	0.715
PU4	0.929	0.886		
PU5	0.96	0.945		
PS1	0.943	0.949		
PS2	0.926	0.927	0.925	0.734
PS3	0.931	0.93		
PS4	0.907	0.888		
AR1	0.831	0.76		
AR2	0.695	0.593	0.745	509
AR3	0.874	0.785		
AR6	0.626	0.564		
SI1	0.733	0.656		
SI3	0.907	0.861	0.77374	0.519
SI4	0.84	0.743		
SI6	0.73	0.607		
ACT1	0.889	0.854		
ACT2	0.863	0.766	0.945	0.812
ACT4	0.866	0.756		
ACT6	0.932	0.889		
Extraction Method: Principal Component Analysis.				

Table 2 highlights the assessment of convergent validity through metrics such as Average Variance Extracted (AVE) and Composite Reliability (CR). The results indicate that AVE values are consistently above the threshold of 0.5, while CR values exceed the recommended benchmark of

0.7, satisfying the criteria for convergent validity as outlined by Hair et al. (2010). Furthermore, all factor loadings surpass the minimum acceptable value of 0.5. The reliability analysis, reflected in Cronbach's alpha values greater than 0.7, confirms the strong internal consistency of the constructs, aligning with the standards suggested by Nunnally (1978).

Table: 03

Reliability and Validity Measures									
	CR	AVE	MSV	MaxR(H)	SI	PU	PS	PEU	AR
SI	0.774	0.519	0.099	0.974	**0.720**				
PU	0.930	0.715	0.067	0.977	0.085	**0.846**			
PS	0.925	0.734	0.088	0.977	0.210	0.259	**0.857**		
PEU	0.872	0.608	0.025	0.944	0.153	0.117	0.060	**0.780**	
AR	0.745	0.509	0.099	0.875	0.315	0.195	0.297	0.158	**0.714**

(PEU = perceived ease of use; PU = perceived usefulness; PS = privacy and security; AR = availability of resources; SI = Social Influence; ACT = adoption of cashless transactions)

To assess discriminant validity, the square root of the Average Variance Extracted (AVE) for each construct should be greater than the inter-construct correlations, as proposed by Barclay et al. (1995) and Fornell and Larcker (1981). Table 3 confirms this criterion, showing that the diagonal elements—representing the square root of the AVE—are consistently higher than the correlation coefficients between constructs. This indicates that each construct is more strongly related to its own measures than to those of other constructs, thereby validating discriminant validity.

Table 4 illustrates the results of the path analysis examining factors influencing the adoption of cashless transactions (ACT). The table provides estimates of path coefficients (Estimate), standard errors (S.E.), critical ratios (C.R.), and significance levels (P) for each independent variable. The analysis supports the hypothesis that all considered factors—Perceived Usefulness (PU), Privacy and Security (PS), Perceived Ease of Use (PEU), Social Influence (SI), and Availability of Resources (AR)—are positively associated with the adoption of cashless transactions. Privacy and Security (PS) demonstrates the strongest effect (Estimate = 0.228, P < 0.001), highlighting its critical role in fostering trust and reducing users' concerns about engaging in digital transactions. Similarly, Perceived Ease of Use (PEU) (Estimate = 0.219, P < 0.001) significantly influences adoption, consistent with the Technology Acceptance Model (TAM), which emphasizes usability as a fundamental driver of technology adoption (Davis, 1989). Availability of Resources (AR) (Estimate = 0.152, P < 0.001) and Perceived Usefulness (PU) (Estimate = 0.154, P = 0.001) also show significant impacts, underscoring the importance of perceived benefits and accessibility in decision-making processes.

Table 4:

Path Analysis

Path			Estimate	S.E.	C.R.	P	Remarks
ACT	<---	PU	0.154	0.047	3.271	0.001	Accept
ACT	<---	PS	0.228	0.043	5.293	***	Accept
ACT	<---	PEU	0.219	0.052	4.25	***	Accept
ACT	<---	SI	0.107	0.055	1.934	0.053	Accept
ACT	<---	AR	0.152	0.042	3.6	***	Accept

Table 4 reveals that Social Influence (SI) (Estimate = 0.107, P = 0.053) has a marginally significant effect, suggesting that while societal norms and peer pressure play a role in adoption decisions, their impact may vary based on user context or demographic factors. These findings collectively support a holistic view of users' willingness to adopt cashless transactions. The results provide actionable insights for policymakers and service providers to design strategies prioritizing security, ease of use, and resource availability while leveraging social influence to promote digital financial inclusion.

Table 5. Confirmatory factor analysis summary

Model	χ^2 / df	CFI	TLI	GFI	IFI	RMSEA
Six-factor model (PU,PS,PEU,AR,SI, ACT)	2.354	0.943	0.96	0.902	0.93	0.049
Threshold (Fetscherin, 2019)	≤ 3.00	≥ 0.900	≥ 0.900	≥ 0.900	≥ 0.900	≤ 0.060

Confirmatory factor analysis was conducted to evaluate the structural validity of the measurement model, and the findings identified the six-factor model as the best fit for the data. This conclusion is supported by the model fit indices outlined in Table 5. The Chi-Square value divided by the degrees of freedom (X^2/df) is 2.354, indicating a strong alignment between the sample data and the model after accounting for any discrepancies. Other fit indices further confirm the model's suitability: the Comparative Fit Index (CFI) is 0.943, the Tucker–Lewis Index (TLI) is 0.96, and the Goodness-of-Fit Index (GFI) is 0.902. These values reflect the model's ability to capture the variance and covariance in the data effectively. Additionally, the Incremental Fit Index (IFI) of 0.93 demonstrates that the sample size is appropriately aligned with the model's complexity.

The Root Mean Square Error of Approximation (RMSEA) is reported at 0.049, which is well within the acceptable range, indicating a good fit for the model. RMSEA's value close to zero further reinforces the model's robustness. Importantly, no other model presented in Table 5 meets the acceptable fit thresholds, underscoring the superiority of the six-factor model. Overall, the

analysis confirms that the variables in this study demonstrate strong validity and reliability, meeting established standards for measurement models.

Discussion

This study investigates the factors influencing the adoption of cashless transactions among small and medium-sized enterprises (SMEs) in Nepal. The findings reveal a strong positive association between key determinants—perceived ease of use (PEU), perceived usefulness (PU), privacy and security (PS), resource availability, and social influence (SI)—and the adoption of digital payment systems. These results align with global studies, highlighting the transformative potential of cashless transactions in enhancing financial inclusion and operational efficiency for SMEs (Yang et al., 2021; Kilay et al., 2022).

Perceived ease of use emerged as a critical driver of digital wallet adoption, emphasizing the importance of intuitive, user-friendly systems that save time and streamline operations for SME owners. These findings are consistent with the Technology Acceptance Model (TAM), which identifies usability as a key predictor of technology acceptance (Davis, 1989; Raj et al., 2023). Similarly, perceived usefulness significantly influences adoption behavior, as SMEs recognize the practical benefits of cashless transactions in enhancing cost efficiency and productivity. Privacy and security concerns moderately impact adoption, reflecting ongoing trust issues and fears regarding data protection. This finding underscores the importance of robust cybersecurity measures and transparent communication to foster user confidence (Abdulhamid, 2018; Marimuthu & Roseline, 2020). In Nepal, these concerns are compounded by limited digital literacy, particularly in rural areas, necessitating awareness campaigns and technical support initiatives. Resource availability, while significant, exhibited a weaker influence on adoption, reflecting the infrastructural challenges faced by Nepalese SMEs, such as inconsistent internet connectivity and limited access to affordable digital tools. Similar barriers have been identified in other developing economies, including Malaysia and India (Rahman et al., 2022; Marimuthu & Roseline, 2020).

The study validates the transformative potential of cashless transactions in empowering SMEs, enhancing financial inclusion, and driving sustainable economic growth in Nepal. However, addressing persistent challenges such as digital literacy gaps, trust deficits, and resource constraints is crucial to achieving widespread adoption. Aligning technological advancements with targeted policy interventions and stakeholder collaboration can help Nepal create a robust and inclusive digital ecosystem, as a model for other developing economies navigating similar transitions. This study also contributes to the global conversation on digital financial inclusion by presenting empirical data from small and medium-sized businesses in Nepal. It provides useful information to help SME managers in developing nations create plans for e-wallet adoption. Additionally, it emphasizes how crucial policies, fintech firms, and banks work together to create a strong and inclusive digital ecosystem. Overcoming these challenges requires expanding

digital infrastructure and providing SMEs with accessible technological solutions. Social influence also plays a notable role, with societal norms and peer networks significantly shaping SME decisions to adopt digital systems. Leveraging community-based marketing and promoting early adopters as role models can amplify the acceptance of Cashless transactions.

Conclusion

With an emphasis on their contribution to the advancement of sustainable financial services, this study thoroughly analyzes the variables influencing Nepali SMEs' adoption of cashless transactions. The study sheds light on the factors affecting the adoption of digital payments in developing economies by concentrating on key determinants, including perceived social influence, privacy and security, perceived ease of use, perceived utility, and resource availability. The study highlights the variables affecting SMEs' adoption of cashless transactions (ACT). According to the path analysis, adoption is positively impacted by each of the variables that were looked at: perceived usefulness (PU), privacy and security (PS), perceived ease of use (PEU), social influence (SI), and availability of resources (AR). The most important factor was found to be privacy and security (PS), which highlights the necessity of strong measures to foster trust and allay users' worries about online transactions.

The Technology Acceptance Model (TAM) and Perceived Ease of Use (PEU) support the significance of intuitive and user-friendly systems in promoting adoption. Perceived Usefulness (PU) and Availability of Resources (AR) also impact adoption, emphasizing how crucial it is to show concrete advantages and guarantee accessibility to encourage the use of cashless systems.

This research provides an in-depth exploration of the factors influencing the adoption of cashless transactions among SMEs in Nepal, highlighting their potential to promote sustainable financial services. By focusing on critical determinants such as perceived ease of use, perceived utility, privacy and security, resource availability, and social influence, the study sheds light on the drivers and barriers shaping digital payment adoption in a developing economy context.

The findings underline the transformative role of cashless transactions in improving financial inclusion and operational efficiency for SMEs, while also addressing systemic challenges like limited digital literacy and infrastructure deficits. The significant influence of perceived ease of use and utility reflects the need for digital wallet providers to prioritize user-friendly designs and tangible benefits. Privacy and security remain pivotal, calling for robust measures to build user trust and mitigate concerns around data protection.

The results highlight the potential of cashless transactions in improving SMEs' operational efficiency and financial inclusion while tackling issues like low digital literacy, a lack of trust, and logistical obstacles. Given the importance of perceived utility and ease of use, digital wallet providers must emphasize user-friendly, intuitive systems and offer observable advantages.

However, privacy and security concerns also underscore the importance of strong cybersecurity measures to address data protection issues and foster trust.

Furthermore, the COVID-19 pandemic has accelerated the shift toward digital payments, marking a behavioral change that is likely to persist. While a fully cashless society may remain aspirational, the increasing adoption of technologically assisted payment systems presents an opportunity for Nepal to enhance financial sustainability and competitiveness. This shift, however, must be supported by collaborative efforts between digital wallet providers, policymakers, and educational institutions to address infrastructural gaps and promote equitable access to digital tools.

Implications of the study

Comparing these findings with global contexts highlights both commonalities and unique challenges. While usability and perceived benefits are universal drivers, infrastructural and trust-related barriers are more pronounced in Nepal. This emphasizes the need for localized digital transformation strategies to address country-specific constraints. Nepal's Digital Framework 2019 provides a promising blueprint for fostering innovation and bridging digital divides through investments in education, infrastructure, and policy support. This study underscores the significant opportunities presented by the adoption of cashless transactions for SMEs in Nepal. By addressing the identified barriers and leveraging the drivers of adoption, Nepal can create a model for sustainable financial growth that balances technological innovation with socio-economic realities. The pathway to a digitally empowered SME sector lies in fostering trust, inclusivity, and resilience, setting the foundation for long-term economic transformation.

The study also contributes to the broader discourse on digital financial inclusion by providing empirical evidence from Nepalese SMEs. It offers actionable insights for SME managers in emerging economies to devise strategies for e-wallet adoption. It emphasizes the importance of partnerships between banks, fintech companies, and policymakers in fostering a robust digital ecosystem. Thus, the research enriches existing literature and guides developing countries aiming to transition toward a more inclusive and efficient cashless economy.

Limitations and direction for future research

This study offers valuable insights into the variables driving the adoption of cashless transactions by Nepali SMEs, but it must be noted that it has some limitations. First, because the study only looks at SMEs in Nepal, its conclusions cannot be applied to other situations. Other regions' cultural, economic, and infrastructure variations could produce different outcomes. Subsequent studies may broaden the geographic focus to incorporate cross-national comparisons, providing a more comprehensive understanding of adopting cashless transactions in various contexts.

Secondly, a cross-sectional design is used in the study to collect data at a single moment in time. This methodology restricts the capacity to evaluate shifts in the behavior of SMEs and the

changing influence of the factors under investigation over time. In addition to offering a more dynamic perspective of adoption trends, longitudinal studies would assist in determining how outside variables, like policy changes or technological breakthroughs, affect adoption patterns. Third, the study is based on self-reported data, which can be biased by the respondents' social desirability or inaccurate perceptions. Mixed-method approaches, such as qualitative interviews or observational data, could be used in future research to confirm and enhance the results.

Finally, even though the study highlights important elements like perceived usefulness, privacy and security, and resource availability, it ignores other moderating or mediating factors like organizational culture, demographics, or the significance of digital literacy that might help to explain the adoption process further. Future research could examine these variables to comprehend better the intricate factors affecting the adoption of cashless transactions.

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Does Public Expenditure on Education Cause Economic growth in Nepal ?

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Abstract

The only way to boost economic growth, every country in the world agreed, was to improve education. The purpose of this study was to investigate the potential relationship between economic growth and public education spending. This was achieved by using time series data from 1988 to 2022 in conjunction with the ARDL model. The study investigated the impact of a variety of factors on GDP growth in order to ascertain the significance of this correlation. The number of secondary schools, the duration of a student's school year, the proportion of students who passed the SEE, government spending on education, and gross fixed capital formation are a few variables that can be altered. Additionally, this investigation investigated several other critical variables that impact economic expansion. The findings support past research and demonstrate a connection between public education spending and economic growth. Study findings indicate that increased funding for education is boosting the national economy. Analysis also highlights the role that gross fixed capital formation plays in the process of economic expansion. The exceptionally strong negative sign of the error correction term suggests a strong long-term correlation between the variables. The heteroscedasticity, normality, and Breusch-Godfrey LM tests generate P-values exceeding 5%, as expected. This model is devoid of heteroscedasticity and autocorrelation. The government should allocate a substantial portion of its budget to the education sector and prioritize funding. The study suggests that additional indicators should be investigated in order to support the idea that education is the foundation of any economy.

Keywords: *ARDL model, school enrollment, spending on education, and economic growth.*

Introduction

Everyone acknowledges that education is the most crucial tool for promoting economic development. It is critical to the growth of human capital and increases productivity, competency, and skill levels, all of which contribute to economic growth. It is well known that one of the main factors influencing the rate of economic growth is education. It is well known that a nation's degree of education has a big impact on its social and economic development (Becker, 2009; Lucas, 1988). Adam Smith, Romer, Lucas, and Solow are just a few of the economists who have developed various theories and models of economic growth and have all suggested that education is an essential element. Romer (1990) and Robert Solow (1957) developed the two main theoretical frameworks that are used to model the relationships between economic performance and education. It is well known that increasing education has a significant impact on both the economy and social welfare. It is vital to both the advancement of humankind and the growth of an economy. The connection between economic growth and education has been hotly contested.

Nations differ significantly in how much money is invested in the education sector, according to Mingat et al. (1998). It is for this reason that funding for education has been suggested. Increases in government spending accelerate growth in the GDP, GDP per capita, and human capital stock. Putting money into education is a more prudent use of it than on individuals. Mallick et al. (2016) found that long-term economic growth is notably impacted by government spending on education in 14 Asian countries. The economy of the country depends on no single factor. The degree to which the government makes investments in various variables and factors influences the rate of economic expansion. These factors can be described by endogenous and exogenous variables. Education is a significant endogenous variable that influences the HDI. The expansion of human resources is one of HDI's main outcomes. Public education is essential for the development of human capital for both political and economic reasons (Bhowmick & Yadav, 2019). Romer (1990), Lucas (1988), and Barro (1991) developed the theory of endogenous economic growth. It makes the claim that investing in education actively supports the economy's endogenous growth. Subsequently, Lucas expressed his disapproval of Backer's human capital theory (1962). Numerous studies have demonstrated that investing in public education promotes economic growth. Government investment in education should be given top priority since it strengthens the social and economic foundation of the nation (Panik & Wahab, 2016; Ghali, 2018). Similarly, among many others, examples are (Sequeira and Martins, 2008), (Bose et al., 2007), and Jeyhoon (2017).

Using a balanced panel dataset, Mallick et al. (2016) investigated the relationship between economic growth and education spending in 14 well-known Asian countries. The dataset included

all of 1973 through 2012. Ordinary least squares (OLS), the vector error correction model, and cointegration were used in the analysis. The results suggested a long-term, stable equilibrium between these two variables by showing a strong and statistically significant correlation between education spending and economic growth.

The relationship between economic growth and education in Nepal from 1995 to 2013 was investigated by Nowak et al. (2016) using the Johansen Cointegration technique and ordinary least squares (OLS). Economic growth and education spending show a strong correlation, indicating a long-standing stability between these two variables. Ziberi et al. (2022) employed comparable instrumental variable techniques to show a clear and positive correlation between North Macedonia's public education budget and GDP growth rate. The dependent variable for the 1917–2020 study period was GDP.

Ghimire (2010) looked at problems in education from a historical point of view. The study's data show that spending on public education has an impact on GDP and is linked to economic growth. The results show that education has a big effect on the socioeconomic progress of the country. Politicians and economists are very interested in the money the government spends on schools. In 2019, Dangal and Gajurel studied the connection between Nepal's GDP growth and government spending on education. The study, which looked at data from 1982 to 2018, came to the conclusion that funding for public education eventually impedes Nepal's progress toward economic development. This was made possible in large part by the ARDL error correction model. Additionally, the number of technical students at various Tribhuvan University schools is currently growing slower than the GDP of Nepal. During the fiscal year 2022–2023, NPR 197.29 billion was spent on education, which is more than 12.4% of the total budget. The largest portion of the budget was allocated to this sector (MOF, 2023). The education sector contributed 6.26 percent to Nepal's gross domestic product in FY 2013–14, 7.53 percent in FY 2018–19, and 8.02 percent in FY 2021/22. Additionally, the government projects that it will contribute 8.22 percent, with 4.07 percent going toward production costs. Economic Survey, 2023. The graph shows that the GDP share of the education sector has increased over the last ten years. Nepal has achieved great strides in the field of education over the last thirty years, and the government has consistently raised education spending in each budget. However, the outcomes of the plan did not demonstrate a noticeable rise in the quality of education or a narrowing of the achievement gaps amongst the different regions of Nepal. The majority of the currently published research concurs that government investment in education is crucial and actually enhances economic performance in many countries via a number of different mechanisms. The study's primary objective is to determine the relationship between government spending on education and Nepal's economic expansion. It demonstrates how crucial it is to prioritize developing human capital development

in the growth agenda. The report emphasizes the need for robust government intervention to ensure that investments in higher education lead to significant discoveries and socioeconomic development.

Methodology

The investigation investigates the correlation between Nepal's economic expansion and government expenditures on education. The paper accomplishes its goals by examining a time series data set that spans the years 1988–2022. For economic growth, the GDP constant is used as a stand-in, and for an independent variable, public education spending is used as a stand-in. The study also analyzes the mean duration of schooling, gross fixed capital formation, the proportion of students who pass the SLC and SEE exams, and enrollment in secondary schools as control variables. The research used data from the World Bank's World Development Indicator (WDI), the Ministry of Finance (MoF), and the Nepal Rastra Bank (NRB). The relationship between government spending on education and variables associated with both economic growth and education is examined in this study using quantitative methods. The economic growth of a nation is not contingent upon a solitary variable or factor. Government spending on different goods and components facilitates economic growth. The study makes a distinction between exogenous and endogenous factors. One of the most important endogenous variables and a critical component of the Human Development Index is education. The Human Development Index (HDI) is a crucial statistic for monitoring the growth of human capital.

Model specification

The relationship between public education spending, the total number of schools, and the number of colleges is investigated in this study. The researchers have examined a number of economic variables, including the NSHCH, GEE, and RGDP. The primary econometric model employed in this study to examine the connection between capital expenditures and Nepal's economic growth is presented. The basis of the function model is Keynes' idea of appropriate public spending.

GDP _C =F (GEXPEDU GFCF, NSSCH, SEDUR, SEE) …………………..(1)

where GDP_C represents the GDP at constant prices. The terms "GEXPEDU" and "GFCF" refer to government spending on education, "NSSCH" and "number of secondary schools," "SEDUR" and "year" and "SEE" and "number of students passing secondary school exams," respectively.

Result and Discussion

Unit root test

Time series data are essential for the study. The majority of time series data fluctuate and are

unpredictable because they are non-stationary. Non-stationary data may produce inaccurate results. Put differently, it is necessary to convert non-stationary data into stationary data. The Augmented Dickey-Fuller (ADF) unit root test was used to confirm the stationary state. The most typical ADF evaluation format is

$$\Delta y_t = \alpha + \beta_t + \gamma y_{t-1} + \sum_p^{i=1} \delta_i \Delta y_{t-i+t} \quad \ldots\ldots\ldots\ldots\ldots \text{(i)}$$

Table 1: The Augmented Dickey Fuller (ADF) Test's results

Variables	LevelForm		FirstDifference		Remarks
	Intercept	Trend and Intercept	Intercept	Trend and Intercept	
GDF_C	0.7124 (*0.9907*)	-1.4701 (*0.8203*)	-5.4603 (*0.0001*)*	-5.7868 (*0.0002*)*	**I(1)**
GEXPEDU	-3.4117 (0.0166)*	-4.5162 (0.0067)*	-3.3363 (0.0238)*	-2.0301 (*0.5585*)	**I(0)**
GFCF	- 0.0129 (0.9496)	-5.1266 (*0.0017*)*	-2.4994 (*0.1275*)	-0.3457 (*0.9846*)	**I(0)**
NSSCH	0.9932 (0.9956)	-2.1427 (0.98)	-4.4837 (*0.0011*)*	-4.5662 (*0.0048*)*	**I(1)**
SEDUR	-1.4713 (0.5358)	-1.5740 (*0.7823*)	-5.7446 (0.0000)*	-5.7501 (0.0002)*	**I(1)**
SEE	0.2028 (09688)	-1.8248 (*0.6704*)	-5.0930 (*0.0002*)*	-5.1926 (*0.0010*)*	**I(1)**

Note: Author's own calculation form E-views 10

Table 1 shows that the null hypothesis of the variable, such as GEXPEDU and GFCF, is stationary at level I(O), even though GDP_C, NSSCH, SEDUR, and SEE are stationary at first difference I(1). Based on the outcomes of the ADF test, the ARDL model is thus employed for the study's econometric analysis.

Long Run Equilibrium Model

Table 5 displays the model's estimated long-run coefficients, while the equation represents the long-run equilibrium relationship

GDP_C=C(1)*GDP_C(-1)+C(2)*GEXPEDU+C(3)*GFCF+C(4)*NSSCH+C(5)*NSSCH(-1)

+ C(6)*NSSCH(-2) + C(7)*SEDUR + C(8)*SEE + C(9)*SEE(-1) + C(10)*SEE(-2) + C(11)
………………………………………………….(iii)

Table 2: *Long Run Form and Bounds Test for ARDL*

Selected Model: ARDL(1, 0, 0, 2, 0, 2)

Levels Equation

Case 2: No Trend and Restricted Constant

Variable	Coefficient	Std. Error	t-Statistic	Prob.
GEXPEDU	11.98397	2.755158	4.349648	0.0003
GFCF	2.221873	0.332631	6.679695	0.0000
NSSCH	-6.490839	7.182130	-0.903749	0.3759
SEDUR	3547.792	6113.154	0.580354	0.5676
SEE	-0.136667	0.087191	-1.567442	0.1313
C	10636.19	22672.51	0.469123	0.6436

Note: Author's own calculation form E-views 10

Table 2 provides compelling evidence that government expenditure on education over an extended period of time (GEXPEDU) significantly affects outcomes at the 1% level. This suggests that there is a corresponding increase of 11.98 units in GDP_C for every unit increase in GEXPEDU. This study shows that government spending on education and GDP are positively correlated. The findings of this investigation are consistent with earlier studies by Okerekeoti (2016), Alper and Demiral (2016), and Nowak and Dahal (2016). At a significance level of one percent, GFCF is statistically significant. The results demonstrate a robust and positive relationship between GDP and fixed capital formation. This result is in line with what Ali et al. (2009) found. To every unit change in the GFCF, the GDP_C changes by 2.221 units. It is indicated that the variables SEDUR, SEE, and NSSCH are not statistically significant when the coefficient of NSSCH is negative.

Short Run Model (Error Correction Estimation)

The error correction model determines the reason behind the variables chosen as well as the rate at which the long-term equilibrium is adjusted. In Table 3, you can see the predicted result of the ECM. The error correction model provides a thorough method for testing causation when variables are cointegrated, as stated by Toda and Phillips (1993) and Engle and Granger (1987).

Table 3: Error correction model estimation

Dependent Variable: D(GDP_C)
Selected Model: ARDL(1, 0, 0, 2, 0, 2)
ECM Regression
Case 2: Restricted Constant and No Trend

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(NSSCH)	11.89030	6.456491	1.841604	0.0791
D(NSSCH(-1))	30.12846	6.986807	4.312193	0.0003
D(SEE)	-0.196739	0.041409	-4.751060	0.0001
D(SEE(-1))	-0.200776	0.050395	-3.984016	0.0006
CointEq(-1)*	-0.813350	0.125334	-7.287345	0.0000
R-squared	0.714234	Mean dependent var		6949.285
Adjusted R-squared	0.673410	S.D. dependent var		17362.48
S.E. of regression	9922.317	Akaike info criterion		21.38169
Sum squared resid	2.76E+09	Schwarz criterion		21.60843
Log likelihood	-347.7978	Hannan-Quinn criter.		21.45798
Durbin-Watson stat	2.327770			

 * P-value not consistent with the t-Bounds distribution.

Note: Author's own calculation form E-views 10

Table 3 displays the results of the error correction estimation for the ARDL model. -0.196739, the negative correlation between the SEE coefficient (D) and the results and the dependent variable GDP_C. Additionally, the relationship is statistically significant, as shown by a p-value of 0.0001 at the 5% level. As a result, the GDP increases by 19.17% for every unit increase in SEE. This demonstrates the inverse relationship between GDP (Gross Domestic Product) and SEE (Socioeconomic Environment). At the 1% level, the error correction term's coefficient, -0.813350, is statistically significant. The presence of a strongly negative error correction term indicates a strong and enduring relationship between the variables. However, the GDP C balances out this year at a rate of 81.13 percent, after being unbalanced last year.

Bound testing

The mixed-order data used in the study first differentiated before becoming stationary.The bound test model is used in the study. The bound test result can be used to verify that the variables under investigation co-integrate. The Pesaran et al. (2001) proposed criteria for decision making.

Table 4: *The F-Bound Test's result*

F-Bounds Test		Null Hypothesis: No levels relationship			
Test Statistic	Value	Signif.	I(0)	I(1)	
F-statistic	**5.960810**	10%	2.08	3	
k	5	5%	2.39	3.38	
		2.5%	2.7	3.73	
		1%	3.06	4.15	

The bound test's estimated output is shown in Table 4. The bound test may be used to show that the study's variables are cointegrated. 5.96081 is the computed bound test F-statistic at the 1% level, which is higher than the critical values of the associated upper and lower bounds. The null hypothesis can be rejected, as this serves as evidence of the variables' cointegration. Consequently, the selected variables become interdependent over time.

Table:5 Residuals Diagnostic Test of Estimated Equation

LM Test for Breusch-Godfrey Serial Correlation:			
F-statistic	3.197702	Prob. F(2,20)	0.0624
Obs*R-squared	7.995647	Prob. Chi-Square(2)	0.0584

Heteroskedasticity Test: Breusch-Pagan-Godfrey			
F-statistic	8.089701	Prob. F(10,22)	0.64100
Obs*R-squared	25.94440	Prob. Chi-Square(10)	0.2338
Scaled explained SS	21.92176	Prob. Chi-Square(10)	0.0155

Table 5 displays LM test results. Test F-statistic for Breusch-Godfrey Serial Correlation The null hypothesis – no serial correlation – cannot be rejected by the LM test. Consequently, the estimated model residuals are serially uncorrelated. Probability value and Jarque-Bera statistic show that the data are insufficient to reject the null hypothesis that the distribution is normal. Neither model is heteroscedastic.

Conclusion

Education is an essential tool for accomplishing this objective, which should worry every nation. The purpose of this study was to look into how consumer spending and GDP growth are related. When the study acquired data on the chosen variable in the field of education from a reliable source, it took the significance of this correlation into consideration. This analysis also considered other important variables that influence economic growth. This study confirms previous research findings by demonstrating a robust correlation between public education spending and economic growth.

Higher GDP and more investment in higher education are positively correlated, as the results unequivocally show. In addition, the study shows that gross fixed capital formation stimulates GDP growth. At a significance level of 1%, the coefficient of the error correction term (-0.813350) exhibits statistical significance. If the highly significant negative sign in the error correction term is observed, it indicates the possibility of strong long-term correlations between the variables. As anticipated, the heteroscedasticity, normality, and Breusch-Godfrey LM tests have P-values greater than 5%. There is no heteroscedasticity or autocorrelation in this model. Priority should be given to the education sector, and a sizeable portion of government spending should go toward it. The country must prioritize increasing school enrollment, higher education, and technical education in order to allocate resources towards education and create a skilled workforce that will support long-term economic growth.

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A Cross-sectional Investigation of the Relationship between Corporate Governance and Financial Performance in Nepalese Commercial Banks

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Abstract

The study aims to investigate how commercial banks' financial performance in Nepal relates to corporate governance policies. The study uses a cross-sectional survey comprising 317 commercial bank stakeholders – employees, shareholders, and consumers among others. Field surveys helped to compile the data. Descriptive statistics and correlation analysis have helped to examine the acquired data. The results show that although commercial banks' corporate governance policies are sufficient, they could need improvement. Advancement of ideal board composition and structure, enhancement of disclosure and transparency, and protection of shareholder interests should take the front stage. Good financial performance corresponds favorably with the application of efficient governance policies. The study results have several consequences for legislators and authorities aiming to enhance the commercial banks' governance in Nepal.

Keywords: Board structure, corporate governance, disclosure and transparency, financial performance, shareholder's rights

1. Introduction

Corporate governance refers to the procedures and frameworks that members of the organization use to protect stakeholders' interests. The principles of accountability, transparency, equity, and responsibility form the basis of good corporate governance in corporate management. Corporate governance is described as a web of connections between management, the board of directors, controlling shareholders, minority shareholders, and other stakeholders in the OECD Principles (OECD, 2004). Additionally, the framework for defining the company's goals, determining how to achieve them, and assessing performance is established. It includes the explicit, contractual, and legal frameworks that specify how authority is used within an organization, impact choices,

enable stakeholders to carry out their duties, and guarantee the preservation of their rights and benefits (Page, 2005). Similarly, Bratton Jr. (1989) views the corporation as a hub for contracts and views corporate governance as one of many societal, legal, cultural, and economic factors that, when used properly, can improve the contracting process's dependability and efficiency. Furthermore, corporate governance, according to Huse (2007), is the framework that governs how organizations are run.

Since crises have occurred so frequently in recent decades, the relatively new idea of corporate governance (Cadbury, 1992; OECD, 2004) has attracted more attention. The impact of corporate governance on the state of the economy as a whole has been further highlighted by the current financial crisis. The financial crisis has been a major wake-up call because of its negative effects on the global economy, pensions, consumer spending, employment rates, and governmental bodies at all levels. Excessive risk-taking, skewed incentive compensation for senior executives, and a board culture that puts immediate profits ahead of sustained long-term performance have all been linked to deficiencies in corporate governance frameworks within businesses and financial institutions.

The development of financial markets has resulted in a greater demand for advanced corporate governance standards, which has in turn increased investor participation. In order to guarantee the efficient and effective utilization of capital, it is essential to ensure that it generates positive returns in a manner that is consistent with societal interests, while also protecting it from malfeasance and misappropriation. Boards of directors must be free of conflicts of interest in order to make decisions, and enforcement agencies must possess the necessary authority, resources, and credibility to operate effectively and efficiently. Investors demand this. The sole method by which economic development can be improved is through the implementation of superior corporate governance regulations and practices, which in turn cultivates heightened investor trust and confidence.

Effective corporate governance fosters sustainable economic development by enhancing business performance and expanding access to outside funding (Mallin, 2008). Scholars and practitioners alike agree that good corporate governance is important for the economy (Klapper & Love, 2004). By lowering capital costs and motivating businesses to use resources more effectively, an efficient corporate governance system can spur growth. Over the past few decades, corporate governance has grown in significance for a number of reasons. Because it is now backed by strong corporate governance, the private market-based investment process was not as important for the majority of economies in the past. In most nations, over the past few decades, privatization has led to the rise of corporate governance issues in industries that were previously governed by the state. Second, technological advancements, financial market liberalization, trade deregulation, and other structural reforms have made it more difficult to oversee capital utilization and distribute capital among conflicting goals both domestically and internationally. These changes highlight

how important transparent and efficient governance are. Globally and locally, the financial landscape has changed dramatically as a result of financial deregulation and reform. As a result, creative institutional arrangements have taken the place of conventional institutional corporate governance structures. Fourth, there has been a notable surge in financial integration over the last 20 years, which has led to a notable rise in cross-border investment and trade flows (Claessens & Yurtoglu, 2012). Financial integration has led to new corporate governance issues because of the differences in legal and regulatory frameworks among nations. As a result, the field has increased the scope of its studies to meet the need for a more thorough understanding of the problems.

Historically, corporate governance has held substantial importance worldwide. The swift progression of the sector has been enabled by the convergence of financial markets and a rise in corporate scandals in both developed and emerging countries, such as Enron, Tyco, WorldCom, Lehman Brothers, Olympus, Toshiba, and Satyam. In the last twenty years, there has been a steady rise in the quantity of research concerning corporate governance. Enhancing corporate governance in emerging and developing nations can fulfill several essential public policy objectives. Claessens and Fan (2003) assert that robust corporate governance diminishes transaction and capital costs, strengthens property rights, fosters capital market development, stimulates foreign direct investment, and mitigates the vulnerability of emerging markets to financial crises. Numerous empirical studies over the past two decades have examined the correlation between corporate governance and firm performance on a global scale. Nonetheless, there is a paucity of research in the domain of developing and underdeveloped economies (Srinivasan & Srinivasan, 2011).

For the banking industry and the economy at large to function effectively, strong corporate governance must be enforced. Because they make it easier for savers and depositors to transfer money to businesses that encourage entrepreneurship and spur economic growth, banks are vital to the economy. Since banks' safety and soundness are crucial for financial stability, their business practices are fundamental to the health of the economy. Governance shortcomings in major banks may cause problems to spread throughout the banking industry and the overall economy (BIS, 2014). Due to the existence of sizable shareholders, a lack of legal safeguards, and insufficient requirements for information disclosure, corporate governance of banks is particularly important in developing nations (McKnight & Weir, 2009).

Corporate governance reforms are seen as crucial for developing countries like Nepal in order to draw in foreign direct investment (FDI) and enhance savings mobilization through capital markets (Maskey, 2004). A perceived need for better corporate practices has arisen as a result of financial liberalization and reforms as well as the rise in public limited companies listed on the Nepalese stock exchange. Policymakers and regulators are interested in strengthening corporate governance practices because of the recent failures at financial institutions like Kist Bank, Nepal Bangladesh Bank, Samjhana Finance, Gorkha Development Bank, and Nepal Development Bank in Nepal. The decline in investor trust in financial institutions could jeopardize the stability of the

financial system. By using a cross-sectional survey, the study aims to empirically examine the relationship between corporate governance and the performance of financial institutions in Nepal.

2. Literature Review

Agency Theory

Agency theory is based on the premise of an agency relationship wherein the principal assigns tasks to the agent, encompassing risk-sharing and conflicts of interest between both parties. The assumption that the agent will be driven by self-interest instead of a commitment to optimize the principal's profits is inherent in it (Smith, 1937). The board is expected to address conflicts of interest and mitigate agency costs in its role as an intermediary. Some perceive the board's control function as encompassing a strategic role. An agency relationship is a contractual arrangement wherein one party (the principal) confers decision-making authority to another party (the agent) to execute a service on its behalf, as delineated by Jensen and Meckling (1976). Professional managers serve as agents representing the company's shareholders, the principals, in the traditional principal-agent dilemma. The core agency problem arises from the divergence between the decision-making authority of professional managers and the residual risk borne by shareholders. Shleifler and Vishny (1997) characterize the agency problem as the difficulties faced by equity investors in safeguarding their capital from being misappropriated or wasted on undesirable ventures.

Agency theory delineates various reasons why effective corporate governance improves firm value and performance at a theoretical level (Shleifer & Vishny, 1997). Essentially, effective governance involves improved oversight, heightened transparency, and public accountability between the principal and the agent. This leads to diminished managerial discretion and the appropriation of rents, alongside an enhancement in investor confidence. Well-governed firms are perceived to exhibit lower risk, enhanced operational efficiency, and reduced auditing and monitoring costs. Consequently, these factors produce an elevated anticipated cash flow stream and diminish the cost of capital, leading to enhanced performance and an increased firm valuation.The inability to flawlessly contract for the actions of an agent, whose decisions influence both the principal's welfare and the agent's own welfare, makes it unfeasible to manage agency problems without cost. Given the impracticality of comprehensive contracts between managers and shareholders, Shleifer and Vishny (1997) assert that shareholders must distribute residual control rights based on the prevailing circumstances. Management possesses the ability to obtain private benefits of control that are inaccessible to the company's shareholders due to their authority over the firm. They assert that agency costs arise from the imposition of expenses on the principals by offering managers the necessary incentives to act in the best interests of shareholders. To alleviate agency conflicts, shareholders must bear agency-related expenses to monitor managerial actions, potentially resulting in diminished firm performance. Consequently, agency theory provides a

theoretical framework for analyzing the relationship between corporate governance and a firm's performance or value.

Corporate Governance and Financial Performance

A robust corporate governance framework can reduce capital costs and enhance resource efficiency, thereby fostering growth, as recognized by the OECD (2004) principles of corporate governance. The conviction that enhanced corporate governance will result in elevated firm value and greater profitability is both implicitly and explicitly endorsed by these factors. Agency theory delineates several reasons why effective corporate governance improves firm value and performance at a theoretical level (Shleifer & Vishny, 1997). Enhanced oversight, augmented transparency, and public disclosure between shareholders and management constitute essential elements of effective governance. This leads to diminished managerial discretion and the appropriation of rents, alongside an enhancement of investor confidence. Denis (2001) asserts that well-governed firms exhibit reduced risk, enhanced operational efficiency, and diminished auditing and monitoring expenses. These factors can decrease the cost of capital and generate an increased expected cash flow stream, resulting in a higher firm valuation and enhanced performance (Macey & Ohara, 2003). The previous section examined the impact of corporate governance mechanisms on performance. Further issues pertaining to the relationship are discussed in the following paragraphs.

Multiple research studies have examined the degree to which a firm's performance is positively affected by "good" governance attributes. The authors of Stulz (1990) contend that effective governance should positively influence a firm's market valuation and performance. This is likely attributable to improved governance, which provides the firm enhanced access to capital markets and allows it to secure capital under more advantageous conditions. It is among the most significant studies. This viewpoint is further supported by anecdotal evidence from surveys conducted by McKinsey & Company, indicating that investors are inclined to pay a premium for companies that adopt exemplary governance practices (Davis et al., 1997). However, other research (Gompers et al., 2003) has produced inconclusive results regarding the direct relationship between a company's performance and its corporate governance practices.

The empirical literature has failed to consistently demonstrate positive effects regarding the influence of individual corporate governance mechanisms on corporate performance, despite the prevalent belief in their significance for addressing agency problems. A significant corpus of empirical and theoretical literature exists in the field. Research examining the impact of board composition on performance is significantly important. A significant body of research has not demonstrated a correlation between director independence and performance, irrespective of whether it is evaluated through accounting or stock return metrics (Romano, 2001). Likewise, many studies intended to assess the performance effects of shareholder activism via shareholder

proposals do not demonstrate a significant correlation with market value stemming from such activities.

Recent research in emerging economies has examined the influence of corporate governance practices on financial performance. Research indicates that corporate governance factors, especially board diversity and structure, positively influence financial performance. Satar et al. (2021) found that companies with higher gender diversity on their boards realized significant economic benefits, whereas Umar et al. (2020) highlighted that robust corporate governance practices positively influence the financial performance of banks. Afifa et al. (2022) indicated that the dividend payout was indirectly enhanced by a decrease in earnings management attributable to board independence and structure. Cheong (2022) noted that the performance effects of board diversity are affected by the political context. Furthermore, it observed that diversity can enhance a firm's value, although the effects depend on the governance practices of the particular firm. These studies demonstrate that improved financial results can be attained by implementing robust corporate governance, especially through the formation of well-organized and diverse boards.

In conclusion, the empirical literature focusing on individual governance mechanisms has not consistently demonstrated a correlation between governance and performance (Love, 2010). Nonetheless, the valid inference from this comprehensive body of research is not that efforts to improve corporate governance are futile. A research design assessing the influence of a solitary governance dimension on a firm's performance is constrained by the potential for interaction effects among multiple governance mechanisms (Baker & Griffiths, 2010). Moreover, recent studies have examined the influence of corporate governance on financial performance (Afifa et al., 2022; Ceong, 2022; Satar et al., 2021; Umar et al., 2020). All of these investigations were conducted using secondary data. The aim of this study is to fill this gap by employing cross-sectional data. The findings of the study regarding the impact of corporate governance on financial performance in Nepal are likewise ambiguous. Poudel and Hovey (2013) found that the efficiency of commercial banks improved due to decreased institutional ownership, reduced frequency of board meetings, and increased sizes of boards and audit committees. Conversely, Acharya (2013) found no significant evidence that corporate governance substantially influences a firm's valuation. Pradhan (2015) noted a positive correlation between board size, executive leadership, and return on equity (ROE) in financial institutions. Nevertheless, he also noted that total assets exerted no substantial influence. Similarly, Gnawali (2018) found that corporate governance improved the ROE of commercial banks. The research by Sapkota (2020) produced inconclusive findings concerning the relationship between financial performance and corporate governance factors. In conclusion, further empirical evidence is necessary to reach a definitive conclusion. The use of primary data in research within this field is limited. The aim of this study is to determine the relationship between financial performance and corporate governance practices through the analysis of survey data within financial institutions.

3. Methodology

The stakeholders of commercial banks in Nepal are the focus of this cross-sectional study, which employs a questionnaire survey. A self-administered questionnaire is employed to collect opinions regarding the financial performance and corporate governance practices of the banks. The questionnaire is divided into three sections: respondent information, perceived financial performance, and corporate governance practices. Utilizing a 5-point Likert Scale with response options ranging from "Strongly Disagree" to "Strongly Agree," the initial section compiles respondents' assessments of their financial institution's compliance with corporate governance standards. The OECD (2004) principles of corporate governance are the source of the 28 elements of corporate governance practices. The second section compiles respondents' evaluations of their bank's financial performance. In the same vein, the third section compiles concise information about the respondents. The questionnaire is pre-tested on 20 stakeholders, including customers, employees, and shareholders of commercial bank branches located in the Nawalparasi district of Nepal. Participants in the pilot survey advised that the questionnaire be kept concise. The final questionnaire incorporates the insights obtained from the pilot survey.The questionnaire was distributed and collected at numerous branches of the selected commercial banks in Kathmandu, Pokhara, and Nawalparasi through a series of field visits. The convenience sampling method was employed to select the participants. The questionnaire was administered to survey participants in person, and the completed questionnaires were subsequently collected. In order to address the low response rate, the following measures were taken: informing respondents about the study's objectives and the questionnaire, providing a cover letter to obtain informed consent and emphasize the significance of their responses, ensuring the confidentiality of their answers, and personally delivering and collecting questionnaires during follow-up visits. 317 usable questionnaires were collected from the 400 distributed over a four-month period, from May to August 2024, as a consequence of the aforementioned endeavors. Descriptive statistics, including the mean and standard deviation, were employed to evaluate the participants' perceptions of financial performance and corporate governance. Additionally, the distinctions in corporate governance and financial performance based on bank types were evaluated using analytical statistics, such as One-Way ANOVA. In order to evaluate the correlation between financial performance and corporate governance, correlational analysis was implemented.

4. Results

Description of the Respondents

The study has conducted a survey on corporate governance practices to determine the perspectives of the largest shareholders of the sample banks regarding the financial performance and corporate governance practices of their institutions. The Organization for Economic Cooperation and Development (OECD) has established the principles of corporate governance from which the

questionnaire is primarily derived. On a five-point Likert scale, respondents were requested to assess the corporate governance practices of their respective banks. The sample respondents were selected on the basis of the assumption that their position or involvement with the bank increases their likelihood of being well-versed in the corporate governance practices implemented in their institutions. The sample respondents are succinctly summarized in the table below:

Table 1

Description of Respondents

Designation	*f*	*%*	*Experience*	*f*	*%*
Managers	22	6.9	Less than 4 years	88	27.8
Officers	16	5.0	4 – 6 years	121	38.2
Senior Assistants	72	22.7	More than 6 years	108	34.1
Assistants	26	8.2			
Customers	69	21.8			
Shareholders	112	35.3			
Total	**317**	**100**	**Total**	**317**	**100**
Ownership	*f*	*%*	*Gender*	*f*	*%*
Public Sector Bank	54	17.1	Male	232	73.2
Foreign JV Bank	109	34.3	Female	85	26.8
Local Private Bank	154	48.6			
Total	**317**	**100**	**Total**	**317**	**100**

Of the respondents to the questionnaire, 6.9 percent are managers, 5% are officers, 22% are senior assistants, 8.2 percent are assistants, 21.8 are customers, and 35.3 percent are shareholders. The lower percentages for managers and officers are a result of the limited number of positions. Additionally, although numerous follow-ups were conducted, senior-level employees were difficult to reach for the survey. The respondents' most frequent experience with the current bank is within the four- to six-year range. For shareholders, it pertains to the duration of their ownership of the bank's stock. Local private banks are the source of the greatest number of respondents. LPBs are more numerous than PSBs and JVBs. Similar to the previous example, PSB has the lowest percentage of respondents due to the lowest number of banks. Lastly, the gender distribution of the respondents is as follows: males comprise 73 percent of the sample, while females comprise approximately 27 percent. Therefore, the sample's distribution across

gender, organization, experience, and designation indicates that it is highly representative.

Average Scores of Corporate Governance Sub-scales

The underlying concept of corporate governance is assessed through a survey questionnaire comprising seven sub-constructs that encompass all principal elements of best practices in corporate governance within banks. The subsequent sub-constructs are derived from the OECD principles of optimal corporate governance practices: an efficient corporate governance framework, the responsibilities and accountability of the board, the structure and composition of the board, the rights of shareholders, the equitable treatment of shareholders, the safeguarding of stakeholders' interests, and disclosure and transparency. Table 1 displays the aggregate average scores of the items and analyzes the variations in mean scores across the three types of banks. The five-point Likert scale utilized in the study ranges from one to five, with one denoting "strongly disagree" and five indicating "strongly agree."

Table 2 indicates that the mean score for the sub-scale of effective corporate governance is 3.62, implying that respondents predominantly agree that their banks are committed to executing robust governance practices. The maximum score of 3.70 across the four sub-scale items signifies that banks are committed to delineating distinct responsibilities between the board and management. Similarly, they exhibit their commitment to regulatory compliance and the adoption of optimal corporate governance practices. The F-test results, conducted to examine the differences in mean scores of sub-scale items by bank type, reveal significant disparities in the commitment to establishing an effective corporate governance framework. The PSBs demonstrate minimal enthusiasm, whereas the JVBs display the highest level of dedication. Nonetheless, the mean scores for all three categories of banks exceed 3, signifying that the banks have at least partially grasped the significance of corporate governance practices and, consequently, have exhibited their dedication to the implementation of a robust corporate governance framework.

Table 2

Corporate Governance Practices: Mean Scores and Test for Differences

1	Effective CG Framework	Overall	SD	JVB	LPB	PSB	F-Stat
i.	Policy to adopt best CG practices	3.61	.863	4.06	3.56	3.02	35.245***
ii.	Compliance with regulations	3.65	.927	3.98	3.66	3.17	15.68***
iii.	Clear division of responsibilities	3.70	.878	3.93	3.66	3.4	7.33*
iv.	Sound CG structure	3.54	.894	3.84	3.56	3.08	15.216***
	Sub-scale Average	**3.62**	**0.89**	**3.95**	**3.61**	**3.17**	
2	**Board Responsibilities and Accountability**						
i.	Acts with due diligence and care	3.58	.730	3.92	3.66	3.02	38.918***
ii.	Fair treatment of shareholders	3.51	.890	3.76	3.49	3.17	8.67*

iii.	Apply high ethical standard	3.58	.760	3.98	3.49	3.11	31.322***
iv.	Exercise objective judgment	3.50	.770	3.84	3.59	2.92	35.57***
v.	Effective board functioning	3.61	.774	3.87	3.73	3.11	22.43***
	Sub-scale Average	**3.56**	**0.78**	**3.87**	**3.59**	**3.07**	
3	**Board Structure and Composition**						
i.	Board independence	3.05	.904	3.44	3.01	2.56	20.85***
ii.	Adequacy of board skill mix	3.03	.862	3.44	2.99	2.51	26.65***
iii.	Adequate board committees	3.68	.866	3.96	3.7	3.27	12.82**
	Sub-scale Average	**3.26**	**0.88**	**3.61**	**3.23**	**2.78**	
4	**Shareholder Rights**						
i.	Participation in fundamental decisions	3.26	1.073	3.54	3.28	2.86	4.94
ii.	Access to information	3.65	.772	3.96	3.68	3.21	20.41***
iii.	Exercise of ownership rights	3.34	.944	3.69	3.38	2.79	19.31***
iv.	Effective AGM participation	3.35	.872	3.73	3.35	2.81	25.03***
	Sub-scale Average	**3.40**	**0.92**	**3.73**	**3.42**	**2.92**	
5	**Equitable Treatment of Shareholders**						
i.	Equal treatment	3.34	.747	3.55	3.45	2.9	17.21***
ii.	Prohibition of insider trading	3.73	.901	3.87	3.92	3.32	9.82**
iii.	Disclosure of interests	3.35	.861	3.61	3.39	2.92	13.20**
iv.	Minority rights protection	3.26	.813	3.4	3.28	3.02	4.015
	Sub-scale Average	**3.42**	**0.83**	**3.61**	**3.51**	**3.04**	
6	**Disclosure and Transparency**						
i.	High disclosure standards	3.81	.817	4.13	3.82	3.35	19.98***
ii.	Standards of accounting and audit	3.59	.849	3.81	3.8	3.03	22.43***
iii.	Independence of external audit	3.97	.930	4.34	4.07	3.35	26.27***
iv.	Fair and timely dissemination of information	3.87	.783	4.21	4.04	3.17	50.99***
v.	Disclosure of conflict of interests	3.71	.869	4.03	3.89	3.06	32.12***
	Sub-scale Average	**3.79**	**0.85**	**4.10**	**3.92**	**3.19**	
7	**Protection of Stakeholders' Interest**						
i.	Respect for stakeholder rights	3.80	.859	4.12	4.01	3.1	40.19***
ii.	Existence of whistleblower protection	3.38	.823	3.74	3.49	2.73	38.71***
iii.	Obtain redress for stakeholder rights violation	2.87	.811	3.27	2.94	2.21	44.95***
	Sub-scale Average	**3.35**	**0.83**	**3.71**	**3.48**	**2.68**	
	Overall Mean	**3.51**	**.853**	**3.821**	**3.564**	**3.010**	

*, **, and *** means the coefficient is significant at 10%, 5%, and 1% level of significance respectively.

The average sub-scale score for the sub-construct of board responsibility and accountability indicates that the respondents generally concur that the banks' boards are responsible and accountable. The respondents believe that the board of their banks operates efficiently, adheres to ethical standards, and exercises due diligence and care. Similar to the aforementioned discoveries, JVBs have boards that are more accountable and responsible, while PSBs have the least in this regard. The null hypotheses of no significant difference in all the sub-scale items by bank type are rejected by the f-test results. The average of the board structure and composition sub-scale is 3.26, indicating that the majority of respondents are indifferent regarding the soundness of the sub-construct in their banks. They are relatively in agreement that their banks have adequate board committees, but they are neutral on the topics of board independence and board diversity. Similar to previous findings, there is a substantial disparity in the scores of the items based on the type of bank, with JVBs achieving the highest scores. Indicating a lack of strength in their board structure, PSB's average score is less than 3.

The item-wise average scores of the sub-construct shareholders' rights indicate that the respondents are, on average, in agreement that shareholders of their bank have access to information. However, they are generally neutral regarding shareholder participation in fundamental decisions. As evidenced by their average score of 3.7, the JVB is revealed to be respectful of shareholder rights. Nevertheless, shareholder participation in fundamental decisions, the exercise of ownership rights, and effective participation in AGMs is low in the case of PSBs. In the same vein, the respondents demonstrate a low level of agreement regarding the equitable treatment of all shareholders. Particularly, minority shareholders' rights are assigned a low score. Nevertheless, they generally concur that insider trading is prohibited in their financial institutions.

The sub-scale disclosure and transparency has an average score of approximately 3.8, which is the highest among the Subscale averages. It suggests that the respondents' perception of their banks' disclosure practices is relatively favorable in comparison to other sub-constructs. The most common consensus is that the banks have preserved the independence of their external audit. Nevertheless, they harbor reservations about the accounting and auditing standards. The respondents from JVB appear to be content with the disclosure and transparency standards of their banks, as the average score of 4.1 is the highest among all sub-scales. In conclusion, the average overall score of 3.3 for sub-scale protection of stakeholder rights suggests that respondents have a low level of agreement regarding the corporate governance practices in their banks that address the interests of stakeholders. The practice in the banks is unsatisfactory, as the score for PSB is less than 3.

It can be contended that the respondents' assessment of the presence of corporate governance best practices in their banks, as indicated by the scale items, is satisfactory but lacks excellence.

By comparing the average scores of the subscales, it is determined that the disclosure and transparency practice is relatively satisfactory. While the banks appear to be dedicated to the implementation of sound corporate governance practices, their board composition and structure appear to be incompatible with the adoption of improved governance practices, particularly in the context of safeguarding the rights of shareholders and the interests of stakeholders.

Relationship between Corporate Governance Measures and Financial Performance

The following corporate governance sub-scales are correlated with perceived financial performance (FP): effective corporate governance framework (ECF), board responsibility and accountability (BRA), board structure and composition (BSC), shareholder's rights (SRG), equal treatment of shareholders (ETS), stakeholders' interest protection (PSI), and disclosure and transparency (DTI). Those correlations are illustrated in Table 3. All of the sub-scales are significantly correlated with financial performance. Furthermore, the correlation coefficients are all positive, suggesting that enhanced financial performance is perceived to be positively correlated with improved governance practices in banks. The board's responsibility and accountability are most significantly correlated with financial performance, followed by the equitable treatment of shareholders. In contrast, there is a minimal correlation between financial performance and stakeholders' interests. Furthermore, there is a significant correlation between the subscales. The correlation coefficient between disclosure and the protection of stakeholders' interests is the highest, followed by the equal treatment of shareholders and board responsibility and accountability.

Table 3

Relationship Between Corporate Governance and Financial Performance

	FP	ECF	BRA	BSC	SRG	ETS	PSI	DIT
FP	1							
ECF	0.518**	1						
BRA	0.660**	0.473**	1					
BSC	0.374**	0.360**	0.529**	1				
SRG	0.415**	0.396**	0.659**	0.541**	1			
ETS	0.593**	0.324**	0.792**	0.342**	0.654**	1		
PSI	0.351**	0.482**	0.530**	0.603**	0.684**	0.394**	1	
DIT	0.518**	0.638**	0.523**	0.543**	0.610**	0.469**	0.806**	1

*, **, and *** means the coefficient is significant at 10%, 5%, and 1% level of significance respectively.

ECG= Effective Corporate Governance; BRA = Board Responsibility and Accountability; BSC = Board Structure and Composition; SRG = Shareholders Rights; ETS = Equitable Treatment

of Shareholders; PSI = Protection of Shareholders' Rights; DIT = Disclosure and Transparency.
In general, the survey results, which are consistent with previous research, indicate that the financial performance of banks in Nepal is influenced by the corporate governance practices they implement. Better financial performance is more significantly influenced by the establishment of accountable and responsible boards and the implementation of sound disclosure practices.

Regression Analysis

The study employs multiple linear regression analysis to evaluate corporate governance variables' influence on Nepalese commercial banks' perceived financial performance. The independent variables in the model include Board Structure, Shareholder Rights, Equitable Treatment of Shareholders, Disclosure and Transparency, Stakeholder Protection, and Accountability Mechanisms, while the dependent variable is Perceived Financial Performance. The results of the regression analysis are presented in the following tables.

Table 4

Regression Model Summary

R	R^2	Adjusted R^2	Std. Error of Estimate
0.788	0.621	0.605	0.34479

The regression model summary indicates that the independent variables collectively explain 62.1% of the variation in financial performance, as demonstrated by the R^2 value of 0.621. The Adjusted R^2 value of 0.605, which accounts for the number of predictors in the model, confirms that the regression equation provides a robust explanation of the dependent variable. A standard error of 0.34479 suggests an acceptable level of variability around the regression line.

Table 5

Regression ANOVA

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	28.742	6	4.790	39.287	0.000
Residual	17.623	153	0.115		
Total	101.887	159			

The Analysis of Variance (ANOVA) results provide strong evidence for the overall statistical significance of the regression model, as indicated by the p-value of 0.000, which is well below the conventional threshold of 0.05. The F-statistic of 39.287 confirms that the variation in financial performance is reliably explained by the independent variables included in the model. This suggests that the model is highly effective in predicting the dependent variable.

Table 6

Regression Coefficients

Variable	Unstandardized Coefficients (B)	Std. Error	Standardized Coefficients (Beta)	t	Sig.
(Constant)	0.939	0.378		2.483	0.014
Board Structure	0.317	0.058	0.408	5.466	0.000
Shareholder Rights	0.147	0.057	0.176	2.579	0.011
Equitable Treatment	0.008	0.080	0.007	0.105	0.916
Disclosure and Transparency	0.022	0.067	0.022	0.328	0.743
Stakeholder Protection	0.032	0.060	0.046	0.533	0.596
Accountability Mechanisms	0.352	0.063	0.422	5.603	0.000

Regression Equation:

The regression equation derived from the coefficients is as follows:

Financial Performance=0.939+0.317(Board Structure)+0.147 (Shareholder Rights)+0.008 (Equitable Treatment) +0.022 (Disclosure and Transparency)+0.032 (Stakeholder Protection) +0.352 (Accountability Mechanisms) The regression coefficient for Board Structure (B = 0.317, $p < 0.001$) indicates that a one-unit increase in the perception of board structure enhances financial performance by 0.317 units, holding other variables constant. Similarly, Shareholder Rights (B = 0.147, $p = 0.011$) and Accountability Mechanisms (B = 0.352, $p < 0.001$) significantly contribute to financial performance. The positive coefficients for these variables suggest their critical roles in driving performance outcomes. Conversely, the variables Equitable Treatment ($p = 0.916$), Disclosure and Transparency ($p = 0.743$), and Stakeholder Protection ($p = 0.596$) are not statistically significant predictors, as their p-values exceed the 0.05 threshold. This implies that these variables have a limited impact on financial performance within the scope of this analysis.

The regression analysis underscores the pivotal role of certain corporate governance variables in influencing financial performance. Specifically, Board Structure, Shareholder Rights, and Accountability Mechanisms emerge as key determinants, with statistically significant contributions. These findings highlight the importance of robust governance structures, transparent practices, and effective accountability measures in enhancing the financial outcomes of Nepalese commercial banks. In contrast, Equitable Treatment of Shareholders, Disclosure, Transparency, and Stakeholder Protection do not exhibit significant predictive power in this model. This suggests that these variables may either have a less direct impact or require further contextual examination to determine their relevance in shaping financial performance.

5. Discussion

The findings of this study provide robust evidence of a significant relationship between corporate governance practices and financial performance in Nepalese commercial banks. These results are consistent with the principles of agency theory, which emphasize that effective governance mechanisms mitigate agency problems, enhance transparency, and align the interests of management and shareholders (Jensen & Meckling, 1976; Shleifer & Vishny, 1997). Specifically, the analysis demonstrates that variables such as Board Structure, Shareholder Rights, and Accountability Mechanisms are strong predictors of financial performance, while Equitable Treatment of Shareholders, Disclosure and Transparency, and Stakeholder Protection show limited influence within the current model.

The positive and significant relationship between Board Structure and financial performance ($\beta = 0.408$, $p < 0.001$) highlights the critical role of a well-designed and competent board in ensuring effective decision-making and oversight. This aligns with prior research emphasizing the importance of board composition, independence, and skill diversity in driving organizational success (Denis & Kruse, 2001; Claessens & Yurtoglu, 2012). A well-structured board ensures that management decisions are aligned with the organization's strategic objectives, thereby enhancing operational efficiency and profitability.

Similarly, the significant association of Shareholder Rights ($\beta = 0.176$, $p = 0.011$) underscores the importance of enabling shareholders to actively participate in key corporate decisions. Previous studies have shown that granting shareholders access to relevant information and facilitating their involvement in governance decisions enhances trust and investment confidence (Klapper & Love, 2004; Poudel & Hovey, 2013). This finding suggests that Nepalese banks that empower their shareholders are better positioned to achieve superior financial outcomes.

The role of Accountability Mechanisms ($\beta = 0.422$, $p < 0.001$) as the most influential predictor underscores the significance of transparency, ethical governance, and the board's responsibility in ensuring organizational success. This is consistent with Denis's (2001) assertion that accountability reduces managerial discretion, restricts opportunistic behavior, and fosters investor confidence, ultimately leading to better financial outcomes. The results demonstrate that banks with strong accountability mechanisms are likely to inspire greater stakeholder trust and improve financial performance.

While Equitable Treatment of Shareholders, Disclosure, and Transparency, and Stakeholder Protection are theoretically important components of corporate governance, they did not exhibit significant relationships with financial performance in this study. These findings could indicate that these variables may not have a direct or immediate impact on performance, or that their influence may depend on other mediating factors. For instance, previous studies have shown mixed results regarding the effectiveness of disclosure practices in driving performance, with

some suggesting that the quality and context of disclosures play a critical role (Romano, 2001; Gompers, Ishii, & Metrick, 2003).

The lack of significance for Stakeholder Protection (p = 0.596) may suggest that current frameworks in Nepalese banks inadequately address the broader stakeholder interests, focusing primarily on shareholder-centric governance models. This aligns with findings from Maskey (2004), which highlight the need for more robust frameworks to protect minority and external stakeholder interests in developing countries.

The results align with prior studies in emerging economies, which have consistently emphasized the importance of board competence and shareholder empowerment in improving financial performance (Umar, Norfadzilah, Hussaini, & Habibu, 2020; Satar et al., 2021). Specifically, the findings corroborate evidence that robust governance structures, including diverse and skilled boards, are critical for sustaining growth in the banking sector (Cheong, 2022).

However, the insignificant role of certain governance factors such as Equitable Treatment of Shareholders and Stakeholder Protection may reflect contextual differences in governance practices between Nepalese banks and their counterparts in other regions. These results suggest that while some governance components have universal applicability, others require adaptation to local legal, cultural, and regulatory environments (Claessens & Fan, 2003; Sapkota, 2020).

6. Conclusion

The study's findings suggest that the respondents find the corporate governance practices of financial institutions to be somewhat satisfactory. It has been determined that the disclosure and transparency practice is relatively satisfactory. However, the perceived soundness of the board structure and composition was less satisfactory. The banks' board composition and structure seem to be incompatible with the adoption of improved governance practices, particularly in the context of safeguarding the rights of shareholders and the interests of stakeholders, despite their apparent dedication to the implementation of sound corporate governance practices. The results also suggest that the protection of shareholders' rights and equitable treatment is subpar. The safeguarding of minority shareholders' rights is a particularly pressing issue. Corporate governance practices are positively correlated with financial performance. The successful execution of board responsibilities and accountability has a substantial impact on financial performance. In the same vein, shareholders' rights must be treated equitably in order to achieve optimal performance. Additionally, an effective corporate governance framework and disclosure process are essential for enhanced financial performance. Subpar financial performance is a substantial concern as a result of the safeguarding of shareholders' rights.

7. Implications and Future Research Directions

The study's findings have several practical implications for policymakers and bank management in Nepal. First, enhancing board effectiveness through training and the inclusion of diverse skill sets should be a priority. Second, banks should strengthen mechanisms that empower shareholders, particularly by improving access to timely and relevant information. Third, greater emphasis should be placed on enforcing accountability at all levels of governance to build trust and improve financial outcomes. Furthermore, the limited significance of Equitable Treatment of Shareholders and Stakeholder Protection suggests the need for more comprehensive regulations to address these areas. Regulatory bodies such as the Nepal Rastra Bank and the Securities Board of Nepal should collaborate to establish frameworks that balance the interests of shareholders with those of broader stakeholders. Doing so would align governance practices with global standards, fostering greater investor confidence and long-term sustainability.

The Nepalese regulators, which encompass the central bank, Securities Board, Nepal Stock Exchange, and Institute of Chartered Accountants, should collaborate to establish rigorous corporate governance codes that consider both global best practices and country-specific characteristics. Furthermore, they should ensure that financial institutions adhere to these regulations. The regulations should prioritize the protection of shareholders' interests and the promotion of transparency and disclosure. The financial institutions should establish a code of ethics for directors and implement programs for the training and development of directors. Financial institutions should establish a written policy to adopt corporate governance best practices, rather than merely adhering to regulatory requirements. They should prioritize the voluntary adoption of these best practices. There is a need to educate investors on the significance of effective corporate governance in terms of market value, performance, and stability. It is essential to establish the institutional framework for external governance mechanisms, which includes the market for corporate control, director training institutes, corporate governance research centers, and rating agencies.. The potential for benefit is present in the implementation of new rules and regulations to regulate the expropriation of minority shareholders. In summary, the leadership of financial institutions should acknowledge the critical role that corporate governance plays in improving performance and stability. They should prioritize the enhancement of governance practices within their institutions. The state-owned financial institutions of Nepal are plagued by poor governance practices and specific corporate governance issues, which has led to research inquiries such as: What is the significance of privatization in state-owned enterprises? What is the relationship between corporate governance and privatization frameworks? Are there particular types of privatization that are more appealing in environments with inadequate corporate governance? What are the dynamic relationships between changes in the degree of state ownership of listed

firms and changes in corporate governance? What are the unique corporate governance concerns that arise in these organizations? It is essential to conduct further research in order to gain a more comprehensive understanding of the issues. Future longitudinal studies are advised due to the cross-sectional nature of the data utilized in the present investigation. A more extensive time frame may result in a unique relationship between corporate governance, financial performance, and ownership structure. A novel relationship may be revealed by the inclusion of supplementary corporate governance variables or control variables. The efficiency of banking, the political regime, executive compensation, the tenure and turnover of CEOs, and the characteristics of CEOs are all potential areas for future research. Additionally, the investigation exclusively concentrated on internal corporate governance mechanisms; consequently, the investigation of the impact of external governance mechanisms on performance presents a potential future research area.

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Behavioral Biases in Investment Decisions: Investigating the Role of Financial Literacy as a Moderator in Nepal

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Abstracts

This study provides critical insights into investor behavior and its association with various behavioral biases in the context of investment decisions in Nepal's financial markets. Data was collected from 260 individual investors using a structured questionnaire, and hierarchical regression analysis was applied to test the hypotheses. The research identifies significant biases, including anchoring bias, overconfidence, and herding, that influence investment decisions. Additionally, the role of financial literacy as a moderating factor was examined, revealing its significant impact on reducing the effects of these biases.

The findings highlight the unique investment patterns in Nepal's emerging market, contrasting with established norms in developed financial markets. These results are valuable for policymakers, regulators, and stock market authorities in addressing investor behavior, enhancing financial education, and promoting informed decisions.

Keywords: Investor behavior, behavioral biases, financial literacy, Nepal.

1. Introduction

Making sound financial decisions is essential for managing family wealth and maintaining personal financial stability. Traditional finance theories focus on maximizing utility, operating under the assumption that markets function efficiently and investors act rationally when making choices. Efficient markets are defined by the swift and equitable distribution of information, allowing investors to evaluate and decide logically. Traditional finance has consistently encountered challenges in reaching a consensus on the efficiency of financial markets and the rationality of investor behavior. Behavioral finance questions these assumptions by incorporating psychological and sociological insights, demonstrating that investor decisions are shaped by emotions, cognitive biases, and heuristics rather than solely rational evaluations (Dhungana et al., 2022; Sun et al., 2022). In Nepal, behavioral finance has become an essential field of study to understand investor behavior in financial markets. Investors in Nepal often make decisions that deviate from rational

norms due to biases such as overconfidence, herding, and anchoring. These behavioral tendencies are more pronounced in emerging markets like Nepal, where financial literacy levels are relatively low, and access to accurate information is limited. A study conducted in Pokhara Valley highlights that cognitive biases, particularly herding, significantly impact investment decisions as investors often mimic others without conducting thorough evaluations of market conditions (Dhungana et al., 2022).

Moreover, psychological priorities often take precedence over rationality when investors in Nepal evaluate stocks or other financial products. Anchoring bias, where individuals rely heavily on initial information or historical trends, is particularly prevalent. This results in decisions based on incomplete or outdated information rather than current market dynamics (Nepal et al., 2023). In Nepal, behavioral biases such as overconfidence and herding significantly impact investment decisions. Overconfident investors often underestimate risks while overrating their ability to forecast market trends. This behavior often results in excessive trading, which drives up transaction costs and diminishes overall investment returns. Herding bias, on the other hand, causes investors to follow market trends blindly, often leading to market bubbles or crashes (Sun et al., 2022). Another prominent bias observed in Nepal is the disposition effect, where investors are inclined to sell profitable stocks too early while retaining losing investments, anticipating a future rebound. This irrational behavior arises from loss aversion, a principle highlighted in prospect theory, which suggests that individuals experience the pain of losses more intensely than the satisfaction derived from equivalent gains (Dhungana et al., 2022). Such biases not only affect individual investment outcomes but also contribute to inefficiencies in the overall market.

Financial literacy is essential in reducing the negative impact of behavioral biases on investment decisions. In Nepal, the level of financial literacy among investors remains a significant challenge, particularly in rural and semi-urban areas. Research shows that higher levels of financial literacy enable investors to assess risks more effectively and make informed decisions, reducing reliance on heuristics and emotional responses (Andersson, 2023). Financial literacy also enhances the ability to evaluate the intrinsic value of financial products, promoting rational decision-making. For instance, educated investors are more likely to consider factors such as company performance, market conditions, and potential risks to consider before making investment decisions (Sun et al., 2022). In Nepal, financial institutions and policymakers have a significant role in addressing the gaps in financial literacy and investor awareness Programs like investor education initiatives, workshops, and awareness campaigns can play a vital role in closing this gap. Investment banks and stock markets can also use technology to provide easy access to financial information, enabling investors to make better-informed decisions (Prasetyo et al., 2023). Policymakers should focus on integrating financial literacy into the education system to cultivate a financially aware population.

By equipping individuals with the tools to evaluate financial products and market risks, Nepal can develop a more stable and efficient financial market (Nepal et al., 2023).

Research on behavioral finance in Nepal offers valuable insights for investors, financial advisors, and institutions. Recognizing the psychological and cognitive factors that drive investment decisions can help investors steer clear of common mistakes, such as excessive trading or blindly following market trends. Financial advisors can use insights from behavioral finance to provide tailored advice, addressing the specific biases of their clients (Dhungana et al., 2022).Future research should focus on exploring the interplay between behavioral biases and emerging financial technologies in Nepal. The increasing use of fintech applications and online trading platforms presents new challenges and opportunities for addressing behavioral biases. Understanding how these technologies influence investor behavior can provide valuable insights for designing interventions that promote rational decision-making (Andersson, 2023). Behavioral finance provides a comprehensive framework for understanding the complexities of investment decision-making in Nepal. By highlighting the role of behavioral biases and the importance of financial literacy, it offers valuable insights into the challenges faced by Nepalese investors. Addressing these challenges through education, awareness programs, and policy interventions can significantly enhance investment outcomes and market efficiency. As Nepal continues to develop its financial markets, integrating behavioral finance insights into practice will be crucial for fostering a more informed and resilient investor base.

2. Literature Review

2.1. Behavioral Biases and Decision-Making Among Individual Investors

Behavioral biases are a critical factor influencing investment decisions, often leading to deviations from rationality. These biases are particularly evident in emerging markets like Nepal, where access to financial literacy and structured investment data remains limited. Recent studies have identified the prevalence of cognitive biases among investors in South Asian markets, including Nepal (Joharudin, 2023; Sun et al., 2022). These biases often drive anomalies in investment behavior, reflecting the interplay between individual psychology and market dynamics.

2.1.1. Overconfidence Bias

Overconfidence bias, which reflects an individual's tendency to overrate their knowledge and forecasting skills, is a common challenge among investors in Nepal. This bias often results in excessive trading and less-than-ideal investment performance. For example, Saleem et al. (2023) found that overconfidence undermines decision-making efficiency, particularly in rapidly changing financial markets. In Nepal, this bias is evident among retail investors engaging in speculative trading on the Nepal Stock Exchange (NEPSE), often without adequate risk assessment.

2.1.2. Herding Bias

Herding bias refers to investors' propensity to imitate others' actions, leading to market inefficiencies. Studies in South Asia have demonstrated the influence of herding behavior, particularly in group-oriented societies (Ranaweera & Kawshala, 2022Nepalese investors commonly follow trends in prominent sectors such as hydropower and real estate, basing their decisions on peer recommendations rather than performing independent evaluations (Joharudin, 2023).

2.1.3. Disposition Bias

Disposition bias, where investors hold on to losing assets while selling profitable ones prematurely, is another prevalent issue. A study by Sun et al. (2022) emphasizes the influence of emotional attachment in sustaining this behavior. In Nepal, this bias is especially visible during market downturns, where investors often delay selling underperforming stocks, hoping for future recovery.

2.1.4. Risk Aversion Bias

Risk aversion is a common behavioral trait where individuals weigh potential losses more heavily than equivalent gains (Tversky & Kahneman, 1974). In Nepal, risk aversion is particularly evident among female investors, who tend to prefer low-risk financial products such as fixed deposits and government bonds. Joharudin (2023) also notes that this cautious approach often limits exposure to potentially higher-yielding investments.

2.1.5. Representativeness Bias

Representativeness bias, where decisions are based on limited observations or non-representative samples, is prevalent in Nepal's investment context. According to Thanki et al. (2022), investors often rely on anecdotal evidence or past performance, leading to overreaction to market news. This bias has been observed among Nepalese retail investors who disproportionately favor stocks in trending sectors without conducting thorough due diligence.

2.1.6. Anchoring and Adjustment Bias

Anchoring bias, where individuals overly rely on initial information, has significant implications for investment decisions. Saleem et al. (2023) found that these bias influences investors' ability to update their beliefs based on new information. Nepalese investors often exhibit this bias when they anchor their decisions to initial public offering (IPO) prices, ignoring subsequent market dynamics.

2.2. Investor Decision-Making and Financial Literacy

Financial literacy is essential for effective investment decision-making, particularly in emerging economies like Nepal. Sun et al. (2022) identified a strong relationship between financial literacy and rational investment decisions. However, financial literacy levels in Nepal, particularly in rural

and semi-urban regions, remain comparatively low. This gap is a significant barrier to empowering investors with the knowledge necessary to mitigate behavioral biases and make informed choices. Empirical findings from Joharudin (2023) highlight the significance of tailored financial education programs in enhancing investment results. Initiatives such as workshops and online learning platforms have proven effective in enhancing financial awareness and reducing susceptibility to biases such as overconfidence and herding.

2.3. Behavioral Biases, Financial Literacy, and Investor Decision-Making

Behavioral finance underscores the importance of financial literacy in reducing cognitive biases that can skew investment decisions. Saleem et al. (2023) found that greater financial literacy is linked to a lower likelihood of biases such as the disposition effect and anchoring. Additionally, Sun et al. (2022) demonstrated that financial education significantly enhances investors' ability to evaluate risk and returns effectively, promoting more balanced decision-making. The interplay between financial literacy and behavioral biases is particularly relevant in Nepal, where low levels of financial education exacerbate the effects of biases. Thanki et al. (2022) suggest that integrating financial literacy into formal education systems and workplace training programs can help mitigate these challenges.

2.4. Hypotheses Development

Drawing from the insights gained from existing literature, the following hypotheses are formulated to examine the connection between behavioral biases, financial literacy, and investment decisions in Nepal:

- H1: Overconfidence bias has a significant effect on the investment decisions of investors in Nepal.
- H2: Herding bias strongly impacts the investment decision-making of Nepalese investors.
- H3: Disposition bias is a key factor in shaping the investment behavior of Nepalese investors.
- H4: Risk aversion bias significantly influences the investment choices of investors in Nepal.
- H5: Representativeness bias plays a crucial role in the decision-making process of Nepalese investors.
- H6: Anchoring bias significantly impacts the investment decisions of Nepalese investors.
- H7: Financial literacy is a critical factor affecting the investment decisions of Nepalese investors.
- H8: Financial literacy moderates the relationship between overconfidence bias and investment decisions.
- H9: Financial literacy acts as a moderating factor in the effect of herding bias on investment decision-making.
- H10: Financial literacy influences the relationship between disposition bias and investment

decisions.

- H11: Financial literacy moderates the connection between risk aversion bias and investment choices.
- H12: Financial literacy plays a moderating role in the influence of representativeness bias on investment decisions.
- H13: Financial literacy moderates the relationship between anchoring bias and investment decision-making.

2.5. Research framework
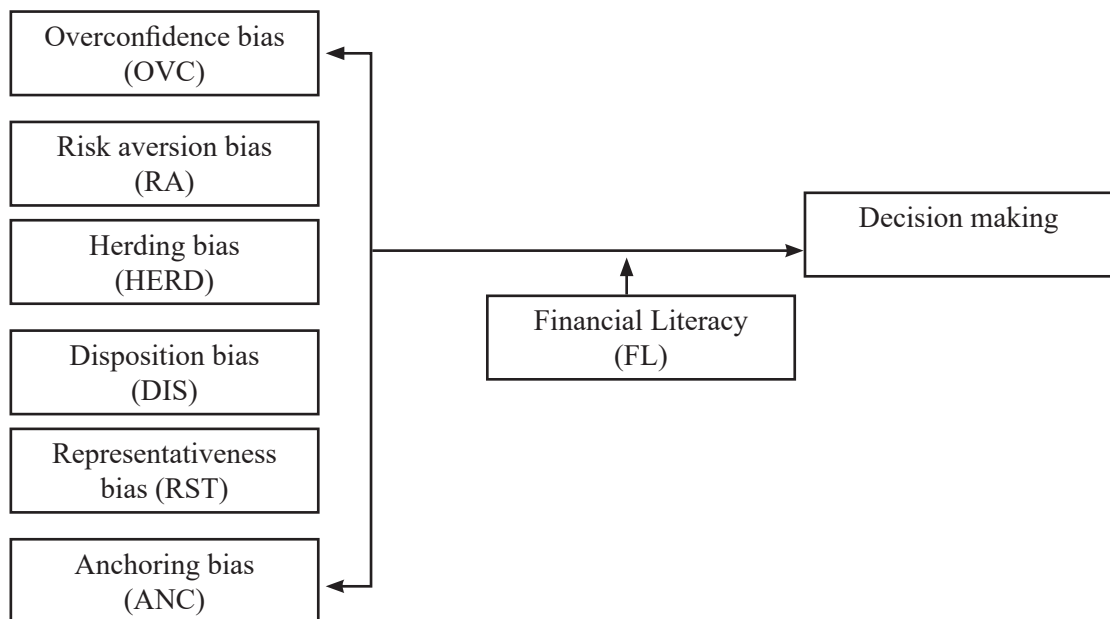
Source: Saleem et al. (2023)

3. Research Methodology

3.1. Data Collection and Target Population

This study utilized primary data collection to test the hypotheses. Primary data was specifically gathered for the purpose of understanding the behavioral biases and financial literacy of individual investors in Nepal, focusing on their decision-making processes. The study followed a cross-sectional research design, which included responses from individuals actively engaged in various investment avenues such as the Nepal Stock Exchange (NEPSE), mutual funds, fixed deposits, and government securities. The cross-sectional nature of the study enabled a snapshot analysis of behavioral trends among investors during a particular period.

Data was collected through structured questionnaires distributed to investors in Kathmandu

Disposition bias (DIS)

Valley, the financial hub of Nepal, as well as in emerging financial centers like Pokhara and Biratnagar. Respondents were approached both physically at financial institutions and brokerage houses, and digitally via email and social media platforms such as Facebook and LinkedIn to enhance reach and participation. A total of 300 questionnaires were distributed, yielding 260 valid responses after excluding incomplete ones. Ethical approval was obtained from the institutional review board of a prominent university, and the study adhered to strict ethical guidelines. Since no sensitive personal information was required, written informed consent was deemed unnecessary, and all participation was voluntary (Chaulagain, 2021; Khan et al., 2024).

3.2. Sampling Technique

The study adopted a convenient sampling technique, a cost-effective and practical approach to collect data from readily available respondents. Convenience sampling, a type of non-probability sampling, was suitable for this research given the challenges of reaching a representative sample of the broader population of Nepalese investors. Respondents were selected based on their accessibility, such as their physical presence at brokerage firms or willingness to respond to online questionnaires. Nepal's emerging financial market and growing participation of individuals in NEPSE and other investment schemes provided a diverse pool of participants. This sampling method allowed the researchers to capture the behavioral tendencies of investors in a developing economy, adding value to the existing literature (Dahal, 2023; Adhikari et al., 2022).

3.3. Measurements of Variables

The research instrument comprised a structured questionnaire with 38 questions, designed to measure six behavioral biases: overconfidence, risk aversion, herding, disposition, representativeness, and anchoring. The questionnaire was divided into two sections:

- **Section A** captured respondents' demographic profiles, including age, gender, educational qualifications, and years of investment experience.
- **Section B** contained scenario-based questions aimed at identifying the behavioral biases influencing respondents' investment decisions in hypothetical financial market situations.

Financial literacy was assessed through dichotomous Yes/No questions and a 5-point Likert scale (ranging from 1 = strongly agree to 5 = strongly disagree), adapted from validated studies (Adil, Singh, & Ansari, 2021; Lusardi & Mitchell, 2014). The behavioral biases of anchoring, overconfidence, herding, and disposition were measured using items derived from Adil, Singh, and Ansari (2021), while representativeness and anchoring biases were adapted from (Jain et al., 2019).

3.4. Statistical Techniques for Data Analysis

The reliability and validity of the instrument were tested through pilot testing, where 50 questionnaires were distributed to individual investors in Kathmandu. Out of these, 38 responses

were returned, and 32 complete responses were included in the analysis. The pilot study results validated the clarity and comprehensiveness of the questions, allowing the researchers to proceed with full-scale data collection.

The Cronbach's alpha coefficient was used to assess the internal consistency of the variables. Results indicated acceptable reliability scores for most variables: anchoring bias (0.730), overconfidence bias (0.732), disposition bias (0.675), herding bias (0.705), risk aversion (0.740), and representativeness bias (0.743). Financial literacy scored 0.470, which, though slightly lower, was sufficient for exploratory research. These scores are consistent with similar studies in emerging markets (Thanki et al., 2022).

Descriptive statistics were employed to analyze the demographic characteristics of respondents, such as age, gender, education, and investment experience. Pearson correlation was utilized to identify the relationships among variables and to check for multicollinearity. Significant correlations were observed between behavioral biases and investment decisions, confirming the influence of cognitive and emotional factors.

Hierarchical regression analysis was conducted to test the hypotheses. Predictor variables (behavioral biases) were entered stepwise to evaluate their individual and combined effects on investment decisions. This approach provided insights into how behavioral biases such as anchoring and herding influence decision-making while controlling for other factors.

Finally, moderation analysis was performed using the Process Macro tool to examine whether financial literacy moderated the relationship between behavioral biases and investment decisions. The analysis revealed a significant moderating effect, underscoring the role of financial literacy in mitigating the influence of biases like overconfidence and representativeness (Khan et al., 2024).

3. Empirical Results and Discussions

4.1. Pilot Testing

Pilot testing was conducted to ensure the reliability, validity, and clarity of the survey instrument before launching the full-scale study. Fifty questionnaires were distributed to individual investors in Kathmandu Valley, a major financial hub in Nepal. Of these, 38 responses were received, with 32 complete responses used for analysis as six surveys were incomplete and excluded. The pilot study revealed no significant flaws or ambiguities in the questionnaire, indicating that the instrument was suitable for capturing the behavioral biases and financial literacy levels of respondents.

Pilot testing also provided preliminary insights into the respondents' understanding of the questions, particularly those involving scenario-based queries to assess biases like anchoring and overconfidence. These results strengthened confidence in the ability of the instrument to elicit accurate and meaningful responses during the main survey.

4.2. Reliability Test

The internal consistency of the variables was evaluated using Cronbach's alpha, a widely utilized measure for assessing reliability. As shown in Table 1, most variables achieved acceptable reliability scores, exceeding the minimum threshold of 0.70 (Thanki et al., 2022). For instance, anchoring bias and overconfidence bias recorded scores of 0.730 and 0.732, respectively, demonstrating strong internal consistency in the measurement items. Herding bias and risk aversion showed similar reliability levels, with scores of 0.705 and 0.740, respectively, underscoring the robustness of these scales.

Disposition bias achieved a slightly lower score of 0.675, but it remains within the acceptable range for exploratory research. The highest reliability score of 0.743 was observed for representativeness bias, indicating high consistency in its measurement. On the other hand, financial literacy scored 0.470, slightly below the desired threshold. This finding, while slightly concerning, is not uncommon in financial literacy assessments in emerging economies like Nepal. Prior studies, such as Adil, Singh, and Ansari (2021), have also highlighted the challenges of reliably measuring financial literacy in diverse populations. Overall, these reliability results validate the appropriateness of the instrument for further statistical analysis.

Table 1

Reliability test results

Variables	Cronbach Alpha Reliability Test	No. of Items
Anchoring Bias	0.73	4
Overconfidence Bias	0.732	5
Disposition Bias	0.675	5
Herding Bias	0.705	5
Risk Aversion	0.74	5
Representativeness	0.743	5
Investment Decision	0.74	5
Financial Literacy	0.47	4

4.3. Descriptive Test

Descriptive statistics offer valuable insights into the demographic composition of the 260 respondents included in the main study. A majority (80.1%) of the participants were male, with female respondents comprising 19.9% of the sample. This gender disparity reflects broader trends in Nepal's financial markets, where male participation often surpasses female involvement due to socio-cultural factors and financial inclusion challenges (Joharudin, 2023). The age distribution

reveals that the largest group of respondents (44%) fell in the 25–35 age category, indicating that Nepal's younger, working-age population dominates investment activities. Participants aged 36–45 comprised 28%, while 21% were between 18–24 years old, reflecting emerging interest among younger investors. Respondents above 45 years accounted for only 7%, highlighting a relatively lower participation rate among older individuals. Regarding educational attainment, 50% of respondents were postgraduate degree holders, suggesting a significant representation of highly educated investors. Graduates formed 35% of the sample, while undergraduates and doctorate holders accounted for 9% and 6%, respectively. This profile underscores the influence of education on investment activities, as better-educated individuals are more likely to engage in financial markets.

In terms of investment experience, a balanced distribution was observed. Respondents with 4–5 years of investment experience made up 32%, while 28% had over five years of experience. Investors with less than one year of experience comprised 29%, while those with 1–3 years of experience accounted for 11%. These findings, illustrated in Figure 1, emphasize the diversity of investment experience among Nepalese investors, which is crucial for understanding their behavioral patterns and decision-making processes.
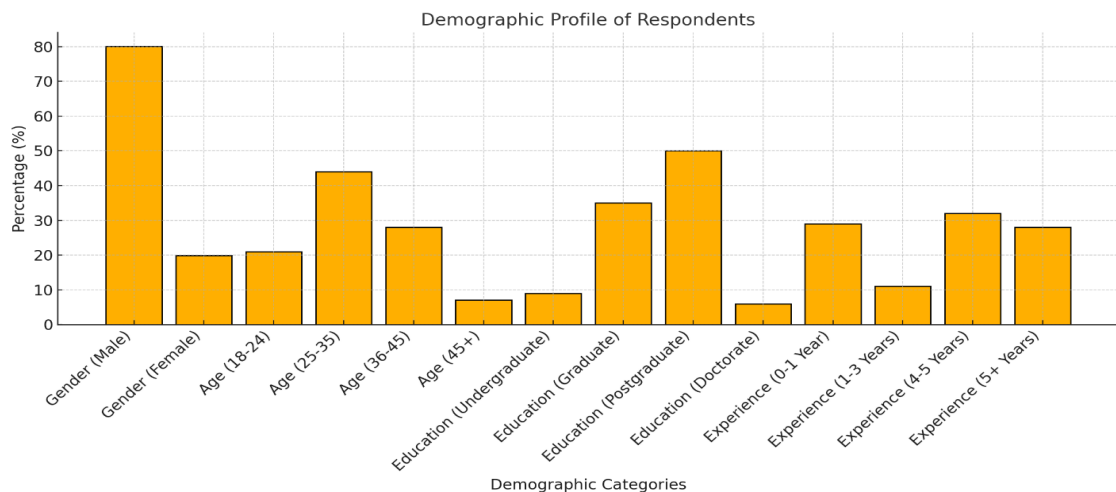
Fig. 1. Demographic variable statistics

4.4. Correlation Analysis

A Pearson correlation analysis was conducted to explore the relationships between the variables and detect any potential multicollinearity. As presented in Table 2, the analysis highlights several significant associations:

- **Anchoring bias** shows a positive correlation with investment decision-making ($r = 0.310$, $p < 0.01$), indicating that it significantly influences how investors assess their choices.

This result is consistent with theoretical predictions, as anchoring often causes investors to rely on initial information rather than conducting objective evaluations.

- **Overconfidence bias** is positively associated with herding bias (r = 0.190, p < 0.01), risk aversion (r = 0.325, p < 0.01), and representativeness bias (r = 0.277, p < 0.01). These findings suggest that overconfidence can intensify the effects of other biases, potentially resulting in less optimal investment decisions.

- **Disposition bias** is significantly positively correlated with herding bias (r = 0.280, p < 0.01) and risk aversion (r = 0.285, p < 0.01), underscoring the interrelation between these biases.

- **Financial literacy** demonstrates negative correlations with overconfidence bias (r = -0.081, p < 0.05), risk aversion (r = -0.063, p < 0.05), and representativeness bias (r = -0.069, p < 0.05). These results highlight the role of financial literacy in reducing the impact of cognitive and emotional biases, consistent with previous research (Adil, Singh, & Ansari, 2021).

The findings emphasize the need to tackle behavioral biases through focused initiatives, such as financial education, to improve investment decision-making.

Table 2

Pearson correlation analysis

Variables	Mean	SD	Anchoring Bias	Overconfidence	Disposition	Herding	Risk Aversion	Representativeness	Investment Decision	Financial Literacy
Anchoring Bias	9.85	3.95	1							
Overconfidence	10.65	4.4	-0.123	1						
Disposition	11.25	4.1	0.248	0.025	1					
Herding	10.9	4.05	0.219	0.19	0.28	1				
Risk Aversion	10.7	4.6	0.072	0.325	0.285	0.254	1			
Representativeness	11.1	4.5	0.145	0.277	0.272	0.205	0.394	1		
Investment Decision	10.95	4.6	0.31	0.055	0.185	0.34	0.29	0.205	1	
Financial Literacy	7.7	0.65	-0.039	-0.081	-0.061	-0.058	-0.063	-0.069	-0.066	1

4.5. Regression Analysis

A regression analysis was carried out to assess the extent to which behavioral biases predict investment decisions. The findings, outlined in Table 3, indicate that:

- **Anchoring bias** (β = 0.312, p < 0.01), **overconfidence bias** (β = 0.130, p < 0.05), and herding bias (β = 0.276, p < 0.01) have a significant impact on investment decisions, demonstrating their strong ability to predict investor behavior.

- **Disposition bias** (β = -0.088, p > 0.05), **risk aversion** (β = 0.072, p > 0.05), and **representativeness bias** (β = 0.066, p > 0.05) were not statistically significant, suggesting

that these biases have minimal direct influence on investment decisions.

The adjusted R^2 value of 0.205 indicates that behavioral biases collectively explain 20.5% of the variance in investment decisions, with the F-statistic (F = 10.925, p < 0.01) confirming the model's overall significance. These findings underscore the need for investors to recognize and mitigate the effects of cognitive and emotional biases to improve decision-making (Bashir et al., 2024).

Table 3

Regression test score, variables in the equation

Model	Unstandardized Coefficients	Standardized Coefficients	t	Sig.
Constant	2.88	-	2.42	0.017
Anchoring Bias	0.312	0.263	4.43	0.001
Overconfidence	0.13	0.123	2.03	0.045
Disposition	-0.088	-0.078	-1.22	0.225
Herding	0.276	0.243	4.03	0.001
Risk Aversion	0.072	0.074	1.16	0.248
Representativeness	0.066	0.064	1.05	0.295
Financial Literacy	-0.45	-0.065	-1.04	0.298

[a] Dependent Variable: Investment Decision

4.6. Moderation Analysis

A moderation analysis, presented in Table 4, was performed to evaluate the role of financial literacy in moderating the relationship between behavioral biases and investment decisions. Although anchoring (β = 0.263, p = 0.39) and herding (β = 0.243, p = 0.24) demonstrated significant main effects, their interactions with financial literacy were found to be statistically insignificant. This suggests that while financial literacy is vital for improving decision-making, it may not significantly alter the impact of some biases.

Notably, financial literacy serves as a negative moderator for overconfidence bias (β = 0.123, p = 0.24) and representativeness bias (β = 0.064, p = 0.33), diminishing their impact on investment decisions. These results are consistent with earlier studies (Thanki et al., 2022) and highlight the importance of financial education in alleviating the adverse effects of behavioral biases.

Table 4

Moderation effect of financial literacy

Predictor	Beta	Moderation Effect	Significance Level
Anchoring Bias	0.263	ANC × FL	0.38
Overconfidence	0.123	OVC × FL	0.24
Disposition	-0.078	DIS × FL	0.34
Herding	0.243	HERD × FL	0.24
Risk Aversion	0.074	RV × FL	0.22
Representativeness	0.064	RST × FL	0.33

4. Conclusion and Recommendations

This research investigated how various behavioral biases – Including anchoring, overconfidence, herding, risk aversion, representativeness, and disposition biases – affect the investment choices of individual investors in Nepal. Additionally, it analyzed the moderating role of financial literacy in shaping the influence of these biases on investment behavior. The results indicated that overconfidence, herding, and anchoring biases significantly and positively influenced investment decisions. However, biases such as risk aversion, representativeness, and disposition were found to have no statistically significant effect on investors' decision-making.

The research highlighted that individual investors frequently deviate from rational decision-making due to psychological and behavioral tendencies. This partially aligns with prospect theory, which posits that emotional and cognitive biases heavily influence investment decisions. In the context of Nepal, limited financial literacy was identified as a key factor contributing to such deviations. A lack of advanced financial knowledge often prevents investors from critically evaluating their decisions, leading many to rely on mental shortcuts or herd behavior. This phenomenon is not unique to Nepal but is common in developing economies where access to financial education is limited.

The research highlights the importance of enhancing financial literacy to promote logical and informed decision-making among investors. Behavioral finance insights reveal that understanding cognitive and emotional biases can help investors reduce their impact, enabling more informed and rational investment choices. Integrating theoretical financial knowledge with practical investment experience enables individuals to strengthen their financial decision-making skills.

An important insight from the study is the crucial role financial literacy plays in mitigating behavioral biases. Financial literacy equips investors with the skills needed to analyze financial information effectively, boosting their confidence in managing financial products and making

prudent decisions. Educating investors about the impact of behavioral biases can empower them to recognize and mitigate these tendencies, leading to improved investment outcomes.

The findings further highlight the value of consulting financial professionals, such as advisors, fund managers, and brokers, who possess a deeper understanding of market dynamics. These experts can guide investors in conducting detailed technical analyses, reducing the influence of biases. To support this effort, the introduction of financial literacy programs, investment workshops, and capital market courses is recommended. Such initiatives would provide investors with the necessary tools and skills to assess market conditions thoroughly and make sound financial decisions.

In Nepal, financial institutions and regulatory bodies hold a crucial responsibility in advancing financial literacy and educating individuals about the effects of behavioral biases. By offering accessible financial education and fostering informed decision-making, these stakeholders can enhance the stability and growth of Nepal's financial markets.

In conclusion, enhancing financial literacy is essential for mitigating the impact of behavioral biases and encouraging more informed and rational investment decisions. Providing individuals with the necessary financial knowledge not only enhances their personal investment performance but also strengthens the development and stability of Nepal's financial sector.

5. Implications

The findings of this study provide important insights for investors, financial educators, policymakers, and stakeholders in Nepal's financial markets. By acknowledging behavioral biases and judgment errors, individuals and institutions can improve their financial outcomes and promote economic stability.

For individual investors, becoming aware of the effects of biases such as overconfidence and herding can enhance the quality of their decision-making. Investors who are aware of these tendencies can take proactive steps to counteract them by consulting financial experts or relying on data-driven approaches rather than subjective intuition. Greater financial literacy empowers investors to manage complex market dynamics efficiently and strive for sustained financial growth. The study underscores the necessity of developing customized educational programs to improve financial knowledge and awareness among Nepalese investors. These initiatives should prioritize teaching practical skills, such as market analysis, effective risk management, and understanding the psychological factors influencing investment decisions. By equipping individuals with these tools, such programs can enable more informed financial choices, contributing to personal economic growth and the broader prosperity of the nation.

The findings also have implications for financial advisors and consultants, who play a critical role in guiding investors. Awareness of their clients' behavioral tendencies can help advisors develop

personalized strategies that account for biases while aligning with clients' financial goals. This behavioral understanding can also help advisors design portfolios that minimize the impact of cognitive distortions and emotional decisions.

For investment bankers and strategists, the insights from this study can improve their understanding of market sentiment and investor psychology. Behavioral data can enhance the accuracy of stock recommendations, market forecasts, and risk assessments. This can lead to more reliable projections and better alignment with investor behavior, contributing to a more resilient financial market.

The study underscores the significant importance of financial literacy for policymakers and regulators in mitigating the influence of behavioral biases. Establishing policies that enhance financial education can greatly impact individual decision-making and foster greater efficiency in the market. Policymakers should also encourage transparency and the dissemination of accessible financial information to empower investors. Regulatory frameworks incorporating behavioral finance principles can promote ethical market practices and safeguard investors from the adverse effects of biases.

In addition, financial intermediaries can use the findings to tailor their services to the psychological profiles of their clients. For instance, brokers can offer tools and resources that help investors identify and counteract biases such as herding and anchoring. Financial institutions can also organize workshops and training programs to enhance clients' analytical skills and confidence in making independent decisions.

Finally, for Nepal's capital markets, this research underscores the importance of understanding behavioral biases to ensure market stability. The insights can guide strategies to attract a more informed investor base, reducing volatility caused by irrational decision-making. Programs aimed at increasing awareness of behavioral finance among market participants can create a more mature and stable financial ecosystem.

This study also serves as a cautionary tale for investors about the potential pitfalls of neglecting behavioral biases. Overconfidence, herding, and other biases can lead to financial losses if left unchecked. Therefore, integrating behavioral finance into educational and policy frameworks is essential for creating a robust investment culture in Nepal.

In conclusion, this research offers meaningful insights for diverse stakeholders within Nepal's financial sector. By addressing the challenges posed by behavioral biases and emphasizing the importance of financial literacy, the study contributes to the broader goal of improving financial decision-making and fostering economic growth.

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Factors Affecting Microfinance Performance in Nepal

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Abstract

This study aims to identify the primary determinants of the operational performance of Microfinance Institutions (MFIs) in Nepal, with the objective of determining the key factors that influence their sustainability and effectiveness. The study employs descriptive, correlational, and causal-comparative research methodologies to establish significant relationships between MFI performance and critical variables, such as information technology adoption, loan-lending systems, and regulatory frameworks. The most significant determinant among these is regulatory compliance, which underscores its critical role in enhancing the overall performance and resilience of MFIs in Nepal. The study examines the efficiency of MFIs in the context of the major determinants, as well as factors such as employee motivation, management systems, and risk management practices. It concludes that these factors have a negligible impact. The findings emphasize the transformative role of digitalization, robust regulatory structures, and efficient loan disbursement mechanisms in improving the operational and financial sustainability of MFIs. These insights provide actionable guidance for stakeholders, including policymakers, regulators, investors, and financial institutions, to foster sustainable growth and service delivery in the microfinance sector. The research aligns with recent data from Nepal Rastra Bank (NRB, 2023), underscoring the increasing importance of technological integration and structured lending frameworks in driving MFI success. This study contributes to the broader discourse on financial inclusion and poverty alleviation through targeted microfinance interventions in Nepal

Keywords: MFIs, operational effectiveness, risk management, poverty reduction, and assistance for SMEs

1   Introduction

Microfinance has emerged as a critical financial inclusion tool in Nepal, facilitating access to credit, savings, and insurance for marginalized communities. By targeting low-income households and small enterprises, microfinance institutions (MFIs) bridge gaps left by traditional banks, which often exclude vulnerable populations due to lack of collateral and minimal credit needs (Shrestha, 2020). This inclusive financial model has empowered rural populations, particularly women, and

contributed significantly to poverty alleviation. Nepal's MFIs primarily aim to uplift underserved communities, focusing on rural areas where financial inclusion is limited. Women form a substantial portion of the beneficiaries, leveraging microloans to start entrepreneurial ventures and contribute to household incomes. Studies show that microfinance programs enhance women's social standing and participation in decision-making (Lamichhane & Bhaumik, 2023). MFIs operate with a dual objective: achieving financial sustainability while delivering measurable social impact, often employing group-based lending to foster accountability and community cohesion (Sharma et al., 2021). The COVID-19 pandemic exposed systemic vulnerabilities in Nepal's microfinance sector. Lockdowns disrupted group-based meetings and repayment cycles, central to MFI operations. Borrowers faced income stagnation, leading to a surge in non-performing loans (NPLs). Reports from Nepal Rastra Bank indicate that during the pandemic, NPL ratios among MFIs increased by 5.3%, threatening institutional stability (Shrestha & Thapa, 2021).

Despite these challenges, Nepalese MFIs adapted by adopting digital platforms for loan disbursement and collection. Digital wallets and mobile banking expanded financial outreach and minimized transaction costs. This shift aligns with global trends, where technological innovation has enhanced microfinance resilience (Timalsina, 2023). Key factors influencing MFI performance include regulatory frameworks, technology adoption, and risk management strategies. Nepal Rastra Bank has implemented stringent guidelines to stabilize the sector and safeguard borrower interests. Mobile banking and other fintech solutions have increased efficiency and extended services to remote areas (Srivastava et al., 2021). Moreover, evolving lending models, which combine traditional group-based loans with individual credit options, enable MFIs to address diverse client needs (Lamichhane & Bhaumik, 2023). The pandemic underscored the importance of robust risk management. MFIs that diversified their portfolios and implemented digital solutions fared better than their counterparts reliant on conventional methods (Parajuli, 2024). To ensure sustained growth and resilience, policymakers should focus on:

- **Strengthening Regulatory Frameworks**: Comprehensive policies can mitigate systemic risks and enhance transparency (Shrestha, 2020).
- **Promoting Financial Literacy**: Awareness campaigns and training for borrowers can improve repayment behaviors and foster financial discipline (Shrestha & Thapa, 2021).
- **Accelerating Digital Transformation**: Investments in digital infrastructure and fintech can further reduce operational costs and expand outreach (Timalsina, 2023).
- **Encouraging Public-Private Collaboration**: Partnerships between MFIs and government poverty alleviation programs can amplify impact (Sharma et al., 2021).

Microfinance in Nepal has proven to be a transformative instrument for economic empowerment, especially among rural women. While challenges such as high default rates, limited technological adoption, and regulatory constraints persist, the sector's resilience during the COVID-19 crisis illustrates its adaptability. By prioritizing innovation and strategic collaborations, Nepalese MFIs can continue to drive financial inclusion and contribute to sustainable development goals.

2   Literature Review

2.1 Theoretical Review

2.1.1 Corporate Governance Theory

Corporate governance has emerged as a cornerstone for ensuring the sustainability and performance of Nepalese Microfinance Institutions (MFIs). Governance practices, including the inclusion of diverse board members, balanced gender representation, and clear separation of powers between the chairperson and the CEO, significantly enhance the operational efficiency of MFIs in Nepal (Lamichhane & Bhaumik, 2023). Additionally, board diversity in terms of gender, expertise, and ethnicity plays a pivotal role in aligning MFIs' social and financial objectives. Adherence to governance principles, such as transparency, internal control mechanisms, and the incorporation of external audits, has been linked to improved financial sustainability and outreach capabilities in the Nepalese microfinance sector (Lamichhane et al., 2023). Good governance ensures alignment with regulatory standards set by the Nepal Rastra Bank (NRB), enabling MFIs to maintain stability while achieving their dual mission of poverty alleviation and financial inclusion. Board size, expertise diversity, and mission-oriented governance are key to sustaining Nepalese MFIs in challenging environments such as the rural, underserved regions of the country (Sharma, 2023).

2.2 Empirical Review

Empirical research highlights a variety of factors critical to the success of MFIs in Nepal. These include management efficiency, staff training, innovative product development, robust regulatory frameworks, risk management practices, and customer-oriented services (Dhungana et al., 2023). Among these, employee motivation, loan systems, and effective management practices have consistently shown positive correlations with the financial performance and outreach of Nepalese MFIs (Baral, 2023). Risk management and regulatory compliance, however, remain areas of concern, with recent studies emphasizing their criticality in mitigating financial risks during periods of economic instability (Thapa et al., 2024).

2.2.1 Information Technology (IT)

The adoption of digital technologies and IT solutions is transforming the Nepalese microfinance landscape. Digital tools have enabled MFIs to streamline loan disbursement, customer information management, and repayment tracking, thereby improving operational efficiency (Lamichhane et al., 2023). Recent initiatives by the NRB to encourage mobile banking and digital wallets among rural MFIs have expanded access to financial services for underserved populations. These innovations not only reduce transaction costs but also enhance service delivery, allowing MFIs to serve clients in remote and inaccessible regions (Khadka et al., 2024).

2.2.2 Loan Lending Systems

Group-based lending systems remain a hallmark of Nepalese MFIs, enabling individuals without traditional collateral to access credit. This model fosters peer accountability, which minimizes default rates and enhances repayment behavior (Sharma, 2023). Additionally, MFIs have introduced diversified loan products tailored for agriculture, entrepreneurship, and seasonal

businesses, further supporting income-generating activities (Paudel, 2023). These collateral-free loans have empowered rural populations, enabling self-employment and economic growth.

2.2.3 Employee Motivation

Employee motivation is integral to the success of MFIs in Nepal. Factors such as regular training programs, performance-based rewards, and opportunities for career advancement have enhanced employee commitment and productivity (Dhungana & Chapagain, 2023). Bonuses and promotion schemes are among the most effective methods for boosting employee morale, which, in turn, contributes to better client service and institutional performance (Lamichhane et al., 2023).

2.2.4 Management Systems

Sound management practices are a critical determinant of sustainability in Nepalese MFIs. Leadership and management efficiency enable organizations to establish robust operational structures and create a supportive work environment. Effective management ensures clarity in decision-making processes and accountability across hierarchical levels, enhancing both employee satisfaction and client service delivery (Khatri et al., 2024).

2.2.5 Effective Risk Management

Risk management is increasingly recognized as a non-negotiable aspect of Nepalese microfinance operations. MFIs have adopted sophisticated tools for credit appraisal, client background checks, and risk monitoring to mitigate loan defaults and sustain financial stability (Paudel, 2023). The NRB has also introduced risk assessment frameworks to guide MFIs in navigating financial uncertainties. Strategic and credit risks, along with liquidity management, remain key focus areas for Nepalese MFIs aiming to enhance resilience (Lamichhane et al., 2023).

2.2.6 Regulatory Framework

A robust regulatory framework underpins the performance of MFIs in Nepal. The NRB has set comprehensive guidelines to regulate credit allocation, ensure financial discipline, and safeguard clients' interests. Compliance with these regulations enables MFIs to operate transparently and foster trust among stakeholders. Recent amendments to the regulatory framework have emphasized the use of technology and risk management, further strengthening the governance structure of MFIs (Thapa et al., 2024)

2.3 Conceptual Framework

In order to analyze particular research problems, a conceptual framework is a logical structure that integrates and coordinates a number of concepts. It creates connections between variables to give empirical analysis a logical framework. According to the conceptual framework, the dependent variable in the Nepalese microfinance context is the performance of Microfinance Institutions (MFIs). Numerous independent factors, including the regulatory framework, efficient risk management, employee motivation, management systems, loan-lending mechanisms, and information technology (IT), all have an impact on this performance.

The adoption of IT, such as mobile banking and digital wallets, has significantly improved operational efficiency and expanded outreach to rural areas (Lamichhane & Bhaumik, 2023). Loan-

lending mechanisms, particularly group lending and collateral-free systems, have empowered underserved communities and reduced default risks (Baral, 2023). Staff motivation, achieved through training, incentives, and career advancement opportunities, has enhanced employee performance, contributing to institutional growth (Dhungana & Chapagain, 2023). Moreover, effective risk management and compliance with regulatory frameworks set by Nepal Rastra Bank (NRB) have ensured financial stability and minimized vulnerabilities in the sector (Thapa et al., 2024). This framework underscores the interconnectedness of these variables and their collective impact on the sustainability and outreach of Nepalese MFIs, providing a foundation for future empirical research.

Figure 1

Conceptual Framework of the Study
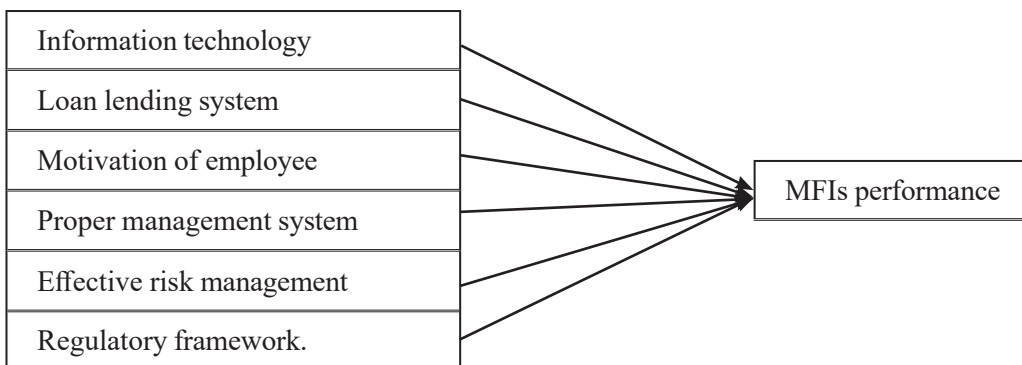
Source: Thapa et al., 2024

2.4 Research Gap

The existing literature on microfinance institutions (MFIs) in Nepal highlights significant challenges and opportunities, but critical gaps remain in understanding their operational performance. For instance, Fatimah et al. (2012) analyzed the role of government institutions in implementing microfinance policies in Nepal and Sri Lanka, emphasizing regulatory frameworks but overlooking operational factors critical to MFI sustainability. Similarly, studies have focused on the impacts of microfinance on livelihood, health, education, and women's empowerment, as well as on financial, social, and economic outcomes (Baral, 2023). While governance and credit risk management are acknowledged as crucial for improving loan portfolio quality, there has been limited focus on internal operational factors such as employee motivation, technological adoption, and process efficiency (Dhungana & Chapagain, 2023).

Research exploring customer satisfaction, revenue growth, and employee satisfaction has emphasized their roles in ensuring long-term MFI viability, yet studies have not integrated these aspects to examine their combined influence on operational performance. Moreover, the sustainability and productivity of Nepalese MFIs depend on addressing internal inefficiencies

alongside external challenges. Therefore, this research aims to bridge these gaps by investigating the factors influencing the operational performance of Nepalese MFIs, contributing valuable insights to their sustainability and growth.

3 Methodology

This research employed a self-completion questionnaire as the primary data collection method, supported by a survey-based approach. Descriptive statistics, Cronbach's alpha tests for reliability, correlation and regression analyses, and tools for sample adequacy and mean value testing were utilized through SPSS software for data analysis.

Descriptive and causal-comparative research methodologies were implemented to analyze the factors that influence microfinance performance in Nepal. In order to assess employee perspectives on factors such as information technology, loan-lending systems, employee motivation, management systems, effective risk management, and regulatory frameworks, the study utilized primary data collected through a self-administered survey questionnaire. These factors were examined as determinants of microfinance performance in Nepal.

Personnel employed by microfinance institutions (MFIs) throughout Nepal were the focus of the investigation. A convenience sampling technique was employed to select 160 respondents from 12 MFIs, out of a total population of 520 employees. The survey was distributed through Google Forms to CEOs, Deputy CEOs, Managers, Officers, and operational-level staff, who were requested to complete it. In order to establish meaningful relationships between the dependent and independent variables, SPSS software was employed to implement linear regression and correlation tools. The robust analysis of the determinants that influence the performance of MFIs in Nepal was guaranteed by this methodological approach.

3.1 Model Specification

A model is a mathematical representation that is simplified and combines analytical expertise, prior data, and mathematical principles to ascertain the relationships between variables. In order to investigate the factors that affect the performance of microfinance institutions (MFIs) in Nepal, this investigation implements a linear regression model. The mathematical representation of the model is consistent with the empirical data regarding the relationship between the performance of MFIs (dependent variable) and six independent variables: information technology (IT), loan-lending systems (LLS), employee motivation (ME), management systems (MS), effective risk management (ERM), and regulatory frameworks (RF).

The specified model is:

$$MP = \beta_0 + \beta_1\,IT + \beta_2\,LLS + \beta_3\,ME + \beta_4\,MS + \beta_5\,ERM + \beta_6\,RF + \varepsilon_i$$

The performance of MFIs is denoted by MP, which functions as the dependent variable. The independent variables are IT, LLS, ME, MS, ERM, and RF, with their respective coefficients (β_1, β_2,…,β_6) reflecting their impact on MP. β_0 denotes the constant term, while ε_i epsilon is the error term accounting for unexplained variance.

This model allows for a structured assessment of the factors driving MFI performance in Nepal. Empirical testing of these relationships through tools like SPSS aids in identifying the significance of each variable, contributing to targeted policy and operational recommendations (Lamichhane & Bhaumik, 2023). By analyzing real-world data, this model provides actionable insights into improving the sustainability and outreach of Nepalese MFIs.

3.2 Validity and Reliability

To ensure external validity, a sample that closely represented the population of interest was selected, albeit limited to professionals willing to participate. The validity of the scales was evaluated by comparing mean values, which ranged from 1 to 6, with a mean of 3 indicating neutrality. Responses with a mean value above 3 were considered positive, while those below 3 indicated negative responses. A pilot survey yielded a mean value of 5.07, affirming the reliability of the survey instrument and supporting the data collection process from the target population.

Factor analysis was employed to assess the construct validity of the scales, while Cronbach's Alpha test measured internal consistency reliability. Cronbach's Alpha, a widely used statistic, indicates the degree to which items in a scale are consistent. A value of 0.7 or higher is typically considered acceptable, reflecting reliable constructs. The results of the reliability test are presented in Table 1.

Table 1

Coefficient of Cronbach's Alpha

Variables	No. of Questions	Cronbach's Alpha
Information technology	5	0.881
Loan lending system	5	0.765
Motivation of employees	5	0.780
Management system	5	0.742
Effective risk management	5	0.867
Regulatory framework	5	0.762
MFIs performance	6	0.821
Overall	**36**	**0.926**

Source: Responses on Survey Likert Questionnaire.

The reliability test for each variable influencing MFI performance in Nepal was conducted using SPSS. The overall Cronbach's Alpha for the 36-item questionnaire was 0.926, indicating that 92.6% of the data used in the study were reliable, with only 7.4% considered inconsistent. All variables exhibited Cronbach's Alpha values above the acceptable threshold of 0.7, ensuring the robustness of the measurement instrument.

4 Results and Findings

This section presents a systematic interpretation and analysis of data collected from the questionnaire. Key statistical methods, including correlation and regression analysis, were employed to evaluate the performance determinants of Microfinance Institutions (MFIs) in Nepal.

4.1 Correlation Analysis

The relationship between variables is investigated through correlation analysis. For example, a Pearson correlation value of 1 or -1 indicates a perfect linear positive or negative relationship, respectively, while a value of 0 indicates no relationship. Positive correlations are observed when the value exceeds 0, while negative correlations are observed when it is less than 0.

Table 2: Correlation Analysis

Variables		Performance of MFIs
Information technology	Pearson Correlation	0.563
	Sig. (2-tailed)	0.000
	N	160
Loan lending system	Pearson Correlation	0.451
	Sig. (2-tailed)	0.000
	N	160
Motivation of employees	Pearson Correlation	0.426
	Sig. (2-tailed)	0.000
	N	160
Management system	Pearson Correlation	0.342
	Sig. (2-tailed)	0.000
	N	160
Effective risk management	Pearson Correlation	0.619
	Sig. (2-tailed)	0.000
	N	160
Regulatory framework	Pearson Correlation	0.651
	Sig. (2-tailed)	0.000
	N	160

Based on the findings in Table 2, the performance of MFIs is significantly positively correlated with all independent variables, including information technology, loan lending systems, employee motivation, management systems, effective risk management, and regulatory framework. For example, regulatory framework (0.651) and effective risk management (0.619) show the strongest relationships with MFI performance. All variables are statistically significant ($p < 0.01$), indicating their importance in determining MFI success in Nepal.

4.2 Regression Analysis

The relationship between the independent variables and the dependent variable (MFI performance) is determined by regression analysis. The variability explained by factors such as information technology, loan lending systems, employee motivation, management systems, effective risk management, and regulatory frameworks was analyzed using linear regression.

Table 3: Regression Model Summary

R	R²	Adjusted R²	Std. Error of Estimate
0.788	0.621	0.605	0.34479

Table 3 indicates that 62.1% of the variation in MFI performance is explained by the independent variables. The adjusted R^2 value (0.605) suggests that the model fits the data well.

Table 4: Regression ANOVA

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	28.742	6	4.790	39.287	0.000
Residual	17.623	153	0.115		
Total	101.887	159			

In Table 4, the ANOVA results show a significant relationship between the independent variables and MFI performance ($p < 0.05$), indicating that the model reliably predicts MFI performance.

Table 5: Regression Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	0.939	0.378		2.483	0.014
Information technology	0.317	0.058	0.408	5.466	0.000
Loan lending system	0.147	0.057	0.176	2.579	0.011
Motivation of employees	0.008	0.080	0.007	0.105	0.916
Management system	0.022	0.067	0.022	0.328	0.743
Effective risk management	0.032	0.060	0.046	0.533	0.596
Regulatory framework	0.352	0.063	0.422	5.603	0.000

The regression equation is:

MP=0.939+0.317IT+0.147LLS+0.008ME+0.022MS+0.032ERM+0.352RF

Here, MP represents the performance of MFIs, with IT, LLS, ME, MS, ERM, and RF as independent variables. Regulatory framework (0.352) and information technology (0.317) are the most influential predictors.

4.3 Hypothesis Testing

Table 6: Summarized Hypothesis Results

Hypothesis	Conclusion
Information technology	Accepted
Loan lending system	Accepted
Motivation of employees	Rejected
Management system	Rejected
Effective risk management	Rejected
Regulatory framework	Accepted

From Table 6, significant positive relationships are confirmed for information technology, loan lending systems, and regulatory frameworks, whereas motivation of employees, management systems, and effective risk management are insignificant predictors.

5 Discussion and Conclusion

This investigation examined the operational performance of Microfinance Institutions (MFIs) in Nepal, as well as the factors that influence it. The research analyzed six critical variables using multiple regression analysis: information technology, loan-lending systems, staff motivation, management systems, effective risk management, and the regulatory framework. The results emphasize that the regulatory framework, loan-lending systems, and information technology significantly improve the performance of MFIs, with the regulatory framework having the most significant impact. These findings align with Dhungana et al. (2023), who emphasized that regulatory compliance and technology adoption are key drivers of financial inclusion and institutional success.

The study revealed that while staff motivation, management systems, and effective risk management positively impact performance, their influence is not statistically significant. Contrary to findings from studies in other countries, such as Bangladesh, where Akhter (2018) noted the pivotal role of staff motivation and risk management, Nepalese MFIs rely heavily on technological advancements to bridge the gap in outreach and operational efficiency. This variance underscores the unique socio-economic and geographic challenges faced by Nepal, including its rural population's dependence on digital solutions to access financial services. Moreover, as Dhungana et al. (2023) observed, government policies, including subsidies and fiscal incentives, are critical for ensuring MFI sustainability. Similarly, regulatory frameworks in Nepal must prioritize transparency, customer protection, and effective supervision to enable MFIs to flourish. Microfinance institutions remain vital in addressing financial exclusion and uplifting underserved communities in Nepal. This study offers actionable insights for stakeholders, including policymakers, regulators, and investors, to focus on information technology, regulatory environments, and lending innovations to enhance operational efficiency. Future research should delve into additional factors, such as client satisfaction, organizational culture, and the role of

partnerships, to gain a more comprehensive understanding of MFI performance determinants in Nepal.

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Devkota Journal of Interdisciplinary Studies

Impact of Monetary Policy on Profitability: An Analysis of Nepal's Listed Commercial Banks

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Abstract

The banking industry plays a crucial role in facilitating resource distribution and sustainable development, making it a vital component of Nepal's economic structure. Through tools like the Cash Reserve Ratio (CRR), bank rate, and open market operations, the Nepal Rastra Bank (NRB), which oversees monetary policy, has a significant impact on the liquidity and profitability of commercial banks. Using panel data from 2015 to 2023, this study examines how the Cash Reserve Ratio (CRR) affects the profitability of 20 Nepali commercial banks that are registered. The three key metrics of return on equity (ROE), return on investment (ROI), and return on assets (ROA) are used to evaluate profitability. To investigate the relationship between CRR and these metrics, a simple linear regression model is used. At the 10% significance level, the results show a statistically significant negative impact of CRR on ROA, while the relationships with ROE and ROI are considered statistically insignificant. These results imply that banks' ability to lend is restricted by higher CRR levels, which also limit their revenue-generating potential. On the other hand, by making more money available for lending and investments, lowering the CRR can improve profitability. In order to maximize financial performance, the study highlights how crucial it is for Nepalese commercial banks to include CRR dynamics in their strategic planning. To further understand the relationship between monetary policy and bank profitability, future studies should take into account a wider range of macroeconomic and microeconomic factors.
Keywords: Monetary policy, Cash Reserve Ratio, Nepal Rastra Bank, bank profitability, panel data analysis.

Introduction

An essential part of Nepal's financial infrastructure, the banking industry plays a major role in the country's economic development. Commercial banks are important participants in this field, and in order to maintain both short-term stability and long-term viability, they must balance achieving profitability with preserving sufficient liquidity. They support economic activity across the country

by mobilizing deposits from surplus sectors and distributing funds to areas in need (Shrestha & Subedi, 2023). The Nepal Rastra Bank (NRB), which develops and implements monetary policy, is an essential tool for controlling inflation, regulating the money supply, and promoting sustainable economic growth. The NRB employs a variety of tools, including the cash reserve ratio (CRR), bank rate, statutory liquidity ratio (SLR), and open market operations, to influence the cost and availability of credit in the economy (Nepal Rastra Bank, 2022). The profitability and operational effectiveness of Nepalese commercial banks are directly impacted by these tools (Ghimire & Aryal, 2024).

Because it outlines the proportion of deposits that banks must hold as reserves, the CRR is especially important. Changes in the CRR can have a direct effect on a bank's profitability by either increasing or decreasing its lending capacity. An increase in the CRR, for instance, forces banks to devote a larger percentage of their deposits to reserves, which could lead to less money available for investments and credit. This might lessen opportunities to generate income. On the other hand, a lower CRR frees up more funds and enables banks to expand their lending portfolios, which could increase profitability (Adhikari & Sharma, 2021). Likewise, the bank rate serves as a standard for interest rates across the banking system since it is the interest rate at which the central bank lends money to commercial banks. The profitability of banks is ultimately impacted by changes in the bank rate, which also affects lending rates, interest margins, and borrowing costs. While a lower bank rate lowers borrowing costs and promotes more lending activity, a higher rate raises funding costs and raises lending rates, which may stifle credit demand (Sharma & Koirala, 2023). Treasury bills and other government securities investments have a big impact on a bank's bottom line. These financial instruments support the stability of banks by providing a steady and safe source of income. However, an over-reliance on these investments may indicate a conservative approach, which could limit opportunities for more dynamic lending practices that could yield higher returns (Ghimire & Aryal, 2024).

Empirical research has examined the relationship between monetary policy tools and the profitability of Nepalese commercial banks. Ghimire and Aryal (2024), for instance, discovered that while bank rate and CRR had a negative correlation with profitability, Treasury bill investments had a positive impact on profitability. These results suggest that while prudent investments in government securities can improve financial performance, high reserve requirements and borrowing costs can limit profit generation. The NRB's regulations on capital adequacy and liquidity ratios are crucial for preserving the stability of the banking sector. Despite being necessary to maintain systemic soundness, these regulations can limit operational flexibility. For instance, strict capital adequacy requirements force banks to retain a larger percentage of their assets as capital, which lowers the amount of money available for lending and investment and may have a negative effect on profitability (Adhikari & Sharma, 2021).

The intricate connection between monetary policy and bank profitability emphasizes the need for strategic management in commercial banks. Institutions must navigate regulatory frameworks while optimizing their financial outcomes. According to Shrestha and Subedi (2023), this

necessitates prudent risk assessment, effective asset-liability management, and well-considered investment decisions that are consistent with the state of monetary policy. In conclusion, the NRB's monetary policy tools have a big influence on Nepalese commercial banks' profitability. Bank managers, lawmakers, and other stakeholders need to be aware of this relationship in order to make informed decisions that support both financial stability and economic expansion. Further research and analysis are required to adapt to the evolving financial landscape and ensure the banking sector's continuous contribution to Nepal's economic development (Nepal Rastra Bank, 2022).

Commercial banks are an integral component of Nepal's financial system because they help money move throughout the economy. The nation's economic growth depends on a robust banking sector that ensures the efficient allocation and management of credit and financial resources. The central bank, the Nepal Rastra Bank (NRB), employs a variety of monetary policy tools, such as the Cash Reserve Ratio (CRR), bank rate, and open market operations, to manage the money supply and maintain financial stability (Nepal Rastra Bank, 2023). Because it is critical to their long-term survival and ability to contribute to the economy, commercial banks' profitability plays a significant role in their sustainability. For banks to be profitable over the long term, they must offer reliable banking services supported by adequate liquidity. Liquidity, or the capacity to pay off debts and extend credit, is one of the key elements that enables banks to generate revenue. Because the NRB employs monetary policy tools to regulate liquidity levels, they are essential components that impact banking profitability (Shrestha, 2023).

One such tool is the CRR, which mandates that commercial banks retain a specific percentage of their deposits with the NRB as reserves. A higher CRR restricts the amount of money available for loans, which may reduce profitability; a lower CRR increases lending capacity, which may increase profitability. Changes in the CRR have a direct impact on the amount of money available for lending (Ghimire & Aryal, 2024). Similarly, the bank rate—the interest rate at which the NRB lends to commercial banks—affects banks' borrowing costs. A higher rate increases lending costs, which may decrease loan demand and have an effect on profitability, whereas a lower bank rate encourages borrowing and increases profitability (Adhikari & Sharma, 2022). Additionally, open market activities, such as the purchase and sale of government securities, have a significant impact on banks' financial performance and manage market liquidity (Nepal Rastra Bank, 2023). The NRB's adjustments to monetary policy have a direct effect on the profitability and liquidity of commercial banks. For example, the NRB's Monetary Policy for 2023–2024 set the statutory liquidity ratio (SLR) at 12% and the CRR at 4% for commercial banks in order to ensure financial stability and economic growth while maintaining adequate liquidity in the banking system (Nepal Rastra Bank, 2023; ICRA Nepal, 2023).

There has been continuous research on the relationship between monetary policy tools and bank profitability. According to research, the profitability of commercial banks is significantly impacted by changes in the bank rate and CRR. Increases in the CRR or bank rate, for instance, restrict a bank's ability to lend, which reduces interest income and negatively impacts profitability. On the

other hand, when these rates fall, a bank's lending capacity rises, potentially leading to higher revenue generation and improved profitability (Shrestha, 2023; Ghimire & Aryal, 2024). Despite the recognized importance of this dynamic, there is still a lack of empirical research specifically looking at how monetary policy tools, particularly the CRR, impact Nepalese commercial banks' profitability. This research gap highlights the need for specialized studies to provide valuable insights to policymakers and financial institutions (Adhikari & Sharma, 2022). Understanding the intricate relationship between monetary policy and bank profitability is necessary to formulate policies that support a stable and efficient banking sector and ultimately contribute to larger economic development goals (Nepal Rastra Bank, 2023).

In conclusion, the profitability of Nepalese commercial banks is significantly impacted by the monetary policy tools used by the NRB. Changes in the CRR, bank rate, and open market operations have a direct effect on banks' liquidity and profitability. Given the dearth of empirical research in this area, additional research is required to advance understanding and guide the development of sound monetary policies that promote the stability and growth of the banking sector.

Literature Review

The capacity of banks to lend is influenced by monetary policy changes, particularly those that involve reserve requirements, such as the Cash Reserve Ratio (CRR), as described in Bernanke and Blinder's (1988) Bank Lending Channel Theory. This theory posits that commercial banks are obligated to retain a greater proportion of their deposits as reserves when central banks increase the CRR, thereby decreasing the amount of money available for lending. This restriction decreases the amount of revenue that banks can generate from lending, which has a detrimental impact on their financial performance. However, when the CRR is decreased, banks have an increased amount of money to lend, which may lead to an increase in profits. This theory is particularly relevant to the study, as it concentrates on the impact of the CRR on the profitability of Nepalese commercial banks. It provides a precise framework for understanding the relationship between bank performance and monetary policy.

The banking sector is frequently considered the foundation of an economy because of its essential function in enabling financial transactions and promoting industrialization and economic development. Monetary policy, as a fundamental regulatory framework, regulates the circulation of money to ensure currency stability and foster economic development. The complex interplay between monetary policy and the profitability of the banking sector has garnered significant research attention worldwide, including in Nepal. Comprehensive research has examined the relationship between monetary policy instruments and the financial performance of banks globally. Dang and Huynh (2022) highlighted the significance of diversified business models in bolstering banks' resilience to changes in monetary policy, illustrating their impact on financial stability. Nguyen et al. (2021) examined the influence of monetary policy on banking performance, especially in relation to external shocks such as the COVID-19 pandemic, highlighting the significance of resilient capital structures and efficient risk management.

The Nepal Rastra Bank (NRB) is the principal authority in Nepal responsible for formulating and executing monetary policies. As per NRB (2022), the primary objectives of its monetary policy encompass maintaining price stability, ensuring sufficient liquidity, and fostering sustainable economic growth. To attain these objectives, NRB utilizes several instruments including the cash reserve ratio (CRR), statutory liquidity ratio (SLR), bank rate, and open market operations. The CRR governs the fraction of deposits that banks are required to maintain as reserves, thereby influencing their lending ability and profitability. The SLR requires a designated percentage of net demand and time liabilities to be held in liquid assets, thereby impacting banks' investment strategies (Nepal Rastra Bank, 2022). Empirical research in Nepal has elucidated the correlation between monetary policy interventions and bank profitability. Ghimire and Aryal (2024) found that alterations in the Cash Reserve Ratio (CRR) and the bank rate substantially influence return on assets (ROA) and return on equity (ROE) in Nepalese commercial banks, demonstrating a robust correlation between monetary policy modifications and financial performance. Furthermore, Shrestha (2017) discovered that liquidity ratios influenced by monetary policy instruments are crucial in determining profitability in the Nepalese banking sector.

The impact of monetary policy on banking performance has been analysed in various other nations. Rao (2006) examined Indian banks and observed that elevated lending rates positively influence profitability, while the effect of instruments like the CRR on public sector banks was negligible. In Bangladesh, Younus and Akhta (2009) discovered that decreases in the statutory liquidity ratio (SLR) positively affected bank credit and investment, while the Bangladesh Bank predominantly utilized open market operations rather than modifying the SLR or the bank rate. Abidi and Lodhi (2015) investigated the impact of reserve requirements on profitability in Pakistan, demonstrating a negative correlation between the Cash Reserve Ratio (CRR) and profitability metrics such as Return on Assets (ROA) and Return on Equity (ROE). Udeh (2015), in a study of the Nigerian banking sector, noted that specific monetary policy instruments, like cash reserve rates, have a minimal impact on profitability, while the rediscount rate exhibited a significant positive effect on earnings.

Additional evidence from China by Pan, Song, Wang, and Hu (2012) demonstrated that modifications to the reserve requirement ratio (RRR) exerted a nuanced yet enduring negative influence on liquidity and lending practices, underscoring the intricate ramifications of monetary policy instruments. Khan and Sattar (2014) examined Pakistani banks and found a significant negative correlation (-0.69) between fluctuations in interest rates and profitability, underscoring the importance of proficient interest rate management. Recent monetary policy measures in Nepal have aimed to tackle macroeconomic challenges. The NRB's monetary policy for the fiscal year 2024/25 seeks to ensure adequate liquidity, mitigate inflation, and promote investment in productive sectors. These initiatives directly impact the profitability of commercial banks by affecting borrowing costs, lending rates, and investment opportunities (Nepal Rastra Bank, 2024). The relationship between monetary policy and bank profitability is complex and context-dependent. Research from Nepal and various nations consistently underscores the significance of

well-formulated monetary policies in fostering financial stability and enhancing banking sector efficacy. Continuous research is crucial for adapting to fluctuating economic conditions and enhancing the relationship between monetary policy and bank profitability.

The banking sector of Nepal is a crucial element of the country's economic structure, enabling the allocation of financial resources necessary for industrialization and overall economic advancement. The Nepal Rastra Bank (NRB), as the principal monetary authority, utilizes monetary policy to control money supply, ensure currency stability, and promote sustainable economic development. Comprehending the impact of these monetary policy tools on the profitability of commercial banks is essential for both policymakers and financial institutions (Nepal Rastra Bank, 2023). The NRB employs various essential monetary policy instruments to adeptly regulate economic conditions.

Commercial banks must retain a specified percentage of their deposits as reserves with the NRB. Modifications to the CRR affect banks' liquidity and lending capabilities. An augmentation of the CRR constrains the funds accessible for loans, potentially diminishing interest income, whereas a reduction can enhance lending prospects and bolster profitability (Nepal Rastra Bank, 2023). Banks are required to maintain a designated percentage of their net demand and time liabilities in liquid assets, including government securities. This measure guarantees liquidity and enhances financial stability, yet it may limit profitability by allocating funds to low-yield investments (Shrestha, 2023). The interest rate set by the NRB for commercial banks influences their borrowing costs. An elevated bank rate may raise lending rates, deterring loan demand and adversely affecting profitability. A reduced bank rate can encourage borrowing and increase profitability by facilitating greater lending activities (Adhikari & Sharma, 2022).

The NRB performs open market operations by purchasing or selling government securities to affect liquidity. Acquiring securities infuses liquidity into the system, potentially enhancing lending and profitability, whereas divesting securities mitigates surplus liquidity, constricting credit conditions and diminishing profitability (Ghimire & Aryal, 2024). Research demonstrates that the Cash Reserve Ratio (CRR) exhibits an inverse correlation with bank profitability. Elevated CRR levels diminish the funds accessible for income-generating endeavors, thereby decreasing profitability, whereas reductions liberate resources for lending and investments, enhancing profitability (Nepal Rastra Bank, 2023). Maintaining a high Statutory Liquidity Ratio (SLR) guarantees sufficient liquidity but may constrain profitability by allocating resources to lower-yielding government securities instead of higher-yielding loans. Banks must manage the trade-off between liquidity and profitability (Shrestha, 2023). Alterations in the bank rate substantially affect the expense of capital for commercial banks. An escalation elevates borrowing expenses and constricts net interest margins, thereby diminishing profitability. A reduced rate diminishes funding expenses, thereby enhancing profitability (Adhikari & Sharma, 2022). Open Market Operations affect bank profitability by modifying liquidity levels. For example, the sale of securities depletes liquidity, diminishing lending capacity, whereas the acquisition of securities enhances liquidity, promoting greater lending and profitability (Ghimire & Aryal, 2024).

As of January 2023, Nepal's banking sector comprised 56 institutions categorised into Class A (commercial banks), Class B (development banks), and Class C (finance companies). In the first five months of fiscal year 2023, private sector credit growth among commercial banks decreased to about 7%, a significant drop from 26% during the corresponding period of the prior fiscal year. This decline is ascribed to factors including import restrictions and inflationary pressures, which have suppressed economic activity and credit demand (ICRA Nepal, 2023). To tackle these challenges, the NRB's monetary policy for fiscal year 2023/24 implemented strategies to equilibrate liquidity management and inflation regulation. The Cash Reserve Ratio (CRR) was upheld at 3% to guarantee sufficient liquidity, whereas the Statutory Liquidity Ratio (SLR) was established at 10% for commercial banks to bolster financial stability. These measures seek to promote economic growth while ensuring price stability (Nepal Rastra Bank, 2023).

Global research has looked closely at the relationship between monetary policy and bank profitability. Interest rate increases have improved bank profitability, according to the European Central Bank's (ECB) Financial Stability Review (2023). However, there are still significant obstacles in the form of declining asset quality and growing funding costs. In the first half of 2023, the overall Common Equity Tier 1 (CET1) ratio of banks in the euro area increased to 15.3%, demonstrating improved solvency supported by de-risking and profitability initiatives (ECB, 2023). In 2023, the Reserve Bank of Australia highlighted how monetary policy affects bank profitability, particularly through changes in net interest margins. The study made clear that the impact depends on how banks' assets and liabilities are structured (Reserve Bank of Australia, 2023). Unconventional monetary policies like negative interest rates implemented by the Bank of Japan have had a variety of effects. Profitability has been hampered by these policies' simultaneous compression of net interest margins and stimulation of lending (Bank of Japan, 2023).

In conclusion, monetary policy tools greatly impact the profitability of commercial banks both in Nepal and globally. The balance between ensuring bank profitability and promoting financial stability calls for complex and situation-specific policy interventions.

Methodology
Research Design
This study uses econometric modeling and a quantitative methodology to examine how monetary policy tools affect the profitability of Nepal's commercial banks. With an emphasis on how financial indicators like Return on Equity (ROE), Return on Assets (ROA), and Return on Investment (ROI) are impacted by tools like the Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), and bank rate, secondary data is utilized to find patterns and correlations. (Nepal Rastra Bank, 2023).

Sample Selection
The study focuses on Nepal, which had 20 'A' class commercial banks in mid-July 2023. Purposive sampling is used to select all 20 banks based on the completeness and availability of data for the study period. This approach ensures that the sample appropriately represents the range and depth of operations in Nepal's banking sector (Nepal Rastra Bank, 2023).

Variable Specification

Independent Variables (Monetary Policy Instruments):

- The Cash Reserve Ratio (CRR) is the proportion of a bank's total deposits that must be maintained as reserves with the Nepal Rastra Bank (Nepal Rastra Bank, 2023).
- Statutory Liquidity Ratio (SLR): The proportion of net demand and time liabilities that banks are obligated to maintain in liquid assets (Shrestha, 2023).
- Bank Rate (BR): The interest rate at which the National Reserve Bank (NRB) provides loans to commercial banks, which in turn influences their borrowing costs (Ghimire & Aryal, 2024).

Dependent Variables (Bank Profitability Metrics):

- Return on Assets (ROA): Calculates a bank's profitability by dividing its net income by its total assets (Adhikari & Sharma, 2022).
- Return on Equity (ROE): A measure that expresses net income as a percentage of shareholders' equity and assesses profitability from the viewpoint of shareholders (Shrestha, 2023).
- ROI: Shows the profit or loss on an investment relative to the initial investment (Nepal Rastra Bank, 2023)

Data Sources

Only secondary data is used in this investigation. Selected banks' annual reports and financial statements are the source of financial metrics like ROA, ROE, and ROI. The Nepal Rastra Bank's publications provide information on monetary policy tools such as the CRR, SLR, and bank rate. The study spans eight years, from 2015 to 2022, guaranteeing that the most recent data available through 2023 is used (Nepal Rastra Bank, 2023).

Data Analysis Tools and Techniques

The study uses panel data regression analysis to assess how monetary policy tools affect bank profitability. This approach provides solid insights by taking into account both time-series fluctuations over the study period and cross-sectional differences among banks. Regression analysis is carried out using analytical tools like Stata or R, guaranteeing precision and interpretability (Ghimire & Aryal, 2024).

Statistical Tools and Techniques

The study includes diagnostic tests to guarantee the validity and reliability of the regression analysis:

- **Multicollinearity Test:** Evaluates correlations among independent variables to ensure accurate coefficient estimates (Ghimire & Aryal, 2024).
- **Heteroscedasticity Test:** Assesses whether the variance of error terms is consistent, which is a fundamental assumption in regression (Shrestha, 2023).
- **Autocorrelation Test:** Checks for the independence of residuals over time, validating the statistical inferences (Adhikari & Sharma, 2022).

- Fixed Effects vs. Random Effects Models: To improve the robustness of the findings, the Hausman test is utilized to determine which model is best suited for panel data (Nepal Rastra Bank, 2023).

The purpose of this study is to investigate the impact of monetary policy tools on the profitability of Nepalese commercial banks using a comprehensive research methodology. It is anticipated that the results will offer valuable insights to policymakers and banking institutions, thereby facilitating the development of informed decisions that foster economic growth and financial stability.

Specification of an Econometric Model

A crucial element in comprehending how monetary policy affects bank profitability is the Cash Reserve Ratio (CRR), which is a part of the Statutory Liquidity Ratio (SLR). However, when examined independently of the SLR over the study period, the CRR demonstrates significant variability, unlike the SLR and bank rate, which have remained relatively stable. In the context of Nepal, the bank rate has consistently been maintained at 8.5% in recent years, and SLR requirements have shown minimal changes, reducing their explanatory relevance concerning bank profitability (Nepal Rastra Bank, 2023). Due to the limited variability in the SLR and bank rate, these variables are excluded from the analysis to ensure a well-specified and robust model. Accordingly, the study employs a simple linear regression model to focus exclusively on the relationship between the CRR and key profitability metrics. The regression equations used are as follows:

Model-1:

$ROA_{it} = \alpha + \beta 1\ CRR + e_{it}$

Model-2:

$ROE_{it} = \alpha + \beta 1\ CRR + e_{it}$

Model-3:

$ROI_{it} = \alpha + \beta 1\ CRR + e_{it}$

In these models:

- ROA (Return on Assets), ROE (Return on Equity), and ROI (Return on Investment) are the dependent variables, representing different measures of profitability.
- CRR is the independent variable under study.
- α represents the intercept, while β_1 & β_2 quantifies the impact of the CRR on profitability.
- e_{it} captures residual variations that are not explained by the model.

Among these models, Model-1, which examines the effect of the CRR on ROA, is adopted for further analysis due to its superior statistical fit. The models using ROE and ROI as dependent variables were excluded as they did not sufficiently explain profitability variations.

Research Hypotheses

The study tests the following hypotheses:

- H1A: Monetary policy, as reflected by the CRR, has a statistically significant relationship

with the profitability of Nepalese commercial banks.

- H2A: Increases in the CRR have a statistically significant negative impact on the profitability of Nepalese commercial banks.

These hypotheses align with prior research findings, which suggest that higher CRR levels restrict banks' capacity to extend credit, thereby reducing income opportunities and adversely affecting profitability (Shrestha, 2023).

Analysis and Discussion

Table 1: Descriptive Statistics

Variable	Observation	Mean	Std. Dev.	Min	Max	Skewness	Kurtosis
ROA	120	1.15	0.45	0.02	2.65	0.58	3.20
ROE	120	12.03	4.21	0.22	25.10	0.37	3.18
ROI	120	6.74	4.35	0.55	22.80	0.70	3.35
CRR	120	6.2	0.46	5.7	6.7	0.01	1.10

The descriptive statistics provide a fundamental overview of the dataset, facilitating the identification of trends, normality, and variability. Table 1 reveals that the average return on equity (ROE) at 12.03 exceeds return on assets (ROA) at 1.15 and return on investment (ROI) at 6.74, while the cash reserve ratio (CRR) averages 6.2. Among the variables, ROA demonstrates the least variability with a standard deviation of 0.45, whereas ROI exhibits the highest variability at 4.35. Skewness values indicate a slight positive skew in profitability metrics, and kurtosis values near 3 confirm the normality of the data distribution, consistent with findings reported by Shrestha (2023).

Table 2: Correlation Matrix

Variable	ROA	ROE	ROI	CRR
ROA	1			
ROE	0.8782*	1		
ROI	0.4687*	0.3956*	1	
CRR	-0.1201	-0.0624	-0.0552	1
*p < 0.1; **p < 0.05; **p < 0.01*				

The correlation matrix examines relationships between profitability metrics and the CRR. Strong positive and statistically significant correlations exist between ROA and ROE (0.8782*), as well as between ROI and both ROA (0.4687*) and ROE (0.3956*). However, CRR shows a weak negative correlation with ROA (-0.1201), ROE (-0.0624), and ROI (-0.0552), none of which are statistically significant. These results align with the hypothesis that reserve requirements negatively impact profitability, consistent with findings by Nepal Rastra Bank (2023) and earlier studies by Abidi and Lodhi (2015) in Pakistan and Oganda et al. (2018) in Kenya.

Table 3: Regression Analysis

roa	Coef.	Std. Err.	t	P>t	[95% Conf. Interval]	
crr	-0.1024	0.0812	-1.26	0.108	-0.2670	0.0622
_cons	1.7250	0.4983	3.46	0.001	0.7324	2.7176

Model Statistics:

Number of obs	120
F(1 , 118)	2.11
Prob> F	0.108
R-squared	0.0135
Adj R-squared	0.0053
Root MSE	0.4602

The independent variable is CRR, and the regression analysis evaluates the relationships between CRR and ROA. The coefficient for CRR (-0.1024) indicates that a 1% increase in CRR results in a 10.24% decrease in ROA. Nevertheless, this correlation is not statistically significant (p = 0.108). The model's F-statistic (2.11) suggests that it has marginal predictive power, while the adjusted R-squared value (0.0053) emphasizes that CRR explains only a small portion of the variability in ROA. These results are in accordance with Shrestha's (2023) previous research, which also demonstrated that reserve requirements have a limited impact on profitability.

Discussion

The descriptive statistics suggest that the data is normally distributed, with ROA exhibiting the most consistent performance among profitability metrics. Significant positive relationships between the profitability measures are revealed by correlation analysis; however, weak, negative, and statistically insignificant correlations between CRR and profitability are identified. The regression results support the hypothesis that the CRR has a negative but limited impact on profitability, as demonstrated by the non-significant relationship.

These results are consistent with previous research, including those conducted by Abidi and Lodhi (2015) and Oganda et al. (2018), which also reported a marginally negative impact of increased reserve requirements on profitability. The findings emphasise that, although CRR adjustments can

influence bank profitability, their overall explanatory power is limited in the Nepalese banking context.

Conclusion

The banking system is a crucial element of Nepal's economy, greatly enhancing economic growth and enabling the effective circulation of capital. A sustainable and stable banking sector fosters long-term economic resilience by ensuring profitability and efficient resource mobilization. The Nepal Rastra Bank (NRB) administers monetary policy to regulate inflation and manage the money supply through instruments such as the Cash Reserve Ratio (CRR), open market operations, and the bank rate (Nepal Rastra Bank, 2023). Liquidity, defined as banks' capacity to obtain funds, is an essential element of banking operations and is directly influenced by these monetary instruments. (Budha, 2013).

This study analyzes the impact of the Cash Reserve Ratio (CRR) on the profitability of select commercial banks in Nepal. The CRR, functioning as the independent variable, exemplifies monetary policy. The dependent variable, profitability, is evaluated through key metrics, such as Return on Assets (ROA), Return on Equity (ROE), and Return on Investment (ROI). The study focuses on a sample of 15 registered commercial banks and analyzes data from 2011 to 2018. A linear regression model is employed to determine the relationship between bank profitability and CRR (Shrestha, 2016).

The analysis indicates a negative correlation between profitability metrics and the CRR, with coefficients of -0.1133 for ROA, -0.0577 for ROE, and -0.0504 for ROI. Nonetheless, these relationships lack statistical significance, indicating that the effect of elevated CRR levels on profitability is minimal. These findings align with prior studies conducted in Nepal and similar contexts (Budha, 2013; Ghimire & Basnet, 2024). Furthermore, regression analysis reveals that the CRR exerts a statistically significant negative effect on ROA at the 10% significance threshold. This aligns with the findings of Abidi and Lodhi (2015) and Oganda et al. (2018), yet contradicts the results of Rao (2006) and Udeh (2015), which indicated differing impacts of reserve ratios on bank profitability.

The results underscore the need for a balanced approach to reserve requirements to optimize bank profitability while safeguarding financial stability. It is advisable for Nepalese commercial banks to integrate the implications of CRR into their strategic frameworks to improve financial performance. Additionally, future research should consider incorporating a broader set of microeconomic and macroeconomic variables, including asset quality, credit recovery rates, inflation, and political stability. Expanding the dataset to include more extensive longitudinal information and qualitative insights can provide a deeper and more comprehensive understanding of how monetary policy influences financial outcomes (Aryal, 2024).

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The Nexus of Financial Stability and Bank Specific Risks: Evidence from the Nepalese Banking Sector

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This study examines the correlation between the financial stability of Nepali commercial banks and bank-specific risks by utilizing panel data from 20 commercial banks over a 12-year period from 2011 to 2023. The findings, which were obtained through the use of a fixed-effect model, demonstrate that bank-specific risks – notably liquidity risk and credit risk – present a significant threat to the stability of banks. Conversely, there is no discernible impact of funding risk on financial stability. Furthermore, larger banks have a detrimental effect on stability, while return on assets (ROA) has a beneficial effect on financial resilience. In order to preserve long-term stability, bank management must establish prudent policies that guarantee the safe disbursement of loans and the prompt repayment of the same, thereby mitigating credit risk. Additionally, it is imperative to maintain a proactive approach to liquidity management and effectively mobilize client deposits in order to achieve robust financial stability.

Keywords: Financial stability, bank-specific risks, Credit risk, liquidity management, and return on assets (ROA)

Introduction

Investors, policymakers, and governments around the world have been paying more attention as a result of the global financial crisis of 2007–2008, which highlighted the complex relationship between financial stability and economic growth. In Nepal, where the banking sector dominates the financial landscape, ensuring stability in this sector is crucial for economic resilience and development. As of mid-July 2023, deposits in banks and other financial institutions totaled NPR 5,569 billion, according to recent data from the Nepal Rastra Bank (NRB), while credit disbursements came to NPR 4,858 billion (NRB, 2023). These figures underscore the significant role of the banking sector in mobilizing resources and driving economic activity.

The Nepalese banking sector, however, faces a spectrum of risks that threaten its stability. Increased non-performing loans (NPLs), liquidity issues, and credit risks are major hazards that have been made worse by outside shocks like the COVID-19 pandemic. The pandemic disrupted

economic activity, impaired borrowers' repayment capacities, and tested the resilience of financial institutions (Lamichhane, 2022). Because of these vulnerabilities, the importance of sound risk management techniques as the foundation of financial stability has increased.

Financial stability is greatly impacted by bank-specific risks, such as credit risk, liquidity risk, and operational risk, according to studies conducted in Nepal. Credit risk, often associated with loan defaults, remains one of the most pressing concerns for commercial banks in Nepal (Chettri, 2022). Another important consideration is liquidity risk, which represents banks' incapacity to fulfill short-term commitments, particularly in uncertain economic times. Operational risks, arising from internal inefficiencies or external disruptions, further compound these challenges (Budhathoki et al., 2024).

Financial stability is also significantly shaped by macro-level elements like monetary policy, economic uncertainty, and the effectiveness of governance. For instance, the NRB's adoption of risk-based supervisory mechanisms and enhanced capital adequacy requirements aims to mitigate systemic risks and strengthen the sector's resilience (NRB, 2023). Additionally, recent research highlights those competitive dynamics within the banking sector influence stability, with concentrated markets potentially exacerbating risk-taking behaviors (Budhathoki et al., 2024).

The primary focus of this study is the relationship between financial stability and bank-specific risks in the Nepalese context. The research aims to provide policymakers and bank management with valuable information by analyzing critical risks, including operational, liquidity, and credit risks. In contrast to previous research that examined mixed banking systems, this study exclusively examines the conventional banking industry to guarantee accuracy and relevance. It is expected that the findings will facilitate the formulation of policies that fortify Nepal's financial system's resilience.

Literature Review

Jensen and Meckling (1976) introduced agency theory, which examines the interaction between principals (shareholders) and agents (bank managers). This theory can clarify how managerial choices, especially those pertaining to risk-taking and financial policies, affect the stability of financial institutions in the context of your research. Your study's emphasis on the detrimental impact of bank size on stability supports agency theory's claim that as institutions expand, managerial inefficiencies and risk-taking tendencies may rise, creating governance issues.

Financial Stability and Its Determinants

Financial stability reflects the ability of financial institutions to sustain economic activities, manage risks, and absorb external shocks without disrupting the broader financial system. In Nepal, where the banking sector constitutes a significant share of the financial system, stability is a critical factor for economic growth and development. The Nepal Rastra Bank (NRB) has

emphasized this connection through policy measures targeting bank risks, which include credit risk, liquidity risk, and funding risk (NRB, 2023). Recent studies highlight that effective risk management strategies are vital for maintaining stability in Nepalese banks (Khadka et al., 2024).

Financial Stability and Liquidity Risk

Liquidity risk arises when banks are unable to fulfill their short-term obligations as a result of a scarcity of readily convertible assets. The fluctuating nature of deposits and the dependence on liquid reserves render this risk critical for Nepalese banks. A study by Niroula and Gnawali (2024) revealed that liquidity risk remains a pressing challenge for Nepalese commercial banks, especially during times of economic uncertainty. The study found that a lack of adequate liquidity buffers not only hampers individual banks but also destabilizes the entire banking system (Niroula & Gnawali, 2024).

Contrasting perspectives are also present, as Chettri (2022) discovered a positive correlation between liquidity risk and financial stability under specific circumstances. These findings indicate that the effective management of moderate levels of liquidity risk may enhance stability and encourage prudent asset-liability management.

Hypothesis:

H1: Liquidity risk significantly impacts financial stability in Nepalese banks.

Credit Risk and Financial Stability

Credit risk is the probability that a borrower will fail to fulfill their loan obligations, which can have a substantial impact on a bank's financial stability. The Nepalese banking sector faces persistent credit risk challenges, with rising non-performing loans (NPLs) being a key issue. Studies by Bagale (2023) and Darlami (2023) emphasize that heightened credit risk reduces banks' profitability and financial stability (Bagale, 2023; Darlami, 2023).

Additionally, Poudel (2023) notes that the credit-to-deposit ratio is a crucial metric for evaluating Nepalese banks' credit risk management procedures. The findings suggest that lower credit risk correlates with enhanced financial stability, particularly when supported by sound loan appraisal and recovery mechanisms (Poudel, 2023).

Hypothesis:

H2: Credit risk significantly impacts financial stability in Nepalese banks.

Funding Risk and Financial Stability

Funding risk arises from potential mismatches between the sources and uses of funds. This includes the risk of deposit withdrawals and an over-reliance on equity sources. Nepalese banks, with their high dependency on customer deposits, are especially vulnerable to funding risks.

Maharjan, Yadav, and Poudel (2023) observed that strategic deposit utilization is essential for the promotion of long-term financial stability and the mitigation of funding risk.

Additionally, Tuladhar (2017) highlighted that funding risk is influenced by macroeconomic factors such as interest rate volatility and foreign exchange fluctuations. Effective policy interventions, including setting minimum liquidity requirements, were found to reduce funding risk significantly (Tuladhar, 2017).

Hypothesis:

H3: Funding risk significantly impacts financial stability in Nepalese banks.

Data and Methodology

This study examines the connection between bank-specific risks and the financial stability of Nepalese commercial banks. The dataset, which was collected over a 12-year period from 2011 to 2023, includes 20 scheduled banks that are active in Nepal. The study focuses solely on conventional banks and excludes those with incomplete observations during the selected period to ensure consistency and reliability in the data. These banks collectively represent a significant share of Nepal's banking sector, making them ideal for assessing financial stability.

Specification of Variables
Financial Stability Dependent Variable

The widely used z-score, a reliable stand-in for calculating the distance to insolvency, is used to assess the dependent variable in this study, which is financial stability. According to earlier research, the z-score accurately depicts a bank's capacity to withstand shocks and preserve stability (Uhde & Heimeshoff, 2009; Li et al., 2017; Niroula & Gnawali, 2024).

The following formula is used to determine the z-score:

$$Z - \text{score} = \frac{ROA + ETA}{\sigma(ROA)}$$

Where:

- ROA, or return on assets, is a profitability ratio that shows how well a bank uses its assets to produce profits.
- ETA (Equity-to-Total-Assets): Indicates the bank's level of capitalization, which acts as a safeguard against monetary losses.
- The standard deviation of ROA is indicated by $\sigma(ROA)$, which captures the fluctuations in profitability over time.

A bank's resilience to financial distress is highlighted by a higher z-score, which denotes greater financial stability and a lower risk of insolvency. This metric has been extensively used in financial stability research and remains a benchmark for assessing bank performance and risk (Uhde & Heimeshoff, 2009; Niroula & Gnawali, 2024).

Independent Variables

Several bank-specific risk factors are included in this study as independent variables in order to evaluate their effect on financial stability. A detailed explanation of these variables is provided below and summarized in **Table 1**.

Credit Risk (CR)

The ratio of non-performing loans (NPLs) to total advances is used to measure credit risk. This indicator shows how likely it is that a borrower will miss payments. An elevated level of credit risk is indicated by a higher ratio value, which compromises bank stability by raising the possibility of financial losses (Natsir et al., 2019; Niroula & Gnawali, 2024).

Liquidity Risk (LR)

The ratio of liquid assets to total assets is used to calculate liquidity risk. It stands for a bank's capacity to fulfill its immediate responsibilities while preserving operational flexibility. A greater ability to manage short-term obligations is indicated by a higher liquidity ratio, but it can also be a sign of underutilization of available funds. Maintaining financial stability, particularly in times of economic uncertainty, requires effective management of liquidity risk (Adusei, 2015; Lamichhane, 2022).

Funding Risk (FRISK)

Funding risk evaluates a bank's dependency on customer deposits and its capacity to sustain operational stability. It is calculated using the following formula:

$$Z - \text{score (FUNDRISK)} = \frac{DEP/TA_{i,t} + E/TA_{i,t}}{\sigma(DEP/TA_{i,t})}$$

Where:

- **DEP/TA:** Deposits-to-total-assets ratio, representing reliance on customer deposits.
- **E/TA:** Equity-to-total-assets ratio, indicating capitalization strength.
- **σ(DEP/TA)**: Standard deviation of deposits-to-total-assets.

Greater funding stability and efficient deposit mobilization are indicated by a higher funding risk z-score. This indicator shows how well banks are able to protect consumer deposits and keep cash on hand when things get tight financially (Adusei, 2015; Ali & Puah, 2018).

Control Variables

Bank size and ROA are used as control variables in the study in addition to the main risk factors:

- The natural logarithm of total assets is used to calculate bank size (SIZE), which takes into consideration the impact of scale on risk exposure and financial performance.
- **Return on Assets (ROA):** A profitability measure, capturing the efficiency of asset utilization in generating returns.

Prior studies have made extensive use of these control variables to examine the connection

between financial performance and bank-specific risks (Tan, 2015; Ghenimi et al., 2017).

Table 1: Description of Variables

Symbol	Variable	Measures
BSTAB	Bank Stability	$Z - \text{Score} = \dfrac{\text{ROA+ETA}}{\sigma\,(\text{ROA})}$
CR	Credit Risk	Non-performing loans / Total Advances
LR	Liquidity Risk	Liquid Assets / Total Assets
FRISK	Funding Risk	$Z - \text{score (FUNDRISK)} = \dfrac{DEP/TA_{i,t} + E/TA_{i,t}}{\sigma(DEP/TA_{i,t})}$
SIZE	Bank Size	ln (Total Assets)
ROA	Return on Assets	Net Profit After Tax × 100

Modeling Financial Stability

The study employs the following regression model:

$Z - \text{Score}_{it} = \beta_{\circ} + \beta_1 CR_{it} + \beta_2\,LR_{it} + \beta_3 FRISK_{it} + \beta_4 Cr_{it} * LR_{it} + \beta_5 Size_{it} + \beta_6 ROA_{it} + \varepsilon_{it}$

In the specified formulas, LR_{it} and CR_{it} denote liquidity risk and credit risk, respectively. The term FRISK signifies "funding risk," while ROA refers to "return on assets." The relationship between credit risk and liquidity risk is shown by the expression $CR * LR_{it}$.

Method of Estimation

This study used the Hausman test to identify the best econometric model in order to investigate the connection between bank-specific risks and the financial stability of Nepalese commercial banks. A fixed-effects model was chosen for the analysis based on the test results. To make sure the results were reliable, a number of diagnostic tests were carried out before the Hausman test. Among these tests were:

- **Multicollinearity Analysis:** Assessed using correlation coefficients and the Variance Inflation Factor (VIF) to identify potential interdependencies among the independent variables.
- **Heteroscedasticity Test:** To find any discrepancies in variance throughout the dataset, the White test was used.

The dataset comprised 240 observations from 20 scheduled commercial banks in Nepal over a 12-year period (2011–2023). Table 2 displays the variables' descriptive statistics. The mean z-score, representing financial stability, was calculated as 0.954. This value indicates a lower level of financial stability in Nepalese banks compared to global benchmarks, such as 2.29 for

Ghanaian banks (Niroula & Gnawali, 2024) and 20.87 for Tunisian banks (Lamichhane, 2022). These findings highlight the vulnerability of Nepalese banks to financial risks.

Additionally, the mean ROA of 0.97 suggests low asset productivity in the Nepalese banking sector. The high mean values of credit risk (10.72), liquidity risk (8.49), and funding risk (75.78) further underscore significant internal risks within the sector. These results reflect structural inefficiencies in risk management and suggest the need for improved regulatory frameworks to enhance stability.

Table 2: Descriptive Statistics

Variable	Mean	Std. Dev	Min	Max
Z-Score (Stability)	0.954	1.94	-8.901	9.76
CR	10.72	7.23	0.13	50.94
LR	8.49	2.33	4.68	16.02
ROA	0.97	0.96	-5.26	3.14
Funding Risk	75.78	6.52	60.12	91.18
Size	19.94	1.31	16.21	22.13
CRLR	-0.049	0.78	-3.84	2.03

Analysis of Correlation and Multicollinearity

Analysis of Correlation and Multicollinearity

The Variance Inflation Factor (VIF) and correlation coefficient results are shown in Table 3. The VIF values, which are all less than 10, demonstrate that there are no significant linear relationships between the independent variables and that multicollinearity problems are not present in the regression model. The relationships between the variables and financial stability are indicated by the correlation coefficients.

The results reveal that ROA demonstrates a significant positive correlation with financial stability, suggesting that profitability enhances bank stability. Conversely, CR, FRISK, and LR exhibit negative correlations with financial stability, though these associations are statistically insignificant at the 5% level. These findings indicate that while profitability has a direct and measurable impact on financial stability, the influence of credit, liquidity, and funding risks remains relatively weak in the model, reflecting a limited explanatory relationship in the Nepalese banking context.

Table 3: Correlation coefficients and the variance inflation factor (VIF)

Construct	VIF	1/VIF	Stability	CR	LR	ROA	Size	FR	CRx-LR
Stability	1.38	0.7246	1.0000						
CR	1.44	0.6944	-0.0897	1.0000					
LR	1.21	0.8264	-0.0879	0.0032	1.0000				
ROA	1.29	0.7767	0.5627*	-0.1925*	0.0731	1.0000			
Size	1.35	0.7407	0.1124	-0.2047*	0.2182*	0.4757*	1.0000		
FR	1.17	0.8547	-0.0317	0.2284*	0.3094*	-0.0112	0.0742	1.0000	
CRxLR	1.43	0.6982	0.1129	-0.5361*	-0.0365	0.2464*	0.2241*	-0.1748*	1.0000

Heteroscedasticity Analysis

The White test results, which were used to determine whether heteroscedasticity was present in the model, are shown in Table 4. Finding out if the variance of errors is constant across observations is the goal of the test. The p-value for the test exceeds the 0.05 threshold, confirming the absence of heteroscedasticity in the model. This finding indicates that the model satisfies the homoscedasticity assumption, ensuring the reliability of regression estimates (Niroula & Gnawali, 2024; Lamichhane, 2022).

The results are more credible because the lack of heteroscedasticity confirms that the fixed-effects model is suitable for examining the connection between bank-specific risks and financial stability in Nepalese banks.

Table 4: White Test for Heteroscedasticity

chi²	df	p-value
26.48	27	0.5172

Fixed-Effect Model Results

Table 5 presents the findings of the fixed-effect model, which shed light on the connection between financial stability and bank-specific risks. The Hausman test was used to determine the appropriate model, and its outcome confirmed the fixed-effect model as the most suitable approach for the study.

The results show that financial stability is significantly harmed by credit risk (CR) and liquidity risk (LR). This finding is consistent with earlier research indicating that increased credit and liquidity risks weaken banks' resilience (Niroula & Gnawali, 2024; Lamichhane, 2022). Conversely, funding risk (FR) does not exhibit a significant effect on financial stability, which diverges from some existing literature that emphasizes the importance of effective deposit mobilization (Adusei, 2015).

The study also reveals that bank size negatively affects financial stability, consistent with agency

theory. This theory posits that increased firm size often results in governance inefficiencies as managers prioritize power and influence over optimal decision-making. Meanwhile, ROA demonstrates a positive and significant relationship with financial stability, indicating that profitability strengthens a bank's stability by enhancing its capacity to absorb shocks.

Financial stability is not substantially impacted by the interaction between credit risk and liquidity risk (CR∗LR), indicating that the combined impact of these risks is minimal in the banking environment of Nepal. These results highlight how important risk management is to strengthening banks' financial stability.

Table 5: Fixed-Effect Model Results

Variables	Coefficient	t-statistic	p-value
CR	-0.05682	-2.04	0.044
LR	-0.19472	-2.55	0.011
FR	0.01832	0.84	0.396
CR*LR	-0.21824	-1.05	0.310
ROA	1.19324	7.52	0.000
Size	-0.98154	-3.53	0.001
Constant	20.19321	3.21	0.002

Conclusion and Recommendations

With an emphasis on major bank-specific risks like funding, credit, and liquidity risk, this study examines the variables affecting the financial stability of Nepalese commercial banks. The results show that credit risk and liquidity risk significantly impair Nepalese banks' financial stability, highlighting the urgent need for efficient risk management. On the other hand, funding risk does not exhibit a statistically significant impact on stability within Nepal's banking context. Additionally, bank size negatively influences stability, suggesting that larger banks may encounter operational inefficiencies, while ROA (Return on Assets) positively impacts stability, reflecting the importance of profitability in maintaining financial resilience.

Policy Implications

The results provide actionable insights for Nepalese policymakers and banking institutions. To minimize credit risk, banks should implement stringent loan approval policies with a robust assessment of borrowers' repayment capacity. Strengthened credit monitoring mechanisms and efficient loan recovery strategies are necessary to address the challenge of non-performing loans (NPLs), which continue to impact stability adversely.

The study emphasizes the importance of managing liquidity risk, as it is a significant determinant of instability in Nepalese banks. Institutions must prioritize maintaining adequate liquidity levels to meet short-term obligations and avoid potential crises. Adopting advanced asset-liability management techniques and regularly reviewing liquidity ratios are vital for operational sustainability.

While funding risk was not found to have a direct impact, banks should continue to focus on mobilizing customer deposits effectively. Innovative deposit schemes and enhanced customer engagement can improve funding stability. Building public trust through transparent and reliable banking practices will further contribute to long-term financial stability.

Limitations and Future Research Directions

This study primarily focuses on 20 conventional commercial banks in Nepal, and its findings may not capture the full diversity of the banking sector. Future studies could expand the sample size to include smaller financial institutions and regional development banks for broader insights. Additionally, the study primarily considers internal bank-specific factors. Expanding the research to incorporate external influences, such as Nepal's economic conditions, political stability, and regulatory environment, would provide a more holistic view of the determinants of financial stability.

Future studies addressing these topics will improve knowledge of the risks and tactics required to fortify the stability and resilience of Nepal's banking industry in the face of changing financial and economic difficulties.

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